

M e m o r a n d u m

To: Mr. Ramon J. Hirsig
Executive Director

Date: April 1, 2009

From: David J. Gau, Deputy Director
Property and Special Taxes Department



Subject: **Data Source for the Calculation of the Annual Tobacco Products Tax Rate – Issue Paper 09-001**
(April 16, 2009 Deputy Director's Report)

At the January 22, 2009 Board meeting, I provided an update to the Board Members regarding the Board's annual determination of the tobacco products tax rate required under Revenue and Taxation Code sections 30126 and 30131.5. At that meeting, I also advised the Members that on November 30, 1988, the Board adopted a staff recommendation that the tobacco products tax rate "be set at the rate of tax on one cigarette divided by the weighted average wholesale cost of a cigarette." The approved formula included the use of the USDA's *Tobacco Outlook* publication as the data source for the wholesale cost component.

In the Fall of 2007, the USDA notified us that they were ceasing publication of *Tobacco Outlook*. Since then, the Excise Taxes Division staff, in collaboration with the Board's Chief Economist, Joe Fitz, has been conducting research to locate another independent source of information for wholesale cigarette costs. To date, three possible data sources have been identified, and staff has explored each data source in the attached Issue Paper 09-001, *Data Source for the Calculation of the Annual Tobacco Products Tax Rate*.

With your approval, this item will be placed on the Board's April 16, 2009 calendar under Deputy Director's Report, Property and Special Taxes Department.

DJG:kn
Attachment

cc: Ms. Diane Olson
Ms. Lynn Bartolo
Mr. Robert Ingenito
Mr. Joe Fitz

Approved:



Ramon J. Hirsig
Executive Director

BOARD APPROVED
at the _____ Board Meeting

Diane Olson, Chief
Board Proceedings Division

Issue Paper Number 09-001



- Board Meeting
- Business Taxes Committee
- Customer Services and Administrative Efficiency Committee
- Legislative Committee
- Property Tax Committee
- Other

Data Source for the Calculation of the Annual Tobacco Products Tax Rate

I. Issue

What data source for the wholesale cost of cigarettes should the Board use to calculate the annual tobacco products tax rate? The data sources identified are:

- The Tobacco Merchants Association (TMA), a trade association dedicated to supplying economic and statistical information to a variety of companies, associations, and other organizations, which provides the wholesale cost of cigarettes for both premium and non-branded (generic) cigarettes. (Alternatives 1A and 1B)
- The United States Department of Agriculture (USDA) *Tobacco Outlook*¹ report in conjunction with the Producer Price Index (PPI) as published by the U.S. Bureau of Labor Statistics for cigarette manufacturers. (Alternatives 2A and 2B)
- The *Tax Burden on Tobacco* published by Orzechowski and Walker, an independent consulting firm to the cigarette industry, which provides retail cigarette prices. Board of Equalization (BOE) staff would back into the wholesale cost of cigarettes based on a predetermined margin from retail prices to wholesale cost. The predetermined margin is calculated from data for the most recent year published in *The Changing Tobacco User's Dollar*, U.S. Department of Agriculture, Economic Research Service, TBS-257-01, October 2004. (Alternative 3)

II. Alternative 1A - Staff Recommendation

Staff recommends Alternative 1A. This alternative would use the TMA to obtain the wholesale cost of premium brand cigarettes and is similar to the current methodology used to calculate the tobacco products tax rate.

III. Other Alternative(s) Considered

- A. **Alternative 1B** - Uses TMA data and the tax rate determined in Alternative 1A and adjusts the rate by adding 0.72 percent to reflect the market share of non-branded (generic) cigarettes. This alternative recognizes and incorporates the volume of both non-branded (generic) and premium cigarettes.

¹ *Tobacco Outlook* report has also been referred to as the *Tobacco Situation and Outlook* report by the USDA. The report name has changed over the years. The USDA ceased publication of this report in 2007.

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- B. Alternative 2A** - Uses the *Tobacco Outlook* report to establish the wholesale cost of premium brand cigarettes and annually adjusts the wholesale cost based on the PPI as published by the U.S. Bureau of Labor Statistics for cigarette manufacturers.
- C. Alternative 2B** - Uses the tax rate determined in Alternative 2A and adjusts the rate by adding 1.25 percent to reflect the market share of non-branded (generic) cigarettes. This alternative is representative of the actual cigarette market in California as it recognizes and incorporates the volume of both non-branded (generic) and premium cigarettes.
- D. Alternative 3** - Uses retail cigarette prices as published in the *Tax Burden on Tobacco* with a predetermined margin from retail prices to calculate wholesale cost of cigarettes.

