MISSOURI STATE AUDITOR'S OFFICE
FISCAL NOTE (14-127)

Subject

Initiative petition from Khristine Heisinger regarding a proposed statutory amendment to Chapter 149. (Received March 11, 2014)

Date

March 31, 2014

Description

This proposal would amend Chapter 149, RSMo.

The amendment is to be voted on in November 2014.

Public comments and other input

The State Auditor's office requested input from the **Attorney General's office,** the **Department of Agriculture,** the **Department of Economic Development,** the **Department of Elementary and Secondary Education,** the **Department of Higher Education,** the **Department of Health and Senior Services,** the **Department of Insurance, Financial Institutions and Professional Registration,** the **Department of Mental Health,** the **Department of Natural Resources,** the **Department of Corrections,** the **Department of Labor and Industrial Relations,** the **Department of Revenue,** the **Department of Public Safety,** the **Department of Social Services,** the **Governor's office,** the **Missouri House of Representatives,** the **Department of Conservation,** the **Department of Transportation,** the **Office of Administration,** the **Office of State Courts Administrator,** the **Missouri Senate,** the **Secretary of State's office,** the **Office of the State Public Defender,** the **State Treasurer's office, Adair County, Boone County, Callaway County, Cass County, Clay County, Cole County, Greene County, Jackson County Legislators, Jasper County, St. Charles County, St. Louis County, Taney County,** the **City of Cape Girardeau,** the **City of Columbia,** the **City of Jefferson,** the **City of Joplin,** the **City of Kansas City,** the **City of Kirksville,** the **City of Kirkwood,** the **City of Mexico,** the **City of Raymore,** the **City of St. Joseph,** the **City of St. Louis,** the **City of Springfield,** the **City of Union,** the **City of Wentzville,** the **City of West Plains, Cape Girardeau 63 School District, Hannibal 60 School District, Rockwood R-VI School District, Linn State Technical College, Metropolitan Community College, University of Missouri** and **St. Louis Community College.**

Charles A. Arnold provided information as a proponent of the proposal to the State Auditor's office.

Assumptions

Officials from the **Attorney General's office** indicated:

The proposal would artificially deem the payment of a new tax as compliance with the state's tobacco escrow laws. However, while such taxes would be deemed compliance with state law, it would not be deemed compliance with certain conditions of the Tobacco Master Settlement Agreement (MSA). The MSA is a contractual agreement between the state and certain tobacco product manufacturers, the terms of which cannot be altered or avoided by statute. Accordingly, the result of the proposal would be that certain tobacco product manufacturers would be deemed in compliance with state law even though they had not in fact complied with state law.

Because certain tobacco product manufacturers would be able to avoid actual compliance with existing state laws, the state would be powerless to diligently enforce its existing state laws on this subject, which enforcement is necessary to avoid a substantial reduction in annual MSA payments known as the "NPM adjustment." Although it is impossible to predict with precision the exact amount of future NPM adjustments, it could be up to the full amount of Missouri's annual MSA payment (approximately $130 million annually at present). However, as disputes over annual NPM adjustments are presently being resolved several years in arrears, NPM adjustments incurred in the current and immediately upcoming fiscal years may not actually be realized until several years into the future.

In sum, the proposal would result in a substantial loss of state revenue, in perpetuity, in the form of either a substantial reduction or possible elimination of the state's annual MSA payments, though the precise amount of loss and the exact fiscal year in which such loss would first be realized cannot be accurately predicted at this time

As noted, the proposal would change the manner in which tobacco manufacturers can comply with certain state laws, but would not eliminate the existing requirements nor the AGO's obligation to enforce them. Moreover, the proposal would not adjust any of the AGO's other duties and obligations under the MSA or related state laws. Accordingly, the AGO would not realize any savings from the proposal but assumes that any increased costs for the AGO associated with the proposal could be absorbed with existing resources.

Officials from the **Department of Agriculture** indicated no fiscal impact on their department.

Officials from the **Department of Economic Development** indicated no impact for their department.

Officials from the **Department of Elementary and Secondary Education** indicated:

Tobacco Master Settlement Agreement

FY 2014 estimated allocations of revenues from the Tobacco Master Settlement Agreement are summarized below:

Estimated Tobacco Master Settlement Agreement	$59,800,000
Allocations	
Life Science Research	$15,000,000
ECDEC	$35,000,000
HFTR	$9,800,000
	$59,800,000

The $35 million portion allocated to ECDEC (Early Childhood Development Education and Care Fund) is further allocated to DESE and the Dept of Social Services.

As indicated in the chart below, DESE uses these funds for First Steps, PAT, MPP, and Early Childhood Special Education. Any decrease in funding to the master settlement agreement will likely result in a reduction to these programs.

	FY 2014
First Steps	$578,644
Foundation - Parents as Teachers	$5,000,000
Foundation - Early Childhood Spec. Ed	$7,412,900
MPP	$11,754,429
	$24,745,973

Tobacco Tax Revenues

A query of SAM II revealed the following revenues from the cigarette tax revenue code (1057):

	FY 2014
Health Initiatives Fund	$20,432,467
State School Moneys Fund	$45,973,051
Fair Share Fund	$20,432,467
St. Louis County Cigarette Tax	$3,155,725
Jackson County Cigarette Tax	$2,316,945
	$92,310,655

Specific to DESE's budget are the revenues in the State School Moneys fund and the Fair Share fund totaling $66,405,518.

This proposal will likely have an impact on these revenues; however, the officials said they have no means to calculate such impact. They deferred to another agency regarding the extent of any impact to tobacco tax revenues as a result of this proposal.

