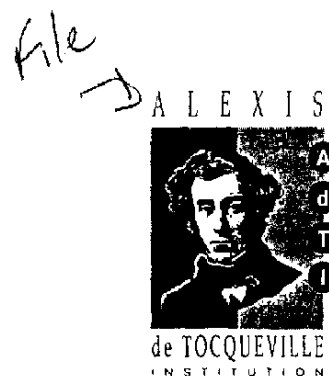


Cigarette Taxes, Smuggling, and Revenues



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INTRODUCTION

In 1993 President Clinton asked Congress to raise the tobacco excise tax by 75 cents per pack of cigarettes in order to help fund his national health insurance program. More recently, a congressional subcommittee has proposed an even larger increase of \$1.25 per pack, also to fund health insurance. Meanwhile, a number of states, such as Maryland, are proposing increases in state tobacco taxes as well.

Although these proposed cigarette tax increases largely are being fueled by anti-smoking pressure and concerns about the impact of smoking on health, they are also driven by fiscal necessity as well. Increased cigarette tax revenues would fund 17% of the Clinton health plan, for example. And throughout the United States tobacco taxes are an important element of state budgets. However, because higher cigarette taxes are motivated by contradictory goals, there is some question as to what the appropriate tax burden on tobacco should be.

On the one hand, those who favor the ultimate abolition of smoking clearly would favor the highest tax rate possible, regardless of the revenue effect, in order to encourage as many people as possible to quit smoking. On the other hand, fiscal requirements would suggest a moderate tax rate in order to minimize any reduction in cigarette sales and raise maximum revenue. Thus the fiscal and non-fiscal goals of tobacco taxation are in conflict with each other.¹

The purpose of this paper is to review some of the economic issues related to tobacco taxation in the interest of furthering public debate on this important question.

BACKGROUND

Contradictory actions with regard to the regulation of tobacco are, of course, nothing new. As early as 1621 the British Crown had forbidden the American colonies from exporting their tobacco anywhere except England. The purpose was to keep down prices for colonial tobacco and allow the mother country to capture high profits by reselling it on the world market. However, the low

¹Another aspect of this contradiction is that tobacco farmers receive de facto government subsidies. They are subsidized by restrictions on tobacco growing and restrictions on foreign tobacco imports, both of which keep tobacco prices artificially high. Thus the government encourages the growing of tobacco at the same time it discourages its use through taxation. See Kenneth C. Carraro, "Farm Policy and Mandatory Supply Controls--The Case of Tobacco," Federal Reserve Bank of St. Louis Review, vol. 70, no. 1 (January/February 1988), pp. 55-64; Michael Janofsky, "A Curb on Imported Tobacco Aids Farms and Philip Morris," New York Times (September 29, 1993).

prices discouraged colonial production and caused great hardship among tobacco growers. So in order to mitigate the effects of the English monopoly on the purchase of colonial tobacco, in 1625 the Crown further ordered that only American tobacco could be sold in England, thus excluding Spanish and Portuguese tobacco from the British market, and forbid the growing of tobacco in England.²

Thus we see an early example of how the Crown's mercantilist desire to enrich England at the expense of the colonies was frustrated by the actions of the colonists, thus requiring the Crown to introduce a form of subsidy for the colonists, in the form of a monopoly on sale in the British market, in order to offset the burden that had been imposed upon them.

First Tobacco Taxes

In 1685 England imposed an import tax on tobacco for the first time.³ Subsequently, the rate was increased to such an extent that smuggling became a serious problem. In fact, by the early 1800s revenue from tobacco taxes was falling even though population and consumption were rising. In 1826, however, a legislative drafting error caused the tobacco tax to be cut by 25%, so reducing smuggling that revenue from the tobacco tax actually increased.⁴

The possibility that tax or tariff rates might be so high as to reduce their revenue yield had been noted by Jonathan Swift as early as 1728:

I will tell you a secret, which I learned many years ago from the commissioners of the customs in London: They said, when any commodity appeared to be taxed above a moderate rate, the consequence was to lessen that branch of the revenue by one half; and one of those gentlemen pleasantly told me, that the mistake of Parliaments, on such occasions, was owing to an error in computing two and two to make four; whereas in the business of laying heavy impositions, two and two never make more than one; which happens by lessening the import, and the

²Jack P. Greene, ed., Great Britain and the American Colonies, 1600-1763 (Columbia: University of South Carolina Press, 1970), pp. 34-35. See also W.A. Speck, "The International and Imperial Context," in Jack P. Greene and J.R. Pole, eds., Colonial British America (Baltimore: The Johns Hopkins Press, 1984), pp. 384-385.

