

Proposition 86
“The Tobacco Tax Act of 2006”
November 7, 2006 General Election Ballot

**STATE BOARD OF EQUALIZATION
LEGISLATIVE AND RESEARCH DIVISION**

PROPOSITION SUMMARY

This measure would impose an additional excise tax on cigarettes of one hundred thirty mills, or \$2.60 per package of 20 and indirectly increase the tax on other tobacco products. In addition, this measure would impose an equivalent compensating cigarette and other tobacco products floor stock tax.¹

The revenue from the cigarette and other tobacco products tax increase would be deposited into the Tobacco Tax of 2006 Trust Fund (Tobacco Trust Fund), which this measure would create.

ANALYSIS

Current Law

Cigarette and Tobacco Products Tax

Pursuant to Revenue and Taxation Code Section 30101 (Cigarette and Tobacco Products Tax Law), an excise tax of 6 mills (or 12 cents per package of 20) is imposed on each cigarette distributed. In addition, Sections 30123 and 30131.2 impose a surtax of 12 1/2 mills (25 cents per package of 20) and 25 mills (50 cents per package of 20), respectively, on each cigarette distributed. The current total tax on cigarettes is 43 1/2 mills per cigarette (87 cents per package of 20).

For other tobacco products (which are defined in Section 30121 and 30131.1 to include cigars, smoking tobacco, chewing tobacco, snuff, and other products containing at least 50 percent tobacco), Section 30123 (Proposition 99) imposes a tax on the wholesale cost of the tobacco products distributed at a rate which is equivalent to the combined rate of tax imposed on cigarettes. In addition, Section 30131.2 (Proposition 10) imposes an additional tax on tobacco products based on the wholesale cost of the tobacco products distributed at a rate which is equivalent to the 50-cent per pack tax on cigarettes also imposed by Section 30131.2. The tobacco products tax rate is determined annually by the Board and based on the March 1 wholesale cost of cigarettes. Currently, the surcharge rate for fiscal year 2006-07 is 46.76 percent.

¹ A floor stock tax is a one-time tax on all tax-paid (stamped) cigarettes, unaffixed tax stamps, and tax-paid tobacco products in the possession of distributors, wholesalers and/or retailers on the effective date of a cigarette and tobacco products tax increase. The floor stock tax rate is the difference between the old tax rate and the new tax rate.

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Of the 87 cent excise tax imposed on a package of 20 cigarettes, 2 cents is deposited into the Breast Cancer Fund, 10 cents into the General Fund, 25 cents into the Cigarette and Tobacco Products Surtax Fund, and 50 cents into the California Children and Families Trust Fund (CCF Trust Fund). The other tobacco products surtax imposed under Section 30123 (Proposition 99) is deposited into the Cigarette and Tobacco Products Surtax Fund (including any revenues that result from an indirect increase in the other tobacco products tax triggered by a cigarette tax increase), while the surtax imposed under Section 30131.2 (Proposition 10) is deposited into the CCF Trust Fund.

Proposition 10 Backfill

Health and Safety Code Section 130105 (added by Proposition 10) requires the Board to determine the revenue reductions to any Proposition 99 state health-related education and research programs and the Breast Cancer Fund that are a direct result of the additional taxes imposed by Proposition 10's additional taxes, and annually backfill these amounts from the tax revenues received from Proposition 10.

Proposed Law

Cigarette Tax and Indirect Other Tobacco Products Tax Increases

Among other things, this measure would add Article 4 (commencing with Section 30132) to Chapter 2 of Part 13 of Division 2 of the Revenue and Taxation Code to impose an additional tax of \$2.60 per package of 20 cigarettes (and, as discussed in Comment #2 below, indirectly increase the tax on other tobacco products). The additional cigarette tax would be imposed beginning January 1, 2007.

Floor Stock Tax

This measure would also impose a compensating floor stock tax for the additional cigarette and other tobacco products tax on every cigarette and on all other tobacco products in the possession or under the control of every dealer, wholesaler, and distributor on and after 12:01 a.m. on January 1, 2007, pursuant to rules and regulations promulgated by the Board.

