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**Tobacco-Settlement: Summers  
Testimony**

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Text as Prepared for Delivery  
April 30, 1998

TREASURY DEPUTY SECRETARY LAWRENCE H. SUMMERS  
SENATE JUDICIARY COMMITTEE

Thank you, Mr. Chairman. I am pleased to be joined this morning by the Director of the Bureau of Alcohol, Tobacco and Firearms, John Magaw and by the Acting Deputy Commissioner of Customs for International Affairs, Doug Browning. We are pleased to have this opportunity to discuss administrative and enforcement issues arising from the implementation of new tobacco legislation, particularly those issues related to controlling illegal domestic diversion and cross-border smuggling of tobacco products.

As you know, the prospect of comprehensive tobacco legislation is an issue of enormous consequence to the health and economic well-being of the American people. Comprehensive tobacco legislation such as Senator McCain's bill would stop 3 million teens from smoking over the next five years, prevent approximately one million premature deaths, and reduce the costs that smoking imposes on our economy by almost \$80 billion in the long run. The Department of the Treasury and the Administration support the efforts of your Committee and others in Congress to protect America's children from the deadly threat of smoking.

In addition, the Administration shares your interest in assuring that the enactment of tobacco legislation does not result in either a domestic black market or smuggling of tobacco products into the United States. We believe that it is essential that comprehensive tobacco legislation contain provisions that will minimize the diversion of cigarettes from legitimate domestic channels of distribution and the smuggling of cigarettes into the United States from abroad.

It is not possible to reach definitive conclusions about the risks of smuggling given the wide range of changes contemplated by comprehensive tobacco legislation. Incentives to smuggle may well be sensitive to details of tobacco legislation, including price changes, the way

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in which assessments are levied and other specifics. Nonetheless, the Treasury Department believes that the creation of a sound regulatory system -- one that will close the distribution chain for tobacco products -- will ensure that the diversion and smuggling of tobacco can be effectively controlled and will not defeat the purposes of comprehensive tobacco legislation.

By closing the distribution chain for tobacco products, we will be able to ensure that these products flow through legitimate channels and effectively police any leakages that do take place. The Treasury Department already licenses tobacco manufacturers and export bonded warehouses in connection with collecting tobacco excise taxes. We believe that such licensing should be extended to the other entities in the upper end of the tobacco distribution chain -- wholesalers, exporters, importers and distributors. We are comfortable with a system that places primary responsibility for licensing retailers on state governments, as provided in Senator McCain's bill. Under this system, tobacco products would move through legitimate channels. Most importantly, such channels would not be open to America's youth.

An effective system must include the following elements:

- **First**, as I have described above, all entities in the distribution chain for tobacco products -- manufacturers, wholesalers, exporters, importers, distributors and retailers -- should be required to hold a license or a permit. Licensing of retailers could be done at the state level. Licenses would be issued based on certain clearly specified criteria and could be revoked or suspended for certain specified violations. Those conducting business without a license would be subject to penalties. Licensed entities should only be authorized to sell tobacco products to other licensed entities. The sale or distribution to any entity that is unlicensed would be unlawful.
- **Second**, legislation should require the marking, branding and identification of packages of tobacco products intended for domestic distribution and for export so that they may not be diverted or smuggled in circumvention of the legitimate channels of distribution.
- **Third**, any regulatory proposal should include penalty and administrative provisions that will allow for effective, efficient and uniform enforcement of controls over distribution.

A regulatory scheme for tobacco products such as that I just described would be similar to the way the Federal Government has effectively regulated alcoholic beverages for over sixty years. The system in place has allowed for effective commerce in alcoholic beverages while effectively curtailing trafficking in illicit, non-tax paid products. In addition, all states currently regulate their alcohol retailers.

Current laws regulating tobacco are aimed at collecting the Federal excise tax and assisting states in their efforts to collect excise taxes imposed on certain tobacco products, not at regulating the distribution of tobacco products and preventing smuggling. For example, the Contraband Cigarette Trafficking Act, or CCTA, was designed solely to assist states in enforcing

their tax laws. It does not address or ensure a closed national distribution system and was only intended to proscribe domestic diversion as it applies to state taxes. The CCTA does not address cross-border smuggling, and it applies only to cigarettes, and not to any other tobacco products.

With the necessary regulatory provisions in place to deal with potential smuggling, we do not expect a large-scale smuggling problem for several reasons. First, the "closed" distribution scheme I just described would limit drastically smugglers' ability to enter products into a legitimate distribution channel. Potential black marketeers will not be able to move products through legitimate wholesalers or distributors. Nor will they be able to sell products to retail consumers at the local convenience stores or other licensed retail outlets. Instead, without a way to place contraband products in the market legally, smugglers would have to sell cigarettes outside channels of legitimate distribution. This would be a risky proposition and one we do not believe will represent a significant problem. Second, U.S. cigarette manufacturers would have great incentives not to become complicit in any smuggling operation, as they would encounter enormous legal risks (such as the possibility of losing their license or, as the McCain bill provides, losing their cap on liability risk) and public opprobrium. Indeed, it is hard to imagine that large scale smuggling could occur without the manufacturers' knowledge. Third, the U.S. Customs Service has the expertise and the experience to deal with imported contraband products and has already made a substantial investment in the currently planned introduction of non-intrusive inspection systems and other equipment needed to detect smuggling of contraband. The organic nature of tobacco and the distinctive shape of cigarettes makes them readily detectable by equipment that Customs currently has in place.

Some have cited current levels of interstate smuggling as a reason why comprehensive tobacco legislation such as Senator McCain's bill will lead to wide-scale smuggling. Such arguments fail to account for the fundamental difference between interstate diversion and cross-border smuggling. Commerce between states is not controlled the way it is across the United States' international borders. The Customs Service simply does not monitor the movement of products across state borders, while it does effectively monitor our international borders. More importantly, the current levels of interstate smuggling exist without having in place a closed distribution system like the one I described earlier. If anything, such a system would be expected to have the collateral benefit of substantially reducing existing interstate diversion of tobacco products.

The Canadian experience is also frequently highlighted by those who predict the emergence of a large black market. There are several reasons to believe, however, that the Canadian experience is not an appropriate predictor of what would occur if tobacco legislation such as that supported by the Administration were to become law.

First, the size of the Canadian population as well as its concentration along the border with the United States, makes the Canadian example not particularly instructive for the United States. Because of its smaller population, the total number of cigarettes sold in Canada is only one-tenth as large as the number sold in the U.S., so small amounts of smuggling have a

noticeable impact on their tobacco market and would have none on ours. That is, it would take ten times as much smuggling by volume to have an equivalent proportional effect on the U.S. market for tobacco products. Moreover, smuggling became a problem in Canada because of the ease of access to alternative markets. Eighty percent of the Canadian population lives within a two-hour drive of the U.S. border, placing it within easy reach of smugglers transporting cigarettes from the United States. The U.S. population is more dispersed, making the logistics of a nationwide black market in smuggled cigarettes more complex and expensive for organized smugglers. The dispersal of the U.S. population also means that a U.S. resident is less likely than a Canadian resident to be able to cross the border routinely for casual cigarette smuggling.

Secondly, and most importantly, Canada did not have in place the type of effective licensing and enforcement regime that is advocated by the Administration. For example, Canada did not mark its cigarette packaging with "For Export Only" labels until after the smuggling problem of 1992-93. Canadian law enforcement had very few personnel devoted to tax evasion. The vast majority of enforcement with respect to Canadian taxes was done at the provincial level and there was little or no coordinated enforcement effort at the national or inter-provincial levels. In addition, Canada does not license the distribution chain with respect to tobacco products, with the exception of manufacturers. Finally, Canada's laws on tax evasion did not contain strong penalties and there were inadequate resources to enforce these laws.

We are confident that a proper regulatory enforcement system will minimize the diversion of tobacco products from legitimate channels and the development of cross-border smuggling. Such a system would closely parallel the regime that has been in place for the regulation of alcoholic beverages for more than sixty years. We look forward to working with you and your Committee, as well as other Committees in Congress, to fashion such a regulatory system.

Thank you, Mr. Chairman.

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SEN. HATCH: Good morning. This is the Judiciary Committee's eighth hearing since the announcement of the proposed global tobacco settlement last June 20th. I remain hopeful that the Congress will succeed this year in passing strong anti-tobacco legislation that is comprehensive, workable and constitutionally permissible. Let there be no mistake about it. For years, the tobacco industry has knowingly marketed harmful products, deliberately targeting our youth in their quest for profits.

We should not give in to the tobacco industry's demands nor to their less than veiled attempts to force both the administration and the Congress into abandoning our objectives: addressing the problem of youth tobacco smoking, reforming the legal system to allow for appropriate compensation to claimants, enhancing biomedical research with respect to tobacco, and improving public health, resolving problems with farmers, and of course, helping a whole new generation to be tobacco-free and, therefore, in many ways, drug-free.