³Stephen Dowell, A History of Taxation and Taxes in England (London: Longmans, Green, 1884), vol. 2, pp. 32-34.

⁴Ibid., p. 283.

strong temptation of running such goods as paid high duties.⁵

By 1776, Swift's observation had been endorsed by Adam Smith, who wrote in The Wealth of Nations:

The high duties which have been imposed upon the importation of many different sorts of foreign goods, in order to discourage their consumption in Great Britain, have in many cases served only to encourage smuggling; and in all cases have reduced the revenue of the customs below what more moderate duties would have afforded. The saying of Dr. Swift, that in the arithmetic of the customs two and two, instead of making four, make sometimes only one, holds perfectly true with regard to such heavy duties.⁶

The Founding Fathers were also concerned about this problem. In the Federalist Papers, Alexander Hamilton wrote extensively about the impact of high taxes and import duties on encouraging smuggling, to the detriment of the Treasury's revenue. In Federalist No. 21, for example, Hamilton said, "If duties are too high, they lessen the consumption; the collection is eluded; and the product to the treasury is not so great as when they are confined within proper and moderate bounds." In Federalist No. 35 he wrote, "Exorbitant duties on imported articles would serve to beget a general spirit of smuggling; which is always prejudicial to the fair trader, and eventually to the revenue itself."

Sumptuary Laws

Despite the negative impact which high tax rates have often had on revenues, such taxes have continued to be imposed throughout time because they also serve a non-revenue purpose: to control behavior. In this respect, the tax laws are often akin to sumptuary laws, which have existed since time immemorial to regulate the consumption of various commodities. In medieval times these laws could be extremely detailed, strictly regulating such things as clothing and dress according to one's precise rank in society. Then, as now, such laws were often justified by the need to protect the lower classes from wasteful extravagance or other evils.⁷

⁵Jonathan Swift, "An Answer to a Paper Called a Memorial of the Poor Inhabitants, Tradesmen, and Labourers of the Kingdom of Ireland," in Herbert Davis, ed., Jonathan Swift: Irish Tracts, 1728-1733 (Oxford: Basil Blackwell, 1964), p. 21.

⁶Adam Smith, The Wealth of Nations (New York: Modern Library, 1937), p. 832.

⁷Wilfrid Hooper, "The Tudor Sumptuary Laws," English Historical Review, vol. 30 (July 1915), pp. 433-449; Frances Elizabeth Baldwin, Sumptuary Legislation and Personal Regulation in England

Today, taxes on alcohol and tobacco are often called sumptuary taxes for this same reason.⁸

In the 20th century, the desire to control individual behavior and prevent the consumption of commodities deemed harmful has often taken the form of outright prohibitions. The best example of this is the federal prohibition on the sale or distribution of alcohol between 1920 and 1933. Today such outright prohibitions are largely confined to narcotics, such as heroin and cocaine. However, taxes can also be used to prohibit consumption. Hugh Dalton explains how:

If, as the rate of a particular duty is increased, the revenue yielded increases, the duty is predominantly a tax. But when the rate is increased above the point at which the yield in revenue is a maximum, it is clear that some element of penalty is present, and we finally reach a duty of prohibitive amount, whose yield is very small or non-existent. This is closely akin to a simple prohibition of production or importation, with a penalty for infraction.⁹

