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Memorandum

Date: February 18, 2025

To: Members of the House Committee on Finance

From: Adam Hoffer, PhD, Director of Excise Tax Policy, Tax Foundation

Subject: Excise Tax Increases in Article 5, Section 8-9 of the Governor's Budget Proposal

Viewpoint: Neither for nor against

Rhode Island faces an estimated budget shortfall of \$250 million, and tax and spending changes will be necessary to close the budget gap. Governor McKee has proposed several changes to balance the budget, including an increase in cigarette tax rates. Unfortunately, excise taxes, particularly those applied to a shrinking tax base, make a poor policy solution to a budget shortfall. Excise taxes supply a volatile source of tax revenue, and many excise tax revenues decrease over time while revenue needs for government services grow.

The budget specifically proposes to increase the excise tax on cigarettes from \$4.50 per pack to \$5.00 per pack. A tax increase on cigarettes is likely to increase revenue in the short term, but the additional revenue generated from the higher cigarette tax rate will decrease each year as the number of smokers continues to fall. Higher tax rates are also likely to induce more smuggling and illicit trade.

Rhode Island already experiences significant amounts of cigarette smuggling, both from consumers shopping across state borders and from illicit markets selling counterfeit cigarettes often smuggled from overseas. The most recent available data show that 19.6 percent of cigarettes consumed in Rhode Island were not purchased in the state, amounting to over \$33 million per year in forgone tax revenue from those sales.

Increasing the tax on legally purchased cigarettes in Rhode Island will increase the price differential between other states and illicit markets, likely spurring more smuggling and driving consumers toward more dangerous illegal products.

The tax increase on cigarettes would also be regressive, disproportionately impacting low-income Rhode Islanders. Simply because a tax is regressive, however, doesn't mean it should not be levied. Most consumption taxes are regressive, but they still have a role in a broader system of tax and transfers that is almost invariably highly progressive. Best practices for tax policy usually include a mix of both progressive and regressive taxes that provide a stable source of revenue but minimize market distortions and the tax burden on the poor.

While most excise taxes are regressive, taxes on tobacco are the most regressive excise tax the Tax Foundation has studied.¹ In Rhode Island, households in the lowest quintile face an effective tax rate that is 16 times greater than individuals in the top income quintile.

Table 1. Effective Tax Rates on Cigarettes Across Income Groups in Rhode Island

| Income Group | Effective Tax Rate |
|---------------------|---------------------------|
| 0% to 20% | 16.0% |
| 20% to 40% | 5.0% |
| 40% to 60% | 3.0% |
| 60% to 80% | 2.0% |
| 80% to 100% | 1.0% |

Source: Adam Hoffer, "Compare Tobacco Tax Data in Your State," Tax Foundation, May 24, 2023, <https://taxfoundation.org/data/all/state/tobacco-tax-data-tool/>.

Legislatures are charged with the difficult task of striking the right balance between reducing the harm caused by smoking, raising enough revenue to fund smoking cessation and other public health programs, and maintaining a legal, well-regulated marketplace where participants can safely transact. As you consider these matters, we are happy to be a resource and would be delighted to provide you with more research on this topic. Thank you for your time.

¹ Adam Hoffer, "Global Excise Tax Application and Trends," Tax Foundation, Apr. 7, 2023, <https://taxfoundation.org/research/all/global/global-excise-tax-policy-application-trends/#regressivity>.