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Memorandum

This is not a legal opinion.

September 12, 2022

TO: Executive Committee of the Legislative Council and Prime Sponsors of HB 20-1427

FROM: Greg Sobetski, Chief Economist, 303-866-4105

SUBJECT: TABOR (3)(c) Refund for Proposition EE

Summary

New taxes imposed under Proposition EE accounted for \$208.5 million in FY 2021-22. Pursuant to a constitutional requirement in TABOR, the 2020 Blue Book estimated the amount of new tax revenue at \$186.5 million, and actual revenue exceeded this estimate by \$22.0 million, or 11.8 percent. In this situation, TABOR requires the General Assembly to either refer a ballot measure to retain the excess revenue, or the following:

1. refund the excess amount to taxpayers during the current FY 2022-23; and
2. reduce the rates of the new taxes in proportion to the excess.

Since it is too late to refer a ballot measure, this memorandum explains the TABOR refund requirement and the options available to the General Assembly. It also provides background information about Proposition EE.

Proposition EE

What is Proposition EE? Proposition EE was referred to voters at the 2020 General Election pursuant to House Bill 20-1427. The measure creates new excise taxes on cigarettes, tobacco products, and nicotine products to fund preschool programs. The measure was approved with 67.6 percent of the vote.

Taxes imposed in Proposition EE took effect on January 1, 2021. The tax rates imposed in the measure phase in over time, with final rates taking effect on July 1, 2027, as follows:

- an additional tax of \$0.055 per cigarette was imposed beginning January 1, 2021; this rate is scheduled to reach \$0.09 per cigarette on July 1, 2027;

- an additional tax of 10 percent on the manufacturer’s list price of tobacco products was imposed beginning January 1, 2021; this rate is scheduled to reach 22 percent on July 1, 2027; and
- a new tax of 30 percent on the manufacturer’s list price of nicotine products was imposed beginning January 1, 2021; this rate is scheduled to reach 62 percent on July 1, 2027.

The measure taxes products designated by the U.S. Food and Drug Administration as “modified risk” tobacco or nicotine products at lower rates than those above. It also imposes a minimum price for sales of cigarettes and a minimum tax for moist snuff, thereby increasing collections of the 2.9 percent general state sales tax that applies to those products.

TABOR requirements for tax measures. The Taxpayer’s Bill of Rights (TABOR) in the Colorado Constitution requires that certain fiscal information be provided to voters when state bonded debt, a new tax, or a tax increase is proposed in an election. Under state law, fiscal information for statewide tax measures is required to be provided in the Blue Book by the Executive Committee of the Legislative Council.¹

Specifically, subsection (3)(b)(iii) of TABOR requires that the state provide, “for the first full fiscal year of each proposed district tax increase, district estimates of the maximum dollar amount of each increase and of district fiscal year spending without the increase.” “Fiscal year spending” is the legal term used in TABOR to signify the amount of revenue subject to the TABOR limit that the state is permitted to keep and either spend or save for a single year.

What estimates were provided for Proposition EE? The 2020 Blue Book provided the following estimates for FY 2021-22, the first full year for which the taxes were in effect:

- \$16.46 billion for fiscal year spending without the tax increase; and
- \$186.5 million from the tax increase.

These estimates were approved by the Executive Committee of the Legislative Council in its meeting on September 3, 2020.

How much revenue was actually collected? According to the State Controller’s September 1, 2022, certification of revenues for FY 2021-22, fiscal year spending for FY 2021-22 was \$16.01 billion, less than the estimate in the Blue Book.

According to preliminary data from the Department of Revenue and the Department of the Treasury, revenue from the new taxes in Proposition EE totaled \$208.0 million. Additionally, revenue from the 2.9 percent general state sales tax is estimated to have increased by \$0.5 million as a result of the minimum price for sales of cigarettes. In total, FY 2021-22 tax revenue attributable to Proposition EE is estimated at \$208.5 million, or \$22.0 million more than the Blue Book estimate.

¹Section 1-40-124.5 (1.5), C.R.S.

