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# Sin Taxes and Sindustry

## *Revenue, Paternalism, and Political Interest*

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AND MICHAEL D. THOMAS

Revenue shortfalls associated with the Great Recession and the slow recovery that followed have placed the budgets of many U.S. state and local governments under heavy stress. In the past several years, lingering economic troubles have eroded governmental tax bases while voters have remained strongly resistant to proposals for cutting public spending or raising taxes on income, property, or other broad bases. This has left many states searching for new revenue sources. Particularly attractive targets for “revenue enhancement” are goods that policymakers deem to be “sinful” or misguided because they are bad for the user or generate negative externalities or both. Historically, consumer goods such as tobacco, alcohol, and motor fuels have been singled out for selective excise taxation.<sup>1</sup>

Recent additions to the sin tax category are foods that are high in sugar, transfats, and other ingredients the public-health establishment has associated with

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1. An excise tax is a per unit tax levied on a particular good. It is not the same as an ad valorem tax, which is levied as a percentage of the value of the good sold. Ad valorem taxes, such as a general sales or payroll tax, are also often levied on much broader tax bases.

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rising incidences of obesity,<sup>2</sup> Type 2 diabetes, and similar so-called epidemics. Indeed, thirty-three states have already implemented a soft-drink tax. Because public-health expenditures are correlated with the consumption of these goods, a case has been made for the selective taxation of all sugar-sweetened beverages (SSBs), junk food, and many items on the menus of fast-food restaurants (see Jacobson and Brownell 2000; Brownell et al. 2009).

This paper discusses the two main motives for taxing activities roughly defined as “sins”: (1) the objective to offset the costs sinners impose on others and (2) the paternalistic impulse to reduce or eliminate sinful behavior. As we shall see, these two motives increasingly interact politically nowadays. Although the primary economic justification for tax intervention is an ostensible failure of certain markets to perform ideally, that discussion hinges on the ability of excise tax policy to deliver on promises of improvement based on a strictly social engineering perspective. Because the “market failure” justification alone cannot explain the resurgence of sin taxes, what remains is a strong revenue-raising objective, coupled with a reinvigoration of paternalism in policymaking circles, which provides political cover for expanding the definition of sin. The effects of these two forces are seen, as discussed, in the recent rapid growth of lobbying and political campaign contributions by what we call the “sindustry”—namely, the producers of the goods selected for taxation as well as the individuals and groups that either will be harmed by or will benefit from sin tax policy changes.

We use the standard public-choice model of rent seeking (Tullock 1967; Krueger 1974) in building a case against the way selective taxation is now framed by the new paternalists. To do so, we first summarize the standard social welfare arguments underlying sin tax policies. We then discuss the shift toward “libertarian paternalism” (e.g., Thaler and Sunstein 2008) and critique the idea that “non-coercive” policy interventions, such as reconfiguring the choice architecture, are mostly unobjectionable ways of “nudging” consumer behavior in directions that will make them better off than they would be otherwise. Although selective excise taxes are policy instruments that obviously are more blunt than “nudges,” we see them as being animated by similar paternalistic impulses. Third, we document the rapid expansion of lobbying by the sindustry in response to proposals for imposing new excise taxes or raising existing tax rates.

## Taxation of Sin

In orthodox welfare economics, selectively taxing a good is justified when consumption of that good has negative external effects. In other words, consuming the good imposes a cost on some third party not involved in either its consumption or its

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2. But one study concludes, based on a meta-analysis of ninety-seven published studies, that “grade 1 obesity,” defined as a body mass index (BMI) between 30 and 35, “overall was not associated with higher mortality, and overweight [BMI between 25 and 30] was associated with significantly lower all-cause mortality” (Flegal et al. 2012, 71–72).

production. Thus, social welfare can in principle be improved by increasing the after-tax price paid by consumers, thereby reducing the quantity of the good they buy and curbing the behavior that generates the negative externality. The Pigouvian rationale (Pigou [1920] 1952) for correcting such market failures rests on a set of strictly technical assumptions.<sup>3</sup> The reasons for taxing sin, by contrast, are much more expansive than these considerations imply, and, moreover, they have morphed over time. As the justification for sin taxes shifts from solving a social engineering problem to a more explicit paternalistic approach, the logic of the argument shifts. The main consequence of expanding the taxation of goods and services that simply are disfavored policywise rather than falling under the traditional definition of “sin” is that the connection between the two weakens and the emphasis on raising revenue or extracting rents by other means becomes more salient.

First, what is meant by the term *sin tax*? Sin taxes are the latest manifestation of a long conversation that harkens to the *sumptuary laws* of the late medieval period and beyond (Tuchman 1987, 19–21).<sup>4</sup> In a public-economics context, W. Mark Crain and his colleagues (1977) discuss sin taxes as modern sumptuary laws. This is a useful comparison as virtually every culture has engaged in singling out one or more socially objectionable goods and taxing or regulating their consumption. Sumptuary laws, it is true, were designed to preserve the status of people at the top of society. Selective excise taxation of what we shall henceforth call “disfavored goods” seems designed to discourage the consumption of things that today’s political elites disapprove of. The phrase *sin taxes* originated in the 1970s but found its first public-policy support in the U.S. surgeon general’s report *Smoking and Health* in 1964. The following text from that document is often pointed to as the beginning of the contemporary sin tax regime: “Cigarette smoking is a health hazard of sufficient importance in the United States to warrant appropriate remedial action” (U.S. Department of Health, Education, and Welfare 1964, 33).

