GLUCKWALRATH LLP

# Tobacco Tax Parity

A Policy Proposal

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Copies of this brief can be found at http://gluckwalrath.com/site/publications/TaxParity.pdf.

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# Bringing fairness to our current tobacco tax laws

## Introduction

Currently, New Jersey collects taxes on tobacco products in a variety of ways which results in giving certain products tax advantages. By focusing primarily upon taxing cigarettes, consumption of smokeless and other non-cigarette tobacco has increased and overall youth tobacco usage and tobacco-caused harms have risen.[1] Smokeless tobacco use is harmful and can be deadly. It causes oral cancer, gum disease, and nicotine addition, increases the risk of cardiovascular disease and heart attacks. Data that suggests that as a result of these inequities, the deterrent factor of taxing tobacco products is undermined by shifting consumption by children and adults from the more expensively taxed products to the less expensively taxed ones. By equalizing tax rates on all tobacco products, New Jersey can achieve similar decreases to use, harms, and costs associated with such consumption as is found in cigarette usage within the State.

The benefits of tax parity legislation will be threefold: First, by treating all tobacco products the same, New Jersey will be embracing a policy that rests on sound public health policy, avoiding the selection of certain tobacco products as winners and others as losers, and instead focusing on fairness and safety across the industry as a whole. Second, such legislation will serve to bolster public health initiatives and will help to continue the downward trend in tobacco consumption that has been offset by non-cigarette usage in recent years. Finally, and perhaps most importantly, in an era in which all states (and notably New Jersey) are seeking new forms of revenue to assist during a deficit-heavy recession, this legislation is estimated to bring in at least $20 million in new revenue for New Jersey.

Figure 1.
Goals of Tobacco Tax Parity

- Equalizing the tax rates on cigars and other tobacco products to the cigarette tax rate.
- Establishing a minimum tax rate for each major type of other tobacco products (OTP) based on the cigarette tax.
- Close tax loopholes that allow some cigarettes to be taxed as cigars.
- Tax roll-your-own tobacco at the same rate as cigarettes (Currently legislation is pending on this issue)
- Fix definitions that could allow some new types of tobacco products to slip through the cracks and escape taxation.
- To avoid illegal activities, increase penalties for tax evasion and contraband trafficking.
- Allocate a portion of the new OTP tax revenues each fiscal year to fund the state tobacco prevention program, including funding for the state Medicaid program's tobacco use cessation assistance.

### Tobacco Fairness

In New Jersey, tobacco products other than cigarettes are taxed using different formulas that lead to inequities in tax collection on tobacco

[1] State Benefits from Increasing Smokeless Tobacco Tax Rates. Campaign for Tobacco-Free Kids. http://tobaccofreekids.org/research/factsheets/pdf/0180.pdf . This factsheet is attached hereto as Appendix A.

products. Currently, cigarettes are taxed at a rate of $2.70 per pack (or 90% of wholesale), yet all other tobacco products and moist snuff products are taxed at a significantly lower rate, generally 30% of wholesale or, in the case of moist snuff, $0.75 per ounce. The result of these policies are obvious; they are a message to the public that the state believes that certain tobacco products are more dangerous than others and indirectly encourages consumers to purchase one type of product over another. From a revenue standpoint, the inequity of these policies leaves money on the table that would otherwise be easily justified from a public policy, neutral governance perspective. By perpetuating the various tax policies, the State is failing to decentivize individuals from making the effort to quit using tobacco products altogether, instead encouraging consumers to quit cigarettes for less expensive products such as moist snuff or other tobacco products (OTPs). Furthermore, an implicit assumption to such inequitable policies is that if the State does not tax certain products as heavily, the dangers associated with that product must not be as great. Such policies are detrimental to tobacco education initiatives and public health generally.

## Tobacco Consumption

In addition to the inequity present in the present policies, the current tax structure assigned to tobacco products also leads to increased tobacco consumption. While true that the nation's total cigarette consumption has decreased at a rate of 2.5% from 2010 to 2011, continuing an 11-year trend, there has been a dramatic increase in the usage of non-cigarette smoked tobacco, slowing the overall consumption trend in recent years. In the 1980s, when state cigarette taxes climbed much more quickly than smokeless tobacco taxes, there was a substantial increase in smokeless tobacco use amongst the youth. The same trend is being observed again today, likely a result of tax inequity in New Jersey and many other states. Data also demonstrates that adolescents substitute smokeless tobacco for cigarettes when smokeless is substantially less expensive (which tax inequity creates).[2]

**Figure 2.**

This Figure lays out the current tax rates and the comparable proposed tax rates if a tax parity provision were to be adopted.

| Tobacco Product | Current Tax Rate | Tax Rate if Reform Enacted |
|---|---|---|
| Cigarettes | $2.70 per pack | Tax is the equivalent of 90% of the wholesale |
| Premium Cigars | 30% of wholesale | 90% of wholesale price or $2.70 each |
| Cigarillos, blunts | 30% of wholesale | 90% of wholesale price or $2.70 per pack of five |
| "Small-cigar" cigarettes | 30% of wholesale | Taxed as cigarettes, not as a separate subproduct |
| Roll-your-own tobacco | 30% of wholesale | 90% of wholesale price or $2.70 per 0.65 ounces |
| Conventional Moist Snuff Smokeless | $0.75 per ounce | 90% of wholesale price or $2.70 per 1.2 ounce can |
| Snus, lozenges, other | 30% of wholesale | 90% of wholesale price or $0.135 per dose ($2.70 per 20) |

It's not only that cigarette smoking is being offset by usage of other tobacco products. Recent research also confirms that cigarette smokers who switch to smokeless tobacco have much greater risks of death and other health harms than those who are are deterred from smoking altogether and quit tobacco usage completely.[3] The public health concerns associated with tobacco tax policies must be addressed in order to offset increases in non-cigarette tobacco consumption.

