

Subcommittee on Crime, Terrorism, and Homeland Security
United States House of Representatives

Hearing on H.R. 4081, the "Prevent All Cigarette Trafficking Act of 2007" and
H.R. 5689, the "Smuggled Tobacco Prevention Act of 2008"
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Mr. Chairman, Thank you for inviting me to testify today on the problem of tobacco product smuggling and tax evasion and, more particularly, on the Prevent All Cigarette Trafficking or PACT Act (H.R. 4081), introduced by Representative Weiner, and the Smuggled Tobacco Prevention Act (H.R. 5689), introduced by Representative Doggett.

The Campaign for Tobacco-Free Kids and other public health organizations – such as the American Cancer Society, the American Lung Association, and the American Heart Association – strongly support the passage of both bills. Each is a carefully crafted piece of legislation that addresses different aspects of the problem caused by the sale of smuggled or counterfeit tobacco products or other tobacco products on which taxes have not been paid. Together, they offer an effective way to supplement and improve existing federal laws to prevent and reduce domestic and international aspects of tobacco product smuggling, tax evasion and illegal sales to youth.

As the members of this Committee are well aware, smuggling and tax evasion are criminal activities that reduce government revenues and hurt honest businesses. That is reason enough to want to minimize the problem. But tobacco product smuggling and tax evasion also have serious public health consequences.

Counterfeit and smuggled cigarettes and other cigarettes sold free of applicable federal or state taxes are offered to consumers at prices far lower than the prices charged by lawful tobacco product retailers. The sales of these illegally tax-free products undermine ongoing state and local efforts to reduce tobacco use by increasing tobacco tax rates. Studies show, for example, that every 10% increase in real cigarette prices will reduce overall use by approximately three or four percent and reduce the number of youth smokers by six or seven percent. The corollary has also been proven true – decreases in cigarette prices – in this case from illegal cigarettes – increase tobacco use. The availability of cheap cigarettes therefore increases overall tobacco

use, thereby leading to higher levels of tobacco-caused disease, deaths and costs. By reducing the easy access to contraband tobacco products and other tobacco products on which taxes have not been paid, these bills will assist in the effort to reduce tobacco use and its harms, especially among youth and lower-income persons.

Another key public health problem from contraband tobacco product trafficking is sales to kids. Black market vendors and other illegal sellers are much more likely to sell to underage buyers than legally operating retailers. This problem is especially clear with illegal Internet sales of cigarettes and other tobacco products.

- The vast majority of Internet tobacco product sellers do not do any age or ID verification.
- Studies show that kids can easily buy – 70 to 90 percent are successful with no ID checks.
- The last nationwide survey of the problem, in 2001, showed that more than three percent of youth smokers aged 12 to 17 (more than 100,000 kids) had recently purchased cigarettes from the Internet.
- Since then, a New York study found that in 2004 and 2005 more than 5% of just 9th graders (14 and 15 year olds) had bought cigarettes online – more than three times as many as in 2001 – and purchase rates are even higher among older kids.

Since then, the problem has become even worse. Put simply, more kids are gaining access to computers and the Internet, more kids are getting their own credit cards and debit cards, and more kids are getting comfortable making purchases over the Internet. To make matters worse, some Internet sellers require minimum purchases of at least one or two cartons. So kids who buy over the Internet can become suppliers for their friends and classmates.

The sale of contraband tobacco products and other tobacco products on which no taxes have been paid also hurts public health by reducing the amount of government tobacco tax revenues available to fund tobacco prevention programs and other public health initiatives.

This problem is exacerbated by the fact that contraband cigarette trafficking can also reduce the annual tobacco settlement payments to the states. Those settlement payments are supposed to be adjusted downward based on U.S. cigarette consumption declines – but the MSA formulas are based solely on changes to legal cigarette sales. When smokers shift to illegal cigarettes, consumption does not actually decline, but payments to the states do.

The illegal sale of tobacco products also opens the door to the sale of tobacco products that don't always have the required health warnings and may contain pesticide levels that exceed those permitted on legally grown domestic tobacco, a problem that will become more significant once the pending federal FDA tobacco legislation becomes law, even more so once FDA sets product standards for cigarettes.

There is another public health reason to institute effective measures to minimize tobacco product smuggling and tax evasion. As mentioned earlier, tobacco tax rate increases are an especially effective way to increase tobacco product prices and, consequently, reduce tobacco use and its many harms and costs. But the tobacco industry and its allies regularly argue against any significant tobacco tax rate increases, claiming that they will drive more smokers to illegal cigarettes. The legislation before this Committee offers the proper response to this tobacco industry argument. Rather than just allow the criminal activity to continue – and forgo the important health and fiscal benefits from increasing the tobacco tax rates – these two bills would implement effective measures to minimize the problem of illegal tobacco product sales.

For all these reasons, minimizing tobacco product smuggling and tax evasion is good fiscal policy and good for public health.

