

City of Alexandria, Virginia

MEMORANDUM

DATE: APRIL 5, 2006

TO: THE HONORABLE MAYOR AND MEMBERS OF CITY COUNCIL

FROM: JAMES K. HARTMANN, CITY MANAGER

SUBJECT: BUDGET MEMO #73: REVENUE FROM CIGARETTE TAX

This is in response to a question from Councilman Macdonald about the cigarette tax. The City of Alexandria increased its tax on a pack of cigarettes from \$0.50 per pack to \$0.70 per pack as of July 1, 2005. It was anticipated that revenue collections would be inelastic and that a 40% tax increase would increase local cigarette tax revenue by 40% from \$2.2 million in FY 2005 to an expected \$3.1 million in FY 2006. In prior cigarette tax increases demand was insensitive to increasing tax levels. Unfortunately cigarette tax revenue has lagged behind projections and is now expected to rise 27% to \$2.8 million in FY 2006 and remain at that level in FY 2007.

There are several possible reasons why cigarette tax collections are lower than expected. Nationally, cigarette usage is dropping. As cigarette taxes rise, the number of smokers gradually diminishes. (That's one reason for high cigarette taxes). In its FY 2004-FY 2006 biennium budget, the Commonwealth increased the tax on a pack of cigarettes from \$0.025 to \$0.20 per pack beginning on August 1, 2004 and to \$0.30 per pack beginning on July 1, 2005. In conjunction with increases in Alexandria's cigarette tax, consumers in Alexandria must pay \$0.50 more tax on pack of cigarettes than they did in 2003.

It is also likely that some smokers travel to Arlington County or Fairfax County to buy their cigarettes, particularly smokers who buy a carton or more at a time. Unlike Alexandria which has no limit on the maximum level of tobacco taxes, by law Fairfax County and Arlington County are allowed to tax a pack of cigarettes up to the state rate of \$0.30. Both counties tax at the maximum rate, but that is \$0.40 cents less per pack (or \$4.00 less per carton) than the level in Alexandria.

Even at the lower rates of taxation, Arlington noted in its proposed budget a decline in the number of packs of cigarettes sold in the County since it raised its rate in September 2004 to \$0.20 cents per pack and projects a decline in FY 2007 cigarette tax revenues. In its FY 2007 budget, Fairfax County (a faster growing jurisdiction) is holding its cigarette tax revenue estimate flat.

All other things being equal, if the cigarette tax is increased beyond 70 cents, one might expect a drop off in volume similar to that experienced in FY 2006. Accordingly, an assumption is made that each 10% increase in the cigarette tax per pack would yield 6.75% increase in revenue, and the marginal revenue might be calculated as shown in the chart below:

Cigarette rate increases

Tax rate per pack	Increase in revenue
70 cent rate	\$0
80 cent rate	\$270,000
90 cent rate	\$540,000
\$1.00 rate	\$810,000

It is also possible that additional increases in the tax on a pack of cigarettes might lead to decreasing marginal revenue as smokers shift more of their cigarette purchases to other jurisdictions.