



## North Dakota Tobacco Prevention and Control Executive Committee

Center for Tobacco Prevention and Control Policy

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### Comments to the Taxation Committee Wednesday, October 19, 2011

Good afternoon Chairman Hogue and members of the Taxation Committee. I am Jeanne Prom, executive director of the Center for Tobacco Prevention and Control Policy. Please consider the attached information, also highlighted below, as you study tobacco tax stamping.

#### 1) **Fact sheet: *The Case for High-Tech Cigarette Tax Stamps***

- High-tech stamps contain encrypted information officials can read with portable scanners.
- Encrypted information helps in tracking and compliance.
- High-tech, encrypted stamps are difficult to counterfeit.
- High-tech stamps aid in more effective prevention and reduction of contraband cigarette trafficking and cigarette tax evasion.
- High-tech stamps help fight crime and allow the government to collect revenue it is otherwise losing.
- High-tech stamps also help protect public health and reduce smoking by stopping illegal cigarette sales at below-market prices.

#### 2) **Fact sheet: *State Options to Prevent and Reduce Cigarette Smuggling and Block Other Illegal State Tobacco Tax Evasion***

- States can implement a number of straightforward and cost-effective measures to minimize tobacco smuggling and tax evasion, including high-tech tobacco tax stamps.
- Options in addition to tobacco stamps are offered, such as raising tobacco taxes in states with low tobacco taxes. NOTE: North Dakota last raised its tobacco tax in 1993, and at 44 cents/pack, is one of the lowest tobacco taxes in the country.

#### 3) **Fact sheet: *The Michigan Story: Cigarette Tax Increases, New Revenues, and the Value of Tax***

- In 1994, Michigan became the only state with both a high tobacco tax and no tobacco tax stamp requirement.
- Soon afterwards, Michigan was dealing with an influx of tobacco smuggled from North Carolina, and later, South Carolina -- two states with very low tobacco taxes and no tobacco tax stamps requirements.
- In 1998, Michigan passed a new cigarette tax stamp law.
- After the law took effect, Michigan's annual cigarette tax revenues increased by more than 20 percent (while tobacco sales in North and South Carolina dropped).
- No large-scale tobacco smuggling problem has existed in Michigan since it initiated its cigarette tax stamp. This is in spite of Michigan raising its tobacco tax significantly in 2002 and 2004, and North and South Carolina continuing to sell no-stamp, low-tax tobacco.

Fact sheets source: Campaign for Tobacco Free Kids, [www.tobaccofreekids.org](http://www.tobaccofreekids.org)

Thank you for the opportunity to provide this information and thank you for studying tobacco tax stamping. I am happy to answer any questions.

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## THE CASE FOR HIGH-TECH CIGARETTE TAX STAMPS

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Most states continue to use old-fashioned cigarette tax stamps that are easy to counterfeit and fail to take advantage of readily available technologies that would increase state revenues by preventing contraband cigarette trafficking and other tobacco tax evasion. Not surprisingly, there continue to be major seizures of counterfeit cigarette tax stamps, both on packs and not yet applied – not only for states with higher cigarette tax rates (e.g., New York, New Jersey) but even for states with some of the lowest cigarette tax rates (e.g., Virginia, Kentucky).<sup>1</sup>

High-tech tax stamps work better because they are easier to see and distinguish than existing state tax stamps and harder to visually counterfeit. More importantly, they also contain useful encrypted codes and information that enforcement officials and others can read with portable scanners, thereby making the stamps almost impossible to counterfeit. With high-tech tax stamps, enforcement officials can scan cigarette packs wherever they find them to distinguish real tax stamps from even the most sophisticated fakes, identify the wholesaler that applied the stamp and initially sold the cigarettes, and obtain other encrypted information useful for tracking, tracing and enforcement purposes.

By preventing contraband trafficking and other cigarette tax evasion, high-tech tax stamps not only fight crime and increase government revenues but also help to protect public health and reduce smoking by stopping illegal cigarette sales at below-market prices.<sup>2</sup>

***In California, the first state with high-tech tax stamps, cigarette tax revenue increased substantially (without any tax rate increase) immediately after the new tax stamps were introduced in 2005.***<sup>3</sup> In June 2007, the California tax collection agency announced that cigarette tax evasion had dropped by 37 percent because of increased enforcement and the new high-tech tax stamps, gaining the state \$110 million in additional annual cigarette tax revenue.<sup>4</sup> Now, the available high-tech tax stamping systems work even more effectively than the original California system, which has been upgraded – and new high-tech tax stamps are also possible for tobacco products other than cigarettes.