Officials from the **Department of Health and Senior Services** indicated this initiative petition is a no impact note for their department.

Officials from the **Department of Insurance, Financial Institutions and Professional Registration** indicated this petition, if passed, will have no cost or savings to their department.

Officials from the **Department of Mental Health** indicated this proposal creates no direct obligations or requirements to their department that would result in a fiscal impact.

Officials from the **Department of Natural Resources** indicated they would not anticipate a direct fiscal impact from this proposal.

Officials from the **Department of Corrections** indicated no impact to their department.

Officials from the **Department of Labor and Industrial Relations** indicated no fiscal impact to their department.

Officials from the **Department of Revenue** indicated the proposal will have no fiscal impact on the department, but it will impact state revenues.

Based upon information reported for 2013, there were 10.29 million sticks of cigarettes stamped for sale in Missouri. Imposing an additional tax of $0.015 per stick would generate $154 million annually. The department cannot provide an estimate for the amount of revenue that would be generated on Roll-Your-Own as the tax is imposed on the manufacturers invoice price and this information is not tracked.

Although the tax established within this petition will increase revenues, the state may lose by as much as $135 million annually if it can no longer comply with the terms of the Master Settlement Agreement.

The petition increases state revenue. However, the increased tax may reduce sales, eventually reducing revenues. The state may also lose revenues that would have been received from the Master Settlement Agreement.

The petition proposes a tax on the sale of cigarettes and roll-your-own (RYO) tobacco equal to one and one-half cents per cigarette and 10.25 percent of the manufacturer's invoice prices on the RYO tobacco products. However, as a result of this petition, the state may not be in compliance with the Master Settlement Agreement, which may result in a loss of revenues up to $135 million annually.

Administrative Impact:
Currently, tobacco product manufacturers must comply with the Master Settlement Agreement, under which they are required to become a participating manufacturer (PM) and perform financial obligations under the Master Settlement Agreement or place funds in an escrow account based upon units sold in the state. Under sections 196.1020 to 196.1035, PM's are required to certify their brands each year to the department in order to be placed in the state tobacco directory.

RYO tobacco is taxed in the same manner as other tobacco products at 10 percent of manufacturers invoice price before discounts and deals. The additional tax being imposed only applies to RYO tobacco. This will require new reporting forms and schedules to separate RYO tobacco from other tobacco products.

Notification of the tax increase and changes to the reporting of RYO tobacco will need to be sent to 250 licensed cigarette and other tobacco product wholesalers.

The additional tax being imposed on cigarettes will require changes to the decal ordering form, minor changes to the accounting system and changes to the cashiering procedures.

NPMs making escrow deposits on April 15, 2014 for 2013 sales are expected to place an amount based upon $0.0299790 a stick into escrow.

Comments:

If the initiative petition becomes law, Non Participating Manufacturers (NPM) would not be required to make the escrow payments required by the Master Settlement Agreement. This would mean the state would not comply with the terms of the agreement which likely would result in the potential loss of the settlement payments from Participating Members.

Subsection 149.018.1 provides that a tobacco product manufacturer shall have been deemed to meet all the Chapter 196 requirements for cigarettes & Roll-Your-Own (RYO) tobacco when the additional tax of $0.015 per cigarette (30 cents per pack of 20) or the additional tax of 10.25% on RYO tobacco is levied upon the sale.

The department assumes this means that an additional tax will be imposed upon all cigarettes & RYO tobacco and therefore all tobacco product manufacturers shall be deemed to meet the requirements of 196.1003 and 196.1020 to 196.1035 without having to either place funds into escrow or making payments under the agreement Participating Manufacturers (PM), will not have to annually certify their brands.

If PM's were required to make payments under the Agreement, the initiative petition would still put the PM's at a disadvantage compared to non-participating manufacturers (NPM) because both PM and NPM cigarettes would have the additional tax on them.

Unless section 196.1023 is repealed, the department will still be required to maintain the tobacco directory. Thus, the department would still need the ability to require tobacco manufacturers to provide a list of their brands each year. The department suggests language be added that would require the filing of brand reports by tobacco product manufacturers or add language to 149.018 so the director may promulgate rules for administration of this section.

Subsection 149.018.2 imposes the additional tax on cigarettes & RYO tobacco but does not designate where the funds are to be deposited. Subsection 3 does state that the additional tax is to be collected in the same manner as the current taxes imposed under Chapter 149, however the current cigarette taxes are deposited into three separate funds by statute (Health Initiatives, Fair Share and the State School Moneys Fund) and the tax on RYO tobacco is deposited into the Health Initiatives Fund by statute. Clarification is needed on where the additional revenue being imposed is to be deposited.

Subsection 149.018.3 requires the additional taxes be collected in the same manner as the current tax imposed upon the sale of cigarettes & RYO tobacco. The department assumes this would then include any allowances currently allowed as well as refunds.

If the tax being imposed applies to current inventories of stamped cigarettes and un-affixed stamps, then the current stamps may be used. However, this would require language providing for a floor stocks tax.

New stamps would be required to be designed and purchased. Because cigarette stamps for the entire fiscal year are purchased prior to beginning of a fiscal year, there may not be adequate funds budgeted for the purchase of additional stamps. This legislation is to be put to a vote of the people on Nov 4, 2014 and would become effective upon certification of the votes cast. If new stamps are needed, there may not be sufficient time to obtain them prior to the probable effective date of January 1, 2015.

