



THE MICHIGAN STORY

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

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.¹ 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.² And some of this smuggling was done by criminal organizations with ties to terrorist organizations.³ In 1997, South Carolina followed North Carolina's example and eliminated its state tax stamp, prompting additional cigarette smuggling out of that state.⁴

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.⁵

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).⁶ 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.⁷

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.⁸

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

- Tax stamps reduce cigarette smuggling.*
- 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.

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* 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/ and 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>.

¹ 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.

² 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.

³ 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>.

⁴ See, e.g., Truby, M, *The Detroit News*, July 8, 1999.

⁵ 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.

⁶ 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.

⁷ 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].

⁸ 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.