

SENATE STAFF ANALYSIS AND ECONOMIC IMPACT STATEMENT

(This document is based only on the provisions contained in the legislation as of the latest date listed below.)

BILL: CS/CS/SB 1998

SPONSOR: Fiscal Resource Committee; Governmental Oversight and Productivity Committee and Senator Horne

SUBJECT: Participating Manufacturers

DATE: April 26, 2000 REVISED: _____

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	<u>Rhea</u>	<u>Wilson</u>	<u>GO</u>	<u>Favorable/CS</u>
2.	_____	<u>Wilson</u>	<u>HC</u>	<u>WD</u>
3.	<u>Fournier</u>	<u>Wood</u>	<u>FR</u>	<u>Favorable/CS</u>
4.	_____	_____	_____	_____
5.	_____	_____	_____	_____

I. Summary:

The committee substitute establishes mechanisms for ensuring that cigarette companies contribute on a fair and equal basis to mitigating the harmful effects of cigarette smoking on citizens and for securing the long-term benefits of the Lawton Chiles Endowment. It authorizes tobacco manufacturers to participate voluntarily in mitigating the impact of the use of tobacco on Floridians. Manufacturers participate by becoming a “participating manufacturer” under the act. The committee substitute provides a statutory cap of 85 percent on the annual appropriations to be made of funds received from participating tobacco companies and the surtax. The unappropriated balance of the annual tobacco revenue stream is to be deposited in the Lawton Chiles Endowment. The committee substitute amends the schedule of annual appropriations to the Lawton Chiles Endowment Fund by establishing a minimum level of \$25 million for appropriations to the fund in all fiscal years subsequent to 2003-2004. The committee substitute creates an additional surtax on cigarettes beginning February 1, 2001, that will apply to cigarettes shipped into Florida by manufacturers other than those able to claim the tax exemption as a participating manufacturer. The committee substitute provides the formula for calculation of the surtax and the payments to received from new participating manufacturers. The committee substitutes creates the Tobacco Settlement financing corporation for the purpose of developing a plan to securitize the state’s tobacco income or insure against its loss.

This committee substitute amends sections 215.5601, 210.02, 210.20, and creates section 215.5603, Florida Statutes.

II. Present Situation:

The State of Florida commenced legal action against a number of tobacco manufacturers and other defendants in February of 1995, asserting various claims for monetary and injunctive relief on behalf of the state . The state entered into a settlement agreement on August 25, 1997, with Phillip Morris, Reynolds Tobacco, B & W American Brands, and Lorillard. This settlement

agreement was subsequently amended.¹ These four cigarette producers hold an estimated market share of 93 percent in the United States. The remaining percentage is shared by smaller producers who were not named in the state's suit as defendants and, as a result, were not parties to the settlement.

Under the agreement as amended, apart from other first year payments, Florida is to receive 5.5 percent of the following unadjusted amounts, in perpetuity:

Year	1999	2000	2001	2002	2003	Thereafter
Dollar Amount	\$4.5 Billion	\$5 Billion	\$6.5 Billion	\$6.5 Billion	\$8 Billion	\$8 Billion

Currently, most of the tobacco proceeds are used to support the Lawton Chiles Endowment Fund, which was created by the Legislature in 1999. The fund is administered by the State Board of Administration. Portions of the non-recurring moneys received pursuant to the settlement are required to be deposited into this fund, and monies are disbursed to tobacco funds in various departments depending on appropriations made by law. The State Board of Administration invests monies in the endowment in order to maximize the rate of return earned by the State.² Funds from the endowment are not available for disbursement to state agencies until after July 1, 2000.

After Florida's settlement, Phillip Morris, Reynolds Tobacco, B & W American Brands, and Lorillard, settled lawsuits with Texas, Mississippi, and Minnesota. These corporations, as well as the other smaller producers, have settled with the remaining states in what has been termed the "Master Settlement Agreement" (MSA). The unadjusted cost of the state settlements ranges between \$212 billion to \$246 billion over the next 25 years. The range is broad because these amounts are subject to numerous adjustments, from inflation to fluctuations in cigarette consumption and market share. As a result, the amount may increase due to inflation but may decrease if cigarette consumption decreases markedly. Other factors that may affect cigarette consumption includes general population growth, cigarette price increases, changes in disposable income, youth consumption, health warnings, smoking bans in public places, nicotine dependence, advertising restrictions, and smoking trends over time.³

What the tobacco companies and the settling state governments cannot factor at this time is the estimated cost of dozens of individual suits and one certified class action (*Engle v. R..J. Reynolds, et.al.*, in Dade County, Florida). While the tobacco settlement payments are to be made in perpetuity, it is possible that the tobacco companies may someday declare bankruptcy and default on their obligations.

