

Tobacco Excise Taxes

Frank J. Chaloupka
The Institute 2010
Atlanta GA, October 5, 2010

1

Overview

Countering Industry Arguments

- Tax Avoidance and Tax Evasion
 - Types
 - Extent
 - Impact on revenues, health outcomes
 - Policy options
- Tobacco Taxes and the Poor

2

**Tobacco Tax Avoidance
& Tax Evasion**

3

Types of Illicit Trade

- Individual tax avoidance
 - Reservation, Internet and other direct, duty-free, and cross-border purchases
 - Generally not illegal, but states require local taxes to be paid
- Bootlegging ("Butt"legging)
 - Small scale purchasing of cigarettes in low-tax/price jurisdictions for resale in high tax/price jurisdictions

4

Types of Illicit Trade

- Large scale, organized smuggling
 - Illegal transportation, distribution and sale of large consignments of tobacco products
 - Generally avoids all taxes
- Counterfeit
 - products bearing a trademark without the approval of the trademark owner
 - Often involved in organized smuggling

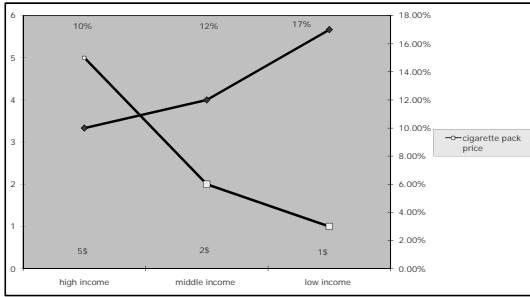
5

Determinants of Illicit Trade

- Tax and price differentials
 - More important for individual tax avoidance and bootlegging
 - Larger scale efforts avoid all taxes

6

The illicit cigarette market share (%) and the average cigarette pack price(\$) in high, middle and low income countries in 2007.



Source: WHO & IUATLD, 2009

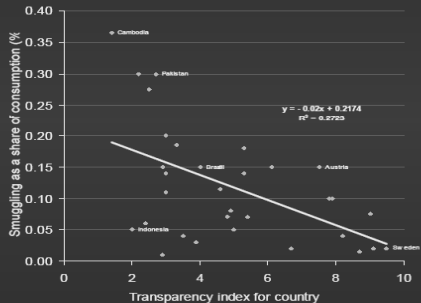
Determinants of Illicit Trade

- Presence of informal distribution channels
 - e.g. Street vendors, unlicensed distributors
- Presence of criminal networks
 - e.g. Organized crime, terrorist organizations
- Weak tax administration
 - Absence of tax stamps; weak or non-existent physical controls; unlicensed manufacturers, distributors, retailers; weak customs authorities
- Poor enforcement
 - Limited resources for border patrols, customs authorities, etc; low penalties
- Corruption

8

Smuggling and Corruption

Smuggling as a function of transparency index



Source: Merriman *et al.*, 2000

Who gains from illicit tobacco trade?

- Major dealers are international criminal networks
- The legal tobacco industry can gain because they are the producers and so sell more of their product AND they use it to try to pressure governments to lower taxes
 - not true where counterfeit is significant
- Illicit trade in tobacco finances at least half a dozen terrorist groups
- The main sources of contraband production are China, Paraguay and Ukraine

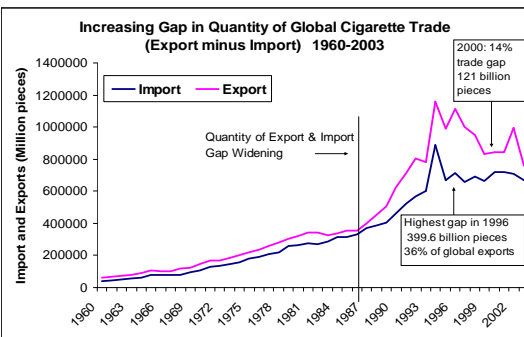
Centre for public integrity, July 2009 www.publicintegrity.org WHO & IUATLD, 2009

Extent of Illicit Trade

- Difficult to measure given illegality
- A variety of approaches have been used, including:
 - Comparing recorded exports of tobacco products to recorded imports
 - Difference reflects leakage into black markets
 - Recent estimates suggest 20-30 percent of exports do not appear as imports
 - 4-10 percent of global consumption
 - Will be largely organized smuggling

