February 20, 2014

Hon. Kamala D. Harris
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Ashley Johansson
Initiative Coordinator

Dear Attorney General Harris:

Pursuant to Elections Code Section 9005, we have reviewed the proposed statutory initiative (A.G. File No. 14-0003, Amendment #1-S) that would increase the state's cigarette excise tax from 87 cents to $1.87 per pack.

BACKGROUND

Tobacco Taxes

Existing State Excise Taxes. Current state law imposes excise taxes on the distribution of cigarettes and other tobacco products, such as cigars and chewing tobacco. Tobacco excise taxes are paid by distributors who supply cigarettes and other tobacco products to retail stores. These taxes are typically passed on to consumers as higher prices on cigarettes and other tobacco products.

The state's cigarette excise tax is currently 87 cents per pack. Figure 1 describes the different components of the per-pack tax. As the figure shows, two voter-approved measures—Proposition 99 in 1988 and Proposition 10 in 1998—are responsible for generating the vast majority of tobacco excise tax revenues. As Figure 1 indicates, total state revenues from existing excise taxes on cigarettes and other tobacco products were roughly $870 million in 2012-13.

Revenues from existing excise taxes on other tobacco products support Proposition 10 and 99 purposes. Under current law, any increase in cigarette taxes automatically triggers an equivalent increase in excise taxes on other tobacco products, with the revenues going to support Proposition 99 purposes.

Existing Federal Excise Tax. The federal government also imposes an excise tax on cigarettes and other tobacco products. In 2009, this tax was increased by 62 cents per pack (to a total of $1.01 per pack) to help fund the Children's Health Insurance Program, which provides subsidized health insurance coverage to children in low-income families.

Figure 1

Existing State Tobacco Excise Taxes

(Dollars in Millions)

Description	Cents Per Pack of Cigarettes	Estimated 2012-13 Net Revenue[a]
State General Fund. Initially enacted by the Legislature in 1959 for general support of the state budget.	10¢	$91
Proposition 99. Enacted by the voters in 1988 for the purposes of supporting tobacco education and prevention efforts, tobacco-related disease research programs, health care services for low-income persons, and environmental protection and recreational resources. Some Proposition 99 revenues are used to support programs that also receive support from the state General Fund.	25	289[b]
Breast Cancer Fund. Enacted by the Legislature in 1993 for the purposes of supporting breast cancer screening programs for uninsured women and research related to breast cancer.	2	21
Proposition 10. Enacted by the voters in 1998 for the purposes of supporting early childhood development programs.	50	469[b]
Totals	**87¢**	**$870[c]**

[a] Accounts for payments from Proposition 10 to other funds in order to maintain pre-Proposition 10 revenue levels.
[b] Total includes excise tax revenue from other types of tobacco products, such as cigars and chewing tobacco.
[c] Does not total due to rounding.

Existing State and Local Sales and Use Taxes. Sales of cigarettes and other tobacco products are also subject to state and local sales and use taxes. These taxes are imposed on the retail price of a product, which includes excise taxes that have generally been passed along from distributors. The average retail price of a pack of cigarettes in California currently is close to $6. More than $400 million in annual revenue from sales and use taxes on cigarettes and other tobacco products go to the state and local governments.

Funding for Brain and Central Nervous System Disorder Research

National Institute of Neurological Disorders and Stroke (NINDS). The federal National Institutes of Health's (NIH) NINDS aims to reduce the burden of neurologic disease by funding and conducting research on the nervous system. The overall budget for NINDS is approximately $1.6 billion annually, of which about 90 percent is allocated to research. In federal fiscal year (FFY) 2013, NINDS awarded almost $285 million to organizations in California.

National Institute of Aging (NIA). The NIH's NIA leads a broad scientific effort to understand the nature of aging. The Division of Neuroscience within NIA supports research and training to further the understanding of how the central nervous system and behavior are affected by aging. The overall budget for NIA is approximately $1.1 billion annually, of which about 40 percent is allocated to NIA's Division of Neuroscience. In FFY 2013, NIA awarded over $170 million to institutes in California to support research related to aging, including brain and central nervous system research.

