A 55¢ CIGARETTE TAX INCREASE WILL HARM NEW YORK RETAILERS

The legislature has passed a tax proposal that would increase 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. 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 could find a better deal in Massachusetts (76¢).

New York would also be threatened with cross border and /or cigarette smuggling from Indian reservations where, in many instances, state sales and excise taxes do not apply. Industry sources note that a carton of full-price cigarettes go for about $23 on a New York Indian reservation compared to $31.20 in a non-tribal store. These savings would blossom to well over $13 per carton after a 55¢ per pack tax hike allowing the consumer to save about $650 per year through tribal sales on the reservation or over the Internet. A New York Association of Convenience Store official recently estimated that New York was losing about $200 million per year in tax revenue on Indian sales of cigarettes and gasoline.[1]

[1] See, the "Daily News," National Association of Convenience Stores, July 15, 1999.

Other sources for cross border sales cigarette include long smuggling distance from Virginia (2.5¢) and Delaware (24¢ and no sales tax). New York City has been traditionally the target of such smuggling enterprises given its big population and its large network of small retailers.

According to estimates by city and state officials over 100 million packs of untaxed cigarettes were sold in New York City.[2] A van load of cigarettes destined for New York City from Virginia would have a profit potential of about $65,000 -- enough to make the state police wince. At $1.11 per pack, the 60-Minutes cameras will be rolling to document New York City's new bootleg problem similar to what they did in the mid-1970's.

New York and The Cross Border Threat

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

[2] "Buttleggers Burning Us," New York Daily News, February 8, 1995.

"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 the New York state could increase tax revenues.

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.

Indian Sales

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 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 Retailers at Risk

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.

Commercial Losses - 55¢ Tax Increase

- 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 (3100 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).

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.

The Regressive Impact of Cigarette Taxes

A recent study by the Barents Group of KPMG Peat Marwick shows that cigarette taxes are incredibly regressive, extracting a far greater percentage of income from modest wage-earners compared to those with high incomes.

Barents looked at U.S. families in the bottom half of the income distribution, those earning approximately $30,000 a year or less. While this group represents roughly 50% of all households in the country, it earns only 16% of all income generated. This group pays about 15.3% of all federal income and FICA taxes, but pays over **47% of all tobacco taxes**.

Barents found that while most excise taxes are regressive, tobacco excise taxes are the most regressive of all. 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 spirits taxes and 34% of beer taxes. Clearly, the New York 55¢ cigarette tax hike will harm those with modest incomes the most. 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), means that the New York smoker could see his cost burden increase by a whopping $625 per year which is about 30% higher than federal income tax payment for the bottom 50% of all federal income tax filers.