At least two major groups of companies offer new high-tech state tax stamping systems, one headed by SICPA Product Security, which developed the California system with Meyercord Revenue, and one headed by Authentix, Inc.<sup>5</sup> According to Authentix, a top of the line, new high-tech tax stamping system could be put in place for a state within just a few months.

Besides California, high-tech tax stamps are in effect or underway in Massachusetts, as well as in Canada, Turkey and Brazil. The World Bank and the International Monetary Fund have each endorsed high-tech tax stamps as an essential measure to reduce tobacco product smuggling.<sup>6</sup>

*Campaign for Tobacco-Free Kids, April 15, 2010 / Ann Boonn*

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<sup>1</sup> See, e.g., Newman, A, "Arrest of Cigarette Seller Is a Coup, Brooklyn Officials Say," *The New York Times*, April 11, 2008.

<sup>2</sup> Written Testimony of Eric N. Lindblom, Hearing on Senate Bill 346 Pertaining to Tax Stamps, Senate Finance Committee, State of Maryland, February 18, 2010.

<sup>3</sup> For more on the CA system, see White, L, "Stamping In: A Look at California's Alternative Cigarette Tax Stamp Program," *Distribution Channels*, March 2007, [http://www.sicpa.com/public/pdf/news/stamping\\_reprint.pdf](http://www.sicpa.com/public/pdf/news/stamping_reprint.pdf).

<sup>4</sup> McIntosh, A, "Tobacco Tax Cheating Falls," *Sacramento Bee*, June 27, 2007.

<sup>5</sup> See [www.sicpa.com](http://www.sicpa.com); and [www.authentix.com/pdf\\_files/Authentix\\_Tax\\_Recovery.pdf](http://www.authentix.com/pdf_files/Authentix_Tax_Recovery.pdf).

<sup>6</sup> "Hologram Advances Seen to Combat Terrorism," *United Press International*, February 19, 2010.



## STATE OPTIONS TO PREVENT AND REDUCE CIGARETTE SMUGGLING AND BLOCK OTHER ILLEGAL STATE TOBACCO TAX EVASION

To try to block or reduce state tobacco tax increases, the major U.S. cigarette companies regularly overstate the amount of cigarette smuggling and tax-avoidance prompted by differences among different states' cigarette tax rates. In fact, every state that has increased its cigarette tax rate significantly has enjoyed substantial revenue increases despite declining smoking levels and pack sales.<sup>1</sup> At the same time, recent research indicates that the highest-tax states could increase their tobacco tax revenues by five or ten percent if they implemented effective measures to reduce sharply both organized cigarette smuggling (which accounts for the majority of untaxed sales) and smoker tax avoidance.<sup>2</sup> New revenue aside, states should not tolerate illegal tobacco smuggling or any other tobacco-related crimes, especially if done by criminal organizations. Fortunately, there are a number of relatively simple and inexpensive measures that states could implement to minimize such smuggling and tobacco tax avoidance.

### **Measures to Make Smuggling & Tobacco Tax Avoidance More Difficult<sup>†</sup>**

1. ***Improve state tobacco tax stamps.*** The few states that do not have tax stamps (NC, SC, and ND) should require them; and all states should take advantage of available new technologies to make their tax stamps larger, highly visible, easy to distinguish from other states' tax stamps, harder to counterfeit, and placed on two sides of the packages and under any cellophane wrapper – with the tax stamp coding providing information on each pack re what retailer or wholesaler originally purchased it from which distributor or manufacturer. California, for example, initiated new high-tech tax stamps and enjoyed a \$120 million boost to its cigarette tax revenues in the following 20 months.<sup>3</sup> Tax stamps on non-cigarette tobacco products should also be established or improved. Tax stamps could also provide a phone number or email address for reporting suspected illegal sales, smuggling, or tax evasion, with rewards for tips that lead to arrests (and new stamps could also include a quitline phone number for smokers who want to quit).
2. ***Require State tax-exempt stamps on all cigarettes and other tobacco products sold in state that are not subject to the state's tobacco taxes.*** Require distributors selling cigarettes to Indian Tribes and others that make legal cigarette sales within the state's borders free from state tax to stamp those cigarettes with special state tax-exempt stamps – and to report all such sales, including amounts sold to whom, to state tax collection officials. The stamps could state "for legal tax-exempt sales only." These stamps would make it more difficult to illegally divert tax-exempt cigarettes into non-tax-exempt sales and would provide state officials with important data on the extent of tax-exempt sales and illegal diversion within the state. Several states already have such tax-exempt stamping requirements.<sup>4</sup>
3. ***Forbid the sale, purchase, or possession in the state of any tobacco products that are not marked with state tobacco tax stamps or other state tax-payment indicia establishing that all applicable state tobacco taxes have already been paid – other than small personal-use amounts and those held by or transported between licensed cigarette manufacturers, distributor/wholesalers, retailers or other licensed tobacco product businesses.*** This catch-all

