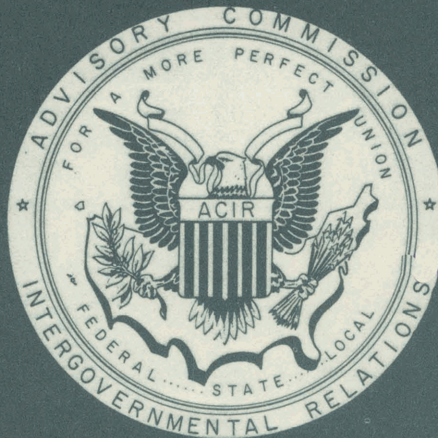
A COMMISSION REPORT

State-Federal Overlapping in Cigarette Taxes



ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS
SEPTEMBER 1964
A-24

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A COMMISSION REPORT

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IN
CIGARETTE TAXES

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PREFACE

The need to maximize tax enforcement while minimizing administrative costs takes on added urgency under a federal system of government because the National Government and the States frequently employ the same taxes. In recognition of this fact, Congress, in establishing the Advisory Commission on Intergovernmental Relations (Public Law 86-380), charged the Commission with the responsibility for recommending methods of coordinating and simplifying tax laws and administrative practices to achieve a more orderly and less competitive fiscal relationship between levels of government and to reduce the burden of compliance for taxpayers.

Cigarettes are taxed by the Federal Government and by all of the States (and the District of Columbia) except North Carolina and Oregon. Over 96 percent of the American people now live in communities where cigarettes are at least twice-taxed, and in some parts of the country tax overlapping has taken on a three-ply character now that over one hundred municipalities also tax cigarettes.

This report places primary emphasis on devising the most efficient means for coordinating the collection of Federal and State cigarette taxes because (a) deeply rooted tax overlapping virtually precludes either Federal or State withdrawal from this highly productive tax field, and (b) the costly collection system presently employed by most States in contrast to the economical method employed by the Federal Government invites exploration of possible opportunities for conserving State resources.

This report was adopted at the meeting of the Commission held on September 17, 1964.

Frank Bane
Chairman

ACKNOWLEDGMENTS

In developing this report the staff of the Commission benefited from information and advice generously provided by Mr. Charles F. Conlon, Executive Director, Federation of Tax Administrators, and Mr. H. Clyde Reeves, Vice President of the University of Alabama and Consultant to the Commission. The Commission also wishes to express its gratitude to Mr. Charles J. Mouhtouris, Chief, Tobacco Tax Branch, Alcohol and Tobacco Tax Division of the Internal Revenue Service for assistance provided the Commission's staff in the preparation of this report. Final responsibility for the staff work reflected in this report rests with us.

Wm. G. Colman
Executive Director

L. L. Ecker-Racz
Assistant Director

WORKING PROCEDURES OF THE COMMISSION

This statement of the procedures followed by the Advisory Commission on Intergovernmental Relations is intended to assist the reader's consideration of this report. The Commission, made up of busy public officials and private persons occupying positions of major responsibility, must deal with diverse and specialized subjects. It is important, therefore, in evaluating reports and recommendations of the Commission to know the processes of consultation, criticism, and review to which particular reports are subjected.

The duty of the Advisory Commission, under Public Law 86-380, is to give continuing attention to intergovernmental problems in Federal-State, Federal-local, and State-local, as well as interstate and inter-local relations. The Commission's approach to this broad area of responsibility is to select specific, discrete intergovernmental problems for analysis and policy recommendation. In some cases, matters proposed for study are introduced by individual members of the Commission; in other cases, public officials, professional organizations, or scholars propose projects. In still others, possible subjects are suggested by the staff. Frequently, two or more subjects compete for a single "slot" on the Commission's work program. In such instances selection is by majority vote.

Once a subject is placed on the work program, a staff member is assigned to it. In limited instances the study is contracted for with an expert in the field or a research organization. The staff's job is to assemble and analyze the facts, identify the differing points of view involved, and develop a range of possible, frequently alternative, policy considerations and recommendations which the Commission might wish to consider. This is all developed and set forth in a preliminary draft report containing (a) historical and factual background, (b) analysis of the issues, and (c) alternative solutions.

The preliminary draft is reviewed within the staff of the Commission and after revision is placed before an informal group of "critics" for searching review and criticism. In assembling these reviewers, care is taken to provide (a) expert knowledge and (b) a diversity of substantive and philosophical viewpoints. Additionally, representatives of the American Municipal Association, Council of State Governments, National Association of Counties, U. S. Conference of Mayors, U. S. Bureau of the Budget and any Federal agencies directly concerned with the subject matter participate, along with the other

"critics" in reviewing the draft. It should be emphasized that participation by an individual or organization in the review process does not imply in any way endorsement of the draft report. Criticisms and suggestions are presented; some may be adopted, others rejected by the Commission staff.

The draft report is then revised by the staff in light of criticisms and comments received and transmitted to the members of the Commission at least two weeks in advance of the meeting at which it is to be considered.

In its formal consideration of the draft report, the Commission registers any general opinion it may have as to further staff work or other considerations which it believes warranted. However, most of the time available is devoted to a specific and detailed examination of conclusions and possible recommendations. Differences of opinion are aired, suggested revisions discussed, amendments considered and voted upon, and finally a recommendation adopted (or modified or diluted as the case may be) with individual dissents registered. The report is then revised in the light of Commission decisions and sent to the printer, with footnotes of dissent by individual members, if any, recorded as appropriate in the copy.

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CHAPTER 1

STATEMENT OF THE PROBLEM

State-Federal overlapping in cigarette taxation is now nearly complete (Table 1). Cigarettes are taxed by the Federal Government and by all of the States (and the District of Columbia) except North Carolina and Oregon. Over 96 percent of the American people now live in communities where cigarettes are at least twice taxed. In some parts of the country, tax overlapping has taken on a three-ply character now that over one hundred municipalities also tax cigarettes.

The Federal tax is 8 cents on a standard pack of 20 cigarettes and this fiscal year is expected to produce over $2.1 billion. The States' taxes should yield about $1.3 billion. In 32 of the States the tax rate is 6 cents or higher. The most popular single rate is 8 cents, within a range from 2 to 9 cents.

The State and Federal taxes are administered independently of one another. Since enforcement occurs at different levels of distribution, one at the manufacturing, the other at the wholesaling level, the opportunity for Federal and State tax administrations to assist one another is minimal.

The Federal Government collects substantially all of its $2.1 billion by semi-monthly returns filed by 16 factories with virtually no evasion and at relatively very little expense. At the State level the tax is collected from thousands of distributors (jobbers, wholesalers, and large retail organizations) primarily through the sale of prepaid stamps or other indicia, which distributors are required to affix to each package of cigarettes. The quality of State tax enforcement is presumed to be less than perfect but the amount of evasion cannot be quantified.

Although the States collect only 60% as much as the Federal Government, the cost of administering the State taxes is almost 100 times greater and consists of three elements: (1) the cost of preparing the stamps and other forms of indicia, (2) compensation of distributors for affixing the stamps, and (3) expense of audit and enforcement.

TABLE 1. - GROWTH OF STATE-FEDERAL CIGARETTE TAX OVERLAPPING

Selected Years 1925-1964

Item	1925	1930	1935	1940	1945	1950	1955	1960	1964
No. of States with cigarette taxes	8	10	18	27	32	43	44	47	49
Percent of total U. S. pop. in these States	11.7	14.6	39.2	59.5	66.1	81.9	81.0	93.3	96.5
State tax rates:									
Average (cents)	2.5	2.4	2.7	2.6	2.6	3.3	3.7	4.7	6.0
Median (cents)	2.0	2.0	2.0	2.0	2.0	3.0	3.0	5.0	6.0
Federal tax rate (cents)	6.0	6.0	6.0	6.0	7.0	7.0	8.0	8.0	8.0

NOTE: Includes District of Columbia; 1964 data as of July 1; data for all other years as of January 1.

Although the Federal Government entered the cigarette tax field well ahead of the States, the advent of State taxation has not materially disadvantaged national policy objectives. The rapid advance of the average level of State tax rates to approximately three-quarters of the 8 cents Federal rate appears to have occurred without appreciable effect on cigarette consumption. Since the advent of State taxation in the early 1920's, when the aggregate Federal and State tax on a pack of cigarettes moved from 8 cents to 14 cents, per capita consumption quintupled. The volume of consumption appears to be affected more by the level of personal income than by the price of the product, including tax. This suggests that State taxation of cigarettes has not had a noticeably adverse effect on Federal revenue.

Neither is there any evidence that the existence of State taxes has influenced the level at which the Congress fixes Federal tax rates. While the initial enactment of this tax and the successive increases in the tax rate were each motivated, almost without exception, by the need for revenue to finance a national crisis (most recently, the Korean War), the retention of the tax after each crisis at the new level attained is obviously not explainable by the Federal Government's revenue needs. The retention of the present 8 cent tax, while income taxes were reduced and general excise tax reduction is under consideration, appears to be explained by those intangible considerations associated with the disapproval of smoking on moral and health grounds and by the sumptuary character of cigarette taxation as well as by the relative ease with which the Federal Government can collect $2 billion annually.

Although the evidence is more difficult to marshall, it is improbable that the existence of the Federal tax materially affects the level of State taxation. The 12 States that are content with less than 5 cent tax rates, while 15 find it practicable to operate with 8 cent or higher rates, are presumably influenced by considerations other than the Federal tax rate which affects them all uniformly. In short, this appears to be one of those rare fish ponds in which one angler's activity does not handicap the catch of the others. In this respect, cigarette taxes differ significantly from other overlapping taxes. They differ from them also in that relatively costly enforcement procedures and duplicate administration have escaped public notice and criticisms.

While the simultaneous taxation of cigarettes by the Federal, State, and some local governments entails no apparent conflict in tax policies, it does raise important intergovernmental problems.

At a time when the States urgently need all the revenue they can muster to provide pressing public services essential to national

strength, they have thought it necessary to employ a tax enforcement procedure which is conspicuously costlier than the one utilized by the Federal Government with the result that millions of dollars collected from the taxpaying public are spent in the administration of the tax and thereby reducing the net amount of revenue available for general purposes.

An intergovernmental difference of this character would normally become the subject of public concern through the efforts of tax administrators in quest of improved operating efficiency and business enterprises seeking relief from excessive compliance requirements. In these respects, the cigarette tax area is somewhat different from other taxes. Here, State tax officials are generally of the view that some evidence of tax payment is necessary so long as they are unable to collect the tax at the primary source -- the manufacturing level -- while the business enterprises affected are compensated, and in many cases, overcompensated for the compliance burden involved in the affixation of stamps to cigarette packages and thus have no cause for complaint.

In this report we explore the possibilities of facilitating State revenue and associated objectives by a closer relationship of State with Federal administration and also by fundamental changes in the manner of collecting State cigarette taxes. We consider this question timely because closer coordination could serve to improve the States' revenue by reducing their cost of tax administration.

CHAPTER 2

TAX OVERLAPPING AND ITS REVENUE SIGNIFICANCE

The cigarette tax now produces almost $3.5 billion revenue with the States (including their local governments) collecting about $1.20 for every two dollars collected by the Federal Government. Fiscal year 1963 collections were divided among the three levels of government as follows:

	Amount (millions)	Percent distribution
Federal	$2,010	63.2
State 1/	1,133	35.6
Local	38	1.2
Total	$3,181	100.0

1/ Includes cigarette taxes for the District of Columbia and municipal cigarette taxes collected by the State of Florida.

Cigarettes are now (as of July 1, 1964) taxed by the Federal Government, 48 States, the District of Columbia, and over 100 municipalities in 7 States (not including over 300 in Florida).1/ The most recent addition to the State list is Colorado, which adopted a 3 cent tax effective July 1, 1964. North Carolina and Oregon are now the only States without cigarette taxes.

1/ Since the State of Florida allows full credit for municipal cigarette taxes and collects them for its municipalities, these municipal cigarette taxes can be considered local levies in name only.

Most States with cigarette taxes require the annual licensing of distributors, wholesalers, and retailers. Ordinarily these fees are nominal and are imposed to facilitate tax administration.

State and Federal Tax Rates

Cigarette taxes are imposed by the Federal Government at $4 per thousand or 8 cents per standard pack of 20, and by the States at rates ranging from 2 to 9 cents. Two States, Hawaii and New Hampshire, base their cigarette taxes on wholesale and retail prices, respectively.

The State cigarette tax rates, as of July 1, 1964, were distributed, by rate, as follows:

Rate (cents)	No. of States 1/
2	2
2½	1
3	4
4	5
5	5
6	10
7	7
8	14
9	1

1/ Includes District of Columbia. Hawaii, with a rate of 20 percent of wholesale price (estimated at about 3.7 cents), is included in the 4 cent group. New Hampshire, with a rate of 15 percent of retail price (about 3 cents), is included in the 3 cent group.