The excess was driven by nicotine taxes. As shown in Table 1, actual collections fell short of estimates for cigarette tax and general sales tax revenue, but exceeded the estimates for tobacco products tax and nicotine products tax revenue. In particular, the estimate for nicotine products taxes was more than three times as much as estimated. A description of the methodology used to build the nicotine tax estimate for Proposition EE and potential reasons for why the estimate understated actual revenue are provided in Appendix A at the end of this memo.

Table 1
FY 2021-22 Estimated and Actual Proposition EE Tax Revenue

	Estimated Amount	Actual Amount	Difference from Estimate
Cigarette Tax	\$160.1 million	\$153.1 million	(\$7.0 million)
Tobacco Products Tax	\$12.5 million	\$12.7 million	\$0.2 million
Nicotine Products Tax	\$12.4 million	\$42.2 million	\$29.8 million
General Sales Tax	\$1.5 million	\$0.5 million	(\$1.0 million)
Total	\$186.5 million	\$208.5 million	\$22.0 million

TABOR (3)(c) Requirements and Legislative Next Steps²

What does TABOR require in this case? Subsection (3)(c) of TABOR states that, except by later voter approval, if the estimate of tax revenue is exceeded, “the tax increase is thereafter reduced up to 100% in proportion to the combined dollar excess, and the combined excess revenue refunded in the next fiscal year.”

Proposition EE tax revenue for FY 2021-22 exceeded the Blue Book estimate by \$22.0 million, or 11.8 percent. Table 2 shows the Proposition EE tax rates for 2023 after application of an 11.8 percent reduction.

Table 2
2023 Proposition EE Tax Rates if Reduced by 11.8 Percent

	2023 Tax Rate in Proposition EE	2023 Tax Rate Reduced by 11.8%	Tax Rate Reduction
Cigarette Tax	\$0.055 per cigarette	\$0.049 per cigarette	(\$0.006 per cigarette)
Tobacco Products Tax	10.0% of MLP*	8.8% of MLP*	(1.2% of MLP*)
Nicotine Products Tax	50.0% of MLP*	44.1% of MLP*	(5.9% of MLP*)

**MLP = manufacturers’ list price.*

The amount collected in excess of the estimate, \$22.0 million, is required to be refunded in FY 2022-23.

It is too late to ask voters for permission to retain the excess. Subsection (3)(c) of TABOR establishes a voter approval exception for the refund and tax rate reductions. Because the refund must occur in FY 2022-23, the only election at which the state could refer a measure to seek this voter-approval is the

²The Office of Legislative Legal Services provided assistance with this portion of the memorandum.

general election to take place on November 8, 2022. As a practical matter, it is too late to refer a ballot measure at this election. On September 12, 2022, the Secretary of State will certify the ballot order and content to the county clerks and recorders,³ and after certification, the counties can begin printing the ballots. Similarly, this year's Blue Book has already been sent to the printer.⁴

The General Assembly must create or specify a Proposition EE refund mechanism via legislation.

The current TABOR refund mechanisms only apply to refunds of state revenues that exceed the state fiscal year spending limit pursuant to subsection (7)(d) of TABOR. There is no law in place to direct refunds of excess revenue collected under Proposition EE. Subsection (1) of TABOR states that the state may use “any reasonable method for refunds under this section, including temporary tax credits or rate reductions.”

It may be possible to use the 2022 income tax return to deliver the \$22 million refund to taxpayers. This would require the General Assembly to pass legislation during a special session to allow the Department of Revenue sufficient time to make changes to the return before tax forms are finalized later this year. If the General Assembly chooses not to use the income tax return to administer refunds, some other mechanism, such as a temporary rate reduction or a direct refund to taxpayers, will need to be created during the 2023 legislative session. Subsection (8)(a) of TABOR prohibits changes to the definition of taxable income from taking effect in the tax year when they first apply.

Only once has the General Assembly created a mechanism to potentially refund revenue under subsection (3)(c) of TABOR. In the event that voters did not approve Proposition BB, which was a measure to allow the state to not refund retail marijuana tax revenue, the Department of Revenue would have been required to refund some of the revenue directly to the retail marijuana cultivation facilities that paid the excise tax, and the remainder would have been refunded to taxpayers as a separate sales tax refund through the state income tax return, similar to the current excess state revenues refund mechanism.⁵

How will the rate reduction occur? The General Assembly will need to enact a bill to implement the required rate reductions for the current year and to reduce the tax rates for all of the future years of the phased-in tax increases. It is unclear whether the state will need to refund any tax revenue that is being collected during FY 2022-23 from the full tax rates that continue to be in place now, prior to the reductions becoming effective.

