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Executive Summary

New York state is currently considering a phenomenal tax increase of $.55 cents per pack! While many special interests are calling for this increase to fund government-sponsored health care coverage, New York legislators should consider the severe and unintended consequences of such a tax increase. The following are just some of the consequences and facts related to the proposed tax increase:

- New York is considering increasing its cigarette tax by an astonishing $.55 cents per pack. This tax is nearly three times the average state tax and would be the highest in the nation. All New York smokers need to do is go to nearby Indian reservations and save $13.50 per carton! New Yorkers can save big money by buying cigarettes from many nearby Atlantic coast states including: Virginia - $11.65 per carton, Delaware - $10.00 per carton, Pennsylvania - $8.00 per carton, Vermont - $6.70 per carton, Connecticut - $6.10 per carton, $3.50 per carton in high-tax Massachusetts, $3.10 per carton in New Jersey and New York City residents can save $3.80 per carton by going across the border to New Jersey.

- New York has had a colorful smuggler's history, tracing back at least 25 years ago. In fact, as far back as 1976 a report by the New York State Department of Taxation estimated that about 22% of New York's cigarettes were of a cross border origin and suggested that an actual reduction of New York State cigarette taxes could increase tax revenues in the long run.

- One only has to look at Canada to see what effect high taxes have on smuggling. In the 1980's Canada raised taxes so high that Prime Minister Jean Chretien called smuggling a " ... threat to the very fabric of Canadian society." (*Toronto Globe and Mail*, February 9, 1994). Canada eventually rolled back taxes and the smuggling subsided.

- In 1995, state and local officials estimated that over 100 million packs of cigarettes were smuggled into New York City alone. In 1997, federal and state law enforcement officials secured 31 indictments for cigarette smuggling in an effort tabbed "Operation Butt-Out." If New York raises cigarette taxes by $.55 per pack, the state's citizens can expect more of this type of crime.

- In 1993, James Wexler, the New York State Tax Commissioner, estimated that Indian sales comprised nearly 7% of the entire New York cigarette market, or 113 million packs per year (*New York Times*, June 11, 1993). More recent estimates suggest that smuggled cigarettes could comprise up to 20% of the market in New York (Forensic International Research, Inc). A $.55 per pack tax increase could send that number even higher.

- According to the American Economics Group (AEG), an additional $.55/pack cigarette tax would reduce legal cigarette sales 27% or 310 million packs.

- If New York increases cigarette taxes $.55 /pack, the gross retail value of lost cigarette sales would be approximately $1 billion (310 million packs evaluated at a final retail price of $3.30/pack).

- In 1998 New Jersey's cigarette tax doubled to 80 cents/pack. Sales have plummeted by more than 20 percent!

- Sundry product sales, or products normally bought in conjunction with tobacco products, would fall by about $450 million (based on past estimates of this phenomenon by Price Waterhouse). By dissuading smokers from shopping in New York, the tax hike will cause multiple sales losses to other merchants in the state.

- Cigarette smuggling will rise to unprecedented levels. A simple vanload of cigarettes from Virginia would be worth an amazing $66,500! (5,700 X $11.65 - price diff. between Virginia and New York.)

- Gross profits, or the value added, lost to New York retailers and wholesalers would be about $320 million due to the loss of cigarette and tie-in sales.

- It is estimated that nearly 6,000 New York jobs could be displaced due to the tax increase (based on a 1998 study of the tobacco industry by AEG).

- Many studies show excise taxes -- especially "sin" taxes -- are particularly regressive in their effect on modest to low-income people. In fact, according to a 1997 Peat Marwick study, the bottom 50% of U.S. households make $30,000 or less per year but only account for about 16% of all income earned. Yet, these same households pay nearly 47% of all state and federal tobacco taxes. Without doubt, those who can least afford the tax will be hit the hardest.

- Tobacco products are sold in many types of stores including convenience stores, gas stations, supermarkets, liquor stores, tobacco stores, drug and proprietary stores. These New York stores had a gross retail value of more than $3.3 billion in FY 1999, generating more than $1 billion in gross profits for New York retailers and wholesalers.

