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December 30, 2010

Ms. Caryn Cohen  
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Food and Drug Administration  
9200 Corporate Boulevard  
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Dear Ms. Cohen:

Altria Client Services (ALCS), on behalf of Philip Morris USA Inc. (PM USA),<sup>1</sup> provides the attached written submission in response to the Food and Drug Administration's request for such submissions as provided in the Notice of Meeting for the January 10-11, 2011, meeting of the Tobacco Products Scientific Advisory Committee (75 Fed. Reg. 76993, December 10, 2010; Docket No. FDA-2010-N-0001).

We are providing this information to further a discussion on the issue of unintended consequences and other countervailing effects associated with potential menthol-related regulatory actions. We encourage the FDA and the Tobacco Products Scientific Advisory Committee to solicit the views of other stakeholders on this topic and include a related discussion on the agenda of an upcoming TPSAC meeting.

The information in the attached submission is entirely available for public release.

If you have any questions, please contact me at (804) 335-2679. Thank you.

Sincerely,

James E. Dillard III

<sup>1</sup> Altria Client Services (ALCS) provides this information on behalf of PM USA. ALCS provides certain services, including regulatory affairs, to the Altria family of companies.

# Countervailing effects of a ban on menthol cigarettes

Prepared and submitted by Altria Client Services on behalf of  
Philip Morris USA

Background information for the January 10-11, 2011 meeting of the  
Tobacco Products Scientific Advisory Committee

This information is entirely available for public release

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# Executive summary:

## Countervailing effects of a ban on menthol cigarettes

Philip Morris USA Inc. (PM USA)<sup>1</sup> provides this submission to the Tobacco Products Scientific Advisory Committee (TPSAC) and the Food and Drug Administration (FDA) to further a discussion on the issue of unintended consequences and other countervailing effects associated with a potential ban on menthol cigarettes or other related regulatory actions.<sup>2</sup> Section 907 (b)(2) of the Family Smoking Prevention and Tobacco Control Act (Act) requires FDA to:

*“...consider all other information submitted in connection with a proposed standard, including information concerning the countervailing effects of the tobacco product standard on the health of adolescent tobacco users, adult tobacco users, or nontobacco users, such as the creation of a significant demand for contraband or other tobacco products that do not meet the requirements of this chapter and the significance of such demand.”*

It is difficult to predict with absolute certainty what consumers would do if menthol cigarettes were banned. Some have speculated that banning menthol cigarettes might benefit the public health if it would cause some menthol smokers to quit smoking or prevent some non-smokers from starting. Although these are possible outcomes for some individuals, they are not the only outcomes, nor demonstrated to be the most probable outcomes. Rather, some would likely smoke a non-menthol brand, obtain menthol cigarettes from unregulated sources, or make their own menthol cigarettes.

Based on the available data, it would be speculative and premature to conclude that banning menthol cigarettes will reduce overall smoking prevalence, even without other variables to take into account. Standing alone, the continued availability of menthol cigarettes will undermine any anticipated public health benefits of removing menthol cigarettes from the legitimate marketplace. As documented in this submission, however, a ban is also certain to trigger a series of lasting and severe unintended consequences that would be detrimental to public health objectives and to society. These significant unintended consequences would likely include: (1) the growth of illicit markets; (2) the unregulated design, manufacturing, labeling, distribution, marketing and selling of menthol cigarettes; (3) reduced control of access

to both menthol and non-menthol cigarettes by minors; and (4) expansion of criminal enterprises and consequent resulting increase in spending on law enforcement, courts and corrections. As a result, there will be a sizeable percentage of cigarettes designed, manufactured, labeled, distributed, marketed, and ultimately sold in the United States that will not meet the objectives and intended consumer benefits of a ban on menthol cigarettes. Countervailing effects would also include substantial declines in tax revenues and payments under the Tobacco Settlement Agreements (TSAs),<sup>3</sup> impacting federal, state and local programs, as well as significant job losses along the legitimate cigarette supply and distribution value chain. These unintended and undesired effects would countervail any intended benefits of a ban on menthol cigarettes, as well as create other problems.

**A ban on menthol cigarettes would likely expand unregulated sources of cigarette supply, mostly through the development and growth of the illicit market**

A ban on menthol cigarettes is likely to dramatically expand the sources of unregulated supply of cigarettes, mostly through expansion of the existing illicit market, out of the purview of FDA and other regulators. The Framework Convention Alliance, in preparation for proceedings related to the World Health Organization's Framework Convention on Tobacco Control, estimated that the illicit cigarette market in North America represents approximately 5% of the total cigarette market by volume. This translates to approximately 16 billion untaxed and unregulated cigarettes, representing \$4.5 billion in revenue and a \$2 billion loss in federal, state and local tax revenues for the United States alone.

Experience suggests that a ban on menthol cigarettes is likely to significantly increase the total demand for illicit cigarettes, as many smokers may turn to unregulated illicit distribution channels to continue purchasing menthol cigarettes. The already well-established and expanding illicit cigarette distribution network in the United States and abroad could readily meet that demand.

Criminal organizations that supply multiple forms of illicit products today have the motivation and capacity to distribute even greater quantities of illicit menthol cigarettes than they already do, by increasing the manufacturing of foreign or domestic illicit product, illegally importing menthol cigarettes from international markets, or distributing non-menthol cigarettes that they illegally mentholate after the fact.

Criminal organizations already distribute large volumes of illicit cigarettes and make significant profits in the United States. A ban on menthol is likely to dramatically expand those criminal operations, the volumes of illicit cigarettes they distribute and their profits. As a reference, if all the current menthol volume shifted to illicit channels, the resulting illicit cigarette market would represent a third of all U.S. cigarettes—more than 100 billion sticks worth \$25 billion in illicit sales annually. If only 20% of current taxed menthol volume migrated to the illicit market, the U.S. illicit cigarette market would double in size and represent 10% of cigarettes sold in the United States—about 33 billion sticks and \$8 billion in illicit annual sales (of which over \$4 billion is lost tax revenue).

Banning menthol cigarettes would not prevent smokers from making their own menthol cigarettes, further undermining the intended benefits of a ban. Adding menthol flavor to non-menthol cigarettes is easy and inexpensive. This “self-mentholation” approach could also lead to normalizing the application of other flavors to give cigarettes characterizing flavors which have already been banned.

#### **Growth in unregulated distribution channels could reduce the effectiveness of existing measures to curtail minors’ access to cigarettes**

The expansion of unregulated distribution channels of menthol cigarettes would undermine efforts to prohibit access to minors at regulated points of distribution. While efforts to prevent the sale of tobacco products to minors at retail outlets have been successful over the past 15 years, minors could turn to illicit markets in the event of greater availability of cigarettes from that channel. Current measures to prevent access to minors could be severely hampered.

#### **Associated increases in crime could require more government spending on law enforcement, courts and prisons**

Federal and state law enforcement officials believe that a wide range of criminals currently distribute and sell illicit cigarettes in the United States, drawn by high profits and low risks. They range from small-time smugglers to organized criminals, some with ties to terrorism. Illicit cigarette profits fund other crimes, including theft, human trafficking and the production and distribution of narcotics.

A significant expansion in illicit cigarette sales would, if it is to be combated, cost money, resulting in increased costs to law enforcement, the courts, and corrections at

the federal, state, and local levels, all at a time when many government budgets are already greatly strained.

### **A decline in legitimate, taxed cigarette sales is likely to lower government revenues and threaten vital programs**

The sale of menthol cigarettes generated more than \$10 billion in federal, state and local government revenues in fiscal year 2009, including sales and excise taxes and TSA payments. A decline in legitimate, taxed cigarette sales would lower these revenues significantly.

A significant amount of cigarette taxes and TSA payments are earmarked for specific purposes, including public education, public health programs and children's health care. For example, all the revenues from the 2009 increase in the federal excise tax on cigarettes are devoted to the State Children's Health Insurance Program (SCHIP), which helps states provide medical insurance for children from low-income families.

A sharp decline in revenues could disrupt government budgets, especially at the state level, which use cigarette tax revenues and TSA payments to cover spending on important items.

### **Hundreds of thousands of jobs could be lost across the tobacco value chain**

Nearly half a million American jobs depend in whole or in part on the sale of menthol cigarettes through existing legal channels. A ban on menthol cigarettes would likely have a direct impact on these jobs as menthol and non-menthol cigarettes sales shift from legitimate to illegitimate avenues. Workers on small, independent farms and in convenience stores could be hit hardest.

Indirect unintended consequences associated with a ban on menthol cigarettes could also include higher prices for non-tobacco products as wholesale distributors and store owners attempt to make up for lost cigarette sales and associated profits.

### **Government statements echo concerns related to the potential countervailing effects**

As it considered the Act, Congress was concerned about this issue as a real possibility. The U.S. House Committee on Energy and Commerce in deciding to ban cigarettes with characterizing flavors other than tobacco and menthol noted:<sup>4</sup>

*[a]ll of these factors – irregular, experimental and social setting use and low overall use within the U.S. population – support the Committee’s conclusion that precipitous removal of these products from the market will not result in a large number of heavily addicted smokers facing the sudden withdrawal of products to which they are addicted, with unknown consequences for the health of the individual users or the overall population. The Committee notes that the prohibition of a product that is used regularly by a large number of heavily addicted adult users would pose different questions of public health than those posed by a ban in section 907(a)(1)...In addition, the sudden removal of a legal source for such a product without the type of consideration and review that FDA will be able to conduct might unnecessarily increase the illegal black market risk, which could also pose a health hazard to users.*

This Congressional concern echoes FDA’s consideration of potential bans of tobacco products during rule-making related to tobacco products in 1996.<sup>5</sup>

*The agency believes that these factors must be considered when developing a regulatory scheme that achieves the best public health result for these products. The sudden withdrawal from the market of products to which so many millions of people are addicted would be dangerous. First, there could be significant health risks to many of these individuals. Second, it is possible that our health care system would be overwhelmed by the treatment demands that these people would create, and it is unlikely that the pharmaceuticals available could successfully treat the withdrawal symptoms of many tobacco users. Third, the agency also believes that, given the strength of the addiction and the resulting difficulty of quitting tobacco use, a black market and smuggling would develop to supply smokers with these products. \27\ It also seems likely that any black market products would be even more dangerous than those currently marketed, in that they could contain even higher levels of tar, nicotine, and toxic additives.*

Footnote 27:

*That a black market and smuggling will occur can be predicted by examining the current situation with illegal drugs in the United States and past experience with prohibition of respect to alcoholic beverages. In both situations, individuals continued using the products. Moreover, in the case of cigarettes, even increased cost due to tax disparities can lead to smuggling and black markets. S. Rept. 95-962, 95th Cong., 2d Sess., (June 28, 1978); Joossens, L., and M. Raw, "Smuggling and Cross Border Shipping of Tobacco in Europe," British Medical Journal, vol. 310, May 27, 1995.*

More recently, the submission of the United States to the World Trade Organization dated November 16, 2010,<sup>6</sup> acknowledged that millions of adults regularly smoke menthol cigarettes and expressed its concerns that banning “any type of cigarette favored by a large portion of U.S. smokers” could significantly expand the existing black market and result in other harmful consequences. The submission noted the following:

*Banning all cigarettes – or any type of cigarette favored by a large portion of U.S. smokers – could significantly increase the existing black market for cigarettes and all the attendant contraband trafficking and other illegal activity. There is already a sizeable black market for cigarettes in the United States. The Treasury Department’s Alcohol and Tobacco Tax and Trade Bureau (“TTB”) estimates that around \$2 billion dollars in federal excise tax revenue is lost each year due to this black market.*

*The expansion of a black market could result in numerous problems, including:*

- *Safety declines: Cigarettes may be even less safe than those that are currently being sold in the U.S. market.*

- *Youth access to tobacco products increases: Federal and state laws in the United States include a number provisions designed to restrict the access of youth to tobacco products, such as proof of age requirements, penalties for retailers that sell to minors, penalties for minors that purchase cigarettes, and bans on self-service displays in establishments that are not adult only. The black market would have none of these provisions designed to restrict access by youth.*
- *Crime increases: Black markets and their associated criminal activities are associated with a substantial number of other public health and societal costs such as violence, incarcerations, etc. These costs would rise as the black market expanded.*
- *Accordingly, any plan to prohibit all cigarettes or a cigarette product with significant market share must be done with appropriate caution.*

## **Summary**

A ban on menthol cigarettes will likely lead to significant unintended consequences and other countervailing effects, including: larger unregulated illicit sources of cigarette supply; self-mentholation; increased access to cigarettes for minors, an expansion of criminal enterprises; new budgetary pressures for federal, state and local governments; and job losses across the cigarette value chain, from farms to convenience stores. This submission details some of these probable and significant unintended consequences.

## REFERENCES

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<sup>1</sup> Altria Client Services (ALCS) is making this submission on behalf of PM USA. ALCS provides certain services, including regulatory affairs, to the Altria Family of companies. “We” is used throughout to refer to PM USA.

<sup>2</sup> We refer the Agency to our submissions of March 22, 2010 (in response to 75 Fed. Reg. 9422) and June 30, 2010 (in response to Docket No. FDA-2010-N-0001) for a further discussion of the science- and evidence-based information related to the use of menthol in cigarettes. We believe there is no science- or evidence-based reason to ban menthol cigarettes or otherwise impose additional restrictions that would deprive adult smokers of menthol cigarettes.

<sup>3</sup> In 1998, the nation’s leading cigarette manufacturers, including Philip Morris USA and the other Original Participating Manufacturers (OPMs), signed a contract called the Master Settlement Agreement (MSA) with the Attorneys General of 46 states, five U.S. territories and the District of Columbia. Prior to entering into the MSA, OPMs had already reached similar agreements with Florida, Minnesota, Mississippi and Texas. These agreements with the Previously Settled States, combined with the MSA, are collectively referred to as the Tobacco Settlement Agreements (TSAs). All language herein referencing TSA is intended to be inclusive of all Tobacco Settlement Agreements payments.

<sup>4</sup> House Energy and Commerce Report regarding the Family Smoking Prevention and Tobacco Control Act (submitted by Rep. Dingell), 110<sup>th</sup> Congress (July 17, 2008) at p. 87.

<sup>5</sup> Final Rule Restricting the Sale and Distribution of Cigarettes, 61 Fed. Reg. 44395, 44413 (Aug. 28, 1996).

<sup>6</sup> First Written Submission of the United States of America, *United States – Measures Affecting the Production and Sale of Clove Cigarettes*. Dispute DS4076. November 16, 2010.

# Chapter 1: Developing an unregulated cigarette supply in illicit markets and self-mentholation

## I. INTRODUCTION

In the wake of a potential ban on menthol in cigarettes, smokers could choose to keep using menthol cigarettes by turning to two sources of supply: unregulated illicit cigarette markets and “self-mentholation.”<sup>1</sup>

The illicit cigarette market in particular could increase significantly due to a ban on menthol cigarettes. Illicit production and distribution networks already exist and could handle the new demand. Many are run by criminal organizations and terrorist groups. Given the current capacity of illicit cigarette suppliers to meet consumer demand through a variety of sources, the high profitability and the low risk of punishment, an illicit market for menthol cigarettes could outpace law enforcement’s ability to enforce it.

## II. CURRENT STATE OF THE ILLICIT CIGARETTE TRADE

### **Incentives for illicit cigarette trafficking are in place**

The illicit cigarette trade is very lucrative. A large percentage of the price of legitimate cigarettes consists of taxes, making tax evasion alone a strong incentive for smuggling. The ATF estimated recently that the profits realized solely from exploiting the differences in state tax rates can be as high as \$23,000 on a carload, \$90,000 on a van load, and \$425,000 on a small truckload.<sup>2</sup> In 2008, before a recent tax increase of nearly 60%, avoiding New York cigarette excise taxes on a standard diverted load of 1,500 cartons of cigarettes would result in a profit of approximately \$60,000.<sup>3</sup>

International or counterfeit smuggling has potentially even greater profitability given that counterfeit cigarettes can be produced and smuggled into the U.S. for as little as \$3.00 per carton — far below the 2009 average U.S. retail price of \$55.10 per carton.<sup>4</sup>

For those involved in the illicit cigarette trade, the attractiveness of this per-unit profit is enhanced by the number of consumers willing to purchase illicit cigarettes. Such willingness is tied to the relative prices of legal and illicit cigarettes, as well as the product characteristics of illicit cigarettes compared to those available through legitimate channels. As the prices or restrictions on legal cigarettes increase, illicit cigarettes become relatively more appealing to consumers. This willingness to turn to the illicit market is encouraged by the relatively low risk of discovery or punishment for consuming such products.

The physical characteristics of cigarettes make them easy to smuggle. Cigarettes are small, light, and do not require special transportation or storage. Also, they are not generally viewed as a controlled or illicit substance. Due to these factors, cigarettes may appear to smugglers as a low-risk, high-return product to distribute.

International shipments of cigarettes can readily be trafficked via existing organized criminal networks. For example, large established networks of international smugglers and tax stamp counterfeiters have been located in Long Beach and Newark, which are two major receiving and distributing points for shipments from abroad.<sup>5</sup> And smuggling cigarettes across state borders can be as simple as filling up the trunk of a car.<sup>6</sup>

### **Numerous distribution networks of illicit cigarettes already exist**

Illicit cigarette manufacturing capacity abroad, manufacturing on certain Native American reservations and an extensive existing illicit cigarette distribution network in the United States could easily supply smokers willing to purchase menthol cigarettes from illicit sources.<sup>7,4</sup> Several forms of illicit cigarettes exist now and are made available to smokers across the United States, including a variety of illicit menthol cigarettes. The organizations that distribute these illicit cigarettes could easily meet any increase in the demand for illicit cigarettes (see Table 1.1).