11

Extent of Illicit Trade Globally



Source: ECOSOC Trade Database: Ayda Yurekli

Extent of Illicit Trade

- Difficult to measure given illegality
- A variety of approaches have been used, including:
 - "Expert Opinions"
 - Customs officials, tobacco industry representatives, tax authorities, and others
 - Widely varying estimates across countries
 - Average: 8.5% (wtd) - 13.3% (unwtd) in mid-1990s
 - Again, largely reflecting organized smuggling

13

Extent of Illicit Trade

- Individual tax avoidance a bit easier to assess
 - Econometric analyses of tax paid sales that account for various factors, including:
 - tax/price differences
 - population density
 - travel patterns
 - Distance
 - US estimates suggest up to 12.5% of total consumption in early 2000s

14

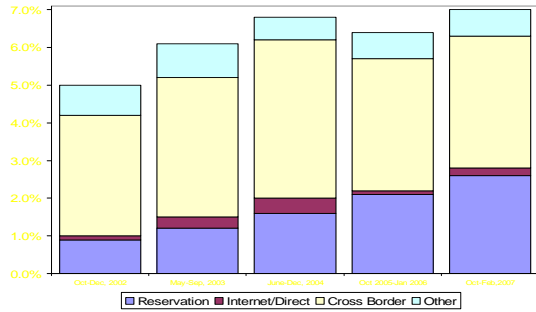
Extent of Illicit Trade

- Individual tax avoidance – self-reported data
 - International Tobacco Control Policy Evaluation Study
 - Longitudinal, annual survey of smokers in numerous countries, including Canada and US
 - Includes questions on purchase locations, including Internet, telephone, cross-border, duty free, reservations, and more

15

Tax Avoidance and Enforcement

US Smokers' Tax Avoidance,
Last Purchase, 2002-2007

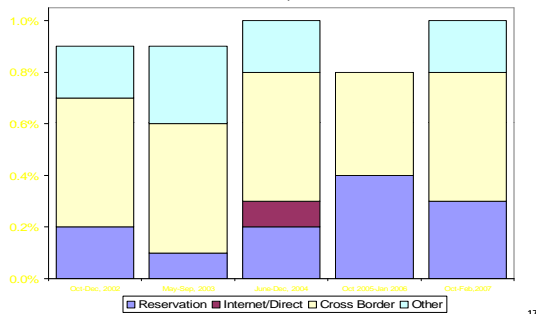


Source, ITC project, US survey, Waves 1-5

16

Tax Avoidance and Enforcement

US Smokers' Tax Avoidance, Most Frequent
Purchase Source, 2002-2007



Source, ITC project, US survey, Waves 1-5

17

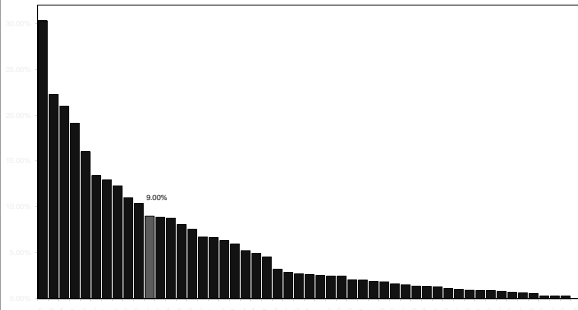
Extent of Illicit Trade

- Individual tax avoidance – self-reported data
 - Tobacco Use Supplement to the Current Population Survey
 - Periodic state representative, cross-sectional samples
 - Includes questions on price paid, whether or not purchased in own state, other state or through other channels (e.g. Internet or phone) – 2003 and 2006/07 surveys only
 - Does not pick up in-state tax avoidance (e.g. reservation purchases)
 - 2003: 5.63% 2006/07: 5.19%