Please note this does not include retailers. The department is not sure how all retailers would be reached as they are not required to be licensed. The department recommends that the following language be added:

> Each licensed wholesaler shall make a final actual inventory of all stamped cigarettes and all unapplied stamps in the licensee's possession. This final actual inventory shall be taken at the end of the day prior to the effective date of the tax increase and shall be certified to the department within 10 days. The director shall discontinue selling stamps to any licensee that fails to certify the actual inventory within the 10-day period and will resume selling when the certification is received.
>
> The increased tax amount shall apply to the final actual inventory and payment of the additional amount shall be paid within sixty days of the effective date of the tax increase. The director shall discontinue selling stamps to any licensee that

fails to remit the additional amount due within the 60-day period and shall assess the licensee for the additional tax due.

The increased tax amount shall apply to all stamps sold by the department beginning on the effective date of the new tax increase.

For a period up to six months prior to the effective date of a tax increase, each licensee shall not be allowed to purchase stamps in an amount greater than 110 percent of the amount that was purchased during the same period during the previous year.

Officials from the **Department of Social Services** indicated there is no direct fiscal impact to the department. Since the budget of any state agency is dependent upon the appropriations process, the department cannot predict whether the department might be affected if this proposal were to result in a change in the total amount of General Revenue available to fund state government.

Officials from the **Governor's Office** indicated there should be no fiscal impact to their office.

Officials from the **House of Representatives** indicated no fiscal impact to their office.

Officials from the **Department of Conservation** indicated no adverse fiscal impact to their department would be expected as a result of this proposal.

Officials from the **Office of Administration** indicated:

This proposal creates, upon voter approval, additional taxes on cigarettes and roll-your-own tobacco products. IP 14-127 lets tobacco product manufacturers meet the requirements of the Master Settlement Agreement (MSA) through paying increased sales taxes. IP 14-128 allows tobacco product manufacturers the choice of paying increased sales taxes on tobacco products or paying the required amounts into the MSA. IP 14-129 eliminates the MSA and increases the tax on tobacco products. Below are estimates of the increased revenue to the state from the increased tax on tobacco products.

The MSA has provided the following revenue to the state by year over the last three years: FY 2011-$132.6M, FY 2012-$135.2M, FY 2013-$135.2M. The estimate of revenues from the MSA in FY 2014 is $59.8M. Funds from the MSA are used to support the Early Childhood Development and Education Fund, the Life Sciences Research Trust Fund and the Healthy Families Trust Fund.

There should be no cost to the Office of Administration.

Budget & Planning (BAP) provides these estimates:

Cigarette Tax (all versions)
The proposals create an additional cigarette tax of $0.30 per pack of twenty. BAP notes that cigarette tax revenues in FY13, at $0.17 per pack of twenty, totaled just over $86.8M. If the number of packs sold remains constant, this would generate over $153M in additional revenues. However it is likely the additional tax would reduce the number of units sold. BAP estimates this additional tax would generate $141.2M of revenues.

Tax on Roll-Your-Own Tobacco Products
These proposals create an additional tax of 10.25% of the invoice price on Roll-Your-Own Tobacco products. While these products are currently taxed as an "Other Tobacco Product," BAP does not have data on what portion of "Other" products may be subject to additional tax under this proposal. BAP notes that "Other Tobacco Product" revenues in FY13, at 10% of the invoice price, totaled just under $16.9M.

These proposals amend Chapter 149. BAP assumes the new revenues above would be deposited to the credit of the State Schools Money Fund, pursuant to RSMo. 149.065.

BAP also notes this proposal may make changes to Missouri's participation in the Master Settlement Agreement. The Attorney General may be able to provide additional information on this issue.

Officials from the **Office of State Courts Administrator** indicated there is no fiscal impact on the courts.

Officials from the **Secretary of State's office** indicated their office is required to pay for publishing in local newspapers the full text of each statewide ballot measure as directed by Article XII, Section 2(b) of the Missouri Constitution and Section 116.230-116.290, RSMo. The Secretary of State's office is provided with core funding to handle a certain amount of normal activity resulting from each year's legislative session. Funding for this item is adjusted each year depending upon the election cycle with $1.3 million historically appropriated in odd numbered fiscal years and $100,000 appropriated in even numbered fiscal years to meet these requirements. The appropriation has historically been an estimated appropriation because the final cost is dependent upon the number of ballot measures approved by the General Assembly and the initiative petitions certified for the ballot. In FY 2013, at the August and November elections, there were 5 statewide Constitutional Amendments or ballot propositions that cost $2.17 million to publish (an average of $434,000 per issue). Therefore, the Secretary of State's office assumes, for the purposes of this fiscal note, that it should have the full appropriation authority it needs to meet the publishing requirements. However, because these requirements are mandatory, we reserve the right to request funding to meet the cost of our publishing requirements if the Governor and the General Assembly change the amount or eliminate the estimated nature of our appropriation.

Officials from the **Office of the State Public Defender** indicated this initiative petition will not have any substantial impact on the State Public Defender System other than if revenues are significantly changed.

Officials from the **State Treasurer's office** indicated no fiscal impact to their office.

Officials from **Cole County** indicated they cannot determine the fiscal impact of this initiative.

Officials from the **City of Kansas City** indicated they are unable to estimate the fiscal impact of the initiative petition.

Officials from the **City of Raymore** indicated no fiscal impact.

Charles A. Arnold provided the following information as a proponent of this initiative petition.

Initiative Petitions 2014-127; 2014-129

Subject

Initiative petition 2014-127 and 2014-129 from Khristine Heisinger regarding a proposed statutory amendment to Chapter 149, Tobacco Excise Tax.

Date

March 17, 2014

Description

This proposal would amend Chapter 149 of the Missouri revised statutes.

