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California Schemin': Cigarette Tax Evasion and Crime In the Golden State

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Earlier this year federal agents closed down a ring that allegedly smuggled millions of packs of cigarettes from North Carolina to California, affixed counterfeit stamps to them, and sold them to the general public. This illicit enterprise reportedly cost the state government some $4.3 million in lost revenue.[1]

On the morning of December 15, 2002, a band of robbers burst into a Merced distribution center and rounded its employees up at gunpoint. After tying up the workers the thieves used forklifts to load pallets of cigarettes into a truck. The robbers then grabbed rolls of California cigarette tax stamps and fled. Police estimated that the group made off with more than $1 million in loot.[2]

The 2002 heist was not the first time that the distribution center or its employees has been victimized. Two years earlier one of its trucks was hijacked by two men. Its driver was forced into a nearby orchard where he was bound and gagged. The bandits then made off with $40,000 worth of cigarettes. The thieves were later apprehended by police.[3]

Introduction

These are just a few examples from the wave of tobacco-related crime that has swept California during the last eight or so years. At first glance these crimes appear bizarre. After all, each describes serious criminal activity involving a product not much different from the others that fill the shelves of convenience stores and gas stations. There is one major difference, however, and that is taxes.

What Proposition 86 says is that the state tax on cigarettes will rise by $2.60, from 87 cents to $3.47 per pack. What it should also say is that as the tax quadruples, so will the black market, bringing a wave of tax avoidance, smuggling and violent crime.

Since 1998 tax hikes have helped raise the price of cigarettes in California to approximately $4.00 per pack, well above the price in other states or elsewhere in the world (see Figure 1). The first two tax hikes occurred in November of 1998 when voters narrowly approved Proposition 10 and California joined

1 For information on this case see Sarah Ovaska, "Raleigh Cigarette Reseller Targeted," *The News and Observer*, February 15, 2006, and "Man Accused of Cigarette Scheme," Associated Press, February 16, 2002.

2 Mike De La Cruz, "Armed Gunmen Steal Pallets of Cigarettes," *Merced Sun-Star*, December 17, 2002.

3 Ibid.

45 other states in the Master Settlement Agreement (MSA) with the four largest tobacco manufacturers.

Proposition 10 raised the state's cigarette tax from 37 to 87 cents per pack,[4] and the MSA raised nationwide taxes on cigarettes by nearly $250 billion over the next 25 years.[5] Two smaller tax hikes soon arrived from Washington, as the federal government raised its tax from 24 to 34 cents per pack in January 2000 and then to 39 cents at the beginning of 2003.[6]

On November 7 voters in California will decide whether to raise the state tax on cigarettes even higher, by an amount much larger than any state has ever considered. Proposition 86 would increase the state cigarette excise by $2.60, from its current rate of 87 cents to $3.47 per pack. Approval would give California the highest cigarette tax in the nation and push the price of a typical pack of cigarettes to around $6.50.

Tax-Induced Crime

Why have high cigarette taxes in California led to crime in the past, and why would a much higher tax lead inevitably to even higher crime rates in the future? The reason is quite simple: cigarette taxes create a disparity between the cost of bringing a pack of cigarettes to market and the price at which it is legally sold. When this gap is small, as used to be the case in California, the incentives to evade the tax are also small. However, when the tax rises, the incentives to evade the tax can overwhelm tax enforcement. California's cigarette taxes are already almost as high as the cost of the product itself.

Figure 1
California Cigarette Tax Rate History

	Cents Per Pack Tax
July 1, 1959 – July 31, 1967	3
August 1, 1967 – September 30, 1967	7
October 1, 1967 – December 31, 1988	10
January 1, 1989 – December 31, 1993	35
January 1, 1994 – December 31, 1998	37
January 1, 1999 – Present	87

Source: Orzechowski & Walker

Three types of tax-induced crime flow from this situation. The first is called cross-border shopping, which some smokers probably consider to be normal bargain hunting. Smokers seek out sources of low-tax cigarettes instead of the legal, highly taxed cigarettes available at the corner store. When high cigarette taxes were first enacted, massive purchases at military bases were most common. Later on, Indian reservations joined in, and for the last decade, the internet has made low-tax or tax-free cigarettes available to virtually any Californian.

Armed robbery, kidnapping, and even murder have been committed because of the cigarette smuggling trade, all because of a hard-to-enforce tax that dangles easy money in front of the criminal element.

The second type of crime we see is smuggling. Smuggling is best known to the public as a crime associated with illegal drugs and immigrants, but cigarettes have entered the black market in a big way. The discrepancy in price between low- and high-tax states now creates a huge profit opportunity for people willing to break federal and state laws against transporting cigarettes across borders.

The third type of crime is what we call "ancillary crime" in this paper. That is, smuggling for profit is dangerous to everyone involved: the smugglers, the police who try to stop them, and the honest citizens who work in convenience stores or anywhere along the cigarette distribution chain. Armed robbery, kidnapping, and even murder have been committed because of the cigarette smuggling trade, all because of a hard-to-enforce tax that dangles easy money in front of the criminal element.

As California voters contemplate enactment through Proposition 86 of the nation's highest cigarette tax, they must also consider

4 "Prop. 10: Cigarette Tax Initiative Squeaks Through in California," Reuters, November 4, 1998.

5 Milo Geyelin, "Forty-Six States Agree to Accept $206 Billion Tobacco Settlement,"*Wall Street Journal*, November 23, 1998.

6 *The Tax Burden on Tobacco*, Volume 40, 2004, (Arlington, VA: Orzechowski & Walker, 2004), p. 249.

the inevitable surge in criminal activity that the new tax would bring. California smokers will have much greater reason to border-shop; smugglers will see California as indeed the "Golden State" where the highest per-pack profits can be earned; and those smugglers will bring with them an ancillary crime wave that will affect smokers and non-smokers alike.