The surgeon general’s announcement of a smoking-related public-health crisis launched a change in policy from merely perceiving cigarette smoking unfavorably (despite the portrayal of smoking as “cool” in many books and movies, cigarettes were called “coffin nails” more than a century ago) to one of attempting to reduce smoking as an outright policy aim.<sup>5</sup> The first major push to impose or to increase

3. Markets are said to fail in the presence of negative externalities because consumers have little or no incentive to take into account the costs their consumption behavior imposes on others and, hence, consume “too much” of the good from a social welfare perspective. If calibrated precisely as the difference between the private cost and the higher social cost of consumption per unit, an excise tax prompts consumers to “internalize the externality.”

4. As Barbara Tuchman explains, the sumptuary laws of the time imposed detailed regulations on allowable dress, including “exact gradations of fabric, color, fur trimming, ornaments, and jewels,” for people of “every rank and income level” (1987, 19). The laws were intended to prevent servants, commoners, and especially the members of the emerging bourgeois merchant class from dressing like their noble betters, to the latter’s evident distress. But “the sumptuary laws proved unenforceable; the prerogative of adornment, like the drinking of liquor in a later century, defied prohibition” (20).

5. See Heckelman and Dinan (2005) for attempts in the early twentieth century to ban smoking altogether.

cigarette taxes in the 1960s helped shift excise tax policy from a tool for generating revenue, primarily at the state level, to a means of modifying behavior. Daniel Horn and Selwyn Waingrow (1966), for example, offered advice intended to assist in the design of public policies for curbing cigarette consumption. Such policy advice, published just two years after the surgeon general informed the public that smoking had been linked to lung cancer, began a new era in selective excise taxation. Cigarette smoking from then on clearly became sinful. And it was a sin not so much because smoking imposed uncompensated costs on others—it wasn't until the late 1980s that exposure to secondhand smoke and recovering the publicly financed costs of treating smoking-related diseases became policy concerns—but rather because smokers were harming themselves. The camel's nose of paternalism was under the fiscal-policy tent.

Taxes on cigarettes and other tobacco products assuredly are not the only modern examples of sin taxes. Alcohol—beer, wine, and distilled spirits—has been taxed selectively since colonial days, and Congress—on the recommendation of Treasury Secretary Alexander Hamilton—imposed a tax on whiskey before the ink on the U.S. Constitution was dry.<sup>6</sup> Taxes on cigarettes, alcohol, and motor fuels (the latter taxes are arguably a highway user fee, as discussed in the next section) are the “Big Three” excise taxes in terms of revenue generation. With the proliferation of land-based and river-based casinos that began in the 1990s, gambling also has emerged as an important taxable sin in many states.

Taxing a sin can be an improvement over banning it. The United States learned that lesson painfully during Prohibition, and many commentators nowadays explicitly question the value of the “war on drugs,” as states including Colorado, Washington, and California roll back restrictions on marijuana. The attention paid to sin taxes in the economics literature reflects acceptance of the conclusion that prohibition is often not an effective policy tool. Not only does prohibition sometimes fail to reduce consumption substantially, but it also generates numerous negative “unintended” consequences. However, very high excise tax rates, such as those imposed on retail cigarette sales in New York City (where the combined state and city tax amounts to \$5.85 per pack) start to look like prohibition. A Tax Foundation report, for example, found that 60.9 percent of the cigarettes sold in New York City either had no tax stamp affixed or displayed another state's tax stamp (Henchman and Drenkard 2013). A substantial black market in cigarettes has developed there. Smuggling, cross-border shopping, political corruption, and violence are the predictable outcomes as buyers and sellers attempt to evade New York's punitively high tobacco tax. Similarly, the State of Washington imposes an excise tax of \$3.02 per pack (nearly double the national average of \$1.53); official estimates suggest that 101.4 million packs currently bought and sold in the state do not carry any tax stamp (Washington State Department of Revenue 2013).

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6. See Yelvington (1997) for a concise history of U.S. excise taxes in general and the essays collected in Shughart (1997b) for analyses of the purposes and effects of specific excise taxes, including many sin taxes.

Setting an excise tax rate that modifies behavior without triggering too many untoward consequences can be thought of as solving a policy-optimization problem. On the one hand, a moderate tax that increases revenue more than it inspires evasion can be revenue maximizing. On the other hand, a tax rate set high enough to trigger widespread dodging must be motivated by other policy objectives, such as paternalism.<sup>7</sup> Combining the paternalistic notion of behavior modification with the social engineering perspective associated with A. C. Pigou complicates the policy argument. In order to clarify this point further, we first consider Pigou's rather straightforward example of taxing motor fuel.