- Table 1.1: Summary of typical forms of illicit trade [further details in Appendix Exhibit 1.1]

<b>Form</b>	<b>Description</b>	<b>Example</b>
<b>Counterfeit</b>	Unregulated production that imitates trademarked brands	Chinese-produced American brand cigarettes disguised as other goods shipped in 40-foot containers
<b>Grey markets</b>	Legitimate production for sale outside the United States diverted and sold illegally in the United States	Cigarettes for sale in Mexico or elsewhere, lost in free-trade zones, that end up at U.S. retailers or in the hands of street sellers
<b>Illicit manufacturing</b>	Non-licensed production and sale of unbranded or uniquely branded cigarettes	Unlicensed manufacturing on Native American reservations. Cigarettes sold to tribal smoke shops or consumers via the Internet
<b>Remote sales</b>	Sales to consumers made by phone or over the Internet	Cigarettes shipped across borders by couriers to avoid taxes and regulations
<b>Smuggling and bootlegging</b>	Illicit transportation and resale of genuine cigarettes within the United States	Car or truckload of legitimate cigarettes covertly transferred from low-tax states to high-tax states to avoid applicable taxes

### **Counterfeit manufacturing and distribution from China are already major contributors to illicit distribution channels**

According to authorities, the majority of counterfeit cigarettes in the United States today come from China. China alone has the capacity to produce more than 400 billion counterfeit cigarettes each year - about 125% of the total U.S. market volume - at thousands of hidden factories in mostly rural areas. Established distribution networks allow producers to send their products to the United States, and they expand production as opportunities arise.<sup>7</sup> Just one such distribution network reportedly shipped up to 50 containers or 500 million cigarettes, to the United States, Europe and Asia each month.<sup>8</sup>

Additionally, China's counterfeit cigarette manufacturing speed to market is constantly improving, as is its counterfeiting technology. It currently takes as little as

two months to replicate a branded product change, including holograms and fake U.S. tax stamps.<sup>7</sup> Menthol cigarettes have been and continue to be a common target for counterfeiters.<sup>9</sup>

Despite continued enforcement efforts in China, counterfeit cigarette manufacturers flourish due to the high profitability of the trade. From 2002 to 2008, Chinese officials reportedly raided 22,000 sites, seized 8,000 cigarette machines and arrested more than 30,000 people for illegal cigarette production.<sup>10</sup> However, given that a 40-foot cargo container of 10 million cigarettes costs just \$175,000 to manufacture and ship to the United States but can be sold in the United States for up to \$2 million to \$4 million, counterfeiting is expected to continue.<sup>7,11,12,13</sup>

To avoid detection at Customs, the product is often disguised as something other than a tobacco product, or the quantity is declared inaccurately.<sup>14</sup> Between 2001 and 2006, cigarettes made up 18% of all goods (as measured by value) seized by federal Customs and Border Patrol agents, making them the second most popular item smuggled into the United States, just behind apparel.<sup>15</sup>

In the event of a ban on menthol cigarettes, expansive production capacity in China could be used to produce (i) counterfeits of menthol cigarettes no longer legally available in the United States; (ii) counterfeits of international menthol brands; and/or (iii) non-trademarked menthol cigarettes that would subsequently be illegally imported into the United States.

■ Exhibit 1.1: Tony Tung<sup>7</sup>

Tung Yan Yuk, also known as Tony Tung from Fujian province, was among China's most notorious cigarette counterfeiters. In the early 1990s, he began smuggling genuine branded cigarettes into China from abroad. From there, he entered into the market for counterfeit cigarettes, which he manufactured in factories in Fujian, the Philippines and North Korea. His enterprise reportedly shipped up to 50 containers or 500 million cigarettes, to the United States, Europe and Asia each month.

Despite the volume of production, authorities found it difficult to find and stop Tung's operations as he employed a variety of methods to avoid discovery. His camouflage techniques included disguising one factory as a People's Liberation Army compound and storing cigarette machines in concrete bunkers. He also used unorthodox transportation, such as fishing boats, to smuggle cigarettes and elude authorities.

In the late 1990s, Tung and his two younger brothers were charged with tax evasion and cigarette smuggling and fined \$90 million. Although Tung's enterprise was dissolved in the early 2000s, thousands of similar factories hidden in China continue to supply billions of counterfeit cigarettes to the United States, Europe and Asia.

### **The grey market – international diverted products – has increased significantly since the mid-1990s**

Due to the growing difference between U.S. cigarette prices and those predominating internationally, the mid-1990s saw the emergence of illegally imported or “grey market” cigarettes as a less expensive alternative to the legitimate domestic market. Grey market traders acquire cigarettes manufactured for sale outside the United States and illegally divert them into the United States.<sup>16</sup> According to ATF and ICE, sources of grey market cigarettes smuggled into the United States include China, Malaysia, Korea, Russia, Latvia, Mexico, Brazil, Paraguay, Uruguay, and the Philippines.<sup>17</sup>

Most grey market cigarettes are either shipped in bulk into U.S. ports and then sold on the streets or in retail stores, or sold in small quantities to individuals through the Internet and shipped via mail or international courier. In California in 2006, smuggled imports of cigarettes accounted for an estimated 36.6% of total cigarette consumption.<sup>18</sup> Authorities also estimated that in 2006, “cigarettes acquired in Mexico represented a large percentage of total cigarette consumption in four Southwestern states: New Mexico (18.3 %), California (15.5%), Arizona (13.3%) and Texas (8.7%).”<sup>18</sup> As of 2009, these rates have increased to 23.6%, 18.5%, 18.9%, and 24.13%, respectively.<sup>19</sup>

### **Illicit manufacturing operations already supply markets in the United States and Canada**

Unlicensed manufacturers within the United States, typically Native American manufacturers, already make and sell cigarettes outside legitimate trade channels.<sup>20</sup> These cigarettes are sold without payment of federal or state taxes, or, where federal taxes are paid, without payment of any state taxes by the manufacturers, who claim sovereign immunity.<sup>21</sup> A ban on menthol cigarettes in the United States could present these existing illicit cigarette manufacturers with lucrative new opportunities.

Law enforcement authorities report that many illicit manufacturing facilities already operate on Native American reservations along the United States/Canada border in clandestine warehouses and garages. These manufacturers produce millions of

untaxed and unregulated cigarettes each day in small and medium-sized factories on reservations in Ontario, Québec, and New York State.<sup>22</sup> While a few Native American manufacturers have applied for and been granted the federal permits required to manufacture cigarettes, many still produce cigarettes without the required permits.<sup>20,23</sup>

■ Figure 1.1: Typical unbranded “baggie” of 200 illicit manufactured cigarettes



Source: [www.smoke-free.ca/eng\\_home/news\\_press\\_2006-12-18-smuggling.htm](http://www.smoke-free.ca/eng_home/news_press_2006-12-18-smuggling.htm)

In Canada, tribally manufactured cigarettes are sometimes sold loose in baggies and are called “loosies.” A baggie of 200 unbranded illicitly manufactured cigarettes, the same number found in a standard legitimate carton, sells for as little as \$6 (Figure 1.1) — substantially less than the price for branded, legal cigarettes in many provinces. In Canada, baggies of illicit cigarettes are sold in public venues such as bingo parlors, billiard halls, coffee shops and on the street. These cigarettes have become so commonplace in some Ontario and Québec communities that they now account for 40-50% of all cigarettes smoked.<sup>24,25</sup>

■ Exhibit 1.2: New York Tribal Sales

Several tribes in New York State claim exemption from state cigarette excise taxes and illegally sell untaxed cigarettes through retail stores on reservation land and on the Internet. In 2008, Native American retailers in New York sold more than 274 million packs of untaxed cigarettes, many of them Newport menthol cigarettes, or

nearly one-third of all the cigarettes sold in New York, despite the fact that these stores account for less than 1% of the retail stores in the state, and fewer than 20,000 Native Americans live on reservations in New York.<sup>27</sup> On the Poospatuck Reservation in Mastic, Long Island, the Native American cigarette outlet closest to New York City, 20 retail outlets sell an estimated 800,000 to 2,300,000 packs of cigarettes per week, or 40 million to 120 million packs per year.<sup>26,27</sup> In addition to selling untaxed cigarettes diverted from legitimate domestic and foreign manufacturers, many tribes manufacture their own unlicensed and unregulated cigarettes.

For example, Jacobs Tobacco is a cigarette manufacturer on the Akwesasne Native American reservation, which straddles the U.S./Canadian border. It does not hold a license to manufacture or sell tobacco in either country. Its 47,000-square-foot factory employs 72 Native Americans full-time with a payroll of US \$2 million per year, and sells its cigarettes through the website Jacobstobacco.com. Although its exact production capacity is unknown, a typical factory on the reservation could process about 5,000 pounds of tobacco to produce 2.5 million cigarettes per day — roughly equivalent to a carton per day for each resident on the Akwesasne reservation, including children. Although Jacobs Tobacco is clearly selling its cigarettes into the United States and Canada, it does not hold a license to manufacture or sell tobacco in either country.

The costs associated with these illicit sales are well known and documented. New York State and New York City lose significant amounts of revenue each year. Indeed, in 2008 Mayor Michael R. Bloomberg's office stated that bootleg cigarettes distributed through New York's reservations cost as much as \$1 billion in lost city and state tax revenue.<sup>26</sup> Further, these sales hurt the legitimate businesses of wholesalers and retailers in New York who comply with tax, licensing and reporting requirements.

■ Exhibit 1.3: Rodney Morrison<sup>28,29</sup>

Rodney Morrison was the owner of Peace Pipe Smoke Shop in Poospatuck, NY, one of the most lucrative Native American smoke shops in the United States. A former drug trafficker in the early 1990s, Morrison switched to selling tax-free cigarettes because the profits were as high and the business was less risky. He reportedly sold nearly 400 million tax-free cigarettes annually to smugglers, who then resold them in

New York City. In just four and half years, Morrison earned an estimated \$172 million.

### **The Internet is already an established channel for illicit sales**

According to retail industry experts, as many as 700 vendors were selling illegal tobacco products over the Internet in 2009.<sup>30</sup> Websites selling cigarettes have proliferated because setup and distribution costs are relatively low, their small, individual consignments are easy to disguise and difficult to detect, and the sellers are hard to prosecute if caught.

The market presents few barriers to entry. A single operation can cost less than \$3,000 to start up and can reach consumers around the world.<sup>31</sup> “With the advent of the Internet,” researchers say, “it has become a lot easier to jump into the bootlegging game: All it takes is a modem and access to a post office. Likewise for smokers, tax-free cigarettes are just a handful of clicks away.”<sup>32</sup> In less than a month, an entrepreneur can set up a website, register with top search engines, identify a source for cigarettes, secure inventory and sell cigarettes directly to consumers.

Increasingly, overseas cigarette vendors drive traffic. The number of sites based overseas jumped from at least 10% in 2003 to over 45% by 2006. Some U.S. Internet cigarette vendors appear to be relocating offshore to escape U.S. regulations.<sup>57,33,34</sup> A ban on menthol cigarettes would provide Internet sellers with even more incentive to move offshore where they have access to a supply of menthol cigarettes.

Small individual mailings are hard to detect at Customs. Even though U.S. law prohibits sending tobacco products through the mail, and FedEx, UPS and DHL have agreed not to ship cigarettes, Customs agents find it difficult to tell which packages contain cigarettes.<sup>35</sup> Canine teams focus on intercepting illegal drugs and explosives. Materials shipped domestically by first-class, priority and express mail are closed to inspection without probable cause.<sup>36</sup>

Depending on their location, buyers and sellers can be difficult if not impossible to prosecute. Citing online merchants is difficult because many do not post their physical addresses. Many of those who are fined refuse to pay and simply set up new websites. Some states also have difficulties enforcing regulations against out-of-state vendors.<sup>37</sup>

Online and phone sales channels may also supply cigarettes to minors, as many do not enforce age restrictions in these channels. In research by the American Wholesale Marketers Association in 2009, only two of 27 tobacco websites paid close attention to the age verification. On the other sites, buyers simply were required to check boxes stating that they were of legal age or otherwise agree to the terms of use. Considering the lack of meaningful controls on most Internet sales of cigarettes, it can reasonably be concluded that minors can purchase cigarettes online with little difficulty.<sup>30</sup>

■ Exhibit 1.4: Otamedia <sup>32,38,39,40</sup>

Otamedia was an online cigarette shop incorporated in Belize that sold millions of premium brand cigarettes. Despite having no physical property or assets in the United States, Otamedia sold millions of cigarettes to U.S. consumers via its website “yesmoke.com.” Offering cartons of Marlboro for \$13.95, rather than the \$65 or more consumers would pay in legal markets, Otamedia sold approximately 6 million cartons to U.S. consumers in one year, generating \$93 million from just one brand.

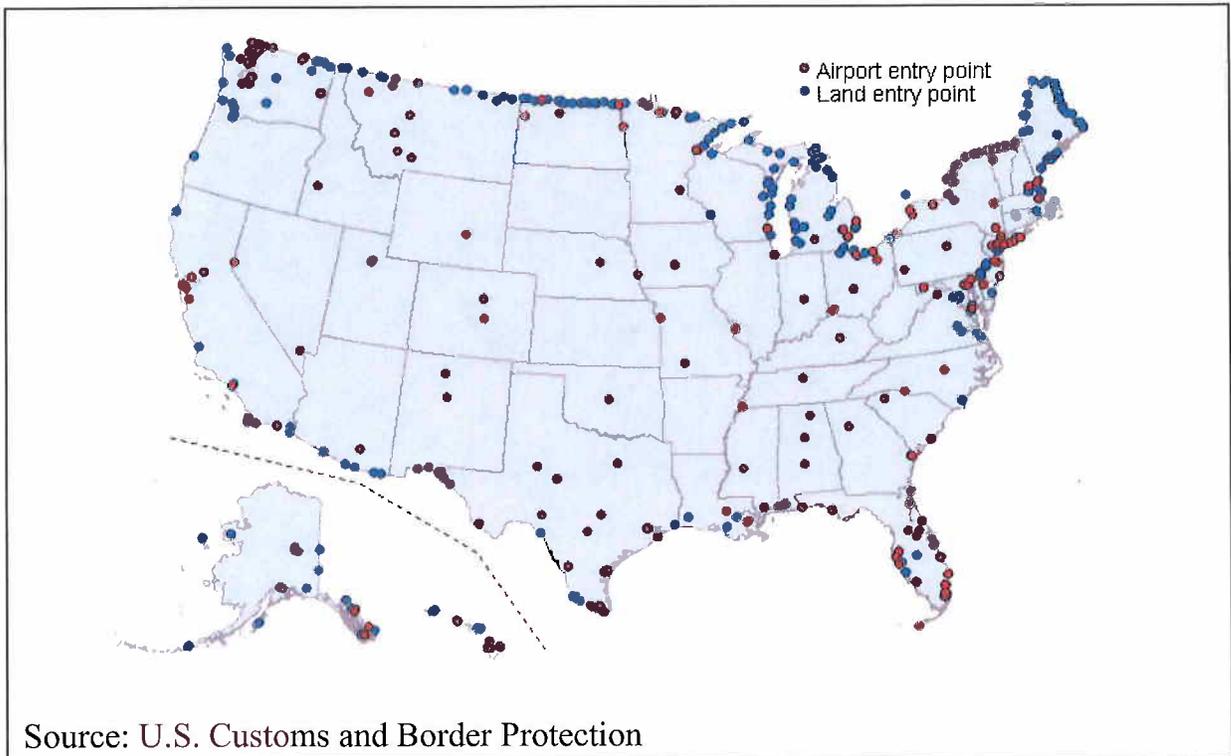
In 2004, authorities seized about 60 million Otamedia cigarettes worth more than \$1.1 million at John F. Kennedy Airport in New York. Officials also shut down the website, charging brand infringement, but Otamedia simply changed the URL to Yesmoke.ch. They continue to sell cigarettes from Italy and are one of many Internet sellers offering to ship illicit cigarettes directly to consumers at home.

### **Customs officials can inspect only a fraction of the cargo coming into the country**

The international supply side of illicit trade of counterfeit cigarettes from China and other markets, illegally re-imported grey market cigarettes, and cigarettes manufactured illicitly abroad and in the United States put a significant burden of inspection on custom authorities and the individuals that serve in these organizations.

The tremendous number of border entry points (Figure 1.2) and volume of goods entering the country every day (Figure 1.3) are among the challenges Customs agents face to stop shipments of illicit cigarettes. The country has 327 official ports of entry, including 190 international airports.<sup>41</sup>

■ Figure 1.2: U.S. points of entry



The volume of container traffic is immense. In 2009, 9.2 million truck containers and 2.1 million rail containers crossed into the United States from Mexico and Canada.<sup>42,43</sup> Another 22.3 million containers came through U.S. seaports.<sup>44,45</sup> In all, more than 33 million shipping containers enter the United States each year carrying more than \$400 billion worth of products.<sup>46</sup>

Consistent inspection is difficult. Less than 40% of truck and rail containers and only 4.6% of sea containers were screened for contraband using imaging and physical inspection in 2009.<sup>47</sup> Additionally, only 20% of the approximately 9 billion pounds of air cargo that enters the United States every year is screened.<sup>48</sup> This means over 28 million containers and 7 billion pounds of cargo enter the United States every year unchecked (see Figure 1.3).

■ Figure 1.3: Inspections by U.S. Customs in 2009 (in thousands of 20-foot container equivalent units)

	Rail	Truck	Sea
<b>Inspected</b>	832	3,606	1,027

<b>Not inspected</b>	1,296	5,617	21,307
<b>Total</b>	2,128	9,223	22,334

Source: U.S. Customs and Border Protection, Performance and Accountability Report (2009); Bureau of Transportation Statistics. American Association of Port Authorities (2009); Individual port statistics.

### **Extensive smuggling and bootlegging operations currently distribute illicit cigarettes throughout the United States**

Extensive criminal operations are already in place and have the ability to covertly transport and distribute a wide variety of illicit tobacco products. These operations deal in counterfeit and grey market illicit product from abroad, and also smuggle genuine cigarettes from low-tax jurisdictions to high-tax jurisdictions without the payment of taxes in the recipient jurisdiction.<sup>49</sup>

These operations use sophisticated distribution networks to sell illicit cigarettes.<sup>50</sup> Cross-border smugglers can be organized criminals that ship contraband cigarettes in large shipping containers or tractor-trailers. Smugglers can also be individuals who load smaller wholesale quantities of cigarettes into the trunk of a car or a van. Organized criminals have exploited the profits to be made from the illicit tobacco trade since the 1940s.<sup>51</sup> The ban on menthol cigarettes would help them greatly expand their businesses and profits.

For example, smuggled cigarettes sold for full retail price in New York City, without payment of any federal, state or local taxes, would yield an illegal profit of roughly \$60 per carton. This translates into about \$3,600 per case, or approximately \$3.2 million per truckload.<sup>52</sup>

In New York City, “five-dollar men” are the “retailers” in an extensive local network of smugglers and bootleggers. Selling packs for five dollars each, they have emerged in response to tax increases in New York City, where a pack of premium cigarettes now sells for more than \$10. The city’s Department of Health and Mental Hygiene’s Community Health Survey found that many people welcome the “five-dollar men” and see bootlegging as a justifiable response to high taxes on cigarettes.<sup>53</sup>

A larger network of smugglers and bootleggers would competitively disadvantage law-abiding wholesalers and retailers in the United States, as they have in other countries. In Canada, “the problem has become societal; everybody is telling everybody how to get illegal cigarettes. And it’s putting stores out of business,” says Dave Bryans, president of the Canadian Convenience Stores Association. In the UK, 88% of retailers surveyed report that smuggling has decreased their tobacco product sales; 25% have cut jobs, and almost one in four retailers is considering closing.<sup>54</sup>

■ Exhibit 1.5: Jorge Abraham<sup>55</sup>

Jorge Abraham, a convicted tobacco smuggler from El Paso, masterminded the trafficking of more than half a billion grey market cigarettes in the United States from 2000 to 2004.

Abraham discovered a grey market smuggling opportunity by accident. As part of his import-export business, he fielded orders of export-bound cigarettes from wholesalers, cleared them through Customs in El Paso, and sent them into Mexico for resale. On one occasion, he cleared a shipment for passage through Customs, but it was rerouted back into the United States. He realized the lucrative opportunity this presented and repeated the process many times, reselling the cigarettes illegally in New York and California while avoiding state and local taxes. Prosecutors say he smuggled about a million dollars’ worth of cigarettes every week. Although authorities occasionally seized Abraham’s illicit shipments, he continued to operate without punishment for four years. When he was finally caught and convicted, he received a five-year prison sentence.