Border-Shopping

Among these crimes, the oldest and most widespread is cross-border shopping. This can occur without the customer leaving home by purchasing products from mail-order and internet retailers, or it can involve travel. While such activity is often thought of as simply a form of bargain shopping, both California and federal law strictly regulate the cigarette market, making it criminal tax evasion to avoid taxes due.

California requires that general sales taxes (or use taxes) as well as the cigarette excise be paid on all cigarettes shipped in from out-of-state merchants.[7] If the vendor does not pay these levies, the consumer becomes liable for them. Individuals physically transporting more than 400 cigarettes (2 cartons or 20 packs) into the state are also liable for payment of state excise and sales taxes. The state's Board of Equalization excise tax division administers the cigarette tax.

The federal government helps states collect cigarette excises by way of the Jenkins Act. This law requires that merchants who sell cigarettes across state lines to consumers provide tax authorities in the destination state with the names and addresses of the recipients as well as the type and quantities of cigarettes shipped.[8]

Border-shopping has a long history in California. While the state's traditionally low cigarette taxes coupled with the distance of the state's population centers from its borders have helped to mitigate the problem of interstate border-shopping, smokers in the Golden State seem to be on constant lookout for a bargain and have historically leapt at just about any opportunity to buy cheap cigarettes – whether on military bases, Indian reservations or over the internet – even if it means skirting the law.

Military Sales

Cigarettes sold on military bases are exempt from state and local taxes.[9] In the early 1960s, when enactment of the state's modest tax of 3 cents per pack (20 cents in today's dollars) sent the first wave of price-conscious consumers to post exchanges and commissaries, the impact on state revenue was fairly small. Taxed sales of cigarettes in the state remained strong, exceeding the national average by around 4 percent until the fall of 1967. [10]

In that year California more than tripled its tax to 10 cents per pack, and tax-free sales at military bases took off. The prospect of saving

Tax-Induced Assault on the Legitimate Industry

Most of the problems that California experienced during the 1960s and 1970s with cigarette tax evasion involved border-shopping by consumers. These were far from the only crimes the state experienced, however.[1] By raising the prices of cigarettes, the tax hikes also encouraged thefts from all along the legitimate cigarette distribution chain.

One tragic case involved Phillip Bacca who worked for a cigarette distribution company. He was making deliveries in the Hastings Ranch area of Pasadena on Friday, October 26, 1973, when he was accosted at gunpoint by three men.[2] They forced him into their van and then loaded it with cases of cigarettes. After driving both vehicles to a nearby shopping center parking lot, they ordered Bacca into the cargo area of his truck. There they shot him in the back of the head execution style and left him for dead.

Incredibly, the bullet splintered upon impact and failed to penetrate his skull. After his attackers left, Bacca pried open the cargo door slightly and dangled his arm outside. Mall employees noticed and called police.

The assault on Bacca was just one of many tax-induced crimes perpetrated on people in California's legitimate cigarette industry since the inception of the tax.

1 Harry L. Say, "Cigarette Tax Administration and the General Business Taxes Enforcement Program," in Proceedings of the 34th Annual Meetings of the National Tobacco Tax Association (Chicago: Federation of Tax Administrators, 1960), pp. 23-5.

2 Ed Pardo, "Hastings Ranch Hijack Victim Reported 'Fair'," Star-News (Pasadena, CA), October 27, 1973.

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7 Technically, sales taxes are replaced by so-called use taxes on those products purchased out-of-state. For a discussion of California's sales and use tax laws as they apply to cigarettes, see California Board of Equalization, *Cigarette and Tobacco Products Taxes*, Publication 93, June 2006.

8 *Internet Cigarette Sales*, (Washington, DC: United States General Accounting Office, 2002), p. 6.

9 J.D. Dotson, "Military Sales in California," in *Presentations at the 1984 Annual Meetings of the Tobacco Tax Section of the National Association of Tax Administrators* (Washington, DC: Federation of Tax Administrators, 1984), p. 16.

