Proposition 56 Tobacco Tax

State Agencies' Weak Administration Reduced Revenue by Millions of Dollars and Led to the Improper Use and Inadequate Disclosure of Funds

January 2021

REPORT 2019-046

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Elaine M. Howle *State Auditor*

January 5, 2021
2019-046

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As required by Revenue and Taxation Code sections 30130.56 and 30130.57, my office conducted an audit of the calculation, distribution, and administration of Proposition 56 tobacco tax funds, and the following report details our audit's findings and conclusions. In general, we determined that the California Department of Tax and Fee Administration (CDTFA) used inaccurate data to calculate the tax; that some state agencies should implement stronger safeguards to ensure that they spend Proposition 56 funds in accordance with the law's requirements; and that many state agencies did not properly disclose to the public their use of the funds.

Voters passed Proposition 56 in 2016, increasing the tax on tobacco products and generating more than a billion dollars per year in tax revenue for various health, education, and enforcement programs. However, CDTFA used arbitrary and inaccurate data when calculating the tax rate on certain tobacco products. These inaccuracies reduced the tax revenue designated for programs to reduce tobacco use and improve the health of Californians by more than $6 million in fiscal year 2018–19 alone.

Furthermore, certain state agencies did not implement adequate safeguards to ensure that they properly awarded and monitored the use of Proposition 56 funds. Without these safeguards, some agencies failed to apply Proposition 56 funds for their intended purposes. For example, the Department of Health Care Services (Health Care Services) receives Proposition 56 funds for its Physicians and Dentists Loan Repayment Act Program. One of this program's priorities is to reduce geographic shortages of health care providers. However, Health Care Services awarded tens of millions of dollars to physicians and dentists located in areas of the State that do not have such provider shortages. Many state agencies also failed to publish the amounts of Proposition 56 funds they received and spent, as Proposition 56 requires, which limits the public's ability to monitor agencies' spending of these funds.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE, CPA
California State Auditor

Selected Abbreviations Used in This Report

CBAS	Community-Based Adult Services
CDA	California Department of Aging
CDTFA	California Department of Tax and Fee Administration
TEROC	Tobacco Education and Research Oversight Committee
TUPE	Tobacco-Use Prevention Education

Contents

Summary

Results in Brief

Cigarette smoking remains the leading cause of preventable death and disability in the United States. Tobacco-related deaths account for 15 percent of all deaths in California, and the State spends $3.5 billion annually on tobacco-related health care. In 2016 voters chose to increase taxes on tobacco products by passing Proposition 56, which created the California Healthcare, Research and Prevention Tobacco Tax Act of 2016. The goals of the proposition included reducing tobacco use and increasing funding for public health programs. The tax increase generated more than $1.3 billion in tax revenue in fiscal year 2018–19 alone. The majority of these funds were allocated to the California Department of Education (Education), the Department of Health Care Services (Health Care Services), the California Department of Justice (Justice), the California Department of Public Health (Public Health), and the University of California (UC). However, the California Department of Tax and Fee Administration (CDTFA) has cost the State millions of dollars in additional Proposition 56 revenue because it did not ensure the accuracy of the tax rate it imposed for certain tobacco products. In addition, the state agencies that have received Proposition 56 funds have not consistently used them for the purposes for which they were intended.

Proposition 56 added a tax of $2 per pack of 20 cigarettes to the existing state taxes on cigarettes, for a total tax of $2.87 per pack. To pay this tax, distributors purchase tobacco tax stamps that they must affix to each pack of cigarettes that they sell. However, the proposition also imposed a tax increase on tobacco products, such as cigars, chewing tobacco, and e-cigarettes containing nicotine (other tobacco products). Because these other tobacco products come in a variety of sizes and quantities, specifying in law a specific tax amount for each individual product would be challenging. Instead, Proposition 56 requires CDTFA to apply a tax rate to the wholesale price of these products that is equivalent to the tax rate the State levies on cigarettes. Because the average price of cigarettes fluctuates while the cost of the tobacco tax stamps that must be applied to each pack does not, the tax rate that CDTFA calculates for other tobacco products changes each year as the price of cigarettes changes.

To determine the appropriate tax rate for other tobacco products, CDTFA must obtain two pieces of information: the average manufacturer price for cigarettes and the amount that distributors add to that price to generate a profit when they sell those cigarettes, known as the *wholesale markup rate*. The tax on other tobacco products is calculated by dividing the taxes on cigarettes by the sum of the manufacturer price and the wholesale markup.

Audit Highlights . . .

Our audit of state agencies receiving Proposition 56 tax revenue highlighted the following:

» ***CDTFA did not ensure the accuracy of the tax rate it imposed for certain tobacco products, which cost the State millions of dollars in additional revenue.***

- ***It only included premium-priced cigarettes in its calculation of the wholesale cost of cigarettes, which resulted in a loss of $1.3 million in tax revenue in fiscal year 2018–19 alone.***

- ***It used an unsupported and higher than warranted wholesale markup rate, which resulted in a loss of an estimated $5 million in tax revenue in fiscal year 2018–19.***

» ***State agencies that received Proposition 56 funds have not consistently used them for the intended purposes—some agencies awarded grants for activities that did not comply with requirements.***

- ***Health Care Services awarded tens of millions of dollars to repay student loans for physicians and dentists who provide services through Medi-Cal, but did not sufficiently prioritize physicians and dentists located in areas that are underserved.***

» ***Four of the six state agencies we reviewed that received these tax funds inadequately disclosed on their websites the amount of funds they received or how they used those funds.***

Because the taxes imposed on cigarettes are fixed, when the costs of cigarettes increase, the tax rate for other tobacco products is lower; and when the costs of cigarettes decrease, the tax rate for other tobacco products is higher, as we explain in detail in the Introduction. Small differences in these numbers can change the total amount of tobacco tax revenue collected by millions of dollars.

Nonetheless, we found evidence that indicates CDTFA has used figures that are too high in both components of its calculation of the tax rate for other tobacco products. Specifically, CDTFA has assumed that the highest-priced class of cigarettes—premium cigarettes—represents the average manufacturer price for all cigarettes, ignoring less expensive discount and deep-discount cigarettes. If CDTFA had included these other classes of cigarettes in its calculation of the wholesale cost of cigarettes, it would have increased the tax rate it applied to other tobacco products, resulting in more than $1.3 million in additional tax revenue during fiscal year 2018–19 alone. Similarly, for more than a decade, it has used a wholesale markup rate of 6 percent in its calculation of the tax rate for other tobacco products, yet CDTFA could not explain how it arrived at this rate, which makes it appear to be arbitrary. Information from a variety of sources suggests that the markup is actually between 2 percent and 4 percent. Had CDTFA used 4 percent in its calculation, the tax rate for other tobacco products in fiscal year 2018–19 would have been around 1 percent higher and would have provided an estimated $5 million in additional funds. These additional revenues would have gone to programs intended to reduce tobacco use and improve the health of Californians.

In addition, some of the state agencies that receive Proposition 56 funds have not established adequate safeguards to ensure that they properly award and monitor the use of those funds. For example, the law requires Justice to award Proposition 56 funds to law enforcement agencies for enforcing tobacco-related laws. However, because of weaknesses in the safeguards it established over its process for selecting grants, Justice awarded nine of the 10 grants we reviewed for purposes that included activities that did not comply with the requirements established in the law for these funds. Similarly, Health Care Services receives Proposition 56 funds for a program that repays the student loans of physicians and dentists who provide services through the California Medical Assistance Program. This program is to prioritize, in part, efforts to reduce the areas of the State that are underserved by health care providers. However, Health Care Services' process for selecting grantees for this program did not require them to be located in areas with a shortage of health care providers, and it consequently awarded tens of millions of dollars to physicians and dentists who practice in areas that do not have shortages.

Four of the six state agencies we reviewed that receive Proposition 56 funding have also failed to adequately disclose the amount of funds they received or how they used those funds, limiting the information available to the public about the use of this tax money. State law requires these agencies to annually publish on their websites how much Proposition 56 funding they received and how the money was spent. However, as of July 2020, four of the six agencies had not published the required information for fiscal year 2018–19, and three of the six agencies had not yet provided information for fiscal year 2017–18. Moreover, the agencies have interpreted the Proposition 56 reporting requirements differently and consequently reported information that was not consistent with the requirements in law. The agencies attributed their failure to publish complete information in a timely manner and the differences in the information that they did publish to their respective interpretations of state law.

Selected Recommendations

CDTFA, Education, Health Care Services, Justice, Public Health, and UC

To provide the public with complete information as state law intends, each state entity that receives Proposition 56 funds should publish the following information on its website by April 2021 for fiscal years 2017–18 through 2019–20, and within six months of the end of each fiscal year, beginning with fiscal year 2020–21:

- The amount of Proposition 56 funds received by each program it administers.
- The amount of Proposition 56 funds spent by each program it administers.
- The amount of Proposition 56 funds obligated for future expenditures by each program it administers.
- Any corrections to the information it reported in previous fiscal years.

CDTFA

To increase the accuracy of its calculation of the tax rate for other tobacco products, CDTFA should take the following steps to update its methodology for calculating the tax by March 2021:

- Include nonpremium cigarettes in its calculation of the average manufacturer price of wholesale cigarettes.

- Determine the current wholesale markup rate for cigarettes and use this rate when calculating the tax rate for other tobacco products.

To ensure that the other tobacco products tax rate accurately reflects changes in the wholesale price of cigarettes, CDTFA should enact a policy to obtain the current wholesale markup rate for cigarettes no less than every three years and to incorporate this number in its calculation of the tax rate.

Health Care Services

To ensure that it awards funds to applicants who address the need for providers in health professional shortage areas, Health Care Services should amend its application selection process to require by June 2021 that all participants practice in geographic areas that have shortages of such health professionals, and annually verify that participants continue to practice in such areas.

Justice

To ensure that it awards Proposition 56 funding in accordance with the requirements in state law, Justice should implement a formal grant application review process by June 2021 that ensures that it does not award Proposition 56 funds for purposes that are not allowable under the law governing its use of funds.

Agency Comments

CDTFA disagreed with our findings, but indicated it would implement our recommendations. Justice disagreed with our finding that it did not use funds for the purposes defined in law but it did not object to our recommendation regarding publishing required information. Public Health and Education agreed with most of our findings, but disagreed with our finding that they did not meet the reporting requirements.

Health Care Services agreed with three of the four recommendations we made, but indicated that it will not implement our recommendation to require all participants in its physician and dentist loan repayment program to practice in areas with shortages of health care professionals. TEROC and UC both stated that they agreed with and will implement our recommendations.

Introduction

Background

Despite a significant decline over the past 50 years in the number of people who smoke, cigarette smoking remains the leading cause of preventable death and disability in the United States. In California smoking-related illnesses cause 40,000 deaths per year—approximately 15 percent of all of the State's deaths. Californians' tobacco-related health care costs total $13.3 billion annually, of which $3.5 billion is state spending.

Since 1959 the State has imposed a number of taxes on various tobacco products. The text box shows the historical amounts these taxes levied on each pack of cigarettes. In 2016 California voters raised taxes on tobacco products when they passed Proposition 56, which created the California Healthcare, Research and Prevention Tobacco Tax Act of 2016, which took effect in April 2017. This tax generated more than $1.3 billion in revenue in each of the two following fiscal years.

Current California Cigarette Taxes

1959: Initial cigarette tax	*$0.03 per pack*
August 1967: Cigarette tax increase	*$0.04 per pack*
October 1967: Cigarette tax increase	*$0.03 per pack*
1989: Proposition 99	*$0.25 per pack*
1994: Breast Cancer Act of 1993	*$0.02 per pack*
1999: Proposition 10	*$0.50 per pack*
2017: Proposition 56	*$2.00 per pack*
Total:	***$2.87 per pack***

Source: State law.

Note: Taxes are per pack of 20 cigarettes.

Supporters of Proposition 56 believed that the measure would improve public health by increasing the costs of tobacco products and thus discouraging consumers from buying them. Further, the majority of Proposition 56 tax revenue goes to programs associated with public health, which supporters argued would help offset tobacco-related health care costs. As Figure 1 shows, the percentage of the State's adults who smoke cigarettes has declined as the taxes imposed on cigarettes have increased. However, despite this decrease, the California Department of Public Health (Public Health) has reported that the number of adult tobacco users in California exceeds the population of each of 23 states.

Examples of Other Tobacco Products

- Chewing tobacco
- Pipe tobacco
- Rolling tobacco
- Snuff
- Cigars
- E-cigarettes containing nicotine (effective April 1, 2017, as a result of Proposition 56)

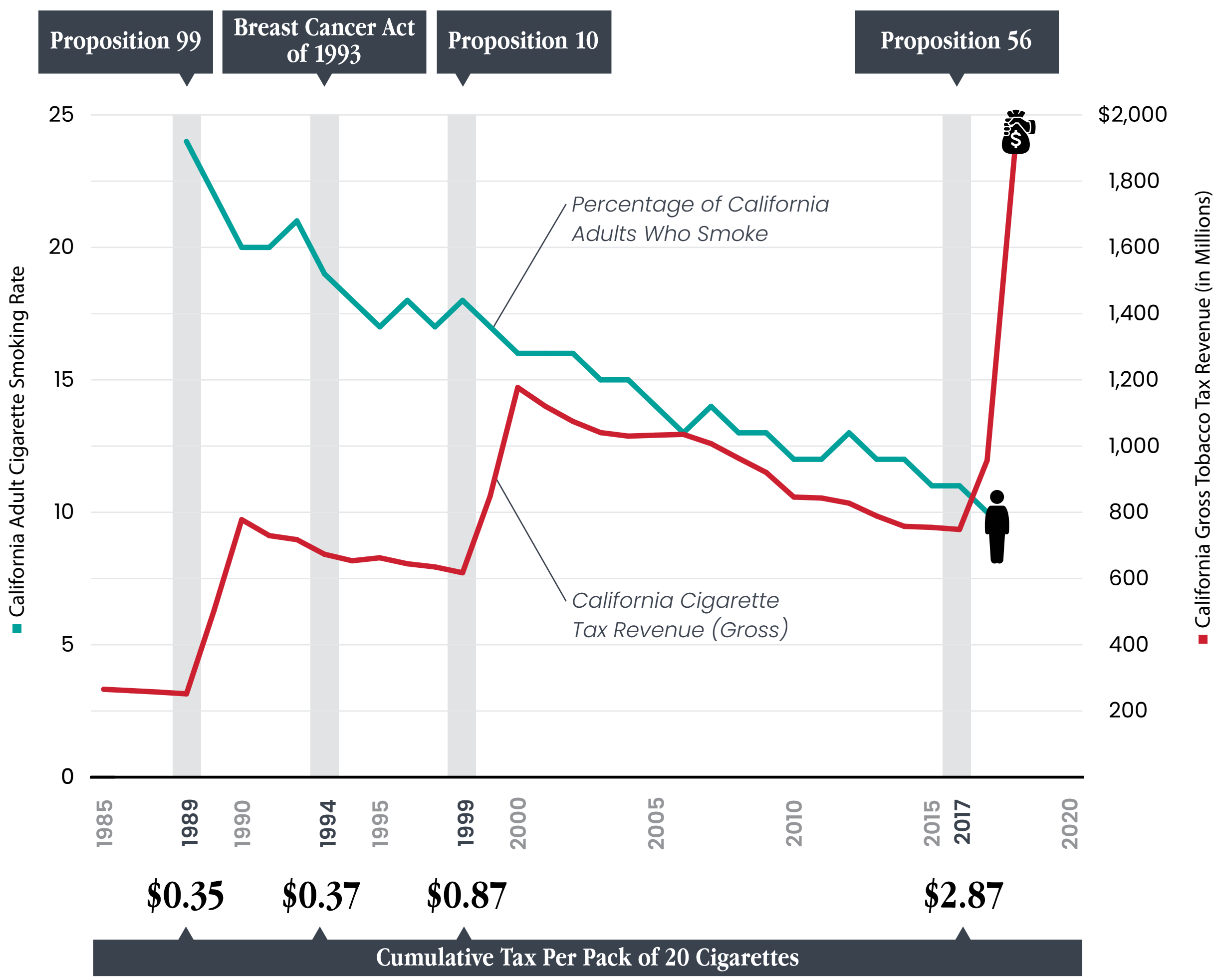
Source: State law and the *Official Voter Information Guide* for Proposition 56.

Proposition 56 Taxes

Proposition 56 raised taxes on cigarettes and imposed an equivalent tax increase on tobacco products such as e-cigarettes containing nicotine and chewing tobacco (other tobacco products). The text box lists examples of the latter category. The California Department of Tax and Fee Administration (CDTFA)—which oversees the entities involved in the sale of cigarettes and other tobacco products—is responsible for collecting taxes on these products.

Rather than imposing cigarette taxes as a percent of the sales price, Proposition 56 specifies an additional tax of 10 cents per cigarette. Because packs of cigarettes generally contain a standard number of cigarettes, distributors pay CDTFA for cigarette tax stamps of specific denominations and attach them to each pack of cigarettes before distributing them to sellers. Thus, Proposition 56 increased the State's taxes on a standard pack of 20 cigarettes by $2, to a total of $2.87 as of July 2020.

