

## Board of Equalization

### Its Implementation of the Cigarette and Tobacco Products Licensing Act of 2003 Has Helped Stem the Decline in Cigarette Tax Revenues, but It Should Update Its Estimate of Cigarette Tax Evasion

REPORT NUMBER 2005-034, JUNE 2006

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

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

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

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

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

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

#### **Audit Highlights . . .**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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