Welfare Consequences of Nominal Excise Taxation *

Eugenio J. Miravete† Katja Seim‡ Jeff Thurk§

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Abstract

A large body of research indicates that alcohol consumption accounts for a significant share of worldwide premature death and disease, especially in low- and middle-income countries. Governments routinely utilize unit taxes to regulate alcoholic beverages but such taxes are rarely indexed to inflation. We use detailed data to estimate a model of alcohol demand and supply that ties consumers' demographic characteristics to heterogeneous preferences for spirits while placing no restrictions on the strategic price response of firms to changes in taxation. We find that federal and state nominal taxes kept retail prices low, benefited firms, and increased alcohol consumption significantly. Using recent epidemiology research, we show that increased consumption due to nominal taxation increased the prevalence of alcohol-attributable diseases such as cancer, cirrhosis, and heart disease, especially among low income, minority, and rural residents – consumers which proponents of alcohol regulation often intend to target. Our results highlight the aggregate and distributional consequences of nominal taxation even in countries with modest rates of inflation.

Keywords: Optimal Taxation, Excise Taxes, Vertical Markets, Market Power, Equity.

JEL Codes: H21, H23, L43, L66

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† The University of Texas at Austin, Department of Economics, Austin, TX 78712; Centre for Competition Policy/UEA; and CEPR. E–mail: *miravete@eco.utexas.edu*; http://www.eugeniomiravete.com

‡ Yale University, New Haven, CT 06520; CEPR and NBER. E–mail: *katja.seim@yale.edu*

§ University of Notre Dame, Department of Economics, Notre Dame, IN 46556. E–mail: *jthurk@nd.edu*; http://www.nd.edu/ jthurk/