Crossing the Border
As Taxes Rise, Locals May Buy Cigarettes Elsewhere

During a time when revenue is difficult to come by for many local and state governments, a number of city councils and state legislatures are looking for ways to raise money. For many of these governing bodies, raising excise taxes, such as those for cigarettes, could seem to offer the least politically contested route to increasing revenue.

Washington, D.C., imposed a 50 cent increase in its cigarette tax, effective October 2009. The tax is now $2.50 per pack.

The economic impact of excise taxes like those for cigarettes has garnered attention from politicians and academics alike. A recent contribution came from economist David Merriman of the University of Illinois at Chicago. Merriman arranged teams to collect a representative random sample of littered cigarette packs in parts of Chicago and neighboring jurisdictions for his paper, "The Micro-Geography of Tax Avoidance: Evidence from Littered Cigarette Packs in Chicago," published recently in the *American Economic Journal: Economic Policy*.

Merriman's results suggest that tax avoidance may be a significant concern. In Chicago, 75 percent of the littered packs displayed no city tax stamp, indicating that they were purchased outside the city. Given the tax differential between Chicago and neighboring locales, it's no surprise. In July 2007, Chicago proper had a combined state and local cigarette tax rate of $3.66 per pack, while nearby Indiana had only a 55.5 cent state levy and no local taxes. Merriman also looked at a sampling of properly disposed packs in Chicago, and those results indicate that the littered boxes were representative of all packs.

A key subtlety that Merriman noticed is when it comes to tax avoidance, distance matters. In Chicago, "the degree of avoidance diminishes rapidly with distance from the [Indiana] border," he said in a phone interview. That observation holds true in cities where he has conducted similar studies. In New York City, for example, about half of littered packs did not include a NYC tax stamp. But in Warsaw, Poland, where consumers must travel much farther for lower-cost cigarettes, only 11 percent of smokers were thought to have participated in the illicit market.

In the case of Washington, D.C., comparisons to New York City and Chicago may be more apt. At $2.50 per pack, the excise tax in D.C. is currently the ninth highest among state taxes in the country, more than $1 higher than the national average for state cigarette taxes. More important, D.C. residents must pay a tax that is more than $2 a pack higher than in neighboring Virginia, which levies a fee of 30 cents per pack. "The proximity of D.C. to Virginia and the ease of transportation between the two lead me to think you could find a ton of Virginia packs there," Merriman says.

From a revenue perspective, the latest numbers from D.C. certainly are not encouraging. For the six-month period following the October 2009 tax increase, cigarette tax revenues in the District of Columbia actually have fallen 23.6 percent, or $4.9 million, compared to the same period a year earlier. Of course, high taxes may not be the only culprit — a slumping economy can diminish consumption and hurt tax revenues as well. But recessionary effects on excise tax income elsewhere seem more modest. In Virginia, for instance, tax revenue from cigarettes fell only 0.32 percent between fiscal years 2008 and 2009. According to the *Washington Business Journal*, D.C. Chief Financial Officer Natwar Gandhi speculated in a February 2010 revenue estimate that D.C.'s tax increase sent local smokers to Virginia and Maryland to buy cigarettes.

While tobacco-industry lobbyists point to decreases in tax revenue as a reason to keep cigarette taxes low, certain advocacy groups, such as the Campaign for Tobacco-Free Kids, argue that cigarette tax avoidance is overhyped and not widespread enough in many places to result in a decline in government revenue.

Merriman suggests that policymakers should avoid generalizations and instead pay close attention to the different circumstances and conditions each locality faces, especially distance to alternative markets. "In D.C., [proximity to Virginia and Maryland] makes avoidance a prime issue, but say for a large city in the middle of a state, it shouldn't feel like it can't raise taxes without encountering a significant avoidance effect."

—ROSS LAWRENCE

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End of an Era
South Carolina Hikes Tax on Smokes

In South Carolina, lawmakers in May voted to raise the cigarette excise tax from 7 cents a pack to 57 cents a pack. For 33 years, South Carolina had the lowest cigarette tax in the country — a reign that ended when the tax hike took effect July 1.

South Carolina has long been a significant tobacco-producing state, which may partially explain its historical commitment to keeping cigarette taxes low. Although the state's economy has diversified considerably from its mostly agrarian origins, tobacco remains an important crop. According to the U.S. Department of Agriculture, South Carolina dedicates about 20,084 acres to tobacco cultivation, the fifth highest of any state. Grown mostly in the northeast part, known as the Pee Dee region, it is South Carolina's most profitable crop by acre and the fourth highest by cash receipts.

The rate increase moves South Carolina closer to the Fifth District average of $1.06 for cigarette taxes. Virginia now sits with the lowest tax in the District at 30 cents per pack, while North Carolina and West Virginia levy 45 cents and 55 cents per pack, respectively. Washington, D.C., on the other hand, charges $2.50 per pack in taxes, while Maryland levies $2 a pack. Both the Fifth District average and South Carolina's tax rate remain considerably lower than the average for all states of $1.45.

Legislators hope the tax increase will provide additional financing for Medicaid programs for the poor and disabled. Of the $135 million the hike is expected to raise in revenue for the state, $125 million will be allotted to Medicaid. That money should largely replace federal bailout dollars that have kept the program in the black for two years.

