IMPACT OF PROPOSED MARYLAND CIGARETTE TAX INCREASE

Prepared for

THE TOBACCO INSTITUTE

December 1996

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I. EXECUTIVE SUMMARY

This report by American Economics Group, Inc. evaluates a proposal to raise the cigarette excise tax in the State of Maryland. The proposed 36 cent increase would raise the state excise tax from 36 cents to 72 cents. Total state taxes per pack would increase to 107.3 cents with the addition of the state sales tax of 5.0% applied to the total price including federal and state excise taxes. There are serious repercussions from such steep changes which would increase the combined state excise and sales taxes by 83.1%. Our results show that had the 36 cent tax increase been in effect during 1996, taxed sales of 377.5 million packs in Maryland would have fallen to 302.4 million packs, a 19.9% decline of 75.1 million packs. Per capita taxed sales would have fallen proportionately from the current estimated 74.3 packs to 59.5 packs.

Most of the loss of taxed sales will not be caused by reduced consumption of tobacco by Maryland residents should the higher tax be levied. The tax increase will not serve to discourage Maryland smokers as much as to nudge them across state lines to make their cigarette purchases. There will also be reduced Maryland sales to residents of neighboring states who will have lost all or part of their price incentive to shop in Maryland. And there will, of course, be increased purchases of imports by Maryland residents who will buy their cigarettes from organized bootleggers.

The higher tax would shift sales from retail establishments in Maryland to those in Delaware, New Jersey, Pennsylvania, Virginia, West Virginia and even the District of Columbia. New Jersey and District of Columbia residents who now avoid their own high tax by shopping in Maryland will lose most of their incentive to travel into Maryland for cigarettes. Thus, raising the tax in Maryland will cost the state sales, jobs and income while reducing collections of a number of other state revenues including sales, income and corporation taxes.

These results come directly from our analysis of historical taxes and sales of cigarettes in the United States and particularly in the six state area which includes Maryland and its neighbors. We used econometric analysis to model the many variables that influence the purchase of tobacco products. We found that, while the overall demand for cigarettes is relatively inelastic, there is significant elasticity concerning the place of purchase. This report describes the relationship between the sale of taxed cigarettes and taxes. It confirms the strong price motivation which propels consumers across state lines to avoid taxes when levies are high and out-of-line with nearby states,

II. ECONOMIC AND DEMOGRAPHIC INFLUENCES ON CIGARETTE SALES

A. Primary Influences on State Taxed Cigarette Sales

Cigarette sales vary from state to state for a variety of reasons. Aggregate sales are directly related to the population of a state, and it is no surprise that there is a rough correspondence between the number of smoking age persons and total annual cigarette sales. Of greater importance is variation in sales among the states which population differences alone are unable to explain.

Two populations of equal size may consume markedly different amounts of tobacco products. The reasons for this may be the demographic characteristics of the two groups, unequal distributions of disposable income, price and tax variations between their locations, the availability of alternative sources of cigarettes such as stores across state lines or bootlegging, and myriad other influences including religion and taste.

In addition to factors which may affect the two populations differently, there are common influences which may affect them equally and adjust their overall level of cigarette consumption. These include national factors which may alter the quantity of cigarettes supplied at various prices, advertising which primarily affects consumers' choice of cigarette brands, and the level of federal taxes on tobacco products.

We have found that among states differential levels of taxed cigarette sales per capita are almost completely explained by differences among the following variables:

- Price Differences Among Neighboring States
- Tax Differences Among Neighboring States
- Border Populations Among Neighboring States
- Customary Driving Distances In Region
- Price Difference With A Distant Low Price State
- Cross-Border Tourism
- Cross-Border Commuting

The variables listed above affect the traffic in cigarettes across state borders and thus taxed cigarette sales. There are other variables that influence the level of cigarette consumption by a state's resident population, which is generally different from taxed sales. These factors must also be taken into account when assessing interstate differences:

- Cigarette Prices Including Federal Excise Tax
- State and Local Cigarette Taxes and Sales Taxes
- Wage and Income Levels
- Relative Prices of Other Goods and Services
- Religious & Ethnic Mix
- Presence of Military Installations
- Presence of Native American Reservations

B. Resident Cigarette Consumption Versus Taxed Sales

There is an important distinction between actual cigarette sales from any location to a state's population (resident consumption) and the purchase of taxed cigarettes within the state (taxed sales). Cross-border sales between two states flow in both directions at the same time. Even with no price or tax incentives to cross state lines, there will be a certain amount of convenience purchases made by residents of one state who commute, vacation or otherwise happen to travel in another state.

However, should cigarette prices including all taxes be significantly different between two neighboring states, the traffic will be decidedly one-sided. Resident consumption in the high price state will include substantial purchases of cigarettes from across the border. Thus, while resident consumption in both states may change little, taxed sales will fall in the high priced state and rise in its neighbor.