10 Author's calculation using data from *The Tax Burden on Tobacco* and Census Bureau.

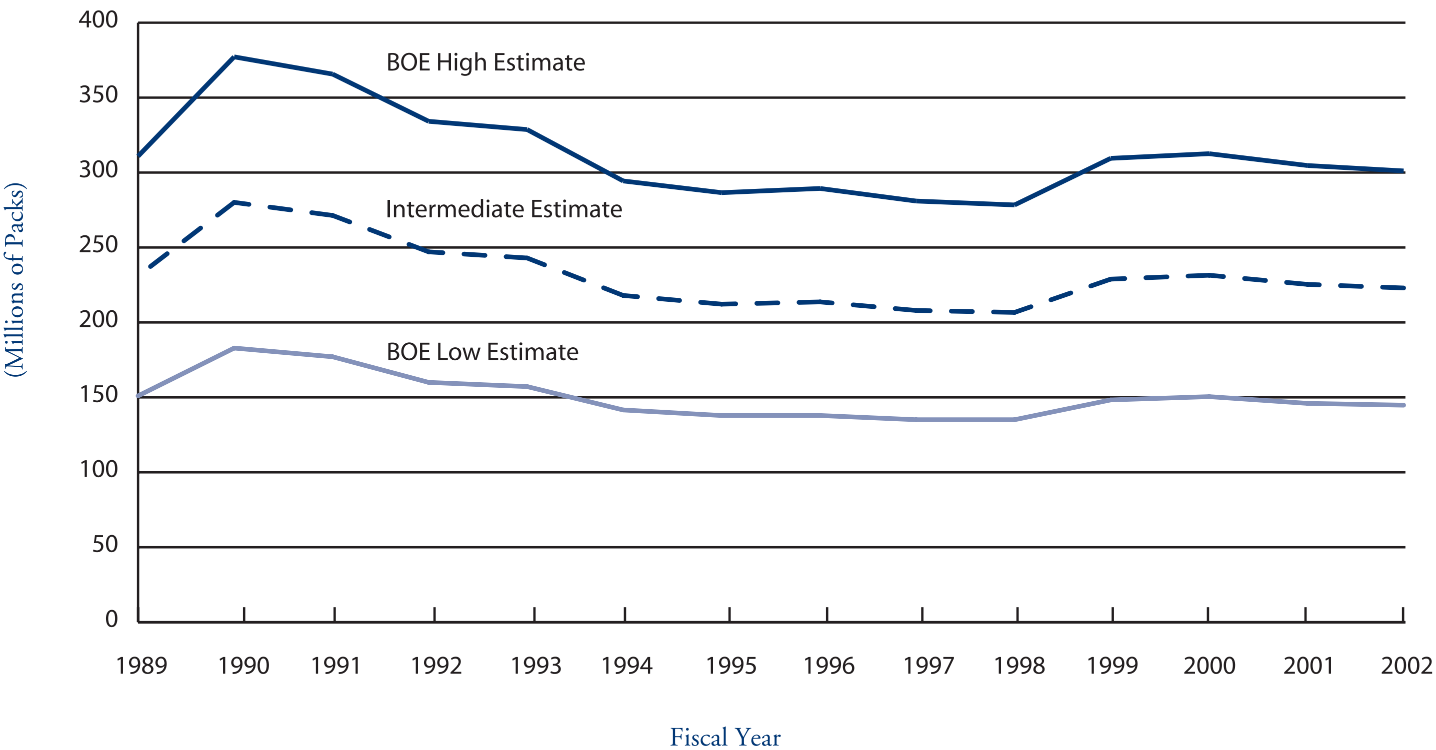
at least $1.00 ($5.80 in today's dollars) on every carton of cigarettes sent smokers with purchasing privileges scrambling to military stores. [11] Those without such privileges often asked friends and relatives to improperly purchase cigarettes for them.[12]

By the early 1970s military stores were selling 225 million packs annually, and these sales had the expected effect on taxed sales elsewhere: they fell by more than seven percent.[13] On a per-pack basis, the cross-border shopping effect is glaring: military stores were selling 725 packs a year for every active duty serviceperson in the state, compared to just 123 packs per capita of tax-paid cigarettes throughout the rest of California.[14]

Despite the small fraction of the population that was entitled to shop on base, tax-free sales reached 8.9 percent of statewide taxed sales in fiscal year 1973. A study by the Advisory Commission on Intergovernmental Relations (ACIR) confirmed that military stores sold significantly more cigarettes than did their civilian counterparts even after controlling for purchases by retirees, the spouses and dependents of active duty personnel, and others who legally would have had access to tax-free cigarettes.[15]

This sharp drop in taxed cigarette sales was the first of two developments that caused California legislators to refrain from raising the tax further after the 1967 tax hike. The other was

Figure 2
Cigarette Tax Evasion in California



Source: California Board of Equalization (BOE) and Tax Foundation

11 In addition to tax savings, products sold at military stores are frequently sold at a discount. Karen Jowers, "Butt Out: Tobacco Sales Plummet As Prices Rise," *Army Times*, October 20, 2003.

12 John Shannon, "The ACIR Study on State Excise Taxation of Sales to the Military," in *Proceedings of the 49th Annual Meetings of the National Tobacco Tax Association* (Chicago: Federation of Tax Administrators, 1975), p. 16.

13 Author's calculation using data from *The Tax Burden on Tobacco.*

14 Author's calculation using data from *State Taxation of Military Income and Store Sales* (Washington, DC: Advisory Commission on Intergovernmental Relations, 1976), U.S. Census Bureau, and *The Tax Burden on Tobacco*.

15 *State Taxation of Military Income and Store Sales,* pp. 13-16.

the specter of smuggling and crime that they saw other states struggling with. New York in particular was dealing with massive levels of cigarette tax evasion and related crime during the 1970s.[16]

More than a decade passed without another California tax hike, and this gave the era's high inflation time to whittle away at the real value of the excise. Over time, Californians had less incentive to border shop, and by 1977 a United States General Accounting Office report showed that tax-free sales on military bases had dropped by nearly half. [17] A follow-up study by the ACIR in 1985 showed that military sales continued to fall as the real value of the excise continued its decline in the 1980s.[18]

This steady decline in military sales came to an abrupt end after voters approved Proposition 99 in November of 1988, raising the state's cigarette tax from 10 to 25 cents per pack. Consumers flocked once again to military bases, and tax-free cigarette sales there rose by more than 10 percent over the next five years.[19]

As states and localities across the country began raising their cigarette excises in the late 1980s and 1990s, they began pressuring the Department of Defense to raise the price of cigarettes sold at military stores. They scored a partial victory in 1996 when the Pentagon ordered commissaries, which are similar to civilian grocery stores and had traditionally sold very inexpensive cigarettes, to raise their prices to the level charged at post exchanges, the military's equivalent of a department store.[20] Four years later the Defense Department ordered cigarette prices at all military stores to be no less than five percent below the price which prevailed in the most competitive local market. These measures have lessened the impact that cigarette sales at military stores have had on the California treasury.