- According to a 1998 study by the American Economics Group (AEG), nearly 72,000 jobs were directly and indirectly created by tobacco sales.

- Smaller "Mom and Pop" stores rely on tobacco for a significant portion of their revenue. In fact, the National Association of Convenience Stores reports that tobacco sales in such stores accounted for nearly 30% of merchandise sales. More than 45% of all tobacco products are sold through convenience stores nationwide. In New York, it is estimated that such stores sell nearly $1.4 billion worth of cigarettes with gross profits of nearly $330 million.

Conclusion

While everyone wants better health care coverage, creating more government programs to achieve that goal is not a good idea. Also, if taxpayer-funded health care subsidies are so important, is it a good idea to rely on cigarette taxes as a source of revenue? Is it logical to rely on cigarette funding for such an important program while the state is actively discouraging its use? Who will pay for the program when tobacco revenues dry up? What costs will the state incur to the increase in crime? Raising cigarette taxes will only cost New York's retail community and businesses money and jobs.

Oppose cigarette-tax funded healthcare subsidies. They are bad for business and bad for the state.

More Taxes: New York's $.55 Per Pack Cigarette Tax Increase

The legislature is considering a tax proposal increasing the New York State cigarette tax by 55¢ per pack. Under the proposal, the New York cigarette tax would rise from 56¢ to $1.11per pack, making it the highest in the country and nearly triple the national average (40.5¢ per pack). In New York City the tax would rise to $1.19 per pack due to an additional 8¢ municipal cigarette tax. The 55¢ per pack tax hike would mean the typical New York smoker would pay an additional $275 in new state taxes per year.

The revenues from this tax will come on top of the monies that New York will receive under last year's settlement between the state attorneys general and the tobacco industry. Under that settlement, New York will gain about $1 billion in annual payments from the cigarette manufacturers, or approximately $25 billion over 25 years (see "New York Receives Big Payday From Tobacco Companies"). The $1 billion in yearly settlement payments is about 50% greater than the amount that New York collects from its current 56¢ per pack cigarette tax (approximately $660 million).

One effect of the settlement has been a steep increase in cigarette prices nationwide. Once fully absorbed, national cigarette prices could rise by as much as $1 per pack compared to prices at the end of 1997. This could boost the annual cost to the typical New York smoker by nearly $350. When this "settlement tax" is combined with New York's cigarette tax increase, smokers will pay a staggering $625 per year.

Consumers aren't the only victims; New York retailers should also be concerned. Cigarette sales are expected to fall by nearly 27%. New York consumers could save big money buying cigarettes on many of its borders. The proposed $1.11 tax would be substantially above the tax in Pennsylvania (31¢), Vermont (44¢), and Connecticut (50¢). New York citizens even could find a better deal in Massachusetts (76¢).

Cigarette Taxes Hurt the Poor the Most

The Regressive Impact of Cigarette Taxes

A recent study by Peat Marwick shows that cigarette taxes are the most regressive taxes — they extract a far greater percentage of income from modest income citizens compared to those with high incomes.

The 1997 Peat Marwick looked at those U.S. families in the bottom half of the income distribution. The cut-off was approximately $30,000, in other words, about 50% of all households make less than $30,000 per year. While this group comprises about 50% of all households, it receives only 16% of all income generated. This group pays about 15.3% of all federal income and FICA taxes. In contrast, it pays over 47% of tobacco taxes.

Furthermore, Peat Marwick found that the tobacco tax is the most regressive of all excise taxes. While the bottom half of U.S. households only reaped 16% of all income, they paid 47% of tobacco taxes, 17% of wine taxes, 30% of gas taxes, 30% of distilled spirit taxes and 34% of beer taxes. The tax increase, in effect, extracts an annual $275 tax increase from the typical New York smoker. On top of the annual cost of the settlement-induced price increases ($350/smoker), that means the New York smoker could see his cost burden increase by a whopping $625 per year.

Clearly, New York's cigarette tax will harm those with modest income the most.