18

Tax Avoidance – United States

% Tax Avoiders, 2003

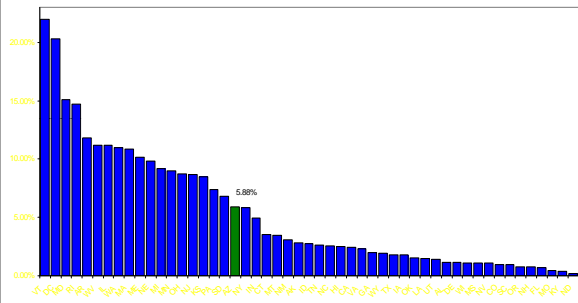


Source: Tax Burden on Tobacco, 2008 and TUS-CPS

19

Tax Avoidance – United States

% Tax Avoiders, 2006/07

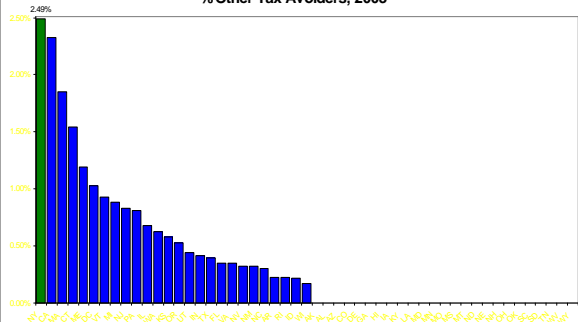


Source: Tax Burden on Tobacco, 2008 and TUS-CPS

20

Tax Avoidance – United States

% Other Tax Avoiders, 2003

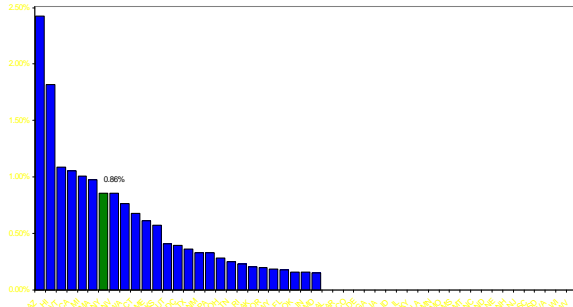


Source: Tax Burden on Tobacco, 2008 and TUS-CPS

21

Tax Avoidance – United States

% Other Tax Avoiders, 2006/07



Source: Tax Burden on Tobacco, 2008 and TUS-CPS

22

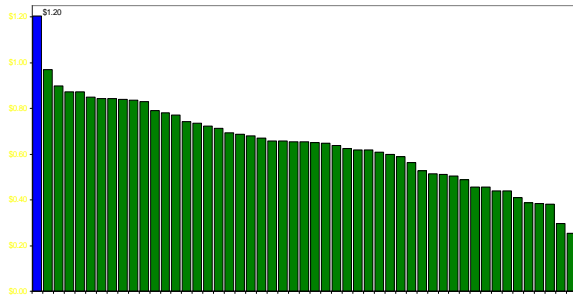
Extent of Illicit Trade

- Individual tax avoidance – self-reported data
 - TUS-CPS
 - Does not pick up within state tax avoidance (e.g. purchases on reservations)
 - Comparison of average price paid by smokers purchasing in state from TUS to average prices reported in *Tax Burden on Tobacco*
 - Difference accounted for by several factors, including reservation purchases