Prohibition

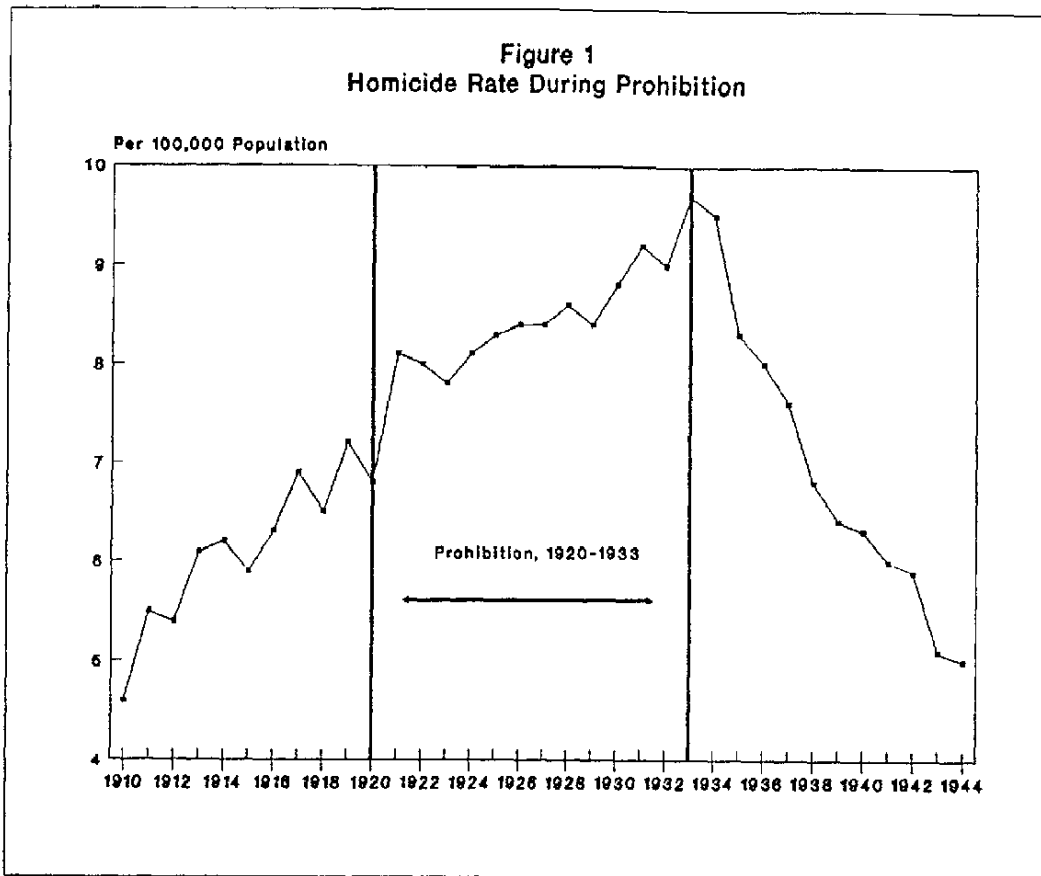
Prohibition, however, was a total failure. Although motivated by the same genuine concerns about health and public safety that today motivate concerns about smoking, the effort to prohibit alcohol consumption altogether proved to be too costly for society to bear. In particular, Prohibition gave rise to a massive increase in crime. Among the reasons increase are the following:

- o Despite Prohibition, millions of Americans still desired to obtain alcoholic beverages.
- o Because such beverages could no longer be produced legally by legitimate producers and because of higher costs associated with illegal production, prices for alcohol increased sharply.
- o Higher profit margins led new producers to enter the industry, leading established firms to use violence in order to protect their market share.
- o Such profits also drew many ordinary citizens into

(Baltimore: The Johns Hopkins Press, 1926).

⁸Joseph A. Pechman, Federal Tax Policy, 4th ed. (Washington: Brookings Institution, 1987), p. 198-99.

⁹Hugh Dalton, Principles of Public Finance, 4th ed. (New York: Augustus M. Kelley, 1954), p. 20.



criminal activity simply because of their desire to consume alcohol.

- o Wide public acceptance of alcohol consumption, high profits and criminal organization eventually led to corruption of public institutions, including the police and the courts.¹⁰

In short, Prohibition led directly to an increase in crime. This fact is shown graphically in Figure 1, which shows the homicide rate before and after Prohibition. As one can see, the onset of Prohibition before World War I caused a sharp increase in murders. Within a few years after the repeal of Prohibition, however, the homicide rate had dropped as sharply as it rose. This strongly suggests that Prohibition itself, for the reasons outlined above, was the direct cause of increased crime.

¹⁰Mark Thornton, The Economics of Prohibition (Salt Lake City: University of Utah Press, 1991), pp. 111-138.

CIGARETTE BOOTLEGGING

As noted earlier, taxes can act like prohibitions when they raise prices to such an extent that they discourage consumption and reduce tax revenues below what more moderate rates would bring in. Cigarette taxes have long been known to have such effects. In particular, the fact that state taxation of cigarettes varies greatly from state to state has given rise to organized cigarette bootlegging--buying cigarettes in low-tax states for resale in high-tax states. As Table 1 illustrates, the range of tax rates between high- and low-tax states can be as much as 63.5 cents per pack (between Virginia and the District of Columbia). Moreover, as in the case of Virginia and D.C., there are often wide variations in tax rates between contiguous jurisdictions, thus making bootlegging an easy crime to commit.