The amendment is to be voted on in November 2014.

The amendment would be effective January 1, 2015

Assumptions

The petitions propose to increase the current excise tax paid on all cigarettes sold in Missouri by .015-cents per cigarette (30-cents per pack of 20 cigarettes). The petitions also impose a tax on the manufacturers invoice price, before discounts and deals, of .1025% on roll-your-own tobacco.

The average price of a pack of 20-cigarettes in Missouri is $4.30 per pack (including the current $.17 per pack cigarette excise tax)[1].

The proposed increase will result in an approximate 7% increase in the average price of a pack of 20-cigarettes sold in the state, causing a slight downward adjustment in total annual cigarette pack sales of approximately 2.8%.[2]

According to information submitted by the Missouri Department of Revenue in response to Auditors information request on note 14-099, there were 536.5 million packs of cigarettes sold in the state of Missouri during 2012.

It is assumed that wholesalers licensed by the Missouri Department of Revenue will receive the 3 percent discount established in Chapter 149, RSMo.

The proposed change in compliance standards could result in a reduction of "between 21% and 100% of the $130 million Tobacco Settlement payment" [3] that Missouri receives annually. Missouri was recently deemed non-compliant by a national arbitration panel for calendar year 2003 over an NPM Adjustment dispute. The result of that decision is an approximate $70 million reduction in the states $130 million annual tobacco settlement payment for 2014.

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[1] *"The Tax Burden on Tobacco, Vol. 46"*, Page 186.

[2] "TobaccoFreeKids.org Facts Sheet 0281", Page 1, Paragraph 2

[3] *Missouri Attorney General Chris Koster letter to Senator Kurt Schaefer*, January 9, 2013. Page 1, Paragraph 2.

Table 1- Calculation of the downward sales adjustment due to the tax increase	
Total packs sold in Missouri 2012	536,500,000
Downward adjustment due to tax increase (2.8% sales reduction)	-15,022,000
Total packs sold after downward adjustment applied	521,478,000

Table 2- Calculation of total new revenues derived from the new tax	
Total packs sold after downward adjustment applied	521,478,000
Additional excise tax per pack of 20-cigarettes (30-cents per pack)	x .30
Total new revenues (gross) derived from the additional excise tax	$ 156,443,400.00

Table 3- Calculation of adjustments to new revenues derived from the new tax	
Total new revenues (gross) derived from the additional excise tax	$ 156,443,400.00
Less: 3% tax stamping allowance per Chapter 149	-$ 4,693,302.00
Net New Revenue	$ 151,750,098.00

Summary

The additional tax proposed by initiative petitions 2014-127 and 2014-129 will generate approximately $151.8 million in net new cigarette excise tax revenue annually.

However, if tobacco settlement payment reductions due to the compliance change contemplated by these petitions are applied to future tobacco settlement payments, net new cigarette excise tax revenues could be affected periodically.

If the maximum reduction for a non-compliant determination is applied, such a reduction could result in no more than 100% of the states annual tobacco settlement payment of $130million in any given year.

Thus, the net affect on new cigarette excise tax revenues generated by these proposals in years where a tobacco settlement payment reduction is applied produces a range of between $21.8million to $151.8million in new cigarette excise tax revenues.

ATTORNEY GENERAL OF MISSOURI

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CHRIS KOSTER
ATTORNEY GENERAL

P.O. Box 899
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January 9, 2013

The Honorable Kurt Schaefer
State Senator, District 19
State Capitol, Room 221
Jefferson City, Missouri 65101

RE: Notice of Possible Revenue Reduction Due to Arbitration of 2003 Master Settlement Agreement (Tobacco Settlement) Payment Dispute

Dear Senator Schaefer:

For many years now, Governor Nixon and I have warned the General Assembly in writing about the need to enact two new pieces of legislation to close the loopholes in Missouri's Tobacco Settlement Agreement Act. One of those laws required eight years to pass (leaving Missouri unprotected during a critical period now in arbitration). The other has never been passed (making Missouri the only State in the nation to have made such a policy determination).

Today, as counsel for the State, I am alerting you to the potential consequences of inaction by your predecessors in the General Assembly. Due to Missouri's delay or failure to pass these two key pieces of legislation, there is now an even chance that Missouri will forfeit between 21% and 100% of the $130 million Tobacco Settlement payment the State previously received for calendar year 2003. To repay that obligation, any forfeiture will be automatically deducted from the $130 million (projected) Tobacco Settlement payment Missouri anticipates receiving in April 2014. The purpose of this letter is to bring this serious risk to Missouri's FY 2014 consensus revenue estimate to your attention.

In 1998, Missouri and 45 other States signed the Master Settlement Agreement (Tobacco Settlement) with several tobacco companies, known as "Participating Manufacturers." The States agreed to dismiss their pending lawsuits against the Participating Manufacturers for the healthcare costs associated with tobacco in exchange for perpetual payments from the Participating Manufacturers in excess of $6 billion per year, 2.27% of which (approximately $130 million per year) is allocated to Missouri.

As part of the Tobacco Settlement, every State agreed to enact a model escrow statute requiring Non-Participating Manufacturers—cigarette manufacturers that did not sign the Tobacco Settlement—to make annual escrow deposits roughly proportional to the Participating Manufacturers' annual Tobacco Settlement payments. The escrow statute served two purposes: it required Non-Participating Manufacturers to set aside sufficient funds to satisfy any future judgments the States might someday obtain against them, and it furthered the public health goals of the Tobacco Settlement by denying Non-Participating Manufacturers a market advantage over the Participating Manufacturers. The States further agreed to give the Participating Manufacturers a treble credit for any market share they lost to the Non-Participating Manufacturers should the States fail to "diligently enforce" their escrow statutes.

