

CAMPAIGN For TOBACCO-FREE Kids®

GRAY MARKET CIGARETTES versus BLACK MARKET CIGARETTES

Current federal (and state) efforts to outlaw or restrict the currently legal importation and sale of "gray market" cigarettes will help to protect state tobacco settlement payments and will take some lower-cost cigarettes off the market, which would help to reduce smoking levels. But blocking gray market imports and sales will also provide a substantial financial benefit to the major cigarette companies, and will do little or nothing to reduce the larger problem of illegal smuggling of black market cigarettes, which is a much greater threat to state tobacco revenues.*

Gray Market Cigarettes

Gray market cigarettes are American-made or foreign-made cigarettes – usually major American brands – sold by the manufacturers specifically for sale outside of the United States that are, instead, legally imported into the United States for sale in full compliance with all federal and state tax laws and labeling requirements. Because all applicable taxes are paid, gray market cigarette sales do not reduce federal or state tobacco tax revenues. Foreign-made or exported American-made brands that are imported into the United States without paying all applicable taxes or without complying with all applicable labeling requirements are not gray market cigarettes but illegal black market cigarettes.

Starting in 1998, the cigarette companies have been increasing the prices they charge wholesalers and distributors for American-made cigarettes destined for sale in the United States -- thereby increasing the price difference between the U.S. brands manufactured and sold for domestic sale and those made in the United States for export or made overseas for foreign sale. As this price differential has grown, the number of imported gray market cigarettes has increased, most notably in the second half of 1999.

The Size of the Gray Market Problem. While there have been estimates that gray market sales may have accounted for 16 percent or more of all cigarette sales in some parts of Florida, gray market cigarettes could not, by definition, account for more than about one percent of all cigarette sales nationwide. Even if the entire increase in the number of legally imported packs of cigarettes from 1998 to 1999 consisted of gray market imports, total gray market sales in 1999 would have totaled about 225 million packs -- or roughly one percent of all U.S. legal cigarette sales. But a significant part of the increase in imports came from increased imports of "bidis" (hand-rolled cigarettes from India), and imports of clove cigarettes and foreign brands of regular cigarettes may also have increased -- which suggests that the gray market is no greater than 200 millions packs per year and could be less.¹ On January 1, 2000 new federal restrictions on gray market sales went into effect, and many states have also passed new laws to restrict or ban gray market cigarette sales within their jurisdictions, with a special focus on blocking exported American-made cigarettes from being imported back into the United States.² In early 2000, however, the total number of imported cigarettes has stayed at late 1999 levels or slightly increased.³

* While gray market sales reduce cigarette company profits, black market sales benefit the companies both economically and politically. In fact, the major cigarette companies have supported international cigarette smuggling to penetrate restricted markets, to increase sales, and to combat increases in cigarette taxes and import duties. The companies also frequently use the specter of increased cigarette smuggling and black markets as an effective tool for fighting proposed cigarette tax increases. See the Campaign fact sheet, "The Big Cigarette Companies & Cigarette Smuggling," www.tobaccofreekids.org.

The Gray Market's Impact on State Tobacco Settlement Revenues. Gray market sales can reduce the states' settlement payments from the cigarette companies because those payments are adjusted downward when the volume of the major cigarette companies' domestic shipments of American-made cigarettes for sale in the United State goes down, and gray market sales reduce those domestic shipments (without the benefits from any corresponding drops in cigarette consumption). Following the volume adjustment formula in the settlement agreements, if gray market sales accounted for one percent of all U.S. cigarette sales they would reduce state settlement receipts by a just under one percent.⁴

The Gray Market's Impact on Smoking Levels. Studies show that every 10 percent decrease in average prices increases consumption by about four percent.⁵ Accordingly, if gray market cigarettes are sold at lower prices than regular cigarettes, they can also increase cigarette consumption. While the importers and retailers typically absorb the lion's share of all gray market savings, gray market packs can still sell at discounts as high as 20 percent.⁶ Nevertheless, gray market cigarettes have not been available in sufficient numbers to have any significant effect on the overall average prices or consumption rates in any particular state -- but their effect in small local markets could be more significant.

Stopping the Gray Market Increases the U.S. Cigarette Companies' Revenues. The cigarette companies lose profits for every gray market pack of cigarettes that is sold instead of a regular pack because they charge less for cigarettes sold for export or manufactured overseas than they do for American-made cigarettes intended for domestic sale. At the end of 1999, the average price-per-pack charged by the companies for American-made cigarettes for export was \$1.46 (or more than 75 percent) lower than the price they charged for packs directly sold in the United States.⁷ Foreign manufacturing prices are even lower, and in some cases U.S. brands are manufactured overseas by entirely different companies. RJR's U.S. brands, for example, are manufactured and sold overseas by Japan Tobacco. Accordingly, eliminating gray market re-import sales from would increase the major cigarette companies' profits by at least \$150 to \$300 million per year.

The U.S. Cigarette Companies Created the Gray Market and They Could Stop It. The gray market exists only because of the big difference between the prices the major U.S. cigarette companies charge for the cigarettes they make in the United States for sale in the United states and those they either make overseas or make in the U.S. for export. The companies claim that the recent increases in these price differences were necessary because they have had to raise money to cover their tobacco settlement costs by raising their U.S. cigarette prices. But their domestic-sale price hikes since 1998 have produced roughly two dollars in new revenue for every dollar they have to pay out in settlement costs.⁸ Moreover, the cigarette companies, themselves, could block the importation of their cigarettes sold for export if they simply required buyers to agree not to re-import them for gray market sale and not to sell them to anyone that did not similarly agree. More generally, the cigarette companies could not only stop all gray market sales but also dramatically reduce illegal international cigarette smuggling, as well, if they would more closely monitor and oversee what happens to the cigarettes they make after they sell them to initial buyers.⁹

Black Market Cigarette Sales in the United States

Black market cigarettes are cigarettes that are illegally sold without proper payment of applicable taxes. In the United States, black market cigarettes are either: 1) cigarettes sold for export that are illegally imported back into the United States and sold without full compliance with federal and state tax laws and labeling requirements (or in violation of new state or federal

laws designed to make gray market sales illegal); or 2) cigarettes obtained by paying federal cigarette taxes and a low state cigarette tax rate and then illegally resold in states with high state cigarette taxes without paying the high-tax state's taxes.