State cigarette tax rates have been moving upward steadily in recent years (Table 2). Two years ago only 5 States matched the 8 cent Federal rate; now (mid-1964), 15 States equal or exceed it. Ten years ago the most frequent State rate was 3 cents. It is now 8 cents (Table 3). In only 2 of the 15 high tax rate States (Florida and New Jersey) are cigarettes also taxed by local governments. New Jersey has only 1 (Atlantic City) local tax, and in Florida, municipal cigarette taxes are not additional to the State

TABLE 2. - STATE CIGARETTE TAX RATES, 1952 THROUGH 1964
(Cents per standard package of 20)

State	1952	1954	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964
Alabama	3	....	....	4	....	....	....	6	....	....	....	6
Alaska	3	....	....	5	....	....	....	....	....	8	....	8
Arizona	2	....	....	....	....	....	....	....	....	....	....	2
Arkansas	6	....	....	....	....	....	....	....	....	....	....	6
California	-	-	-	-	-	-	-	3	....	....	....	3
Colorado	-	-	-	-	-	-	-	-	-	-	-	3
Connecticut	3	....	....	....	....	....	....	....	....	5	....	6
Delaware	2	3	....	....	....	....	....	....	....	5	....	5
District of Columbia	1	....	2	....	....	....	....	....	....	....	....	2
Florida	5	....	....	....	....	....	....	....	....	....	....	8
Georgia	3	....	....	5	....	....	....	....	....	....	....	8
Hawaii					20 percent of wholesale price							
Idaho	3	....	....	4	....	....	....	5	....	6	....	7
Illinois	3	....	....	....	....	....	....	4	3	4	....	4
Indiana	3	....	....	....	....	....	....	....	....	....	....	4
Iowa	2	3	....	....	....	....	....	4	....	....	....	5
Kansas	3	....	....	....	....	4	....	....	....	....	....	6
Kentucky	1/	....	3	....	....	....	....	....	2½	....	....	2½
Louisiana	8	....	....	....	....	....	....	....	....	....	....	8
Maine	4	....	....	5	....	....	....	....	....	6	....	6
Maryland	-	-	-	-	-	-	3	....	....	6	....	6
Massachusetts	5	....	....	....	....	....	6	....	....	....	....	6
Michigan	3	....	....	....	....	5	....	....	6	5	7	7
Minnesota	4	....	....	....	....	....	....	5½	....	7	....	8
Mississippi	4	....	....	5	....	....	6	....	....	....	8	9
Missouri	-	-	-	2	....	....	....	....	....	4	....	4
Montana	4	....	....	....	....	8	....	....	....	....	....	8
Nebraska	3	....	....	....	....	4	....	....	....	....	....	6
Nevada	3	....	....	....	....	....	....	....	....	7	....	7
New Hampshire					15 percent of retail price							
New Jersey	3	....	....	....	5	....	....	....	....	7	....	8
New Mexico	4	....	....	5	....	....	....	....	....	8	....	8
New York	3	....	....	....	....	....	....	5	....	....	....	5
North Carolina	-	-	-	-	-	-	-	-	-	-	-	-
North Dakota	6	....	....	....	....	....	....	....	....	....	....	7
Ohio	2	....	....	....	3	....	....	5	....	....	....	5
Oklahoma	5	....	....	....	....	....	....	....	....	7	....	7
Oregon	-	-	-	-	-	-	-	-	-	-	-	-
Pennsylvania	4	....	....	5	....	....	....	6	....	....	....	8
Rhode Island	3	....	....	....	....	....	5	....	6	....	....	8
South Carolina	3	....	....	....	....	....	....	5	....	....	....	5
South Dakota	3	....	....	3¼	....	....	....	5	....	....	....	6
Tennessee	5	....	....	....	....	....	....	....	....	....	....	7
Texas	4	....	....	5	....	....	....	8	....	....	....	8
Utah	2	....	4	....	....	....	....	....	....	....	....	8
Vermont	4	....	....	....	....	5	....	7	....	....	....	8
Virginia	-	-	-	-	-	-	-	-	3	....	....	3
Washington	2/	....	....	3/	....	....	....	6	....	7	....	7
West Virginia	4	....	....	....	5	....	....	....	....	6	....	6
Wisconsin	3	....	....	4	....	5	....	....	....	6	....	8
Wyoming	2	....	....	....	....	3	....	4	....	....	....	4
No. of States with tax 4/	44	44	44	45	45	45	46	47	48	48	48	49

See footnotes on next page.

TABLE 2. - STATE CIGARETTE TAX RATES, 1952 THROUGH 1964 (Cont'd)

Note: 1964 rates are as of July 1; all other rates are as of January 1.

A blank space (....) indicates no rate change since previous rate shown.

A dash (-) indicates no cigarette tax was in effect as of January 1.

1/ Prior to July 1, 1954 the statutory rate was 1¢ for each 10¢ or fraction of the retail price.

2/ The statutory rate was 2¢ for each 10¢ or fraction of the retail price.

3/ The statutory rate was 2½¢ for each 10¢ or fraction of the retail price.

4/ Includes District of Columbia; also includes Alaska and Hawaii for the period prior to attaining statehood.

TABLE 3. - DISTRIBUTION OF STATE CIGARETTE TAX RATES
Selected Years 1950-1964

Cents per standard package of 20	1950	1952	1954	1956	1958	1960	1962	1964
1	2	1	1	--	--	--	--	--
2	7	6	5	5	3	3	2	2
$2\frac{1}{2}$	1	--	--	--	--	--	1	1
3	18	20	20	16	13	7	4	4
$3\frac{1}{4}$	--	--	--	1	1	--	--	--
$3\frac{1}{2}$	--	--	--	--	1	1	1	--
4	8	10	11	8	6	7	9	5
5	6	4	4	12	17	17	11	5
$5\frac{1}{2}$	--	--	--	--	--	1	--	--
6	--	2	2	2	2	7	11	10
7	--	--	--	--	--	1	5	7
8	1	1	1	1	2	3	4	14
9	--	--	--	--	--	--	--	1
Total	43	44	44	45	45	47	48	49

Note: 1964 distribution is as of July 1; all other years as of January 1. Includes the District of Columbia; also includes Alaska and Hawaii for the period prior to attaining statehood.

tax but are credited in full against it. In lieu of authorizing local taxes, 9 States share their own cigarette tax collections with cities and counties.1/

The recent emphasis on the health hazards of smoking has occasioned some curtailment (possibly temporary) of State cigarette tax revenues. Similar experience in earlier years materialized in only temporary declines. On past occasions, the tendency toward higher tax rates has speeded the recovery of collections.

Thirty-six of the States with cigarette taxes employ also a general sales tax and only 14 of these exempt cigarette sales. However, some of the States which subject tobacco sales to their general sales tax exclude the Federal and State cigarette tax from the sales tax base.

Development of Tax Overlapping

The growth of cigarette tax collections over the past 40 years (Table 4) points up the atypical development of the respective State and Federal revenue shares. While both levels of government are registering steady and impressive cigarette tax collection gains, the States are gaining rapidly on the commanding lead held by the Federal Government. This State tax collection performance has not been duplicated in any other tax area.

A two-stage development marked the emergence of the States as a major force in tobacco taxation -- a tax field long the exclusive domain of the Federal Government. The spread of State cigarette taxation constituted the first stage. It covered the period from the enactment of the first State tax by Iowa in 1921 to 1950, and was characterized by both the steady spread of State cigarette taxation across the nation (42 States and the District of Columbia by 1950), and by the imposition of relatively low tax rates. The average tax rate per pack of cigarettes remained close to 2.6 cents during most of these three decades.

The increase in State cigarette tax rates distinguishes the second stage of development and covers the period since 1950. During these 14 years, the median tax rate moved from 3 to 6 cents; the average rate from 3.3 to 6.0 cents. During this period also, six States joined the cigarette tax ranks (Table 1, page 2).

1/ For the details of local taxes and State cigarette revenue sharing with local governments, see ACIR, Tax Overlapping in the United States, 1964, Chapter 12.

TABLE 4. - FEDERAL, STATE, AND LOCAL CIGARETTE TAX COLLECTIONS

Selected Years 1920 - 1963
(Dollar amounts in thousands)

Year	Total	Federal	State 1/	Local
1920	$ 151,262	$ 151,262	- -	- -
1930	371,808	359,816	$ 11,992	- -
1940	628,339 2/	533,043	95,296	n.a.
1950	1,656,536 2/	1,242,845	413,691	n.a.
1960	2,833,297	1,863,561	929,936	$39,800 3/
1963	3,181,404	2,010,524	1,132,804	38,076

PERCENT DISTRIBUTION

Year	Total	Federal	State 1/	Local
1920	100.0	100.0	- -	- -
1930	100.0	96.8	3.2	- -
1940	100.0	84.8	15.2	n.a.
1950	100.0	75.0	25.0	n.a.
1960	100.0	65.8	32.8	1.4
1963	100.0	63.2	35.6	1.2

n.a. - Data not available.

1/ Includes cigarette taxes for the District of Columbia and municipal cigarette taxes collected by the State of Florida.

2/ Excluding local government collections.

3/ Estimated.

SOURCE: Tobacco Tax Council, Cigarette Taxes in the United States, Vol. XII, 1963.

Spread of the Tax: 1921 - 1950

While the Federal Government's entry into the tobacco tax field was prompted by revenue needs to finance the Civil War, regulatory objectives rather than revenue requirements explain the origin of the first State taxes:

> "The early road of the State cigarette tax was laid by the anti-tobacconists who, though they found the going rough and the climbing difficult, nevertheless tried by taxation to make one last discouraging stand against the 'cigarette fiend.' The Victorian world frowned upon smoking as a masculine habit but tacitly accepted it when it took the form of pipe or cigar. The cigarette it found hard to accept. Preachers, fanatics and other men of the calibre of Henry Ford and Thomas Edison railed against it. Before the 19th Century closed, North Dakota, Iowa, and Tennessee passed cigarette prohibition enactments ... Many States repealed the law (cigarette prohibition) for tax purposes, as Iowa in 1921, Utah in 1923, North Dakota in 1925, and Kansas in 1927."1/

In other parts of the country, the need for revenue to provide general property tax relief for hard pressed farmers appears to have provided the impetus.2/

In retrospect, the enactment of cigarette tax legislation by 10 predominately agricultural States during the Twenties can be attributed both to the contemporary anti-tobacco sentiment and to growing demand for property tax relief for depressed agriculture. Because "city people" were the heavy consumers of luxury-type goods in general and cigarettes in particular, the cigarette tax was viewed as a vehicle for shifting a portion of the State tax burden from real property to consumer goods, from the farms to the cities, and from non-smokers to smokers. The consuming public was apparently willing to take the punishment since the opposition appears to have been limited to dealers confronted with the nuisance of purchasing and affixing tax stamps.3/

1/ Bristol Goodman, Coordinating State and Federal Tobacco Taxes, p. 21. A monograph prepared for the Committee on Federal-State-local Fiscal Relations, U. S. Treasury Department, Washington, D. C., May 1, 1942.

2/ Ralph Tower, Luxury Taxation and its Place in a System of Public Revenues, Special Report of the State Tax Commission, No. 4. Albany, 1931. p. 16.

3/ Ibid. p. 66.

As the Depression deepened the demand for property tax relief first heard in the cotton States spread to the industrial States. Between 1935 and 1940, Connecticut, Massachusetts, Pennsylvania, Rhode Island, and New York enacted such legislation. The Thirties also marked the beginning of "three-deep" cigarette taxation as certain States authorized local governments to enter the field.

The support for State cigarette tax legislation underwent as drastic a transformation as the economic character of States that adopted it. Whereas many of the most vigorous champions of State cigarette taxation had previously sought to discourage the public consumption of this "noxious" weed, their place was now taken by those who were far more concerned with selecting a tax rate which would maximize revenue receipts. The fear of discouraging cigarette consumption was reflected in the 1939 report of the Michigan Tax Study Commission.

> "The highest efficient rate of taxation would seem to be 1 cent on each 10 cigarettes or fraction thereof inasmuch as such a tax makes a 12½ cents package of 20 a 15 cents purchase. This rate is most commonly found in the States with a cigarette tax. From a revenue point of view, it is no more costly to administer a 2 cent tax on a package of 20 than a tax at a lower rate. However, a higher tax might lead to extensive bootlegging or reduced consumption of cigarettes."1/

Increase in Tax Rates: 1950-1964

Since 1950, State cigarette taxation has been marked by a sharp advance in tax rates. The median State tax rate doubled, from 3 to 6 cents. The most frequent State tax rate was no higher than 3 cents as recently as 1956. It rose to 5 cents by 1958, 5 and 6 cents by 1962 and reached 8 cents by the beginning of 1964.

Two factors contributed to this development: a persistent need for additional tax revenue to meet the States' expanding expenditure commitments and a marked decline in concern with the effect of tax increases on consumption.

1/ Staff Studies of the Michigan Tax Study Commission, 1938-39, Part II, pp. 283-284.

The concern about bootlegging prompted States to develop cooperative programs for halting the trafficking in untaxed cigarettes. State efforts to seal off bootlegging opportunities received a powerful Congressional assist in 1949 when the Jenkins Act effectively ended the use of parcel post for evading State cigarette tax laws.[1/]

The growing realization that the demand for cigarettes is not sensitive to small changes in the price of cigarettes stands out as the second major factor responsible for the decision of State lawmakers to hike cigarette tax rates. Between 1920 and 1963, per capita cigarette consumption increased from 475 to 2,705. This sixfold increase took place while the combined Federal-State tax rate increased 75 percent and in the face of the dire health warnings of recent years.

With the emergence of the health issue in 1956, the State cigarette tax wheel has turned full circle. The tax was ushered in by the anti-cigarette spirit of the Twenties. That same spirit is now an important factor in raising tax rates and revenue yields to new heights. The upsurge in State legislative activity is tallied below. The number of States participating in it tripled between the beginning of the 1950's and the early 1960's.

MAJOR STATE CIGARETTE TAX LEGISLATION

Biennium	Total Actions	No. of Tax Rate Increases	No. of New Enactments
1951/'52	7	6	1
1953/'54	5	5	--
1955/'56	17	16	1
1957/'58	11	10	1
1959/'60	18	16	2
1961/'62	18	18	--
1963/'64	22	21	1

1/ P. L. 81-363, approved October 19, 1949.

Reflecting this quickened pace of legislative activity since 1956, State cigarette tax collections advanced at a more rapid pace than other tax receipts rising from 3.9 percent of all State tax collections in 1957 to 5.1 percent by 1963. For individual States, the 1963 cigarette tax yield ranged from zero in the three non-taxing States and 1.6 percent in Hawaii to almost 13 percent in New Jersey (Table 5).

