Sage Policy Group, Inc.

Increasing Maryland's State Tax Revenues while Enhancing Tax Fairness: The Case for Equal Tax Treatment for Sellers of Cigars

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Increasing Maryland's State Tax Revenues while Enhancing Tax Fairness:
The Case for Equal Tax Treatment for Sellers of Cigars

Executive Summary

<u>An Instance of Unequal Taxation</u>

Since 2000, the State of Maryland has imposed a 15 percent excise tax on 'other tobacco products' (OTPs) including premium cigars at the wholesale level. There is also the more general 6 percent retail sales tax. While one of these tax rates applies to the wholesale level and one to the retail level, the implication of these tax rates is that the tax on wholesale prices is at least 21 percent. Moreover, effective July 1st, 2012, the tax rates on small cigars and OTPs were increased to 70 percent and 30 percent, respectively.

Importantly, current law excludes out-of-state online and direct mail sellers from these excise taxes. Consequently, Maryland's cigar retailers face unfair price competition from sellers located in other states. The recent increases in taxation on small cigars and OTPs have served to create an even more uneven competitive playing field. In addition to creating unfair competition, the State of Maryland is foregoing substantial tax revenues due to the excise tax exclusions.

Accordingly, on behalf of the International Premium Cigar & Pipe Retailers Association, Sage Policy Group, Inc. (Sage) conducted this study to investigate the economic implications of unequal tax treatment on local sellers of premium cigars as well as on the State's finances. More specifically, this report attempts to provide precise estimates of the level of tax revenue lost due to current tax policy. The study does not attempt to quantify the impact of unequal tax treatment on the small cigar and OTP markets.

To obtain information necessary for the analysis, the Sage study team conducted a survey of Maryland's premium cigar retailers. The study team also used estimates derived by other scholars to determine the impact of shifts in tax policy on purchases of cigars (i.e., measures of elasticity). Below are Sage's key analytical findings:

- Differences in tax rates between states have served to increase interstate commerce in cigars due to associated arbitrage opportunities;
- Retail prices are extremely sensitive to differences in tax rates between states;
- Between May 1st and June 20th, the State of Maryland temporarily banned interstate shipments of cigar products and OTPs in 2011. During that time, survey participants reported a 16.7 percent year-over-year increase in in-store sales;
- Sage estimates that equal tax treatment will generate an additional $2.2 million for the State's treasury per annum;

<u>Conclusion – An Opportunity for Better, Fairer Tax Policy</u>

Rarely do State policymakers have an opportunity to 1) vastly increase tax fairness; 2) increase the size of the local economy; and 3) increase State tax revenues with a single policy. This study identifies just such an opportunity. State policymakers should consider applying tax rates presently applicable to in-state retailers of premium cigars to those who sell into the State via online or direct mail mechanisms. This means that those out-of-state sellers would pay a 15 percent excise tax at the wholesale level.

Increasing Maryland's State Tax Revenues while Enhancing Tax Fairness:
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Introduction

<u>Purpose</u>

The federal government first implemented a tobacco excise tax in 1862. Over time, the practice has become virtually ubiquitous. Presently, all 50 states with the exceptions of Pennsylvania and Florida impose excise taxes on both cigars and other tobacco products (OTPs).[1] Excise taxes on tobacco products have become an important source of revenue for federal and local governments. According to the nonpartisan Tax Policy Center, it is estimated that tobacco excise taxes contributed approximately $17.2 billion in revenue to the federal government in 2010.[2] State governments cumulatively raised $17.3 billion in revenue from excise taxes on tobacco products that year.[3]

From a public policy perspective, there are a number of considerations that help explain the popularity of tobacco taxes among policymakers. These taxes fall within the general category of sin taxes and are often supported on the basis that they deter harmful behavior. However, given the known inelasticity of these products (consumption does not respond proportionately to increases in price), this explanation seems partial at best. The fact that people continue to use these products even in the face of large increases in taxes over time render tobacco taxes a relatively effective way to generate revenues under the right circumstances. However, excessive taxation can trigger smuggling and other forms of tax avoidance.

Since 2000, the State of Maryland has imposed a 15 percent excise tax on 'other tobacco products' including premium cigars at the wholesale level.[4] There is also the more general 6 percent retail sales tax. While one of these tax rates applies to the wholesale level and one to the retail level, the combined implication of these tax rates is that the tax on wholesale prices is at least 21 percent. Moreover, effective July 1st, 2012, the tax rates on small cigars and OTPs were increased to 70 percent and 30 percent, respectively.

