

SPECIAL REPORT

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How the McCain Bill Will Affect Smokers' Wallets and the Underground Cigarette Market

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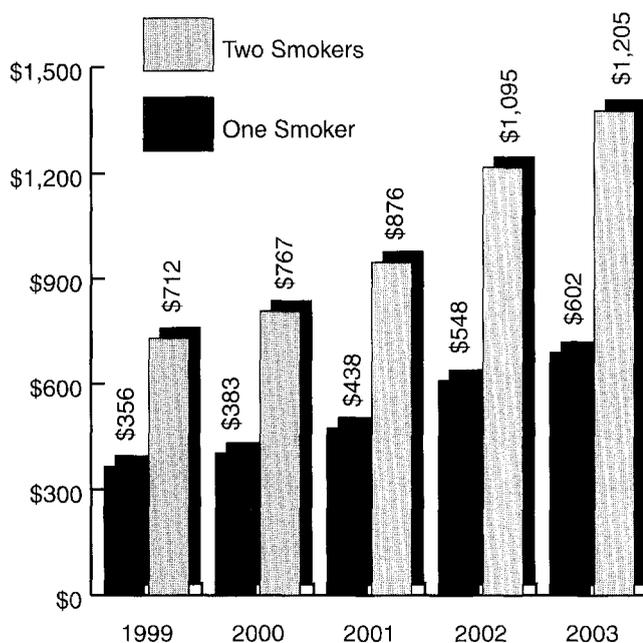
In June 1997 representatives of the tobacco industry reached an agreement with a number of state attorneys general. Under this settlement the industry would pay federal and state governments as well as other entities \$368.5 billion over the next 25 years and would agree to accept a host of new regulations and restrictions on tobacco marketing, advertising, and product access. In exchange, the settlement placed limits on both future litigation against the industry and on the Food and Drug Administration's authority

to regulate tobacco products and smoking.

Any settlement of this type would require federal legislation. As a result the Senate Commerce Committee set about drafting legislation codifying the settlement. On April 29, 1998, the Committee reported out the National Tobacco Policy and Youth Smoking Reduction Act (herein referred to as "the Act"), sponsored by the Committee's Chairman, Sen. John McCain (R-Ariz.). This Act would require that the industry make much larger payments than those called for in the initial settlement. It also sharply curtails or eliminates some provisions viewed as favorable to the industry.

The first half of this report examines the financial impact this legislation is likely to have on smokers. The second half looks at a phenomena that has arisen in other countries when they have raised tobacco taxes by similar magnitudes — a growth of an illegal tobacco market and an increase in cigarette smuggling.

Figure 1
Annual Cost of the McCain Bill for Average One- and Two-Smoker Households under the Baseline Scenario, 1999-2003 (1998 Dollars)



Source: Tax Foundation.

The Legislation

The Act would create a National Tobacco Settlement Trust Fund. Upon passage of the Act the industry would be required to pay this fund \$10.0 billion. Payments would be apportioned by historical market share. Additional payments would be required in subsequent years. These payments would gradually grow from \$14.4 billion in 1999 to approximately \$43.9 billion in 2024.¹ In order to make these payments each pack of cigarettes sold in this country would be assessed a "per pack licensing fee." These excises would gradually rise from 65¢ per pack in 1999 to around \$2.34 per pack in 2024.² These levels were set to meet the Clinton Administration's demand that the price of cigarettes rise by \$1.10 per pack in real terms by 2003.³

The Act also sets reduction targets for under-

age smoking. Under the legislation the level of youth smoking must decline by 15 percent from an estimated base of 4.5 million youth smokers by 2002 and then by an additional 15 percent by 2007. By 2014 youth smoking must decline by another 20 percentage points. By 2024 the Act requires that youth smoking decline by 10 more points.