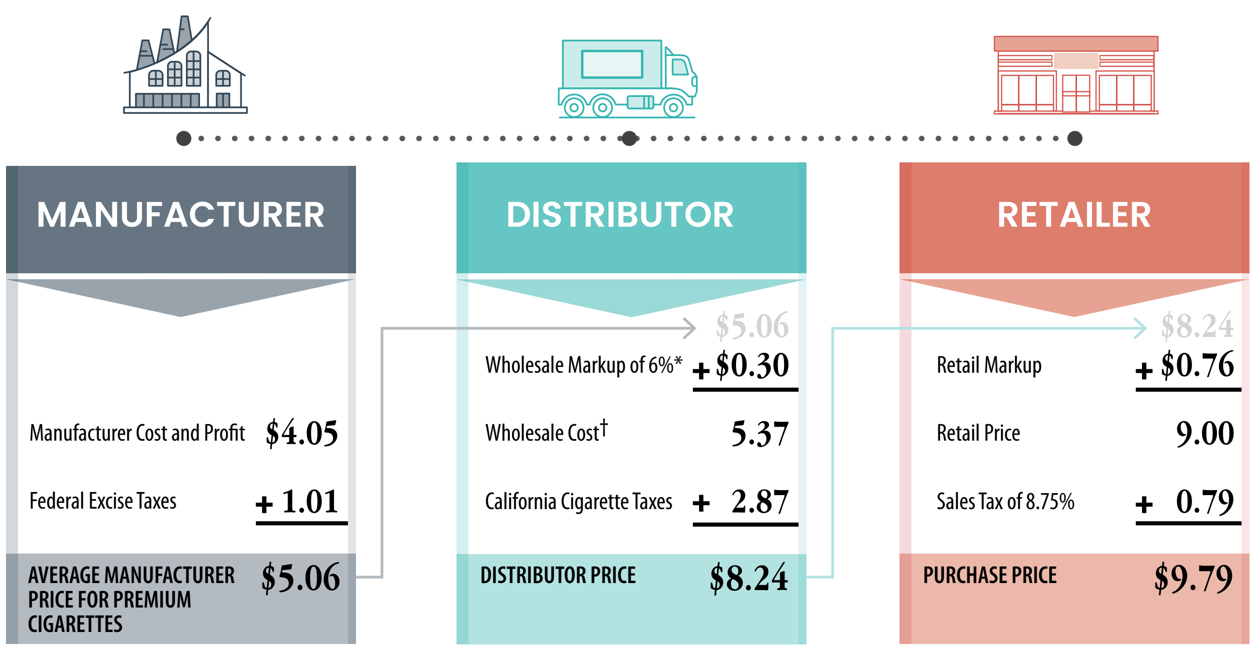
Figure 1
The Percentage of Adult Cigarette Smokers in California Has Declined as Cigarette Taxes Have Increased



Source: Public Health's *California Tobacco Facts and Figures 2018*, Public Health's *California Tobacco Facts and Figures 2019*, Centers for Disease Control and Prevention, and state law.

In contrast, other tobacco products come in a variety of sizes and quantities, making it less feasible to specify in law a specific tax amount for each individual product. Instead, state law directs CDTFA to apply a tax rate to the wholesale price of other tobacco products that is equivalent to the tax rate the State levies on cigarettes. CDTFA uses the wholesale cost of cigarettes to calculate this equivalent rate, which it must determine annually. As Figure 2 shows, the wholesale cost is the average manufacturer price plus the wholesale markup, which is the amount tobacco distributors add to the cost of the product to cover their expenses and generate a profit. The wholesale markup on cigarettes is a key component of CDTFA's calculation of the tax rate for other tobacco products, and we describe how CDTFA obtains this information later in the report.

Figure 2
The Purchase Price of a Pack of Cigarettes Includes Markups and Taxes



Source: CDTFA's *Tax Guide for Tobacco Products*, fiscal year 2018–19 other tobacco products tax calculations, California city and county sales and use tax rates, federal law, and auditor observation.

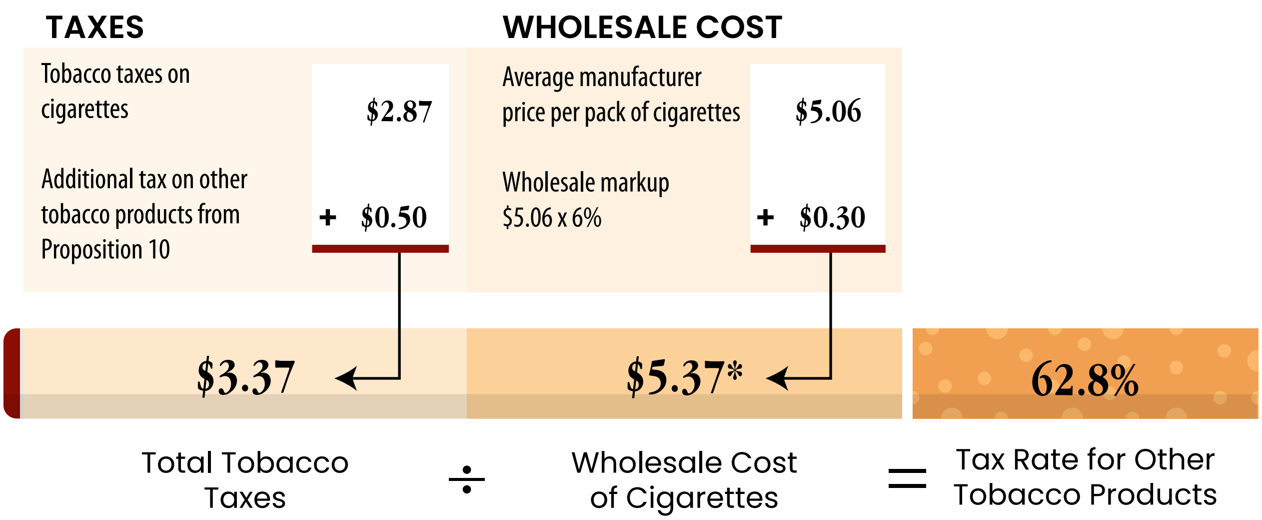
Note: With the exception of federal excise taxes and California cigarette taxes, the amounts in this figure are estimates and averages.

* CDTFA's estimate of 6 percent used in its other tobacco products tax calculation ($5.06 x 6 percent = $0.30).

† The wholesale cost is greater than the sum of the manufacturer price and the wholesale markup because those amounts are rounded down to the nearest cent.

Once CDTFA has estimated the wholesale cost of cigarettes, it calculates the total taxes that apply to other tobacco products. As Figure 3 shows, these include the $2.87 currently applied to each pack of 20 cigarettes and an additional tax equivalent to 50 cents per pack of 20 cigarettes that applies only to other tobacco products.[1] CDTFA calculates the annual tax rate for other tobacco products by dividing the total taxes of $3.37 for other tobacco products by the average wholesale cost of cigarettes, which CDTFA calculated as $5.37 per pack of 20 cigarettes in fiscal year 2018–19. This resulted in a tax rate for other tobacco products of slightly less than 63 percent for fiscal year 2018–19. Because this tax rate is based on the wholesale cost of cigarettes—which changes from year to year—the tax rate for other tobacco products also changes from year to year. Each month distributors must use the annual tax rate to determine and pay the taxes they owe on the other tobacco products they sell.

Figure 3
CDTFA Bases Its Calculation of the Tax Rate for Other Tobacco Products on the Wholesale Cost of Cigarettes



Source: CDTFA's fiscal year 2018–19 other tobacco products tax rate calculation.
* Because of rounding, the sum of the manufacturer price and the wholesale markup is less than the wholesale cost of cigarettes.

1 Proposition 10 added this tax to state law in 1999.

As the text box shows, the tax rate on other tobacco products has decreased each year since fiscal year 2017–18. As the wholesale cost of cigarettes has risen, taxes have represented a decreasing proportion of their total cost, and the effective tax rate has thus decreased. In other words, because the taxes on cigarettes do not change, an increase in the wholesale cost of cigarettes causes a decrease in the effective tax rate. The inverse is true as well: if the wholesale cost of cigarettes should decrease, the effective tax rate will increase. These tax rate changes affect how much revenue the State collects from taxes on other tobacco products.

Tax Rates for Other Tobacco Products (by fiscal year)

2017–18: 65.08 percent

2018–19: 62.78 percent

2019–20: 59.27 percent

2020–21: 56.93 percent

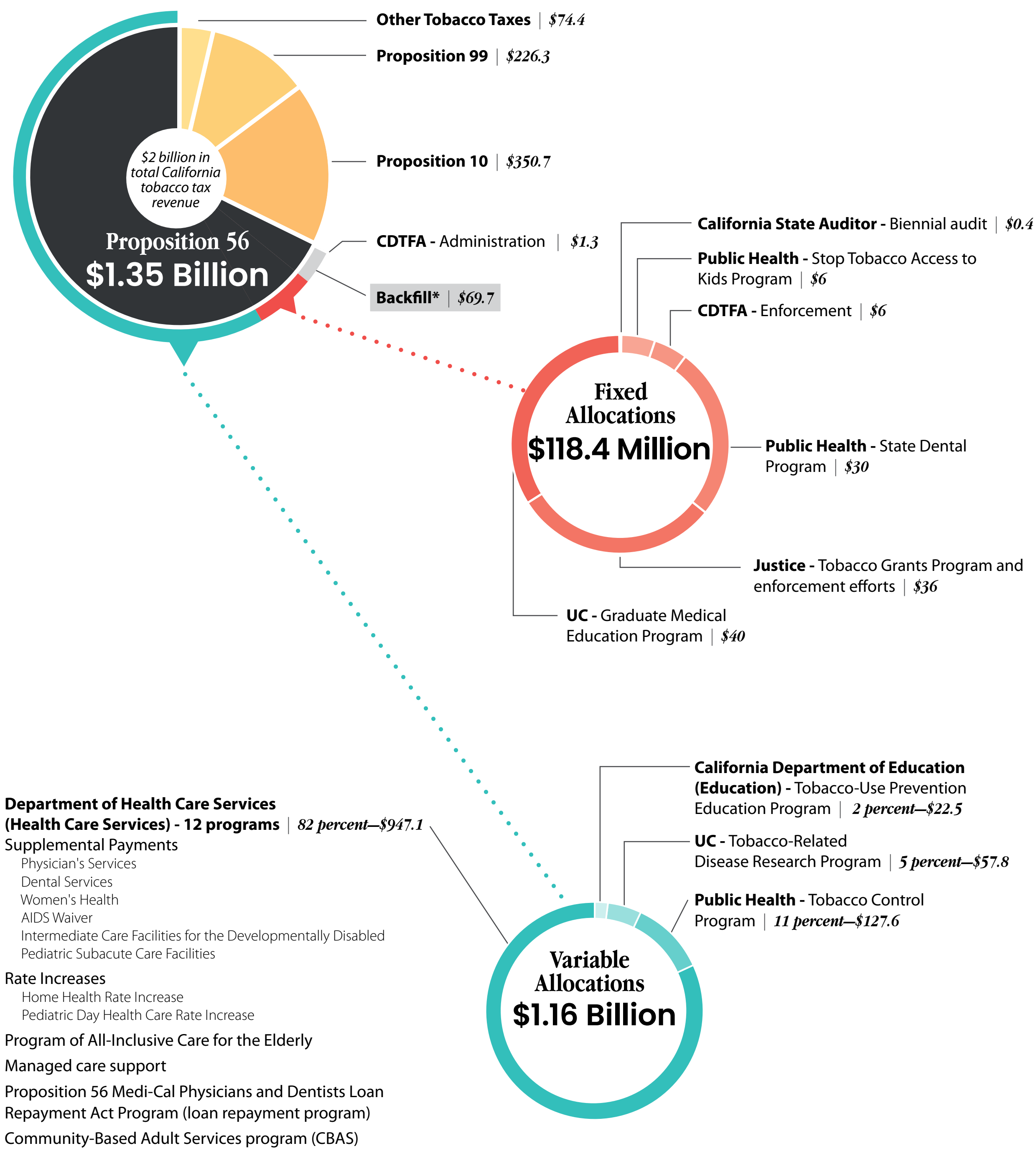
Source: CDTFA other tobacco products tax rate calculations.

Distribution and Oversight of Proposition 56 Revenue

CDTFA deposits revenue collected from the Proposition 56 taxes into the California Healthcare, Research and Prevention Tobacco Tax Act of 2016 Fund (tobacco tax fund). State law specifies how the money in the tobacco tax fund must be allocated. Because the supporters of Proposition 56 believed the additional tax would lead to a decline in tobacco product consumption, Proposition 56 directs CDTFA to annually determine the amount of certain tax revenues lost due to the imposition of additional taxes by Proposition 56, and it directs the State Controller's Office (State Controller) to replace those revenues with Proposition 56 funds. The portion of Proposition 56 funding that the State Controller transfers to the funds to replace those other taxes—almost $70 million in fiscal year 2018–19—is called the *backfill*.

The State Controller must allocate and transfer the remaining revenue in the tobacco tax fund according to requirements in law. Following the State Controller's backfill allocations, CDTFA receives a portion of the Proposition 56 revenue for its costs to administer the tax. Then five state agencies receive fixed allocations for specific purposes. After the State Controller allocates these defined amounts, it distributes the remaining revenue to specified agencies based on percentages established in state law. The law also includes requirements for how the receiving agencies must use this revenue. For example, the University of California (UC) receives $40 million each year to increase the number of primary care and emergency physicians trained in the State. In deciding how to use these funds, UC must prioritize direct graduate medical education costs for programs serving medically underserved areas and populations, among other requirements. Figure 4 shows how the law allocated the $1.35 billion in Proposition 56 tobacco tax revenue that CDTFA collected in fiscal year 2018–19.

Figure 4
California Collected and Allocated $1.35 Billion in Proposition 56 Tobacco Tax Revenue During Fiscal Year 2018–19
(Dollars in Millions)



Source: State Controller's financial system, Department of Finance (Finance) revenue transfer letters, and state law.

* The backfill is the amount CDTFA distributes to earlier tobacco tax funds and state and local governments to replace certain tax revenues lost as a result of any decrease in tobacco sales caused by the price increase associated with Proposition 56.

State law also addresses the oversight and transparency of the state agencies' use of Proposition 56 tax revenue. The agencies may not spend more than 5 percent of their Proposition 56 allocations for administrative costs and they must publish on their websites—and any social media sites they deem appropriate—an accounting of the money they received and how they spent it. Further, state law requires the California State Auditor (State Auditor) to conduct a biennial independent audit of the agencies receiving Proposition 56 tax revenue.

To assess how state agencies are spending Proposition 56 funds, we selected the 12 programs listed in the text box and reviewed the safeguards they have established over selected processes to ensure that Proposition 56 funds are properly spent. Although CDTFA and the State Controller do not oversee Proposition 56-funded grant programs, we reviewed how CDTFA calculates tobacco taxes and how the State Controller distributes the tax revenue.

Selected Programs Receiving Proposition 56 Funds

Health Care Services:

- Supplemental payments for physician's services, dental services, and women's health services.
- Rate increases for home health and pediatric day health care.
- CBAS program
- Physicians and Dentists Loan Repayment Act Program

UC:

- Graduate medical education programs
- Tobacco-Related Disease Research Program

Public Health:

Tobacco Control Program

Education:

Tobacco-Use Prevention Education Program

California Department of Justice (Justice):

Tobacco Grant Program

Source: State law, budget documentation from Health Care Services, and Health Care Services' website.

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Audit Results

The State Could Have Collected Millions in Additional Revenue Had CDTFA Used More Accurate Information in Its Tax Rate Calculation

As the Introduction describes, CDTFA must annually calculate the tax rate for other tobacco products based on the tax rate applied to cigarettes. To do so, it calculates the wholesale cost of cigarettes, which requires two pieces of information: the average manufacturer price of cigarettes and the wholesale markup rate. As Figure 3 in the Introduction shows, in fiscal year 2018–19, CDTFA used an average manufacturer price of $5.06 per pack of 20 cigarettes and a wholesale markup 30 cents, which is 6 percent of the average manufacturer price. However, CDTFA used higher values than warranted for both components. As we describe in the Introduction, if the wholesale cost used in the calculation increases, the tax rate for other tobacco products decreases.

Although CDTFA's deputy director of its Business Tax and Fee Division (deputy director) stated that the department uses the best available, most reliable, and most current data when determining cigarettes' average wholesale cost, we found that the data it has used were incomplete and that better data were readily available. When calculating the tax rate for other tobacco products, CDTFA chose to base the average manufacturer price of cigarettes on the prices of premium cigarettes only, ignoring the prices of less costly cigarettes. In addition, it used a wholesale markup rate that multiple sources indicate is too high. Had CDTFA used more accurate amounts for both the average manufacturer price and the wholesale markup rate in its calculation, it would have collected $6.3 million in additional tax revenue during fiscal year 2018–19 alone. This additional revenue would have helped to fund programs to reduce tobacco use and improve the health of Californians.

CDTFA Excluded the Prices of Discount and Deep-Discount Cigarettes When Calculating the Average Manufacturer Wholesale Price

CDTFA annually obtains the average manufacturer wholesale price of cigarettes from the Tobacco Merchants Association (Merchants Association), a tobacco industry trade association. The Merchants Association publishes the average manufacturer wholesale prices for three classes of cigarettes: premium, discount, and deep-discount. Despite the significant impact of the manufacturers' wholesale price of cigarettes on the tax rate for other tobacco products, CDTFA has assumed that the highest-priced class of cigarettes—premium cigarettes—represents the average manufacturer wholesale price for all cigarettes, ignoring less expensive discount and deep-discount cigarettes.