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[1] TMA.(June 1st 2012). Tobacco Tax Guide. NOTE: Pennsylvania taxes little cigars at the same rate as cigarettes. Florida imposes taxes on OTPs.
[2] Tax Policy Center. (March 2nd, 2012). *Historical Excise Tax Receipts,* (Composition of excise tax receipts: 1940-2016). Retrieved on December 11th, 2012, from http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=561&Topic2id=80
[3] Tax Policy Center. (October 15th, 2012). *Tobacco Tax Revenue*. Retrieved on December 11th, 2012, from http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=403
[4] Office of Policy Analysis, Department of Legislative Services. (November 14th, 2002). Tobacco Tax. *Overview of Maryland's Tax Structure.* Presented to the Commission on Maryland's Fiscal Structure. Retrieved on December 19th, 2012, from http://msa.maryland.gov/megafile/msa/speccol/sc5300/sc5339/000113/003000/003142/unrestricted/20066516e.pdf , p.26.

While the State of Maryland has chosen to impose high taxes on in-store sales taking place within the State, online and direct mail sellers located out-of-state are excluded from taxation by law. In order to investigate the economic implications of unequal tax treatment on local sellers of cigars and associated loss of State tax revenue potential, the Maryland International Premium Cigar & Pipe Retailers Association hired Sage Policy Group, Inc. (Sage) to conduct a study of Maryland's market for premium cigars. This report provides estimates of the level of tax revenue lost due to market penetration of both online and direct mail services located out-of-state. Primary data were collected using a survey of retailers who sell premium cigars and OTPs in Maryland. Survey questions were heavily focused on shifts in sales patterns over the past few years. The study team received responses from approximately one-third of the total statewide industry.

I. A Brief History of Cigar Taxation in the U.S.

Although the consumption of tobacco products did not become widespread until the mid-19th century, tobacco excise taxes had been contemplated since the nation's birth. Alexander Hamilton, the first secretary of the U.S. Treasury, suggested an excise tax on tobacco products shortly after independence and it was formally passed by Congress in 1794 (only to be repealed immediately afterwards). The proposition was resurrected in 1862 when the federal government implemented a series of new taxes, including an excise tax on tobacco products in an effort to finance a widening budget deficit after a prolonged period of civil war.[5]

While the practice of taxing cigarettes has been long-lived, policymakers have been relatively less concerned with cigars. For instance, cigars have been exempted from many of the regulations that apply to cigarettes. The 1970 Controlled Substances Act excluded cigar products from the definition of "controlled substance." Cigar products are also exempt from labeling requirements that make it mandatory to provide health warnings to consumers. These requirements only apply to cigarettes and smokeless tobacco.[6] Many states did not impose a tax on cigars until the late-1990s although cigarette taxes were quite common decades earlier. Iowa

[5] McGrew, Jane L. (n.d.). *History of Tobacco Regulation.*(Prepared for the National Commission on Marijuana and Drug Abuse).Retrieved on December 10th, 2012, from http://www.druglibrary.org/schaffer/library/studies/nc/nc2b_3.htm.
Based on archeological records, tobacco is believed to have originated in the continent of Americas, though the exact location remains unknown today. By the time of the first European arrivals in the late 15th century, the cultivation and consumption of the product had been extended to the Caribbean islands. Interestingly, the term "cigar" is similar to "cigarro" in Spanish and is believed to have been derived from the ancient Mayan-Indian term, *sikar*, meaning "smoking." After tobacco plants were brought back to Europe by Spaniards and other European settlers, the habit of smoking spread rapidly around the continent. The first cigar that is similar to what is known today appeared in Spain during the early part of the 18th century. Until 1817, Spain monopolized the Cuban cigar market by mandating all tobacco exports to be registered in its port city, Seville. In the United States, the popularity of cigars steadily rose as the nation's middle-class accumulated wealth during the mid-19th century. Today, it is estimated that 5.4 percent of American adults smoke cigars.

[6] Connolly, Gregory N. (1998). Policies regulating cigars. *Smoking and Tobacco Control Monograph*, No. 9. Retrieved on January 5th, 2013, from http://cancercontrol.cancer.gov/tcrb/monographs/9/m9_8.PDF

became the first state to impose tax on tobacco products in 1921 and other states immediately followed suit. By 1970, all 50 states and the District of Columbia had adopted a cigarette tax.[7] Cigar taxes, on the other hand, had been implemented in only 22 states by that time. That said, the number of states levying cigar taxes has been rising ever since. By 1996, the number of states with cigar taxes had risen to 41.[8]

The federal tax reform implemented in April 2009 entailed 'the largest federal tobacco tax increase' in history.[9] Under the provisions of Children's Health Insurance Program Excise Reauthorization Act of 2009 (CHIPRA), rates were raised for a variety of tobacco products, including for both cigarettes and cigars. The largest increases in tax rates among cigar products were experienced by two segments: 1) roll-your-own cigars (from $1.096 to $24.78 per pound) and 2) small cigars ($1.828 to $50.33 per 1,000 units sold).[10] The tax rate on large cigars increased from 20.719 percent of sales price to 52.75 percent of sales price. As a reflection of the tax hikes, the prices of tobacco and smoking products rose 24.1 percent between 2008 and 2009 and 10.6 percent between 2009 and 2010. This occurred during periods associated with significant macroeconomic weakness.[11]

In response to taxation, consumption of tobacco products has declined. The consumption of all tobacco products (including cigarettes and cigars) fell an average of 2.5 percent annually between 2004 and 2011. The rate of decline accelerated to more than 5 percent after 2008 for two years, but sales volume then essentially stabilized in 2011.

