

June 14, 2016

L E G I S L A T I V E A N A L Y S T ' S O F F I C E

LAO 
75
YEARS OF
SERVICE

Cigarette Tax Initiative

Presented to:

Assembly Health Committee

Hon. Jim Wood, Chair;

Assembly Revenue and Taxation Committee

Hon. Sebastian Ridley-Thomas, Chair; and

Senate Health Committee

Hon. Ed Hernandez, Chair





LAO Role in Initiative Process



Fiscal Analysis Prior to Signature Collection

- State law requires our office to work with the Department of Finance to prepare a joint impartial fiscal analysis of each initiative before it can be circulated for signatures.
- State law requires that this analysis provide an estimate of the measure's fiscal impact on state and local governments.
- A summary of the estimated fiscal impact is included on the initiative petitions circulated for signatures.



Analysis After Measure Collects Sufficient Signatures to Qualify for the Ballot

- State law requires our office to provide impartial analyses of all statewide ballot propositions for the voter information guide. These analyses are required to include a description of the measure and its fiscal effects.
- We currently are in the process of preparing these materials.



Summary of Measure



Increases State Excise Taxes on Tobacco Products

- Raises tax on cigarettes from 87 cents per pack to \$2.87 per pack.
- Taxes on other tobacco products—such as cigars—would increase by an equivalent amount.
- Taxes would be extended to electronic cigarettes for the first time.



New Revenues Predominantly Used for Additional Spending on the State's Medi-Cal Program

Background



Types of Products Affected by the Measure

- **Cigarettes.** Smoking cigarettes is the most common way to use tobacco.
- **Other Tobacco Products.** Other tobacco products, such as cigars and chewing tobacco, can be consumed by smoking or other forms of ingestion.
- **Electronic Cigarettes.** These are battery-operated devices that turn specially designed liquid, which can contain nicotine, into a vapor. The vapor is inhaled by the user.



Existing Taxes on Products Affected by the Measure

- **Excise Taxes.** Taxes on a specific good.
 - Current state excise taxes on cigarettes are 87 cents per pack. The state excise taxes on other tobacco products are the equivalent of \$1.37 per pack of cigarettes. Excise taxes on these products currently support a number of purposes.
 - Current federal excise taxes are \$1.01 per pack of cigarettes and varying amounts for other tobacco products.
 - There are currently no state or federal excise taxes on electronic cigarettes.
- **State and Local Sales Taxes.** Taxes based on the retail price of a wide assortment of goods.
 - Current state and local sales taxes apply to retail sale of cigarettes, other tobacco products, and electronic cigarettes.
 - Current state and local sales taxes range from 7.5 percent to 10 percent depending on the city or county.



State and Local Health Programs

- **Medi-Cal.** Medi-Cal is California's Medicaid program, which provides health care coverage to over 13 million low-income individuals, or nearly one-third of California residents, with a budget of nearly \$95 billion (about \$23 billion General Fund) for 2015-16.
- **Public Health Programs.** Local governments provide many public health programs, while the state provides funding (primarily federal and special funds), oversight, and leadership for these programs.



Smoking Trends in California

- While cigarette smoking rates in California declined over the past couple of decades for a variety of reasons, more recently this trend appears to have stalled. In 2013, roughly 12 percent of adults in California smoked cigarettes.
- As electronic cigarettes are relatively new products, historical trend data on use is limited.



Recent Changes to State Law and Federal Rules

- As part of the special session on health care, the Legislature passed and the Governor signed a package of legislation affecting tobacco products and electronic cigarettes. This legislation does not directly affect the taxes on these products or the programs that receive funding from the taxes.
- Recently, the U.S. Food and Drug Administration (FDA) ruled that electronic cigarettes are subject to the existing Federal Food, Drug, and Cosmetic Act, which gives the FDA the authority to regulate various products. As above, this recent federal rule change does not directly affect state taxes on tobacco products and electronic cigarettes or the programs that receive funding from these taxes.



Proposal

- Increases State Excise Taxes on Cigarettes and Other Tobacco Products**
 - Increases cigarette tax by \$2 per pack—from 87 cents to \$2.87 per pack.
 - Raises equivalent tax on other tobacco products by the same \$2—from \$1.37 to \$3.37.

- Imposes State Excise Taxes on Electronic Cigarettes**
 - Changes the definition of other tobacco products for purposes of taxation to include electronic cigarettes that contain nicotine or liquid containing nicotine. Changing the definition in this way causes the \$3.37 equivalent tax to apply to these products.