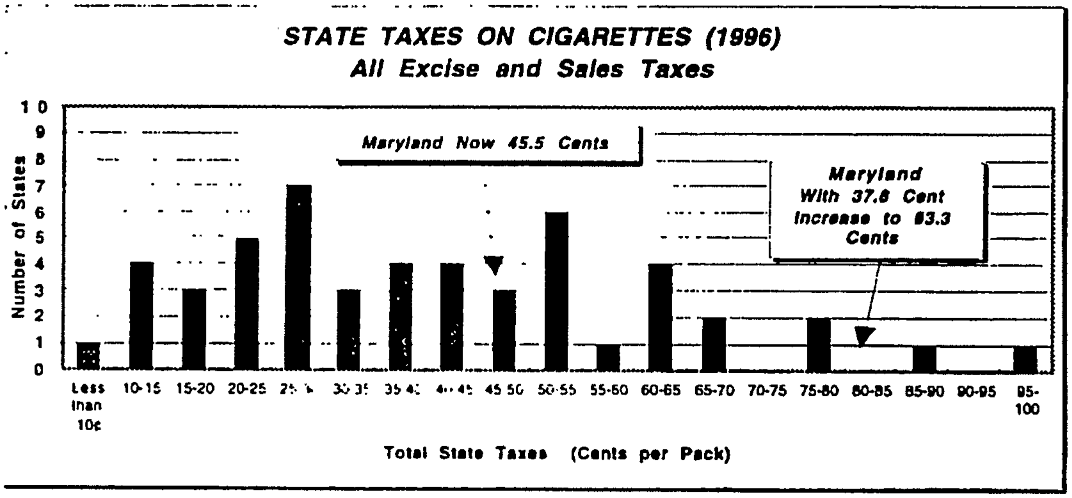
This analysis is directed at measuring the change in Maryland's sales of taxed cigarettes should the State increase its cigarette tax by 36 cents. Consequently, it is necessary to isolate the effect of all variables listed above and to calculate the change in taxed sales in Maryland and neighboring states caused by a 37.8 cent (36 cents excise tax plus 1.8 cents sales tax) increase in Maryland cigarette prices.

C. Cross-Border Sales of Cigarettes and Bootlegging

Taxed cigarette sales in a state can differ significantly from resident cigarette consumption whenever cigarette price and tax differentials among states are sufficient to make cross-border purchases profitable. Even small price differentials will create a level of casual traffic across borders. When differentials become large, organized bootlegging becomes a profitable enterprise and long distance shipments, even over thousands of miles, have become a matter of routine. Both casual cross-border sales and organized bootlegging occur between neighboring states and over long distances, although the longer the distance involved the more likely the shipments are larger and carried out by illegal business-like enterprises.

Tax differentials among states vary widely, as figure 1 demonstrates, and provide profitable cross-border trading activities. The average state cigarette tax plus sales tax was 41.1 cents in 1996, however the range of variation is extreme.

Figure 1



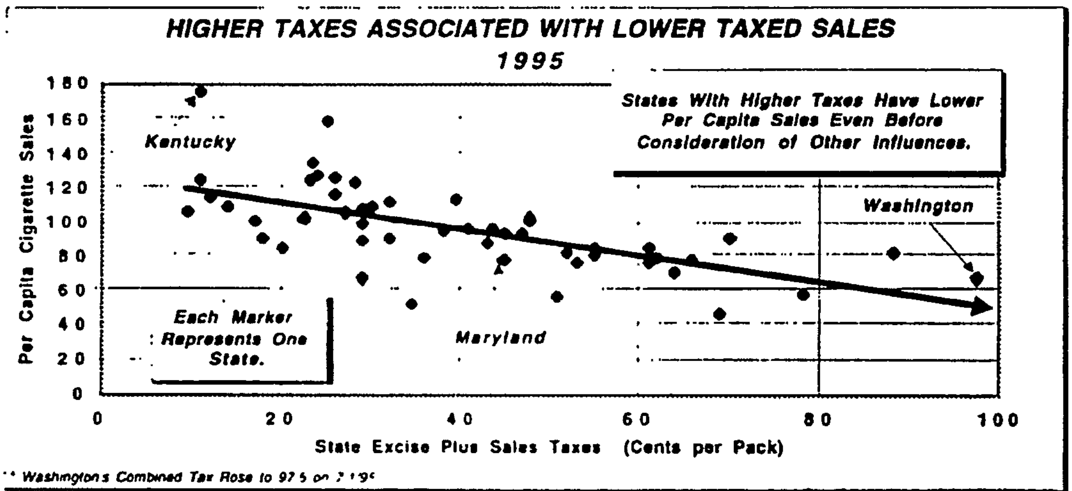
Virginia was the lowest taxing state at 9.7 cents, 2.5 cents excise plus 7.2 cents sales tax* . The highest state, Washington, taxed at 97.5 cents per pack, 81.5 cents excise plus 16.0 cents sales tax. The proposed 36 cent increase in Maryland would position that state near the high extreme in figure 1.

* Several Virginia jurisdictions assess their own cigarette excise tax in addition to the state tax which are not included here.

In later sections of this report econometric analysis measures the relationship between state taxes and cross-border activity. However, it is useful to take a snapshot of how the large tax differentials among states relate to per capita sales of taxed cigarettes. Figure 2 is a scatter diagram in which each marker represents a single state and is positioned to show the state's 1995 tax level along the horizontal axis and its 1995 per capita sales of taxed cigarettes along the vertical axis.

The marker in the upper left hand corner, which represents Kentucky, reveals that state taxing at 11 cents per pack and having huge sales of 175.3 packs per capita. It takes little imagination to recognize that the large Kentucky sales figure includes sales to residents of other states. At the other extreme is the State of Washington*. Its 97.5 cent tax per pack drives taxed sales down to 67.4 packs per capita and its marker is seen near the lower right hand corner. Maryland's 44.8 cent combined tax in 1995 is 12% higher than the US average of 40 cents in 1995; and its sales of 77.1 packs per capita are quite a bit below the average of 95.9 packs for the 50 states and the District of Columbia during the same year.

Figure 2



* Washington state increased its excise tax to 81.5 cents effective July 1, 1995.

