

October 11, 2005

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

Attention: Ms. Tricia Knight
Initiative Coordinator

Dear Attorney General Lockyer:

Pursuant to Elections Code Section 2005, we have reviewed the proposed constitutional and statutory initiative entitled "The Emergency Services and Tobacco Tax Act of 2006" (File No. SA2005RF0097). This measure would increase excise taxes on cigarettes (and indirectly on other tobacco products) mainly to provide funding to hospitals for emergency services and for various other health and education programs.

BACKGROUND

Tobacco Taxes

Existing Tax Rate. Current state law imposes excise taxes on cigarettes and other tobacco products. The state's cigarette tax is currently 87 cents per pack (with an equivalent tax on other types of tobacco products) and is levied on cigarette distributors, who supply cigarettes to retail stores. The proceeds are used for both General Fund and certain special funds purposes enacted by the Legislature and voter-approved initiatives.

The total 87 cents per pack tax is made up of the following components:

- 10 cents per pack for the state General Fund.
- 25 cents per pack pursuant to the Tobacco Tax and Health Protection Act. This initiative, enacted by the voters as Proposition 99 in 1988, increased the cigarette tax by 25 cents per pack, created the equivalent tax on other tobacco products, and allocated all of the additional funding for a number of health-related purposes. These include tobacco education and prevention efforts, tobacco-related disease research programs, and health care services for low-

income uninsured persons, as well as for environmental protection and recreational resources.

- 2 cents per pack enacted through a separate measure approved by the Legislature and Governor in 1993 to create the Breast Cancer Research Fund, which supports research efforts related to breast cancer.
- 50 cents per pack pursuant to the California Children and Families First Act of 1998. This measure, enacted by the voters that year as Proposition 10, supports early childhood development programs.

Current taxes on cigarettes and other tobacco products are estimated to raise in excess of \$1 billion in 2005-06. Because per-capita consumption of tobacco is declining, tobacco tax revenues have been decreasing and will likely continue to decrease slightly over time.

Backfill Provisions

Part of the Proposition 10 revenues are used to “backfill” or offset any revenue losses experienced by Proposition 99’s health-related education and research programs and the Breast Cancer Research Fund due to decreased consumption resulting from the tax increase. The Proposition 10 tax increase resulted in a drop in consumption of tobacco products that reduced the revenues going to the programs funded under Proposition 99. This occurred because the increase in the price of cigarettes (1) reduced cigarette sales and (2) resulted in more out-of-state sales (as well as sales on tribal lands) and smuggled products, for which taxes are not collected.

The backfill provided under Proposition 10 offsets the loss of tens of millions of dollars annually to certain Proposition 99 accounts, although other Proposition 99 accounts do not receive backfill for their losses.

PROPOSAL

New State Revenues

This measure increases the existing excise tax on cigarettes by \$1.50 per pack and uses the resulting revenue to provide additional funding for hospitals for emergency and trauma medical care and for other health and education programs. If this measure were placed on the June 2006 ballot, the tax increase would take effect in July 2006. Otherwise, the tax increase would take effect in January 2007.

Existing state law requires the Board of Equalization to increase taxes on other tobacco products—such as loose tobacco and snuff—in an amount equivalent to any increase in the tax on cigarettes. Thus, this measure would also result in a comparable increase in the excise tax on other tobacco products.

How Additional Revenues Would Be Spent

Hospital Funding. Receipts from the cigarette tax increase would be deposited in a new special fund called the Emergency Services and Tobacco Tax Trust Fund. As much as 65 percent of the additional cigarette tax revenues deposited into this fund would be used to provide funding to hospitals. The measure specifies that hospitals use the funds to pay their unreimbursed costs for emergency services and to improve or expand emergency services, facilities, or equipment. Funds would generally be allocated to certain eligible hospitals according to a formula based largely on the number of persons that a hospital had treated in its emergency department. The formula also takes into account the costs to hospitals for providing health care for indigents. Hospitals that are owned or operated by the state or federal government would not be eligible to receive funding.