We reviewed cigarette industry market research and found that premium cigarettes represent only about 83 percent of cigarettes sold in the United States and that discount and deep-discount brands constitute the remainder.[2] If CDTFA had included discount and deep-discount cigarettes in its calculation of the wholesale cost of cigarettes, it would have arrived at a lower average manufacturer wholesale price, thus increasing the tax rate it applied to other tobacco products, as Figure 5 shows. Although their exclusion increased the average manufacturer wholesale price of cigarettes by only 2 cents in fiscal year 2018–19, that small shift cost the State $1.3 million in lost other tobacco products tax revenue during that fiscal year alone.

Figure 5
CDTFA Reduced the Tax Rate on Other Tobacco Products When It Excluded the Sales of Discount and Deep-Discount Cigarettes

	Premium Cigarettes Only	Premium, Discount, and Deep-discount Cigarettes
Average manufacturer price per pack of 20 cigarettes	$5.06	$5.04
Wholesale markup rate	6%	6%
Average wholesale price per pack of 20 cigarettes	$5.37	$5.34
Tax rate on other tobacco products	62.78%	63.09%
Fiscal year 2018–19 wholesale sales of other tobacco products	× $411.9 Million	× $411.9 Million
Calculated fiscal year 2018–19 other tobacco product tax revenue	$258.6 Million	$259.9 Million
Difference	$1.3 Million	

Source: CDTFA's fiscal year 2018–19 other tobacco products tax calculation, CDTFA tobacco sales data, average manufacturer prices reported by the Merchants Association, number of cigarettes sold by brand reported by Euromonitor International, and auditor analysis.

2 *Cigarettes in the US*, July 2020, Euromonitor International, an independent market research provider.

CDTFA's deputy director explained that CDTFA has relied on the average manufacturer wholesale price of only premium cigarettes because it did not have a reliable source of information for determining the various classes of cigarettes' proportion of total sales. She asserted that CDTFA would have to make assumptions about these proportions and that the calculation would not be simple or reliable. However, for a fee of less than $1,000, we were able to purchase a tobacco industry market analysis that included information on the quantity of cigarettes sold by brand for each of the previous 10 years. Using this information, we calculated a weighted average manufacturer wholesale price of cigarettes that incorporated premium, discount, and deep-discount cigarettes by multiplying the proportion of cigarettes each brand sold by the price of the cigarette class that the Merchants Association assigned to that brand. Unless CDTFA incorporates a similar process into its rate calculation, it will consistently overstate the wholesale price of cigarettes and will therefore continue to undercollect tobacco taxes meant to help Californians stop smoking and live healthier lives.

CDTFA's Use of a Seemingly Arbitrary Figure for the Wholesale Markup Rate Has Further Reduced Tax Revenue From Other Tobacco Products

Although it obtains updated information on the wholesale manufacturer price of cigarettes from the Merchants Association each year, CDTFA has estimated the wholesale markup rate to be 6 percent in its calculations for more than a decade—first for Propositions 10 and 99 taxes, and then for Proposition 56 taxes when it began collecting them in 2017. However, this markup rate is higher than warranted, further reducing the tax rate on other tobacco products. CDTFA's deputy director was unable to explain how it first estimated 6 percent and stated that before our review, it had not prioritized obtaining more current information. According to the deputy director, the staff members who originally estimated the 6 percent rate no longer work for CDTFA. Although the methodology incorporating the 6 percent was adopted in a public meeting in 2009, she stated that she worked in an unrelated part of the agency at the time and she does not know how they made this determination. In the absence of evidence or a rationale, CDTFA's use of 6 percent appears to be arbitrary.

In the absence of evidence or a rationale, CDTFA's use of a 6 percent wholesale markup rate appears to be arbitrary.

After we brought our concern to CDTFA's attention, it obtained information that it asserted justifies a 6 percent markup rate. Specifically, CDTFA offered two primary bases to support its markup rate: a calculation and estimates from three studies. However, we identified significant flaws with both of these bases. First, CDTFA's calculation combined information from different sources to reach a markup rate in excess of 6 percent. However, combining information from these sources is not logical.

Studies of Wholesale Markup Rates CDTFA Obtained in Response to This Audit

State Cigarette Minimum Price Laws—United States, 2009

- Source: Centers for Disease Control and Prevention
- Markups range: 2 percent to 6.5 percent
- Average markup rate: 4.1 percent

Tobacco Product Pricing Laws: A State-by-State Analysis, 2015 (Published in 2016)

- Source: University of Illinois at Chicago
- Markups range: 2 percent to 6 percent
- Average markup rate: 3.7 percent

Tobacco and Vapor Tax Guide—July 2020 (Premium Price Sector)

- Source: Merchants Association
- Markups range: 2 percent to 5.75 percent
- Average markup rate: 3.6 percent

Source: As noted in text.

For example, although one piece of information that CDTFA used relates solely to cigarettes, another piece of information averages the markups for cigarettes, other tobacco, and nontobacco products, despite the fact that the source from which CDTFA obtained these data explicitly states that markups are generally higher for other tobacco products. Second, CDTFA provided three studies that it asserted support the rate that it calculated. However, as the text box shows, we found that the studies do not consistently support a markup rate of 6 percent and that one of the studies is more than 10 years old.

Information from a variety of sources we analyzed indicates that the 6 percent markup rate is too high. A 2020 tobacco industry analysis reported that wholesale markup rates decreased considerably in 2016 and 2017, in part because of declining cigarette consumption.[3] This report also estimated that the average markup would be slightly more than 2 percent in 2020. In addition, the Merchants Association has compiled information on the wholesale markup rates that 25 states have established in law. Because California is not included in the Merchants Association's information, we analyzed the data on the states that are included. As of July 1, 2020, the average of those rates was less than 4 percent, and none of the states had a wholesale markup rate of 6 percent or more. Finally, the 2019 financial statements of two large cigarette distributors—one of which is the fourth largest distributor of cigarettes—indicate that their wholesale markup rates on cigarettes were both less than 2 percent.

Based on the information we reviewed, CDTFA should have used a wholesale markup rate between 2 percent and 4 percent. As Figure 6 shows, had CDTFA used a wholesale markup rate of 4 percent—the more conservative number—we estimate that it would have collected an additional $5 million in tobacco tax revenue during fiscal year 2018–19 alone. After we brought this issue to CDTFA's attention, the deputy director stated that in the future it could use information gathered by its research and statistics group to determine the appropriate markup rate; however, CDTFA's failure to proactively update the markup rate has already cost the State millions of dollars in lost revenue. The State Board of Equalization, the agency that administered tobacco taxes in 2009, estimated at that time that it would cost about $35,000 annually to determine the wholesale costs of cigarettes by surveying tobacco industry companies. According to CDTFA's deputy director, the

3 *Cigarette & Tobacco Products Wholesaling in the US*, February 2020, IBISWorld Inc.

State Board of Equalization instructed staff not to periodically review the markup rate. However, in comparison to the millions of dollars in additional revenue that would have resulted from the use of more accurate tax rates, the price of obtaining this information seems reasonable.

Figure 6

CDTFA Would Have Collected Millions in Additional Revenue if It Had Used a More Accurate Wholesale Markup Rate to Calculate the Other Tobacco Products Tax Rate for Fiscal Year 2018–19

	Wholesale Markup Used by CDTFA	Conservative Estimate of Actual Wholesale Markup
Cigarette wholesale markup rate	6 Percent	4 Percent
Tax rate on other tobacco products	62.8 Percent	64 Percent
Fiscal year 2018–19 wholesale sales of other tobacco products	× $411.9 Million	× $411.9 Million
Calculated fiscal year 2018–19 other tobacco products tax revenue	$258.6 Million	$263.6 Million
Difference		$5 Million

Source: CDTFA's fiscal year 2018–19 other tobacco products tax calculation, CDTFA tobacco sales data, and auditor analysis.

If CDTFA Had Accurately Calculated the Cigarette Wholesale Cost, the State Could Have Provided At Least an Additional $6.3 Million Annually to Improving the Lives of Californians

Although the deputy director described several reasons for CDTFA's approach to calculating the average wholesale cost of cigarettes, we question its conclusions. For example, she stated that CDTFA bases its calculation on minimal estimates and assumptions, which is necessary for it to stand up to scrutiny in court. However, CDTFA's calculation incorporates both estimates and assumptions. Not only did it estimate that the wholesale markup rate was 6 percent, it cannot explain how it arrived at this estimate. Further, for the purposes of this calculation, it assumed that all cigarettes sold are premium cigarettes, despite market research showing otherwise. If CDTFA based its calculation on more accurate information instead of on estimates and assumptions, it would have a more logical basis for defending that calculation. Further, CDTFA could incorporate more accurate information into the calculation without dramatically increasing its complexity. Although consistently adopting assumptions that minimize taxes on other tobacco products may reduce the likelihood of litigation from the tobacco industry, it also reduces the revenue resulting from that tax.

Although consistently adopting assumptions that minimize taxes on other tobacco products may reduce the likelihood of litigation from the tobacco industry, it also reduces the revenue resulting from the tax.

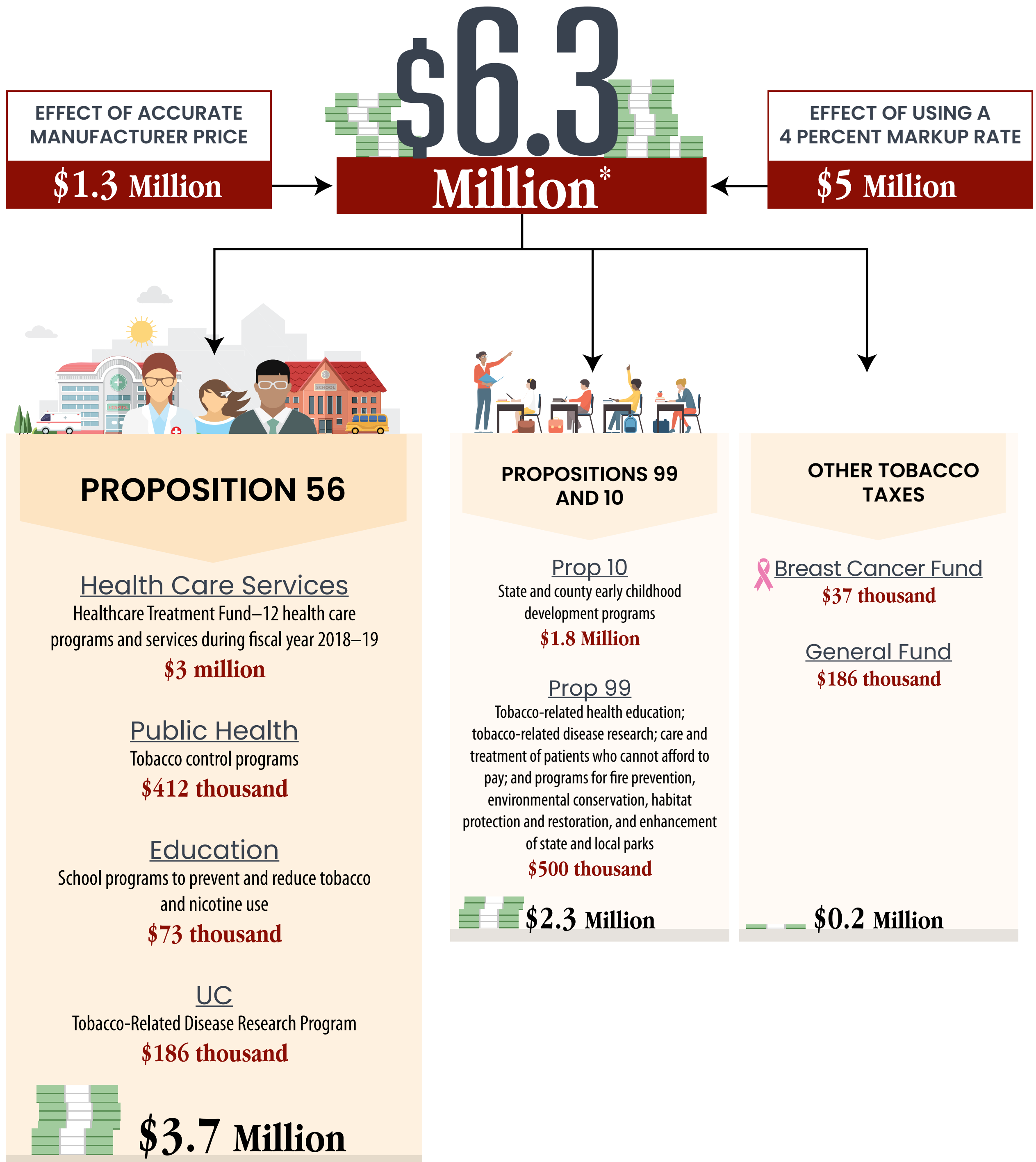
Had CDTFA used more accurate figures for both the average manufacturer price of cigarettes and the wholesale markup rate, it would have increased the tax revenue the State collected under Proposition 56 during fiscal year 2018–19 by more than $3.7 million and the tax revenue it collected under Propositions 99 and 10 and the other distributor taxes by approximately $2.6 million. Although this represents a small proportion of the overall tobacco tax revenue the State collects, it could have used this additional $6.3 million for programs designed to reduce tobacco use and improve the health of Californians, as Figure 7 shows. For example, the Tobacco Control Program that Public Health administers would have received an additional $412,000, School Programs to Prevent and Reduce Tobacco and Nicotine Use that Education administers would have received an additional $73,000, and the 12 Proposition 56 programs that Health Care Services administers would have received an additional $3 million.

Some State Agencies Have Not Established Adequate Controls Over Their Distribution of Proposition 56 Funds

Although state law establishes requirements for the use of Proposition 56 funds, some of the state agencies that receive this money have not implemented sufficient safeguards to ensure that they are distributing the funds for their intended purposes. For example, state law requires Justice to award its Tobacco Grant Program funds for law enforcement efforts to reduce the illegal sales of tobacco products, particularly illegal sales to minors. However, in fiscal years 2017–18 and 2018–19, Justice awarded funds that were not used exclusively for activities that aligned with these requirements. The law also allocates funds to Health Care Services to pay for the student loans of physicians and dentists who provide services to California Medical Assistance Program (Medi-Cal) recipients.[4] This program is to prioritize, in part, underserved parts of the State. However, Health Care Services has not ensured that the grantees it selects are located in geographic areas with provider shortages, undermining one of the program's priorities.

[4] California participates in the federal Medicaid program through Medi-Cal. Health Care Services administers Medi-Cal through an agreement with the federal Centers for Medicare and Medicaid Services.

Figure 7
Had CDTFA Used Accurate Numbers in Its Calculations, It Would Have Provided Millions in Additional Funds to Support the Health of Californians (Fiscal Year 2018–19)



Source: State law, CDTFA's fiscal year 2018–19 other tobacco products tax calculation, CDTFA's tobacco sales data, average manufacturer prices reported by the Merchants Association, number of cigarettes sold by brand reported by Euromonitor International, Health Care Services' internal budget and expenditure documents, and auditor analysis.

* Figure not exact due to rounding.

Health Care Services has not established a procedure to verify whether health care professionals continue to treat Medi-Cal patients after it begins paying off their student loans.

Further, some state agencies had not established processes to monitor whether the grantees to whom they award Proposition 56 funds spend those funds appropriately. For example, Health Care Services has not established a procedure to verify whether health care professionals continue to treat Medi-Cal patients after it begins paying off their student loans. By failing to establish adequate safeguards over Proposition 56 funds, the agencies have not advanced the purposes established in law or maximized the benefits the funds provide.

Some State Agencies Lack Processes to Ensure That They Spend or Award Proposition 56 Grants for the Purposes Established in Law

Some of the state agencies that receive Proposition 56 funding have insufficient safeguards over the use of those funds. To determine if the agencies we reviewed were using funds appropriately, we reviewed their policies and procedures for awarding Proposition 56 funds and for monitoring the use of those funds by grant recipients. We found that some agencies' processes were not sufficient to ensure that funds were being used for their intended purposes. We describe such processes as *deficient safeguards*. Table 1 shows that five of the 12 programs we reviewed had deficient safeguards over their use of Proposition 56 funds.

For example, Justice did not effectively ensure that the grants that it awarded would be used exclusively for the requirements described in state law. State law requires Justice to distribute its Tobacco Grant Program funds to law enforcement agencies to support and hire front-line law enforcement peace officers to reduce the illegal sales of tobacco products, particularly illegal sales to minors. These activities include enforcing tobacco-related laws, increasing investigative activities, and reducing illegal sales. However, Justice did not establish a process for awarding Proposition 56 funds that ensured that the grants it selected were used exclusively for these requirements. Specifically, for fiscal year 2017–18, Justice used a grant evaluation form that assessed whether a grant application included certain activities, some of which are permitted by Proposition 56. However, the form did not disqualify applications that included activities other than those permitted by Proposition 56. Further, the potential activities described on the form included education and outreach, which are not activities permitted by Proposition 56 for Justice's use of these funds. For fiscal year 2018–19, Justice's grant evaluation form was even less detailed. It required reviewers to indicate whether the activities in the application were within the scope of Proposition 56, but did not define what Proposition 56 required. In both years Justice lacked any formal policies or guidance accurately describing what activities were allowable under Proposition 56. In addition, Justice communicated inaccurate information about the program to potential applicants. The website for Justice's Tobacco Grant

Program incorrectly stated that applicants were also allowed to use these funds for public education outreach and media campaigns, instead of exclusively for enforcement of tobacco-related laws, as Proposition 56 requires.