From all indications, legislative interest in the revenue potential of cigarette taxation continues, portending increased intergovernmental overlapping.

TABLE 5. - STATE CIGARETTE TAX COLLECTIONS, IN RELATION TO TOTAL STATE TAX COLLECTIONS, BY STATE
SELECTED YEARS, 1952 - 1963

(Dollar amounts in thousands)

State	1952		1957		1960		1963	
	Amount	Percent of State taxes	Amount	Percent of State taxes	Amount	Percent of State taxes	Amount	Percent of State taxes
Alabama	$ 6,607	5.0	$ 9,528	4.1	$ 14,666	5.4	$ 17,491	5.3
Alaska	n.a.	n.a.	1,070	5.1	1,219	4.5	2,084	5.3
Arizona	1,841	2.6	2,228	2.1	3,041	1.8	3,583	1.7
Arkansas	6,620	6.6	7,298	5.8	8,836	5.6	10,635	5.6
California	- -	- -	- -	- -	64,390	3.0	70,829	2.8
Colorado	- -	- -	- -	- -	- -	- -	- -	- -
Connecticut	8,366	6.3	10,059	4.4	10,942	4.6	19,943	5.9
Delaware	1,016	4.2	1,609	3.6	2,002	2.8	3,772	3.9
District of Columbia	1,281	1.2	2,059	1.4	2,692	1.6	3,630	1.7
Florida	17,813	7.8	24,622	6.6	31,604	6.1	35,650	6.0
Georgia	8,437	3.7	15,570	5.0	19,338	5.2	21,530	4.9
Hawaii	n.a.	n.a.	1,090	1.4	1,725	1.4	2,074	1.6
Idaho	1,651	4.3	2,199	4.3	3,152	4.6	3,927	5.2
Illinois	29,081	6.4	33,801	4.9	48,487	5.8	56,097	5.2
Indiana	13,154	5.1	14,286	4.8	16,502	4.1	18,993	4.3
Iowa	5,004	3.0	7,291	2.9	11,320	4.3	12,121	4.2
Kansas	5,293	4.0	6,107	3.9	8,743	4.2	9,762	4.1
Kentucky	5,533	4.3	8,640	4.3	9,693	4.2	9,183	2.7
Louisiana	16,236	5.7	21,096	5.7	25,289	5.6	27,637	5.4
Maine	4,667	8.3	5,759	8.2	6,551	7.5	8,043	8.2
Maryland	- -	- -	- -	- -	10,917	3.2	22,320	5.2
Massachusetts	27,607	8.8	29,642	7.2	39,271	8.0	43,229	7.4
Michigan	24,110	4.8	27,190	3.5	51,967	5.7	68,123	6.0
Minnesota	11,591	5.0	12,179	4.2	19,455	5.5	26,785	6.1
Mississippi	6,152	5.6	7,030	4.4	9,811	5.0	13,762	6.2
Missouri	- -	- -	9,760	3.7	10,875	3.5	22,460	5.4
Montana	2,765	7.4	3,132	6.0	5,900	9.1	6,405	8.7
Nebraska	3,991	7.1	3,927	5.3	5,962	6.5	6,825	6.9
Nevada	843	5.9	1,177	3.3	1,586	3.5	4,789	7.1
New Hampshire	2,759	10.9	2,865	8.6	3,817	9.1	4,496	9.5
New Jersey	19,128	10.7	33,694	12.0	40,777	11.2	60,705	12.9
New Mexico	2,448	3.8	3,378	3.5	4,637	3.8	7,207	4.8
New York	60,313	5.9	62,051	4.3	117,279	6.0	124,687	5.0
North Carolina	- -	- -	- -	- -	- -	- -	- -	- -
North Dakota	3,019	6.7	2,936	5.7	3,491	5.7	3,781	5.5
Ohio	19,860	4.4	32,847	4.9	60,985	7.0	64,084	6.9
Oklahoma	9,590	5.1	10,380	4.4	12,479	4.5	18,684	5.8
Oregon	- -	- -	- -	- -	- -	- -	- -	- -
Pennsylvania	44,176	8.2	56,133	5.7	77,139	7.5	86,704	6.8
Rhode Island	3,333	6.3	3,415	5.5	5,975	6.9	7,205	6.8
South Carolina	4,976	3.4	5,027	2.7	9,752	4.1	10,202	3.9
South Dakota	1,721	4.4	1,816	4.3	3,279	6.2	3,552	5.5
Tennessee	12,486	7.0	13,953	5.2	16,625	5.5	19,611	5.6
Texas	34,926	8.4	44,933	6.8	72,815	9.2	89,706	8.5
Utah	916	1.7	1,964	2.6	2,299	2.3	2,645	2.2
Vermont	1,894	6.6	1,868	5.3	3,173	7.3	3,516	6.8
Virginia	- -	- -	- -	- -	- -	- -	14,616	3.6
Washington	10,366	4.2	13,443	3.8	17,034	3.7	20,375	3.7
West Virginia	7,647	6.2	8,676	5.6	9,523	5.3	11,406	5.1
Wisconsin	10,366	4.3	14,810	4.2	21,207	5.0	26,208	4.4
Wyoming	729	3.0	731	2.2	1,716	4.1	1,731	3.8
All States	460,311	4.6 1/	583,267	3.9 1/	929,936	5.1 1/	1,132,804	5.1 1/

n.a. - Data not available.

1/ Based on total State tax collections including States that do not levy cigarette taxes and including District of Columbia. Data for 1952 exclude Alaska and Hawaii.

SOURCE: U. S. Bureau of the Census, Compendium of State Government Finances (Annual); and Tobacco Tax Council, Cigarette Taxes in the United States, Vol. XII, 1963.

CHAPTER 3

PAST COORDINATION EFFORTS

As noted earlier, the coordination of State and Federal cigarette taxes is receiving little current attention and such notice as this subject received in earlier years was largely in the context of proposals to rearrange the intergovernmental division of a large group of taxes -- in plans for the separation of revenue sources.

Spokesmen for State policies recognize that this is one of the tax areas in which the National Government has an overwhelming administrative advantage so that closer interrelationship between the two tax levels may entail some reduction in the States' policy-making freedom. The interest in the _status quo_ is perhaps also shared by the distributors of cigarettes for whom the compensation for affixing the State's tax stamps is a significant income factor. The United States Treasury also lacks a strong motivation for disturbing the _status quo_, particularly since it replaced the stamp method of collection with semi-monthly return method now in use. The Internal Revenue Service is now able to collect over $2 billion of tax revenue at an administrative cost of substantially less than a million dollars. Moreover, its relationship with the manufacturers is unfettered by contact with State tax administrations.

The first tobacco tax coordination proposal to receive attention was advanced jointly by F. S. Edmonds of the Pennsylvania Senate and Mark Graves, then president of the New York State Tax Commission, in the early 1930's. The Graves-Edmonds plan would have distributed one-sixth of Federal cigarette tax revenues (one cent per pack) among the States in proportion to their population, on the condition that the States withdraw from the cigarette tax field. Congressman Doughton, then Chairman of the House Committee on Ways and Means, introduced a resolution calling for sharing Federal cigarette revenues with the States along the lines of the Edmonds-Graves plan.

These early proposals were motivated by the belief that State taxation of cigarettes would reduce consumption and impair

Federal revenues. The Interstate Commission on Conflicting Taxes (organized by the American Legislators' Association) analyzed the Doughton resolution and concluded:

> "... On the basis of conditions prevailing in the recent past, it is estimated that an additional tax of 2 cents per package on cigarettes reduces the consumption of cigarettes by 5 percent. It is estimated, further, that when the average State imposes a 2 cent cigarette tax, the Federal Government loses 15 cents through reduced cigarette consumption for every dollar of new tax revenue collected by the State.
>
> "State tobacco taxes undoubtedly diminish the yield of the Federal tobacco tax. Up to the present, however, with only 15 States imposing these taxes, the loss of Federal revenue is far from equalizing the sum of 55 million dollars which the Doughton resolution would require the Federal Government to distribute among the States. From a purely revenue standpoint, the adoption of the Doughton proposal would not be profitable to the Federal Government at this time. It is not beyond the bounds of possibility, however, that State tobacco taxes may at some future time reduce the consumption of cigarettes by as much as a sixth. If this is regarded as a likely contingency, the Doughton resolution may perhaps be justified as an insurance measure."1/

The Interstate Commission listed four arguments in support of the revenue sharing proposal:

(1) The tobacco-tax revenues of the Federal Government would be stabilized and preserved;

(2) the cost to the Federal Government would purchase insurance against further State encroachment in the tobacco-tax field;

(3) States would be supplied with much-needed revenue; and

1/ American Legislators' Association, Coordination of Federal and State Tobacco Taxation, Chicago, 1934, pp. 1-2.

(4) consumption would be stimulated by relief from State tobacco taxation and the tobacco farmers would be benefited by the resulting expansion of sales.

Against the proposal it listed these arguments:

(1) There is no indication that repeal of State tobacco taxes would stimulate cigarette sales sufficiently to compensate the Federal Government for the surrender of one-sixth of its cigarette-tax receipts;

(2) the chances that all States will adopt cigarette taxes are exceedingly remote;

(3) there is no guaranty that States which are now collecting more under their present tobacco taxes than they would receive from the proposed Federal distribution would elect to accept the provisions of the Doughton resolution; and

(4) the per capita consumption of cigarettes is higher in the urban and industrial States than in the predominantly agricultural States; because of this the division of a part of the proceeds of the Federal cigarette tax among the States on a basis of population would force citizens in the industrial States to contribute toward the cost of purely State and local functions in the less industrialized States.

On the basis of this analysis, the Interstate Commission concluded that no additional tobacco taxes should be imposed by the States for revenue purposes.

The coordination of cigarette taxes next received attention from a Special Committee appointed by the Secretary of the Treasury in June 1941 to conduct a study on intergovernmental relations. In its report, transmitted to the U. S. Senate on June 23, 1943, the Treasury Special Committee embraced the Edmonds-Graves and Doughton approach and recommended exclusive Federal taxation of cigarettes with the States sharing in the revenue.

A few sentences from the group's report explain its rationale:

"The taxation of tobacco products has gradually become heavily involved in our overlapping tax system... The tax is becoming increasingly popular as a source of State revenue, and it seems but a matter of time

before the tax will be universally applied at the State level. The tax is admirably adapted for Federal collection and State sharing, and while this device is open to general objection in its curtailment of State independence, its application in this instance would have so many advantages that it is recommended at least as an experiment.

"State administration of the tobacco tax has important inherent limitations... Joint administration in this instance is not practical, for the two governmental levels mainly involved make their collections from different distributors...

"The sharing device is well adapted to application in the tobacco tax field also because the diversity in State laws, while substantial, is not as great as in most other State taxes... Moreover, a formula distribution should not be too difficult to agree upon... The field is not one in which the maintenance of State discretion as to rate and administration should be regarded as of great significance..."1/

Specifically, the Treasury group recommended that the Federal tax on cigarettes be increased by 2 cents per pack and that the share of Federal revenues represented by this portion of the tax be distributed to the States on a per capita basis. The distribution would be conditional upon State and municipal withdrawal from the field. The group recommended also that the program begin with guarantees to the States that the sharing arrangement would entail no revenue loss for them; that such guarantee might be eliminated gradually over a 10-year period.

Involvement in World War II diverted attention from long range coordination problems, and the Treasury Committee's tax recommendations were never considered by the Congress.

As war's end came into view, many in Washington and elsewhere turned their thoughts to postwar planning, including the development of a tax structure appropriate for stable peacetime economic progress. In the Employment Act of 1946, Congress recognized the need for coordinated intergovernmental fiscal policies

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1/ U. S. Treasury Department Special Committee, Federal, State and Local Government Fiscal Relations, 76th Congress, 1st Session, Senate Document No. 69, 1943, pp. 16-17.

to national prosperity. In the Legislative Reorganization Act of 1946 it charged the two committees on Expenditures in Executive Departments (now the Committee(s) on Government Operations) with the continuing duty of studying "intergovernmental relations between the U. S. and municipalities." These committees in turn created subcommittees on intergovernmental fiscal relations. Simultaneously, the professional associations and the organizations of State and the local officials also resumed consideration of intergovernmental tax problems. Their efforts were largely concerned with the separation of Federal and State-local tax sources.

A significant landmark was the 1947 report of the Joint Committee of the American Bar Association, the National Tax Association and the National Association of Tax Administrators. Each of these organizations had appointed committees on the coordination of Federal, State and local taxes in 1940. The following year the three separate committees pooled forces in the Joint Committee under the chairmanship of Henry F. Long, Massachusetts Commissioner of Corporations and Taxation, who chaired each of the three separate committees. The work of the group, interrupted during the war, was resumed after the war.

The Joint Committee's comprehensive report expressed a preference for the States' relinquishing tobacco taxes for exclusive Federal use. It concluded:

> "Tobacco taxation was developed by the federal government for substantial revenues before the states came into the field. The federal government has administrative advantages and can exploit this revenue more effectively, as a rule, than the states. As evidence of the earnest desire of the states to promote tax coordination, it is recommended by the Joint Committee that the states forego this revenue for the benefit of the federal government. However, if the arrangement is not found to be feasible, the states should be free to tax tobacco in order to raise independent revenues. In this event, it will be desirable to increase the cooperation of the governments taxing tobacco for their mutual advantage and the benefit of the taxpayers who desire more convenient and equitable taxation."[1/]

1/ Joint Committee of the American Bar Association, the National Tax Association and the National Association of Tax Administrators, The Coordination of Federal, State and Local Taxation, 1947, pp. 69-70.