Exhibit 1: Tobacco Product Sales (in billions of sticks), 2004 – 2011

Fiscal year	**Cigarettes**	*Roll-your-own*	*Pipe*	*Small cigars*	*Large cigars*	***Subtotal***	**Total: cigarettes & OTPs**	**% ch.**
2004	372.24	6.02	1.96	2.49	4.17	14.64	386.88	-0.9%
2005	367.23	7.16	1.79	3.45	4.39	16.78	384.01	-0.7%
2006	363.01	8.10	1.77	4.15	4.54	18.56	381.58	-0.6%
2007	356.05	8.37	1.58	4.58	4.57	19.10	375.15	-1.7%
2008	337.64	9.68	1.55	5.34	4.76	21.33	358.98	-4.3%
2009	316.40	7.96	4.31	3.35	6.88	22.50	338.90	-5.6%
2010	296.23	3.03	10.25	0.91	9.88	24.07	320.29	-5.5%
2011	288.50	2.56	15.02	0.80	10.27	28.65	317.14	-1.0%

Source: Government Accountability Office; U.S. Department of Treasury

[7] McGrew, Jane L. (n.d.). Id.
[8] Connolly, Gregory N. (1998). Id.
[9] Koch, Wendy. (April 3rd, 2009). Biggest U.S. tax hike on tobacco takes effect, *USA Today*. Retrieved on January 2nd, 2013, from http://usatoday30.usatoday.com/money/perfi/taxes/2009-03-31-cigarettetax_N.htm
[10] Alcohol and Tobacco Tax and Trade Bureau. (n.d.) *Federal excise tax increase and related provisions.* Retrieved on December 10th, 2012, from http://www.cdc.gov/mmwr/preview/mmwrhtml/mm6112a1.htm
[11] Bureau of Labor Statistics. (n.d.) *Consumer Price Index – All Urban Consumers* (Tobacco and smoking products). Retrieved on December 10th, 2012, from http://data.bls.gov/cgi-bin/dsrv

In addition to the decline in overall sales, the 2009 CHIPRA triggered a significant shift in consumption patterns by creating disparities among tax rates on different products. According to an analysis conducted by the Government Accountability Office (GAO), sales of roll-your-own cigars declined 62 percent between FY 2009 and 2010. During the same period, sales of pipe cigars, a category in which the tax rate increase was limited to less than $2, rose by 47 percent.[12]

The GAO's analysis also concludes that the Act caused a market shift from small cigars to large cigars. Between FY2009 and FY2010, sales of small cigars declined 73 percent while large cigar sales rose 44 percent. Exhibit 1summarizes shifts in consumption over time.

<u>Recent State Tax Policies Regarding Tobacco Products</u>

With many states still wrestling with harsh fiscal realities, excise taxes on tobacco products continue to represent a popular option. According to the Centers for Disease Control and Prevention (CDC), nine states raised their cigarette taxes in 2010 and 2011. Rates vary among the states, ranging from the lowest rate of 17 cents per pack in Missouri to $4.35 per pack in New York. Overall, the average cigarette excise tax among all states rose from $1.34 to $1.46 per pack between 2009 and 2011.[13]

Taxes on cigars (particularly large or premium cigars) and OTPs are differentiated from cigarette taxes in the majority of states although small cigars are taxed as cigarettes in 16 states. According to the Tobacco Merchants Association (TMA), in 2012, 48 states (including the District) imposed taxes on both cigars and OTPs. In two states, Pennsylvania and Florida, not all products are taxed. In Florida, cigars are untaxed. The State taxes OTPs at 85 percent of wholesale price. Pennsylvania has no taxes on large cigars and OTPs, but small cigars are taxed at the same rate as cigarettes.[14] As of September 2012, Wisconsin imposed the highest cigar tax at 100 percent of manufacturers' price, followed by Colorado (95%) and Vermont (92%).[15]

Differences in taxes and fees among states result in varying retail sales prices for cigar products. Exhibit 2 compares the retail box prices of Avo products (a globally known brand) sold in four different states with varying tax policies. The same cigar products are sold at lower prices in

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[12] Government Accountability Office. (April 18th, 2012). *Large disparities in rates for smoking products trigger significant market shifts to avoid higher taxes* (GAO 12-475).Retrieved on December 10th, 2012, from http://www.gao.gov/assets/600/590192.pdf

[13] Center for Disease Control and Prevention. (March 30th, 2012). State Cigarette Excise Taxes – United States, 2010-2011.*Morbidity and Mortality Weekly Report*.61(12), p.201-204. Retrieved on December 14th, 2012, from http://www.cdc.gov/mmwr/preview/mmwrhtml/mm6112a1.htm

[14] Tobacco Merchants Association. (June, 2012). *Tobacco tax guide*.p.7-18.