These measures can be quickly implemented. They will stop criminals from profiting from contraband tobacco product trafficking. The provisions in H.R. 5689 and H.R. 4081 will protect honest businesses from illegal competition, increase revenues at all levels of government, and significantly improve public health.

The Prevent All Cigarette Trafficking Act (PACT ACT, H.R. 4081)

The PACT Act introduced by Representative Weiner focuses primarily on one part of the tobacco product smuggling and tax evasion problem: illegal Internet and other mail-order sales.

Illegal Internet sales take money away from all levels of government, and provide a distribution and sales network for sellers to who don't pay taxes and sell counterfeit cigarettes and other black market tobacco products. As I already noted, this makes it possible for illegal Internet sellers to charge lower prices than legal sellers, and cheaper cigarettes increase overall tobacco use. One recent study found that adult smokers who purchased cheaper cigarettes from the Internet significantly increased their consumption over time compared to smokers who reported paying full-price at traditional bricks-and-mortar retail stores.

As mentioned before, tobacco products are also typically sold over the Internet without any effective safeguards against sales to kids. This means that minors who find it hard to purchase cigarettes from bricks and mortar retailers can simply go to the Internet instead.

At present neither the federal government, nor the states have the tools to adequately address these problems. The only federal law available today to stop illegal Internet sales of tobacco products is the Jenkins Act, which was passed decades ago to stop mail order cigarette sales that evade state taxation. The Jenkins Act requires mail-order vendors to report their cigarette sales into a state to the state's tax administrator. Many don't do so.

Only federal officials can enforce the Jenkins Act, and enforcing the Act is, to say the least, very difficult. Consequently, federal enforcement efforts have been minimal. In fact, a U.S. General Accounting Office report of a few years ago found that more than three-quarters of all Internet-selling websites explicitly indicate that they do not comply with the Jenkins Act. The same report found that state efforts to prompt compliance by Internet sellers have not been successful.

Without this legislation, state governments cannot address this problem adequately on their own. Trying to stop illegally operating Internet sellers through traditional enforcement lawsuits on a case-by-case basis does not work because of the large number of illegal Internet sellers, with many based overseas or in other hard-to-reach jurisdictions, the ease with which new Internet sellers can appear, and the ability of illegal Internet sellers to evade enforcement by closing down and then re-opening at another location or website.

States have entered into innovative settlement agreements with common carriers, credit card companies and others in an effort to interrupt the ability of illegal Internet sellers to sell and deliver their products. But the illegal Internet sellers can still largely evade compliance by using the U.S. mails over which states have no authority. In addition, all of these agreements are based on New York's law prohibiting deliveries of cigarettes to consumers in the state. If that law is found invalid or otherwise overturned, all the agreements terminate, a concern that is heightened by the recent U.S. Supreme Court ruling that federal law preempts state laws dealing with common carrier deliveries of tobacco products.

Stopping illegal Internet tobacco product sales will require stronger and more sophisticated federal legislation – and that is what the PACT Act (H.R. 4081) offers.

Because federal laws can reach further than state laws, the PACT Act would succeed where the states have failed. It not only places needed restrictions and requirements on Internet sellers but also provides for their quick and effective enforcement.

A key element of the legislation is that it makes cigarettes and smokeless tobacco non-mailable matter and establishes a system that would block illegal Internet sellers from obtaining any other delivery services. Any effort to eliminate or curtail the non-mailable matter provision or the so-called common carrier list-enforcement mechanism would make the act unenforceable, and so should be rejected by the Committee.

While the PACT Act is primarily directed at stopping contraband tobacco product trafficking and tax evasion via the Internet, it also contains constructive provisions to require age and ID verification before tobacco products are sold or delivered. These provisions can help to stop cigarette and smokeless tobacco sales to kids.

The PACT Act has been continuously revised since 2003 to stop illegal Internet sales of cigarettes and smokeless tobacco much more effectively and efficiently. As a result, it is a carefully crafted piece of legislation that has benefited from the thoughtful input of state enforcement officials, Indian Tribes, common carriers, the U.S. Postal Service, and the Bureau of Alcohol, Tobacco, Firearms and Explosives (BATFE), as well as the public health community. Numerous substantive changes have been made to address the concerns of many groups and to eliminate any unnecessary burdens or complications – all without weakening the PACT Act's ability to address and reduce the problem of Internet-based contraband tobacco product trafficking.

As a further step in that process, we would like to recommend to the Committee that the following changes be made to strengthen the nonmailable matter section:

- Revise Section (j)(1)(B) that reads "primarily engaged in the business of transmitting cigarettes or smokeless tobacco made nonmailable by this section" so that it reads "regularly engaged in the business . . .". This change would ensure that the bill reaches large-scale mailers of cigarettes or smokeless products which also have other unrelated business activities that are their primary business. Such businesses would include bricks-and-mortar multi-product retailers that also sell cigarettes by mail; Internet sellers that sell and mail cigarettes but primarily sell other products; and foreign-based Internet

sellers that use the mail for sales to the U.S. but primarily use common carriers or other delivery services for sales to other countries.