## Tobacco Control Program Funding

At the same time as seeing an increase in non-cigarette tobacco

[2] See, e.g., Chaloupka, FJ & Warner, K, "Section 2.4: Econometric studies of the demand for other tobacco products," *Economics of Smoking* 36-27, January 12, 1999; HHS, *Preventing Tobacco Use Among Young People: A Report to the Surgeon General*, 1994 http://www.cdc.gov/tobacco/data_statistics/sgr/1994/index.htm.

[3] Henley, SJ, et al., "Tobacco-Related Disease Mortality Among Men Who Switched From Cigarettes to Spit Tobacco," Tobacco Control 16:22-28, February 2007.

consumption , New Jersey has virtually eliminated its tobacco control program budget. State funding has dropped from $30 million in FY2003 to $1.2 million FY2012. This trend continued in FY2013, where $0 was allocated to such spending. The U.S. Center for Disease Control and Preventuion (CDC) recommends that New Jersey spend $119.8 million per year to have an effective, comprehensive, tobacco prevention program. With our present spending level, it is no shock that New Jersey ranks last among the states in the funding of tobacco prevention programs. While New Jersey receives $2.6 million in federal funds dedicated to tobacco prevention, such a number is greatly deficient when attempting to appropriately address programming that aims to control tobacco consumption. A tax parity law would provide a new source of revenue for the State, giving New Jersey a perfect opportunity to utilize some of this money in a way that benefits public health. Our analysis suggests that $20 million in new revenues will be realized in year one of enactment of such a policy and believe tha if 10% of this money is specifically allocated towards tobacco control funding, New Jersey can take steps to reverse it's recent efforts in this area. In an attempt to further thwart any increases in tobacco consumption, as actual revenues realized from tax policy changes exceed this level, a higher percentage, perhaps 30%, of this excess, should be designated towards such programming. The purpose of proposing such a concept would be to establish a baseline funding level to stimulate tobacco control education, and as the public health dangers of tobacco usage rise past a threshold level, increased investment towards preventing such usage .

**Figure 3.**

This Figure outlines the sale of cigarettes, moist snuff products, and other tobacco products (OTPs) from 2009 through 2012. It also provides the actual tax receipts on Moist Snuff products and OTPs during this time.

| | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|
| **Cigarette Sales** | $726 mill | $738 mill | $769.8 mill | $702 mill |
| **Cigarette Stamps Sold (in thousands)** | 282.7 | 273.8 | 285.6 | 278.9 |
| **Moist Snuff Sales** | 4.5 mill oz | 6.2 mill oz | 6.17 mill oz | 6.39 mill oz * |
| **Moist Snuff Tax Receipts ($0.75 per oz)** | $3.4 mill | $4.5 mill | $4.6 mill | $4.8 mill * |
| **Tax receipts on OTP (30% wholesale price)** | $12.1 mill | $9.67 mill | $14.5 mill | $14.07 mill* |

**Figure 4.**

Estimated calculations of Other Tobacco Products (OTPs) taxes from 2009 through 2012 using the current rates as well as estimating the returns if the proposed tax rates had been in effect at the time. his calculation is done by first estimating a "Wholesale Ratio" which we define as the estimated raw revenue pre-tax, based upon the knowledge that 30% tax is collected on these products, and then multiplying this Wholesale Ration by 90% of the wholesale to simulate an estimate of what the tax receipts would be at 90% rather than 30% of wholesale.

| | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|
| **Tax receipts on OTP (30% wholesale price)** | $12.1 mill | $9.67 mill | $14.5 mill | $14.07 mill |
| **Wholesale Ratio (Tax collected/30%)** | 40.3 mill | 32.23 mill | 48.33 mill | 46.9 mill |
| **Estimated proposed tax receipts of OTPs (90% of wholesale)** | $36.27 mill | $29.00 mill | $43.50 mill | $42.21 mill |
| **Difference between tax receipts at existing rate versus tax parity rate** | $24.17 mill | $19.33 mill | $29 mill | **$28.14 mill** |

## Tax Evasion

Following the lead of states such as California, additional revenues may also be generated by increasing enforcement of tobacco tax evasion laws. In California, after implementation of the Cigarette and Tobacco Products Licensing Act of 2003, the

State realized an additional $75 million in tobacco tax revenue between January 2004 and March 2006.[4] In association with the tax parity efforts, this measure could be tied to new law enforcement initiatives to ensure that residents of the state are complying with current State law. The details of this initiative are outside the scope of this brief, but are mentioned to point out the synergetic effects of this initiative and how a series of tobacco focused laws could be assembled in a package that would bring new revenues to the State while building a coalition of support for these initiatives.

