April 5, 1999

Hon. Bill Lockyer
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Connie Lemus
Initiative Coordinator

Dear Attorney General Lockyer:

Pursuant to Section 9005 of the Elections Code, we have reviewed the proposed initiative (File Number: SA 1999 RF 0004) which, among other things, would repeal the excise tax imposed on cigarettes and other tobacco products by Proposition 10, adopted by the voters in November 1998.

BACKGROUND ON PROPOSITION 10

Proposition 10 created the California Children and Families First Program, which is intended to fund early childhood development programs from revenues generated by increases in the state excise taxes on cigarettes and other tobacco products. Figure 1 (see next page) summarizes the major features of the measure.

Increased Tax on Tobacco Products

Proposition 10 increased the excise tax on cigarettes by 50 cents per pack beginning January 1, 1999, bringing the total state excise tax on this product to 87 cents per pack.

The measure also increased the excise tax on other types of tobacco products, such as cigars, chewing tobacco, pipe tobacco, and snuff.

Figure 1

Proposition10
Major Features

General Purpose

- Established the California Children and Families First Program to support early childhood development programs.

Governance

- State Children and Families First Commission.
  - Seven voting members: appointed by Governor (3), Speaker of Assembly (2), and Senate Rules Committee (2). Also two nonvoting members.
  - To adopt statewide guidelines for program.
- County commissions
  - Five to nine members: appointed by county board of supervisors.
  - To adopt strategic plan, consistent with state commission guidelines.

Revenues

- Derived from tax on cigarettes and other tobacco products.
- Estimated to be approximately $360 million in 1998-99 and approximately $690 million in 1999-00, with slightly declining amounts annually thereafter.
- Allocated 20 percent for state commission and 80 percent for county commissions.

Expenditures

- State commission must spend funds on (1) mass media campaign, (2) educational activities, (3) support for child care providers, (4) research, and (5) administration.
- County commissions have broad discretion on how to spend funds. Expenditures must be consistent with the purposes of the act (generally, for early childhood development programs).
- Must supplement and not supplant existing levels of service.

Proposition 10 increased the excise tax on these "other" tobacco products in two ways. First, it imposed a *new* excise tax on these products that is equivalent (in terms of the wholesale costs of these products) to a 50 cent per pack tax on cigarettes, effective January 1, 1999. Second, the measure will increase the *preexisting* excise tax on these products by the equivalent of a 50 cent per pack increase in the tax on cigarettes, effective July 1, 1999. This latter effect occurs because, under current law, an increase in the tax on cigarettes also automatically triggers an equivalent tax increase on other tobacco products. Thus, the measure ultimately will increase the total excise tax on other tobacco products by the equivalent of a $1 per pack increase in the tax on cigarettes.

Proposition 10 requires that the revenues generated by the *new* excise taxes on cigarettes and other tobacco products be placed in a new special fund– the California Children and Families First Trust Fund. These revenues fund:

- Early childhood development programs.
- Revenue losses to Proposition 99 health education and research programs and Breast Cancer Fund programs that are the result of the excise taxes imposed by the measure.

The revenues generated by the increase in the *preexisting* excise tax on other tobacco products are directed to the Cigarette and Tobacco Products Surtax Fund (for Proposition 99 programs).

California Children and Families First Program

Proposition 10 established the California Children and Families First Program to promote and develop early childhood development programs. The program is funded by the revenues generated by the new taxes on cigarettes and other tobacco products. The new program is carried out by state and county commissions.

State Commission. The measure created a new state commission– the California Children and Families First Commission– which is responsible for state-level administration of the early childhood development program. The commission is composed of seven voting members– three appointed by the Governor, two by the Speaker of the Assembly, and two by the Senate Rules Committee– and two ex officio nonvoting members (the Secretary of Health and Human Services Agency and the Secretary of Education). Twenty percent of the available revenues are allocated annually to the state commission, and spent for specified purposes.

County Commissions. Eighty percent of the available revenues under Proposition 10 are to be allocated annually to counties that create county commissions. The formula for allocating revenues to the county commissions is based on the annual number of births in each participating county.

Each county commission is to consist of five to nine members, appointed by the county board of supervisors. At least one member must be from the board of supervisors, and at least two members must be selected from among the county health officer and the county managers responsible for providing children's services, public health services, behavioral health services, social services, and tobacco and other substance abuse prevention and treatment services.

The county commissions adopt strategic plans and implement programs in accordance with the strategic plans to support and improve early childhood development. The local strategic plans must be consistent with any guidelines adopted by the state Children and Families First Commission, and must include a description of how programs and services relating to early childhood development in the county will be integrated into a consumer-oriented and easily accessible system.

MAJOR PROVISIONS OF THE INITIATIVE

The proposed initiative would eliminate certain provisions of Proposition 10, including the California Children and Families First Fund. It would eliminate the 50 cents per pack excise tax on cigarettes and the equivalent tax on other tobacco products imposed by Proposition 10, which were effective January 1, 1999. The proposed initiative would also have the effect of eliminating the additional increase in the *preexisting* excise tax imposed on other tobacco products which was triggered by the increase in the excise tax on cigarettes, and which will be effective July 1, 1999. For purposes of our fiscal estimates, we assume that the initiative would be effective the date following its passage (March 8, 2000). The proposed initiative would not specifically result in the elimination of the state and county commissions authorized by Proposition 10, although it would eliminate their source of funding.