<sup>\*</sup> U.S. interstate cigarette smuggling typically occurs when smugglers purchase cigarettes in a low-tax state or other low-tax or no-tax jurisdiction (such as Indian Tribal lands) and then illegally smuggle them into a high-tax state for illegal resale to otherwise-legal retailers. Otherwise legal retailers then purchase the cigarettes from the smugglers at prices that reflect the avoided state cigarette taxes, and the retailers subsequently sell the cigarettes to unknowing consumers. Through this process, the retailers and the smugglers, and not the smokers, enjoy the lion's share of the tax-avoidance "savings." In some cases, the cigarettes smuggled from the low-tax jurisdiction are sold directly to final customers via black-market sales, but these black-market sales are quite small compared to the sales through otherwise legal retailers. Some smokers also avoid paying the cigarette tax in their state by purchasing their cigarettes in a nearby lower-tax state, from stores on nearby military bases or Indian Lands (which typically do not charge state taxes), or from the Internet (where sales of cigarettes from Tribal lands and low-tax states are common).

<sup>†</sup> Although many of these measures refer only to cigarettes, they could be applied to other tobacco products, as well.



requirement prohibits all sorts of cigarette smuggling and tax avoidance, mandates tax payments, and facilitates enforcement by establishing that any significant amount of tobacco products found in the state without the appropriate tax stamp or tax-payment indicia are illegal goods (unless in the possession of licensed tobacco product businesses or their delivery services).

4. **Require better record keeping by distributor/wholesalers.** Require distributors and wholesalers selling cigarettes to retailers (which, in turn, sell them to state residents) to keep and maintain records of amounts sold, to whom, tax-stamp status, etc., and to regularly provide this information to state officials.
5. **Require better record keeping by retailers.** Require all retailers that sell cigarettes in the state to keep and retain accurate records regarding: a) their receipt of cigarettes from others (including date, quantity, from whom received, etc.); b) their total cigarette sales in the state (with monthly totals); and c) their sale of any cigarettes in quantities exceeding 2,000 cigarettes, or 10 cartons (including date, quantity, description, to whom sold, etc.).
6. **Block retail sales clearly not for personal use.** Place a maximum sale amount of 2,000 cigarettes (10 cartons) for any single sale to a consumer in the state – with parallel limits for the sales of other tobacco products.
7. **Educate smokers about existing state laws restricting smuggling and tax avoidance.** Most states already have laws that prohibit state smokers from bringing more than two cartons of cigarettes (or some other maximum amount) into the state from any other jurisdiction (including nearby states, Tribal lands, military bases, and duty-free shops) – and states that do not have any such laws should pass them. While enforcing such laws is difficult, many smokers do not even know they exist – and some would stop going to other jurisdictions to buy cheaper cigarettes (or at least reduce the size of their purchases) if they did know about these laws. Similarly, many smokers do not know that it is against state law to avoid paying state cigarette taxes by purchasing them over the Internet from website sellers that do not collect or pay the tax owed to the state. To educate smokers about existing laws prohibiting tax avoidance the State could post the information on various state website pages, issue related press releases, run related public education announcements, and require retailers to post notices or include notices with each tobacco product sale they make. Making periodic highly publicized “stings” to catch some of the cross-border or Internet shoppers who are illegally evading the state cigarette tax might be an even more effective way to dampen many smokers’ enthusiasm for these tax avoidance strategies.
8. **Publicize toll-free hot lines to encourage reports of smuggling or tax-avoidance activities.** Require state-based wholesalers, distributors, importers, exporters, and retailers of tobacco products to post prominent signs that provide a toll-free number and email address for reporting anyone suspected of smuggling tobacco products or buying or selling smuggled tobacco products. These or other signs could also provide information on how to identify legal versus smuggled cigarettes, notify smokers and others of the existing laws and penalties re buying smuggled cigarettes, bringing cigarettes into the state from other jurisdictions, etc., and inform employees of existing whistleblower protections. The toll-free number could also be included on the state tax stamps placed on tobacco products.
9. **Protect “Whistleblowers.”** To encourage the reporting of smuggling activities and protect witnesses, states could pass laws to protect the employees of retailers, distributors, wholesalers, importers, exporters, manufacturers, and delivery services from being fired or otherwise penalized by their employers if the employee notifies authorities about their employers’ smuggling-related wrongdoing or testifies about it in court.
10. **Work with Neighboring States.** To increase each state’s cigarette tax revenues, groups of neighboring states can work together to make their cigarette tax rates equal or similar to each other’s (by the lower-tax states raising their rates) and can coordinate and expand their mutual efforts to minimize cigarette smuggling and other tax avoidance through new parallel state laws and coordinated enforcement efforts.