Table 1
State Cigarette Tax Rates
(cents/pack)

State	Tax	State	Tax
District of Columbia	65.0	Michigan	25.0
Hawaii	60.0	New Hampshire	25.0
New York	56.0	Ohio	24.0
Washington	54.0	Delaware	24.0
Massachusetts	51.0	Kansas	24.0
Minnesota	48.0	Oklahoma	23.0
Connecticut	47.0	South Dakota	23.0
Illinois	44.0	New Mexico	21.0
North Dakota	44.0	Colorado	20.0
Rhode Island	44.0	Louisiana	20.0
Texas	41.0	Vermont	20.0
New Jersey	40.0	Montana	18.0
Wisconsin	38.0	Mississippi	18.0
Oregon	38.0	Arizona	18.0
Maine	37.0	Idaho	18.0
California	37.0	West Virginia	17.0
Maryland	36.0	Missouri	17.0
Iowa	36.0	Alabama	16.5
Nevada	35.0	Indiana	15.5
Nebraska	34.0	Tennessee	13.0
Florida	33.9	Georgia	12.0
Arkansas	31.5	Wyoming	12.0
Pennsylvania	31.0	South Carolina	7.0
Alaska	29.0	North Carolina	5.0
Utah	26.5	Kentucky	3.0
		Virginia	2.5

Source: Tobacco Institute

A 1977 report from the Advisory Commission on Intergovernmental Relations indicated that cigarette bootlegging was one of the fastest rising crimes in the U.S. Among the reasons:

- o Cigarettes are relatively easy to handle and transport, and smuggling them across open borders is difficult to detect.
- o Penalties for cigarette bootlegging are generally light and are not an effective deterrent to bootleggers.
- o Cigarette bootlegging is not a federal offense and the interstate nature of the problem hampers state and local law enforcement efforts.
- o Potential profits in cigarette bootlegging are so great that a wide variety of people are attracted to this illegal activity.
- o Because of the high profit potential, organized crime has become heavily involved in bootlegging.

The ACIR concluded that high-tax states were losing \$391 million per year in revenue due to cigarette smuggling (equivalent to \$540 million today).¹¹

Other research confirmed the growth of cigarette smuggling. A study of tax evasion by economists Carl Simon and Ann Witte found that in 1975 cigarette smugglers earned between \$100 and \$200 million. New York was a major target of such bootlegging, earning smugglers \$30 to \$50 million in that state alone.¹² The magnitude of such losses even led to a major effort in New York to cut the cigarette tax precisely in order to reduce crime. Supporters of the effort estimated that state and local governments combined were losing \$100 million per year due to smuggling and that organized crime was earning \$1.5 million per week in the process.¹³ In an editorial, the New York Times backed the proposal, arguing that it might even lead to an increase in tax revenue:

¹¹Advisory Commission on Intergovernmental Relations, Cigarette Bootlegging: A State AND Federal Responsibility (Washington: U.S. Government Printing Office, 1977).

¹²Carl P. Simon and Ann D. Witte, Beating the System: The Underground Economy (Boston: Auburn House, 1982), pp. 31-48.

¹³Richard J. Meislin, "Cut in Cigarette Tax is Backed in Albany," New York Times (March 13, 1977); "Tobacco Industry in a Drive Asking 9c-a-Pack Tax Cut in New York City," New York Times (May 9, 1977).

Moved by pure greed, the state has raised the tax on cigarettes so high...that half the smokers in New York City buy bootlegged cigarettes, usually without knowing it. The money that should flow as tax payment to government goes instead into the pockets of well-organized criminals and their truck-driving colleagues....Since the state's present taxes took effect in 1972, revenue from cigarette taxes has dropped far below estimates even though smoking has not. The difference is so great that a reduction in the tax rate to put the smugglers out of business would probably produce greater income for the state. It is estimated that a 9-cent reduction in the tax would take the profit out of smuggling and stimulate the growth of normal, tax-paying patterns of distribution. It would also, in time, end the threat of gangster control of large parts of the cigarette business.¹⁴

Although passage of a federal law against interstate cigarette smuggling in 1978 (Public Law 95-575) has reduced bootlegging, it remains a serious problem.¹⁵