### The User-Fee Concept

A user fee establishes a feedback loop between a particular activity and an externality (an effect on someone other than the consumer or producer of the product). State-level motor fuel taxes can be defended in this way when they resolve local issues. Air pollution is often cited as a reason for selectively taxing the burning of gasoline and diesel fuel.<sup>8</sup> Although additional flexibility in travel plans is beneficial to individuals who have access to their own vehicles, choosing to drive rather than to take the bus or subway generates more air pollution and traffic congestion and perhaps contributes to climate change. The adverse health effects of air pollution rise with increases in the emissions of sulfur dioxide and other particulate matter from tailpipes. Therefore, a marginal reduction in gallons of gas burned in a local area will promote the public's health as air quality improves. In theory, then, social welfare can be enhanced by a targeted tax on the good (motor fuel) equal to the difference between the private cost and the social cost per gallon bought and sold. Scaled in this way, such a tax would reduce the consumption of gasoline, including the negative effects of pollution, to the socially optimal level. Of course, getting the tax rate "right" is much easier in theory than in practice.

Controlling negative environmental externalities at the city level can be motivated by the goals of reducing smog and improving air quality, which helps justify taxes on gasoline and diesel fuels.<sup>9</sup> These taxes face major implementation problems, however, such as establishing a targeted level of acceptable pollution and calculating

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7. If the policy is not effective in modifying behavior because of widespread tax evasion but is still "on the books" and nominally enforced, public-choice reasoning could explain its persistence. One explanation is the bootlegger-and-Baptist theory discussed later; the other is what Bryan Caplan (2001) has called "rational irrationality." The latter concept points to voters' and their political representatives' failure to update in light of the policy's actual effects because the current policy position is consistent with other widely held beliefs.

8. So, too, is the wear and tear that drivers impose on the public roads, bridges, and highways. It is in this sense of a "user fee" that motor fuel taxes were justified initially. At the state and federal levels of government, the revenues generated by such taxes are deposited into highway "trust funds," from which monies are dispersed for road repair and new construction (discussed more fully later).

9. Beijing, for example, imposed heavy restrictions on auto traffic to help reduce air pollution ahead of and during the 2008 Olympics.

the correct tax rate to achieve that level. Some states have been more aggressive than others in raising their motor fuel taxes. California's recent \$0.035 increase raised the state's gas tax to \$0.395 per gallon, accounting for nearly 55 percent of the total state, local, and federal tax per gallon (\$0.72). The federal gas tax, in contrast, has remained constant at \$0.18 per gallon since 1992.

Imagine, however, that we dismiss all other concerns and simply think about levying a motor fuel tax designed as a user fee for road maintenance. This would be the clearest example of Pigouvian tax because it builds a relatively tight feedback loop.<sup>10</sup> Although the federal excise tax on gasoline dates to the early 1930s (mainly as way of reducing the federal budget deficit),<sup>11</sup> Pigouvian arguments were advanced to justify the creation of the federal highway trust fund in 1956. Gasoline taxation for this program represented a "user fee" to help pay for the construction and maintenance of the Dwight D. Eisenhower National System of Interstate and Defense Highways. The United States remains the only country in the world to have established a fund to recoup expenses, pay maintenance, and finance new road construction through a user fee. The theory has not played out in practice, however. The user fee has failed to keep pace with inflation and to vary with projected cost outlays.<sup>12</sup> In addition, the political temptation to raid the trust fund for other public-spending programs proved too great and has weakened the user-fee rationale for taxing gasoline and diesel fuel.<sup>13</sup>

Ian Parry, Margaret Walls, and Winston Harrington (2007) argue that the externality rationale for excise taxes on gasoline has failed in modern society. Technological innovations have created far more efficient means for addressing specific externalities associated with driving. Global positioning systems, electronic road pricing, and pay-as-you-drive insurance can efficiently replace user fees, and lower-emission vehicles have made local pollution far less of a concern. Regarding climate change, far superior policy alternatives exist: "taxing all oil products, including aviation fuel,

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10. See Pigou's discussion of the classic example of road pricing: "The principle is susceptible of general application. It is employed, though in a very incomplete and partial manner, in the British levy of a petrol duty and a motor-car license tax upon the users of motor cars, the proceeds of which are devoted to the service of the roads" ([1920] 1952, 194). Pigou points out in footnote 2 that "[t]he application of the principle is incomplete, because the revenue from these taxes, administered through the Road Board, must be devoted, 'not to the ordinary road maintenance at all, however onerous it might be, but exclusively to the execution of new and specific road improvements' (Webb, *The King's Highway*, p. 250). Thus, in the main, the motorist does not pay for the damage he does to the ordinary roads but obtains in return for this payment an additional service useful to him rather than to the general public" (194). See also the discussion of the history and implications of this example for common goods in Buchanan (1956).

11. See the National Tax Foundation's website at <http://taxfoundation.org/article/federal-gasoline-excise-tax-rate-1932-2008>, accessed February 6, 2014.