Table 1
State Entities Did Not Adequately Oversee the Awarding and Spending of Some Proposition 56 Grant Funds

			GRANT SELECTION	GRANT MONITORING
		FISCAL YEARS 2017–18 AND 2018–19 PROPOSITION 56 APPROPRIATIONS (IN MILLIONS)	ESTABLISHED A PROCESS FOR SELECTING APPLICATIONS FOR GRANT FUNDS BASED ON CRITERIA IN THE LAW	CREATED A PROCESS TO DETERMINE WHETHER FUNDS WERE SPENT IN ACCORDANCE WITH THE LAW
Education	Tobacco-Use Prevention	$53	X	✓
Health Care Services	CBAS Program	2	X	NA*
	Physician Services Supplemental Payments	825	†	✓
	Dental Services Supplemental Payments	350	†	✓
	Women's Health Supplemental Payments–Pregnancy Termination	20	†	✓
	Home Health Rate Increase	28	†	✓
	Pediatric Day Care Rate Increase	7	†	✓
	Physicians and Dentists Loan Repayment Act Program	220	X	X
Justice	Tobacco Grant Program	74	X	X
Public Health	Tobacco Control Program	309	X	✓
UC	Tobacco Related Disease Research Program	143	✓	✓
	Graduate Medical Education	90	✓	✓

Source: State law, the U.S. Government Accountability Office's *Standards for Internal Control*, State Controller's financial records, and interviews and documentation from each of the entities listed.

* It was not possible to assess whether these funds were spent for their intended purpose because neither Proposition 56 nor Health Care Services established requirements for the use of the funds beyond ensuring timely access, limiting geographic shortages, and ensuring quality of care.

† These programs provide additional payments to Medi-Cal providers for delivering certain preselected services. According to Health Care Services' chief financial officer, it automatically applies the additional payments for those services and does not require the providers to engage in an application process.

✓ = Adequate safeguards

X = Deficient safeguards

Justice awarded nine of the 10 grants we reviewed to projects that included activities that did not comply with the requirements of Proposition 56.

As a result of these weaknesses in its processes, Justice awarded nine of the 10 grants we reviewed to projects that included activities that did not comply with the requirements of Proposition 56. For example, it gave one grantee funds for providing tobacco and nicotine education programs to students, and it provided another with funds to implement tobacco cessation and intervention services. However, although Proposition 56 allocates funds to Education for school programs to prevent and reduce the use of tobacco and nicotine products by young people, it requires the funds it allocates to Justice to be used for law enforcement purposes. Justice's Tobacco Grant Program manager (program manager) stated that Justice's process for awarding these grants consisted of three levels of review, and it assumed that this review was sufficient to ensure that grant applications were in compliance with the requirements of Proposition 56. However, because the process did not evaluate whether applications were exclusively for the activities permitted by Proposition 56, Justice's staff apparently did not consider those requirements when approving the grants.

By awarding Proposition 56 funds for activities outside the legal requirements for its use, Justice reduced the resources devoted to enforcing tobacco laws and preventing the inappropriate sale of tobacco products. Inappropriate sales of tobacco products can cost the State millions of dollars in tax revenue. For example, in 2010 the Office of the Attorney General reported that a three-year investigation by Justice had uncovered tobacco smuggling and tax evasion schemes that cost the State more than $80 million in uncollected tobacco taxes. Increasing the resources available to prevent this could result in increased revenue in addition to furthering efforts to reduce youth smoking.

Health Care Services has also awarded funds that did not address the priorities state law establishes for their use. In fiscal year 2018–19, the State allocated Health Care Services a total of $220 million in Proposition 56 funds to pay the student loans of certain physicians and dentists. The loan repayment program is intended to encourage dentists and physicians to maintain or increase their Medi-Cal patient caseloads. In exchange for a five-year obligation to maintain a caseload of 30 percent or more Medi-Cal patients, Health Care Services will repay up to $300,000 of an individual's student loans. State law establishes three priorities for this program: ensuring timely access to care, ensuring quality care in the Medi-Cal program, and limiting geographic shortages of services. However, although Health Care Services' application review process for the program assigned a certain number of points to applicants located in areas with shortages of health professionals (health professional shortage areas), it assigned twice as many points to a review of the applicants' personal statements. Health Care Services' failure to require that grantees be located in geographic shortage areas undermined one of the priorities that state law establishes for the use of these funds.

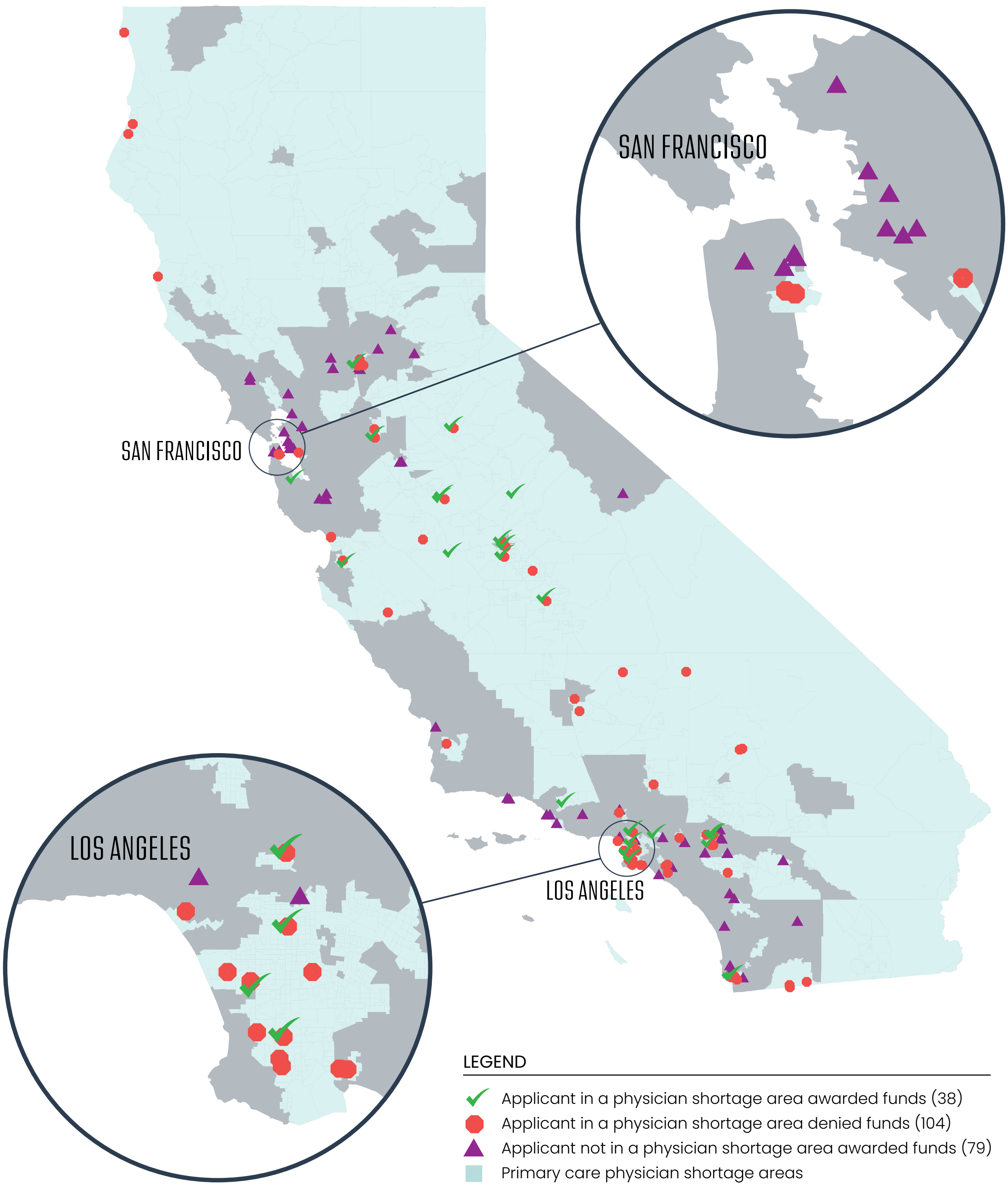
As a result, many of the primary care physicians and dentists that Health Care Services selected for the program are not located in areas that the federal government defines as health professional shortage areas. The federal Health Resources and Services Administration identifies several different types of health professional shortage areas, including geographic areas that have a shortage of primary care, dental, or mental health care providers either for the entire population within that area or for a specific group within that area, such as individuals with low income. However, according to Health Care Services' deputy director of health care financing (deputy director of financing), Health Care Services wanted to award loan repayment program funds to providers in as many different geographic areas and specialties as possible, and therefore did not require applicants to operate in geographic shortage areas. According to data that the deputy director of financing provided, 79 of the 117 primary care physicians Health Care Services selected for participation in the loan repayment program during fiscal year 2018–19 were not located in health professional shortage areas. In total, Health Care Services agreed to repay $18.5 million in loans for these 79 primary care physicians.

Consequently, Health Care Services spent fewer funds to support health care providers in health professional shortage areas. The lack of health care professionals in these areas has a significant impact on Medi-Cal beneficiaries. In our March 2019 audit report titled *Department of Health Care Services: Millions of Children in Medi-Cal Are Not Receiving Preventive Health Services*, Report 2018-111, we concluded that Medi-Cal beneficiaries do not have adequate access to the providers they need in many parts of California. For example, because of health care provider shortages, Health Care Services approved access standards in certain parts of the State that allow managed care plans providing services to Medi-Cal beneficiaries to require children to travel as far as 85 miles to see their primary care physician.

By prioritizing program applicants in these health professional shortage areas, Health Care Services could have better addressed this need. In fiscal year 2018–19, it denied the applications of 104 primary care physicians located in such areas, while granting funds to the 79 who were not in a shortage area. Figure 8 shows the locations of primary care physician loan repayment applicants in health care provider shortage areas who were denied funds and those applicants not located in health professional shortage areas who were awarded funds. Although Figure 8 does not take into account all of the other factors that Health Care Services considered when selecting applicants, it does demonstrate that Health Care Services did not award funds to numerous applicants who could have helped address the need for providers in health professional shortage areas.

Health Care Services denied the applications of 104 primary care physicians located in health professional shortage areas, while granting funds to 79 who were not in a shortage area.

Figure 8
Health Care Services Awarded Proposition 56 Funds for Fiscal Year 2018–19 to Primary Care Physicians Who Were Not in Areas With Provider Shortages



Source: State Auditor analysis of data from Health Care Services, the U.S. Health Resources and Services Administration, and the U.S. Census Bureau.
Note: Due to their close proximity, not all applicants are visible on the map.

In addition, Health Care Services also selected 121 physician specialists for the loan repayment program, agreeing to repay a total of $28.4 million of their student loans. However, according to the deputy director of financing, Health Care Services' selection process did not assess whether these specialists would address shortages. Although Health Care Services used the federal designations to determine whether primary care physician and dental applicants were located in geographic areas with shortages of primary care physicians and dentists, the deputy director of financing confirmed that Health Care Services has not established a process to determine whether specialist applicants are located within a shortage area. As a result, it cannot determine if the specialists it awards funds are meeting one of the fundamental priorities of the loan repayment program.

We also identified deficiencies in the safeguards that Health Care Services has established over the award of funds for its CBAS program. Health Care Services, the California Department of Aging (CDA), and Public Health jointly administer the CBAS program under an interagency agreement. The CBAS program provides services to elderly individuals and adults with chronic health conditions or disabilities who are at risk of needing institutional care and who are enrolled in Medi-Cal managed care plans. According to CDA's website, about 259 CBAS centers operate statewide. CBAS' services include, among other things, professional nursing; personal care; and physical, occupational and speech therapies. For fiscal year 2018–19, the Legislature allowed Health Care Services to allocate up to $2 million of its Proposition 56 appropriation for one-time funding to CBAS centers based on criteria that include, but are not limited to, their need for funds based on operating costs in high-cost areas of the State.

Health Care Services' method of awarding funds for the Community-Based Adult Services program did not ensure that the State received a benefit from their use.

Health Care Services' method of awarding these funds did not ensure that the State received a benefit from their use. According to the chief of Health Care Services' Home and Community-Based Services Section (section chief), Health Care Services did not establish a formal process to review the funding requests it received from the centers. Instead, it used information that the centers self-reported on the amount of funds they needed, awarded the full amounts requested by those centers located in the City and County of San Francisco, and divided the remaining funds proportionally based on the requested amounts of those centers located in the 10 other counties in the State with the highest costs of living, regardless of need. Health Care Services' section chief indicated that it was not necessary to establish policies and procedures for this process because it was a one-time funding allocation and required minimal direction. Because it did not require centers to demonstrate a need for funds or require those funds to be spent for specific purposes, Health Care Services could not explain what benefit the State received from the funds that it granted through this program. Neither Proposition 56 nor Health Care Services defined how these funds could be spent, and as a result Health Care Services did not monitor how they were used. The lack of effective grant management increases the likelihood that the funds were spent for purposes that did not contribute to Health Care Services' goals.

Two agencies also failed to establish formal processes to ensure that they award sufficient funding to address tobacco-related disparities. State law requires both Public Health, with respect to the portion of the Proposition 56 revenues funding its Tobacco Control Program, and Education, through its Tobacco-Use Prevention Education (TUPE) program, to ensure that at least 15 percent of these Proposition 56 funds are used to accelerate and monitor the rate of decline in tobacco-related disparities with the goal of eliminating them. Tobacco-related disparities are differences in the use by or effects of tobacco on different groups of people. They include using tobacco products at a higher rate, experiencing greater secondhand smoke exposure, being disproportionately targeted by the tobacco industry, or having higher rates of tobacco-related diseases compared to the general population.

Neither Public Health nor Education could demonstrate that they had formalized a process to ensure that they awarded at least 15 percent of those Proposition 56 funds to address tobacco-related disparities, which are differences in the use by or effects of tobacco on different groups of people.

Neither Public Health nor Education could demonstrate that they had formalized a process to ensure that they awarded at least 15 percent of those Proposition 56 funds to address disparities during the period we reviewed. Public Health's assistant branch chief stated that it has been working to reduce tobacco-related health disparities for many years, and it did not seem necessary to formalize the processes it uses to ensure that it awards sufficient funding. However, in response to our inquiries, he stated that Public Health has begun work to create written policies and procedures for meeting this requirement. Similarly, Education failed to create a formal process to ensure that it awarded 15 percent of its Proposition 56 funds for disparities. The administrator for Education's TUPE office indicated that to expedite payments to grantees, Education increased payments to existing grants and as a result, the grant award language for that first funding year was not tailored specifically to the requirements of Proposition 56. The administrator also stated that Education did not subsequently verify that 15 percent of the funds were spent to accelerate and monitor the rate of decline in disparities. Although she stated that in fiscal year 2018–19 Education amended the agreements for these grants to require additional information in the grantees' progress reports, it did not award any additional grants in that year. Without formal policies and procedures to award at least 15 percent of its Proposition 56 funds to address disparities, agencies increase their risk of failing to apply the amount of funding required by law to accelerate and monitor the rate of decline in tobacco-related disparities.

Some State Agencies Have Not Sufficiently Monitored Grantees' Use of Proposition 56 Funds

Two state agencies we reviewed had not implemented adequate processes to monitor whether grantees spent Proposition 56 funds in accordance with the requirements Proposition 56 establishes. Because state agencies should monitor the use of funds after grantees receive them, we reviewed the safeguards each entity created to ensure that the grantees use the funds appropriately. Depending on the nature of a grant, these safeguards could consist of ensuring that the grantee's eligibility to receive the funds has not changed, verifying whether the grantee has met the terms of the grant agreement, and reviewing costs charged to the grant to ensure that those costs are allowable, necessary, and reasonable. In the absence of such safeguards, the State has little assurance that grantees are using Proposition 56 funds in the way in which it intended.

In the absence of safeguards to monitor whether grantees spent Proposition 56 funds in accordance with requirements, the State has little assurance that grantees are using the funds in the way in which it intended.

Nonetheless, Health Care Services has not established a formal process to assess whether the health care providers to whom it awards funds remain eligible to participate in the loan repayment program. As part of the application process, Health Care Services reviews the percentage of Medi-Cal patients that applicants report serving and the percentage that they propose serving. Its contract with program participants allows them to self-report the percentage of Medi-Cal patients in their caseload during their five-year obligation to provide services; however, according to the deputy director of financing, Health Care Services has not yet formalized a process to verify the caseload information the participants provide. If participants' caseloads fall below 10 percent of their proposed Medi-Cal caseloads for two consecutive years, the contract allows Health Care Services to cease making loan payments. However, without a process in place to verify this information, participants have little motivation to accurately report if their Medi-Cal caseloads drop below the required percentage.

Without assurance that the information that participants report is accurate, Health Care Services may have made payments toward the student loans of participants who are not serving Medi-Cal patients or are serving fewer such patients than agreed. After we discussed this concern with Health Care Services, the deputy director of financing indicated that as of September 2020, Health Care Services was working on formalizing a process to verify the caseloads that participants report.

