PROPOSITION 203

TOBACCO TAX INCREASE

A FISCAL HAZZARD
ARIZONANS SHOULD OPPOSE

August 10, 2006

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Introduction

On November 7, Proposition (Prop.) 203, or the Arizona Early Childhood Development and Health Initiative, will ask Arizonans to increase the tax rate 80 cents on a pack of cigarettes or a 68% increase, from $1.18 to $1.98, and also varying amounts on other tobacco products (OTP). This would propel the state to the sixth highest tobacco tax rate in the nation.

If approved, Prop. 203 would establish an Early Childhood Development and Education Board, which would assemble regional partnership councils throughout the state. The board would consist of nine members appointed by the Governor and confirmed by the Senate to serve six-year staggered terms. Representatives from the Departments of Education, Economic Security, and Health Services would serve as ex-officio non-voting members.

The councils, on the other hand, are assigned field coordinators, offices, and staff and are granted the autonomy to assess early childhood education and health needs to develop programs in their respective communities. The councils will be composed of 11 members with specific qualifications. For instance, one member must be a parent with a child aged five or younger, another must be from the business community, and another must be from a faith-based organization.

The board directs and raises funds from outside sources such as individuals, corporations, and foundations, but the board will be relying most on the tobacco tax increase for its funding needs. Proponents estimate the tobacco tax increase will raise $150 million annually for their cause.

Ballot Box Budgeting

While much of the public debate on this initiative will center on the tax increase and the programs receiving the earmarked funding, the most significant public policy issue, from ATRA's perspective, is the earmarking of revenues. For decades, ATRA has consistently expressed concern about the practice of earmarking revenues outside the appropriations process through what is commonly referred to as *ballot box budgeting*. Regrettably, determining state budget priorities at the ballot box has become so commonplace in Arizona that much of the flexibility to annually develop a state budget has been stripped from the Legislature.

Earmarking, in and of itself, is not always bad. Some forms of earmarking make sound fiscal sense and are appropriate. In most instances, those earmarked revenues are in the area of fees and assessments as opposed to general taxes. It is common, for instance, for tuition revenues to be earmarked for university spending or fishing and hunting licenses to be earmarked to agency budgets that support those activities. The best example at the state level for earmarked taxes is gas taxes that are primarily dedicated to road construction and maintenance. In order for earmarking to be appropriate, there should be a direct link between those paying the earmarked taxes or fees and those receiving the benefits of the government service they fund.

Clearly, the most important and fundamental responsibility of the Legislature and Governor is to annually establish budget priorities within available revenues and economic conditions. *Ballot box budgeting* overrides their responsibility and handcuffs policymakers' ability to respond to the state's changing demands. Furthermore, by circumventing the annual appropriations process, the earmarked revenues and the programs they fund escape the periodic legislative scrutiny that is so important to maintain accountability for the expenditure of taxpayer dollars.

Prop. 203 attempts to provide oversight of the funds through the nine-member appointed board. However, once approved by the Senate, there are no mechanisms available to hold these unelected political appointees accountable for the expenditure of an estimated $150 million annually. A similar program created through a voter initiative in California in 1998 has been rocked by allegations of improprieties. This year, filmmaker Rob Reiner had to resign from the First 5 California Children and Families Commission due to allegations that he used the money earmarked for early childhood programs to promote a political agenda.

Lastly, the policy implications of *ballot box budgeting* took on an overwhelming importance in Arizona following the passage of the Voter Protection Act in 1998. That initiative placed strict limits on the Legislature's ability to make changes to voter-approved measures. As a result, statutory initiatives, for all practical purposes, rise to the level of constitutional amendments.

The Declining Revenue Source

Arizona has increased the tax rate on tobacco twice in little more than a decade. The first was in 1994 with the passage of Prop. 200 (A.R.S. §42-3251), which was the Tobacco Tax and Health Care Act. The tobacco tax rate was increased from 18 cents to 58 cents, creating the Tobacco Tax & Health Care Fund. Funds were directed to the Medically Needy Account for the Arizona Health Care Cost Containment System (AHCCCS), the Health Education Account, the Health Research Account, and the Corrections Fund.