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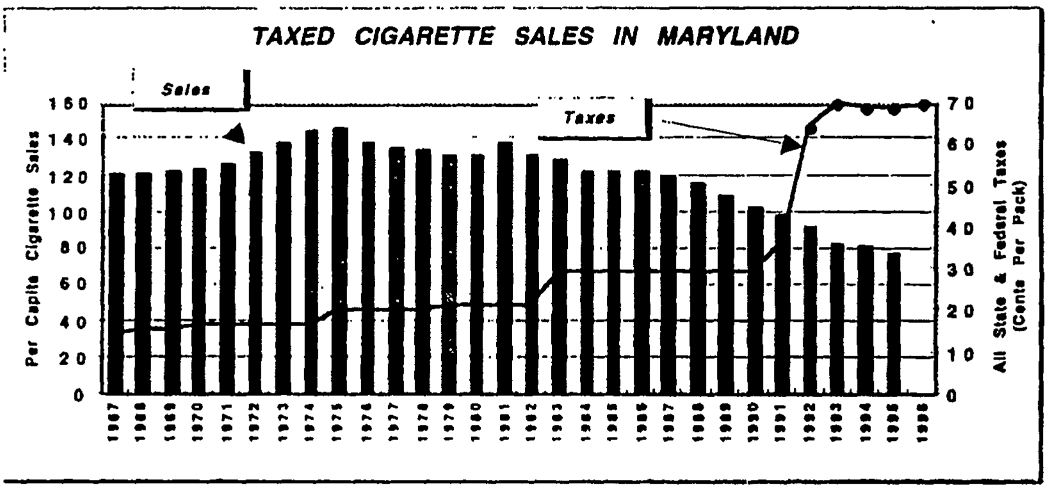
III. IMPACT OF PROPOSED MARYLAND 36 CENT TAX INCREASE

A. Historical Sales and Prices in Maryland

Historically, Maryland has experienced a strong correlation between cigarette sales per capita and the level of taxes per pack. A comparison of the bar graph in figure 3, which depicts sales per capita, with that chart's line graph, which shows state and federal cigarette taxes, makes the point.

There is a simple correlation of 88.6% between taxes and per capita sales in Maryland. Although it is necessary to consider simultaneously a number of other factors, such as taxes in neighboring states and national cigarette trends, it seems that there is a strong relationship between taxes and sales in Maryland, and that increased taxes reduce sales, other things equal. (Econometric analysis demonstrates a significant negative relationship between taxes and sales.)

Figure 3



In 1967, the earliest consistent data available, per capita taxed cigarette sales in Maryland stood at 121.7 packs per capita, slightly less than the national average of 134. By 1993, after substantial tax increases, Maryland's sales which had risen to 146.1 packs in 1975 had fallen to 82.6 packs per capita. Currently, Maryland sells an estimated 74.3 packs of taxed cigarettes per capita, while nationwide the average is 95.9 packs.

B. Maryland's Tax Position Among Neighboring States

Maryland stands in the middle of the tax ladder among its neighboring states. Figure 4 is a table demonstrating the differences between Maryland's combined state excise and sales tax (current and proposed) and those of its neighbors. Figure 5 shows that there is already a substantial tax incentive for Maryland residents to travel across its borders to buy cigarettes. Only District of Columbia and New Jersey residents can benefit by cross-border purchases in Maryland.

Figure 4

MARYLAND'S TAX POSITION VIS-A-VIS ITS NEIGHBORS

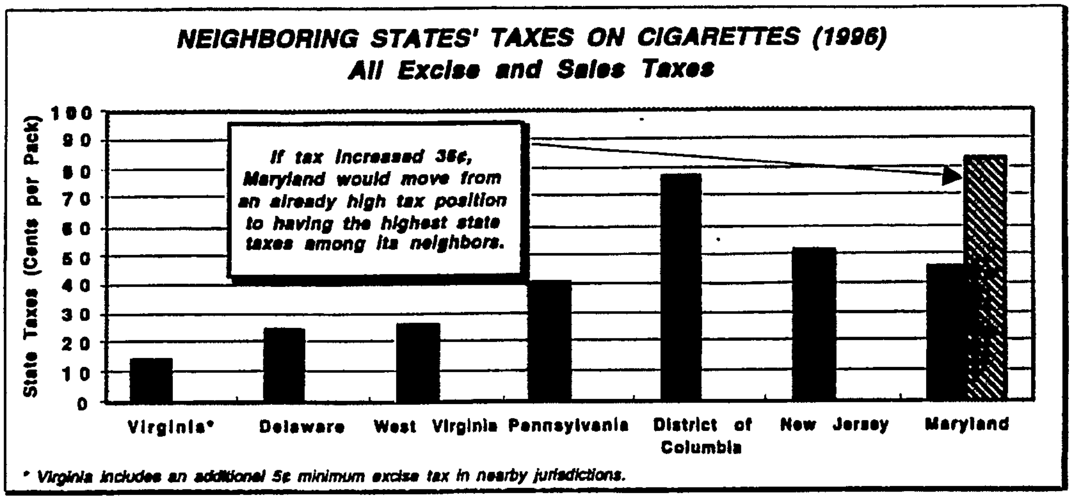
	CURRENT		WITH 36¢ INCREASE	
State	Total State Taxes	Difference from Maryland	Total State Taxes	Difference from Maryland
Virginia*	14.7	(30.8)	14.7	(68.6)
Delaware	24.0	(21.5)	24.0	(59.3)
West Virginia	26.4	(19.1)	26.4	(56.9)
Pennsylvania	41.2	(4.3)	41.2	(42.1)
Maryland	**45.5**	-	**83.3**	
New Jersey	51.7	6.2	51.7	(31.6)
District of Columbia	78.4	32.9	78.4	(4.9)

Note: All figures in cents per pack.