If youth smoking rates do not decline at these rates, the Act prescribes monetary penalties. If underage smoking rates are between 1 and 5 points above the targets these penalties would total \$80.0 million per point. If underage smoking rates are 6 to 10 points above the targets these penalties would total \$160 million per point. Finally, if underage smoking rates are 10 or more percentage points above the targets the penalties would total \$240 million per point subject to a yearly cap of \$3.5 billion.

While most analysts agree that both licensing fees and any penalties would be passed along to consumers in the form of higher cigarette prices, what is not known is how much cigarette prices may ultimately rise. The cigarette industry is comprised of a few large firms. Oligopolistic market theory suggests that prices could rise by much more than is necessary to make industry payments. When the Federal Trade Commission examined the likely effect of the original settlement — which called for price hikes on the order of 65¢ per pack — it estimated that, based on past experience with federal and state tax increases, the price of cigarettes would rise by \$1.20 per pack within five years.⁴ These results were similar to industry projections which estimated that cigarette prices would rise by at least \$1.20 per pack over five years under the settlement and by at least \$1.50 per pack over 10 years.⁵

Because of the uncertainty concerning both youth smoking and the magnitude of the price rise, the analysis presented here considers three scenarios. In the first scenario, cigarette prices rise and underage smoking declines by the levels specified in the legislation. In this baseline case industry payments total \$527.9 billion (measured in 1998 dollars) over 25 years. In the second scenario the rate of underage smoking declines, but by less than is required by the legislation and half of the maximum penalties are assessed. All other assumptions are identical to those in the first scenario. Industry payments total \$568.2 billion (measured in 1998 dollars) over 25 years in this case. In the third scenario the assumption that cigarette prices will rise to levels that simply reflect industry payments is relaxed and prices are assumed to rise by \$1.85 per pack. All other assumptions are identical to those in the initial case. Under this scenario the cost to consumers would be \$849.8 billion (measured in 1998 dol-

lars) over 25 years.

Table 1 presents a distributional analysis of the proposed legislation for the first five years of the plan under the three scenarios. The table also gives the estimated per pack price increase associated with each scenario. All amounts are given in constant 1998 dollars so that comparisons can be made over time.

Overall, the analysis shows that the costs of the legislation will largely be borne by low-income individuals. Under all of the scenarios more than a third of the legislation's total cost is paid by individuals with adjusted gross incomes (AGIs) of less than \$15,000 per year. More than two-thirds will be paid by those making less than \$35,000. On the other hand, only about 3.7 percent will borne by individuals with AGIs in excess of \$115,000 or more per year.

In the first scenario where cigarette prices rise and levels of underage smoking decline by levels specified in the legislation, industry payments rise from \$14.0 billion in 1999 to \$20.6 billion in 2003. Over five years industry payments total \$94.5 billion in this scenario. Over ten years such payments will total \$197.7 billion. During the 25 year life of the plan industry payments total \$527.9 billion.

The legislation requires that firms raise cigarette prices to reflect industry payments. In this case cigarette prices rise 65¢ per pack in 1999 as a result of the passage of this legislation. Over the next four years the price of cigarettes is projected to gradually rise an additional 45¢, to \$1.10 per pack in 2003. After this date the impact of the legislation on cigarette prices is projected to remain constant in real terms at \$1.10 per pack.

Under the second scenario the rate of underage smoking declines, but by less than is required by the legislation and half of the maximum penalties are assessed. In this case industry payments rise from \$14.0 billion in 1999 to \$22.4 billion in 2003. Over five years industry payments would total \$98.0 billion under this scenario. Over 10 years such payments total \$210.0 billion, and over 25 years industry payments would total \$568.2 billion.

Because underage smoking penalties would not be assessed until 2002, the price increase associated with this scenario is the same as those in the initial case during the first three years of the plan. After this date, it is estimated that cigarette prices would rise by an additional 9¢ per pack as a result of the assessment of the penalties.