23

Tax Avoidance – United States

Difference in TBOT and TUS Prices, 2003

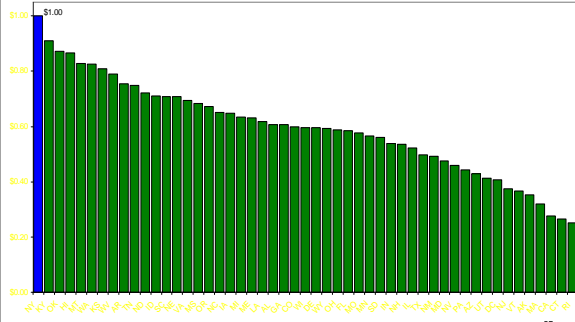


Source: Tax Burden on Tobacco, 2008 and TUS-CPS

24

Tax Avoidance – United States

Difference in TBOT and TUS Prices, 2006/07

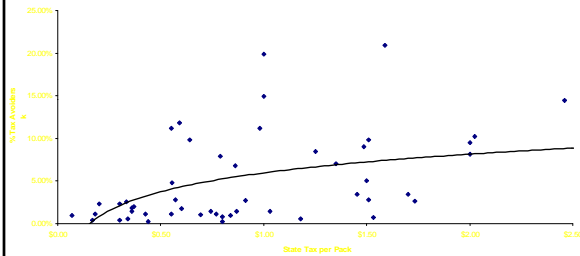


Source: Tax Burden on Tobacco, 2008 and TUS-CPS

25

Tax Avoidance – United States

Cross Border Tax Avoidance and State Cigarette Taxes, 2006/07

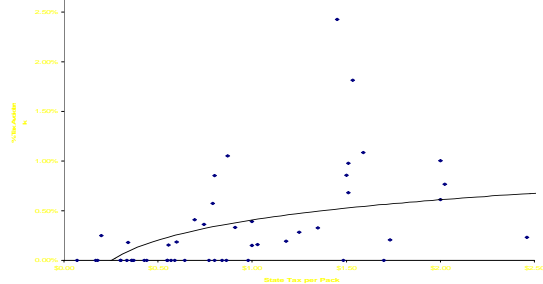


Source: Tax Burden on Tobacco, 2008 and TUS-CPS

26

Tax Avoidance – United States

Other Tax Avoidance and State Cigarette Taxes, 2006/07



Source: Tax Burden on Tobacco, 2008 and TUS-CPS

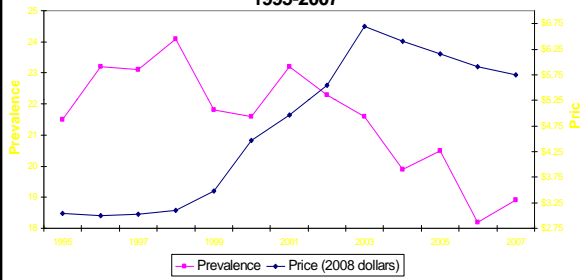
27

Illicit Trade, Public Health, and Revenues

- Even in the presence of illicit trade, higher cigarette and other tobacco taxes lead to:
 - Reductions in youth and adult tobacco use
 - Increases in tobacco tax revenues
- Rather than forego tax increases, appropriate response is to crack down on illicit trade

28

Illicit Trade Does NOT Eliminate Health and Revenue Impact of Higher Taxes Cigarette Prices and Adult Prevalence, New York, 1995-2007