- Revise Section (j)(1)(D) to delete the text "or into". This change is necessary to stop mailings of cigarettes or smokeless into Alaska or Hawaii from outside of those states by illegal operating Internet sellers. The revised text will still maintain an exception allowing mailings entirely within Alaska or Hawaii by in-state grocery stores to consumers who rely on the mails for supplies -- which is the reason that has been given for this exemption.

The Smuggled Tobacco Prevention Act (STOP Act, H.R. 5689)

While effectively addressing the problem of illegal Internet tobacco product sales would be extremely constructive by itself, more also needs to be done to address the many other aspects of the overall contraband tobacco product trafficking problem. Representative Doggett's bill – H.R. 5689 – does just that.

H.R. 5689 is the latest version of legislation that was introduced in prior Congresses and has undergone continuous improvement. Among other things, it takes full advantage of the lessons learned from growing efforts worldwide to address the problem of cigarette and other tobacco product smuggling that crosses international borders and the problem of counterfeit tobacco products and counterfeit tax stamps. At the same time, H.R. 5689 also offers effective measures to reduce the special characteristics of the smuggling and tax evasion problem within the United States.

The common sense principles behind H.R. 5689 are simple and effective:

1) Make sure that it is difficult for illegal vendors to sell counterfeit tobacco products or make or sell counterfeit tax stamps and easy for enforcement officials and others to distinguish legal from illegal tobacco products. H.R. 5689 does that by requiring clear markings on tobacco product packages that identify the manufacturer and show where the products may be legally sold. The legislation requires new, readily available high-tech tax stamps that establish legality and cannot be effectively counterfeited, and it includes provisions to keep tobacco product manufacturing and tax-stamping machinery from getting into the hands of counterfeiters.

2) Make it easier to track and trace tobacco products as they are transported from one business to another so that diversion to illegal distribution channels is more difficult and easier to spot.

H.R. 5689 requires reasonable reporting and record-keeping requirements by businesses throughout the distribution and delivery chain; adds tobacco product distributors into the federal permit system that now applies to manufacturers, exporters and importers (creating a closed system of authorized legal businesses that can sell and deliver tobacco products to each other); provides for encrypted information on the high-tech tax stamps to identify not only the entities applying the tax stamp but also subsequent recipients; and establishes a system of export bonds to ensure that the tobacco products actually end up in legal markets where they are reportedly destined.

3) Prohibit transactions that serve only to supply contraband trafficking. H.R. 5689 blocks sales of tobacco products that exceed the amount needed for personal use. For example, the bill stops the sale of more than 5,000 cigarettes (250 packs) to any single retail customer at any one time. Those kinds of large retail sales are needed only by those engaged in illegal smuggling and re-sales, and this bill would stop them.

4) Untie the hands of federal enforcement officials. To help enforcement efforts, the legislation creates clearer and more extensive federal jurisdiction over contraband trafficking. For example, H.R. 5689 makes the definition of contraband tobacco product clearer and more comprehensive. It includes all tobacco products for the first time, and would also enable federal enforcement officials to stop and prosecute any contraband trafficking of more than 2,000 cigarettes (rather than the current jurisdictional minimum of 10,000 cigarettes).

(5) Protect citizens who report criminal trafficking acts. H.R. 5689 does that by providing new whistleblower protections for civic minded workers who witness contraband trafficking activity while on the job.

6) Establish strong new financial incentives for good behavior and appropriately large financial disincentives for bad behavior. Rep. Doggett's legislation establishes new export bond requirements that would penalize exporters for allowing their shipments to be diverted from the reported legal destinations; provides clearer standards for proper behavior; establishes clearer descriptions of wrongful acts, and subjects lawbreakers to higher fines and penalties.

These examples of some of the measures in H.R. 5689 provide a quick overview of this comprehensive and carefully thought-out legislation. Once passed into law, we believe it will

operate effectively to reduce contraband trafficking both within the United States and across its borders. H.R. 5689 – both by itself and particularly if supplemented by the PACT Act – offers a model that the world's nations could follow both in the current development of the Illicit Trade Protocol of the Framework Convention on Tobacco Control (FCTC) (which the United States has signed but not yet ratified) and in subsequent efforts by individual countries to comply with the FCTC international treaty by passing their own stronger and more comprehensive national laws.

Mr. Chairman, passing the STOP Act and the PACT Act would not only cap current tobacco product smuggling and tax evasion preventing it from getting any larger in the United States, but would also make the problem much smaller. These measures would increase the costs and reduce the profits from smuggling and tobacco-product related tax evasion. They would also close down lucrative opportunities for criminal and terrorist organizations. They protect honest businesses from illegal competition and increase public revenues at all levels of government. For all the reasons I outlined at the beginning of my testimony, passing these two pieces of legislation would also work directly to improve public health by helping to reduce tobacco use and the horrible toll it takes on our country.

Thank you, again, for this opportunity to testify before this Committee. I would, of course, be happy to answer any questions.