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Unintended consequences of cigarette prohibition, regulation, and taxation

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ABSTRACT

Laws that prohibit, regulate, or tax cigarettes can generate illicit markets for tobacco products. Illicit markets both reduce the efficacy of policies intended to improve public health and create harms of their own. Enforcement can reduce evasion but creates additional harms, including incarceration and violence. There is strong evidence that more enforcement in illicit drug markets can spur violence. The presence of licit substitutes, such as electronic cigarettes, has the potential to greatly reduce the size of illicit markets. We present a model demonstrating why enforcement can increase revenues in the illicit market, show that states with higher tobacco taxes have larger illicit markets, and apply the findings to discussion of public policy toward a potential ban on menthol cigarettes. The social calculus involved in determining public policy toward tobacco cigarettes should include the harms from both consumption and control. We conclude by highlighting areas where more research is needed for effective policymaking.

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1. Introduction

Cigarette smoking and other uses of tobacco damage health. Restrictions—regulations, taxes, or (in the extreme) prohibition—are intended to reduce that damage. Full prohibition of tobacco would be expected to create some of the negative consequences of the prohibitions of other drugs: illicit markets and the costs of enforcement (Reuter, 2013). Regulations and taxes can be thought of as lesser prohibitions, and create to some extent similar opportunities for profitable evasion.

As stricter controls on cigarettes are implemented, basic economic analysis as well as historical evidence suggest that we should expect to see an expansion of tobacco smuggling, tax avoidance, and counterfeiting. Large markets already exist in the United States for cigarettes transported in violation of laws, most notably cigarettes that are licitly produced, sold in low-tax states, and smuggled into higher-tax states. Illicit transactions reduce the ability of taxes and regulations to reduce consumption and thus protect health, in addition to generating damage to health and the social welfare on their own account. While the focus below is on violence as an unintended consequence of prohibition and enforcement; other authors suggest that illicit markets may also lead to corruption, the negative social consequences following from increased incarceration rates, and degradation of collective social capital (Kleiman, 2009). Optimal decision-making about taxes and regulations would weigh the health and other harms from illicit markets against the health gains from reduced smoking.

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We discuss some of the unintended consequences of regulating and taxing cigarettes. Our methodology includes a formal review of the literature on enforcement against illicit drugs and violence (section 2.3) and presentation of an economic model showing why a positive association between enforcement and illicit revenue might exist (section 3.3). On the theoretical side, we focus on the harms caused by law enforcement against illicit markets, most notably increased violence from more active enforcement. In our application to public policy, we pay particular attention to a potential ban on menthol cigarettes, currently under consideration in the United States. Section 2 discusses these unintended consequences and reviews what is known about the link between enforcement against illicit drug markets and violence. Section 3 presents a simple model of a market for a contraband product and the increased market revenue that might follow, which can increase violence. Policy implications of the analysis for cigarette regulation are discussed in section 4. In deciding whether to tighten controls on cigarettes in various ways, a key question facing policymakers becomes: How much health benefit will a tighter rule in fact create, once the effects of evasion are considered, and would that gain in health justify the increase in cost and damage from criminal activity and enforcement? A final section points out areas in which further research is needed to inform policymakers and concludes.

2. Consequences of stricter regulation and taxation

Before delving into the formal modeling in the next section, we explore some of the consequences of regulating tobacco discussed in the literature. In section 2.1, we discuss how smokers respond to higher prices induced by regulation or taxes. The characteristics, modalities, and scale of illicit trade in cigarettes are reviewed in the following section. In section 2.3, we conduct a systematic review of empirical literature and find that most studies find a positive association between violent crime and enforcement against illicit drug markets.

2.1. Responses by smokers to higher prices

Consumers employ a variety of legal and illegal strategies to reduce the price they pay for cigarettes (Chaloupka, 2013; Xu et al., 2013). Taxation raises prices; regulations banning specific product types make those products either entirely unavailable on the licit market or more costly to procure by requiring travel to another jurisdiction. In response to a ban, smokers could switch to lower-taxed licit tobacco product, switch to e-cigarettes, quit tobacco altogether, evade taxes by crossing jurisdictional borders, or purchase untaxed or banned products in the black market. According to survey respondents in the United States, UK, Canada, and Australia, 8% of smokers reported buying from lower-tax or untaxed sources in response to increased cigarette taxes, 36% switched to discount or generic brands, and 14% used loose tobacco (“roll your own”) (Licht et al., 2011). Respondents who use these price-minimizing strategies are less likely to make attempts to quit smoking and less likely overall to succeed when they do attempt to quit. Should tax increases further raise the retail price of cigarettes, such smokers would potentially constitute an expanded market for illicit product, as we discuss in the following section. Stehr (2005) examines what happens after there is an increase in cigarette excise tax rates and estimates that up to 85% of the change in taxes paid may be due to tax avoidance rather than reduced consumption.

Cigarette smokers can also switch from cigarettes to other tobacco products because of the higher taxes or prohibitions on the former, trading one source of health hazards for another. By comparing U.S. Department of Treasury and Department of Agriculture sales data for various tobacco products over the 2000–2007 period, and imputing cigarette equivalencies to the other products, Connolly and Alpert (2008) attributed nearly a third of the decline in legal cigarette sales in the United States over the previous decade to switching to tobacco products such as small cigars, moist snuff, and loose tobacco. The U.S. GAO (2012) reports that in the three years after the increase in federal taxes on cigarettes in 2009, sales of pipe tobacco rose to over twelve times their previous level¹ (from 1.5B to 18B cigarette-stick equivalents, compared with a decline in cigarette consumption of 50B sticks in the same period). Tynan et al. (2012) conclude that large tax differentials between cigarettes and other tobacco products lessen the impact of taxes on smoker behavior and public health. The popularity of flavored cigars, particularly little cigars and cigarillos,² increased markedly after flavored cigarettes other than menthol were banned in the United States in 2009. Little cigars, which look and perform like cigarettes, are especially popular among groups of particular public-health concern such as youth and African Americans (Delnevo et al., 2014; King et al., 2014). Sales of little cigars grew 240% from 1997 to 2007; about four out of five little cigars are flavored (King et al., 2014).

2.2. Illicit trade

There is a large literature from criminologists and other on illicit trade in tobacco products (Andreas and Wallman, 2009; Blecher, 2010; Pelfrey, 2015; Reuter, 2013; Reuter and Majmundar, 2015; Shelley and Melzer, 2008; Von Lampe, 2002; Shen

¹ Before 2009, pipe tobacco and roll-your-own [RYO] tobacco were taxed at the same rate (\$1.10/lb). The 2009 increase in cigarette taxes was accompanied by increases in taxes for pipe (to \$2.31/lb) and RYO tobacco (to \$24.78/lb); pipe and RYO tobacco are effectively interchangeable (Manfreda, 2014).

² Little cigars are the same size as cigarettes, have filters, come 20 to a pack, and otherwise are designed to mimic cigarettes. Cigarillos are shorter, slimmer versions of the large cigar shape, but otherwise look like traditional cigars. The statutory distinction between cigars and cigarettes is that the former is wrapped in tobacco leaf and the latter is wrapped in paper.

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