

# Masters of Tax Avoidance

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Kansans and The Cigarette Excise, 1927-2009

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## Introduction

*On the eve of a 2002 tax hike that would send the Kansas cigarette levy to a record 70 cents per pack, three-pack-a-day smoker Kathy Moss explained how she would react: "I'm going to buy wherever cigarettes are cheapest. ... I will drive to Missouri."*<sup>1</sup>

*Joining consumers in their exodus across the Missouri line was tobacconist Steve Barbour. "They gave us one month's notice (from the time the governor signed the law until the time it became effective). So the first thing that I did was come across into Missouri and find some space that I could use closest to the Kansas line."<sup>2</sup> A few months later he moved a second store across the Missouri line.<sup>3</sup> Along with the businesses went income, property and sales tax payments to state and local government coffers.*

*But smokers do not always have to travel for bargains; sometimes the bargain cigarettes come to them. The proprietor of one Kansas tobacco shop explained how, telling a reporter that his customers were being approached by individuals peddling cigarettes out of their cars. "It's easy to spot a smoker," the man said.<sup>4</sup>*

These are just a few examples of how consumers, businesses and criminals have reacted to Kansas's most recent cigarette tax hike.<sup>5</sup> The Department of Revenue's data show that tax evasion reached near-epidemic proportions after the 2002 hike, as sales of legal, tax-paid cigarettes plunged 21 percent.

Wishful thinkers claimed that many of the state's smokers had gone cold turkey overnight, but health surveys show that this did not happen; many merely found an untaxed source of cigarettes. And health wasn't the only area of wishful thinking.

Revenue officials had learned from previous tax hikes that they could expect a sudden drop in legal sales. They certainly didn't anticipate such a large drop as 21 percent, but they remained confident that revenue would bounce back because it had in the past.

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<sup>1</sup> Sara Sleyster, "Cigarette Taxes Divide States," *St. Joseph (MO) News-Press*, June 29, 2002.

<sup>2</sup> Jim Flink, "Smokers Cross State Line to Buy Cigarettes," *KMBC (Kansas, MO)*, July 16, 2002.

<sup>3</sup> Amy Bauer, "Higher Price to Pay," *Topeka Capital-Journal*, July 18, 2003.

<sup>4</sup> Alicia Henrikson, "A Taxing Habit," *Topeka Capital-Journal*, November 17, 2002.

<sup>5</sup> The most recent tax hike passed in 2002 raised the tax to 70 cents on July 1, 2002 and then to 79 cents on January 1, 2003.

<b>Figure 1</b>			
<b>Kansas Cigarette Tax Rate History</b>			
(cents per pack)			
June 1, 1927			2
June 30, 1947			3
April 1, 1957			4
April 1, 1964			6
May 1, 1965			8
July 1, 1970			11
July 1, 1983			16
October 1, 1985			24
July 1, 2002			70
January 1, 2003			79
Source: Fiscal Economics, Inc.			

Alas, at the worst possible time, when budgets are especially tight, the expected resurgence of revenue has not materialized. Instead, tax-paid sales have remained at artificially depressed levels ever since the tax hike (see Figure 2). The explanation for this unpleasant budgetary surprise is evident in the long history of Kansas’s tobacco tax.

### **Kansas’s History Teaches Hard Lesson: High Tobacco Taxes Cause More Problems Than They Solve**

Over the years Kansans have become masters of avoiding high cigarette levies. Anecdotes like the three above give us a colorful glimpse at the problem, but anecdotes do not offer proof. Fortunately, the state government keeps sufficient data on tax-paid cigarette sales to trace the effects of changes in tax law all the way back to the adoption of the tobacco tax in Kansas.

#### **Trouble from the Beginning**

Kansas became the 11th state to institute a cigarette excise when its tax became effective on June 1, 1927. A decade earlier, so-called reformers had pushed through a measure that actually banned cigarettes in Kansas. The massive smuggling network that was undoubtedly built up during that decade from the late teens to the middle of 1927 is not evident in the data, of course, because no cigarettes were legally sold. But when the legislature reversed course and legalized tobacco, they also enacted a tax of two cents per pack.<sup>6</sup>

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<sup>6</sup> Statement of John M. Wall in *Report of Proceedings of the Ninth Annual Conventions of the National Tobacco Tax Conference*, October 1935, p. 27.