INTERNATIONAL EXPERIENCE

The recent experiences of Europe and Canada illustrate the potential of tax differentials to stimulate smuggling on a massive scale when tax rates get too far out of line. In Europe, this resulted from the elimination of all tariffs among members of the European Community starting on January 1, 1993. With the elimination of tariffs, this meant that different rates of domestic sales taxes--especially value-added taxes (VAT)--took on new economic significance. It was now far easier than it had ever been before to drive across national borders to buy goods with lower taxes than would be available in one's own country. Indeed, entrepreneurs quickly set up retail operations just across borders, catering to those seeking such tax bargains.¹⁶

¹⁴"Taxing Cigarettes Less to Take in More," New York Times (June 24, 1977).

¹⁵Advisory Commission on Intergovernmental Relations, Cigarette Tax Evasion: A Second Look (Washington: U.S. Government Printing Office, 1985); Kenneth E. Warner, "Cigarette Excise Taxation and Interstate Smuggling: An Assessment of Recent Activity," National Tax Journal, vol. 35, no. 4 (December 1982), pp. 483-490; Badi H. Baltagi and Dan Levin, "Estimating Dynamic Demand for Cigarettes Using Panel Data: The Effects of Bootlegging, Taxation and Advertising Reconsidered," Review of Economics and Statistics, vol. 68, no. 1 (February 1986), pp. 148-155.

¹⁶Tony Horwitz, "Europe's Borders Fade, and People and Goods Can Move More Freely," Wall Street Journal (May 18, 1993); William E. Schmidt, "Under the Chalk Cliffs, Mountains of Contraband," New

Canada

The experience of Canada is even more dramatic. Owing to imposition of a VAT in 1991, as well as higher rates on tobacco, the price differential between Canadian cigarettes and those sold in the United States rose to over \$35 (Canadian) per carton. Organized as well as casual smuggling skyrocketed. According to an industry-sponsored study, one in nine cigarettes smoked in Canada in 1991 had evaded Canadian taxes. As a result, Canadian governments lost approximately \$1 billion (Canadian) in revenue that year alone. The study also noted that consumption of contraband cigarettes was increasing rapidly and that such smuggling was giving rise to a vast criminal network, to which ordinary people were turning a blind eye. The study concluded:

Many ordinary Canadians feel no compunction about breaking tax-related law. Canadians now wink at cigarette smugglers the same way Americans did at bootleggers in 1920s. Smokers and non-smokers alike not only feel the high taxation rates on tobacco products are unfair, but have now engaged in the smuggling of tobacco solely for profit with little regard for the law and law enforcement officers. As long as the disparity in prices between Canada and the U.S. exists, smuggling organizations will become increasingly more sophisticated to avoid detection from the authorities. Once these organizations become established and, from our intelligence they have indeed become so, it becomes virtually impossible to dismantle them. As we have reported, commercial smugglers have merely adapted their operations to maintain the flow of supply to their distributors. Unless prices are substantially reduced, it appears Canada's tobacco smuggling problem will not disappear.¹⁷

Among the major smuggling networks are the Mohawk Indians, whose reservation straddles the New York/Canadian border, who may be responsible for half of all contraband cigarette sales in Canada. (The Mohawks also do a healthy business selling contraband cigarettes in New York as well.)¹⁸ Fishermen are another major

York Times (January 17, 1994).

¹⁷Contraband Tobacco Estimate--June 30, 1992 (Toronto: Lindquist Avey Macdonald Baskerville, Inc., 1992). See also Timothy Appleby, "Prohibitive Taxes Spur Billion-Dollar Black Market," Toronto Globe and Mail (October 29, 1992).

¹⁸Nina Munk, "Smuggled Smokes," Forbes (December 7, 1992), pp. 47-48; Michelle Lalonde, "Sales of Tax-Free Cigarettes Still Booming for Kanesatake Mohawks," Ottawa Citizen (January 26, 1994). On the involvement of other Indian tribes, see John C. Thompson, Sin-Tax Failure: The Market in Contraband Tobacco and Public Safety

source of bootleg cigarettes.¹⁹ And, of course, organized crime is heavily involved. Canadian police have identified Asian gangs known as Triads as especially active in cigarette smuggling. The use of violence in their activities is commonplace.²⁰ The mayor of the border town of Cornwall, Ontario was even forced into hiding recently due to threats on his life from organized crime, after launching a campaign against cigarette smuggling.²¹