12. For more on this discussion of the motor fuel tax as a user fee, see Thomas and Heaslip (2011).

13. Moreover, as vehicle fuel efficiency increases and gasoline burned per mile driven declines, gas tax revenue has been falling. The State of Virginia, for instance, enacted a new \$64 tax on hybrid automobiles to ensure that their drivers pay "fair" shares of the costs of building and maintaining state highways. The tax is very unpopular, and two state legislators have said they will introduce a bill in the next session of the legislature to repeal it (Sullivan 2013).

diesel fuel, home heating oil, and petro chemicals, would be more cost-effective than taxing gasoline alone” (Parry, Walls, and Harrington 2007, 395).

Justifying tobacco taxes as user fees is similarly problematic because of the greater complexities of the medical and behavioral issues surrounding smoking. Setting the optimal tax on tobacco faces policymakers with accounting and implementation issues. Were policies aiming simply to align the private costs of individual consumption choices with their social costs, which include the costs borne by others, public policymakers could close the gap by levying an excise tax equal to the external cost per unit purchased. Because cigarette smoking causes cancer, and treatment for smoking-related diseases is financed at least in part by taxpayers through Medicaid, Medicare, and publicly owned hospitals and nursing-care facilities, excise taxes are levied at the state and federal levels on cigarettes and other tobacco products ostensibly (*a*) to reduce tobacco use and (*b*) to generate revenue that helps defray the costs that smokers impose on the public budget.<sup>14</sup> Governments also impose other costs on smokers when they prohibit smoking in public places and in private firms. Lawsuits against cigarette manufacturers have created problems of their own (see, for example, the discussion of the Master Settlement Agreement up next). At first glance, the Pigouvian formulation might appear to be an acceptable strategy for dealing with the consumption of a good that generates negative externalities (tobacco) or with the production of one that is consumed collectively (highways), but this line of reasoning assumes that the revenue raised by selective excise taxes is spent in the ways intended—that is, for treating smoking-related disease or for maintaining the interstate highway system.

Once a new source of public revenue is identified, how the revenue will be spent becomes a political issue. In the Master Settlement Agreement (MSA), for example, the major U.S. tobacco companies resolved lawsuits seeking recovery of the public costs of treating smoking-related diseases with the attorneys general of forty-six states.<sup>15</sup> The tobacco company defendants agreed in 1998 to pay \$264 billion into the states’ treasuries over the next twenty-five years. The funds supposedly would be used to offset uncompensated smoking-related public health-care costs and to finance antismoking campaigns and other smoking-cessation programs, thereby preventing young people especially from starting that bad habit and lowering future publicly financed health-care costs. One problem with the settlement’s windfall was that budgetary outlays associated with smoking don’t match the timing of the tax receipts. Revenue windfalls that were justified on the basis of financing smoking-related public health-care costs were reallocated to the general fund budget and spent quickly.<sup>16</sup>

14. For discussions of the question whether smokers are net contributors or net receivers from the taxpayer, see Viscusi (1994) as well as Bagchi and Feigenbaum (2014).

15. Florida, Minnesota, Mississippi and Texas settled their claims against the tobacco industry separately.

16. Many states, including California, did this by “securitizing” the expected future MSA revenue stream either by using that revenue as collateral for financing new state bond issues or by selling the right to collect



Mississippi, for example, received the most revenue per capita but spent only 29.8 percent of the settlement funds on health-care measures recommended by the Centers for Disease Control and only 4.6 percent on antismoking campaigns (Stevenson and Shughart 2006). Across all states, less than five cents was spent on antismoking programs for every dollar of MSA revenue received (Hoffer and Pellillo 2012). Most of the remainder has found its way into the general budget and has been used to offset revenue shortfalls. This flexible accounting might be the best way to allocate the windfall in times of tight public budgets, but it represents a significant departure from the Pigouvian theory of excise taxes as user fees that generate revenue linked more or less tightly to identifiable spending programs.

Political reality undermines the user-fee model to the point of irrelevance. Taylor Stevenson and William Shughart (2006) discuss the political factors that explain the considerable variation across states in the distribution of MSA payments, grounded in a rent-seeking model of the pressure exerted by special-interest groups and their political allies (such as the National Association of Attorneys General) rather than in one based on providing compensation for the social costs of smoking. Adam Hoffer (2012) finds that state-level excise taxes on cigarettes are similarly determined by special interests rather than by social costs; in 2007, the average cigarette excise tax in tobacco-producing states was \$0.68 per pack compared to \$1.17 per pack in non-tobacco-producing states. The corresponding average excise tax rates for 2013 are \$1.56 per pack in nonproducing states and \$1.25 in producing states.<sup>17</sup> The benefits of tobacco industry lobbying have eroded substantially in recent years owing to the growth in state-level excise tax rates and the convergence of tax rates between tobacco-producing and non-tobacco-producing states.

