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Border Zone Cigarette Taxation: Arkansas's Novel Solution to the Border Shopping Problem

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On February 12, the Arkansas General Assembly passed legislation to increase the state's excise rates on all tobacco products. As required by the bill, on March 1 the cigarette tax went from 59 cents to $1.15 per twenty-pack.[1] But the same tax rate will not be enforced statewide. In a novel provision, the legislation, Act 180 of 2009, included a lower, variable rate for certain towns and stores located near the Arkansas border.

A First in Cigarette Excise Taxation
The new law states that whenever there are two adjoining towns separated by the state line, the cigarette tax in the Arkansas town is required to be equal to the cigarette tax in the adjoining town outside of Arkansas plus 3 cents, as long as the resulting tax rate is not greater than Arkansas's standard tax rate. According to the law, both towns must have a population of 5,000 or more for the town on the Arkansas side to qualify for the reduced tax rate. Similarly, the law provides that the excise tax on cigarettes sold in Arkansas within 300 feet of the state line, regardless of the area's population, be taxed at the bordering state's rate plus 3 cents if the resulting rate is lower than Arkansas's standard rate.[2]

Arkansas legislators are shrewdly acknowledging that cross-border shopping for low-tax cigarettes is a major problem for tax enforcement. To retain tax revenue and stop tax evasion, Arkansas has established a low-tax zone on its own side of the border. If this policy is successful in Arkansas other state legislatures may follow suit. To understand the rationale for this policy, the first of its kind among states, it is necessary to understand the problems that sometimes accompany cigarette taxation.

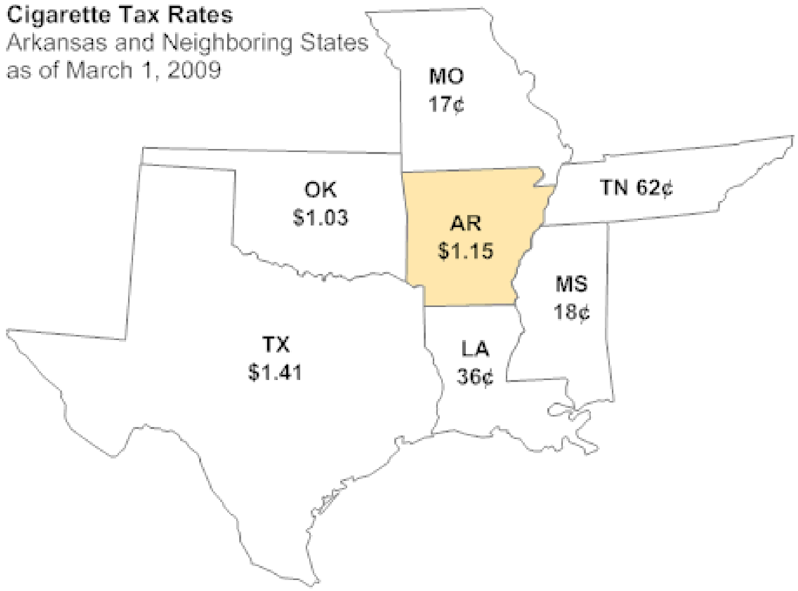
Issues in Cigarette Excise Taxation

In addition to the federal excise tax rate of $1.01 per pack of twenty, every state levies its own cigarette tax. The rates vary widely, from $3.46 per pack in Rhode Island to $0.07 in South Carolina.[3] In addition, states may permit localities to levy an additional excise tax. The combination of federal, state and local cigarette excise taxes can add up to a significant total tax rate. The average U.S. smoker is now paying about $1,000 a year in tobacco taxes; and in New York City where cigarette taxes add up to $5.26 per pack, an average smoker is paying tobacco taxes of about $2,000 per year. On top of excise taxes, tobacco companies are required by the 1998 tobacco Master Settlement Agreement to increase the wholesale price of their cigarettes, using the proceeds to make annual payments to reimburse state governments for the harm caused by cigarette smoking in the past. The price increases vary from state to state but average about $0.50 per pack nationwide.

