Proposition 56: Tobacco Tax Increase
(Official Title: Cigarette Tax to Fund Healthcare, Tobacco Use Prevention, Research, and Law Enforcement. Initiative Constitutional Amendment and Statute.)

CALTAX POSITION: OPPOSE
The California Taxpayers Association opposes Proposition 56, which would impose an increase in the state tobacco tax, and would dedicate almost $1 billion in very unstable revenue to Medi-Cal, a critical service relied upon by millions of the most vulnerable Californians. When tobacco consumption declines, the state will receive less revenue, creating additional pressure for budget shifts or higher taxes on other taxpayers to make up the loss.

DIGEST
Increases tobacco taxes by $2 per package of 20 cigarettes, with an equivalent tax on other tobacco products, for a total tax increase estimated at $1.4 billion per year. The initiative expands the definition of “other tobacco products” to include electronic cigarettes and similar vapor products that do not contain tobacco. Most of the additional revenue generated by the tax increase would fund Medi-Cal, California’s health care program for low-income residents.

MAJOR PROVISIONS
- **Tobacco Tax Increase.** Imposes an additional tax, beginning July 1, 2017, of 10 cents per cigarette (or $2 per package of 20 cigarettes) and an equivalent tax on other tobacco products. If approved, the new state excise tax rate on a package of 20 cigarettes would be $2.87. This would be in addition to the federal tax of $1.01 per pack of cigarettes, for a total of $3.88 per pack in taxes alone.

- **One-Time Tax on Tobacco Products Ready for Retail.** Imposes a one-time “floor tax” of 10 cents per cigarette (or $2 per package of 20 cigarettes) stored by businesses at the time the new tax is levied.

- **Expands Definition of Tobacco.** Expands the definition of “other tobacco products” for purposes of taxation to also include electronic cigarettes and other similar products that do not contain any tobacco. Under current law, other tobacco products (cigars, cigarillos, chewing tobacco, snuff, etc.) are taxed at rate equivalent to $1.37 per pack of 20 cigarettes. The new definition would be used not just for the tax proposed in this measure, but also for previously approved tobacco taxes.
- **Exemption for Certain Nicotine Products.** Exempts from taxation nicotine products approved by the U.S. Food and Drug Administration for use as a tobacco-cessation product or for a therapeutic purpose. The initiative also exempts food products from the definition of “other tobacco products.”

- **Declining Revenue Offsets.** Requires the State Board of Equalization to review the effect of this tax increase on tobacco consumption and tax revenue. BOE statistical studies show that as tobacco taxes are increased, fewer people smoke, and pre-existing tobacco taxes thus generate less revenue. To offset these revenue losses, the BOE would determine the revenue loss to pre-existing programs, and the state controller would transfer new revenue to make up the loss. The Legislative Analyst’s Office estimates that this backfill could amount to $200 million to $230 million per year.

- **Exemption From the Gann Spending Limit.** Exempts all revenue generated from the tax from the constitutional Gann Spending Limit, which limits the growth in state and local appropriations and tax revenue collections.

- **No Funding for Education.** Proposition 56 excludes any new tobacco tax revenue from being earmarked to K-12 schools and community colleges under Proposition 98, a 1988 voter-approved measure that requires more than 40 percent of new revenue to be dedicated to K-14 schools.

- **Ballot-Box Budgeting.** Earmarks additional tax revenue to the Medi-Cal program and to fund new government healthcare and research programs. The initiative first directs funding to offset revenue losses for existing programs funded by tobacco taxes (see note on “Declining Revenue Offsets” above), and secondly earmarks specific dollar amounts to various programs. The initiative then directs the remaining funds in a percentage appropriation to various programs (see chart below.)
California Healthcare, Research and Prevention Tobacco Tax Act of 2016 Fund
(Generates up to $1.4 billion annually)

OFF-THE-TOP EXPENDITURES

- **Bureau of State Audits**: $400,000 to evaluate program spending.
- **University of California**: $40 million to increase the number of California physicians.

- **Dept. of Public Health State Dental Program**: $30 million to prevent and treat tobacco-related dental disease.
- **Law Enforcement**: 
  - **State Board of Equalization**: $6 million to enforce regulations.
  - **Attorney General’s Office**: $6 million to fight cigarette smuggling and other illegal activities.

REMAINING FUNDS

- **University of California**: 5% (about $40 million) to fund UC medical research and preventative treatments.
- **Dept. of Health Care Services**: 82% (about $710 million to $1.01 billion) to fund existing healthcare programs and services.
- **Tobacco Prevention and Control Programs**: 13%
- **Dept. of Public Health Tobacco Control Program**: 85% (about $100 million) to award funding to state and local gov’t, higher edu., and non-profits to evaluate tobacco and nicotine reduction activities.
- **Dept. of Education**: 15% (about $20 million) to school programs to reduce tobacco and nicotine use among young people.

Source: Information from text of Proposition 56.
BACKGROUND

California has imposed five tobacco tax increases since 1959 (see chart below), including two that were imposed by voters via statewide ballot measures – Proposition 99 of 1988, and Proposition 10 of 1998.