Despite being earmarked for expenditures on roads, highways, and bridges in most states, the revenue generated by motor fuel taxes often is raided to supplement general tax revenue because money is fungible (Crowley and Hoffer 2012). Similarly, “trust funds” ostensibly established as repositories for payroll taxes financing public pensions or health-care programs are frequently treated as ordinary revenue at all levels of government, further separating tax payments from the user-fee rationale. Political incentives undermine lawmakers’ ability to spend tax revenues in the “intended” ways. Revenue “windfalls” for one spending program are reallocated to other budgetary line items for which the political returns per dollar spent are higher. Hence, although taxing disfavored goods is especially popular, the public budget is a common-pool resource. All well-organized interest groups that benefit from public spending are rivals for the additions to governmental revenue generated by selective taxes.

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the revenue to other entities in return for a lump-sum payment equal the revenue stream’s discounted present value.

17. Current tax rates are taken from the Tax Foundation (<http://taxfoundation.org/article/state-cigarette-excise-tax-rates-2009-2013>) and used to recalculate the findings in Hoffer (2012).

## Social Engineering Gives Way to Unproductive Political Entrepreneurship

If we disregard the pretense of the Pigouvian social engineering perspective on selective excise taxes, public-choice considerations offer other reasons why paternalism has returned in full force as the primary justification for selectively taxing some goods and expanding the category of “disfavored” goods beyond traditional “sins.” The public-choice model of political entrepreneurship builds on the “bootlegger and Baptist” theory of regulation (Yandle 1983; Simmons, Yonk, and Thomas 2011). In that theory, which extends the more general interest-group theory of government (Stigler 1971; Peltzman 1976; McCormick and Tollison 1981; Becker 1985), public regulation of private industry responds not to the public’s interest, but rather to the self-serving interests of individuals and groups able to apply effective political pressure on politicians and regulatory agencies. An implication of the public-choice model is that popular and seemingly well-intended policy interventions mask the underlying private motives of interest groups that stand to benefit from specific governmental policy actions.

So selective taxes on alcoholic beverages and restrictions on their sale, for example, benefit the individuals and groups who object to drinking on moral grounds (the Baptists), but they also benefit sellers of moonshine (the bootleggers), who profit from supplying the demands for (untaxed) booze. The American Cancer Society and other antitobacco groups likewise benefit from excise taxes on cigarettes, especially if their research and antitobacco advertising campaigns are funded in part by tobacco tax receipts. But the cigarette bootleggers also benefit, promoting large underground markets for cigarettes, such as those in New York City. The tobacco industry itself may also benefit.<sup>18</sup>

The first modern public-choice motive for relying heavily on selective excise taxes is an old one: to generate revenue for self-interested politicians whose prime imperative is to buy enough votes to be reelected to office. Emphasizing the dire consequences of the budget “crises” now evident at the local, state, and federal levels is a ploy to achieve that objective. “Public-school teachers, police officers, and fire-fighters will be fired!” “Felons will be released from prison!” Politicians seemingly are faced with the problematic combination of ever-growing demands for public spending and shrinking tax bases. The second motive is that although taxes always have been unpopular, selective excise taxes frequently are something of an exception to that rule. The reason is that the consumers of alcohol, tobacco, and other traditional sin goods can be portrayed as behaving unwholesomely and imposing uncompensated costs on society that can be recovered by taxing the goods’ buyers. Moreover,

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18. One explanation for this turn of events is that the MSA helped “lock in” the incumbent tobacco producers’ oligopoly status by requiring new entrants, if any, to contribute to the settlement fund if their shares of the cigarette market ever exceed a predetermined percentage. See Stevenson and Shughart (2006).

the consumption of those goods tends to be concentrated among individuals of low income (and correspondingly low social status). And if the disfavored goods are purchased by a minority of taxpayers and the benefits of spending the associated tax revenue are spread widely or are earmarked for apparently worthy causes, so much the better because the tax then is a political majority-rule winner.

The 1964 surgeon general’s warning about the health consequences of cigarette smoking represented a sea change in political rhetoric that began justifying what some have called, perhaps inaptly, “modern sumptuary laws.” Smoking “warranted appropriate remedial action,” according to the 1964 report (U.S. Department of Health, Education, and Welfare 1964, 33). More recently, the new paternalism is correlated with the ascendancy of so-called behavioral economics, which lends support to experts’ paternalistic interventions and proposed policy changes. Many paternalists want to craft policy interventions that save consumers from their own poor choices. Richard Thaler and Cass Sunstein’s book *Nudge: Improving Decisions about Health, Wealth, and Happiness* (2008) supplies evidence underlying a “new” approach to regulating consumers’ choices. The goal is to modify individual behavior so that it matches the outcomes that—in the authors’ judgment and consistent with empirical findings of loss aversion, biases toward the present, and other apparent violations of the neoclassical model of rational behavior—are somehow “better.”

Although the nudge argument attempts to offer less-intrusive alternatives to sin taxation, it eases policymakers into accepting a new “libertarian paternalism” that places the state in loco parentis, not necessarily to the family, but to the otherwise unfettered choices of adults who choose badly. Paternalism recognizes the systematically erroneous decisions made by ordinary individuals—erroneous, that is to say, from the viewpoints of experts and political elites—whereas libertarianism suggests that individual freedom of choice is paramount (see, e.g., Coons and Weber 2013). This rise in the popularity of behavioral economics’ insights has informed a whole new generation of policy recommendations.