California Institute for Regenerative Medicine (CIRM). The CIRM was established in 2004 by Proposition 71 to award grants and loans for stem cell research and research facilities in California. The CIRM supports stem cell research for the discovery and development of cures, therapies, diagnostics, and research technologies to relieve human suffering from chronic disease and injury. Grants awarded by CIRM fund research on neurological diseases, heart disease, blood disorders, cancer, and a wide range of other diseases and disorders. The CIRM is funded by $3 billion in general obligation bonds. Since 2004, CIRM has awarded over $285 million for research related specifically to neurological diseases.

PROPOSAL

This measure increases excise taxes on the distribution of cigarettes. The additional revenues would be used to fund research of brain and central nervous system disorders, and for other specified purposes. The major provisions of the measure are described below.

New State Tobacco Tax Revenues

This measure increases—effective on the date the Secretary of State certifies the election results—the existing state excise tax on cigarettes by $1 per pack. The total state excise tax, therefore, would be $1.87 per pack. This measure also creates a one-time tax on cigarettes that are stored by wholesalers and dealers on April 1, 2015.

How New Cigarette Tax Revenues Would Be Spent

Revenues from the cigarette excise tax increase would be deposited in a new special fund, called the California Brain Research Trust Fund (hereafter referred to as the fund). These revenues would be dedicated to the support of research on brain and central nervous system diseases and disorders. Revenues deposited in the fund would only be used for purposes set forth in the measure and would not be subject to appropriation by the Legislature. After compensating existing tobacco tax program funds for any losses due to the imposition of the new tax (as described in the next section), the remaining money would be distributed as follows:

- ***Research Subfund.*** Fifty percent of the funds would be used to award grants and loans to support research in California into brain mapping, and brain and central nervous system diseases and disorders. Not more than 15 percent of the funds could be used for grants and loans for facilities and equipment. The funds would be awarded through a peer review process that would be modeled on the NIH's grant-making process.
- ***CIRM.*** Thirty percent of the funds would be allocated to CIRM to award grants and loans for stem cell research in California with an emphasis on research on brain and central nervous system diseases and disorders.
- ***Tobacco and Substance Prevention and Cessation Subfund.*** Fifteen percent of the funds would be used to carry out brain research in California on the causes, early detection, treatment, prevention, and cessation of the use of cigarettes, other tobacco products, and other addictive substances and behaviors.

- ***Unallocated Subfund.*** Three percent of the funds would be used to carry out any of the purposes of this measure except for general administrative functions.
- ***Administrative Subfund.*** Two percent of the funds would be used for the general administrative functions of the committee which oversees the fund (described below).

Backfill of Existing Tobacco Tax Programs. This measure requires the transfer of some revenues raised by the new tax to "backfill," or offset, any revenue losses that occur to existing state cigarette and tobacco taxes as a direct result of the imposition of the new tax. These revenue losses would occur mainly because an increase in the price of cigarettes and other tobacco products generally reduces consumption and results in more sales for which California taxes are not collected. This, in turn, would reduce the amount of revenues collected through the existing state excise taxes described above. The amount of backfill payments needed to offset any loss of funding in these areas would be determined by the Board of Equalization (BOE).

Committee Established to Administer Fund

The trust fund would be overseen by a newly created California Brain Research Citizen's Oversight Committee (hereafter referred to as the committee). The committee would be composed of 11 members, including 4 members appointed by the Governor, the president of the University of California (UC), and the chancellors of the UC at San Francisco, Berkeley, Davis, San Diego, Los Angeles, and Irvine.