During the fiscal years we reviewed, 2017–18 and 2018–19, Justice also lacked a formal process for monitoring how grantees spent Proposition 56 funds. Although Justice now has a formal process in place to verify that the costs it reimburses are consistent with grant agreements, its program manager stated that it created this guidance sometime after July 2019, more than a year after it awarded some of the Proposition 56 grants that we reviewed. In addition, Justice has not ensured that the grants it awards are to be used exclusively for purposes aligned with Proposition 56 requirements. As a result, although its process may ensure that grantees spend funds in accordance with their grant agreements, it does not ensure that those expenditures comply with the requirements that state law establishes for the funds.

Most State Agencies Did Not Meet the Reporting Requirements to Publish Information on the Proposition 56 Funds They Received and Used

Most of the state agencies that received Proposition 56 funds did not meet the associated reporting requirements related to the receipt and use of those funds, limiting the information available to the public about the use of this tax money. State law requires each state entity that receives Proposition 56 funding to annually publish on its website how much money it receives from the tobacco tax fund and how that money was spent. This information allows the public to monitor how the agencies use the taxes the public pays. Although Proposition 56 does not define a specific date by which agencies must publish this information, we determined for the purposes of our review whether agencies had published information for fiscal years 2017–18 and 2018–19 by July 2020, one year after the end of fiscal year 2018–19 and two years after the end of fiscal year 2017–18.

Four of the six state agencies that we reviewed had not reported as of July 2020 the amount of Proposition 56 funds they had received or used in fiscal year 2018–19.

Table 2 shows that by July 2020, four of the six state agencies that we reviewed had not reported either the amount of Proposition 56 funds they had received or the amount they had used in fiscal year 2018–19. Further, three of those agencies had not yet reported the amounts they received or spent in fiscal year 2017–18. The agencies that reported information for fiscal year 2017–18 did not do so in a timely manner: they provided it more than 12 months after the end of the fiscal year in which they received the funds.

Table 2
Some Entities Did Not Disclose Their Receipt and Use of Proposition 56 Funds in a Timely or Complete Manner

	FISCAL YEAR 2017–18			FISCAL YEAR 2018–19		
ENTITY	AMOUNT RECEIVED	USE OF FUNDS	DATE POSTED	AMOUNT RECEIVED	USE OF FUNDS	DATE POSTED
Public Health	X*	X	–	X*	X	–
Health Care Services	X	X	–	X	X	–
UC	✓	✓	May 2020†	✓	✓	April 2020
Justice	✓	✓	July 2019	✓	✓	June 2020
Education	✓	✓	April 2019	X	X	–
CDTFA	X	X	–	X	X‡	–

Source: State law, the websites as of July 2020 for each entity listed, and documentation from each of the entities listed.

* Public Health posted the amount of Proposition 56 funds budgeted for its tobacco control programs. However, it did not post the amounts for the state dental program or the local law enforcement programs to prevent the sale of cigarettes and tobacco products to minors, nor did it post the amounts of funds it actually received or spent.

† UC updated its webpage to publish the required information after we brought the issue to its attention.

‡ After we inquired about CDTFA's Proposition 56 reporting, the chief of its financial operations bureau asserted that CDTFA had updated its website to include Proposition 56 expenditure information. However, we were not able to verify this assertion because CDTFA restricted access to users who accepted a terms of use agreement, as we describe in the Other Areas Reviewed section of this report.

The agencies attributed the reporting problems we identified to factors such as staff turnover, waiting for the State's accounting system to close for the year, and a lack of a due date in the law. However, we did not find these reasons compelling. Although Proposition 56 does not identify a due date, the law does specify that the agencies provide the required information to the public annually. It is therefore unreasonable for agencies to assume that they have an unlimited amount of time to do so. The State Controller generally requires agencies to submit year-end financial reports within four months of the end of the fiscal year, which occurs on June 30. Further, agencies could publish information for the public's use before the State's accounting system closes for the year by using the preliminary data that they provide to the State Controller and then, if necessary, updating that information at a later date. By failing to provide information in a timely manner or at all, the agencies limited the public's ability to monitor their spending of Proposition 56 funds and reduced the relevance of the information they ultimately provided.

Further, agencies interpreted the Proposition 56 reporting requirements differently and consequently reported information that was not consistent with the requirements in law or with each other's reporting. For example, Public Health published information on some of the Proposition 56 funds that it was budgeted to receive. However, it did not provide information on the actual amounts that it received, omitted two of its programs entirely, and did not publish the amount of Proposition 56 funds that it spent. In contrast, CDTFA chose to post only its Proposition 56 spending, which the chief of its financial operations bureau asserted is equivalent to the amount that it receives and is the information of primary interest to its stakeholders. These variations in the agencies' reporting reduce the ability of the public to easily understand and compare information from different agencies. Some agencies attributed the differences we identified to their respective interpretations of the requirements in law. However, the law clearly requires agencies to report both the amounts of Proposition 56 funds that they have received and the amounts that they have spent.

Recommendations

CDTFA, Education, Health Care Services, Justice, Public Health, and UC

To provide the public with relevant information and ensure the level of accountability that state law intends, each state entity that receives Proposition 56 funds should publish the following information on its website by April 2021 for fiscal years 2017–18 through 2019–20, and within six months of the end of each fiscal year, beginning with fiscal year 2020–21:

- The amount of Proposition 56 funds received by each program it administers.
- The amount of Proposition 56 funds spent by each program it administers.
- The amount of Proposition 56 funds obligated for future expenditures by each program it administers.
- Any corrections to the information it reported in previous fiscal years.

CDTFA

To increase the accuracy of its calculation of the tax rate for other tobacco products, CDTFA should take the following steps to update its methodology for calculating the tax by March 2021:

- Include nonpremium cigarettes in its calculation of the average manufacturer wholesale cigarette price.
- Determine the current wholesale markup rate for cigarettes and use this rate when calculating the tax rate for other tobacco products.

To ensure that the other tobacco products tax rate accurately reflects changes in the wholesale price of cigarettes, CDTFA should enact a policy to obtain the current wholesale markup rate for cigarettes no less than every three years and to incorporate this number in its calculation of the tax rate.

Education

To ensure that it applies sufficient funding to address tobacco-related health disparities, by June 2021, Education should establish a formal procedure for meeting the requirement that it spend at least 15 percent of the Proposition 56 revenues funding its TUPE program to accelerate and monitor the rate of decline in tobacco-related health disparities.

Health Care Services

To ensure that the State benefits from its use of Proposition 56 funds, Health Care Services should, by June 2021, implement a policy to establish formal processes for granting all funds, regardless of whether a program receives a one-time allocation or is ongoing. The policy should require sufficient criteria to ensure that the funds awarded provide the benefit intended by the program.

To ensure that it awards funds to applicants who address the need for providers in health professional shortage areas, Health Care Services should amend its application selection process to require by June 2021 that all participants practice in geographic areas that have shortages of such health care professionals, and annually verify that participants continue to practice in such areas.

To ensure that participants are serving the agreed-upon Medi-Cal patient caseloads, Health Care Services should finalize its formal process by June 2021 to verify the caseload percentage that participants self-report.

Justice

To ensure that it awards Proposition 56 funding in accordance with the requirements in state law, Justice should implement a formal grant application review process by June 2021 that ensures that it does not award Proposition 56 funds for purposes—such as education and outreach—that are not described in the law governing its use of funds.

Public Health

To ensure that it applies sufficient funding to address tobacco-related health disparities, by June 2021, Public Health should establish a formal procedure for meeting the requirement that it award at least 15 percent of the Proposition 56 revenues funding its Tobacco Control Program to accelerate and monitor the rate of decline in tobacco-related health disparities.

Other Areas We Reviewed

In addition to the issues we describe in the Audit Results, we also reviewed the distribution of Proposition 56 funds, state agencies' use of Proposition 56 funds for administrative costs, the methods CDTFA used to report required information, and the oversight provided by the Tobacco Education and Research Oversight Committee (TEROC) over certain tobacco tax programs. Portions of our reviews in these areas resulted in recommendations that we do not present in previous sections of the report.

Distribution of Proposition 56 Funds

As the Introduction describes, state law directs CDTFA to determine the amount of certain tax revenues lost due to lower cigarette or tobacco consumption as a result of Proposition 56's cigarette and tobacco tax increase, and it directs the State Controller to replace those revenues. The legislative analysis for Proposition 56 states that by increasing taxes on tobacco products, Proposition 56 reduces tobacco sales and thus it decreases the amount of money generated by those earlier taxes. CDTFA refers to the portion of Proposition 56 funding it allocates to the funds for other taxes as the *backfill*. We examined CDTFA's process for calculating the backfill and evaluated whether the backfill amounts during fiscal years 2017–18 and 2018–19 were reasonable. We found that the model that CDTFA used to calculate the backfill allocations was reasonable and that the backfill amounts it requested the State Controller to transfer for fiscal years 2017–18 and 2018–19 matched the model.

We also examined the State Controller's policies and procedures for allocating and transferring Proposition 56 funds to state agencies, and we determined whether those allocations and transfers were appropriate for fiscal years 2017–18 and 2018–19. We identified a discrepancy between the amounts that should have been transferred in May and June 2019 and the amounts that the State Controller transferred to the agencies; the actual amounts transferred were smaller than they should have been. According to the State Controller's consulting section supervisor (section supervisor), the State Controller used an incorrect fund balance in the May and June 2019 calculations. According to the section supervisor, the State Controller transferred the missing funds in the following transfers, which occurred in June 2019 and November 2019. The State Controller subsequently added instructions to the spreadsheet that it uses to calculate the transfers in order to prevent the mistake from happening again. We found that these delayed transfer amounts did not have a material effect on the Proposition 56 transfers overall and that the State Controller now has appropriate processes in place to ensure that it transfers Proposition 56 funds appropriately.

For fiscal year 2017–18, the budget act appropriated specific amounts for the four entities that receive a percentage of Proposition 56 revenue: Health Care Services, Public Health, Education, and UC. However, some of those appropriations were greater than the agencies' proportional share of the actual revenue collected. Further, the variable allocations for Public Health and Education were transferred into a single fund. Public Health subsequently spent or obligated nearly all of the fiscal year 2017–18 funds it was appropriated, which was $2.5 million more than its proportional share of the revenue. As a result, there are insufficient funds to pay Education the percentage of Proposition 56 funds that it should have received for fiscal year 2017–18.

However, Education failed to spend or obligate the full amount of its own appropriation, and its authority to spend those funds subsequently expired. According to the section supervisor, any funds that are not spent remain in the fund. Beginning in fiscal year 2018–19, Finance created separate funds for the two entities and provided spending authority for the newly created funds based on the amounts transferred into the funds. A manager in Education's fiscal and administrative services division stated that Finance intends to transfer the unspent funds from fiscal year 2017–18 to the new fund created for Education. However, even if Finance restores authority to spend the full amount of the funds remaining, there are insufficient funds in the account for Education to spend its proportional share.

Recommendation

To obtain its full share of the fiscal year 2017–18 Proposition 56 revenues, Education should negotiate with Finance and Public Health to ensure that it receives the full amount of its proportional share of the fiscal year 2017–18 Proposition 56 funds.

Management of Administrative Costs

State law prohibits state and local entities from spending more than 5 percent of the Proposition 56 funds they receive on administrative costs. For fiscal years 2017–18 and 2018–19, we determined the total amount of Proposition 56 funds that each entity spent on administrative costs and then compared them to the total amount that each entity was allocated for all of the programs using Proposition 56 funds it administered. Based on that information, we found that none of the state agencies we reviewed exceeded the limit on administrative costs.[5]

[5] As described in the data reliability section of this report, Public Health was unable to provide us with the necessary information for fiscal year 2017–18 to confirm whether the data that it had provided for that year were complete and accurate. Therefore we could not determine whether Public Health's administrative costs were less than 5 percent for that fiscal year.

However, Public Health did not have policies or procedures in place to monitor the administrative costs of its Proposition 56-funded Office of Oral Health. Although the administrative costs for this program did not exceed 5 percent during the audit period, Public Health risks doing so in the future in the absence of policies and procedures. Public Health provided evidence that it is currently developing such policies and procedures, but did not provide a timeline for completing them.

Recommendation

To reduce the risk of exceeding Proposition 56's limit on the use of funds for administrative costs, Public Health should, by June 2021, develop and implement a procedure for verifying that its combined administrative costs for its Proposition 56-funded programs do not exceed 5 percent.

Required Reporting by CDTFA

As we describe previously, CDTFA failed to publish sufficient information regarding the amount of Proposition 56 funds it received and how they were used. In addition, CDTFA also inappropriately limited access to the information. According to the chief of its financial operations bureau, CDTFA intended to report the Proposition 56 expenditures in its annual financial report, which is available on its website. However, CDTFA placed this information in a footnote in the middle of the 95-page financial report, and it provided no indication to the public that it could find the information in the report. When we questioned the transparency of such an approach, the chief of the financial operations bureau asserted that CDTFA also included the information on a page of its website. However, to access this information, CDTFA required users to accept a Terms of Use agreement, as Figure 9 shows. The Terms of Use represent a legal agreement, and by imposing this requirement, CDTFA created a barrier to the public's ability to access the information. CDTFA's actions do not meet the definition of publish, nor do they adequately align with the law's goal of providing public accountability.

Recommendation

To provide public accountability for the Proposition 56 funds it receives, CDTFA should publish on its website information about the Proposition 56 funds that it receives and spends in a manner that allows the public to easily find the information and that does not restrict the public's access.

Figure 9
CDTFA Failed to Make Its Proposition 56 Financial Information Freely Available to the Public by Requiring Acceptance of a "Terms of Use" Agreement

Source: CDTFA's website.

Oversight Provided By TEROC

TEROC is a legislatively mandated advisory committee charged with overseeing the use of certain portions of the Proposition 99 and Proposition 56 tobacco tax revenues. According to the assistant branch chief of Public Health's Tobacco Control Program, which provides TEROC with administrative support, TEROC's expenses are absorbed through the Tobacco Control Program's budget and personnel costs, and it uses funds from the taxes imposed by Proposition 99 and Proposition 56 for its meeting, equipment, and staffing expenses. He indicated that TEROC spent $144,000 and $149,000 for fiscal years 2017–18 and 2018–19, respectively. State law directs TEROC to advise the Legislature on relevant public policy and certain tobacco tax funds used by Public Health, Education, and UC. Specifically, it requires TEROC to provide an annual report to the Legislature on the elements in the text box (annual report). Further, every two years, it must provide a comprehensive master plan for implementing the tobacco education programs throughout the State, including certain tobacco-related programs that Public Health, Education, and UC administer.

Required Elements of TEROC's Annual Report to the Legislature

- The number and amount of tobacco education programs funded by the Health Education Account created by Proposition 99.
- The fund balances and amount of funds appropriated to, but unspent by Public Health, Education, and UC.
- A description and assessment of certain programs funded by Propositions 99 and 56.
- Recommendations for necessary policy changes or improvements for tobacco education programs.

Source: State law.

We found that TEROC has not provided the required annual reports to the Legislature. TEROC's committee chair stated that it does not provide the annual report, but he asserted that Finance already produces the required financial information and that if TEROC were to compile the data, it would duplicate Finance's work. He also stated that TEROC frequently provides recommendations to the Legislature on necessary policy changes. However, he acknowledged that although Finance annually provides information about Proposition 99 funds, it does not provide similar information for Proposition 56 funds. In addition, the recommendations TEROC has provided do not constitute an annual description and assessment of the programs funded by the Health Education Account tobacco tax funds, as the law requires. Without this information, the Legislature lacks a useful resource for informing its decisions about tobacco tax-funded programs.

Further, TEROC has created master plans every three years instead of every two years, as required. TEROC's committee chair once again referred to its recommendations to the Legislature on necessary policy changes and stated that since the 1990s, it has been TEROC's practice to submit its master plan every three years. The committee chair stated that the Legislature has not questioned the frequency of the master plans; that to return to creating a master plan every two years would have increased Proposition 99 expenditures; and that as tobacco sales fell, the programs relying on those funds saw a decrease in available funding. He indicated that TEROC felt pressured not to increase expenditures because it was aware of the decline in Proposition 99 revenues. However, the assistant branch chief of Public Health's Tobacco Control Program indicated that TEROC did not have a budget limit. Although the committee chair stated that TEROC had no clear directive from the Legislature to return to creating a master plan every two years, the law clearly states that TEROC must submit the plan to the Legislature once every two years.

Recommendations

To ensure that the Legislature has the knowledge necessary to make informed decisions about tobacco tax-funded programs, TEROC should produce the annual report each year, as state law requires.

To ensure that it is meeting the Legislature's expectations, TEROC should either provide the master plan to the Legislature every two years, as state law requires, or seek legislative change to reduce the frequency with which it is required to produce the master plan.

We conducted this performance audit in accordance with generally accepted government auditing standards and under the authority vested in the California State Auditor by Government Code 8543 et seq. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on the audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE, CPA
California State Auditor

January 5, 2021

Appendix

Scope and Methodology

We conducted this audit pursuant to the audit requirements in the Revenue and Taxation Code. Specifically, we reviewed the calculation of Proposition 56 taxes, the distribution of those funds, how each state entity that received Proposition 56 funds ensured that it used those funds for appropriate purposes, and whether state agencies complied with the reporting and administrative costs requirements of Proposition 56. The Table lists the audit's objectives and the methods we used to address them.