It is well documented that various tax evasion techniques are often associated with high excise taxes on cigarettes.[4] As cigarette taxes have increased around the country, smuggling cigarettes from low-tax to high-tax states has become an extremely profitable criminal activity. Internet sales are another source of excise tax evasion. When cigarettes are purchased tax-free on the internet the buyer is legally obligated to pay any applicable state and federal excise taxes, but in practice this can prove difficult to enforce, especially when the sellers are located overseas. Similarly, Native American Reservations are allowed to sell cigarettes to Native Americans without charging the state excise tax rate, but in practice the cheaper cigarettes are often sold to non-Native Americans. The same is true for military bases, where cigarettes are sold tax-free but often end up in the civilian market.[5] All these illegal activities can be very difficult to prevent and consequently are a significant source of cigarette excise tax evasion. Economists recognize that this is one reason that actual revenues received from cigarette tax increases often fall short of projections.[6]

Another concern when states raise cigarette taxes is that high cigarette taxes tend to induce border shopping.[7] Border shopping is another form of tax evasion and occurs when the residents of a state cross state lines to purchase cigarettes in a lower-tax state. Obviously the closer an individual lives to the border of a lower-tax jurisdiction the more economically feasible border shopping becomes. As when making online purchases, when the buyer crosses back into his or her own state there is a legal obligation to pay the higher excise tax in the home state. But again, this can be difficult and costly to enforce. While the buyer saves an amount per pack equal to the tax differential between the two jurisdictions, the home state misses out completely on any revenue it could have raised from the purchase.

Arkansas's new policy of reducing excise tax rates in border towns is probably designed to mitigate the revenue loss the state could experience from border shopping. Before the passage of Act 180 the state's rate was $0.59 per pack and it had three neighbors with lower rates: Louisiana ($0.36), Mississippi ($0.18) and Missouri ($0.17). With the increase to $1.15 Arkansas has surpassed Tennessee ($0.62) and Oklahoma ($1.03), leaving it with only one neighbor with a higher excise tax on cigarettes: Texas ($1.41). Five of the six neighboring states now have a lower cigarette tax, with Missouri's and Mississippi's taxes each being nearly a dollar less per pack than Arkansas's.



Lawmakers often ignore the realities of border shopping induced by high excise taxes, so it is significant that the Arkansas legislature is explicitly recognizing the problem of border shopping and is attempting to address it by eliminating the incentive to shop in these lower-tax states.

Effects of the New Policy

It is important to note that this policy effectively shrinks the "tax border" of Arkansas. While there is still a minimum rate differential of three cents between Arkansas and any low-tax neighbor, this amount is small enough to provide almost no incentive for Arkansas residents to buy in other states. A significant tax differential does still exist however. The differential is now between different jurisdictions within the borders of Arkansas rather than between Arkansas and other states. Consumers in a reduced-tax border zone will simply purchase within their home market. Consumers in an interior area subject to the standard tax rate, now $1.15, will have an incentive to shop in the border areas, an activity which is legal under the new border zone structure as long as the cigarettes are purchased for personal consumption. Either way, moving the tax differential within the state will eliminate most of the incentive for Arkansas residents to shop for cigarettes out-of-state since they can pay virtually the same price in-state.

This new tax structure will probably result in a net revenue gain for Arkansas. Instead of giving up all of the revenue that would normally be lost in border shopping, they are now giving up only the revenue represented by the tax differential.

Take for example, an Arkansas smoker living in a qualifying city that borders Louisiana. In the absence of the new border zone tax policy, the resident of Arkansas, which has a standard tax of $1.15 per pack, would have an incentive to travel to Louisiana, which has a tax of $0.36 per pack, to purchase cigarettes. In that case the revenue loss for the Arkansas government would be $1.15 since the purchase is made outside of its borders and it collects no tax on the purchase. However, under Arkansas's new policy there is little tax advantage in traveling to Louisiana to purchase cigarettes, all other things being held equal. In this case the buyer pays the reduced $0.39 excise tax (Louisiana's rate plus 3 cents) to Arkansas. Although Arkansas is not collecting the whole $1.15 required of normal cigarette purchases, it does collect significant revenue. Ideally the state would like to collect $1.15, but at that rate the buyer will border shop and the state will end up collecting nothing. To avoid this, the state sacrifices the 76-cent differential between its regular rate and the reduced border zone rate in order to make the sale in state, keeping its citizens legal and collecting some revenue.