Backfill Provisions

This measure would require the Board to determine, within one year of passage and then annually thereafter, the effect that the additional tax imposed on cigarettes and other tobacco products has on the consumption of cigarettes and other tobacco products in this state. To the extent that a decrease in consumption is determined by the Board to be the direct result of the additional cigarette and other tobacco products tax, the Board shall determine the fiscal effect the decrease in consumption has on the CCF Trust Fund (Proposition 10).

Funds would be transferred from the Tobacco Trust Fund to the CCF Trust Fund (Proposition 10) as necessary to offset the revenue decrease directly resulting from the imposition of the additional cigarette and indirect tobacco products tax.

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Fiscal Provisions

The proceeds from the cigarette and tobacco products tax increase, less the Proposition 10 backfill funding, refunds, administrative and collection costs, would be deposited into the Tobacco Trust Fund, which this measure would create in the State Treasury. Moneys would be allocated and appropriated as follows:

- 5 percent to the Health and Disease Research Account to support medical research relating to cancer in general and breast and lung cancer in particular, research into tobacco-related diseases, and a statewide population-based cancer surveillance system.
- 42.25 percent to the Health Maintenance and Disease Prevention Account for children's health coverage expansion, breast and cervical cancer prevention and early detection services, enforcement of tobacco-related statutes and policies, tobacco-related programs, and health and education programs.

Of the funds appropriated and allocated to the Health Maintenance and Disease Prevention Account, 2.25 percent would be allocated and deposited in the Tobacco Control Enforcement Sub-Account from which 25 percent would be continuously appropriated to the Board "to be used to enforce laws that regulate the distribution and sale of cigarettes and other tobacco products, such as laws that prohibit cigarette smuggling, counterfeiting, selling untaxed tobacco, and selling tobacco without a proper license."

- 52.75 percent to the Health Treatment and Services Account for hospital funding, nursing education programs, and other services such as nonprofit community clinics, to help pay for uncompensated health care for uninsured persons provided by physicians, for college loan repayments to encourage physicians to provide medical services to low-income persons in communities with insufficient physicians, to provide prostate cancer treatment services, and for services to assist individuals to quit smoking.

Amendments

Generally, amendments to the statutory provisions of this measure, including the provisions that would impose an additional excise tax on cigarettes, are only possible by the electors pursuant to Article II, Section 10(c) of the California Constitution. This measure provides specified exceptions where amendments may be made by a majority, $\frac{2}{3}$ ^{rds} or $\frac{4}{5}$ ^{ths} vote of the Legislature; however, these exceptions do not relate to the Board's administration and collection of the proposed cigarette tax increase or indirect increase in the other tobacco products tax.

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Background

Proposition 99, approved by voters in November 1988 and effective January 1, 1989, imposed a surtax of 25 cents per package of 20 cigarettes, and also created an equivalent tax on other tobacco products. Proceeds from the taxes provide funding for health education, disease research, hospital care, fire prevention, and environmental conservation.

Assembly Bill 478 (Ch. 660, 1993) and Assembly Bill 2055 (Ch. 661, 1993), effective January 1, 1994, added an excise tax of 2 cents per package of 20 cigarettes for breast cancer research and early detection services.

Proposition 10, approved by voters in November 1998 and effective January 1, 1999, imposed an additional surtax of 50 cents per package of 20 cigarettes. Additionally, the measure imposed an additional excise tax on the distribution of other tobacco products equivalent to the additional cigarette tax and imposed an equivalent compensating floor stock tax. The revenues from the additional tax are deposited into the CCF Trust Fund and are used to fund early childhood development programs, and to offset any revenue losses to certain Proposition 99 programs as a result of the additional tax imposed by Proposition 10.