Audit Objectives and the Methods Used to Address Them

	AUDIT OBJECTIVE	METHOD
1	Review and evaluate the laws, rules, and regulations significant to the audit objectives.	Reviewed relevant laws, regulations, and portions of the state budgets for fiscal years 2017–18 and 2018–19.
2	Evaluate the administrative agencies' processes for collecting and distributing the appropriate funds to agencies specified in state law.	• Reviewed CDTFA's policies and procedures and interviewed staff to determine how CDTFA ensures that it collects tobacco tax funds appropriately. • Evaluated the appropriateness of CDTFA's process for calculating backfill allocations, reviewed the reasonableness of the data used to support the calculation for fiscal years 2017–18 and 2018–19, and confirmed the accuracy of the calculations for those years. • Reviewed the State Controller's policies and procedures, interviewed staff to determine how it allocates and transfers funds to state agencies, and assessed whether it has appropriate safeguards over this process. • Determined the amount of Proposition 56 funds distributed to each state entity for fiscal years 2017–18 and 2018–19.
3	For the state agencies that receive tax revenue, review and assess how each entity ensures that it uses the funds for appropriate purposes, including any oversight over the funds.	• Selected Proposition 56-funded programs administered by Health Care Services, Public Health, UC, Justice, and Education. We assessed each entity's safeguards over the awarding and monitoring of funds through those programs and, for programs that award funds through a grant process, reviewed a selection of the grants to determine whether the entity followed its control processes. • Reviewed whether agencies established secondary reviews for their awarding and monitoring processes to reduce the risk of error or fraud. We found that agencies generally had established such processes. We identified one exception at Health Care Services, but did not identify any funds spent inappropriately as a result of this lack of oversight. • Reviewed documents and interviewed staff to determine TEROC's role in providing guidance and oversight to Education, Public Health, and UC, and evaluated whether it is meeting its obligations related to this role.
4	Determine whether each entity published on its website the appropriate amount of tax revenue it received and how it spent the money in fiscal years 2017–18 and 2018–19.	• Reviewed the website of each of the selected state agencies as of July 2020 and determined whether the agencies had published information regarding the Proposition 56 revenue they received and spent in fiscal years 2017–18 and 2018–19. Because of the existing exceptions we identified in the course of our review of the agencies' compliance with these requirements, we did not assess their compliance with the requirement to post this information on the social media outlets they deem appropriate. • Identified what information the agencies published and verified whether the amounts they reported were accurate.

continued on next page . . .

	AUDIT OBJECTIVE	METHOD
5	Determine whether each state entity used the appropriate amount of administrative funds as specified in state law in fiscal years 2017–18 and 2018–19.	• Determined the Proposition 56 funds each entity spent on administrative costs during fiscal years 2017–18 and 2018–19 and whether the proportions were less than 5 percent of the total amount they received. • Determined whether the selected agencies had established safeguards over their use of Proposition 56 funds for administrative purposes.

Source: Analysis of state law, planning documents, and information and documentation identified in the table column titled Method.

Factors Related to Auditor Independence

Revenue and Taxation Code Section 30130.57(g) required the State Auditor to promulgate regulations to define *administrative costs* for the purposes of the California Healthcare, Research and Prevention Tobacco Tax Act of 2016. The regulations that define those administrative costs, 2 CCR §§ 61200-61240, became effective March 14, 2018, and were used, in part, as criteria for this audit. Further, each state entity that receives funds pursuant to the act, including the State Auditor, must comply with the California Healthcare, Research and Prevention Tobacco Tax Act of 2016.

Assessment of Data Reliability

The U.S. Government Accountability Office, whose standards we are statutorily obligated to follow, requires us to assess the sufficiency and appropriateness of computer processed information we use to support our findings, conclusions, and recommendations. In performing this audit, we relied on the following data and systems:

State Controller's Financial Data

We used data from the State Controller's Appropriation Control Ledger and Budgetary/Legal Basis Reporting System to determine the amounts of Proposition 56 taxes collected and distributed to state agencies and to determine the amounts of Proposition 56 funds that Health Care Services and Education spent on administrative costs during fiscal years 2017–18 and 2018–19. We assessed the reliability of this information by reviewing the tests of this system's features and control environment that our office performed as part of the State's financial audit. We determined that the data were sufficiently reliable for our purposes.

State Agencies Financial Data

We used data from the internal accounting systems of Public Health, UC, and Justice to determine the amounts of Proposition 56 funds each agency spent on administrative costs during fiscal years 2017–18 and 2018–19. To assess the accuracy of these data, we reviewed a selection of expenditures and determined whether the agencies classified them appropriately. To assess the completeness of these data, we reviewed the agencies' accounting data and determined whether they matched totals in the State Controller's reporting system. Based on these determinations, we found the data sufficiently reliable to support our audit findings, conclusions, and recommendations for UC, for Justice, and for Public Health for fiscal year 2018–19. Public Health did not demonstrate that its fiscal year 2017–18 data were complete and accurate. Although its financial management branch chief repeatedly asserted that Public Health could provide sufficient detail for the fiscal year 2017–18 data, the detailed information that Public Health provided did not match the totals in the State Controller's reporting system. The financial management branch chief subsequently indicated that Public Health could provide complete data, but that it could not do so in the immediate future because it needed its resources to address COVID-19 issues. Because Public Health could not provide certain individual transactions, we could not determine if Public Health had classified them correctly. As a result, we found that the data Public Health provided for fiscal year 2017–18 were not sufficiently reliable for the purposes of this audit.

CDTFA's Taxable Sales Amount

We used data from a CDTFA report on sales of other tobacco products to determine the dollar amount of those sales in fiscal year 2018–19, and the potential change in tax revenue had the other tobacco products tax rate been different. We compared these data with more current lists of payments from distributors and manufacturers provided by CDTFA and found the lists included more revenue than CDTFA reported. CDTFA explained that this was due to adjustments made after the report was generated. Although this information indicates that the amount of revenue CDTFA collected was higher than it reported and would have increased our estimates of the additional revenue that could have been collected had the tax rate on other tobacco products been higher, we used the more conservative figure from CDTFA's report. We did not perform further testing of these data and determined that they were of undetermined reliability. Although we recognize that this limitation may affect the precision of the numbers we present, there is sufficient evidence in total to support our audit findings, conclusions, and recommendations.

Awardee Locations from Health Care Services' Loan Repayment Program

We used data from a Health Care Services' list of physicians' and dentists' loan repayment program applications to identify the location of loan repayment program applicants. We verified that the data included logical information, but Health Care Services reported that they do not verify the location data. Therefore, we concluded that the data were of undetermined reliability. Although we recognize that this limitation may affect the precision of the numbers we present, there is sufficient evidence in total to support our audit findings, conclusions, and recommendations.

Health Professional Shortage Areas

We used data from the federal Health Resources and Services Administration to determine the locations of health professional shortage areas in California. This federal agency determines which areas should be considered shortage areas and is the sole source of this information. As a result, we did not conduct a data reliability assessment on these data. Although we recognize that this limitation may affect the precision of the information that we present, there is sufficient evidence in total to support our audit findings, conclusions, and recommendations.

Smoking Rates in California

We used data from Public Health's *Tobacco Facts & Figures 2018* report to determine the smoking rates of adults in California over time. Because these data were used for contextual information and do not materially affect findings, conclusions, or recommendations, we determined that a data reliability assessment was not necessary.

Smoking-Related Health Care Costs and Deaths

We used data from the federal Centers for Disease Control and Prevention's state fact sheets to determine the number of smoking-related deaths in California and the amount of money spent on tobacco-related health care costs in California. Because these data were used for contextual information and do not materially affect findings, conclusions, or recommendations, we determined that a data reliability assessment was not necessary.

California Department of Education

Tony Thurmond
State Superintendent of Public Instruction

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December 11, 2020

Elaine M. Howle, State Auditor*
California State Auditor
621 Capitol Mall, Suite 1200
Sacramento, CA 95814

Subject: *Proposition 56 Tobacco Tax: State Agencies' Weak Administration Reduced Revenue by Millions of Dollars and Led to the Improper Use and Inadequate Disclosure of Funds,* Report Number 2019-046, January 5, 2020

Dear Ms. Howle:

The California Department of Education (Education) appreciates the opportunity to provide comments and address the recommendations outlined in the California State Auditor's (CSA) Audit Report titled, *Proposition 56 Tobacco Tax: State Agencies' Weak Administration Reduced Revenue by Millions of Dollars and Led to the Improper Use and Inadequate Disclosure of Funds.*

Recommendation 1

To provide the public with relevant information and ensure the level of accountability that state law intends, each state agency that receives Proposition 56 funds should publish the following information on its website by April 2021 for fiscal years 2017-18 through 2019-20, and within six months of the end of the fiscal year, beginning with the fiscal year 2020-21:

- The amount of Proposition 56 funds received by each program it administers.
- The amount of Proposition 56 funds spent by each program it administers.
- The amount of Proposition 56 funds obligated for future expenditures by each program it administers.
- Any corrections to the information reported in previous fiscal years.

<u>Education's Comments</u>

Partially concur. Education published the required data listed above on its web site as it became available each year as follows:

- Fiscal year 2017-18 was posted on April 18, 2019 1
- Fiscal year 2018-19 was posted on October 1, 2020.

* California State Auditor's comments begin on page 47.

Ms. Elaine M. Howle, State Auditor
December 11, 2020
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2 Education respectfully requests that the CSA revise the draft report, page 40, Table 2, to reflect the April 18, 2019 posting date for the 2017-18 data. Links to the relevant web pages are provided below.

https://www.cde.ca.gov/ls/he/at/tupefunding.asp

https://www.cde.ca.gov/fg/fo/r8/expendreportfy1718.asp

https://www.cde.ca.gov/ls/he/at/tupefunding.asp

https://www.cde.ca.gov/fg/fo/r8/expendreportfy1819.asp

Education strives to ensure that information posted on its web pages is transparent, accurate, and reliable, which requires final accounting reports. Because the public relies upon the information posted, Education does not believe that posting unreconciled funding information or funding estimates and subsequent corrections would be appropriate, especially since Education was in the process of implementing the new state-wide Financial Information System for California
3 (FI$Cal) system. Going forward, Education anticipates timely posting the fully reconciled Proposition 56 funding information annually.

Recommendation 2

To ensure that it applies sufficient funding to address tobacco-related health disparities, by June 2021, Education should establish a formal procedure for meeting the requirement that it spend at least 15 percent of the Proposition 56 revenues funding its TUPE program to accelerate and to monitor the rate of decline in tobacco-related health disparities.

Education's Comments

Concur. Education strengthened existing processes by: 1) creating a Proposition 56 Funding Tree, which is incorporated into the TUPE Office Manual; and 2) establishing and implementing the "Youth Engagement to Address Tobacco Related Health Disparities Grant 2019-2022," to accelerate and monitor the rate of decline in tobacco-related disparities in California in accordance with Proposition 56.

Recommendation 3

To obtain its full share of the 2017-18 Proposition 56 revenues, Education should negotiate with Finance and Public Health to ensure that it receives the full amount of its proportional share of the 2017-18 Proposition 56 funds.

Ms. Elaine M. Howle, State Auditor
December 11, 2020
Page 3

Education's Comments

Concur. Finance anticipates the transfer of Education's unspent 2017-18 funds to the 2021-22 budget by the Spring of 2021. 4

If you have any questions regarding Education's comments, please contact Kimberly Tarvin, Director, Audits and Investigations Division, by phone at 916-323-1547 or by email at ktarvin@cde.ca.gov.

Sincerely,

S. Gregson

Stephanie Gregson, Ed.D.
Chief Deputy Superintendent of Public Instruction

SG:kl

Comments

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM EDUCATION

To provide clarity and perspective, we are commenting on the response to our audit report from Education. The numbers below correspond to the numbers we placed in the margin of Education's response.

Our research indicated that Education had published this information by July 2019. Although we discussed this information with Education during the audit, it did not indicate that the date was incorrect. Based on the additional documentation that Education provided in its response, we have revised Table 2 for fiscal year 2017–18 to reflect the April 2019 date. ①

During the publication process for the audit report, page numbers shifted. Therefore, the page number cited by Education in its response does not correspond to the page numbers in the final published audit report. ②

Education's response does not adequately address our concern that it does not publish information in a timely manner. Specifically, delaying its reporting until it has fully reconciled its accounting for the year may result in significant delays in presenting required financial information to the public. As we state on page 30, Education limits the public's ability to monitor its spending of Proposition 56 funds and reduces the relevance of the information it ultimately provides by not publishing this information in a timely manner. Therefore, we stand by our recommendation that Education provide required information within six months of the close of the fiscal year and make any subsequent corrections to this information if necessary. ③

Education does not appear to fully understand our finding and recommendation. Education stated that it anticipates Finance will transfer Education's unspent 2017–18 funds by the Spring of 2021. However, as we state on page 34, even if the Department of Finance restores authority to spend the full amount of the funds remaining, there are insufficient funds in the account for Education to spend its proportional share of Proposition 56 funds for fiscal year 2017–18. Thus, we recommended that Education negotiate with Finance and Public Health—which spent more than its proportional share—to ensure that it receives the full amount established by the proposition. ④

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-STATE OF CALIFORNIA

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December 11, 2020

Elaine M. Howle, State Auditor*
California State Auditor
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Re: Response to California State Auditor's Draft Report: Proposition 56 Tobacco Tax--Report 2019-046

The California Department of Tax and Fee Administration (CDTFA) appreciates the work of the California State Auditor (CSA) team. CDTFA administers the cigarette and tobacco product tax program, which generates more than $2 billion in annual revenue, with approximately $1.4 billion generated by Proposition 56, and we are committed to fulfilling our obligations as accurately and efficiently as possible. To that end, CDTFA will review and implement the CSA recommendations. Indeed, as our detailed response makes clear, we have already implemented a number of the recommended changes. As we have expressed to the CSA audit team, however, CDTFA believes that the audit report makes a number of assumptions regarding revenue and disclosure requirements that require additional context.

With regard to the analysis of the Other Tobacco Products (OTP) mark-up rate, CDTFA is concerned that the CSA's assumptions regarding impact to revenue are premature and may be inaccurate. The audit report asserts that the Department under collected tobacco taxes because a component used in the OTP rate calculation, specifically the wholesale mark-up rate, is inaccurate. The CSA report asserts that, "information from a variety of sources suggests that the markup is actually between 2 percent and 4 percent," versus the 6% that CDTFA has used since the rate was set by the Board of Equalization. While CDTFA agrees that the rate components should be reviewed and adjusted on a routine basis, until we complete a thorough market analysis, we believe that any discussion of impact to revenue is speculative. For reference, the mark-up rates used by a number of other states, including New Jersey, Delaware, Montana, Hawaii and Maryland, are all higher than the 4% rate that CSA asserts is the upper end of the range based on their preliminary review. As recommended, the Department will review and adjust, as appropriate, the mark-up rate at least every three years. (1)

Regarding the CSA review of CDTFA's data disclosure practices, CDTFA believes that the department has fulfilled all required disclosure requirements. Proposition 56 states that each department, "shall, on an annual basis, publish on its respective Internet Web site an accounting of how much money was received from the California Healthcare, Research and Prevention Tobacco Tax Act of 2016 Fund and how that money was spent." As required, the department has annually published its Proposition 56 expenditures, which equal the amount of funds received, both on our online date portal and in our annual report, which is freely available online. (2)
Additionally, the data is available along with all of our tax and fee data through our open data

* California State Auditor's comments begin on page 53.

3 portal. CSA's assertion that the standard Terms of Use agreement for our open data portal brings the department out of compliance seems to us at odds with the plain language of the disclosure requirement quoted above and appears to overlook that the information is also available in our annual report without any Terms of Use agreement. While CDTFA believes it has fulfilled the requirement, the Department has already implemented the CSA's recommendation by: a) removing the Terms of Use Agreement from our Open Data Portal, and b) adding a separate webpage specifically for Proposition 56 funding.

Below are our responses to each of the specific items in the CSA audit report.

The State Could Have Collected Millions in Additional Revenue Had CDTFA Used More Accurate Information in Its Tax Rate Calculation

a. *CDTFA Excluded the Prices of Discount and Deep-Discount Cigarettes When Calculating the Average Manufacturer Wholesale Price*

CDTFA Response:

CDTFA uses the premium brand cigarette prices in calculating the tobacco product tax rate since it represents the vast majority of the cigarette market and is based on published industry data
4 rather than multiple estimates. CDTFA believes this methodology produces a substantially accurate calculation of the tax equivalent to a cigarette in the most fair, consistent, reliable, and
5 defensible manner. CDTFA is unable to validate the reliability, and impartiality, of the market share data source CSA used to calculate the tobacco product tax rate which was then used to
6 estimate the potential revenue loss noted in the report. Also, CSA criticized (on page 22 of report) CDTFA for using various sources to support a six percent mark-up rate as reasonable. However,
7 CSA appears to have also combined data and information from multiple sources when calculating the cigarette prices and market share. Also, it is important to note that there is no standard
8 definition of what constitutes a premium brand cigarette and a discount brand cigarette. Various sources categorize brands differently. CDTFA will conduct industry research and procure, where available, the necessary subscriptions to identify market share, brand categorization and pricing to determine the impact that including discount cigarette prices has on the tobacco products tax rate. It is premature to estimate the actual revenue impact from including the discount cigarette prices.

b. *CDTFA's Use of an Arbitrary Figure for the Wholesale Markup Rate Further Reduced Tax Revenue From Other Tobacco Products*

CDTFA Response:

9 CDTFA provided information that the 6 percent wholesale mark-up was set by the Board of Equalization in 1988 and reviewed again in 2009 with the approval of the tobacco product tax rate calculation. CDTFA researched the cigarette manufacturers' mark-up rate and determined that the mark-up still appears reasonable based on various data sources and studies. The studies reviewed did show other states, including Delaware, Hawaii, Maryland, Montana, and New
10 Jersey, have similar mark-up rates ranging between 5 and 6 percent (see Tobacconomics 2015). While the mark-up is on the high end of the range, California is certainly not alone in using a mark-up above the 4%, which CSA cites as the upper end of the acceptable range. CDTFA will at least every 3 years conduct a review of the markup rate, beginning March 2021 as directed, to ensure it is representative of our California industry and adjust as appropriate. It should be noted that, while the audit presumes the rate will decrease and associates under collected revenue with

this assumption, the rate and its revenue impact cannot be definitively known until detailed research is performed. Such research may, in fact, support a mark-up rate of 6 percent or higher.