11. **Put pressure on the States with extremely low cigarette tax rates to raise them.** The average state cigarette tax is \$1.47 per pack, but Missouri has a tax rate of only 17 cents per pack, and low-tax states North Carolina, South Carolina, and North Dakota do not even put tax stamps on their cigarettes, making them even easier to smuggle and resell. Numerous other states also have rates way below the national average of over a dollar per pack. Cigarette tax increases in those states would help to dampen interstate cigarette smuggling by sharply reducing the available illegal profits. Similarly, very few Indian Tribes have their own Tribal tobacco taxes, and they should be encouraged to establish them (see the next item). States and Tribes with low or no taxes on other tobacco products should also be urged to establish or raise them.
12. **Enter into treaties with in-state Indian Tribes to eliminate tobacco product price disparities.** Some smokers and smugglers go onto Tribal lands to purchase cigarettes and other tobacco products free of any state taxes. To reduce this problem, some states have entered into special compacts or agreements with the Indian Tribes located within the states' borders whereby the Tribe agrees to collect the state's tax (or a similar Tribal tax) on all of cigarette or other tobacco product sales on the Tribe's lands (whether sold to Tribal members or nonmembers) – thereby making the Tribal prices comparable to the prices charged elsewhere in the state – and the state agrees that the Tribe can keep all of the revenues it raises from charging the state (or Tribal) tax. These kinds of state-Tribal agreements are necessary because, otherwise, when a Tribe establishes a Tribal cigarette tax it is legally required to collect that Tribal tax on top of any state cigarette tax in all sales to non-tribal members, which produces an odd double-taxation problem.<sup>5</sup>
13. **Support Federal Anti-Smuggling Legislation.** While each state can do a lot, the federal government can do more. Most notably, the federal government could require all states to put tax stamps on their cigarettes, thereby stopping the sale in some low-tax states of blank packs that can easily be used for smuggling – and could require special tax stamps or restricted-sale notices on all tobacco products sold free of state taxes on Indian reservations, military bases, and duty-free shops. The federal government can also create nationwide standards for tax stamps; cigarette labeling (e.g., requiring unique serial numbers or markings indicating where packs may be legally sold); record keeping by manufacturers, wholesalers, and retailers; maximum sales amounts; and the like.<sup>6</sup> Federal legislation could also block tax-avoidance via Internet sales (see below).
14. **Coordinate enforcement with efforts to stop illegal sales to youth.** To qualify for federal grants to reduce substance abuse, each state must annually do compliance checks to confirm that less than 20 percent of all tobacco product retailers in the state are selling to youth. By also checking to make sure that the packs of cigarettes sold by the retailers in these youth-access compliance checks are legal cigarette packs on which all applicable state taxes have been paid, a state can greatly expand its efforts to identify those bad-apple retailers who are selling contraband cigarettes.

