# LAO

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INITIATIVE COORDINATOR
ATTORNEY GENERAL'S OFFICE

Hon. Kamala D. Harris
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Ashley Johansson
Initiative Coordinator

Dear Attorney General Harris:

Pursuant to Elections Code Section 9005, we have reviewed the proposed statutory initiative (A.G. File No. 15-0030) that would increase the state's cigarette excise tax from 87 cents to $2.87 per pack.

## BACKGROUND

### Tobacco Taxes

***Existing State Excise Taxes on Tobacco Products.*** Current state law imposes excise taxes on the distribution of cigarettes and other tobacco products, such as cigars and chewing tobacco. Tobacco excise taxes are paid by distributors who supply cigarettes and other tobacco products to retail stores. These taxes are typically passed on to consumers as higher prices on cigarettes and other tobacco products.

The state's cigarette excise tax is currently 87 cents per pack. Figure 1 describes the different components of the per-pack tax. As the figure shows, two voter-approved measures—Proposition 99 in 1988 and Proposition 10 in 1998—are responsible for generating the vast majority of tobacco excise tax revenues. As the figure indicates, total state revenues from existing excise taxes on cigarettes and other tobacco products were just under $840 million in 2013-14.

Revenues from existing excise taxes on other tobacco products support Proposition 10 and Proposition 99 purposes. Under current law, any increase in cigarette taxes automatically triggers an equivalent increase in excise taxes on other tobacco products, with the latter revenues going to support Proposition 99 purposes.

***Existing Federal Excise Tax on Tobacco Products.*** The federal government imposes an excise tax on cigarettes and other tobacco products. In 2009, this tax was increased by 62 cents per pack (to a total of $1.01 per pack) to help fund the Children's Health Insurance Program, which provides subsidized health insurance coverage to children in low-income families.

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**Figure 1**

**Existing State Tobacco Excise Taxes**

*(Dollars in Millions)*

| Description | Cents Per Pack of Cigarettes | Estimated 2013-14 Net Revenue[a] |
|---|---|---|
| ***State General Fund:*** Initially enacted by the Legislature in 1959 for general support of the state budget. | 10¢ | $86 |
| ***Proposition 99:*** Enacted by the voters in 1988 for the purposes of supporting tobacco education and prevention efforts, tobacco-related disease research programs, health care services for low-income persons, and environmental protection and recreational resources. | 25 | 269[b] |
| ***Breast Cancer Fund:*** Enacted by the Legislature in 1993 for the purposes of supporting breast cancer screening programs for uninsured women and research related to breast cancer. | 2 | 20 |
| ***Proposition 10:*** Enacted by the voters in 1998 for the purpose of supporting early childhood development programs. | 50 | 462[b] |
| **Totals** | 87¢ | $838[c] |

[a] Accounts for payments from Proposition 10 to other funds in order to maintain pre-Proposition 10 revenue levels.
[b] Total includes excise tax revenue from other types of tobacco products, such as cigars and chewing tobacco.
[c] Does not total due to rounding.

***Existing State and Local Sales and Use Taxes on Tobacco Products.*** Sales of cigarettes and other tobacco products are subject to state and local sales and use taxes. These taxes are imposed on the retail price of a product, which includes excise taxes that have generally been passed along from distributors. The average retail price of a pack of cigarettes in California currently is close to $6. Roughly $400 million in annual revenue from sales and use taxes on cigarettes and other tobacco products go to state and local governments.

## State and Local Health Programs

***Department of Health Care Services (DHCS).*** The DHCS administers the Medicaid program, known as the California Medical Assistance Program (Medi-Cal) in California. Medi-Cal is a joint federal-state program that provides health care services to qualified low-income persons. Currently, Medi-Cal provides health care services to over 12 million people, with a General Fund budget estimated at $17 billion for 2014-15. Federal law establishes some minimum requirements for state Medicaid programs regarding the types of services offered and who is eligible to receive them. Required services include hospital inpatient and outpatient care, skilled nursing care, and doctor visits. In addition, California offers an array of services considered optional under federal law, such as coverage of prescription drugs and durable medical equipment. While Medi-Cal is by far the largest healthcare program that DHCS administers in terms of both funding level and persons served, the department also administers a few other programs that provide health care services.