Over the next few weeks, we intend to devote full attention toward refocusing our efforts on a bill which can be enacted. To accomplish that, it is important that the Congress and the administration reflect on what our objective has actually been and should continue to be. Last June, the 40 state attorneys general, public health representatives, tobacco company officials, and representatives of the Costano (sp) group announced a bold new initiative focused on eradicating the scourge of youth tobacco use.

This proposed global settlement presents Washington with a once-in-a-generation opportunity to help families and communities raise a whole generation of youth tobacco-free. Certainly, no one in Congress is bound to the particulars of the June agreement. But we would not be here today debating any of the legislative proposals were it not for this agreement. In short, our objective in 1997 was to improve the public health, but specifically the health of our youth through a constitutional package of reforms which relies on a guaranteed stream of revenue from tobacco companies. Our objective should be the same today, but it appears it is not.

Unfortunately, partisan politics, fear, greed, and Washington's pile-on mentality have caused us to lose sight of this objective. Instead, we are simply trying to out-tobacco one another. If that continues, the public interest will not be served and big tobacco will win.

Last Friday, I received a bipartisan letter from four of the state attorneys general who participated in last year's settlement negotiations. This letter, which I believe is a serious effort to help Congress make the corrections necessary before we consider the Commerce Committee legislation next month, highlighted three areas of concern, three particular areas in which Congress runs the risk of undermining the settlement's objectives if it continues down the current road. These concerns are:

Number one. The difficulties created by enacting legislation without the industry's voluntary waiver of several constitutional prerogatives. The generals, the attorneys general, raised specific legal concerns about attempting to legislate in the absence of consent decrees and other voluntary agreements with the industry. These concerns go to several major features of any comprehensive bill: advertising and marketing restrictions, including restrictions affecting retailers, distributors and

advertisers; look-back penalties; and document disclosure.

Earlier this week, I had the honor of attending with Senator Chafee and Senator Frist a White House meeting at which the surgeon general reported to the president on the alarming rise in smoking in four key minority populations: African Americans, Native Americans and Hawaiians, Asians and Pacific Islanders, and Hispanics. It just seems to me that if we really want to put the maximal dent into this problem, we would be better off working with the industry to curtail advertising and promotion practices beyond which the Constitution will not allow us to legislate.

We should also take to heart General Mike Moore's observation before this committee, that in the nearly three years since it was first proposed, the FDA's rule on tobacco advertising has not gone into effect. We all know the cause. It's litigation. But by settling the lawsuit in Mississippi, there is no billboard advertising today, a result that goes far beyond the FDA rule of what the Constitution would permit us to do legislatively.

Number two. The second concern is the untoward effects that the potential bankruptcy of the tobacco industry would entail. Let me be clear about my position on this. I would like nothing more than for the tobacco industry to pay a trillion dollars or more. It would make me very happy if we could do that. But I also want an anti-tobacco program that works. All of the bills before Congress have in common a serious effort to curtail youth tobacco use. All of the bills rely on industry payments to fund those efforts. If we bankrupt the companies or if we drive them offshore, ultimately no one wins, because we need the industry payments to fund the massive anti-tobacco program the American public wants, and without that funding source, the whole program goes down the drain.

If the companies become bankrupt and move offshore, it is a whole new ball game and one which we definitely will not be able to control. We would be more intellectually honest just to ban tobacco.

Number three. The third major point of concern is the potential for increasing the black market for illegal contraband cigarettes, about which we will hear more from our panelists. And as you all know, the AGs and the top law enforcement officials in each state do not want to create a contraband market for tobacco products, a new product line for organized crime which would hurt our children by providing a new entry point for drug dealers.

They note there is already a \$1 billion tobacco contraband problem in this country which could be exacerbated by ill-crafted legislation. As they point out, there is a strong correlation between tax rates and the level of smuggling which now has reached international proportions.

I have also received a letter from the Fraternal Order of Police, whose 272,000 members will provide the first line of defense against these smugglers.

The FOP, in their words, is, quote, "extremely apprehensive," unquote, that passage of the legislation on the floor will precipitate the emergence of a thriving black market in cigarettes, posing huge problems for law enforcement at every level. They say the Commerce bill in particular will

inevitably lead to a creation of a massive black market, giving organized crime a new line of business and undermining not only respect for the rule of law, but also the real goal of the legislation, preventing underaged tobacco use.

I might also add that one of the most frightening outcomes of a new black market would be the likelihood that children will find it easier than ever to purchase tobacco products. And many of them may even be pushed into smoking marijuana or other harder drugs.

One of the government's principal responsibilities is to help families and communities keep children from smoking. A large, lucrative black market could have the unintended consequences of making parents' jobs harder. It is not hard to envision unregulated cigarettes being sold on literally every street corner in America.

The purpose of today's hearing is to shed light on this issue of black market tobacco products, and I believe we will hear very compelling testimony. We have a number of distinguished panelists who will appear today. On our first panel, we will hear from Deputy Treasury Secretary Lawrence Summers, who is accompanied today by the director of the Bureau of Alcohol, Tobacco and Firearms, John Magaw, and by the acting deputy Customs commissioner for international affairs, Doug Browning (sp).

We welcome all of you here, and we're honored to have you here in front of our committee, and we'll look forward to your testimony. We appreciate the benefit of Secretary Summers' considerable experience and the effort he has made to appear before the committee today. It's been a very serious and hard effort, and we appreciate it.

For our second panel, we will hear from Mr. John Hough, senior assistant attorney general from Washington state. Mr. Hough played a leadership role in analyzing the black market issue for the 40 state attorneys general who participated in the proposed global tobacco settlement.

After Mr. Hough, we will hear the testimony of Mr. David Sweanor, senior legal counsel for the Non-Smokers Rights Association of Canada.

Mr. Sweanor will provide the committee with his considerable analysis of the black market which did occur in Canada and still exists. There are valuable lessons to be learned from the Canadian experience.

We will also hear from Mr. Ron Martelle, the former mayor of Cornwall, Ontario, whose small town became a hotbed for cigarette smuggling.

And finally, we will hear from Mr. David Adelman, tobacco analyst for Morgan-Stanley/Dean Witter. Let me note that Mr. Martin Feldman of Salomon Smith Barney was scheduled to testify at the hearing, but could not appear today after we rescheduled the hearing. And I greatly appreciate the work he did in preparing his testimony and intend to provide him with the opportunity to give us the benefit of his expert analysis at a later date. And we will put his statement in the record.



We are especially appreciative of Mr. Adelman's appearance here today, given that he was only invited to testify late yesterday after it became apparent that Mr. Feldman had a scheduling conflict.

Now, let me turn to the ranking member, and we'll move on from there

SEN. PATRICK LEAHY (D-VT): Thank you, Mr. Chairman. For the past two weeks, the public has been bombarded with millions of dollars' worth of radio and television and newspaper ads from the tobacco industry about the dangers of a black market if Congress passes comprehensive tobacco legislation to curb teenage smoking. I hope this hearing might cut through the rhetoric and bring a little reality back to Washington.

The same tobacco industry who assured us under oath that nicotine is not addictive now claims that higher tobacco prices will create a market for contraband products; the same tobacco industry that for years has denied to everybody that it's marketed its products to children, which we now know is a bald-faced lie because thousands of their own internal documents prove the industry did target minors.

Now, excuse my skepticism, but the tobacco industry has not built a reputation for candor with either the Congress or the American people. Last week, Stephen Goldstone, chairman of R.G.R. Nabisco, was once again in the news. He devoted an entire press conference to his newfound concern. Lord, bring us to the altar, he found this newfound concern over the black market consequences of Senator McCain's comprehensive tobacco legislation. Mr. Goldstone claims that the McCain bill will create a raging black market for cheap cigarettes on street corners and in schoolyards. I know how much he must worry about children smoking.

And I have two tobacco industry handbills that were passed out in Kentucky this week. These are the two handbills. I will put them in the record. But let me tell you, these handbills are outrageous, they are distortions, they are lies, they are not dissimilar to everything the tobacco has been doing for years and continues to do. These guys haven't learned a single thing, as far as I'm concerned.

One asks, Will raising taxes by 458 percent stop kids from smoking? And they reply that the answer is found in Canada, where a similar tobacco tax was levied. Well, a few months ago, the tobacco industry was pushing for federal government action to enact the proposed national settlement to supposedly curb teen smoking, but not anymore.

I guess the Congress should only act to reduce teen smoking if the tobacco industry gets immunity from lawsuits. What hypocrisy by big tobacco. All this raging demand for a black market was supposedly to be caused by an annual price increase of 22 cents per pack over the next five years. The tobacco industry's fear-mongering is not helpful for the serious debate needed to build consensus for a strong national tobacco policy. And excuse me if I do not trust an industry that has lied and lied and lied and lied and continues to lie.

And despite the tobacco industry's scare tactics, obviously we will seriously address any potential

for these black market problems from higher cigarette problems. But we should base it on reality, not tobacco industry rhetoric.