COMMENTS

1. **Sponsor and purpose.** The sponsor of this measure is the Coalition for a Healthy California. The stated purpose of the measure is to reduce the economic costs of tobacco use in California and to provide supplemental funding to promote medical research into chronic diseases, particularly cancer, to reduce the impact of chronic diseases through prevention, early detection, treatment and comprehensive health insurance, and to improve access to and delivery of health care, particularly emergency health services.
2. **Other tobacco products.** This measure does not contain a direct tax increase on other tobacco products. However, the \$2.60 cigarette tax increase would indirectly increase the other tobacco products tax rate July 1, 2007, as a result of Proposition 99. Section 30123(b) (Proposition 99) generally provides that the other tobacco products tax rate, which is required to be determined annually by the Board, must be equivalent to the combined rate of all taxes imposed on cigarettes. As such, a tax increase on other tobacco products is automatically triggered whenever the tax imposed on cigarettes is increased.
3. **Deposit of the proceeds from the indirect tax increase on other tobacco products.** Under existing law, the proceeds from an indirect increase in the other tobacco products tax as a result of Proposition 99 are required to be deposited into the Cigarette and Tobacco Products Surtax Fund (created by Proposition 99).

This measure, however, specifically requires the proceeds from the indirect increase in the other tobacco products tax be deposited into Proposition 86's Tobacco Trust Fund instead of Proposition 99's Cigarette and Tobacco Products Surtax Fund. Therefore, all of the additional cigarette and other tobacco products tax revenues generated as a result of this measure would be deposited into Proposition 86's

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Tobacco Trust Fund and used to support various new and existing programs specified in this measure, which includes programs similar to those currently supported by Proposition 99 revenues.

4. **Floor stock tax provisions.** Proposed Section 30132.1(c) contains language to impose a floor stock tax on the cigarette and other tobacco products inventory of every dealer, wholesaler, and distributor. A floor stock tax is a one-time tax on all tax-paid (stamped) cigarettes, unaffixed tax stamps, and tax-paid other tobacco products in the possession of distributors, wholesalers and/or retailers on the effective date of a cigarette and other tobacco products tax increase. The floor stock tax rate is the difference between the old tax rate and the new tax rate. Generally, a floor stock tax is imposed to equalize the excise tax paid by cigarette and other tobacco products dealers, wholesalers, or distributors on their inventory and those cigarettes and other tobacco products purchased after the effective date of a tax increase.

Having a large cigarette or other tobacco products inventory before a tax rate increase takes effect can result in a windfall profit to a cigarette or other tobacco products seller. The selling price of cigarettes or other tobacco products purchased before the increase, but sold after, can be raised and attributed to the rate increase. These additional funds would represent a windfall profit rather than excise taxes paid to the state. A floor stock tax mitigates this windfall profit.

Since this measure would increase the cigarette tax on January 1, 2007, the cigarette floor stock tax would be imposed on the cigarette inventory, as of January 1, 2007, of every dealer, wholesaler, and distributor. The indirect increase on other tobacco products pursuant to Section 30123(b) (Proposition 99) would become effective July 1, 2007. As such, the other tobacco products floor stock tax would be imposed on the July 1, 2007, other tobacco products inventory of every dealer, wholesaler, and distributor.

While the Board would incur additional costs associated with administering the floor stock tax, these costs would be offset by the proceeds from the tax.

5. **Cigarette and tobacco product tax evasion.** Tax evasion is one of the major areas that can reduce state revenues generated from cigarettes and other tobacco products taxes.

During the mid-1990's, the Board's cigarette tax evasion estimates changed little since there was little change to cigarette prices and excise taxes during that time. However, two major events that occurred since November 1998 dramatically increased California excise taxes as well as cigarette prices (excluding taxes): Proposition 10 and the Tobacco Master Settlement Agreement between states and tobacco manufacturers (tobacco settlement). Together, these two developments, when coupled with typical wholesaler and retailer distribution margins, coincided with an increase in the average prices of cigarettes to California consumers by about 50 percent in relation to early November 1998 prices. It is estimated that the impacts of Proposition 10 and the tobacco settlement more than doubled the dollar amount of cigarette tax evasion in California.

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Since the 1998 experience, many new measures have been implemented to reduce cigarette and other tobacco products tax evasion. These include the Cigarette and Tobacco Products Licensing Act, an encrypted cigarette tax stamp, and various Internet restrictions (such as agreements with UPS, DHL, and FedEx under which those companies have agreed to stop transporting cigarettes directly to individual consumers nationwide and credit card companies adopting policies to prohibit the use of credit cards for the illegal sale of cigarettes over the Internet).

