#541

Joint Legislative Committee on Performance Evaluation and Expenditure Review (PEER)

Report to
the Mississippi Legislature

A Review of the Department of Revenue's Enforcement of Mississippi's "Unfair Cigarette Sales Law"

Minimum pricing laws for cigarettes are believed to promote fair trade and counteract the effects of manufacturers' discounting on consumption, thus helping to protect public health. Mississippi is one of twenty-five states with minimum pricing laws governing the sale of cigarettes.

Mississippi's "Unfair Cigarette Sales Law" does not establish a minimum price applicable to all wholesalers and retailers, but sets a minimum markup. Even when they are complying with the legally mandated pricing structure, wholesalers' and retailers' minimum prices may vary depending on their individual costs. The Department of Revenue, which is responsible for enforcing the Unfair Cigarette Sales Law, is hampered in its enforcement by an insufficient number of staff assigned to this task and by a provision of the law that allows pricing below legally mandated requirements in order to meet a competitor's price.

Three options are available for changes to Mississippi's Unfair Cigarette Sales Law: remove the "meeting competition" provision, increase enforcement efforts, or repeal the law.

October 12, 2010

PEER: The Mississippi Legislature's Oversight Agency

The Mississippi Legislature created the Joint Legislative Committee on Performance Evaluation and Expenditure Review (PEER Committee) by statute in 1973. A joint committee, the PEER Committee is composed of seven members of the House of Representatives appointed by the Speaker and seven members of the Senate appointed by the Lieutenant Governor. Appointments are made for four-year terms, with one Senator and one Representative appointed from each of the U. S. Congressional Districts and three at-large members appointed from each house. Committee officers are elected by the membership, with officers alternating annually between the two houses. All Committee actions by statute require a majority vote of four Representatives and four Senators voting in the affirmative.

Mississippi's constitution gives the Legislature broad power to conduct examinations and investigations. PEER is authorized by law to review any public entity, including contractors supported in whole or in part by public funds, and to address any issues that may require legislative action. PEER has statutory access to all state and local records and has subpoena power to compel testimony or the production of documents.

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The Committee assigns top priority to written requests from individual legislators and legislative committees. The Committee also considers PEER staff proposals and written requests from state officials and others.

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October 12, 2010

Honorable Haley Barbour, Governor
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On October 12, 2010, the PEER Committee authorized release of the report entitled **A Review of the Department of Revenue's Enforcement of Mississippi's "Unfair Cigarette Sales Law."**

Senator Nolan Mettetal, Chair

This report does not recommend increased funding or additional staff.

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A Review of the Department of Revenue's Enforcement of Mississippi's "Unfair Cigarette Sales Law"

Executive Summary

Introduction

In 1954, in order to protect the public against the effects of unfair business practices in the sale of cigarettes, the Mississippi Legislature passed what is now codified as MISS. CODE ANN. Section 75-23-1 et seq., known as the "Unfair Cigarette Sales Law."

Recently a legislator brought concerns regarding the adequacy of the law and its success in achieving the above-stated intent to the PEER Committee's attention. The substance of the legislator's concerns was that retailers around the state may not be complying with federal and state requirements for pricing standards for cigarettes and that certain retail outlets may be selling cigarettes at prices below required minimums, thus creating an unfair market environment for vendors that fully comply with pricing laws.

PEER reviewed enforcement of the Unfair Cigarette Sales Law to determine the adequacy of the current law and how well the enforcement efforts of the Department of Revenue (DOR) help to ensure compliance with that law.

Background

Minimum pricing of cigarettes is envisioned to have two primary effects: to promote fair trade and to counteract the effects of manufacturers' discounting on consumption, thus helping to protect public health.

Mississippi's Unfair Cigarette Sales Law sets a minimum markup for wholesalers and retailers but also allows wholesalers and retailers to meet the price of a competitor who is selling the same cigarettes at cost as defined by law. The federal Robinson-Patman Act was intended to prevent monopolies and prohibit price discrimination

between different purchasers of commodities of like grade or quality.

Twenty-five states have minimum pricing laws governing the sale of cigarettes. In the southeast, Mississippi, Louisiana, Tennessee, and Arkansas have minimum pricing laws, while Alabama, Georgia, and Florida do not.

Conclusion

Mississippi's Unfair Cigarette Sales law establishes a formula for determining the legal minimum price of cigarettes but does not set a minimum price applicable to all wholesalers and retailers. Further, the Department of Revenue's enforcement efforts are hampered by an insufficient number of staff assigned to enforcing the law and a provision of the law that allows pricing below legally mandated prices in order to meet a competitor's price.

Mississippi's Unfair Cigarette Sales Law does not establish a minimum price applicable to all wholesalers and retailers. Even when complying with the legally mandated pricing structure, wholesalers' and retailers' minimum prices may vary depending on their individual costs.