**Virginia includes an additional 5c minimum excise tax assessed in jurisdictions within commuting distance to Maryland*

Should Maryland raise its excise tax by 36 cents (plus 1.8 cents additional sales tax) to 83.3 cents per pack, it loses its advantage with the District of Columbia and New Jersey and greatly increases its tax differential with all other neighboring states. The incentive for neighboring states to buy cigarettes in Maryland would be eliminated as Maryland's residents would be encouraged to patronize out-of-state retailers. That would mean lost sales in Maryland, harming retailers, costing jobs and squeezing state tobacco, sales and income tax revenues.

Figure 5



C. Estimated Change in Maryland Cigarette Sales After 36 Cent Tax Increase

Raising the cigarette excise tax by 36 cents to 72 cents, a 100% increase, would have a large, depressing impact on taxed cigarette sales within the state. Existing taxed sales of 377.5 million packs in 1996 would fall to 302.4 million packs, a 19.9% decline of 75.1 million packs. Per capita sales would fall proportionately from the current 74.3 packs to 59.5 packs.

Figure 6 itemizes the components of the impact of the 36 cent cigarette tax increase. Including an additional 1.8 cent sales tax levied on the additional excise tax, the total price of cigarettes in Maryland would rise by approximately 18.9%. Because this is an average weight price for sales throughout the state, some localities would experience greater or lesser changes. Because prices vary throughout state regions, the tax differential among neighboring states is often a more reliable indicator of price advantage in one place over another.

Figure 6

[illegible]

	Existing Tax	Tax Increased by 36 Cents	Change	Percent Change
TAX AND PRICE CHANGE				
Price Without Taxes	130.0	130.0		
Federal Excise Tax	24.0	24.0		
MD Sales Tax	9.5	11.3	1.8	18.9%
MD Cigarette Tax	36.0	72.0	36.0	100.0%
Total Price With Tax (cents per pack)	**199.5**	**237.3**	**37.8**	**18.9%**
CHANGE IN TAXED SALES				
Taxed Sales Per Capita*	74.3	59.5	(14.8)	
Total Taxed Sales (million packs)	**377.5**	**302.4**	**(75.1)**	**-19.9%**
CHANGE IN TAXED SALES				**Share of Change**
Change in Resident Sales			(17.9)	23.8%
Change in Cross-Border Sales			(57.2)	76.2%
Total Change			**(75.1)**	

* *Estimated*

Much of the response of cross-border sales will be triggered by the steep rise of 83.1% in the combined state excise and sales tax, a change which directly affects the differential among states no matter the pre-tax price. Of the total reduction, taxed sales of about 57.2 million packs will be lost in Maryland to cross-border effects. These include both reduced Maryland sales to residents of neighboring states, who have lost all or part of their incentive to shop in Maryland, and increased imports by Maryland residents from their neighbors and elsewhere.

MINNESOTA CIGARETTE TAX INCREASES WILL HARM RETAILERS

Minnesota is currently considering cigarette tax increase proposals of 25¢, 15¢, and 10¢ per pack. Under the 25¢ per pack tax increase proposal, the Minnesota cigarette tax would rise from 48¢ to 73¢ per pack, making it the fourth highest in the country and twice the national average (33¢ per pack). Even the 15¢ and 10¢ tax increase options would place Minnesota well beyond the average state tax.

Minnesota retailers should be concerned. Cigarette sales are expected to fall by about 12.5% with a 25¢ per pack tax hike. When the tax was increased by 15¢ per pack in FY 1998 cigarette sales fell by 12%. Minnesota consumers can save money buying cigarettes from Indian reservations, or from low-tax states like South Dakota, Iowa, and Wisconsin. Organized smugglers of cigarettes would likely tax advantage of low-tax Missouri. The proposed 73¢ tax option would tower over the tax in Missouri (17¢), South Dakota (33¢), Iowa (36¢), Wisconsin (44¢), and North Dakota (44¢).

Minnesota smokers could save through Indian reservations within the state (36.5¢ under a 50% refund provision and 50% of sales taxes on cigarettes). A typical two smoker family could save over $400 per year purchasing cigarettes on Indian reservations under the 25¢ tax hike proposal.

Retailer Incentives Dimmed

Minnesota retailers would lose customers to low-tax states. After a 25¢ tax hike, Minnesota consumers could save nearly $5.60 per carton in Missouri, $4.30 on Indian reservations, $4.00 in South Dakota, $3.70 in Iowa, and $2.90 in Wisconsin and North Dakota. The American Economics Group (AEG) estimates that Minnesota currently loses about 50 million packs, or 13% of its annual sales volume to such areas already. This is corroborated by the fact that 1996 per capita cigarette sales in Minnesota (81.7 packs) were about 10% smaller, on average, than its bordering states (about 90 packs per capita). **Minnesota Department of Tax Revenue data reveal that nearly 28 million packs of cigarettes were sold on Minnesota Indian reservation in 1996 - over 15 times the amount sold in 1988 (about 1.8 million packs).**

Minnesota retailers, and ultimately state law enforcement budgets, would be vulnerable to smuggling. A smuggler purchasing cigarettes from a wholesaler in Missouri, South Dakota, Iowa, or an Indian reservation in the state would have a profit potential that ranges from nearly $5.60 to $3.70 per carton after a 25¢ tax hike. All these margins exceed the Advisory Council on Intergovernmental Relation's bootleg "flashpoint" of $3.60 per carton. Tax differences above the "flashpoint" are likely to encourage serious investments in cigarette smuggling.

