Written testimony regarding the impact of increased cigarette taxation on cigarette smuggling
Ohio House of Representatives Finance Committee
March 26, 2015

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Chairman Smith and members of the committee, I thank you for your time and consideration of this testimony regarding the potential for increased tax avoidance and evasion, hereafter collectively referenced as smuggling, in response to the proposed cigarette tax increase in the state of Ohio. The majority of my academic research over the course of my career has concerned the cross-border economic phenomena and the secondary and unintended effects of various excise taxes. Furthermore, over the past eight years, I have specifically examined the extent to which cigarette smuggling results from the imposition of cigarette taxation.

Cigarette smuggling takes on two forms: commercial and casual. Commercial smuggling—arguably the more concerning form of smuggling from a public safety perspective—involves organized criminal distribution networks in which contraband cigarettes are primarily distributed via diversion from bonded warehouses and over-the-road from low-taxing states to high-taxing states. Casual smuggling occurs when the ultimate consumer drives across state, international, or other legal boundaries in an effort to avoid paying the higher prices resulting from higher taxes in the home state. While some cross-border shopping, depending on the quantity carried across the state line, is legal, the impact on state revenues is the same regardless of legality.

My co-author, Michael LaFaive, and I released earlier this year our updated estimates of tax-induced cigarette smuggling for the contiguous states based on data covering 1990 through 2013. North Carolina is excluded from the sample since we model it as the primary source of commercial cigarettes, a common approach in studies of commercial cigarette smuggling. We developed an econometric model of cigarette smuggling, employing data on legal cigarette sales, smoking prevalence, tax rates, population along state borders, presence of Native American reservations, and international borders. Our results indicate that, as a percent of in-state consumption, New York (57.9 percent), Arizona (49.3 percent), Washington (46.4 percent), New Mexico (46.1 percent), and Rhode Island (32.0 percent) are the top five net importers of smuggled cigarettes in 2013. On the other side of the distribution, New Hampshire (28.7 percent), Idaho (24.2 percent), Virginia (22.6 percent), Delaware (22.6 percent), and Wyoming (21.0 percent) are the largest net exporters (other than North Carolina) of smuggled cigarettes as a percent of in-state consumption.

Relative to our estimates from 2012, the most notable change smuggling estimate and ranking is observed in Illinois. Given that our estimation procedure uses tax rates effective as of January 1 of each year, the impacts of the July 1, 2012 state tax increase from $0.98 to $1.98 per pack were not incorporated until the 2013 estimates. Whereas we estimated that only 1 percent of in-state cigarette consumption in 2012 resulted from smuggling, we estimate that the post-tax increase smuggling in 2013 accounted for nearly 21 percent of consumption. As a result, the state went from ranking 30th on the list of the top net importing state for smuggled cigarettes to 14th.

As of 2013, Ohio's cigarette tax rate of $1.25 per pack exceeded the tax of 23 other states in the U.S. and was below the national average of $1.42. Given the relatively moderate tax rate, we estimate net cigarette smuggling as a percentage of consumption to be a modest 7.1 percent, ranking the state as the 27th largest net importer of smuggled cigarettes. At the $1.25 per pack tax rate, we estimate that Ohio is, on net, a source state for cross-border sales: for every 100 packs consumed in the state an additional two packs are purchased by consumers of nearby states, namely Michigan ($2.00 per pack tax) and Pennsylvania ($1.60 per pack tax). Despite serving as a source state for casual, cross-border shopping, Ohio remains a destination state for illicit cigarettes given that over nine percent of consumption is sourced via commercial smugglers who illegally transport large quantities of cigarettes into the state for resale.

If Ohio is to raise the state cigarette tax by $1.00 and to $2.25 per pack, not only would the state tax be higher than cigarette taxes in all but ten other contiguous states, but it would also be higher than the tax rate of all our bordering states. As a result, state-to-state smuggling—both legal and illegal forms—should be expected to rise substantially. We estimate that net tax-induced smuggling of cigarettes into the state would increase from nearly 48 million packs annually to more than 146 million packs. As a percent of consumption, this represents an increase from 7.1 percent to 21.5 percent.

The trafficking of large shipments of illicit cigarettes is estimated to double in size with a $1.00 tax increase. We also estimate that Ohio would switch from serving as a net source state for cross-border shopping to a destination state, with casual smuggling accounting for just over two percent of in-state consumption.

Given the dramatic rise in smuggling, the impact of the one dollar tax increase, an 80 percent increase, on tax revenue for the state, while still positive and substantial, is muted to some extent. We estimate that the 80 percent tax increase would raise revenue by an estimated 52.0 percent, or just over $410 million.

Proponents of cigarette tax increases typically justify such tax increases based on some combination of two primary arguments. First, cigarette taxation is often argued to be a low-cost means to increasing revenue for the government, particularly given the inelastic demand for the product. Second, cigarette taxes discourage the consumption of cigarettes, thereby promoting the health of the citizens in the state, particularly among the young and the less wealthy.

The results of our studies conflict with each these claims. First, given that commercial cigarette smuggling is a crime and has been shown to be closely linked to other major crimes, expenditures on law enforcement must rise to combat the increased criminal activity. Other major costs affiliated with organized commercial smuggling include property damage, bodily injury, and death of innocent citizens. Thus, the costs of raising this revenue should not be viewed as negligible by any means.

Second, while increased cigarette taxes do encourage some people to reduce their consumption of cigarettes, the figures stated by proponents of such tax increases are over-stated as they attribute all of the reduced legal sales to a reduction in consumption, drastically underestimating smuggling if not ignoring it altogether. However, as our results indicate, smuggling is extensive and a large share of the change in legal in-state sales is due to contraband sales, not consumption reductions. Indeed, some of these academic studies suggest that up to 85 percent of the reduction in legal sales in a state following a tax increase is the result of tax avoidance rather than reduced consumption.

Rather than reducing consumption by desired levels, cigarette tax increases do little more than discourage the legal purchase of cigarettes within the state and thus exert little positive influence on health and family welfare. Even worse, the tax increases actually harm the very people they are intended to help by creating an environment in which people spend less time with their families as they travel to bordering states rather than down the street to purchase cigarettes and in which they are expose their families to the dangers associated with illegal markets.

As is the case with many taxes, increases in the cigarette tax cause a wide array of unintended secondary effects which, when properly considered, can be argued to outweigh the benefits from the tax increase. As such, cigarette tax increases should be resisted.

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