The Department of Revenue's enforcement of Mississippi's Unfair Cigarette Sales Law is hampered by an insufficient number of staff assigned to enforcing the law and provisions of the law that allow pricing below minimum price requirements to meet competitors' prices. Also, a single employee of the department's Miscellaneous Tax Bureau has, in addition to other responsibilities, the responsibility of enforcing the Unfair Cigarette Sales Law.

Even if a wholesaler or retailer is found selling cigarettes at prices below that required by the Unfair Cigarette Sales Law, MISS. CODE ANN. Section 75-23-15 (a) (1972) allows wholesalers and retailers to sell below minimum prices to meet a competitor's price.

Recommendation

The Legislature should consider the following options or a combination of options to determine which option or options represent the most appropriate public policy and promote the best interest of the state.

- *Option 1: Remove the "Meeting Competition" Provision*--The Legislature could amend MISS. CODE ANN. Section 75-23-15 (a) (1972) by removing the "meeting the competitor's price" provision. This option would allow vendors to be held liable for selling cigarettes below the legally allowed price, but could cause vendors economic harm by preventing a vendor from meeting a competitor's price and thereby losing revenue.

- *Option 2: Increase Enforcement Efforts*--The Department of Revenue could increase enforcement efforts by increasing the number of staff assigned to enforcement of Mississippi's Unfair Cigarette Sales Law. Currently, the Department of Revenue does not have statutory authority to charge a fee for the licensing of the state's approximately 7,500 retailers of cigarettes. An annual licensing fee of $100 per licensee could produce approximately $750,000 annually, which could be directed toward increased enforcement efforts.
- *Option 3: Repeal the Unfair Cigarette Sales Law*--The Legislature could repeal Mississippi's "Unfair Cigarette Sales Law" (MISS. CODE ANN. Section 75-23-1 et seq.). Under this option, cigarettes would be viewed as any other commodity and wholesalers and retailers would be allowed to set prices through the free market.

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A Review of the Department of Revenue's Enforcement of Mississippi's "Unfair Cigarette Sales Law"

Introduction

Authority

The PEER Committee reviewed enforcement of the state's "Unfair Cigarette Sales Law" (MISS. CODE ANN. Section 75-23-1 et seq.) to determine the adequacy of the current law and how well the enforcement efforts of the Department of Revenue (DOR) help to ensure compliance with that law. PEER conducted the review pursuant to the authority granted by MISS. CODE ANN. Section 5-3-51 et seq. (1972).

Problem Statement

During the 1954 session, in order to protect the public against the effects of unfair business practices in the sale of cigarettes, the Mississippi Legislature passed what is now codified as MISS. CODE ANN. Section 75-23-1 et seq., known as the "Unfair Cigarette Sales Law." Section 75-23-3 declared the intent of this law to be:

> *. . .to encourage fair and honest competition, and to safeguard the public against unfair, dishonest, deceptive, destructive, and fraudulent business practices existing in transactions involving the sale of, offer to sell, or inducement to sell, cigarettes in the wholesale and retail trades in this state. It is further declared that the advertising, offering for sale, or sale of cigarettes below cost in the wholesale or retail trades with the intent of injuring competitors or destroying or substantially lessening competition, is an unfair and deceptive trade practice. The policy of the state is to promote the general welfare through the prohibition of such sales, the purpose of the Unfair Cigarette Sales Law being to carry out that policy in the public interest.*

A legislator brought concerns regarding the adequacy of the law and its success in achieving the above-stated intent to the PEER Committee's attention. The substance of the legislator's concerns was that retailers around the state may not be complying with federal and state requirements for pricing standards for cigarettes and that certain retail outlets may be selling cigarettes at prices below required minimums, thus creating an unfair market environment for vendors that fully comply with pricing laws.

Scope and Purpose

In conducting this review, the PEER Committee assessed the relevancy and adequacy of the current law and the effectiveness of the Department of Revenue's enforcement efforts at both the retail and wholesale levels.

PEER sought to answer the following questions:

- How are minimum cigarette prices determined?
- What state and federal laws govern cigarette pricing and what do they require?
- What enforcement mechanism has been put in place to ensure compliance with relevant laws?
- What are the strengths and weaknesses of current enforcement efforts?
- Could the Department of Revenue improve its procedures to enhance the effectiveness of its enforcement efforts?
- Is legislative action necessary to make the enforcement program more effective?

In addition, the Committee sought to develop broader policy perspectives on the reason and necessity for such laws--specifically, whether the citizens and retailers in the state need the price protections provided to them under the law and whether the law may need to be reformed or repealed.

Method

In conducting this review, PEER:

- reviewed Mississippi laws governing the minimum pricing of cigarettes;
- reviewed applicable federal laws concerning the sale of cigarettes;
- conducted interviews with staff of the Department of Revenue's Miscellaneous Tax Bureau; and,

- reviewed enforcement efforts of the Department of Revenue's Miscellaneous Tax Bureau.

Background

Minimum pricing laws are believed to promote fair trade and counteract the effects of manufacturers' discounting on consumption. Mississippi is one of twenty-five states with minimum pricing laws governing the sale of cigarettes.

