*THE ECONOMIC IMPACT OF A 54¢PER PACK CIGARETTE TAX INCREASE IN RHODE ISLAND*

## Background

The Rhode Island legislature is considering a proposal to increase the state cigarette tax by 54¢ per pack. The Rhode Island cigarette tax would rise from 71¢ to $1.25 per pack – making it the highest cigarette tax in the country. Consumers and retailers alike would be hurt by this tax proposal.

Rhode Island smokers are already reeling from the "settlement tax" – the price effect of the Master Settlement Agreement (MSA) between the state attorneys general and the tobacco industry. Under the MSA, Rhode Island will collect about $1.4 billion over 25 years from the nations' largest cigarette manufacturers.[1] Rhode will receive about $56 million in annual MSA payments. This is close to the amount that Rhode Island derives from its 71¢ per pack cigarette tax ($58.8 million in FY 2000.)

National cigarette prices have risen rise by over $1 per pack compared to prices at the end of 1997, primarily to finance these payments to the states. It is estimated that this "settlement tax" could boost the annual cost to the typical Rhode Island smoker by nearly $375 per year. Moreover, Rhode Island smokers are also paying an additional 10¢ per pack due to a rise in the federal excise tax on tobacco.[2]

The tax proposal that the Rhode Island legislature is considering represents the latest assault on Rhode Island smokers. The 54¢ tax increase would cost the typical smoker an additional $270 in new state taxes per year. This tax, when combined with the "settlement tax," would increase the annual cost to Rhode Island smokers by a staggering $645.

Rhode Island retailers will also feel the pain of the tax. A 54¢-tax hike would increase the Rhode Island cigarette tax to $1.25per pack, and put retailers at a competitive disadvantage with Connecticut and Massachusetts where the taxes are 50¢ and 76¢ respectively. A new menace would be Internet sales from Indian reservations where there are *no* excise taxes. In addition Rhode Island would face smuggling pressures from low tax states where the tax rate is as low as *2.5¢* per pack. Rhode Island consumers could save roughly $15 per carton.

[1] Although payments are calculated over a 25-year timeframe, in fact they go on for perpetuity.

[2] The Federal Excise Tax on tobacco rose from 24¢ per pack to 34¢ per pack on January 1, 2000.

## National Cross Border Trends

In order to understand why Rhode Island's retailers could suffer significant repercussions as a result of the tax, it is critical to understand the incredible changes in the national cigarette market over the last decade. 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, sold 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 than, the gap has widened. In FY 2000, tax reported sales in the low-tax block were about 20% greater than such sales in the high-tax block.

Consider the case of Michigan. Since Michigan increased its cigarette tax from 25¢ to 75¢ per pack in May of 1994, Michigan cigarette sales nose-dived by 33 percent between FY 1994 and FY 1998. During the same time period, annual cigarette sales went up by 8% in Kentucky, 14% in South Carolina, 12% in Indiana, 8% in Tennessee, 6% in North Carolina, 4% in Missouri, and 2% in Ohio. Incredibly, the sales volume gain in the low-tax states more than matched the 280 million pack loss in Michigan and occurred during a time period when national cigarette sales volumes were relatively flat.

Clearly the tax increase was pushing consumers across borders where they could buy cheaper smokes; more ominously, it was fueling cigarette smuggling. In the words of Robert Manes, head of the Michigan State Police Treasury Enforcement Division, "[E]fforts to get around the tax increase are a growing problem. With the amount of money that can be made now, everybody who has an avenue is getting into it."[3]

[3] Associated Press, December 14, 1994.

## The Rhode Island Cigarette Market

After a 54¢-tax hike, Rhode Islanders could save big on either of its borders -- $7.50 per carton in Connecticut and $4.90 per carton in Massachusetts. These margins exceed the Advisory Commission on Intergovernmental Relation's bootleg "flashpoint" of $3.75 per carton. Tax differences above the "flashpoint" are likely to encourage serious investments in cigarette smuggling. Rhode Island retailers, and ultimately state law enforcement budgets, would be vulnerable to smuggling.

Rhode Island was fortunate not to experience these problems in the 1990s; luckily for the state's retailers, Connecticut and Massachusetts were raising their taxes at the same time as Rhode Island. From 1988 to 1994, Connecticut increased its tax from 26¢ to 50¢. From 1992 to 1997, Massachusetts increased its tax from 26¢ to 76¢. These tax increases enabled Rhode Island to hoist its tax from 44¢ in 1993 to 71¢ in 1997 without creating large tax differences across borders. However, a 54¢-tax hike would greatly upset this balance. Under the proposed increase, Rhode Island's retailers would likely see considerable sales losses to retailers in neighboring states. The reaction would be similar to 1969 or 1989 when Rhode Island had significant tax increases relative to it's border states (a 5¢ increase in 1969 and 10¢ in 1989). In both cases, Rhode Island cigarette sales fell by about 16%.