Indian Sales

As the problem of lost cigarette sales to military stores began to subside during the late 1970s another potentially large source of tax-free cigarettes emerged when the Chemehuevi Indian Tribe began selling untaxed cigarettes on its reservation in May of 1977.[21]

Then, as now, courts had generally held that purchases of cigarettes by Native Americans from establishments on tribal lands were exempt from state excise taxes unless they were authorized by federal law. Sales to non-Indians, on the other hand, were generally held to be taxable.[22] When the state of California attempted to collect excise and use taxes on Chemehuevi cigarette sales to non-Indians, however, the tribe balked and a lengthy legal battle ensued.[23]

By the middle of 1980, the state estimated that cigarette sales at just 13 Indian smokeshops totaled 25.5 million packs and cost the state $3.5 million annually.

The case was not resolved until the U.S. Supreme Court ruled on it eight years later. In the interim, the ambiguity of the law encouraged other Native American Tribes to open

16 For a discussion of cigarette tax evasion in the United States during the mid-1970s see *Cigarette Bootlegging: A State and Federal Responsibility,* (Washington, DC: Advisory Commission on Intergovernmental Relations, 1977) and Patrick Fleenor, *Cigarette Taxes, Black Markets, and Crime*, Cato Institute Policy Analysis No. 468, February 6, 2003.

17 *The Tax Status of Federal Resale Activities*, (Washington, DC: United States General Accounting Office, 1979), p. 35.

18 *Cigarette Tax Evasion: A Second Look,* (Washington, DC: Advisory Commission on Intergovernmental Relations, 1985).

19 Stephen Green, "More Smokes Smuggled, Taxes Lost," *Sacramento Bee*, April 14, 1994.

20 Jowers.

21 J.D. Dotson, "Indian Smokeshop Tax Evasion in California," in *Presentations at the 1981 Annual Meetings of the Tobacco Tax Section of the National Association of Tax Administrators* (Washington, DC: Federation of Tax Administrators, 1981), p. 28.

22 For a discussion of this topic see Glenn A. Bystorm, "Collection of the California Cigarette Tax on Indian Reservations," in *Presentations at the 1987 Annual Meetings of the Tobacco Tax Section of the National Association of Tax Administrators* (Washington, DC: Federation of Tax Administrators, 1987), pp. 14-16.

23 The legal dispute in this case basically revolved around who was assumed to bear the legal incidence of the tax in this case. Initially a U.S. District Court found that the legal incidence of the tax fell on the non-Indian buyer of cigarettes and the transaction was therefore taxable. The U.S. Court of Appeals later overturned this ruling on the basis that the legal incidence of the tax fell on the tribe and was therefore not taxable. The U.S. Supreme Court later overturned this finding and sided with the District Court.

smokeshops and aggressively market their wares across the state. By the middle of 1980 the state estimated that cigarette sales at just 13 Indian smokeshops totaled more than 25.5 million packs and cost the state $3.5 million annually.[24]

On November 4, 1985, the U.S. Supreme Court ruled against the Chemehuevi, finding that the state could tax sales of cigarettes to non-Indians. Without the tax advantage, many Indian smokeshops quickly closed their doors, and sales at others declined as they started collecting taxes from people who didn't live on the reservation.

For a little over a decade, the ruling in the Chemehuevi case mitigated the effects that cigarette sales on Indian lands had on state tax revenue. This began to change in the mid-1990s, however, when the tribes both in and outside the state began selling cigarettes over the internet. The state has attempted to curb these sales as part of its overall campaign against tax dodging via the internet.

Internet Sales

At one time, the opportunity to regularly shop across borders was only available to those fortunate enough to live near a low-tax state or other source of low-cost cigarettes. The internet revolution over the past decade has changed all of this. Now, for anyone with access to the web, inexpensive cigarettes, as little as $1.25 per pack for premium brands, are just a mouse click away.

Initially the relatively low federal excise meant that most American cyber-shoppers were buying from internet retailers located in the United States. Change came in 1998 when the states signed the Master Settlement Agreement and similar pacts with the major cigarette companies, raising cigarette prices throughout the U.S. above what they were selling for in many countries. Consumers turned increasingly to foreign sources for inexpensive cigarettes.

By the late 1990s internet cigarette sales were digging into California's sales of taxed cigarettes. In an effort to boost falling tax revenue, the Board of Equalization launched a public relations campaign reminding smokers that both excise and use taxes were due on internet purchases.[25]

Beginning in 1999 it also mounted an aggressive campaign against internet retailers, threatening them with legal action under the Jenkins Act if they didn't turn over lists of their California consumers. While only a fraction of internet retailers complied with the state's demands, the consumers of those who did were promptly sent tax bills sometimes totaling thousands of dollars.[26] Few actually paid those bills, however.[27]

California's heavy-handed efforts to enforce its cigarette taxes on internet sales have strengthened foreign web-based retailers. They openly promise to defy tax authorities and ship their cigarettes in unmarked packages.

After failing to put much of a dent in internet cigarette sales by going after retailers and consumers, state tax collectors tried another approach. They started pressuring package delivery and credit card companies whose services were facilitating internet sales of cigarettes.[28]

California's heavy-handed efforts to enforce its cigarette taxes on internet sales have strengthened the position of foreign e-tailers relative to domestic firms. Many foreign sites openly promise to deny tax authorities access to their records and to ship their cigarettes in unmarked packages. Moreover, because they are located abroad, they are much less susceptible to pressure from the California government. Federal cigarette tax hikes in 2000 and 2003 also increased incentives to purchase cigarettes from foreign sources.

In 2003 testimony before the U.S. Con-

24 Dotson (1981), p. 28.

25 *California Excise Tax and Use Tax Due on Cigarettes Purchased from Outside California*, California Board of Equalization, News Release #4-G, January 18, 2000.