Interestingly, the source of most contraband cigarettes is Canada itself. Legitimate cigarette manufacturers, who produce cigarettes specially for the Canadian market, have lately been exporting cigarettes to the U.S. in large numbers. In just the first seven months of 1993 Canada exported 9.7 billion cigarettes to the U.S.--an 88% increase. Since there is no apparent demand for Canadian cigarettes in the U.S., the presumption is that virtually all of these cigarettes are ultimately smuggled back into Canada.²²

Smuggling Encourages Tax Evasion

By the end of 1993, the Canadian government was becoming alarmed by the extent of cigarette tax evasion, which was contributing significantly to its fiscal problems. Said Canadian Finance Minister Paul Martin, "More and more people consider it acceptable not to pay taxes."²³ In December, Canada's IRS commissioner, David Anderson, suggested that perhaps the tobacco tax rate ought to be cut so as to reduce smuggling. "Tobacco taxes have gone up so sharply in the last three or four years that people feel it is very much an overtaxed commodity," he said.²⁴

(Toronto: Mackenzie Institute, 1994), pp. 13-30.

¹⁹Jon Newton, "Sin Tax Creates Jobs--for Bootleggers," Wall Street Journal (June 4, 1993).

²⁰Organized Crime Committee Report (Ottawa: Canadian Association of Chiefs of Police, 1993), pp. 71-78.

²¹Claudia Peel, "Martelle Goes Into Hiding," Cornwall Standard-Freeholder (September 21, 1993).

²²Bernard Simon, "Smugglers Make a Packet Out of Canadian Smokers," Financial Times (September 20, 1993).

²³John Urquhart and Christopher J. Chipello, "Canada's Liberal Government Predicts a Record High Deficit in Fiscal 1994," Wall Street Journal (November 30, 1993).

²⁴Rosanna Tamburri, "Canada May Cut Its Tobacco Taxes to Curb Smuggling," Wall Street Journal (December 8, 1993).

In January, opposition to high cigarette taxes went beyond passive tax evasion and developed into a political revolt. On January 24, seventy-five store owners in the border town of St. Eustache, Quebec, who had seen their sales and profits suffer as a result of smuggling, began openly selling contraband cigarettes at cut-rate prices, in open defiance of the police. A large crowd of people turned out to buy the cheap cigarettes and to protest Canadian taxes.²⁵

Such open defiance of the law is unusual in Canada and government leaders were becoming alarmed. In particular, there was concern that cigarette tax evasion was having a spill-over effect, leading to evasion of other taxes as well.²⁶ It was noted that since imposition of the VAT in 1991 use of cash in the economy had surged, which is often a sign of a growing underground economy, where cash, rather than checks or credit cards, is the preferred medium of exchange.²⁷ Tax evasion was said to be rampant in certain businesses, such as home renovation, where such evasion could cut costs by up to 50%. A poll found that one in four Canadians considered tax evasion to be acceptable and 30% saw nothing wrong with smuggling.²⁸

²⁵Alexander Norris, "Cigarette Tax Protesters Flout Law," Montreal Gazette (January 25, 1994), pp. A1-2.

²⁶Richard Mackie, "High Taxes Feed Defiance of Law," Toronto Globe and Mail (January 26, 1994).

²⁷On the increased use of cash as an indicator of the underground economy, see Peter M. Gutmann, "The Subterranean Economy," Financial Analysts Journal (November-December 1977), pp. 26-27, 34; David Whitehead, "Explaining the Cash Explosion," Federal Reserve Bank of Atlanta Economic Review (March 1982), pp. 14-18; Robert D. Laurent, "Currency and the Subterranean Economy," Federal Reserve Bank of Chicago Economic Perspectives, vol. 3, no. 2 (March/April 1979), pp. 3-6; Richard D. Porter and Amanda S. Bayer, "A Monetary Perspective on Underground Economic Activity in the United States," Federal Reserve Bulletin, vol. 70, no. 3 (March 1984), pp. 177-190; David J. Pyle, Tax Evasion and the Black Economy (New York: St. Martin's Press, 1989), pp. 12-33.