This measure would increase the cigarette tax substantially, which would result in an increase in the retail price, to the extent that the tax increase is passed along to consumers. Based on previous experience related to Proposition 10 and the tobacco settlement, along with research of experiences in other states, Board staff believes the proposed cigarette tax increase and resulting increase in the other tobacco products tax could result in both a decrease in actual consumption and an increase in cigarette and other tobacco products tax evasion. The exact magnitude of these responses is uncertain since the proposed excise tax increases are significantly greater than previously experienced.

The Board staff is currently in the process of updating the cigarette and other tobacco products tax evasion estimate using data gathered after implementation of the Cigarette and Tobacco Products Licensing Act, as recommended in the Bureau of State Audits report titled "[Board of Equalization: Its Implementation of the Cigarette and Tobacco Products Licensing Act of 2003 Has Helped Stem the Decline in Cigarette Tax Revenues, but It Should Update Its Estimate of Cigarette Tax Evasion](#)." It is anticipated that the updated evasion estimate will be completed by June 29, 2007.

6. **Administrative start-up cost funding for the Board.** This measure would impose an additional excise tax on cigarettes, beginning January 1, 2007, which is in the middle of the state's fiscal year. In order to properly administer a floor stock tax, notify cigarette distributors, wholesalers and retailers of the additional tax, develop computer programs, reporting forms, and hire appropriate staff, funding is required to cover the Board's administrative start-up costs that are not already identified in the Board's 2006-07 budget.
7. **Backfill of the California Children and Families Trust Fund.** This bill would require the Board to determine the effect that the additional cigarette and tobacco products taxes has had on the consumption of cigarettes and other tobacco products in this state. To the extent that a decrease in consumption is determined to be a direct result of the additional cigarette or tobacco products tax, the Board would be required to determine the fiscal effect the decrease in consumption has on the California Children and Families Trust Fund (Proposition 10). Funds would be transferred from the Tobacco Trust Fund and deposited into the California Children and Families Trust Fund as necessary to offset the revenue decrease directly resulting from the additional cigarette or tobacco products tax.

This measure would not backfill the Cigarette and Tobacco Products Surtax Fund (Proposition 99). However, additional revenues generated by this measure would

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increase funding for programs similar to those currently supported by Proposition 99 revenues.

8. **Increase in state and local sales and use tax revenues.** Under current Sales and Use Tax Law, the total amount of the retail sale is subject to sales or use tax unless specifically exempted or excluded by law. Because the excise tax on cigarettes and other tobacco products is not specifically exempted or excluded, the excise tax is included in the total amount of the sale and subject to sales or use tax.

This measure would increase the excise tax on cigarettes and result in an other tobacco products tax rate increase, which may be passed on to the ultimate consumer through an increase in the retail-selling price of cigarettes and other tobacco products. Any increase in the amount of the retail-selling price of cigarettes as a result of this measure would be included in the amount on which sales or use tax is computed.

9. **Distributor discount.** Under existing law, Section 30166 of the Revenue and Taxation Code provides that stamps and meter impression settings shall be sold at their denominated values less 0.85 percent to licensed distributors. The discount is intended to help defray the cost (leasing of equipment/labor cost) to the distributor for affixing the stamps.

Currently, distributors receive a discount of \$221.85 [(30,000 stamps x \$0.87 tax per package of cigarettes) x 0.85 percent discount = \$221.85 discount] per roll of 30,000 cigarette tax stamps. By increasing the excise tax on a package of 20 cigarettes to \$3.47, this measure would increase the distributor's discount to \$884.85 [(30,000 stamps x \$3.47 tax per package of cigarettes) x 0.85 percent discount = \$884.85 discount] per roll of 30,000 stamps.

COST ESTIMATE

Administration and Collection

A detailed cost estimate is pending. However, the Board would likely incur significant costs related to the administration and collection of the additional cigarette and tobacco products tax proposed by this measure. These costs would be related to notifying taxpayers, developing returns, programming computers, developing and carrying out compliance and audit efforts to ensure proper reporting, and administering a floor stock tax.