Such a small tax by current standards, two cents per pack was not trivial in 1927. As soon as it passed and the state began recording taxed sales, the tax records revealed that the citizens' engrained smuggling habits made them excellent tax evaders. Consumers living in border areas could save as much as 20 cents per carton (about \$2.50 in today's dollars) by making their purchases in any of the surrounding states, none of which levied a cigarette tax at the time.

Enactment of the tax also meant that smugglers could earn \$2,000 (about \$25,000 in today's dollars) on every truckload of bootleg cigarettes smuggled into the state. Not a bad day's pay in the midst of the Great Depression.

During the first two decades of cigarette taxation in Kansas, border-shopping and smuggling continually thwarted attempts to collect taxes on a large fraction of sales. Kansas was (and is) particularly susceptible to this problem because more than 45 percent of its population lived in counties bordering neighboring states. During the '20s and '30s, approximately 10 percent of the state's population lived in counties along the Nebraska border. Another 21 percent lived on the Missouri border, and some 13 percent lived in counties bordering Oklahoma. Only the Colorado border was sparsely populated, with less than two percent of the Kansas population living in border counties.

By 1934, state officials estimated that as many as 60 percent of the cigarettes consumed in Kansas evaded the tax.<sup>7</sup> Some of this resulted from complex schemes by wholesalers and retailers. Other evasion was less sophisticated; one common ploy involved the reuse of tax stamps, some of which were reused as many as 11 times.<sup>8</sup>

Although technologies of manufacturing, transportation and law enforcement have changed dramatically during the eight decades of Kansas's tobacco tax, a clear pattern persists in the records of taxed cigarette sales and the tax rate. During periods of moderate taxation, legal sales of taxed cigarettes remain high. Sharp increases in the levy, on the other hand, have cut sharply into tax-paid sales, and hurt revenue, as smokers secure their nicotine fix outside of the state's borders.

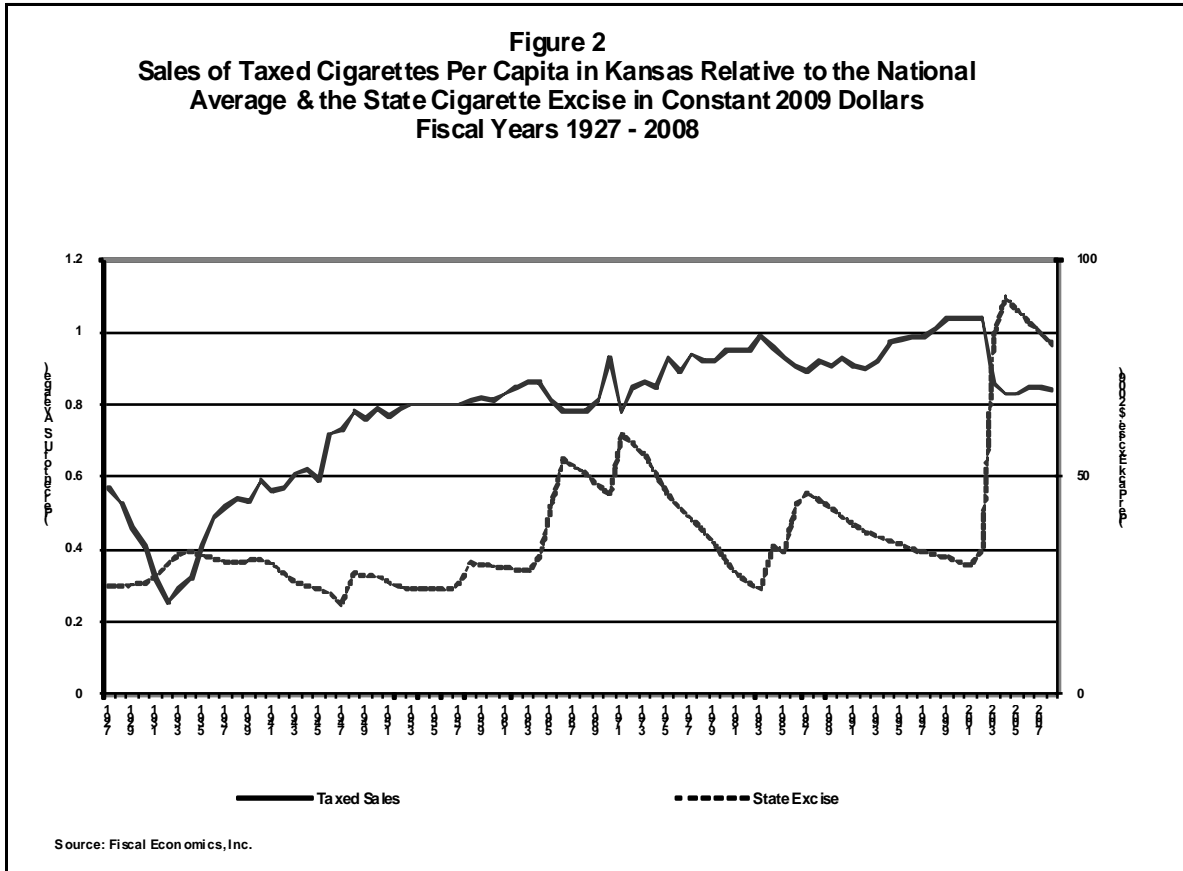
The history of cigarette taxation in Kansas is neatly summarized by the two series in Figure 2. The solid line in the graph shows the legal sale of taxed cigarettes in Kansas compared to the national average over time. (It is important to include the national average so that when nationwide changes in tobacco consumption occur, the chart does not mistakenly correlate those changes with Kansas's tax law.) The dashed line shows the state's cigarette excise tax rate in constant 2009 dollars so that rates can be compared over time without worrying that inflation affects the comparison.