The reality is the Canada experience during the 1980s and early 1990s, a time when excise taxes were raised on tobacco products. The reality is something that teaches us valuable lessons. If we understand the Canadian experience better, we'll know what we're going

to face here. And that's why I invited David Sweanor, the top Canadian public health tobacco advocate, to share his expertise.

The first question that Canada can teach us is that higher prices of tobacco products do in fact reduce teenage smoking. From 1981 to 1992 in Canada, smoking declined by 38 percent overall and by 60 percent among teenagers. The Treasury Department has estimated the gradual \$1.10-per-pack price increase in the Commerce bill would reduce teenage smoking by as much as 46 percent in the next five years. That's a million young people spared from premature deaths resulting from smoking.

And the second lesson that Canada can teach us is that the tobacco industry itself will exploit higher cigarette prices to make a fast buck from tobacco smuggling. "The New York Times" reported last year that cigarette makers helped fuel the tobacco contraband trade in Canada during the 1980s and 1990s. In one case, two sales managers from Brown & Williamson Tobacco Company pled guilty. Sales managers pled guilty to aiding these smugglers, these same smugglers they're now telling us, well, we've got to worry about them.

In another case, R.J. Reynolds Tobacco Company sponsored trips to a luxury Canadian fishing resort for several dealers who had been charged with conspiring to smuggle cigarettes into Canada.

Well, I'll say one thing for these tobacco companies: they are apparently aware of what happens in smuggling. But I don't share -- I'm not willing to accept their great concern. In fact, the Department of Justice is investigating allegations that Canadian subsidiaries of U.S. companies increased exports to border states in the U.S. with the intent to promote smuggling into Canada. Former Surgeon General C. Everett Koop testified recently to a Senate forum that Philip Morris and British-American Tobacco are already setting up potential black market mechanisms in Mexico by buying out Mexican tobacco companies for \$2.1 billion. So I think we have to hold big tobacco accountable to do everything possible to stop illegal sales.

The FOP, in their words, is, quote, "extremely apprehensive," unquote, that passage of the legislation on the floor will precipitate the emergence of a thriving black market in cigarettes, posing huge problems for law enforcement at every level. They say the Commerce bill in particular will inevitably lead to a creation of a massive black market, giving organized crime a new line of business and undermining not only respect for the rule of law, but also the real goal of the legislation, preventing underaged tobacco use.

I might also add that one of the most frightening outcomes of a new black market would be the

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And I have two tobacco industry handbills that were passed out in Kentucky this week. These are the two handbills. I will put them in the record. But let me tell you, these handbills are outrageous, they are distortions, they are lies, they are not dissimilar to everything the tobacco has been doing for years and continues to do. These guys haven't learned a single thing, as far as I'm concerned.

One asks, Will raising taxes by 458 percent stop kids from smoking? And they reply that the answer is found in Canada, where a similar tobacco tax was levied. Well, a few months ago, the tobacco industry was pushing for federal government action to enact the proposed national settlement to supposedly curb teen smoking, but not anymore.

I guess the Congress should only act to reduce teen smoking if the tobacco industry gets immunity from lawsuits. What hypocrisy by big tobacco. All this raging demand for a black market was supposedly to be caused by an annual price increase of 22 cents per pack over the next five years. The tobacco industry's fear-mongering is not helpful for the serious debate needed to build consensus for a strong national tobacco policy. And excuse me if I do not trust an industry that has lied and lied and lied and lied and continues to lie.

And despite the tobacco industry's scare tactics, obviously we will seriously address any potential for these black market problems from higher cigarette problems. But we should base it on reality, not tobacco industry rhetoric.

The reality is the Canada experience during the 1980s and early 1990s, a time when excise taxes were raised on tobacco products. The reality is something that teaches us valuable lessons. If we understand the Canadian experience better, we'll know what we're going to face here. And that's why I invited David Swenor, the top Canadian public health tobacco advocate, to share his expertise.

The first question that Canada can teach us is that higher prices of tobacco products do in fact reduce teenage smoking. From 1981 to 1992 in Canada, smoking declined by 38 percent overall and by 60 percent among teenagers. The Treasury Department has estimated the gradual \$1.10-per-pack price increase in the Commerce bill would reduce teenage smoking by as much as 46 percent in the

next five years. That's a million young people spared from premature deaths resulting from smoking.

And the second lesson that Canada can teach us is that the tobacco industry itself will exploit higher cigarette prices to make a fast buck from tobacco smuggling. "The New York Times" reported last year that cigarette makers helped fuel the tobacco contraband trade in Canada during the 1980s and 1990s. In one case, two sales managers from Brown & Williamson Tobacco Company pled guilty. Sales managers pled guilty to aiding these smugglers, these same smugglers they're now telling us, well, we've got to worry about them.

In another case, R.J. Reynolds Tobacco Company sponsored trips to a luxury Canadian fishing resort for several dealers who had been charged with conspiring to smuggle cigarettes into Canada.

Well, I'll say one thing for these tobacco companies: they are apparently aware of what happens in smuggling. But I don't share -- I'm not willing to accept their great concern. In fact, the Department of Justice is investigating allegations that Canadian subsidiaries of U.S. companies increased exports to border states in the U.S. with the intent to promote smuggling into Canada. Former Surgeon General C. Everett Koop testified recently to a Senate forum that Philip Morris and British-American Tobacco are already setting up potential black market mechanisms in Mexico by buying out Mexican tobacco companies for \$2.1 billion. So I think we have to hold big tobacco accountable to do everything possible to stop illegal sales.

That's all the administration could give us at that time.

Now, it just seems to me that we shouldn't be starting up a half-trillion-dollar program with only one page of financial backup to justify it. And your staff verbally indicated that other factors were considered in coming up with these estimates, such as state excise taxes, wholesaler and retailer markups, effects of smuggling, look-back penalties, attorney fees, but that there existed no formal model beyond the one-page document or any written analysis that accompanied the one-page document on what assumptions were made in assessing these factors or in making these critical economic projections.

Now, in the interest of moving this legislation forward, I have a number of questions that I'd like to ask you in connection with this summary table and your projections. First, I'd appreciate it if you would provide for the committee a more complete model, together with the discussion of all the relevant assumptions and any memoranda that you may have prepared in making this model or projections and any responses and memoranda that you, the administration or others with the administration may have prepared to comments and criticisms of



your model and assumptions, if such documents exist.

Second, can you explain briefly today and follow up in writing how the administration accounted for the following factors in making its projections, with particular emphasis on how these projections would be made over a 25-year period under the policies required by the Commerce Committee bill. Let me just list these factors. One -- well, let me just go down through them.

The effect of state and local excise taxes; the effect of black and gray market products; wholesalers' and retailers' price increases; look-back penalties likely to be imposed; the elasticity of demand function used over the entire relevant price range; an estimate of price versus non-price effects, that is, the presence of counter-advertising and a stronger FDA role, et cetera; attorneys' fees; liability exposure, including the settlements in Florida, Mississippi and Texas and the Broin (sp) case; the application of the liability cap; export fees; and any and all other relevant factors. Those are just to mention a few of them.

I think the public debate over this legislation would be improved greatly if you placed this information in the public domain.

Now, let me just ask one last question because my five-minute time is about up. How do you explain the fact that so many of the financial analysts of major Wall Street investment firms, such as our witness today, David Adelman of Morgan Stanley, and others, like Martin Feldman of Salomon Smith Barney, who could not appear today, have projected substantially higher, about \$1.25 to \$1.50 per pack higher in the cost of cigarette prices than, you know, than you're -- than Treasury is projecting today?

MR. SUMMERS: Mr. Chairman, you'll understand if I can't respond orally to all the aspects of --

SEN. HATCH: Some of those I know you have to go to work on and get them to us.

MR. SUMMERS: -- of the question that you asked. But I would

highlight three primary areas of importance in understanding why there were discrepancies.

First, markup behavior. There is a question as to how, when the price at the producer level of tobacco products is increased, how that will be passed on. One view is that when the convenience store has to pay more and there is a kind of sticker shock for the customer, it can't all be passed on. Another view is that the markup will actually be increased to be a constant percentage.

The assumption that we've made, which follows a good deal of the academic literature and the work of the FTC, is to assume a constant markup. So if the markup was 10 cents at a given stage in the distribution chain, it would continue to be 10 cents. I think that's -- in our reading, that is supported by the academic literature and the work of the FTC.

The analysts --

SEN. HATCH: So you estimate -- go ahead. Go ahead. Excuse me. Didn't mean to interrupt.

MR. SUMMERS: The analysts that you're referring to, in a number of cases, made a different assumption and assumed that the profit margin that distributors and convenience stores and the like could

obtain would actually increase when the production price of cigarettes, the price at the producer level, was increased. They assumed that, you know, that if the price at the producer level, just in hypothetical numbers, went from two dollars to three dollars, that the markup that would get extracted at each point in the process would increase by 50 percent. Our reading of the FTC's work on patterns of competition in the industry and a number of academic studies suggested that that assumption was not appropriate.

