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CIGARETTE SMUGGLING

Interstate and U.S.-Canadian Experience

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Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to discuss the preliminary results of our work on cigarette smuggling. As you know, this is part of a larger body of work we are conducting on issues surrounding the proposed tobacco settlement. In conducting this work, we are addressing a wide variety of issues, including the national and regional economic impacts of the tobacco industry, smoking trends among youth in the United States and Canada, and the effect of a settlement on state excise taxes. As you requested, our statement today focuses on information developed to date concerning cigarette smuggling; in particular, interstate cigarette smuggling in the United States and Canada's recent experience with international smuggling. In summary, we found the following:

- Smuggling cigarettes from low- to high-tax states, or interstate smuggling, prominent in the 1970s, may now be a reemerging problem. Such activity is likely to occur when the differences in cigarette taxes across the states are significant enough to make it profitable. Recently, many states have opted to sharply increase their cigarette taxes. Yet most low-tax states have not. As a result, studies suggest that the level of interstate smuggling activity may now be increasing. In fact, recent estimates suggest that smuggling is responsible for states collectively losing hundreds of millions of dollars in annual tax revenues.
- In addition, recent experiences demonstrate that international smuggling can occur when cigarette tax rates are substantial. International smuggling has occurred recently between Canada and the United States. According to the Canadian government, sharp increases in Canadian federal and provincial cigarette taxes in the late 1980s and early 1990s led to large-scale smuggling between the United States and Canada conducted almost entirely by organized crime. Violence increased, merchants suffered, and in one year alone, Canada and its provinces lost over $2 billion (in Canadian dollars) in tax revenues. Canada responded in 1994 by sharply reducing federal and provincial cigarette taxes and increasing its enforcement efforts, among other steps. Since then, smuggling has declined considerably.

To address these issues, we discussed U.S. interstate cigarette smuggling and U.S.-Canadian international smuggling with the Bureau of Alcohol, Tobacco, and Firearms (ATF) officials; reviewed a study conducted by the Washington State Department of Health; and developed our own economic model to estimate the level of interstate cigarette smuggling in the United States. To understand Canada's experience with international smuggling, we also reviewed the Canadian Government Action Plan on Smuggling, a study conducted for the National Coalition Against Crime and Tobacco Contraband,[1] and a report by the Canadian Office of the Auditor General. Again, we would like to stress that the information that follows is preliminary and will be part of a larger effort that we plan to complete in April 1998.

Interstate Smuggling: a Reemerging Problem as Differences in States' Taxes Increase

According to ATF, cigarettes are currently being smuggled across state borders to avoid payment of state excise taxes, which can violate federal and/or state laws.[2] The opportunity for individuals to profit from interstate smuggling exists because of the wide disparity in excise taxes across states. Currently, state excise taxes on cigarettes range from more than 70 cents a pack to less than 10 cents a pack. (See attachment 1 for a listing of state excise tax rates.) According to estimates that we and the Washington State Department of Health developed on the extent of current smuggling activity, some states are losing as much as $100 million or more annually in potential tax revenues.[3]

The incentives to smuggle cigarettes into any particular state obviously depend on the amount that the state's tax rate exceeds that of neighboring or other states. Substantial differences in states' tax rates in the late 1960s and early 1970s encouraged significant smuggling activity. By the early 1980s, the nominal value of tax rate differentials had stabilized, but because of inflation, the constant dollar value of the differentials—and thus the profitability from smuggling—had eroded. For example, a 25-cent difference in tax rates in 1997 dollars is worth less than a 25-cent difference in tax rates in 1980 dollars. In addition, law enforcement efforts may have added to the risk of smuggling. As a result, smuggling declined. Since the mid-1980s, however, tax rates have increased substantially in some states. By 1996, differences in states' tax rates had returned to mid-1970s levels in constant dollars—thereby restoring incentives for

[1]The National Coalition Against Crime and Tobacco Contraband is a U.S. coalition composed primarily of retailers, wholesalers, and tobacco manufacturers. The coalition's report on smuggling entitled Cigarette Smuggling in the United States (Aug. 15, 1994) was prepared by Lindquist Avey Macdonald Baskerville, Inc.

