

Written Submission of  
**Scott Drenkard**  
**Economist & Manager of State Projects**  
**Tax Foundation**

Hearing on  
**Tobacco: Taxes Owed, Avoided, and Evaded**

Before the United States Senate Committee on Finance

July 29, 2014



## Tobacco Taxation and Unintended Consequences

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### **Chairman Wyden, Ranking Member Hatch, and members of the Committee:**

I appreciate the opportunity to submit this statement on tobacco taxes and their impact across the country. In the 77 years since our founding in 1937, the Tax Foundation has monitored tax policy trends at the federal and state levels, and our data and research are heavily relied upon by policymakers, the media, and the general public. Our analysis is guided by the idea that taxes should be as simple, neutral, transparent, and stable as possible, and as a 501(c)(3) nonprofit, nonpartisan organization, we take no position on any pending legislation.

We hope that the material we provide will be helpful in the Committee's consideration of the issue.

### **Executive Summary**

- Tobacco taxes are the highest they have ever been in the United States. The federal rate currently stands at \$1.0066 per pack of cigarettes, and state and local rates add as much as an additional \$6.16 per pack (as in Chicago, Illinois). These combined rates are equivalent to a tax in excess of 200 percent in some locales.
- The high tax burden on tobacco results in de facto prohibition of the products, bringing all the undesirable outcomes associated with alcohol prohibition in the 1920s. In our research we have found evidence of substantial tobacco smuggling from low to high tax jurisdictions, violent crime, theft of tobacco and tobacco tax stamps, corruption of law-enforcement officers, and even funding of terrorist organizations through crime rings.
- The Mackinac Center for Public Policy estimates that 56.9 percent of the cigarettes consumed in New York State in 2012 were smuggled into the state from other locales. Other states with substantial smuggling problems include Arizona (51.5 percent), New Mexico (48.1 percent), Washington (48.0 percent) and Wisconsin (34.6 percent).
- In addition to smuggling authentic cigarettes from low to high tax jurisdictions, criminals sometimes skirt the legal market altogether and counterfeit name brand products and state tobacco tax stamps. Cigarette counterfeiting is a highly profitable international business that exposes consumers to products with increased levels of dangerous chemicals like lead and thallium. Other sources report finding insect eggs, dead flies, mold, and human feces in

counterfeit cigarettes. One source estimates that the Chinese cigarette counterfeiting business produces 400 billion cigarettes per year.

- In 1994, federal cigarette excise taxes in Canada were cut from \$16 to \$11 per carton because cigarette smuggling had grown so pervasive.
- The steady decline in tobacco consumption since the 1960s makes tobacco tax revenue an unstable revenue source. Administration plans to fund pre-kindergarten education with a federal cigarette tax increase are not sustainable in the long term, because revenues are projected to decline, while costs will grow.

## Tobacco Tax Differentials across States Cause Significant Smuggling

Public policies often have unintended consequences that outweigh their benefits. One consequence of high state cigarette tax rates has been increased smuggling as criminals procure discounted packs from low-tax states to sell in high-tax states. Growing cigarette tax differentials have made cigarette smuggling both a national problem and a lucrative criminal enterprise. The Virginia Crime Commission found that a well-organized cross-state smuggling operation could bring in \$4 million with one shipment.<sup>1</sup>

Each year, scholars at the Mackinac Center for Public Policy, a Michigan think tank, use a statistical analysis of available data to estimate smuggling rates for each state.<sup>2</sup> Their most recent report uses 2012 data and finds that smuggling rates generally rise in states after they adopt large cigarette tax increases. Figure 1 shows smuggled cigarettes as a percentage of consumption in each of the fifty states.

New York is the highest net importer of smuggled cigarettes, totaling 56.9 percent of the total cigarette market in the state. New York also has one of the highest state cigarette taxes (\$4.35 per pack), not counting the local New York City cigarette tax (an additional \$1.50 per pack). Smuggling in New York has risen sharply since 2006 (+59 percent), as has the tax rate (+190 percent).<sup>3</sup>

Other peer-reviewed studies provide support for these findings of substantial black market activity.<sup>4</sup> Recently, a study in *Tobacco Control* examined littered packs of cigarettes in five

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<sup>1</sup> Virginia Crime Commission, *SJR 21: Illegal Cigarette Trafficking* (Sept. 5, 2012), [http://services.dlas.virginia.gov/User\\_db/frmvsc.asp?ViewId=3160](http://services.dlas.virginia.gov/User_db/frmvsc.asp?ViewId=3160).