**Figure 5.**

Estimated calculations of Moist Snuff taxes from 2009 through 2012 using the current rates as well as estimating the returns if the proposed tax rates had been in effect at the time. This calculation is done by first estimating a "Snuff Can Ratio" which we define as the estimated raw number of snuff cans sold, based upon the knowledge that snuff cans are typically sold in 1.2 oz cans, and then multiplying the Snuff Can Ratio by the proposed 90% tax rate. To simply our process and keep our assumptions consistent, we utilized the $2.70 equivalency to the 90% tax rate, since current moist snuff products are currently taxed at a $0.75 rate per ounce.

| | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|
| **Moist Snuff Sales** | 4.5 mill oz | 6.2 mill oz | 6.17 mill oz | 6.39 mill oz |
| **Moist Snuff tax due ($0.75 per oz)** | $3.4 mill | $4.5 mill | $4.6 mill | $4.8 mill |
| **Snuff Can Ratio (Sales per oz/1.2 oz)** | 3.75 mill | 5.17 mill | 5.14 mill | 5.33 mill |
| **Estimated Taxes if proposed 90% rate implemented ($2.70 x Snuff Can Ratio)** | $10.125 mill | $13.96 mill | $13.88 mill | **$14.39 mill** |
| **Difference between tax receipts at existing rate versus tax parity rate** | $6.725 mill | $9.46 mill | $9.28 mill | $9.59 mill |

## New Revenue

Currently, New Jersey taxes cigarettes at a rate significantly greater than all other tobacco products. As shown below, the existing state tax on "moist snuff" smokeless is, at most, only half the amount of the state tax on cigarettes, and the state tax on all other tobacco products is less than one-fourth the amount of the cigarette tax. Moreover, the totals for "moist snuff" pertain to standard cans of loose smokeless tobacco (e.g., Skoal, Copenhagen). But the state's "moist snuff" weight-based tax also applies to the new generation of super-low-weight smokeless products such as Marlboro & Camel snus, Camel Orbs, Sticks and Strips, and Ariva and Stonewall lozenges, which weigh as little as one-eighth as much as regular moist snuff. As a result, the current state tax rates on these low-weight "moist snuff" products go as low as $0.10 or less per standard package or well under a half a cent per dose.[5]

Our proposal aims to generate significant new revenues for the State. The main focus in the proposal is to raise the existing percentage-of-price tax on other tobacco products to 90% of the wholesale price and apply that rate to all tobacco products other than cigarettes, including "moist snuff". By adopting a percentage of wholesale formula, the same flat-tax rate would be applied to many different types, styles, packages, prices and weights of tobacco products other than cigarettes.

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[4] California State Auditor. Board of Equalization: Its Implementation of the Cigarette and Tobacco Products Licensing Act of 2003 Has Helped Stem the Decline of Cigarette Tax Revenues, but It Should Update Its Estimate of Cigarette Tax Evasion. June 2006, 2005-034. A copy of an overview of this program is attached hereto as Exhibit B.

[5] This matter is discussed in the Campaign for Tobacco-Free Kids (CFTFK) factsheets. Two factsheets in particular, *The Best Way to Tax Smokeless Tobacco,* http://tobaccofreekids.org/research/factsheets/pdf/0282.pdf and *Closing Weight-Based Tax Loopholes for the New Generation of Low Weight Moist Snuff Smokeless Tobacco Products,* www.tobaccofreekids.org/research/factsheets/pdf/0355.pdf
, are attached hereto as Appendix B and C.

> "Based upon our analysis, we believe that enacting such a measure would result in at least an additional $20 million to the state."

However, a percentage-of-price tax, alone, also allows tobacco products or brands with below-market or "bargain-basement" pricing to pay significantly smaller amounts of tax on a per dose basis than the same type of tobacco product sold at average or premium market prices. This can encourage and facilitate predatory pricing and other unfair competition strategies. This problem is eliminated by complementing the percentage-of-price tax with a minimum tax on each of the major types of OTPs. Such a strategy ensure that all OTPs parallel the state cigarette tax rate.[6] The table found in Figure 2 outlines the current and proposed tax rates on cigarettes and OTPs within the state.

The calculations for predicting the expected new revenues to be generated as a result of this proposal is not exact and subject to a variety of variables, which allows us to confidently predict the revenues in the first year.[7]

## Conclusion

We believe that enacting a tax parity is one of the easiest solutions available in New Jersey to address public health that has the secondary benefit of generating revenue for the State in a way that promotes fairness and is supported by a broad section of the electorate. Without addressing the tax inequity between various tobacco products in New Jersey, the benefits of a high cigarette tax are undermined, leading to more tobacco consumption by adults and children. It also deprives the State of revenues, both directly, due to the lower rates, and indirectly, as cigarette sales continue to lag as moist snuff and OTPs offset such purchasing. Based upon our analysis, we believe that enacting such a measure would result in at least an additional $20 million to the state.

To compliment this initiative, we believe that we can utilize a small portion of the new revenue collected in order to fund tobacco control programming in New Jersey. In recent years, such funding has declined to record lows, placing New Jersey 50th amongst states who spend on tobacco control. In an effort to reverse this trend, we believe it is appropriate to dedicate 10% of the estimated $20 million in new taxes collected as a result of this initiative towards tobacco control programming. If taxes exceed this amount, suggesting that tobacco consumption is rising within the state, we also hope that excess revenues will be earmarked at a 30% rate in an effort to curb tobacco usage.