Then in 2002, Prop. 303 (A.R.S. §42-3251.01) was passed and increased the tobacco tax rate again by 60 cents to $1.18, creating the Tobacco Products Tax Fund. Prop. 303 also "reauthorized" Prop. 200 thereby extending Prop. 105 protection (requiring 3/4 Legislative approval to change, equating it to a constitutional amendment) to the 1994 measure. It also provided a partial general fund bailout for the deficit created by Prop. 204, the "Healthy Arizona Initiative," which earmarked all of the state's receipts from the tobacco litigation settlement agreement to expand state-funded health care coverage.

A major problem with Prop. 203 is that it is tied to a declining revenue source. According to the Center for Disease Control, smoking among adults in Arizona has declined from 23.1% in 1996 to 18.6% in 2004. National experts estimate that cigarette consumption will decline 1.5% annually regardless of future tax changes. In fact, the National Association of Attorneys General announced this year that the number of cigarettes sold in the U.S. fell to its lowest level since 1950. Therefore, with the supply of tobacco users declining, the tax collection base will decline as well.

Based on actual data, the Tobacco Tax and Health Care Fund experienced an 11.8% decline in receipts between fiscal year (FY) 1996 and FY2003 (the years in which Prop. 200 could be measured). Once Prop. 303 passed, the fund experienced a further decline. For instance, in FY2001, according to the data collected by the Department of Revenue's (DOR) Luxury Tax Section, over $43 million was received in tobacco tax collections but declined 11% to over $38 million by FY2005.

NOTE: The FY2005 total collections for all funds actually showed an increase of over $10 million. The reason for the increase is that in 2003, the Legislature passed Senate Bill (SB) 1310 and appropriated $900,000 to DOR's Tobacco Enforcement Unit within the Criminal Investigation Section. In August and September of that year, SB1310 permitted DOR to hire and train 10 new investigators and four new auditors to enforce A.R.S. §44-7101 and crack down on illegal stamping and enforce retailers to purchase legitimate stamps. SB1310 also established A.R.S. §44-7111, prohibiting the stamping, sale, or possession for sale, any and all cigarettes not listed in the directory of cigarettes approved for stamping and sale maintained at the Attorney General's office. DOR attributes a $10.7 million increase in collections between FY2004 and FY2005 from increased public awareness of enforcement activities. The reason this is mentioned is due to the anomaly it has produced in tax collections.

TOBACCO TAX COLLECTIONS AND DISTRIBUTION					
Fiscal Year	General Fund	Corrections Fund	Tobacco Tax & Health Care Fund	Tobacco Products Tax Fund	Total
2005	$38,360,525	$5,980,213	$102,310,127	$138,510,628	$285,844,998
2004	$36,757,081	$6,206,674	$98,163,310	$133,563,168	$275,104,562
2003	$41,174,667	$6,206,674	$105,027,137	$59,938,321	$212,346,799
2002	$43,206,460	$6,206,674	$108,177,154		$157,590,288
2001	$43,124,883	$6,206,674	$108,709,176		$158,040,733
2000	$43,446,233	$6,206,674	$109,786,025		$159,428,932
1999	$43,895,551	$6,206,674	$112,735,957		$162,838,182
1998	$44,443,108	$6,206,674	$114,104,507		$164,754,289
1997	$43,676,616	$6,206,675	$115,961,006		$165,844,297
1996	$45,461,621	$6,206,673	$119,127,689		$170,795,983
1995	$47,728,667	$6,837,337	$54,623,325		$109,189,329
1994	$46,870,529	$6,206,674			$53,077,203
1993	$47,385,665	$6,261,724			$53,647,389
1992	$46,419,433	$6,128,751			$52,548,184
1991	$45,474,466	$6,321,584			$51,796,050

SOURCE: Department of Revenue, Luxury Tax Section

Based on previous experience with Prop. 200 and Prop. 303, ATRA predicts the state will see a reduction in the taxable sales of cigarettes. In order to estimate the anticipated reduction from this 80-cent increase, economists use elasticity of demand projections. In this case, it was found that for every 1% increase in the price of cigarettes, there will be a range of 0.2% to 0.8% decrease in cigarette sales.

In the Joint Legislative Budget Committee's (JLBC) Prop. 203 fiscal analysis, the average Arizona retail price of a pack of cigarettes is $4.30 and increasing the tax by $0.80 would generate an 18.6% increase in the price of cigarettes. Thus applying the

18.6% increase to a JLBC elasticity estimate rate of 0.4%, the tax increase is estimated to decrease cigarette consumption by 7.4% annually. With these estimates, the adjusted actual FY2005 collections decline $21 million, from $285 million to $264 million, as reflected below.