[15] Campaign for Tobacco-Free Kids. (February 10th, 2010). *State excise tax rates for non-cigarette tobacco products.* Retrieved on December 12th, 2012, from www.tobaccofreekids.org/research/factsheets/pdf/0169.pdf

Pennsylvania and Florida where there are no taxes on cigars. The average price of seven Avo products in Pennsylvania is roughly $109 lower than in New Jersey.[16]

Exhibit 2: Prices of Avo ($ per box) by Brand in Six States

	New Jersey	**Florida**	**Oregon (in-state prices)**	**Pennsylvania**
*Tax Policy**	*30%*	*No Tax for Cigars/85% for some OTPs*	*65% $.50 cap*	*No Tax*
Avo Brands				
No. 2	$258.75/box	$218.25/box	$238.65/box	$145.99/box
No. 3	287.50	243.00	264.50	161.99
No. 5	255.30	216.00	236.40	143.99
No. 9	226.55	191.25	210.50	127.99
Corona	200.10	171.00	173.40	113.99
Robusto	236.90	202.50	220.65	134.99
Piramides	287.50	243.00	264.50	161.99
Average price of Avo products	**250.37**	**212.14**	**229.80**	**141.56**

Source: International Association of Premium Cigars Distributors; *Tax rates apply to wholesale price.

<u>Interstate Trade of Tobacco Products: Opportunities for Additional Revenue Source</u>

Different tax and fee structures among states have predictably resulted in growing interstate trade of tobacco products as consumers search for relief from ever-rising tax rates. California suffered a loss of sales when that state raised taxes on OTPs to 61.53 percent from less than 30 percent of wholesale price in 1998. During the 4-year period between 1998 and 2002, sales of tobacco products (other than cigarettes) in California declined at an annual average rate of 12.3 percent. Arizona and Nevada, where tax rates did not change significantly, experienced sales increases. In 2002, sales of premium cigars were up 16.8 percent in Arizona and 19.3 percent in Nevada.[17] The implication is that raising taxes does not generate a proportionate increase in tax revenues. In fact, states that increase tax rates often allow neighboring states to collect more revenues by simply maintaining constant tax rates.

Occasionally, implementing a cap on tax rates can actually result in higher revenues. Oregon, where cigars are taxed at 65 percent of the box price, enacted a law placing a 50-cent cap on cigar taxes in 2001.As a result, the retail price of cigars declined 16.5 percent.[18] OTP tax

[16] Based on the information obtained from email communication between Bruce Seaman and Gary Kolesaire.
[17] Cigar Association of America. (June 20, 2003). *Proposal for a tax cap on large cigars.*
[18] Fitz, Joe. (October 27, 2004). *Cigar Excise Tax Proposal.* Board of Equalization, Research and Statistics Section, State of California [Memorandum]

revenue for fiscal year 2002-2003 rose 2.4 percent.[19] Furthermore, between 2001 and 2004, tax revenue from large cigar sales rose by $1.3 million.[20]

Taxation in Maryland

The State of Maryland has imposed a 15-percent tax on the wholesale price of cigars and OTPs since 2002. The rate was uniform among tobacco products until 2012. Effective July 1st, 2012, small cigars were taxed at 70 percent of wholesale prices while taxes imposed upon OTPs were raised to 30 percent. The tax on premium cigars remained unchanged at 15 percent.[21] As a result of the tax hike, Maryland's cigar tax rate is now the 10th highest in the nation.[22]