IV. Background

The BOE administers the California Cigarette and Tobacco Products Tax Law. Based on the passage of Proposition 99 in 1988 and Proposition 10 in 1998, the BOE is required to annually set a tax rate to be applied to the wholesale cost of tobacco products that are distributed in this state. The requirements are set forth in Revenue and Taxation Code sections 30123(b) (Proposition 99) and 30131.2(b) (Proposition 10) as follows:

30123(b). There shall be imposed upon every distributor a tax upon the distribution of tobacco products, based on the wholesale cost of these products, at a tax rate, as determined annually by the State Board of Equalization, which is equivalent to the combined rate of tax imposed on cigarettes by subdivision (a) and the other provisions of this part.

30131.2(b). In addition to the taxes imposed upon the distribution of tobacco products by Article 1 (commencing with Section 30101) and Article 2 (commencing with Section 30121), and any other taxes in this chapter, there shall be imposed an additional tax upon every distributor of tobacco products, based on the wholesale cost of these products, at a tax rate, as determined annually by the State Board of Equalization, which is equivalent to the rate of tax imposed on cigarettes by subdivision (a).

Revenue and Taxation Code sections 30126 and 30131.5 provide that the annual determination required of the State Board of Equalization shall be made based on the wholesale cost of tobacco products as of March 1, and shall be effective during the state's next fiscal year.

Tobacco products, not including cigarettes, are subject to the surtax. Tobacco products include all forms of cigars, smoking tobacco, chewing tobacco, and snuff, as well as other products containing at least 50 percent tobacco.

In fiscal year 2007-2008, tobacco products revenue was \$85.9 million. This revenue funds a variety of health programs, such as hospital services, health education, physician services, public resources, research, early childhood development, and anti-smoking campaigns for the public. Currently, the tax rate is 45.13 percent.

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The current formula for determining the tobacco products tax rate was jointly developed by BOE staff and industry and approved by the Board in 1988 after the passage of Proposition 99. The rate is calculated by dividing the tax imposed by statute on one cigarette by the average wholesale cost of one cigarette, as represented in the following formula:

$$C/W = X$$

C = tax rate per cigarette

W = average wholesale cost of one cigarette

X = tax rate on tobacco products

The average wholesale cost of one cigarette (the "W" variable) has historically been calculated by using the wholesale cigarette price as of March 1st, as published in the *Tobacco Outlook* report, and adding a 6 percent margin, representing the average wholesale markup of these products. The 6 percent margin is added to the manufacturer's average wholesale cost of one cigarette in order to bring the wholesale cost to the distributor level, which is the same point of taxation as tobacco products. The following shows how the formula was used to establish the current tobacco products tax rate of 45.13 percent:

Manufacturer's List Cigarette Prices

Type:	Price*
Standard	\$ 143.20
King Size	\$ 143.20
Filter Tips	\$ 143.20
100 mm	\$ 143.20

* USDA Tobacco Outlook report

Wholesale Cost Per Cigarette Computation:

1. Avg. Mfg. Price Per 1,000 Cigarettes	\$ 143.20
2. Add: Wholesale Markup @ 6% (line 1 x 0.06)	<u>\$ 8.59</u>
3. Avg. Wholesale Cost (line 1 + line 2)	\$ 151.79
4. Avg. Wholesale Cost (line 3 / 1,000)	<u><u>\$ 0.1518</u></u>

Rate Calculation

C = Tax rate per cigarette \$0.0685

(includes (i) the tax rate per cigarette of \$0.0435, plus (ii) the Prop. 10 increase per cigarette of \$0.025 effective 7/1/99)

W = Weighted average wholesale cost of one cigarette \$0.1518

X = Tax rate on tobacco products

$$C/W = X \quad \text{or} \quad \$0.0685 / \$0.1518 = 45.13\%$$

V. Discussion

In the fall of 2007, the USDA ceased publication of its *Tobacco Outlook* report. Upon learning that the report was no longer in publication, Excise Taxes Division (ETD) staff entered into a dialogue with the USDA in the hopes that the publication would be revived and continued; however, staff received confirmation from the USDA in September 2008 that the report and its tables would no longer be published. ETD staff has conducted research to find other viable sources of information for the wholesale cigarette prices.

In early February 2009, H.R. 2 was signed into law by President Obama. This bill funds the federal Children's Health Insurance Program (CHIP) with increases in federal excise tax rates on cigarettes and tobacco products. Under the law, the federal cigarette tax rate will increase from \$0.39 to \$1.01 per package of cigarettes on *April 1, 2009*. In March 2009, BOE staff conducted taxpayer outreach regarding the annual calculation of the tobacco products tax rate by contacting industry representatives, interested parties and other stakeholders. BOE staff asked for comments on Issue Paper 09-001, specifically regarding the data sources identified, as well as the effect of a recent federal excise tax rate increase.