After the Tobacco Settlement was signed, Missouri and the other States identified several loopholes in the model escrow statute that made enforcement difficult. For example, more than half of the Non-Participating Manufacturers' cigarettes sold in Missouri in 2003 were manufactured by Native American tribes or foreign (offshore) companies that failed to make the necessary escrow deposits. States were unable to force tribal manufacturers to deposit the escrow they owed because Native American tribes are entitled to sovereign immunity in the nation's courts, including those in Missouri. Nor were States able to ensure the necessary deposits from offshore manufacturers due to the extraordinary difficulty in obtaining service of legal process outside the borders of the United States.

Working with the Participating Manufacturers, the States proposed a series of legislative solutions to these common enforcement problems. The first of these solutions, called "Complementary Legislation," required any Non-Participating Manufacturer selling cigarettes into the adopting State to have a registered agent in the State to receive service of process. It also allowed the adopting State to maintain a directory of Non-Participating Manufacturers that made the necessary escrow deposits and, more importantly, to ban all other Non-Participating Manufacturers from that State's markets.

Then-Attorney General Nixon first proposed Complementary Legislation to the Missouri General Assembly in 2002, and subsequently proposed the same legislation every year thereafter. Despite those persistent requests, Missouri did not enact Complementary Legislation until 2010. Missouri was the last State in the country to pass this legislation, by many years.

The second legislative solution, called "Allocable Share Release (ASR) Repeal," prevented Non-Participating Manufacturers from avoiding their full escrow obligations by concentrating their sales in only a few States. ASR Repeal was first proposed to our General Assembly by then-Attorney General Nixon in 2002 and every year thereafter until he became Governor. Since I assumed the Office of Attorney General, I too have implored the General Assembly to pass ASR Repeal in each of the last four years. Despite the persistent pleas of two Attorneys General over ten years, Missouri remains the ***only*** State in the nation not to enact ASR Repeal.

Missouri is now engaged in a nationwide arbitration between more than 20 Participating Manufacturers and 46 States to determine whether the Participating Manufacturers are entitled to treble damages for their market share loss in calendar year 2003. The attorneys in my office have worked aggressively for more than two years to prevent Missouri from having to pay any part of these damages, presenting Missouri's best defense before three federal judges empanelled to decide the arbitration. However, past General Assemblies' delay in passing Complementary Legislation and their decision not to pass ASR repeal have significantly hindered Missouri's defense and made it all but impossible for Missouri to reach a settlement with the Participating Manufacturers.

If the Missouri General Assembly had acted to pass Complementary Legislation when then-Attorney General Nixon first proposed it, Missouri would have been able to obtain service of process on foreign Non-Participating Manufacturers that, under the terms of the legislation, would have been forced to identify a registered agent within the borders of our State. Complementary Legislation would also have banned sales by Native American Non-Participating Manufacturers that failed to deposit the required escrow. Both of these enforcement issues are central to the case presently before the arbitration panel.

A number of States have negotiated a potential settlement of the Participating Manufacturers' claims for market share losses from 2003 through 2012. Unfortunately for Missouri, the passage of ASR Repeal is a necessary condition of the proposed settlement agreement. As Missouri is the only State that has refused to pass ASR Repeal, the General Assembly's policy choice effectively prevents Missouri from joining with other States to settle nine years' worth of potential losses with the Participating Manufacturers.

Furthermore, because Missouri was unable to ensure the necessary escrow deposits by foreign and tribal manufacturers in calendar year 2003 due to prior General Assemblies' decisions not to enact Complementary Legislation until 2010, and because we cannot settle the current arbitration under the proposed settlement terms in the absence of ASR Repeal, the Participating Manufacturers' claim against Missouri to recoup part or all of their 2003 Tobacco Settlement payment ***will*** go to verdict sometime next fall.

The Office of Attorney General advised your predecessors every year for the last decade that their legislative inaction could eventually harm the State. While we hope our legal defenses will be successful, we estimate an even chance that the arbitration panel will find Missouri did not "diligently enforce" its escrow statute in 2003 because the State lacked the enforcement tools that Complementary Legislation would have provided. If the panel rules against Missouri, this State will forfeit between 21% and 100% of the $130 million Tobacco Settlement payment the State previously received for calendar year 2003. That forfeiture will be deducted from the $130 million (projected) payment Missouri anticipates receiving in April 2014. As counsel for the State, I am therefore formally putting this General Assembly on notice of that possibility and advising you to budget accordingly.

Respectfully,

Chris Koster

CHRIS KOSTER
Attorney General

cc: Mike Price, House Appropriations
Adam Koenigsfeld, Senate Appropriations

STATE CIGARETTE TAX INCREASES: EXPLANATIONS AND SOURCES FOR PROJECTIONS OF NEW REVENUES & BENEFITS

The economic model developed jointly by the Campaign for Tobacco-Free Kids (TFK) and the American Cancer Society Cancer Action Network (ACS CAN) projects the increase in state revenues, public health benefits, and health care cost savings resulting from increases in state cigarette tax rates. The projections are based on economic modeling by Frank Chaloupka, Ph.D., and John Tauras, Ph.D., at the Institute for Health Research and Policy at the University of Illinois at Chicago and are updated annually.

