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CENTER *for* POLICY RESEARCH *of* NEW JERSEY

TESTIMONY FROM
GREGG M. EDWARDS
PRESIDENT

Finance, Revenue, and Bonding Joint Committee
Bill Number 930
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The Center for Policy Research of New Jersey (CPR) is grateful for this opportunity to testify on the legislation that proposes to increase the cigarette tax.

CPR is an independent non-profit organization that addresses the public policy challenges facing New Jersey. My testimony is offered not for the purpose of taking a specific position on the legislation being considered today, but rather to provide you with information on that may be useful in your deliberations.

Specifically, I want to relate to you New Jersey's recent experience with the cigarette tax.

Put succinctly, the lessons from this experience are:

1. **Revenue projections for tax increases typically are overstated;**

2. **It is important to pay close attention to volume sales trends;**

3. **It is possible for a tax rate increase to result in an actual revenue loss and;**

4. **Price increases resulting tax increases can cause serious adverse effects. Lawmakers should consider whether or not these effects negate the benefit a meager revenue increase.**

Between 2002 and 2006, New Jersey increased its cigarette tax rate four times. Twice during that time period, New Jersey's state tax was the nation's highest. It's current rate is $2.575 per pack.

In 2006 - - when the most recent tax increase was being considered by the Legislature - - CPR asserted that the executive branch's projected revenue increase was contradicted by the trend in sales. In fact, the rate at which sales were declining strongly suggested that the tax increase would cause sales to decline to the point that the tax increase would cause revenues to fall. In other words, New Jersey's tax rate was at a "tipping point;" another rate increase would cause enough smokers to buy in less expensive venues so that the value of the rate increase would be negated by the loss of sales.

CPR's prediction was accurate. In fiscal year 2007 - - the year that the last rate increase went into effect - - New Jersey collected $22 million *less* than the previous fiscal year. It became the first state to experience a revenue decline in the same year as a rate increase.

In fiscal year 2008, the revenue loss continued; it fell another $2 million. In all, New Jersey's tax increase cost $24 million in lost revenues.

Some of the sales decline, no doubt, resulted from price-sensitive smokers who were motivated to quit the habit. But the lion's share of the decline was due smokers who responded rationally to the tax increase. They refused to purchase expensive cigarettes when opportunities existed to buy cheaper ones.

This phenomenon is not limited to smokers who venture across the state border or use the Internet to buy cigarettes for their personal consumption. It also includes underground or black market purchases. A study by the Mackinac Center for Public Policy (Midland, Michigan) concluded that in 2006, thirty percent of the cigarettes consumed in New Jersey were smuggled into the State for commercial purposes.

The emergence of a cigarette black market should trouble all of us. Cigarette sales now provide a lucrative and low-risk income source for organized crime and street gangs. They traffic in cigarettes smuggled from low-tax states and also counterfeit cigarettes from foreign sources. Counterfeit cigarettes pose health and safety concerns.

The black market also provides teenagers with access to cigarettes.

In a high-tax state, such as Connecticut, the potential benefit of a cigarette tax increase should be weighed against these realities and adverse consequences:

- **Actual revenue increases often are less than the original projections;**
- **There is the real risk that revenues actually may decline;**
- **In-state brick-and-mortar retailers lose business;**
- **Black market cigarette sales fuel criminal activity;**
- **Law enforcement resources must be devoted to enforcing cigarette tax laws and;**
- **Underage smokers are given greater access to cigarettes.**

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It's time for state to cut cigarette tax rate

By GREGG M. EDWARDS and MICHAEL LAFAIVE

In April 2006, the Philadelphia Inquirer reported that several law enforcement agencies, including the New Jersey State Police, uncovered a 10-person operation that was selling counterfeit cigarettes. Commenting on the trafficking of illegal cigarettes, the state police lieutenant who led the investigation observed that, "If you want to make money, it's even easier than selling drugs."

One month later, the Star-Ledger reported that Newark's Narcotics Enforcement Team arrested two individuals for selling untaxed cigarettes on a street corner.

A month after that, the state Treasurer's office announced the sentencing of an individual who pled guilty to criminal violations of the cigarette tax laws, including selling untaxed cigarettes. He was caught after the local police department received complaints that he was selling cigarettes to high school students.

It's unlikely that New Jersey citizens knowingly would countenance a cigarette tax policy that fuels organized crime, diverts resources away from policing narcotics, and makes cigarettes more accessible to teenagers. But these consequences are precisely the results of that policy.

From 2002-2006, New Jersey lawmakers increased the cigarette tax rate four times. Twice in that period, New Jersey had the highest state tax in the nation. The high tax made cigarettes sold in New Jersey very expensive. So expensive, in fact, that New Jersey became a magnet for smuggled cigarettes. Some smuggling is simply New Jersey smokers buying cheaper cigarettes in cheaper venues. Neighboring Delaware, for example, is a major source of cigarettes for casual smugglers. According to a recent study from the Mackinac Center for Public Policy, for every 100 cigarettes consumed in Delaware, more than 80 additional cigarettes were smuggled out to other states.

Smuggling, however, also occurs for nefarious reasons. Professional and petty criminals take advantage of New Jersey's high demand for less expensive cigarettes by re-selling cigarettes purchased in low-cost jurisdictions or selling counterfeit cigarettes manufactured in China and Russia.