Fiscal Year	TOBACCO TAX COLLECTIONS AND DISTRIBUTION (0.4% Adjusted)				
	General Fund	Corrections Fund	Tobacco Tax & Health Care Fund	Tobacco Products Tax Fund	Total
2005	**$35,521,847**	**$5,537,677**	**$94,739,178**	**$128,260,842**	**$264,692,468**

Source: Arizona Tax Research Association

JLBC also states that the current recipients are estimated to receive $305 million from tobacco tax revenues in FY2007 and FY2008 but Prop. 203 would reduce those amounts by $13.2 million and $22.7 million, respectively.

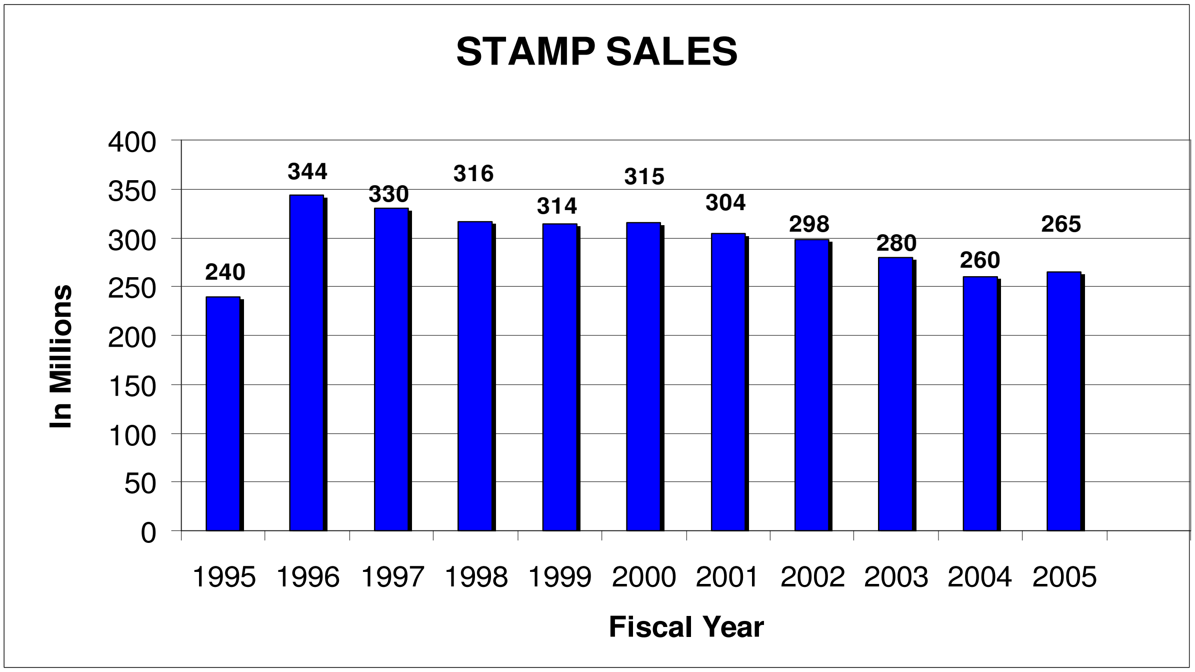
Effect of Proposition 203 on Current Revenues