Finally, tax parity would fit neatly in a package of initiatives that bolsters the enforcement of individuals and groups attempting to evade tobacco taxes. We believe that by increasing the law enforcement efforts to curb such evasion, even greater revenues can be realized on the sale of tobacco products in New Jersey.

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[6] For more on this problem and the even bigger problem from taxing "moist snuff" smokeless with just a weight-based tax, see CFTFK factsheet, *The Best Way to Tax Smokeless Toboacco*, http://tobaccofreekids.org/research/factsheets/pdf/0282.pdf, attached hereto as Appendix 1.

[7] We attach a brief explanation of the process undertaken in our calculations, attached hereto as Appendix D.

# Appendix A

# 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

### REPORT NUMBER 2005-034, JUNE 2006

***Board of Equalization's response as of June 2007***

Section 22971.1 of the Business and Professions Code (code) requires the Bureau of State Audits to conduct a performance audit of the licensing and enforcement provisions of the Cigarette and Tobacco Products Licensing Act of 2003 (act) and report its findings by July 1, 2006. The code section requires the report to include the following information: (1) the actual costs of the program, (2) the level of additional revenues generated by the program compared with the period before its implementation, (3) tax compliance rates, (4) the costs of enforcement at the various levels, (5) the appropriateness of penalties assessed, and (6) the overall effectiveness of enforcement programs. We found that:

***Audit Highlights . . .***

*Our review of the Board of Equalization's (Equalization) implementation of the Cigarette and Tobacco Products Licensing Act of 2003 (act) revealed the following:*

- *Based on its analysis of cigarette tax stamps sold, Equalization estimates it received $75 million in additional cigarette tax revenues between January 2004 and March 2006 because of the act and the new tax stamp.*
- *Equalization's estimate of $292 million in annual cigarette tax evasion is based on an unrepresentative sample and an overstated number of retailers of cigarettes and tobacco products.*
- *Although the act and new tax stamp have caused a stabilization of the historical decline in cigarette tax revenues, these revenues will continue to decline as long as more Californians stop smoking.*
- *In fiscal years 2003–04 and 2004–05, Equalization spent $9.2 million to implement the provisions of the act, with most of that amount paid toward staff salaries and benefits for licensing and enforcement activities.*
- *Equalization imposes penalties in accordance with the provisions of the act.*

#### Finding #1: The Board of Equalization uses its analysis of taxes paid to support its position that cigarette tax compliance has improved.

At the request of Board of Equalization (Equalization) management, Equalization's chief economist performed an analysis and estimated that the act generated $75 million in additional revenues from cigarette sales between January 2004 and March 2006. This estimate is based on Equalization's calculation of an average annual decline in cigarette sales (and by extension, cigarette consumption) of 3 percent over the past 22 years as measured by the number of tax stamps sold, which Equalization calls the tax paid distribution.[1] The 3 percent decline reflects several factors, including fewer people smoking and tax evasion. Equalization's 3 percent decline is consistent with the 2.3 percent average annual decline in smoking prevalence among California adults between 1997 and 2004, based on information published by the Tobacco Control Section of the Department of Health Services.

Equalization assumes that if all factors are equal and the market does not experience major changes, any variations in tax paid distributions are the result of Equalization's implementing the provisions of the act and, after January 2005, its new tax stamp. When Equalization compared its estimate of an annual average decline in cigarette consumption of 3 percent to the change in the rate of sales of cigarette tax stamps since the act went into effect, it found that sales of cigarette tax stamps were greater than it expected based on the historical data. By multiplying the difference in expected sales of cigarette tax stamps and actual stamps sold by the 87 cents cigarette tax rate per pack, Equalization calculated that cigarette tax revenues increased by $75 million between January 2004 and March 2006. Equalization attributes this to its

[1] Equalization's calculation actually showed that the tax paid distribution had decreased by an average of 3.8 percent annually, but for the purposes of its analysis of the effects of the act, it reduced the estimate to the more conservative 3 percent.

additional enforcement authorized by the act, although Equalization concurs that the replacement, starting in January 2005, of its old cigarette tax stamp with a new stamp encrypted with a unique digital signature may also play a part.

Rather than relying on cigarette tax stamps sold, we prepared an estimate of the effect of the act using actual revenues collected, and our results were similar to those of Equalization. To determine how the act affected actual collections of cigarette tax revenues, we used Equalization's methodology but replaced the tax paid distributions with the actual cigarette tax revenues that Equalization collected. Our analysis indicates that actual revenues were about $49 million higher in calendar year 2004 and nearly $79 million higher in calendar year 2005 compared with the revenues expected for the same years, assuming a 3 percent average annual decline in consumption. The higher collection of cigarette tax revenues in calendar years 2004 and 2005 compared with the expected revenues shows that certain factors were causing the reversal of the historical decline in cigarette tax stamps sold. The smoking prevalence rates among California adults as determined by the Tobacco Control Section of the Department of Health Services for calendar years 2003 and 2004 show declines of 2.4 percent and 4.9 percent, respectively. Therefore, we assume that the increased collections of cigarette tax revenues are the result of increased compliance with cigarette taxes. However, neither Equalization nor we can isolate how much of the increased revenue in calendar year 2005 was the result of the act and how much was the result of the new tax stamp.