[2]Under the Trafficking in Contraband Cigarettes Act, it is unlawful for any person to ship, transport, receive, sell, distribute, or purchase 60,000 cigarettes or more that bear no evidence of state tax payment in the state in which the cigarettes are found, if such state requires a stamp to demonstrate payment of taxes. States may also have stricter laws related to cigarette smuggling. For example, in Maryland, it is generally illegal for a consumer to bring more than two packs of cigarettes into the state for which Maryland taxes have not been paid.

[3]Both estimates treat all forms of tax avoidance—both large and small—as "smuggling," even though some actions, such as local cross-border purchases in small quantities, may not be illegal.

smuggling. Consequently, according to recent studies, the profitability, and therefore the extent, of interstate smuggling activity is likely to have increased in recent years.

In 1997, the state of Washington estimated the extent of interstate smuggling activity in terms of tax per day by state—which we converted to the associated loss (or gain) of state tax revenue. The Washington State estimates were derived using an approach that statistically determines how demographic factors, such as income and religious preferences, and differences in tax rates relative to other states affect cigarette sales on which state taxes were paid. The estimated relationships can then be used to simulate actual consumption.[4] The amount by which estimates of actual consumption exceed estimates of taxed sales in a state would then represent the net cigarettes smuggled into that state. In addition to examining the Washington State results, we developed another set of estimates by using survey data provided by the Centers for Disease Control and Prevention. Using survey data at the state level on the prevalence of smoking and cigarettes smoked per day, we developed estimates of actual taxable consumption in each state.[5] Then, for each state, we compared the estimates of taxable actual consumption to reported taxed sales to arrive at estimates of cigarette smuggling.

On a national level, both the Washington State study and our analysis produced roughly similar results, suggesting substantial smuggling from states with low tax rates to states with high tax rates. For example, from both studies, the estimates of tax revenue losses in states with the highest tax rates such as Massachusetts and Washington ranged between $52 million and $115 million annually. Similarly, estimates of tax revenues lost for New York, a state with slightly lower tax rates but which has a large population, still exceeded $90 million annually. Exporting states, such as Kentucky, North Carolina, and Virginia showed only modest revenue gains because their tax rates are so low that extra sales to buyers in the high-tax states do not generate significant tax revenue.

[4]This approach was pioneered by the Advisory Commission on Intergovernmental Relations in Cigarette Tax Evasion: A Second Look, ACIR, Washington, D.C., March 1985, and recently updated in A Tax Study: Cigarette Consumption in Washington State, Washington State Department of Health, January 1997.

[5]Our estimates of actual taxable consumption exclude smokers on military bases and Indian reservations, where purchases of cigarettes are exempt from state excise taxes. Also, this approach requires adjusting the survey on the basis of estimates of actual consumption in order to correct somewhat for the known bias in the survey data toward underreporting consumption.

Because there are disadvantages with each estimation method, the results of the studies should be viewed as providing ball-park estimates. The estimates may also be imprecise for a number of other reasons. Estimates of revenues lost[6] may be (1) overstated because they do not account for the fact that smokers would buy fewer cigarettes if they were unable to avoid the state cigarette tax (and therefore pay more for their cigarettes on average), or (2) understated because they do not account for federal and state tax revenues avoided because of international smuggling.

Large Increases in Canadian Cigarette Taxes Led to Widespread Smuggling Into Canada