Minnesota 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 Minnesota stores had gross cigarette sales of nearly $862 million in FY 1996, generating over $180 million in gross profits for Minnesota retailers and wholesalers. According to a 1996 study by the American Economics Group (AEG), nearly 24,384 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 1996, The National Association of Convenience Stores reports that tobacco sales in such stores accounted for nearly 30% of merchandise sales. 38% of all tobacco products are sold through convenience stores nationwide. In Minnesota, it is estimated that such stores sell nearly $305 million worth of cigarettes with gross profits of nearly $64 million.

Commercial Losses - 25¢ Tax Increase

- Loss in Cigarette Sales Volume - AEG projects that the 25c/pack tax increase will reduce Minnesota cigarette sales by approximately 12.5%. Cigarette volume is likely to fall by about 47 million packs in FY 1997. 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 $108 million (46.8 million packs evaluated at a final retail price of $2.30/pack). Sundry product sales, or products normally bought in conjunction with tobacco products, would fall by about $70 million (based on past estimates of this phenomenon by Price Waterhouse).

- Loss in Minnesota Gross Profits (value added) - Gross profits, or the value added, lost to Minnesota retailers and wholesalers would be about $37 million.

- Lost Jobs - It is estimated that nearly 3,000 Minnesota jobs could be displaced due to the tax increase (based on a 1996 study of the tobacco industry by AEG).

Commercial Losses - 15¢ Tax Increase

- Loss in Cigarette Sales Volume - The American Economics Group (AEG) projects that the 15¢ per pack tax increase will reduce Minnesota cigarette sales by approximately 7.5%. Cigarette volume is likely to fall by about 28 million packs in FY 1997. 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 $65 million (28.1 million packs evaluated at a final retail price of $2.30/pack). Sundry product sales, or products normally bought in conjunction with tobacco products, would fall by about $42 million (based on past estimates of this phenomenon by Price Waterhouse).

- Loss in Minnesota Gross Profits (value added) - Gross profits, or the value added, lost to Minnesota retailers and wholesalers would be about $22 million.

- Lost Jobs - It is estimated that nearly 1,800 Minnesota jobs could be displaced due to the tax increase (based on a 1996 study of the tobacco industry by the AEG).

Commercial Losses - 10¢ Tax Increase

- Loss in Cigarette Sales Volume - AEG projects that the 10¢ per pack tax increase will reduce Minnesota cigarette sales by approximately 5%. Cigarette volume is likely to fall by about 19 million packs in FY 1997. 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 $43 million (18.7 million packs evaluated at a final retail price of $2.30/pack). Sundry product sales, or products normally bought in conjunction with tobacco products, would fall by about $28 million (based on past estimates of this phenomenon by Price Waterhouse).

- Loss in Minnesota Gross Profits (value added) - Gross profits, or the value added lost to Minnesota retailers and wholesalers would be about $14 million.

- Lost Jobs - It is estimated that nearly 1,200 Minnesota jobs could be displaced due to the tax increase (based on a 1996 study of the tobacco industry by the AEG).

Convenience Store Losses

According to the National Association of Convenience Stores there are 2,103 convenience stores operating in Minnesota. Each store, on average, registers about $152,000 in cigarette sales on an annual basis. It is estimated that the 25c/pack tax hike will lead to about a $38 million reduction in cigarette sales for Minnesota convenience stores. Sundry product losses would be about $24 million.

Each Minnesota convenience store on average would lose about $19,000 in cigarette sales and another $12,000 in sundry product sales. Gross profit losses would average about $7,000 per store. This means each store would have to boost gross retail sales of other items by $31,000 to make up for the damage wrought by the 25c/pack cigarette tax hike.

Some stores may go out of business, but all of them will feel the profit squeeze. Michigan's recent 50c/pack tax hike on cigarettes provides an excellent case study of the impact of such large taxes on convenience stores. The Associated Food Dealers of Michigan estimated that about 10 percent of the convenience stores in Michigan would close in 1995. Nationally only about 2 percent of such stores go out of business. The Associated Food Dealers believe that Michigan's abnormally high rate of business failure is due to the recent tobacco tax hike.

MINNESOTA INDIAN RESERVATIONS

CIGARETTE EXCISE TAX REFUNDS BY CARTON

FISCAL YEAR	EXCISE TAX REFUND	# OF CARTONS
1988	$ 680,848	179,167
1989	$1,083,081	327,019
1990	$1,252,811	393,956
1991	$1,557,153	511,947
1992	$3,313,963	867,291
1993	$6,161,064	1,692,619
1994	$7,113,721	1,901,008
1995	$7,788,672	**
1996	$7,821,020	2,833,267

** During Fiscal Year 1995, the Minnesota Department of Revenue entered into new refund compacts with various Indian Reservations. Due to the change in the refund formulas, the Department of Revenue does not have a specific number of cartons of cigarettes on which refunds were paid in Fiscal Year 1995.

Source of Data: Minnesota Department of Revenue, Special Taxes Division.

