

October 17, 2005

Hon. Bill Lockyer
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Tricia Knight
Initiative Coordinator

Dear Attorney General Lockyer:

Pursuant to Elections Code Section 2005, we have reviewed the proposed constitutional and statutory initiative entitled "The Tobacco Tax and Disease Prevention Act of 2006" (File No. SA2005RF0098). This measure would increase excise taxes on cigarettes (and indirectly on other tobacco products) to provide funding to support various new and existing health programs and for programs to curb tobacco use and regulate tobacco sales.

BACKGROUND

Tobacco Taxes

Existing Tax Rate. Current state law imposes excise taxes on cigarettes and other tobacco products. The state's cigarette tax is currently 87 cents per pack (with an equivalent tax on other types of tobacco products) and is levied on cigarette distributors, who supply cigarettes to retail stores. The proceeds are used for both General Fund and certain special funds purposes enacted by the Legislature and voter-approved initiatives.

The total 87 cents per pack tax is made up of the following components:

- 10 cents per pack for the state General Fund.
- 25 cents per pack pursuant to the Tobacco Tax and Health Protection Act. This initiative, enacted by the voters as Proposition 99 in 1988, increased the cigarette tax by 25 cents per pack, created the equivalent tax on other tobacco products, and allocated all of the additional funding for a number of health-related purposes. These include tobacco education and prevention efforts, tobacco-related disease research programs, and health care services for low-

income uninsured persons, as well as for environmental protection and recreational resources.

- 2 cents per pack enacted through a separate measure approved by the Legislature and Governor in 1993 to create the Breast Cancer Research Fund, which supports research efforts related to breast cancer.
- 50 cents per pack pursuant to the California Children and Families First Act of 1998. This measure, enacted by the voters that year as Proposition 10, supports early childhood development programs.

Current taxes on cigarettes and other tobacco products are estimated to raise in excess of \$1 billion in 2005-06. Because per-capita consumption of tobacco is declining, tobacco tax revenues have been decreasing and will likely continue to decrease slightly over time.

Backfill Provisions

Part of the Proposition 10 revenues are used to “backfill” or offset any revenue losses experienced by Proposition 99’s health-related education and research programs and the Breast Cancer Research Fund due to decreased consumption resulting from the tax increase. The Proposition 10 tax increase resulted in a drop in consumption of tobacco products that reduced the revenues going to the programs funded under Proposition 99. This occurred because the increase in the price of cigarettes (1) reduced cigarette sales and (2) resulted in more out-of-state sales (as well as sales on tribal lands) and smuggled products for which taxes are not collected.

The backfill provided under Proposition 10 offsets the loss of tens of millions of dollars annually to certain Proposition 99 accounts, although other Proposition 99 accounts do not receive backfill for their losses.

PROPOSAL

New State Revenues

This measure increases the existing excise tax on cigarettes by \$1 per pack effective January 2007. Existing state law requires the Board of Equalization to increase taxes on other tobacco products—such as loose tobacco and snuff—in an amount equivalent to any increase in the tax on cigarettes. Thus, this measure would also result in a comparable increase in the excise tax on other tobacco products. This measure specifies that all of the additional tobacco revenues (including those on other tobacco products) be used to support various new and existing health programs and for programs to curb tobacco use and regulate tobacco sales.

How Additional Revenues Would Be Spent

Receipts from the tobacco tax increases would be deposited in a new special fund called the Tobacco Surtax and Disease Prevention Fund and would be allocated under the provisions of this initiative for various specified purposes.

Backfill of Other Programs. Some of these additional tobacco tax revenues would be used to help backfill certain other programs funded with tobacco taxes for a loss of funding that is likely to occur as a result of this measure. (This loss of funds would result because of the tax increases contained in this measure.) This backfill funding would be provided for certain Proposition 99 accounts—those created for support of hospital and physician services as well as for unallocated funds—but not for other Proposition 99 accounts. Backfill would also be provided for all Proposition 10 programs. No backfill would be provided for the Breast Cancer Research Fund, although new allocations provided under this measure for this program would more than offset this loss of funding. Part of the additional revenues generated under this measure would be used to offset the costs of collecting these additional taxes, and to provide any necessary refunds for over-collection of taxes.

Health Programs. Of the funds that remained after the above allocations were made, 65 percent would be set aside for the administration and operation of various new or existing health programs. Specific allocations of funding would be provided for programs related to prevention or treatment of breast and cervical cancer, prostate cancer, heart disease and stroke, obesity, asthma, and colorectal cancer, as well as for cancer research, breast cancer research, and establishment of a statewide cancer registry.