More recently, voters and the Legislature have rejected every proposal to increase taxes on cigarettes and tobacco products – in 2006, voters rejected Proposition 86; and in 2010, voters rejected Proposition 29. The most recent measure, backed largely by the same group of people who support this measure, sought to increase the tobacco tax by $1 per pack.

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<th>Existing and Proposed Excise Taxes on Tobacco</th>
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<tbody>
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<td>Tax</td>
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<td>Federal Tax</td>
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<td>AB 1172 of 1959 (MacBride, Ch. 1040)</td>
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<td>Proposition 99 of 1988</td>
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<td>AB 478 of 1993 (Friedman, Ch. 1172)</td>
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<td>Proposition 10</td>
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<td>Proposition 56</td>
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Total State and Federal Tax if Proposition 56 Is Approved: $3.88

FISCAL IMPACT

The Legislative Analyst’s Office estimates that the tax increase on cigarettes and other tobacco products (including taxation of electronic cigarettes) would cost taxpayers $1.4 billion annually. However, the analyst estimates that these figures would decline in subsequent years, as tobacco consumption declines.

POLICY CONSIDERATIONS

Declining Revenue Source Creates Unstable Funding for Health Care

One-time and declining revenue sources should be used for one-time expenditures, not ongoing expenditures. This initiative would create a funding shortfall for a vital program relied upon by millions of Californians.
The California Medical Assistance Program (known as Medi-Cal, the state’s version of the federal Medicaid program) provides health services to families, individuals, children in foster care, and others with an income of 138 percent below poverty levels. There are approximately 12.5 million Californians who receive care under Medi-Cal.

According to the Legislative Analyst’s Office, this initiative likely would create a funding shortage for Medi-Cal over time. Of the $1.4 billion in revenue that may be generated by the initiative, 82 percent of the remaining funds (after off-the-top expenditures are made) would be earmarked to Medi-Cal. The analyst notes: “Higher provider payments created by the measure could establish an expectation that similar payment 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.”

When the State Board of Equalization began collecting cigarette tax data in 1959-60, Californians consumed 139.7 packs of cigarettes per capita. By the end of the 1960s, cigarette consumption had decreased to 130.2 packs per capita. More recently, per capita consumption was 23.2 packs of cigarettes per capita. As consumption has declined, cigarette tax revenue also has declined. After Proposition 10 was passed in 1998, the BOE reported $1.16 billion in cigarette tax revenue. By 2007-08, cigarette tax revenue declined to $955 million, and is expected to continue declining.

When this initiative’s funds from tobacco taxes earmarked to Medi-Cal programs decline in future years, there would be pressure to backfill revenue losses by increasing other taxes.

**Ballot-Box Budgeting Is Unwise**

This initiative earmarks revenue from the tax increase to several specific programs. This type of ballot-box budgeting is a bad budget practice, as it limits the ability of lawmakers to respond to changing budget priorities and fiscal conditions.

**Targeted Taxes Are Bad Tax Policy**

Taxes imposed to change consumer behavior intentionally create market distortions, and are bad tax policy. Taxes should seek to achieve neutrality by not discriminating against certain industries, activities or products. Consumers benefit most when their decisions in the marketplace are unaffected by price distortions. While targeted taxes generally are designed to penalize a company or reduce an activity or consumption of a product, such taxes often have unintended consequences.

**Regressive Tax Targets Low-Income Taxpayers**

Cigarette taxes disproportionately impact low-income families. Data shows that smoking is more prevalent among populations in the income range of $10,000 to $20,000. If this initiative were to go into effect, California’s tobacco taxes would be the sixth highest in the country – mostly paid by California’s poor.

**Public Safety Concerns**

There is a direct relationship between tax increases on tobacco products and increased
tax evasion. The U.S. Bureau of Alcohol, Tobacco, Firearms and Explosives notes, “The incentive to evade cigarette taxes has risen dramatically along with tax rates, resulting in billions of dollars of lost revenue from cigarette smuggling, cigarette diversion, stamp counterfeiting and Internet sales.”

U.S. Customs and Border Protection (CBP) officials continually report on counterfeit cigarette seizures at California’s ports and borders: 28,260 cartons were reported seized in 2007; more than 96,000 cartons of cigarettes were seized in 2008; and 11,000 cartons of counterfeit cigarettes were seized in 2011. According to CBP: “Organized crime organizations smuggle counterfeit cigarettes because of the substantial profits it generates. Much of these profits fund other criminal activities including money laundering and terrorism.”

The Mackinac Center for Public Policy, which tracks cigarette smuggling, reported in 2015 that approximately one-third of the cigarettes consumed in California are smuggled into the state to avoid taxes, and also reported that smuggling increased significantly in Illinois after tobacco taxes were increased there.

The Legislative Analyst’s Office questioned whether the measure’s funding for law enforcement would be enough to counter the increased crime that would be prompted by the tax increase.