MINNESOTA INDIAN RESERVATIONS

CIGARETTE EXCISE TAX REFUNDS/CARTON SALES

FISCAL YEAR	EXCISE TAX REFUND	# OF CARTONS	% CHANGE FROM PRIOR FY
1988	$ 680,848	179,167	NA
1989	$1,083,081	327,019	83%
1990	$1,252,811	393,956	20%
1991	$1,557,153	511,947	30%
1992	$3,313,963	867,291	69%
1993	$6,161,064	1,692,619	95%
1994	$7,113,721	1,901,008	12%

NOTE: The above data on cigarette sales by, and cigarette excise tax refunds to, Minnesota Indian Reservations was provided by the Minnesota Department of Revenue, Special Taxes Division. A Minnesota Indian Reservation can receive a refund of cigarette excise taxes in two ways. First, a reservation can apply for a refund based on the per capita consumption of cigarettes by the reservation's population. Second, a reservation may also enter into a contract with the State of Minnesota to receive a refund of 70% of the cigarette excise taxes paid by the reservation to a licensed tobacco wholesaler. The number of cartons of cigarettes listed include the number of cartons on which excise taxes were refunded based on population and the gross number of cartons sold by Indian reservations upon which the 70% refund is calculated.

THE ECONOMIC EFFECTS OF INCREASING THE MONTANA CIGARETTE TAX BY 10C PER PACK

Montana is considering a proposal to increase its current 18-cent cigarette tax to 28 cents per pack. Tax-free sales on Montana's looming Indian reservations would be a big competitive threat. Consumers can often purchase cigarettes on reservations without state sales or excise taxes. This would enable a Montana resident to save $2.80 per carton. This situation could lead to significant tax avoidance and financial losses. Dwindling sales would make Montana retailers the big losers.

FINANCIAL LOSSES

* Cigarette sales have been very sensitive to tax increases in Montana's region. Consider these cases:

  Wyoming raised its cigarette tax by 4 cents per pack (from 8 cents to 12 cents/pack) on July 1, 1989. Wyoming cigarette sales plunged by 13% during FY 1989.

  Idaho raised its cigarette tax by 8.9 cents per pack in FY 1987 and sales fell by 11% in the subsequent year.

  Idaho cigarette pack sales grew by nearly 10% during FY 1994 in response to a large cigarette tax hike in neighboring Washington. Idaho cigarette sales collapsed by 8% in FY 1995 after it increased its cigarette tax by 10c/pack at the beginning of FY 1995.

* The Montana situation is more ripe for tax-evading sales than Wyoming or Idaho. The major reason is that Montana Indian reservations are numerous. According to a 1985 study by the Advisory Council on Intergovernmental Relations (ACIR), tax exempt cigarette sales on Montana's Indian reservations represented 17.4% of all cigarette sales in the state - tops in the nation. Recent estimates by the Montana Department of Revenue suggest that the Indian share of the cigarette market may be close to 30%.

* The American Economics Group estimates that a 10 cent per pack tax increase would cause cigarette sales to drop by about 9%. Most these lost sales would go Indian reservations or low tax Wyoming. Nearly $20 million in Montana retail sales would be lost.

  * $11.2 million in lost cigarette sales.

  * $7.8 million in lost tie-in sales to retailers.

  * Cigarette volume could drop by 6.8 million packs (about a 9% reduction in sales).

* **The cost to Montana retailers and wholesalers would be a $2.4 million drop in annual income from the decrease in cigarette sales.**

CONVENIENCE STORE LOSSES

Montana's 428 convenience stores would be especially hard hit. The National Association of Convenience Stores reports that tobacco sales in such stores account for nearly 30% of merchandise (in-store) sales - the top merchandise category. Thirty-eight percent of all tobacco products are sold through convenience stores nationwide. In Montana, it is estimated that such stores sell, on an annual basis, nearly $47 million worth of cigarettes with gross profits of nearly $10 million.

A 10c/pack tax hike would cause about a $16,500 loss in cigarette and sundry product sales for the typical Montana convenience store.

CROSS BORDER IMPACT

Due to more than 62 tax increases since 1989, cigarette purchasing patterns are shifting away from high-tax states toward low-tax states. High taxes are skirted in a number of ways, ranging from organized smuggling to casual trips across the border. The Tax Foundation, in a 1996 study ("The Effect of Excise Tax Differentials on Cross Border Sales and Smuggling of Cigarettes"), has found that cigarette smuggling has greatly accelerated over the past decade. As a result, the following high-tax block of states - California, Massachusetts, Michigan, and New York - with an average tax of 62c/pack, are selling fewer cigarettes than the following low-tax states - Indiana, Kentucky, Missouri, New Hampshire, North Carolina, Tennessee, and Virginia - with an average tax of 12c/pack. Yet the four high tax state 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 (4.5 billion packs) than the high-tax block (4.3 billion packs). In 1996, the gap has widened even further. The implications for Montana are significant since it already has a well known problem with Indian reservations. Montana only needs to look at itself and states in its region for evidence of potential problems.

* Montana - In 1983, the Advisory Council on Intergovernmental Relations estimated that Montana was losing over $2.5 million per year in cigarette tax revenue due to cigarette sales on Indian reservations. This represented 22% of all cigarette tax revenue in Montana. As a percent of revenue, this was the largest tax "drain" in the nation.

Montana's tax department estimated in 1991 (Independent Record, April 9, 1991) that Indian sales accounted for about 29% of all Montana cigarette sales. This adds up to about 4,582 packs per tribal member!

* Washington - In response to a large cigarette tax increase in 1993, Washington cigarette sales have fallen by approximately 80 million packs. The Washington Department of Revenue (DOR), however, has a good idea where these "lost" packs have gone. In a recent report ("Untaxed Goods In Commerce: Tax Evasion in the State of Washington", 1996), the DOR estimates that 29% of total cigarette tax revenue (about 90 million packs) is lost due to tax evasion. About 60% of this evasion is due to tax-free sales on Indian reservations.