Revenue and Taxation Code sections 30126 and 30131.5 provide that the annual determination required of the State Board of Equalization shall be made based on the wholesale cost of tobacco products as of *March 1*; however, the federal excise tax rate increase becomes effective on April 1.

Based on comments received from the California Distributors Association (CDA), the California Association of Retail Tobacconists (CART) and the Cigar Association of America (CAA), one additional data source (TMA) was identified. Upon researching the various data collected and published by TMA, available by subscription, it was confirmed that the data on the wholesale cost of premium cigarettes is available and is materially consistent with the data formerly provided by the *Tobacco Outlook* report.

Other responses received indicated that the federal excise tax rate increase should be a factor in the *Fiscal Year 2010-2011* tobacco products tax rate setting, since California law references the wholesale cost of tobacco products as of *March 1*. Two responses, one from CAA and one from CART, stated that the federal excise tax rate increase should be considered for *Fiscal Year 2009-10*, due to mitigating circumstances.

BOE staff has identified three feasible data sources for the wholesale cost of cigarettes that can be used in the annual determination of the tobacco products tax rate. The data sources are:

- The TMA, a trade association dedicated to supplying economic and statistical information to a variety of companies, associations, and other organizations, which provides the wholesale cost of cigarettes for both premium and non-branded cigarettes. (Alternatives 1A and 1B)
- The USDA *Tobacco Outlook* report in conjunction with the PPI as published by the U.S. Bureau of Labor Statistics for cigarette manufacturers to determine the wholesale cost of cigarettes. (Alternatives 2A and 2B)

- The *Tax Burden on Tobacco* published by Orzechowski and Walker, an independent consulting firm to the cigarette industry, which provides retail cigarette prices. BOE staff would back into the wholesale cost of cigarettes based on a predetermined margin from retail prices to wholesale cost. The predetermined margin is calculated from data for the most recent year published in *The Changing Tobacco User's Dollar*, U.S. Department of Agriculture, Economic Research Service, TBS-257-01, October 2004. (Alternative 3)

VI. Alternative 1

Use the TMA to obtain the wholesale cost of cigarettes.

A. Description of Alternative 1

The TMA is a trade association dedicated to supplying economic and statistical information to a variety of companies, associations, and other organizations and publishes the wholesale cost of cigarettes for both premium and non-branded cigarettes. The data is materially consistent with the data formerly published in *Tobacco Outlook*, which had been used for the annual tobacco products tax rate setting since 1989. Staff recommends Alternative 1A. This alternative would use the TMA to obtain the wholesale cost of premium brand cigarettes and is similar to the current methodology used to calculate the tobacco products tax rate.

Alternative 1A – Staff Recommendation

Staff recommends Alternative 1A. Currently, BOE staff uses the average wholesale cost of premium cigarettes in the tax rate calculation. Under this alternative, BOE staff would use the last published wholesale cost of premium cigarettes as provided by the TMA as of March 1st and add a 6 percent margin to wholesale cost as done previously. This alternative is very similar to the current method used in determining the tobacco products tax rate.

Alternative 1B

Alternative 1B utilizes the tax rate determined in Alternative 1A and adjusts the rate by adding 0.72 percent to reflect the market share of non-branded (generic) cigarettes.

Under this alternative, BOE staff would establish a weighted average wholesale cost using premium brand cigarette prices and “deep discount” prices of non-branded (generic) cigarettes as published by the TMA. BOE staff would use estimates of California market shares of premium brand cigarettes and non-branded cigarettes as weights in calculating the weighted average. BOE staff would then add a 6 percent margin factor to represent the wholesale cost of cigarettes.

Based on federal data, BOE staff estimates that non-branded (generic) cigarettes represented about 30 percent of the entire California cigarette market in 2002. Therefore, the average price of premium cigarettes and non-branded cigarettes is weighted 70 percent of premium price and 30 percent deep discount price. The calculated tobacco products tax rates using the data indicate that the tobacco tax rate using the weighted average prices is about 0.72 percent higher than the tobacco product tax rate using only the price for premium brands.

In summary, Alternative 1B calculations are completed using a two-step process. First, staff would calculate the tobacco products tax rate using Alternative 1A. Second, staff would add 0.72 percent to the rate; this 0.72 percent figure comes from the set of calculations discussed above.

FORMAL ISSUE PAPER 09-001**B. Pros of Alternatives 1A and 1B**

- Uses the most current manufacturers' prices. The data is based on manufacturers' price lists and updated when manufacturers announce price adjustments.
- Data is materially consistent with the data formerly provided in the *Tobacco Outlook*.
- Calculations are simple and require minimal staff time.
- Data is available timely for the spring rate setting.
- Avoids using an index such as the PPI to update manufacturers' prices.

Additional Pros of Alternative 1A only

- Very similar to the current method of determining the tobacco tax rate.