***Department of Public Health (DPH).*** The DPH administers and oversees a wide variety of programs with the goal of optimizing the health and well-being of Californians. The department's programs address a broad range of health issues, including tobacco-related diseases, maternal and child health, cancer and other chronic diseases, communicable disease

control, and inspection of health facilities. Many public health programs and services are delivered at the local level, while the state provides funding, oversight, and overall strategic leadership for improving population health. The state also centrally administers certain public health programs, such as licensing and certification of health facilities.

## PROPOSAL

This measure increases excise taxes on the distribution of cigarettes and other tobacco products. The additional revenues would be used to increase funding for existing healthcare programs and services, tobacco-related prevention and cessation programs, law enforcement programs, medical research on tobacco-related diseases, and for other specified purposes. The major provisions of the measure are described below.

### New State Tobacco Tax Revenues

This measure increases—effective April 1, 2017—the existing state excise tax on cigarettes by $2 per pack. The total state excise tax, therefore, would be $2.87 per pack. This measure also creates a one-time "floor tax" on cigarettes that are stored by businesses at the time the new excise tax is levied. Floor taxes are typically used to prevent businesses from avoiding taxes by stockpiling products before a tax goes into effect.

As described above, any increase in cigarette taxes automatically triggers an equivalent increase in excise taxes on other tobacco products. As a result, the $2 per pack cigarette tax increase would lead to an equivalent increase in the tax rate on other tobacco products.

### How New Tobacco Tax Revenues Would Be Spent

Revenues from the cigarette and other tobacco product excise taxes would be deposited directly into a new special fund, called the California Healthcare, Research and Prevention Tobacco Tax Act of 2016 Fund (hereafter referred to as the fund). Revenues deposited in the fund would only be used for purposes set forth in the measure and would not be subject to appropriation by the Legislature. Here we describe how the revenues would be spent in the order required by the measure.

***Backfill of Existing Tobacco Tax Programs.*** This measure requires the transfer of some revenues raised by the new taxes to "backfill," or offset, any revenue losses that occur to funds supported by existing state cigarette and tobacco taxes as a direct result of the imposition of the new taxes. These revenue losses would occur mainly because an increase in the price of cigarettes and other tobacco products generally reduces consumption and leads some consumers to acquire untaxed products instead of taxed ones. This, in turn, would reduce the amount of revenues collected through the existing state excise taxes described above. The amount of backfill payments needed to offset any loss of funding in these areas would be determined by the Board of Equalization (BOE).

***Backfill of State and Local Sales and Use Tax Revenue Losses.*** Similarly, the measure requires backfill payments to the state and affected local governments in respect of any revenue losses of state and local sales and use taxes resulting directly from the new taxes on cigarettes and tobacco products.

***BOE Would Receive 1 Percent of Remaining Funds for Administrative Costs.*** The BOE would receive not more than 1 percent of the funds remaining after backfill of existing tobacco programs to cover administrative expenses resulting from the new tax. (The BOE would also receive additional funds for enforcement of the new tax as explained below.)

***Specified State Entities Would Receive Predetermined Amounts.*** After backfilling for specified revenue losses due to the imposition of the new taxes and providing funds to BOE for administrative costs, the University of California (UC), California Department of Justice (DOJ), Office of the Attorney General (OAG), BOE, and DPH would annually receive predetermined amounts of funding as follows.

