LAO

The 2017-18 Budget:

An Overview of the Governor's Proposition 56 Proposals

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Summary

Proposition 56 Increases Tobacco Taxes and Directs the Use of Those Revenues. In November 2016, voters approved Proposition 56, which increases excise taxes on tobacco products by $2. The measure also prescribes how to distribute the revenues from the increased tax. In some cases, Proposition 56 requires the new revenue to supplement existing spending on the programs. The measure dedicates the bulk of the new revenue to Medi-Cal. The Proposition 56 revenues dedicated to Medi-Cal are required to supplement, not supplant, the existing spending on the program.

Revenue Estimate Reasonable; Allocation Amounts Generally Follow Requirements. Overall, we are comfortable with the administration's $1.4 billion revenue estimate for 2017-18. In all but one instance, the Governor's allocation proposals follow the amounts prescribed in the measure. For State Board of Equalization (BOE) enforcement activities, however, the Governor's budget provides $5.8 million when the measure requires BOE to receive $6 million annually.

Supplantation or Not? Questions have been raised as to whether the Governor's proposals for the use of Proposition 56 Medi-Cal revenues meet the initiative's requirement to supplement existing spending. The Governor's Medi-Cal proposal uses the Proposition 56 revenue to pay for typical year-to-year cost increases in the program. Taken at face value, voter approval of Proposition 56 arguably demonstrates a desire to increase Medi-Cal funding beyond year-to-year growth in the program. The administration, however, argues that the Proposition 56 revenues are used to increase Medi-Cal spending above the *2016-17 Budget Act* level and therefore the revenues do not supplant *existing* resources. In our review, we found few court decisions regarding supplantation.

Legislature Could Consider Alternative Uses of Medi-Cal Funds. Under the administration's revenue estimates, using the Proposition 56 Medi-Cal revenues differently—by increasing provider rates, for example—would have trade-offs. In particular, the Legislature would need to allocate an additional $1.3 billion from the General Fund to pay for the costs Proposition 56 covers under the Governor's proposal. Should revenue estimates be higher in May, however, the Legislature may have more flexibility to allocate additional revenues to Medi-Cal.

INTRODUCTION

Proposition 56 was approved by voters in November 2016 to increase taxes on cigarettes and other tobacco products. Questions have been raised as to whether the Governor's proposals for allocating Proposition 56 revenues meet the initiative's requirement to supplement—and not supplant—existing spending in several areas. To examine these questions, we begin by reviewing the provisions of Proposition 56 and the Governor's budget proposals. We then discuss whether the Governor's proposals for Medi-Cal could be viewed as supplanting General Fund resources and identify the relevant case law. We conclude by describing some trade-offs for the Legislature to consider in allocating the Proposition 56 revenues.

BACKGROUND

Proposition 56 increased the state's excise tax on cigarettes and other tobacco products beginning April 1, 2017. In most cases, excise taxes are levied on the distributors of goods. Typically, increasing excise taxes raises prices for consumers. In this section, we describe the tax provisions of the measure and how the measure distributes those revenues for various purposes.

Taxes

Increases Tobacco Excise Taxes. Beginning in April, the excise tax on a pack of cigarettes will increase from 87 cents to $2.87. Existing law requires taxes on other tobacco products—such as cigars—to increase any time the tax on cigarettes increases. Accordingly, taxes on other tobacco products also will increase by $2—from the equivalent of $1.37 per pack of cigarettes to $3.37. The measure also extends the definition of other tobacco products to include electronic cigarettes, which previously were subject only to sales tax.

Allocation of Revenues

Measure Prescribes the Distribution of the Revenues. Revenues from the new tobacco taxes are deposited directly into a new special fund. As shown in Figure 1, the measure outlines a series of steps for allocating the revenue, which we describe below.

- ***Step One.*** The measure requires that new revenues raised by the measure first replace revenue losses—or "backfill"—to certain sources (particularly existing state tobacco funds and sales taxes) that occur as a result of the measure. These revenue losses occur due to lower consumption of tobacco products due to the higher taxes.

- ***Step Two.*** The State Board of Equalization (BOE) receives up to 5 percent of remaining funds to pay for the costs of administering the tax.