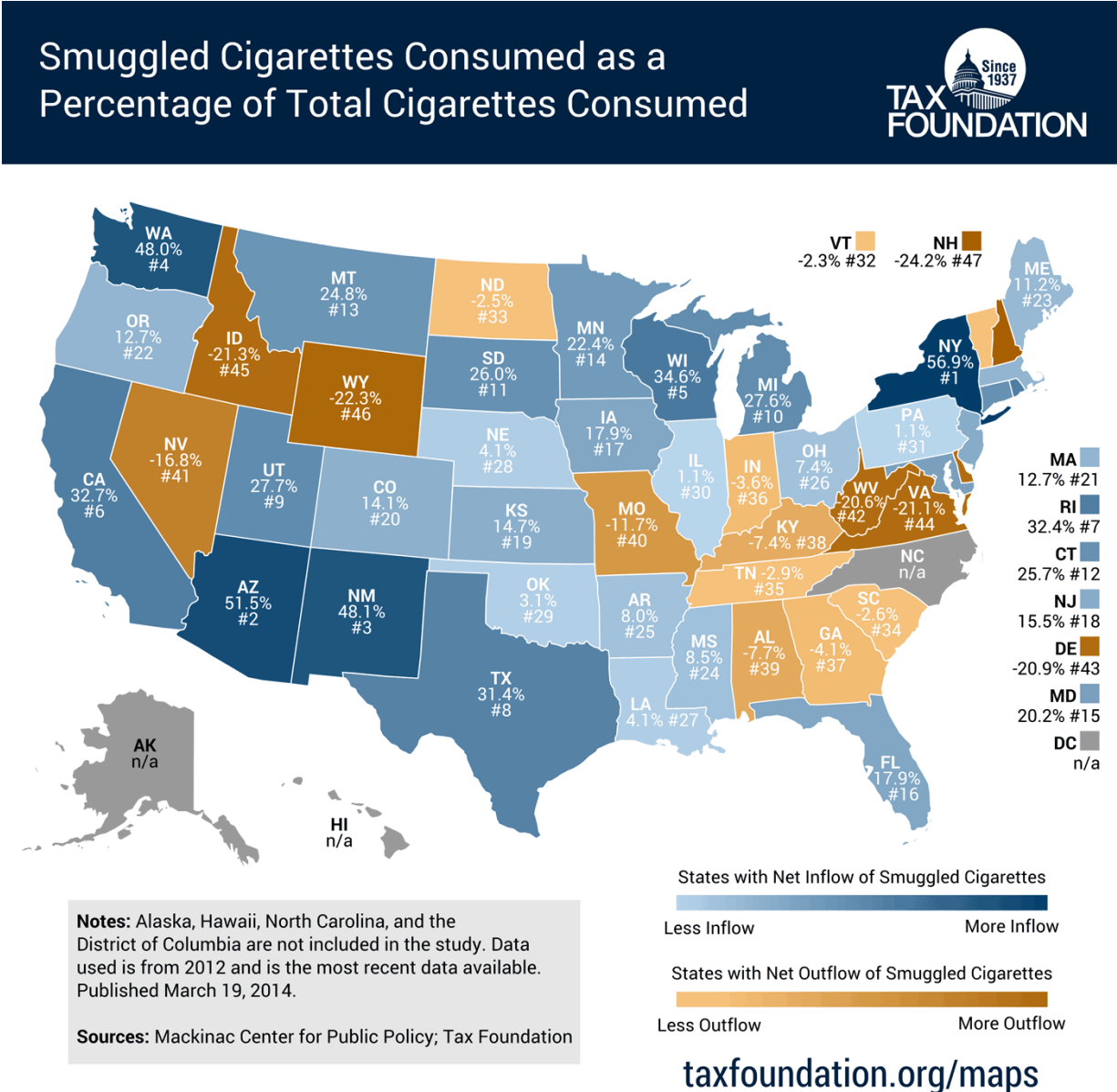
<sup>2</sup> See, e.g., Mackinac Center for Public Policy, Michael LaFaive, & Todd Nesbit, *Cigarette Smuggling Still Rampant in Michigan*, *Nation* (Feb. 2014), <http://www.mackinac.org/19725>; Mackinac Center for Public Policy, Michael LaFaive, & Todd Nesbit, *Higher Cigarette Taxes Create Lucrative, Dangerous Black Market* (Jan. 2013), <http://www.mackinac.org/18128>; Mackinac Center for Public Policy, Michael LaFaive, *Cigarette Taxes and Smuggling 2010: An Update of Earlier Research* (Dec. 2010), <http://www.mackinac.org/14210>; Mackinac Center for Public Policy, Michael LaFaive, Patrick Fleenor, & Todd Nesbit, *Cigarette Taxes and Smuggling: A Statistical Analysis and Historical Review* (Dec. 2008), <http://www.mackinac.org/10005>.

