LAO

# The 2015-16 Budget: Cigarette Tax and Licensing Programs

MAC TAYLOR • LEGISLATIVE ANALYST • APRIL 22, 2015


## Summary

***Tobacco Excise Taxes and Licensing.*** California imposes excise taxes on cigarettes and on other tobacco products such as cigars and chewing tobacco. Most revenue from these taxes goes to special funds established by ballot measures. The state also licenses tobacco sellers and distributors.

***State Administrative Costs.*** The State Board of Equalization (BOE) administers the cigarette and tobacco excise tax and licensing programs. Recently, there has been considerable legislative interest in these programs' costs. The Legislature faces two key decisions: (1) how to pay for BOE's cigarette and tobacco programs, and (2) how much to spend on them.

***Recommendations.*** We recommend that the state use excise tax revenue to pay for excise tax administration but not for the cigarette and tobacco licensing program. To address the current imbalance between the licensing program's costs and revenue, we further recommend the Legislature (1) temporarily increase fees on tobacco retailers, wholesalers, and distributors, and (2) direct BOE and the California Department of Justice (DOJ) to explore options to reduce the program's costs by promoting electronic filing of schedules and tax returns.


## Background

Cigarettes, along with other tobacco products such as cigars and chewing tobacco, are subject to various federal, state, and local taxes and fees. In California, in addition to sales taxes, the state imposes "excise" taxes on each pack of cigarettes and on each dollar of tobacco products. California also levies licensing fees on businesses that sell or distribute tobacco. The BOE administers these tobacco excise tax and licensing programs.

### State Imposes Excise Tax on Distributors

Under the state's Cigarette and Tobacco Products Tax Program, BOE administers and collects California's excise taxes on tobacco products. The state levies these taxes on distributors who supply cigarettes or other tobacco products to wholesalers or retailers. In the case of cigarettes, distributors pay this tax by buying tax stamps with a face value equivalent to the cigarette excise tax rate of 87 cents per pack. To comply with the excise tax, distributors must affix one of these stamps to each pack that they distribute to wholesalers or retailers. In the case of other tobacco products, distributors pay a tax equivalent to roughly 29 percent of the products' wholesale price. BOE adjusts this rate each year based on price changes.

***Most Cigarette and Tobacco Excise Tax Revenue Goes to Special Funds.*** Figure 1 shows the distribution of tobacco excise tax revenues in 2013-14. The state's General Fund received $90 million of these revenues. The rest was allocated to special funds to support specific programs as follows:

- $460 million for childhood development programs pursuant to Proposition 10, approved by voters in 1998.
- $270 million for tobacco education and prevention, tobacco-related disease research, health care for low-income persons, environmental protection, and recreation programs pursuant to Proposition 99, approved by voters in 1988.
- $20 million for breast cancer-related research and breast cancer screening for uninsured women pursuant to Chapter 661, Statutes of 1993 (AB 2055, Friedman).

***Each Fund Pays Share of Cost for Tax Administration.*** BOE spreads the cost of administering the excise tax across each of the funds receiving revenue from this source, with each fund paying a share of costs that is roughly in proportion to its share of total excise tax revenue. The *2015-16 Governor's Budget* proposes spending $25 million on BOE excise tax administration and continuing to apportion these costs across the four funds that receive the excise tax revenue.

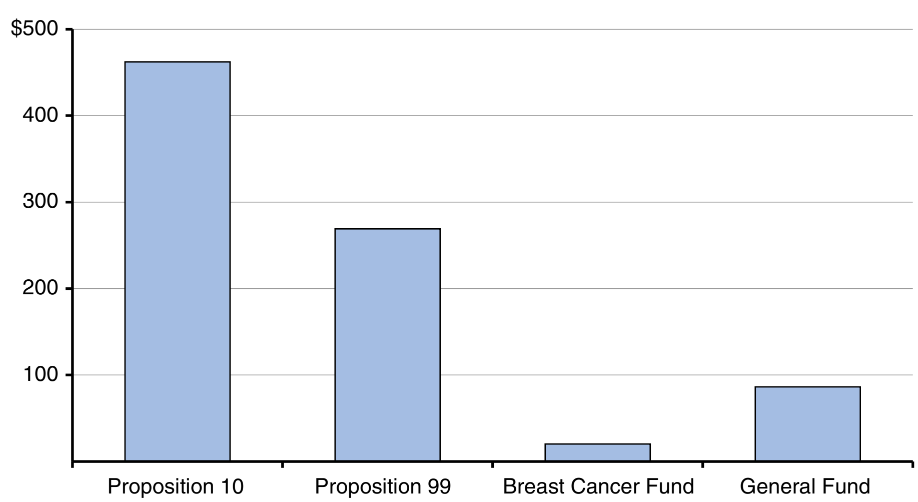
### State Licenses Retailers, Wholesalers, and Distributors

