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Smoking and Smuggling

Cigarette taxes have been in the news lately, and for good reason: federal taxes per pack recently jumped a nickel to 39 cents, and a majority of the states either have instituted their own tax increases or have such hikes on the legislative agenda. Indeed, higher federal and state taxes have helped to more than double the average price of a pack of cigarettes in the United States since 1995.

A variety of motives is pushing the increase in tax rates. Partly, the higher taxes are an effort to reduce smoking, particularly among young people. Taxpayers often end up paying the tobacco-induced medical bills of smokers, through Medicare (for the elderly) and Medicaid (for the poor). Reducing the number of smokers, it is argued, will help cut these costs. In addition, given the current low state of public opinion about smoking, cigarette taxes are proving to be a politically palatable way of raising tax revenues. Sometimes (as in California) these receipts are used in part to fund antismoking advertising campaigns; other times cigarette tax receipts are seen as a source of funds for publicly provided health care initiatives.

Cigarette prices also have been pushed up by a second force. Several years ago, the major tobacco companies settled a series of lawsuits filed by state governments. The companies agreed to pay $246 billion over 25 years into a fund to be distributed to the states. The purpose of the fund was said to be to help states promote antismoking campaigns. In fact, thus far most of the states have spent most of the money on almost anything *but* antismoking campaigns. Roads have been paved, college scholarships funded, and—in the latest economic downturn—budgetary shortfalls have been made up. Nevertheless, the settlement has had an antismoking impact along a different dimension. In the aftermath of the settlement,

cigarette companies hiked their wholesale prices by up to $1.00 per pack. When added to state taxes that now range up to $1.50 (in the state of New York), this helped push retail cigarette prices past $5.00 per pack in some places. Many smokers have responded by becoming ex-smokers.

There is little doubt that, despite the addictive attributes of nicotine, higher cigarette prices make inroads on smoking—after all, the demand curve for cigarettes, like the demand curve for any other good, is downward sloping. For each 10 percent that taxes push up the retail price, the number of packs sold drops by 4 to 8 percent. Interestingly, however, although smokers respond to higher taxes by smoking fewer cigarettes, they also tend to smoke cigarettes that are longer and have higher nicotine and tar content. This effect is so pronounced among people aged 18 to 24 that the average daily tar intake among the young people who continue to smoke is actually higher when the tax rate is higher. Because tar is believed to be the principal carcinogenic substance in cigarettes, higher taxes probably lead to *more* adverse health consequences among young smokers.

Smoking tends to be concentrated among lower-income individuals, which means that the burden of cigarette taxes also tends to be concentrated in this segment of the population. For example, one survey several years ago revealed that only 19 percent of people earning more than $50,000 per year smoked, whereas 32 percent of those earning less than $10,000 smoked. As a result, cigarette taxes consumed 0.4 percent of the income of smokers in the high-income group but an amazing 5.1 percent of the income of the low-income smokers. Indeed, it is estimated that more than half of the latest increases in federal taxes will be borne by people earning less than $25,000 per year.

Perhaps the most interesting consequence of changes in cigarette taxes, however, is the change in distribution channels that results. Cigarettes are both light and compact relative to their market value, and this becomes increasingly important when the taxes on them are raised. Thus, cigarettes are prime candidates for smuggling—and taxes are a prime stimulus to such smuggling. Worldwide, of the 1 trillion cigarettes exported from producing nations, it is estimated that roughly 300 billion were sold by smugglers, up from 100 billion 15 years ago. The chief reason for this smuggling is

that cigarette taxes vary enormously around the world, creating price differences across nations of several dollars per pack.

For example, in Britain, where cigarettes cost about $6.00 per pack, it is estimated that one-half of all British smokers consume at least some smuggled cigarettes each year. About one in four cigarettes consumed in Spain are illegal, 20 percent of Italian cigarettes are black-market, and perhaps 40 percent of all cigarettes consumed in Hong Kong are contraband. In low-tax Luxembourg, it is estimated that only 15 percent of tobacco purchased is consumed in-country—with the rest being moved covertly to higher-tax locales elsewhere in Europe.

In 1991 the Canadian federal government raised cigarette taxes by 146 percent, yielding a price per pack of $3.50, compared to an average U.S. price of $1.00 at the time. Provincial governments soon followed suit with higher cigarette taxes of their own. By 1994, black-market cigarette consumption in Canada had jumped to 25 percent of total consumption, up from about 2 percent. How did this happen? When Canadian cigarettes are exported, they are exempt from Canadian cigarette taxes. Soon after the higher federal and provincial taxes went into effect, there was a huge rise in (tax-exempt) exports to the United States, where the cigarettes were promptly—and illegally—reexported back to Canada. The federal and provincial goverments ultimately were forced to slash their taxes down to about what they had been before the smuggling outbreak.

How big are the potential cigarette smuggling stakes in the United States? With an average $1.00-per-pack hike in combined state and federal taxes, the potential net revenue to smugglers would be on the order of $3 billion to $6 billion per year, even if only a quarter of all smokers turned to the black market. And where would these smuggled cigarettes come from? Almost anywhere. Mexico, a transshipment point for much of America's illegal drug imports, is one place. Between 1989 and 1995, U.S. exports of cigarettes to Mexico went from 5 million packs a year to 150 million. Some of this surely was due to increased Mexican consumption, but a significant amount is believed to be due to reexports to California: In 1989 that state had raised cigarette taxes to 35 cents a pack from 10 cents a pack. In 2004 the federal government broke up a smuggling ring that had brought more than 100 million cigarettes into the United States from Mexico. Other likely

sources of smuggled cigarettes are domestic U.S. military bases and Indian reservations, where cigarettes generally are tax-exempt. Both of these venues have been sources of bootleg cigarettes in the past, when combined federal and state taxes were far lower than they are now.

The potential problems facing states when they raise their cigarette taxes are magnified by the fact that other states represent potential sources of supply. Economists Daniel K. Benjamin and William R. Dougan have studied the role of bootleg cigarettes in shaping cigarette taxes around the country. They found that cigarette smuggling is highly sensitive to interstate tax differentials of only a few cents per pack, and that state governments are thus forced to consider the taxing behavior of other states or suffer the consequences. For example, the late 1940s saw an outbreak of smuggling when a significant number of states first began using cigarettes as a source of tax revenue. Another outbreak of smuggling occurred in the 1970s as states raised taxes to make up for other revenue losses caused by the recession of the early 1970s.

Recent experience in Michigan reveals that the latest round of state cigarette tax increases are producing yet another epidemic of interstate smuggling. In 1994 Michigan hiked its tax to 75 cents per pack from 25 cents. Within just over a year, 20 percent of the cigarettes consumed in Michigan were smuggled in, as smokers traveled to Ohio and Indiana to save more than $6.00 (about one-third) on the cost of a carton. There has been a sharp rise in organized, large-scale heists of cigarettes from convenience stores, and even a major law enforcement push against cigarette bootlegging seems unable to quell the onslaught of illegal imports.

None of these developments would be surprising to the British, who two centuries ago relied on import tariffs to fund much of their government spending and suffered the consequences. Between 1698 and 1758 the standard tariff rate went from 10 percent to 25 percent. After further increases in tariffs during the American Revolution, smuggled goods accounted for a full 20 percent of all imports to Britain. Tea was particularly popular and thus heavily taxed. Indeed, the tax rate reached 119 percent, and by 1784 it was estimated that two-thirds of all tea consumed in Britain was contraband. Given the direction that cigarette taxes are going, cigarette smuggling seems headed the same way.