<sup>3</sup> Joseph Henchman and Scott Drenkard, *Cigarette Taxes and Cigarette Smuggling by State*, TAX FOUNDATION FISCAL FACT NO. 421 (Mar. 19, 2014), <http://taxfoundation.org/article/cigarette-taxes-and-cigarette-smuggling-state>.

<sup>4</sup> See, e.g., Michael F. Lovenheim, *How Far to the Border?: The Extent and Impact of Cross-Border Casual Cigarette Smuggling*, 61 *National Tax Journal* 7-33 (Mar. 2008), [http://ntj.tax.org/wwtax/ntjrec.nsf/BF515771548F9D538525742E006CCBBA/\\$FILE/Article%2001-Lovenheim.pdf](http://ntj.tax.org/wwtax/ntjrec.nsf/BF515771548F9D538525742E006CCBBA/$FILE/Article%2001-Lovenheim.pdf);

northeast cities, finding that 58.7 percent of packs did not have proper local stamps. The authors estimated 30.5 to 42.1 percent of packs were trafficked.<sup>5</sup>

**Figure 1: Cigarette Smuggling Rates by State (2012)**

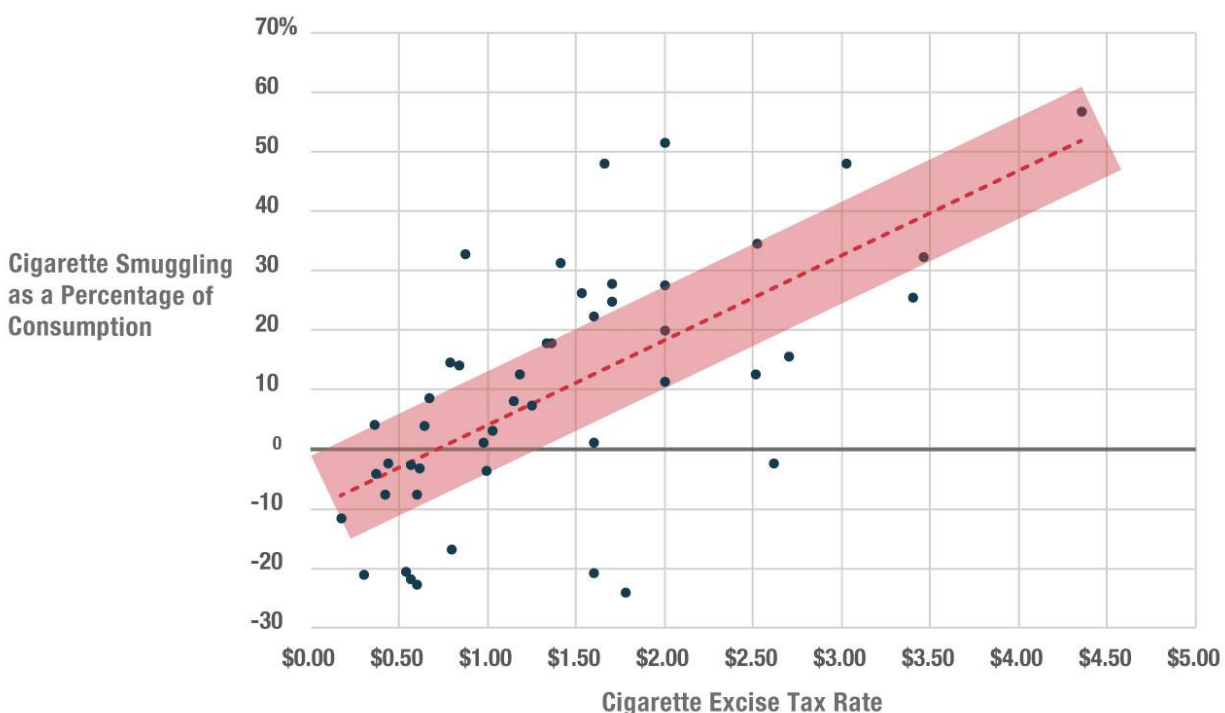


R. Morris Coats, *A Note on Estimating Cross Border Effects of State Cigarette Taxes*, 48 National Tax Journal 573-584 (Dec. 1995), [http://ntj.tax.org/wwtax/ntjrec.nsf/notesview/D7AF38C6EF8BF6D7852567EF0057A8C0/\\$file/v48n4573.pdf](http://ntj.tax.org/wwtax/ntjrec.nsf/notesview/D7AF38C6EF8BF6D7852567EF0057A8C0/$file/v48n4573.pdf); Mark Stehr, *Cigarette Tax Avoidance and Evasion*, 23 Journal of Health Economics 277-297 (2005), <http://legacy.library.ucsf.edu/documentStore/h/j/o/hjo10j00/Shjo10j00.pdf>.  
<sup>5</sup> Kevin C. Davis et al., *Cigarette Trafficking in Five Northeastern US Cities* (Dec. 11, 2013), <http://tobaccocontrol.bmj.com/content/early/2013/12/11/tobaccocontrol-2013-051244>.