The proposed tax increase would require enhanced efforts to ensure that the floor stock tax is properly reported and collected, greater compliance efforts for additional billings and delinquencies, and increased investigative staff presence due to increased tax evasion.

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Supplementary Funding

In addition to reimbursement of the Board's expenses incurred in the administration and collection of the additional cigarette and tobacco products tax, 25 percent of the moneys deposited into the Tobacco Control Enforcement Sub-Account would be continuously appropriated to the Board to be used to enforce laws that regulate the distribution and sale of cigarettes and other tobacco products, such as laws that prohibit cigarette smuggling, counterfeiting, selling untaxed tobacco, and selling tobacco without a proper license.

For fiscal year 2007-08, it is anticipated that the Board would be appropriated approximately \$5 million for enhanced enforcement based on the Board's revenue estimate (see below).

REVENUE ESTIMATE

Background, Methodology, and Assumptions

Fiscal Year 2006-07

Cigarette Tax. Tax-paid cigarette distributions were about 1,190 million packs in fiscal year 2005-06. The Department of Finance projected similar distributions for fiscal year 2006-07. Since the new rate would take effect January 1, 2007, the impacts for fiscal year 2006-07 are about half of the full-year impacts.

Based on previous tax increases and research of experiences in other states, we believe an increase in the tax rate as large as the one proposed by this measure is likely to cause both a decrease in actual consumption and an increase in tax evasion. Although the exact magnitude of the effects is uncertain, we have assumed that Proposition 86 would cause an additional decrease of 26 percent in tax paid distributions. This estimate assumes a price elasticity of demand of -0.60 using the arc price elasticity formula, applied to estimated average 2005 prices of approximately \$3.95 per pack.²

This measure would impose a corresponding floor stock tax, which would be imposed on January 1, 2007, inventories. We assume a three weeks supply of cigarettes would be subject to the floor stock tax, based on a combination of expected sales rates before and after the tax takes effect. We assume floor stock taxes are paid in fiscal year 2006-07.

Other Tobacco Products Tax.³ The Board has set the other tobacco products tax rate for fiscal year 2006-07. The proposed \$2.60 per pack increase in the cigarette excise tax rate would not affect the other tobacco products tax rate until fiscal year 2007-08.

² The general price elasticity of demand formula is: $e_p = (Q_1 - Q_2) / ((Q_1 + Q_2) / 2) / (P_1 - P_2) / ((P_1 + P_2) / 2)$, where P = price, and Q = sales.

³ As used here, the term "tobacco products" refers to all tobacco products except cigarettes. Examples of such products include chewing tobacco, snuff, cigars, pipe tobacco, and roll-your-own cigarette tobacco.

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Fiscal Year 2007-08

Cigarette Tax. Over the past twenty years tax paid distributions have averaged a decline of about 3 percent per year. We believe this is a reasonable estimate of the underlying trend for future years. Therefore, under the current-law excise tax rate of \$0.87 per pack we would expect a 3 percent decline in fiscal year 2007-08.

Other Tobacco Products Tax. Pursuant to Proposition 99, this measure would result in an additional tax on other tobacco products at a rate equivalent to the new \$2.60 per pack rate this measure would impose on cigarettes. This tax increase would be effective on July 1, 2007.

The effective other tobacco products tax is currently based on the wholesale cost of these products at a tax rate that is equivalent to the rate of tax imposed on cigarettes. The rate is determined by dividing the tax rate per cigarette by the average wholesale cost per cigarette. For rate setting purposes, the average cost per cigarette for the 2006-07 fiscal year is \$0.1465. The current tax rate on cigarettes is \$0.0685 per cigarette. The tobacco tax rate for 2006-07 is 46.76 percent ($\$0.0685 / \$0.1465 = 0.4676$). Under Proposition 86 the other tobacco products tax rate would rise from 47.76 percent to 135.49 percent in fiscal year 2007-08. This assumes no change in the average wholesale price of cigarettes for 2006.

The wholesale cost (or wholesale sales) of other tobacco products was about \$125 million in fiscal year 2005-06. We will assume wholesale costs to stay at approximately this level over the next few years under current law.