²⁸John Urquhart, "Canada Tries to Stem Tide of Tax Evasion," Wall Street Journal (January 4, 1994). On the Canadian underground economy, see Rolf Mirus and Roger S. Smith, "Canada's Irregular Economy," Canadian Public Policy, vol. 7, no. 3 (Summer 1981), pp. 444-453; idem, "Canada's Underground Economy," in Edgar L. Feige, ed., The Underground Economies: Tax Evasion and Information Distortion (New York: Cambridge University Press, 1989), pp. 267-280. The latter put the size of Canada's underground economy at about 10% of GDP. Recent reports have tied growth of Canada's underground economy directly to cigarette tax evasion, which appears to

Finally, in February the government decided to cut the cigarette tax by \$5 per carton and also enacted measures to encourage the provinces to cut their cigarette taxes as well. At the same time, an \$8 per carton tax was levied on cigarette exports in order to discourage round-tripping, and the corporate tax rate was increased for tobacco companies. The tax on cigarettes in Quebec was expected to fall from \$44 per carton to \$23.²⁹ Combined with the proposed increase in U.S. tobacco taxes, this action is expected to sharply reduce the profit and incentive to smuggle cigarettes across the Canadian border.

CONCLUSION

The lessons of history and foreign experience make it clear that there is a limit to excise taxation. When rates get too high they simply encourage smuggling. They may even reduce government revenue below what more moderate rates might raise. The prime beneficiaries are organized crime.

It is difficult to say whether President Clinton's proposed 75 cent per pack increase in the federal cigarette tax would have the kind of impact which higher cigarette taxes had in Canada. Obviously, purchasing cheaper cigarettes in Canada is not a viable alternative. However, one should not underestimate the ingenuity of the American people in evading taxes--there is already an underground economy in the United States of probably 10% of GDP, some \$600 billion per year.³⁰ And the failures of our nation's

have made it more acceptable to evade other taxes even by non-smokers. See Anne Swardson, "Canadians Pay Cash and Skip the Tax," Washington Post (February 16, 1994); Pierre Lemieux, "Canada's Taxing Poles Outwitted by Underground Economy," Wall Street Journal (April 8, 1994).

²⁹Clyde Farnsworth, "Canada Cuts Cigarette Taxes to Fight Smuggling," New York Times (February 9, 1994); Bernard Simon, "Canadian Tobacco Taxes Cut Sharply to Curb Smuggling," Financial Times (February 9, 1994); Charles Trueheart, "Canada Cuts Tobacco Tax to Halt Smuggling," Washington Post (February 9, 1994).

³⁰For various estimates, see Joel F. Houston, "The Underground Economy: A Troubling Issue for Policymakers," Federal Reserve Bank of Philadelphia Business Review (September-October 1987), pp. 3-12; Vito Tanzi, "The Underground Economy in the United States: Annual Estimates, 1930-80," IMF Staff Papers, vol. 30, no. 2 (June 1983), pp. 283-305; idem, "The Underground Economy in the United States: Estimates and Implications," Banca Nazionale del Lavoro Quarterly Review (December 1980), pp. 427-453; Edgar L. Feige, "How Big Is the Irregular Economy?" Challenge (November-December 1979), pp. 5-13; David M. O'Neill, Growth of the Underground Economy, 1950-81: Some Evidence from the Current Population Survey, U.S. Congress,

wars on alcohol in the 1920s and on drugs more recently do not inspire confidence that governments effectively can prevent people from evading cigarette taxes if rates are set too high.

While it is true that most other countries tax cigarettes more heavily than the U.S. even with President Clinton's proposed increase, it should be remembered that rates charged do not necessarily correspond to rates paid.³¹ Especially in developing countries, virtually all economic activity takes place in the underground economy. High statutory tax rates on incomes and commodities simply are not paid. Thus comparisons between the U.S. and other countries in this regard are not necessarily meaningful.³²

The effectiveness of a given tax to accomplish its objective may also be related to the question of fairness. If it were believed that the government was unfairly picking on smokers simply because they are vulnerable, many non-smokers would sympathize with their plight and look the other way at efforts to evade such taxes. In this respect, it is also worth noting that tobacco taxes are extremely regressive, taking far more out of the pockets of those with lower incomes than those with high incomes.

Table 2
Tobacco Expenditures as a Share of Income, 1991

Quintile	Average Income	Tobacco Expenditures	Percent
Lowest	\$5,981	\$181	3.0
Second	\$14,821	\$274	1.8
Third	\$26,073	\$310	1.2
Fourth	\$40,868	\$339	0.8
Highest	\$81,594	\$285	0.3

Source: Bureau of Labor Statistics, Consumer Expenditure Survey.