- ***Step Three.*** Specified state entities receive fixed dollar amounts for specific purposes.

- ***Step Four.*** Remaining funds are allocated—using specified percentages—to various programs, primarily to augment spending on health care services for low-income individuals and families covered by the Medi-Cal program. Medi-Cal provides health care services to low-income Californians.

Figure 1

How Measure Directs New Tax Revenue Be Spent

Program or Entity[a]	Amount	Purpose
Step 1: Replace Lost Revenues		
Existing Tobacco Tax Funds	Determined by BOE	To maintain tobacco-related revenues that tobacco tax funds would have received before this measure.
State and Local Sales and Use Tax	Determined by BOE	To maintain tobacco-related revenues the state and local governments would have received before this measure.
Step 2: Pay for Tax Administration		
State Board of Equalization (BOE)—administration	5 percent of remaining funds	For costs to administer the tax.
Step 3: Allocate Specific Amounts for Various State Entities[b]		
Various state entities—enforcement[c]	$48 million	For various enforcement activities of tobacco-related laws.
University of California (UC)—physician training	$40 million	For physician training to increase the number of primary care and emergency physicians in California.
Department of Public Health (DPH)—State Dental Program	$30 million	For education on preventing and treating dental disease.
California State Auditor	$400,000	For audits of agencies receiving funds from new taxes, at least every other year.
Step 4: Distribute Remaining Funds for State Health Programs		
Medi-Cal—Department of Health Care Services	82 percent of remaining funds	For increasing the level of payment for health care, services, and treatment provided to Medi-Cal beneficiaries.
California Tobacco Control Program—DPH	11 percent of remaining funds	For tobacco prevention and control programs aimed at reducing illness and death from tobacco-related diseases.
Tobacco-Related Disease Program—UC	5 percent of remaining funds	For medical research into prevention, early detection, treatments, and potential cures of all types of cancer, cardiovascular and lung disease, and other tobacco-related diseases.
School Programs—California Department of Education	2 percent of remaining funds	For school programs to prevent and reduce the use of tobacco products by young people.

[a] The measure limits the amount of revenues raised that could be used to pay for administrative costs, to be defined by the State Auditor through regulation, to not more than 5 percent for each recipient of funding.

[b] Predetermined amounts will be adjusted proportionately by BOE annually, beginning two years after the measure went into effect, if the BOE determines that there has been a reduction in revenues resulting from a reduction in the consumption of cigarette and tobacco products due to the measure.

[c] Funds distributed to Department of Justice ($36 million), DPH ($6 million), and BOE ($6 million).

For Some Allocations, New Revenues Cannot Replace General Fund Dollars. For some of the allocations show in Figure 1, the measure specifies that the new revenues are to supplement and not supplant—or replace—existing state resources for the programs. Figure 2 (see next page) shows the allocations that contain this provision and the language included in the measure.

GOVERNOR'S BUDGET PROPOSALS

This section describes the administration's estimates for the new tobacco tax revenues and how the administration proposes to use those revenues. (We discuss the programmatic aspects of some of these proposals in our other program-specific analyses.) As Proposition 56 becomes effective April 1, 2017, there will be one quarter of revenue in 2016-17. The administration proposes to allocate the revenue generated in 2016-17 in 2017-18. As a result, the uses of the funds described below reflect five quarters of revenue proposed for spending in 2017-18.

Revenue Estimates

The administration projects that the new tobacco taxes will raise $368 million in 2016-17 and $1.4 billion in 2017-18 for the new special fund, for a total of $1.8 billion. Of this total, the administration estimates that $24 million will come from taxes on electronic cigarettes. Figure 3 shows how the administration would allocate the revenues to the various Proposition 56 purposes. We discuss these allocations in more detail below.

Backfill, Administration, and Audits

$37.2 Million for Backfill Payments in 2017-18. The administration estimates that the new special fund will make backfill payments totaling $37.2 million in 2017-18. The proposed budget allocates all of this money to existing special funds. The Governor's budget did not provide a backfill to the tobacco tax that supports the General Fund, which the measure requires. The administration plans to correct this error in the May Revision and estimates this backfill to be $4.2 million.