Smuggling takes many forms: counterfeit state tax stamps, counterfeit versions of legitimate brands, hijacked trucks, or officials turning a blind eye.<sup>6</sup> The study's authors, LaFaive and Nesbit, cite examples of a Maryland police officer running illicit cigarettes while on duty, a Virginia man hiring a contract killer over a cigarette smuggling dispute, and prison guards caught smuggling cigarettes into prisons. Policy responses have included banning common carrier delivery of cigarettes,<sup>7</sup> greater law enforcement activity on interstate roads,<sup>8</sup> differential tax rates near low-tax jurisdictions,<sup>9</sup> and cracking down on tribal reservations that sell tax-free cigarettes.<sup>10</sup> However, the underlying problem remains: high cigarette taxes that amount to a “price prohibition” of the product in many U.S. states (Figure 2).<sup>11</sup>

**Figure 2: Cigarette Smuggling per State vs. Cigarette Excise Tax Rates, 2012**

### Cigarette Smuggling per State vs. Cigarette Excise Tax Rates, 2012



<sup>6</sup> See, e.g., Scott Drenkard, *Cigarette Smuggling Can Make You \$4 Million Richer*, TAX FOUNDATION TAX POLICY BLOG, Sept. 27, 2012, <http://taxfoundation.org/blog/cigarette-smuggling-can-make-you-4-million-dollars-richer>.

<sup>7</sup> See, e.g., Curtis Dubay, *UPS Decision Unlikely to Stop Cigarette Smuggling*, TAX FOUNDATION TAX POLICY BLOG, Oct. 25, 2005, <http://taxfoundation.org/blog/ups-decision-unlikely-stop-cigarette-smuggling>.

<sup>8</sup> See, e.g., Gary Fields, *States Go to War on Cigarette Smuggling*, WALL STREET JOURNAL, July 20, 2009, <http://professional.wsj.com/article/SB124804682785163691.html?mg=reno64-wsj>.