Following the traditional justification for taxing sin goods, fast food, junk food, and SSBs might be singled out for excise taxation. However, it is hard to think of a moral argument against the consumption of potato chips, Big Macs, and sweetened ice tea. Pigou also is inapt because the consumers of those goods do not impose costs on others in the same way as a coal-burning factory does. The costs associated with eating unhealthy diets are borne mostly by consumers themselves—they largely are private costs, not (negative) external ones.<sup>19</sup> Furthermore, Pigouvian taxes are meant to align the private and social costs of activities that produce negative externalities and not to generate revenue for the public sector to be spent in particular ways. As new

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19. The paternalistic argument, of course, is that the present self imposes a negative externality on the future self by discounting too heavily the long-term consequences of consuming “calorie-dense” fast food or sugary beverages. The counterargument is that by reconfiguring the choice architecture, paternalists deny individuals the ability to experiment and learn from their own experiences.

taxes are added, they are more clearly motivated by their ability to raise revenue and not their ability to internalize the externalities.

It probably is no coincidence that the rise of the new paternalism coincides with the growing socialization of health-care finance in the United States. If prescription drugs, surgery, and other medical treatments are paid for at least in part by publicly financed programs such as Medicare and Medicaid, then a case can be made that people who make bad lifestyle choices shift some of the health-care costs associated with their own consumption choices onto third-party payers.<sup>20</sup> The combination of public budget “crises” and growing acceptance of libertarian paternalism has created a perfect storm that is changing the way political elites view consumer behavior and, at the same time, has provided opportunities for political entrepreneurs to expand the range of consumer goods subject to selective taxation.

Political entrepreneurs who seize these new opportunities benefit in two ways. First, the new “sin” taxes generate revenue that can be used either to plug holes in the public budget or to finance spending programs for which the beneficiaries are willing to pay in the form of votes and other forms of political support for the politicians who champion them. Second, threatening to impose a new tax or to raise the rate on an existing one prompts individuals and groups on both sides of the proposal to contribute to the reelection campaigns of the politicians who will determine the proposal’s fate. The politicians and lobbyists win no matter what the final outcome happens to be.

The activities of firms to influence legislation favorable to their business practices are described as “rent seeking” (Tullock 1967; Krueger 1974). When legislatures can extort lobbying expenditures from these firms, it is called “rent extraction” (McChesney 1987, 1997). All funds used in securing politically mediated favors, although potentially rational from the producer’s profit-maximizing perspective, come with an opportunity cost. Those monies and efforts, which previously were used for things such as research and development, plant expansion, and job creation, are now engaged in directly unproductive, profit-seeking activities (Bhagwati 1982; Baumol 1990). Such expenditures are privately rational but socially wasteful in the sense that nothing new is created. Rent seeking, sometimes known as “directly unproductive entrepreneurship,” redistributes existing wealth and consumes scarce resources in the process. Rent seeking by beneficiaries of public policies and rent extraction by politicians are opposite sides of the same coin. Rent seeking and rent defending are not simply costs of doing business; they tie up productive resources in the economy in ways that reduce its productive capacity overall.

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20. Alarmed by a near doubling of emergency-room visits between 2007 and 2011 attributed to the consumption of highly caffeinated energy drinks, about 1,200 of which involved young people twelve to seventeen years old, three U.S. senators held public hearings to urge the Food and Drug Administration to investigate the health risks of energy drinks, especially for minors (Koseff 2013).

## A Public-Choice Analysis of Sindustries

Targeting industries for selective excise taxation is a growing trend. Many firms that produce and supply sin goods obviously want to counter the policies that impose or raise tax rates on their products (Shughart 1997a).<sup>21</sup> Lobbying and contributing to political campaigns at both the state and federal levels of government are the main tools available for achieving that goal in a democratic polity that guarantees freedom of speech.

The “fat tax” provides an excellent example of how industries can engage in strategies both to respond to and possibly to preempt proposed tax-rate increases. The term *fat tax* encompasses a variety of public processes meant to discourage the consumption of ostensibly unhealthy foods and beverages or, alternatively, to punish overweight individuals. The tax is motivated by claims that imposing it will help guide consumers toward healthier lifestyles while simultaneously raising government revenue that partially offsets the additional public costs (primarily medical costs) they cause.<sup>22</sup> Those rationales help explain the attention First Lady Michelle Obama pays to healthy diets and exercise as well as the \$50 “fat tax” proposed by Arizona governor Jan Brewer.<sup>23</sup>

Newly proposed taxes seek to extend the tax base even further. Kelly Brownell and his colleagues (2009) propose a national excise tax on SSBs of one cent per ounce. The authors estimate that the tax would generate \$14.9 billion in revenue in the first year alone, a substantial blow to the beverage industry. To help prevent these taxes from passing, firms in the fast-food and beverage industries have substantially expanded their lobbying activities and political campaign contributions.