***California Entered Master Settlement Agreement.*** In the 1990s, many states sued tobacco companies for damages related to the effects of smoking. In 1998, 46 states—including California—and the four largest cigarette manufacturers settled these lawsuits with a "Master Settlement Agreement" (MSA). As described in the nearby box, the MSA imposes a variety of obligations on participating tobacco companies, including a requirement to make annual payments to each settling state. Annual MSA payments to California's state and local governments total hundreds of millions of dollars.

**Figure 1**

**Most Revenue Goes to Special Funds**

*2013-14 Cigarette and Tobacco Tax Revenue (In Millions)*



***Licensing Program Supports Activities Related to MSA.*** Under the MSA, states must maintain accurate records of cigarette sales and must "diligently enforce" various payment requirements related to those sales, including the payment of state excise taxes. To fulfill California's obligations under the MSA, the Legislature created new programs administered by BOE and DOJ, including a new Cigarette and Tobacco Products Licensing Program (Chapter 890, Statutes of 2003 [AB 71, Horton]). Under this program, BOE registers several types of businesses involved in the sale or distribution of cigarettes and tobacco products. To register, cigarette and tobacco retailers pay a one-time licensing fee of $100. Distributors and wholesalers pay an annual licensing fee of $1,000. Once licensed, businesses are subject to recordkeeping and inspection requirements.

### The Tobacco Master Settlement Agreement

***Agreement Created Ongoing Revenue Stream.*** California and 45 other states entered a Master Settlement Agreement (MSA) with the four largest cigarette manufacturers in 1998. (Since then, many other manufacturers have become "participating manufacturers" by agreeing to the terms of the MSA.) Under the MSA, participating manufacturers make payments to California totaling hundreds of millions of dollars annually. One-half of this money goes to local governments while the other half goes to the state. In the past, the state borrowed against its share of this payment stream in order to balance the budget. The state's share of settlement revenue currently is dedicated to repaying this debt.

***Revenue Depends on Enforcement.*** Although many tobacco manufacturers have decided to participate in the MSA, some have not. Under the MSA, each state must (1) pass laws requiring these non-participating manufacturers to make certain payments to the state based on their cigarette sales and (2) "diligently enforce" these payment requirements by tracking all cigarettes sold in the state. If a state does not fulfill these obligations, participating manufacturers can seek to lower their payments through arbitration. To fulfill California's obligations under the MSA, the Legislature created new programs administered by the State Board of Equalization (BOE) and the Department of Justice, including BOE's Cigarette and Tobacco Licensing Program.

***Recent Arbitration Reduced Payments to Some States.*** In recent years, participating cigarette manufacturers have argued that their payments to some states—including California—should be smaller because the states did not diligently enforce the MSA's provisions related to non-participating manufacturers. Under the MSA, a federal arbitration panel is responsible for resolving these types of disagreements. Many states, including California, settled this dispute prior to arbitration. Under this settlement, the tobacco manufacturers made the disputed payments, but the states provided the manufacturers with some credits against their future payments. Fifteen states chose to proceed with arbitration instead of settling. In 2013, the arbitration panel ruled that nine of those fifteen states had enforced their laws diligently and were entitled to the money that the tobacco companies had withheld. However, the panel found that six states had not enforced their laws diligently, and it reduced payments to those states accordingly. This arbitration applied to payments for the 2003 sales year; later years are still in dispute.

### Licensing Program Expenditures Exceed Fee Revenue

As shown in Figure 2, licensing fees generated $18 million for the state licensing program in 2003-04. This initial influx of revenue was more than sufficient to pay the program's costs in 2003-04. In subsequent years, however, fee revenue typically has been one-tenth of this initial level, and expenditures have consistently exceeded revenue. From 2005-06 to 2013-14, annual expenditures averaged $7 million more than annual fee revenue.

***2006-07 Budget Shifted Funding.*** In 2006-07, the Legislature approved a budget proposal to begin charging the four funds that receive cigarette and tobacco excise tax revenue for part of the costs of administering the licensing program. As a result of this change, these funds have had reduced resources for programmatic purposes. Today, these funds pay about four-fifths of the licensing program's costs, and the rest is paid from licensing fees.