**Finding #2: Equalization based its $292 million estimate of cigarette tax evasion on an unrepresentative sample.**

In 2003, Equalization estimated that cigarette tax evasion—lost taxes to the State because of illegal sales of counterfeit cigarettes—amounted to $292 million for fiscal year 2001–02.[2] However, we believe Equalization's estimate is inflated because it reviewed a sample of retailers that is not representative of all retailers in the State and the number of retailers it used in its calculation of the estimate is overstated. Moreover, Equalization has not updated its tax evasion estimate since 2003 but continues to use that amount as the amount that the State loses each year from cigarette tax evasion.

Equalization attempted to determine the extent of California's counterfeit cigarette problem by having its Investigations Division (Investigations) review roughly 1,300 retailer inspections conducted throughout California between July 2001 and September 2002. Based on the results of the inspections, 25 percent of the State's retailers were selling counterfeit cigarettes, resulting in Equalization's estimate of $238 million in cigarette tax evasion by retailers that purchase and distribute untaxed cigarettes to consumers. In addition, Equalization estimated that individual consumers evade cigarette taxes totaling about $54 million each year by purchasing cigarettes over the Internet or by purchasing cigarettes in other states that have lower cigarette taxes. Thus, Equalization estimated that annual cigarette tax evasion totaled $292 million for fiscal year 2001–02.

Because Equalization's inspectors typically visit stores and areas more likely to exhibit noncompliance—a reasonable approach given its workload and staff—Equalization likely overestimated retailer tax evasion for the entire State. Investigations did not visit major grocery and discount chains, which Equalization pointed out have not historically posed problems with cigarette tax compliance. Additionally, because of limited resources, Equalization focused its inspections on major metropolitan areas. Consequently, the actual percentage of retailers in California that carry counterfeit or untaxed cigarettes is likely less than the 25 percent identified by the inspections, and the amount of cigarette tax evasion Equalization estimated may be overstated.

In addition, the number of retailers Equalization used to estimate cigarette tax evasion appears to be overstated, which also results in an overestimation of the $238 million in cigarette tax evasion by businesses. Assuming that retail locations that sell alcohol also sell cigarettes, Investigations originally estimated that about 85,000 retail locations in California sold cigarettes, because this was the number

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2 The term *counterfeit cigarettes* refers to cigarette packs that bear counterfeit tax stamps as well as truly counterfeit products—cigarettes manufactured overseas and patterned after major brands.

of retail locations licensed by the California Department of Alcoholic Beverage Control. However, after passage of the act, only about 40,000 retailers registered as selling cigarettes. Thus, Equalization's original estimate of 85,000 retailers was overstated, although the number of small businesses that stopped selling cigarettes because of the act's licensing requirements may have accounted for a portion of the difference. Using 40,000 as the number of retailers in Equalization's formula results in an estimated amount of cigarette tax evasion by retailers of $112 million, which is $126 million less than Equalization's estimate. Since the act was implemented, Equalization has not updated its cigarette tax evasion estimate, even though many of the factors have changed since it prepared its original estimate.

To provide a more accurate estimate of the extent of cigarette tax evasion, we recommended that Equalization update its calculation of cigarette tax evasion using data gathered after implementation of the act.

***Equalization's Action: Corrective action taken.***

Equalization reported that its new calculation of cigarette tax evasion resulted in an estimated $182 million of lost excise taxes per year, which is a decrease of $88 million per year from its previous estimate. Equalization stated that its use of an updated econometric model allowed it to use more recent data and consider the estimated combined effects of the implementation of the act and the new cigarette tax stamp.

**Finding #3: The act has had a positive effect on tax revenues from cigarettes and tobacco products.**

Collections of cigarette tax revenues fell between fiscal years 2001–02 and 2004–05, although they stabilized at about $1.025 billion in fiscal years 2003–04 and 2004–05. As we noted previously, the stabilization and reversal of the historical decline in cigarette tax revenue is to some degree the result of the implementation of the act, in addition to the effects of the new cigarette tax stamp. However, collections of cigarette tax revenues will continue to decline as long as more Californians quit smoking.

Collections of the tobacco products surtax have varied from year to year and are not demonstrating a consistent trend. According to Equalization, the tobacco products category comprises several different products, including cigars, snuff, and chewing tobacco, and the market for each product relies on unique demographic and income characteristics. Without the act, Equalization believes that wholesale sales of tobacco products would not have changed from calendar years 2003 to 2004. However, wholesale sales for tobacco products jumped 38.9 percent in calendar year 2004, leading to an estimated $14 million increase in tax revenue from tobacco products. Because national data do not show an increase in tobacco product sales during that period and Equalization is unaware of any anecdotal evidence demonstrating why the rise occurred, it appears that the most likely reason for the increase is the set of regulatory changes brought about by the act.

Actual revenues for the administrative and license fees that the act instituted were greatest in fiscal year 2003–04, with some collections occurring in fiscal year 2004–05. The administrative fee is a one-time fee that will continue to generate some revenue as new manufacturers and importers qualify to do business in California. In addition, a modest amount of revenue will continue to be realized from distributors and wholesalers paying the $1,000 annual renewal fee. Also, a retailer that changes ownership or opens a new sales location must obtain a license and pay the license fee. Collections of fines assessed on civil citations do not currently play a large role in total revenues, but may increase over time.