The final scenario relaxes the assumption that cigarette prices would rise to levels that simply reflect industry payments. In this scenario cigarette prices are predicted to rise by 65¢ per pack in 1999 and gradually rise over the

subsequent 4 years to \$1.85 in 2003.⁶

In this scenario the total cost to consumers is estimated to be \$122.3 billion over five years. Over ten years the total cost to consumers would be \$295.5 billion. Over 25 years consumers would pay additional \$849.8 billion for cigarettes under this scenario.

Effects on Household Budgets

While tax hikes amounting to cents per pack may not seem like a lot, they can take a sizable bite out of household budgets over the course of the year, particularly for taxpayers with modest incomes. Table II shows the annual cost of the proposed tobacco deal for one- and two-smoker households under the various scenarios.⁷ As before, all monetary figures are given in constant 1998 dollars so that meaningful comparisons can be made over time.

In the first scenario the typical household with a single smoker could expect to pay an additional \$356 for cigarettes next year under this legislation. By 2003 this figure is expected to rise to \$602. Meanwhile, the typical two-smoker household could expect to pay an additional \$712 next year for cigarettes under this baseline scenario. By 2003 this figure is expected to rise to \$1,205.

The effect of the legislation on one- and two-smoker households under the second scenario is identical to that in the first scenario during the first three years of the legislation since youth smoking penalties are not assessed until after 2002. But beginning in 2003, single smoker households can expect to pay approximately \$50 more per year than in the baseline case as a result of the youth smoking penalties in the legislation. The cost to two-smoker households would be twice this amount.

In the final scenario, which assumes that the price of cigarettes will eventually rise by \$1.85 per pack, the effect of the legislation on household budgets rises sharply over time. As in the other scenarios, next year the typical single-smoker household could expect to pay an additional \$356 for cigarettes under this scenario. By 2003 this figure is expected to rise to \$1,011 per year, or approximately 67.9 percent higher than in the baseline case. The additional cost to two-smoker households would grow from \$712 in 1999 to \$2,022 in 2003 under this scenario.

Cigarette Smuggling — The Problem of the Competing Tax Collector

High cigarette excise taxes also create an arbitrage opportunity whereby individuals willing to break the law can purchase cigarettes that

are either not taxed or taxed a very low rate and then resell them in a market where they are subject to heavy taxation. By doing so such individuals are effectively able to act as a competing tax collector and collect a sum up to the amount of the tax on every pack sold. The compact, lightweight nature of cigarettes makes them an ideal product for bootleggers and engaging in this type of activity can be very profitable. As a result, cigarette smuggling has become a serious problem around the World. A study by the World Health Organization estimates that worldwide approximately one-third of all exported cigarettes, or about 6 percent of total production, end up on the black market each year.⁸

Smuggling, of course, is not a new phenomena. For thousands of years smugglers have made their living avoiding taxes and tariffs. In fact, eighteenth century England faced a problem very similar to that faced around the World today. Throughout the eighteenth century, England continually raised its tariff on tobacco. Then, as now, this had the effect of encouraging smuggling. By the early part of the eighteenth century the situation had reached a point where, even though tobacco consumption in England was on the rise, tobacco tariff revenue was falling. Then in 1826, a drafting error inadvertently caused the tobacco tariff rate to be cut by 25 percent. This had the effect of decreasing smuggling to such an extent that revenue from the tobacco tax actually increased.⁹

Astute observers at the time recognized the link between excise taxes and smuggling as well as the possibility that excise taxes could be raised to such levels that they became counterproductive from a revenue standpoint. Adam Smith, the father of modern economics, commented in his book *The Wealth of Nations* that:

The high duties which have been imposed upon the importation of many different sorts of foreign goods, in order to discourage their consumption in Great Britain, have in many cases served only to encourage smuggling; and in all cases have reduced the revenue of the customs below what more moderate duties would have afforded.¹⁰