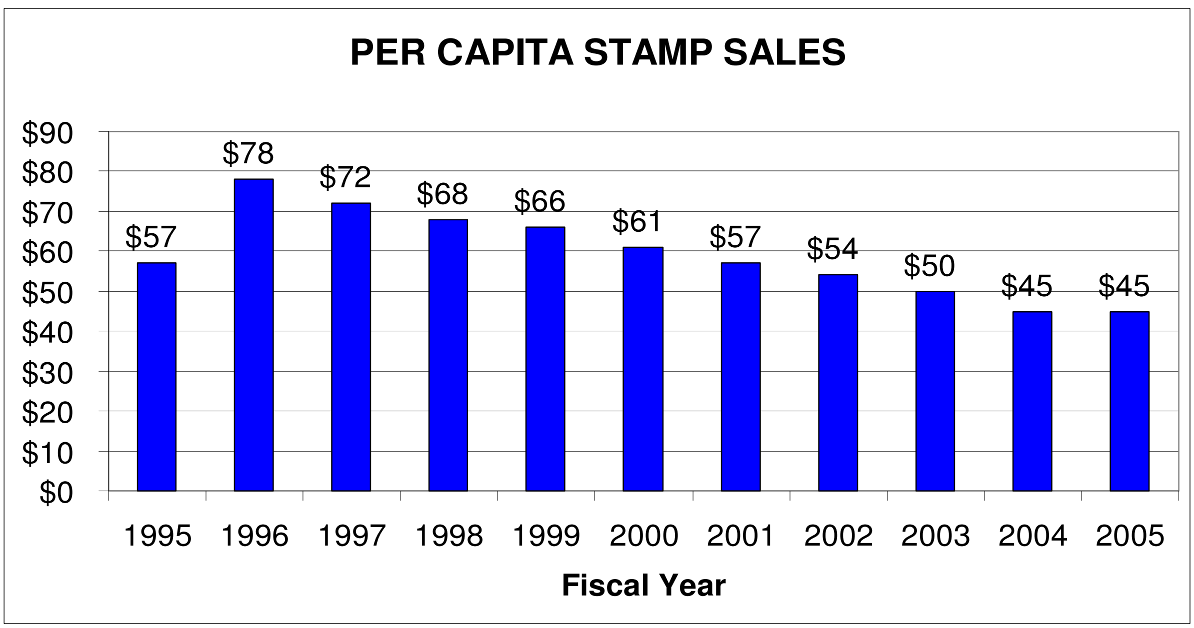
	Current Estimated Revenue	Change in Revenue as a Result of Tax Increase	Estimated Revenue Under Proposition 203
General Fund			
FY2007 [1]	$40,870,000	($1,774,200)	$39,095,800
FY2008	40,870,000	(3,041,500)	37,828,500
Corrections Fund			
FY2007 [1]	$6,405,000	($278,100)	$6,126,900
FY2008	6,405,000	(476,700)	5,928,300
Tobacco Tax and Health Care Fund			
FY2007 [1]	$109,495,000	($4,753,300)	$104,741,700
FY2008	109,495,000	(8,148,500)	101,346,500
Tobacco Products Tax Fund			
FY2007 [1]	$148,230,000	($6,434,800)	$141,795,200
FY2008	148,230,000	(11,031,100)	137,198,900
Total			
FY2007 [1]	$305,000,000	($13,240,400)	$291,759,600
FY2008	$305,000,000	($22,697,800)	$282,302,200.00

1/ Assumes tax increase will take effect December 1, 2006

Source: Joint Legislative Budget Committee

The effect of tax increases on the demand for cigarettes is masked in Arizona by dramatic population growth. According to the U.S. Census Bureau, Arizona has added over two million people to its population between 1990 and 2005, growing from 3,684,097 to 5,939,292, or a 61.2% increase. As the tables on page 5 reflect, overall stamp sales have declined from 1996 to 2005 - 343,677,700 to 264,921,600 - or a 22.9% decrease. Moreover, per capita sales have declined from $78 in FY1996 to $45 in FY2005 or a 42.3% decline.





In an article in *Governing Magazine*, Executive Editor Alan Ehrenhalt questioned both the sincerity and the fiscal Manichaean wisdom of state's increasing their addiction to tobacco taxes:

"There are times when so-called 'sin taxes' are treated mostly as a fiscal proposition, others when they are portrayed largely in moral terms… Then there are moments, perhaps including the present, when the two arguments seem to converge. In fact, however, the arguments are not entirely compatible. If government's main goal is to make money off of tobacco and alcohol, it needs to have people drink and smoke more, not less."

To their credit, the Prop. 203 proponents have not attempted to disguise their effort as an attempt to eliminate smoking. It has been in the planning stages for four years, stalled only by identifying an appropriate funding source, according to the *Arizona Republic*. Its proponents looked at increasing liquor and beer taxes but left alcohol out because cigarette taxes, according to a spokesman, "are the avenue of least resistance."

> "If there comes a time in the state where there are no more smokers, we're going to be really delighted to take on the task of finding a new revenue stream."
> -- Nadine Mathis Basha
> *Arizona Daily Star,* December 7, 2005

According to the *Arizona Daily Star*, First Things First Chairwoman Nadine Mathis Basha, which is spearheading the Prop. 203 campaign, acknowledged she chose the tobacco tax for political reasons: It raises the right amount of money and "this is what we know will pass." Campaign consultant Steve Roman said other options, like higher sales or income taxes, did not poll as well.