**Finding #4: Costs of carrying out the provisions of the act largely comprise staff salaries and benefits.**

In fiscal years 2003–04 and 2004–05, Equalization spent $9.2 million to implement the provisions of the act, with most of that amount paid toward staff salaries and benefits. A large portion of the costs in the first two years were for enforcing the provisions of the act, although licensing activities and overhead costs to make programming changes to Equalization's information systems were a large proportion of costs that Equalization incurred in fiscal year 2003–04.

**Finding #5: In addition to having a reasonable investigative process, Equalization imposes penalties in accordance with the act.**

Investigations has a clearly defined and reasonable process for conducting inspections and investigations relating to cigarettes and tobacco products. Furthermore, the Excise Taxes and Fees Division (Excise Taxes) has documented and Equalization's five-member board (board) has approved procedures to assess penalties in accordance with the provisions of the act. Based on our testing of felony investigations and inspection citations, we determined that Investigations and Excise Taxes follow the procedures for conducting inspections and investigations, issuing citations, and assessing penalties for civil citations. By following board-approved procedures, Equalization can maintain case-to-case consistency and ensure that it is enforcing the provisions of the act.

# Appendix B

# THE BEST WAY TO TAX SMOKELESS TOBACCO
## [A Simple Weight-Based Tax Hurts State Revenues and Increases Youth Use]

To protect state revenues, promote tax equity, and most effectively prevent and reduce tobacco use, especially among youth, states must avoid simple weight-based tax systems for moist snuff or smokeless tobacco. Taxing smokeless tobacco at a percentage of wholesale price better accommodates the many varieties of smokeless tobacco products, keeps up with inflation and product pricing over time, better promotes public health, and is much fairer than a simple weight-based tax. A simple percentage-of-price tax could allow brands sold at low predatory or anti-competitive prices to evade reasonable taxation, but adding a minimum tax can solve that problem. Switching to a simple weight-based tax, however, would create a host of new tax loopholes, reduce revenues, and cause other problems for the state.

**Percentage-of-Price Taxes (and How to Make Them Even Better)**

The most common practice among the states is to tax smokeless tobacco – and all other tobacco products other than cigarettes – at a percentage of their wholesale price (sometimes referred to as the manufacturer's price) tax. These state tax rates on other tobacco products (OTPs) range from a low of five percent (SC) to 100 percent (WI).

A percentage-of-price tax is one of the simplest and most effective ways to tax OTPs because it establishes an identical percentage tax rate, or flat tax, on all the different types, brands, weights, and packages of OTPs, and it keeps up with inflation over time. But state percentage-of-price taxes have come under attack by UST (the largest U.S. smokeless tobacco company, now owned by Altria, the parent company of Philip Morris USA) for subjecting UST's higher-priced, premium brands of regular moist snuff to a larger tax, per can or package, than brands with much lower prices. A higher per-can tax on higher-priced premium products (when all products pay the same flat-tax percentage rate) actually makes sense because those premium products bring in much larger amounts of income and profits per can. However, states can effectively address the problem of some smokeless brands being sold at bargain-basement or predatory prices not paying an adequate tax per can by supplementing the state's percentage-of-price tax with a reasonable minimum tax.

An effective minimum tax could simply state that any smokeless product with a wholesale price of less than $2.50 per ounce shall be taxed as if its price were $2.50 per ounce. Or even better, the minimum tax could set the tax rate on smokeless to be the higher of the percentage-of-price tax, or an amount equal to the state's tax on a pack of 20 cigarettes for each 1.2 ounces (a standard can of smokeless, roughly equal to a pack of cigarettes, weighs 1.2 oz.).

**The Problems with A Simple Weight-Based Tax (and How to Fix Them)**

Some states tax moist snuff tobacco products (a subset of all smokeless tobacco) on a per-weight basis. This approach has been pushed aggressively for years by UST. The advantages to UST and Altria from a state switching to a simple weight-based tax are enormous. It will sharply increase the tax on the lower-priced moist snuff smokeless sold by UST's competitors; and, over time (if not immediately), it will reduce the tax on UST's and Philip Morris's own premium smokeless products. In fact, getting a weight-based tax established is so beneficial to UST and Altria that they often design the tax-switch proposals to be especially attractive to states to make state moist snuff tax revenues increase in the year following the switch. But UST and Altria fail to inform the states that the switches they propose will, over time, actually increase overall smokeless tobacco use, especially among kids, and significantly reduce state revenues.