Based on previous tax increases, an increase in the tax rate as large as the one proposed by this proposition is likely to cause both a decrease in actual consumption and an increase in tax evasion. We estimate the decline in sales of other tobacco products would be similar to the percentage decline in cigarette sales.⁴ We assume a two-week inventory in calculating the floor stock tax on other tobacco products, and that floor stock taxes are paid in fiscal year 2007-08.⁵

Sales and Use Tax Impacts

We expect that all of the cigarette and other tobacco products tax increases would be passed on to consumers. For both cigarettes and other tobacco products we added sales taxes on the excise tax increases and subtracted sales taxes resulting from projected declines in sales to determine net sales tax gains. Sales taxes are calculated assuming current and projected average retail prices.

⁴ The current tobacco products tax rate is the equivalent of \$1.37 per pack, \$0.87 per pack for Proposition 99 funds and \$0.50 per pack for Proposition 10 funds. Since the \$1.37 per pack tax rate for tobacco products is higher than that of cigarettes (\$0.87 per pack), a \$2.60 per pack tax increase implies a slightly smaller price increase for tobacco products than it does for cigarettes (24 percent for tobacco products compared to 26 percent for cigarettes).

⁵ We assumed a smaller inventory of tobacco products than cigarettes (a two-week supply for tobacco products and a three-week supply for cigarettes) because we believe that some of these products have shorter shelf lives than do cigarettes.

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Revenue Summary

The revenue impacts of Proposition 86 are shown in the table below. The first complete year that all the provisions of the proposal are in effect would be fiscal year 2007-08. For fiscal year 2007-08 the Tobacco Trust Fund (created by Proposition 86) would receive \$2,206.5 million from cigarette sales. However, the existing cigarette excise funds would lose a combined total of \$257.5 million, resulting in a net gain of \$1,949.0 million in all cigarette excise taxes. The impacts on other tobacco products tax revenues and sales tax revenues are also shown in the table. Other tobacco products revenues would increase by \$69.5 million (excluding an estimated \$3.2 million in floor tax revenues). State and local sales and use tax revenues would increase by a combined \$86.9 million.

	Proposition 86 Revenue Impacts Summary		Fiscal Year
	2006-07	2007-08	Millions of Dollars
Cigarette Excise Tax Revenues by Fund (Excludes Floor Stock Tax)			
General Fund	-\$19.4	-\$29.6	
Breast Cancer	-\$3.9	-\$5.9	
Proposition 99	-\$48.6	-\$74.0	
Proposition 10 (Excludes backfill from Tobacco Trust Fund)	-\$97.2	-\$148.0	
Tobacco Trust Fund (Excludes Board administrative costs and Proposition 10 backfill)	\$1,015.7	\$2,206.5	
Total Cigarette Excise Tax Revenues (Excludes Floor Stock Tax)	\$846.6	\$1,949.0	
Cigarette Floor Stocks Tax	\$154.1	0.0	
Other tobacco products Excise Tax Revenue Increase	\$0.0	\$69.5	
Other tobacco products Floor Stocks Tax	\$0.0	\$3.2	
Total Net Excise Tax Increase (Cigarettes Plus Other tobacco products Taxes, Includes Floor Stock Tax Revenues)	\$1,000.7	\$2,021.7	
State Sales and Use Tax (at 5.25%)	\$28.3	\$57.5	
Local Sales & Use Tax (at 2.0%)	\$10.8	\$21.9	
Transit Tax (at 0.68%)	\$3.7	\$7.5	
TOTALS	\$1,043.5	\$2,108.6	

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Under Proposition 86 the Board would receive a portion of the increased revenues for enforcement purposes (approximately 0.24 percent of the increase in excise taxes). Based on our revenue estimates, we estimate that the Board would receive about \$5.0 million in fiscal year 2007-08. The Department of Health Services and the Attorney General's Office would also receive additional enforcement funds of \$10.1 million and \$5.0 million, respectively.

The Board's estimate of revenues as a result of this measure is substantially similar to that estimated by the Legislative Analyst's Office.

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