The projections indicate that cigarette tax increases boost state cigarette tax revenues and reduce smoking. When cigarette tax rates are increased by significant amounts, the higher amount of tax collected per pack generates more new revenue than is lost from the decline in pack sales caused by a decline in consumption or increased smoker tax avoidance prompted by the price increase. The projections are based, in part, on research findings that a 10 percent cigarette price increase, if maintained against inflation, reduces youth smoking rates by 6.5 percent or more, adult smoking prevalence by 2 percent, and total consumption by 4 percent.[1 2 3]

The projections are fiscally conservative because they include generous adjustments for lost state pack sales and the corresponding loss of state revenue caused by tax avoidance and tax evasion. For the purposes of our modeling, tax avoidance includes informal smuggling by individual smokers, such as obtaining lower-taxed or untaxed cigarettes either legally or illegally across state lines, from multistate internet sellers, from tribal vendors not subject to state taxes, or from other sources. Tax evasion refers to organized criminal smuggling activity.[4] Despite such practices, cigarette tax increases generate new revenue and reduce smoking rates, which, in turn, reduce smoking-caused disease, deaths, and related economic costs.

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[1] Chaloupka, FJ, "Macro-Social Influences: The Effects of Prices and Tobacco Control Policies on the Demand for Tobacco Products," *Nicotine & Tobacco Research*, 1999, and other price studies at http://tigger.uic.edu/~fjc.

[2] Tauras, J, et al., "Effects of Price and Access Laws on Teenage Smoking Initiation: A National Longitudinal Analysis," Bridging the Gap Research, ImpacTeen, April 24, 2001, and other price studies at http://www.impacteen.org.

[3] Chaloupka, FJ & Pacula, R, "The Impact of Price on Youth Tobacco Use," Chapter 12 in National Cancer Institute, Smoking and Tobacco Control Monograph 14, *Changing Adolescent Smoking Prevalence*, November 2001; International Agency for Research on Cancer (IARC), *Effectiveness of Tax and Price Policies for Tobacco Control*, IARC Handbooks of Cancer Prevention in Tobacco Control, Volume 14, 2011.

[4] Farrelly, M, et al., "Cigarette Smuggling Revisited," U.S. Centers for Disease Control & Prevention (CDC), in press, and Farrelly, M, et al., *State Cigarette Excise Taxes: Implications for Revenue and Tax Evasion*, RTI International, 2003, http://www.rti.org/pubs/8742_Excise_Taxes_FR_5-03.pdf.

Econometric studies indicate that cigarettes and other tobacco products are substitutes for one another, meaning if cigarette taxes/prices are increased while other tobacco product taxes/prices remain unchanged, some of the reductions in cigarette smoking would be offset by increases in the use of other tobacco products.[5] Equalizing the tax rates on other tobacco product taxes would reduce this potential substitution, as well as reduce the use of other tobacco products, while at the same time generate additional revenue.

These projections incorporate the impact of annual background declines of 2 percent on adult and future youth smoking prevalence and 2.5 percent on pack sales, as well as changing pack prices. The background decline is the annual reduction in cigarette use that would be expected to occur without any changes in the tax rate due to other tobacco control policies, changing social norms, and a changing tobacco product landscape. It is calculated based on trends in recent years and current activity. Smoking and pack sale declines in any particular state will vary depending on its existing smoking rates, pack prices, and other tobacco prevention, cessation, and industry activities. To be even more conservative, the projected amounts have also been rounded down.

Despite all of these adjustments to avoid over-estimates, the projections still show that measurable state cigarette tax increases will both significantly reduce smoking levels and substantially increase state revenues. The increased tax per pack will still bring in more new state revenue than is lost from the decrease in the number of packs sold caused by consumption declines, tax avoidance, and smuggling resulting from the tax increase. In those states that apply their sales tax percentage to the total retail price of a pack of cigarettes (including the state cigarette tax amount), a cigarette tax increase will raise state sales tax revenues per pack, which will offset sales tax revenue losses from fewer packs being sold. In addition, smokers who quit or cut back will likely spend the money they previously spent on cigarettes largely on other goods on which sales tax is collected, which further increases state sales tax revenues.

These projections assume that the tax increase is fully passed on to the consumer in higher prices, and keeps up with inflation over time, which is consistent with economic research on the impact of cigarette taxes on cigarette prices.[6] [7] [8] If a tax increase is not fully passed on in the form of higher prices, but is instead partially absorbed by the industry, then the reductions in smoking and its consequences in response to the tax increase will be smaller, while the revenues generated from the tax increase will be larger. Alternatively, if cigarette companies use the tax increase as an opportunity to raise net-of-tax prices and the tax increase is more than passed on, then the reductions in smoking and its consequences will be larger, while the increase in revenues will be smaller.

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[5] Chaloupka, FJ & Warner, KE, "The Economics of Smoking," in Culyer, AJ & Newhouse, JP, eds., *Handbook of Health Economics*, Amsterdam: North-Holland, 2000.
[6] U.S. Department of Health and Human Services (HHS), *Reducing Tobacco Use: A Report of the Surgeon General*, Atlanta: HHS, CDC, National Center for Chronic Disease Prevention & Health Promotion, Office on Smoking and Health, 2000.
[7] Chaloupka, et al., 2000.
[8] HHS, *Preventing Tobacco Use Among Youth and Young Adults: A Report of the Surgeon General,* Atlanta: HHS, CDC, National Center for Chronic Disease Prevention & Health Promotion, Office on Smoking and Health, 2012.