The Rationale for Establishing Minimum Pricing Laws

Minimum pricing of cigarettes is envisioned to have two primary effects: to promote fair trade and to counteract the effects of manufacturers' discounting on consumption, thus helping to protect public health.

The Small Business Perspective

Large retailers have an advantage in pricing strategies by virtue of their ability to buy large volumes of merchandise at lower wholesale costs than smaller retailers. This purchasing advantage allows large retailers to draw shoppers into their businesses.

Small retailers believe minimum pricing laws promote fair trade by prohibiting large retailers from pricing merchandise below specified levels in an effort to attract shoppers. Without minimum pricing, large retailers could select cigarettes to serve as loss leaders (i. e., items priced below cost or closer to cost than normal profit margins) to draw customers into their stores to the potential detriment of smaller retailers.

The Public Health Perspective

According to the Centers for Disease Control (CDC), cigarette price increases reduce the demand for cigarettes and thereby reduce smoking prevalence, cigarette consumption, and youth initiation of smoking. All fifty states and the District of Columbia assess a state excise tax on cigarettes.

Cigarette manufacturers use trade discounts, coupons, and other promotions to counteract the effects of cigarette excise taxes and to appeal to price-sensitive smokers. From a public health standpoint, minimum price laws can help prevent trade discounting from eroding the positive effects of state excise tax increases and higher cigarette prices on public health and creating or strengthening minimum price laws is a way to increase cigarette prices.

The CDC indicated that more research is needed to determine how cigarette minimum price laws affect consumer prices and state revenue. It suggests that state tobacco control programs partner with state agencies that have enforcement authority for cigarette minimum price

laws to determine how to enforce these laws and identify gaps in the law that do not address practices that might be used by cigarette manufacturers and retailers to reduce cigarette prices (e. g., remote sales via the internet and mail order, direct sales from manufacturers to consumers, or coupons and other direct-to-consumer discounts).

Statutory Requirements Relative to Minimum Cigarette Prices

Mississippi's minimum pricing law sets a minimum markup for wholesalers and retailers but also allows wholesalers and retailers to meet the price of a competitor who is selling the same cigarettes at cost as defined by law. The federal Robinson-Patman Act was intended to prevent monopolies and prohibit price discrimination between different purchasers of commodities of like grade or quality.

Requirements of Mississippi's Unfair Cigarette Sales Law

Summary of the Law's Major Provisions

As noted on page 1, the Legislature established the Unfair Cigarette Sales Law (MISS. CODE ANN. Section 75-23-1 et seq. [1972]) to encourage fair and honest competition and to safeguard the public against unfair, dishonest business practices in transactions involving the sale of cigarettes, both wholesale and resale, in Mississippi. Generally, the law prohibits wholesalers and retailers from advertising, offering for sale, or selling cigarettes below cost with the intent of injuring or destroying competition.

The law requires a minimum markup of 2% for wholesalers and 6% for retailers, or actual cost of doing business if proof exists of a higher or lower percentage than the prescribed percentages, to be added to wholesale and retail basic cost. The Unfair Cigarette Sales Law allows wholesalers and retailers to advertise and sell cigarettes to meet the price of a competitor that is selling the same cigarettes at cost as defined by law.

In addition, the law provides that advertisement to sell by wholesaler or retailer at less than cost to wholesaler or retailer is *prima facie* evidence of intent to injure, destroy, and lessen competition. Mississippi's Unfair Cigarette Sales Law also prohibits wholesalers from offering rebates to retailers, but does not prohibit rebates between the manufacturer and the retailer.

The Unfair Cigarette Sales Law establishes several definitions used in reference to determining minimum cigarette prices (see Exhibit 1, page 6.) These definitions are important because they serve as guidelines for wholesalers, retailers, and the Department of Revenue's staff to follow in determining the legally allowed minimum price for cigarettes.

Exhibit 1: Definitions Used in Determining Compliance with Mississippi's Unfair Cigarette Sales Law (MISS. CODE ANN. Section 75-23-1 et seq.)

Basic Cost of Cigarettes: the lower of either the invoice cost or the replacement cost to the wholesaler or retailer in the volume last purchased within thirty days prior to the date of sale. Use of the thirty-day replacement cost can lower the wholesaler's or retailer's cost if a manufacturer lowers the product price on a seller's existing product inventory. Regardless of which cost (invoice or replacement) is used, all trade discounts, except for customary discounts for cash, are subtracted and the full excise tax is added.

Cost to Wholesaler: the basic cost to the wholesaler plus the cost of doing business as evidenced by the standards and methods of accounting regularly used by the wholesaler. In the absence of proof of a higher or lower cost of doing business, the wholesaler shall use two percent of the basic cost of the cigarettes. If the wholesaler delivers the cigarettes to the retailer, the wholesaler shall add the actual costs of delivery or in the absence of proof of a higher or lower cost of delivery, the wholesaler may use one-half of one percent of the basic cost.