## **The Early Years**

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<sup>7</sup> Wall, p. 28.

<sup>8</sup> Wall, p. 29.



During the '30s and early '40s, unacceptably high levels of tax evasion dampened politicians' enthusiasm for cigarette taxes. However, Kansas never repealed or even lowered its rate. Instead, the legislature just froze it, and over the next decade and a half, inflation whittled down the impact of the tax. That sapped the gains from border-shopping and bootlegging, and taxed cigarette sales in Kansas rose to about 80 percent of national levels in 1950.

Probably even more important than inflation during this period of progress for Kansas's tax enforcement, new cigarette taxes in neighboring states made border-shopping less of a bargain and cut into smuggling profits. Oklahoma adopted a 3-cent-per-pack tax in 1935. Twelve years later, in 1947, Nebraska enacted its first tax, also 3 cents per pack. Colorado continued to levy no excise on cigarettes, but the sparse population along that border mitigated the problem there.

Border-shopping and bootlegging along the Missouri border, however, continued to be significant problems and in Kansas's interior, high taxes sent price-conscious consumers scurrying to such tax-free oases as Indian lands, military bases and other federal facilities.<sup>9</sup>

<sup>9</sup> Harry M. O'Riley during the Round Table on Tax-Exempt Sales in *Proceeding of the 29<sup>th</sup> Annual Meeting of the National Tobacco Tax Association* (Chicago: Federation of Tax Administrators, 1955), p. 25.

The state responded by ramping up enforcement. One source of bootleg cigarettes was thought to be wholesalers who supplied retailers on both sides of the border.<sup>10</sup> Tax authorities suspected that sales made to Kansas retailers were sometimes allocated to low-tax Missouri. Kansas and Missouri tax authorities entered into a joint auditing program, but it was largely ineffective. By the end of the decade, legally taxed sales had risen only slightly when compared to the national level.

Assistance soon came from Jefferson City, however, when the Missouri legislature doubled its tax from 2 to 4 cents per pack on May 1, 1961. For the first time Missouri did not have a tax advantage over Kansas. This dampened bootlegging and border-shopping and helped pushed legal, taxed sales in Kansas to their highest level ever.

### **The Power of Border-shopping**

The power of border-shopping was clearly demonstrated over the next decade when a series of tax hikes sent tax-paid sales in Kansas on a roller-coaster ride. Two months after the Missouri hike in May of 1961, Oklahoma raised its tax from 5 to 7 cents per pack. Nebraska followed suit two years later, raising its tax from 4 to 6 cents. The resulting influx into Kansas of border shoppers from these two states helped push taxed cigarette sales in Kansas to record levels by 1964.

These gains lasted only three years, though. At the end of fiscal 1964, Kansas raised its own cigarette tax to 6 cents and barely a year later raised it again to 8 cents. Tax-paid sales plummeted to levels not seen since the early 1950s.