#### **Special Measures to Stop Illegal Tax-Free Internet & Mail Order Sales of Cigarettes**

The federal Jenkins Act requires all Internet sellers to provide each state with monthly reports listing state residents who have purchased cigarettes from the Internet sellers (including the quantities sold to each and the residents' mailing addresses), thereby enabling states to go after the in-state consumers to collect state taxes owed on the sales. The vast majority of Internet sellers, however, do not make the required Jenkins Act reports to the states, and federal officials rarely enforce the Act.<sup>7</sup> Some states have marginally increased the Internet sellers' compliance rate simply by contacting them and demanding the reports, and a few states have initiated lawsuits against some Internet sellers to try to force compliance, but overall compliance rates remain low. While these state efforts could be expanded, they are ultimately of limited value given the large number of Internet sellers and the ability of customers to find new non-complying vendors quickly and easily on the Internet. Even when Internet vendors comply with the Jenkins Act and provide the states with the customer information, going after each individual customer to

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<sup>5</sup> Retailers on Indian Lands are allowed to sell tobacco products to members of the same Tribe free of state tobacco taxes but are not allowed (unless expressly authorized by a state) to sell state-tax-free cigarettes to anyone who is not a Tribal member. However, a state's ability to take enforcement action against Indian Tribes that fail to collect and remit state taxes on sales to non-members of the Tribe are severely limited because of Indian Tribes' sovereign immunity (e.g., states cannot bring Tribes into state court to enforce state tax collection laws).



collect owed taxes is an inevitably time consuming and ineffective process. Accordingly, states that wish to minimize Internet-based tobacco tax evasion must go beyond trying to enforce the Jenkins Act and also establish more effective tax collection strategies.

- **Implement new State laws banning or restricting Internet tobacco product sales.** New York State has a law in place that prohibits Internet or mail order sales of cigarettes into the state – and the courts have upheld that law against cigarette company and Internet vendor attacks.<sup>8</sup> To minimize Internet sales that avoid paying state taxes, a state could pass a ban similar to the New York law.<sup>9</sup> Alternatively, a state could establish laws – such as those in Maine, California, Texas and other states – placing new requirements on all Internet and mail-order sales of any tobacco products to any state residents.<sup>10</sup> To be effective, any such law must provide some way of interrupting illegal Internet sales without the state having to try to find and bring every one of the hundreds of active illegal internet sellers into court. The best way to do that is to block the illegal Internet sellers' deliveries to their customers in the state by instructing common carriers and other delivery services operating in the state not to make any deliveries for Internet sellers that are breaking state laws.<sup>11</sup>
- **Support new federal laws to minimize Internet-based tobacco tax evasion.** As with smuggling in general, new federal laws can more effectively restrict Internet-based tobacco tax evasion than state laws because the federal government has nationwide authority, can restrict interstate commerce in ways that states cannot, and can restrict U.S. Postal Service deliveries of illegally sold or contraband tobacco products. One new effective federal law that will reduce tobacco tax evasion by restricting Internet tobacco product sales and strengthening other federal laws against contraband tobacco products is the Prevent All Cigarette Trafficking Act (PACT Act), which became effective in June 2010. The PACT Act creates a more level playing field and reduce the unfair cost and price advantage of Internet tobacco product sellers (which underlies Internet-based tax evasion), by making sure anti-smuggling provisions and other state laws that apply to in-state retail sellers of tobacco products also apply to Internet or mail-order companies that sell cigarettes to persons in the state, including all federal and state excise taxes collections with tax stamps applied, record-keeping requirements, and applicable penalties, among other provisions.<sup>12</sup>

#### **Stronger Disincentives and Punishments for Smuggling**

- **Expand definition of illegal smuggling subject to state prosecution and penalties.** To reach more illegal smuggling and tax avoidance through state law enforcement, reduce the minimum number of cartons/packs/cigarettes that trigger smuggling violations or major smuggling penalties. Establish or fortify penalties for the manufacture, possession, or sale of counterfeit tobacco tax stamps or counterfeit tobacco products.
- **Increase existing fines for cigarette or other tobacco product smuggling.** Increase the minimum dollar amounts of existing fines and have no maximum amount so that meaningful fines can be levied against large economic entities involved in smuggling.
- **Seize vehicles and properties used in cigarette or other tobacco product smuggling.** Establish new provisions to allow for the state's seizure of vehicles used in cigarette smuggling, putting liens on property for the value of smuggled goods, etc. (as with state laws pertaining to illegal drug trafficking).
- **Withdraw right to sell tobacco products from retailers involved in smuggling.** State anti-smuggling laws could ensure that retail outlets in the state that buy smuggled cigarettes or knowingly sell smuggled cigarettes will lose their right to sell any cigarettes in the state for some period of time (e.g., from one to ten years depending on the severity of the violation).
- **Include jail or prison time for guilty large-scale smugglers or repeat offenders.** Going beyond just fines and other economic disincentives, state laws could call for jail or prison sentences for persons participating in large smuggling efforts or who are guilty of repeatedly violating the states anti-smuggling or tax-avoidance laws.