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New York Receives Big Payday From Tobacco Companies

Recently, the major tobacco companies settled tobacco lawsuits with all 50 states in the United States. Tobacco companies agreed to fundamentally change the way they do business in the state of New York and in the rest of the country. Among other things, the tobacco companies agreed to: end all outdoor advertising, limit advertising at retail, limit sports/other sponsorships, no cartoon characters and, of course, significant monetary payments to the states.

New York will receive almost $25 billion from tobacco companies over the next 25 years. The following is an overview of the projected payments to the state of New York (National Association of Attorneys General – NAAG):

1998	$ 306,288,745.07
1999	$ .00
2000	$ 818,269,525.50
2001	$ 883,599,638.62
2002	$1,060,945,263.21
2003	$1,070,985,962.65
2004 - 2007	$ 893,852,654.37
2008 - 2017	$ 911,591,877.52
2018 - 2025	$1,021,472,964,43
Total	**$25,003,202,243.12**

These payments average almost $1 billion a year or about 50% greater than the amount New York currently collects from its $.56 per pack cigarette tax.

Increase Would Devastate Retailers

Tobacco Sales Support Many Retailers

Tobacco products are sold in many types of stores including convenience stores, gas stations, supermarkets, liquor stores, tobacco stores, drug, and proprietary stores. These New York stores sold about 1.1 billion packs of cigarettes in FY 1999. This had a gross retail value of nearly $3.3 billion in FY 1999, generating over $1 billion in gross profits for New York retailers and wholesalers. According to a 1999 study by the American Economics Group (AEG), nearly 72,000 jobs were directly and indirectly created due to such activities.

Tobacco sales have an especially magnified impact on smaller establishments. This is because cigarette sales comprise such a large share of their sales. In 1997, The National Association of Convenience Stores reports that tobacco sales in such stores accounted for nearly 30% of merchandise sales. Nearly 45% of all tobacco products are sold through convenience stores nationwide. In New York, it is estimated that such stores sell over $1.4 million worth of cigarettes with gross profits of nearly $330 million in FY 1999.

Convenience Store Losses

According to the *Convenience Store News* there are about 3,450 convenience stores operating in New York. It is estimated that the 55¢/pack-tax hike will lead to about a $470 million reduction in cigarette sales for New York convenience stores. Sundry product losses would be about $211 million.

Each New York convenience store on average would lose about $190,000 in cigarette and sundry product sales. Gross profit losses would average about $42,000 per store. This means each store would have to boost gross retail sales of other items by $190,000 to make up for the damage wrought by the 55¢/pack cigarette tax hike.

Commercial Losses

- Loss in Cigarette Sales Volume

  The American Economics Group projects that the 55¢/pack-tax increase will reduce New York's cigarette sales by approximately 28%. Cigarette volume is likely to fall by about 310 million packs in 2000. Most of this would be due to lost sales to low-tax states and zones.

- Loss in Retail Sales

  The gross retail value of lost cigarette sales would be approximately $1 billion (310 million packs evaluated at a final retail price of $3.30/pack). Sundry product sales, or products normally bought in conjunction with tobacco products, would fall by about $450 million (based on past estimates of this phenomenon by Price Waterhouse).

- Loss in New York Gross Profits (value added)
  Gross profits, or the value added, lost to New York retailers and wholesalers would be about $320 million.

- Lost Jobs

  It is estimated that nearly 6,000 New York jobs could be displaced due to the tax increase (based on a 1998 study of the tobacco industry by AEG).

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Tobacco Sales Thrive on Indian Reservations

Cigarette sales on Indian reservations are a relatively recent phenomenon. The 1976 Donati report does not mention this as a prominent factor. Estimates by the Advisory Council on Intergovernmental Relations (ACIR) in 1985 came up with only a negligible share of the market for tribal sales. This changed as the cigarette tax rose from 21¢ to 56¢ between 1989 and 1993. By 1993, tribal sales had become a vexing problem for non-tribal retailers. In an August 31, 1993 *New York Times* article, Robert Reid of the Independent Petroleum Marketers of New York stated that " the Indian's tax exempt status gives them an unfair advantage over non-Indian business." In a June 11, 1993 *New York Times* article, James Wexler, the State Tax Commissioner, estimated that Indian sales took about 7% of the entire New York cigarette market, or 113 million packs per year. More recent estimates suggest that it could exceed 10% of the market.