Authority Granted to the Committee. The measure would authorize the committee to act as the trustee of the fund and oversee the operations of the fund. The measure would give the committee the authority to:

- Appoint a chief executive officer who would have the authority to hire employees as necessary for the administration of the fund.
- Establish a process for soliciting, reviewing, and awarding grants and loans for research and facilities, and for revoking or rescinding grants and loans that do not conform to approved research standards.
- Establish and appoint additional committees and advisory bodies as necessary to carry out the committee's duties.
- Develop annual and long-term strategic research and financial plans and periodically review the income and expenditures of the fund.
- Establish policies regarding intellectual property rights arising from research funded by this measure consistent with those implemented by the UC.
- Establish rules and guidelines for the operation of the fund and its employees.

Committee Accountability. The measure includes conflict-of-interest provisions that govern the conduct of the committee members. The measure would require the committee to issue an annual report to the public that includes information on its administrative expenses, the number and amount of grants provided, and a summary of research accomplishments. The committee would be required to have an independent financial audit each year which would be reviewed by

the State Controller. The measure would also establish the Citizen's Financial Accountability Oversight Committee which would be chaired by the State Controller to review the annual financial audit and provide recommendations on the committee's financial practices and performance.

Other Major Provisions

Committee Would Establish Standards to Ensure Grantees Purchase Goods and Services From California Suppliers. The committee would be required to establish standards to ensure that grantees purchase goods and services from California suppliers, to the extent reasonably possible, in a good faith effort to achieve a goal of more than 50 percent of such purchases from California suppliers.

FISCAL EFFECTS

This measure would have a number of fiscal effects on state and local governments. The major impacts are discussed below.

Impacts on State and Local Revenues

Revenues Would Be Affected by Consumer Response. Our revenue estimates assume that the proposed excise tax increase would be passed along to consumers. In other words, we assume that the retail prices of cigarettes and other tobacco products would be raised to include the excise tax increase. We expect consumers to respond to this price increase in two ways: by reducing their consumption of cigarettes and other tobacco products and by changing the way they acquire cigarettes and other tobacco products so that fewer transactions are taxed. For example, consumers could substitute toward electronic cigarettes, which are not subject to the excise tax on cigarettes and other tobacco products. In addition, consumers could avoid paying cigarette taxes by purchasing untaxed cigarettes from Internet vendors. Although state and federal laws generally prohibit this form of tax avoidance, the effectiveness of these policies is uncertain. As a result, the magnitude of the consumer response to the proposed tax increase is difficult to estimate precisely.

New Cigarette Excise Tax Revenues. We estimate that the increase in cigarette excise taxes required by this measure would raise an estimated $700 million to $800 million in revenue. The range reflects the uncertainty of the magnitude of the consumer response to the proposed tax increase discussed above. Our estimate of the allocation of new cigarette excise tax revenues in 2015-16 (the first full-year impact) is shown in Figure 2. After backfilling losses in existing tobacco excise tax revenue (described in more detail below), the new cigarette excise tax would generate an estimated $500 million to $750 million in net revenue in 2015-16 for the purposes described in the measure. (These estimates do not include revenue from the one-time tax on cigarettes stored by wholesalers and dealers.) The cigarette excise tax increase would generate somewhat lower amounts of revenue each year thereafter, based on our projections of continued declines in cigarette consumption.

Figure 2

How Estimated Revenue From New Cigarette Tax Would Be Allocated

(Dollars in Millions)

	Allocation	2015-16 Funding[a] (Full Year) Low - High Estimate[b]
Estimated Revenue From New Cigarette Tax		**$686 - $789**
Less backfill to Proposition 99, Proposition 10, General Fund, and Breast Cancer Fund	—	147 - 57[c,d]
Estimated Net Revenue		**$539 - $732**
Allocation of Estimated Net Revenue		
Research Subfund	50%	$269 - $366
CIRM	30	162 - 220
Tobacco and Substance Prevention and Cessation Subfund	15	81 - 110
Unallocated Subfund	3	16 - 22
Administrative Subfund	2	11 - 15

[a] The estimates do not include revenue from the one-time floor stock tax.