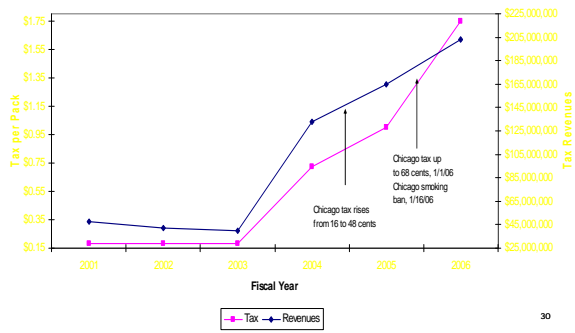


Source: Tax Burden on Tobacco, 2008 and TUS-CPS

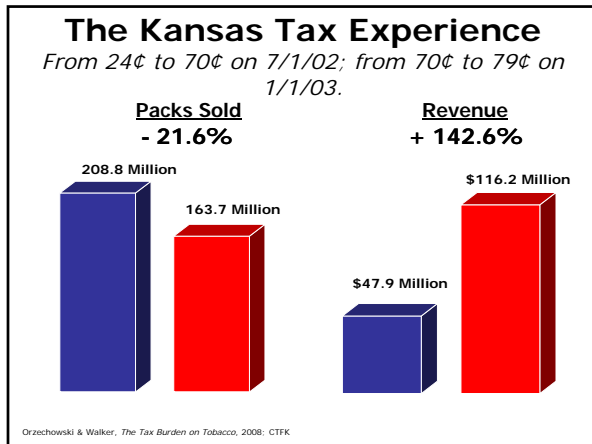
29

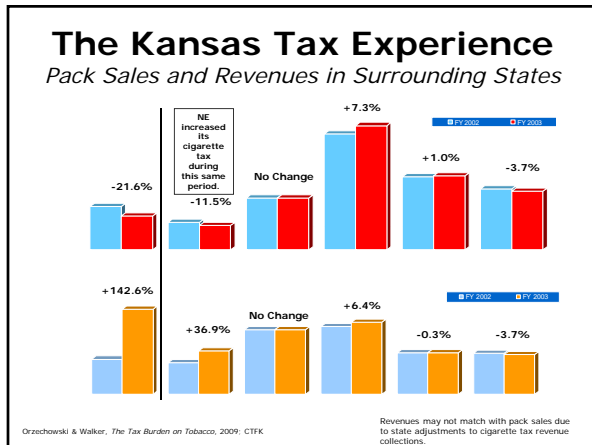
Tax Increases and Tax Avoidance

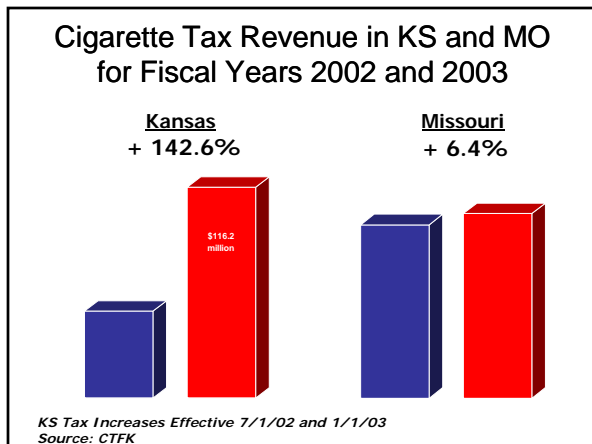
Cook County Cigarette Tax and Tax Revenues - FY01-FY06



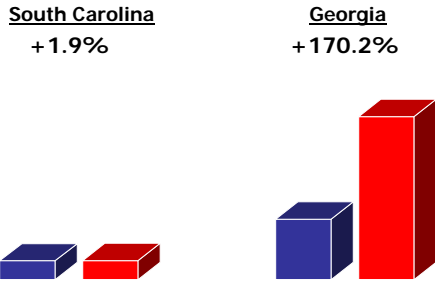
30





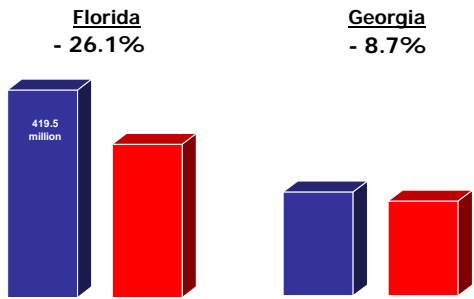


Cigarette Tax Revenue in SC and GA for Fiscal Years 2003 and 2004



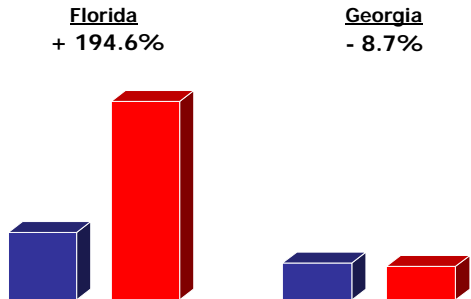
GA Tax Increase In Effect 7/1/03

Cigarette Pack Sales in FL and GA from July-Oct 2008 vs. 2009



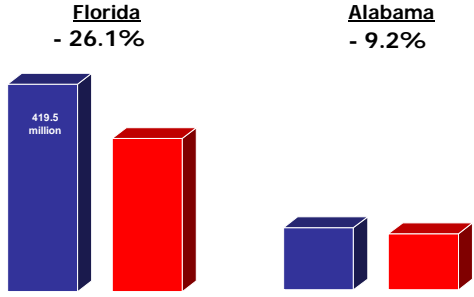
FL Tax Increase from 34 cents to \$1.34 Effective 7/1/2009; GA Tax is 37 cents. Source: CTFK

Cigarette Tax Revenue in FL and GA from July-Oct 2008 vs. 2009



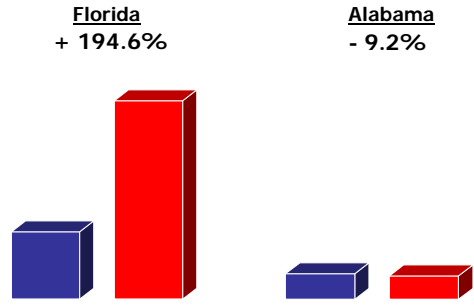
FL Tax Increase from 34 cents to \$1.34 Effective 7/1/2009; GA Tax is 37 cents. Source: CTFK

Cigarette Pack Sales in FL and AL from July-Oct 2008 vs. 2009



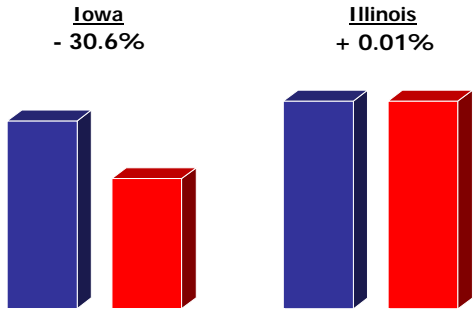
FL Tax Increase from 34 cents to \$1.34 Effective 7/1/2009; AL Tax is 42.5 cents. Source: CTFK