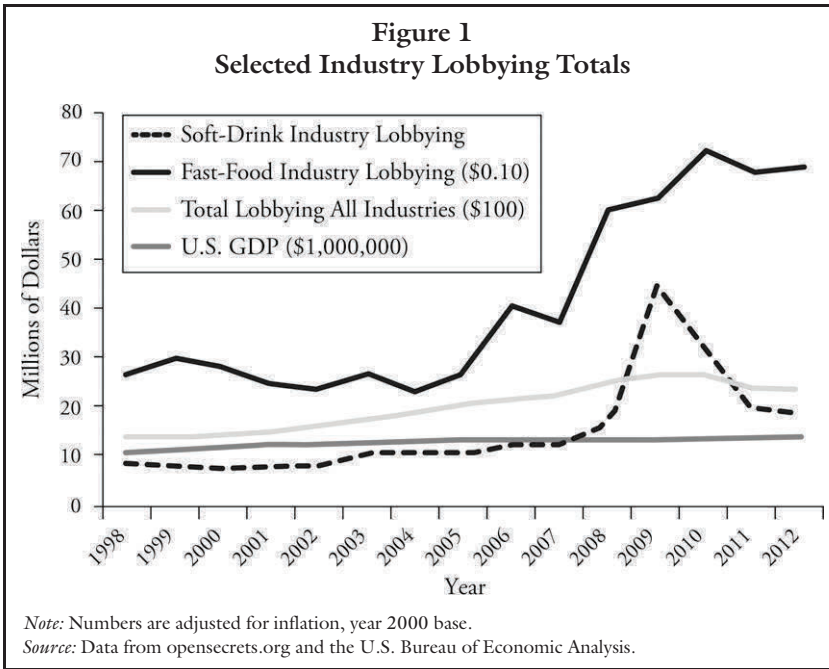
From 2002 to 2012, U.S. gross domestic product (GDP) grew at a compound annual rate of only 2.0 percent. Over that same span, total U.S. lobbying expenditures doubled that growth rate, rising at an annual rate of 4.0 percent. Lobbying in both the soft-drink industry and the fast-food industry, however, was taken to an entirely new level. Figure 1 illustrates that from 2002 to 2012, soft-drink lobbying

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21. Similar to legislation and legal settlements (Stevenson and Shughart 2006), taxation may benefit some firms within an industry at the expense of other firms within the same industry.

22. Two studies (Malik, Schulze, and Hu 2006; Vartanian, Schwartz, and Brownell 2007) connect the consumption of SSBs to obesity by conducting systemic literature reviews. Another (Duffey et al. 2010) examines four foods (soda, whole milk, pizza, and hamburgers) and concludes that a tax on soda and pizza would reduce consumption and therefore substantially lower energy intake and weight. And yet another (Lin, Smith, and Lee 2010) analyzes the elasticity differences between high- and low-income households for various beverages, finding that high-income households had elastic demands for sugary soft drinks, whereas low-income households (those more likely to be eligible for Medicaid) had inelastic demands for that product category. This evidence suggests that after the implementation of the tax, the relative consumption of SSBs will shift to the less wealthy, increasing the tax’s burden on the poor.

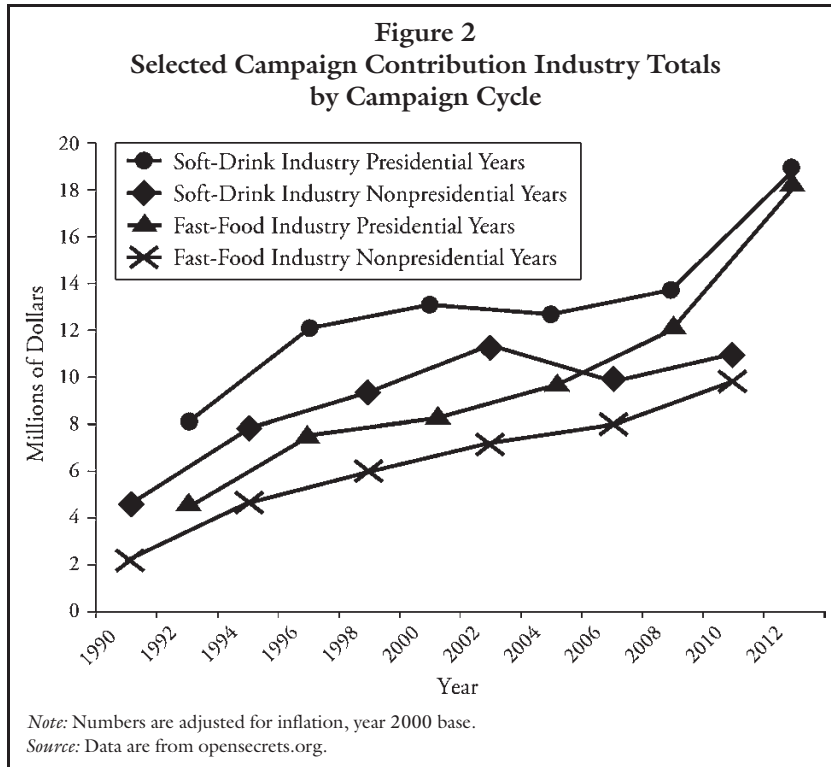
23. The Arizona fat tax would be imposed on Medicaid patients who are obese or smoke and do not follow a doctor’s recommended plan for becoming healthier. Bomsdorf (2012) details the repeal of a fat tax in Denmark after one year, citing harm to the economy and particularly to small businesses caused primarily by cross-border shopping in Germany, which dominated politically any prospective health gains.