$1.1 Million for Tax Administration in 2017-18. The Governor's Budget proposes to spend $1.1 million for BOE to administer the new taxes. This amount is well below the maximum level, or "cap," established by Proposition 56. (Based on the administration's revenue and backfill projections, we estimate that this cap will be $88 million in 2017-18.) As noted below, Proposition 56 separately provides funding for BOE's enforcement activities.

$400,000 for State Auditor in 2017-18. The Governor's Budget proposes to spend $400,000 for the State Auditor to conduct audits required by Proposition 56. This amount is $100,000 below the cap for 2017-18 (with five quarters of revenue) but equal to the cap in subsequent years.

Figure 2

Non-Supplantation Provisions in Proposition 56[a]

Program or Entity	Language of the Measure
Enforcement[b]	These funds are not to be used to supplant existing state or local funds for these same purposes (Section 30130.57, paragraph e).
Medi-Cal	To the extent possible given the limits of funding under this article, payments and support for the nonfederal share of payments for healthcare, services, and treatment shall be increased based on criteria developed and periodically updated as part of the annual state budget process, provided that these funds shall not be used to supplant existing state general funds for these same purposes (Section 30130.55, paragraph a).
Tobacco Control Program	These funds are not to be used to supplant existing state or local funds for these same purposes (Section 30130.55, paragraph b).
UC Tobacco-Related Disease Research	The funds shall not be used to supplant existing state or local funds for these same purposes (Section 30130.55, paragraph c).
School Programs	These funds shall not be used to supplant existing state or local funds for these same purposes (Section 30130.55, paragraph b).

[a] Section references are from Revenue and Taxation code.

[b] Includes enforcement funds allocated to Department of Justice, Office of the Attorney General, Department of Public Health, and the State Board of Equalization.

Proposals for Specified Dollar Amounts in the Measure

$58.3 Million for Enforcement Activities. The administration allocates $45 million for local law enforcement grants ($37.5 million through the Department of Justice and $7.5 million through the Department of Public Heath, respectively) to prevent illegal sales of tobacco products. In addition, the administration allocates $7.5 million to the Department of Justice for tobacco law enforcement activities, particularly enforcing compliance with tax obligations. Lastly, the administration allocates $5.8 million to BOE for regulating the distribution of tobacco products. This amount is less than the annual $6 million (or $7.5 million for five quarters of revenue) specified by the measure. Under the Governor's proposal, these funds supplement existing programs, which is required by the measure.

$37.5 Million for State Oral Health Program. The administration proposes to use the Proposition 56 funds to support 11 additional positions at the Department of Public Health's (DPH's) Oral Health Program (OHP). Proposition 56 provides the department significant discretion in how to use the resources allocated to the state dental program. OHP proposes using the new funds to implement a forthcoming California State Oral Health Plan, which is currently past due.

$50 Million for Graduate Medical Education. The administration proposes allocating $50 million to the University of California (UC) for graduate medical education. The administration uses Proposition 56 revenue in place of $50 million General Fund revenue that the administration estimates supported graduate medical education in 2016-17. (General Fund for UC generally is not earmarked for specific purposes.) The administration proposes repurposing the $50 million General Fund for the Governor's commitment to provide a 4 percent unallocated base funding increase to UC.

Proposal for Medi-Cal

Over $1.3 Billion to Medi-Cal. As required by the measure, the Governor's budget allocates the bulk of the Proposition 56 revenues to Medi-Cal. (Of this amount, $1.2 billion would be allocated to Medi-Cal in 2017-18 and the remainder would be allocated in 2018-19 due to Medi-Cal's accounting structure.) These Proposition 56 revenues largely would support anticipated cost increases in the program from 2016-17 to 2017-18. The measure restricts Proposition 56 revenues from supplanting existing General Fund support for Medi-Cal. While the administration does not reduce *overall* state funding for Medi-Cal as a result of the Proposition 56 revenues, the administration's

Figure 3

Governor's Budget Proposal for Proposition 56 Revenue

(In Millions)