### **III. THE ILLICIT MARKET IS LIKELY TO INCREASE SIGNIFICANTLY IN THE WAKE OF ANY BAN ON MENTHOL CIGARETTES**

Any menthol ban would represent a significant opportunity for criminal organizations operating in the illicit market. Although the illicit cigarette market is of course clandestine, various governmental bodies have attempted to quantify the scale of the issue. By any measure, it is substantial.

In 2007, the Framework Convention Alliance (FCA), in preparation for proceedings related to the World Health Organization’s Framework Convention on Tobacco

Control (FCTC), estimated that the illicit cigarette market in North America represented approximately 5% of the total cigarette market by volume. In 2009, the United States made up more than 82% of North American cigarette volume.<sup>56</sup> Five percent of the total market in the United States translates to approximately 16 billion untaxed and unregulated cigarettes, representing a \$2 billion loss in federal, state and local tax revenues.

Criminal organizations already distribute large volumes of illicit cigarettes and make significant profits in the United States. A ban on menthol would be an irresistible opportunity to dramatically expand those criminal operations, the volumes of illicit cigarettes they distribute, and their profits. As a reference, if all the current menthol volume shifted to illicit channels, the resulting illicit cigarette market would represent a third of all U.S. cigarettes, more than 100 billion sticks worth \$25 billion in illicit sales annually. If only 20% of current taxed menthol volume migrated to the illicit market, it would double the size of the existing illicit cigarette market and come to represent 10% of cigarettes in the United States — about 33 billion sticks and \$8 billion in untaxed annual sales — roughly equivalent to the revenues of Campbell’s Soup or eBay. Of these \$8 billion in illicit, untaxed sales, lost tax revenues for federal, state and local governments amount to over \$4 billion.<sup>57</sup> Table 1.2 shows the potential impacts of menthol smoker migration to illicit cigarette markets.

Table 1.2: Potential impacts of menthol cigarette volume moving to the U.S. illicit cigarette market

<b>Migration of additional menthol cigarette volume to illicit market</b>	<b>0%</b>	<b>10%</b>	<b>20%</b>	<b>30%</b>	<b>40%</b>	<b>100%</b>
Resulting illicit market (billions of sticks)	16	25	33	42	50	102
Share of U.S. cigarette market	5%	8%	10%	13%	16%	32%
Approximate illicit sales (\$ billion)	4	6	8	10	12	25
Of which approximate tax losses (\$ billion)	2	3	4	5	6	12

Source data: Total U.S. total volume of 317.7 billion sticks, \$77 billion in retail sales, 27% menthol share, and \$37.5 billion in total tax revenue.<sup>58,59,60,61</sup>

#### **IV. INCREASING NUMBERS OF SMOKERS COULD SEEK TO PURCHASE MENTHOL CIGARETTES THROUGH ILLICIT CHANNELS**

Consumer responses to sharp cigarette tax increases in California, New York and elsewhere show that significant cigarette volume migrates in response, including to illicit markets.

In 1988, after California raised cigarette taxes by 250%, legal cigarette sales dropped by 33%. Another study, however, showed that actual consumption decreased by less than 5%.<sup>62</sup> This suggests that nearly 30% of cigarette volume had migrated, including to the illicit market.

After New York doubled its cigarette tax in 1965, illicit cigarette activity in the state increased by 60% over the next five years.<sup>63</sup> This result did not seem to deter legislators from dramatically raising cigarette taxes again. In 2002, after New York City and state tax hikes raised retail cigarette prices by 150%, local newspapers reported a “flood” of cigarette smuggling into New York City and a rise in illegal street sales of untaxed cigarettes, particularly in low-income neighborhoods. The 2003 New York City Department of Health and Mental Hygiene’s Community Health Survey showed an 89% increase in cigarettes purchased through alternative sales channels.<sup>53</sup>

It is estimated that, as of 2009, the five states with the highest inbound smuggling rates were Arizona (51.8% of the total state’s cigarette consumption), New York (47.5%), Rhode Island (40.5%), New Mexico (37.2%), and California (36.3%). In 2006, Arizona was not among the top five states. However, in 2007, Arizona substantially increased its state excise taxes on cigarettes and in 2009 the U.S. government substantially increased the federal cigarette excise tax. Combined, these tax increases amounted to an additional \$1.43 per pack tax increase in Arizona, which increased the incentive to smuggle cigarettes from Mexico to Arizona. Of the five states that experienced the largest increases in smuggling rates from 2006 to 2009, each had significant increases in excise taxes. Of the four states that experienced the largest decreases in smuggling rates from 2006 to 2009, none of them increased their excise tax rates during that period (while neighboring states increased their tax rates).<sup>64</sup>

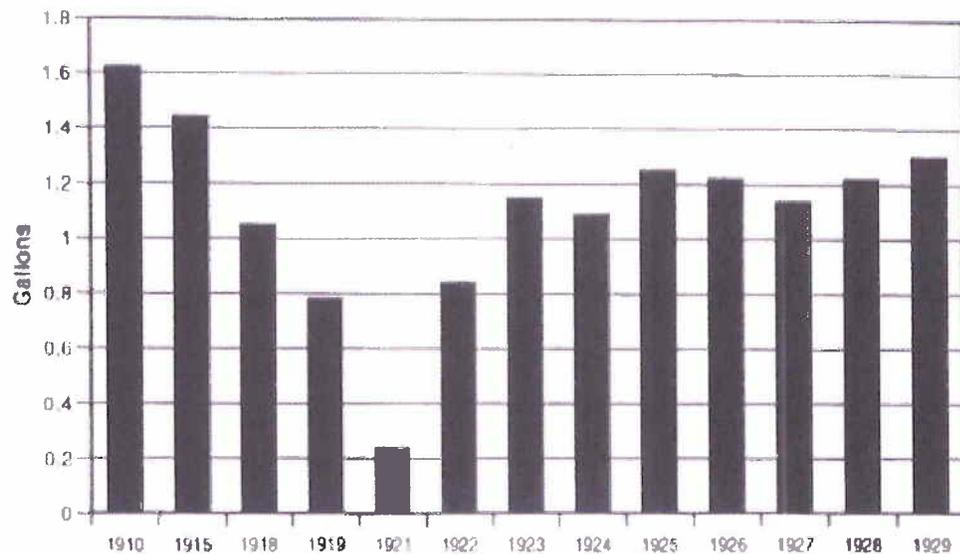
According to John D’Angelo of the Bureau of Alcohol, Tobacco, Firearms and Explosives, “There is no doubt that there’s a direct relationship between the increase in a state’s tax and an increase in illegal trafficking.”<sup>65</sup>

■ Exhibit 1.6: Prohibition<sup>66,67,68,69</sup>

From 1920 to 1933, the sale, manufacture and transportation of alcohol were banned in the United States. Prohibition aimed to promote “temperance” and reduce consumption and alcohol-related crime and corruption. By any measure, Prohibition was a legal, economic and social failure.

Although the federal government devoted nearly half its law enforcement resources to enforcing Prohibition, millions of otherwise honest citizens routinely flouted the law. Research shows that per capita consumption actually increased during Prohibition (see the chart below). Within two years, the illicit alcohol market became larger than the pre-Prohibition alcohol market, and by the end of 1926, annual sales of bootlegged liquor reportedly reached \$3.6 billion, a figure equivalent to the entire federal budget.

**Per capita consumption of pure alcohol, 1910-1929**



Source: Warburton, C. (1932). *The Economic Results of Prohibition*. New York: Columbia University Press.

In addition to increased consumption, tax revenues plummeted and official corruption ran wild. Thousands were sickened and even killed by homemade brews. Violent gangs formed syndicates that modernized criminal activity throughout the country,

and they made massive profits. By some estimates, Al Capone made over \$100 million per year in the illicit alcohol business.

The country's experiment with Prohibition illustrates some of the likely consequences of a menthol product ban, including a new, unregulated supply of products manufactured without production standards, dramatic growth in criminal activity and profits, declines in much-needed tax revenues, heavy new burdens on law enforcement agencies, and widespread flouting of the law by otherwise honest citizens.

### **Other countries struggle with sizable illicit cigarette markets**

In assessing the potential for growth of illicit trade and the capabilities of illicit cigarette trade channels in the United States, it is useful to consider a few case examples outside the United States. These examples demonstrate that new regulations often have unintended consequences, including creating new illicit trade, and further serve to identify potential sources for illicit trade in the United States.

#### ■ Exhibit 1.7: Canada

In Canada, tax increases have contributed to the prevalence of international smuggling of cigarettes to Canada, and a rise, on Native American reservations, in the illegal manufacture of cigarettes made from imported and smuggled raw materials. In the late 1980s and early 1990s, the Canadian federal and provincial governments raised tobacco taxes and duties significantly, creating a demand for untaxed contraband cigarettes. Historically, as “Canadian taxes increased, the differential between Canadian and U.S cigarette prices widened and thus increased the incentive to smuggle cigarettes in from the United States.”<sup>70</sup>

The smuggling was “conducted almost entirely by organized crime. Violence increased, merchants suffered, and in one year alone, Canada and its provinces lost over \$2 billion in Canadian dollars.”<sup>71</sup> A wave of violent crime accompanied the growth of cigarette black markets in Canada. Disputes flared among rival organized crime groups. Criminals also laid siege to the legitimate cigarette industry and subjected employees at all levels of the distribution chain to danger. A rash of truck hijackings occurred, and warehouses and shops were robbed and burglarized. In one case a convenience store clerk was shot and killed for just ten cartons of cigarettes.

The Canadian government cut cigarette taxes in 1994, thus eliminating much of the demand for contraband products. However, since 1994, taxes began to rise again – so much so, that by early 2008, the federal and provincial taxes in Canada totaled \$5.55 per pack, nearly 75% of the price of a pack of cigarettes. This has fueled demand for baggies and “loosies.” In 2007, it was reported that almost one-third of all cigarettes purchased in Ontario and Québec were illegal and that Canada loses an estimated \$1.6 billion in tax revenue each year.<sup>72</sup>

■ Exhibit 1.8: Bhutan

In 2004, the Kingdom of Bhutan enacted a tobacco product sales ban (Penal Code of Bhutan Act of 2004, effective December 17, 2004), becoming the first country to ban the sale of tobacco products nationwide. The Act permitted personal consumption of tobacco, but imposed a 100% sales tax and 100% import tax on tobacco products. The Act further prohibited the use of tobacco in public places and contained anti-tobacco smuggling provisions. A recent study by a University of Oklahoma professor found that “[a]n immediate and long-term problem after the passage of the 2004 anti-tobacco legislation included a thriving black market and significant and increasing tobacco smuggling.” The data indicate that smuggling significantly increased following the tobacco product sales ban.<sup>73</sup>

## **V. EXISTING NETWORKS COULD DISTRIBUTE SEVERAL FORMS OF ILLICIT MENTHOL CIGARETTES IN THE UNITED STATES**

Criminals who engage in the illicit trade of tobacco products deal in multiple forms of illicit cigarettes. Many do not distinguish between forms of illicit trade and freely switch between them, combine them and trade in whatever is in demand. When cut off from one source, they often search for another form to replace it:

- In 2008, 14 smoke shops in Mastic, New York, were charged with selling more than 10 million contraband cigarettes. In 2009, after they were cut off from their legitimate suppliers, the Mastic smoke shops were charged with selling counterfeit cigarettes.<sup>74</sup>
- In 2009, five men in Madison County, Kentucky, were indicted by a federal grand jury for their participation in a black market cigarette ring. They stole

more than 6 million Kent Ultra Lights and then either resold them or traded them for smuggled, unstamped Marlboros. They were also indicted for selling more than 2,000 packs of Marlboro with counterfeit Virginia and California tax stamps.<sup>75</sup>

- In 2010, Amadou Bah, Kenneth Clee and Mamadu Djalo were convicted of trafficking in 87,800 counterfeit cigarettes and another 10,000 contraband cigarettes in Clayton, Georgia.<sup>76</sup>

## VI. ILLICIT CIGARETTES LACK REGULATORY OVERSIGHT

Congress found that enacting legislation granting FDA “the authority to regulate tobacco products” was “in the public interest” and that the “benefits to the American people from enacting such legislation would be significant in human [ ] terms.”<sup>77</sup>

Congress also found that:

The Food and Drug Administration is a regulatory agency with the scientific expertise to identify harmful substances in products to which consumers are exposed, to design standards to limit exposure to those substances, to evaluate scientific studies supporting claims about the safety of products, and to evaluate the impact of labels, labeling, and advertising on consumer behavior in order to reduce the risk of harm and promote understanding of the impact of the product on health.<sup>78</sup>

At the same time, Congress was concerned about the potential of tobacco product standards, such as a ban on menthol in cigarettes, to result in “the creation of a significant demand for contraband or other tobacco products that *do not meet the requirements of [the Act]*” (emphasis added).<sup>79</sup> Illicit menthol cigarettes and many of the facilities that manufacture them will not comply with requirements under the Act or with other federal or state cigarette-related requirements. As a consequence, widespread availability and use of illicit menthol cigarettes will clearly frustrate Congress’ objectives in regulating the design, manufacture, labeling, marketing and sale of tobacco products. Simply put, illicit manufacturers, the criminal networks that support them and their illicit tobacco products cannot be effectively regulated, thus depriving Americans of the intended “significant benefits” of the Act.

Illicit menthol cigarette manufacturers, for example, will not submit ingredient information to the Agency as is currently required for legally marketed cigarettes.<sup>80</sup> Nor will they report to the FDA either 1) the harmful or potentially harmful constituents in their tobacco or smoke;<sup>81</sup> or 2) any new or modified illicit menthol cigarette designs so the Agency can conduct a premarket review.<sup>82</sup> Indeed, the Agency noted in 1996 that it “seems likely that any black market products would be even more dangerous than those currently marketed, in that they could contain even higher levels of tar, nicotine, and toxic additives.”<sup>83</sup>

It is virtually certain that illicit menthol cigarette manufacturers – who are already flouting the law – will ignore any federal and state requirements for performance standards intended to reduce the harm from tobacco products. For example, as of January 2011 all states will require cigarettes to meet self-extinguishment performance standards (i.e., Fire Standards Compliant (FSC) standards). We are not aware of illegally manufactured illicit cigarettes or illegally imported cigarettes with banded, “reduced cigarette ignition propensity” paper technology, which is used by legitimate manufacturers to achieve FSC compliance. The expected increase in volume of illicit cigarettes and the resulting proliferation of illicit menthol cigarettes which are non-FSC compliant will undermine the integrity of the state fire marshal FSC programs for reduced ignition propensity throughout the country.

New and existing illicit cigarette manufacturers also clearly will not register their facilities with FDA<sup>84</sup> and also will not be inspected by FDA.<sup>85</sup> Illicit menthol cigarette manufacturers will have no incentive to follow sanitation requirements or otherwise assure they do not adulterate their products.

Illicit menthol cigarettes are highly unlikely to comply with mandated labeling requirements. Unlike counterfeit cigarettes where there is a high incentive to mimic packaging, including warnings and other requirements, in order to pass off the cigarettes as legitimate, there is no incentive to do so where there will be widespread knowledge that menthol cigarettes in the packaging are themselves illegal. Illicit products without compliant package labels, again, will deprive consumers of benefits FDA believes may be associated with regulatory labeling statements.

■ Figure 1.4: Mobile cigarette factories in rural China



In sum, illicit menthol cigarettes and the facilities that manufacture them will not comply with current and future requirements under the Act and other federal and state laws. As a result, there will be a sizeable percentage of cigarettes designed, manufactured, labeled, distributed, marketed, and ultimately sold in the United States that will not meet the objectives and intended consumer benefits of these regulatory measures.

The production of illicit products in unlawful facilities has led to the repeal of government measures intended to decrease consumption of products intended for adults in other contexts. In 2006, for example, the Russian government attempted to curb alcoholism through regulations and higher excise taxes, spawning an illicit alcohol market across the country. Manufacturers began producing alcohol from cheap medical disinfectants and industrial cleaners, detergents and window-cleaning solutions. The unregulated counterfeit vodka caused a variety of illnesses such as toxic hepatitis and one of the worst cases killed 120 people and sickened over 1,000 people more. It is estimated that over 40,000 people in Russia may have been killed from consuming the illicitly manufactured alcohol. Authorities hoped that alcohol reform would reduce the number of alcohol-poisoning deaths, but the legislation had the opposite effect and was eventually rolled back.<sup>86,87</sup>

## **VII. SMOKERS WHO WISH TO CONTINUE USING MENTHOL CIGARETTES COULD EASILY AND INEXPENSIVELY MAKE THEIR OWN BY ADDING MENTHOL TO READY-MADE NON-MENTHOL CIGARETTES OR TO CIGARETTES THEY ROLL THEMSELVES**

Today, while most menthol cigarettes are purchased ready-made, some adult smokers roll their own and add menthol flavoring to the tobacco or use menthol-flavored papers or filters. Others add menthol flavoring to ready-made non-menthol cigarettes. The ability for smokers to mentholate their own cigarettes would undermine any anticipated public health benefits of a ban on menthol in cigarettes. Some smokers – adults and minors – who add menthol to their cigarettes might also begin adding other flavors to a point where they become “characterizing,” which would undermine the current ban on cigarettes with characterizing flavors other than tobacco or menthol.<sup>88</sup>

Smokers currently use a variety of approaches to add menthol to their own cigarettes. One or two drops of liquid menthol, for example, can flavor a whole pack of cigarettes. Cigarettes stored in a box with menthol crystals reportedly take on the flavor in just a few days. Dozens of blogs, websites and online forums offer instructions on mentholating cigarettes, including [cassiopea.org](http://cassiopea.org), [entheogen.com](http://entheogen.com) and [ryorevolution.com](http://ryorevolution.com). Advice can even be found on such mainstream sites as <http://answers.yahoo.com>.<sup>89</sup>

According to these sites, self-mentholation is simple and straightforward. On [cassiopea.org](http://cassiopea.org), for example, one commentator explains his approach: “You just touch the top of the dropper with your finger, and then rub the oil on the cigarette. That’s it!”<sup>90</sup>

The only ingredient required to mentholate cigarettes — menthol flavoring — is inexpensive and readily available, online and in stores, in liquid and crystal form (Appendix Table 1.1). On [amazon.com](http://amazon.com), for example, four ounces of menthol crystals sell for \$8.25, and two ounces of peppermint oil for \$11.07.<sup>91,92</sup> At these prices, flavoring a pack of cigarettes could cost as little as 13 cents.<sup>93,94</sup> In addition to menthol-based flavoring agents, retailers sell peppermint, spearmint and wintergreen crystals, oils and sprays. Of possible concern, however, is that not all mentholating ingredients may be pure or intended for human consumption, such as menthol medical products or balms intended for external use. In general, a failure to

use appropriate ingredients could expose people to unknown effects. The starkest examples may be from Prohibition, when bootleg liquor sickened thousands.<sup>67</sup>

## APPENDIX

### ■ Appendix Exhibit 1.1: Definitions

For purposes of this analysis, we define the following terms to mean:

- **Illicit cigarette market:** The illicit cigarette market consists of smuggling and selling contraband or counterfeit cigarettes to consumers. Smuggling of goods is conducted for two main reasons: to avoid taxes, and/or to evade rules prohibiting the sale of such goods.<sup>95</sup>
- **Contraband:** Contraband cigarettes are produced by legitimate manufacturers according to corporate and government standards. At some point in their distribution, however, smugglers obtain these cigarettes and subsequently avoid the payment of applicable taxes.
- **Bootlegging/Smuggling/Diversion:** These terms are used interchangeably to describe the illicit trade of contraband cigarettes. The legal purchase of tobacco products in one state but the illicit resale in another state without paying applicable taxes or duties. In general, this involves transporting cigarettes over relatively short distances (e.g., between neighboring states or other nearby jurisdictions).<sup>95</sup>
- **Large-scale or wholesale smuggling/diverting:** Large-scale smugglers move shipping containers or tractor-trailer loads of contraband cigarettes. These activities, typically undertaken by organized criminals, tend to be more sophisticated, take advantage of free-trade zones, may involve legitimate manufacturers and distributors, and may require the commission of other crimes, such as fraudulent documents and money laundering.
- **Counterfeiting:** Counterfeit cigarettes are produced in contravention of a country's taxation, licensing or trademark related laws. Criminals produce counterfeit cigarettes - usually using unregulated ingredients - and then package them to imitate well-known and trademarked cigarette brands. Counterfeiting is traditionally done outside of the United States, with the majority coming from China.
- **Illicit/unlicensed production or manufacturing:** While counterfeit cigarettes imitate trademarked cigarette brands without the consent of the trademark owner, illicit production cigarettes are unique/independent brands that do not have proper licensing from the U.S. government. Some of these operations

also avoid applicable taxes and are sold to the public. These are typically unregulated Native American brands that are sold to off-reservation consumers.

