An Economic Critique of SB17-139

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Under consideration this session is Senate Bill 17-139, which aims to permanently extend the tax credit for tobacco products that a distributor ships or transports to an out-of-state customer. The tax credit was created in 2015 when the General Assembly passed the Cigar On-line Sales Equalization Act. It applies to cigars and other tobacco products, excluding cigarettes. The current sunset date on the tax credit is September 1, 2018 unless SB17-139 passes.

The rationalization for SB17-139 is conveniently outlined in the Cigar On-line Sales Equalization Act itself. Under the initial bill, HB15-1301, the General Assembly declared three distinct reasons for why it deemed the tax credit for out-of-state tobacco sales necessary. (1) Out-of-state consumers that purchase tobacco products are already subject to his or her state's sales tax. (2) Colorado distributors are at a competitive disadvantage to distributors in other states where excise tax is not assessed to out-of-state sales. (3) Granting tax credit presents an opportunity to facilitate growth of the online cigar industry in Colorado and give Colorado business a price advantage in the market place.

This analysis attempts to reconcile the thinking that led to the creation of the Cigar On-line Sales Equalization Act with actual economic outcomes. The arguments for extending the tax credits under the Act seem sound at face value. However, under the scrutiny of economics they fall short of a compelling case.

Three counter-arguments will be presented and explained in this analysis. First, claims that distributors and consumers of tobacco face double taxation are exaggerated and not typical of what we see empirically in the online cigar market. Second, the apparent price advantage Colorado distributors receive under the Cigar On-line Sales Equalization Act is almost certain to be short-term, while creating more complex problems for the State in future years.

Lastly, the Cigar On-line Sales Equalization Act is a tax incentive, which prioritizes the interests of certain beneficiaries at the cost of others while creating exacerbated market imperfections.

The primary argument for the retention of the Cigar On-Line Sales Equalization Act is that the excise tax on cigars and other tobacco products was never intended to apply to out-of-state sales. The rational is that the 40% tax levied on the distributor in Colorado should not apply because out-of-state customers are already responsible to pay their own state's sales tax. The result is a double taxation that puts Colorado distributors at a steep price disadvantage.

When excise tax is not directly applied to the distributor in the state of origin, it creates a difficult administrative issue. The statutory incidence of tax falls on consumers through sales tax, not on the supplier. Consumers are legally supposed to remit their state's sales tax on tobacco products that are bought online or out-of-state (Federation of Tax Administrators). However, it is difficult for states to investigate and enforce these tax bills. According to the Federation of Tax Administrators, many consumers get away paying no tax at all.

In *Quill v. North Dakota,* the Supreme Court ruled that a state could not force a business to collect state taxes if its primary operation or headquarters is not located within the state (Atkin). This means states have little choice but to rely on consumers to self-assess tax owed on tobacco products they buy from out-of-state suppliers. Consumers find it fairly easy to evade their tax obligations since it remains difficult for state governments to keep track of out-of-state purchases with companies under no obligation to assist (Graff).

Strides have been made in a few states to compel companies to report their out-of-state sales to states that seek to collect their respective taxes from customers. Still, these efforts have been limited in both number and scope (Chen). A few states have passed laws requiring online sales be reported, but the decision in *Quill v. North Dakota* gives distributors legal precedent to snub state officials (Graff). Most states simply do not have the resources to track and collect the taxes from individual consumers. To truly enforce excise tax on cigars and tobacco, states "must find the staff power to calculate individual tax obligations, generate tax bills, and pursue residents who decline to pay" (Graff). Increased enforcement remains both implausible and politically unacceptable in most jurisdictions around the country.

The Colorado General Assembly should consider that administratively it makes more sense to apply excise tax to the tobacco distributor in interstate situations. Otherwise, in many cases, no tax is being paid at all. This should be rather alarming for those who believe tobacco is rightly taxed by government. In practice, the Cigar On-line Sales Equalization Act does not eliminate double taxation, but instead helps facilitate known tax evasion on cigars and other tobacco products in out-of-state transactions.