¹Florida negotiated a "Most Favored Nations" clause in the settlement which provided the state with additional monies for a period of time after Minnesota settled with the defendants on terms more favorable than Florida's.

²Section 215.5601, F.S.

³According to a report prepared by WEFA, Inc., an international econometric and consulting firm, on behalf of the Westchester Tobacco Asset Securitization Corporation, dated December 15, 1999, adult consumption of cigarettes declined 0.65% annually for the period 1965 to 1981, 3.31% for the period 1981 to 1990, and 2.47% for the period 1991 to 1998. According to these trends, consumption could decline from the roughly 539 million cigarettes consumed in 1990 to under 200 million cigarettes for the year 2040.

In a story dated March 26, 2000, the Associated Press reported that the National Association of Attorneys General retained a Los Angeles bankruptcy law firm to insure states receive a combined \$246 billion in tobacco settlements. According to the story, the nation's five biggest cigarette makers owe about \$10 billion this year, and also face a potentially record-setting punitive damages award in *Engle*. The tobacco industry fears an estimated 500,000 sick Florida smokers may be awarded \$300 billion.

According to Salomon Smith Barney, tobacco industry credit fundamentals make bankruptcy of a major manufacturer unlikely due to the significant domestic demand, the profitability of the industry, and the ability of the industry to pass additional costs to consumers in the form of higher prices.⁴ In a series of scenarios presented by WEFA included within the Salomon Smith Barney materials projected an industry settlement three times the size of the MSA (approximately \$700 billion) resulting in a cigarette price increase of more than 50 percent causing a consumption decline of more than 14 percent. WEFA concluded that even in those "extreme and unlikely conditions" consumption is still projected to generate sufficient tobacco settlement revenues to meet the planned principal amortization schedule. While it appears that the industry could survive payments that are amortized and made over time, it is unknown how the industry would react to a \$300 billion jury award that was upheld on appeal and immediately payable.

Section 210.02, F.S., provides for a tax on cigarettes. On the most common size package (20 cigarettes), the cost is 33.9 cents per package. The tax is paid by the wholesale dealer to the Division of Alcoholic Beverages and Tobacco upon the first sale or transaction within the state, whether or not such sale or transfer is to the ultimate purchaser or consumer. Stamps representing various denominations of tax are purchased in bulk by wholesale dealers and affixed to packages as proof of payment. Cigarettes that are not properly stamped may not be sold in Florida. The amount of the tax then becomes a part of the price of the cigarettes to be paid by the purchaser or consumer. Section 210.20, F.S., provides that the Division of Alcoholic Beverages and Tobacco collections from cigarette taxes be deposited into the "Cigarette Tax Collection Trust Fund," and allocated as provided by law.

III. Effect of Proposed Changes:

The committee substitute amends s. 215.5601, F.S., the Lawton Chiles Endowment Fund, to include a definition of the term "participating manufacturer," which is:

any manufacturer of tobacco products which meets the requirements of subsection (4).

Subsection (4) provides how a manufacturer of tobacco products may become a participating manufacturer. Under the subsection, a manufacturer must enter into an agreement with the Attorney General that provides for:

- Elimination of the manufacturer's outdoor advertising and transit advertisements at the earlier of the expiration of applicable contracts or 4 months after the date the final list of outdoor advertising signs is supplied to the Attorney General. The manufacturer must provide a final

⁴Opinions in Tobacco Settlement Securitization, dated February 29, 2000, page 19.

list of all its outdoor advertising signs and transit advertisements to the Attorney General within 45 days after entering the agreement.

- Support of the state's efforts to mitigate the impact of the use of tobacco through annual payments to the state. On January 1 of each year, the Division of Alcoholic Beverages and Tobacco of the Department of Business and Professional Regulation shall calculate the payment amount which is due by January 31 of that year. The payment amount must be based on the number of cigarette packages delivered to wholesale dealers for sale in Florida by the manufacturer from January 1 until December 31 of the prior year. The payment amount per package must be calculated as the total annual payment due to the state pursuant to the settlement agreement divided by the total number of packages delivered to wholesale dealers for sale in the previous 12 months, rounded to the nearest tenth of a cent.

Cigarettes produced by each manufacturer that fully complies with the agreement entered into with the Attorney General under subparagraph 1. and who makes the annual payment by January 31 are exempt from the surtax on cigarettes imposed under s. 210.02(6), F.S., for the subsequent 12-month period.