* Nevada - The Nevada Department of Revenue reports that tribal sales accounted for about 24% of cigarette sales in 1995. In 1987, these sales were estimated to be 11% of cigarette sales. The culprit, once again, is rising cigarette taxes. The Nevada cigarette tax was doubled to 35c/pack during this time, and subsequently avoided through tribal sales.

The prevalence of Indian reservations in Montana means that the state cigarette market is very sensitive to even modest increases of the Montana cigarette tax. The experience of states with Indian reservations in the West indicates that cigarette tax increases just send more business to these tax-free areas. The big loser is the legitimate non-tribal merchant such as convenience stores where cigarette sales are the top merchandise category.

Finally, over 30% of Montana's population resides close to I-90. This highway passes through Butte, Bozeman, and Billings. These relatively populous areas are close to the border of low-tax Wyoming, where the cigarette tax is only 12 cents per pack. 1996 per capita sales in Wyoming (110 packs) have been significantly greater than per capita sales in Montana (87 packs), suggesting that some cross border activity is under way.

REGRESSIVE AND UNFAIR TAXATION

* The 131,000 Montana residents who choose to smoke would be unfairly taxed. Especially hard hit would be Montana's low income families. According to the 1991 Sales and Marketing: Survey of Buying Power, nearly 100,000 Montana families (30% of all Montana households) had an effective buying income less than $20,000 per year. An average two-smoker family would have to pay an additional $105 per year in excise taxes if the cigarette tax were raised by 10 cents per pack.

* According to Who Pays, a 1996 study by the Citizens for Tax Justice, Montana families with incomes in the bottom 20% of the Montana income distribution pay about 6 times more in cigarette taxes, as a percentage of income, than those Montana families in the top 15% of the Montana income distribution. Clearly, a Montana cigarette tax increase is aimed mostly at those least able to pay it.

* At 18 cents per pack Montana's current cigarette tax takes nearly 2% of income from a two-smoker family with a $10,000 annual income. A two-smoker family with $60,000 would pay less than a half of one percent of income. A 28 cent cigarette tax (10-cent/pack increase) would take nearly 3% of income from a two smoker family with $10,000 annual income.

THE ECONOMIC IMPACT OF INCREASING THE NEW MEXICO CIGARETTE TAX BY 40 CENTS PER PACK

Background

It is a basic principle of economics that consumers will often seek lower price substitutes when they are available. This principle is quite apparent in matters relating to excise taxation. A high cigarette tax in one state or along a country border is likely to reduce cigarette sales within that jurisdiction if consumers can find a lower tax in an adjoining jurisdiction. Case studies of this cross border phenomenon are numerous. Canada, for example, recently reduced its cigarette tax by as much as $22/carton in some provinces, to stem a smuggling epidemic. It was generally reported that smuggled cigarettes were taking somewhere between 30 to 50 percent of the Canadian market.

Similar purchasing patterns shifts are now taking place in the United States. Due to more than more than 62 state tax increases since 1989, cigarette purchasing patterns are shifting from high-tax states to low-tax states. The Tax Foundation found in a 1996 study ("The Effect of Excise Differentials on Cross Border Cigarette Sales") that cigarette smuggling has greatly accelerated over the last decade. As a result, the following high tax block of states - California, Massachusetts, Michigan, and New York - with an average tax of 62c/pack, are selling fewer cigarettes than the following low-tax states - Indiana, Kentucky, Missouri, New Hampshire, North Carolina, Tennessee, and Virginia - with an average tax of 12c/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 (4.5 billion packs) than the high-tax block (4.3 billion packs). In 1996, the gap has widened even further. The implications of this phenomenon are ominous for New Mexico since it already has a well known problem with Indian reservations and military bases.

The Danger To New Mexico: Tax-Free Zones

Cigarette sales on Indian reservations are exempt from state excise and sales taxation. This means a New Mexico smoker could currently save about $3.00/carton in sales and excise taxes. If New Mexico raised its cigarette tax by 40c/pack (from 21 to 61c/pack), sales and excise tax savings would jump to an astounding $7.20 per carton. An average two smoker family could save about $750 per year buying cigarettes on Indian reservations.

New Mexico has a well chronicled problem with Indian reservations and military bases. Some of New Mexico's most populous areas, such as Albuquerque and Santa Fe, are not far from Indian reservations and military bases. There are approximately 22 Indian reservations in New Mexico and many are close to large cities. Bernalillio County (Albuquerque), with 520,000, people or 31 percent of New Mexico's population, contains part of the Isleta Indian reservation and is adjacent to two other reservations. Interstate 40 running west of Albuquerque cuts through the Laguna and Acoma reservations. The Sandia reservation is just north of Albuquerque next to Interstate 25. The Santa Fe area is also close to a variety of reservations, some of them nestled south of the city close to Interstate 25.

Tax-Free Cigarette Sales in New Mexico - The Evidence

Early studies of the New Mexican cigarette market estimated significant levels of tax-free cigarette sales. In 1985, the Advisory Commission on Intergovernmental Relations (ACIR) estimated that military bases accounted for 7.7 percent of all cigarette sales in New Mexico. Transactions on Indian reservations accounted for 10.3 percent of cigarette sales.

Recent evidence indicates that tax-free sales are growing. A 1996 industry survey of 16 of New Mexico's Indian stores revealed that such stores sold 18 million packs of cigarettes anually. This represented 16.3 percent of 1996 New Mexico tax-reported cigarette sales, or 13.4 percent of total cigarette sales. Tax-free sales are on upward trend due to the excellent access of these stores to interstate highways and the popularity of Indian gaming facilities.