Tax Avoidance

While this huge tax increase will certainly drive more smokers to quit, it will also drive more smokers to avoid paying the tax. Increased taxation has led to the proliferation of purchasing cigarettes and other tobacco products from alternative sources, resulting in the loss of expected revenues. The first is through the Internet in which Philip Morris USA estimates roughly 1,000 web sites exist today for the purchase of these products where in 2001 there appeared to be only 200. Indeed, the loss of uncollected excise taxes nationwide was estimated at $1.4 billion between the years of 2002 and 2005 (state specific figures are not available).

One mitigating factor to the expected shift to tax-free sales on the Internet is that national credit card companies no longer handle transactions with Internet tobacco sellers since March 2005. While DOR has not yet seen a decline in Internet tobacco sales, it has concluded that a decline should occur if credit card sales are limited. Regardless, DOR possesses and has collected limited data on cigarette purchases by Arizona residents via the Internet. Personal checks and money orders may still be used to purchase tobacco products.

Another method for evading paying excise taxes is through purchasing tobacco products on Indian reservations. The collection of taxes on various Indian reservations is quite complex. Prior to the enactment of Prop. 200, there were no taxes collected on any of the reservations.

In order for retailers to be able to sell tobacco products tax-free, they are required to register with DOR. Whether they sell tax-free product, product taxed at the Prop. 200 or Prop. 303 rate, or product taxed at the full rate, is dependent on their registering, and on the ownership of the retail store. If the store is registered and is owned by the tribe or by a member of that tribe, the store would receive tax-free product to sell to other members of the tribe, and product taxed at the Prop. 200 or Prop. 303 rate to sell to non-members. If the store is registered and owned by a federally licensed Indian trader, they would also receive tax-free product to sell to members of that reservation's tribe, but would receive product taxed at the full rate to sale to non-members. Any retailer located on a reservation, who does not register with DOR will only receive tobacco product taxed at the full rate.

Prop. 200, however, did allow for the reservations to offset this "reservation tax" by enacting their own luxury, sales, or similar tax on tobacco products that are equal to the amount of the proposition tax rate or 40 cents. If a reservation decides to take this route, the tax then goes to the reservation and not to the state of Arizona.

Arizona's three stamp system

Arizona currently utilizes a three stamp system: blue, red, and green. Blue (general luxury tax) stamps are sold for $1.18 each for a pack of 20 cigarettes and $1.475 for a pack of 25 cigarettes. They are affixed to cigarettes sold to retailers not located on Indian Reservations or to a non-Indian owned retailer on the reservation for sale to non-Indians. These are the most prevalent and can be found in grocery stores and gas stations like Circle K, where the cost of a 20-cigarette pack of Marlboro's is roughly $4.70.

Red (Indian Reservation luxury tax) stamps are sold and are affixed to cigarettes sold on any reservation by an Indian-owned retailer to a non-Indian consumer. For a pack of 20 cigarettes, the tax is $1.00 while for a pack of 25 cigarettes, the tax is $1.25. Even if the Indian tribe passes their own tax on tobacco products sold on their reservation, red stamps must still be affixed to cigarettes sold by Indian retailers to non-Indians and to the members of the tribe. For instance, if someone were to go to Baja Gas on the Fort McDowell Reservation, the cost of a 20-cigarette pack of Marlboro's is roughly $4.10.

The green (Indian Reservation tax-free) stamps are given to Indian tribes who have not enacted their own tobacco tax or who have exempted their own members from the tribe's tax. Since the stamp is not taxed, it is not included in the chart on page 5. For instance, if a purchase is made at Basha's grocery store on the Colorado River Indian Reservation, a pack of Marlboro's is roughly $4.39.

In the state, two reservations (Havasupai and San Juan Paiute) have no registered retailers through DOR so their tobacco products are taxed at the full rate and must have blue stamps affixed. Therefore, the tax rate of $1.18 for a pack of 20 and $1.475 for a pack of 25 cigarettes must be applied.

Reservations that <u>have not</u> enacted their own tax

Five reservations (Cocopah, Fort Apache (White Mountain), Fort Yuma Quechan, Hopi and Hualapai) have retail stores that are registered with the state but have not enacted their own tax. This means that the stores will receive tobacco products tax-free and/or taxed at the Prop. 200 rate if they are owned by the tribe or by a member of the tribe, and will receive tobacco products tax-free and/or taxed at the full rate if they are not. Therefore, they would affix their taxed cigarettes with red ($1.00) stamps and their tax-free cigarettes with green stamps.