Exhibit 3: State Cigar Tax Rates, As of September 2012

Washington	95% taxable sales price, 75¢ cap; LC	North Dakota	28% wholesale price
Vermont	92% wholesale price for <$1.08 price; $2 per cigar for $1.08-$10; $4 per cigar for ≥ $10; LC	New Mexico	25% mfr. price; LC
Utah	86% mfr. price; LC	Indiana	24% wholesale price
Florida	85% wholesale price for OTP; No excise tax on cigars	Georgia	23% wholesale price
Rhode Island	80% wholesale price, 50¢ cap; LC	Maine	20% wholesale price
New York	***75% wholesale price; LC***	Nebraska	20% wholesale price
Alaska	75% wholesale price	Wyoming	20% wholesale price
Wisconsin	71% mfr. price, 50¢ cap	Louisiana	8%-20% mfr. Price
Minnesota	70% wholesale price	Ohio	17% wholesale price
Maryland	**70% wholesale for non-premium; 15% wholesale for premium cigar**	***Delaware***	***15% wholesale price***
Arkansas	68% mfr. Price	Kentucky	15% wholesale price
Oregon	65% wholesale price, 50¢ cap	Mississippi	15% mfr. price
Hawaii	50% wholesale price; LC	North Carolina	12.8% wholesale price
Montana	50% wholesale price; LC	***D.C.***	***12% retail price (cigars<$2); LC***
Connecticut	50% wholesale price, 50¢ cap; LC	Kansas	10% wholesale price
Iowa	50% wholesale price, 50¢ cap; LC	Missouri	10% mfr. price
New Hampshire	48% whole sales price (not premium); LC	***Virginia***	***10% mfr. price***
Idaho	40% wholesale price	***West Virginia***	***7% wholesale price***
Colorado	40% mfr. Price	Tennessee	6.6% wholesale price; LC
Illinois	36% wholesale price; LC	South Carolina	5% mfr. price
South Dakota	35% wholesale price	**Other states with different tax structure**	
Michigan	32% wholesale price	Alabama	4.0-40.5¢/10 cigars
California	30.68% wholesale price; LC	Arizona	22.05-218¢/10 cigars
Massachusetts	30% wholesale price; LC	Oklahoma	3.6-120¢/10 cigars
Nevada	30% wholesale price	Texas	1-15¢/10 cigars
New Jersey	***30% wholesale price***	***Pennsylvania***	***No excise tax on premium cigars; LC***
Note: "LC" indicates that the "Little Cigars" as defined in state law are taxed at the same rate as cigarettes. "mfr. price" = Manufacturers' price			

Source: Campaign for Tobacco-Free Kids

[19] Fitz, Joe. (October 27, 2004).
[20] Source provided by International Association of Premium Cigar Distributors.
[21] Field Enforcement Division, Comptroller of Maryland. (June 18, 2012). OTP tax increase – Floor tax (TT-73).
[22] Haar, Melissa V. (July 3rd, 2012). Maryland tobacco tax goes into effect: Taxes includes drastic increases on little cigars and OTP. *CSPnet.com.* Retrieved on December 5th, 2012, from http://www.cspnet.com/news/tobacco/articles/maryland-tobacco-tax-goes-effect

A Natural Experiment

In an effort to protect in-state cigar retailers, the State of Maryland temporarily banned online and direct mail sales of cigars and other tobacco products in 2011. The legislation was signed into law in 2010 and took effect on May 1st, 2011, receiving much criticism from cigar aficionados. The controversial law came to a halt when Comptroller Peter Franchot submitted a letter to the presiding officers of the legislature indicating that the Maryland Comptroller's Office would defer the enforcement of the law until the General Assembly had further opportunity to consider the legislation. His decision was legitimized by the State's Attorney General on June 20th, 2011.[23]

This episode provided analysts with a natural experiment. The extent to which in-store sales at Maryland's premium cigar retailers increased during this period reflects how large an impact out-of-state online and direct mail sellers have on local merchants. To determine the impact of the ban on in-state, in-store retailers and develop other study parameters, the Sage study team generated a survey of local merchants – a survey that ultimately encompassed fully a third of the statewide industry.

II. Analysis of Survey Results

a. Survey Methods

In order to collect general information as well as sales data for Maryland's cigar retailers, the study team distributed a survey questionnaire to members of the Maryland Premium Cigar Association. The questionnaire was conducted based upon an agreement that no identification of respondents will be presented in this report. Some of the questions are specifically related to an individual member's sales of premium cigars and OTPs, including small cigars. One of the questions inquired about monthly sales during the two-month ban of inter-state shipments of cigars and OTPs. Responses to this question are particularly important in terms of estimating foregone in-store sales of cigars in Maryland. The survey also included a question regarding changes in sales revenue both before and after the tax rates for OTPs and small cigars were raised in July 2012.

b. Survey Results

Respondent Profile

Sage received responses from 12 cigar retailers currently operating in Maryland, or from roughly one-third of Maryland-based operators. The majority of respondents were small businesses with

[23] *Baltimore Sun* (June 23, 2012). *Franchot: I won't bust online premium cigar buyers*. Retrieved on December 5th, 2012, from http://weblogs.baltimoresun.com/business/hancock/blog/2011/06/franchot_i_wont_bust_online_pr.html

fewer than 10 employees. Half are classified as subchapter S-corporations while others were C-Corporations and LLCs. Most respondents (80%) answered that more than 50 percent of their revenue is derived from sales of cigar products. The cumulative annual sales of all respondents are approximately $12.7 million. According to the International Premium Cigar & Pipe Retailers Association, the respondents' total cumulative sales for 2011 represent approximately one-third of the state's total, implying that this is a highly representative sample. Exhibit 4 provides summary results regarding key survey findings.