In America, while discussing methods of financing the operations of the federal government, the founding fathers also recognized the problems associated with high excise taxes. In Federalist No. 31 Alexander Hamilton wrote that “[e]xorbitant duties on imported articles would beget a general spirit of smuggling; which is always prejudicial to the fair trader, and eventually to revenue itself.”¹¹

Today, the modest federal tax of 24¢ per pack and widely varying state and local cigarette

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Table 1
Incidence Analysis of the National Tobacco Policy and Youth Smoking Reduction Act Under the Various Scenarios
(Millions of 1998 Dollars)

	1999	2000	2001	2002	2003	5 Year* Total	10 Year* Total	25 Year* Total
Scenario I								
Total	\$14,048.8	\$14,629.4	\$16,356.3	\$18,877.3	\$20,636.6	\$94,548.4	\$197,731.4	\$527,917.2
<u>Adjusted Gross Income</u>								
under \$15,000	4,774.9	4,972.2	5,559.2	6,416.0	7,013.9	32,135.0	67,204.7	179,427.8
\$15,000 under \$22,500	1,843.1	1,919.3	2,145.9	2,476.6	2,707.4	12,404.4	25,941.5	69,260.5
\$22,500 under \$30,000	1,734.5	1,806.2	2,019.4	2,330.6	2,547.9	11,673.2	24,412.5	65,178.3
\$30,000 under \$35,000	1,197.9	1,247.4	1,394.6	1,609.6	1,759.6	8,061.6	16,859.5	45,012.7
\$35,000 under \$45,000	970.5	1,010.6	1,129.9	1,304.1	1,425.6	6,531.6	13,659.7	36,469.7
\$45,000 under \$60,000	1,235.2	1,286.3	1,438.1	1,659.7	1,814.4	8,312.9	17,385.0	46,415.8
\$60,000 under \$75,000	853.8	889.1	994.0	1,147.2	1,254.1	5,746.0	12,016.7	32,083.0
\$75,000 under \$115,000	919.9	957.9	1,070.9	1,236.0	1,351.2	6,190.6	12,946.6	34,565.9
\$115,000 under \$150,000	260.4	271.1	303.2	349.9	382.5	1,752.4	3,664.8	9,784.5
\$150,000 under \$300,000	183.7	191.3	213.9	246.8	269.9	1,236.3	2,585.6	6,903.2
\$300,000 under \$750,000	56.7	59.0	66.0	76.1	83.2	381.3	797.5	2,129.2
\$750,000 or more	18.3	19.0	21.3	24.6	26.8	123.0	257.2	686.6
Memo: Per Pack Cost of Act	\$0.65	\$0.70	\$0.80	\$1.00	\$1.10			
Scenario II								
Total	\$14,048.8	\$14,629.4	\$16,356.3	\$20,627.3	\$22,386.6	\$98,048.4	\$209,981.4	\$568,167.2
<u>Adjusted Gross Income</u>								
under \$15,000	4,774.9	4,972.2	5,559.2	7,010.8	7,608.7	33,324.5	71,368.2	193,107.9
\$15,000 under \$22,500	1,843.1	1,919.3	2,145.9	2,706.2	2,937.0	12,863.5	27,548.7	74,541.2
\$22,500 under \$30,000	1,734.5	1,806.2	2,019.4	2,546.7	2,763.9	12,105.4	25,924.9	70,147.7
\$30,000 under \$35,000	1,197.9	1,247.4	1,394.6	1,758.8	1,908.8	8,360.1	17,904.0	48,444.6
\$35,000 under \$45,000	970.5	1,010.6	1,129.9	1,425.0	1,546.5	6,773.4	14,506.0	39,250.2
\$45,000 under \$60,000	1,235.2	1,286.3	1,438.1	1,813.6	1,968.3	8,620.7	18,462.1	49,954.7
\$60,000 under \$75,000	853.8	889.1	994.0	1,253.6	1,360.5	5,958.7	12,761.2	34,529.1
\$75,000 under \$115,000	919.9	957.9	1,070.9	1,350.6	1,465.8	6,419.8	13,748.7	37,201.3
\$115,000 under \$150,000	260.4	271.1	303.2	382.3	414.9	1,817.3	3,891.8	10,530.5
\$150,000 under \$300,000	183.7	191.3	213.9	269.7	292.7	1,282.1	2,745.8	7,429.6
\$300,000 under \$750,000	56.7	59.0	66.0	83.2	90.3	395.4	846.9	2,291.5
\$750,000 or more	18.3	19.0	21.3	26.8	29.1	127.5	273.1	739.0
Memo: Per Pack Cost of Act	\$0.65	\$0.70	\$0.80	\$1.09	\$1.19			
Scenario III								
Total	\$14,048.8	\$20,091.7	\$24,651.7	\$28,820.9	\$34,647.0	\$122,260.1	\$295,495.3	\$849,847.6
<u>Adjusted Gross Income</u>								
under \$15,000	4,774.9	6,828.8	8,378.6	9,795.6	11,775.8	41,553.6	100,432.5	288,845.1
\$15,000 under \$22,500	1,843.1	2,636.0	3,234.2	3,781.2	4,545.5	16,040.0	38,767.7	111,496.5
\$22,500 under \$30,000	1,734.5	2,480.6	3,043.6	3,558.3	4,277.6	15,094.6	36,482.7	104,924.8
\$30,000 under \$35,000	1,197.9	1,713.1	2,101.9	2,457.4	2,954.2	10,424.5	25,195.3	72,462.0
\$35,000 under \$45,000	970.5	1,388.0	1,703.0	1,991.0	2,393.5	8,446.0	20,413.5	58,709.3
\$45,000 under \$60,000	1,235.2	1,766.5	2,167.4	2,534.0	3,046.3	10,749.4	25,980.7	74,720.7
\$60,000 under \$75,000	853.8	1,221.0	1,498.2	1,751.5	2,105.6	7,430.1	17,958.1	51,647.7
\$75,000 under \$115,000	919.9	1,315.5	1,614.1	1,887.1	2,268.5	8,005.1	19,347.8	55,644.5
\$115,000 under \$150,000	260.4	372.4	456.9	534.2	642.2	2,266.0	5,476.8	15,751.3
\$150,000 under \$300,000	183.7	262.7	322.4	376.9	453.1	1,598.7	3,864.0	11,112.9
\$300,000 under \$750,000	56.7	81.0	99.4	116.2	139.7	493.1	1,191.8	3,427.6
\$750,000 or more	18.3	26.1	32.1	37.5	45.1	159.0	384.3	1,105.3
Memo: Per Pack Cost of Act	\$0.65	\$0.96	\$1.21	\$1.53	\$1.85			