26 Troy Wolverton and Greg Sandoval, "Taxes Threaten Booming Sales of Cigarettes Online," CNET News.com, February 18, 2000.

27 Ibid.

28 Andrew McIntosh, "State Targets Online Cigarette Sales," *Sacramento Bee,* March 18, 2005. Also see Steve Geissinger, "Illegal Cigarette Trafficking Target of Panned Crackdown, *Daily News* (Los Angeles), March 19, 2005.

gress, this author estimated that internet retailers sold Californians 49.4 million packs of cigarettes in fiscal 2003, or about 4.1 percent of taxed sales.[29] The cost to the treasury in lost tax revenue was $64.2 million. By 2005, internet sales in California were projected to rise to 140 million packs and cost the state $190 million.

Cigarette Smuggling in California

On March 7 of last year, in a federal court in Roanoke, VA, seven men pled guilty to smuggling 5.4 million packs of cigarettes from Virginia to California.[1] The next month the Los Angeles offices of the federal Bureau of Alcohol, Tobacco and Firearms and U.S. Immigration and Customs Enforcement agency announced that they had broken up a ring which smuggled nearly 4 million packs of counterfeit cigarettes into the state from abroad.[2] These two cases illustrate the workings of a traditional cigarette smuggling operation as well as the newer, international variety which has taken hold since the signing of the Master Settlement Agreement.

The March 2005 case was a conventional cigarette bootlegging operation. In that case the smugglers simply traveled to Virginia and submitted phony paperwork that allowed them to purchase millions of packs of tax-free cigarettes. The cigarettes were then shipped via tractor-trailer across the country to California where they were sold to consumers. According to federal authorities the scheme cost the state $4.7 million in tax revenue.

The April 2005 operation was a bit more sophisticated, but also potentially much more profitable. In that case a group of bootleggers imported counterfeit versions of popular brands into the state, mostly from China where they can be had for as little as 20 cents per pack.[3] They then affixed counterfeit California tax stamps to them and distributed the cigarettes to retail outlets across southern California. Importing counterfeit cigarettes from abroad allowed the smugglers to abscond not only with federal and state taxes but also with the MSA payment and the premium that consumers were willing to pay for brand name cigarettes.

1 For information on this case see Rex Bowman, "7 Plead Guilty to Smuggling Cigarettes," *Times Dispatch* (Richmond, VA), March 8, 2005, and Jen McCaffery, "7 Plead Guilty in Cigarette Smuggling Case," *Roanoke (VA) Times*, March 8, 2005.

2 For information on this case see "ATF, ICE Break Up Major Contraband Cigarette Trafficking Ring," Bureau of Alcohol, Tobacco, Firearms and Explosives Los Angeles Press Release, April 15, 2005; Greg Botonis, "Cigarette Ring Goes Up in Smoke," *The Daily News of Los Angeles*, April 16, 2005; and Peggy Kelly, "Owners of Santa Paula Tobacco Shop Arrested for Alleged Trafficking," *Santa Paula News*, April 22, 2005.

3 "Department of Homeland Security Dismantles Massive Cigarette Smuggling Enterprise," United States Immigration and Customs Enforcement, Press Release, January 28, 2004.

Cigarette Smuggling

Smugglers are best known for trafficking in contraband such as illicit drugs. Otherwise legal products will appear on the black market, however, if there is a sufficient price disparity between the two markets. In the case of cigarettes, this price disparity is caused by taxes.

Since enacting its first cigarette tax, California has employed an army of auditors and inspectors to combat bootlegging and enforce the rigid control over cigarette sales and distribution that state law requires.[30] All cigarettes sold in the Golden State must bear a tax stamp showing payment of the state excise. To enforce the Master Settlement Agreement, stores may only sell cigarette brands from a list approved by the state's Attorney General.[31] All retailers, distributors and wholesalers must be licensed by the state, and retailers must submit to surprise inspections by state Board of Equalization agents.[32]

The federal Bureau of Alcohol, Tobacco, Firearms and Explosives augments state efforts by enforcing the Contraband Cigarette Act. Passed in 1978 in response to the nationwide surge of cigarette bootlegging during the mid-1970s, this law prohibits the transport, receipt, shipment, possession, distribution or purchase of large quantities of cigarettes not bearing the official tax stamp of the state in which the cigarettes are located. In addition, the U.S. Customs Service's Immigration Custom Enforcement branch attempts to prevent the smuggling of cigarettes from abroad.

Bootlegging in California

The traditional cigarette smuggling operation in the U.S. was a bootlegger who bought large quantities of cigarettes in Kentucky, North Carolina or Virginia, where taxes were low, then trucked them to where taxes were high, leaving him with the tax differential on each pack. At the tax levels in law during the 1970s

29 Statement of Patrick Fleenor before Courts, the Internet and Intellectual Property Subcommittee of the Judiciary Committee of the United States House of Representatives, May 1, 2003.

30 Harry L. Say, "Cigarette Tax Administration and the General Business Taxes Enforcement Program," in *Proceedings of the 34th Annual Meetings of the National Tobacco Tax Association* (Chicago: Federation of Tax Administrators, 1960), p 23.

31 *Inspectors Won't Be Blowing Smoke*, California Board Of Equalization News Release #30-M, June 1, 2004.

32 Michelle Machado, "California Equalization Board Hopes to Halt Tobacco Product Tax Evasion," *The (Stockton, CA) Record*, June 25, 2004.

Lessons from the Big Apple

If voters approve Proposition 86 on November 7, California will levy the highest cigarette taxes in the nation. Over the last 40 years that dubious distinction has frequently belonged to New York City. There, high taxes have spawned a massive black market for cigarettes which has diverted billions of dollars from legitimate business and government coffers to criminals, exposing many average citizens to violence.