In a sense border shopping will still occur, but to a large degree it will be contained within Arkansas since the tax differential is now contained within Arkansas. People who live close to qualifying reduced-tax jurisdictions within their state will now travel to those lower-tax areas to purchase cigarettes instead of traveling to a neighboring state. It is important to note that if other states were to adopt similar policies, the result would not be a net revenue increase in every case. The reduced tax in border zones could result in a net gain or a net loss, depending on the tax differential and the fraction of buyers that buy cigarettes out-of-state.

For example, a relatively low tax differential may not induce a large amount of border shopping, in which case reducing the tax would result in lower tax revenue per pack without much gain in the form of reduced border shopping. In such a case the state could see a net revenue loss from the policy. However, given that the tax differential between Arkansas and some of its neighbors approaches one dollar per pack, it seems likely that the result would be a net revenue increase. The revenue records over time will not yield a definitive conclusion, however, because this law takes effect at the same time as the state is nearly doubling its main tax rate.

Effects on Neighboring States

Since the reduced-tax zones will shift purchases from neighboring states back to Arkansas, the policy will serve to reduce neighboring states' revenues while it increases Arkansas's. It is unknown how neighboring states will react to Arkansas's policy change. The revenue loss might not be significant enough for them to take any action. In fact, it is difficult to imagine any policy that neighboring states could implement that would result in a large resurgence of border shopping. Any reduction in excise taxes would automatically be matched (plus 3 cents) in Arkansas's border jurisdictions. Moreover, adopting a similar border zone policy in response to Arkansas's policy would not induce Arkansas smokers to border shop since the tax rates in the two states are already so close to equal. If neighboring states wanted to recover the revenue loss that Arkansas shoppers had been providing, they might think to increase their statewide cigarette tax slightly, depending on the rates in other neighboring states.

Since the new border zone tax equalization policy is likely to be successful at reducing border shopping and boosting revenue in Arkansas, other states may start to enact similar policies. With state tax receipts suffering in the current economic climate, many states are looking for creative ways to raise revenue. Although Arkansas's border zone policy was enacted in conjunction with a tax increase, similar legislation could be enacted as a stand-alone revenue raiser by state legislatures reluctant to raise taxes in the current economic climate.

Potential Drawbacks

There could be some drawbacks to the border tax equalization policy. First, while the policy makes sense from a revenue-maximizing perspective, it is questionable whether it is fair to tax the same purchases differently based solely on where the purchases are made. For instance, one could raise the objection that if the purpose of the excise tax is to offset some externality from smoking, and assuming the rate is set at the optimal level to achieve this goal, then reducing the tax would be harmful to the smoker and others. That is, smoking near the border is no less damaging than smoking in the middle of the state, so why should Arkansas tax the two activities differently?

Another concern is that this policy effectively allows neighboring states to set Arkansas's excise tax rate in the border zones. If the neighbor raises its tax, the tax in Arkansas's border zones will increase, up to a maximum of Arkansas's regular rate. Likewise, if the neighbor decreases its tax the same will be true in Arkansas's border zones. The result is that Arkansas's border zone rate can be raised or lowered based on the actions of other states' legislatures and without any action from Arkansas's legislature, which may not be desirable for citizens or lawmakers in Arkansas.

There are also administrative challenges that will accompany this policy. First, Arkansas now has six cigarette excise tax rates to administer instead of just one. This added complexity makes administering and complying with the tax more burdensome for tax officials and retailers.

In addition, cigarette smuggling is still a concern. Cigarette smugglers make a profit by buying cigarettes in lower-tax jurisdictions, reselling them in higher-tax jurisdictions, and pocketing the difference. Ordinarily, one would expect that by raising the tax rate from $0.59 to $1.15, the second-highest rate in the region, Arkansas legislators would have made the state more appealing as a destination for smugglers. But the border zone policy might well counteract that effect and even reduce interstate smuggling.