Exhibit 4: Summary Statistics of the Sage Survey Result

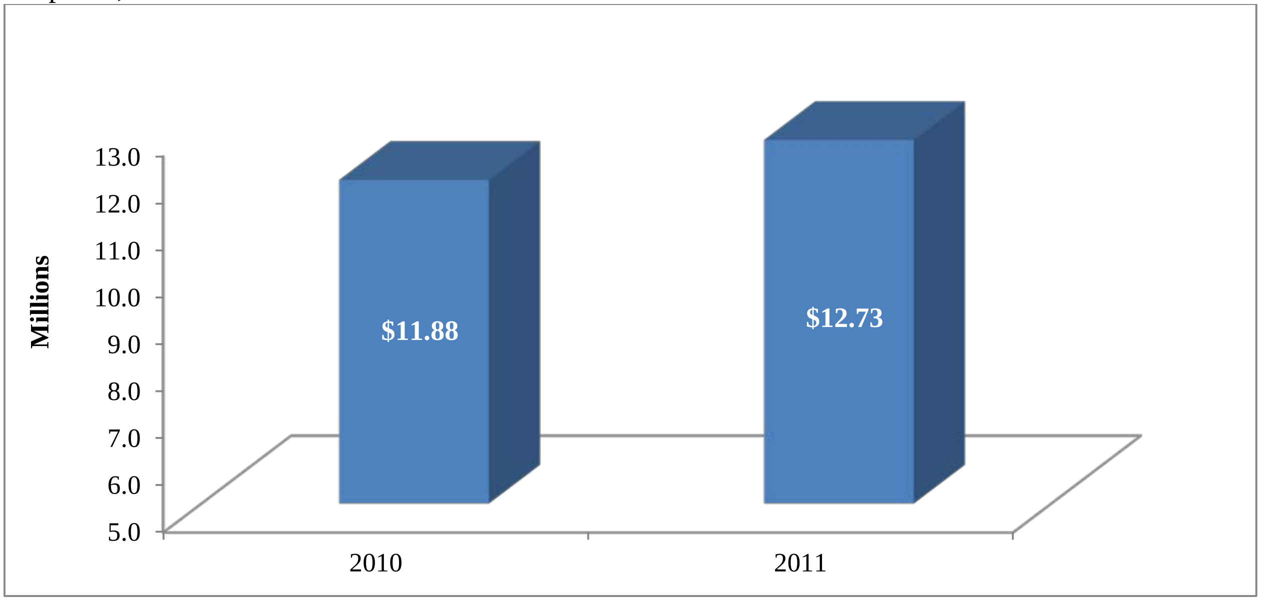
Number of employees*	
Less than 5	40% (of respondents)
5-10 employees	30%
Over 10 employees	20%
N.A.	10%
Revenue from cigar products	
Less than 50%	10%
50%-80%	30%
Over 80%	50%
N.A.	10%
Total cumulative revenue across all respondents	
2010	$11,879,307
2011	$12,730,082

* Including both full-time and part-time

Sales Data

The latter part of the questionnaire includes a series of questions relating to the respondent's annual sales, monthly sales and excise tax payments. Exhibit 5 reflects respondents' annual sales statistics for 2010 and 2011. The total cumulative annual revenue in 2010 exceeded $11.9 million and was nearly $12.7 million in 2011, a reflection of an improving economy, unchanged tax rates during that period and a temporary ban on out-of-state online and direct mail sales for part of 2011. The vast majority of annual revenue is derived from sales of premium cigars for most respondents. Among those firms selling OTPs, sales revenue of those products accounts for just 9 percent of total sales on average.