Severe problems began in 1964 with a doubling of the state's cigarette excise. Literally overnight this raised the value of cigarettes, making the legitimate industry an attractive target for thieves. Soon the hijacking of trucks carrying cigarettes became commonplace. As had occurred in other high-tax jurisdictions, it became difficult to find firms that were willing to transport legal cigarettes from southern factories to the New York City metropolitan area. Those that dared to do so faced exorbitant rates for insurance and needed to invest in elaborate security systems.

A state commission investigated, finding that the situation had deteriorated to the point where it was often necessary to transport cigarettes around the city in convoys: a delivery truck, which itself had someone "riding shotgun," would be surrounded by additional vehicles with armed guards. Such conditions drove up costs and, coupled with employee fears of violence, forced many legitimate businesses to close.

Much to the dismay of other states and localities, the ancillary crime associated with New York's illegal cigarette trade quickly spread beyond its borders. Across the country, trucks carrying cigarettes were hijacked and businesses selling cigarettes were robbed to supply the illicit market in New York. New York mobsters also infiltrated the legitimate cigarette industry in low-tax states to secure reliable sources of inexpensive cigarettes.

Throughout the late 1960s governments in New York made numerous efforts to rein in the illicit cigarette trade. They spent more on enforcement, they enacted mandatory sentences, and they regulated the industry more heavily. But none of these strategies worked well, prompting the city's finance administrator at the time to comment, "Of all of the assignments that [the Finance Administrator's Office has] had, none of them was more challenging, and frankly none more vexatious, more frustrating, than that of administering the cigarette tax in New York City."

By the mid-1970s the legitimate cigarette trade in the city lived under constant threat and was forced to undertake extraordinary security measures. One official who had headed a commission investigating the illicit cigarette trade testified to Congress that workers were "confronted almost daily with the risk and dangers of personal violence which are now inherent in their industry." Commenting on the security measures being taken, one New York City police detective noted that "many dealerships in the New York area are secured like fortresses and trucks making deliveries are more like armored cars than delivery vans."

Nevertheless, after a temporary lull in the late 1970s and early 1980s, the state continued to hike its tax. This created conditions where by the late 1980s it became "literally more profitable to hijack a cigarette delivery truck than an armored truck," according to one official in the state's Department of Taxation and Finance Tax enforcement office.

Ever in search of additional revenue, state and city officials hiked cigarette taxes in the Big Apple throughout the 1990s and into the new century even as wave after wave of violent, tax-induced crime battered the legitimate industry. Today state and local taxes totaling $3.00 per pack mean that the illicit market supplies at least half of all cigarettes consumed in the city today.

Text adapted from *Cigarette Taxes, Black Markets, and Crime*, Cato Institute Policy Analysis No. 468.

and '80s, a truckload of 200,000 packs could net the smuggler $10,000 to $50,000 in a couple days.

When Prop. 99 raised the tax in November of 1988, bootlegging surged and regular taxed sales dropped by one-third. Wishful thinkers said smokers had quit in droves rather than pay the tax, but the U.S. Centers for Disease Control showed that smoking had barely dipped.

It is difficult for police or academics to figure out how much of this is going on at any one time. However, it is widely believed that California's historically low cigarette taxes, combined with its distance from the low-tax states kept large-scale, over-the-road bootlegging at a minimum during much of the first three decades of its cigarette excise.[33]

This changed after California voters approved Proposition 99 in November of 1988. By raising the state's cigarette tax from 10 to 25 cents per pack, Proposition 99 enabled smugglers to drive away with as much as $50,000 in excise taxes ($85,250 in 2006 dollars) on every tractor-trailer load of cigarettes smuggled into the state. Bootlegging surged and regular taxed sales dropped by one-third over the next decade. Wishful thinkers asserted that smokers had quit in droves rather than pay the tax, but the U.S. Centers for Disease Control showed that actual cigarette consumption dipped by less then 5 percent.[34]

Concern over a dramatic rise in smuggling prompted the Board of Equalization to develop a statistical model that could produce reliable estimates of cigarette tax evasion.[35] In June of 1999, the board released the first results from this new model. They showed a spike in smuggling in the wake of the 1988 tax hike (see Figure 2). During fiscal 1990, between 183 and 377 million packs of cigarettes had illegally entered California. That is the equivalent of 2 to 5 tractor trailers full entering the state each day, and the lost excise tax revenue was in the range of $64 to $132 million.

During the early 1990s, other states raised their cigarette taxes, making them more smuggler-friendly than California, and inflation acted to reduce the real impact of California's 25-cent excise tax. By fiscal 1993, the Board of Equalization estimated that tax evasion had dropped 13.2 percent in three years. A two-cent per pack hike in the state excise on January 1, 1994, temporarily reversed this trend slightly, but by 1998, Board of Equalization estimates show that cigarette tax evasion had fallen 26.2 percent since 1990. Even with smuggling on the decline, the volumes were still staggering: between 135 and 278 million packs of cigarettes illegally entered California that year, costing the state $50 to $103 million in lost excise tax revenue.

Two events in November of 1998 would fundamentally alter the illicit cigarette market in California. The first occurred on the third day of that month when voters in the state narrowly approved Proposition 10, which raised the cigarette tax by 50 cents per pack. Then on the 22nd day, California signed the Master Settlement Agreement with the major tobacco companies. This agreement immediately boosted cigarette prices by some 45 cents per pack and for the first time in modern history created significant incentives to smuggle from abroad. That way, smugglers could not only expropriate the 87-cent state excise but also the 45-cent MSA payment and the 24-cent federal tax.[36] This would allow bootleggers to earn as much as $312,000 in evaded taxes on every shipping container of cigarettes smuggled into the state.