Additional Pros of Alternative 1B only

- Recognizes and incorporates the volume of "deep discount" non-branded (generic) cigarettes in the cigarette market.

C. Cons of Alternatives 1A and 1B

- Actual wholesale cost of cigarettes paid by wholesalers is unknown (a manufacturers' list price is the suggested manufacturers' price, but promotions may impact actual cost paid).
- Annual subscription cost of \$2,000.
- Although TMA has been in business since 1915, there no guarantee that the data will continue to be published in future years.

Additional Cons of Alternative 1A only

- Does not recognize and incorporate the volume of "deep discount" non-branded (generic) cigarettes in the cigarette market.

Additional Cons of Alternative 1B only

- BOE staff will need to estimate the California market share of non-branded (generic) cigarettes sold at the USDA "deep discount" prices in order to calculate a weighted average.
- Determining which brands of cigarettes are generic is a subjective process.

D. Statutory or Regulatory Change for Alternative 1

None

E. Operational Impact of Alternative 1

None

F. Administrative Impact of Alternative 1**1. Cost Impact**

Annual subscription cost is estimated to be \$2,000.

2. Revenue Impact

Under Alternative 1A, the fiscal year 2007-08 tobacco tax rate would have been 41.11 percent of wholesale costs instead of the actual rate set of 45.13 percent, 4.02 percent lower. Revenues would have decreased by about \$3.15 million under Alternative 1A. Details of these tax rates and revenue estimates are provided in the Appendix Tables (Attachment 1).

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Under Alternative 1B, the fiscal year 2007-08 tobacco tax rate would have been 41.83 percent of wholesale costs instead of the actual rate set of 45.13 percent, 3.30 percent lower. Revenues would have decreased by about \$ 2.57 million under Alternative 1B. Details of these tax rates and revenue estimates are also provided in the Appendix Tables (Attachment 1).

Alternative 1B results in a 0.72 percent increase in the tax rate and \$0.57 million increase in revenue when compared to Alternative 1A.

G. Taxpayer/Customer Impact of Alternative 1

Under Alternative 1A, the tax rate would be lower than the current rate. Details of these tax rates and revenue estimates are provided in the Appendix Tables (Attachment 1).

Under Alternative 1B, the tax rate would be lower than the current rate (Attachment 1). However, when comparing Alternative 1B to Alternative 1A, tobacco products distributors would be liable for more taxes under Alternative 1B.

H. Critical Time Frames

In the past, the Board has generally approved the tobacco products tax rate in the spring in order to provide sufficient notice to taxpayers regarding the tax rate for the upcoming fiscal year (July 1). To provide adequate time for taxpayers to implement the new rate, BOE staff recommends a new method of determining the tobacco products tax rate be determined and the new rate calculated by May 31 each year.

VII. Alternative 2

Use the *Tobacco Outlook* report to establish a wholesale cost of cigarettes and annually adjust this wholesale cost based on the Producer Price Index (PPI) as published by the U.S. Bureau of Labor Statistics for cigarette manufacturers.

A. Description of Alternative 2**Alternative 2A**

Currently, BOE staff uses the average wholesale cost of premium cigarettes in the tax rate calculation. Under this alternative, BOE staff would establish a base wholesale cost to begin the tax rate calculation and annually adjust the wholesale cost based on the PPI for the previous calendar year, using a 12-month average.

BOE staff would use the last published manufacturers' cigarette price of premium brand cigarettes as published in the April 24, 2007, *Tobacco Outlook* (which has wholesale premium brand prices for December 2006), add a 6 percent margin to wholesale price as done previously, and then annually adjust the wholesale cost based on the PPI for calendar years 2007, 2008, and future years using a 12-month average of the PPI.

The PPI excludes federal excise taxes. If there are federal cigarette excise tax rate increases in future years, BOE staff would add these to the average manufacturers' price per cigarette. After adding increases in federal taxes to manufacturers' prices, BOE staff would apply the 6 percent margin for wholesale costs.

Alternative 2B

Alternative 2B utilizes the tax rate determined in Alternative 2A and adjusts the rate by adding 1.25 percent to reflect the market share of non-branded (generic) cigarettes.

Under this alternative, BOE staff would establish a weighted average wholesale cost using premium brand cigarette prices and “deep discount” prices of non-branded (generic) cigarettes. BOE staff would use estimates of California market shares of premium brand cigarettes and non-branded cigarettes as weights in calculating the weighted average. BOE staff would use the manufacturers’ cigarette price of premium brand cigarettes (as published in the October 24, 2007, *Tobacco Outlook* which has wholesale premium brand prices for April 2002) and the “deep discount” price of non-branded cigarettes (as published in the October 24, 2007, *Tobacco Outlook* which has the wholesale non-branded cigarette prices for April 2002), and add a 6 percent margin factor to represent the wholesale cost of cigarettes.