Program or Entity	Amount[a]
Backfill existing funds[b]	$37
BOE administration[c]	1
Fixed Allocations	
Enforcement	58
UC Physician Training	50
DPH State Dental Health Program	38
California State Auditor	0.4
Remaining Allocations	
Medi-Cal[d]	1,324
DPH Tobacco Control Program	179
UC Tobacco-Related Disease Research	81
School Programs	32
Total	**$1,799**

[a] Amounts reflect five quarters of revenue.
[b] Replaces lost revenue to existing tobacco tax funds as well as state and local sales and use taxes. Excludes General Fund backfill, which Department of Finance indicates will be reflected in May.
[c] Includes enforcement funds allocated to the Department of Justice, Office of the Attorney General, Department of Public Health, and the Board of Equalization.
[d] Includes $87 million which will be expended in 2018-19.

BOE = Board of Equalization; UC = University of California; and DPH = Department of Public Health.

proposals do not include any new policy changes to provider rates or fee-for-service payments. We describe the use of the Proposition 56 revenues in more detail below.

Over $900 Million Supports Increased Managed Care Costs. The majority of Proposition 56 Medi-Cal revenue would go to managed care plans under the Governor's proposal. Based on data from the Department of Finance, a large portion of that revenue would pay for the state's increased share of cost for the Patient Protection and Affordable Care Act (ACA) Medi-Cal optional expansion. (Each year the state's share of cost under the expansion increases as federal funds decline.) In effect, these payments would backfill the anticipated decline in federal funds. Proposition 56 revenues also would pay almost all of the annual capitated rate adjustment that managed care plans receive to cover the increased cost of providing services year to year. In addition, some portion of these funds would support costs associated with higher utilization of Hepatitis C medications and caseload increases.

Remainder Paid to Medicare. The Governor proposes using the remaining $323 million to support increased payments to the federal government. Most of this funding would pay for increased payments for Medicare premiums, which Medi-Cal covers for those program beneficiaries who also are eligible for Medicare.

Proposal for Department of Public Health—Tobacco Control

$178.5 Million for DPH Tobacco Control Board (TCB). Using revenues from Proposition 99, TCB works to reduce smoking and exposure to second-hand smoke in California through a variety of statewide and community-based activities. TCB proposes to use the additional revenue from Proposition 56 to support 26 additional staff and award additional competitive grants to local governments and community-based organizations. These grants would expand prevention and reduction programs and other local smoking cessation activities. TCB also would boost phone hotline services for smoking cessation. These funds supplement TCB's existing efforts, as required by the measure.

Proposal for Medical Research and School Programs

$80.7 Million for UC Research. The Governor's budget allocates almost $81 million in Proposition 56 revenues to support tobacco-related medical research. The measure requires UC to allocate these grants on a competitive basis to individuals or entities within California. These funds supplement existing research grants for tobacco-related medical research, as required by the measure.

$31.5 Million for Schools. The administration allocates $31.5 million to the California Department of Education's Tobacco Use Prevention Education program. This program provides competitive grants to schools to educate students on avoiding tobacco use. These funds supplement exiting tobacco-related school programs, as required by the measure.

LAO FINDINGS

Revenue Estimates and Allocations

Governor's Overall Estimate for Proposition 56 Revenues Reasonable. Our revenue assumptions differ from the administration's in two ways. First, we expect a stronger consumer response to the tax increases, which would reduce revenue. (This response includes both lower rates of actual tobacco consumption and higher rates of tax avoidance.) Second, we expect higher revenues from certain parts of the new taxes—such as the new tax on electronic cigarettes—which would increase revenue. These differences largely offset each other, so we are comfortable with the administration's overall revenue estimate.

Generally, Administration's Proposals Allocate Funds to the Required Programs. In all but one instance, the Governor's allocation proposals follow the amounts prescribed in the measure. Specifically, the measure requires BOE to receive $6 million annually ($7.5 million for five quarters of revenue) for enforcement activities. The administration's proposal only provides $5.8 million in 2017-18. The administration argues that the measure does not require the funds to be allocated to BOE but simply designated as revenue owed BOE. The measure states, in relevant part, "Six million dollars ($6,000,000) annually to the board to be used to enforce laws."