Cost to Retailer: the basic cost to the retailer plus the cost of doing business as evidenced by the standards and methods of accounting regularly used by the retailer. In the absence of proof of a higher or lower cost of doing business, the retailer shall use six percent of the basic cost of the cigarettes. In the event a retailer receives in whole or in part any discount ordinarily allowed to a wholesale dealer, such discounts are included in calculating the retailer's cost.

Trade discounts: discounts offered from manufacturers to wholesalers or from manufacturers to retailers. Such discounts vary depending on costs of products, purchase volumes, sales volumes, working relationships, negotiating skills of parties involved, and competitive market forces.

Buydowns: discounts offered by the manufacturer to wholesalers and retailers participating in a manufacturer's incentive program. The buydown varies depending on the contract negotiated with the manufacturer. Influencing factors in determining the buydown include purchase commitments and sales volumes.

Off-invoice discounts: discounts from manufacturers to retailers nationwide. All retailers receive the same discount regardless of a retailer's purchase commitments or sales volumes. Off-invoice discounts appear on the invoice from the wholesaler to the retailer and lower the basic cost of cigarettes.

SOURCE: MISS. CODE ANN. Section 75-23-1 et seq.; staff of the Department of Revenue.

Enforcement Responsibility and Penalties

Under MISS. CODE ANN. Section 75-23-25 (1972), the State Tax Commission (now the Department of Revenue) has the authority to prescribe, adopt, and enforce rules and regulations relating to the administration and enforcement of the Unfair Cigarette Sales Law. After a show cause hearing, the department (or a hearing officer or the board of review, as designated by the commissioner) may revoke or suspend a non-compliant party's wholesale or retail license to sell cigarettes. Rulings, orders, or decisions of the department may be appealed to the state's Tax Appeals Board and are subject to review by courts in the county where the affected party resides, has a place of business, or in Hinds County. The department may also appeal decisions of the Tax Appeals Board to the relevant court.

Also, under MISS. CODE ANN. Section 75-23-7 (a) (1972), any wholesaler or retailer who advertises, offers to sell, or sells cigarettes at less than cost with intent to injure competitors or destroy or substantially lessen competition, is guilty of a misdemeanor and be punishable by a fine of not more than $500. Evidence of advertisement, offering to sell, or sale of cigarettes at less than cost or evidence of offers of a rebate in price or concession which the price to below cost shall be *prima facie* evidence of intent to injure competitors and to destroy or substantially lessen competition.

Under MISS. CODE ANN. Section 75-23-23 (1972), the DOR, or any person injured by any violation or who would suffer injury from any threatened violation of the Unfair Cigarette Sales Law, may bring an action in the appropriate court to prevent, restrain, or enjoin such violation or threatened violation. If a violation or threatened violation is established, the plaintiff is entitled to recover damages and attorney fees.

MISS. CODE ANN. § 75-23-13 allows exceptions to the Unfair Cigarette Sales Law for wholesale or a retail sales made: (a) in an isolated transaction and not in the usual course of business; (b) where cigarettes are sold in a clearance sale for the purpose of discontinuing trade in cigarettes; (c) where cigarettes are sold as imperfect or damaged; (d) where cigarettes are sold upon the final liquidation of a business; or (e) where cigarettes are sold by any fiduciary or other officer acting under the order or direction of any court; (f) or the resale of any of the cigarettes purchased from sales under (c) and (e) above.

The Federal Robinson-Patman Act

The Robinson-Patman Act of 1936 was intended to prevent monopolies and prohibit price discrimination between different purchasers of commodities of like grade or quality, if the effect of such discrimination is to lessen competition or injure individual competitors. However, the act does permit price variances due to differences in the cost of manufacture, sale, or delivery that arise from differing methods or quantities of commodities sold and delivered to purchasers. The act also permits discounts to buyers that perform services, such as promotions, that the seller would otherwise perform. Similar, but not exact, discounts must be offered to all buyers of like goods.

The following are possible exceptions if a seller is accused of pricing discrimination under the Robinson-Patman Act:

- *meeting competition*--a seller may justify pricing by establishing that prices offered were made in good faith to meet the price of a competitor;
- *cost justification*--a seller may justify lower prices to one buyer than another by establishing the price difference was justified by differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which the goods are sold; or,
- *functional availability*--seller establishes that the accusing buyer qualified for a discount offered by the seller, but failed to take advantage of the available discount.

Other States' Minimum Pricing Laws for Cigarettes

Twenty-five states have minimum pricing laws governing the sale of cigarettes. In the southeast, Mississippi, Louisiana, Tennessee, and Arkansas have minimum pricing laws, while Alabama, Georgia, and Florida do not.

As of December 31, 2009, the CDC had identified twenty-five states with minimum price laws governing the sale of cigarettes. Among the southeastern states, Mississippi, Louisiana, Tennessee, and Arkansas have minimum pricing laws while Alabama, Georgia, and Florida do not. Louisiana's law is unique because it addresses the sale of any merchandise by wholesalers and retailers and Tennessee's law only applies to retailers.