The starting price per pack (before the proposed cigarette tax increase) used in these projections includes all federal and state excise and sales taxes and, where applicable, local taxes (i.e., New York City's $1.50 per pack tax is factored into the overall New York State price per pack). The prices are based on data from *The Tax Burden on Tobacco*, 2012,[9] reports of state cigarette tax increases, media reports on tobacco company price changes, the USDA Economic Research Service, the U.S. Bureau of Labor Statistics (for inflation adjustments), and the U.S. Federal Trade Commission's *Cigarette Report for 2011*[10] (to adjust prices for retailer-based discounts, promotions, and coupons). The projections assume that the state will follow standard practice and apply the cigarette tax increase to all previously tax-stamped or otherwise tax-paid cigarettes held in inventory by wholesalers or retailers on the effective date of the increase. Failing to tax such cigarettes held in inventory would open the door to massive pre-increase stockpiling by retailers and wholesalers to evade the increase, delaying and reducing the amount of new state revenues.

The projected adult and youth smoking and smoking-harmed birth declines, and related mortality reductions are calculated by applying the above findings regarding the effects of tax and price increases to the number of current adult smokers in each state and to estimates of the number of youth (under 18 years old) alive today in each state who will become adult smokers and the number projected to die from smoking.[11] [12] [13] [14]

The projected five-year savings from fewer smoking-caused heart attacks and strokes, fewer smoking-affected pregnancies and related birth complications, and fewer lung cancer cases show just some of the many substantial savings from the smoking reductions prompted by a tax increase that begin to accrue immediately. The projected five-year lung cancer cost savings as a result of adult smokers quitting due to the tax increase takes into account the relative risk of developing lung cancer among quitters and the number of lung cancer deaths attributable to smoking.[15] [16] These savings will increase steadily in subsequent years. The projected five-year smoking-affected pregnancy and birth savings accrue from declines in smoking among pregnant women and corresponding reductions in smoking-caused birth

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[9] Orzechowski and Walker, *The Tax Burden on Tobacco, 2012*, 47, Arlington, VA: Orzechowski and Walker, 2013.

[10] Federal Trade Commission, *Federal Trade Commission Cigarette Report for 2011*, May 2013. Available at http://www.ftc.gov/reports/federal-trade-commission-cigarette-report-2011.

[11] CDC, "Smoking During Pregnancy—United States, 1990-2002," *Morbidity and Mortality Weekly Report (MMWR)* 53(39):911-915, October 8, 2004, http://www.cdc.gov/mmwr/PDF/wk/mm5339.pdf.

[12] CDC, "Annual Smoking-Attributable Mortality, Years of Potential Life Lost, and Economic Costs—United States 1995-1999," *MMWR* 51(14):300-03, April 11, 2002, www.cdc.gov/mmwr/preview/mmwrhtml/mm5114a2.htm.

[13] CDC, "Annual Smoking-Attributable Mortality, Years of Potential Life Lost, and Economic Costs—United States 2000-2004," *MMWR* 57(45):1226-1228, November 14, 2008, http://www.cdc.gov/mmwr/preview/mmwrhtml/mm5745a3.htm.

[14] CDC, "Projected Smoking-Related Deaths Among Youth—United States," *MMWR* 45(44):971-974, November 11, 1996, http://www.cdc.gov/mmwr/preview/mmwrhtml/00044348.htm, for data on relative death risks of smokers, nonsmokers, and former smokers.

[15] Chang, S, et al., "Estimating the cost of cancer: results on the basis of claims data analyses for cancer patients diagnosed with seven types of cancer during 1999 to 2000," *Journal of Clinical Oncology* 22(17):3524-30, September 2004.

[16] Khuder, SA & Mutgi, AB, "Effect of smoking cessation on major histologic types of lung cancer," *Chest* 120(5):1577-83, November 2001.

complications and related health care costs for the children in their first year or life.[17] The five-year heart attack and stroke savings projections show the estimated reductions in smoking-caused health care expenditures from reduced smoking-caused heart attacks within the first five years after the tax increase.[18 19]

Because of research and data limitations, it is not yet possible to estimate total health care cost savings in each year following a cigarette tax increase, or even to provide reasonable estimates of the total health care savings over the first five or ten years. Since many smoking-related diseases take years to develop, smoking-caused health care cost savings from a cigarette tax increase will be relatively small in the first year after an increase; however, they grow quickly. The projected long-term total health care cost savings from reducing the number of future youth and current adult smokers accrue over the lifetimes of youth (under 18 years old) alive in the state today who quit or don't start because of the tax increase and over the lifetimes of current adult smokers who quit because of the tax increase. Smokers' lifetime health care costs average at least $17,500 higher than nonsmokers (in 2004 dollars), despite shorter life spans. However, the savings per adult quitter are less than that amount (at least $9,500 in 2004 dollars) because adult smokers have already been significantly harmed by their smoking and have already incurred or locked-in extra future smoking-caused health costs.[20 21 22 23]

The five-year savings to the state Medicaid program are estimated based on the number of adult Medicaid recipients expected to quit due to the tax increase and the costs averted per quitting Medicaid recipient.[24] Estimates for adults enrolled in state Medicaid programs include the additional expected enrollment in states that expanded their Medicaid eligibility as part of the Affordable Care Act[25] and adults who were previously eligible under existing rules and are expected to enroll in 2014,

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[17] Miller, D, et al., "Birth and First-Year Costs for Mothers and Infants Attributable to Maternal Smoking," *Nicotine & Tobacco Research* 3:25-35, 2001; and state pregnancy-smoking and birth data.

[18] Lightwood & Glantz, "Short-Term Economic and Health Benefits of Smoking Cessation – Myocardial Infarction and Stroke," *Circulation* 96(4), August 19, 1997.