*Totals include \$10.0 Billion Up Front Payment
Source: Tax Foundation.

*Table 2
Average Annual Cost Per Household of the National Tobacco Policy and Youth Smoking Reduction Act (1998 Dollars)*

	1999	2000	2001	2002	2003
Scenario I					
Single Smoker	\$356	\$383	\$438	\$548	\$602
Two Smokers	712	767	876	1,095	1,205
Scenario II					
Single Smoker	356	383	438	598	653
Two Smokers	712	767	876	1,197	1,307
Scenario III					
Single Smoker	356	526	660	836	1,011
Two Smokers	712	1,053	1,320	1,672	2,022

Source: Tax Foundation.

excises mean that most of the smuggling activity within the United States involves the evasion of state and local taxes. Currently, state cigarette taxes range anywhere from 2.5¢ to \$1.00 per pack with local cigarette taxes adding to this disparity in some jurisdictions. This has created a situation where it is very profitable to purchase large quantities of cigarettes in low-tax states, such as Virginia, Kentucky, and North Carolina, and then resell them in high-tax states, such as New York, Michigan, and Washington.¹²

If the federal cigarette tax were increased by \$1.10 or more per pack it would add a whole new dimension to this problem. In the aftermath of such a tax hike the incentives to evade the federal tax would rise dramatically and it is likely that the country would experience more cigarette smuggling from abroad, increased diversion from tax-exempt stocks, as well as other ancillary problems associated with the illegal cigarette trade. These are the problems which have afflicted other nations — such as Canada as well as those of Europe and Asia — when they have hiked their national cigarette excises.