Reservations that <u>have</u> enacted their own tax

Nine reservations have enacted their own tax. The Ak Chin, Fort McDowell, Gila River, Kaibab-Paiute, Salt River, Fort Mojave, Pascua Yaqui, Tohono O'Odham and Yavapai Apache Tribe's have enacted taxes to offset both Prop. 200 and Prop. 303 taxes. Therefore, for retailers receiving blue stamps, distributors must collect $0.18 for a pack of 20 and $0.25 for a pack of 25. For both red and blue stamped cigarettes, distributors may claim a rebate from DOR for the amount prescribed by the Tribe's taxes (up to $1.00 for a pack of 20 and $1.25 for a pack of 25). No green stamps may be sent to the tribes unless authorized by DOR.

The Yavapai-Prescott Indian Tribe collects its tribal tax from distributors and has stores owned by the tribe, or members of the tribe, and stores that are owned by licensed Indian traders. For retailers receiving blue stamps, distributors must collect $1.18 for a pack of 20 and $1.475 for a pack of 25. For red stamps, $1.00 for a pack of 20 and $1.25 for a pack of 25 are to be collected. If red and blue stamped cigarettes are both sold to the retailer, the distributor may claim a rebate from DOR. No green stamps may be sent to the tribes unless authorized by DOR.

The Navajo and San Carlos Apache Tribe have entered into an intergovernmental agreement (IGA) with DOR to have that agency collect the tax for them. DOR does not issue rebates to the tobacco distributors so all distributors making tobacco sales must collect the tax from the reservation's retailers. Distributors collect $1.18/pack (20's) and $1.475/pack (25's) from retailers receiving blue stamped cigarettes. They also receive red stamps but no green stamps.

The Colorado River Reservation has also entered into an IGA with DOR to collect the tax on behalf of the Tribe. As with the Navajo Nation and San Carlos Apache, distributors will be responsible for collecting the tax from the reservation's retailers. However, unlike these two tribes, the Colorado River Tribe has exempted their members from the tax and they will be permitted to affix green stamps to their cigarette products. Thus, distributors must collect $1.18 for blue and $1.00 for red stamps and must not ship more than the maximum of tax-free packs to any retailer. The Tribe enacted Prop. 200 and are issued a refund of 40 cents from the DOR.

The final tribe, Tonto Apache, like the Colorado River Tribe, also enacted Prop. 200 and affixes red stamps to their cigarette products. However, the 40 cent refund is issued from the distributor and occurs when the distributor charges only 60 cents for the $1.00 red stamp. Therefore, the Tribe realizes the refund immediately.

Prior to Prop. 200, Arizona's cigarette tax was pre-collected from distributors of tobacco products. When the distributor sells the products to retailers, they recapture the cost of the taxes paid to DOR. This shift allowed the state to assess a tax on cigarettes sold to non-Indian consumers on the reservation. After the passage of Prop. 200, sales on reservations which were previously tax-free and untracked by DOR are now included in gross collections.

Finally, increased taxation highlights the discrepancy between low tax states such as Utah, Colorado and New Mexico, where the tax is 69.5 cents, 84 cents, and 91 cents, respectively. Interstate contraband increases as does bootlegging operations in which illegal imports or cigarettes intended for sale outside the U.S. enter the country without state taxes. For example, federal "stings" found that cigarettes are often exported tax-free to Mexico and then smuggled back into the U.S. without taxes.

Arizona was among the states to sign the massive 1998 Master Settlement Agreement (MSA) with the four major tobacco distributors. In the Agreement, the non-participating manufacturers adjustment exists which states that if the aggregate market share of the participating manufacturer decreases more than two percent and an economic consulting firm confirms that the MSA was a significant factor contributing to the loss, payments to the states may be adjusted accordingly.

In FY2005, Arizona received $93.9 million and was expected to receive $89.5 million in FY2006 in MSA payments. Prop. 204, passed in 2000, stipulated that all MSA payments be applied to AHCCCS to provide health care services for the state's uninsured. Considering the fact that the tobacco companies are reducing their payments to states, Arizona is expected to receive $86.3 million in FY2006, according to the JLBC figures.