The Black Market for Cigarettes is Larger Than the Gray Market. There are no good estimates of the number of cigarettes illegally re-imported into the United States and sold without payment of applicable taxes; but studies have estimated that organized cigarette smuggling in the United States, overall, accounts for roughly three or four percent of all cigarette sales – with informal cross-border purchases by consumers and informal, small-time smugglers accounting for another one percent or so.¹⁰ Some reports (typically by groups opposed to cigarette tax increases or by organizations funded by the cigarette companies) have estimated much higher levels of organized smuggling and cross-border purchases.¹¹ But even the most reasonable, low estimates establish that sales of illegally smuggled black market cigarettes are at least four times larger than gray market cigarette sales.

The U.S. Black Market Reduces State Tobacco Revenues More Than the Gray Market. Accordingly, illegal cigarette smuggling and black market sales certainly reduce overall state tobacco revenues by much more than gray market sales, and especially hurt those states with cigarette tax rates notably higher than North Carolina (five cents per pack) and the other low-tax states that are the major suppliers of smuggled cigarettes within the United States. Currently, 33 states have cigarette tax rates at least 20 cents higher than North Carolina's, and 15 states have cigarette taxes that are at least 50 cents higher.

Using the volume adjustment formula in the state tobacco settlement agreements, if gray market sales account for one percent of all cigarettes consumed in the United States, they would reduce state settlement revenues by slightly less than one percent.¹² This drop would produce a settlement payment reduction of about \$9.2 million in California. But if cigarette smuggling and black markets account for just three percent of all cigarettes consumed in California (which has a per-pack tax of 87 cents), they are reducing that state's tobacco tax revenues by more than \$37 million per year. The parallel figures for Michigan (75 cents) are \$3.2 million in losses from gray market sales and \$17 million from black market sales. In Maryland (66 cents), the amounts are about \$6.8 million for black market lost revenues versus only \$1.7 million in gray market losses.

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¹ U.S. Bureau of Alcohol, Tobacco and Firearms, <http://www.atf.treas.gov>; Tobacco Briefing Room, Economic Research Service, U.S. Department of Agriculture, www.ers.usda.gov/Briefing/tobacco.

² U.S. Bureau of Alcohol, Tobacco and Firearms, Industry Circular, "Importation of Previously Exported Tobacco Products And Cigarette Papers and Tubes" (October 5, 1999); Title 27, *Code of Federal Regulations*, Parts 200, 270, 275, 290; "U.S. States Pass Gray Market Restrictions," (December 1999). For examples of new state laws, see, e.g., Comptroller of the Treasury, State of Maryland, Tobacco Tax Bulletin, "Cigarette 'Primary Source' Legislation (August 23, 1999); State Board of Equalization, California, "New Legislation Affects the Sale of Cigarette Packages labeled for Sale Outside the United States" (October 12, 1999).

³ Economic Research Service, U.S. Department of Agriculture.

⁴ Master Settlement Agreement, www.naag.org.

⁵ For a survey of the research literature, see, e.g., Chaloupka, F. J., "Macro-Social Influences: The Effects of Prices and Tobacco Control Policies on the Demand for Tobacco Products," *Nicotine and Tobacco Research* (forthcoming); or Chaloupka, F. J. & R. Pacula, *An Examination of Gender and Race Differences in Youth Smoking Responsiveness to Price and Tobacco Control Policies*, National Bureau of Economic Research, Working Paper 6541 (April 1998).

⁶ See, e.g., Hwang, S.L., "As Cigarette Prices Soar, Gray Market Booms," *Wall Street Journal* (January 28, 1999).

⁷ Economic Research Service, U.S. Department of Agriculture.

⁸ Campaign for Tobacco-Free Kids Fact Sheet, "U.S. Cigarette Companies Settlement-Related Price Hikes Excessive," www.tobaccofreekids.org.

⁹ See, e.g., Campaign Fact Sheet, "The Big Cigarette Companies & Cigarette Smuggling," www.tobaccofreekids.org.

¹⁰ See, e.g., Thursby, J.G. & M. C. Thursby, "Interstate Cigarette Bootlegging: Extent, Revenue Losses, and Effects of Federal Intervention," unpublished manuscript (January 1998) [earlier version published as National Bureau of Economic Research report; see, also, Thursby, M., et al., "Smuggling, Camouflaging, and Market Structure," *Quarterly Journal of Economics*, 106: 789-814 (August 1991)]; Saba, R. P., et al., "The Demand for Cigarette Smuggling," *Economic Inquiry* 33: 189-202 (April 1995).

¹¹ See, e.g., Fleenor, P., "The Effect of Excise Tax Differentials on the Interstate Smuggling and Cross-Border Sales of Cigarettes in the United States," The Tax Foundation (October 1996).

¹² Master Settlement Agreement, www.naaq.org. State-specific gray market sales levels are irrelevant to the volume adjustment formula; and states suffer no loss of cigarette tax revenues from gray market sales.