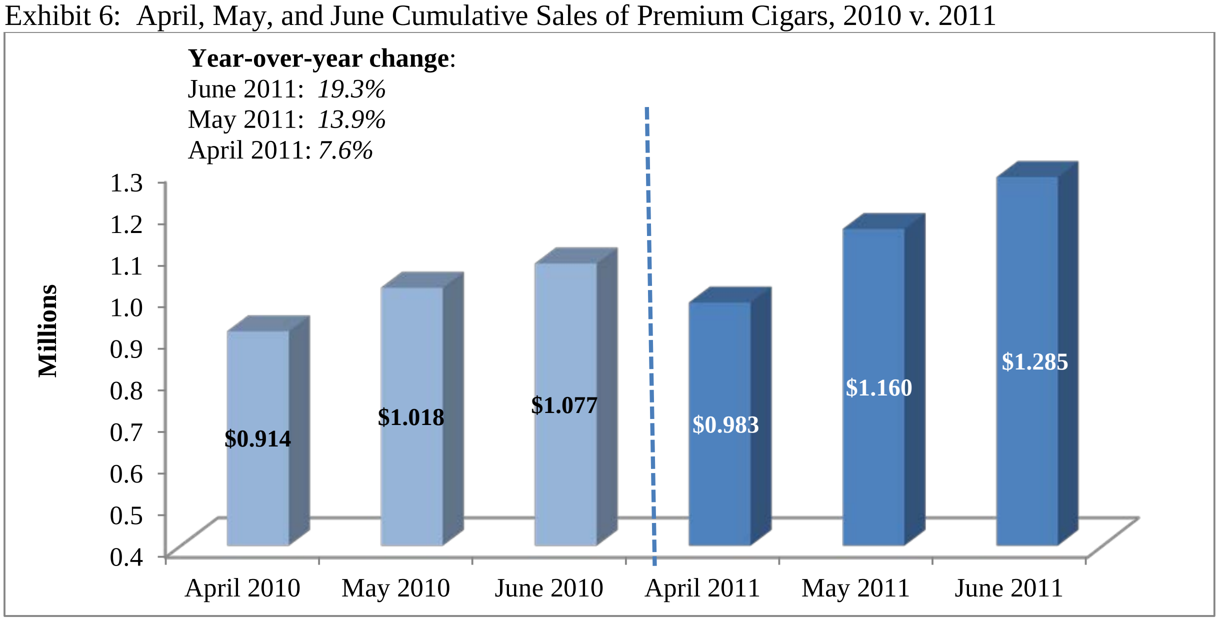
Exhibit 5: Cumulative Total Annual Sales* of Cigar Retailers in Maryland, Based on the Survey Response, 2010 v. 2011



Sage Survey; *Combines both premium cigar and OTP sales

Exhibit 6 provides statistical detail regarding sales of premium cigars during the April-June period in 2010 and the corresponding months in 2011. May and June of 2011 represent the period of the temporary ban on shipments of online purchases of all cigar products and OTPs. On a year-over-year basis, total cumulative in-store sales of premium cigars rose 13.9 percent in May and 19.3 percent in June. Cumulative sales over the two-month period in 2011 rose 16.7 percent compared to the corresponding period in the previous year. Prior to the ban, year-over-year sales were expanding at a 7.6 percent rate.

Exhibit 6: April, May, and June Cumulative Sales of Premium Cigars, 2010 v. 2011



Sage Survey

III. Analysis of Foregone Maryland Tax Revenue Attributable to Unequal Tax Treatment

This section provides estimates of how much tax revenue could be generated if the State of Maryland taxed out-of-state sellers of premium cigars the same way that it taxes in-state, in-store retailers. A shift in policy would:

1) Increase excise tax payments from out-of-state shippers;
2) Modestly decrease overall consumption of premium cigars via online/direct mail services in Maryland due to broader taxation and higher average prices; and
3) Increase sales at local merchants, thereby generating more tax revenues from that source.

In total, more than **$2.16 million** in tax revenue is foregone annually due to unfair tax treatment of out-of-state sellers of premium cigars. The overwhelming majority of this revenue is associated with the failure to fairly tax out-of-state sellers of premium cigars who distribute their products using online or direct mail channels. Exhibit 7 details the steps of the computation. Explanatory notes are provided on the following page.

Exhibit 7: Additional Tax Revenue from Equal Treatment of In-state, In-store Sales and Out-of-state Online/Direct Mail Sales

a) Additional tax revenue that would be collected from out-of-state online/direct mail sellers of premium cigars is estimated to be *$2.142 million* annually.

Estimation method

1) Total annual revenue generated in Maryland by all sellers of premium cigars, in-state + out-of-state:	$34,775,999
2) Online/direct mail sales share of total Maryland sales (70% of Line 1 – see below for the source of this parameter):	$24,343,199
3) Retail price increase is assumed to increase by 15 percent as sellers pass along costs to consumers:	*15%*
4) Decline in online/direct mail sales due to 15-pct. price increase (12% of Line 2 based on -0.8 elasticity of demand):	$2,921,184
5) Out-of-state online/direct mail sales after policy shift:	$21,422,016
6) Amount subject to the 15-pct. tax (66.7% of Line 5, tax is at the wholesale level, not the retail level):	$14,281,344
7) Additional Maryland tax revenues from tax at wholesale level (15% of Line 6)	**$2,142,202**

Explanatory Notes pertaining to Calculations Presented in

b) Additional tax revenue collected from increased Maryland in-store sales in response to a prospective decline in market share of out-of-state premium cigar sellers is calculated as *$21,256*.