Although the impetus for the new law may have been financial in nature, antismoking groups have stepped up pressure on states in recent years to use excise taxes — among other policy options — to reduce demand for tobacco products. In April, the Centers for Disease Control and Prevention issued a report about state excise taxes, highlighting that a 10 percent increase in the effective price of cigarettes can curb consumption by 4 percent. Of the states that increased cigarette taxes in 2009, or thus far in 2010, South Carolina is the first to allocate some of the projected revenue to tobacco prevention and control. The state will set aside $5 million for cancer research and smoking cessation programs.

— ROSS LAWRENCE

State Cigarette Excise Taxes

Highest Rates	
New York	$4.35
Rhode Island	$3.46
Washington	$3.03
Connecticut	$3.00
Hawaii	$3.00
New Jersey	$2.70
Wisconsin	$2.52
Massachusetts	$2.51
District of Columbia	$2.50
Vermont	$2.24

Lowest Rates	
Missouri	$0.17
Virginia	$0.30
Louisiana	$0.36
Georgia	$0.37
Alabama	$0.43
North Dakota	$0.44
North Carolina	$0.45
West Virginia	$0.55
Idaho	$0.57
South Carolina	$0.57

NOTES: Average state tax: $1.45 per pack. Chart lists state tax rates noninclusive of federal excise tax or any local taxes.
SOURCE: Campaign for Tobacco-Free Kids

Taxing e-Commerce
Amazon Fights N.C. Access to Records

People owe sales taxes on goods purchased online, even if remote sellers don't collect. Some catalog and Internet retailers don't charge the tax in states where they have no stores (or other physical presence). So several states have intensified efforts to collect. North Carolina, for instance, asked Amazon late last year for information on transactions to North Carolina addresses. Amazon subsequently sued.

Sales and use collection on Internet purchases are mired in the confusing concept of "nexus," or physical presence, and the issue will likely go unresolved until the U.S. Congress weighs in. Until then, states will keep trying to persuade retailers to collect.

For example, North Carolina unveiled a compromise for Internet retailers who have operated affiliate programs in the state. Those who agree to collect future sales/use taxes and sign onto the program by Aug. 31, 2010, won't pay penalties, back taxes, or interest. Earlier efforts to extract taxes included a 2009 law requiring online retailers to collect when affiliate Web sites operated by state residents refer customers to those retailers.

Other states have passed these "Amazon" laws, named for the major online-only seller. In response to the North Carolina law, Amazon ended its agreements with bloggers and business Web sites that referred business to the seller. The firm did likewise last spring in Colorado when the state passed a similar law. Amazon lost its court challenge to New York state's Amazon law, but is appealing.

Amazon's federal lawsuit seeks to block the request of the North Carolina Department of Revenue (DOR) for seven years' worth of customer order information. The legal action reads, in part: "The DOR's actions threaten to chill the exercise of customers' expressive choices and to cause Amazon customers not to purchase certain books, music, movies, or other expressive material from Amazon that they might otherwise purchase if they did not fear disclosure of those choices to the government." Amazon wants the court to agree, so that other states won't do likewise. In late June, the American Civil Liberties Union filed a complaint on behalf of one named and six anonymous North Carolinians, in support of Amazon's complaint. The ACLU intervened, according to its press release, because of free speech and privacy issues.

The secretary of the DOR, Kenneth R. Lay, wrote the American Booksellers Association in June, in response to a request, that the department isn't interested in customers' specific book titles but needs product codes to calculate the taxes.

The stakes are rising, along with the value of goods and services sold online. In 2008, the value reached $3.7 trillion, according to the U.S. Census Bureau's latest adjusted figures. About $142 billion were business-to-consumer retail sales. As consumer spending picks up, it's likely that online and catalog sales will too.

Donald Bruce, William Fox, and LeAnn Luna of the University of Tennessee estimate state and local revenue losses nationwide may grow to $11.4 billion by 2012. Estimates of losses in North Carolina, with a 5.75 percent sales tax, could reach $213.8 million.

Warehouses are apparently excluded from the definition of "physical presence." Amazon operates a warehouse in Virginia, from which merchandise is shipped, but pays no sales and use tax in Virginia. An Amazon bill introduced during the Virginia General Assembly in 2010 failed to pass.

The courts last weighed in on remote sellers and tax collection in 1992. The U.S. Supreme Court ruled in *Quill Corp. v. North Dakota* that a business wasn't required to charge sales tax in states where it had no physical presence. The opinion suggested Congress had the authority to resolve the issue. So far it has not, though some states have simplified tax rates and administration to make collection easier. Remote sellers have objected to the complexity and variation among state and local tax regimes. Through the Streamlined Sales and Use Tax Agreement, 23 states of the 45 that collect sales taxes have legislated changes conforming to the agreement. North Carolina and West Virginia are two Fifth District states that have done so.

There's a possible advantage for remote sellers who don't collect taxes. "Theory would suggest you have out-of-state firms competing on something other than a level playing field," says Don Bruce, one of the University of Tennessee economists who has studied sales tax revenue losses from electronic commerce. They operate at an advantage over local firms that do remit this tax. "So there's an inflow of activity from those sellers, presumably at the expense of a local business." The lack of clarity on the sales tax issue also can distort remote sellers' organization and location decisions, he notes.

States are likely to get more aggressive in trying to collect from catalog and Internet retailers, but many customers are unlikely to voluntarily pay the tax when it's not collected at the time of purchase.

—BETTY JOYCE NASH