<sup>9</sup> See, e.g., Mark Robyn, *Border Zone Cigarette Taxation: Arkansas's Novel Solution to the Border Shopping Problem*, TAX FOUNDATION FISCAL FACT NO. 168 (Apr. 9, 2009), <http://taxfoundation.org/article/border-zone-cigarette-taxation-arkansas-novel-solution-border-shopping-problem>.

<sup>10</sup> See, e.g., Joseph Henchman, *New York Governor Signs Law to Tax Cigarettes Sold on Tribal Lands*, Tax Foundation Tax Policy Blog, Dec. 16, 2008, <http://taxfoundation.org/blog/new-york-governor-signs-law-tax-cigarettes-sold-tribal-lands>.

<sup>11</sup> See Patrick Fleener, *Tax Differentials on the Interstate Smuggling and Cross-Border Sales of Cigarettes in the United States*, TAX FOUNDATION BACKGROUND PAPER NO. 16 (Oct. 1, 1996), <http://taxfoundation.org/article/tax-differentials-interstate-smuggling-and-cross-border-sales-cigarettes-united-states>.

## International Smuggling and Counterfeiting Puts Consumers at Risk

While the practice of buying cigarettes in low tax states and selling in high tax states is highly prevalent in the United States, other methods for evading federal, state, and local taxes are also popular. One way that criminals procure even higher profits is by skirting the legal market altogether and producing counterfeit cigarettes with all the look and feel of legitimate brands, and selling them with counterfeit tax stamps. Many of these products are smuggled from China, with one source estimating that Chinese counterfeiters produce 400 billion cigarettes per year to meet international demand.<sup>12</sup>

These counterfeit cigarettes are dangerous products, and do not adhere to quality control standards found in cigarettes from authentic brands. Pappas et al. (2007) find that counterfeit cigarettes can have as much as seven times the lead of legitimate brands, and close to three times as much thallium.<sup>13</sup> Other sources report finding insect eggs, dead flies, mold, and human feces in counterfeit cigarettes.<sup>14</sup>

As was the case during the prohibition of alcohol in the United States during the 1920s, increased enforcement has not yielded beneficial results for decreasing the prevalence of bootlegging because the profit margins are so large and the distribution networks are growing more sophisticated. The Center for Public Integrity reports that:

In May, UK authorities seized over 20 million counterfeit Regals (valued at \$8.6 million) imported from China into Southampton. Likewise that month, Spanish authorities grabbed 20 million fake Marlboros—falsely described as mattresses—imported from the Chinese ports of Chiwan and Shekou. Also in May, French customs intercepted more than 15 million made-in-China fake Marlboros outside Paris, some bearing Vietnamese as well as Arabic and French health warnings.

Nevertheless, says OLAF’s [Austin] Rowan, such seizures are just “the tip of the iceberg.” Smugglers frequently ship cigarettes through an array of destinations such as Dubai and Singapore to mask a container’s origin, with some spending up to three months at sea before delivery. And even if a container is seized, given exorbitant per-container profits, the loss is a slim deterrent. “With nine containers seized in ten,” Rowan says, “[smugglers] still would not be losing money.”<sup>15</sup>

Canada had such tremendous problems with counterfeit and smuggled cigarettes that in 1994 the

<sup>12</sup> Center for Public Integrity, Te-Ping Chen. *China’s Marlboro Country* (June 29, 2009), [https://reportingproject.net/underground/index.php?option=com\\_content&view=article&id=9:chinas-marlboro-country&catid=3:stories&Itemid=22](https://reportingproject.net/underground/index.php?option=com_content&view=article&id=9:chinas-marlboro-country&catid=3:stories&Itemid=22).

<sup>13</sup> R.S. Pappas et al., *Cadmium, Lead, and Thallium in Smoke Particulate from Counterfeit Cigarettes Compared to Authentic US Brands*, 45 Food and Chemical Toxicology 202-209 (2007).

<sup>14</sup> International Chamber of Commerce, Commercial Crime Services, *Counterfeit Cigarettes Contain Disturbing Toxic Substances*, <http://www.icc-ccs.org/component/flexicontent/85-news/360-counterfeit-cigarettes-contain-disturbing-toxic-substances>.

