March 13, 1998

Hon. Daniel E. Lungren
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Connie Lemus
Initiative Coordinator

Dear Attorney General Lungren:

Pursuant to Elections Code Section 9005, we have reviewed the proposed initiative providing a tax credit for health insurance and establishing a State Health Insurance Fund (File No. SA 98 RF 0009).

MAJOR PROVISIONS

This measure would establish a new state tax credit for the cost of purchasing health care coverage, create a new State Health Insurance Fund, and provide for regulation of health insurance payments to health care providers.

CREATION OF NEW STATE HEALTH INSURANCE FUND AND BOARD

The measure establishes a new State Health Insurance Fund, which would offer health insurance in California in competition with other private insurers. The operations of the fund would be governed by a board, also established by the measure. In addition to overseeing the operation of the fund, the board would regulate the scope of health insurance coverage and payments to health care providers by other health insurers in the state.

State Health Insurance Fund

The initiative establishes the fund to offer health insurance to groups or individuals on a fee-for-service basis. That is, the fund would operate as a traditional insurer paying health care providers for individual services provided to insured persons, rather than as a health care service plan, which may pay providers fixed periodic payments per member (capitation) to provide all necessary services to those plan members assigned to them. The measure limits the state's liability for insurance issued by the fund to the assets of the fund.

Under the measure, the fund would be exempt from most laws governing the operations of state agencies, including requirements for public records and open meetings. However, employees of the fund would be subject to collective bargaining and civil service protections.

General Fund Loan for Initial Capital. The initiative transfers $2 million from the state General Fund to the new State Health Insurance Fund as a loan for initial capital to be repaid with interest in five annual installments starting January 1, 2000.

Board of Directors

The initiative establishes a 21-member board of directors that would govern the operation of the State Health Insurance Fund and also regulate some aspects of health insurance generally. Board members would be appointed by the Governor for two-year terms, but the measure specifies that a majority of the initial board shall be appointed by G. Y. Hadjian, the measure's proponent, and that Mr. Hadjian would serve as a permanent member of the board. We note that Article II, Section 12 of the California Constitution prohibits initiatives that name any individual to hold an office from taking effect. Consequently, this provision, or the entire measure, may be subject to invalidation by the courts.

The measure directs the board to establish fees that the fund would pay to health care providers for services to insured persons. These fees would be set at a level intended to cover, but not exceed, the actual costs of providers.

REGULATION OF HEALTH INSURANCE

The measure establishes new requirements for health insurers that would be in addition to requirements of existing law.

Direct Payment by Health Insurers

Under Existing Law. Health insurers may pay health care providers directly for covered services provided to an insured person, or they may choose to pay on a reimbursement basis. For policies that are on a reimbursement basis, the insured person pays for the service, submits a claim to the insurance company, and then is reimbursed for their covered costs.

Under the Initiative. Health insurers, including the State Health Insurance Fund, would have to pay providers directly and would not have the option of making payments on a reimbursement basis.

Regulation of Provider Fees And Charges

Under Existing Law. The state does not regulate the amounts paid by health insurers to health care providers. Instead these payments are based on the usual and customary charges of providers or they are based on a negotiated contractual rate. Furthermore, health insurance policies may require copayments by the insured person or may limit insurance coverage for services to specific dollar amounts or to a percentage of the bill.

Under the Initiative. The board of the State Health Insurance Fund would establish a schedule of fees that insurers would pay to health care providers. The measure requires the board to set fees that "fairly compensate" providers, and these fees would have to at least equal the lesser of either the fees paid by the State Health Insurance Fund or the fees paid by the Medi-Cal program. The measure also requires the board to set maximum dollar amounts for copayments or user fees charged by providers directly to insured persons. The initiative prohibits health care providers from charging more for services to insured persons than the fees set by the board.

Federal Law May Limit the Scope of This Measure

The federal Employee Retirement Income Security Act (ERISA) of 1974 broadly preempts state regulation of *benefits* provided by private employers, including health benefits. However, ERISA allows states to regulate insurers and to license and regulate the practice of medicine and other health care professions. Generally, this has meant that states cannot regulate the provision of health benefits or plans provided by employers who are self-insured (that is, employers who bear the financial risk of paying for benefits themselves rather than paying fixed amounts to insurers or health plans). Furthermore, ERISA precludes states from requiring employers (whether self-insured or not) to provide a specific scope or type of coverage (or any coverage at all). At this time, the extent of states' authority to impose requirements on the manner in which insurers and health plans provide employer-sponsored health benefits is not a well-settled area of the law. Consequently, the degree to which certain provisions of this measure (provisions that would regulate the terms of health insurance policies) would apply to employer-sponsored health benefits is uncertain and subject to interpretation by the courts.

TAX CREDIT FOR HEALTH COVERAGE

The measure establishes a new tax credit for health care coverage.