The second large, substantial difference from my understanding is that in some cases, it was assumed by the analysts that look-back

penalties would apply because they assumed in the face of what we regard as quite compelling scientific evidence from half a dozen

careful studies that the program would not have a large impact on youth smoking, and therefore that the look-back penalties would go into effect and that the look-back penalties would then be marked up into higher prices.

The judgment from our research, based on a review of the evidence, was that certainly in the five-year time frame, there was every reason to expect that the combination of price increases and restrictions embodied in legislation would be sufficient to meet the 30 percent after five-year look-back target so there wouldn't be look-back penalties which in turn would be picked up in prices.

The third large factor accounting for the difference, from my understanding, Mr. Chairman, is that there is some difference in view about the extent to which demand will fall. And the more demand falls, with the given revenue that results, the more the price will increase, which in turn causes demand to fall further and pushes the price up. And some of the analysts apparently have made different judgments about the extent to which demand will be likely to fall off.

Our work, I believe -- the work of the -- not my work, it's the work of the Treasury staff -- is based on estimates that are very much in the center of the range, and I think the estimates are quite close to those of the CBO and the FTC and other groups.

Of course, it is true that in part, as part of an effort to be conservative and to make sure that the health benefits were realized, we did make, as I had explained in some earlier testimony before the Commerce Committee, relatively conservative assumptions in this area so as to make sure that the health benefits we were estimating would

in fact be delivered.

SEN. HATCH: Well, let me just -- before I turn to the ranking member, let me just say that as I understand it, the original budget estimate was \$3.19, but when you evaluated the Commerce bill, you came up with \$3.53 as what a pack of cigarettes would cost. Am I right on that? Just so we establish that right off the bat.

MR. SUMMERS: I don't think that that is -- I don't think that it -- that that is precisely correct.

SEN. HATCH: All right, well, could you get us a final --

MR. SUMMERS: If I could just -- I think I can actually clarify. The two numbers you used, Mr. Chairman, were \$3.19 and \$3.58?

SEN. HATCH: Yeah -- \$3.53 per pack.

SEN.: I think \$3.19 is probably right.

SEN. HATCH: No, that was what the original was, but I'm talking about the Commerce bill. They estimated about \$3.53.

MR. SUMMERS: I think the \$3.19 figure --

SEN. HATCH: Senator McCain estimated it at between \$3.50 and \$4.00, so I think that's where he got those figures.

MR. SUMMERS: There's a distinction, if I might, Mr. Chairman, between --

SEN. HATCH: Yeah, just submit it to the record for us.

MR. SUMMERS: We'll submit it for the record.

SEN. HATCH: Okay now, one last thing. You seem to be saying that the tobacco companies are so evil, but yet you don't think the look-back provisions will be triggered, which naturally would, according to the Wall Street analysts, would raise the price higher. They're assuming that you may have some look-back penalties triggered, I presume. We'll have to talk to them. But you're assuming that the tobacco industries on one side are evil, but on the other side, they're not going to be so evil as to have the look-back penalties triggered.

MR. SUMMERS: Well, I'd make two responses to that. One --

SEN. HATCH: Okay.

MR. SUMMERS: If I could, Mr. Chairman. One is I don't think it's my place to join in the moral discussion.

SEN. HATCH: (Laughing.) I'm so glad to hear that.

MR. SUMMERS: So I'm not making any judgment about evil or not.

Rather, what I think is the basis for our analysis is a hard-headed judgment about the consequences of increases prices for youth. And increasing the price of youth smoking coupled with restrictions on advertising would, in our judgment, produce a reduction in youth smoking over five years of approximately 42 percent, which substantially exceeds the 30 percent that would be necessary to trigger the youth penalty.

My understanding is that there are others -- and there is an isolated study that can be interpreted as pointing in this direction -- that there are others who believe that price increases will not have a large effect smoking and therefore assume that the youth look-back penalty will be triggered. I don't think that's so

much based on moral judgments about the companies as it is based on differing views about our capacity to reduce youth smoking.

SEN. HATCH: That's right. Where I got the \$3.53 is from your own Treasury statement of nominal prices. When they came up with a nominal price, they came up with \$3.53.

MR. SUMMERS: I think, if I could -- we will clear this up as clearly as we can in writing, Mr. Chairman, but I think the distinction between the \$3.19 figure and the \$3.53 figure is that the \$3.19 figure is a figure in real dollars, in 1998 dollars, whereas the \$3.53 is a nominal figure in 2003 dollars. It doesn't go to the difference between our budget and the Commerce Committee bill. It goes to the nominal real distinction.

But we will submit some materials in writing that will, I hope, shed some light on these issues.

SEN. HATCH: Fine. The real concern I have is even at \$3.53, which is less than what the Wall Street analysts say, that we're going to be flooded with these type of cigarettes. This is -- these are contraband cigarettes from China, as I understand it, and so we're going to be flooded with this stuff. And the question is, how do you solve that problem? And of course, Mr. Magaw's going to have a major

SEN. DIANE FEINSTEIN (D-CA): Could you speak up, Mr. Chairman?

SEN. HATCH: Yeah. The question is, how are we going to solve that problem of contraband? Well, let me -- obviously, my time is up. I apologize for going over a little bit, but I wanted to at least get us thinking along the same lines as to what we need to do. But even at \$3.53, you've got problems. But if it goes to five (dollars) or more, there are a myriad of problems that -- I'm talking about the Commerce Committee bill -- there are a myriad -- or even some other bills that would go much more tough on the tobacco companies than the Commerce Committee bill does, and as you know, the tobacco companies are not going to voluntarily consent to anything under the Commerce bill.

Well, let me turn --

MR. SUMMERS: Mr. Chairman, I don't think it's anybody's -- the

administration's intent to send prices to \$5.00 and above. I would just note that --

SEN. HATCH: Well, I'm sure of that, but that doesn't mean it won't happen. That's my point.

MR. SUMMERS: Our intent does not provide a guarantee, but I think the balance of evidence in the various considerations I suggested go that way. I would just also note that while prices probably do have some effect on the incentive to smuggle, what I think

is most important is whether we have an effective system in place that closes the distribution chain. Nobody -- no doubt, people are more eager to steal a valuable car than a less valuable car, but how well the car is protected has a lot more to do with whether the car can be stolen or not. And that's why I think the kind of closed distribution mechanism that I spoke about, that Director Magaw implements in the context of alcohol, is really key.

SEN. HATCH: Whatever is done here is going to have to have at least that, whatever bill is passed. So we're very grateful for the

thoughtfulness that you have in that area.

Let me turn to the ranking member.

SEN. LEAHY: It's the case, Mr. Chairman, that you can have burglary laws in your state and my state and everything else, but burglary law is a felony. I mean, it's a felony to burgle a place. If you've got two warehouses side by side, one with locks and an alarm system and one with open doors, the law is the same, but you know which one is going to get robbed. And it's -- we could put these in.

I'm not going -- notwithstanding the great efforts of the Edmundites (?) and the Jesuits to educate me, I'm not going to make moral judgments about the tobacco companies. I'll just reiterate what I said before. They've lied to us and lied to us and lied to us and lied to us, and I must admit that they have a certain threshold to overcome, certainly for this senator.

And I also noticed, we talked about testimony getting in here. Mr. Sweanor did give us his testimony a couple days ago, and Mr. Hough and Mr. Adelman came in with theirs around 10:00 and 11:30 last night.

Let's talk about the law enforcement issues here. That's the

real reason we're here, or should be. We put 100,000 -- the administration and the Congress working together put 100,000 cops in the street to reduce violent crime over the past few years. Might I ask you this, Secretary Summers? What are some of the most effective law enforcement measures that Congress could include in a comprehensive tobacco bill? I mean, whatever kind of tobacco bill it is, what are some of the most -- or some of the best law enforcement measures we could put in it?

MR. SUMMERS: I think the -- I'll give a very brief answer and then, if I might, ask you to turn to Director Magaw.

I think the key is to close the distribution chain, and what that means is greater licensing upstream, it means requiring state licensing at the retail level, it means requiring that packs of cigarettes that are produced in the United States be marked clearly as

to whether they are for export or not, and it means, more generally, seeking to emulate the kind of system that we have in place that I think has provided for the viable distribution, without excessive black market problems, in alcohol for a long time.

SEN. LEAHY: Just before we go to Mr. Magaw, I want to underscore one point you made in there. One of the things we're hearing in the tobacco ads is that there's huge federal bureaucracy of licensing. And you spoke of state licensing. In other words, similar to what we do today in the liquor stores or package stores in every state. Is that correct?

MR. SUMMERS: That's correct.

SEN. LEAHY: Thank you. Mr. Magaw?

MR. MAGAW: In support of what the undersecretary has said, in addition to the closed chain, you don't have a totally closed chain here. You have to remember that the farmers with the tobacco, that still can be purchased. But if it's -- if the states do as they have said they will do and have done in alcohol, then you really have a fairly well closed chain.