Fiscal Effects

By repealing the provisions of Proposition 10, the initiative will eliminate the cigarette and tobacco product excise taxes used to fund the California Children and Families First Program. The measure will also lead to changes in revenues for Proposition 99 programs, the Breast Cancer Fund, the state's General Fund, and local governments.

Below, we discuss the fiscal effects of Proposition 10. Then we discuss how those effects would be altered by the passage of the proposed measure.

Effect on California Children and Families First Trust Fund. We estimate that the Proposition 10 excise tax would raise revenues of approximately $690 million in 1999-00, to fund childhood development programs and activities. Thus, assuming this initiative to repeal Proposition 10 is effective the day following its passage, it would result in an estimated revenue reduction of approximately $220 million for 1999-00 (a partial-year effect). The estimated revenue reduction for 2000-01 is approximately

$680 million, with declining annual amounts thereafter. We note that there is some uncertainty surrounding these estimates, due to the difficulty of predicting the effects of increases in excise taxes, the recent manufacturers' price increases for cigarettes (associated with the tobacco settlement), and the excise tax reduction being proposed on the consumption of cigarettes and other tobacco products.

Effect on Cigarette and Tobacco Products Surtax Fund Revenues. We estimate that Proposition 10 will result in a net decrease in revenues to the Cigarette and Tobacco Products Surtax Fund (Proposition 99). This effect is due to two offsetting factors. First, to the extent that Proposition 10 results in a reduction in the sales of cigarettes and other tobacco products, it will *decrease* the revenues generated by the *preexisting* excise taxes (as enacted prior to the passage of Proposition 10) on these products, beginning January 1, 1999. Second, the measure will *increase* the revenues generated by the preexisting excise tax on other (noncigarette) tobacco products that are allocated to the Cigarette and Tobacco Products Surtax Fund, beginning July 1, 1999. This occurs because, under current law, Proposition 10 triggers an increase in the rate of this preexisting excise tax on other tobacco products.

Under the requirements of Proposition 10, revenue losses to Proposition 99 health-related education and research programs are to be offset by revenues generated by the new excise taxes established by Proposition 10. However, revenue reductions to Proposition 99 health care and resources programs will not be offset. We estimate net revenue losses of several million dollars annually for Proposition 99 health care and resources programs due to Proposition 10.

This proposed initiative will have the effect of slightly reducing revenues for all Proposition 99 programs. This is due to the offsetting factors described above. If Proposition 10 is repealed, the revenues generated from the preexisting excise tax will rise due to the increase in cigarette and other tobacco products sales stemming from the resulting price reduction. However, this will be slightly more than offset by the revenue decline due to the elimination of the *increase* in the preexisting excise tax on other tobacco products scheduled for July 1, 1999. Thus, Proposition 99 revenues are estimated to decrease by less than several million dollars in 1999-00, and by declining amounts thereafter. (We note that the fiscal impact of the initiative does *not* result in a simple reversal of the impact of Proposition 10, for behavioral and technical reasons.)

Effect on Breast Cancer Fund Revenues. Under the requirements of Proposition 10, revenue losses to the Breast Cancer Fund are to be offset by revenues generated by the new excise taxes established by Proposition 10. This proposed initiative will lead to a relatively small revenue decline of less than $1 million to the Breast Cancer Fund. This is because the revenue increase generated by increased consumption stemming from the decline in the price of cigarettes and other tobacco products is slightly less than the "backfill" amounts estimated to be provided under Proposition 10. (This backfill will no longer occur under the proposed initiative.)

Effect on the State General Fund and Local Tax Revenues. We estimate that Proposition 10 will result in a net increase in General Fund revenues of about $7 million annually, and an increase in local government revenues of about $6 million annually. These state and local impacts result from the effect of Proposition 10 on sales tax revenues and (with respect to the state's General Fund) excise taxes.

The proposed initiative will result in a General Fund revenue loss of approximately $6 million in 1999-00 (partial year) and annual losses thereafter of about $20 million. For local governments, the estimated general sales tax revenue reductions are estimated to be $3 million in 1999-00 (partial year) and approximately $8 million thereafter. These estimates take into account assumptions about the response of consumers to cigarette price declines, and the fact that the General Fund's excise tax revenue increase is not sufficient to compensate for the decline in sales tax revenue.

Other Potential Fiscal Effects. We identified two types of, potential unknown long-term savings from the passage of Proposition 10. First, to the extent that the measure results in a decrease in the consumption of tobacco products, it would probably reduce state and local health care costs by an unknown amount over the long term. Second, the additional expenditures on early childhood development programs could result in state and local savings, over the long run, of unknown amounts in programs such as special education. IN view of the above, the proposed initiative to repeal Proposition 10 could result in unknown potential long-term costs to the state and local governments to the extent that it leads to (1) an increase in the consumption of tobacco products and an increase in related health care costs, and (2) a decrease in expenditures on early childhood development programs.

SUMMARY OF FISCAL EFFECTS

The proposed initiative would repeal Proposition 10, thereby resulting in the following fiscal effects:

- A reduction in annual state special fund revenues of approximately $680 million that would otherwise be allocated for early childhood development programs and activities.

- Relatively small annual reductions in Proposition 99 revenues (less than several million dollars) and in Breast Cancer Fund revenues (less than $1 million).

- Annual decreases in state General Fund revenues of approximately $20 million and local government general sales tax revenues of about $8 million.

- Unknown potential long-term state and local costs associated with an increase in tobacco consumption and/or a decrease in expenditures on early childhood development programs.

Sincerely,

Elizabeth G. Hill
Legislative Analyst

B. Timothy Gage
Director of Finance