- ***UC Would Receive $40 Million for Physician Training.*** Forty million dollars would be used to provide funding to UC for the purpose of increasing the number of physicians trained in California. The UC provides instruction to about 8,000 graduate medical students at six of its campuses. In addition, the university operates five teaching hospitals that support clinical teaching programs.
- ***DOJ and OAG Would Receive $30 Million for Local Law Enforcement.*** Thirty million dollars would be provided to the DOJ and the OAG to, in turn, distribute to local law enforcement agencies. The funds would be used to support and hire law enforcement officers for programs including, but not limited to, enforcement of state and local laws related to the illegal sales and marketing of tobacco to minors, increasing investigative activities, and compliance checks to reduce illegal sales of tobacco products to minors and youth tobacco use.
- ***OAG Would Receive $6 Million to Enforce Tobacco Laws.*** Six million dollars would be provided to the OAG for activities including, but not limited to, enforcing laws that regulate the distribution and sale of cigarettes and other tobacco products.
- ***DPH Would Receive $6 Million for Tobacco Enforcement Programs.*** Six million dollars would be provided to DPH to support programs, including, but not limited to, providing grants and contracts to local law enforcement agencies to provide training and funding for the enforcement of state and local laws related to the illegal sales of tobacco to minors, increasing investigative activities and compliance checks, and other activities to reduce the illegal sales of tobacco to minors.
- ***BOE Would Receive $6 Million for Enforcement.*** Six million dollars would be provided to the BOE for enforcement of laws that regulate the distribution and retail sale of cigarettes and other tobacco products. The BOE administers a variety of tax programs, including sales and use taxes, property taxes, and special taxes, such as those on cigarettes and other tobacco products.

***Predetermined Amounts Would Be Adjusted to Reflect Revenues.*** If the BOE determines that there has been a reduction in revenues resulting from a reduction in the consumption of cigarette and tobacco products due to the measure, the predetermined amounts of funding described above would be adjusted proportionately. The BOE would make such determinations annually beginning two years after the measure went into effect.

***Remaining Funds Go to State Health Programs.*** After backfilling for specified revenue losses, paying BOE administrative costs, and distributing predetermined amounts of funding to specified state entities, the following state agencies would receive the remaining funds for health programs.

- ***Medi-Cal in DHCS.*** Eighty-two percent of the remaining funds would be allocated to DHCS to provide funding to increase the level of reimbursement for health care, services, and treatment provided to Medi-Cal beneficiaries. Examples of health care, services, and treatment would include physician visits, hospital care, and prescription drugs. While this measure requires DHCS to use revenues from this measure to supplement, not supplant, existing state funding for Medi-Cal, it is unclear how this requirement would be interpreted and enforced.
- ***California Tobacco Control Program (CTCP) in DPH.*** About 11 percent of the remaining funds would fund tobacco prevention and control programs administered by CTCP. The DPH administers the CTCP with the aim of reducing illness and death from tobacco-related diseases. The CTCP, with a budget estimated at $38 million in 2014-15, funds programs aimed at countering pro-tobacco messages, reducing secondhand smoke exposure, reducing access to tobacco products, and increasing smoking cessation services.
- ***California Department of Education (CDE).*** About 2 percent of the remaining funds would be provided to CDE for school programs to prevent and reduce the use of tobacco products by young people. The department administers various education programs, and allocates funding to various types of local education agencies, including county offices of education, school districts, and charter schools. The CDE's budget for tobacco education and prevention programs is estimated at $16 million for 2014-15, with the funding for these programs coming from Proposition 99.
- ***Tobacco-Related Disease Research Program Administered by UC.*** Five percent of the remaining funds would be allocated to the Tobacco-Related Disease Research Program administered by UC for medical research into prevention, early detection, treatments, and potential cures of all types of cancer, cardiovascular and lung disease, and other tobacco-related diseases. Currently funded with Proposition 99 tobacco tax revenues, this research program supports research on the prevention and treatment of tobacco-related disease in California by awarding grant funding to researchers at California public, private, and nonprofit entities, such as universities, hospitals, laboratories, local health departments, and managed care organizations.