Cigarette Tax Revenue in FL and AL from July-Oct 2008 vs. 2009



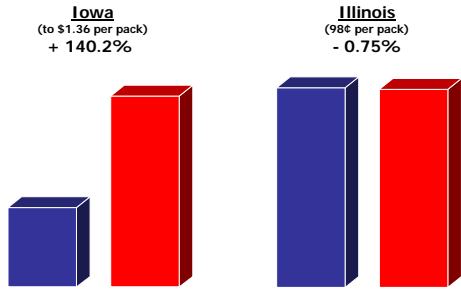
FL Tax Increase from 34 cents to \$1.34 Effective 7/1/2009; AL Tax is 42.5 cents. Source: CTFK

Cigarette Pack Sales in IA and IL after IA's 2007 cigarette tax increase



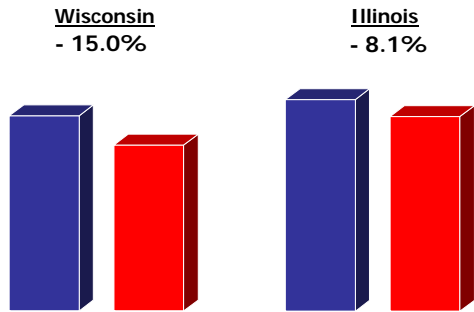
Orzechowski & Walker, The Tax Burden on Tobacco monthly reports. CTFK

**Cigarette Tax Revenue in IA and IL
after IA's \$1.00 cigarette tax increase in 2007**



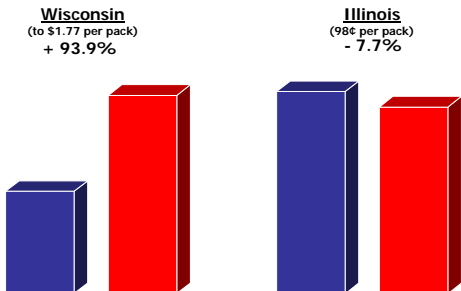
Orzechowski & Walker, The Tax Burden on Tobacco monthly reports, CTFK

**Cigarette Pack Sales in WI and IL
after WI's 2008 cigarette tax increase**

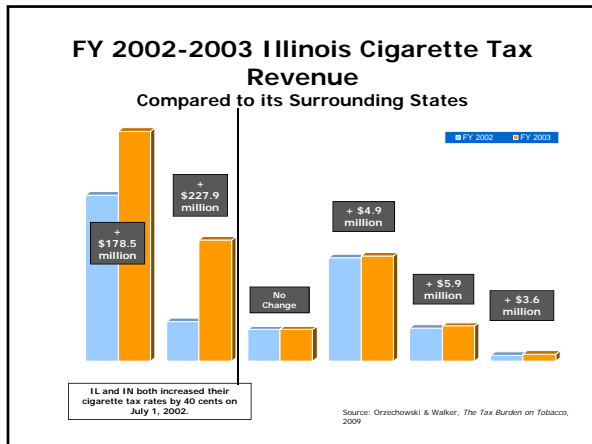


Orzechowski & Walker, The Tax Burden on Tobacco monthly reports.

**Cigarette Tax Revenue in WI and IL
after WI's \$1.00 cigarette tax increase in 2008**



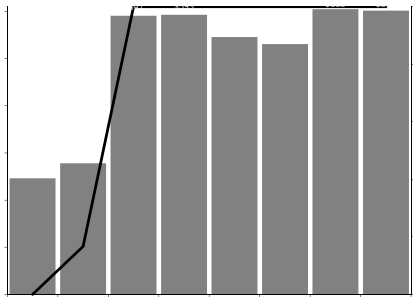
Source: Orzechowski & Walker, The Tax Burden on Tobacco monthly reports: CTFK



- ### Combating Illicit Trade
- Strong tax administration
 - Prominent, high-tech tax stamps and other pack markings
 - Licensing of manufacturers, exporters, distributors, retailers
 - Export bonds
 - Unique identification codes on packages
 - Better enforcement
 - Increased resources
 - Focus on large scale smuggling
 - Stronger penalties
 - Multilateral tax increases