The separation of revenue sources approach to tax coordination continued to enjoy the support of State government organizations after 1947. They continued to urge the Federal Government to repeal or reduce some of its taxes in order that State and local governments might make greater use of them. However, the suggestion that the States vacate the cigarette tax field appears to have been dropped.

In 1947, responding to the request of the Governors' Conference, the Congressional tax committees and the committees on Expenditures in Executive Departments designated a number of their members to work with the Governors' Conference on Federal-State fiscal problems. Later that year, this informal group, including Governors and members of Congress, issued a joint statement proposing that the Federal Government voluntarily limit its impositions in certain tax fields adapted to State and local use and that State and local governments reciprocate.1/ Tobacco taxes, however, were not explicitly mentioned.

By 1948 the reversal of the spokesmen for the States on the role of the cigarette tax was complete. In its report submitted to the (Hoover) Commission on the Organization of the Executive Branch of the Government, the Council of State Governments said, in part:

> "The National Government, for emergency purposes, has greatly increased its tax rates on liquor and tobacco, thereby limiting the ability of the States to use these tax sources. Material reduction of national tax rates in the fields of liquor and tobacco would enable the States to use effectively these widespread sources of revenue for the support of State governments generally."2/

Others, however, continued to speak of State relinquishment of the cigarette tax for a while longer. This, for example, was the solution urged on the Hoover Commission by Roswell Magill on behalf of the Tax Foundation. The Hoover Commission itself made no specific tax recommendations beyond recommending the creation of a continuing agency on Federal-State relations.

1/ State Government, November 1947.

2/ Council of State Governments, Federal-State Relations, 81st Congress, 1st Session, Senate Document No. 81, 1949, p. 108.

When spokesmen for State and local governments met next with Federal officials under Treasury Department auspices in April 1949, officials of the Executive Branch operated within the limitations of a "no Federal tax reduction, at this time" policy. This tended to guide the discussion to "long term objectives" and centered on Federal withdrawal from the excise field (amusements, gasoline, electrical energy, and local telephone). By that time State withdrawal from cigarette taxation had been dropped from the revenue separation program.[1/]

In the meanwhile, in response to the urging of the National Tobacco Tax Association, the Congress in 1949 passed the Jenkins Act designed to relieve the States of the special problems they encountered in collecting taxes on interstate parcel post shipments (from tax free States). This problem was effectively relieved by the requirement of monthly reports to State administrators by persons who sell cigarettes in interstate commerce and ship them to other than licensed distributors in a State which taxes cigarettes. This requirement meant the end of the parcel post business where tax evasion or avoidance was the only purpose served.

The emergence of the Korea crisis in 1950 once again diverted attention from long range coordination plans. When in 1953 the Ways and Means Committee's subcommittee on Coordination of Federal, State and Local Taxes filed its report, it limited itself to transmitting factual and analytical materials prepared for it by the Treasury Department, the Congressional staff and the Library of Congress. Its comment on the 1942 Treasury Special Committee recommendation that States withdraw from this field was limited to the following observation:

> "Since the formulation of this latter recommendation, State taxation of tobacco has become more widespread and varied and the problems of coordination more difficult. In 1942, State sharing in Federal revenues would have left most of the States at least as well off as they were on the basis of their own imposed tax. That situation no longer prevails since many States have taxes in excess of 2 cents. The wide variations in the level of State rates adds to the complexity of the problem."[2/]

1/ U. S. Treasury Department Conference with Representatives of State and Local Governments on Intergovernmental Fiscal Problems, April 21-22, 1949, "Summary of Proceedings." (Mimeo.)

2/ 82nd Congress, 2nd Session, House Report No. 2519, 1953, p. 69.

The changed direction of thought was reflected also in the discussions of the National Tax Association. When Federal-State tax coordination was debated at its 1950 conference, two of the three speakers urged exclusive Federal taxation, the third exclusive State taxation with local sharing.1/

By 1954, the National Tax Association's Committee on Intergovernmental Fiscal Relations explicitly rejected State withdrawal from the field and by 1956, the President of the Association voiced reconciliation with State-Federal overlapping in cigarette taxation.2/ "It is probably now an accepted fact by everyone," he said, "that this overlapping (liquor and tobacco taxes) will never be eliminated ...concurrent taxation by the Federal and state governments in this field is here to stay..."3/ All thought of separation in the revenue sources of the Federal and State governments appears to have been abandoned.

By this time attention began to be focused on another approach to coordination, one which would leave the States free to set their own tax rates, but would strengthen their administration by providing for the collection of their taxes from cigarette manufacturers, rather than distributors. Before probing this suggestion (Chapter 6), we turn to a brief review of the range of other possibilities for the coordination of State and Federal cigarette taxes.

1/ National Tax Association, Proceedings of 1950.

2/ National Tax Association, Proceedings 1954, p. 353.

3/ National Tax Association, Proceedings 1956, p. 355.

CHAPTER 4

COORDINATION TECHNIQUES

The trend of thinking over the last three decades on ways to remedy tax overlapping in cigarette taxation, summarized in the preceding chapter, should help to underscore the progressively narrowing range of coordination possibilities in this tax field. Federal collection with State sharing in revenues, the coordination device which garnered substantial support in the early years of State-Federal tax overlapping, gradually lost its sponsors as State taxation became more and more widespread and differences in the revenue importance of the tax to individual States increased.

Over the years, a variety of techniques have been invented to mitigate tax overlapping. Not all of them are equally applicable to cigarette taxation. We review the more important of them, nonetheless, to better enable those interested to make their independent evaluation of possible remedies.

The coordination possibilities divide themselves into two broad groups: (a) one would require either the Federal Government or the States to withdraw from the field and vacate it for the other; (b) the other group is compatible with continued taxation of cigarettes by both levels of government.

The first group of possibilities accords with the separation of revenue sources approach and contemplates either exclusive State or exclusive Federal cigarette taxation. This result could be achieved in different ways, depending on the type of arrangement employed to compensate (for its revenue loss) the level of government which vacates the field.

The second group of possibilities (compatible with both levels of government remaining in the tax field) could also be structured in different ways: by tax credit arrangements, tax supplements, and pooled tax administration.

The possibilities can be summarized schematically as follows:

A. Single Level Taxation

1. Exclusive State taxation (Federal withdrawal)
2. Exclusive Federal taxation (State withdrawal)

    a. Exchanging tax sources
    b. Federal collection with State sharing
    c. Federal collection with tax rental arrangement

B. Continued Tax Overlapping, with:

1. Cooperation in tax administration
2. State supplements
3. Tax credits

Federal Withdrawal - Exclusive State Taxation

Although the Federal cigarette tax now produces over $2 billion, the revenue which would be lost if it were repealed to leave the field clear for the States would not necessarily raise insurmountable problems. It now represents less than 3 percent of Federal net budget receipts and if national economic policy objectives require further Federal tax reduction, the cigarette tax could be a contender for repeal. Moreover, in view of the Federal Government's strong revenue position relative to the States', the consideration of the States making compensating tax concession to the Federal Government is not critical, perhaps not even germane. Repeal of the Federal tax would improve tax burden distribution since the cigarette tax tends to fall with relatively more weight on low income groups than on those in the middle and upper brackets.

The arguments against repeal of the Federal tax, however, are formidable. While it would doubtless enable the States to increase their tax rates, it is unlikely that most of them would go the full extent of the 8 cents Federal tax and some would increase their taxes substantially less than others. Therefore, the aggregate amount of tax revenue available to the Federal and State governments would be reduced.

State Withdrawal - Exclusive Federal Taxation

Since the war, and more particularly within the last half-dozen years, the role of the cigarette tax in State revenue systems has increased. While interstate variations are wide, the majority of the States obtain 5 percent or more of their tax revenue from this source. In 1963, one State (New Jersey) obtained 12.9 percent.

The revenue loss from cigarette tax repeal would be very significant for some States and its impact would be uneven among the several States. Since the States' pressing need for revenue is already a cause for national concern, State withdrawal from cigarette taxation could be considered only if coupled with arrangements to compensate them for the revenue lost.

It is appropriate to note here that the withdrawal of the States from this or any other tax area would have to be voluntary. States could be mandated to vacate the cigarette tax field only by an amendment to the Constitution, not a readily accessible route. Therefore, those proposing that the States withdraw from the cigarette tax field have to assume the burden of developing a plan for compensating the States in circumstances and terms attractive to the States.

Plans for the separation of Federal and State tax sources sometimes contemplate arrangements under which the Federal Government obtains exclusive use of one tax source and in turn relinquishes a compensating tax source for the exclusive use of the States. A prerequisite of such arrangements is that the tax vacated for the benefit of the States afford substantially all of them revenue at least equal to that they receive and anticipate from the cigarette tax. We have been unable to identify any excise or group of excises now used by the Federal Government that satisfy this condition.

Revenue Sharing and Tax Rentals

States could be compensated for vacating the cigarette tax area by sharing in Federal tax collections on the basis of an appropriate allocation formula. The sharing of collections from one or more taxes, while without significant precedent at the Federal level, is practiced on a substantial scale in the sharing of State tax collections with local governments. Typically, the tax is State administered. On occasions, however, as in the case of some State death duties, it is sometimes locally administered with a portion of collections retained by the administering jurisdiction.

The proposal that the Federal Government share with the States the revenue from some of its taxes has been advanced for various purposes, most recently in plans to provide financial aid for public education through sharing Federal income tax collections. A Federal tax shared with States has certain advantages over separately imposed State taxes. If combined with State withdrawal, dual tax administration is eliminated. States are afforded the benefit of the Federal Government's superior enforcement

facilities. It eliminates scope for interstate tax competition and results in a nationwide tax rate level deemed consistent with national policy. These benefits are obtained without destroying State independence with respect to expenditures.

State sharing of Federal taxes, however, is not without its shortcomings. State fiscal independence is impaired to the extent that the decision respecting tax rates, etc., is removed from State determination. Conceivably some States have no need for the revenue or would prefer to do without the cigarette tax burden and the revenue (Oregon and North Carolina). The basis of sharing, moreover, poses difficulties akin to those present in grants-in-aid. We encountered some of these problems in earlier tax sharing proposals (Chapter 3).

Revenue sharing as ordinarily discussed contemplates the distribution of an aggregate amount of Federal collections among the States on the basis of such formulas as source of collections, population or number of school age children. In view of the wide variation in the relative importance of the cigarette tax in the revenue systems of the 50 States, the conventional revenue sharing procedures would be very inefficient in terms of cost to the U. S. Treasury. They would presumably have to be generous enough to compensate the States making the most intensive use of the cigarette tax and the application of that formula would automatically bestow windfalls on the other States, varying in amount inversely to the present importance of the cigarette tax revenue. The revenue sharing arrangements are criticized also because they separate the responsibility for raising revenue from the responsibility for spending it.

While replacement of the overlapping Federal and State taxes with exclusive Federal taxation shared with the States would not necessarily so require, it could be accompanied by some increase in the Federal tax rate to finance the States' share. Such increase in the tax rate would necessarily have to have uniform application in all of the States. The average State cigarette tax rate is now 6 cents per pack. An increase in the 8 cents Federal tax by 6 cents would provide more than the $1 billion now raised by the States themselves. Cent for cent, cigarette tax raises significantly more revenue at the Federal than State level because it minimizes tax evasion, obviates the need to compensate distributors for affixing tax stamps, and applies in all the States (not only the 48 with State taxes) and to transactions (on military installations, etc.) which escape State taxation.

Substituting an increased Federal tax rate for State rates would reduce the cost of collection in all States and the weight

of regressivity particularly in the States with high cigarette tax rates. Since some of these are low income States in the Southeastern part of the United States, the effect on tax burden distribution would be favorable. Moreover, existing State enforcement personnel would be made available to serve other urgent State tax enforcement needs.

The substitution of an increased Federal tax for the State taxes is not likely to enjoy strong State support, however. It would limit the States' tax freedom, which some of them prize highly. Moreover, however generously the sharing arrangement compensated the States, it is not likely to have the support of the State personnel currently engaged in administering the States' taxes. Finally, efforts to tailor the state-by-state distribution of collections to revenue needs would involve the coordination problem in the whole range of issues entwined in the debate surrounding the role of equalization in Federal-State fiscal relations.

A related approach to the problem of compensating the States for vacating the cigarette tax is that identified by the shorthand term, tax rental arrangement, a device employed by Canada. In that country, a majority of the provinces agreed to vacate certain tax areas for a number of years in return for a specified revenue distribution from the Dominion Treasury. The arrangement has not met with universal applause.

A tax rental arrangement would require the Federal Government to negotiate with each State the price at which it would "sell" its cigarette tax. It would pose more problems in the United States than it did in Canada, not only because the latter's negotiations occurred during the war but more importantly also because Canada has 12 provinces, the United States 50 States.

The rental terms individual States would consider acceptable would vary, reflecting their present tax rates, differences in their attitudes toward smoking (Utah and Nevada), and their estimate of future cigarette consumption and attainable tax rate levels.

Tax sharing and tax rental arrangements are possible approaches to the elimination of tax overlapping but under circumstances which prescribe voluntary acceptance by all of the States, they hold little promise.

Coordination Within Continued Tax Overlapping

The taxation of the same object or activity by two or more levels of government occurs frequently in the United States. In some cases its consequences are mitigated, notably in income

taxation, by exchange of tax information and other cooperative arrangements among tax administrations. Administrative cooperation within cigarette taxation, however, affords limited scope for relief because the two administrations function at different levels of distribution. Data assembled by the Internal Revenue Service from manufacturers, on the basis of cigarette production aggregates, is of little use to State administrators enforcing taxes collected from wholesalers, jobbers, and retailers.

Tax Supplements and Tax Credits

The tax supplement is without precedent in Federal-State relations but is a familiar device in State-local relations. Where a particular tax is used for both Federal and State purposes, the supplement is a possible coordination device. It contemplates the addition of the State rate to the Federal rate and the collection of both by the Federal administration with the allocate share of collection credited to the accounts of the States.