In fact, the simple weight-based proposals and laws supported by UST and Altria suffer from several major structural flaws:

- ***Unlike a percentage-of-price tax, a simple weight-based tax will not keep up with inflation or product price increases.*** As a result, the weight-based tax will erode over time, bringing the state increasingly lower revenues than a percentage-of-price tax. This problem can be fixed by adding in automatic inflation adjustment to the weight-based tax or by setting the weight-based tax amount to equal the state's tax on a pack of 20 cigarettes (so that the weight-based tax will go up every time the state increases its cigarette tax).
- ***Unlike a percentage-of-price tax, a simple weight-based tax will grossly under-tax the new generation of super-light-weight moist snuff products, sharply reducing future state revenues.*** The newest trend in smokeless is toward very low weight spit-less, pre-packed, single-dose units – such as UST's Skoal Dry, Philip Morris's Marlboro Snus, and R.J. Reynolds's Camel Snus and new Camel Dissolvable Orbs, Sticks, and Strips. Weighing as little as one-eighth as much per dose as standard moist snuff that comes in a can, these emerging new products pay almost nothing under a weight-based tax. This problem can be fixed by making sure that any weight-based tax applies only to conventional moist snuff (e.g., moist snuff that has a moisture content no lower than 45%) and not to any smokeless tobacco products that come in discrete, single-use units or doses.
- ***The weight-based tax proposals being pushed by UST and Altria require states to rely on whatever weight the manufacturer lists on the can or package when calculating the tax owed, leaving the door wide open door to fraud and abuse.*** This problem can be fixed by applying any weight-based tax to the weight listed in good faith by the manufacturer, as periodically confirmed by the state department of finance.
- ***A simple weight-based tax increases youth tobacco use and related public health harms****.* UST's best-selling premium smokeless tobacco products are among the most popular with youth, with just two of its brands (Copenhagen and Skoal) accounting for roughly half of all youth consumption. By reducing the taxes and prices on these brands, either immediately or over time, the simple weight-based taxes supported by UST and Altria directly increase youth smokeless initiation and use, dooming even more kids to a lifetime of tobacco addiction and related harms. This problem can be largely avoided by implementing the fixes described above; but a more effective solution would be to set the state's tax on smokeless to be the higher of a percentage-of-price tax or the fixed weight-based tax.

Simple weight-based tax systems for moist snuff or smokeless contradict tax equity, create tax loopholes, and are bad for state revenues and public health. Fortunately, these problems can be fixed quite easily with common sense modifications. Similarly, the concerns raised by UST and Altria regarding percentage-of-price tax systems can be effectively addressed (without causing any new problems) by adding a minimum tax. Moreover, adding minimum tax will also bring the state new revenues (and public health benefits) both in the short term and over time.[*]

***Campaign for Tobacco-Free Kids, July 15, 2009 / Ann Boonn***

**More information on increasing tax rates on other tobacco products is available at http://www.tobaccofreekids.org/facts_issues/fact_sheets/policies/tax/other_products/.**

[*] The Campaign for Tobacco-Free Kids has model legislative language to fix existing weight-based taxes or proposals or to establish the optimal system for taxing moist snuff, all smokeless, or all tobacco products. For more information, please contact factsheets@tobaccofreekids.org.

Model legislation is also available for: a) establishing strong minimum price laws for all tobacco products, both to prevent the kind of predatory and anti-competitive bargain-basement pricing by some manufacturers that UST complains about, and to block youth initiation into tobacco use and otherwise promote public health; and b) requiring smokeless tobacco companies that have not signed onto the Smokeless MSA (UST is the only signer) to make special payments to the states – just like the existing state laws that require payments from the nonparticipating cigarette companies (NPMs) that have not signed onto the cigarette MSA.

# Appendix C

## CLOSING WEIGHT-BASED TAX LOOPHOLES FOR THE NEW GENERATION OF LOW WEIGHT MOIST SNUFF SMOKELESS TOBACCO PRODUCTS

Below are some of the new super-low-weight moist snuff smokeless tobacco products that are grossly under-taxed by simple weight-based tax systems, such as those promoted by UST (the United States Smokeless Tobacco Company) and its parent company, Altria (which also owns Philip Morris, maker of Marlboro Snus). For example, on a per-dose basis, a weight-based tax on Marlboro Snus is less than one-fourth the tax on conventional moist snuff brands, such as Skoal and Copenhagen – and the tax on Camel Orbs would be less than one-eighth as much.*

By under-taxing these low-weight moist snuff products, a simple weight-based tax contradicts basic principles of tax fairness and equity and steals revenues from the state. In addition, a simple weight-based tax fails to keep up with product price increases and inflation, thereby reducing state revenues further. Under the weight-based tax systems promoted by UST, a state will lose even more revenues every time a regular moist snuff user, or any state smoker, switches to using one of these new under-taxed lower-weight moist snuff products, instead.


***Typical Moist Snuff Smokeless***
***1 tin ≈ 1.2 to 1.5 oz.***


***Camel Snus***
***1 tin (15 pouches) ≈ 0.32 oz.***

***Marlboro Snus***
***1 "foil pack" (6 pouches) ≈ 0.1 oz.***


***UST Skoal Pouches***
***1 tin (20 pouches) ≈ 0.82 oz***


***Stonewall Hard Snuff***
***1 box of 20 "Pieces" = 0.335 oz.***


***Ariva Hard Snuff***
***1 box of 20 "Pieces" = 0.335 oz.***

* Alpert, HR, et al., "Free Nicotine Content and Strategic Marketing of Moist Snuff Tobacco Products in the U.S.: 2000-2006," *Tobacco Control* 17:332-38, October 2008. [1.2 oz. of conventional moist snuff = 16-18 pinches or doses].

