REVENUE ESTIMATE

CIGARETTE AND TOBACCO PRODUCTS TAX EVASION

Summary – Current Law

The Board of Equalization (BOE) estimates that cigarette and tobacco products excise tax revenue evasion was approximately $172 million in fiscal year 2015-2016. This estimate is comprised of $154 million in evasion by retailers who purchase and sell untaxed cigarettes and tobacco products to consumers and $18 million in casual evasion by consumers. The estimates are broken out by type of tax and program in Table 1.

Table 1
Summary of Cigarette and Tobacco Products Excise Tax Evasion Estimates: Current Law

	Tax Rate or Price	Retailers	Consumers	Total
		Millions of Dollars - Fiscal Year 2015-16		
Cigarettes				
Distributions (Millions of Packs)	n.a	133.1	12.9	146.0
All Excise Taxes	$0.87	$115.8	$11.2	$127.1
General Fund	$0.10	$13.3	$1.3	$14.6
Breast Cancer	$0.02	$2.7	$0.3	$2.9
Proposition 99	$0.25	$33.3	$3.2	$36.5
Proposition 10	$0.50	$66.6	$6.4	$73.0
Tobacco Products				
Distributions (Wholesale Cost)	n.a.	$135	$23	$158.2
All Excise Taxes	28.13%	$38.1	$6.4	$44.5
Proposition 99	17.86%	$24.2	$4.1	$28.3
Proposition 10	10.27%	$13.9	$2.4	$16.2
Summary: Cigarettes and Tobacco Products				
General Fund		$13.3	$1.3	$14.6
Breast Cancer		$2.7	$0.3	$2.9
Proposition 99		$57.4	$7.3	$64.8
Proposition 10		$80.5	$8.8	$89.3
All Excise Taxes		**$153.9**	**$17.7**	**$171.6**
Note: Some numbers in the table may not match calculated figures due to rounding.				

Background, Methodology, and Assumptions

Methodology. BOE staff updated these estimates with a similar methodology used in the last set of estimates published in 2014.[1] The cigarette estimates were made using BOE's econometric model.[2]

Cigarettes

Retailers. The cigarette tax evasion estimate methodology involves several steps: (1) predict tax paid distributions in fiscal year 2015-16, running the model with the actual excise tax rate of $0.87 per pack; (2) run the model a second time for the same fiscal year, this time using a cigarette excise tax rate of $0.10 per pack, the rate in effect prior to 1989 (when it was likely that there was little tax evasion); (3) predict what tax paid distributions would have been with a tax rate of $0.10 per pack; and (4) multiply the difference in tax paid distributions between the $0.10 model and the $0.87 model by 25 percent.[3] Based on these calculations, we conclude that retailers evade $115.8 million in tax on 133.1 million packs of cigarettes annually, as shown in the first row of data in Table 1.

Consumers. BOE staff assumes that consumer cigarette evasion is 1.5 percent of tax paid distributions, which is 12.9 million packs of cigarettes, as shown in Table 1.

The assumption of 1.5 percent is based on discussions with the BOE Policy and Compliance Division of the Business Tax and Fee Department and Investigations Division staff members. The percentage is relatively low because the federal Jenkins Act imposes reporting and licensing requirements on remote sellers. Furthermore, the PACT Act of 2009 amended the Jenkins Act to revise provisions governing the collection of taxes and trafficking by requiring Internet and other remote sellers of cigarettes and smokeless tobacco to comply with the same laws that apply to local cigarette and tobacco licensees. In addition, all of the major credit card companies agreed to stop processing credit card payments for Internet cigarette retailers, and DHL, UPS and FedEx have agreed to stop shipping packages for vendors selling to consumers.

Tobacco Products

Retailers. BOE staff estimated tobacco products[4] evasion using data available from the *2012 Economic Census.*[5] BOE staff adjusted the U.S. Census Bureau's California retail estimates of cigarette and tobacco product sales to wholesale sales, assumed ten percent of these sales were tobacco products, and calculated the difference in the Census-based sales estimates from sales indicated by BOE administrative records for 2012. The Census data shows higher sales, implying evasion. The resulting 2012 figure was then updated to reflect the 2015-16 market growth and tobacco products tax rate.