<sup>1</sup> Farrelly, M, et al., *State Cigarette Excise Taxes: Implications for Revenue and Tax Evasion*, Research Triangle International, May 2003, [http://www.rti.org/pubs/8742\\_Excise\\_Taxes\\_FR\\_5-03.pdf](http://www.rti.org/pubs/8742_Excise_Taxes_FR_5-03.pdf). See also, Campaign for Tobacco-Free Kids (TFK), *Raising State Tobacco Taxes Always Increases State Revenues & Always Reduces Tobacco Use*, <http://tobaccofreekids.org/research/factsheets/pdf/0098.pdf>.

<sup>2</sup> Yurekli, A & Zhang, P, "The Impact of Clean Indoor-Air Laws and Cigarette Smuggling on Demand for Cigarettes: An Empirical Model," *Health Economics* 9:159-170, 2000; Farrelly, M, et al., "Cigarette Smuggling Revisited," U.S. Centers for Disease Control & Prevention (CDC), in press. See, also, the references listed in endnote 1.

<sup>3</sup> Halper, E, "States Tobacco Revenue Surges," *Los Angeles Times*, December 27, 2005. TFK factsheet, *The Case for High-Tech Cigarette Tax Stamps*, <http://tobaccofreekids.org/research/factsheets/pdf/0287.pdf>. California Revenue and Taxation Code Section 30162, <http://www.leginfo.ca.gov/cgi-bin/displaycode?section=rtc&group=30001-31000&file=30161-30165.2>. For the underlying legislation, see [http://www.leginfo.ca.gov/pub/01-02/bill/sen/sb\\_1701-1750/sb\\_1701\\_bill\\_20020926\\_chaptered.pdf](http://www.leginfo.ca.gov/pub/01-02/bill/sen/sb_1701-1750/sb_1701_bill_20020926_chaptered.pdf).

<sup>4</sup> See, e.g., Arizona's separate tobacco tax, with tax stamps, on Tribal sales, with the revenues remitted to the Tribes. AZ Revised Statutes, 42-3301 to 42-3307, <http://www.azleg.gov/ArizonaRevisedStatutes.asp?Title=42>.

<sup>5</sup> See above note re: AZ. For examples of State-Tribal tobacco tax compacts, National Congress of American Indians, <http://www.ncai.org/Tax-Agreements.97.0.html>.

<sup>6</sup> For a list of effective federal anti-smuggling provisions, see American Cancer Society, et al., *Proposed Federal Measures to Reduce Cigarette Smuggling and Protect Federal and State Tobacco Tax Revenues*, January 2003, <http://tobaccofreekids.org/research/factsheets/pdf/0226.pdf>. See also, TFK Factsheet, *The Federal Smuggled Tobacco Prevention Act: Promoting Health and Protecting Revenues By Combating Tobacco Smuggling*, <http://www.tobaccofreekids.org/research/factsheets/pdf/0364.pdf>.

<sup>7</sup> See, e.g., U.S. General Accounting Office, *Internet Cigarette Sales: Giving ATF Investigative Authority May Improve Reporting and Enforcement*, August 9, 2002, <http://www.gao.gov/new.items/d02743.pdf>.

<sup>8</sup> New York Public Health Article 13F, Section 1399-II. *Brown & Williamson Tobacco Corp. v. Pataki*, U.S. Court of Appeals for the Second Circuit, Docket Nos. 01-7806, 01-7813, February 13, 2003.

<sup>9</sup> For model legislation, see [http://www.tobaccofreekids.org/facts\\_issues/fact\\_sheets/policies/internet/](http://www.tobaccofreekids.org/facts_issues/fact_sheets/policies/internet/).

<sup>10</sup> For model legislation, see <http://tobaccofreekids.org/research/factsheets/pdf/0230.pdf>.