### Legislature Required Report on Funding Options

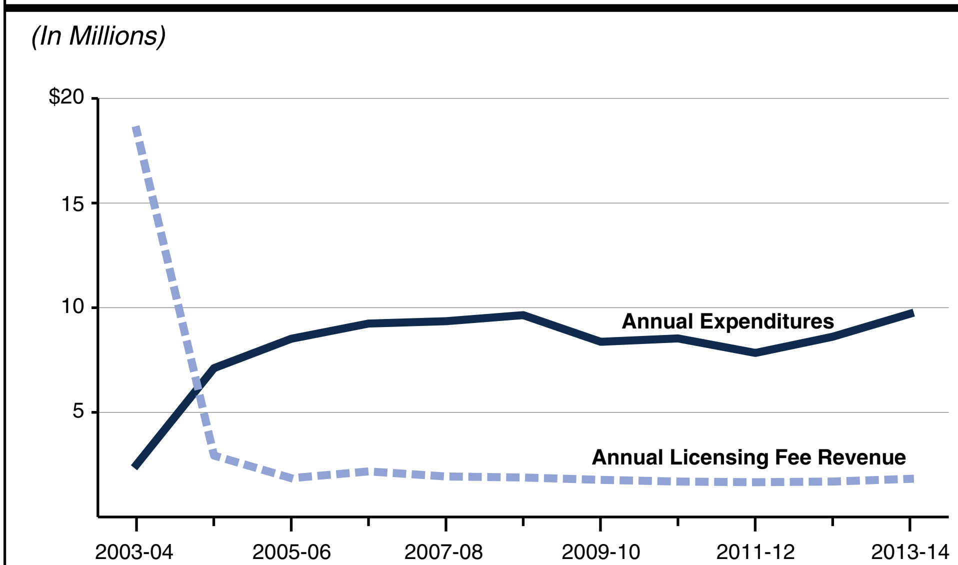
In 2014, representatives from Proposition 10 programs expressed concerns about the costs and funding of BOE's cigarette and tobacco programs, particularly the licensing program. Specifically, they expressed concern that administrative costs of the licensing program were being supported by excise tax funds, resulting in reduced programmatic funds for special and General Fund programs. In response to these concerns, the Legislature approved supplemental reporting language (SRL) requiring BOE to:

- Submit a report on the administrative costs of the cigarette and tobacco excise tax and licensing programs.
- Hold a stakeholder meeting.
- Submit a report on alternative approaches for funding the licensing program.

***BOE's Report on Funding Options.*** The report BOE submitted in response to the SRL describes 11 options, listed in Figure 3, that focus on the licensing program. (Although the SRL did not require BOE to report on tax administration, stakeholders have also raised concerns in that area.) The report does not make a recommendation. Six of the options included in the report raise revenue to pay for licensing program administrative costs, thereby reducing the costs paid with excise tax revenue. For example, one option replaces the current one-time retailer

**Figure 2**

**Licensing Expenditures Exceed Fee Revenue**



licensing fee with a recurring fee. Four of the options reduce administrative costs—such as by requiring licensees to file schedules and returns electronically. One option does not raise additional revenue or decrease costs, but shifts greater responsibility for paying for this program's costs to the General Fund.

## Analysis

The Legislature faces two key decisions regarding BOE's cigarette and tobacco programs: (1) how to pay for them, and (2) how much to spend on them.

### Funding Sources for BOE's Cigarette and Tobacco Programs

***Reasonable for Excise Taxes to Pay for Excise Tax Administration.*** California has many revenue sources that are shared by multiple funds or entities, including the sales tax. When multiple entities or funds share revenues, it is common for the cost of tax administration to be split across all beneficiaries in direct proportion to the revenues they receive. The current system of cost allocation for the cigarette and tobacco excise tax program appears to be consistent with this practice and consistent with the provisions of Propositions 99 and 10.

***Use Licensing Fees to Pay for Licensing Program.*** In general, we think it is preferable to pay for the licensing program with licensing fees. Using cigarette and tobacco excise tax revenue for this purpose appears somewhat inconsistent with the provisions of Propositions 99 and 10. Specifically, these measures provide that their funds are to be used for specific programmatic purposes, with a portion of the revenues set aside for tax administration and collection. (We note that the tobacco licensing program did not exist at the time voters approved Propositions 99 and 10.)