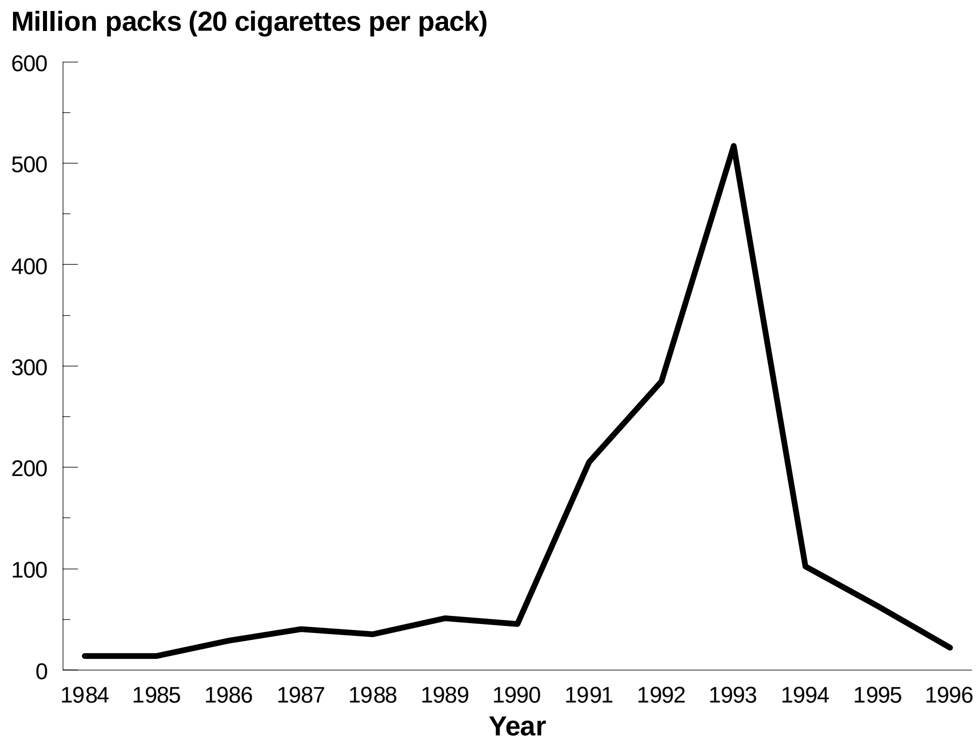
According to the Canadian government, for several years Canada increased the price of cigarettes through federal and provincial excise taxes, which resulted in a steady decline in the number of Canadians who smoke. However, these efforts had an unintended consequence—a sharp increase in smuggling activity resulting in revenue losses exceeding $2 billion (in Canadian dollars) for the federal and provincial governments in 1993 alone, according to the Canadian government. From 1984 through 1993, federal taxes on a pack of 20 cigarettes increased from 42 cents to $1.93 in Canadian dollars. Provincial taxes, levied in addition to the federal taxes, increased significantly as well. For example, from 1984 through 1993, Québec's cigarette taxes rose from 46 cents to $1.78 per pack, and Ontario's rose from 63 cents to $1.66 per pack (in Canadian dollars). As a result, the average real price of a pack of cigarettes in Canada—in 1994 Canadian dollars—increased from $2.64 in 1984 to $5.65 in 1993.

According to a 1994 study for the National Coalition Against Crime and Tobacco Contraband, because of these price increases, Canadians found lower-priced alternatives on the black market. During most of this period, cigarettes made in Canada were exported tax-free to the United States. Organized criminal groups purchased Canadian cigarettes that had been exported to the United States and smuggled them back into Canada. This resulted in more than an 11-fold increase in United States cigarette imports from Canada from 1990 to 1993 (see fig. 1). The 1994 study found that an Indian reserve that straddles the U.S.-Canadian border between Cornwall, Ontario, and Massena, New York, had become the primary conduit for smuggling cigarettes into Canada. Once in Canada, the cigarettes were passed through elaborate networks for distribution to vendors throughout the country. By evading the Canadian federal and provincial taxes, smugglers were able to earn huge profits from contraband cigarettes. According to the Canadian government, profits for

[6]For some states, revenue from state sales taxes, in addition to cigarette taxes, may also decline because of cross-border purchases and contraband sales.

smuggled cigarettes were an estimated $500 per case,[7] or $500,000 per truckload, in Canadian dollars.[8]

Figure 1: U.S. Cigarette Imports From Canada, 1984 Through 1996



Source: GAO analysis of U.S. Department of Agriculture's data

In 1993, approximately 2.1 million Canadians consumed an estimated 90 million to 100 million cartons of contraband cigarettes with a legal retail value of about $4.5 billion in Canadian dollars. That year, the problem was greatest in the province of Québec, where, the Canadian government estimated, contraband cigarettes made up over 60 percent of the market. In other parts of the country, according to the government, between 15 and 40 percent of the cigarettes sold were contraband.