Most of the twenty-five states that have a minimum cigarette price law require a minimum percentage markup. For wholesale cigarette prices, the percentages range from 2% in the District of Columbia, Louisiana, and Mississippi to 6.5% in Connecticut. The minimum percentage markup

on the retail price of cigarettes ranged from 6% in six states to 25% in Massachusetts.

The minimum price laws in Rhode Island and Washington do not require a wholesale or retail percentage markup; instead, minimum price was set as the "replacement cost" and "actual price paid," respectively. Delaware was the only state that required a minimum price for wholesalers but not for retailers, and Tennessee was the only state that required a minimum price for retailers but not for wholesalers.

The CDC indicated that its findings were limited to include those states with minimum price laws that apply specifically to cigarettes. At least seven other states have general minimum price laws that apply to other types or classes of goods that could possibly include cigarettes. The CDC's survey also only included a review of state statutes and did not include other actions (e. g., attorney generals' opinions, case law decisions, or regulatory guidelines) that could possibly affect how the statutes would be implemented or affected if challenged legally. Finally, the CDC's survey did not include an evaluation of how rigorously states enforce their cigarette minimum price laws.

Minimum Pricing of Cigarettes and the Department of Revenue's Enforcement Efforts

Mississippi's Unfair Cigarette Sales law establishes a formula for determining the legal minimum price of cigarettes but does not set a minimum price applicable to all wholesalers and retailers. Further, the Department of Revenue's enforcement efforts are hampered by an insufficient number of staff assigned to enforcing the law and a provision of the law that allows pricing below legally mandated prices in order to meet a competitor's price.

Although Mississippi's Unfair Cigarette Sales Law sets a formula to be used by wholesalers and retailers to determine the legally allowed minimum price for cigarettes, the law does not set a market-wide minimum price applicable to all wholesalers and retailers. Rather, the law mandates that each wholesaler and retailer must use their own specific costs in calculating minimum prices. Because costs vary between wholesalers and between retailers, the legal minimum price will also vary between wholesalers and between retailers.

PEER found that the Department of Revenue's enforcement efforts are hampered by an insufficient number of staff assigned to enforcement of the Unfair Cigarette Sales Law. In addition to enforcing this law, personnel in the Department of Revenue's Miscellaneous Tax Bureau, which is responsible for enforcement of the law, have other responsibilities competing with enforcement efforts for staff time. Further, even if a wholesaler or retailer is found in violation of minimum pricing requirement, provisions of the law allow wholesalers and retailers to set a price on their cigarettes that is below the legally mandated price in order to meet a competitor's price.

Minimum Pricing of Cigarettes

Mississippi's Unfair Cigarette Sales Law does not establish a minimum price applicable to all wholesalers and retailers. Even when complying with the legally mandated pricing structure, wholesalers' and retailers' minimum prices may vary depending on their individual costs.

As noted previously, the Legislature intended the Unfair Cigarette Sales Law to encourage fair and honest competition and to safeguard the public against unfair, dishonest, deceptive, destructive, and fraudulent business practices in transactions involving the sale of cigarettes. With these goals in mind, the law establishes a formula for determining the legally allowed minimum price of cigarettes. However, the law does not set a minimum price of cigarettes applicable to all wholesalers or retailers

statewide. Due to varying costs and competitive market forces, one should reasonably expect different minimum prices for wholesalers and retailers, even when such wholesalers and retailers are in close proximity.

Minimum Price Varies Between Wholesalers and Retailers

The Unfair Cigarette Sales Law defines the components and calculations required to determine the legal minimum price of cigarettes. (See discussion of components and calculation beginning on page 5.) The law does not mandate each wholesaler or retailer have the same minimum price. Due to the competitive marketplace in which all wholesalers and retailers operate, one should expect cost to vary from wholesaler to wholesaler and retailer to retailer.

Two wholesalers may pay different prices for the same brand and same product of cigarettes from the same manufacturer. Such differences are attributable to factors such as negotiating prowess of the parties involved, working relationship between the parties, purchase commitments, sales volumes, and costs relative to individual sales.

As noted on page 8, the federal Robinson-Patman Act prohibits price discrimination between different purchasers of commodities of like grade or quality, if the effect of such discrimination is to lessen competition or injure individual competitors. However, the act permits price variances due to differences in the cost of manufacture, sale, or delivery that arise from differing methods or quantities of commodities sold and delivered to purchasers. The act also permits discounts to buyers that perform services, such as promotions, that the seller would otherwise perform. As a result, a manufacturer may sell the same product to different wholesalers at different prices, which would result in different legal minimum prices.

As noted on page 5, the Unfair Cigarette Sales Law requires that wholesalers mark up their basic cost of cigarettes by 2% or the actual cost of doing business. Although the law requires at least 2%, if actual cost is not used, the law does not prohibit wholesalers from marking prices up by more than 2%. Given the free market in which commerce is conducted, it would not be unreasonable to expect that wholesalers may mark up cigarettes by 2% to one retailer and by a greater percentage to another retailer. As a result, the legal minimum price would differ between the retailers.