Estimation method

8) Approximate proportion of lost out-of-state revenue captured by in-state, in-store retailers due to higher taxes on out-of-state product (see below for origin of this parameter)	*4.548%*
9) Amount of sales captured by in-state, in-store retailers (roughly 4.55% of Line 4):	$132,848
10) Revenue generated from Maryland's 6 percent sales tax on these additional sales	***$7,971***
11) Amount subject to the 15 percent wholesale tax (66.7% of Line 9):	$88,565
12) Revenue generated through applications of Maryland's 15 percent tax on premium cigars at wholesale level	***$13,285***
13) Total tax collected from additional in-store retail sales:	**$21,256**

CONCLUSION
TOTAL FOREGONE TAX REVENUES = $2,163,458

Exhibit 7 additional details:

Line 1: Cumulative premium cigar sales of Sage survey respondents in 2010 and 2011 averaged $11.6 million, which represents approximately one-third of the state's total sales;[24]

Line 2: It is estimated that for every $3 of in-store sales, there are $7 of online/direct mail sales. In other words, approximately 70 percent of premium cigar sales occurs via online/direct mail services;[25]

Line 3: Retail prices presumed to rise 15 percent due to 15 percent tax on wholesale prices;

Line 4: Elasticity of demand for premium cigars is -0.8 based on a study conducted for Minnesota's Department of Revenue; [26]

Line 5: Subtraction of Line 4 from Line 2 as out-of-state premium cigar sales volume declines in response to higher prices;

Line 6: Based on a study conducted for the New Jersey Association[27], the ratio of wholesale dollar sales to retail dollar sales is 66.7 percent;

Line 7: Line 6, which reflects wholesale dollar sales, multiplied by Maryland's 15 percent tax at the wholesale level;

Line 8: Sage estimates that 4.55 percent of lost out-of-state online/direct mail sales will be captured by in-store premium cigar sellers in Maryland based upon survey data;

Line 9: Line 5, lost out-of-state online/direct mail sales multiplied by Line 8;

Line 10: 6 percent, which in Maryland's sales tax rate, of Line 9;

Line 11: See Line 6;

Line 12: 15 percent of Line 11, which represents the increase in wholesale volume associated with higher sales at Maryland's in-store premium cigar retailers;

Line 13: Line 10 (additional retail sales tax revenues) plus Line 12 (additional wholesale level tax revenues).

Conclusion: Because of favorable treatment of out-of-state sellers of premium cigars that use direct mail or online channels, the State of Maryland is foregoing $2.16 million in revenues per annum.

IV. Conclusion

Current law excludes out-of-state online and direct mail sellers from excise taxes that impact Maryland-based, in-store retailers of premium cigars. Consequently, Maryland's cigar retailers face unfair price competition from sellers located in other states. Recent increases in taxation on small cigars and OTPs have served to create an even more uneven competitive playing field. In addition to creating unfair competition, the State is Maryland is foregoing substantial tax revenues due to the excise tax exclusions.

Sage estimates that equal tax treatment will generate an additional $2.16 million for Maryland's treasury per annum. But there are other issues at stake. Rarely do State policymakers have an opportunity to 1) vastly increase tax fairness; 2) increase the size of the local economy; and 3) increase State tax revenues with a single policy. This study identifies just such an opportunity. State policymakers should require out-of-state sellers who use direct mail and online distribution channels to pay a 15 percent excise tax at the wholesale level.

[24] Based on an estimate provided by the Association of Cigar and Pipe Retailers. According to the estimate, Sage's sample represents between one-quarter and one-third of the state's total in-store sales.
[25] Estimates provided by the Association of Cigar and Pipe Retailers.
[26] Minnesota Department of Revenue. (March 25, 2008). Analysis for H.F 3751: Tobacco Products Tax/Fee Reduce Rates – Maximum Tax on Cigars
[27] New Jersey State Association.

Appendix

This appendix provides additional detail regarding the estimate of the proportion of sales captured by in-state, in-store retailers after the 15-percent excise tax is applied to online/direct mail sellers at the wholesale level

As indicated by Sage's survey results, sales of premium cigars for the May-June period in 2011 (the period of the out-of-state shipment ban) surged 16.7 percent year-over-year. Even without the ban, there would have likely been a year-over-year increase in in-state, in-store sales due to ongoing economic recovery at that time. Sage conservatively estimates that 9.1 percent of the 16.7 percent increase in sales was due to the out-of-state shipment ban. In other words, Sage assumes that 7.7 percent of the year-over-year increase in April 2011 was attributable to an improving economy and/or to other factors.

There is not much basis to know the extent to which a 15 percent wholesale level tax on out-of-state sellers would result in market share shift to Maryland-based, in-store retailers. However, it is reasonable to presume that the impact of a tax increase would be less in magnitude than an outright ban. The study team assumed that the impact of a 15 percent wholesale level tax increase on out-of-state sellers using direct mail and online channels would be roughly one-half the impact of the May/June 2011 ban. This means that for purposes of computation, roughly 4.55 percent of the sales lost by out-of-state sellers would be captured by Maryland-based retailers. See Line 8 in Exhibit 7.