Sales rebounded slightly over the next six years as inflation whittled away at the value of the excise. Then the Missouri legislature again rode to Kansas's rescue; at the beginning of fiscal 1970, it raised its tax to 9 cents per pack. For the first time, Kansas had a tax advantage over its neighbor. Even though the advantage was only one cent per pack, Kansas stores saw many Missouri residents, and tax-paid cigarette sales in Kansas climbed to the highest level yet recorded. Once again, however, these gains were short-lived, this time only one year. At the beginning of fiscal 1971 Kansas raised its cigarette tax to 11 cents. Tax-paid sales plunged by over 14 percent, finishing a wild decade for taxed cigarette sales in Kansas.

In addition to encouraging border-shopping, the tax hikes also brought with them an increased incidence of tax-related crime, including the theft of a machine used to mark cigarette packs as being tax-paid.<sup>11</sup> Such a machine would have been used illegally to affix counterfeit indicia to

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<sup>10</sup> John E. Kirchner during the Business of the Thirty-Second Annual Meeting in *Proceeding of the 32<sup>nd</sup> Annual Meeting of the National Tobacco Tax Association* (Chicago: Federation of Tax Administrators, 1958), pp. 39-40. Also see "Reciprocal Audits and Reporting Forms" in *Proceeding of the 34<sup>th</sup> Annual Meeting of the National Tobacco Tax Association* (Chicago: Federation of Tax Administrators, 1960), pp. 2-3.

<sup>11</sup> Report of the Committee on Tax Evasion in *Proceeding of the 45<sup>th</sup> Annual Meeting of the National Tobacco Tax Association* (Chicago: Federation of Tax Administrators, 1971), p.4.

cigarette packs so that they could be slipped into the legitimate supply chain. The rise of such crime, coupled with the state's experience with border-shopping, helped to discourage additional tax hikes for the next 13 years. By the early 1980s the era's high inflation had reduced real cigarette tax rates to levels not seen since the 1940s. This resulted in tax-paid cigarette sales nearly equaling the national level by 1983.

Sales were also buoyed by tax hikes in neighboring states. At the end of April 1971, Nebraska raised its cigarette excise from 8 to 13 cents. This reversed border activity and helped to boost Kansas's taxed cigarette sales 8.4 percent in the first year. Three years later, at the beginning of fiscal 1974, Colorado raised its tax to 10 cents per pack, substantially reducing its tax advantage over Kansas.

### **Military Sales**

Cigarettes sold on military bases are exempt from state and local taxes. While price-conscious consumers had long flocked to post exchanges and commissaries to purchase cheap cigarettes, their impact on state revenues was initially small. This changed in 1964 when the state's cigarette levy was hiked to 8 cents per pack. The prospect of saving at least 80 cents (\$5.71 in today's dollars) on every carton sent smokers with purchasing privileges scrambling to military stores.<sup>12</sup> Those without access asked friends and relatives to buy cigarettes for them.<sup>13</sup>

By the early 1970s military stores were selling around 14 million packs annually - about 435 packs for every active duty serviceperson in the state. This compares to statewide taxed sales of around 115 per capita. Despite the small fraction of the population that was entitled to shop on base, tax-free military sales reached 8.9 percent of statewide taxed sales in fiscal year 1973.<sup>14</sup> 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.<sup>15</sup>

By the end of the 1970s, inflation had reduced the incentive for Kansans to take the trouble of obtaining tax-free cigarettes on base, and military cigarette sales dipped to around 4.0 percent of

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<sup>12</sup> In addition to tax savings, products sold at military stores were frequently sold at a discount. Karen Jowers, "Butt Out: Tobacco Sales Plummet As Prices Rise," *Army Times*, October 20, 2003.

<sup>13</sup> 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.

<sup>14</sup> 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* (Arlington, VA: Orzechowski and Walker, 2007).

<sup>15</sup> *Taxation of Military Income and Store Sales*, pp. 13-16.

taxed sales, according to a United States General Accounting Office study.<sup>16</sup> A follow-up study by ACIR, however, showed a sharp resurgence of such sales in the state during the early 1980s.<sup>17</sup>

### **The Tax Hikes of the Mid-1980s**

The steady progress that Kansas had made eradicating border-shopping and bootlegging came to an abrupt end when the state hiked its cigarette tax to 16 cents per pack at the beginning of the 1984 fiscal year. Over the next two years, sales of taxed cigarettes in the state dropped by nearly 10 percent. An additional 8-cent hike in October 1985 caused taxed sales to plunge even further, to 89 percent of the national level in fiscal 1987. After this taxing binge, fear of bootlegging and ancillary crime kept the cigarette tax rate stable for more than 17 years.