Joint Economic Committee, 98th Congress, 1st session (Washington: U.S. Government Printing Office, 1983).

³¹Comparisons of international cigarette prices and taxes can be found in World Taxation and Price Database (Brentford, Middlesex, England: Tobacco Documentation Centre, May 1993).

³²Recent estimates of the underground economy can be found in "Ghostbusters," The Economist (August 14, 1993), p. 55; and "Grossly Deceptive Product," The Economist (September 19, 1987), pp. 25-28. See also Alejandro Portes, Manuel Castells, and Lauren A. Benton, eds., The Informal Economy (Baltimore: The Johns Hopkins Press, 1989); Sergio Alessandrini and Bruno Dallago, eds., The Unofficial Economy (Brookfield, VT: Gower, 1987); Jerry Jenkins, ed., Beyond the Informal Sector (San Francisco: ICS Press, 1988).

Given that many people will not quit or reduce smoking in response to higher taxes, the effect of such taxes will simply be to reduce their real incomes, leaving them less money to spend on food, shelter or other necessities. Thus one can be opposed to smoking without necessarily endorsing higher taxes on tobacco products.³³

There is also the question of revenue. As noted at the beginning of this paper, the sumptuary effect of tobacco taxes is clearly in conflict with their revenue purpose. Insofar as such taxes reduce smoking they reduce tax revenue as well.³⁴ The most recent evidence indicates that a permanent 10% increase in the price of cigarettes reduces consumption by 4% in the short-run and 7.5% in the long-run.³⁵ Thus both the Clinton Administration and the Congressional Budget Office have forecast that cigarette tax revenues will rise by about half of the percentage increase in the cigarette tax rate.

Meanwhile, a number of states have found that recent increases in cigarette taxes have failed to raise as much revenue as anticipated. Although this partly may be due to more aggressive anti-smoking campaigns, bootlegging has also been cited by state tax officials as a major factor.³⁶ California officials are especially concerned about an increase in smuggling across the Mexican border, which accelerated after a tripling of the state cigarette tax in 1989, where cigarette seizures have increased by 887% since 1991. And this was before passage of the North American Free Trade Agreement (NAFTA), which will presumably make cross-border cigarette smuggling easier. Interestingly, many of the cigarettes

³³Charles E. McLure, Jr. and Wayne R. Thirsk, "The Inequality of Taxing Iniquity: A Plea for Reduced Sumptuary Taxes in Developing Countries," Economic Development and Cultural Change, vol. 26, no. 3 (April 1978), pp. 487-503; Gary Becker, "Higher 'Sin' Taxes: A Low Blow to the Poor," Business Week (June 5, 1989), p. 23.

³⁴See Rick Wartzman, "Clinton's Proposal for 'Sin Taxes' May Stumble by Turning Too Many Americans Into Saints," Wall Street Journal (April 14, 1993).

³⁵Gary S. Becker, Michael Grossman, and Kevin M. Murphy, "An Empirical Analysis of Cigarette Addiction," National Bureau of Economic Research Working Paper No. 3322 (April 1990). See also Jeffrey Wasserman, Willard G. Manning, Joseph P. Newhouse, and John D. Winkler, "The Effects of Excise Taxes and Regulations on Cigarette Smoking," Journal of Health Economics, vol. 10, no. 1 (May 1991), pp. 43-64.

³⁶Jerry Gray, "Wages of Sin Down, and That's Hurting State Tax Revenues," New York Times (March 2, 1993). See also "Anti-Smokers Are Set Back by a Success," New York Times (April 3, 1994).

seized are not Mexican brands, as had been the case earlier, but American brands that had been exported to Mexico.³⁷

In conclusion, there are strong reasons for being cautious about raising cigarette excise taxes. Bootlegging is already a serious problem at the state level and a 75 cent or \$1.25 per pack increase in the federal tax on top of already high state rates may only stimulate more of this activity. Moreover, the potential from cross-border smuggling between the Mexico and the U.S. cannot be dismissed casually, given the recent experience of Canada and the passage of NAFTA. In the end, not only will revenues suffer, but we could see spillover effects in the form of increased crime and its attendant violence and an increase in overall tax evasion. Thus higher cigarette tax revenues may be offset by lower revenues from other taxes.

³⁷Statement by Monte Williams, Administrator, Excise Taxes Division, California State Board of Equalization, before the FTA Tobacco Tax Annual Conference, September 1993.