<sup>15</sup> Chen, *supra* note 12.

federal cigarette excise tax was cut from \$16 to \$11 per carton.<sup>16</sup>

## SCHIP Reauthorization in 2009 Was the Largest Federal Cigarette Excise Tax Increase in History

The reauthorization of SCHIP in 2009 included the largest federal cigarette excise tax increase in history, bringing the tax to one of its highest levels ever in inflation-adjusted terms (See Figure 3).<sup>17</sup> State and local cigarette excise tax rates have grown dramatically in recent years as well, with the highest combined federal, state, and local rate totaling to \$7.17 in Chicago, Illinois, and \$5.85 in New York, New York (See Figure 4). These taxes contribute substantially to the cost of a pack of cigarettes, with prices in New York reaching as high as \$10.54 according to an official price survey in 2013,<sup>18</sup> and as high as \$14.50 according to a more recent informal survey.<sup>19</sup>

**Figure 3: Inflation-Adjusted Federal Cigarette Excise Tax Rates Per 20-Pack (1951-2013)<sup>20</sup>**

### Federal Cigarette Tax Rate (1951-2013)

Per 20-Pack Adjusted for Inflation in 2013 Dollars



<sup>16</sup> Clyde Farnsworth, *Canada Cuts Cigarette Taxes to Fight Smuggling*. The New York Times, February 9, 1994. <http://www.nytimes.com/1994/02/09/world/canada-cuts-cigarette-taxes-to-fight-smuggling.html>.

<sup>17</sup> Centers for Disease Control, *Federal and State Cigarette Excise Taxes—United States, 1995—2009* (May 22, 2009), <http://www.cdc.gov/mmwr/preview/mmwrhtml/mm5819a2.htm>.

<sup>18</sup> Orzechowski & Walker, *The Tax Burden on Tobacco* (2013).

<sup>19</sup> Sarah Jampel, *What A Pack Of Cigarettes Costs Now, State By State*, THE AWL, July 12, 2013, <http://www.theawl.com/2013/07/what-a-pack-of-cigarettes-costs-now-state-by-state>.

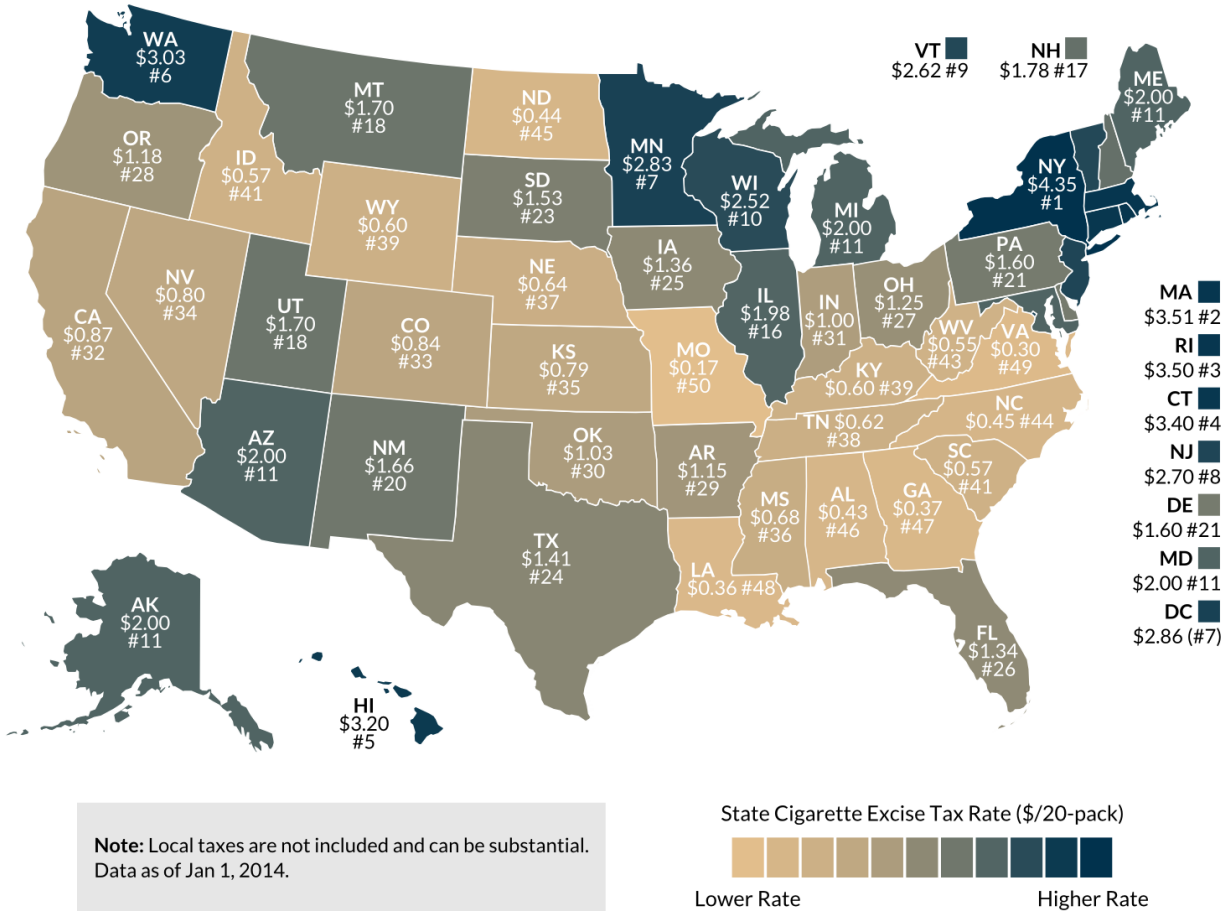
<sup>20</sup> See Orzechowski & Walker, *supra* note 17, at 305. Author's calculations completed using Bureau of Economic Analysis CPI-U.