In the aftermath of the 1998 tax hikes, the Board of Equalization's model showed that tax

33 For a discussion of this topic see ACIR (1977), pp. 79-90 and *Preliminary Estimates of California Cigarette Tax Evasion*, California Board of Equalization, June 1999. While traditional over-the-road bootlegging has been less of a problem in the state, according to government officials, California has experienced diversion of tax-free cigarettes – such as those sold at military bases and on Indian reservations – into its ordinary retail market. See, for example, ACIR 1976, p. 13.

34 Author's calculations using data from *The Tax Burden on Tobacco*, U.S. Centers for Disease Control, and U.S. Census Bureau.

35 Board of Equalization, 1999.

36 Ibid.

evasion surged 12 percent as sales of taxed cigarettes fell sharply. Increasingly investigators examining cigarette tax evasion cases came across cigarettes illegally imported into the U.S. from abroad (see sidebar on page 7). In a report examining the smuggling of cigarettes into the United States, the federal General Accounting Office found that seizures of counterfeit cigarettes at the ports of Los Angeles and Long Beach had increased dramatically in the years following the tax hike.[37]

The Board of Equalization wanted to gain more insight into the cigarette smuggling problem in California and to check the accuracy of its model's estimates, so in 2003 it analyzed survey data of more than 1,300 retailers.[38] More than one-quarter of the retailers surveyed had untaxed cigarettes in current inventory, and the board surmised that 274 million packs of untaxed cigarettes were being sold annually in the state. This estimate supported the validity of the board's statistical model, confirming that tax-induced smuggling was rampant.

Death of a Bootlegger

Before his murder on November 25, 2003, 19-year-old Cody Knox usually sold bootleg cigarettes on the corner of Fulton and Nevins Streets in Brooklyn, NY. Looking to explore other opportunities, one day he meandered several blocks to the west to test the waters at Hoyt and Schermerhorn Streets. There he encountered 28-year-old Jermaine Cox and 35-year-old Harry Wilson, who were also peddling illegal smokes.

In order to get a foothold in this market Knox lowered the price of his cigarettes by $1.00 per pack, undercutting Cox and Wilson. This angered the duo and an altercation ensued. Knox returned to his home base at Fulton and Nevins, but Cox and Wilson were determined never to let him threaten their illicit profits again. They followed Knox and stabbed him to death. Police later tracked the two down after they had been identified by witnesses.

"Obviously [Cox] wasn't happy about [the competition]," prosecutor Anna-Sigga Nicolazzi stated at his trial. Bootleg cigarettes are "big business… This was a thriving illegal trade!"[1]

New York's black market in cigarettes had gotten a big boost in 2002 when both the state and city governments raised their respective cigarette excises to $1.50 per pack. The combined $3.00 tax helped to push cigarette prices up to $7.50 per pack and created the situation where it was possible to earn as much as $600,000 on every truckload of cigarettes smuggled into the city from domestic sources. The resulting influx of illicit smokes caused sales of taxed cigarettes to fall by 50 percent in the aftermath of the tax.

On June 7, 2005, after one hour of deliberation, a New York jury found Cox guilty in the murder of his rival. Knox's death was one in a string of homicides and shootings related to the Big Apple's illicit cigarette market in recent years.[2]

1 Nancie L. Katz, "Man Guilty in Bootleg Cig Killing," (New York) *Daily News,* June 8, 2005.

2 For a discussion of crimes resulting from rivalries among New York bootleggers see Murray Weiss, "Deadly War for Bootleg Smokes," *New York Post*, December 10, 2004; Michelle McPhee, "The Deadly Butt-Leg War," *Daily News* (New York), December 10, 2003; and Michelle McPhee, "NYPD Set to Smoke Out Black Market Cig Trade," *Daily News* (New York), December 11, 2003.

Ancillary Crime

While both border-shopping and bootlegging divert revenue from state coffers, neither of these activities directly involves the use of violence. Unfortunately the same can not be said of the cigarette thefts and other offenses associated with the black markets created by cigarette tax hikes.

Cigarette Thefts

In the past, when initiatives have proposed cigarette tax hikes, the stated goal of their supporters has often been to discourage consumption with high prices.[39] An unintended side effect is that high prices make cigarettes more attractive to thieves who can turn around and sell them quickly on the bustling black market. This has placed workers at all levels of the cigarette distribution chain — as well as innocent bystanders — at increased rise of violence. The sidebar on page 8 describes the effect of tax-induced crime on the legitimate cigarette industry in New York City, the jurisdiction with what is now the highest cigarette tax in the country.

Because of the sheer quantity of cigarettes they have on hand, wholesalers often find themselves targeted by highly organized groups of thieves. After the 1998 tax hike, in a case eerily similar to the heist described in the in-

37 *Cigarette Smuggling*, (Washington, DC: United States General Accounting Office, 2004). Also see Lisa Friedman, "Smoking Gun at Ports?" *The Daily News* (Los Angeles), July 3, 2004.

38 *Documentation of Board of Equalization 2003 Cigarette Tax Revenue Evasion Estimates*, California Board of Equalization, February 2003.

39 "California Cigarette Sales Plunge After New Tax," Reuters, September 13, 1999.

troduction of this paper, a group of four men stole a tractor-trailer and drove it to a Corona warehouse.[40] After donning hoods the men entered the warehouse and rounded up the employees at gunpoint, tying some up and forcing others to use forklifts to load the truck with pallets of cigarettes valued at $1.0 million. Eight hours after the heist, the tractor-trailer was found empty and abandoned. Police suspect that the cigarettes were quickly sold on the black market.