In New Jersey, this commercial smuggling is a common occurrence. The Mackinac Center's study concluded that New Jersey has the highest commercial smuggling import rate in 47 of the 48 contiguous states (because it would distort the results, North Carolina was excluded from the study). In 2006, slightly more than 30 percent of the cigarettes consumed here were smuggled for commercial purposes.

Smuggling is so prevalent that New Jersey was the first state to experience an actual decline in cigarette tax revenues in the same year that the tax rate was increased. In the fiscal year of the most recent tax hike, the tax raised $22 million less than the previous year. In the following fiscal year, revenues declined by another $2 million. The drop in legal sales resulting from that tax increase was so significant that it negated the affect of the tax increase.

While a portion of sales decline was the consequence of smokers kicking the habit, the Mackinac Center's report makes clear that most of the sales decline was attributable to smokers who were purchasing smuggled cigarettes.

So New Jersey's high cigarette excise tax policy has reduced tax revenues, driven consumers away from New Jersey retailers, encouraged the expansion of a cigarette black market, increased criminal activity, compelled local police to enforce tax laws, and made cigarettes more available to teenagers.

There's an obvious remedy to these negative effects. A modest decrease in the cigarette tax rate would stem the demand for cheaper cigarettes. Many New Jersey smokers would return to purchasing cigarettes from New Jersey retailers. Tax revenues would increase. The cigarette black market and the criminal activity associated with it would diminish.

Some people might worry that a lower tax rate would prompt non-smokers to start smoking. That possibility is highly unlikely. There are powerful health arguments against smoking. These arguments are the primary explanation for the national decline in smoking rates. A small price reduction is unlikely to subvert this trend.

It's time to acknowledge that New Jersey's high tax policy is having only negative consequences and some of the consequences actually undermine efforts to discourage smoking. The ideology of anti-smoking zealots must be discarded and replaced by a policy that deals effectively with time-tested economic realities.

Gregg M. Edwards is the president of the Center for Policy Research of New Jersey, an independent non-profit organization that addresses public policy issues affecting New Jersey. Michael LaFaive is the director of the Morey Fiscal Policy Initiative of the Mackinac Center for Public Policy, a research institute located in Midland, Mich.

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CENTER *for* POLICY RESEARCH *of* NEW JERSEY

Dope Smokers

New Jersey citizens have long thought their politicians were smoking something, and now they know for sure. Read on for a lesson in vice, taxes and diminishing returns.

Of cigarettes, taxes, and falling revenue.

Cigarettes have become every pol's favorite tax target, and last year Trenton raised its cigarette tax to $2.575 per pack—the highest state levy in the nation. Governor Jon Corzine forecast that the tax increase of 17.5 cents a pack would fetch $30 million in revenue to help balance the state's $1 billion deficit. Not quite. A new analysis by the Center for Policy Research of New Jersey finds that the state collected $23 million *less* revenue from tobacco taxes in Fiscal 2007 than it did the year before.

Anti-smoking and health advocates say this proves that high taxes on cigarettes reduce smoking. And they're partly right: When you tax something, you get less of it. If only politicians kept that in mind when they were taxing work, investment and saving—as opposed to "sin."

But this isn't the main explanation for the revenue plunge. New Jersey residents are still lighting up; they're simply buying more Camels and Marlboros outside their state. In neighboring Delaware, for example, cigarette sales at convenience stores are up, in part because Garden State residents save about $20 per carton by stocking up when they cross the state line.

Something similar is going on all over the U.S., where cigarette taxes have on average tripled in the last decade, but treasuries aren't getting the revenue boost. For consumers, tax-free online cigarettes are only a mouse click away, and these purchases now cost the states more than $1 billion a year in lost tobacco taxes, according to the Campaign for Tobacco-Free Kids. Washington state, which levies a tax of $2.03 a pack, loses an estimated $200 million a year to out-of-state purchases, according to the Seattle Times. Californians smoke 300 million untaxed packs of cigarettes a year thanks to the Internet, smuggling, and out of state sales.

In New York City, where the combined city and state tax is $3 a pack, smugglers sell bootlegged cigarettes on street corners much like drug dealers. Three weeks ago a sting operation in Queens busted a black market tobacco ring of "unbelievable proportions," in the words of one official. The sting found a half-million untaxed cartons of cigarettes that were being sold out of car trunks to avoid the tax hit. The Tax Foundation estimates that half the cigarettes smoked in the Big Apple come from such illicit operations.

Patrick Fleenor of the Tax Foundation says states that tax cigarettes at more than $2 a pack "are getting close to that tipping point" where they may start to lose money from further tax increases. This is a special problem for those states—such as California, Maryland and Wisconsin—planning to raise cigarette taxes to pay for expanded government health-care coverage. The new spending commitments will be permanent and rapidly expand, while the revenues from tobacco taxes will decline.

State cigarette tax collections may fall by an estimated $1 billion more if Congress goes ahead with its plan to raise the federal cigarette tax to $1 a pack from 39 cents in the name of funding an expansion in health-care spending of $132.6 billion. The Heritage Foundation calculates that, to make those numbers add up, some 22 million Americans would have to *start* smoking over the next decade.

So, light up, friends. You may kill yourself, but your bad habits will let the politicians continue theirs.

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