Figure 4: State Cigarette Excise Tax Rates as of January 1, 2014

# State Cigarette Excise Tax Rates in 2014

(Dollars per pack of 20 cigarettes)

**Note:** Local taxes are not included and can be substantial. Data as of Jan 1, 2014.

**Source:** RJ Reynolds, state revenue departments.



[taxfoundation.org/maps](http://taxfoundation.org/maps)

## Tobacco Consumption is Declining, Making Tax Revenue a Poor Long-Run Funding Mechanism

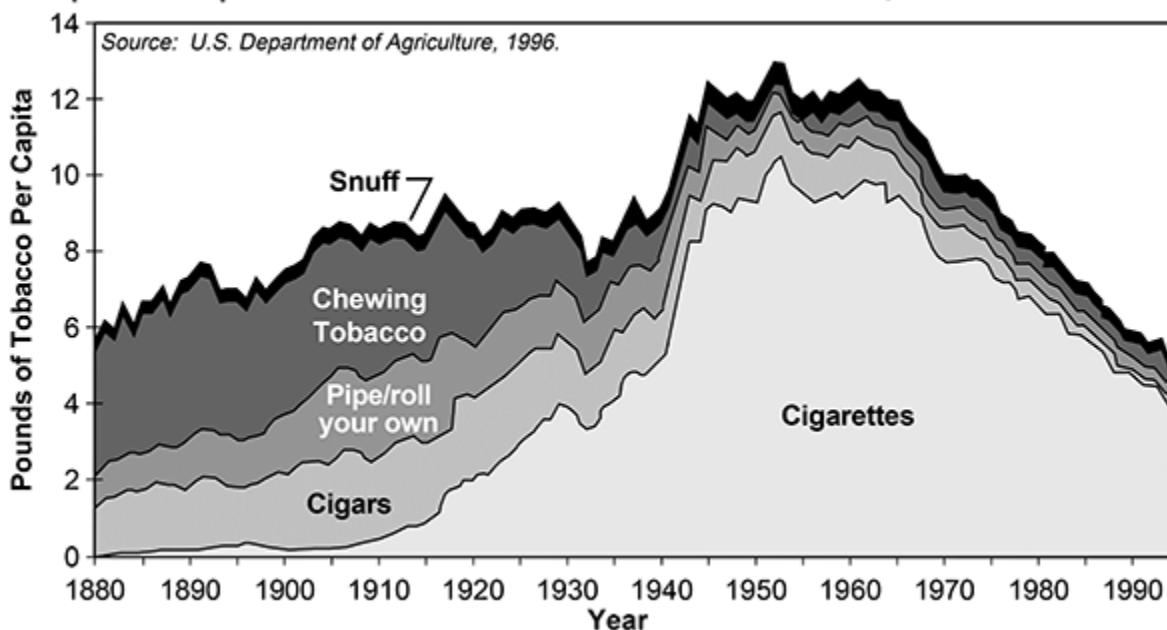
One recent proposal circulated by the administration is to fund universal preschool by increasing the federal cigarette excise tax from \$1.0066 to \$1.95 a pack. While it might be politically expedient to isolate a small, unpopular group (smokers) to pay for a service to a popular group (preschoolers), universal education would in fact be universal—and therefore should be paid for with broad based, universal taxes.