- ### Combating Illicit Trade
- Michigan and tax stamps
 - Raised tax from 25 to 75 cents per pack, May 1, 1994; no tax stamp at the time
 - Initial large increase in revenues
 - From just under \$250 million last full fiscal year before increase to almost \$600 million first full year after increase
 - Smuggled cigarettes gain significant market share
 - NC (5 cent tax) eliminated tax stamp soon after MI tax increase; SC (7 cents) followed in 1997
 - Michigan adopts tax stamp in 1998
 - 14% increase in revenues following stamp
 - NC sales fall about 9%; SC more than 13%

Michigan: Taxes & Tax Revenues



Source: Tax Burden on Tobacco and author's calculations

49

Combating Illicit Trade

- California's high-tech tax stamp
 - Adopted 2002; fully implemented 2005
 - Coupled with better licensing standards
 - Can be examined with hand-held scanners
 - Thousands of compliance checks, hundreds of citations
 - Generated over \$124 million in revenues during 20 month period (mid-2004 through late 2005)

50

Efforts to Curb Tax Evasion

Many US efforts focused on Internet, phone and mail order sales:

- Outright ban on direct sales (e.g. New York state policy)
- Major shipping companies (e.g. UPS, Federal Express) agree not to ship cigarettes to consumers
 - USPS hasn't established similar policy
- Major credit card companies agree to ban use of credit cards for direct cigarette purchases
- States apply Jenkins Act to identify direct purchasers and to collect taxes due
 - Promising approach based on early data from several states
 - MA collected over \$4.6 million in FY07

Efforts to Curb Tax Evasion

Reservation sales similar focus in some states

- Some states (e.g. MN) impose tax on reservation sales with refund to reservation residents
- Other states (e.g. WA) enter into "compacts" with tribes that result in comparable taxes imposed on reservation sales with most/all of revenues kept by tribe
- Others apply different tax stamps for cigarettes sold to residents and non-residents of reservations
 - Quota on distributor sales to reservation outlets to reflect expected resident consumption (e.g. NY)

Combating Illicit Trade

■ FCTC and Illicit Trade

- Article 15 addresses illicit trade, calling for:
 - Pack markings to identify where intended for sale and to help identify illicit products
 - Adoption of 'track and trace' regime
 - Stronger penalties and better enforcement
 - Better tax administration
 - International cooperation
- High priority; negotiation of protocol ongoing

53

WHO's Best Practices in Tobacco Taxation

- Eliminate tax or duty free sales of tobacco products
 - As called for in Article 6 of FCTC
 - Reduces opportunities for individual tax avoidance
 - Maximizes public health and revenue impact of taxes/tax increases

54

WHO's Best Practices in Tobacco Taxation

- Adopt new technologies to strengthen tobacco tax administration and minimize tax avoidance and evasion
 - Sophisticated tax stamps
 - Tracking and tracing technologies
 - Production monitoring technologies

55

WHO's Best Practices in Tobacco Taxation

- Strengthen tobacco tax administrators' capacity by licensing all involved in tobacco product manufacturing and distribution
 - Facilitates identification of those engaged in illegal trade
 - Enhances ability to penalize those engaged in illegal trade
 - License suspension, revocation

56

WHO's Best Practices in Tobacco Taxation

- Ensure certain, swift and severe penalties for those caught engaging in illicit trade in tobacco products
 - Increased the expected costs of engaging in illicit trade
 - Administrative sanctions coupled with licensing

57

WHO's Best Practices in Tobacco Taxation

- Strengthen tobacco tax administrators' capacity to monitor tobacco product markets and evaluate the impact of tobacco tax increases
 - "Trust but verify"
 - Monitoring of tobacco production and distribution
 - Physical control over tobacco products
 - Periodic audits
 - Capacity to estimate impact of tax changes on consumption, revenues
 - Regional and international collaborations for monitoring, administration, enforcement