Other Funding Allocations. The remaining portion of these additional cigarette tax revenues would be used to help pay for uncompensated health care for indigents provided by physicians, expand nursing education programs, curb smoking by youth and young adults, and enforce laws against evasion of tobacco taxes and illegal smuggling and black marketing of tobacco products.

Local Governments Would Receive Funding. Some of the additional cigarette tax revenues would be passed through to local government agencies, such as counties that operate hospitals (which could receive funding for emergency services) and counties that received allocations to reimburse physicians for uncompensated care for indigents. Certain other programs enacted under this measure would also support local government activities.

Backfill of Other Programs. Some of these additional cigarette tax revenues would be used to help backfill other programs funded with tobacco taxes for a loss of funding that is likely to occur as a result of this measure. (This loss of funds would result because of the tax increases contained in this measure.) This backfill funding would be provided for Proposition 99 and Proposition 10 programs and the Breast Cancer Research Fund.

Other Spending Provisions. The measure creates various new accounts to set aside funds for the purposes described above and specifies the share of cigarette tax proceeds that would be devoted to each purpose. These funds would not be provided through the annual state budget act for ten years after this initiative took effect and thus amounts would not be subject to change by actions of the Legislature and Governor. After ten years, the funding allocations set forth in the initiative could be changed by the Legislature, although the share of funding allocated for support of emergency hospital services could not be reduced.

The additional cigarette tax revenues allocated by this measure would have to be used to supplement existing levels of state, federal, and local funding and could not take the place of existing spending. Some of the additional cigarette tax revenues would be used to offset the cost to various state agencies of administering these various new programs.

Revenues From Other Tobacco Products. As noted earlier, the increase in the cigarette tax enacted under this measure would, under existing law, trigger an equivalent increase in taxes for other tobacco products. This initiative does not allocate these additional revenues. According to existing law, any additional revenues would be allocated to Proposition 99 programs.

Other Provisions

Rules for Hospital Charity Care and Bill Collections. This initiative establishes various new state requirements relating to charity care and collection of unpaid bills, which would apply to hospitals that were allocated funds under this measure for emergency and trauma care services. For example, hospitals allocated these new funds would generally be limited in what they could charge to certain patients in families with incomes at or below 300 percent of the federal poverty level who lack health coverage and who apply for financial assistance from the hospital. Rural hospitals would be allowed to limit assistance to patients in families with lower income levels. These hospitals would also have to assist patients in determining if they were eligible for government-sponsored health care programs and would have to adopt written policies on charity care and discounts for patients. Hospitals that were allocated new funds under this measure would also have to adopt written policies on their bill collection practices and conform to new limits on the steps they could take to collect on unpaid bills from their patients. For example, under certain circumstances, such hospitals would not be allowed to send unpaid bills to outside collection agencies, garnish wages, or place liens on the homes of patients as a means of collecting unpaid hospital bills.

Coordination of Medical Services by Hospitals. Subject to the approval of certain local officials, this measure permits hospitals receiving funding allocated under this measure to coordinate certain medical services, including emergency services, with other hospitals. For example, hospitals would be permitted to jointly share the costs of ensuring the availability of on-call physicians who provide emergency services. This measure contains a provision that seeks to exempt such coordination of emergency services from federal and state antitrust laws.

Existing State Indigent Care Funding Continued. In recent years, the state has spent almost \$25 million per year in Proposition 99 funds for allocations to counties to reimburse physicians for uncompensated medical care for indigents. This measure

requires that this same level of Proposition 99 funds be allocated each year for this same purpose in the future.

Increased Penalties for Tobacco Tax Evasion. State law classifies crimes as felonies, misdemeanors, or infractions. This initiative increases the penalties for felony tobacco tax evasion, which occurs when the evasion of taxes involves more than \$25,000 within a year's time. The *minimum* fine for persons convicted of such an offense would be increased from the present fine of \$5,000 to \$25,000. The *maximum* fine allowed would increase from \$20,000 to a fine of three times the amount of taxes owed as a result of tax evasion. The maximum prison term would be increased from the present term of three years to five years.