Based on federal data, BOE staff estimates that non-branded (generic) cigarettes represented about 30 percent of the entire California cigarette market in 2002. Therefore, the average price of premium cigarettes and non-branded cigarettes is weighted 70 percent of premium price and 30 percent deep discount price. The calculated tobacco products tax rates using the 2002 data indicate that the tobacco tax rate using the weighted average prices is about 1.25 percent higher than the tobacco product tax rate using only the price for premium brands.

In summary, Alternative 2B calculations are completed using a two-step process. First, staff would calculate the tobacco products tax rate using Alternative 2A. Second, staff would add 1.25 percent to the rate; this 1.25 percent figure comes from the set of calculations discussed above.

B. Pros of Alternatives 2A and 2B

- No need to annually locate a source for wholesale cost of cigarettes.
- PPI is readily available through the U.S. Bureau of Labor Statistics.
- Data source is free.
- Data source is from an agency of the federal government. (The methodology is documented in a publicly available handbook and is not published for individual industries unless minimum sample size requirements and other criteria are met.)
- Data is likely to continue to be published in the future since it is part of the PPI, an important data series for policymakers.
- Data is timely available for the spring rate setting.
- The wholesaler-manufacturer margin is smaller than the retailer-wholesaler margin (a 6 percent margin for manufacturer to wholesaler, compared to a margin of 19 percent for retailer to wholesaler, which will be discussed under Alternative 3) and is generally less variable than retailer-wholesaler margins. Since the margin used in the calculations is much smaller, revisions in the margin rates are likely to have a smaller impact on the tax rate calculations.
- Calculations are simple and require minimal staff time.
- Calculated wholesale cost of cigarettes can be benchmarked by surveying cigarette manufacturers and distributors to address problems that may arise by using old data in perpetuity. Adjustments to the base can be made if warranted by the survey results.

Additional Pros of Alternative 2B only

- Recognizes and incorporates the volume of “deep discount” non-branded (generic) cigarettes in the cigarette market.

C. Cons of Alternatives 2A and 2B

- Actual wholesale margins on manufacturers’ prices are unknown, and could vary widely. However, while unknown, available data indicate that wholesale margins, when weighted by tax-paid distributions, do not vary as much as retail margins on wholesale costs.
- Federal excise taxes are not included in the calculation of the PPI. Federal excise taxes were included in the USDA data that have been used in the past to calculate the tobacco tax rate. In our calculations, BOE staff can adjust for federal excise taxes by adding changes in the federal excise tax rate per cigarette to manufacturers’ costs per cigarette.
- Uses the most recently published USDA price paid to cigarette manufacturers in perpetuity and applies changes in the PPI to the manufacturers’ price for setting the tobacco products tax rate in future years. The most recently published USDA manufacturers’ price remains the basis of the calculations in the future and this data is no longer published.

Additional Cons of Alternative 2A only

- Does not recognize and incorporate the volume of “deep discount” non-branded (generic) cigarettes in the cigarette market.

Additional Cons of Alternative 2B only

- BOE staff will need to estimate the California market share of non-branded (generic) cigarettes sold at the USDA “deep discount” prices in order to calculate a weighted average.
- USDA “deep discount” prices after April 2002 are not available.
- Determining which brands of cigarettes are generic is a subjective process.

D. Statutory or Regulatory Change for Alternative 2

None

E. Operational Impact of Alternative 2

None

F. Administrative Impact of Alternative 2

1. Cost Impact

Costs are minor and absorbable.

2. Revenue Impact

Under Alternative 2A, the fiscal year 2007-08 tobacco tax rate would have been 42.24 percent of wholesale costs instead of the actual rate set of 45.13 percent, 2.89 percent lower. Revenues would have decreased by about \$2.24 million under Alternative 2A. Details of these tax rates and revenue estimates are provided in the Appendix Tables (Attachment 1).

Under Alternative 2B, the fiscal year 2007-08 tobacco tax rate would have been 43.49 percent of wholesale costs instead of the actual rate set of 45.13 percent, 1.64 percent lower. Revenues would have decreased by about \$ 1.30 million under Alternative 2B. Details of these tax rates and revenue estimates are also provided in the Appendix Tables (Attachment 1).

Alternative 2B results in a 1.25 percent increase in the tax rate and \$0.9 million increase in revenue when compared to Alternative 2A.

G. Taxpayer/Customer Impact of Alternative 2

Under Alternative 2A, the tax rate would be lower than the current rate. Details of these tax rates and revenue estimates are provided in the Appendix Tables (Attachment 1).

Under Alternative 2B, the tax rate would be lower than the current rate (Attachment 1). However, when comparing Alternative 2B to Alternative 2A, tobacco products distributors would be liable for more taxes under Alternative 2B than under Alternative 2A.