Adjusted for inflation, the impact of cigarette taxes gradually declined from fiscal 1987 to 2002, and taxed cigarette sales rebounded. By 1998, Kansas's taxed sales eclipsed the national level, and by 2002 they were 104 percent of the national average.

This pronounced increase in tax-paid cigarettes could be misinterpreted as an increase in the smoking rate instead of being a tax-related phenomenon. But according to the U.S. Centers for Disease Control, in 1992 (the earliest year for which data is available) 23.0 percent of the adults in Kansas smoked cigarettes. This figure fell slightly to 22.7 in 1997 and to 22.2 percent in 2001.

### **Kansas's Huge 2002 Tax Hike**

Once again, however, years of progress in mitigating border-shopping and bootlegging were wiped out with the stroke of a pen. In early 2002 the state government found itself facing a large budget shortfall.<sup>18</sup> Governor Bill Graves proposed closing this gap with a series of tax hikes including a 65-cent increase in the cigarette excise. The legislature initially balked at the proposal, and a protracted stalemate ensued. Finally, after the longest legislative session to date, lawmakers compromised on a 55-cent hike.<sup>19</sup>

Aware of the state's past problems with border-activity, revenue officials estimated that the hike would cause taxed cigarette sales to drop by about 10 percent in fiscal 2003 but still raise \$81 million in new revenue.<sup>20</sup> They then predicted that taxed sales would rebound to about 95 percent of the pre-hike level in fiscal 2004 and raise \$104 million in additional revenue.

These estimates proved to be too optimistic; taxed sales dropped by more than 20 percent in fiscal 2003. Instead of rebounding in 2004 they fell by another 5 percent and have remained at these depressed levels ever since.

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<sup>16</sup> *The Tax Status of Federal Resale Activities* (Washington, DC: United States General Accounting Office, 1979).

<sup>17</sup> *Cigarette Tax Evasion: A Second Look* (Washington, DC: Advisory Commission on Intergovernmental Relations, 1985).

<sup>18</sup> John Hanna, "House Rejects Tax Plan, Despite Pressure From Graves, GOP Leaders" *Topeka Capital-Journal*, May 13, 2002.

<sup>19</sup> Dick Lipsey, "Smokers, Smoke Shops Upset Over Tax Increase," *Topeka Capital-Journal*, May 19, 2002.

<sup>20</sup> *Ibid*

## Lessons from the Big Apple

So far Kansas's experience with cigarette tax avoidance has been generally benign. Legislators, however, need to be aware that there are limits to how high taxes can be raised before they begin to exact a large toll on society. New York City offers an illustrative example. There, high taxes have spawned a massive black market that 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 \$4.25 per pack sustain an illicit market that supplies at least half of all cigarettes consumed in the city today.

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

Persistently low cigarette tax revenue two, three and even five years after a tax hike may surprise politicians, but it is explained by the same factors that have always hampered tax collection efforts in Kansas.

### *Higher Tax Rate than Neighboring States*

Most obviously, Kansas's tax rate is higher than any neighboring state's. At present, the amounts a Kansan smoker can save on each carton purchased out of state – \$4.50 in Nebraska, \$6.20 in Missouri, \$5.60 in Oklahoma and \$5.90 in Colorado – are powerful incentives. Consumers are traveling across borders in every direction, and they're lined up at smoke shops on Indian reservations. "I'm in Wichita, and I know for a fact that lots and lots of people are going to Oklahoma to buy cigarettes," groused one retailer. "And in Topeka, a lot of people are going to the Indian reservations."<sup>21</sup>

### *Internet Shopping*

Like smokers everywhere, Kansans have increasingly shopped online to dodge the tax. Twenty years ago, the opportunity to regularly shop across borders was limited to people who lived near a low-tax state or other source of low-cost cigarettes. The internet revolution of the past two decades has changed this in a big way. Now smokers have access to tobacconists across the globe, including those outside the U.S. who don't charge federal, state or local taxes.

During the mid-1990s, both the federal rate and the Kansas rate were comparatively modest, mitigating this potential tax enforcement nightmare. Then, in 1998, Kansas and the other states signed the Master Settlement Agreement and similar pacts with the major cigarette companies. This raised cigarette prices in Kansas to around \$20.00 per carton, compared to just \$12.00 from offshore internet retailers.