Changes in Nursing Workforce Commission. Current state law establishes a 15-person state commission to establish standards and to review and make recommendations for funding to state agencies regarding certain nursing training programs. This initiative would expand the commission to 17 members, change the criteria for selecting certain members, and assign the commission the task of developing a master plan for nursing education.

Fiscal Effects

This measure is likely to have a number of fiscal effects on state and local government.

Impacts on State and Local Revenues

The revenue estimates for this measure are based on the assumption that the amount of the \$1.50 per pack increase is fully reflected in the purchase price. The associated price increase is likely to cause (1) a decrease in the quantity of taxable cigarettes sold, and (2) an increase in out-of-state sales (as well as sales on tribal lands) and smuggled products for which taxes would not be collected.

Revenues From Cigarette Tax Increase. Assuming this measure takes effect in July 2006, the cigarette tax increase that it enacts would raise approximately \$1.4 billion in 2006-07 for the new special fund created by this measure. This cigarette tax increase would generate slightly declining amounts of revenues annually thereafter.

Indirect Effects on General Fund Revenues. The increase in the cigarette tax imposed by this measure, and the additional increase in the tax that would result for other tobacco products, are likely to have indirect effects on state General Fund revenues. As a result of the decline in consumption of tobacco products, there would be reduced revenues from the existing excise taxes on tobacco for the General Fund. These General Fund revenue losses are likely to be more than offset by increases in state General Fund sales tax receipts stemming from the increased cost of tobacco products upon which the

sales tax is levied. As a result, the state is likely to have a net gain of General Fund revenues in the low millions of dollars annually. Local governments would also likely experience a net gain in sales tax revenues in the low millions of dollars annually.

Indirect Effects on Existing Tobacco Tax Revenues. The decline in consumption of cigarettes caused by this measure would similarly reduce the cigarette tax revenues that would be generated under Propositions 99 and 10 and for the Breast Cancer Research Fund. The annual revenue losses could amount to as much as \$90 million for Proposition 10, \$45 million for Proposition 99, and \$4 million for the Breast Cancer Research Fund. As we discuss below, this measure would partly or fully offset these losses with additional tax revenues generated by this measure.

Additional Revenues From Increased Taxes on Other Tobacco Products. As discussed above, the cigarette tax increase proposed in this measure would trigger a tax increase on other tobacco products. The resulting revenues would likely be in the middle to high tens of millions of dollars annually and would go to Proposition 99 programs.

Increased State and Local Expenditures for Health and Education Programs

State and local government expenditures for the administration and operation of various health and education programs would generally increase in line with the proposed increase in cigarette tax revenues. Figure 1 shows the main purpose of the accounts established by the initiative, the stated percentage of funds allocated to each purpose, and our estimate of the funding that would be available for each account in the first full year of tax collection. After the new higher level of spending for these programs was reached, expenditures for these purposes would probably decline in subsequent years in keeping with an anticipated overall decline in cigarette tax revenues.

Revenues and Costs from Provisions Affecting Hospitals

Some of the funding provided under this measure for hospital emergency services could be allocated to public hospitals, such as county hospitals and hospitals operated by health care districts, potentially resulting in increased revenues and expenditures for support of their hospital operations. The availability of these funds could allow certain hospitals to obtain additional federal funds through existing programs that match their spending for hospital services with federal funds. To the extent that public hospitals were allocated additional funds, they could incur some partly offsetting additional costs or a loss of some revenues for complying with the provisions of this measure regarding charity care and collection of unpaid bills from patients. They might also achieve savings through the provisions allowing coordination of medical services among hospitals. The magnitude of all of these fiscal effects is unknown, but these provisions

are likely to result in a net financial gain for these public hospitals amounting to the low hundreds of millions of dollars annually on the statewide basis.