Further, funding pre-kindergarten education with tobacco tax revenue is not sustainable in the

long run, as tobacco use has steadily declined since 1963.<sup>21</sup> As Figure 5 demonstrates, per capita consumption of tobacco surged in the mid-20th century, but has since declined year after year.

**Figure 5: Per Capita Tobacco Consumption by Type**

Per capita consumption of different forms of tobacco in the United States, 1880-1995



Source: David M. Burns et al.<sup>22</sup>

Table 6, from the president's FY 2014 Budget, shows revenue projections for increasing the tobacco tax and indexing it for inflation.

In the first ten years, the tax will raise \$78.091 billion, which is enough to pay for the \$75 billion costs of the program. But the administration predicts that the revenue from the tax will decline towards the end of the ten year window. Revenue from the tax would peak in 2015 at \$9.844 billion, but by 2023, the revenue would fall to just over \$6 billion. The table also shows that the majority of the new revenue would come during the first five years of the program (2014-2018). Consider also that the President's own projections show spending on universal preschool approaching \$8 billion in 2023, even though projected revenues would be just over \$6 billion.

This is a recipe for increasingly large deficits, as the cigarette tax will fail to raise enough revenue beyond the first ten years. If states are unable to pay for their share of the universal preschool as the plan dictates, it is also possible that the federal government will have to pick up an even bigger percentage of the cost.

<sup>21</sup> American Lung Association, *Trends in Tobacco Use* (July 2011), <http://www.lung.org/finding-cures/our-research/trend-reports/Tobacco-Trend-Report.pdf>.

<sup>22</sup> David M. Burns et al, *Cigarette Smoking Behavior in the United States*, in *SMOKING AND TOBACCO CONTROL MONOGRAPH NO. 8*, [http://cancercontrol.cancer.gov/brp/tcrb/monographs/8/m8\\_2.pdf](http://cancercontrol.cancer.gov/brp/tcrb/monographs/8/m8_2.pdf).

**Table 6: Revenue and Spending Expectations for Preschool for All**  
(billions of dollars)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Totals	
											2014- 2018	2014- 2023
<b>Additional Mandatory and Receipt Proposals</b>												
-Early Childhood Investments												
--Support preschool for all	130	1,235	3,110	5,456	7,360	8,773	9,787	10,560	10,275	9,356	17,291	66,042
--Extend and expand home visiting	...	150	250	625	900	1,150	1,450	1,900	2,075	2,225	1,925	10,725
-Total, early childhood investments	130	1,385	3,360	6,081	8,260	9,923	11,237	12,460	12,350	11,581	19,216	76,767
-Increase tobacco taxes and index for inflation	-7,725	-9,844	-9,264	-8,718	-8,205	-7,723	-7,268	-6,842	-6,440	-6,062	-43,756	-78,091
Source: President Obama's FY 2014 Budget												

## Conclusion

Tobacco excise taxes are not a reasonable revenue source for additional public spending. Already sizeable burdens at the federal, state, and local level have made for lucrative black market operations that result in violent crime and a breakdown of the rule of law. Tobacco excise taxes also fail the test of providing for sustainable revenues, as their revenue declines year over, making budgeting more difficult than it already is.

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