- **Grey Market:** Cigarettes that are manufactured for sale in a foreign market, but actually sold in the United States. Almost always illicit, they are only legal if the producer or importer pass a number of regulatory hurdles (U.S. product certification tests, trademark owner consent, etc.).
- **Non-certified brands:** Cigarettes that are produced legally, but are sold in such a way as to avoid state MSA / escrow payments. Typically done one of two ways:
  - Brands not on a state's agreed MSA list sold directly in a state that allows only MSA sales.
  - Certified cigarettes registered for sale by a distributor in a non-MSA state (e.g., Mississippi) and then transported and actually sold in an MSA state without MSA payments.
- **Organized crime:** Criminal activity on the part of an organized and extensive group of people. Those groups who typically engage in large-scale smuggling operations among other illicit activities. The Royal Mounted Canadian Police defines organized crime as three or more people conspiring to commit a serious criminal offense for financial or material benefit.

■ Appendix Exhibit 1.2: Illicit manufacturing details

The global trading website Alibaba.com offers sale and delivery of all equipment and materials needed to manufacture illicit cigarettes in bulk; one Mark 9 cigarette machine is capable of producing more than seven million cigarettes per day.



**Mark - 9 Cigarette Making Machine**

FOB Price: [Get Latest Price](#)  
 Minimum Order Quantity: 1 Piece/Pieces

Mr. Syed Roome  
 al-Indones

[Contact Supplier](#)

**Sell offer for fine cured Virginia tobacco**

FOB Price: US \$10 - 20/Kilogram [Negotiable](#)  
 Min. Order: 100 Kilogram per  
 Minimum Order Quantity: 100 Kilogram per  
 Supply Ability: 5000 Metric Tons per Year  
 Exported Items: 10

Mr. Ejaz Ahmad Malik  
 al-Indones

[Contact Supplier](#)

**aluminium foil paper**

FOB Price: [Get Latest Price](#)  
 FOB: 0.484

Minimum Order Quantity: 10 Tons/Tons  
 Supply Ability: 100 Tons/Tons per Month  
 Exported Items: 100,000

Mr. Hina Khan  
 al-Indones

[Contact Supplier](#)

**marlboro menthol**

FOB Price: US \$10 - 20/Kilogram [Negotiable](#)  
 Min. Order: 100 Kilogram per  
 Minimum Order Quantity: 100 Kilogram per  
 Supply Ability: 5000 Metric Tons per Year  
 Exported Items: 100,000

Mr. Hina Khan  
 al-Indones

[Contact Supplier](#)

**Cigarette Paper**

FOB Price: [Get Latest Price](#)  
 Supply Ability: 1000 Tons/Tons per Month  
 Exported Items: 10,000

Mr. Hina Khan  
 al-Indones

[Contact Supplier](#)

**acetate tow**

FOB Price: US \$10 - 20/Kilogram [Negotiable](#)  
 Min. Order: 100 Kilogram per  
 Minimum Order Quantity: 100 Kilogram per  
 Supply Ability: 5000 Metric Tons per Year  
 Exported Items: 100,000

Mr. Hina Khan  
 al-Indones

[Contact Supplier](#)

**Printing Material - Blanks & Cartons  
Cigarette and Cigar's product**

FOB Price: [Get Latest Price](#)

Mr. Hina Khan  
 al-Indones

[Contact Supplier](#)

**MENTHOL (USP) CRYSTALS**

FOB Price: US \$10 - 20/Kilogram [Negotiable](#)  
 Min. Order: 100 Kilogram per  
 Minimum Order Quantity: 100 Kilogram per  
 Supply Ability: 5000 Metric Tons per Year  
 Exported Items: 100,000

Mr. Hina Khan  
 al-Indones

[Contact Supplier](#)

■ Appendix Table 1.1: Sources of menthol flavoring

<b>Products</b>	<b>Merchants</b>	<b>Prices</b>	<b>Cost of flavoring 1 pack</b>
Menthol flavoring agents (most labeled for external use only)	Online, herb and beauty stores, roll-your-own cigarette suppliers: <ul style="list-style-type: none"> <li>▪ amazon.com</li> <li>▪ mountainroseherbs.com</li> <li>▪ camdengrey.com</li> <li>▪ bouncingbearbotanicals.com</li> <li>▪ essentialoil.com</li> <li>▪ zooscape.com</li> </ul>	Crystals from \$14.00 per ½ lb  Pure liquid from \$16.48 per 1/2 ounce	\$0.14  \$0.16
Other tobacco flavoring agents	Online, RYO cigarette suppliers, e-liquid providers: <ul style="list-style-type: none"> <li>▪ seedman.com/flavor.htm</li> <li>▪ thetobaccoshop.com/</li> <li>▪ nicotinenirvana.com/</li> </ul>	\$5.00 for 2 ounces pre-mixed in spray bottle, “enough to flavor 1 pound of tobacco”  \$525.50 for 1 gallon, “enough to flavor 256 pounds” or more than 4,000 packs <sup>93</sup>	\$0.30  \$0.13
Peppermint, wintergreen and other “essential oils”	Online and brick-and-mortar herb stores, and GNC, CVS and other pharmacies: <ul style="list-style-type: none"> <li>▪ amazon.com</li> <li>▪ drugstore.com</li> </ul>	\$11.08 for 2 ounces of peppermint oil <sup>91</sup>	\$0.70

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# Chapter 2: Reducing the effectiveness of underage access prevention measures and increasing minors' exposure to criminal activity

## I. INTRODUCTION

Any ban on menthol cigarettes is likely to encourage a large number of menthol smokers to seek menthol cigarettes through illicit channels, feeding money into and accelerating the development of the illicit cigarette market for both menthol and non-menthol cigarettes. As the illicit, unregulated cigarette trade channels grow, the effectiveness of underage access prevention measures in regulated retail trade channels would diminish and jeopardize progress on reducing underage initiation. In addition, with increased access to cigarettes through the illicit market comes the likely exposure of minors to other criminal activities associated with those markets.

## II. POTENTIAL REDUCTION IN THE IMPACT OF ACCESS PREVENTION MEASURES

### **Many effective access prevention measures are in place at regulated points of cigarette distribution**

Government and industry, particularly Philip Morris USA, have worked diligently to reduce minors' access to cigarettes, most notably by implementing significant retail access prevention measures. As a result, many effective measures are in place at regulated points of cigarette distribution.

Recent legislation giving FDA regulatory authority over tobacco products includes provisions to further help prevent underage access. For instance, (1) retailers may not sell cigarettes or smokeless tobacco products to persons under 18; (2) retailers must check photographic ID for consumers under age 27; (3) the sale of cigarettes and smokeless tobacco in vending machines and "self-service" displays are prohibited, except in very limited situations; (4) standards for retailer training designed to prevent underage sales of tobacco products are to be established; (5) FDA is authorized to contract with states and U.S. territories to assist with

compliance checks and enforcement activities to help limit the availability of tobacco products to minors; and (6) the issuance of a “no sale order” for repeat violations by retailers is contemplated.<sup>1</sup>

Individual state legislation also helps prevent underage access. For example, 23 states and Puerto Rico have enacted or enhanced legislation to require non-self service sales of all tobacco products. In addition, 41 states and Puerto Rico have made it illegal for adults to buy tobacco products for minors.

These provisions build on existing underage access prevention measures. The Synar Amendment of 1992 required states to enact and enforce laws prohibiting the sale of tobacco products to anyone under 18. To determine compliance with the legislation, each state and U.S. territory conducts annual random and unannounced inspections of retail tobacco outlets.

Some retailers have taken additional steps to help prevent underage tobacco sales. For example, 13 major retail chains have agreements with states, known as “assurances for voluntary compliance,” or AVCs, to adhere to certain standards and practices. These chains include 7-11, BP West Coast Products, Chevron, Conoco Philips, CVS, ExxonMobil, Kroger, Rite Aid, Safeway, Shell, Valero, Walgreens and Wal-Mart. They are part of an ongoing, multi-state access prevention effort by Attorneys General in consultation with public health researchers and state and federal tobacco control officials. The terms of each AVC vary, but most contain restrictions on advertising, restrictions on selling candy made to look like cigarettes, age verification tool requirements, monitoring and enforcement, hiring and training policies and guidelines for placement of cigarettes within the store.<sup>2</sup>

Retailers receive education, training and tools to help them prevent underage sales. In 1995, for example, the Coalition for Responsible Tobacco Retailing, with significant support from Philip Morris USA, launched the We Card<sup>®</sup> program to provide additional resources to retailers. More than 100,000 stores have received We Card<sup>®</sup> training since then. The We Card<sup>®</sup> program also provides retailers with signs to help remind consumers about the minimum age to purchase tobacco products, and tools to help retailers identify fake IDs and calculate the minimum age for purchase. Over 200,000 stores across the nation have posted a We Card<sup>®</sup> sign or equivalent.<sup>3</sup>

Manufacturers and retailers have worked together on measures addressing underage access to cigarettes. For example, prior to FDA regulation and continuing today, Philip Morris USA’s retail trade programs offer incentives to retailers addressing how

to merchandise and sell tobacco products. Elements of the retail trade programs include: requiring retailer training; using an age verification resource; merchandising tobacco products in a non-self-service environment; placing and maintaining We Card<sup>®</sup> or equivalent signage; and requiring retail signage that tells adults not to buy tobacco products for kids.

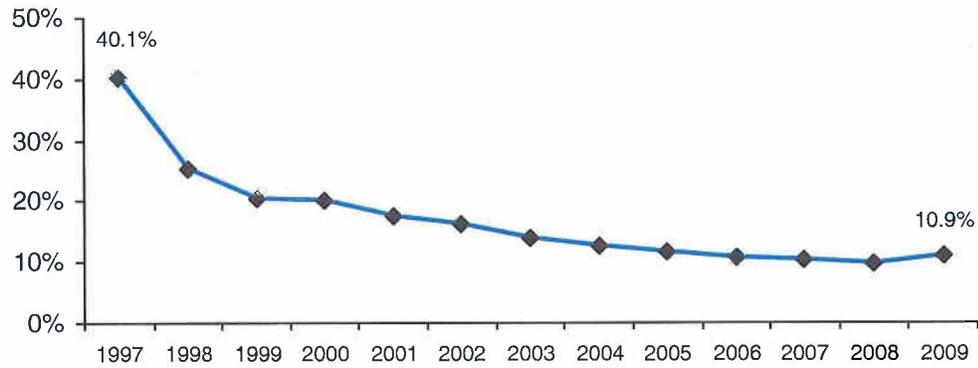
■ Figure 2.1: Types of underage access prevention measures at points of distribution (non-exhaustive)

Type of prevention measure	Points of distribution	
	Legitimate retail channel	Illicit trade channel
Minimum age enforcement		
Retailer training		
Compliance checks		
Access prevention communications		
Strict limitations on self-service sales		
Additional voluntary retail actions		

### The United States has made dramatic progress in reducing minors' access to cigarettes at regulated points of distribution

Underage tobacco sales have declined substantially at regulated points of distribution. As shown in Figure 2.2 below, sales to minors have fallen significantly. Retailer underage sale violation rates have declined from more than 40% in 1997 to under 11% in 2009.<sup>4</sup>

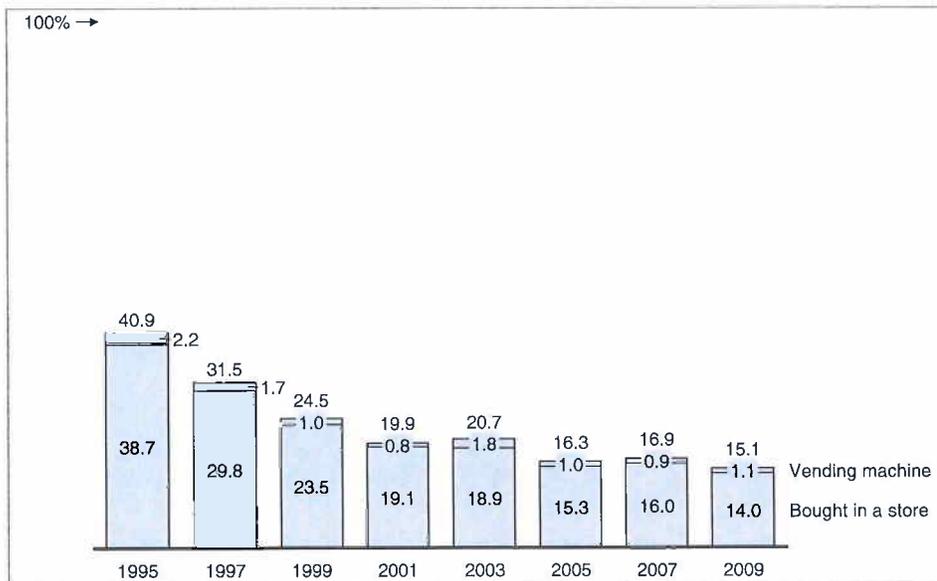
■ Figure 2.2: State-reported retailer violation rate (weighted average of state data)



Note: Adapted from SAMHSA (2009)

A much smaller proportion of minors now report self-purchase as their usual source of access (Figure 2.3).

■ Figure 2.3: Percent of current underage high-school student smokers who reported usually getting their cigarettes from commercial sources in the past 30 days.<sup>5</sup>



Underage smoking rates have declined significantly since reaching peak levels in the late 1990's. Compared to peak levels, current rates of reported past 30-day cigarette use represent declines of 66%, 55% and 47% for 8<sup>th</sup>-, 10<sup>th</sup>- and 12<sup>th</sup>-graders, respectively. Ever smoking and daily smoking also have shown similar, dramatic declines among students in these grades. For illustration, compared to peak levels, current rates of reported daily cigarette smoking represent declines of 72% (8<sup>th</sup> graders), 64% (10<sup>th</sup> graders) and 57% (12<sup>th</sup> graders).<sup>6</sup>

Other national research, including the National Survey on Drug Use and Health (NSDUH) and the Youth Risk Behavior Survey, also suggest positive progress has been made in reducing underage cigarette smoking. As an example, the most recent NSDUH results have the rate of reported past 30-day cigarette use among 12 to 17 year olds at a new low (8.9%).<sup>7,8</sup>

### **The development of illicit unregulated distribution channels would counteract recent progress in reducing underage access to cigarettes**

An expansion of unregulated distribution channels surely would undermine the nation's progress toward preventing underage access to tobacco products.<sup>9</sup> Effective measures against underage access to cigarettes are not present in an unregulated environment. For instance, illicit sellers have no incentive to comply with age restrictions associated with the sale of cigarettes.<sup>10</sup>

Further, the illicit cigarette market could become a primary channel for minors seeking cigarettes, as illustrated by the Canadian situation. In 2008, research sponsored by the Canadian Convenience Store Association found that the penetration of illegal tobacco products among minors was as high as 50% in Ontario and 40% in Québec.<sup>11</sup> A new study from the Centre for Addiction and Mental Health found that contraband tobacco products account for 43% of all cigarettes consumed by Ontario daily smokers in grades 9 to 12.<sup>12</sup> Put simply, illicit channels have become a prevalent source of supply for minors in Canada.

In addition, any ban on menthol cigarettes does not address curtailing social sources of access to cigarettes for minors. While significant progress has been made in reducing underage access through commercial channels (see Figure 2.3), there has been a shift towards social sources such as family members and friends, and giving money to other people to buy cigarettes for those underage. Consequently, the next battlefield in curtailing access to cigarettes to minors is discouraging these "social

sources.” The diversion of cigarette sales away from traditional, controlled, commercial channels to uncontrolled, unregulated channels could also undermine efforts to curtail these social sources.

### **III. POTENTIAL INCREASE IN MINORS’ EXPOSURE TO CRIMINAL ACTIVITY**

Beyond reducing the effectiveness of underage access prevention measures, the development of illicit cigarette markets could translate into a higher level of exposure to criminal activities and uncontrolled environments. Illicit sales occur through a variety of informal channels including the trunks of cars and vans, street corners, busy shopping areas, subway entrances, all removed from any regulatory authority.<sup>10</sup>

In addition to exposure to uncontrolled environments, there could be increased opportunities for contact between minors and criminal organizations, most notably gangs, which are already involved in the illicit cigarette trade.<sup>13, 14</sup>

Participating in illicit markets could also increase the likelihood of minors being exposed to the illegal distribution of other goods, such as alcohol, drugs, prescription pharmaceuticals or weapons, which are also often handled by criminal organizations involved in illicit cigarette markets. Research suggests that criminal organizations are often involved in several illegal activities,<sup>15</sup> as described in detail in the following section of this submission. Exposure in this context could increase minors’ use of these products.

### **IV. OTHER POTENTIAL CONSIDERATIONS NOT EXAMINED IN THIS SUBMISSION**

Social efforts and programs are needed to contribute to the healthy development of kids and steer them away from risky behaviors, including tobacco use - thereby reducing demand. Access prevention strategies are one aspect of a comprehensive approach and can complement these efforts by preventing minors from gaining access to tobacco products and reinforcing tobacco-free norms for all minors. These potential issues are not examined in this submission, but should be considered.

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# Chapter 3: Implications on criminal enterprises and law enforcement

## I. INTRODUCTION

Criminal organizations manufacture, transport and sell illicit cigarettes. They profit from wide tax differentials across national and state borders. Authorities say that the profits from these sales fund other criminal activity, including theft, human trafficking and terrorism. Some of these criminal organizations have also been found to produce, distribute, and sell narcotics.

An increase in the illicit cigarette market would certainly require increased federal, state and local spending on law enforcement, the courts and prisons. Certain places, such as New York City and Los Angeles, could be hit particularly hard and could require the largest responses.