The classic American example of the tax supplement is the property tax with its combined administration of the State and local levies. Currently the tax supplement is being applied successfully in retail sales taxation, as in California, Illinois, Mississippi, etc. Here local sales taxes are collected as supplements to the State tax.

The tax supplement device would give the States the benefit of Federal administration without depriving them of the privilege of setting their own tax rates. Its adaption to the cigarette tax field would be practicable if States employed uniform tax rates. In these circumstances the State tax would be collected at the manufacturing level and there would remain only the problem of allocating the revenues produced by the supplement among States on the basis of cigarette consumption. As noted, however, State tax rates range all the way from zero to 9 cents. The addition of these rates to the Federal rate would, therefore, require differentiation (at the manufacturing stage) on the basis of destination or place of ultimate consumption of cigarettes. An administrative burden of these proportions is not likely to be viewed favorably by the industry, Congress, or the Treasury Department. For the time being, therefore, the tax supplement holds little promise in cigarette taxation.

The tax credit is a device by which a taxing jurisdiction (say, the Federal Government) invites other jurisdictions (say, the States) to share with it a prescribed portion of tax collections. This is accomplished by permitting the taxpayer to discharge a

specific portion of his tax liability to the Federal Government with receipts for an identical kind of tax paid to the States. While the tax credit was used as early as 1918 to minimize international double taxation of Federal income taxpayers, its use in Federal-State tax coordination dates from 1924 when it was first employed to share the Federal estate tax with the States. In 1936, it began to be employed to insure that all States establish unemployment compensation programs.

The credit it will be noted, is to the taxpayer, and not to the taxing jurisdiction. Since the taxpayer's liability is the same whether a particular State uses the tax (which gives rise to credit) or not, the availability of the credit exerts a strong compulsion on the States to impose the tax up to the limit of the credit. Why forego the tax when it adds nothing to the tax burden of the State's citizen; when it merely diverts to the State's treasury revenues which otherwise would go to the U. S. Treasury?

An essential feature of the tax credit, it will be noted, is its coercive effect. It exerts a compelling influence on the States to raise their rates up to the level of the tax credit without adding to the tax liability of its taxpayers. This rate-equalizing influence of the tax credit, which was a value for estate and unemployment tax purposes, is its weakness for cigarette tax purposes. In this area, tax rate differences reflect variations in the States' tax philosophies. Some States choose to shun cigarette taxes entirely, while others elect to tax them heavily. Here, the preservation of interstate rate differentials is an essential objective.

We conclude that at the present stage of State taxation the customary coordination techniques are not adaptable to cigarette taxation; that relief to the States from the high cost of administering their cigarette taxes must be sought within the confines of overlapping taxation with independent State administration. For this purpose, an understanding of State cigarette tax administration is essential. Chapter 5 aims to supply that understanding.

CHAPTER 5

TAX ADMINISTRATION

In 44 of the 48 States which tax cigarettes and in the District of Columbia, the payment of this tax is evidenced by the affixation of a transfer stamp or a meter impression on each pack of cigarettes. The four exceptions are Alaska, Hawaii, Massachusetts, and Michigan.

To compensate the stamp-affixing vendor, usually a wholesale distributor, for the expense incurred in breaking open cases and cartons, stamping each package and resealing and repacking, these stamps and impressions are sold to him at a discount from face value. In 1963, these discounts aggregated about $41 million -- about 4 percent of the face value of all stamps and impressions purchased by affixing vendors. Since the discount is a deduction from the vendors' gross liability for stamps, the States as a whole receive approximately 96 percent of the tax actually paid by the public. In States which employ stamps, the price of the stamps represents an additional element of cost. To the extent that States achieve effective tax administration without the necessity of breaking open cases and cartons to affix a stamp or meter impression to each package, their net revenues from this tax source approximate more nearly the amount collected from the taxpaying public.

Use of Stamps

During the 1930's when many States introduced taxes on alcoholic beverages and tobacco products, it was the general policy, with few exceptions, to require that a stamp of some kind evidencing the payment of the tax be affixed to each package, bottle or other container sold to the public.

In the alcoholic beverage field, stamps, tax paid crowns, and tax paid lids were commonly used. Because of the nature of the packaging process, the strict regulation of distribution and manufacturer-wholesaler relationships in the distilled spirits business, the bottling distiller assumed most of the burden of affixing the stamps on this product. Where tax-paid crowns or lids were required to be used, they, too, were affixed at the source -- the brewery. In other instances the beer tax was evidenced by stamps affixed to the case or barrel. Taxes on wine were largely evidenced by stamps affixed to the bottle.

As time went on, however, it became apparent that State control of the manufacture, distribution, and transportation of alcoholic beverages under the 21st amendment was so complete that it was feasible to rely on accounting procedures as the primary means of enforcing tax liability. In this situation, what little additional protection the stamp offered was out of proportion to the cost involved in using it. As a result, the use of stamps as the primary means of collecting alcoholic beverage taxes was dropped in many States. While stamps have not yet completely passed out of the picture, by and large alcoholic beverage taxes are now collected on a return basis, backed up by strict accounting controls and audits (Table 6).

In the tobacco products tax field, and particularly in respect to cigarette taxes, the use of stamps and meter impressions as the primary means of collecting the tax is as firmly established as ever. There are some exceptions. When Massachusetts enacted its cigarette excise in 1939, its legislature provided that the tax be administered solely on a return basis -- perhaps implicitly recognizing that Commonwealth's historic aversion to stamp taxes. Michigan followed Massachusetts' lead when the Michigan cigarette tax was adopted in 1947. The Alaska tax, enacted while that State was in territorial status, is enforced on a return basis. This is true also in Hawaii, where in form the tax is a general business excise with a special rate for tobacco products.

Other States have also given some indications of interest in the return method of administration but without positive action to that end. The statutes in Kentucky and New York, for example, authorize the tax administrator to dispense with the use of stamps in the collection of the cigarette tax. However, neither State has exercised the authority. At the time the California tax was proposed, administrative officials and one house of the legislature were strongly in favor of a return basis of collection, but as eventually approved the law called for the use of stamps or meter impressions. In the late 1950's the tax commissioner of Minnesota recommended to the legislature that the cigarette tax be administered solely on a return basis but the proposal was not accepted. Despite these tentative gestures toward the use of the return basis, the use of stamps or meters remains firmly established -- how firmly may best be indicated by the fact that the seven States that have adopted a cigarette tax since 1947, each prescribed the use of one or the other or both these types of indicia.

To complete the account, it should be noted that the Treasury did not replace its century old stamp payment system with a semimonthly reporting and payment process for cigarette taxes until the middle of 1959. The change-over followed years of protestation by the tobacco industry that the prepayment of the tax in advance of

Table 6. - ALCOHOLIC BEVERAGE TAXES: USE OF STAMPS, CROWNS OR OTHER INDICIA

State	Beer	Wine	Distilled Spirits (License States)
Alabama	X	X	1/
Alaska	-	-	-
Arizona	-	-	-
Arkansas	-	X	X
California	-	-	-
Colorado	-	-	-
Connecticut	-	-	-
Delaware	-	-	-
Florida	-	-	X
Georgia	X	X	X
Hawaii	-	-	-
Idaho	-	1/	1/
Illinois	-	-	-
Indiana	2/	-	X
Iowa	-	1/	1/
Kansas	-	-	X
Kentucky	-	-	-
Louisiana	-	-	-
Maine	-	1/	1/
Maryland	X 3/	X	X
Massachusetts	-	-	-
Michigan	1/	-	1/
Minnesota	-	-	X
Mississippi	X	X	4/
Missouri	-	-	-
Montana	-	-	1/
Nebraska	-	-	-
Nevada	-	-	-
New Hampshire	-	1/	1/
New Jersey	-	-	-
New Mexico	-	-	-
New York	-	-	-
North Carolina	X	X	5/
North Dakota	-	-	-
Ohio	X	1/	1/
Oklahoma	-	X	X
Oregon	-	1/	1/
Pennsylvania	X	X 6/	1/
Rhode Island	-	-	X
South Carolina	X	X	X
South Dakota	-	X	X
Tennessee	-	X	X
Texas	7/	X	X
Utah	-	1/	1/
Vermont	-	-	1/
Virginia	X	X	1/
Washington	-	-	1/
West Virginia	X	1/	1/
Wisconsin	-	X	X
Wyoming	-	-	1/
Dist. of Columbia	-	-	-

See footnotes on next page.

Table 6. - ALCOHOLIC BEVERAGE TAXES: USE OF STAMPS, CROWNS OR OTHER INDICIA (Cont'd)

1/ State alcoholic beverage monopoly system.

2/ Indicia required on out of state beer on reciprocal basis.

3/ Out of state beer only.

4/ Sale prohibited.

5/ State supervised county monopoly system.

6/ Imports only.

7/ Stamps for over 4% beer.

SOURCE: Federation of Tax Administrators.

the sale of cigarettes, represented by the cost of the stamps, constituted an unfair tax compliance burden. The tobacco industry's case was fortified by the fact that the Treasury Department administered most other Federal excise taxes on a deferred payment basis.

The benefits of the change-over for the tobacco industry have been summarized as follows:

> "... It is relieved from the payment of the tax in advance of disposition of the goods, which tied up large amounts of capital in the stamp inventories necessary in modern operations. Moreover, the deferral period of up to two weeks shortens the time intervening between the payment of tax by the manufacturer and his receipt of payments on sales. In addition to these financial benefits, manufacturers have greater flexibility in packaging their products because now they are not limited to packaging in quantities for which denominations of stamps are provided. Elimination of the federal stamps will also provide greater flexibility in package design, particularly as to means of closure..."[1]

While the substitution of the return system for stamps was accompanied by increased audit expenditures, the amount was negligible in comparison to the $1½ million saved annually in the cost of printing tax stamps. The change-over from prepayment to post payment was necessarily accompanied by a one-time delay in the receipts of a part of a year's collections by the Treasury. The desire to spread this budgetary impact over two fiscal years explains the effective date selected for the change-over, June 24, 1959. The impact on 1959 receipts was reported to have been $40 million.

<u>Organization of Distribution</u>

State cigarette tax administrators have organized their enforcement procedures to localize the collection activity as close to the source as possible. In practice, this means that the tax is collected from the consignees who first receive cigarettes within the State from manufacturers. These are primarily wholesalers

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1/ Charles J. Mouhtouris, "Recent Developments in Federal Tobacco Tax Administration," <u>Proceedings of the National Tobacco Tax Association</u>, 1959, Chicago, Illinois, pp. 16-17.

and large retail outlets, such as chain stores, that buy directly from manufacturers. In order to appraise the tax indicia system or feasible alternatives, it is necessary to review briefly the manner in which the distribution of cigarettes from manufacturers to retailers is organized.

A factor of major importance in this connection is that the production of cigarettes is concentrated in a small number of manufacturers. In fact, over 99 percent of the domestic market for cigarettes is supplied by six companies.[1/] Cigarette manufacturing plants are located almost exclusively in three States -- Kentucky, North Carolina, and Virginia.

Cigarettes are made, packaged, cartoned, and cased mechanically. These cases, usually containing 12,000 cigarettes in 60 cartons of 200 cigarettes, are temporarily stored in shipping warehouses and sorted as to brand, filter type, size, and type of package. This factory storage facility normally houses only a day's production. This limitation is dictated by the nature of the manufacturing process, the desire to achieve a quick turnover of the merchandise on retail shelves, and the bulky quality of the product which makes storage expensive. Initial distribution from the factory warehouse is effected by rail and truck typically to company distribution warehouses, although direct shipments may be made to large scale distributors. Distributors and jobbers located near the manufacturing plant are normally serviced from a portion of the factory warehouse. Company distribution warehouses are located across the country to accord with the pattern of the company's sales. For example, one company with about 10 percent of the market maintains approximately 50 distribution warehouses. In some of the more populous States, a company may maintain several distribution warehouses while in other areas one warehouse may serve several States. Any distribution warehouse may serve a multi-state area.

The home office invoices the wholesale purchaser directly or otherwise maintains financial control over distributions of cigarettes through the various warehouses. Centralized accounting is accomplished with modern machines.

It is a common practice for company sales representatives to visit retail outlets. Effective sales promotion requires that

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1/ They are R. J. Reynolds Tobacco Company, The American Tobacco Company, Phillip Morris, Inc., P. Lorillard Company, Liggett and Myers Tobacco Company, and Brown and Williamson Tobacco Corporation.

these representatives be able to stock the retailer promptly. For that reason, sales representatives normally carry a supply of the various varieties of cigarettes manufactured by their company. The salesmen pick up these tax paid cigarettes from a wholesaler in the area. Tobacco manufacturers are ordinarily authorized to pay the tax on small sample packages direct to the States without the use of stamps. Infrequently, the manufacturer also affixes the tax indicia to regular-sized packages used to stock retail outlets in an emergency.

In all cases, the tobacco companies have a record of cigarettes distributed to those dealers, whether wholesalers or large retail buyers, who are responsible for the payment of State taxes -- that is, those dealers who first receive cigarettes within the State. Manufacturers do not have records which show the subsequent distribution of cigarettes to other wholesalers, jobbers, or retailers within or outside the State.

Discounts Allowed Distributors

The discount feature of cigarette tax laws raises two important problems in administering the tax. From the point of view of cost, discounts allowed wholesale distributors make the cigarette tax among the most expensive of State taxes to administer. In terms of equity, the evidence presented below suggests that in most States the compensation paid distributors is considerably in excess of the cost they incur in affixing tax indicia.

Moreover, rising tax rates have usually been accompanied by higher payments to distributors. Since in recent years State legislatures have raised cigarette tax rates more frequently than any other tax, problems in cost and equity have been magnified.