You are welcome to contact Ed DeCecco at the Office of Legislative Legal Services to discuss refund and rate reduction options.

³Section 1-5-203 (1), C.R.S.

⁴The only other time a TABOR (3)(c) estimate was exceeded was the Proposition AA fiscal year spending estimate for FY 2014-15. In that case, however, the General Assembly anticipated that state fiscal year spending would exceed the estimate and was able to enact House Bill 15-1367 during the 2015 legislative session to refer Proposition BB at the 2015 statewide election.

⁵Section 39-28.8-605, C.R.S.; see https://leg.colorado.gov/sites/default/files/images/olls/2015a_sl_271.pdf. Proposition BB was approved by the voters, so it was unnecessary to use these refund methods.

Discussion of Nicotine Tax Revenue Estimate

This appendix discusses how the 2020 Blue Book estimate of FY 2021-22 nicotine products tax revenue was prepared and lists eight reasons why the estimate may have understated actual collections.

How was the estimate of nicotine products tax revenue prepared? The estimate of nicotine products tax revenue was based on proprietary Nielsen data provided to Legislative Council Staff (LCS) by the proponents of the measure. The data represented retail sales of vaping products in Colorado for calendar year 2018, based on universal product code (UPC) transactions at grocery stores and convenience stores. LCS adjusted these data to account for:

- 2018 retail sales of vaping products that were thought to be underrepresented in the Nielsen data, such as sales at specialty tobacco stores and online;
- retailer markups, in order to arrive at the manufacturer's list price on which taxes are assessed;
- growth in vaping sales and inflation between calendar year 2018 and FY 2021-22; and
- expected declines in consumption based on price increases associated with the new tax.

After application of these adjustments, LCS estimated a FY 2021-22 tax base (manufacturer's list price) of \$38.6 million. LCS calculated a tax amount of \$12.5 million before the vendor fee in the measure, and a revenue amount of \$12.4 million after application of the vendor fee.

Through 2019, nine states and the District of Columbia had enacted taxes on nicotine products. At the time, many of these taxes had been enacted recently enough that revenue data were unavailable when LCS was working to prepare a revenue estimate for Proposition EE. LCS obtained collections data from three states with established revenue histories: Louisiana, Minnesota, and North Carolina. Only one of these states, Minnesota, imposes an excise tax on the wholesale price of nicotine products. According to the Minnesota Department of Revenue, the state's 95 percent excise tax generated \$4.5 million in FY 2014-15, \$5.7 million in FY 2015-16, and \$7.4 million in FY 2016-17. Based on Minnesota's experience and Colorado's similar population and much lower tax rate, the \$12.4 million estimate was thought to potentially overstate the revenue impact of the nicotine products tax.

Why did nicotine products tax revenue exceed the estimate? Eight possible reasons why the Blue Book estimate may have understated nicotine products tax revenue are listed below. At this point, LCS has not investigated which of these causes most contributed to the forecast error.

1. The Nielsen data used to prepare the estimate may have understated 2018 retail sales of nicotine products by more than was assumed.
2. Retailer markups may have been less than was assumed, such that manufacturers' list prices were closer to retail prices than thought.
3. Manufacturers' list prices may have grown by more than was assumed, particularly as a result of higher-than-expected inflation.
4. The retail and wholesale markets for nicotine products may have grown more quickly between 2018 and 2022 than was assumed, for example as a result of changing consumption patterns during the COVID-19 pandemic.

5. Imposition of the tax and the corresponding increase in retail prices may not have caused declines in consumption to the extent expected.
6. Minnesota collects nicotine and tobacco product taxes together, and then attempts to separate the revenue attributable to each for reporting purposes. Minnesota revenue analysts may have underestimated the extent to which consumption of nicotine products had replaced consumption of tobacco products when performing that analysis.
7. Coloradans may purchase more nicotine products per capita than Minnesotans.
8. Tax enforcement in Colorado may have outperformed enforcement in Minnesota, resulting in a higher share of tax-compliant Colorado sales.