The two additional things that I believe you need along with the closed chain, as we refer to it, is the authority for the secretary to set and issue regulations, just as you have in the alcohol side, because as you move along, there will be things that we weren't able to anticipate today that regulation can take care of, just as it has since 1935 and the beginning of the alcohol regulations.

And then the other key thing is appropriate penalties. And I'm concerned that as we look at these, that we have appropriate penalties so that it does cause people to think twice before they violate that law.

SEN. LEAHY: You could certainly do it in a way that would focus their attention, would it not, Mr. Magaw?

MR. MAGAW: That's correct. I think it has to be reasonable, but it doesn't have to be overdone either. It's not overdone in the alcohol area. I don't think it will have to be here.

SEN. LEAHY: You know, is the question, then, enforcement, too? We had tobacco companies in the -- you know, the billboard that shows what they're doing. They talk about -- (inaudible) -- black market



crime and all. But aren't we talking about a time in Canada where there was fairly weak tobacco export controls, there weren't many officers patrolling the borders, a lot of differences between them and U.S. law enforcement? I say this as one who lives an hour's drive from the Canadian border. I mean, is that a fair analogy?

MR. SUMMERS: That is a fair judgment, Senator Leahy. I think there are two critical points. One is the one you emphasized, that the -- Canada did not at that time have the kind of regime in place that is contemplated here.

The second point that I think we have to keep in mind in terms of all these cross-border flows is the size of our market relative to the size of the Canadian market or that of another country. If 10 percent of the cigarettes in America found their way to Canada, that would represent 100 percent of Canadian consumption.

On the other hand, 10 percent of the cigarettes in Canada found their way to America, that would represent 1 percent of American consumption, simply because of the difference in size of the two countries.

And so we don't think that the Canadian example -- we think the Canadian example makes a very powerful point, which is the need to have the kind of controls that the chairman just referred to and that Director Magaw has been speaking about. But it doesn't in any way invalidate our ability to carry out comprehensive legislation.

If I might just make one more general point in that regard, if you look at international experience, if legislation like that that is under discussion were to be passed by the Congress, the United States would still have tobacco prices that would be in the middle range of those which prevail internationally, that in other countries in which tobacco companies continue to find it advantageous to produce and sell tobacco products, in other countries in which the government is able to function collecting revenues from tobacco products, we are not talking about moving the United States to any kind of range that is internationally without precedent, but rather to the middle of the

range of industrialized countries.

SEN. LEAHY: And Mr. Browning, on the enforcement matters, you agree with what Secretary Summers said?

MR. BROWNING: Senator, I fully agree. In fact, one very important point that the deputy secretary made is that there is a very significant difference, both in terms of the size of our counterpart agencies in Canada at the time that this occurred, there were some very distinct differences in the way in which they developed their regime, and in addition to that, some very significant differences in their law enforcement jurisdiction and authority. We have far more

legal authority to address these issues, and we are structured very differently from Canadian Customs and have far more experience in these areas.

SEN. LEAHY: And Mr. Magaw, do you agree?

MR. MAGAW: I do agree, yes, sir.

SEN. LEAHY: I feel, Mr. Chairman, and I realize time is gone, but I think it's possible to work with the members of this committee and Treasury and the Department of Justice for good law enforcement measures. This is -- when you're talking about the dollar amounts, the kind of bulk you're talking about is not like carrying through a

kilo of heroin or cocaine. You're talking about truckloads of things that go on.

I know that you have been and have developed and are developing sensor devices that sniff out tobacco products. There are a lot of things that could be done. There's consecutive serial numbers, there's origin serial numbers. I mean, if again we're speaking of the Canadian border and material coming in, absent the kind of activity that "The New York Times" accused some of the tobacco companies of, of purposely trying to put extra supply in there to smuggle it back, you're really -- of the various things that can be smuggled across the border, you're talking about something that is somewhat easier to find than a lot of the things we have to guard against today. Is that not

correct, especially among drugs?

MR. SUMMERS: That is correct. The other thing that I think we need to consider is that you have a different dimension here because you're talking, in one case -- I don't mean you, but I mean in general, we talk about smuggling drugs and put this in the same classification. We really ought not to do that because drugs are not available, and they're being brought in because they're not available. You're going to have quality cigarettes, quality tobacco products available here. And that's a big difference, a huge difference, as we see it.

Plus the smuggling of tobacco from outside the country in here, foreign-made tobacco, has not been a problem, generally, because there's no demand for it.

SEN. LEAHY: Thank you.

MR. SUMMERS: The quality of this product is much different.

SEN. HATCH: Well, let me just say this. We asked the staffs at BATF and Customs if they could identify any specific new tobacco control initiatives in the present Fiscal Year 1999 budget or in the supplementary agency-specific budgets, whether they could find specific budget justifications submitted to Congress. And they could not identify any new -- any such new contraband tobacco initiative.

In contrast, the FDA budget justification contains a whole section on tobacco, outlining new spending and new personnel requests. Now, it's my understanding that the Bureau of Alcohol, Tobacco and Firearms diversion branch, that at that branch, there is not even one full-time person assigned to tobacco diversion. And so naturally -- we know that tobacco seizures have gone up 12-fold just since 1995.

SEN. LEAHY: We've also had in this period of time, Customs Service has developed better technology to detect tobacco. That's certainly going to discourage tobacco smuggling. It's also going to help catch those people who are there. We don't want to compare the technology we might have had 10 or 15 years ago with some of the technology we have today, some of the sensing technology I've seen being used. It makes it a lot easier to detect these people.

SEN. HATCH: But see, I'm talking about just two years ago. We've had a 12-fold increase in seizures.

SEN. LEAHY: Well, we've got better equipment.

SEN. HATCH: Well, maybe, but the point is there's nothing in the budget to provide for further help to really solve the problem of contraband, and we have a billion dollars of contraband today in our country.

Now, I'm just raising these points because they're important.

MR. SUMMERS: Mr. Chairman, I --

SEN. HATCH: Let me go to Senator Kennedy.

SEN. EDWARD KENNEDY (D-MA): Mr. Chairman, I appreciate it. We're under -- we're trying colleagues here and know that you have additional panels, but I'll try and just get into three areas.

Mr. Summers, many of the factors the analysts such as Feldman and Adelman cite to reach the exorbitant projected price increases are really in the control of the tobacco industry, as I understand it. Manufacturer level price increases in excess of the cost of them, \$1.10 per package payment, this is in -- the manufacturers can make the judgment. The manufacturers' decisions to pass on 100 percent of their litigation costs rather than absorbing some internally, that's a decision for them to make. The dramatic increases in markups by wholesalers, distributors and retail, that's again within their power.

So if they want to maintain the price of the \$3.50-per-pack range, it's largely within the tobacco industry's power to do it, notwithstanding the statutory fee of even \$1.10 a pack, as I understand it. Is that fair?

MR. SUMMERS: I would agree with your understanding on that, Senator, and I would -- I would agree with your understanding, and I would note that tobacco is an oligopoly industry, and in such an industry, experience suggests that it is very much the pricing decisions made, in particular by larger companies, that have an important impact on overall price.

SEN. KENNEDY: Well, I think that -- I appreciate your response, and I think that that's helpful in terms of looking through the analysis that you provide. You could have books five times as large as the chairman held up if you looking at all these flexibilities and

all these possibilities and these -- all these other considerations. But as I understand, you were, in your own analysis, making some judgments based upon the power of the manufacturer in terms of what was going to happen and making the best judgment on that matter.

Let me ask you, as I understand, the Treasury Department's analysis concluded that with \$1.10 price increase, at the manufacturers' level, there would be a reduction in the operating profits of the tobacco industry of about 23 percent. In other words, the industry would remain highly profitable. Is that right?

MR. SUMMERS: That is correct, Senator Kennedy. And that is because the comprehensive tobacco legislation is structured so as to facilitate the passing on of the industry payments to consumers, which in turn serves the public health objective. While there are certainly commercial risks facing tobacco companies, as there are many other companies, and there are risks in the litigation environment, there are a whole set of risks, we do not see any reason to expect that the pricing impact of this legislation would make it not possible to market tobacco products in the United States.

And indeed, I would emphasize, as I noted to Senator Leahy a moment ago, that tobacco is marketed in many countries where the price is substantially greater than anything that is envisioned in these discussions.

SEN. KENNEDY: Well, we'll put in the record -- I want to continue, and then I'll just come back to your last point. As I understand, since the entire \$1.10-per-pack paid by the industry is intended to be passed on to the consumer, that the only financial impact on the companies will be reduced volume of sales. And what percent reduction in sales do you project on that? Can you give us -- well, all right. You could just give that to us later.

MR. SUMMERS: About -- a little -- just above 20 percent reduction in total sales.

SEN. KENNEDY: Okay.

MR. SUMMERS: I would just clarify one other point, if I could, Senator Kennedy.

SEN. KENNEDY: Right.

MR. SUMMERS: The \$1.10 figure is a real figure. It's \$1.10 in 1998 dollars.

SEN. KENNEDY: I understand.

MR. SUMMERS: And so, although inflation is very low these days, the number would rise a little bit in terms of the price per pack that people see.