At the same time, the new multi-zone rate structure will probably induce smuggling activity within the borders of Arkansas, an activity which is explicitly prohibited as part of the new border zone policy. While the new law allows residents of higher-tax jurisdictions to freely shop for personal consumption in lower-tax jurisdictions in state, wholesalers, retailers and individuals are prohibited from buying cigarettes in lower-tax jurisdictions and reselling them in higher-tax jurisdictions without paying the tax in the higher-tax jurisdiction.[8] Though smuggling between the different tax jurisdictions within the state is illegal, it remains to be seen if it will become a significant problem in the same way that interstate smuggling has been in the past.

Other Similar Policies in Arkansas

Arkansas has actually implemented similar policies in the past with regard to other state taxes. For instance, Arkansas allows the citizens of certain cities or towns that are split by a state border to vote to replace their income tax with a 1% sales tax if the bordering state does not levy a state income tax.[9] There is also a border equalization law for the state's motor fuels tax that keeps the tax rate in qualified border areas from being more than 1 cent greater than the neighboring jurisdiction.[10] These policies, along with the new cigarette tax policy outlined above, are unique to Arkansas and represent an acknowledgement of the fact that tax competition and tax evasion are real and are significant concerns for lawmakers when they are creating tax policy.

Conclusion

Arkansas's border zone tax policy is a first in the world of cigarette excise taxation. This choice of policy is an acknowledgement of what many policy experts have been pointing out for a long time, that cigarette excise taxes are very susceptible to evasion through border shopping and other means, and that as tax differentials increase, these illegal activities become an increasing problem. Arkansas's policy may be successful enough that other states will consider similar policies in the future. While the policy will likely reduce border shopping and increase revenue to some degree, there are pros and cons that need to be weighed when states are considering whether to implement such a policy. The Arkansas experience will be instructive.

1. Arkansas State Legislature, Act 180, February 17, 2009. http://www.arkleg.state.ar.us/assembly/2009/R/Acts/Act180.pdf, accessed 4/02/2009.

2. *Ibid.*

3. "State Sales, Gasoline, Cigarette, and Alcohol Tax Rates by State, 2000-2009," Tax Foundation, January 28, 2009. http://taxfoundation.org/taxdata/show/245.html, accessed 4/02/2009.

4. Fleenor, Patrick. "Cigarette Taxes, Black Markets, and Crime: Lessons from New York's 50-Year Losing Battle," *Cato Institute Policy Analysis*, No. 468, February 6, 2003. http://www.cato.org/pubs/pas/pa468.pdf, accessed 4/02/2009.

5. Wagner, Richard E. "State Excise Taxation: Horse-and-Buggy Taxes In an Electronic Age," *Tax Foundation Background Paper*, No. 48, May 2005. http://www.taxfoundation.org/files/72c2d12f36538b66b90f75f8f17052c7.pdf, accessed 4/02/2009.

6. *Ibid.*

7. Fleenor, Patrick. "How Excise Tax Differentials Affect Interstate Smuggling and Cross-Border Sales of Cigarettes in the United States," *Tax Foundation Background Paper*, No. 26, October 1998. http://www.taxfoundation.org/files/4cd5774343c1f82447a1381a01c62980.pdf, accessed 4/02/2009.

8. Arkansas State Legislature, Act 180, February 17, 2009. http://www.arkleg.state.ar.us/assembly/2009/R/Acts/Act180.pdf, accessed 4/02/2009.

9. Arkansas Code §26-52-601 through §26-52-607. http://www.arkleg.state.ar.us/SearchCenter/Pages/ArkansasCodeSearchResultPage.aspx, accessed 4/02/2009.

10. Arkansas Code §26-55-210. http://www.arkleg.state.ar.us/SearchCenter/Pages/ArkansasCodeSearchResultPage.aspx, accessed 4/02/2009.

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