Less organized groups often target retailers. Also in the wake of the 1988 tax hike, a group of knife-wielding bandits began robbing convenience stores in Orange County. In each case three men entered a store. While one man threatened the clerk, the others retrieved trash bags from their pockets and filled them with cartons of cigarettes. The cigarettes were later sold on the black market.[41]

In the San Diego area, three men wearing ski masks and brandishing automatic weapons burst into a series of convenience stores and gas stations. They disabled security cameras, and with escalating violence, they imprisoned clerks and customers in bathrooms after assaulting them before making off with the stores' stocks of cigarettes.[42]

Crimes Associated with Illicit Cigarette Markets

California's illicit cigarette market has grown rapidly over the last 17 years. If Board of Equalization estimates of tax evasion are correct, they imply that hundreds of millions of packs of cigarettes are currently being smuggled into California across state and international borders annually. Others arrive in this market via theft.

There is nothing about cigarettes themselves or the people who work in their distribution that fosters this criminal activity. No one is hijacking trucks of disposable razors and Hostess Twinkies, even though these products sit on the same convenience store shelves. It is simply the misguided effort by governments to levy an extremely high tax on an easily transported product that people consume a significant number of each day.

Crimes Stemming from the Nature of the Black Market

At first glance the sheer size of this illicit market may give the impression that it is highly stable. In fact, nothing could be further from the truth. California's black market for cigarettes, like all illicit markets, is ruled by force.

The police and the courts keep sellers of legal products, including cigarettes, from threatening each other or refusing to pay for shipments to their stores, but no one performs this arbitrator's role in a black market. It is no surprise that assault weapons are frequently found during raids on illicit cigarette dealers.[43]

The recent string of homicides and shootings in New York City illustrates just how severe these problems can be (see sidebar on page 10). With millions of dollars at stake, competitors arm themselves to the teeth. In this environment, naturally the business is dominated by people who have already armed themselves: organized criminals and dealers of illegal drugs.

Business operations in such a system are maintained by a series of threats and counter-threats. When this precarious system breaks down, the usual result is bloodshed.

Crimes to Avoid Detection

In addition to being under constant threat from competitors, cigarette bootleggers must also be on guard against the police. Law enforcement officials at all levels are often under intense pressure to collect these millions of dollars, and so they mount aggressive campaigns to curtail cigarette smuggling.

Such efforts include paying informants cash rewards for information on cigarette smuggling operations and offering low-level offenders leniency in exchange for information on higher-ups. Bootleggers across the country have responded by sometimes murdering indi-

40 For details of the Corona heist see "Men Steal $1M in Tobacco Products," Associated Press, March 31, 1999; "Nicotine Fiends Score $1 Million," Associated Press, March 31, 1999; and C.J. Schexnayder, "Getaway Big Rig Is Found," *Press-Enterprise* (Riverside, CA), April 2, 1999.

41 Janine Anderson, "Cigarette Thefts Reignite Issue of Tax Increase," *The Orange County Register*, April 13, 1989.

42 "Police United On Cigarette Case," *San Diego Union-Tribune*, February 2, 2001.

43 See, for example, Erik Javier Olvera, "Father and Son Arrested in Cigarette Tax Evasion," *Fresno Bee*, November 24, 2002.

viduals who provide information to law enforcement.[44] Others have also bribed law enforcement officials.[45]

Proposition 86

California's history of cigarette tax avoidance, evasion and ancillary crime would seem to make a fairly convincing case for reduction – if not outright elimination – of the excise. Unfortunately, not everyone has learned this lesson and a measure has been placed on the November 7 ballot – Proposition 86 – which would nearly *quadruple* the state's cigarette excise to \$3.47 per pack. Such a tax hike would significantly exacerbate all of the problems that the state is currently experiencing with its cigarette excise.

California's history of cigarette tax avoidance, evasion and ancillary crime makes a convincing case for reduction – if not outright elimination – of the cigarette tax.

If a \$2.60 tax increase were enacted, smokers could save as much as \$50 on every carton of cigarettes purchased online rather than locally. More ominously, criminals could earn truly staggering profits from smuggling cigarettes into the state or stealing them. With a \$3.47 excise tax, just California's tax alone would give bootleggers smuggling cigarettes from other states as much as \$700,000 on every tractor-trailer load of cigarettes.

For bootleggers importing cigarettes from abroad into California, the potential illicit profits would soar to \$1.2 million per shipping container. Meanwhile the value of a couple hundred cartons of cigarettes stored in the backroom of a corner market would increase to some \$13,000 while the value of those stored in a warehouse could increase into the millions, making them very tempting targets for thieves. Growth of the black market would most certainly increase other forms of ancillary crime as well.

Conclusion

Over the last five decades many California smokers have shown themselves to be quite sensitive to excise tax hikes, though probably not in the way that many supporters of these tax increases intended. Instead of quitting their habit, many smokers simply flocked to military bases and Indian lands when these areas were oases from high taxes. When the internet revolution gave everyone the opportunity to border shop for cheap cigarettes, the click of computer mice resounded across the state.

While this rampant, casual tax evasion has undermined respect for the law, these effects pale in comparison to those created by the black market spawned by the tax. Cigarette thefts place the safety of many innocent people at risk while the inherent weaknesses of this illicit market threaten public safety.

Unfortunately many have not learned – or are unaware of – these lessons. Consequently, we may soon look back and note how comparatively mild these problems were prior to January 1, 2007 – the effective date of the \$2.60 tax hike called for in Proposition 86.

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44 See for example "Bureau Regulating Cigarettes Most Corrupt?" *Bucks County Courier Times* (PA), December 14, 1977.

45 ACIR 1977.