Under Existing Law. The cost of employee benefits, including health coverage, is a deductible business expense for employers under either the Personal Income Tax (PIT) or the Bank and Corporation Tax (B&CT). Some individuals who itemize their deductions may take a partial deduction for health care expenses for themselves or their dependents (including premiums for health coverage) under the PIT. The allowable deduction is the amount of these expenses that exceeds 7.5 percent of adjusted gross income.

Under the Initiative. A new state tax credit for the cost of "health insurance or similar coverage" would be established for the PIT and the B&CT. The amount of the credit would be 20 percent of the cost of coverage for the taxpayer and members of the taxpayer's immediate family or of the cost to an employer of providing coverage for employees. Credit amounts that exceed a taxpayer's tax liability could be carried over to future years. The credit would take effect for tax years beginning on or after January 1, 1999. The credit would be in lieu of any deduction. The scope of the new tax credit appears to be broad enough to include the cost of coverage provided by traditional health insurance or by health care service plans.

FISCAL EFFECTS

The primary fiscal effect of this measure would be to reduce state revenues due to the new tax credit for health care coverage.

Effect on State Revenues

Based on recent estimates of health care spending in California by the Lewin Group, we estimate that employers, other than governments and nonprofit organizations, spend a total of about $32 billion annually in California to provide health benefits to employees and their families, and to retirees. In addition, individuals in California spend a total of about $12 billion annually for employee contributions to employer-provided health coverage, purchase of individual coverage, and for Medicare Part B premiums. Thus, a total of about $44 billion of spending potentially would qualify for the 20 percent tax credit established by this measure.

However, the actual net revenue loss would be less than the full potential amount of $8.8 billion (20 percent of $44 billion) for two reasons. First, the credit would eliminate the current deductions allowed for these costs. Second, the California tax liability of many employers and some individuals would be less than the full amount of their credit, so some of the credit would go unused (even after accounting for carry-forwards to future years). After taking these adjustments into account, we estimate that the net combined annual loss of PIT and B&CT revenue to the state would be about $4 billion.

Effect on State Expenditures

The measure's effect on spending would depend primarily on whether the Legislature acts to offset some or all of the revenue loss. In the absence of such action, the revenue loss would result in spending reductions of a roughly similar magnitude. More specifically, there would be the following spending impacts.

Proposition 98 Spending. Current law (Proposition 98) provides a minimum state funding guarantee for K-14 education. The amount of the guarantee in any year is based on a number of factors, including General Fund tax revenues. Depending on the year involved and on the values of the various factors used to calculate the guarantee, the amount of the reduction in the Proposition 98 guarantee would be about one-half of the annual revenue loss (approximately $2 billion). The reduction in K-14 funding would be less if the Legislature chose to spend more than the minimum guarantee, but this would result in a commensurate additional reduction in non-Proposition 98 spending.

Non-Proposition 98 Spending. Non-Proposition 98 spending funds programs in health, social services, youth and adult corrections, higher education, debt-service, local assistance, and a wide variety of other programs supported by the state's General Fund. The amount of the reduction in non-Proposition 98 spending would be roughly the amount of the net revenue loss remaining after accounting for Proposition 98 spending reductions and potential savings from increased health coverage discussed below.

Potential Savings to State Health Programs. The tax credit established by this measure would reduce the effective cost to many employers and individuals of purchasing health coverage. As a result, it is likely that somewhat more employers would provide health coverage, and that somewhat more individuals would purchase health coverage. Increased private health coverage would likely reduce somewhat the number of poor and low-income persons obtaining coverage from state health programs, such as Medi-Cal or the new Healthy Families Program. We estimate that the General Fund savings due to this increased private coverage, although uncertain, could be in the high tens of millions of dollars annually.

Loan to State Health Insurance Fund. There would be a one-time cost to the state General Fund of $2 million for a start-up loan to the newly created State Health Insurance Fund. The measure provides for repayment by the new fund, but repayment would be problematic. First of all, the loan probably would not cover the administrative expenses, marketing costs, and capital requirements of establishing a new health insurance entity. Secondly, the fund may not be able to sell a sufficient number of policies to generate enough revenues to repay the loan.

Effect on Local Expenditures

Potential Savings to County Health Programs. Counties provide necessary health care to uninsured, generally poor, persons who do not qualify for Medi-Cal or other related state or federal programs. The tax credit established by this measure would likely increase private health coverage and reduce somewhat the need for county health care for the same reasons that the state would realize savings, as discussed above. We estimate that these potential county savings, although uncertain, could be up to high tens of millions of dollars annually statewide.

SUMMARY OF FISCAL EFFECTS

We estimate that the measure's provisions would have the following major fiscal effects:

- Net reduction in state General Fund revenues of about $4 billion annually.

- Absent legislative action to offset the revenue loss, there would be a roughly commensurate reduction in state spending, with about one-half of the spending reduction for K-14 schools and the remainder in other programs.

- Potential state General Fund savings of up to high tens of millions of dollars annually in state health care programs.

- Potential county savings of up to high tens of millions of dollars annually for indigent health care programs.

Sincerely,

Elizabeth G. Hill
Legislative Analyst

Craig L. Brown
Director of Finance