

January 15, 2010

Hon. Edmund G. Brown Jr.
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Krystal Paris
Initiative Coordinator

Dear Attorney General Brown:

Pursuant to Elections Code Section 9005, we have reviewed the proposed initiative (File No. 09-0097). This measure would increase excise taxes on cigarettes and use these revenues to fund various health research and tobacco-related programs.

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 fund purposes.

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

- Fifty 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.
- Twenty-five 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, and provided that the tax on other tobacco products be raised commensurately with this and any future tax on cigarettes. These revenues are allocated to 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.

- Ten cents per pack for the state General Fund.
- Two cents per pack enacted through a separate measure approved by the Legislature and Governor in 1993 to create the Breast Cancer Fund, which supports research efforts related to breast cancer and of breast cancer screening programs for uninsured women.

Sales of cigarettes and other tobacco products also are subject to the sales and use tax, which is imposed on their price including excise taxes.

Existing Backfill Provisions. Part of the Proposition 10 revenues are used to “back-fill” or offset any revenue losses experienced by Proposition 99’s health-related education and research programs and the Breast Cancer Fund due to decreased consumption of tobacco products resulting from Proposition 10’s tax increase. (Revenue reductions to Proposition 99 health care and resources programs were not backfilled under the provisions of Proposition 10.) The revenue reductions occur because an increase in the price of cigarettes generally reduces cigarette consumption and results in more sales for which taxes are not collected, such as smuggled products and out-of-state sales.

PROPOSAL

New State Tobacco Tax Revenues

The average retail price of a pack of cigarettes currently is roughly \$5 in California, including all taxes. This measure increases the existing excise tax on cigarettes by \$1 per pack effective 90 days after its passage. Existing state law requires the Board of Equalization (BOE) 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. The measure does not specify how revenues from increased excise taxes on other tobacco products would be used. Under current law, those revenues would be deposited in the Cigarette and Tobacco Products Surtax Fund and used to support Proposition 99 programs.

How Additional Tobacco Revenues Would Be Spent

Receipts from the tobacco tax increases would be deposited in a new special fund created by the measure called the California Cancer Research and Life Sciences Innovation Trust Fund. After compensating existing tobacco tax programs for any losses due to the imposition of the new tax, the monies would be distributed from the trust fund among five funds as follows:

- *Hope 2010 Research Fund.* Sixty percent of the funds would be used to provide grants and loans to support research on prevention, diagnosis, treat-

ment, and potential cures for tobacco-related diseases such as cancer and heart disease.

- ***Hope 2010 Facilities Fund.*** Fifteen percent would be used to provide grants and loans to build and lease facilities and provide capital equipment for research on tobacco-related diseases.
- ***Hope 2010 Smoking Cessation Fund.*** Twenty percent would be used for tobacco prevention and cessation programs administered by the California Department of Public Health (DPH) and the California Department of Education.
- ***Hope 2010 Law Enforcement Fund.*** Three percent would be allocated to state agencies to support law enforcement efforts to reduce smuggling, tobacco tax evasion, illegal sales of tobacco to minors, and to otherwise improve enforcement of existing law.
- ***Hope 2010 Committee Account.*** Two percent would be deposited into an account that would be used to pay the costs of tax collection and expenses of administering the measure.

Committee Established to Administer Trust Fund

The trust fund would be overseen by a nine-member Cancer Research Citizen's Oversight Committee established by the measure. The committee would be composed of four members appointed by the Governor, three of whom are directors of designated cancer centers; two members appointed by DPH; and three chancellors from certain University of California campuses where biomedical scientific research is conducted.

Authority Granted to the Committee. The measure gives the committee the authority to develop a long-term financial plan including an annual budget and to establish a process for soliciting, reviewing, and awarding grants and loans for researchers and facilities. The committee would have the authority to appoint a chief executive officer and other employees. The committee also would have the authority to make final decisions on awards of loans and grants and to establish policies regarding intellectual property rights arising from research funded by this measure.

Tax Collection and Administrative Costs. The committee would be authorized by this measure to reimburse BOE from the Hope 2010 Committee Account for the cost of collecting the new tax levy. This account would also be used to pay for any expenses of administering the act, such as hiring employees.

Accountability Measures. The measure would require the committee to issue an annual report to the public that included information on its administrative expenses, the number and amount of grants and loans provided, and a summary of research findings. The committee would also be required to commission an independent financial audit

that would be provided each year to the State Controller, who would then review the audit and publicly report on the review. The State Controller would also provide the committee with reports that set forth the allowable costs for general administration of the trust fund.

The measure includes conflict-of-interest provisions that govern the conduct of committee members, and includes specific criminal penalties for anyone convicted for the misuse of trust fund monies.

Other Expenditure Rules

Committee Administers Trust Fund. Under this measure, the committee would be authorized to administer the trust fund. The funds allocated under this measure would not be subject to appropriation by the Legislature through the annual state budget act, and thus, amounts would not be subject to change by actions of the Legislature and Governor.

Transfers Permitted From Facilities Fund. In the event the committee determined that there was a surplus in the Hope 2010 Facilities Fund, the measure authorizes the committee to transfer those monies to the Hope 2010 Research Fund, the Hope 2010 Smoking Cessation Fund, or the Hope 2010 Law Enforcement Fund.