H. Critical Time Frames

In the past, the Board has generally approved the tobacco products tax rate in the spring in order to provide sufficient notice to taxpayers regarding the tax rate for the upcoming fiscal year (July 1). To provide adequate time for taxpayers to implement the new rate, BOE staff recommends a new method of determining the tobacco products tax rate be determined and the new rate calculated by May 31 each year.

VIII. Alternative 3 - Use retail cigarette prices as published in the *Tax Burden on Tobacco* with a predetermined margin from retail prices to wholesale cost.

A. Description of Alternative 3

Under this alternative, BOE staff would rely on published retail price information as published in the *Tax Burden on Tobacco*. This publication is written by Orzechowski and Walker, an independent consulting firm to the cigarette industry, and would be free of charge to the BOE. BOE staff would be tasked with making assumptions in order to “back into” the weighted wholesale cost needed for the tobacco products tax rate calculation. The formula would be established by the BOE’s Chief Economist and approved annually by the Board.

BOE staff would use the retail price for the previous year (current prices as of November 1), published in the spring of the following year. BOE staff would estimate wholesale costs by dividing the average California retail price of all cigarettes by a retail-manufacturers’ margin rate of 25 percent, less a 6 percent margin rate for the manufacturer-wholesaler portion, resulting in a margin rate adjustment of 19 percent to be applied to retail prices. The calculations would divide the retail price by a factor of 1.19.

The 25 percent retail-manufacturers’ margin is calculated from data for the most recent year published in *The Changing Tobacco User's Dollar*, by Tom Capehart, U.S. Department of Agriculture, Economic Research Service, TBS-257-01, October 2004. The specific data is for fiscal year 2003-04 for manufacturing costs and wholesaling and retailing costs. (Wholesaling costs are not broken out separately in this publication.)

B. Pros of Alternative 3

- Uses current market data each year rather than updating the last-published USDA data in perpetuity as is done in Alternative 2. To the extent that changes in the PPI do not accurately reflect changes in manufacturers’ prices, they will not be reflected in future rates in Alternatives 2A and 2B.

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- To the extent that the data represent the market, the data accurately take into account the mix of prices for premium and non-branded (generic) cigarettes without having to make separate estimates. Changes in market shares of premium brand and non-branded cigarettes are automatically reflected in the average price data each year.
- Cigarette price data is available and free of charge to BOE.
- Cigarette price data source is independent and likely to be free of industry bias.
- Cigarette price data is available timely for the spring rate setting.
- Calculations are simple and require minimal staff time.

C. Cons of Alternative 3

- Retail margins on wholesale prices are unknown, and may vary widely by type of retail outlet and degree of competition from other retailers.
- The methodology relies on retailer-wholesaler margin data for cigarettes and tobacco products from the U.S. Department of Agriculture, which may not be published in the future.
- Average California retail margins on wholesale prices are unknown and may differ from average U.S. margins.
- Cigarette price data would be based upon survey responses and the statistical reliability of the data is unknown.
- Since data is provided by an independent consultant to the cigarette industry, there is uncertainty as to whether the data will continue to be published in the future.

D. Statutory or Regulatory Change for Alternative 3

None

E. Operational Impact of Alternative 3

None

F. Administrative Impact of Alternative 3**1. Cost Impact**

Costs are minor and absorbable.

2. Revenue Impact

Under Alternative 3, the fiscal year 2007-08 tobacco tax rate would have been 48.96 percent of wholesale costs instead of the actual rate set of 45.13 percent, 3.83 percent higher. Revenues are estimated to increase by about \$2.85 million in Alternative 3. Details of these tax rates and revenue estimates are provided in the Appendix Tables (Attachment 1).

G. Taxpayer/Customer Impact of Alternative 3

The tobacco product tax rate would be higher than the current rate.

H. Critical Time Frames

In the past, the Board has generally approved the tobacco products tax rate in the spring in order to provide sufficient notice to taxpayers regarding the tax rate for the upcoming fiscal year (July 1). To provide adequate time for taxpayers to implement the new rate, BOE staff recommends a new method of determining the tobacco products tax rate be determined and the new rate calculated by May 31 each year.

IX. Impact of New Federal Legislation on Tobacco Products Tax Rate

A. Overview

In addition to determining a data source to use for the wholesale cost of cigarettes in the annual tax rate setting process, a future increase in the federal excise tax will also have an impact on the tobacco products tax rate calculation. In early February 2009, H.R. 2 was signed into law by President Obama. This bill funds the federal Children's Health Insurance Program (CHIP) with increases in federal excise tax rates on cigarettes and tobacco products. Under the law, the federal cigarette tax rate will increase from \$0.39 to \$1.01 per package of cigarettes on April 1, 2009. When this increase in the federal excise tax rate on cigarettes from H.R. 2 is added to the manufacturers' prices used to calculate the tobacco tax rate, it will impact the tobacco product tax rate and revenues.

