

Maine Issue Brief

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Smoke and Borders:

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How tobacco tax increases promote cross-border shopping.

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Governor John E. Baldacci's General Fund budget proposal includes a dramatic hike in tobacco taxes. The budget includes a 50 percent increase in the cigarette tax to \$3.00 per pack from \$2.00 per pack starting in state fiscal year (FY) 2008. Additionally, the tax on "smokeless tobacco" would increase by 50 percent to 117 percent of the wholesale price from 78 percent, while "other tobacco" (cigars, pipe tobacco, etc.) would increase by 50 percent to 30 percent of the wholesale price from 20 percent.

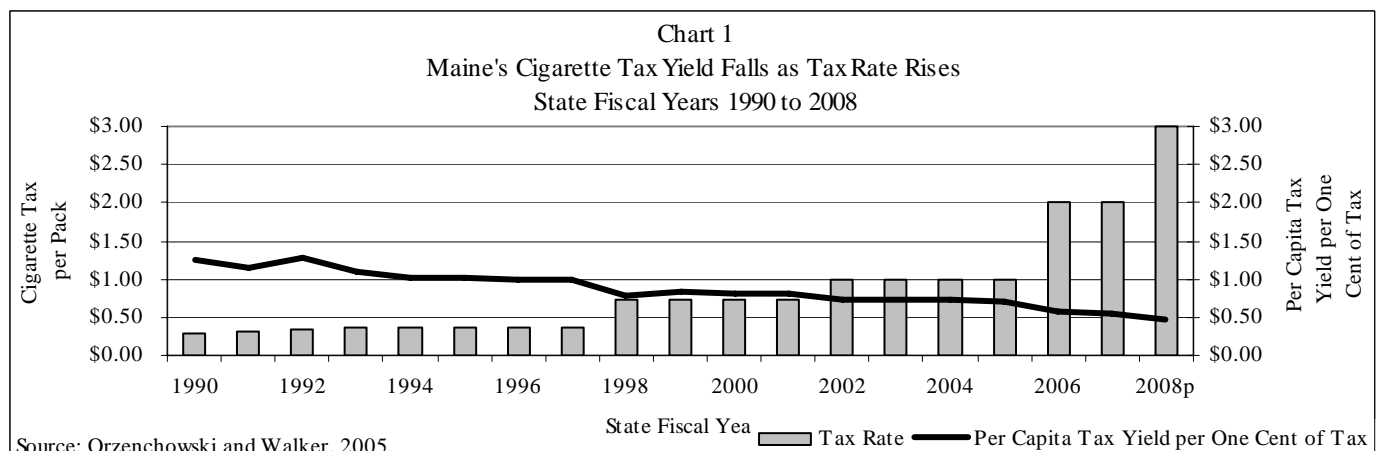
Overall, the tobacco tax increase is estimated to generate \$66 million in new revenue. However, the new revenue estimate was clearly made through rose (or is it smoke?) colored glasses. In particular, a reasonable adjustment for the effect of cross-border shopping reveals a much reduced revenue gain. Cross-border shopping for cigarettes is a nationwide phenomenon and occurs when there are significant differences in the price of cigarettes between states.[1] Since cigarette taxes affect the price of cigarettes, differences in the tax rate between states encourage people to buy cigarettes over state lines.

Among the New England states, New Hampshire benefits greatly from cross-border shopping for cigarettes. New Hampshire's cigarette tax rate (80 cents per pack) is significantly lower than the rate in Maine (\$2 per pack), Massachusetts (\$1.51 per pack) and Vermont (\$1.19 per pack) in FY 2006.[2]

A quick comparison between New Hampshire and Maine gives an especially compelling example of cross-border shopping to avoid paying cigarette taxes. Despite New Hampshire having a much lower cigarette tax rate (80 cents versus \$2 per pack), and both states having nearly the same size population, New Hampshire raised almost the same revenue as Maine did from cigarette taxes in FY 2006 (\$138 million versus \$153 million).