The committee substitute provides that all tobacco manufacturers that are signatories to the settlement agreement entered on August 25, 1997, in the case of *The State of Florida et. al. v. American Tobacco Company, et. al.*, and the settlement agreement entered on March 15, 1996, in the case of *State of West Virginia, State of Florida, State of Mississippi, Commonwealth of Massachusetts, and State of Louisiana v. Brooke Group Ltd. And Liggett Group, Inc.*, are participating manufacturers. Cigarettes produced by each such manufacturer that fully complies with the applicable settlement agreement and makes the annual payment required under the agreement by December 31 are exempt from the surtax on cigarettes imposed under s. 210.02(6) for the subsequent 12-month period.

The committee substitute provides that funds received from participating manufacturers will be deposited into the Department of Banking and Finance Tobacco Settlement Clearing Trust Fund.

The committee substitute provides that the Legislature may not appropriate more than 85 percent of the revenue that is received from participating manufacturers or pursuant to s. 210.02, F.S., in any fiscal year and made available for appropriation in the subsequent fiscal year. Revenue received from participating manufacturers or pursuant to s. 210.02, F.S., in any fiscal year which is not appropriated by the Legislature must be deposited into the Lawton Chiles Endowment Fund.

The committee substitute amends subsection (8) of the section to provide that for all fiscal years subsequent to fiscal year 2002-2003, a minimum of \$25 million is appropriated from the Department of Banking and Finance Tobacco Settlement Clearing Trust Fund to the Lawton Chiles Endowment Fund for Health and Human Services.

The committee substitute amends s. 210.02, F.S., to provide that, beginning February 1, 2001, for cigarettes not manufactured by a participating manufacturer as defined in s. 215.5601, F.S., an additional surtax will be added to the amounts otherwise provided in the section. The division is required to calculate the surtax on January 1 of each year, and the surtax must apply on February 1. The per package surtax is calculated in the same manner as the amount that otherwise would be

paid directly to the state by a participating manufacturer (per package rate based on the total annual payment due to the state pursuant to the settlement agreement in the case of *The State of Florida et. al. v. American Tobacco Company et. al.*, divided by the total number of packages of cigarettes delivered to wholesale dealers for sale in Florida by the four settling manufacturers during the previous 12 months, rounded to the nearest tenth of a cent).

The committee substitute requires the division to certify to the Comptroller, month to month, the amount derived from the cigarette surtax imposed by s. 210.02(6), F.S., and that amount must be transferred from the Cigarette Tax Collection Trust Fund and credited to the Department of Banking and Finance Tobacco Settlement Clearing Trust Fund.

The committee substitute creates the Tobacco Settlement Financing Corporation. Its board of directors includes the Governor, Treasurer, Comptroller, and Attorney General, or their respective designees, and two directors appointed from the Senate by the President of the Senate, and two from the House of Representatives appointed by the Speaker of the House. It authorizes the board of directors to plan a purchase of insurance to insure the state, for seven years, against the loss of 50 percent of the revenues to be paid to the state pursuant to the tobacco settlement agreement. The total premium may not exceed \$200,000,000, and the purchase is subject to approval by the legislature. The decision to begin such a plan must be approved by six members of the board. It also authorizes the board of directors to develop a plan to enter into an agreement to purchase part of the state's tobacco settlement income, and, subject to approval by the legislature, to purchase part of the state's tobacco settlement income. the decision to develop the plan must be approved by six members of the board. Also subject to approval by the legislature, the board of directors may issue bonds payable from and secured by tobacco settlement payments. The total principal amount of bonds issued by the corporation shall not exceed \$3.0 billion, and the amount issued in any one year may not exceed \$1.5 billion. The term of the bonds may not exceed 40 years and the rate of interest on such bonds may not exceed 10 percent. The corporation shall administer the sale of bonds if approval is granted by the legislature.

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

None.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

D. Other Constitutional Issues:

The Commerce Clause, contained in Article I, section 8 of the United States Constitution, provides that “[t]he Congress shall have Power...[t]o regulate Commerce...among the several

States.” Though phrased as a grant of regulatory power to Congress, the clause has long been understood to have a “negative” or “dormant” aspect that denies the states the power unjustifiably to discriminate against or burden the interstate flow of articles of commerce.⁵ In its negative aspect, the Commerce Clause prohibits economic protectionism, that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors.⁶

In evaluating state regulatory measures under the dormant Commerce Clause, the first step is to determine whether it regulates evenhandedly with only incidental effects on interstate commerce, or whether it discriminates against interstate commerce.⁷ The U. S. Supreme Court has ruled the term “discrimination” in this context simply means differential treatment of in-state and out-of-state economic interests that benefit the former and burden the latter.⁸ Nondiscriminatory regulations that have only incidental effects on interstate commerce are valid unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits.⁹

Arguably, the bill’s proposed tax on wholesalers is not facially discriminatory as it applies to all Florida wholesalers of cigarettes, not just wholesalers who distribute the cigarettes of certain manufacturers. Additionally, the tax applies evenly to all Florida wholesalers regardless of whether the cigarette manufacturer whose cigarettes they are distributing are located in Florida or outside Florida. This is similar to the regulation in *Pike* which was interpreted to be facially nondiscriminatory because it provided that all cantaloupes grown in Arizona and offered for sale must “be packed in regular compact arrangement in closed standard containers approved by the supervisor...”