## II. CRIMINAL ORGANIZATIONS ALREADY MANUFACTURE AND DISTRIBUTE ILLICIT CIGARETTES

Authorities say that illicit cigarette sales appeal to criminal organizations because the profits are high and the penalties low in comparison to many other illegal activities. Cigarette smuggling reportedly draws less attention from law enforcement authorities than drug smuggling, firearms trafficking or violent crime, and the fines and prison terms associated with trade in illicit cigarettes are relatively light.

Law enforcement officials report that major international criminal and terror organizations participate in the sale of illicit cigarettes today, including the Mafia and Hezbollah. Criminal elements engaged in the distribution of illicit cigarettes were also found to be operating within the Hells Angels. According to the Royal Canadian Mounted Police, more than 100 criminal groups and known criminal elements with varying levels of sophistication are involved in the illicit cigarette trade.<sup>1</sup> American officials say that criminal organizations in the Middle East, China and South America manufacture and smuggle contraband and counterfeit cigarettes. These organizations reportedly rely on well-established trafficking routes, front companies and business contacts.<sup>2</sup>

Customs officials inspect only about 5% of cargo containers, and drug dogs do not go on alert for cigarettes.<sup>3</sup> According to industry officials, even when a container of smuggled cigarettes is seized, “tracing a seized container to its producer ... is almost impossible.”<sup>4</sup>

Punishment for illicit cigarette activity is significantly lighter than punishment for other crimes. Law enforcement officials say that a smuggler can make roughly \$100,000 in profit by shipping 2,500 cartons of cigarettes, five kilos of cocaine or 50 kilos of marijuana. Table 3.1 shows that dollar for dollar, trafficking in illegal cigarettes exposes criminals to much lighter penalties than they would face for trafficking in illicit drugs.

■ **Table 3.1: Illicit smuggling options to make \$100,000 in profit**<sup>4,5,6,7,8,9</sup>

	<b>Amount smuggled</b>	<b>Prison term</b>	<b>Fine</b>
<b>Cigarettes</b>	2,500 cartons	Up to 5 years	Up to \$250,000
<b>Cocaine</b>	5 kilos	Minimum 10 years	Up to \$10 million
<b>Marijuana</b>	50 kilos	Up to 20 years	Up to \$1 million

Profit made from selling illicit cigarettes reportedly funds other criminal activity, such as terrorism, and the production, distribution and sale of illegal narcotics. Cigarette-related crime includes hijackings, theft, and even murder. Drivers, shopkeepers, innocent bystanders and police have been threatened and injured.<sup>10</sup> Some traffickers use their illicit cigarette distribution infrastructure to smuggle drugs, guns and people.<sup>11</sup> Cigarette profits are reportedly used to buy cocaine and marijuana, which are smuggled into the country using the same networks.<sup>12</sup>

Bureau of Alcohol, Tobacco and Firearms (ATF) Agent Willie Brownlee summarizes the situation in New York: “because New York has the highest cigarette tax in the country, it has become a haven for cigarette bootleggers and coveted territory for ruthless criminals. In March of 2010, a Virginia man pleaded guilty to hiring a hit man to murder a couple he suspected of stealing his bootleg cigarettes. His gang was planning to sell 388,000 cartons in New York for a profit of more than \$1 million. This investigation highlights the illicit profits and potential violence associated with those who illegally traffic in contraband cigarettes.”<sup>13</sup>

As significant as the immediate threat of increased criminal activity, many argue that the most real and present danger of the illicit cigarette trade is in the terrorism financing capabilities. Some international terrorist groups finance their activities through illicit cigarette profits. A report issued in June by the International Consortium of Investigative Journalists found that at least six international terrorist organizations, including al-Qaeda, the Taliban, the Real Irish Republican Army and the Revolutionary Armed Forces of Columbia, use proceeds from cigarette smuggling to fund their activities.<sup>11</sup>

### **Example of illicit cigarette criminal organization: Hells Angels**

The Hells Angels, a “motorcycle gang” with over 2,000 members in 26 countries, has been implicated in many criminal activities including murder, illegal weapons possession, and the manufacturing and distribution of methamphetamines, cocaine and illicit cigarettes.<sup>14,15</sup> Documented cigarette smuggling activities include:

- In March 2009, the Royal Canada Mounted Police and First Nations police charged 22 people on a Native American reservation in Canada, including two Hells Angels, with smuggling cigarettes from the reservation and investing profits in illegal drug production. Police seized contraband cigarettes, guns and 20,000 methamphetamine pills.<sup>12,16</sup>
- Also in 2009, 60 police officers raided the bunker-like compound of Rice Mohawk Industries and arrested 46 people. Authorities say the Hells Angels, including Salvatore Gazzetta, reputed leader of their Montreal chapter, used the Rice compound as a base for trafficking contraband cigarettes and cocaine.<sup>17</sup>

### **III. GOVERNMENT RESPONSE TO INCREASED ILLICIT ACTIVITY COULD REQUIRE ADDITIONAL SPENDING**

If the illicit cigarette market were to expand significantly, government spending would need to increase accordingly to attempt to prevent and combat the growth in illicit sales and other associated criminal activity. While many skilled and dedicated people are engaged in combating the illicit cigarette trade, it is clear that law enforcement resources are stretched thin. The lack of sufficient resources has become even more pronounced during the current economic recession and the need to fund

additional spending on law enforcement capacity could place governments in the position of needing to increase taxes, increase government debt or divert funds from other critical programs.

Today, multiple government agencies help combat the illicit cigarette market. The ATF is the principal federal law enforcement agency investigating illicit cigarette cases, although other federal agencies such as the Federal Bureau of Investigation (FBI), U.S. Customs and Border Protection (CPB), and Immigration and Customs Enforcement (ICE) also investigate such cases.<sup>18</sup> The FDA recently also obtained jurisdiction over tobacco violations with the passage of the Act in June 2009. Table 3.2 summarizes each agency’s duties in combating trade in illicit cigarettes (further details in Appendix Exhibit 3.1).

■ Table 3.2: Illicit cigarette responsibilities by government agency

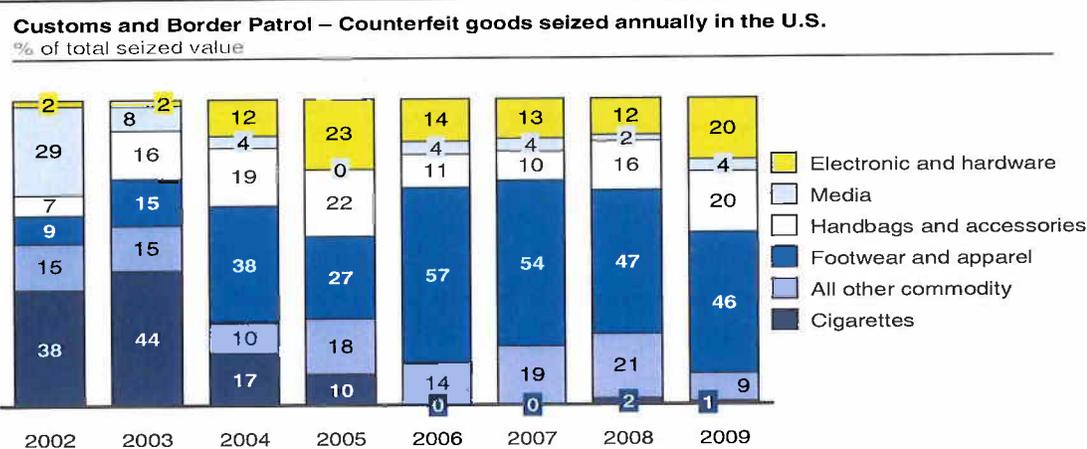
<b>Government Agency</b>	<b>Responsibility</b>
ATF – Bureau of Alcohol, Tobacco, Firearms and Explosives	Identify, investigate and present for prosecution those who violate federal laws involving cigarettes
CBP – Customs and Border Protection	Ensure that all cigarettes entering and exiting the United States do so in accordance with all applicable laws and regulations
ICE – U.S. Immigrations and Customs Enforcement	Investigate trade-related cigarette crimes, including smuggling
FBI – Federal Bureau of Investigation	Combat large-scale cigarette smuggling linked to criminal organizations and enterprises
FDA – Food and Drug Administration	Authority to regulate the content, marketing and sale of tobacco products
State and local law enforcement	Work with ATF and other agencies on investigations at headquarters and in the field

Historically, these agencies have spent little time, resources or money on illicit cigarette enforcement. For example, priorities of national security require ATF to spend the vast majority of its time and resources preventing and combating the illegal trade and use of firearms and explosives,<sup>19</sup> leaving only about 2% of its budget to combat both the illicit cigarette and alcohol markets, according to federal budget figures. This is despite pleas from legislators and a report from the Inspector General of the Department of Justice that the ATF needs more funding to focus

more closely on illicit cigarettes. In 2008, the ATF requested – and was denied – 28 new positions and an increase of \$8.56 million to combat the illicit tobacco trade.<sup>20</sup>

The CBP and other agencies also do not focus sufficiently on illicit cigarettes. The CBP reports that cigarettes are third on their list of priorities, alongside other trade commodities, such as toys and textiles. The CBP has recently shifted its intellectual property focus from seizing counterfeit cigarettes to seizing watches, footwear and handbags. Figure 3.1 shows that seizures of cigarettes accounted for only 1% of the total value of goods seized by CBP in 2009, down from 44% in 2003.<sup>21,22</sup> Worse, the problem is exacerbated by outdated technology and poor communications at various customs agencies worldwide.<sup>23</sup>

■ Figure 3.1: Counterfeit goods seized annually in the United States



Source: Government Accountability Office, May 2004, April 2010

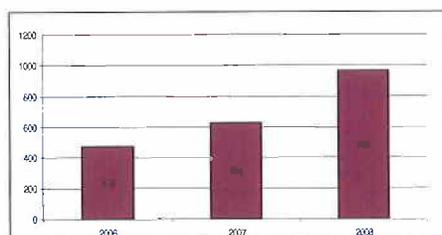
Increased spending for enforcement, prosecution, and incarceration would strain already tight federal, state, and local budgets. If there are no funds available through current budgets, resources would need to be diverted from other law enforcement priorities.

Even an increase in effort may not be enough. In Canada, increased government effort without additional resources was unable to combat the rise in the illicit market. From 2006 to 2008, the Royal Canadian Mounted Police implemented the Federal Tobacco Control Strategy, greatly increasing its efforts to combat illicit cigarette sales. The police more than doubled their cigarette seizures, but illicit

cigarettes' share of the Canadian market share still increased dramatically, as shown in Figures 3.2 and 3.3.<sup>24,25</sup>

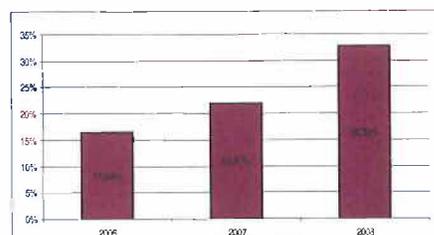
■ Figures 3.2 and 3.3

**Figure 3.2: Cigarette seizures by RCMP**  
Thousands of cartons



Source: RCMP Contraband Enforcement Strategy Progress Report 2009

**Figure 3.3: % of illicit cigarettes in Canada**



Source: GIK Research Dynamics (2008)

Despite the increased volume, seized cigarettes are still only a small fraction of the total illicit market in Canada. Authorities seized about 193 million cigarettes in 2008, less than 2% of the estimated 13 billion illegal cigarettes sold in Canada that year.<sup>26</sup> The police have “concluded that the solutions put in place to date have not had a long-term influence on the illicit tobacco market.”<sup>1</sup>

A menthol ban could also breed disrespect for the law. It could spur otherwise law-abiding citizens to disregard the rule of law, similar to the United States during Prohibition and the current situation in Canada. In Ontario, 81% of illicit cigarette users, when made aware of the illegality, have stated that they were not concerned about criminal penalties.<sup>27</sup>

### **New York City and Los Angeles could be hit especially hard by increased trade in illicit cigarettes**

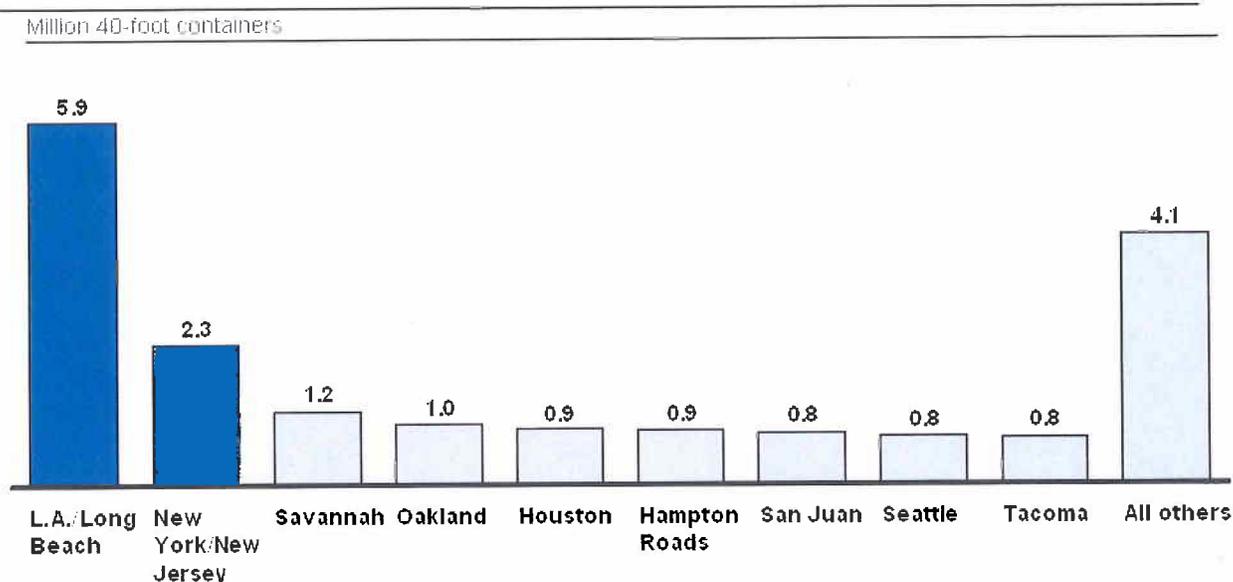
Certain geographies, such as border states and major cities, could be hit especially hard by an increase in the illicit cigarette market. They could require more significant increases in enforcement, prosecution and incarceration expenditures.

As the nation's largest port cities, New York and Los Angeles could be among the most severely impacted. They are reportedly already centers of counterfeiting,

large-scale smuggling and “grey market” imports. Both cities are also facing severe budget challenges.

In 2009, Los Angeles/Long Beach cargo traffic consisted of about 5.9 million 40-foot containers; about 2.3 million containers passed through New York City. Together, the two cities accounted for 44% of the total cargo traffic in the United States (Figure 3.4).<sup>28</sup> Since approximately two-thirds are imports, and only about 5% of shipped cargo is inspected, about 14,000 40-foot containers enter the United States every day uninspected through New York and Los Angeles.<sup>3,29</sup>

■ Figure 3.4: U.S. port ranking by traffic volume, 2009



Source: U.S. Ports Ranking by American Association of Port Authorities, North American Port Container Traffic (1990-2009)

Law enforcement authorities say that the two cities have the largest, most established illicit distribution and retail networks in the United States. New York is used as a base for distributing counterfeit merchandise throughout the United States and is considered a major hub of global counterfeiting.<sup>30</sup> An attorney for the City of New York says that “the cigarette black market [in NYC] is enormous, it’s brazen, and it’s carried out right under the nose of the government.”<sup>31</sup> In 2003, authorities estimated the value of counterfeit goods in New York State at \$34 billion.<sup>32</sup>

The illicit market is also a sizeable problem in Los Angeles. The head of the LAPD’s Central Division vice squad claims that “downtown Los Angeles has

become the nation's second counterfeit capital — after Canal Street in New York City.” From 2003 to 2005, LAPD seized an estimated \$40 million in counterfeit merchandise in just 40 raids.<sup>33</sup>

Like many other American cities, New York and Los Angeles are now facing deep budget crises. New York, looking at a more than \$3 billion budget shortfall for next year, is requiring the police department to cut 2.7% of its current budget and another 5.4% in 2011.<sup>34</sup> Los Angeles is facing at least a \$212 million budget shortfall in 2010, and expects that gap to widen to \$485 million for fiscal year 2011.<sup>35</sup> Neither city would be able to significantly increase spending on the enforcement, prosecution and incarceration needed to combat expanding trade in illicit cigarettes.

The lack of enforcement resources simply underscores the importance of carefully analyzing any regulation of tobacco products that could inadvertently create new demand for illicit cigarettes. Any increase of illicit activity resulting from such measures would in effect impose an unfunded mandate on the law enforcement agencies charged with keeping up with the growing illegal traffic.<sup>36</sup> That unfunded mandate could lead to increased taxes in the middle of an economic downturn, which could further exacerbate many of the unintended consequences discussed throughout this submission.

## APPENDIX

- Appendix Exhibit 3.1: Agencies that combat the illicit cigarette trade
  - **ATF:** The Bureau of Alcohol, Tobacco, Firearms and Explosives enforces the Contraband Cigarette Trafficking Act (CCTA) and Jenkins Act, employs federal agents, auditors and investigators, and directly or through partnerships with other law enforcement agencies take responsibility for identifying, investigating, and presenting for prosecution people who violate federal laws involving firearms, explosives, arson, and alcohol and tobacco trade.
  - **ICE:** U.S. Immigration and Customs Enforcement investigates trade-related crimes, including cigarette smuggling, circumvention of international trade agreements and importer and broker non-compliance. It enforces U.S. laws related to cigarette smuggling for which it has investigative jurisdiction.<sup>37</sup>
  - **CBP:** The U.S. Customs and Border Protection is responsible for ensuring that all goods (including cigarettes and other tobacco products) entering and exiting the United States do so in accordance with all applicable U.S. laws and regulations.<sup>38</sup>
  - **FBI:** Combats large-scale cigarette smuggling linked to transnational and national criminal organizations and enterprises.<sup>39</sup>
  - **State and local law and tax enforcement:** Interact with ATF at headquarters and in the field, exchanging information and working jointly on cigarette diversion investigations.<sup>18</sup>

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# Chapter 4: Potential impact on federal, state and local budgets

## I. INTRODUCTION

Cigarette taxes and TSA payments are major sources of federal, state and local revenue. Important programs are funded in whole or in part with those monies. A decline in the legal, taxed sale of menthol cigarettes as a result of an increase in illicit cigarette sales would place new pressures on federal, state and local budgets already hard-hit by the economic downturn.

In fiscal year 2009, the sale of cigarettes generated approximately \$37.7 billion in federal, state and local government revenues.<sup>1</sup> Menthol cigarettes accounted for approximately 27% of the U.S. taxed cigarette base that year.<sup>2</sup> As a result, if all menthol cigarettes were removed from the taxed cigarette market, up to \$10.2 billion in government revenues would be lost.<sup>3</sup>

A significant amount of cigarette taxes and TSA payments are earmarked for specific purposes, including public education and children's health care. In addition to threatening health care and education programs, sharp declines in legal, taxed cigarette sales could place new financial burdens on states and localities that use cigarette tax revenues and TSA payments to fund other important programs.