It is also important to note that the variance in revenue generated by tobacco taxes is not the result of dramatic differences in the smoking rates between the two states. For men, Maine has the 25th (22.1 percent) highest smoking rate while New Hampshire is the 39th (20.2 percent). For women, Maine has the 22nd (19.4 percent) highest smoking rate while New Hampshire is the 14th (20.4 percent).[3]

Chart 1 shows over time, as Maine's cigarette tax rate has increased, the "per capita tax yield per one cent of tax" (hereafter called "tax yield") has fallen dramatically. This drop in "tax yield" is strong evidence of cross-border cigarette shopping. The "tax yield" measures the change in per capita tax revenue per one cent change in the cigarette tax rate. For example, in FY 1996, a tax of one cent per pack raised exactly \$1 per person of revenue. Multiply \$1 by the tax rate (37 cents) equals per capita revenue of \$37, then multiply by the number of people (1,246,270) and the resulting number equals total revenue collected of \$46 million.



Between FY 1990 and FY 2006, the cigarette tax rate has increased 614 percent to \$2 per pack from 28 cents per pack. At the same time, the tax yield has decreased 54 percent to 58 cents from \$1.25. A significant portion of this overall drop occurred between FY 2005 and FY 2006 when the cigarette tax rate increased 100 percent to \$2 a pack from \$1 a pack. Correspondingly, the tax yield dropped 18.3 percent to 58 cents from 71 cents.

The dramatic drop in tax yield is a clear warning to policymakers that continued increases in the cigarette tax will result in increased cross-border shopping with New Hampshire and in the process, a boost to their cigarette tax revenue.[4] Currently, Maine has the historically highest tax rate differential with New Hampshire at \$1.20 per pack (\$2 Maine tax minus 80 cents New Hampshire tax). The differential would grow to \$2.20 a pack under the proposed \$1 tax rate increase.

Chart 1 also illustrates the estimated drop in tax yield in FY 2008 if the cigarette tax is increased. The estimate conservatively assumes that the tax yield would decrease by half the drop experienced in FY 2005 and FY 2007.[5] As a result, Table 2 shows that the increase in revenue would only be \$43 million, or \$23 million lower than the Governor's estimate of \$66 million.[6]

While there is strong circumstantial evidence in support of cross-border shopping, what "hard evidence" is there? Chart 2 shows the percent change in cigarette sales at Big Apple/CN Brown convenience stores in Oxford County, York County and New Hampshire after the \$1 per pack cigarette tax increase between 2005 and 2006.[7] Since Oxford and York County directly border New Hampshire, the cross-border shopping effect is most acute there. In fact, the average cigarette sales fell by 9.9 percent in Oxford County and 7.1 percent in York County. At the same time, sales rose in their New Hampshire stores by an average of 7.8 percent.

Notes and Sources:

- [1] Fleenor, Patrick, "How Excise Tax Differentials Affect Interstate Smuggling and Cross-Border Sales of Cigarettes in the United States," Background Paper No. 26, The Tax Foundation, October 1, 1998. <http://www.taxfoundation.org/files/4cd5774343c1f82447a1381a01c62980.pdf>
- [2] Vermont's cigarette tax rate increased to \$1.79 a pack in FY 2007.
- [3] Kaiser Family Foundation, *Smoking Rates for Adults by Sex*, 2005. <http://www.statehealthfacts.org>
- [4] In addition to lower cigarette tax revenue, Maine would also suffer lower income tax and sales tax revenue due not only to lost cigarette sales, but also due to lower sales of other complementary goods such as gasoline and food.
- [5] The tax yield dropped 16 cents between FY 2005 and FY 2007. While both the actual and proposed tax rate increases are of the same magnitude (\$1 per pack), this analysis conservatively assumes a drop in tax yield that is half, 8 cents, the drop between FY 2005 and FY 2007.
- [6] If the drop in tax yield is assumed to equal the drop between FY 2005 and FY 2007 (16 cents), the increase in revenue would only be \$11 million, or \$55 million lower than the Governor's estimate of \$66 million.
- [7] Proprietary sales data provided by Jinger Duryea, President of CN Brown Company.

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Table 1
\$23 Million of Projected Cigarette Tax Revenue Goes up in Smoke
State Fiscal Years 2005 to 2008

State Fiscal Year	Cigarette Tax Rate per Pack	Per Capita Tax Yield per One Cent of Tax	Cigarette Tax Collections Millions of Dollars		
			Governor's Budget Proposal	MHPC Estimate	Difference
2005	\$1.00	\$0.71	\$94	\$94	\$0
2006	\$2.00	\$0.58	\$153	\$153	\$0
2007p	\$2.00	\$0.55	\$148	\$148	\$0
2008p	\$3.00	\$0.47	\$214	\$191	-\$23

Source: Orzencowski and Walker, 2005; Governor's Budget, MHPC.