A final component affecting cigarette prices is agreements between the retailer and manufacturer. The Unfair Cigarette Sales Law does not require manufacturers to offer the same incentive to retailers of similar size.

Although the incentives to similar size retailers may be close, it is not unreasonable to expect variances due to the competitive market forces such as purchase commitments, sales volumes, negotiating skills of the retailer, and working relationship between the manufacturer and the retailer. Differences in incentives will result in different legal minimum cigarette prices.

Exhibit 2, below, provides an example of how market forces may result in different minimum cigarette prices. Both hypothetical cases in the example set their prices within the legal requirements of the law. As shown in the example, subtle differences in incentives at various points in the calculation may make a noticeable difference in the final retail price.

Exhibit 2: Example of Calculation of Legal Minimum Cigarette Prices per Carton for Two Hypothetical Cases

Item	Wholesaler A and Retailer X	Wholesaler B and Retailer Y
Manufacturer list price	$40.00	$40.00
less off-invoice discount	(3.00)	(3.00)
less manufacturer discount[1]	(2.00)	(1.60)
plus state excise tax	6.80	6.80
Basic cost (subtotal)	*41.80*	*42.20*
plus cost of doing business[2]	.84	1.06
plus delivery to retailer[3]	.21	.32
Final wholesaler cost (subtotal)	*42.85*	*43.58*
less purchase volume buydown[4]	(.80)	(.60)
Net wholesaler price to retailer (subtotal)	*42.05*	*42.98*
plus cost of doing business (6%)	2.52	2.58
Retailer's price before sales tax (subtotal)	*44.57*	*45.56*
plus sales tax	3.12	3.19
less sales volume buydown[5]	(1.60)	(1.20)
Final retail price (total)	**$46.09**	**$47.55**

Assumptions:

[1] Wholesaler A receives a 5% volume discount and Wholesaler B receives a 4% volume discount
[2] Wholesaler A's markup for cost of doing business is 2% and Wholesaler's B markup is 2.5%
[3] Wholesaler A's delivery charge is 0.5% of basic cost and Wholesaler B's delivery charge is 0.75% of basic cost
[4] Retailer X receives a 2% buydown of manufacturer list price based on purchase volume and Retailer Y receives a 1.5% buydown of manufacturer list price
[5] Retailer X receives a buydown of 4% of manufacturer list price for each carton sold and Retailer Y receives a buydown of 3% of manufacturer list price for each carton sold

NOTE: See Exhibit 1, page 6, for definitions of terms used in this calculation.

SOURCE: PEER analysis.

Since the law does not set a definite minimum cigarette price applicable to all retailers, DOR operates in an enforcement environment in which all complaints have "face validity" and must be investigated. DOR cannot determine the validity of a complaint based solely on differences in prices. Differences in prices may be based on differences in costs to retailers or may indeed be a violation of the law. Therefore, to enforce the Unfair Cigarette Sales Law, the DOR would need to investigate each complaint fully, which is a labor-intensive, time-consuming process.

The Department of Revenue's Enforcement Efforts

The Department of Revenue's enforcement of Mississippi's Unfair Cigarette Sales Law is hampered by an insufficient number of staff assigned to enforcing the law and provisions of the law that allow pricing below minimum price requirements to meet competitors' prices.

Staffing for Enforcement of the Unfair Cigarette Sales Law

Among other responsibilities, one employee of the Department of Revenue's Miscellaneous Tax Bureau has responsibility for enforcing the Unfair Cigarette Sales Law.

The Department of Revenue's Miscellaneous Tax Bureau has three full-time employees with responsibility for overseeing tobacco-related activities, such as maintaining and selling the department's inventory of tobacco stamps, processing tobacco applications and permits and issuing licenses to wholesalers and retailers, and processing and auditing tobacco excise tax returns. The Miscellaneous Tax Bureau is also responsible for other miscellaneous taxes such as beer; insurance premium; finance company; E-911 emergency telecommunications; estate; public utilities regulatory; municipal gas utility; and oil, gas, and timber severance.

One employee of the Miscellaneous Tax Bureau has primary responsibility for enforcement of the Unfair Cigarette Sales Law. Enforcement responsibilities include answering taxpayer questions, receiving complaints, and performing price checks. In addition to enforcement responsibilities, this employee also has other responsibilities relating to tobacco and beer taxes such as serving as back-up employee for tobacco stamping, auditing tobacco excise tax returns, and issuing permits for vendors selling beer.

Given that one employee has enforcement responsibilities in addition to other responsibilities and the state has approximately 7,500 licensed retail cigarette outlets and

145 licensed cigarette wholesalers, enforcement efforts are of necessity a complaint-driven process rather than a proactive monitoring process. Since the law allows minimum pricing based on individual costs, all complaints should be investigated because the merit of a complaint cannot be determined on appearance.