New Backfill Provisions. The measure requires the transfer of monies from the trust fund to backfill any losses that occur to the Cigarette and Tobacco Products Surtax Fund (Proposition 99), the California Children and Families First Fund (Proposition 10), the Breast Cancer Fund, and the General Fund that directly result from imposition of the additional tax.

FISCAL EFFECTS

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

Impacts on State and Local Revenues

Revenues Will Be Affected by Consumer Response. Our revenue estimates assume that the distributors of tobacco products, who actually remit the excise tax, largely pass along the excise tax increase of \$1 per pack to consumers. In other words, we assume that the prices of tobacco products would be raised to include the excise tax increase. This would result in various consumer responses. The price increase is likely to result in consumers reducing the quantity of taxable tobacco products they purchase. Consumers could also change the way they acquire tobacco products so that fewer transactions are taxed, such as through Internet purchases or purchases of out-of-state products.

The magnitude of these consumer responses is uncertain given the size of the proposed tax increase. There is substantial evidence regarding the response of consumers

to small and moderate tax increases on tobacco products in terms of reduced tobacco consumption. However, the increase in taxes proposed in this measure is greater than experienced previously in the state. A reasonable projection of consumer response is incorporated into our revenue estimates, but these estimates are still subject to uncertainty given a variety of factors, including the large tax change involved.

New Excise Tax Revenues. Estimated revenues from current excise taxes on cigarettes and other tobacco products are about \$850 million a year. We estimate that the increase in excise taxes required by this measure would raise about \$450 million in 2010-11 (partial-year effect from January 1 through June 30, 2010) and about \$855 million in 2011-12 (the first full-year impact). Our estimate of the allocation of new excise tax revenues is shown in Figure 1 below. The excise tax increase would raise somewhat less revenue each year thereafter, due to the well-established trend of declining per capita cigarette consumption in the state. The higher tax also would reduce revenues from the existing excise tax, as discussed further below.

Figure 1		
Allocation of New Tobacco Tax Revenues		
<i>(Dollars in Millions)</i>		
Backfill	Allocation	2011-12 Funding (Full Year)
Backfill of Proposition 99, Proposition 10, General Fund, and Breast Cancer Account	To be determined by BOE	\$75
Account/Fund		
Research Fund	60 percent of remaining funds	\$468
Facilities Fund	15 percent of remaining funds	117
Smoking Cessation Fund	20 percent of remaining funds	156
Law Enforcement Fund	3 percent of remaining funds	23
Committee Account	2 percent of remaining funds	16
Total Tobacco Tax Funding Allocations		\$855
BOE = Board of Equalization.		

Effects on Existing Tobacco Excise Tax Revenues. The decline in consumption of tobacco products caused by this measure would similarly reduce revenues from the existing tobacco taxes. The measure ensures that revenues for the existing tobacco taxes do not decline due to lower cigarette consumption caused by the new excise tax. We estimate that this allocation of backfill funding would initially amount to about \$75 million annually.

In addition to its allocation of backfill funding, Proposition 99 programs would receive additional revenues because of the existing provision in state law under which any cigarette tax increase triggers an the automatic increase in the taxes collected on

other tobacco products. We estimate that this factor would result in a revenue gain for Proposition 99 programs of about \$45 million annually.

Effects on Excise Tax Collection. As discussed above, the measure would deposit 3 percent of total revenues into a Law Enforcement Fund to support law enforcement efforts. These funds would be used to support increased enforcement efforts to reduce tax evasion, counterfeiting, smuggling, and the unlicensed sales of cigarette tobacco products; increased enforcement of existing laws; and efforts to reduce sales of tobacco products to minors. These activities would probably have a minor impact on the amount of revenues collected through the excise tax.

Effect on State Sales Tax Revenues. Sales taxes are levied on the final price of cigarettes and other tobacco products, including all excise taxes. The higher price of cigarettes resulting from the new excise tax, therefore, would increase state General Fund revenues. We estimate that the state's General Fund sales tax revenues would increase by about \$22 million annually.

Effects on Local Revenues. Local governments would likely experience an annual increase in sales tax revenues of approximately \$10 million.

Impact on State and Local Government Costs

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.

The use of tobacco products has been linked to various adverse health effects by federal health authorities and numerous scientific studies. 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. To the extent that these changes affect publicly funded health care programs, they are likely to reduce state and local government health care spending on tobacco-related diseases.

However, this measure may have other fiscal effects that may partially or fully offset these cost savings. For example, the state and local governments may incur future costs for the provision of health care and social services that may otherwise not have occurred, such as long-term care for individuals who avoid tobacco-related diseases and live longer. Thus, the net fiscal impact of this measure on state and local government costs is unknown.

Summary

The measure would have the following major impacts:

- Increase in new cigarette tax revenues of about \$855 million annually by 2011-12, declining slightly annually thereafter, for various health research and tobacco-related programs.
- Increase of about \$45 million annually to existing health, natural resources, and research programs funded by existing tobacco taxes.
- Increase in state and local sales taxes of about \$32 million annually.

Sincerely,

Mac Taylor
Legislative Analyst

Ana J. Matosantos
Director of Finance