<sup>11</sup> For more information on blocking Internet deliveries, see the provisions in the above cited model statutes and the TFK Factsheet, *The Critical Importance of a Delivery-List Enforcement Provision in State Internet Tobacco Sales Legislation*, <http://tobaccofreekids.org/research/factsheets/pdf/0259.pdf>. More on how to address Internet tobacco product sale is at [http://www.tobaccofreekids.org/facts\\_issues/fact\\_sheets/policies/internet/](http://www.tobaccofreekids.org/facts_issues/fact_sheets/policies/internet/).

<sup>12</sup> For more information on the PACT Act, see [http://www.tobaccofreekids.org/facts\\_issues/fact\\_sheets/policies/internet/](http://www.tobaccofreekids.org/facts_issues/fact_sheets/policies/internet/).





## THE MICHIGAN STORY

### CIGARETTE TAX INCREASES, NEW REVENUES, AND THE VALUE OF TAX

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When a significant cigarette tax increase is proposed in a state, opponents often bring up a story about how Michigan allegedly had big problems with cigarette smuggling after increasing its cigarette tax by 50 cents in 1994, and how that supposedly means that no other state should ever increase its cigarette tax rate. But they never tell the whole story. In fact, after Michigan raised its cigarette taxes by 50 cents to 75 cents per pack on May 1, 1994, the state's cigarette tax revenues went way up – and the smuggling story is a lot more interesting than the tax-increase opponents let on.

When Michigan raised its cigarette tax in 1994, its new 75 cents per pack rate was the highest state cigarette tax in the country. More importantly, Michigan was also the only high-tax state that did not have a cigarette tax stamp. In other words, no stamp or other indicia was put on the packs once the distributor paid the related cigarette tax to the state – and there were no stamps on the packs sold to consumers in Michigan to show that they were legal packs on which the state cigarette tax had already been paid, as required by law.

Soon afterwards, North Carolina, with a cigarette tax of only five cents per pack, eliminated the tax stamps on packs of cigarettes sold within its boundaries. As a result, it was very easy for smugglers to take low-cost cigarettes purchased in North Carolina, bring them into Michigan for illegal resale, and pocket a profit per pack of up to the difference between the two states' tax rates. There was no way to distinguish the smuggled, contraband cigarettes from legal cigarettes; and otherwise legal retailers in Michigan could easily sell smuggled cigarettes to unsuspecting customers with little risk of being caught by law enforcement officials.<sup>1</sup> The cigarettes could also be taken from North Carolina for illegal resale in Michigan without the smugglers first having either to take any low-tax-state tax stamp off the packs or having to put any new illegal or counterfeit tax stamps on the packs to avoid detection.

Not surprisingly, cigarette smuggling from North Carolina blossomed after the Michigan cigarette tax increase.<sup>2</sup> And some of this smuggling was done by criminal organizations with ties to terrorist organizations.<sup>3</sup> In 1997, South Carolina followed North Carolina's example and eliminated its state tax stamp, prompting additional cigarette smuggling out of that state.<sup>4</sup>

Despite all this new cigarette smuggling from North and South Carolina (and despite the Michigan smoking declines prompted by the cigarette tax) Michigan cigarette tax revenues still went up by more than 112 percent (or by more than \$309 million) after its 1994 cigarette tax increase of 50 cents per pack.<sup>5</sup>

Nevertheless, Michigan still wanted to reduce the cigarette smuggling that was going on, and wanted to minimize any related revenue losses. Accordingly, the state passed a new cigarette tax stamp requirement in 1998 -- which immediately prompted an increase to its annual cigarette tax revenues of more than twenty percent (about \$70 million).<sup>6</sup> It is also worth noting that North Carolina's cigarette pack sales increased significantly after 1994 (when Michigan raised its cigarette tax) but then dropped sharply from 1998 to 1999 (after Michigan instituted its tax stamp), mirroring the pack sales and revenue patterns in Michigan. Similarly, South Carolina's pack sales increased after it eliminated its tax stamp but then dropped after Michigan initiated its tax stamp.<sup>7</sup>

Since instating its tax stamp, Michigan has increased its cigarette tax two more times – to \$1.25 per pack in 2002 and to \$2.00 per pack in 2004 – enjoying substantial increases to its cigarette tax revenues both times. Despite these increases, and despite Michigan and consistently being among the highest cigarette tax states in the country (the national average is now about 85¢/pack) – and despite North and South Carolina still having the same low tax rates and no tax stamps – no large-scale smuggling problem like the one in the mid 1990s has returned to Michigan since it initiated its cigarette tax stamp.<sup>8</sup>