## II. IN FISCAL YEAR 2009, THE SALE OF CIGARETTES GENERATED APPROXIMATELY \$37.7 BILLION IN FEDERAL, STATE AND LOCAL GOVERNMENT REVENUES<sup>1</sup>

Menthol cigarettes have approximately a 27% share of the U.S. taxed cigarette market.<sup>2</sup> As a result, if all menthol cigarettes were removed from the taxed cigarette market (without any shift towards non-menthol cigarettes or other legitimate tobacco products), about \$10.2 billion in government revenues could be lost.

The government revenues generated from cigarette sales can be divided into four categories: federal taxes, state taxes, local taxes, and TSA payments to the states.

These revenues totaled about \$37.7 billion from July 2008 to June 2009, the most recent period publicly available, including about \$10.2 billion from the sale of menthol cigarettes. Table 4.1 below breaks out the \$37.7 billion total tax revenues by type of tax:

- Table 4.1. Estimated fiscal 2009 cigarette revenue by category, based on the assumption that menthol cigarettes made up 27% of the U.S. taxed cigarette market<sup>2</sup> that year (\$ billion)

Revenues	Total <sup>1</sup>	Menthol <sup>4</sup>
Federal excise tax	8.5	2.3
State excise tax	15.8	4.3
State sales tax	4.1	1.1
Local excise tax	0.5	0.1
MSA	8.8	2.4
<b>Total</b>	<b>\$37.7 billion</b>	<b>\$10.2 billion</b>

**The federal cigarette excise tax rate**, which increased from \$0.39 to \$1.01 per pack effective April 1, 2009, generated approximately \$8.5 billion in revenues during the fiscal year ended June 2009.<sup>1</sup> We estimate that \$2.3 billion of those revenues came from the sale of menthol cigarettes.

**State cigarette excise taxes rates**, as of July 2010, ranged from 17 cents per pack in Missouri to \$4.35 per pack in New York. In total, they generated about \$15.8 billion in fiscal 2009,<sup>1</sup> including an estimated \$4.3 billion from menthol cigarettes. In 2010, Hawaii, New Mexico, New York, South Carolina, Utah and Washington raised cigarette excise tax rates.<sup>5</sup>

**State cigarette sales tax rates** range from zero in Alaska, Montana, New Hampshire, Oregon and Delaware to 8.25% in California. Overall, these taxes generated about \$4.1 billion in state revenues in fiscal 2009, of which an estimated \$1.1 billion came from the sale of menthol cigarettes.

**Local cigarette excise taxes** generated approximately \$500 million overall in fiscal 2009, including about \$135 million from menthol. About 500 local governments impose excise taxes on cigarettes, although 70% of revenue collected comes from

city and county taxes in New York City (\$1.50/pack; \$178 million in revenue) and Cook County/Chicago (\$2.68/pack; \$173 million in revenue).

**Payments to states under the TSA** totaled approximately \$8.8 billion in fiscal 2009, including an estimated \$2.4 billion from the sale of menthol cigarettes.

### **III. A SIGNIFICANT AMOUNT OF CIGARETTE TAXES AND TSA PAYMENTS ARE EARMARKED FOR SPECIFIC PURPOSES, INCLUDING EDUCATION AND CHILDREN'S HEALTH CARE PROGRAMS**

Federal, state and local governments often earmark cigarette tax revenues and TSA payments to fund specific programs such as children's health care, education, and tobacco control. Declines in these revenues could require some of these programs to cut their budgets, take revenue from other programs or seek funding elsewhere.

#### **Federal cigarette excise taxes fund SCHIP<sup>6</sup>**

Revenue from the 2009 federal cigarette excise tax increase funds the State Children's Health Insurance Program (SCHIP), which provides health insurance to low-income children.<sup>7</sup> Each state operates and partially funds its own SCHIP program, with matching funds from the federal government. In the past ten years, the program has provided about \$20 billion to children in need.<sup>6</sup> Given that the SCHIP program was re-authorized based on earmarked funding from federal excise taxes on cigarettes, a decline in those revenues could force the program to cut spending or seek funding through alternative methods.

#### **State excise and sales tax revenues fund important programs**

State excise taxes substantially fund a diverse array of programs, from tobacco education and cancer research to capital projects and smoking cessation programs. Some states, such as Virginia, earmark all of its tobacco-related tax revenue for specific programs, often related to education or healthcare. Examples of how states earmark cigarette revenues include:

- **Virginia:** Since September 1, 2004, all cigarette tax revenues have been deposited into the Virginia Health Care Fund.<sup>8</sup> The Fund is used to pay for health care services including Medicaid payments, disease diagnosis, prevention and control, and community health services.<sup>9</sup>

- **Tennessee:** Approximately 90% of cigarette tax revenues are appropriated to the Education Fund, which funds various education initiatives including at-risk K-12 student needs and need-based financial aid for higher education.<sup>10</sup> The remaining 10% is allocated to the state's General Fund, under which cigarette revenues are earmarked for programs such as the Trauma System Fund and state agencies such as the Department of Agriculture.<sup>11</sup>
- **California:** Approximately 57% of California's cigarette tax revenues are earmarked for the California Children and Families First Trust Fund, for the purpose of supporting early childhood development and education. Another 29% goes to Proposition 99, which supports the state's Health Education Account and Research Account, covering anti-smoking education, behavioral and biomedical research, and medical care for the medically indigent. Two percent of cigarette revenues are earmarked for breast cancer research, prevention and screening. The remaining 11% is allocated to the state's General Fund for state budget administrative purposes.<sup>12</sup>

Programs funded by such earmarked revenues would face new challenges if legal, taxed cigarette sales were to decline significantly. California is already facing such a challenge: state cigarette tax revenue has declined steadily from \$1.2 billion in 2000 to \$920 million in 2009. Organizations that depend on cigarette tax revenues to fund early childhood health and education programs, such as First 5 California, are required to develop alternate financing strategies.<sup>13</sup>

### **Local excise tax revenues fund important programs**

Like states, some local governments use cigarette tax revenues to fund a variety of programs, including health care and public safety. Over 500 local municipalities impose a local excise tax on cigarettes. Seventy percent of that is collected in New York City (\$178 million in 2009<sup>1</sup>) and Cook County/Chicago (\$173 million in 2009<sup>1</sup>), which have excise taxes per pack of \$1.50 and \$2.68, respectively.

For example, in fiscal year 2007, Cook County collected cigarette tax revenues of about \$175 million, representing approximately 6% of total funds for Cook County Public Services. About \$126 million funded 17% of the County's Bureau of Health Services budget. The remainder paid for other services such as courts, public safety administration, and corrections.<sup>14</sup>

**States collectively allocated a large portion of their payments to health care, including Medicaid, health insurance, hospitals, medical technology and research**<sup>15,16</sup>

The companies that entered into the TSA agreed to make annual payments to the states in perpetuity. About two-thirds of the states have earmarked their TSA payments for special funds or endowments; others use the money as directed by voters or special commissions. From 2000-2005, states collectively allocated a large portion of their payments to health care, including Medicaid, health insurance, hospitals, medical technology and research. Some also funded infrastructure, education, and tobacco control. Another 23% of the TSA funds went to cover budget shortfalls.<sup>16</sup> Table 4.3 below provides a breakdown of state allocations of TSA proceeds from 2000-2005.

■ Table 4.3. State allocations of TSA payments and securitized proceeds, fiscal years 2000-2005<sup>16</sup>

<b>Activity</b>	<b>Dollars allocated (billions)</b>	<b>Percent allocated</b>
Health care	\$16.8	30.0%
Budget shortfalls	12.8	22.9
Other/general purposes	15.0	26.8
Infrastructure	3.4	6.0
Education and social services	3.1	5.5
Debt service on securitized funds <sup>17</sup>	3.0	5.4
Tobacco control	2.0	3.5
<b>Total</b>	<b>56.0</b>	<b>100%</b>

A number of states have securitized a portion of their TSA payments; funding for debt service on securitized funds accounted for about 25% of total payments in fiscal 2010. Funding for health services has also increased since 2005, to 48% of total expenditures in fiscal 2010. Other prominent spending categories are education and social services (6%) and tobacco control (2%).

- Table 4.4. Total state allocations of TSA payments and securitized proceeds, fiscal year 2010<sup>18</sup>

Activity	Percent allocated
Health care	48.0%
Debt service on securitized funds <sup>17</sup>	26.0
Other/general purposes	18.0
Education and social services	6.0
Tobacco control	2.0
<b>Total</b>	<b>100%</b>

*Note:* This summary is based on available data from 33 of the 46 states party to the Master Settlement Agreement.

More information on the potential implications associated with securitization of TSA payments is discussed below. (To see how some states have allocated their TSA payments, please refer to Appendix exhibit 4.1.)

#### **IV. SHARP DECLINES IN LEGAL, TAXED CIGARETTE SALES COULD PLACE NEW FINANCIAL BURDENS ON STATES AND LOCALITIES THAT USE CIGARETTE TAX REVENUES AND TSA PAYMENTS**

Since 1950, cigarette-related government revenues have grown at a compound rate of more than 4% per year. A sharp decline in cigarette-related taxes could interrupt a significant source of revenue, potentially destabilizing government budgets.

The national weighted average state tobacco excise reached \$1.03 in 2009. Federal, state and local governments now receive a significant portion of the total retail price of cigarettes. And menthol cigarettes now represent a larger share of all cigarette tax revenues than they did a few years ago. Menthol cigarette share of the cigarette market has increased from about 25% in 2006 to about 27% in 2009.<sup>2</sup>

Table 4.6. Sources of total tobacco taxes and TSA payments, fiscal 2006-2009<sup>1</sup>

	2006	2007	2008	2009	CAGR (%)
Taxed-paid sales (billions of packs) <sup>1</sup>	18.1	17.6	16.7	16.0	-4.0
Federal excise taxes (\$ billion) <sup>1</sup>	7.5	7.3	6.9	8.5	4.3
State sales taxes (\$ billion) <sup>1</sup>	3.7	3.9	3.9	4.1	3.5
State excise taxes (\$ billion) <sup>1</sup>	14.0	14.5	15.6	15.8	4.1
TSA (\$ billion) <sup>1</sup>	7.0	7.2	8.2	8.8	7.9
Local excise taxes (\$ billion) <sup>1</sup>	0.6	0.6	0.6	0.5	-5.9
<b>Total</b>	<b>32.8</b>	<b>33.5</b>	<b>35.2</b>	<b>37.7</b>	<b>4.8</b>
Menthol cigarette share <sup>2</sup>	25%	26%	26%	27%	
Estimated menthol revenue (\$ billion)	8.2	8.7	9.2	10.2	7.5

*Note:* The base TSA payment (prior to upward and downward adjustments to the payment as specified in the TSA) due in April 2008 was increased, per the TSA, by \$1 billion.

*Note 2:* The CAGR (Compound Annual Growth Rate) is the smoothed annualized growth rate.

### Impact on federal government

In fiscal year 2009, the federal government received about \$2 billion in excise tax revenues from the sale of menthol cigarettes, a significant amount that funds important programs and agencies. For example, one year's federal excise tax revenues from menthol cigarettes would fund one of the following:<sup>19</sup>

- 119 million influenza vaccinations, or
- The annual salaries of 71,524 border patrol agents, or

- About 300% of the annual budget of the Bureau of Alcohol, Tobacco, Firearms and Explosives, or
- About 160% of the annual budget of the Drug Enforcement Agency, or
- Approximately 130% of the annual budget of FDA.

### **A decline in cigarette taxes would hurt revenues of state governments**

While each state and the District of Columbia impose excise taxes on cigarettes, the portion of their budgets funded by tobacco sales and excise taxes and TSA payments ranged in fiscal 2009 from 0.6% in Alaska to 3.6% in Michigan.<sup>1,23</sup> States that depend more heavily on cigarette tax revenue, such as New Hampshire, South Dakota and Maine, would feel the impact of declines more acutely. To see the percentage of each state's budget that is contributed by cigarette revenues, please refer to Appendix table 4.2.

Any ban on menthol cigarettes would reduce tobacco tax revenues and TSA payments in every state, creating new fiscal challenges at a time when state budgets are already strained. For example, if all legitimate menthol cigarette volume were eliminated, the ensuing reduction in revenues in Michigan could represent 1% of the total state budget.<sup>20</sup>

#### **Case study: Michigan<sup>20</sup>**

- Michigan derived 3.59% of its revenue from tobacco taxes and TSA payments in fiscal 2009. About 80% of those funds, or \$800 million, are earmarked for health and education programs. They include:
  - The School Aid Fund, which pays for K-12 education. Tobacco-related revenue contributes about \$400 million, covering 4% of the program's expenses.
  - The Medicaid Benefit Trust Fund covers shortfalls in Medicaid and/or offsetting declines in sources of revenue due to changes in federal legislation. Tobacco-related revenue amounts to about \$312 million, covering 84% of fund's costs.
  - Nearly all of the Healthy Michigan Fund is funded by \$37 million in tobacco-related revenues. Its programs include family planning and maternal care, smoking prevention, diabetes care, immunization, and cancer prevention and control.

- The Health and Safety Fund is funded almost entirely by tobacco-related revenues. About \$25 million supports state and county health care initiatives and safety programs, such as city courts and jails.

Every state would see its TSA payments decline if legal cigarette sales decline, but a number of states have already securitized part of their TSA payments. Should TSA payments fall sharply, bondholders or potentially even taxpayers might have to make up the difference, depending on the terms of the securitization. Even in states where bondholders bear the risk of a significant decline in the TSA payment stream, some analysts believe that states could face political pressure to reimburse pension and retirement fund investors. This could threaten states' bond and credit ratings, raising their cost of borrowing in the years ahead.<sup>21</sup>

For case studies of how states have used TSA securitization proceeds, please refer to Appendix Exhibit 4.2.

### **Raising taxes is not an effective mitigating strategy**

Although not a focus of this submission, it is important to note that raising excise taxes on cigarettes is not an effective mitigating strategy in response to declining tax revenues. Raising excise taxes on cigarettes would lead to further significant risks and consequences, including altered consumer purchasing patterns in which consumers seek their products from lower tax or even untaxed sources and growth of the illicit market (see chapters 1 and 3 of this submission). A summary of risks associated with cigarette tax increases can be found on Philip Morris USA's website.<sup>22</sup>

## **V. OTHER POTENTIAL CONSIDERATIONS NOT EXAMINED IN THIS SUBMISSION**

Virtually every participant in the legal tobacco value chain, from tobacco seed producers to convenience store clerks, is subject to federal, state and local taxes. Job loss associated with a potential ban on menthol cigarettes could lead to substantial loss of these tax revenues, which would compound the impact of the unemployment benefits paid to those people, and other unintended consequences of job loss.

Federal, state or local governments may be forced to raise taxes on non-tobacco products to compensate for lost revenues on menthol cigarettes. This would have a

detrimental impact on business and consumers, particularly small business and low-income consumers already struggling to make ends meet.

## APPENDIX

- Appendix exhibit 4.1: Case studies of TSA payment allocations
  - **Kentucky** sets aside 25% of its TSA funding to support the Kids Now Initiative, funding public health campaigns and prevention services to support maternal and infant child health; programs to support healthy families, including home visiting services and early childhood mental health services; programs to support the enhancement of early care and education, including a quality rating system for childcare as well as additional subsidies and scholarships to increase access to high quality childcare; and infrastructure supports, including support for the Early Childhood Development Authority, who oversees expenditures for the Kids Now Initiative.<sup>18</sup>
  - **North Carolina** dedicates 25% of its tobacco settlement revenues to the Health and Wellness Trust Fund (HWTF). The trust fund supports a wide variety of smoking cessation and prevention programming for minors, with a goal of reducing teen smoking in schools. By its own measure, HWTF has succeeded in reducing teen smoking among high school students by 30%, and by 52% among middle school students.<sup>18</sup>
  - For the past ten years, **Georgia** has allocated about half of its TSA spending to direct health care services. In FY 2009, TSA payments were used to fund programs in the Department of Community Health and the Department of Human Resources, including Medicaid expansion for pregnant women and infants, reimbursements to Critical Access Hospitals and home- and community-based care for the elderly. TSA funds also support cancer research and education, including breast and cervical cancer treatment under Medicaid, cancer screening and treatment services, and university cancer research.<sup>23</sup>

- Appendix table 4.1. State tobacco sales tax, tobacco excise tax and TSA payments as a share of total state revenue (2008-2009)<sup>1,24</sup>

State	% of revenues	State (continued)	% of revenues
Michigan	3.59	Washington	1.83
New Hampshire	3.34	Oregon	1.83
S. Dakota	3.27	Alabama	1.71
Maine	2.93	Oklahoma	1.68
Rhode Island	2.77	Nebraska	1.64
Indiana	2.77	Florida	1.62
Wisconsin	2.75	Arkansas	1.57
Connecticut	2.39	Kansas	1.56
Pennsylvania	2.27	Massachusetts	1.54
Delaware	2.24	Mississippi	1.46
Iowa	2.23	Idaho	1.35
Ohio	2.20	Missouri	1.34
Tennessee	2.18	New York	1.33
West Virginia	2.15	North Dakota	1.31
New Jersey	2.10	Louisiana	1.16
Vermont	2.10	Colorado	1.14
Nevada	2.08	Georgia	1.13
Maryland	2.08	Virginia	1.12
Arizona	2.07	California	1.06
Kentucky	2.04	North Carolina	0.97
Texas	1.94	New Mexico	0.93
Minnesota	1.94	South Carolina	0.82
Illinois	1.89	Wyoming	0.78
Montana	1.88	Utah	0.75
Hawaii	1.84	Alaska	0.62

- Appendix exhibit 4.2: TSA securitization state case studies<sup>18</sup>
  - **Wisconsin:** In 2001, Wisconsin securitized a part of its TSA payments to close a budget deficit, receiving \$1.6 billion in up-front payments in exchange for projected total TSA revenues of \$5.2 billion. Wisconsin planned to use \$350 million of the securitized proceeds to eliminate the budget deficit, and the remainder to create an endowment fund for tobacco control efforts. In 2002, however, the budget gap was greater than expected, and all remaining funds from securitization were used to balance the budget.
  - **California:** In 2003, facing a \$17 billion deficit, the governor proposed securitizing half of the state's share of TSA funds for a one-time payment of \$2.5 billion; annual payments would have totaled \$12.5 billion. In FY 2003, California securitized the remainder of its settlement payments and received \$3 billion – all of which was allocated to the FY 2004 state budget.
  - **Rhode Island:** In 2002, Rhode Island approved a plan to securitize parts of the state's rights to \$1.19 billion in future settlement payments for a one-time payment of \$600 million. The funds closed budget shortfalls and covered capital and operating expenses in fiscal years 2002-2004.

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<sup>3</sup> For purposes of this discussion, this estimate assumes that all federal tax removals were subject to the payment of all applicable state excise taxes. As discussed throughout this submission, there are various situations where, through illicit activity, these state excise taxes are not collected.

<sup>4</sup> Menthol revenue calculations are estimated based upon a 27% market share assumption; state figures do not represent a weighted-average calculation.