grew at an annual rate of 9.2 percent, and fast-food lobbying grew at an annual rate of 12.3 percent. The difference has been even sharper over the past five years. Across all industries, total lobbying rose by only 0.8 percent per year, but the annual growth rate in lobbying for soft drinks was 7.7 percent and 10.4 percent for fast food. Lobbying by the two industries outpaced the growth rates in total lobbying and GDP by factors of approximately 10.

Following a U.S. Senate proposal to enact a federal soft-drink tax of three cents per twelve-ounce serving in May 2009, the soft-drink industry mobilized in opposition and increased its lobbying expenditures dramatically. In 2009, it spent \$46.2 million in lobbying—a more than 260 percent increase from the previous year and more than the industry’s cumulative lobbying expenditures in the three previous years. The tax wasn’t passed.

Political campaign contributions from the soft-drink industry also grew rapidly in recent years. The fast-food industry is an important retailer of soft drinks and likewise was opposed to the proposed excise tax on SSBs. Figure 2 shows campaign contributions from the fast-food and the soft-drink industries since 1990. Those campaign contributions predictably spike every four years when races for the White House, the House of Representative, and the U.S. Senate are on the ballot. Following all-time highs in 2008 of \$12 million (\$9.6 million in real, inflation-adjusted 2000 dollars) for the fast-food industry and of more than \$17.3 million (\$13.9 million in real, inflation-adjusted 2000 dollars) for the soft-drink and beverage industry, campaign donations soared even higher in 2012. Contributions from the soft-drink



industry hit \$25 million (\$19.0 million inflation adjusted), and contributions from the fast-food industry reached \$18.32 million (\$13.74 million inflation adjusted).

Overall, it is difficult to argue against the success of rent-defending expenditures. Although there is no guarantee that the national soft-drink tax would have been enacted in absence of dramatic increases in industry lobbying and campaign contributions—a recent \$1 per pack increase in the state cigarette tax was voted down by California residents in part because, as one member of the California state legislature put it, California’s voters “are disinclined to give money, even tobacco money, to the Legislature to spend; they don’t trust them with the money” (qtd. in Nagourney 2012)<sup>24</sup>—some form of the tax proposal would have been much more likely to pass if the producers targeted by the tax didn’t express their strong disfavor.

The evidence suggests that the SSB issue has become more salient because of growing concerns about “epidemics” of obesity and Type 2 diabetes, thereby making soft-drink producers more vulnerable to political extortion. These extractive

24. A key source of opposition was that the tax revenue was earmarked for cancer research at a time when the state’s budget was deeply in the red and funding other spending programs (e.g., public education, police, and state prisons) arguably ranked higher in priority.

rent-seeking activities further undermine the Pigouvian welfare arguments justifying intervention in the first place. In some cases, the deadweight loss from lobbying may exceed any social welfare gains from reducing negative externalities.

## Conclusion

The intellectual underpinnings for the expansion of selective taxation of sin goods and other disfavored goods are built on a welfare economics argument—namely, that penalizing buyers and thereby controlling a negative externality will help to limit the production of these public “bads.” However, the methodology for singling out negative externalities for taxation is ultimately a political game. Producers that can resist higher taxes will invest resources in the attempt to do so. Because consumption taxes are regressive, low-income consumers, who have the fewest alternatives available to them, will shoulder the heaviest tax burdens, while others who have more consumption alternatives will get off comparatively lightly.

Although a policy of “tax and regulate” rather than outright prohibition is often a step toward compromise, the application of selective taxation is only as good as the paternalism that such a policy represents. For consumers, higher excise taxes compromise the ability to maximize their own welfare at the lowest possible prices. Even if such taxes—and the implied income redistribution—can be justified somehow, the benefits to the public must be larger than the destruction of value to the individual. If not, selective tax policies simply become ones of political opportunism that raise additional revenue for the public sector by selectively levying heavier taxes on some consumers at the expense of others. An important principle of public finance argues in favor of raising revenue, politically unpopular as it may be in a majoritarian system of collective choice, by levying broader-based but in some sense “fairer” taxes on all. By contrast, sin taxes are a movement toward taxing selected unpopular groups.

Selective taxation of specific goods because of the supposed negative externalities their consumption generates is an old but fatally flawed “theory” of public finance. The flaw is the idea that the consumers of some private goods should be taxed to provide benefits for the public at large. Taxing “sin” is an elastic concept that, as James Madison and his colleagues feared, represents nothing more than “the superior force of an interested and overbearing majority” (*Federalist* No. 10)

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