Attachment 2 depicts the potential impact of this federal excise tax increase on the tobacco products tax rates and revenues.

Preparer/Reviewer Information

Prepared by: Joe Fitz, Research and Statistics Section

Chris Lee, Excise Taxes Division

Current as of: April 1, 2009

Appendix Tables
Revenue Impacts Summaries For All Alternatives for Fiscal Year 2007-08
Revenue Impacts Summary- Alternative 1A

	Fiscal Year 2007-08 Actuals (Tobacco Products Tax Rate 45.13%)	Fiscal Year 2007-08 Comparison (Tobacco Products Tax Rate 41.11%)	Difference -4.02%
Tobacco Products Tax Revenues	(\$Millions)	(\$Millions)	
Proposition 99	\$54.56	\$52.57	-\$2.00
Proposition 10	\$31.36	\$30.21	-\$1.15
Totals	\$85.92	\$82.78	-\$3.15

Revenue Impacts Summary- Alternative 1B

	Fiscal Year 2007-08 Actuals (Tobacco Products Tax Rate 45.13%)	Fiscal Year 2007-08 Comparison (Tobacco Products Tax Rate 41.83%)	Difference -3.30%
Tobacco Products Tax Revenues	(\$Millions)	(\$Millions)	
Proposition 99	\$54.56	\$52.93	-\$1.63
Proposition 10	\$31.36	\$30.42	-\$0.94
Totals	\$85.92	\$83.35	-\$2.57

Revenue Impacts Summary - Alternative 2A

	Fiscal Year 2007-08 Actuals (Tobacco Products Tax Rate 45.13%)	Fiscal Year 2007-08 Comparison (Tobacco Products Tax Rate 42.24%)	Difference -2.89%
Tobacco Products Tax Revenues	(\$Millions)	(\$Millions)	
Proposition 99	\$54.56	\$53.14	-\$1.42
Proposition 10	\$31.36	\$30.54	-\$0.82
Totals	\$85.92	\$83.68	-\$2.24

Revenue Impacts Summary - Alternative 2B

	Fiscal Year 2007-08 Actuals (Tobacco Products Tax Rate 45.13%)	Fiscal Year 2007-08 Comparison (Tobacco Products Tax Rate 43.49%)	Difference -1.64%
Tobacco Products Tax Revenues	(\$Millions)	(\$Millions)	
Proposition 99	\$54.56	\$53.74	-\$0.82
Proposition 10	\$31.36	\$30.88	-\$0.48
Totals	\$85.92	\$84.62	-\$1.30

**Appendix Tables
 Revenue Impacts Summaries For All Alternatives for Fiscal Year 2007-08 (continued)**

Revenue Impacts Summary - Alternative 3

	Fiscal Year 2007-08 Actuals (Tobacco Products Tax Rate 45.13%)	Fiscal Year 2007-08 Comparison (Tobacco Products Tax Rate 48.96%)	Difference 3.83%
Tobacco Products Tax Revenues	(\$Millions)	(\$Millions)	
Proposition 99	\$54.56	\$56.38	\$1.81
Proposition 10	\$31.36	\$32.40	\$1.04
Totals	\$85.92	\$88.78	\$2.85

Major Assumptions Common to Alternatives 1A, 1B, 2A, 2B, and 3:

Fiscal year 2007-08 revenues are used to estimate wholesale sales. The fiscal year 2007-08 tobacco tax rate is used as the current rate.

All tax changes are assumed to be passed on to consumers.

The price elasticity of demand is assumed to be -0.6, and the arc elasticity formula is used to estimate changes in quantity demanded at different tax rates.^{1/}

1/ The general price elasticity of demand formula is: $e_p = (Q_1 - Q_2) / ((Q_1 + Q_2) / 2) / (P_1 - P_2) / ((P_1 + P_2) / 2)$, where P = price, and Q = sales.

**Projected FY 2009-10 Tobacco Products Tax Rate and Revenue Impacts
Without and With the Federal Children's Health Insurance Program (CHIP)**

	Alt. 1A		Alt. 1B		Alt. 2A		Alt. 2B		Alt. 3	
	Without CHIP	With CHIP								
Tobacco Products Tax Rate	41.11%	34.34%	41.83%	35.06%	40.57%	33.00%	41.82%	34.25%	47.67%	38.80%
Tobacco Products Tax Revenues 1/ (in millions)										
Proposition 99	\$51.79	\$48.19	\$52.70	\$49.10	\$51.12	\$47.05	\$52.69	\$48.64	\$60.06	\$55.30
Proposition 10	\$29.77	\$27.69	\$30.29	\$28.22	\$29.38	\$27.04	\$30.28	\$27.95	\$34.52	\$31.78
Totals 2/	\$81.56	\$75.88	\$82.99	\$77.31	\$80.50	\$74.09	\$82.98	\$76.59	\$94.58	\$87.07

1/ Projected revenues based on fiscal year 2007-08 revenues and the rest of the assumptions listed at the bottom of Attachment 1 are also made.