The existence of a large tax-free market in New Mexico is corroborated by Center for Disease Control (CDC) data. According to the CDC, 21.2 percent of New Mexico adults smoked in 1995. This is very close to the national average. However, New Mexico's 1995 tax-reported per capita cigarette sales of 67 packs was 26 percent lower than national tax-reported per capita sales of 90 packs. This data suggests that many New Mexicans are purchasing a significant amount of tax-free cigarettes on Indian reservations and military bases -- perhaps as much as 28 million packs per year.

Indian Sales in Nevada and Oklahoma

Evidence from states in New Mexico's region reveal the same pattern of tax-evading sales. This can be clearly seen by looking at the record of a comparable state - Nevada. Nevada is similar to New Mexico in that Nevada has a variety of tribal smoke shops located close to its major cities - Las Vegas and Reno. Unlike New Mexico, Nevada's Department of Revenue keeps accurate and current statistics on tribal sales since they must be affixed with state provided stamps even though there is no tax liability.

The record is startling. Nevada's tribal sales sky-rocketed from 18.2 million packs in FY 1987 to 41.2 million packs in FY 1994. Tribal sales accounted for 11.5 percent of total cigarette sales in 1987. By 1994 tribal sales accounted for 23 percent of total cigarette sales -- nearly 1 pack out of every 4 sold in the state. Over the same time period, the Nevada cigarette tax was increased from 15 to 35c/pack. Should New Mexico attempt similar tax increases, its consumers will likely be headed in the same direction - the tribal smoke-shop.

Oklahoma experienced a similar situation. Prior to 1994, Oklahoma did not tax cigarettes on Indian reservations. This made it difficult to obtain tax revenue statistics concerning the size of the tribal cigarette market. In FY 1994, however, Oklahoma struck an agreement with the local tribes to tax cigarettes on Indian reservations at a low level - about 5c/pack. Oklahoma could begin to collect at least some revenue from tribal sales while allowing the tribes to still sell cigarettes at a very low tax rate. It also allowed Oklahoma to collect data on tribal sales. Oklahoma's Department of Revenue was surprised to discover that tribal sales amounted to 68 million packs in FY 1995, or more than 20 percent of the Oklahoma cigarette market. The tribal market has grown by another 10 percent in FY 1996.

Financial Impact of a 40c/pack Tax increase

New Mexico is considering a tax proposal that would increase the current 21c/pack cigarette tax to 61c/pack. However, the evidence indicates that New Mexico has a well developed tax-free cigarette market. This tax-free zone could take close to 20 percent of the New Mexico cigarette market. Any further tax increases are likely to inflame this problem for New Mexico's non-tribal merchants.

In addition, low-tax Colorado (20c/pack and with no sales tax applied to tobacco products) and Oklahoma (23c/pack) lurk on New Mexico's borders. Tax savings would be nearly $5.00 per carton with Colorado and $4.00 with Oklahoma. These savings exceed the ACIR bootleg "flashpoint" of $3.60 per carton. According to the Advisory Commission of Intergovernmental Relations (ACIR), tax differentials above this point are likely to lead to significant investments in cigarette smuggling.

* Percentage Decline in Sales - Given the existence of tax-free zones in New Mexico and low tax options in bordering states, the American Economics Group estimates that cigarette sales would fall by nearly 25 percent.

* Loss In Cigarette Sales Volume - Cigarette sales volume is likely to fall by about 28 million packs. Most of this would be a shift to tax-free zones, other states, and smuggling.

* Loss in Gross Retail Sales Volume - The retail value of lost cigarette sales would be $50 million annually (27.5 million packs lost with a final retail price of $1.85/pack).

* Loss in Sundry Product Sales - Sundry product sales, or products normally bought in conjunction with tobacco products, would fall by about $32 million annually for non-tribal merchants (based on past estimates of this phenomenon by Price Waterhouse).

* Loss in New Mexico Gross Profits - New Mexico's non-tribal merchants would lose about $17 million annually in gross profits, or the value added, due to a reduction in cigarette and sundry product sales.

* Lost Jobs - It is estimated that about 387 New Mexico jobs related to the distribution and sale of tobacco products could be displaced because of the 40c/pack tax increase (based on a 1996 study of the tobacco industry by the American Economics Group). Other job losses could occur as well due to the so-called expenditure induced impact of lost tobacco and sundry product sales.

Convenience Store Impact

Tobacco sales have an especially magnified effect on smaller establishments. This is because cigarette sales comprise such a large share of their sales. In 1996, The National Association of Convenience Stores (NACS) reports that tobacco sales in such stores accounted for nearly 30 percent of merchandise (in-store) sales. Thirty-eight percent of all tobacco products are sold through convenience stores nationwide. In New Mexico, it is estimated that such stores sell nearly $76 million of tobacco products with gross profits of $16 million.

According to NACS, there are 662 convenience stores operating in New Mexico. Each store, on average, registers about $115,000 in cigarette sales on annual basis. it is estimated that the 40c/pack tax hike will lead to about a $18 million reduction in cigarette sales for New Mexico non-tribal convenience stores. Sundry product losses would be about $12 million.

Each New Mexico non-tribal convenience store on average would lose about $27,000 in cigarette sales and $17,000 in sundry product sales. Gross profit losses would average about $9,200 per store. This means each store would have to boost gross retail sales of other items by $44,000 to make up for the damage wrought by the New Mexico tax hike. For those stores located near Indian reservations the damage could be far worse.