Exclusive of discounts, the cost of cigarette tax administration is comparable to that for other excise taxes. However, in the 44 States using tax indicia, when costs of discounts and stamps are added to other enforcement expense, administration accounts for a substantially larger proportion of collections than for any other major tax.

The percentage discount allowed to distributors for affixing stamps ranges from 2 percent in California to 10 percent

in Colorado (Tables 7 and 8).[1/] The median discount, 5 percent, is also the discount allowed most frequently in cigarette tax laws. In 1963, a flat 5 percent discount was provided in 12 States; discounts above 5 percent were in effect in seven States and the District of Columbia; below 5 percent, in 19 States. Graduated discounts were used in five States: Florida, Illinois, Minnesota, New Mexico, and New York. In these States, the largest discount is allowed on the amount of stamp purchases in the lowest bracket; the smallest discount on purchases in higher brackets. The graduated discount principle is based on the premise that smaller distributors incur higher stamping costs on a per case basis.

While the statutory discount is indicative of the proportion of State cigarette tax collections paid to distributors, it is not an adequate measure of the revenue cost to the State or of the financial compensation received by the distributor. State payments to distributors vary not only with the percentage discount, but also with the tax rate. As an example, Arizona, Idaho and North Dakota have 5 percent discounts. In Arizona, where the tax rate is 2 cents per pack, distributors are paid 60 cents for stamping a standard case of 12,000 cigarettes while Idaho and North Dakota, with a 7 cent rate, pay distributors $2.10 for stamping a standard case.

For a meaningful comparison of compensation payments to distributors it is necessary to relate the statutory discount to the tax rate, and determine the dollar amount involved. This computation (Tables 7 and 8) reveals that the amount of the discount per case for affixing stamps varies even more sharply among the States than the statutory discount. For the 44 States using indicia, the discounts in dollars per standard case of 12,000 cigarettes range from 36 cents in California to $4.32 in Louisiana and Mississippi. The median discount in dollar amounts is $1.44 -- $1.08 more than the minimum discount and $2.88 less than the

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1/ For the four States which do not use tax indicia in cigarette tax administration, the percentage of collections retained by distributors as compensation for collection cost is, as follows: Hawaii, none; Alaska and Michigan, 1 percent; and Massachusetts, 2 percent. Massachusetts allows a deduction of 1 percent to vending machine operators and 1/2 of 1 percent to chain stores. On January 1, 1965, when Massachusetts raises its tax rate from 6 cents to 8 cents per pack (by 1964 legislation), compensation will be reduced to 1-1/2 percent for wholesalers, 3/4 of one percent for vending machine operators, and 3/8 of one percent for chain stores.

TABLE 7. - STATE CIGARETTE TAX DISCOUNTS AND REVENUES, 1963
(Dollar amounts in thousands)

State	Gross revenue	Net revenue	Revenue cost of discount	Discount as a percent of net revenue
Alabama	$ 19,471	$ 18,011	$ 1,460	8.1
Alaska	2,156	2,134	22	1.0
Arizona	3,947	3,750	197	5.3
Arkansas	11,626	10,928	698	6.4
California	73,642	72,169	1,473	2.0
Connecticut	21,956	21,319	637	3.0
Delaware	3,889	3,772	117	3.1
Florida	47,899 1/	45,684	2,215 1/	4.8
Georgia	22,673	21,993	680	3.1
Hawaii	2,386	2,386	- -	- -
Idaho	4,480	4,256	224	5.3
Illinois	60,269	57,256	3,013	5.3
Indiana	25,156	23,488	1,668	7.1
Iowa	14,443	13,721	722	5.3
Kansas	10,480	9,956	524	5.3
Kentucky	9,723	9,140	583	6.4
Louisiana	31,118	28,317	2,801	9.9
Maine	8,301	8,052	249	3.1
Maryland	24,055	22,852	1,203	5.3
Massachusetts	44,494 1/	43,680	814 1/	1.9
Michigan	72,101	71,380	721	1.0
Minnesota	28,965 1/	28,174	791 1/	2.8
Mississippi	14,617	13,155	1,462	11.1
Missouri	23,325	22,625	700	3.1
Montana	6,661	6,328	333	5.3
Nebraska	8,545	8,118	427	5.3
Nevada	5,251	5,041	210	4.2
New Hampshire	5,215	4,954	261	5.3
New Jersey	67,683	65,734	1,949	3.0
New Mexico	7,471 1/	7,195	276 1/	3.8
New York	128,585 1/	125,242	3,343 1/	2.7
North Dakota	3,384	3,215	169	5.3
Ohio	67,153	65,360	1,793	2.7
Oklahoma	19,918	19,121	797	4.2
Pennsylvania	100,882	98,486	2,396	2.4
Rhode Island	7,630	7,325	305	4.2
South Carolina	11,035	10,483	552	5.3
South Dakota	4,350	4,089	261	6.4
Tennessee	25,283	24,145	1,138	4.7
Texas	101,597	99,311	2,286	2.3
Utah	3,863	3,689	174	4.7
Vermont	3,926	3,784	142	3.8
Virginia	15,685	14,901	784	5.3
Washington	20,697	20,180	517	2.6
West Virginia	12,069	11,586	483	4.2
Wisconsin	30,834	29,931	903	3.0
Wyoming	1,871	1,759	112	6.4
District of Columbia	3,860	3,628	232	6.4
TOTALS	1,244,620	1,201,803	42,817	3.6

1/ Unofficial estimates for graduated discount States.

SOURCE: National Tobacco Tax Association. For method of cost computation, see Comparative Cigarette Tax Collections, for 1963, National Tobacco Tax Association, July 1964, Table I Footnotes.

TABLE 8. - COST OF CIGARETTE TAX DISCOUNTS, CALENDAR YEAR OF 1963

State	Tax rate (cents per package of 20 cigarettes)	Discount rate (%)	Amount of discount per case of 12,000 cigarettes	Cost of discounts ($000)
Alabama	6	7.5	$ 2.70	1,460
Alaska 1/	8	1	.48	22
Arizona	2	5	.60	197
Arkansas	6	6	2.16	698
California	3	2	.36	1,473
Colorado 2/	--	--	--	--
Connecticut	6	2.7	.972	637
Delaware	5	3	.90	117
Florida	8	3.5 to 5	1.68 to 2.40	2,215 3/
Georgia	5	3	.90	680
Hawaii 1/	3.9 (est.)	0	0	0
Idaho	7	5	2.10	224
Illinois	4	2-5	.48 to 1.20	3,013
Indiana	4	6	1.44	1,668
Iowa	5	5	1.50	722
Kansas	4	5	1.20	524
Kentucky	2.5	6	.90	583
Louisiana	8	9	4.32	2,801
Maine	6	3	1.08	249
Maryland	6	5	1.80	1,203
Massachusetts 1/	6	0.5-2	.18 to .72	814 3/
Michigan 1/	7	1	.42	721
Minnesota	8	2.5-3.25	1.20 to 1.56	791 3/
Mississippi 2/	8	10	4.80	1,462
Missouri	4	3	.72	700
Montana	8	8 (on 5¢)	2.40	333
Nebraska	6	5	1.80	427
Nevada	7	4	1.68	210
New Hampshire	3-3.5	5	.90 to 1.05	261
New Jersey	8	2.8	1.34	1,949
New Mexico	8	2-4	.96 to 1.92	276 3/
New York	5	2.4-2.8	.72 to .84	3,343 3/
North Carolina	--	--	--	--
North Dakota	7	5	2.10	169
Ohio	5	2.67	.80	1,793
Oklahoma	7	4	1.68	797
Oregon	--	--	--	--
Pennsylvania	8	3	1.44	2,396
Rhode Island	6	4	1.44	305
South Carolina	5	5	1.50	552
South Dakota	6	5	1.80	261
Tennessee	7	4.15	1.74	1,138
Texas	8	2.25	1.08	2,286
Utah	8	4	1.92	174
Vermont	8	3.5	1.68	142
Virginia	3	5	.90	784
Washington	7	2.5	1.05	517
West Virginia	6	4	1.44	483
Wisconsin	8	2.6	1.25	903
Wyoming	4	6	1.44	112
District of Columbia	2	6	.72	232
State total	-	-	-	42,817
Federal Government	8	0	0	- -

See footnotes on next page.

TABLE 8. - COST OF CIGARETTE TAX DISCOUNTS CALENDAR YEAR OF 1963 (Cont'd)

1/ No indicia.

2/ Legislation in 1964 included the enactment in Colorado of a 3¢ per pack tax with a 10% discount ($1.80 per case); in Mississippi an increase in tax rate from 8 to 9¢ per pack, effective July 1, 1964 and a reduction in the percentage discount from 10 to 8% (reduction in discount per case from $4.80 to $4.32). Kansas, Massachusetts, and Rhode Island reduced their discount rates while Delaware increased its discount.

3/ Unofficial estimates prepared by National Tobacco Tax Association.

SOURCE: National Tobacco Tax Association. For method of cost computation see Comparative Cigarette Tax Collections for 1963, National Tobacco Tax Association, July 1964, Table I Footnotes.

maximum. These wide differences prevail among these States even though stamp-affixing procedures are basically similar throughout the country and, in the main, are conducted through the use of standardized equipment.

Nor does the compilation in dollar amounts show any regional similarity in discount allowances. For example, on the Pacific Coast, California pays distributors 36 cents per case of 12,000 cigarettes, while in Washington the discount is $1.05. Among Southern States, the discount is $1.08 in Texas, $1.50 in South Carolina, and $2.70 in Alabama -- compared with the national maximum of $4.32 in Louisiana and Mississippi. In the Mideast area, distributors are paid $1.80 per case in Maryland, $1.44 in Pennsylvania, 90 cents in Virginia, and 72 cents in the District of Columbia.

Principal tax cost factors to the distributor affixing tax stamps normally involve the following:

Investment in stamps or meter impressions;

labor for opening and closing cases and cartons and affixing the indicia;

insurance and credit risks of inventories (enlarged by the value of loose and affixed indicia on hand);

the housing and related services required to maintain stamped and unstamped inventories; and

reporting and accounting for the tax.

Labor is naturally the largest cost item and although it varies from State to State, the variance is relatively small when compared with the sharp differences in the discounts provided in State laws.

The wide range among the States in the amount of discount per case allowed distributors demonstrates, in itself, the lack of relationship between the distributors' stamping costs and the amounts they receive from the States. Evidence of what constitutes a reasonable compensation is limited. However, the few studies that have been made in this area indicate that overpayment by the State is general. A survey conducted by the Cigarette Tax Bureau in the New Jersey Division of Taxation in 1956 found that for all distributors surveyed the cost of affixing stamps was 59.2 cents per case of 10,000 (the standard size at that time) and that the discount then allowed by New Jersey -- 75 cents per case -- exceeded the cost for all categories of distributors except for the small

distributor and the small operator of vending machines where the cost per case was 88.7 cents and 98.1 cents, respectively. These latter two categories accounted for less than 10 percent of the annual volume of cigarettes sold in the State. In 1956, a discount of 75 cents per case of 10,000 was considerably below the discount allowed by a large majority of the States.

Also, in 1956, the Ohio Department of Taxation conducted a study of the same type and arrived at similar findings. The analysis of information collected by the Department from a sampling of medium, small, and large sized jobbers led to the determination that the discount then allowed by Ohio -- 5 percent applied to a 2 cent tax rate (60 cents per case of 12,000 cigarettes) -- was sufficient to compensate wholesalers for the costs involved.[1/] A later survey conducted by the Ohio Tax Department covering the calendar year 1957 also indicated that costs incurred by distributors were substantially below the average discount allowed by the taxing States and were frequently below the minimum discount allowed in any of the States. The present discount allowed by New York -- 84 cents per case of 12,000 for distributors purchasing no more than $300,000 in stamps, and 72 cents for distributors making larger purchases -- was decided upon after a study made in 1960.

The frequency with which legislatures have raised cigarette tax rates in recent years has accentuated the already apparent inequities in State discount payments. When a State raises its cigarette tax rate, the amount of the discount per case increases in the same proportion unless an adjustment is made in the discount rate. Legislative action affecting rates has resulted in a substantial increase in State payments to distributors. This has occurred although cigarette tax administrators have pointed out that the discount is intended to compensate distributors for collection expense and no increase in stamping costs results from a higher tax rate.

A compilation by the Federation of Tax Administrators comparing dollar discounts in 1959 and 1962 showed that, in that

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1/ Gene Tosca, "Cost of Affixing Indicia of Tax Payment," Proceedings of the Thirtieth Annual Meeting, National Tobacco Tax Association, 1956, Federation of Tax Administrators, Chicago, Illinois, pages 36-38. Since this study was completed, a machine has been developed for mechanically affixing cigarette stamps a carton-at-a-time, thus enabling the reduction of labor costs. Postage-type meters were in use for imprinting cigarette packages much earlier.

short span, payments to distributors per standard case were increased in each of 23 States which had raised tax rates.[1] In 15 of these States, the dollar discount per case rose one-third or more above the 1959 level. In eight States, smaller increases resulted -- in six, due to cuts in percentage discount. Four States which raised rates in 1959-1962, lowered the statutory discount to a point where the monetary discount remained unchanged.

Most recent data indicate a continuance in this trend. In 1963, 15 States increased their cigarette tax rates. In 13 of these 15 States, tax rate raises were accompanied by an increase in the monetary discount rate. In 1963, the proportionate jumps in the monetary discount were as high as 167 percent, and, in general, represented an increase in payments to distributors that was much higher than any assumed rise in the actual stamp affixing costs. The effect of the tax rate increases on discounts is reflected in the substantial rise in the aggregate compensation paid to distributors by the States. Between 1961 and 1963, such payments rose from an estimated $35 million to $43 million.