***Administrative Costs Subject to Limits Imposed by the Measure.*** The measure would limit the amount of revenues raised by the measure that could be used to pay for administrative costs. The CTCP, CDE, and the Tobacco-Related Disease Research Program administered by UC would be allowed to use 5 percent of the funds allocated to them from the new tax for administrative costs. All other entities receiving funds would be allowed to use 1 percent of the funds for administrative costs unless as otherwise noted in this analysis.

### Other Major Provisions

***California State Auditor.*** The California State Auditor would conduct audits of agencies receiving funds from the new taxes at least every other year. The Auditor would receive up to $400,000 annually to cover costs incurred from conducting these audits. The Auditor provides independent and nonpartisan assessments of the California government's financial and operational activities in compliance with generally accepted government accounting standards.

## FISCAL EFFECTS

This measure would have a number of fiscal effects on state and local governments. The major impacts are discussed below.

### Impacts on State and Local Revenues

***Revenues Would Be Affected by Consumer Response.*** Our revenue estimates assume that the proposed excise tax increases would be passed along to consumers. In other words, we assume that the retail prices of cigarettes and other tobacco products would be raised to include the excise tax increase. We expect consumers to respond to this price increase in two ways: by reducing their consumption of cigarettes and other tobacco products and by changing the way they acquire cigarettes and other tobacco products so that fewer transactions are taxed. For example, consumers could avoid paying excise taxes by purchasing cigarettes that have been smuggled into California.

***New Excise Tax Revenues.*** We estimate that the increase in cigarette and other tobacco product excise taxes required by this measure would raise an estimated $1.3 billion to $1.5 billion in annual revenue. The range reflects the uncertainty of the magnitude of the consumer response to the proposed tax increase discussed above. Our estimate of the allocation of new excise tax revenues in 2017-18 (the first full-year impact) is shown in Figure 2. After backfilling losses in existing tax revenue (described in more detail below), the new excise taxes would generate an estimated $1 billion to $1.3 billion in net revenue in 2017-18 for the purposes described in the measure. (These estimates do not include revenue from the one-time floor stock tax.) The excise tax increases would generate somewhat lower amounts of revenue in subsequent years, based on our projections of continued declines in cigarette consumption.

***Effects on Existing Tax Revenues.*** The decline in consumption of cigarettes and other tobacco products caused by this measure would reduce revenues from the existing excise taxes that go to support Proposition 99 and Proposition 10 purposes, the General Fund, and the Breast Cancer Fund. The measure provides for the backfill of these losses from revenues raised by the new excise taxes. We estimate that the amount of backfill funding needed to comply with this requirement would range from $160 million to $220 million annually.

**Figure 2**

**How Estimated Revenue From New Tobacco Excise Taxes Would be Allocated[a]**

*(In Millions)*

| | 2017-18 Funding[b] (Full Year) | |
|---|---|---|
| | Low Estimate[c] | High Estimate[c] |
| **Estimated Revenue From New Excise Taxes** | $1,230 | $1,440 |
| Less backfill for specified revenue losses | 220[d,e] | 160[d,e] |
| **Estimated Net Revenue** | **$1,010** | **$1,280** |
| **Allocation of Estimated Net Revenue** | | |
| Board of Equalization—administrative expenses | $10 | $13 |
| University of California | 40 | 40 |
| Department of Justice and Office of the Attorney General | 30 | 30 |
| Office of the Attorney General | 6 | 6 |
| Department of Public Health | 6 | 6 |
| Board of Equalization—enforcement | 6 | 6 |
| Medi-Cal | 750 | 970 |
| Tobacco Control Program | 100 | 130 |
| Department of Education | 18 | 24 |
| University of California Tobacco-Related Disease Program | 46 | 59 |
| Bureau of State Audits | 0.4 | 0.4 |

[a] Numbers may not add due to rounding.
[b] The estimates do not include revenues from the one-time floor stock tax.
[c] The consumer response to the proposed tax increase is uncertain, so we present a range of plausible outcomes. The low revenue estimate reflects a strong consumer response, while the high revenue estimate reflects a weak consumer response.
[d] LAO estimate. Backfill amounts would be determined by the Board of Equalization.
[e] A strong consumer response would reduce estimated revenues from the new excise taxes but increase the amount needed to backfill for specified revenue losses.