<sup>5</sup> State Cigarette Excise Taxes: 2010. (2010, July 1). *National Conference of State Legislatures*. Retrieved October 2010, from NCSL website: <http://www.ncsl.org/default.aspx?tabid=14349>.

<sup>6</sup> Children's Health Insurance Program Reauthorization Act (CHIPRA) of 2009. (2010, August 30). *U.S. Department of Health & Human Services*. Retrieved October 2010 from U.S. DHHS Centers for Medicare and Medicaid Services website: <http://www.cms.gov/CHIPRA/>.

<sup>7</sup> Retrieved on November 15, 2010 from [http://www.ttb.gov/main\\_pages/schip-summary.shtml](http://www.ttb.gov/main_pages/schip-summary.shtml)

<sup>8</sup> Virginia Department of Taxation. (2009). Annual Report Fiscal 2009. Retrieved October 2010 from Virginia Department of Taxation website: <http://www.tax.virginia.gov/documents%5CAnnualReportFY2009.pdf>.

<sup>9</sup> Uses of Virginia Health Care Fund. (2004). Virginia General Assembly Legislative Information System. Retrieved October 2010 from Virginia LIS website: <http://leg1.state.va.us/cgi-bin/legp504.exe?000+cod+32.1-367>.

<sup>10</sup> Chamberlain, Andrew and Gerald Prante. (2007). Who Will Pay Taxes for Tennessee's Governor's "Schools First" Initiative, and Who Will Receive the Spending? *The Tax Foundation: Fiscal Facts*. Retrieved October 2010 from the Tax Foundation website: <http://taxfoundation.org/research/show/22346.html>.

<sup>11</sup> Bredesen, Phil. (2010). State of Tennessee: The Budget. Fiscal Year 2010-2011. Retrieved October 2010 from State of Tennessee government website: <http://tennessee.gov/finance/bud/documents/10-11BudgetVol1.pdf>

<sup>12</sup> Tobacco Facts: California. (2010). [www.tobacco-facts.net](http://www.tobacco-facts.net). Retrieved October 2010 from Tobacco Facts website: <http://www.tobacco-facts.net/usa-tobacco-policy/california>.

<sup>13</sup> *State's Tobacco Tax Revenue Drops as Cigarette Sales Fall*. (2010, July 28). *California Healthline*. Retrieved October 2010 from California Healthline website:

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<http://www.californiahealthline.org/articles/2010/7/28/states-tobacco-tax-revenue-drops-as-cigarette-sales-fall.aspx>.

<sup>14</sup> O'Donnell, Heather and Ralph Martire. (2007). Cook County's Revenue System is Structurally Unable to Support the Public Services it Provides. *Center for Tax and Budget Accountability*. Retrieved October 2010 from Center for Tax and Budget Accountability's website:  
<http://www.ctbaonline.org/All%20Links%20to%20Research%20Areas%20and%20Reports/Budget,%20Tax%20and%20Revenue/Structural%20Deficit%20Report%20on%20Cook%20County.pdf>.

<sup>15</sup> For purposes of this analysis, we have assumed that TSA payments go directly into state revenues. The domestic tobacco companies, including PM USA, who are original signatories to the MSA (the "Original Participating Manufacturers" or "OPMs") are participating in proceedings that may result in downward adjustments to the amount paid by the OPMs and other MSA-participating manufacturers to the Settling States for each of the years 2003 to 2009. The proceedings relate to an MSA payment adjustment (the "NPM Adjustment") based on the collective loss of market share for the relevant year by all participating manufacturers who are subject to the MSA's payment obligations and marketing restrictions to non-participating manufacturers ("NPMs") who are not subject to such obligations and restrictions. The Settling States dispute the participating manufacturers' NPM Adjustment claims. For some of the years in dispute, certain participating manufacturers paid the disputed amount into a disputed payments account or withheld it altogether, as the MSAs permit them to do. To date, PM USA has made its full MSA payments each year to the states subject to a right to recoup the NPM Adjustment amount in the form of a credit against future MSA payments.

<sup>16</sup> Tobacco Settlement: States' Allocations of Payments from Tobacco Companies for Fiscal Years 2000 through 2005. (2007, February 27). *United States Government Accountability Office*. Retrieved October 2010 from GAO website: <http://www.gao.gov/new.items/d07534t.pdf>

<sup>17</sup> A number of states have securitized their TSA payments, or issued bonds backed by the payment stream. Through securitization, states can receive funds as a lump sum up front rather than over time, allowing them to fund large, one-time needs. Thus far, the majority of bond issues have been in the form of tax exempt bonds, the proceeds of which often are earmarked for capital projects or reducing existing state debt levels.

<sup>18</sup> 2010 Master Settlement Agreement (MSA) Payment Highlights. (2010). *The Finance Project*. Retrieved October 2010 from The Finance Project website:  
<http://www.financeproject.org/publications/2010MSAHighlights.pdf>; State Securitization of Tobacco Master Settlement Agreement (MSA) Payments. (2007, March 3). *Tobacco Public Policy Center at Capital University Law School*. Retrieved October 2010 from Capital University Law School website:  
[http://www.law.capital.edu/Tobacco/documents/securitization\\_fact\\_sheet.pdf](http://www.law.capital.edu/Tobacco/documents/securitization_fact_sheet.pdf)

<sup>19</sup> Modi, Nik. (2009, June 18). FDA: What Does It Mean for Investors? *UBS Investment Research, U.S. Tobacco*.

<sup>20</sup> Granholm, Jennifer M. and Robert L. Emerson. (2010, February 11). State of Michigan Executive Budget, Fiscal Year 2011. *State of Michigan*. Retrieved October 2010 from State of Michigan government website:  
<http://www.michigan.gov/budget>.

<sup>21</sup> Lindblom, Eric. (2002, December 4). Problems with Securitizing State Tobacco Settlements. *Campaign for Tobacco Free Kids*. Retrieved October 2010 from CTFK website:  
<http://tobaccofreekids.org/research/factsheets/pdf/0217.pdf>

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<sup>22</sup> Cigarette Excise Taxes: A National View. (2010). Philip Morris USA, an Altria Company. Retrieved October 2010 from PM USA website:

[http://www.philipmorrisusa.com/en/cms/Responsibility/Government\\_Affairs/Legislative\\_Issues/Cigt\\_Excise\\_Tax/default.aspx?src=search](http://www.philipmorrisusa.com/en/cms/Responsibility/Government_Affairs/Legislative_Issues/Cigt_Excise_Tax/default.aspx?src=search).

<sup>23</sup> Sweeney, Timothy and Sarah Ray. (2008). Examining How Georgia Spends Tobacco Settlement Revenues.

*Georgia Budget and Policy Institute*. Retrieved October 2010 from Georgia Budget and Policy Institute Website: <http://www.gbpi.org/documents/20081007.pdf>

<sup>24</sup> State & Local Government Downloadable Data. (2010). *US Census Bureau, State & Local Government Finance*. Retrieved October 2010 from US Census Bureau website: <http://www.census.gov/govs/estimate/>.

# Chapter 5: Potential impact on employment

## **I. INTRODUCTION**

Nearly 500,000 American jobs depend at least in part on the legal sale of menthol cigarettes. Any ban on menthol cigarettes, and consequent shift from legal to illicit sales, would likely have a direct impact on these jobs. Job losses would vary by stage in the tobacco value chain, but are likely to have a disproportionate impact on small, independent convenience store owners, tobacco growers and independent distributors to convenience stores. A menthol cigarette ban could also have the unintended indirect consequence of higher prices for non-tobacco products sold in convenience stores.

## **II. NEARLY 500,000 AMERICAN JOBS DEPEND AT LEAST IN PART ON MENTHOL CIGARETTE SALES**

Hundreds of thousands of American jobs rely in whole or in part on the tobacco industry, from growers to neighborhood convenience stores. A decline in legitimate cigarette sales in the wake of any ban on menthol cigarettes could have a direct impact on jobs across the tobacco value chain. Table 5.1 below illustrates the major components of the tobacco value chain, and the estimated impact on each of a potential ban on menthol cigarettes.

■ Table 5.1. Summary of employment across the tobacco value chain

Please refer to Appendix Exhibit 5.1 for a list of definitions used in this analysis.

	<b>Growers</b>	<b>Processors &amp; Manufacturers</b>	<b>Distributors &amp; Transportation</b>	<b>Selling organizations</b>
<b>Primary activities</b>	Farm, harvest, cure, grade, and wholesale tobacco leaf	Procure, process, pack, and supply tobacco for the manufacture of cigarettes	Warehousing and transport of cigarettes to retail outlets	Retail outlets such as convenience stores that sell cigarettes to adults
<b>Estimated total employment</b>	62,000	19,000	40,000	Convenience only: 1-1.5 million Other outlets: 4-5 million
<b>Jobs at risk if all menthol cigarette volume were eliminated</b>	25,000	3,500	3,000	475,000

### Convenience stores

If convenience stores were to compensate for the profit declines associated with the loss of all taxed menthol cigarette sales through labor cuts alone, about 475,000 jobs could be at risk. Please see Table 5.2 for detailed assumptions and analysis.

### Growers

A significant loss of legitimate volume due to a menthol cigarette ban could drive thousands of farms into bankruptcy. As many as 25,000 related jobs could be lost if the full volume of menthol cigarettes shifted away from the legitimate market. Job losses would be concentrated in a few states, including Kentucky and North Carolina. North Carolina, the country's largest producer of flue-cured tobacco, has in the past year suffered from jobless rates near a 30-year high. Please see Table 5.3 for detailed assumptions and analysis.

## **Distributors to convenience stores**

Distributors to convenience stores depend on cigarette sales for more than 70% of revenues. A decline in cigarette volume could therefore force many small, family-owned and independent operators out of business. We estimate that if the entire volume from menthol cigarettes left the legitimate system, about 3,000 of the 15,000 people employed by small, independent distributors could lose their jobs. Please see Table 5.5 for detailed assumptions and analysis.

## **Processors and tobacco manufacturers**

Although this submission does not provide an in-depth assessment of potential job losses in tobacco processing or manufacturing, jobs in these segments of the industry are equally at risk.

A few large manufacturers produce about 85% of the country's legitimate cigarettes. Most of their employees work in North Carolina and Virginia. Tobacco manufacturers employ approximately 11,000 workers,<sup>1</sup> providing solid wages and the opportunity for those employees to actively participate in their local economies. The impact of losses of any tobacco manufacturing-related jobs as a result of a ban on menthol cigarettes, particularly in times of economic uncertainty, would not be limited to the individual employees. Rather, these states and their communities would also experience the negative economic consequences.

There are also a small number of key players operating "stemmeries" or dedicated tobacco storage and distribution facilities, with U.S. employment of approximately 2,000 workers relatively concentrated in the Southeast (particularly Virginia).

Processor and tobacco manufacturer jobs losses can be expected to directly correlate with reductions in volume. Loss of all menthol volume could affect 3,500 jobs (see Appendix table 5.5).

### **III. JOB LOSSES COULD DISPROPORTIONATELY IMPACT SMALL, INDEPENDENT CONVENIENCE STORE OWNERS, TOBACCO GROWERS AND INDEPENDENT DISTRIBUTORS TO CONVENIENCE STORES**

#### **A. Convenience stores**

*For an overview of industry players and economics for convenience stores, please see Appendix Exhibit 5.2.*

More than 250,000 retail outlets in the United States sell tobacco products, including grocery stores, general merchandise stores and drugstores. They employ more than five million people in total. We focus here on the roughly 125,000 convenience stores where two-thirds of cigarettes are sold.<sup>2</sup> About a third of the average convenience store's revenue, and approximately 15% of its gross margin, come from cigarettes sales. Other items purchased with cigarettes during the same trip, such as gum and packaged beverages, constitute another third of revenues. Many convenience store businesses operate on thin profit margins, putting them at risk of bankruptcy if profits fall suddenly.

Table 5.2 below illustrates the estimated cumulative profit and loss statement for the convenience store industry (excluding fuel), and outlines the estimated impact of a 10% to 100% decline in taxed menthol cigarette volume on the industry.

- Table 5.2. Potential impact of a menthol cigarette ban on the convenience store industry P&L, and potential employment reductions required to compensate for lost profits (estimates, rounded numbers)

	Existing industry P&L <sup>3</sup>		Industry P&L if 100% of 2009 taxed menthol cigarette volume were removed
	\$ billions	Percent	
<b>Total revenue (cigarettes and all other sales)</b>	<b>150.0</b>	<b>100</b>	<b>123.0</b>
Menthol cigarettes	13.5	9	0
Regular cigarettes	36.5	24	36.5
Other items purchased with cigarettes	50.0	33	36.5
Non cigarette-related items	50.0	33	50.0
<b>Gross profit</b>	<b>48.0</b>	<b>32</b>	<b>40.4</b>
Menthol cigarettes	2.2	16	0
Regular cigarettes	5.8	16	5.8
Other items purchased with cigarettes	20.0	40	14.6
Non cigarette-related items	20.0	40	20.0
<b>Operating expenses:</b>	<b>42.0</b>	<b>28</b>	<b>42.0</b>
Labor	15.0	10	15.0
Fixed costs	27.0	18	27.0
<b>Net income</b>	<b>6.0</b>	<b>4</b>	<b>(1.6)</b>
<b>Lost profit</b>			<b>7.6</b>
<b>Labor cuts required to preserve lost profit</b>			<b>472,500</b>

Note: Job loss calculation assumes annual salary per worker of \$16,000 per year<sup>20</sup>

Many dynamics contribute to the importance of cigarettes to an average convenience store's business model, underscoring the industry's vulnerability to a ban on menthol cigarettes. Cigarettes drive foot traffic, for example, raising sales of non-tobacco products.

### **Cigarettes drive traffic to convenience stores**

For many adults, cigarettes are a “destination purchase,” bringing customers into convenience stores. Approximately 20% of convenience store customers surveyed said they entered the store to purchase cigarettes.<sup>4</sup> Cigarette shoppers also purchase cigarettes more often per month than any other category examined: an average of eight cigarette purchases per month vs. 4.7 for packaged beverages. About 21% of customers who buy cigarettes make 15 or more purchases per month. As a result, cigarette purchasers account for over 30% of trips to the average convenience store.<sup>3</sup>

### **Cigarette purchasers frequently purchase non-tobacco items that contribute to convenience store revenues and profits**

Many adults who visit convenience stores buy other products that add to convenience store profits. The average convenience store shopper spends about \$11-12 per visit,<sup>3</sup> roughly half of which goes for cigarettes for those who purchase cigarettes.<sup>5</sup> Shoppers spend the other half on other items such as packaged beverages, candy, gum, and beer. For a detailed analysis of average basket size, please refer to Appendix table 5.1.

Adults who purchase tobacco products are significantly more likely than the average customers to purchase a certain set of products, including beer and canned or bottled soda.<sup>3,6</sup> Together, these three products represent 67% of total c-store sales.<sup>7</sup> Please refer to Appendix table 5.2 for details on cigarette shoppers' “co-purchase” behavior.

A decline in foot traffic or cigarette volume could decrease sales in non-cigarette categories, especially those highly correlated with cigarette purchases. Losing some of these sales could hurt convenience stores; if all 2009 taxed menthol sales were removed, the decline in convenience store industry profits could reach about \$7.6 billion.

## B. Tobacco growers

*For an overview of the industry and economics for tobacco growers, please refer to Appendix Exhibit 5.3.*

The U.S. tobacco farming industry, which employs more than 60,000 people on over 10,000 farms, has faced serious challenges in recent years, including the buyout of government quotas and a 159% increase in the federal excise tax on cigarettes. Many farms, especially smaller ones, are now operating on the brink, and a significant loss of revenue due to a menthol cigarette ban could drive thousands into bankruptcy. A total of 25,000 jobs could be lost if the full volume of taxed menthol cigarettes shifts away from the legitimate market. For detailed job loss estimations, please see Table 5.3, below.

■ Table 5.3. Grower job losses associated with declines in menthol cigarette volume<sup>10,11</sup> (estimates, rounded numbers)

	<b>Current situation</b>	<b>Potential situation if all 2009 taxed menthol cigarette volume were removed</b>
Decline in taxed menthol cigarette volume		100%
Translating to a decline in total taxed cigarette volume of		27%
Share of tobacco leaves sold domestically	50%	50%
Grower impact multiplier <sup>8</sup>	3.0	41%
Production (millions of pounds)	648	386
Acreage (thousands)	300	179
Total farms	10,000	6,000
Seasonal laborers	42,000	25,000
Owner/operator laborers	20,000	12,000
Total employment	62,000	37,000
<b>Total jobs lost</b>		<b>25,000</b>

Tobacco farmers are vulnerable to a sharp decline in cigarette volume for two main reasons:

### **Growers experience the impact of cigarette volume declines at a magnified rate**

Since many cigarette manufacturers purchase tobacco inventory two to three years in advance, they may have surplus on hand. A sudden decline in forecast demand for cigarettes could therefore have a magnified impact on the growing community. For example, if manufacturers expected a 5% decrease in retail demand for cigarettes, they might decrease their tobacco purchases by 10-15% to use their inventory on hand. Even a one-time decrease of this size could put many small growers out of business.

The industry demonstrated this magnifying dynamic in the wake of the 2009 federal excise tax increase, which caused taxed sales to decline. (For a full analysis of the potential tax implications associated with a ban on menthol cigarettes, please refer to Chapter 4).

### **FET case study**

In 2007, when the FET increase was being considered, the Joint Committee on Taxation predicted that an increase in the FET to \$1 would have the effect of reducing the incidence of taxed cigarette purchases in the United States by about 5% in the first year.<sup>9</sup> But in the year following the 2009 passage of the FET increase, sales of the two main types of cigarette tobacco - flue-cured and burley - have declined much more sharply. Flue-cured contract volume is down by about 20% this year, and burley sales are forecast to be down 16%.<sup>10</sup> In other words, grower volume declined by a “multiplier” of about three to four times more than retail sales.

### **Highly variable, labor-intensive cost structure**

The cost structure of tobacco farms is more variable than that of many other crops, making labor and employment associated with tobacco production more susceptible to changes in volume and production. Variable costs, especially labor, represent a significant portion of total costs for a tobacco grower because tobacco farms tend to be small, and because tobacco farming tends to require more labor.

The average tobacco farm is about 30 acres, compared to the average farm size of about 480 acres for a typical American farm.<sup>11</sup> A smaller farm has fewer economies of scale and less ability to invest in expensive machinery for automated farming. In

addition, farming tobacco is labor-intensive. At the end of the season in particular, cutting, hanging, stripping and baling requires many hours of manual labor.<sup>12</sup> The labor intensity of tobacco is illustrated in Table 5.4, which outlines the share of total production costs attributed to labor for tobacco versus other U.S. crops.

■ Table 5.4. Grower labor as a share of total production costs<sup>13</sup>

Crop	Burley tobacco	Flue-cured tobacco	Corn	Soybeans	Wheat	Sugar beets
Labor as a share of total costs	16%	15%	0.4%	0.6%	0.9%	6.9%

Furthermore, farmers who lease land to grow tobacco pay higher rents for tobacco land than for other crop land in their farming areas. Farmers could not continue to pay these higher lease rates to grow another crop on that same plot of land. Therefore, they could lose the ability to lease the land for farming and be forced out of business. To illustrate, the net revenue growers receive for tobacco average about 2.5 times higher than the net revenue for crops such as food grains, cotton and oilseed.<sup>14</sup> Higher revenues per acre of land for tobacco result in significantly higher land prices for tobacco acreage.

