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"Primary Source of Supply" Law Would Add Needed Safeguards to Cigarette Regulation in Florida

In recent years, a new cigarette distribution system has developed in Florida. This system, dubbed the "gray market", imports American-made cigarettes originally meant for foreign markets and sells them in Florida. Although it is possible under current state law to operate legally in the gray market, this system raises numerous concerns about tax compliance, competition and consumer protection.

Legislation before the 1997 Florida Legislature would help address these concerns. House Bill 1065 and Senate Bill 334 would create a tested regulatory system for cigarette distribution that would help erase the problems of the gray market.

How the Gray Market Works

Under this system, wholesalers obtain tax-exempt cigarettes which have been shipped by a cigarette manufacturer to a foreign country but have been diverted back to the U.S. Often, these are obtained from independent international brokers that have excess inventories. There also is evidence that sometimes, while the paper trail may go out of the country and back, the cigarettes may not ever leave the docks in Miami. The importer/wholesaler then files a consumption entry document for returned American goods with the federal government and pays federal cigarette taxes. After the cigarettes clear U.S. Customs they are moved from a bonded warehouse to a non-bonded one and the importer/wholesaler is required to affix the Florida cigarette tax stamp before distribution to retailers or other wholesalers.

Tax Compliance Issues

If the importer/wholesaler adheres to U.S. Customs requirements and pays the required federal and state taxes, this is currently a legal operation. However, there is concern that the gray market can help provide product for the black market. Black markets develop when governments impose high taxes on a product, as is the case with cigarettes. If the appropriate taxes are not paid, then those cigarettes become contraband or "bootleg." The Florida Department of Business and Professional Regulation's Division of Alcoholic Beverages and Tobacco (DABT) has limited ability to monitor gray market transactions since they occur outside the state's jurisdiction.

In normal cigarette distribution the product is invoiced directly from the manufacturer to the Florida wholesale distributor and a copy of that invoice does to DABT. At that point, DABT knows how many unstamped cigarettes are in possession of the Florida wholesaler. Each year the state audits every wholesaler to reconcile the number of cigarettes handled with the number of tax stamps purchased. By contrast, the state has no knowledge of the quantity of cigarettes in a gray market operation and thus does not know how many state tax stamps the wholesaler should be buying. The state has no audit trail to evidence payment of state excise taxes on diverted products.

Competition

Cigarettes intended for export only are usually priced below domestic products. Costs may be lower in the foreign market and manufacturers may reduce prices to expand international sales or to enter an emerging market. A study by the financial investigative firm FIA International Research Ltd. states that gray market distributors pay an average of about seven dollars per carton, compared to over \$11.50 per carton for other distributors.

The Florida Tobacco and Candy Association states that this price discrepancy and the fact that the gray market cannot be as strictly regulated and monitored, places traditional cigarette wholesalers at a significant competitive disadvantage.

Consumer Protection and Limiting Minor Access

Another concern with gray market cigarettes is one that is sometimes overlooked but should nonetheless be very important. It must be remembered that gray market cigarettes were not intended for sale in the U.S. market and the product can be different than those to which American consumers are accustomed. Often, cigarettes are blended differently for overseas markets and the taste can be quite different from domestic ones. When consumers buy a brand name product, they should have assurance they are getting what they expect. In a letter submitted to the House Regulated Services Committee expressing support for the legislation, Philip Morris states that they believe that the diversion of export product has created confusion among consumers of their cigarettes and has affected sales in Florida.

Some other problems with gray market product:

- ▶ Freshness cannot be assured. If the product travels to a foreign market and returns, then it's likely to be stale by the time its sold in the U.S.;
- ▶ The diverted product does not qualify for manufacturer incentive and rebate programs for consumers and wholesalers and retailers cannot participated in the manufacturer incentive programs available for the sale of traditional domestic products;
- ▶ The warning labels on the diverted product differ slightly from those on the domestic product and are not rotated in accordance with U.S. requirements;
- ▶ If there is a problem with the product and a recall is in order, diverted cigarettes would be difficult to recall; and
- ▶ None of the diverted products contains the statement Underage Sale Prohibited now

found on some domestic brand products. In addition, gray market cigarettes are often not sold through recognized chain groceries or convenience stores but rather through lunch wagons and vans that temporarily sell to agricultural workers, construction workers and students. This makes it easier for minors to acquire cigarettes.

Legislation Would Stop the Gray Market

The proposed legislation would prohibit a distributing agent or wholesaler from purchasing cigarettes from anyone other than the "primary source of supply." Each domestic manufacturer who sells in Florida must register with the Division of Alcoholic Beverages and Tobacco (DABT) as the primary source of supply. For cigarettes manufactured outside the U.S., the primary source may be the manufacturer or an agent. In order to assist DABT in the tracking of all cigarettes, the primary source of supply would be required to submit monthly a listing of its complete product line and a report of all shipments into the state. Before a cigarette permit is issued or renewed, the applicant must file an affirmation from the manufacturer which attests the manufacturer's intent to provide cigarettes to the applicant.

This is largely the same regulatory structure that Florida currently uses for wine and liquor. It would stop wholesalers from importing into Florida cigarettes which were intended for a foreign market.

DABT has historically been quite effective in collecting the taxes due the state. This would give it another tool to do that job even better. It would provide DABT with increased capability to track cigarettes as they move from the manufacturer to the consumer. Cigarettes in violation of this law could be seized and forfeited. DABT would also be authorized to fine, suspend or revoke the permit or registration of violators.

In summary, HB 1065 and SB 334 would set up the same regulatory structure currently use by the state for wine and liquor. It would increase confidence in tax compliance, level the playing field for cigarette wholesalers, help limit access to minors, and ensure that consumers get the product they are paying for.

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