Use of Graduate Medical Education Funds May Not Meet Goal of Measure. While the measure does not require Proposition 56 revenues to supplement existing resources for medical education programs, the measure does state those funds are to be used "for the purpose and goal of increasing the number of primary care and emergency physicians training in California." Using the Proposition 56 revenues to replace General Fund resources used for graduate medical education (at least according to administration estimates) arguably does not meet this goal.

Supplantation or Not for Medi-Cal?

As noted earlier, we believe the Governor's proposals for tobacco enforcement, TCB, medical research, and school programs meet the proposition's requirements that the new revenues supplement existing funds to the programs. We discuss whether the Governor's use of Proposition 56 Medi-Cal funds meets the measure's requirements below.

Common Sense View of Supplantation. Some believe that the Governor's proposal does not comply with the measure's non-supplantation requirements for Medi-Cal. One of the purposes of Proposition 56, as outlined in the measure, was to "provide funds to increase funding for existing health care programs and services." Taken at face value, voter approval of Proposition 56 arguably demonstrates a desire to increase funding to Medi-Cal beyond year-to-year growth in the program absent policy changes. The Governor's proposal, by contrast, uses the new revenues to pay for typical year-to-year cost increases in Medi-Cal. Proposition 56 funds are not used to increase provider rates or expand the current scope of the Medi-Cal program in any way.

Governor's View of Measure's Requirements. As noted in Figure 2, Proposition 56 directs that its revenues "shall not be used to supplant existing state general funds for these same purposes," namely, state Medi-Cal payments. The Governor's proposal takes a literal view of this text. That is, the administration argues that the *existing* General Fund support to Medi-Cal is the amount provided in the *2016-17 Budget Act*, which, relative to the Governor's 2017-18 budget proposal, does not decline. Moreover, under the Governor's proposal, the majority of the Proposition 56 revenues pay for the state's increased share of cost for the ACA Medi-Cal expansion, thereby supplanting federal funds, not state funds, which the measure does not explicitly prohibit.

Relevant Case Law Thin. In our review, we found few court decisions regarding supplantation. Though Superior Court decisions generally are not binding precedent, one California Superior Court decision (*Children and Families Commission of Fresno County et al. v. Edmund G. Brown, Jr., et al*) considered issues concerning supplantation of funds related to Proposition 10 (1998), another voter-approved tobacco measure. In that case, the question before the court was whether the state could shift Proposition 10 revenues from First 5 Commissions to Medi-Cal. Proposition 10 stipulated, "no monies from [Proposition 10] shall be used to supplant state or local General Fund money for any purpose." The court found that transferring funds from Proposition 10 to avoid cuts in Medi-Cal was "disingenuous." Under that rationale, the court stated that "the state could cut Medi-Cal funding entirely and replace it with all with [Proposition] 10 funds, claiming at the same time that they were not 'supplanting' existing services because the services no longer existed."

Potential Alternatives

Legislature Could Consider Alternative Uses of Medi-Cal Funds. Should the Legislature disagree with the administration's interpretation of the requirements under Proposition 56, the revenues for Medi-Cal could be used to increase fee-for-service payments or managed care rates. Using the Proposition 56 revenues to increase provider payments would have trade-offs. In particular, the Legislature would need to allocate an additional $1.3 billion from the General Fund to Medi-Cal to pay for the costs Proposition 56 covers under the Governor's proposal. Under the Governor's revenue estimates, doing so could require reductions to other programs or smaller budget reserves. Should the revenue estimates be higher in May, however, the Legislature may have more flexibility to allocate additional revenues to Medi-Cal.

CONCLUSION

The Governor's proposal for the use of Proposition 56 revenues generally allocates the revenues to the entities and in the amounts specified in the measure. The proposed use of the revenues for Medi-Cal, however, may be problematic, although we cannot be certain how the courts would interpret the proposal if enacted. In any case, the Legislature must make its own determination about how to implement the Medi-Cal provisions of the measure.

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This brief was prepared by Carolyn Chu, with assistance from various analysts, and reviewed by Jason Sisney. The Legislative Analyst's Office (LAO) is a nonpartisan office that provides fiscal and policy information and advice to the Legislature.

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