When a complaint is received, the complainant is asked to provide the name of the retailer, the brands of cigarettes allegedly being sold below minimum, and their own selling prices for the brands named in the complaint. Miscellaneous Tax Bureau staff request that Office of Audit and Compliance's field agents complete a worksheet on-site at the retailer's store named in the complaint indicating the sales price before tax, sales price after tax and the current advertised sale price for each brand in the complaint and to provide their findings to the Miscellaneous Tax Bureau's staff. Because historical price information is not readily available, field observations are limited to the advertised selling price the day the on-site inspection is performed.

The Miscellaneous Tax Bureau's staff also notifies the accused retailer by letter of the requirements of the Unfair Cigarette Sales Law, penalties for violation, instructions on how to calculate minimum price, and copies of the minimum price calculation worksheet. The retailer named in the complaint must also furnish a copy of a sales invoice for the period in question and to provide information regarding any manufacturers' discounts not reflected on the invoice for each brand in the complaint. Once the requested information is received, the bureau's staff calculates the legally allowed minimum price to determine whether the retailer is selling below minimum price. Even if a retailer is found to be selling below the legally required price, the retailer may assert that such pricing was necessary to meet a competitor's price, as discussed in the following section.

The Law's Provision for Meeting Competitors' Prices

Even if a wholesaler or retailer is found selling cigarettes at prices below that required by the Unfair Cigarette Sales Law, MISS. CODE ANN. Section 75-23-15 (a) (1972) allows wholesalers and retailers to sell below minimum prices to meet a competitor's price.

MISS. CODE ANN. Section 75-23-15 (a) (1972) allows any wholesaler or retailer to advertise and sell cigarettes at the same price of a competitor, if the competitor's price complies with the Unfair Cigarette Sales Law. Therefore, for example, if a retailer is found to be selling cigarettes at a price below that required by the Unfair Cigarette Sales Law, the retailer may assert that such pricing was in response to a competitor's price. To determine whether the other competitor is in compliance with pricing

requirements, another investigation would have to be conducted. However, since historical pricing is not readily available, investigators would not be able to establish the actual selling price of a retailer at a previous date. Further, even if the other retailer were found to be in violation of pricing guidelines, the retailer need only claim that it was responding to the price of yet another competitor. Thus, investigators could enter a never-ending circle of claims and counter-claims of pricing accusations.

The Miscellaneous Tax Bureau's staff stated that when retailers are found to be in violation of the minimum pricing requirements based on current advertised prices, the retailer usually asserts the "meeting the competition" argument. As of July 1, 2010, the bureau had never assessed a fine for violating minimum pricing requirements or suspended or revoked a wholesaler's or retailer's license to sell cigarettes for violating minimum pricing requirements.

Given that any retailer found to be in violation of minimum pricing requirements could legally assert that it was only meeting a competitor's price, which makes it unlikely that an investigation would yield an actionable result, the DOR's reluctance to commit additional staff to an enforcement effort is understandable. A public policy debate is needed to discuss viable options for Mississippi's Unfair Cigarette Sales Law.

Options for Change

Three options are available for changes to Mississippi's Unfair Cigarette Sales Law: remove the "meeting competition" provision, increase enforcement efforts, or repeal the law.

The question of how to address the difficulties in enforcing Mississippi's Unfair Cigarette Sales Law is a public policy decision. PEER offers three viable options for addressing the law's enforcement difficulties. PEER does not find one option superior and believes an open debate of the alternatives would offer interested parties an opportunity to voice concerns that should be considered in choosing a final option or combination of the options.

Option 1: Remove the "Meeting Competition" Provision

Removal of the "meeting the competition" clause would allow for a business to be held responsible for violating minimum pricing requirements, but could cause a business to suffer economic damages.

As noted previously, currently if a wholesaler or retailer is found to be selling cigarettes at below cost, it may assert that such pricing was necessary to meet a competitor's prices. Further, the competitor could make a similar claim, creating a never-ending cycle in which no wholesaler or retailer could be held responsible for selling below minimum pricing requirements.

Removing the "meeting the competition" clause would allow wholesalers and retailers to be held responsible for selling below minimum pricing requirements. However, removing this clause would eliminate the ability of a business from responding to local market conditions and could lead to a business suffering economic harm, particularly from larger retailers. If this option were chosen exclusively, an insufficient number of DOR staff assigned to enforcement would still impair efforts to enforce the minimum pricing requirements.

Option 2: Increase Enforcement Efforts

The state could increase enforcement efforts by increasing the number of staff assigned to enforcement of Mississippi's Unfair Cigarette Sales Law. Charging a fee for the licensing of cigarette retailers could fund the increased costs of additional staffing.

The DOR could allocate additional staff and resources for enforcement of the Unfair Cigarette Sales Law. This could

include requirements for wholesalers and retailers to maintain documentation of information needed for the DOR to enforce the Unfair Cigarette Sales Law. Increased enforcement efforts would acknowledge the importance of minimum pricing as a method of reducing the demand for cigarettes and thereby reducing smoking prevalence and associated health costs.