2/ Totals may not sum due to rounding.

Memorandum

To : Mr. Ramon J. Hirsig
Executive Director

Date: March 27, 2009

From : David J. Gau, Deputy Director
Property and Special Taxes Department



Subject : **Fiscal Year 2009-10 Tobacco Products Tax Rate**
(April 16, 2009 Deputy Director's Report)

Revenue and Taxation Code section 30126 requires the Board's annual determination of the tobacco products tax rate pursuant to subdivision (b) of section 30123. The new rate is effective July 1, 2009, and will remain in effect for the 2009-10 fiscal year.

Should the Board adopt the staff-recommended data source Alternative 1A identified in Issue Paper 09-001, the 2009-10 Tobacco Products Tax Rate will be based on the wholesale premium brand cigarette price as of March 1, 2009, as published by the Tobacco Merchants Association, and will be 41.11 percent.

Staff's calculation of the 2009-10 Tobacco Products Tax Rate is detailed on Attachment 1, and the Board-adopted Tobacco Products Tax Rates from fiscal year 1988-89 through 2008-09 are shown on Attachment 2.

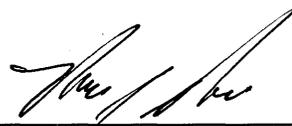
I recommend that the fiscal year 2009-10 Tobacco Products Tax Rate be set at 41.11 percent.

With your approval, this item will be placed on the Board's April 16, 2009 calendar under Deputy Director's Report, Property and Special Taxes Department.

DJG:kn
Attachments

cc: Ms. Diane Olson
Ms. Lynn Bartolo

Approved:



Ramon J. Hirsig, Executive Director

BOARD APPROVED

At the _____ Board Meeting

Diane Olson, Chief
Board Proceedings Division

**STATE OF CALIFORNIA
TOBACCO PRODUCTS RATE CALCULATION
July 1, 2009 to June 30, 2010**

Type:	Manufacturer's List Cigarette Prices	Price*
Standard		\$ 157.20
King Size		\$ 157.20
Filter Tips		\$ 157.20
100 mm		\$ 157.20

* Tobacco Merchants Association TABLE 4a. — PREMIUM BRANDED CIGARETTE WHOLESALE PRICE CHANGES (1993 - present)

Wholesale Cost Per Cigarette	
Computation:	
1. Avg. Mfg. Price Per 1,000 Cigarettes	\$ 157.20
2. Add: Wholesale Markup @ 6% (line 1 x 0.06)	<u>\$ 9.43</u>
3. Avg. Wholesale Cost (line 1 + line 2)	\$ 166.63
4. Avg. Wholesale Cost (line 3 / 1,000)	<u><u>\$ 0.1666</u></u>

Rate Calculation

c = Tax rate per cigarette \$0.0685
 (includes (i) the tax rate per cigarette of \$0.0435,
 plus (ii) the Prop. 10 increase per cigarette of \$0.025 effective
 7/1/99)

w = Weighted average wholesale cost of one cigarette \$0.1666

x = Tax rate on tobacco products

$$\frac{c}{w} = x \quad \text{or} \quad \$0.0685 / \$0.1666 = \mathbf{41.11\%}$$

STATE OF CALIFORNIA TOBACCO PRODUCTS RATE HISTORY		
FISCAL YEAR	TOBACCO PRODUCTS TYPE	RATE
08/09	All product types	45.13%
07/08	All product types	45.13%
06/07	All product types	46.76%
05/06	All product types	46.76%
04/05	All product types	46.76%
03/04	All product types	46.76%
02/03	All product types	48.89%
9/10/01 to 6/30/02	All product types	52.65%
7/1/01 to 9/9/01	Moist Snuff \$0 to \$1.69 per oz	248.00%
	\$1.70 and above per oz	131.00%
	Dry Snuff	256.00%
	Chewing Tobacco	490.00%
	Other Tobacco Products	52.65%
00/01	All product types	54.89%
99/00	All product types	66.50%
1/99-6/99	All product types	61.53%
7/98-12/98	All product types	26.17%
97/98	All product types	29.37%
96/97	All product types	30.38%
95/96	All product types	31.20%
94/95	All product types	31.20%
93/94	All product types	23.03%
92/93	All product types	26.82%
91/92	All product types	29.35%
90/91	All product types	34.17%
89/90	All product types	37.47%
88/89	All product types	41.67%