Assuming the bill’s tax is facially nondiscriminatory, the test under the Commerce Clause, as stated in *Pike*, becomes one of degree. The extent of the burden on interstate commerce that will be tolerated will depend on the nature of the local interest involved and on whether it could be promoted with a lesser impact on interstate activities. A state interest protected by the bill’s tax is the mitigation of the impact of tobacco use on the citizens of the state. This is arguably a legitimate and compelling state interest which could, pursuant to the *Pike* test, justify the bill’s incidental consequence of affecting the allocation of a cigarette manufacturer’s interstate resources resulting from the proposed tax scheme.

If a court is to determine that the bill’s tax scheme is facially discriminatory because it only provides an exemption from the tax for those cigarettes manufactured by the manufacturers that are part of the state’s settlement agreement, then it would be deemed *per se* invalid and

⁵See *Oregon Waste Systems, Inc. v. Department of Environmental Quality of Ore.*, 511 U.S. 93, 114 S.Ct. 1345, 128 L.Ed.2d 13 (1994).

⁶See *Fulton Corp. v. Faulkner*, 516 U.S. 325, 116 S.Ct. 848, 133 L.Ed.2d 796 (1996).

⁷*Oregon Waste, supra.*

⁸*Id.*

⁹See *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 90 S.Ct. 844, 25 L.Ed.2d 174 (1970).

will only withstand constitutional muster if it is truly a “compensatory tax” designed simply to make interstate commerce bear a burden already borne by intrastate commerce.¹⁰ Three conditions must be met for a compensatory tax to be valid: (1) a state must identify the intrastate tax burden for which the state is attempting to compensate; (2) the tax must be shown roughly to approximate, but not exceed, the amount of the tax on intrastate commerce; and (3) the events on which the interstate and intrastate taxes are imposed must be substantially equivalent.¹¹

Arguably, the bill’s tax scheme meets the *Fulton Corp.* test. First, the identifiable burden the tax is compensating is the state payment for the impact of cigarette smoking on the citizens. Second, the tax imposed on wholesalers who distribute cigarettes manufactured by entities that are not participating manufacturers under the bill approximates the amount of the payments received from the participating manufacturers (i.e. the equivalent of the tax on intrastate commerce.) Third, the events on which the tax and the settlement payments are imposed are equivalent as the critical trigger is the sale of cigarettes---the settlement payments are based upon the amount of the manufacturers’ domestic cigarettes sold in Florida and the bill’s tax and payments to be received from other participating manufacturers are also based on the sale of cigarettes in Florida. Due to the fact it has been established that the settling cigarette manufacturers are “passing through” the costs of the settlement payments to the consumer, and the amount of that “pass through” can be closely approximated, the bill’s tax is the “substantial equivalent” since its proceeds will be applied to the same items as the settlement payments.

V. Economic Impact and Fiscal Note:

A. Tax/Fee Issues:

The bill imposes a surtax on cigarettes not manufactured by a participating manufacturer.

B. Private Sector Impact:

The impact is indeterminate. The committee substitute creates an additional surtax on cigarettes that will apply to cigarettes shipped into Florida by manufacturers other than those able to claim the tax exemption as a participating manufacturer. As a result, other manufacturers will either pay as a participating manufacturer or pay the surtax.

The sale of bonds would create opportunities for businesses involved in the issuance of such bonds.

¹⁰*Fulton Corp., supra.*

¹¹*Id.*

C. Government Sector Impact:

The fiscal impact of this committee substitute is indeterminate. The committee substitute, however, would be expected to result in the collection of additional revenues.

The decision to purchase insurance on or securitize the tobacco settlement will affect the state's revenue from this source. It is not possible to know the impact of such actions *ex ante*, but it is likely that the state would lose some income in exchange for reduced uncertainty about the income stream.

VI. Technical Deficiencies:

None.

VII. Related Issues:

None.

VIII. Amendments:

None.

This Senate staff analysis does not reflect the intent or official position of the bill's sponsor or the Florida Senate.