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[1] "Cigarette and Tobacco Products Tax Evasion,"
http://www.boe.ca.gov/legdiv/pdf/CigaretteEvasion.pdf

[2] Copies of the model's documentation are available upon request from Joe Fitz, Chief, Research and Statistics Section, (916) 323-3802.

[3] Twenty-five percent represents the percentage of revenue difference reasonably attributable to evasion based on our review of several studies.

[4] As used here, the term "tobacco products" refers to all tobacco products except cigarettes. Examples of such products include chewing tobacco, snuff, cigars, pipe tobacco, and roll-your-own cigarette tobacco.

[5] U.S. Census Bureau, http://www.census.gov/econ/census/

Consumers. BOE staff believes that consumers purchase tobacco products online or by mail order in the same proportions that they purchase any other consumer product they typically buy online. The enforcement tools discussed for cigarettes are less applicable for tobacco products, since the Jenkins and PACT Act provisions do not extend to sales of cigars or pipe tobacco. Data from the U.S. Census Bureau show that e-commerce accounted for 7.7 percent of retail sales in 2015-16.[6] BOE staff assumes that consumer evasion is 7.7 percent of tobacco products sales. This proportion accounts for $6.4 million in consumer tobacco revenues, as shown in Table 1.

Compliance Improvement Estimates. Cigarette and tobacco products evasion would be much higher without 2003 legislation that improved compliance significantly. These improvements, which include licensing (AB 71), a counterfeit-resistant encrypted cigarette tax stamp (SB 1701), and retail inspections, were fully implemented during fiscal years 2004-05 and 2005-06.

BOE staff estimated the impacts of these measures during a thirty-month implementation period (January 1, 2004 through July 1, 2006). A Bureau of State Audits report replicated our analysis, and produced similar results. BOE staff updated the estimates to account for market size changes since fiscal year 2005-06. BOE staff estimate that these compliance improvement measures could produce as much as $88.7 million in excise tax revenue on an annual basis. The evasion estimates exclude these compliance improvement revenues.

Proposition 56

Proposition 56 would increase the California cigarette excise tax by $2.00 per pack and indirectly raise the tax rate on other tobacco products by a similar equivalent amount. BOE staff estimated evasion using the same methodology with cigarette and tobacco product tax rates imposed by Proposition 56 using all other data for fiscal year 2015-16. Proposition 56 would also tax e-vapor products as tobacco products. However, this estimate does not include e-vapor products because they are relatively new, and identifying e-vapor products evasion is challenging. BOE staff is not aware of evasion data on them for any state.

Summary. Table 2 shows that cigarette and tobacco products excise tax revenue evasion will range from $523 million to $617 million if Proposition 56 passes. The low-end estimate assumes current evasion behavior, but with the Proposition 56 cigarette and tobacco product tax rates. The high-end estimate assumes additional evasion is caused by the greater illicit profit incentive resulting from the higher rates.

Table 2 Range of Cigarette and Tobacco Products Revenue Evasion Estimates Under Proposition 56 (Retailers and Households, $ Millions)			
	Cigarettes	Tobacco Products	Total
Current Law (FY 2015-16)	$127	$45	$172
Low: Current Law Sales, Proposition 56 Tax Rates	$419	$104	$523
High: Proposition 56 Rates With Behavioral Responses	$500	$117	$617

Methodology. For cigarette retailers, BOE staff used the exact same procedure as for the estimates made under current law. The econometric model is run with the tax rate of $2.87 per pack instead of $0.87 per pack. For tobacco products retailers, a price elasticity of demand

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[6] U.S. Census Bureau, http://www.census.gov/retail/

approach is used instead of an econometric model. This approach is similar to that used in revenue estimation.

Preparation

This evasion and revenue estimate was prepared by Joe Fitz, Research and Statistics Section, Legislative and Research Division. For additional information, please contact Mr. Fitz at 1-916-323-3802.

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