[b] The consumer response to the proposed tax increase 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.

[c] LAO estimate. Backfill amounts would be determined by the Board of Equalization.

[d] A strong consumer response would reduce estimated revenues from the new cigarette tax but increase the amount needed to backfill other funds.

CIRM = California Institute for Regenerative Medicine.

Effects on Existing Tobacco Excise Tax Revenues. The decline in consumption of cigarettes and other tobacco products caused by this measure would reduce revenues from the existing excise taxes that go to support Propositions 99 and 10 purposes, the General Fund, and the Breast Cancer Fund. The measure provides for the backfill of these losses from revenues raised by the new excise tax. We estimate that the amount of backfill funding needed to comply with this requirement would be at least $50 million but not more than $150 million annually, as shown in Figure 2.

As noted earlier, this measure would have an additional fiscal effect on excise taxes that go to support Proposition 99 purposes. Under current law, any cigarette tax increase triggers an automatic corresponding increase in the taxes on other tobacco products, with the additional revenues going to support Proposition 99 purposes. We estimate that the higher tax on other tobacco products would result in a full-year Proposition 99 revenue gain of roughly $50 million, beginning in 2015-16.

Effect on State and Local Sales and Use Tax Revenues. Sales and use taxes are levied on a variety of products, including the retail price of cigarettes and other tobacco products. The retail price usually includes the cost of all excise taxes. The excise tax increase under the measure would raise the retail price of taxable cigarettes and tobacco products, and consumers would respond by buying fewer of those goods. The net effect on sales and use tax revenue from the

sale of cigarettes and tobacco products could be positive or negative, depending on the magnitude of the consumer response. The excise tax increase could also lead to changes in spending on other products subject to sales and use taxes. On net, we estimate sales and use tax revenue effects ranging from a $30 million annual loss to a $40 million annual gain. Again, this range reflects the uncertainty of the magnitude of the consumer response to the proposed tax increase under the measure. For example, sales and use tax revenue losses could result if consumers respond to the proposed tax increase by buying far fewer taxed cigarettes and other tobacco products.

Impact on State Administrative Costs

This measure would result in administrative costs for the State Controller's Office (SCO) and BOE. The costs to SCO would be minor and absorbable. The BOE estimates costs resulting from this measure of approximately $14 million to $17 million annually. This measure authorizes but does not require the committee to reimburse BOE for its costs associated with the measure. (We note that the administrative costs of the committee created by this measure are supported by the revenues generated by this measure.)

Impact on State and Local Government Health Care Costs

The state and local governments in California incur costs for providing (1) health care for low-income and uninsured persons and (2) health insurance coverage for state and local government employees and retirees. Consequently, changes in state law such as those made by this measure that affect the health of the general population—and low-income and uninsured persons and public employees in particular—would affect publicly funded health care costs.

For example, as discussed above, this measure would result in a decrease in the consumption of tobacco products as a result of the expected price increase of tobacco products. The use of tobacco products has been linked to various adverse health effects by the federal health authorities and numerous scientific studies. Thus, this measure would reduce state and local government health care spending on tobacco-related diseases over the long term. This measure would have other fiscal effects that offset these cost savings. For example, social services that otherwise would not have occurred as a result of individuals who avoid tobacco-related diseases living longer. Thus, the net long-term fiscal impact of this measure on state and local government health care costs is unknown.

Summary of Fiscal Effects

This measure would have the following significant fiscal effects:

- Net increase in cigarette excise tax revenues in the range of $500 million to $750 million annually by 2015-16. Revenues would decrease slightly each year thereafter. The funds would be used to support research on brain and central nervous system diseases and disorders.
- Increase in excise tax revenues on other tobacco products of roughly $50 million annually going mainly to existing health programs.

- Change in state and local sales tax revenues ranging from a $30 million loss to a $40 million gain annually.

Sincerely,

_____
Mac Taylor
Legislative Analyst

_____
Michael Cohen
Director of Finance