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***R.J. Reynolds "Dissolvable" Orbs, Sticks and Strips***

***1 package (12 pieces) = weights unknown***

The following table shows how a simple weight-based tax of $1.00 per ounce would put a much lower per-pack or per-dose tax on each of the emerging new lower-weight moist snuff products shown above, compared to its tax on a standard 1.2 ounce can of conventional moist snuff.

| **Moist Snuff Products** | **Weigh-Based Tax Per Package ($1.00 per Ounce)** | **Weight-Based Tax Per Dose ($1.00 per Ounce)** |
|---|---|---|
| ***Skoal Long Cut (1.2 ounce can)*** | **$1.20** | **6.7¢ to 7.5¢** |
| ***Camel Snus (15 pack)*** | **32¢** | **2.1¢** |
| ***Marlboro Snus (6 pack)*** | **10¢** | **1.7¢** |
| ***Skoal Pouches (20 pack)*** | **82¢** | **4.1¢** |
| ***Stonewall Hard Snuff (20 pack)*** | **34¢** | **1.7¢** |
| ***Ariva Hard Snuff (20 pack)*** | **34¢** | **1.7¢** |
| ***Camel Orbs (15 pack)*** | **12¢** | **0.8¢** |

## A Better Way to Tax Moist Snuff Smokeless Tobacco

There are several easy options to avoid all the problems with a simple weight-based tax on all moist snuff tobacco products:

- To maximize both public health benefits and state revenues, set the tax rate on smokeless tobacco products to directly parallel the state's cigarette tax. For example, the tax on a standard 1.2-ounce can of loose moist snuff would equal the state tax on a pack of 20 cigarettes, and the tax per each single-dose unit of snus, hard snuff tablets, or Camel Orbs would equal the state tax on a single cigarette. Ideally, these parallel state tax rates on moist snuff (and other tobacco products) would be set up so that they rise automatically whenever the state increases its cigarette tax rate; and the tax on each product would be the higher of the new cigarette-parallel rates or the state's existing percentage-of-price rate.

- For a quick fix of existing weight-based taxes on moist snuff, make sure they apply only to conventional loose moist snuff – and subject all other moist snuff and smokeless tobacco to the state's percentage of price tax – or set the tax on all smokeless tobacco to be the higher of the existing state percentage-of-price tax or the existing state weight-based tax.

***Campaign for Tobacco-Free Kids, June 7, 2011***

**For more on increasing smokeless tobacco tax rates, see http://www.tobaccofreekids.org/facts_issues/fact_sheets/policies/tax/other_products/.**

# Appendix D

## A more detailed explanation of the tax parity analysis

Our approach attempts to conservatively estimate the potential revenues by examining existing data, estimating the change in tax receipts based on the existing and proposed rates, and taking into account a liberal decline in usage and possible tax evasion.

As outlined in Figure 3, Figure 4, and Figure 5, the last four years of sales of various tobacco products as provided for analysis. Figure 3 looks at the sales of various classes of tobacco products along with tax receipts on them to the best of our knowledge. Figure 4 examines the category known as all OTPs, which includes all products other than cigarettes and moist snuff products. Figure 5 looks specifically at the category referred to as moist snuff. The analysis attempts to compare dissimilarly measured products in similar ways, embracing the percentage of wholesale tax calculation when appropriate, and extrapolating to the minimum $2.70 equivalent in cases where current tax receipts are calculated on a flat price per ounce basis.

As shown in Figure 3 and 4, the tax receipts on OTPs in 2012 were $14.07 million (not taking into account December numbers, which were unavailable at the time of publication). This amount is collected from a tax of 30% of the wholesale price on all OTPs sold in 2012. Similarly, the tax receipts on Moist Snuff products in 2012 were $4.8 million (also not taking into account December numbers, which were unavailable at the time of publication). This amount is collected using a tax rate of $0.75 per ounce of Moist Snuff sold in 2012. Thus, to reach our prediction of tax receipts on these products based on tax parity of all tobacco products, an estimate of the total revenues based upon these tax receipts, which are referred to as the Wholesale Ratio and Snuff Can Ratio. From this point, the tax parity rate is applied to this ratio, which offers an estimate of the tax receipts of OTPs at $42.21 million and of Moist Snuff at $14.39 million (a reminder that these numbers do not include any December numbers, so the actual predicted 2012 receipts at tax parity would likely be a bit higher).

What this calculation provides is that when using tax parity rates to generate tobacco tax revenue, OTPs would provide for an additional $28.14 million, while Moist Snuff products would provide for an additional $14.39 million. Together, this totals over $56.6 million in tax receipts on OTPs and Moist Snuff, versus only $18.87 million when comparing the tax parity rates to the actual current rates. However, the analysis adds variables to consider a "worst case scenario". The prediction incorporates a 21% reduction in tobacco consumption in 2013, to ensure estimates remain conservative (resulting in tax parity receipts on OTPs and Moist Snuff of $44.7 mill, or an increase in tax receipts of $25.83 mill). The prediction also includes a 15% increase in tax evasion due to tobacco smuggling, etc (resulting in tax parity receipts on OTPs and Moist Snuff of $37.99 mill, or an increase in tax receipts of $19.13 million). Because our entire analysis takes only conservative approaches with respect to incoming revenue estimates, combined with exaggerated assumptions that potentially reduce revenues, we believe our calculation of over $20 million in new revenues from these new taxes would be on the lower side of realized tax receipts, if enacted.