Canada

During the late 1980s and early 1990s governments in Canada raised their cigarette taxes to the point where cigarettes cost approximately \$4.50 per pack, as compared to between \$1.50 and \$2.00 per pack in the United States. This tax gap created a situation where it was possible to earn as much as \$350,000 on every semi-trailer load of cigarettes smuggled into Canada.

Not surprisingly, the prospect of earning such profits caused cigarette smuggling into Canada to soar. Trucks, vans, cars, boats, and even kayaks and snowmobiles were soon employed smuggling cigarettes across the border. In addition, the country experienced significant

diversion of tax-exempt cigarettes into its ordinary consumer market. By 1994 it was estimated that one third of the cigarettes sold in the province of Ontario and two-thirds of the cigarettes sold in Quebec were contraband.¹³

Lost tax revenue was not the only problem associated with the smuggling. Organized crime soon became involved in the illegal cigarette trade and violence erupted in cities and towns across Canada. Small shops were robbed and burglarized because they suddenly held a very valuable commodity — cigarettes. In addition, there was widespread flouting of the law by ordinary Canadian citizens who sometimes lined up for blocks in the presence of police to knowingly buy contraband cigarettes.

The rise of the illegal cigarette market and the problems associated with it caused considerable concern at the highest levels of Canadian government. Prime Minister Jean Chretien stated that “[s]muggling is threatening the safety of our communities and the livelihood of law-abiding merchants.” He went on to state that “[cigarette smuggling] is a threat to the very fabric of Canadian society.”¹⁴ Solicitor General Herb Gray added that:

Organized crime has become a major player in the contraband cigarette market. What we are seeing is a frightening growth in criminal activity. We are seeing a breakdown in respect for Canadian law. Canadian society is the victim.¹⁵

After trying various methods of combating this problem, the Canadian government sharply cut its cigarette taxes in February 1994 and encouraged the provinces to follow suit. These measures significantly reduced smuggling and attendant problems in the Canada.

Europe

Europe currently has a thriving black market in cigarettes driven by very high cigarette excises which typically account for 70 percent or more of the price of cigarettes. A report published by the European Parliament estimates that approximately 10 percent of the cigarette market on the continent is contraband.¹⁶ Others argue that this figure is much higher, with up to 50 percent of the market in some countries being contraband.¹⁷ The Tobacco Manufacturers Association in the United Kingdom estimates that at least one million consumers purchase black market tobacco products at a cost to the British government of \$1.7 billion annually.¹⁸

Like Canada, Europe has also experienced many of the ancillary problems associated with illegal markets. Germany has experienced a rash of cigarette-related murders and disappearances over the past several years. "We have never seen anything as brutal as this" says Detlef Schade, a police detective in Berlin, who notes that "People are being executed in cold blood in their apartments and in broad daylight on the streets, on subway platforms, in front of hundreds of witnesses." According to news reports, the illegal cigarette trade has made the streets of Germany's capital more dangerous than at any time since World War II.¹⁹

Asia

In Asia, rising affluence and changing tastes have increased the demand for American and

European cigarettes. In this, the world's largest market for cigarettes, the illegal cigarette trade has been driven by two factors. In some countries, most notably China, state monopolies still control much of the tobacco market. In these countries, where legal sales of Western brands is relatively small and heavily taxed or sometimes nonexistent, the demand has been filled by smuggled smokes. China, for example, estimates that 99 percent of the foreign cigarettes sold in the country are the product of smuggling.²⁰ Such smuggling is estimated to cost the government more than \$1.8 billion in lost revenue annually.²¹ In other countries in the region the illegal cigarette trade is driven by high cigarette excise taxes, the same factor that drives smuggling in North America and Europe.