### Expenditures on BOE's Cigarette and Tobacco Programs

***Potential Efficiencies in Licensing Program.*** As noted above, there is currently a significant operating deficit in the licensing program. Closing this gap primarily through reduced spending, however, would be risky. This is because the Legislature created the licensing program to comply with the MSA requirement for diligent enforcement of tobacco laws, and states found not to be diligent have had their revenues reduced. There are ways, though, to reduce administrative

**Figure 3**

**Proposals Listed in BOE's Supplemental Report**

**Proposals to Raise Revenue to Pay for Licensing Program Costs**

- Institute a recurring fee at the retail level to increase the share of costs covered by the licensing fees.
- Increase the taxes assessed on cigarettes and tobacco products by an unspecified amount.
- Reevaluate the cigarette stamp discount in order to increase revenue.
- Increase penalties and fines to mitigate the shortfall of the licensing program.
- Tax electronic cigarettes, dissolvable tobacco, and other recently developed products by expanding the definition of "tobacco products."
- Increase collection efforts related to tax due on out-of-state cigars shipped into California by unregistered distributors.

**Proposals to Reduce Licensing Program Administrative Costs**

- Reduce spending and cap administrative costs on the cigarette and tobacco products licensing program.
- Allow cigarette and tobacco retailer licenses to be issued in perpetuity.
- Require cigarette and tobacco products licensees to file electronically.
- Create efficiencies between state and local agencies in order to reduce the duplication of efforts.

**Proposal to Change Allocation of Administrative Costs**

- Pay for the cigarette and tobacco products licensing program with funds from the General Fund.

BOE = Board of Equalization.

costs without sacrificing program effectiveness. For example, the stakeholder proposal related to electronic filing of schedules and tax returns identifies a likely administrative efficiency. As described above, the MSA requires the state to keep accurate records of cigarette sales. With hundreds of millions of packs of cigarettes sold in California each year, managing these records is costly. Cigarette distributors, wholesalers, and retailers often submit schedules and returns on paper, increasing the cost of entering and verifying data. If the state received more of these records in electronic form, it could potentially achieve similar outcomes with lower state administrative costs. We note, however, that requiring electronic filing could be costly for some businesses, at least initially.

## Recommendations

### Use Excise Tax Revenue to Fund Tax Administration, Not Licensing Costs

As described above, using cigarette and tobacco excise tax revenue to pay for excise tax administration is reasonable and is authorized under Propositions 99 and 10. Most revenue from cigarette and tobacco excise taxes goes to special funds created by ballot measures. These ballot measures specify that the funds are available for programmatic purposes and for the cost of tax administration and collection. These ballot measures do not explicitly authorize the use of these funds to administer a licensing program. Consequently, we recommend that the Legislature direct the administration to discontinue the practice of charging funds receiving tobacco excise tax revenues for licensing program costs.

### Temporarily Increase Amount and Frequency of License Fees

We recommend that the Legislature temporarily increase the fees charged for the cigarette and tobacco licensing program with the goal of using fee revenues to pay for all licensing program costs. For example, we estimate that the following changes in the fee structure would generate sufficient revenue for this purpose: (1) replace the current $100 one-time fee for retailers of cigarettes and tobacco products with an annual fee of $250, and (2) increase the annual fee paid by wholesalers and distributors from $1,000 to $1,250.

We recommend that the Legislature implement the fee increases on a temporary basis, expiring after about four years. A fixed expiration date would provide an opportunity for the Legislature to reassess whether fee revenues line up with ongoing program costs. If electronic filing or other efficiencies reduced state administrative costs, the Legislature could reduce the fees. Alternatively, if the fees generated less revenue than needed, the Legislature could evaluate whether additional cost containment measures were needed or further fee increases were warranted. Any shortfall in funding over the next four years could be addressed by directing the administration to use the balance of the licensing fee fund (estimated to be $8.6 million in 2014-15).

### Direct BOE and DOJ to Develop Electronic Filing Proposal

As described above, BOE's cigarette and tobacco programs are data-intensive, so increasing the rate of electronic filing likely would reduce state administrative costs. We recommend that the Legislature adopt budget bill language requiring BOE and DOJ to develop and report on at least one proposal for a statutory change related to electronic filing. Such a report should address:

- How the proposal would affect each department's ongoing administrative costs.

- Whether to require electronic filing or to provide an incentive. For example, the state could charge a higher fee for licensees that submit information on paper and a lower fee for licensees that submit information electronically.
- Whether to extend this requirement or incentive to all licensees, or to apply it only to certain types of businesses, such as wholesalers and distributors.

**LAO Publications**

This brief was prepared by Seth Kerstein and reviewed by Marianne O'Malley. The Legislative Analyst's Office (LAO) is a nonpartisan office that provides fiscal and policy information and advice to the Legislature.

To request publications call (916) 445-4656. This brief and others, as well as an e-mail subscription service, are available on the LAO's website at www.lao.ca.gov. The LAO is located at 925 L Street, Suite 1000, Sacramento, CA 95814.