Rhode Island's massive tax increase could create the same kind of problems for retailers that high taxes in Massachusetts have created for its merchants. Many Bay State consumers avoided "Taxachusetts" by traveling to New Hampshire where there is no sales tax and the cigarette excise tax was relatively low. In 1995, Price Waterhouse estimated that about 40% of New Hampshire cigarette sales, or 72 million packs, were cross-border sales (most of those sales were to Massachusetts' consumers). This purchasing shift generated about $127 million in gross retail cigarette sales and nearly $20 million in gross profits, or value added, for the New Hampshire economy.

In 1997, when the New Hampshire tax was 37¢ per pack compared to 76¢ in Massachusetts, tax paid per capita cigarette sales in New Hampshire were 174 packs compared to 67 packs in Massachusetts. In other words, tax-paid per capita sales were 150% greater in New Hampshire. Government smoking prevalence studies at this time, however, showed that smoking prevalence among adults in New Hampshire (24.8%) was only 20% greater than in the Bay States (20.4%). Clearly many Massachusetts smokers went shopping in New Hampshire. Massachusetts' merchants will be the beneficiaries of the same effect if Rhode Island hoists its cigarette tax to $1.25 per pack.

## Jumping Borders with the Internet

Beleaguered smokers may also turn to the Internet for low cost cigarettes. Merchants from low tax states often market cigarettes over the Internet to customers in high tax states. In a recent survey it was found that most of the Internet merchants were located on Indian reservations. There is a good reason for this -- many reservations do not apply state tobacco sales and excise taxes. Savings from such places could save Rhode Island customers about $15 per carton. New York, which recently increased its cigarette tax by 56¢, is grappling with this problem right now.

**Rhode Island 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 Rhode Island stores had gross cigarette sales of nearly $287 million in FY 2000, generating about $63 million in gross profits for Rhode Island retailers and wholesalers. According to a 1998 study by the American Economics Group (AEG), nearly 3,000 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. The National Association of Convenience Stores reports that tobacco sales in such stores accounted for nearly 30% of merchandise sales in 2000. About 50% of all tobacco products are sold through convenience stores nationwide. In Rhode Island, it is estimated that such stores sell nearly $143 million worth of cigarettes with gross profits of nearly $31 million.

**Commercial Losses - 54¢ Tax Increase[4]**

- **Loss in Cigarette Sales Volume** – It is estimated by the American Economics Group, Inc., that the 54¢-tax hike will reduce cigarette sales by 23 million packs in FY 2002. In other words, cigarette sales will fall by nearly 28% using projected FY 2001 sales as the baseline.

- **Loss in Retail Cigarette Sales and Tie-In Sales** - The gross retail value of lost cigarette sales would be approximately $80 million (23 million packs evaluated at a final retail price of $3.50 per pack). Sundry product sales, or products normally bought in conjunction with tobacco products, would fall by about $27 million (based on past estimates of this phenomenon by Price Waterhouse).

[4] Some versions of the tax increase legislation contain provisions that would raise the state minimum markup price for cigarettes. It is very difficult to evaluate the impact of this since such markups are often eroded by discounting and other competitive market forces. For this reason only the tax impact is evaluated.

- **Lost Gross Profits** - Gross profits, or the value added, lost to Rhode Island retailers and wholesalers would be about $24 million due to the loss of cigarette and tie-in sales.

- **Lost Jobs** - It is estimated that nearly 350 Rhode Island 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 National Association of Convenience Stores there are about 320 convenience stores operating in Rhode Island. Each store, on average, registers about $440,000 in cigarette sales on an annual basis. It is estimated that the 36¢-tax hike will lead to about a $40 million reduction in cigarette sales for Rhode Island convenience stores. Sundry product losses would be about $14 million.

Each Rhode Island convenience store, on average, would lose about $160,000 in cigarette and sundry product sales. Gross profit losses would average about $38,000 per store. This means each store would have to boost gross retail sales of other items by $160,000 to make up for the damage wrought by the 54¢ tax hike.

**Consumers Hit Hard by Tax**

While the tax will hurt retailers, consumers will feel it as well. When the 54¢-tax increase is considered along with the "settlement tax," Rhode Island smokers can expect to pay $645 a year more than they paid at the end of 1997. Unfortunately, those who pay the most tend to be able to afford it the least. Following on the heels of a similar report by the U.S. Congress' Congressional Budget Office (CBO), a recent study by the Barents Group of KPMG Peat Marwick found 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 nationwide. This group pays about 15.3% of all federal income and FICA taxes, but pays over **47% of all tobacco taxes**.[5]

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[5] Barents Group LLC, The Burden of Consumer Excise Taxes on Lower-Income Taxpayers (Washington, D.C.), 19 May 1997. Prepared for the Tobacco Institute.

As the CBO report states, excise taxes are the most regressive type of tax and tobacco excise taxes are "the most regressive of all." A 54¢ per pack increase is just one more burden that low- and middle-income wage earners would be forced to shoulder. A typical Rhode Island smoker would pay an additional $270 per year after a 54¢ tax increase. Add to that the "settlement tax," and the additional costs to the typical Rhode Island smoker will be over $640 per year. This burden is equal to roughly 33% of per capita taxes collected by the state of Rhode Island.