The parallel rise in discount payments and cigarette tax rates has often been attributed to the fact that tobacco wholesalers are potentially a major source of opposition to cigarette tax rate increases; that their opposition is lessened or eliminated by increasing their amount when the tax rate is increased.[2] Such dollar and cent considerations may have influenced some legislative decisions about discount allowances.

State Compliance Procedures

Since the early days, it has been a fundamental point in cigarette tax administration that accountability must be established as soon as cigarettes enter the taxing State. Cigarette jobbers are licensed. The license is conditioned upon keeping records subject to audit of receipts and sales, making reports to State authorities,

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1/ Tax Administrators News, June 1962, p. 69.

2/ Sometimes a tax increase enables retailers to increase prices in the over-the-counter sales by an amount in excess of the tax increase. See "Cigarette Tax Jump Aids Some," The Miami News, July 22, 1963, page 7 A. Also, in States with unfair cigarette sales laws, tax increases are typically included in cost subject to a minimum mark-up.

affixing tax stamps, and paying the tax. Untaxed cigarettes are required to be shipped by common carrier and the carriers are required to make reports of origin and destination. State authorities depend upon reports, audits and inspection of tax indicia on the merchandise in jobber storage and on retail shelves to assure compliance. Where cigarettes are shipped from a dealer in one taxing State to a dealer in another taxing State, the transactions are scheduled and a copy of the schedule sent to the receiving State for verification. These procedures have worked fairly well.

Tax evasion and tax avoidance through tax free mail order sales of cigarettes were substantial at one time, but as already noted this situation was eliminated when Congress adopted the Jenkins Act, which required the mail order vendor to report to the tax authorities of the State to which the cigarettes were shipped the quantity shipped and the name and address of the purchaser.[1]

The availability of cigarettes from non-taxing States plus the steady increase in cigarette tax rates still poses the threat of tax evasion. At one time, it was alleged that gangsters had moved into the business of distributing untaxed cigarettes in a few areas. For example, in Chicago one sample purchase of cigarettes in the city showed that 20 percent of the cigarettes being distributed there bore counterfeit meter impressions purporting to evidence payment of the Illinois State tax.[2] Vigorous enforcement efforts and prosecution effectively discouraged these evasion practices.

By 1956, the National Tobacco Tax Association (an organization of State tobacco tax administrators) was able to report that "cigarette tax evasion has been declining steadily and in the last few years has been reduced to a trickle" and that all but 2.4 percent of the difference between Federal and State per capita tax collections could definitely be accounted for and

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1/ P. L. 81-363, approved October 19, 1949.

2/ Hildred N. Carney, "Tax Evasion - Current Developments," Proceedings of the Twenty-sixth Annual Meeting, National Tobacco Tax Association, Federation of Tax Administrators, Chicago, 1952, p. 4.

that today that difference is even less.[1] At that time six States did not levy cigarette taxes and such State tax evasion as existed was attributed to (a) a small volume of cigarettes transported from non-tax States into tax States for resale; (b) conceivably, some degree of meter and stamp counterfeiting, and (c) across-the-border consumer purchases by residents in taxing States.

Recent developments in cigarette tax rates and per capita cigarette consumption were reported in Chapter 2. Since 1956 four States have first imposed cigarette taxes and 40 States have raised their rates at least once while per capita consumption has increased 17 percent.[2] This smooth sailing of State cigarette taxes has been accompanied by a continuing and increased interest in improving State tax audit procedures and practices and careful watching of the administration in Massachusetts and Michigan where 6 and 7 cent taxes (respectively) are imposed and neither stamps nor indicia are used to evidence tax payment. Cigarette tax administration in these States has been recognized as vigorous and effective.

It is interesting that the 1962 per capita consumption based on estimated gross State cigarette tax revenue is higher in Massachusetts than in Maryland, New Jersey, or Pennsylvania though less than in Connecticut, Delaware, New York or the District of Columbia. Corresponding data for Michigan is higher than for Minnesota or Wisconsin but below that for Illinois, Indiana, Missouri, and Ohio.

Many factors other than geographical location may affect per capita consumption of cigarettes. Among those that might affect interstate comparisons are the percent of urban population, personal income per capita, and population age.[3]

Massachusetts is exceeded in percent of urban population only by four States and the District of Columbia and ranks tenth highest in per capita consumption among the 46 States for which

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1/ _Proceedings of the Thirty-first Annual Meeting_, National Tobacco Tax Association, Federation of Tax Administrators, Chicago, 1957, p. 17. It is noted that the Tobacco Tax Council, an industry organization, estimated the percentage of evasion somewhat higher.

2/ Leon Rothenberg, "The Impact of Cigarette Tax Rate Raises on State Revenues," paper presented to the Thirty-sixth Annual Conference of the National Tobacco Tax Association, October 1962.

3/ The tax rate does not appear to affect smoking volume permanently except as it may shift the source of supply of interstate commuters. See Rothenberg, _Op. Cit._

data is available. Michigan ranks thirteenth highest among these States in percent of urban population and twenty-first from the top in per capita consumption. Massachusetts and Michigan rank eighth and twelfth, respectively, from the top in personal income per capita.

Since smoking is substantially restricted to adults, it is probably appropriate to consider only the population over 17 years of age as consumers. When only the population over 17 years of age is considered, Massachusetts is exceeded in such population by the District of Columbia, New Jersey, New York, and Rhode Island. These States, except New Jersey and eight others, exceed Massachusetts in per capita consumption based on population over 17 years of age. In Michigan 61.9 percent of the population is over 17 years of age. Twenty-nine of the 49 States (including the District of Columbia) levying cigarette taxes have older populations while only 20 exceed it in per capita consumption of cigarettes by the population over 17 years of age.

Rankings of States by these measures could be subject to annual fluctuations. Spot checking of corresponding population data for 1950 related to consumption for 1952, however, revealed no relative changes that are significant.

Although the use of various data related to per capita consumption based on estimated gross State cigarette tax revenues is certainly a crude measure of the relative significance of tax evasion occurring in any State, the comparisons that are made here may suggest that the cigarette tax collection record in Massachusetts and Michigan without stamps or other indicia evidencing tax payment is only average. However, this suggestion is subject to the further qualification that tax rate differentials in bordering States may cause a diversion of sales into those States with a consequent dampening effect on the per capita consumption figures in Massachusetts and Michigan. The use of stamps would not make any significant difference in such a situation.[1/]

Stamps and Accountability

Experience indicates that effective tax collection in the cigarette field depends on accountability and accountability in turn is largely dependent on an adequate auditing program. At

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1/ Rothenberg, Op. Cit.

least from a theoretical standpoint, auditing procedures and means for checking the entry of cigarettes into a State through trade channels have been developed to the point where tax evasion of any significant scale, except by interstate commuting consumers, is practically ruled out. Moreover, the existence of other excises, for example, the retail sales tax with its auditing and enforcement procedures, supplements the degree of control that can be achieved through cigarette tax audits alone.

Yet cigarette tax administrators generally agree that their audit programs are inadequate. On the whole, there are not enough auditors available to the administrator to do the kind of an effective job that needs to be done in order to insure full collection of the tax. Moreover, it is likely that auditors will be assigned to other tax fields, in preference to the cigarette tax field.

Obviously tax auditing requires more skill than that needed merely to see whether stamps are affixed. Therefore, auditors may often be deployed in areas of tax administration where other apparently simple means of checking compliance, such as stamps, are unavailable. This seems to have been the case in Tennessee in 1961 when an operation was found to have been using counterfeit indicia for about fifteen months resulting in a tax deficit of about $120,000 When this came to light the Tennessee State Commissioner of Revenue was quoted to the effect that inadequate effort had been placed on cigarette tax administration and that personnel would be shifted so as to provide adequate enforcement.[1]

That too much reliance may be placed on the efficacy of stamps and other indicia is indicated by the fact that in recent years counterfeit stamps or meter impressions have been found also in Georgia, Missouri, Ohio, Pennsylvania, and Texas.

There has also been some feeling that the use of tax stamps may be prejudicial to the most effective State cigarette tax administration because it beguiles administrators into placing emphasis upon the use of the wrong tools. States now spend much less in auditing cigarette taxpayers than is involved in the tax discount. Once counterfeiting is detected, it is necessary to resort to audits to determine the tax liability attributed to fraudulent evasion. The expenditure of a small fraction of the amount of the discount for additional auditing might be most productive in tax yield.

1/ Neil Cunningham, "Capitol Hill" (Column), Nashville Banner, June 13, 1961.

Whatever the reasons may be, the fact is that in spite of the development of audit techniques and despite the fact that there are now only two States where tax free cigarettes are available, State tax administrators have not evidenced an active interest in possibilities for collecting the tax without the use of indicia.[1] The use of stamps may, itself, stand in the way of the organization of the kind of audit program required to insure full collection of the tax.

We turn next to the possibility of dispensing with the use of stamps and other indicia in the collection of the States' taxes.

1/ Tobacco Record, April 1963, Vol. 53, No. 4.

CHAPTER 6

CENTRALIZED CIGARETTE TAX COLLECTION

With Tax Stamps

Since proposals to collect the State cigarette tax simply by eliminating the stamp and improving audit programs have not attracted support, the question arises whether there is any other method by which the tax can be collected effectively without the need for breaking open cases and affixing an indicium to each pack of cigarettes. This brings us to the possibility of collecting the State tax at the source, at the manufacturer level. Some consideration has been given to the proposal that the several States' collection indicia be imprinted by manufacturers at the packaging stage but this approach would place a considerable burden on such operational factors as packaging, warehousing, and transporting cigarettes, and holds little promise.

Cigarettes are produced and packaged by assembly line units known as "making machines." A large manufacturing plant contains a number of these units. Affixing an indicium to each package could be incorporated into the final stages of the packaging process with relatively little difficulty. A day's production of a plant is distributed among many, or all States and changing the indicia so as to evidence merely the cigarette tax rate for the various States in approximately the same proportion as cigarettes are distributed clearly poses some problems.

Greater problems, however, are confronted in warehousing. Under present conditions the manufacturer must maintain warehouse space at the plant for a volume of each type and brand sufficient to meet immediate shipping needs. This space needs to be readily accessible to freight loading facilities. It is normal practice for the shipping clerk to fill orders by moving with a hand or motorized truck from an area containing a given brand and type of cigarette to another, and for the brands and types that are distributed in the greatest volume to be located adjacent to rail sidings. While identical tax rates are in effect in several groups of adjacent States, a total of 11 different tax rates are in use in the 48 States. As a minimum, a manufacturer would have to maintain 11 different inventories of each kind of cigarette

held for distribution to affix evidence that shows only the correct amount of tax paid. Even then the State of destination would not have been identified. Such identification would require 49 such inventories. Such a minimum requirement would necessitate considerable enlargement of inventory areas. Some manufacturers are now operating in cramped warehouse quarters in areas of limited available land and expansion of plant shipping warehouses would be very costly.

Centralized affixing of tax payment evidence would probably impose an even greater burden upon transportation. Enlarged storage area would slow up the loading process and increase its cost. More important, however, are the elements of human error involved. Typically, each month several shipments of the production of a cigarette manufacturing plant are erroneously made up or misdirected. These errors are prejudicial to good trade relationships and involve emergency communications, special shipments and billing adjustments that are costly. Each additional variety of product distributed complicates the shipping process and increases the likelihood of error in a proportion greater than the additive of one. To multiply the product variations by 11 would significantly increase the volume of error. The fact that State tax rates are changed from time to time would introduce a variant into shipping and production routines that would also operate to increase errors. Finally, the burden to plant warehouses of having to handle separate inventories of State-taxed cigarettes would be duplicated in proportion to the volume of merchandise and outbound shipments in the distribution warehouses.

For these reasons, no progress has been made with sporadic proposals to collect the cigarette tax through the use of stamps affixed at the source. The continued widening in the range of tax rates in use has lent support to the critics of these proposals.1/ As might be expected, cigarette manufacturers are strongly opposed to centralized tax collection procedures that would interfere with their routine operations to the extent here outlined. Their reaction to a program partially free of this objectionable feature remains to be ascertained. We turn next to the specifics of such a program.

1/ Most of these have been informal but see, I. D. Meredith, "R. C. Reed System for Collection of Cigarette Tax" Proceedings of the Thirtieth Annual Meeting, National Tobacco Tax Association, 1956, Federation of Tax Administrators, Chicago, pp. 24-31.

Without Tax Stamps

This analysis of State cigarette tax collection procedures and previous proposals for centralized collection at the manufacturing level shows that in both cases the troublesome factor is the requirement that there be some kind of indicium on each package to evidence the payment of tax. If this requirement could be eliminated, much of the difficulty that otherwise would be encountered in the processes of packaging, shipping, and storing cigarettes as well as in accounting for receipts from sales including tax receipts would be automatically eliminated.

For example, if the manufacturer added to his invoice the amount of tax imposed by the State to which he shipped the cigarettes, there would be no interference with his packaging, storing, or shipping routine and only a slight modification of his billing procedure. State accountability would begin at the point of delivery. If the cigarettes were thereafter ultimately delivered to retailers within the State, no collection problem would arise. If the distributor sold to wholesalers or retailers in another State or States, where the tax rate might be higher or lower than the tax already collected by the manufacturer, then the necessary adjustments would need to be made on the distributor's return. That is to say, he would remit the additional tax due to the State of receipt or claim a refund from his own State. Each State would pay over to another State the pre-collected tax due on shipments originally received within the State but subsequently sold by the receiving distributor to a dealer in another State. The handling of these adjustments could be accomplished on a mechanized, schedular basis not unlike the schedule method presently used to report shipments from one taxing State to another. Such reports would, of course, be subject to verification by periodic audit. Most State tax departments have already installed electronic data processing equipment which is readily adaptable to an accountability system such as that required here.