Most State Agencies Did Not Meet the Reporting Requirements to Publish Information on the Proposition 56 Funds They Received and Used

a. Required Reporting by CDTFA

CDTFA Response:

CDTFA uses its Annual Report to display all revenue and costs for all programs administered by 11
the department, including Proposition 56 revenue and expenditures. This Annual Report is
available on our website and does not require a terms of use agreement. Additionally, we posted 2
more detailed Proposition 56 revenue and expenditure by fund information in our data portal,
which did require a standard terms of use agreement. It should be noted that CDTFA is unaware 3
of any concerns ever being expressed from the public or any stakeholder regarding the accessibility or clarity of the data at issue. While CDTFA believes it has fulfilled the disclosure requirement, we have made the information more accessible by 1) removing the terms of use agreement from our data portal and 2) creating a webpage specifically for the Proposition 56 funds.

Sincerely,

Nick Maduros
Director, CDTFA

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Comments

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM CDTFA

To provide clarity and perspective, we are commenting on the response to our audit report from CDTFA. The numbers below correspond to the numbers we placed in the margin of CDTFA's response.

We stand by our analysis and conclusions regarding the markup rate. The information we reviewed from a variety of sources consistently indicated that the current markup rate is between 2 and 4 percent. In addition, as we state on page 16, a 2020 tobacco industry analysis reported that wholesale markup rates have decreased considerably, and projected an average markup rate of slightly more than 2 percent. Finally, notwithstanding the higher rates CDTFA describes for several states from the Merchant's Association's data, as of July 1, 2020, the average markup rate for the 23 states included in the data is less than four percent and no state has a markup rate of six percent or more. ①

CDTFA's reference to its annual report lacks context. As we describe on page 35, CDTFA placed the relevant information in a footnote in the middle of its 95-page report. Further, CDTFA presented only its expenditure amounts. By placing the information in such an obscure location, and providing no other indication to the public of where it could find this information, CDTFA failed to meet the law's intent for agencies to provide public accountability of their use of Proposition 56 funds. ②

As we state on page 35, we believe CDTFA's terms of use agreement represents a barrier to the public's access to information about the Proposition 56 funds it received and how those funds were used. The information is not published if a person has to enter into a legal agreement before being granted access to the information. Therefore we stand by our assertion that CDTFA did not publish this information. ③

CDTFA's assertion that its calculation is substantially accurate is mistaken. As we describe on page 15, by using information for premium, discount, and deep discount cigarettes, CDTFA could have increased tobacco tax revenue by $1.3 million. These funds would be used for programs that support the health of Californians. ④

CDTFA's questions about the reliability and impartiality of the market share data we used are unfounded. The information we used came from a credible independent industry analysis report we identify on page 14. We provided this information to CDTFA ⑤ during the audit. Thus, it is not clear why it was unable to validate the reliability and impartiality of this data. Moreover, CDTFA did not inform us of any other sources of better data.

6 During the publication process for the audit report, page numbers shifted. Therefore, the page number cited by CDTFA in its response does not correspond to the page numbers in the final published audit report.

7 CDTFA's concern that we used data from multiple sources is misplaced. As we describe on page 15, we multiplied prices related to each brand of cigarettes by the number of cigarettes those brands sold. In contrast, CDTFA illogically combined information from incompatible sources. As we state on page 16, one piece of information that CDTFA used relates solely to cigarettes, while another piece is related to cigarettes, other tobacco, and nontobacco products. Thus, we stand by our calculation, and our assertion that CDTFA's analysis is flawed.

8 CDTFA's reference to different definitions of premium and discount classes of cigarette brands is puzzling. While different sources may classify brands in different ways, our analysis is based solely on the classifications established by the Merchant's Association, the same source that CDTFA uses in its calculation, as we report on page 13.

9 The documentation CDTFA provided to us regarding the 6 percent markup rate did not indicate its source or how it was derived. As we describe on page 15, although CDTFA provided documentation that the 6 percent wholesale markup rate it uses was adopted in a public meeting in 2009, CDTFA could not provide evidence or a rationale for how it arrived at this determination.

10 The "Tobacconomics" report that CDTFA refers to does not support its assertions. As described in the text box on page 16, this report from the University of Illinois at Chicago is entitled Tobacco Products Pricing Laws: A State-by-State Analysis, 2015. It shows that 25 states applied a statutory markup rate ranging from 2 percent to 6 percent with an average markup rate of 3.7 percent. Although that report indicates that several states had rates as high as 5 and 6 percent, CDTFA has not provided any evidence supporting why California's markup rate should equal that of the highest rate listed in the report. Thus, based on the variety of sources we reviewed, we stand by our assertion that the current markup rate is between 2 and 4 percent.

11 CDTFA has misrepresented the nature of the information it included in its annual report. Although it stated that the annual report included both Proposition 56 revenues and expenditures, as we describe on page 30, CDTFA included only its Proposition 56 expenditures. Further, it placed this information in a footnote in the middle of the 95-page report. CDTFA provided no indication to the public that it could find the information in the report. Thus, its method of publishing this information does not meet reporting requirements.

State of California—Health and Human Services Agency
Department of Health Care Services

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December 11, 2020

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Sacramento, CA 95814

DRAFT REPORT RESPONSE

Dear Ms. Howle:

The California Department of Health Care Services (DHCS) is submitting the enclosed response to the California State Auditor's (CSA) draft audit report titled, "Proposition 56 Tobacco Tax: State Agencies' Weak Administration Reduced Revenue by Millions of Dollars and Led to the Improper Use and Inadequate Disclosure of Funds." CSA issued four recommendations for DHCS.

With the exception of Recommendation No. 3 of Finding No. 2, DHCS agrees with all of CSA's recommendations and has prepared corrective action plans for implementation.

DHCS appreciates the work performed by CSA and the opportunity to respond to the draft audit report. If you have any other questions, please contact Internal Audits at (916) 445-0759.

Sincerely,

Will Lightbourne
Director

Enclosure

cc: See Next Page

Director's Office
1501 Capitol Avenue, MS 0000
P.O. Box 997413, Sacramento, CA 95899-7413
Phone (916) 440-7400
Internet address: www.dhcs.ca.gov

* California State Auditor's comments begin on page 59.

Department of Health Care Services

Audit: Proposition 56 Tobacco Tax: State Agencies' Weak Administration Reduced Revenue by Millions of Dollars and Led to the Improper Use and Inadequate Disclosure of Funds

Audit Entity: California State Auditor
Report Number: 2019-046 (20-01)
Response Type: Draft Report Response

Finding 1 Most State Agencies Did Not Meet the Reporting Requirements to Publish Information on the Proposition 56 Funds They Received and Used

Recommendation 1
To provide the public with relevant information and ensure the level of accountability that state law intends, each state entity that receives Proposition 56 funds should publish the following information on its website by April 2021 for fiscal years 2017-18 through 2019-20, and within six months of the end of each fiscal year, beginning with fiscal year 2020-21:

- The amount of Proposition 56 funds received by each program it administers.
- The amount of Proposition 56 funds spent by each program it administers.
- The amount of Proposition 56 funds obligated for future expenditures by each program it administers.
- Any corrections to the information it reported in previous fiscal years.

DHCS Agreement: DHCS agrees with the finding.

Current Status: Will Implement

Estimated Implementation Date: February 28, 2021

Implementation Plan:
DHCS has developed a webpage for the Prop 56 programs that include a website for the funds received by each program administered. Additionally, the webpage shows the amount of funds spent by the program. We will update the internet financial information to include the data elements noted in the audit finding which includes funds obligated for future expenditures by program. Any corrections to the financial information reported by DHCS for previous fiscal years, will be reflected in the current year as this fund operates on a cash basis.

Finding 2 Some State Agencies Have Not Established Adequate Controls Over Their Distribution of Proposition 56 Funds

Recommendation 2
To ensure that the State benefits from its use of Proposition 56 funds, Department of Health Care Services (DHCS) should, by June 2021, implement a policy to establish formal processes for granting all funds, regardless of whether a program receives a one-time allocation or is ongoing. The policy should require sufficient criteria to ensure that the funds awarded provide the benefit intended by the program.

DHCS Agreement: DHCS agrees with the recommendation

Current Status: Will Implement

Estimated Implementation Date: June 30, 2021

Implementation Plan:
DHCS will develop a policy to evaluate the process for granting Proposition 56 funds, whether the funding appropriation is one-time or ongoing. This policy will specify categories of qualifying criteria for granting funds that align with the stated intent of the funding and the purpose of the program. Upon implementation, the policy will be used to evaluate future requests for available Proposition 56 funding and make final determinations of funding allocations.

Recommendation 3
To ensure it awards funds to applicants who help address the need for providers in health professional shortage areas (HPSA), Health Care Services should amend its application selection process to require, by June 2021, that all participants practice in geographic areas that have shortages of such health care professionals, and annually verify that participants continue to practice in such areas.

DHCS Agreement: DHCS disagrees with the recommendation

Current Status: Will Not Implement

Estimated Implementation Date: Will Not Implement

Implementation Plan:
As written, the statute requires only that DHCS prioritize, among other things, limiting geographic shortages of services. The current methods employed by DHCS accomplish (1) this goal, and elevating the priority of a consideration for geographic shortage areas may eliminate awards to qualified providers outside a geographic shortage area who, for example, significantly increase their caseload or speak another language which ensures more timely access or a heightened quality of care for certain beneficiaries. As such, DHCS disagrees with the recommendation to further emphasize or make limiting geographic shortages a program requirement. Furthermore, when available, DHCS

2 incorporates an applicant's HPSA score which assigns additional points to physicians/dentists who practice in identified areas with a shortage. Unfortunately,
3 HPSA has not developed a scoring criteria for specialists, which may account for a portion of the disparities identified in the report. Perhaps most notably, an overwhelming majority of Medi-Cal beneficiaries are enrolled in a Managed Care Plan. As such, the
4 program's award process was amended during Cohort 2 (not reviewed during this audit) to include consideration for the approved alternative access standards applied to Medi-Cal Managed Care Plans which weighs geographic shortages within the applicable funding decisions.

<u>Recommendation 4</u>
To ensure participants are serving the agreed upon Medi-Cal patient caseloads, Health Care Services should finish its formal process, by June 2021, to verify the caseload percentage that participants self-report.

DHCS Agreement: DHCS agrees with the recommendation

Current Status: Will Implement

Estimated Implementation Date: December 2020

Implementation Plan:
DHCS will finalize the formal process with our contractor for reviewing the Annual Review documentation submitted by awardees for each cohort to ensure compliance with program requirements including caseload percentage.

Comments

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM HEALTH CARE SERVICES

To provide clarity and perspective, we are commenting on the response to our audit report from Health Care Services. The numbers below correspond to the numbers we placed in the margin of Health Care Services' response.

Health Care Services' suggestion that its awarding of funds has prioritized limiting geographic shortages is not supported by the information we reviewed. As we state on page 23, out of 117 primary care physicians that were awarded funds, 79 were not in areas with geographic shortages. Thus, the majority of participants did not address this priority. Further, requiring that applicants be located in a geographic area with a provider shortage would not preclude Health Care Services from taking other factors into consideration. Health Care Services already uses a similar requirement for provider caseloads. As we describe on page 22, Health Care Services requires participants to maintain a caseload of 30 percent or more Medi-Cal patients. Health Care Services could, similarly, require that applicants be located in geographic areas with provider shortages, and award additional points to those applicants that exhibit the other characteristics that Health Care Services intends to prioritize. Given the significant dollar amount of funds awarded to these individuals and the need for Medi-Cal providers in certain geographic areas, we stand by our recommendation that Health Care Services should amend its application selection process to require that all participants practice in geographic areas that have shortages of health care professionals. 1

Health Care Services' suggestion that its use of applicants' Health Professional Shortage Area (HPSA) score addresses the need to prioritize participants in areas with geographic shortages is misleading. As we describe on page 22, Health Care Services' scoring method assigned only 11 percent of the points for being located in an area with a shortage of health care providers. As a result, the applicants' HPSA scores had a relatively small effect on their selection. Furthermore, as we state on page 23, Health Care Services denied applications of 104 primary care physicians working in areas with shortages of health care providers while granting funds to 79 physicians who were not in such areas. 2

Health Care Services' suggestion that specialists account for the discrepancies we identified in the report is misleading. Our description on page 23 of Department of Health Care Services' failure to award funds to applicants in health professional shortage areas is specific to primary care physicians. Similarly, Figure 8 3 is related solely to primary care physicians. We discuss Health Care Services selection of physician specialists separately on page 25. Specifically, it selected 121 physician specialists for the loan repayment program, agreeing to repay a total of $28.4 million of their students loans. However, Health Care Services' selection process did not assess whether these specialists would address shortages.

4 As Health Care Services notes, we did not review its process for awarding funds in Cohort 2, as it occurred in 2020, after the period that we reviewed. We discussed the updated process with Health Care Services staff during the audit; however, at that time it had not finalized its updated procedures for awarding funds.

STATE OF CALIFORNIA

OFFICE OF THE ATTORNEY GENERAL

SEAN E. MCCLUSKIE
CHIEF DEPUTY TO THE ATTORNEY GENERAL

December 11, 2020

Elaine M. Howle, CPA*
California State Auditor
621 Capitol Mall, Suite 1200
Sacramento, CA 95814

Re: Report 2019-046 State Auditor's Report on Proposition 56 Tobacco Tax

Dear Ms. Howle:

The California Department of Justice (DOJ) has reviewed the California State Auditor's (CSA) draft report titled "Proposition 56 Tobacco Tax" and appreciates the opportunity to respond to the report.

In response to the enactment of Proposition 56 in November 2016, the DOJ implemented a tobacco grant program for local law enforcement agencies. This program operates pursuant to Section 30130.57(e) of the Revenue and Tax Code, which allocates $48 million annually to support tobacco-related law enforcement efforts, including $30 million to be distributed by the DOJ to local law enforcement agencies. Funds distributed to local law enforcement agencies are 1
to be used to support and hire peace officers for programs that include enforcement of state and local laws related to illegal sales and marketing of tobacco to minors, and investigative activities and compliance checks to reduce illegal tobacco sales to minors. Consistent with this statutory 2
mandate, the DOJ awarded grants to local law enforcement agencies through a competitive grant application process. Prospective applicants were notified that grant funds could be used only for authorized purposes and could not be used to supplant other sources of funding for the same purposes. Grant applications were subjected to a multi-step internal review. This process included a review to determine whether the activities for which grant funds were requested were eligible for funding; applications that sought funding for activities deemed not authorized by statute were denied. Beginning with fiscal year (FY) 2018-19, for grant reimbursements, 3
processes have also been in place to monitor that the grant activities were consistent with approved awards. Claims against each respective approved grant were only reimbursed if the expenses were allowable, chargeable to the grant, and substantiated with source documents, such as time records and invoices. In July 2019, these grant monitoring policies and procedures were documented and formalized.

1300 I STREET • SUITE 1730 • SACRAMENTO, CALIFORNIA 95814 • PHONE (916) 210-6178

* California State Auditor's comments begin on page 65.

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Page 2

The Proposition 56 Tobacco Tax Report faults the DOJ for making grant awards to local law enforcement agencies that have included funding for tobacco-related education and training as well as for failing to make grant awards to enforce tobacco tax laws. The report states that educational activities do not qualify as law enforcement activities that can be funded with Proposition 65 grant monies, while tax evasion enforcement efforts do. The DOJ respectfully
4 disagrees with this interpretation. Public education materials and training efforts by law enforcement agencies qualify for DOJ grant funding because they aid in preventing illegal tobacco sales to minors in much the same way that compliance checks of retailers can help prevent such sales. In other words, education is a permissible component of a DOJ grant funded
5 law enforcement program related to illegal sales and marketing of tobacco to minors. Activities to enforce tobacco tax laws, rather, do not qualify for DOJ grant funding because they are unlikely to prevent or detect illegal sales and marketing to minors.

In response to the CSA's specific recommendations identified in the draft report, DOJ submits the following responses:

Finding 1

To ensure that it awards Proposition 56 funding in accordance with the requirements in state law, Justice should implement a formal grant application review process by June 2021 that ensures it does not award Proposition 56 funds for purposes—such as education and outreach—that are not described in the law governing its use of funds.

DOJ Response:

DOJ views that new and supplemental education and outreach activities are permissible components of a law enforcement program related to illegal sales and marketing of tobacco to minors. As previously mentioned, these efforts by law enforcement agencies can help prevent illegal tobacco sales to minors in much the same way that compliance checks of retailers can help prevent such sales.