SEN. KENNEDY: Now, if you use the same criteria, what would be the impact of the tobacco industry's profitability at a \$1.50-per-pack increase?

MR. SUMMERS: Let me give you an answer in writing.

SEN. KENNEDY: All right.

MR. SUMMERS: And it is, I think, important to emphasize that these estimates go to operating profits.

SEN. KENNEDY: Well, can you tell me, do you believe that it will bankrupt the industry?

MR. SUMMERS: I think it's very unlikely that the pricing impact changes in that range would have any decisive impact on the industry's overall health, given that the industry has substantial operating cash flows, given that the increases are passed on to consumers and given also that the industry has very substantial assets outside of U.S. tobacco, which those assets and the fruits of those assets are available to meet debt obligations.

SEN. KENNEDY: Well, I'm just talking about tobacco-related activities, though. I mean, you know, not talking about sort of cross-subsidies of these various -- just on that -- you know, we had

testimony here previously that it would have to get up to just, I think, in terms of about \$4.04 or \$4.05 a pack before you'd really see the dramatic sort of reduction. We're not even in that range even with \$1.50.

MR. SUMMERS: I don't -- as I said, I think that the pricing impact of the type of legislation and the broad range of what is under discussion in different proposals is unlikely to be decisive. These are companies whose bonds carried a risk premium before all of this legislation was under discussion, and no doubt will carry a risk in the future. But in terms of this legislation tipping the balance, I think the pricing impact is very unlikely.

SEN. KENNEDY: I just want to come back to a final issue. The

4

Treasury Department, as I understand, has testified that each 10 cents' increase in the price will deter 270,000 youth from taking up smoking over the next five years. And based on this, you project the administration's proposed price increase of \$1.10 per pack will deter three million teens from smoking. As you know, many of us in the Senate support a steeper price increase, \$1.50 a pack within three years. Using the department's youth smoking reduction formula, isn't a fact that an increase of \$1.50 will result in more than a million additional teens deterred from smoking over the next five years?

MR. SUMMERS: That is, going from \$1.10 --

SEN. KENNEDY: Yeah.

MR. SUMMERS: The incremental impact from \$1.10 --

SEN. KENNEDY: To \$1.50.

MR. SUMMERS: -- to \$1.50. We will furnish you a precise calculation, but I think your estimate that multiplying 40 cents times 270,000 per dime, which works very closely, does take you someplace just over a million. Yes.

SEN. KENNEDY: Okay. Finally, Mr. Chairman, I appreciated the

secretary -- appreciate your testimony here, in any event, and what your recommendations are in terms of trying to deal with black marketing. I think it's enormously impressive myself, and very commendable.

I would hope that we could put in the record the real international cigarette prices. They've been provided. They show that Germany is \$3.32, Canada \$3.35, \$3.50 for France, UK \$4.40, Denmark \$5.10, Norway \$6.18. I believe Northern Ireland is up there as well, somewhere between the \$4.40 -- or Ireland is -- and the \$5.10. They still are able to make a profit on those.

MR. SUMMERS: Correct.

SEN. KENNEDY: I want to thank you very much. It's always a pleasure to have -- it's been very, very helpful to us, and I appreciate all of our witnesses here today. Thank you, Mr. Chairman.

SEN. HATCH: Thank you, Senator Kennedy.

Senator Feinstein.

SEN. FEINSTEIN: I thank you, Mr. Chairman. I am not now supporting any particular tobacco settlement version. And the reason is that I think the street-level concerns are really addressed too easily and with not enough relationship to what is actually happening on our borders. I assume we have a closed distribution system now with respect to drugs, and yet we can make an arrest in New York City of four tons of cocaine brought in across the border.

The chief of California's Excise Taxes Division told my staff that smuggling of cigarettes across the U.S. California border today is a major problem and it costs the state an estimated 20 (million dollars) to \$50 million annually in lost state excise tax revenues. The loss in federal excise tax from California alone is estimated to be 13 (million dollars) to \$30 million annually.

So what I'm saying is that today, cigarette smuggling at the border is already a major problem. According to the chief, the smugglers usually purchase less than commercial quantities of cigarettes, less than \$2,400, or 230 cartons, at duty-free shops at the border which have larger quantity limits than airports, with a limit of one or two cartons.



The cost at the duty-free shops are \$8 per carton versus \$15 in regular stores. These cigarettes are then taken to Mexico since they are purchased in duty-free stores and cannot be brought back into the United States, and smuggled back to the United States for resale.

The smugglers usually bring the cigarettes across the border in smaller lots of several hundred cartons hidden in vehicles, and if they're caught, the cigarettes are confiscated and the smuggler often goes free, either because they're not prosecuted and often because they cannot be prosecuted under the requirements of the Contraband Cigarette Act.

So, Mr. Chairman, as we continue to debate the tobacco legislation and the right approach in curbing teen smoking, we must, I think, also look at our current ability to control cigarette smuggling by toughening the Contraband Cigarette Act or risk facing a larger law enforcement problem in the future.

I think, too, when we combine a reduction in nicotine through the FDA with the per-pack pricing of cigarettes, we indeed have a much more complicated problem than anyone here would suggest.

Additionally, you know, this very committee is going to take Section 110 and essentially junk it, which will provide an open exit-entry system all across our Canadian border, all across our Mexican border. And I don't know how we're going to have a closed distribution system, Mr. Summers.

This senator, I must say, has no confidence that we can have a closed distribution system. We can't do it for drugs. How are we going to do it for cigarettes? And you know, once we start to ratchet down that nicotine level and we increase the per-pack price, we're going to be a smuggler's dream house. How can I, representing California, be confident that any of this stuff is going to be stopped at the border?

MR. SUMMERS: Senator Feinstein, let me, if I could, respond very briefly, and then ask my colleagues, who have extensive experience, to respond.

First, we do not have a satisfactory attempt to close the

distribution chain with respect to smuggling cigarettes across the California border today. We do not mark packs for domestic use versus

export use, we do not have a satisfactory set of controls in place with respect to duty-free shops. We would not claim to you that there is a fully satisfactory process in place.

Indeed, in my testimony, I suggested that one of the important benefits from closing the distribution chain, from the kinds of steps that we take, is that the substantial amount of illegal activity that takes place with respect to cigarettes today would be curtailed and that that would be an offset to any increased activity that would be induced.

I would suggest to you, and my colleagues can speak to this more knowledgeably, that while I don't minimize the problem, and you and I have had a chance to discuss before the very serious problems at Otay (sp) Mesa and other places, that the volume-to-value ratio is different by several orders of magnitude with respect to cigarettes than it is with respect to illegal drugs.

SEN. FEINSTEIN: No, but Mr. Summers, you said we could have a closed distribution system. You said, if I understand your testimony, that there won't be a problem. What I'm saying is I don't believe it.

MR. SUMMERS: I'm conceding that there is a problem now. I'm saying that a virtue of a new system that cracks down in an appropriate way at the duty-free shop level and at some of the other points that you mentioned, would make a very substantial positive contribution.

With respect to the ability to -- with respect to the smuggling, the first place to control it is by requiring that any pack of cigarettes that's made in the United States that leaves the United States has to be marked for export and then it's there for all to see that it's marked for export and so there's a real problem if you re-import.

The incentive to bring in -- Americans smoke American cigarettes,

and so the incentive to bring in non-American cigarettes is, in the judgment of the experts in this area, likely to be quite small.

But let me ask Director Magaw and --

SEN. FEINSTEIN: May I ask which experts are saying this, that if we crack down on nicotine, and you've got all these people addicted, you crack down on the amount of nicotine in a cigarette, you raise the

price per pack, and I'm not -- I want to do both -- that we don't create a market and that the likelihood of cigarettes coming in from out of this country is remote?

I mean, my goodness, what is somebody smoking?

MR. MAGAW: Well, there's been no indication at all so far that the American public, whether it's a teenager or a senior citizen, has any interest in the cigarettes that are produced outside this country. The quality is different, the taste is different. And it's anyone's guess as to whether they'll develop that or not, Senator. That's a guess-timate.

But right now, what is being smuggled, for instance, in California, a lot of that is coming from North Carolina and other places. North Carolina has a very low tax, they don't mark their cigarettes at all, it comes all the way across the country. A closed system would not allow that to happen.

When you have a closed system that I as a wholesaler cannot sell to you as a retailer unless we're both licensed, if it comes outside that system, it's very easy for us to see that. In terms of the borders and that, I'd have to defer to Mr. Browning at Customs for that, but what you're having now, we have had an agent in Canada for quite a while trying to help with that situation, and have been fairly successful with it. But this closed system would just not give them the opportunity. If it's not -- if it doesn't meet the requirements, it's going to stick out like a sore thumb.

SEN. FEINSTEIN: Well, why don't we do something about today, the law? I mean, we don't even enforce it.