[19] Kabir, et al., "Coronary Heart Disease Deaths and Decreased Smoking Prevalence in Massachusetts, 1993-2003," *American Journal of Public Health* 98(8):1468-69, August 2008.

[20] Hodgson, TA, "Cigarette Smoking and Lifetime Medical Expenditures," *The Milbank Quarterly* 70(1), 1992. CDC, "Projected Smoking-Related Deaths Among Youth—United States," *MMWR* 45(44):971-974, November 8, 1996, http://www.cdc.gov/mmwr/preview/mmwrhtml/00044348.htm.

[21] Nusselder, W, et al., "Smoking and the Compression of Morbidity," E*pidemiology & Community Health*, 2000.

[22] Warner, K, et al., "Medical Costs of Smoking in the United States: Estimates, Their Validity, and Their Implications," *Tobacco Control* 8(3):290-300, Autumn 1999, http://tc.bmjjournals.com/content/vol8/issue3/index.shtml.

[23] CDC, "Annual Smoking-Attributable Mortality, Years of Potential Life Lost, and Economic Costs—United States 2000-2004," *MMWR* 57(45):1226-1228, November 14, 2008, http://www.cdc.gov/mmwr/preview/mmwrhtml/mm5745a3.htm.

[24] Miller, LS, et al., "State estimates of Medicaid expenditures attributable to cigarette smoking, fiscal year 1993," *Public Health Reports* 113(2):140-51, 1998.

[25] States considered to have expanded their Medicaid eligibility are those noted to be "Implementing expansion in 2014," according to: Kaiser Family Foundation, "Status of State Action on the Medicaid Expansion Decision, 2014." January 28, 2014. Available at http://kff.org/health-reform/state-indicator/state-activity-around-expanding-medicaid-under-the-affordable-care-act/.

2015, and 2016. The projected Medicaid cost savings are calculated using per capita adult Medicaid spending data[26] and separately take into account the costs of newly-eligible adult Medicaid enrollees, previously-eligible but newly-enrolled adult Medicaid beneficiaries, adult Medicaid beneficiaries enrolled before 2014, as well as future projected cost increases. Additional data and cost analyses were provided through correspondence by Matthew Buettgens, Ph.D., and Hanna Recht at the Urban Institute.[27] The proportion of the state Medicaid program's projected cost savings that would accrue to the state government are calculated based on the state's Federal Medical Assistance Percentage (FMAP), calculated separately for newly-eligible and previously-eligible enrollees. Only the projected cost savings that would accrue to the state government are reported.

All projected savings have been adjusted to 2014 dollars, using the Consumer Price Index for Medical Care (MCPI). Forecasted costs are estimated using the average of the difference between annual medical inflation and annual inflation that occurred between the years 2007 and 2012. These projections do not include a range of additional short and long-term savings from other declines in smoking-caused health problems and other smoking-caused costs.[28]

Projections for cigarette tax increases much higher than $1.00 per pack are limited, especially for states with relatively low current tax rates, because of the lack of research on the effects of larger cigarette tax increase amounts on consumption and prevalence. Projections for cigarette tax increases much lower than $1.00 per pack are also limited because small tax increases are unlikely to produce significant public health benefits.

February 17, 2014

Projections change when new data or research findings become available and the underlying data and methodologies are updated or revised.

Please direct questions to:

Campaign for Tobacco-Free Kids: Ann Boonn, aboonn@tobaccofreekids.org
American Cancer Society Cancer Action Network: Melissa Maitin-Shepard, Melissa.Maitin-Shepard@cancer.org

Campaign for Tobacco-Free Kids' resources on state tobacco tax increases:
http://www.tobaccofreekids.org/what_we_do/state_local/taxes/
http://www.tobaccofreekids.org/facts_issues/fact_sheets/policies/tax/us_state_local/

American Cancer Society Cancer Action Network's resources on tobacco taxes:
http://acscan.org/tobacco/taxes

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[26] Projected current and future costs are extrapolated from FY 2010 per capita Medicaid spending estimates from the Kaiser Family Foundation. State Health Facts. Available at http://kff.org/medicaid/state-indicator/medicaid-payments-per-enrollee/.

[27] Buettgens, M, et al., *Eligibility for Assistance and Projected Changes in Coverage Under the ACA: Variation Across States*, October 2013, http://www.urban.org/publications/412918.html.

[28] See, e.g., U.S. Department of the Treasury, *The Economic Costs of Smoking in the U.S. and the Benefits of Comprehensive Tobacco Legislation*, 1998.

The State Auditor's office did not receive a response from the **Department of Higher Education,** the **Department of Public Safety,** the **Department of Transportation,** the **Missouri Senate, Adair County, Boone County, Callaway County, Cass County, Clay County, Greene County, Jackson County Legislators, Jasper County, St. Charles County, St. Louis County, Taney County,** the **City of Cape Girardeau,** the **City of Columbia,** the **City of Jefferson,** the **City of Joplin,** the **City of Kirksville,** the **City of Kirkwood,** the **City of Mexico,** the **City of St. Joseph,** the **City of St. Louis,** the **City of Springfield,** the **City of Union,** the **City of Wentzville,** the **City of West Plains, Cape Girardeau 63 School District, Hannibal 60 School District, Rockwood R-VI School District, Linn State Technical College, Metropolitan Community College, University of Missouri,** and **St. Louis Community College**.

Fiscal Note Summary

State government revenue will increase by approximately $150 million annually from the tax changes in this proposal. State government revenue from the Master Settlement Agreement may decrease by an unknown amount annually up to approximately $135 million depending on dispute and litigation outcomes. The potential fiscal impact to local governments is unknown.