In 2003 testimony before the U.S. Congress, this author estimated that internet retailers sold Kansans 3.7 million packs of cigarettes in fiscal 2003, or about 2.2 percent of taxed sales, costing state and local treasuries \$3.7 million in lost tax revenue.<sup>22</sup> By 2005 internet sales in the state were projected to rise to as high as 26.5 million and cost governments \$29.8 million.

### *Off-Brand Adventures and Rolling your Own*

In addition to altering where they shop, smokers are also increasingly purchasing discount brands and rolling their own cigarettes, two activities which further cut into state revenues. The switch to cheaper cigarettes reduces sales tax revenue. It also decreases annual payments from the tobacco settlement since the agreement allows participating members to reduce payments if they lose market share to nonparticipating manufacturers. After losing millions in recent years

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<sup>21</sup> "Smokers Roll With Cigarette Tax Increase," *Lawrence Journal-World*, April 13, 2003.

<sup>22</sup> 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.

Kansas authorities have taken steps to stanch the loss of MSA payments including increasing effective tax rates on discount brands.<sup>23</sup>

Retailers also report that the sale of loose tobacco and other products used to make cigarettes at home soared in the aftermath of the 2002 tax hike. “A huge percentage has gone to rolling their own, which is much, much cheaper” reported Bryan Walz, the manager of 19 tobacco shops in Kansas, a year after the tax hike.<sup>24</sup> “You can make a carton of roll-your-owns for \$7 or \$8,” substantially less than the \$34 he charged for premium brands.

### *Retail Flight*

Kansas retailers are feeling the pressure acutely, and some are fleeing. “They’re running a lot of good people out of business, honest people,” commented one retailer. “I’m ready to leave, and I’ve lived here all my life.” said another contemplating a move. “You can’t operate a business here.”<sup>25</sup>

Less than one third of the convenience store chain QwikTrip’s establishments are located on the Kansas side of the border in the Kansas City metropolitan area. This, in spite of the fact that more than 40 percent of the region’s residents live there. After the 2002 tax hike the company moved one of its store’s 100 feet into Missouri to take advantage of the favorable tax climate.<sup>26</sup> “The return in Missouri is presently much greater,” said a company spokesman.

More than just taxed cigarette sales leave the state when shoppers and retailers flee a state. Purchases of complementary products, such as gasoline and coffee, also suffer. “If they’re not coming in for cigarettes, they’re not going to buy the other stuff here,” lamented the manager of a gas station near the state line in Wathena.<sup>27</sup> As sales decline, sales tax collections fall. Likewise, falling profits mean less income tax revenue. As retail space becomes less and less attractive, property tax receipts fall.

### **More Proposed Hikes**

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<sup>23</sup> “Kline Promises Plan to Protect Tobacco Revenues,” *Lawrence Journal-World*, January 21, 2004.

<sup>24</sup> “Smokers Roll With Cigarette Tax Increase.”

<sup>25</sup> John Hanna, “Feeling Taxed to the Limit,” *Topeka Capital-Journal*, July 1, 2002.

<sup>26</sup> “Smoking Could Get A Lot More Expensive,” *Lawrence Journal-World*, December 2, 2007.

<sup>27</sup> Sleyster.