***Effect on State and Local Sales and Use Tax Revenues.*** Sales and use taxes are levied on a variety of products, including the retail price of cigarettes and other tobacco products. The retail price usually includes the cost of all excise taxes. The excise tax increases under the measure would raise the retail price of taxable cigarettes and tobacco products, and consumers would respond by buying fewer of those goods. As a result, the effect of the measure's tax increases on sales and use tax revenue from the sale of cigarettes and tobacco products could be positive or negative, depending on the magnitude of the consumer response. The measure provides for the backfill of sales and use tax revenue losses from revenues raised by the new excise taxes. We estimate this provision is not likely to be used.

***Effects on Excise Tax Collection.*** As discussed above, the measure would allocate $48 million to the DOJ, OAG, DPH, and BOE to support state law enforcement efforts. These funds would be used to support increased enforcement efforts to reduce tax evasion, counterfeiting, smuggling, and the unlicensed sales of cigarettes and other tobacco products. The funds would also be used to support efforts to reduce sales of tobacco products to minors. These activities could bring in more excise tax revenue, but the magnitude of this effect is uncertain.

## Impact on State and Local Government Health Care Costs

The state and local governments in California incur costs for providing (1) health care for low-income and uninsured persons and (2) health insurance coverage for state and local government employees and retirees. Consequently, changes in state law such as those made by this measure that affect the health of the general population—and low-income and uninsured persons and public employees in particular—would affect publicly funded health care costs.

For example, as discussed above, this measure would result in a decrease in the consumption of tobacco products as a result of the expected price increase of tobacco products. Further, this measure provides funding for tobacco prevention and cessation programs, and to the extent these programs are effective, this would further decrease consumption of tobacco products. The use of tobacco products has been linked to various adverse health effects by the federal health authorities and numerous scientific studies. Thus, this measure would reduce state and local government health care spending on tobacco-related diseases over the long term. This measure would have other fiscal effects that offset these cost savings. For example, health care and social services that otherwise would not have occurred as a result of individuals who avoid tobacco-related diseases living longer. Thus, the net long-term fiscal impact of this measure on state and local government costs is unknown.

***Potential Other Effects on State General Fund Resulting From Increases in Health Care Provider Reimbursement.*** As noted above, a portion of the funds from this measure are to be used to increase the level of reimbursement for health care providers that provide services to individuals enrolled in Medi-Cal. Currently, certain types of Medi-Cal providers, such as managed care plans, typically receive rate increases that account for such things as medical inflation and changes in the amount and types of health care services provided to enrollees. These rate increases are partially funded with state General Fund monies. In addition, absent the measure, there may be some pressure for the state to increase reimbursement to other types of Medi-Cal providers to ensure beneficiaries have adequate access to health care services. To the extent funds generated by the measure are used to increase provider reimbursements that would otherwise have been covered by the General Fund, the measure would reduce state General Fund costs. On the other hand, higher provider reimbursements created by the measure could establish an expectation that similar reimbursement levels will be maintained in future years. The funds generated from this measure are expected to decline over time as cigarette consumption decreases and fewer cigarettes are purchased. To the extent the measure would create pressure to maintain the level of provider reimbursements initially achieved by this measure, it could create pressure to use state General Fund monies to backfill the expected decline in funds available from this measure. The net fiscal effect of these two potential impacts cannot be estimated.

**Summary of Fiscal Effects**

This measure would have the following major fiscal effects:

- Net increase in excise tax revenues in the range of $1 billion to $1.3 billion annually by 2017-18, with revenues decreasing slightly in subsequent years. The funds would be used for health care expenses, tobacco-related prevention and cessation programs, law enforcement programs, and medical research on tobacco-related diseases.

Sincerely,

for Mac Taylor
Legislative Analyst

for Michael Cohen
Director of Finance