MR. BROWNING: Actually, Senator, I think -- if I may, Mr. Magaw -- I think, as you are aware, over the last several years, we've made a very concerted effort along our southern tier to try to increase the resources, both from a manpower standpoint and non-intrusive technology standpoint. I think one of the points that the chairman raised early on was that there is no specific component within the FY99 budget for tobacco smuggling initiatives. In fact, there is \$54 million in the president's budget for non-intrusive inspection technology, primarily along our southern tier.

My sense is, Senator, that based on the fact that cigarettes, unlike illicit narcotics, are manufactured legally, and in the process of being manufactured legally, there is a paper trail that is created, it is my sense that working in cooperation with ATF, utilizing the closed distribution system, we should have a much better means of identifying anomalies in the movement of U.S.-manufactured cigarettes across the border and back in.

Senator, I can point to at least two instances in which we have had significant seizures of U.S. cigarettes exported out of the country, exported back in. In one case, we were able to see the cigarettes valued at about \$1.1 million, but we were only able to do it because we recognized that missing from the cigarette package was the surgeon general's warning.

As the deputy secretary has indicated, when those cigarettes are marked for export only, our chances of identifying a product that is reentering the U.S. illegally will be much better increased. I don't think you can ever stop all leakage, Senator. But my sense is that a process and an approach can be developed that will allow us to do a more effective job at addressing this issue.

MR. MAGAW: Senator, if I could make --

SEN. FEINSTEIN: I'll tell you, I could just see this stuff coming through in the line release program, boom, boom, boom. I mean,

I just think we're overly naive when it comes to --

MR. MAGAW: You asked us, Senator, about the enforcement today.

We at ATF and the federal authorities don't have any authority over the chain of distribution. Once it leaves the manufacturer, there is no control over it today.

But we still do enforcement. We usually -- or constantly have about 50 fairly large cases going on within ATF and virtually hundreds within the state. Because of the jurisdiction, because of the manpower and because of the states wanting to do the alcohol and the tobacco themselves, we give them intelligence, in fact, just with New York and other states just a short few days ago, where large seizures were made by the state authorities.

We try to do the intelligence work where it's being tracked down the line and give it to those local authorities so that they can enforce the laws that they have within the states.

So we're trying band-aid solutions right now in order to try to be helpful.

SEN. FEINSTEIN: Thank you. I don't want to take any more time, Mr. Chairman. I mean, I -- this is a huge problem.

MR. SUMMERS: If I could just make one more point very quickly. I think this is a very -- I think it is a critical issue, and we have to work on it.

You made reference, Senator, to the question of low nicotine. I think it should be understood that the focus of this legislation, as we envision it, is on reducing youth smoking. We do not intend to make it -- to try to make it difficult or impossible for the 40 to 50 million adults who are now smokers to obtain cigarettes through any kind of low-nicotine requirement. And so there would not be an effect of that kind, creating an inducement --

SEN. FEINSTEIN: Well, are you saying the administration, then, does not support the FDA over time reducing nicotine in cigarettes, or regulating the contents of cigarettes?

MR. SUMMERS: The administration does support FDA regs -- we're getting out of the Treasury's area so I'm going to speak slightly generally and give you a more detailed answer in writing.

The administration does support FDA regulation of cigarettes in the health -- obviously, in the interest of public health. But it is not our intention to use that FDA regulation as a tool for denying cigarettes to adult smokers.

SEN. HATCH: Well, let me just build -- and then I want to go to Senator Durbin -- building on Senator Feinstein's concerns, I'd like to just point out that it would not be hard for organized crime, or even disorganized crime, to make substantial profits from tobacco contraband with very little effort.

For instance, to supply five percent of the U.S. market, a smuggler would only need to bring in four and a half trailer trucks a day into the United States. And that operation alone would yield an annual profit of \$1 billion.

And you see, I think what we're getting to is, other than the FDA, which the Commerce bill seems to give enforcement power to, and they have no real enforcement facilities to do it, the administration has absolutely no enforcement program because there's nothing in the budget for it. And ATF only has one person assigned. So you can see why this is a matter of great concern to us. I'm just raising this and -- go ahead, Mr. Summers.

MR. SUMMERS: Mr. Chairman, I think you're right with respect to your concern, and I think that we all agree that any legislation in this area will require as a concomitant, a substantial increase in our enforcement effort, which will mean --

SEN. HATCH: But there's nothing there now, and I might add that the enforcement under the Commerce bill seems to come from FDA, which is, I think, totally unqualified to handle the enforcement.

Now, in some ways, on the drug aspect, they may have some qualifications, but not what we're talking about here today.

We've got to go to Senator Durbin.

SEN. LEAHY: Well, I just want to add on that point, though, I mean, you talk about there's no enforcement. One, there is enforcement. There's a lot of people on the border already. There's a lot of technical things that have been done.

SEN. HATCH: Not on this issue, there isn't.

SEN. LEAHY: On tobacco smuggling. They check for tobacco smugglers on the border between Vermont and Canada, I know, all the time.

But also, let's not put the cart before the horse. We haven't passed any tobacco legislation. You keep talking about what kind of enforcement there's going to be if we have this tobacco legislation. So far, Congress hasn't passed any tobacco legislation. And I cannot believe that as part of the package if we ever do pass tobacco legislation, there'd be (may mean he can't believe there wouldn't be) a strong enforcement component in it.

SEN. HATCH: Well, that's a good point, but we're talking about the only bill on the floor right now, and that's the Commerce bill. And we want to at least point out that there are many deficiencies there.

Senator Durbin.

SEN. RICHARD DURBIN (D-IL): Thank you, Mr. Chairman. I think everyone's come to appreciate what being toward the end of the panel means. You are the last to ask questions and you get the worst camera angles.

(Laughter.)

SEN. LEAHY: Senator Durbin, would you like to take my seat? I'll sit over there.

(Laughter.)

SEN. LEAHY: I'm serious.

SEN. DURBIN: No, I have a passion for anonymity. (Laughter.)

Let me just say on the question of nicotine content, from the start, I believe the administration has been sensitive to the fact that we do have 50 million people who are addicted at some level or another to nicotine. And the thought that we would either dramatically reduce or eliminate nicotine from cigarettes is not in

the cards.

At this point, we have to accept the reality that this is going to take some time before America's smoking rate starts to decline, not just because of the smuggling problem -- and I think Senator Feinstein is right; if there was a precipitous decline in nicotine content, it would invite that smuggling -- but also because it's, first, politically unpopular, and (second), physically impossible to achieve. No one has ever set this out as a goal nor should we accept this as a premise for any tobacco legislation. I believe the FDA should have jurisdiction. I think it's one of the few federal agencies that has shown real courage when it comes to the health side of this issue.

If anybody on this panel has a better suggestion of another agency to take over enforcement, I'll listen to it. But to this date, the FDA has been showing real leadership in the -- in light of the determined resistance from the tobacco industry.

But I want to go after one element here. When we start talking about smuggling and organized crime, I want to ask Mr. Summers, Secretary Summers, is it not true that there is ample evidence that the wholesale smuggling in the past has not been at the behest as much of organized crime as of the tobacco industry itself? Haven't tobacco companies, even before we put in place the licensing that we've been talking about, been shown to have been complicitous in some of the smuggling efforts between the United States and Canada and the United States and Europe?

MR. SUMMERS: I think it would be fair to say that in some

instances, there was complicity, yes.

SEN. DURBIN: Let's use as an example the Canadian case. And this comes from the Campaign for Tobacco-Free Kids. I give attribution to a group that I work with all the time. In Canada, over 90 percent of the contraband market was comprised of cigarettes manufactured in Canada, exported to the United States to avoid higher Canadian taxes, then smuggled back into Canada. After the tax increased, Canadian tobacco companies exported unprecedented quantities of cigarettes into border areas of the United States,



knowing they'd be illegally smuggled back into Canada.

They also changed how they shipped them to make them harder to trace, changed how they packaged them to make them harder to identify. Once the industry was successful in getting taxes lowered in Canada, Canadian tobacco exports fell again.

There are other illustrations here of this smuggling activity into Europe and other places, and I think you've said in your testimony, if I'm not mistaken, that once we put in place a licensing system, it is clear that no large-scale smuggling could occur without the manufacturers' knowledge. Is that not true?

MR. SUMMERS: Senator, I would very much agree with you. There is no way in our judgment that substantial smuggling of the tobacco products that Americans appear to want to consume, American tobacco products, could possibly take place without the complicity of those who were involved in the industry. And as long as those who are involved in the industry are constructive in resisting black markets or are inducted to be constructive by the threat of penalties, it is very difficult to see how you could have smuggling on any kind of a substantial scale.

That doesn't mean you wouldn't have an occasional instance of a tobacco equivalent of moonshine, but the overall control, I think, is very much within the capacity of the industry to influence, and I think it is fair to say that at some points in the past, there is at least good reason to think that the industry has not been fully sharing the law enforcement's objective of minimizing the extent of smuggling and diversion in tobacco products.

SEN. DURBIN: And so we have evidence that smuggling in the past, in the Canadian example and others, has been at least with some knowledge of the tobacco companies and some complicity by at least

some of their employees. I mean, I think that is a fair statement to make.