■ Exhibit 5.1. Snapshot: A tobacco grower shares his hopes and fears

In 1932, Bill Harrell’s great-grandfather borrowed four silver dollars to begin farming tobacco in Wilson County, North Carolina. Mr. Harrell’s grandfather and father grew tobacco on the same land, and now, as his two sons graduate from college and return home to help manage the farm, he hopes it will continue to support them and their families, and his retirement.

The business is more challenging today. As many neighboring farms have gone out of business, Mr. Harrell has attempted to diversify, planting other relatively high-value crops like strawberries and cantaloupes. He has also contracted with small manufacturers and export companies to offset declining purchases from major U.S. manufacturers. “Tobacco,” he says, “is the one crop we can count on.”

Despite his efforts, other crops aren’t as hardy as tobacco, which thrives year after year in the region’s variable growing conditions. “This isn’t California,” he explains.

“The weather in North Carolina is unpredictable. Planting other crops may work for a year or two, but eventually the weather or changing commodity prices will put you out of business. You can’t make a living in Wilson County without tobacco.”

Asked what keeps him up at night, Mr. Harrell sums up it up in one word: “uncertainty.” “I’ve borrowed a lot of money to keep my business going. What would I do without my contracts?”

He worries about the 50 employees who work on his land, many of whom have been with him for more than 10 years, and their families. He worries about his community, its history of tobacco culture, and the many people, from retailers to schoolteachers, who rely directly or indirectly on the tobacco economy. Most of all, like any parent, he worries about his sons’ future.

“After all the investments we’ve made,” he asks, “will this crop still be here to be the backbone of the agricultural economy for my children?”

## **Distributors to convenience stores**

*For an overview of industry participants and economics for distributors to convenience stores, please refer to Appendix Exhibit 5.4.*

The distribution and transportation industry operates on profit margins of less than 1% overall;<sup>15</sup> many companies operate at essentially breakeven levels. A ban on menthol cigarettes would likely put many out of business, especially small, independent operators, and cause job losses.

Cigarettes provide about 70% of the revenues and about 35% of the gross profit of top distributors to convenience stores. The next-largest category, candy and salty snacks, make up about 5% of revenues.<sup>16</sup> For larger firms, menthol cigarettes, at about 27% of the total cigarette market, make up about 20% of total sales. Smaller distributors in certain areas might depend even more heavily on cigarettes in general and on menthol cigarettes in particular. A decline in menthol cigarette sales could therefore affect large and small operators in different ways.

## **Large national and regional distributors**

Large distributors distribute everything from candy to health and beauty products to convenience and general merchandise stores. Cigarette sales make an especially large

profit contribution that effectively subsidizes the prices of lower-contribution consumer products and staples. A decline in cigarette volume could compromise this business model, forcing distributors to compensate for the loss in cigarette profits by raising delivery charges or prices on non-tobacco products. This dynamic could impact not only convenience stores, which might lose access to affordable distribution, but also consumers, who could lose access to or face higher prices on food and other staples.

### Small local distributors

A decline in menthol cigarette volume could force many small, family-owned and independent distributors out of business. We estimate that if the entire volume of menthol cigarettes left the legitimate system, about 3,000 of the 15,000 people employed by small, independent distributors could lose their jobs. This effect could be compounded if convenience stores, facing higher distribution costs, opted to consolidate their suppliers or purchase cigarettes in bulk from club warehouse stores rather than distributors. Table 5.5 below details estimated job losses if all 2009 taxed menthol cigarette volume were removed, assuming that menthol cigarettes are a flat 27% of the overall cigarette market.

■ Table 5.5. Estimated small distributor job losses if all 2009 taxed menthol cigarette volume were removed (numbers rounded)

Decline in taxed menthol cigarette volume	100%
Decline in total taxed cigarette volume	27%
Estimated decline in small distributor revenue	19%
<b>Jobs lost</b>	<b>2,835</b>

*Note:* We made the following assumptions: (a) menthol cigarettes are 27% of total cigarette volume; (b) cigarettes represent 70% of small distributor revenues; (c) small distributors in the United States employ about 15,000 people; and (d) job losses are directly proportional to the total revenue lost.

#### **IV. A MENTHOL BAN COULD ALSO HAVE UNINTENDED INDIRECT CONSEQUENCES, SUCH AS HIGHER PRICES FOR NON-TOBACCO PRODUCTS SOLD IN CONVENIENCE STORES**

Secondary effects could arise in addition to or associated with job losses:

##### **Increased costs to the consumer**

Loss of tobacco sales and profit could result in higher prices for non-tobacco products sold through convenience stores. As an alternative to cutting jobs, convenience stores could increase prices of other products in an effort to make up for the lost profits; if this scenario plays out, the purchasing power of the average consumer could be damaged.

##### **Unemployment benefits**

In many cases, Americans suffering from short- and long-term unemployment are eligible to receive unemployment benefits averaging about \$400 per week for up to 68 weeks (specific benefits vary by state.) The Department of Labor reports that more than 4.3 million Americans are collecting state unemployment insurance today.<sup>17</sup> At this rate, every 100,000 jobs lost could cost up to \$2.8 billion in state benefits; if all menthol cigarette volume were eliminated, unemployment benefits associated with job loss could cost taxpayers \$14 billion.

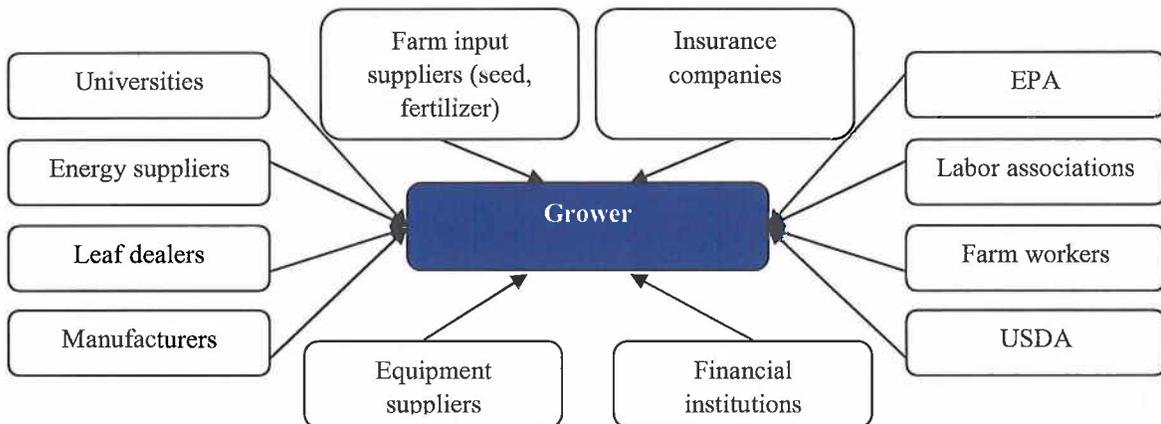
#### **V. OTHER POTENTIAL CONSIDERATIONS NOT EXAMINED IN THIS SUBMISSION**

##### **Loss of small businesses and the associated impacts on local communities**

Independent tobacco farms, small distributors and independent retailers could all be greatly impacted by a ban on menthol cigarettes. They provide significant intangible benefits, such as leadership and involvement, to their communities, as well as providing outsized contributions in innovation, job creation, and female and minority ownership<sup>18</sup>. For example, according to the 2007 U.S. Census, about 17% of companies classified as wholesalers, and 20% of companies engaged in retail trade, were owned by minorities.<sup>19</sup>

As illustrated in the figure below, tobacco growers create a variety of jobs away from the farm, especially in North and South Carolina, Kentucky and Virginia, where most U.S. tobacco is grown.

■ Figure 5.1: Stakeholders in the tobacco-growing community



**Other retail distributors:** Many major grocery and drugstore chains operate their own distribution businesses. While tobacco products represent a smaller percentage of their overall business than it does distributors to convenience stores, a decline in profit contribution from cigarette sales could result in lost profits or disruption to their operating models.

**Other manufacturers and suppliers:** Many companies serve the tobacco processing and cigarette manufacturing industries, including transportation providers, machine manufacturers, and input suppliers, such as paper and packaging manufacturers.

### Reduced access to staple products in certain areas

If some convenience stores were forced to close, consumers in their neighborhoods could lose easy access to food and other staples. If distributors serving small retailers go out of business, those retailers might have to pay more for delivery, to the detriment of margins and potentially employment.

## APPENDIX

### ■ Appendix exhibit 5.1. Tobacco value chain definitions<sup>20</sup>

For this analysis, we have defined the primary players in the U.S. tobacco value chain as follows:

- Growers: Agricultural enterprises in the business of farming, harvesting, curing, grading, and wholesaling tobacco leaf and menthol
- Processors: Businesses involved in the procurement, processing, packing, and supply of flue-cured and burley tobacco to manufacturers of cigarettes
- Manufacturers: Physical manufacturing of the cigarettes and packaging. Flavor production is also required for menthol cigarettes.
- Distribution & transportation providers:
  - General wholesaling: Wholesaling of tobacco products through distribution warehouses and complementary functions such as transportation to retail outlets.
  - Distribution to convenience stores: distributors primarily serving convenience stores that derive a majority of their annual sales from tobacco products and candy.<sup>16</sup>
  - Other distribution: Freight carriers transporting tobacco from growers to processors and to manufacturers.
  - Selling organizations: Distributors of tobacco products through retail outlets such as supermarkets and convenience stores.
- Appendix exhibit 5.2. Industry overview: Convenience stores
  - More than 250,000 retail outlets in the United States sell tobacco products, including grocery stores, general merchandise stores and drugstores, among others. Together, they employ more than five million people.<sup>21</sup>
  - We have focused on convenience stores because of their prominence as a distribution channel for cigarettes. About two-thirds of cigarette sales occur in approximately 125,000 convenience stores.<sup>2</sup>
  - Approximately 1-1.5 million people work full-time or part-time in these 125,000 convenience stores, with an average of 8-12 per store. Convenience stores include small-format grocery stores, newsstands, and gas stations.<sup>3</sup>

- Employment in about 6,500 tobacco specialty stores generates an additional 26,000 jobs. For example, California’s more than 500 specialty stores employ about 1,275 people. Tobacco specialty stores employ only about four employees each, but an estimated 80-90% of their business is the sale of cigarettes and other tobacco products.<sup>20</sup>
- About 40-50% of convenience stores, or some 58,000 in all, belong to chains of 60 or more. The remainder are part of smaller chains or independent “mom & pop” formats.<sup>22</sup>

■ Appendix table 5.1. Average basket size per c-store purchase<sup>4</sup>

<b>Amount spent</b>	<b>Distribution</b>	<b>Average basket</b>
Less than \$1	2%	\$0.50
\$1 - 4.99	31%	\$2.50
\$5 – 9.99	30%	\$7.50
\$10 – 14.99	15%	\$12.50
\$15 – 19.99	5%	\$17.50
\$20 – 29.99	7%	\$25.00
\$30+	9%	\$40.00
<b>Total</b>	<b>100%</b>	<b>\$11.28</b>

- Appendix table 5.2. Adult cigarette buyers' cross-purchase behavior in convenience stores<sup>23</sup>

<b>Product purchased</b>	<b>Total adult buyers</b>	<b>Adult cigarette buyers</b>	<b>Difference</b>
Gasoline	61%	69%	8
Canned/bottled soda	42	49	7
Candy/gum	38	43	5
Bottled water	29	33	4
Milk	28	33	5
Hot beverages	25	29	4
Sports drinks	18	23	5
Beer	14	23	9
Other tobacco products	5	9	4

*(How to read this chart: 61% of all adult buyers at convenience stores purchase gasoline vs. 69% of those adult buyers who buy cigarettes at convenience stores)*

- Appendix table 5.3. Estimated United States tobacco growers, 2010<sup>24,25,10</sup>

<b>Type of acreage</b>	<b>Flue-cured</b>	<b>Burley</b>	<b>Total</b>
Total acres (2010 estimate)	207,000	93,500	300,500
Labor hours per acre	95	150	112
Labor hours per worker	800	800	800
Seasonal laborers needed	24,500	17,500	42,000
Farms	7,000	3,000	10,000
Owner/operator labor	14,000	6,000	20,000
<b>Total labor</b>	<b>38,500</b>	<b>23,500</b>	<b>62,000</b>

Over 60,000 Americans rely on tobacco farming for their primary source of employment, while scores of others are employed by agribusinesses supporting tobacco farms.

Roughly 90% of American tobacco is grown in five states: Kentucky, North Carolina, Tennessee, Pennsylvania and Virginia. About 75-80% of flue-cured tobacco is grown in North Carolina and 70-75% of burley in Kentucky.<sup>26</sup>

■ Appendix Exhibit 5.4. Industry overview: Distributors to convenience stores

Convenience wholesaling, an industry with \$54 billion in annual revenues, relies heavily on cigarettes, which account for about 70% of the revenues of top distributors and about 35% of gross profit. The next-largest category, candy and salty snacks, make up about 5% of revenues.<sup>16</sup> Many large beer, beverage and snack manufacturers, such as Coca-Cola and Pepsi, operate their own distribution systems, so distributors to convenience stores rely even more on cigarette volume than convenience stores.

The convenience wholesaling and distribution industry has a small number of large national and regional players, and a large number of small, local distributors.

■ Appendix table 5.4. Convenience distribution industry landscape (estimated)<sup>16,20</sup>

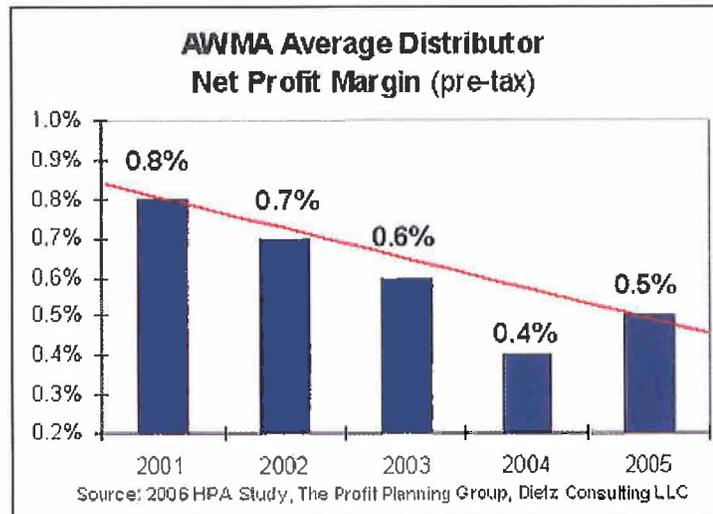
Type of distributor	Number of companies	Average employees per company	Total employees	Share of industry sales
Large & mid-sized	50	500	25,000	~90%
Small and local	1,300	11-12	15,000	10%

More than one distributor may serve some retailers, especially smaller, independent stores. For example, a large distributor may purchase products directly from the manufacturer and dispense from centralized warehouses to non-core regional areas via smaller, regional transportation firms. For the smallest independent stores in more outlying areas, a small local distributor might receive shipments from regional players and ultimately dispense to the retail outlet.

**Industry economics**

Distributors large and small operate at thin – and declining – margins. Average net profit margins for large and small players average less than 1%:

- Appendix figure 5.1: Distributors to convenience stores average net profit margins, 2001-2005<sup>15</sup>



The industry's margin dynamics reflect a variety of challenges and pressures:<sup>15</sup>

- Rising operating expenses, including health and property insurance and investments in necessary technologies
- Increasing competition from traditional distributors and non-wholesale channels, such as small independent stores that purchase inventory directly from warehouse stores

■ Appendix table 5.5: Tobacco processing and manufacturing jobs in the United States<sup>20</sup>

2007 NAICS code meaning	Thousands of employees	Primary geography
Tobacco stemming and re-drying	2	VA
Cigarette manufacturing	11	NC, VA
<b>Total</b>	<b>13</b>	

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- <sup>8</sup> The "multiple" reflects the fact that manufacturers might reduce tobacco purchases more than retail sales are projected to decline. Many tobacco manufacturers purchase tobacco inventory 2-3 years in advance; as a result, they may have surplus on hand in the event of a decline in projected demand for cigarettes. This can have the effect of magnifying the impact of a projected decrease in retail demand for the growing community. For example, given a 5% forecast decrease in retail demand for cigarettes, manufacturers could decrease tobacco purchasing by 10-15% -- two to three times more than the retail volume decline -- to use inventory on hand.
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## Conclusion:

# Countervailing effects of a ban on menthol cigarettes

Section 907 (b)(2) of the Act requires the FDA to consider countervailing effects of a ban on menthol cigarettes. This report demonstrates that such a ban would likely trigger a series of lasting significant unintended consequences and other countervailing effects that would be detrimental to public health objectives and to society more generally.

Any ban is likely to spur the increase of unregulated sources of cigarette supply, mostly through the growth of unregulated illicit cigarette markets, as well as an increase in self-mentholation. If a ban on menthol led to an expansion of illicit cigarette distribution channels, it would hinder the progress the country has made toward reducing access to cigarettes for minors. A shift toward illicit markets would expand criminal activity, while also reducing tax and TSA revenue at the federal, state and local levels, thus creating the need to find alternative sources of funding for a number of programs supported by these monies. Finally, any ban on menthol cigarettes could lead to significant job losses, particularly among tobacco growers and cigarette retailers.

In addition, the expected proliferation of illicit menthol cigarettes would significantly increase the number of cigarettes being introduced into interstate commerce without being subject to federal and state regulations. As with existing illicit cigarettes, this could undermine the current and future objectives of the FDA and other federal and state frameworks for regulating cigarettes.

While each of these consequences stands on its own, they would likely have compounded effects that are even more significant than those detailed in this submission. For example, if a decline in legitimate, taxed menthol cigarette sales lowered excise and sales taxes and TSA payments, new budgetary pressures could force legislatures to cut law enforcement or prison budgets, making it easier for illicit cigarette market participants to operate. As a result, criminal organizations in the United States and abroad could gain new sources of profit and expand their operations, further straining law enforcement resources, the courts and prisons. Similarly, wider availability of illicit cigarettes could cause more adults to turn away

from legitimate retailers, placing these retailers at a competitive disadvantage and in some cases forcing them out of business, raising unemployment and putting additional pressures on government agencies and budgets.

Scientific and other information presented and submitted to the TPSAC demonstrates that menthol added to cigarettes does not increase the inherent health risks of cigarette smoking and that menthol cigarettes do not play a unique role in smoking initiation (based on the limited available scientific evidence), dependence or cessation. Given this record, there is no science- or evidence-based reason that would support a TPSAC recommendation to ban menthol cigarettes.

In addition to the scientific and other information previously presented and submitted to TPSAC and FDA, we urge the Agency to carefully consider these significant countervailing effects as it contemplates any possible ban or other restrictions that would deprive adult smokers of regulated and legitimate menthol cigarettes.