The region has also been visited by some of the attendant problems associated with the illegal cigarette trade. Several years ago, for example, the badly beaten body of a man was fished out of a Singapore harbor after he threatened to expose a major smuggling operation. In a message to other potential informants his mouth had been taped shut and a padlocked chain was wrapped around his neck.²² Since 1994 the Hong Kong Customs and Excise Department has had to deploy a special "Anti-Cigarette-Smuggling Task Force" to combat cigarette smuggling in the territory.²³ In China, gangs are estimated to have paid millions of dollars in bribes to Chinese officials who assist them in their bootlegging operations.²⁴

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Endnotes

¹ Measured in nominal dollars. Smoking levels assumed to remain constant at current levels.

² Measured in nominal dollars.

³ Measured in 1998 dollars.

⁴ See Federal Trade Commission, Competition and the Financial Impact of the Proposed Tobacco Industry Settlement.

⁵ See Lorillard Tobacco Company, Phillip Morris Companies, Inc., R.J. Reynolds Tobacco Company, and UST, Inc., Impact of the Proposed Resolution of the U.S. Cigarette Industry, (October 1997).

⁶ Such a price rise is similar in magnitude to that predicted by both the Federal Trade Commission and the industry when they examined the effect that the initial settlement would have on price.

⁷ The analysis assumes that consumers smoke 1.5 packs per day.

⁸ See Anthony Flint, "Cigarette Firms Condemn Smuggling and Gain from It," *Boston Globe*, June 10, 1996.

⁹ See Bruce Bartlett, Cigarette Taxes, Smuggling, and Revenues, (Arlington, VA: Alexis de Tocqueville Institution, 1994), p. 2.

¹⁰ Adam Smith, *The Wealth of Nations*, (New York: Modern Library, 1937), p. 832.

¹¹ Alexander Hamilton, "The Federalist No. 35," in Alexander Hamilton, James Madison, and John Jay, *The Federalist Papers*, (New York: Bantam Books), p. 164.

¹² Patrick Fleenor, *The Effect of Excise Tax Differentials on the Interstate Smuggling and Cross-border Sales of Cigarettes in the United States*, (Washington, DC: Tax Foundation, 1996).

¹³ Jacob Sullum, *For Your Own Good*, (New York: The Free Press, 1998), p. 136.

¹⁴ Sullum, p. 137.

¹⁵ Sullum, p. 137.

¹⁶ *Committee of Inquiry Into the Community Transit System*, European Parliament, February 19, 1997.

¹⁷ Bruce Bartlett, "Hiking Cigarette Taxes Is Good for (Illegal) Business," *Wall Street Journal*, May 12, 1998, p. A22.

¹⁸ Tobacco Manufacturers Association, "Further Surge in Smuggling Expected Following Cigarette Tax Increase," Press Release, March 17, 1998.

¹⁹ For a discussion of European cigarette smuggling see: Bruce Bartlett, "When the Clouds of Smoke Settle," *Washington Times*, August 28, 1997; Paul Geitner, "Smuggling Hard to Snuff Out," *USA Today*, June 13, 1996; Erik Kirschbaum, "Vietnamese Crime Syndicates Smoke with German Smuggling," *Washington Times*, February 3, 1996.

²⁰ See Bartlett (1998).

²¹ Antonio Tambunan, "China: Tax Cuts to Curb Cigarette Smuggling," *Pacific Rim Review*, May 11, 1997.

²² See Flint.

²³ Hong Kong Customs and Revenue Department internet Web site.

²⁴ See Bartlett (1998).