<b>Figure 3</b>					
<b>The Effects of the Tax Hikes Contained in House Bill 2327 on Taxed Cigarette Sales in Kansas</b>					
<b>(Fiscal Years 2010-2015)</b>					
	<b>Excise</b>		<b>Price</b>		<b>Tax-Paid Sales</b>
	<b>Nominal</b>	<b>Real (\$2009)</b>	<b>Nominal</b>	<b>Real (\$2009)</b>	<b>(millions of packs)</b>
<b>Scenario I: No Tax Increase</b>					
<b>2009</b>	<b>\$0.79</b>	<b>\$0.79</b>	<b>\$4.13</b>	<b>\$4.13</b>	<b>158.0</b>
<b>2010</b>	<b>0.79</b>	<b>0.78</b>	<b>4.09</b>	<b>4.05</b>	<b>161.5</b>
<b>2011</b>	<b>0.79</b>	<b>0.77</b>	<b>4.08</b>	<b>3.96</b>	<b>162.3</b>
<b>2012</b>	<b>0.79</b>	<b>0.75</b>	<b>4.07</b>	<b>3.88</b>	<b>162.9</b>
<b>2013</b>	<b>0.79</b>	<b>0.74</b>	<b>4.04</b>	<b>3.78</b>	<b>165.4</b>
<b>2014</b>	<b>0.79</b>	<b>0.72</b>	<b>4.02</b>	<b>3.69</b>	<b>167.7</b>
<b>2015</b>	<b>0.79</b>	<b>0.71</b>	<b>4.00</b>	<b>3.57</b>	<b>169.5</b>
<b>Scenario II: 75 cent per pack tax increase in 2010, additional 4 cent per pack hikes in 2011-15</b>					
<b>2009</b>	<b>0.79</b>	<b>0.79</b>	<b>4.13</b>	<b>4.13</b>	<b>158.0</b>
<b>2010</b>	<b>1.54</b>	<b>1.52</b>	<b>4.84</b>	<b>4.79</b>	<b>112.5</b>
<b>2011</b>	<b>1.58</b>	<b>1.53</b>	<b>4.87</b>	<b>4.73</b>	<b>111.0</b>
<b>2012</b>	<b>1.62</b>	<b>1.54</b>	<b>4.90</b>	<b>4.67</b>	<b>109.3</b>
<b>2013</b>	<b>1.66</b>	<b>1.55</b>	<b>4.91</b>	<b>4.59</b>	<b>108.7</b>
<b>2014</b>	<b>1.70</b>	<b>1.56</b>	<b>4.93</b>	<b>4.52</b>	<b>108.1</b>
<b>2015</b>	<b>1.74</b>	<b>1.55</b>	<b>4.95</b>	<b>4.42</b>	<b>107.1</b>
<b>Source: Fiscal Economics, Inc.</b>					

In spite of eight decades of experience, which clearly demonstrate that smokers in Kansas have become masters of dodging the cigarette excise, the temptation to levy taxes on a minority to fund popular public programs has proven to be too strong for some politicians. In 2004 Governor Kathleen Sebelius proposed raising the tax by 50 cents to pay for a health insurance program. Concern over border activity helped scuttle the proposal.<sup>28</sup> Undeterred, the governor put forth a similar proposal in 2007 to help pay for the expansion of health insurance coverage in the state. Again concern over border-shopping and bootlegging helped shoot down the plan. “It isn’t a reliable source of income to pay for health care” stated Senator Jim Barnett, the lead of sponsor of the health insurance plan.

This year House Bill 2327 has been introduced into the state legislature. It would raise the state cigarette excise by 75 cents per pack to \$1.54 on July 1, 2009. Additional, 4 cent per pack hikes would be imposed at the beginning of each of the following fiscal years. Figure 3 shows the

<sup>28</sup> “Cigarette Tax Increase Still Smoldering,” *Lawrence Journal-World*, August 2, 2005.

likely effects of such a hike. These estimates were produced using a Kansas-specific model developed by Fiscal Economics, Inc. to examine the effects of price changes on taxed cigarette sales in the state while holding all other factors affecting taxed sales constant. The model was used to examine two scenarios. In the first, current law was assumed to remain in place through 2015. As illustrated in the second column of the table, under this scenario inflation gradually reduces the real, or inflation-adjusted, excise from 79 cents in 2009 to 71 cents in 2015. This helps reduce the real average price of cigarettes from \$4.13 to \$3.57 per pack. As prices fall both increased consumption and a reduction in out-of-state purchases help increase taxed sales from 158.0 million in 2009 to 169.5 million in 2015.

In the second scenario a 75-cent per pack tax hike is enacted and becomes effective at the beginning of fiscal 2010. Additional 4 cent per pack hikes are assumed to be enacted at the beginning of each of the subsequent fiscal years. Under this scenario real cigarette excises rise from 79 cents in 2009 to \$1.55 in 2015. Reductions in consumption as well as increases in border activity in response to this price hike cause tax-paid cigarette sales to fall to 107.1 million in 2015, more than 62 million packs – or 36.8 percent - below the current law forecast.

## **Conclusion**

Over the last eight decades smokers in Kansas have shown themselves to be quite sensitive to excise tax hikes, though probably not in the way that supporters of these tax increases intended. Instead of quitting their habit, many smokers simply flocked to neighboring states and other 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.

This rampant, casual tax evasion has sent both economic activity and tax revenue out of the state. It has also undermined respect for the law. These problems could be avoided if policymakers recognized that popular public programs – which purportedly benefit all citizens – should be paid for using broad-based levies such as income, property and sales taxes rather than select, easily avoided excise taxes. Adherence to this principle would bolster economic activity in the state, increase respect for the law, reduce crime, and improve equity in the state's fiscal system.