Tobacco-Related Programs. The 35 percent of funds that remained after allocations for the purposes noted above would be used to help pay for the administration and operation of various programs to curb tobacco use and regulate tobacco sales.

Specific allocations of funding would be provided for media advertising and public relations campaigns, grants to local health departments and other local organizations, and education programs for schoolchildren to prevent and reduce smoking. Part of the funds would be allocated for services to assist individuals to quit smoking, and other parts would be set aside to evaluate the effectiveness of tobacco control programs and to research effective prevention and treatment methods for tobacco-related diseases. Specific allocations would also go to state and local law agencies responsible for enforcing laws and civil court judgments and settlements which regulate and tax the sale of tobacco products.

Local Governments Would Receive Funding. Some of the additional tobacco tax revenues would be passed through to local government agencies. For example, local

health departments would be among those receiving funds for tobacco prevention efforts as well as allocations for the expansion of programs to prevent obesity. Local law enforcement agencies would likewise receive grants for training and enforcement of laws regulating the sale of tobacco products.

Other Spending Provisions. The additional tobacco tax revenues allocated by this measure would have to be used to supplement existing levels of service and could not take the place of existing state or local General Fund spending. The measure also specifies that the new state revenues could be used to draw down additional federal funds.

This measure creates various new accounts to set aside funds for these various purposes and specifies the share of tobacco tax proceeds that would be devoted to each purpose. These funds would not be appropriated through the annual state budget act and thus amounts would not be subject to change by actions of the Legislature and Governor.

Oversight and Contracting Provisions

This initiative requires the state Department of Health Services (DHS) to prepare an annual report describing the programs that received funding under this measure. This report would be made available to the public on DHS' Web site. The measure also specifies that all programs and departments receiving funds would be subject to audit by the Bureau of State Audits.

In addition, this measure specifies that contracts to implement the initiative would not be subject to a part of the Public Contract Code which contains, among other provisions, requirements for competitive bidding of state contracts and prohibitions on conflicts of interest in the letting of such state contracts.

Fiscal Effects

This measure is likely to have a number of fiscal effects on state and local governments.

Impacts on State and Local Revenues

The revenue estimates for this measure are based on the assumption that the amount of the \$1 per pack increase is fully reflected in the purchase price. The associated price increase is likely to cause (1) a decrease in the quantity of taxable tobacco products sold, and (2) an increase in out-of-state sales (as well as sales on tribal lands) and smuggled products for which taxes would not be collected.

Revenues From Tax Increase on Tobacco Products. The tobacco tax increase that would be enacted under this measure would raise somewhat less than \$500 million in

2006-07 (half-year effect) and \$1 billion in 2007-08 (first full-year impact) for the new special fund created by this measure. This tobacco tax increase would raise slightly declining amounts of revenues thereafter.

Indirect Effects on General Fund Revenues. The increase in the cigarette tax imposed by this measure, and the additional increase in the tax that would result for other tobacco products, are likely to have indirect effects on state General Fund revenues for reasons we discuss below. As a result of the decline in consumption of tobacco products, there would be reduced revenues from the existing excise taxes on tobacco for the state General Fund. These General Fund revenue losses are likely to be more than offset by increases in state General Fund sales tax receipts stemming from the increased costs of cigarettes upon which the sales tax is levied. As a result, the state is likely to have a net gain of General Fund revenues in the low millions of dollars annually. Local governments would also likely experience a net gain in sales tax revenues in the low millions of dollars annually.

Indirect Effects on Existing Tobacco Tax Revenues. The decline in consumption of tobacco products caused by this measure would similarly reduce the tobacco tax revenues that would be generated under Propositions 99 and 10 and for the Breast Cancer Research Fund. The annual revenue losses could amount to as much as \$70 million for Proposition 10, \$34 million for Proposition 99, and \$3 million for the Breast Cancer Research Fund. As we discuss below, this measure would partly or fully offset some of these losses with additional tax revenues generated by this measure.

Increased State and Local Expenditures for Health and Tobacco-Related Programs

State and local government expenditures for the administration and operation of various health and tobacco-related programs would generally increase in line with the proposed increase in tobacco tax revenues. Figure 1 shows the main purpose of the accounts established by the initiative, the stated percentage of funds allocated to each purpose, and our estimate of the funding that would be available for each account in the first full year of tax collection. After the new higher level of spending for these programs was reached, expenditures for these purposes would probably decline in subsequent years in keeping with an anticipated overall decline in tobacco tax revenues.