Manufacturers would probably incur some out-of-pocket costs under the return system (without tax stamps) here described and can be expected to raise the question of reimbursement. In many States, the audit staff would have to be increased, also at an additional cost. Both these costs could be met, however, from a small part of the money now being paid out in the form of discounts on sales of stamp and meter impressions. In addition to the savings on discounts, the States would enjoy the benefits of an improved level of tax compliance. The pre-collection of the States' tax at the manufacturing level would have the effect of a one-time acceleration of the States' collections but the date of accountability is a negotiable matter in which the States might be inclined

to accommodate the convenience of manufacturers. Provision for adequate audit would absorb some part of the net gain to the States. However, the case for investment in audit coverage is recognized even under present collection procedures.

The revenue stake involved in restructuring the system for collecting the States' cigarette taxes is in excess of $30 million a year. The quality of tax enforcement, administration efficiency, and the public image of the conduct of the business of government are also involved. In our view, these values are warrant for serious consideration at the highest administrative and policy levels of State government. It is our purpose to stimulate that consideration at the earliest opportunity.

CHAPTER 7

SUMMARY OF FINDINGS AND RECOMMENDATIONS

<u>The Problem</u> (Chapter 1)

This is a report on State-Federal overlapping in cigarette taxation, an area in which duplicate taxation is now nearly nationwide. It extends over 48 States (all except North Carolina and Oregon) representing over 96 percent of the nation's population. In some parts of the country local governments also tax cigarettes.

This combination of taxes is now producing $3.5 billion, about 60% accruing to the Federal Government.

From a revenue standpoint, the fact that the Federal Government and the several States pursue independent taxation policies appears to be no cause for concern to either. State taxation is not materially disadvantaging national policy objectives nor affecting Federal revenues adversely. It is improbable also that the existence of the Federal tax materially restricts the States' freedom in this area. Concern with this area of tax overlapping stems from administrative considerations.

The States are employing an enforcement procedure which is a hundred times costlier than that used by the Federal Government to collect about 60% as much revenue. Because the Federal Government collects its cigarette tax directly from a small number of manufacturers (six firms account for more than 99 percent of the sales) and employs a semi-monthly return system thereby eliminating the need to rely on the costly procedure of affixing tax stamps, its collection cost is minimal -- less than one thirtieth of one percent of the revenue yield. In sharp contrast, the States' average collection cost is approximately five percent because they collect from thousands of jobbers, wholesalers, and retailers and generally rely on an enforcement procedure which requires the affixing of stamps to individual packs of cigarettes for which distributors are compensated.

It is appropriate, therefore, to explore the possibilities for closer association between the administration of State and Federal cigarette taxes.

In our report on Intergovernmental Cooperation in Tax Administration (June 1961) we identified overlapping cigarette taxation as an area worthy of exploration. It is particularly appropriate that this be done now. In the last couple of years, governors and State legislatures have turned to the cigarette tax for additional revenue more frequently than to any other source available to them. The indications are that they will continue to do so and will be encouraged in this direction by the public concern with the health hazards of smoking. Simultaneously, a Congressional committee has been holding public hearings on Federal excise reduction preparatory to legislative action in 1965. The cigarette tax is one of the most important Federal excises. In passing on its future, the Congress will want to consider the States' interests in it.

In the words of the declared purpose of the Congress in creating this Commission "...the complexity of modern life intensifies the need in a federal form of government for the fullest cooperation and coordination of activities between the levels of government..."

Development of Tax Overlapping (Chapter 2)

The Federal cigarette tax has been in uninterrupted use for a century. State taxation began in 1921. Sentiment against smoking and interest in relieving the pressure on real property in rural areas appear to have been the motivating forces that prompted 10 predominately agricultural States to adopt this tax during the 1920's. After 1930, revenue considerations accounted for its spread across the nation. By 1950, cigarette taxes were being collected by 42 States and the District of Columbia, most of which employed relatively low tax rates. The average tax rate per pack at that time was just over 3 cents.

In the period since 1950 the cigarette tax expanded into all but two of the remaining States but its conspicuous feature has been the increase in the level of rates. The most frequent rate was no higher than 3 cents 10 years ago (20 States); it has now reached 8 cents (14 States).

Pressures for additional revenue and decline in the concern with the effect of tax increases on consumption (and therefore on tax collections) were important factors in the post-1950 developments. With the emergence of the health issue in 1956, much of the remaining inhibition against high cigarette tax rates was removed. In recent years when the count of separate State enactments to increase tax revenues reached new levels, the cigarette tax was

more active than any other. Cigarette tax increases are expected to receive widespread attention again in 1965 when most of the State legislatures reconvene.

The Commission concludes that the recent rapid growth in the yield of the cigarette tax at the State level, now in the billion dollar category, lends additional urgency to a re-examination of coordination possibilities for effecting significant economies in the administration of this tax.

Past Coordination Efforts (Chapter 3)

The overlapping of State and Federal taxes has received intermittent, albeit unproductive, attention for over 30 years. State tax officials, State and Federal legislators, professional organizations, and tax scholars have all participated.

The early proposals for mitigating the tax overlapping focused on the separation between Federal and State revenue sources. The most popular plans contemplated State withdrawal from the cigarette tax field for the benefit of exclusive Federal taxation, coupled with the States' receiving a share of Federal tax collections to compensate them for their revenue loss. After cigarette taxes spread to most of the States and wide variations appeared in the level of their rates, exclusive Federal taxation with the States sharing the revenue began to lose its attractiveness. A sharing formula generous enough to compensate States with relatively high tax rates would be costly of Federal revenue and would bestow windfalls on all States with low rates. Those who had previously suggested this approach abandoned it without offering a substitute remedy. Appreciation of the revenue potential of cigarette taxes against the background of the health hazard discussion submerged any concern with intergovernmental tax relations.

It is now clear, with benefit of hindsight, that past proposals for eliminating overlapping taxation, while prompted by the incorrect premise that overlapping was affecting tax revenues adversely, could have produced Federal-State coordination at the time when the States' taxes were still in their infancy.

Possible Coordination Techniques (Chapter 4)

These developments (widespread State taxation with varying tax rates) which militated against Federal collection with State revenue sharing as a device for cigarette tax coordination, also reduced the usefulness of other coordination techniques. In Chapter 4 we examine briefly the range of possibilities:

A. Single Level Taxation

1. Exclusive State taxation (Federal withdrawal)
2. Exclusive Federal taxation (State withdrawal)

   a. Exchanging tax sources
   b. Federal collection with tax rental arrangement
   c. Federal collection with State Sharing

B. Continued Overlapping Taxation, with:

1. Cooperation in tax administration
2. Tax credit arrangements
3. State supplements to Federal tax
4. Collection of State taxes without tax stamps

   a. At the wholesaler level
   b. At the manufacturer level

We conclude that while Federal withdrawal to vacate this field for the States may not be incompatible with the Federal Government's revenue requirements, it probably is unacceptable on other counts. There is little prospect also for the States' withdrawing from the field. The cigarette tax has demonstrated significant revenue-producing potential and the States' need for revenue is pressing.

States could not be mandated to vacate the cigarette tax field. Their withdrawal would need to be voluntary and, therefore, would have to be under circumstances and terms acceptable to them. The arrangements for compensating the States for the revenue loss incident to their abandoning cigarette taxation, including tax rental arrangements and exchange of tax sources, appear to hold little promise. Revenue sharing arrangements, although more promising, pose difficult "windfall" problems because the non-cigarette tax States and those with the low tax rates would stand to gain a disproportionate amount under any revenue sharing arrangement. We conclude, therefore, that the prospects for removing tax overlapping are not too bright, and we turn our attention to coordination possibilities with continued tax overlapping.

In some cases, as in the income tax field, the consequences of tax overlapping are mitigated by the exchange of tax information between State and Federal tax administrations and by other cooperative arrangements. The opportunities on this score are limited in cigarette taxation so long as the two administrations function at different levels of distribution.

The other coordination possibilities assuming continued tax overlapping, namely, tax supplements and tax credits, appear also unsuitable. They are incompatible with the preservation of wide tax rate differentials among the States. Some States choose to shun cigarette taxation entirely, while others elect to tax them heavily. Such tax differentials reflect interstate differences in tax philosophies and while troublesome to those concerned with administrative efficiency, are cherished attributes of this federal system.

We conclude that at this stage of State taxation the customary coordination techniques are not adaptable to cigarette taxes; that relief to the States from the high cost of administering their cigarette taxes must be sought within the confines of overlapping taxes with independent State tax administration.

Administration of State Taxes (Chapter 5)

Our concern with overlapping cigarette taxation, as already noted, stems in part from the fact that a significant share of the cigarette taxes paid by the public is spent in tax enforcement. This attribute of the States' present collection procedures is particularly conspicuous when contrasted with Federal cigarette tax administration where cost is minimized and tax compliance is maximized.

The high cost of the States' cigarette tax administration is associated largely with the use of stamps and other indicia which need to be affixed to each pack of cigarettes by distributors and for which distributors are compensated. This circumstance logically focuses attention on the possibility of dispensing with the use of stamps or indicia in the collection of the States' taxes.

The States' experience in administering other excises and, more particularly, the experience of at least two of the four States in administering the cigarette tax on the basis of tax returns without the use of stamps, provide support for the view that stamps are not essential to effective administration.

However, recent efforts in two States (Minnesota and California) to adopt the return system for the administration of cigarette taxes have been unsuccessful. Even in these instances where it had strong executive branch support, it was rejected by legislatures.

We conclude, on the basis of this record, that the stamp system is inextricably tied to the wholesale level of administration and continued efforts to dispense with the use of stamps, therefore, is not likely to be either constructive or productive so long as the compensation of distributors for affixing stamps is an important factor in their way of doing business.

State Administration at the Manufacturing Level (Chapter 6)

There remains for us only to consider the possibility of shifting the administration of the State taxes to the manufacturing stage where the administration of cigarette taxes on a return basis (as opposed to stamps) is an accomplished fact and where the affixing of stamps is not an essential element of the profit picture.

We are advised that the administration of the States' cigarette taxes at the manufacturing level is practicable, despite wide variations in tax rates, provided that (1) the tax collection process is structured so that the manufacturer's responsibility for collecting this tax is limited to the liability indicated by the location (State) of his first consignee; and (2) that the responsibility for adjustments required in those cases where cigarettes are re-shipped to other States, is left to arrangements between the re-shipper and the States' tax administrations. The specifics of these procedures were described more fully in Chapter 6.

We conclude that administration at the manufacturing level without the use of stamps is compatible with effective tax enforcement.

Experience with the collection of cigarette taxes at the manufacturing level on a return basis is presently the exclusive monopoly of the Internal Revenue Service. That expertness would be very helpful to the States in their efforts to adapt the Federal experience for State use and in identifying and resolving the problems posed in the organization of a new system of tax administration. It would doubtless be made available to them at their request. Cooperation between Federal and State administrations is now firmly established and enjoys strong Executive and Congressional support. The States' urgent need to maximize the yield of their limited tax resources by improving enforcement and reducing administrative costs lends it special force at this time.

The collection of State cigarette taxes by manufacturers would pose a variety of problems which could be solved only with the coordinated efforts of the States and the good will of the

manufacturers. Manufacturers understandably would be reluctant to assume the responsibility, particularly if the plan imposed upon them uncompensated compliance costs as well as a financial burden associated with the prepayment of State taxes. Wholesalers can be expected to resist not only because of their financial stake in the status quo, but because changes in established business practices are rarely embraced readily. Officials charged with policy-making responsibility at the State level need to be assured that the cooperation of manufacturers and officials of the other States would be forthcoming before embarking on a marked change in administration. The administrators of State cigarette taxes cannot be expected to push for a marked change in tax collection procedures without benefit of their executive and legislative leaders' support and understanding.

We conclude, therefore, that the issues involved in providing more economical and efficient administration for the States' cigarette taxes, albeit important for State revenue, will be faced squarely only if the Governors direct that this be done and the leadership in State legislatures supports it.

Recommendation

The Commission recommends that (1) the Governors direct their tax policy officials (possibly through the instrumentality of the Governors' Conference and the Federation of Tax Administrators) to explore with representatives of the tobacco industry the procedures that would be required to place the cigarette tax on a return basis at the manufacturing level in such a way that the burden on the industry would be minimized; and (2) the Treasury Department, Internal Revenue Service, participate in this exploration, which should include the potential scope of Federal-State administrative cooperation.1/

As indicated by the foregoing analysis, this collection procedure scores high on grounds of efficiency because it would maximize compliance opportunities while it would minimize administrative costs -- annual savings to the States could exceed

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1/ Mr. Fountain wishes to make clear his understanding that the type of agreement contemplated for tax collection at the manufacturing level would be voluntary and that Federal coercion would not be brought to bear on the tobacco industry to secure its participation in the recommended arrangement.

$30 million. Only by going to the manufacturing level can States attain the greatest degree of efficiency in the administration of this tax. It is more economical and effective to collect the tax at the source from relatively few manufacturers than from thousands of wholesale distributors. Federal and State governments could maximize the benefits of coordinated audit programs and by so doing, lay the foundation for closer intergovernmental cooperation.

This arrangement would continue some relationships between State tax administrators and wholesalers because tax adjustments (refunds or additional assessments) would be required in the case of re-shipments to a State where the tax rate is different.

Shifting the tax collection responsibility to the manufacturers now appears feasible because: (1) the automation of the manufacturers' record-keeping systems, now in process, will simplify the handling of the compliance burden which would be imposed by charging manufacturers with the responsibility for collecting the States' cigarette taxes; and (2) the States' need for revenue to meet urgent public needs is widely recognized, insuring public support for ways to reduce State administrative costs and to improve tax compliance.

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