[7]A case of Canadian cigarettes contains 50 cartons.

[8]Prime Minister Jean Chrétien, Government Action Plan on Smuggling, House of Commons, February 8, 1994.

While citing the effectiveness of past efforts to reduce smoking by increasing cigarette taxes, Prime Minister Chrétien stated in February 1994 that the widespread availability of relatively inexpensive contraband cigarettes was negating government controls on the distribution, sale, and consumption of cigarettes. According to the Canadian Prime Minister, as the portion of the Canadian market supplied by smuggled tobacco increased, the average price paid for cigarettes dropped. Access to cheap contraband tobacco undermined the government's health policy objectives of reducing tobacco consumption, particularly among youth.

In February 1994, Prime Minister Chrétien addressed the smuggling problem by proposing, among other actions,

- strengthening enforcement at targeted smuggling areas, particularly along the U.S.-Canadian border;
- reducing the federal cigarette tax by $5 per carton in all provinces, effective February 9, 1994, and matching any provincial tax reduction over $5, to a maximum federal reduction of $10 (in Canadian dollars);
- imposing an export tax of $8 per carton (in Canadian dollars) to be paid by tobacco manufacturers;
- imposing a 3-year federal surtax on tobacco manufacturers' profits to fund a major public education program and other health measures;
- requiring manufacturers to clearly mark individual cigarettes to differentiate cigarettes manufactured for domestic and export use; and
- further restricting access to cigarettes by minors.

From February 9 through April 15, 1994, federal and provincial taxes were significantly lowered in the five provinces where international smuggling was particularly troublesome, including Québec and Ontario. For example, combined taxes in Québec fell by $2.10 per pack, and taxes in Ontario fell by $1.92 per pack in Canadian dollars.[9] Although taxes in these provinces have increased slightly since, once the initial tax cuts took effect, the contraband cigarette market dried up, according to the 1994 study for the National Coalition Against Crime and Tobacco Contraband. Consistent with the study's findings, U.S. cigarette imports from Canada dropped about 96 percent from 1993 through 1996 (see fig. 1).

Thank you again for the opportunity to appear before you today. We would be pleased to respond to any questions you may have.

[9]Based on 20 cigarettes per pack.

Table 1: State Cigarette Tax Rates Per Pack of 20 Cigarettes, as of July 1, 1997 (In cents)

State	State cigarette tax rate
Alabama	16.5
Alaska	29.0
Arizona	58.0
Arkansas	31.5
California	37.0
Colorado	20.0
Connecticut	50.0
Delaware	24.0
District of Columbia	65.0
Florida	33.9
Georgia	12.0
Hawaii	60.0
Idaho	28.0
Illinois	44.0
Indiana	15.5
Iowa	36.0
Kansas	24.0
Kentucky	3.0
Louisiana	20.0
Maine	37.0
Maryland	36.0
Massachusetts	76.0
Michigan	75.0
Minnesota	48.0
Mississippi	18.0
Missouri	17.0
Montana	18.0
Nebraska	34.0
Nevada	35.0
New Hampshire	37.0
New Jersey	40.0
New Mexico	21.0
New York	56.0
North Carolina	5.0
North Dakota	44.0
Ohio	24.0

(continued)

State	State cigarette tax rate
Oklahoma	23.0
Oregon	68.0
Pennsylvania	31.0
Rhode Island	71.0
South Carolina	7.0
South Dakota	33.0
Tennessee	13.0
Texas	41.0
Utah	51.5
Vermont	44.0
Virginia	2.5
Washington	82.5
West Virginia	17.0
Wisconsin	44.0
Wyoming	12.0

Source: ATF.

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