- Specifies Distribution of the Revenues to a Variety of State Programs and Other Purposes (See Figure on Next Page)**

- Exempts Revenues From State Spending Limit and Proposition 98 Education Funding Requirements**

| How New Tax Revenue Would Be Spent | | |
|---|-------------------------------|--|
| Program or Entity^a | Amount | Purpose |
| Step 1: Replace Revenues Lost | | |
| Existing Tobacco Tax Funds | Determined by BOE | To maintain tobacco-related revenues that tobacco tax funds would have received before this measure. |
| State and Local Sales and Use Tax | Determined by BOE | To maintain tobacco-related revenues the state and local governments would have received before this measure. |
| Step 2: Pay for Tax Administration | | |
| Board of Equalization (BOE)—administration | 5 percent of remaining funds | For costs to administer the tax. |
| Step 3: Allocate Specific Amounts for Various State Entities^b | | |
| Various state entities—enforcement ^c | \$48 million | For various enforcement activities of tobacco-related laws. |
| University of California (UC)—physician training | \$40 million | For physician training to increase the number of primary care and emergency physicians in California. |
| Department of Public Health (DPH)—State Dental Program | \$30 million | For education on preventing and treating dental disease. |
| California State Auditor | \$400,000 | For audits of agencies receiving funds from new taxes, at least every other year. |
| Step 4: Distribute Remaining Funds for State Health Programs | | |
| Medi-Cal—Department of Health Care Services (DHCS) | 82 percent of remaining funds | For increasing the level of payment for health care, services, and treatment provided to Medi-Cal beneficiaries. DHCS cannot use these funds to replace existing state funds for these same purposes. |
| California Tobacco Control Program—DPH | 11 percent of remaining funds | For tobacco prevention and control programs aimed at reducing illness and death from tobacco-related diseases. |
| Tobacco-Related Disease Program—UC | 5 percent of remaining funds | 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. UC cannot replace existing state and local funds for this purpose with these new revenues. |
| School Programs—California Department of Education | 2 percent of remaining funds | For school programs to prevent and reduce the use of tobacco products by young people. |
| ^a The measure would limit the amount of revenues raised that could be used to pay for administrative costs, to be defined by the State Auditor through regulation, to not more than 5 percent for each recipient of funding. | | |
| ^b Predetermined amounts would be adjusted proportionately by BOE annually, beginning two years after the measure went into effect, 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. | | |
| ^c Funds distributed to Department of Justice/Office of Attorney General (\$30 million), Office of Attorney General (\$6 million), DPH (\$6 million) and BOE (\$6 million). | | |



Fiscal Effects

- New Excise Taxes Would Increase State Revenue by Over \$1 Billion in 2017-18, With Likely Lower Annual Amounts in Future Years**
- Over \$1 Billion in Increased Funding in 2017-18 Mostly for State Health Programs**
- Net Long-Term Impact on State and Local Governments' Health Care Costs Unknown**

| How Estimated Revenues in 2017-18 Would Be Allocated | | |
|--|------------------------|-------------------------|
| <i>(In Millions)</i> | | |
| | 2017-18 | |
| | Low Range ^a | High Range ^a |
| Estimated revenue from new excise taxes | \$1,270 | \$1,610 |
| Replace revenue loss ^b | 230 | 200 |
| Estimated Net Revenue to Be Allocated | \$1,040 | \$1,410 |
| Tax Administration | | |
| Board of Equalization—administrative expenses | \$50 | \$70 |
| Specific Amounts Allocated to State Entities | | |
| Various state entities—enforcement | \$48 | \$48 |
| University of California—physician training | 40 | 40 |
| Department of Public Health—State Dental Program | 30 | 30 |
| California State Auditor—audits | 0.4 | 0.4 |
| Remaining Funds Allocated to State Health Programs | | |
| Medi-Cal | \$710 | \$1,000 |
| Tobacco Control Program | 100 | 130 |
| University of California Tobacco-Related Disease Program | 40 | 60 |
| School Programs | 20 | 20 |
| ^a The consumer response to the proposed tax increases 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. Figures not presented as a range reflect fixed allocations prescribed by the measure. | | |
| ^b LAO estimate. Revenue loss replacement amounts would be determined by the Board of Equalization. | | |



Issues Raised by Stakeholders



Two Statutory Interpretation Issues Raised Regarding Initiative's Language That Would Need to Be Resolved by the Board of Equalization as Administrator of the Taxes Imposed by the Measure

- Two potential definitions of electronic cigarettes.
 - “Electronic cigarettes include any component part, accessory of such a device that is used during the operation of the device when sold in combination with any liquid or substance containing nicotine.”
 - “Such regulations shall include imposition of an equivalent tax on any device intended to be used to deliver aerosolized or vaporized nicotine to the person inhaling from the device when sold separately or as a package; any component, part, or accessory of such a device that is used during the operation of the device; and any liquid or substance containing nicotine, whether sold separately or as a package with any device that would allow it to be inhaled.”
- Potential for additional \$2 tax on electronic cigarettes as levied on other tobacco products under Proposition 10, which would bring the total excise tax on electronic cigarettes to \$5.37 under the measure.