Contrary to what the opponents of state cigarette tax increases say, the bottom line lessons from Michigan are that:

- Tax stamps reduce cigarette smuggling.<sup>1</sup>
- Even when a state's cigarette tax increases prompt high levels of cigarette smuggling (along with significant smoking declines), the cigarette tax increase still produces substantial net increases to state tax revenues.
- Cigarette tax increases are not likely to prompt large amounts of new cigarette smuggling unless:
  - 1) the increase is very large; and
  - 2) the increase makes the state cigarette tax rate one of the highest in the country; and
  - 3) there is a ready supply of low-cost cigarettes to bring into the state; and
  - 4) state does not have a tax stamp.
- North Carolina and South Carolina should start putting tax stamps on cigarettes sold within their borders and stop being suppliers for criminal smuggling organizations.

**Campaign for Tobacco-Free Kids, June 21, 2011 / Ann Boonn**

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<sup>\*</sup> States can take a range of other actions, beyond just having tax stamps, to further reduce cigarette smuggling and tobacco tax evasion (and thereby increase state tobacco tax revenues). See the Campaign factsheet, *State Options to Prevent and Reduce Cigarette Smuggling and to Block Other Tobacco Tax Evasion*, <http://tobaccofreekids.org/research/factsheets/pdf/0274.pdf>.

**More information on state cigarette taxes and the many benefits from increasing them, is available at**  
[http://www.tobaccofreekids.org/what\\_we\\_do/state\\_local/taxes/](http://www.tobaccofreekids.org/what_we_do/state_local/taxes/) and  
[http://www.tobaccofreekids.org/facts\\_issues/fact\\_sheets/policies/tax/us\\_state\\_local/](http://www.tobaccofreekids.org/facts_issues/fact_sheets/policies/tax/us_state_local/).

**For information on steps states can take to prevent and reduce cigarette smuggling and cigarette tax evasion, see the Campaign factsheet at** <http://tobaccofreekids.org/research/factsheets/pdf/0274.pdf>.

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<sup>1</sup> See, e.g., Truby, M, "Michigan battles cigarette smugglers: Big-time criminals haul truckloads of cheap tobacco into state, costing millions in taxes," *The Detroit News*, July 8, 1999.

<sup>2</sup> See, e.g., Williams, B, "Bootleg Cigarettes Heading North," *Raleigh News & Observer*, June 1, 1997. "Cigarette Smugglers Evade Michigan Tax," *Associated Press*, June 2, 1997. Truby, M, *The Detroit News*, July 8, 1999.

<sup>3</sup> See, e.g., Frazier, E & Wright, GL, "Charlotte on legal forefront of terror fight: Smuggling case reflects intrigue of tracking terrorist supporters," *Charlotte Observer*, October 14, 2001. U.S. General Accounting Office, *Terrorist Financing: U.S. Agencies Should Systematically Assess Terrorists' Use of Alternative Financing Mechanisms*, GAO-04-163, November 2003, <http://www.gao.gov/new.items/d04163.pdf>.

<sup>4</sup> See, e.g., Truby, M, *The Detroit News*, July 8, 1999.

<sup>5</sup> Net state cigarette tax revenues were \$275.3 million in fiscal year 1994 and \$584.8 million in fiscal year 1995 – and the cigarette tax increase went into effect on May 1, 1994, two months before the fiscal year changed. Looking just at the twelve months before and after the increase shows an even larger increase in revenues.

<sup>6</sup> See, e.g., Truby, M, *The Detroit News*, July 8, 1999. The state's net cigarette tax revenues increased from \$525.0 million in 1998 to \$597.2 million in 1999, despite significant increases in cigarette prices caused by the major cigarette manufacturers increasing the prices they charge. Without the new state tax stamps, those cigarette company price increases should have reduced state cigarette tax revenues, as they did nationwide in other states.

<sup>7</sup> All state cigarette tax revenue and taxable pack sales data is from Orzechowski & Walker, *The Tax Burden on Tobacco*, 2004 [an annual report of data relating to tobacco taxes subsidized by the major cigarette companies].

<sup>8</sup> North Carolina and South Carolina, with cigarette tax rates of 45 and 57 cents per pack, respectively, have among the lowest state cigarette tax rates in the country. North Dakota, with a cigarette tax of 44 cents per pack, also doesn't have a tax stamp.