Since the inception of the Tobacco Tax Program, DOJ established a process that consistently affords the following:

- Thoughtful selection of a team of committee members who participate in scheduled formal meetings to review and score the grant applications.
- Use of scoring checklists, rubrics, benchmarks, budget worksheets and checklists by the committee for the review and approval of applications, awards, and eligible activities.
- Announcement of grants to all local law enforcement agencies.
- Assignment of grant administrators consisting of DOJ's legal and other professionals to each awarded agency for assistance with implementation, oversight and lawful expenditures at the onset of the award notification.
- Frequent phone and email communications, and site visits between grant administrators and the awarded agency to provide guidance on expenditures and implementation of their specific grant program.

Ms. Howle
December 11, 2020
Page 3

- A continuous informal review processes throughout each grant life cycle.

These actions will be documented as DOJ's formal grant application review process.

Finding 2

To provide the public with relevant information and ensure the level of accountability that state law intends, each state entity that receives Proposition 56 funds should publish the following information on its website by April 2021 for FY 2017-18 through 2019-20, and within six months of the end of each fiscal year, beginning with FY 2020-21:

- *The amount of Proposition 56 funds received by each program it administers.*
- *The amount of Proposition 56 funds spent by each program it administers.*
- *The amount of Proposition 56 funds obligated for future expenditures by each program it administers.*
- *Any corrections to the information it reported in previous fiscal years.*

DOJ Response:

Once the grant had been announced for the above-mentioned grant period, the amount available was published on the DOJ website. In addition, once awarded, grantees and a brief description of their awards were published on the DOJ website. In June 2020, DOJ also summarized and published the funds received, spent, and obligated for FY 2017-18 and FY 2018-19. A summary of FY 2019-20 grant fund activities will be published on the DOJ website by April 2021.

Sincerely,

Sean McCluskie

SEAN E. McCLUSKIE
Chief Deputy to the Attorney General

cc: Chris Ryan, Chief, Division of Operations
Renuka George, Senior Assistant Attorney General, Public Rights Division
Michael Fong, Director, Office of Fiscal Services, Division of Operations
Chris Prasad, CPA, CFE, Director, Office of Program Oversight and Accountability

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Comments

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM JUSTICE

To provide clarity and perspective, we are commenting on the response to our audit report from Justice. The numbers below correspond to the numbers we placed in the margin of Justice's response.

Justice's description of the legal requirements for its awarding of its Proposition 56 law enforcement funds is misleading. Justice states that funds are to be used "for programs that include enforcement of state and local laws," implying that other activities are allowable even if they are not for such law enforcement efforts. However, as we indicate on page 18, state law does not specify other allowable purposes for these funds. ①

Justice's suggestion that the grants it awarded were consistent with the law's mandate is misleading. As we indicate on page 22, most of its grants that we reviewed were used for projects that included activities that did not align with the requirements in law, such as one grant that included funding for tobacco and nicotine education programs. ②

Justice's description of the process it had in place for monitoring the use of grant funds misrepresents when these processes were instituted. Although Justice asserts that it monitored whether expenses were allowable for grant reimbursements during fiscal year 2018–19, it did not create its formal guidance for monitoring how grantees spent Proposition 56 funds until after fiscal year 2018–19. As we state on page 28, this was more than a year after it awarded some of the grants that we reviewed. ③

Notwithstanding Justice's statement, we stand by our conclusion that its use of these funds was incorrect. Although educating law enforcement officers on how to enforce the law is an allowable use, Justice awarded funds for providing tobacco education in schools and providing tobacco cessation programs. While these efforts may encourage minors to stop using tobacco and nicotine products, they do not constitute law enforcement efforts. As we describe on page 22, Proposition 56 allocates funds to Education for school programs to reduce and prevent the use of tobacco and nicotine products by young people, but it requires the funds allocated to Justice to be used for law enforcement efforts. ④

Justice incorrectly asserts that grant funds cannot be used for activities to enforce tobacco tax laws, and suggests that allowable activities are limited to those focused on detecting and preventing ⑤ sales to minors. As we state on page 18, state law prioritizes law enforcement efforts to prevent sales to minors; however, it does not limit Justice's law enforcement efforts to only preventing illegal sales to minors. Further, Justice did not provide any evidence to support its assertion that activities to enforce tobacco tax laws are unlikely to prevent or detect illegal sales to minors.

State of California—Health and Human Services Agency
California Department of Public Health

SANDRA SHEWRY, MPH, MSW
Acting Director

GAVIN NEWSOM
Governor

December 11, 2020

Elaine Howle*
California State Auditor
621 Capitol Mall, Suite 1200
Sacramento, CA 95814

Dear Ms. Howle:

The California Department of Public Health (Public Health) has reviewed the California State Auditor's draft audit report titled "Proposition 56 Tobacco Tax: State Agencies' Weak Administration Reduced Revenue by Millions of Dollars and Led to the Improper Use and Inadequate Disclosure of Funds." Public Health appreciates the opportunity to respond to the report and provide our assessment of the recommendations contained therein.

Below we reiterate the audit findings pertaining to Public Health and our response to the auditor's specific recommendations.

Finding: "Most State Agencies Did Not Meet the Reporting Requirements to Publish Information on the Proposition 56 Funds They Received and Used."

Recommendation to Public Health:
To provide the public with relevant information and ensure the level of accountability that state law intends, each state entity that receives Proposition 56 funds should publish the following information on its website by April 2021 for fiscal year 2017-18 through 2019-20, and within six months of the end of each fiscal year, beginning with fiscal year 2020-21:

(a) The amount of Proposition 56 funds received by each program it administers.
(b) The amount of Proposition 56 funds spent by each program it administers.
(c) The amount of Proposition 56 funds obligated for future expenditures by each program it administers.
(d) Any corrections to the information it reported in previous fiscal years.

Management Response:
Public Health partially agrees with this recommendation. In response to parts (a) and (b), as soon as available, the California Tobacco Control Program (CTCP), the Office of

* California State Auditor's comments begin on page 71.

Elaine Howle
December 11, 2020
Page 2

1 Oral Health (OOH), and the Stop Tobacco Access to Kids Enforcement Act (STAKE) Program (who are recipients of Proposition 56 funds) will each post on its program website a link to the Department of Finance Fund Condition Statements that detail the current year appropriation and prior year expenditures. These statements are typically available by the January 10th release of the state's budget.

2 In response to (c) and (d), pursuant to Revenue & Taxation Code section 30130.56(c), "Each state agency and department receiving funds pursuant to this act shall, on an annual basis, publish…an accounting of how much money was received…and how that money was spent." Thus, Public Health is not required to publish future obligated expenditures or corrections from the previous year.

Finding: "Some State Agencies Lack Processes to Ensure That They Spend or Award Proposition 56 Grants for the Purposes Established in Law."

Recommendation to Public Health:
To ensure that it applies sufficient funding to address tobacco-related health disparities, by June 2021, Public Health should establish a formal procedure for meeting the requirement that it award at least 15 percent of the Proposition 56 revenues funding its Tobacco Control Program to accelerate and monitor the rate of decline in tobacco-related health disparities.

Management Response:
Public Health agrees with this recommendation. To demonstrate that at least 15 percent of the Proposition 56 revenues appropriated to its Tobacco Control Program are awarded to accelerate and to monitor the rate of decline in tobacco-related disparities, Public Health will take the following actions:

1. By January 1, 2021, consistent with its existing business practice of awarding a minimum of 15 percent of its Proposition 56 funds toward accelerating and monitoring the rate of decline in tobacco-related disparities, CTCP will create a formal procedure, which will be incorporated into its *Solicitation Manual, Chapter 1 Pre-Planning*.
2. CTCP annually releases a *Tobacco Facts and Figures* report that summarizes California tobacco-related data. A section will be added to this annual report that clearly describes efforts to monitor the rate of decline in tobacco-related disparities and the progress made.
3. The CTCP *Story of Inequity* website tracks 22 tobacco-related disparity measures for eight population groups disproportionately burdened by tobacco-related disparities. To improve awareness and access to this website, by January 1, 2021, the link to the *Story of Inequity* website will be added to the Data Section of Public Health's California Tobacco Control Branch website.

Elaine Howle
December 11, 2020
Page 3

Finding: "Management of Administrative Costs"

<u>Recommendation to Public Health:</u>
To reduce the risk of exceeding Proposition 56's limit on the use of funds for administrative costs, Public Health should, by June 2021, develop and implement a procedure for verifying that its administrative costs for its Proposition 56-funded programs do not exceed 5 percent.

<u>Management Response:</u>
Public Health agrees with the recommendation and will take the following actions: 3
CTCP, OOH, and the STAKE programs will review available financial data monthly in order to monitor administrative spending. The Financial Management Branch will provide program KK reports (detailed accounting data) monthly and pivot tables that identify the administrative costs to date. Identified administrative cost discrepancies will be resolved as part of the monthly review.

We appreciate the opportunity to respond to the audit. If you have any questions, please contact Monica Vazquez, Chief, Office of Compliance, at (916) 306-2251.

Sincerely,

Sandra Shewry, MPH, MSW
Acting Director

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Comments

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM PUBLIC HEALTH

To provide clarity and perspective, we are commenting on the response to our audit report from Public Health. The numbers below correspond to the numbers we placed in the margin of Public Health's response.

The course of action Public Health intends to take does not comply with the requirements of Proposition 56. Proposition 56 requires each agency receiving funds to publish on its own website an accounting of how much money was received and how that money was spent. Public Health's plan imposes a burden on the public to access Finance's website and identify the fund related to Proposition 56 among more than 30 other tobacco tax related funds. As a result, we stand by our recommendation that Public Health should post the relevant information on its own website, as required by law. 1

Public Health is correct that the law does not specifically require that state agencies publish the amount of Proposition 56 funds obligated for future expenditures or corrections to information they previously published. However, the amount of funds obligated is necessary information for understanding how funds are being used when state agencies do not spend the entire amount that they receive. Further, as we describe on page 29, state agencies stated that they could not publish information timely for a number of different reasons, including waiting for the State's accounting system to close. Thus, to ensure that the public receives information when it may be of use to them, we recommend that state agencies publish preliminary information. If state agencies use preliminary information, it may be necessary to correct that information once it has been finalized. For these reasons, we stand by our recommendation that Public Health should publish this information. 2

Public Health did not indicate whether it intends to implement a key aspect of our recommendation. Specifically, in addition to performing a calculation to verify that its administrative costs do not exceed 5 percent, Public Health should develop and implement a written procedure to ensure that it continues to do so in the future. As we state on page 35, in the absence of such procedures, Public Health risks exceeding the allowed amount of administrative costs in the future. 3

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STATE OF CALIFORNIA
TOBACCO EDUCATION AND RESEARCH OVERSIGHT COMMITTEE

December 11, 2020

Attn: Ms. Elaine Howle*
California State Auditor
621 Capitol Mall, Suite 1200
Sacramento, CA 95814

Re: Response to Recommendations from the California State Auditor for Audit 2019-046

Dear Ms. Howle,

The Tobacco Education and Research Oversight Committee (TEROC) would like to thank the California State Auditors for providing conclusions and recommendations based on an audit of TEROC and Proposition 56 as required by Revenue and Taxation Code Sections 30130.56 (a) and (b).

TEROC is a legislatively mandated oversight committee that monitors the use of Proposition 99 and Proposition 56 tobacco tax revenues for tobacco control, prevention education, and tobacco-related research in California.[1,2] TEROC advises the California Department of Public Health California Tobacco Control Program (CTCP); the University of California (UC); and the California Department of Education (CDE) with respect to policy development, integration, and evaluation of tobacco education programs funded by Proposition 99 and Proposition 56.

TEROC appreciates the opportunity to respond to the two recommendations included in the audit findings.

1. State law directs TEROC to evaluate the use of tobacco tax funds by Public Health, Education, and the University of California and requires TEROC to provide an annual report to the Legislature (Health and Safety Code Section 104370 (d)). **The audit report recommends: "To ensure that the Legislature has the knowledge necessary to make informed decisions about tobacco tax-funded programs, TEROC should produce the annual report each year, as state law requires."**

   In order to comply with state law, TEROC will provide an annual report to the Legislature by December 31 of each year that includes information on: a) the number and amount of programs funded by Proposition 99 and Proposition 56 through CTCP, CDE and the UC; b) the funds appropriated, funds expended, and any unspent balance for CTCP, CDE and the UC; c) a description and assessment of certain programs funded by Propositions 99 and 56; and d) recommendations for necessary policy changes or improvements for tobacco education programs.

* California State Auditor's comments begin on page 77.

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December 11, 2020

Although TEROC does not currently produce a single report annually, it does collect
1 most of the data required by law and makes this information publicly available throughout each year. TEROC provides the Legislature with information on a regular basis through letters that TEROC members vote to write at each quarterly meeting. The financial information required by law is also publicly available from the annual reports produced by the Department of Finance and already included in public meeting information. Finally, meeting minutes from each quarterly meeting are public information and includes the recommendations and assessment information about the programs. In the future, this information will be compiled into a single report and submitted annually to the Legislature.

2. State law requires TEROC to produce comprehensive master plan for implementing tobacco-related programs administered by Public Health, Education, and the University of California biennially and submit it to the Legislature (Health and Safety Code Section 104370 (f)). **The audit report recommends: "To ensure it is meeting the Legislature's expectations, TEROC should either provide the master plan to the Legislature every two years, as state law requires, or seek legislative change to reduce the frequency with which it is required to produce the master plan."**

To comply with state law, TEROC will produce and submit its master plan to the Legislature by January 31 biennially so that subsequent master plans will cover two
2 calendar years. TEROC had previously interpreted for over 20 years that it met the biennial requirement with reports covering fiscal years, e.g., 1995-1997[3]. As this interpretation has not been raised as a concern by the Legislature, TEROC has not undertaken any changes in its master plan timeframe, particularly in light of diminishing Proposition 99 funds each year (as a result of decreased tobacco use) and the current process for developing a master plan, which requires significant funds and time commitments from both TEROC members and staff from the California Tobacco Control Program. In order to comply with the two-year requirement in state law and resolve any confusion, TEROC will provide subsequent master plans that cover two calendar years. TEROC will budget funds provided by Proposition 56 in order to compensate for the depletion of Proposition 99 funds available for master plan development. TEROC will also modify the process for writing and disseminating the plan to make the current process less cumbersome on TEROC members and staff.

We appreciate the opportunity provided by the audit conducted by the California State Auditor to improve the legislative reporting processes conducted by TEROC, and to ensure that California's tobacco control program continues to lead the nation and the world in tobacco control. Since the passage of Proposition 56 in 2016, California has reduced its cigarette use prevalence rate from 11.9 percent in 2016 to 6.9 percent in 2019 based on data from the California Health Interview Survey. We believe that California's tobacco control programs are critical to this success, and we expect that in future years that California can do even better.

Page 3
December 11, 2020

Sincerely,

Michael K. Ong, M.D., PhD.
Chairperson

References

1. Health & Safety Code Section 104365-104370.
2. Revenue & Taxation Code Section 30130.56(e).
3. Tobacco Education and Research Oversight Committee. *Toward a Tobacco Free California: Mastering the Challenge 1995-1997, Strategic Plan for the California Tobacco Control Program.* 1997.

Comments

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM TEROC

To provide clarity and perspective, we are commenting on the response to our audit report from TEROC. The numbers below correspond to the numbers we placed in the margin of TEROC's response.

TEROC's statement that it provides most of the information it is required to publish each year is an overstatement. As we state on page 37, it does not provide the required financial information for Proposition 56 funds, and the recommendations TEROC has provided do not constitute an annual description and assessment of certain programs funded by Propositions 99 and 56, as the law requires. Further, the Legislature should not be required to examine various documents, as suggested by TEROC, to obtain the information TEROC is required to provide. However, we are pleased to see that TEROC intends to compile all pertinent information into a single report and will submit that report annually to the Legislature. 1

TEROC did not meet the requirement to produce a biennial report. As we describe on page 37, it published the master plans once every three years, rather than every two years as required by state law. 2

UNIVERSITY
OF
CALIFORNIA

Michael V. Drake, MD
President

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December 11, 2020

Ms. Elaine M. Howle
California State Auditor
621 Capitol Mall, Suite 1200
Sacramento, California 95814

Dear State Auditor Howle:

Thank you for the opportunity to review and respond to the draft audit report on Proposition 56 tobacco tax. Below is the University's response to the recommendation in the report directed to the University of California Office of the President (UCOP).

1. To provide the public with relevant information and ensure the level of accountability that state law intends, each state entity that receives Proposition 56 funds should publish the following information on its website by April 2021 for fiscal years 2017-2018 through 2019-20, and within six months of the end of each fiscal year, beginning with fiscal year 2020-21:
    - The amount of Proposition 56 funds received by each program it administers.
    - The amount of Proposition 56 funds spent by each program it administers.
    - The amount of Proposition 56 funds obligated for future expenditures by each program it administers.
    - Any corrections to the information it reported in previous fiscal years.

We agree with this recommendation and will update our UCOP websites to include this additional information for fiscal years 2017-2018 and 2018-2019 by April 2021. We will publish this information for fiscal year 2020-2021 by the end of December 2021, and for each fiscal year thereafter, within six months of the end of each fiscal year.

We appreciate your team's professionalism and cooperation during the audit process, and we look forward to implementing the report's recommendations.

Sincerely,

Michael V. Drake, M.D.
President