| Figure 1 | | |
|--|--------------------|------------------------------------|
| How New Cigarette Tax Revenues Would Be Allocated | | |
| Purpose | Allocation | Estimate of 2006-07 Funding |
| Funding provided to hospitals for emergency and trauma care services | Up to 65 percent | Up to \$970 million |
| Backfill for loss of Proposition 99 funds | 3 percent | \$42 million |
| Backfill for loss to Breast Cancer Research Fund | 1 percent | \$14 million |
| Backfill for loss of Proposition 10 funds | 5 percent | \$70 million |
| Programs to prevent tobacco tax evasion | 3 percent | \$42 million |
| Funding for county programs to reimburse emergency care physicians for uncompensated care for indigents | 4.5 percent | \$63 million |
| Funding for programs in rural counties to reimburse emergency care physicians for uncompensated care for indigents | 0.5 percent | \$7 million |
| New Proposition 99 programs to prevent and reduce tobacco use by youth, teenagers, and young adults | 9 percent | \$126 million |
| Funding to develop, improve, and expand programs to educate registered nurses | 9 percent | \$126 million |
| Administrative expenses for collection of new cigarette tax | Up to 0.25 percent | Up to \$4 million |
| Total Allocations | | \$1.4 billion |

Fiscal Effects on Other Tobacco Tax-Funded Programs

This measure would have a number of significant fiscal effects on the three existing programs supported by tobacco taxes—Proposition 99, Proposition 10, and the Breast Cancer Research Fund.

Proposition 99. The backfill provisions contained in this measure would probably almost fully backfill any loss to Proposition 99 revenues that resulted from the cigarette tax increase proposed in this measure. Moreover, in addition to providing this backfill funding, this measure would transfer as much as \$126 million in new funding into a Proposition 99 account for the support of programs to curb smoking by youth and

young adults. As noted above, additional state revenues in the high tens of millions of dollars annually from the tax increase on other tobacco products that would be triggered by this measure would all be allocated to Proposition 99 programs.

Also, as noted earlier, this measure requires that about \$25 million in Proposition 99 funds continue to be allocated to counties to reimburse physicians for uncompensated medical care. While it would provide fixed ongoing revenues for these purposes, it would also mean that future funding for other programs which now rely on Proposition 99 revenues would have to be reduced or alternative sources of funding found as tobacco tax revenues decline.

Breast Cancer Research Fund. This initiative would probably result in a net gain in funding for the Breast Cancer Research Fund. The backfill funding allocated for this fund would likely exceed by as much as \$10 million annually the revenue loss to that fund likely to occur from the imposition of the additional cigarette tax increase proposed in this measure.

Proposition 10. The revenue losses resulting from this initiative would probably bring about a net loss of funding for Proposition 10 programs of as much as \$20 million annually. The backfill allocation specified in this measure is less than the projected loss of revenues to Proposition 10 programs that is likely to occur as a result of the imposition of the additional cigarette tax increase proposed in this measure.

Potential State and Local Savings on Health Costs

The use of tobacco products has been linked to various adverse health effects by federal health authorities and numerous scientific studies. The state and local governments incur costs for providing (1) health care for low-income persons and (2) health insurance coverage for state and local government employees. Consequently, changes in state law that affect the health of the general populace—and low-income persons and public employees in particular—would affect publicly funded health care costs.

This measure is likely to result in a decrease in the consumption of tobacco products because of its provisions increasing the cost of these products and curbing tobacco use. To the extent that this happened, there would likely be reduced state and local government health care costs over time. The magnitude of these savings is unknown but would likely be significant.

Summary

The measure would have the following major fiscal impacts:

- An increase in new state cigarette tax revenues of about \$1.4 billion annually, declining slightly annually thereafter. Those revenues would be used for various health and education programs.
- Unknown but probably significant savings in state and local government health care costs over time due to expected reduction in consumption of tobacco products.

Sincerely,

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Legislative Analyst

Michael Genest
Acting Director of Finance