Figure 1**How New Tobacco Tax Revenues Would Be Allocated***(Dollars in Millions)*

Purpose	Allocation	Estimate of 2007-08 Funding
Backfill of certain tobacco-tax funded programs, tax collection costs, and tax refunds	Unspecified amounts determined by Board of Equalization (BOE)	\$100
Tobacco Use Prevention, Education and Enforcement Account , allocated as follows:	35 percent of remaining funds	\$315
Media advertisements, public relations	24 percent of the account	(\$76)
Competitive grants program	16 percent of the account	(50)
Local health department-based programs	14 percent of the account	(44)
Tobacco cessation services	8 percent of the account	(25)
Evaluations	4 percent of the account	(13)
School education programs	13 percent of the account	(41)
Research programs	14 percent of the account	(44)
Tobacco law enforcement activities subaccount, consisting of:		
— Programs to reduce illegal tobacco sales to minors, local grants	50 percent of the subaccount	(11)
— Department of Justice activities	25 percent of the subaccount	(6)
— BOE activities	25 percent of the subaccount	(6)
Disease Prevention, Treatment, and Research Account , allocated as follows:	65 percent of remaining funds	\$585
Breast and cervical cancer services	20 percent of the account	(\$117)
Prostate cancer treatment services	5 percent of the account	(29)
Statewide cancer registry	3 percent of the account	(18)
Breast Cancer Research Program	8 percent of the account	(47)
Cancer Research Program	3 percent of the account	(18)
Heart disease and stroke prevention	20 percent of the account	(117)
Colorectal cancer services	11 percent of the account	(64)
Subaccount for obesity programs, consisting of:		
— Media advertising, public relations, grants, research, other activities	70 percent of the subaccount	(82)
— School programs	30 percent of the subaccount	(35)
Subaccount for asthma programs, consisting of:		
— Community programs, research, media advertising, public relations, other activities	60 percent of the subaccount	(35)
— School programs	40 percent of the subaccount	(24)
Total Tobacco Tax Funding Allocations		\$1,000

Fiscal Effects on Other Tobacco Tax-Funded Programs

This measure would have a number of significant fiscal effects on the three existing programs supported by tobacco taxes—Proposition 99, Proposition 10, and the Breast Cancer Research Fund.

Proposition 99. As noted earlier, this measure contains provisions that would fully backfill any loss of revenues resulting from the tobacco tax increase proposed in this measure to certain Proposition 99 accounts—specifically, those created for support of hospital and physician services as well as for unallocated funds. This measure does not backfill the Proposition 99 accounts established for health education and for tobacco research. However, this measure would provide about \$315 million annually in new funding for various tobacco-related programs, most of which are similar to the activities now funded through Proposition 99 accounts for health education and tobacco research. Thus, these activities would have a significant net gain in funding if this measure were enacted.

This measure would not provide any backfill funding for the Proposition 99 account for resources programs to protect or restore wildlife habitat or improve park and recreation facilities. We estimate that this measure would result in a \$10 million reduction in annual funding for these purposes.

Proposition 10 and Breast Cancer Research Fund. Proposition 10 would receive full backfill funding under the terms of this measure. No backfill funding would be provided for the Breast Cancer Research Fund to offset the loss of revenues resulting from the tax increases proposed in this measure. However, this measure would allocate a set portion of the new tax revenues for the fund, with the result that it would be likely to have a net gain of funding of about \$44 million annually.

Potential State and Local Savings on Health Costs

The use of tobacco products has been linked to various adverse health effects by federal health authorities and numerous scientific studies. The state and local governments incur costs for providing (1) health care for low-income persons and (2) health insurance coverage for state and local government employees. Consequently, changes in state law that affect the health of the general populace—and low-income persons and public employees in particular—would affect publicly funded health care costs.

This measure is likely to result in a decrease in the consumption of tobacco products because of its provisions increasing the cost of these products and curbing tobacco use. Also, some of the health programs funded in this measure are intended to prevent individuals from experiencing serious health problems that could be costly to treat. To the extent that these changes affect publicly funded health care programs, they are

likely to reduce state and local government health care costs over time. In addition, the proposed expansion of state health programs could reduce county costs for providing health care for indigents. The magnitude of savings from these factors is unknown but would likely be significant.

Summary

The measure would have the following major impacts:

- Increase in new state tobacco tax revenues of about \$1 billion annually by 2007-08, declining slightly annually thereafter. Those revenues would be used for various health and tobacco-related programs.
- Unknown but probably significant savings in state and local government health care costs over time due to expected reduction in consumption of tobacco products and due to other factors.

Sincerely,

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Legislative Analyst

Michael Genest
Acting Director of Finance