Clearly, the Indian problem was ignited by the large tax increase of the early 1990's. A 55¢-tax hike would only inflame this problem. Eventually, tribal sales could reach the levels found in Oklahoma or Washington where such sales take from 15% to well over 20% of the market.

New York and the Cross Border Threat

Recent Cross Border Trends

Cigarette purchasing patterns have changed dramatically due to more than 70-state cigarette tax increases since 1989. High-tax states have seen tax reported sales plunge, while low-tax states have seen a corresponding increase. The Tax Foundation examined this shift in a 1996 study, The Effect of Excise Tax Differentials on Smuggling and Cross Border Cigarette Sales. They discovered that tax differentials between high and low-tax states were creating substantial increases in both casual cross-border purchases and the organized smuggling of cigarettes. In a subsequent study, the Tax Foundation estimated that cross-border sales represented nearly 14% of total U.S. sales in 1997.

The Tax Foundation noted that the following high-tax block of states -- California, Massachusetts, Michigan, and New York -- with an average tax of 73¢ per pack, sell fewer cigarettes than the following low-tax states -- Indiana, Kentucky, Missouri, New Hampshire, North Carolina, Tennessee, and Virginia -- with an average tax of 13¢ per pack. Yet the four high-tax states have a population (65.4 million) nearly double that of the low-tax states (34.4 million).

In 1995, for the first time in history, the low-tax block sold more cigarettes (4.4 billion packs) than the high-tax block (4.3 billion packs). Since then, the gap has widened. In FY 1998, tax-reported sales in the low-tax block were 16% greater than such sales in the high-tax block. New York could easily be swept up in the cigarette smuggling epidemic that now plagues some other states. In fact, New York already has significant problems with Indian reservations and long distance smuggling.

New York retailers have a lot to lose. After a 55¢ tax hike, New York consumers could save $13.50 per carton on Indian reservations, $11.65 in Virginia, $10.00 in Delaware, $8.00 in Pennsylvania, $6.70 in Vermont, $6.10 in Connecticut and $3.50 in Massachusetts. All these margins exceed -- some by leaps and bounds -- the Advisory Council on Intergovernmental Relation's (ACIR) bootleg "flashpoint" of $3.50 per carton. Tax differences above the "flashpoint" are likely to encourage serious investments in cigarette smuggling. New York retailers, and ultimately state law enforcement budgets, would be vulnerable to rampant smuggling.

New York's Cigarette Smuggling History

New York has had a colorful smuggler's history, tracing back at least 25 years ago. At that time the focus was on the infamous Tobacco Road -- the Interstate 95 connection between New York City and North Carolina. The state and local cigarette tax in New York City was 23¢ compared to 2¢ in North Carolina. The tax savings led to a significant smuggling problem for New York City, where some 160 smuggler arrests were made between 1974 through 1976. This is reflected in a 1976 report by the New York State Department of Taxation. This report is often referred to as the Donati Report in honor of the task force chairman Alfred Donati. The Donati report estimated that about 22% of New York's cigarettes were of a cross border origin and suggested that an actual reduction of cigarette taxes in New York State could increase tax revenues in the long run.

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From 1975 to 1989, New York only increased its tax by 6¢. The effects of the tax hike were minimized by the rapid inflation of the 1970's and early 1980's. Consequently, the smuggler incentives melted away. This rapidly changed beginning in 1989 as a series of tax hikes boosted the tax from 21¢ in 1989 to 56¢ in 1993. Cigarette volume fell by a staggering 32% from 1988 to 1994.

Once again the cigarette smuggling problem reared its head. State and local officials estimated in 1995 that over 100 million packs of cigarettes were smuggled into New York City. In 1997, federal and state law enforcement officials secured 31 indictments for cigarette smuggling in an effort tabbed "Operation Butt-Out." The focus of the investigation was the smuggling route from Virginia to New York City. The tax gap between the two areas was $6.55 per carton. According to law enforcement official this was more alluring than many forms of drug smuggling. If the tax goes up 55¢, many more indictments could be on the way.