One might argue that abetting tax evasion in other states is not necessarily a problem for Colorado. In fact, the goal was to give Colorado distributors a competitive advantage in the online industry. Without having to assess the 40% excise tax themselves, online distributors in Colorado could charge a lower price knowing they would attract out-of-state buyers looking to find lower deals than what is available in their state. If out-of-state residents believe it is unlikely to be forced to pay their own state's sales tax, this is good for Colorado distributors.

This type of thinking may be rational in the short-term. However, if other states think economically they could enact their own laws eliminating their excise tax on out-of-state sales as well. This would negate any advantage that Colorado distributors enjoyed. In addition, Colorado then faces the same tax collection issues other states face.

Here is where the Cigar On-line Equalization Act misses the real problem the online tobacco industry creates. Other states that eliminate the excise tax obligation on out-of-state sales put Colorado distributors in a disadvantaged situation. Consumers in Colorado likely have the same incentive to find cheaper tobacco products across state lines or on the Internet. In-state purchases are still subject to the 40% excise tax the State of Colorado assesses. If other states pass measures similar to the Cigar On-line Equalization Act, their cigar distributors are then more attractive to Colorado residents who believe they too, can avoid paying taxes.

This creates a pressing issue for Colorado that SB17-139 does not address. Colorado, like other states, is ill equipped to assess sales tax on all tobacco purchases made out-of-state or online. Stimulating the growth of the online cigar market may in the long-term come at expense of both Colorado distributors who do business in state and the State of Colorado who relies on revenue from excise tax on tobacco.

This leads to the third and final argument against SB17-139. The Cigar On-line Equalization Act is essentially a tax incentive created to attract online tobacco distributors to Colorado. The tax credit heavily favors online distributors, while ignoring in-state brick and mortar shops and local Colorado companies.

Furthermore, it is not immediately clear why online distributors are deserving of preferential tax treatment. Tobacco is rightly taxed. It creates a negative externality that produces a social cost. Additionally, the excise tax on tobacco products in Colorado is not an extreme price to bear. In fact, it is on par with the national average, 39.6% (Cigar Taxes By State 2017). It is reasonable to expect that online distributors pay the same excise tax that local Colorado sellers do. This is especially true when tax evasion, the primary reason people buy tobacco online, allows online distributors to operate essentially tax-free.

The Cigar On-line Equalization Act's intent is to remedy a purported market imperfection citing that online tobacco distributors are treated unfairly when doing business with out-of-state customers. However, in practice, it only exacerbates the market imperfection that online tobacco sales create. Online distributors operate on the belief and practice that tax on out-of-state tobacco sales is difficult for state governments to enforce. In turn, tobacco consumers buy out-of-state product instead of buying products that are easily and properly taxed. The result is economic inefficiency. Producers and consumers in the market are not all on a level playing field.

The Cigar On-line Equalization Act singles out online tobacco distributors as a beneficiary for the tax credit on the basis that doing so will expand the industry in Colorado. The rational is that this will create economic and job growth. This thinking fails to realize that the result is most likely zero-sum. The economic benefits realized by online distributors are at the cost of local businesses that are non-beneficiaries and state funds that are hurt by tax evasion.

The benefits from the tax credit realized by distributors, estimated at $12,000 per year, are unlikely to spur any significant economic growth (SB17-139 Fiscal Note). Helping business encourage tax evasion seems to create little economic benefit for the state as a whole. It is not appropriate for the General Assembly to choose an industry winner, when the potential costs outweigh the benefits only enjoyed by a few. In short, the Cigar On-line Equalization Act is simple redistribution to those who are not necessarily in need.

The Colorado General Assembly should reconsider extending the tax credits presented under the Cigar On-Line Equalization Act and vote no on SB17-139. The bill looks to save online tobacco distributors from a double taxation that is not realized in practice. The short-term benefit of increased presence of online distributors in Colorado is not worth exacerbating issues of out-of-state tax evasion that all states must deal with. Finally, online distributors of tobacco products are not necessarily deserving of a tax incentive that damages other like producers and Colorado taxpayers.

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