MR. SUMMERS: Yes.

SEN. DURBIN: We know now that if we are going to have any kind of effective effort at enforcement to reduce smuggling in the future, it will take the cooperation of tobacco companies, which frankly have walked away from the table, said that the Commerce Committee bill is unacceptable, and they've decided to exercise, I suppose, in their own mind their right to veto legislation, which I don't believe they have.

Now, I understand this, I think most people do here today, that this is not a trustworthy group. And if we are relying on the good faith and good intentions of the tobacco industry, we're bound to be disappointed. That's why I think we have to build into the law, as the Commerce Committee does, licensing requirements and penalties to be paid if there is evidence of smuggling.

And I think what the secretary has said here in testimony is that with the cooperation of the tobacco companies, either voluntarily or involuntarily, that we have some chance to control this problem. But to throw up our arms and say we have to walk away from this problem for fear that there may be smuggling is very short-sighted. I thank you for your testimony today.

SEN. HATCH: Well, thank you, Senator.

Let me just say this, Senator Leahy. I just have a couple comments to make. Before our Treasury witnesses leave, let me just make a couple of points that I think are important.

I earnestly want to work with the administration to resolve these problems. There's no question about it. And I believe I speak for most, if not all members of the committee in saying that it's abundantly clear that price is an important factor in whether increased tobacco contraband is going to occur.

Secretary Rubin is aware that I have attempted to get detailed information on how the Treasury made its estimates. And I appreciate very much the efforts of Treasury officials and White House staff to brief my staff on this, but I think it's fair to say that that table that we had up here, provided in response to my written request for a Treasury model, is very scant on detail.

So that's why I've asked you to give us more than that. This table is pathetic, really. I've learned to not use the word pitiful anymore, but --

(Laughter.)

SEN. HATCH: -- if that is the extent of a Treasury model for a calculation which could have such a profound impact on America, on our economy and on each of our citizens, then I think we ought to just wrap up this exercise right now because I think it would be an exercise in futility if that's all we have.

Now, concerns have been raised, and I believe valid concerns, about the assumptions underlying Treasury's calculations and assumptions. And in sum, there appear to be some glaring discrepancies here. And I think it's incumbent upon us in Congress to pursue this and get to the bottom.

Now, I'd just like to point out that there are -- just for my colleagues on the committee, there are 230 companies around the world who manufacture tobacco products and cigarettes who have absolutely no affiliation with the U.S. manufacturers. I showed this contraband package of Chinese cigarettes. One of the problems is that there are all kinds of gives and takes here. If you reduce the nicotine content, then people are going to want to buy the contraband, which has no standards at all. And so you lend even more support to the racketeers and criminals and Mafia and everybody else to get into the business.

So what we're talking about here today is pretty darn important. The president uses the tobacco, quote, "proceeds," unquote, in his Fiscal Year 99 budget for other programs. My point is why not law enforcement? And why doesn't he have something in there on law enforcement? Then all of this, you know, does make me wonder who's watching the store over there at Treasury, because I've been over at the Finance Committee's hearings on the IRS, where we're hearing story after story of innocent Americans who have been wrongfully pursued and wrongfully treated by overzealous IRS agents.

Now, maybe some of these people ought to be assigned to this, where they can really get their teeth into some people who deserve it.

(Laughter.)

SEN. HATCH: And my point is that it's nice to talk about -- I

think \$3.53 is a pretty high price, but on the other hand, if I thought I could get away with it, I'd charge 10 bucks a pack if it wouldn't create contraband, wouldn't create a black market. And unfortunately, we're reaching a point where if the Wall Street analysts are correct, and we'll have to hear what they have to say, we may have a situation where not only are you going to be able to run, Director Magaw and Mr. Browning, but we're going to have a big, big problem on our hands.

So these pricing considerations are very, very important. And you just -- and in order to really accomplish something, it's coming home to me, we need to have these companies on the hook. They need to be part of the settlement. That's why the attorneys general agreement, in my opinion, was a monumental achievement of something we ought to try to model or emulate instead of just piling on and getting a situation where we have a big black market, racketeering and all the rest, murders and everything else, and in the end, the American people are going to have even lower quality cigarettes than we have now.

Well, enough said. But these are concerns I have. But having said that, I intend to work with the administration, with you, Mr. Summers, as I always have, to try and get this done right and get it done where we do the very best we can to solve all these problems. And I hope our colleagues -- I think our colleagues on the committee will also try to do the same.

Senator Leahy, I didn't mean to take --

SEN. LEAHY: No. Aside from any type of questions of advertising or anything else like that, if the question is, do we need the companies to agree to obeying the laws against smuggling and black marketing and everything like that, I could care less whether they agree to it or not because I've heard their statements in the past, many of which we discount quickly because they now tell us they didn't tell the truth.

But that's not the issue. I mean, that's sort of like saying to people, will you agree not to break into a warehouse, all the people in this area? If you all agree to that, we won't bother to lock the

doors, we won't bother to put lights on and we won't have any police officers. The fact of the matter is we don't ask agreement on that. We lock the doors and we have the police stand by.

I have to assume that most people want to obey the law. I also, having spent almost nine years in law enforcement myself, I know that it helps to have good, strong, effective law enforcement there.

In the tobacco legislation that's on the floor now from the Commerce Committee, it does have a title on tobacco smuggling. It requires tobacco manufacturers to print serial numbers and the country-of-final-destination label on all their products. I would have to assume that that would be helpful on the question of smuggling, and I see by the nods of our panel that they agree also. It provides for stricter tobacco export permits and bonding requirements. And I'm sure that we could think of some other things that could be added. I mean, we're talking about legislation that's now moving its way through the Congress.

I have a great deal of confidence in the three witnesses here before us today, Mr. Chairman, and I think they've come up with even more suggestions. But we can label, we can number, we can bond, and we can use technology that has improved enormously on being able to catch smugglers.

So I would not want to see -- and I know this is not the chairman's suggestion, but I would not want to see legislation get diverted because we fear our ability to stop smugglers. I'm convinced we can do it. I know we can do it. I know we would certainly -- I'm thinking of the Canadian end -- we'd get cooperation from the

Canadians, as we do today on a whole lot of issues, including some that we would not discuss here in an open session.

SEN. HATCH: Thank you, Senator Leahy.

I want to thank you, Mr. Summers and Mr. Magaw and Mr. Browning, for being with us. And I know it's been a pain for you to be here, having traveled back so quickly and so forth. You go all over the world and represent us well, and we appreciate your attempts to help us here today.

MR. SUMMERS: Thank you.

SEN. HATCH: And hopefully, we can get this done.

MR. SUMMERS: Thank you very much, Mr. Chairman. And I know I speak for all my colleagues in the administration in appreciating your very great emphasis on a constructive, cooperative approach to getting this done, which I think is so very important. And I think working together, a nation that can accomplish what this nation has accomplished in so many spheres can find a way to do this while the controlling contraband problem, but I think there is no question that it will take resources and careful thought, and I think there's no question that it will take a belt and suspenders approach that involves controls at several levels.

We look forward to working with you and other members of your committee on this issue and on the many other difficult issues that are necessary to achieve what I think we agree is a very compelling end, the substantial reduction in the scourge of youth smoking.

SEN. HATCH: Well, thank you for that statement.

MR. SUMMERS: Thank you very much for having me.

SEN. HATCH: We're in total agreement, and we're going to do everything we can to work with you and help get this done and work with Senator McCain or anybody else, for that matter, and try and get this done right. But we've got to find some way that we stop people from piling on in ways that actually are counterproductive rather than productive.

And I think the administration can play a significant -- the most significant role in this. So I hope that we can work together.

MR. SUMMERS: We'll be looking for win-win solutions.

SEN. HATCH: Thanks so much for coming.

MR. SUMMERS: Thank you very much.

SEN. HATCH: Thanks for being here.

Now, we're going to call on those on panel 2 now, and I appreciate each of your cooperation in bearing with us. Scheduling of this hearing has not been easy.

In particular, I want to note that Mr. Martelle missed his anniversary yesterday, so the committee offers its apology to Mrs. Martelle.

We also want to thank Mr. Adelman, who was able to appear on a very, very short notice.

So our three witnesses, in this order -- if we could have order -- (pounds gavel). Thank you.

(Pause.)

SEN. HATCH: Okay, our witnesses will be in this order. John Hough, who is senior assistant attorney general of the state of Washington; David Sweanor, the senior legal counsel of the Non-Smokers Rights Association of Ottawa, Ontario, Canada; Ron Martelle, the former mayor of Cornwall, Ontario, Canada; and David Adelman, the financial analyst for Morgan Stanley Dean Witter in New York.

So, Mr. Hough, we'll begin with you. We'll go to you, Mr. Sweanor, then, and to Mr. Martelle. We welcome you from Canada and hope you're enjoying yourself in your country. We always enjoy ourselves in yours. And Mr. Adelman, we're grateful to have you here as well. Mr. Hough.