New York and the Potential for Increased Cigarette Smuggling

These trends should have been anticipated given prior research. In 1985, the Advisory Council on Intergovernmental Relations (ACIR) published a report on cigarette smuggling. The ACIR estimated that if a tax difference of $2.30/carton emerged between low and high-tax states within a geographic region, then it would be profitable for cigarette smuggling to take place. Adjusting for inflation since that time, this ACIR "flashpoint" would be about $3.60/carton in 1998. It is little wonder that cigarette-purchasing patterns are shifting. There are 28 "flashpoint" situations in the U.S.—up from just 6 cases in 1990.

A $1.00/pack New York cigarette tax would create the following "flashpoint" situations:

- **Indian Reservations — a difference of $13.20/carton**
- **Virginia— a difference of $11.65/carton**
- **Delaware— a difference of $10.00/carton**
- **Pennsylvania— a difference of $8.00/carton**
- **Vermont— a difference of $6.70/carton**
- **Connecticut— a difference of $6.10/carton**

The Canadian Experience

Canada provides an excellent case study of the problems that can develop when cigarette taxes reach an excessively high level. Throughout the 1980s, federal cigarette taxes, as well as provincial taxes, increased steadily. At its peak in 1994, cigarette taxes reached nearly $30 per carton in Ontario and Quebec. The lure of cheaper cigarettes in the United Stated led to a rash of smuggling that became so pervasive that Prime Minister Jean Chretien announced plans in early 1994 to roll back federal cigarette taxes by $5 per carton. Provinces were encouraged to follow suit. In Quebec, the tax dropped by $21 per carton.

This decision naturally antagonized an anti-smoking lobby that looked to Canada as a model of anti-tobacco policy. They had argued that Canada's experiment with high cigarette taxes had led to lower cigarette consumption, higher tax revenues and acted as a deterrent to youth smoking.

In reality, the Canadian "model" had failed. Cigarette consumption never fell appreciably compared to the United States. Moreover, smuggling and theft increased dramatically and created a huge black market for cigarettes. In turn, this underground economy made it more difficult to deter youths from smoking. Finally, Canadian smokers became openly resentful of their government.

The anti-smoking lobby alleged that Canadian cigarette consumption had fallen in tandem with the giant cigarette tax hikes of the 1980s. This would be the case if one measured consumption by domestic sales, which did nosedive. However, many Canadian smokers and smugglers simply avoided the taxes by purchasing Canadian cigarettes in the United States. These shipments are called "export duty-free" and can be tracked quite easily.

When total Canadian cigarette production is measured, including export duty-free, Canadian cigarette production decreased by about 14 percent between 1988-1993, compared to a 13.7 percent drop in the United States. In other words, higher taxes did not lead to a relative reduction in cigarette consumption when compared with the United States – it just led to more consumption of smuggled products.

In fact, smuggling became so pervasive in Canada that it even attracted the attention of the international press. In a December 1993 *Wall Street Journal* report, the Quebec government estimated that 50 percent of the cigarettes consumed in the province were smuggled. More recent estimates pegged the share at 75 percent. The National Association of Convenience Stores noted at the time that, "the underground or bootleg market for cigarettes in Canada had grown so large that it now outpaces, in terms of volume, the entire Canadian convenience store industry's sale of cigarettes."

Organized crime and theft were rampant, with record levels of robberies at stores that sell cigarettes. The Mayor of Cornwall, Ontario, was under police protection after a series of death threats were attributed to his vocal opposition to smuggling. A group of 75 store owners openly defied Canadian law by selling cigarettes at cut-rate prices to hordes of delighted customers. This action was in protest of the lost sales and lost jobs absorbed by these legitimate retailers.

Given the emergence of an underground market, high taxes also made it more difficult to deter youths from smoking. The anti-smoking lobby has consistently argued that high taxes keep cigarettes out of the hands of young people. Yet when taxes are raised like they were in Canada, a significant share of the cigarette market goes underground, where there is little or no regard for the age of the consumer. It was estimated that about 33 percent of all cigarettes in Canada were purchased illegally at the peak of the tax hikes. This type of scenario makes it more difficult, not easier, to control youth sales.