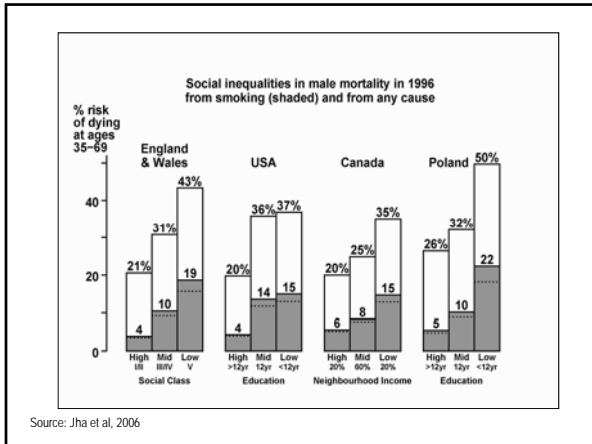
58

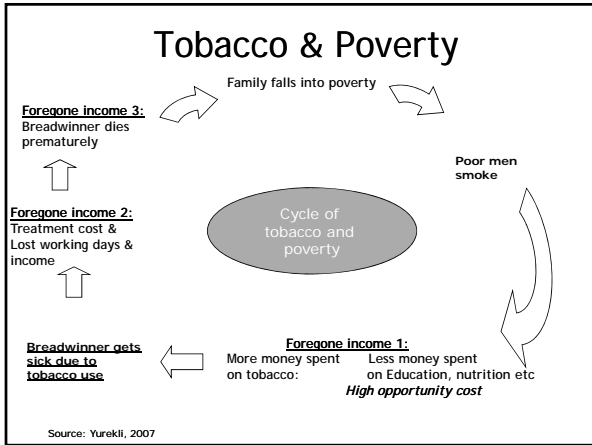
Tobacco Taxes and the Poor

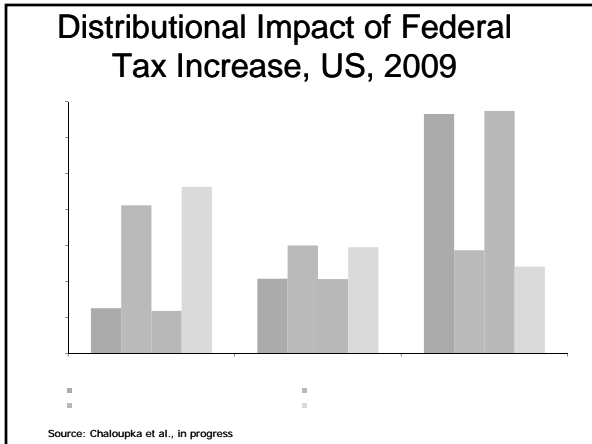
59

Tobacco Taxes & Equity

- Concerns about "fairness" of tobacco taxes
 - Regressivity of existing tobacco taxes
- Harms from tobacco clearly regressive
 - Greater prevalence of tobacco use among the poor
 - Contributions of tobacco to poverty
 - Crowding out of spending on food, housing, and other necessities
- Progressive impact of tax increases







Tobacco Taxes & Equity

- Overall fiscal system
 - Need to consider fairness of overall fiscal system
 - Key issue with tobacco taxes is what's done with the revenues generated by the tax
 - Greater public support for tobacco tax increases when revenues are used for tobacco control and/or other health programs
 - Net financial impact on low income households can be positive when taxes are used to support programs targeting the poor
 - Concerns about regressivity offset by use of revenues for programs directed to poor

Tobacco Tax Increases and the Poor

- Examined impact of "Measure 50" in Oregon
 - proposed \$0.845 increase in state cigarette tax and comparable increases in other tobacco product taxes
 - most revenues dedicated to expansion of state health insurance program to cover more low-income households
 - some revenues for state tobacco control program
 - Estimated that tax increase would add \$20.5 million to cigarette costs for continuing low-income smokers
 - Value of health insurance benefits for low-income Oregon population estimated to be \$183.2 million
 - Net economic impact of Measure 50 on low-income population estimated to be \$162.7 million

WHO "Best Practices" for Tobacco Excise Taxes

- *Do not view low taxes and prices for some tobacco products as a "pro-poor" policy*
 - High tobacco taxes on all tobacco products will result in greater reductions in tobacco use among the poor and to a progressive distribution of the health and economic benefits that result – a truly "pro-poor" policy

WHO “Best Practices” for Tobacco Excise Taxes

- *Do not allow concerns about the regressivity of higher tobacco taxes to prevent tobacco tax increases*

- Regressive impact often overstated; concerns about impact on the poor can be offset by using new revenues to support efforts to help poor tobacco users quit, health promotion efforts targeting poor and/or other poverty alleviation programs