Currently, the DOR does not have statutory authority to charge a fee for the licensing of the state's approximately 7,500 retailers of cigarettes. An annual licensing fee of $100 per licensee could produce approximately $750,000 annually, which could be directed toward increased enforcement efforts. If this option were chosen exclusively, vendors found in violation of the Unfair Cigarette Sales Law could avoid penalties by claiming the "meeting the competition's price" provision.

Option 3: Repeal the Unfair Cigarette Sales Law

Repealing Mississippi's Unfair Cigarette Sales Law would allow competitive market forces to regulate cigarette prices.

Historically, when price protections have been removed from commodities such as milk, competitive market forces regulate prices and determine competition. Under this option, cigarettes would be viewed as any other commodity and wholesalers and retailers would be allowed to set prices through the free market.

An advantage of this option would be the removal of enforcement duties from the Miscellaneous Tax Bureau, which would allow staff additional time for other duties. A disadvantage of this option would be the possibility of retailers using cigarettes as a loss leader that could increase cigarette consumption.

Conclusion

In its current form, Mississippi's Unfair Cigarette Sales law requires large amounts of staff time to investigate complaints and the "meeting the competition's price" clause makes staff efforts to assess penalties virtually impossible. A public policy debate is needed to determine which course of action represents the state's best option concerning minimum cigarette pricing.

Recommendation

The Legislature should consider the following options or combination of options to determine which option or options represent the most appropriate public policy and promote the best interest of the state.

Option One: Remove the "Meeting Competition" Provision

The Legislature could amend MISS. CODE ANN. Section 75-23-15 (a) (1972) by removing the "meeting the competitor's price" provision. This option would allow vendors to be held liable for selling cigarettes below the legally allowed price, but could cause vendors economic harm by preventing a vendor from meeting a competitor's price and thereby losing revenue.

Option Two: Increase Enforcement Efforts

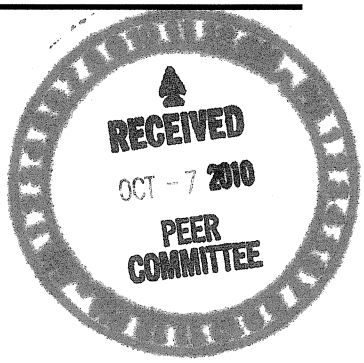
The Department of Revenue could increase enforcement efforts by increasing the number of staff assigned to enforcement of Mississippi's Unfair Cigarette Sales Law. Currently, the Department of Revenue does not have statutory authority to charge a fee for the licensing of the state's approximately 7,500 retailers of cigarettes. An annual licensing fee of $100 per licensee could produce approximately $750,000 annually, which could be directed toward increased enforcement efforts.

Option Three: Repeal the Unfair Cigarette Sales Law

The Legislature could repeal Mississippi's "Unfair Cigarette Sales Law" (MISS. CODE ANN. Section 75-23-1 et seq.). Under this option, cigarettes would be viewed as any other commodity and wholesalers and retailers would be allowed to set prices through the free market.

Agency Response

Office of the Commissioner of Revenue



October 4, 2010

Max K. Arinder, Ph.D.
Executive Director
Joint Committee on Performance Evaluation and Expenditure Review
P. O. Box 1204
Jackson, MS 39215-1204

RE: Unfair Cigarette Sales Law, Review of Enforcement

Dear Dr. Arinder:

The Department of Revenue appreciates this opportunity to respond to the Peer Committee's report *"A Review of the Department of Revenue's Enforcement of Mississippi's Unfair Cigarette Sales Law."* The Peer Committee Staff drafted a concise report of the complicated process of enforcing minimum price laws. We agree with the facts contained in the report; however, we would like to make an additional comment.

In the report, three possible solutions were proposed. It is our opinion that option three, "Repeal the Unfair Cigarette Sales Law," is the only viable option. The other options marginally aid enforcement of this law.

The Unfair Cigarette Sales Law is an archaic law enacted during a period when other minimum pricing laws, or fair trade laws, were passed to protect certain businesses from unfair competition. Over time, marketing strategies and business practices changed. As the modern marketplace evolved, enforcement of this law became unrealistic. The formula provided in this law no longer guarantees a minimum price for a specific brand of cigarettes.

Under current law and the other two options (Remove the Meeting Competition Provision and Increase Enforcement Efforts,) the enforcement of a commodity pricing law is required of an agency whose mission is collecting revenue. Enforcement of the Unfair Cigarette Sales Law does not raise or increase revenue. Any resource the Department of Revenue assigns to enforcing this law is a resource not assigned to collecting revenue necessary for this State to fund its services.

If either option one or option two are considered, it is our opinion that another agency, whose purpose is more closely aligned to consumer and business protection, should enforce compliance of this pricing law.

Respectfully,

Ed Morgan
Commissioner of Revenue

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