November 29, 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 Tobacco Tax, Disease Prevention, and Children's Health Insurance Act of 2006" (File No. SA2005RF0114). This measure would increase excise taxes on cigarettes (and indirectly on other tobacco products) to provide funding to support various new and existing health programs, for programs to curb tobacco use and regulate tobacco sales, and to increase access to children's health insurance.

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 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 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.

Children's Health Care Coverage

Medi-Cal. The Medi-Cal Program (the federal Medicaid Program in California) provides health care services to low-income persons who meet the program's eligibility criteria (primarily families with children and the elderly, blind, or disabled). Specifically, Medi-Cal provides health services to eligible children in families with income up to 133 percent of the federal poverty level (FPL), depending on the age of the child. The program is administered by the state Department of Health Services (DHS).

The state and federal governments share most of the program costs on a roughly equal basis. Federal law requires a state that seeks to obtain federal matching funds under the Medicaid program to provide certain medical services generally to United States citizens and persons deemed to be "qualified aliens"—that is, immigrants who are permanent residents, refugees, or a member of certain other groups granted the legal right to remain in the United States. In addition, federal law provides federal Medicaid matching funds for emergency services only for nonqualified aliens.

Healthy Families. The Healthy Families Program (HFP) implements the federal State Children's Health Insurance Program (SCHIP), enacted in 1997. Funding generally is on a two-to-one federal/state matching basis. The program generally offers health insurance to eligible children in families with incomes below 250 percent of FPL, who do not qualify for Medi-Cal. Children up to age two in families with incomes below 300 percent of FPL, and who have transferred from the state's Access for Infants and Mothers program, also receive coverage under HFP.

Children for whom HFP applications are filed must generally be an eligible United States citizen or a qualified alien. Also, participating families must pay a monthly premium (generally between $4 and $15 per child) and are offered coverage similar to that available to state employees. The HFP is administered by the Managed Risk Medical Insurance Board (MRMIB).

County Health Initiative Matching Fund. Existing law also establishes the County Health Initiative Matching (CHIM) Fund program administered by MRMIB and counties to fund children's health coverage for children in families with income between 250 percent and 300 percent of FPL. The CHIM program relies on county funds as the match required to draw down federal SCHIP funds to pay for this health coverage.

Additionally, some counties have established their own health coverage programs for children that are ineligible for HFP. These programs are locally funded.

PROPOSAL

New State Revenues

This measure increases the existing excise tax on cigarettes by $1.50 per pack effective 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. This measure specifies that all of the additional tobacco revenues (including those on other tobacco products) be used to support various new and existing health programs, programs to curb tobacco use and regulate tobacco sales, and children's health coverage.

How Additional Revenues Would Be Spent

Receipts from the tobacco tax increases would generally be deposited in a new special fund called the Tobacco Surtax, Disease Prevention and Children's Health Insurance Fund and would be allocated under the provisions of this initiative for various specified purposes.

Health Programs. Thirty-three percent of the special fund allocations would be set aside for the administration and operation of various new or existing health programs. Specific allocations of funding would be provided for programs related to prevention or treatment of breast and cervical cancer, prostate cancer, heart disease and stroke, obesity, diabetes, asthma, and colorectal cancer, as well as for cancer research, breast cancer research, lung disease research, and establishment of a statewide cancer registry.

Children's Health Insurance. Thirty-two percent of the funds would be allocated to expand the HFP to provide health coverage for additional children not now eligible for coverage. The measure expands HFP eligibility to include (1) children from families with income between 250 and 300 percent of the FPL and (2) children from families with income up to 300 percent of the FPL who are residents of California and who are undocumented immigrants or legal immigrants who are not now eligible for HFP. This measure thus expands HFP eligibility to include children who were previously only eligible for CHIM and other local health coverage programs. This measure authorizes a shift in health care coverage for these children from CHIM and other county health care coverage programs to HFP.

This measure requires MRMIB and DHS to streamline the application, enrollment, and retention of benefits under Healthy Families and Medi-Cal. For example, the measure requires the simplification of paperwork requirements to enroll children and retain them in coverage. Furthermore, it requires a pilot project to test strategies to increase coverage for uninsured children in families with income above 300 percent of the FPL.

Additionally, this measure establishes a new 15-member Healthy Kids Oversight and Accountability Commission to advise MRMIB and the DHS on the implementation of this initiative.

Tobacco-Related Programs. Twenty percent of funds would be used to help pay for the administration and operation of various programs to curb tobacco use and regulate tobacco sales. Specific allocations of funding would be provided for media advertising and public relations campaigns, grants to local health departments and other local organizations, and education programs for school children to prevent and reduce smoking. Also, part of the funds would be allocated for services to assist individuals to quit smoking, and other parts would be set aside to evaluate the effectiveness of tobacco control programs and to research effective prevention and treatment methods for tobacco-related diseases. Specific allocations would also go to state and local law agencies responsible for enforcing laws and civil court judgments and settlements which regulate and tax the sale of tobacco products.

Other Funding Allocations. Under the terms of this measure, 6 percent of the funds would be distributed to community clinics, 4 percent would be used for nursing education programs, and 5 percent would be deposited into the Proposition 10 account to backfill it for losses resulting from the tobacco tax increase imposed by this initiative. We discuss the full fiscal effect of this measure on Proposition 10 funding later in this analysis.

Local Governments Would Receive Funding. Some of the additional tobacco tax revenues would be passed through to local government agencies. For example, local health departments would be among those receiving funds for tobacco prevention efforts as well as allocations for the expansion of programs to prevent obesity. Local law enforcement agencies would likewise receive grants for training and enforcement of laws regulating the sale of tobacco products.

Other Spending Provisions. The additional tobacco tax revenues allocated by this measure would generally have to be used to supplement existing levels of service and could not take the place of existing state or local spending. The measure also specifies that the new state revenues could be used to draw down additional federal funds.

This measure creates various new accounts to set aside funds for these various purposes and specifies the share of tobacco tax proceeds that would be devoted to each purpose. These funds would not be appropriated through the annual state budget act and thus amounts would not be subject to change by actions of the Legislature and Governor.

Oversight and Contracting Provisions

This initiative requires DHS to prepare an annual report describing the programs that received funding under this measure. This report would be made available to the public on DHS' Web site. The measure also specifies that all programs and departments receiving funds would be subject to audit by the Bureau of State Audits.

In addition, this measure specifies that contracts to implement the initiative would not be subject to a part of the Public Contract Code which contains, among other provisions, requirements for competitive bidding of state contracts and prohibitions on conflicts of interest in the letting of such state contracts. This exemption would apply for the first five years after this measure was enacted.

FISCAL EFFECTS

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

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 tobacco products 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 Tax Increase on Tobacco Products. The tobacco tax increase that would be enacted under this measure would raise somewhat less than $700 million in 2006-07 (half-year effect) and $1.4 billion in 2007-08 (first full-year impact) for the new special fund created by this measure. This tobacco tax increase would raise slightly declining amounts of revenues 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 for reasons we discuss below. 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 state 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 costs of cigarettes upon which the sales tax is levied. As a result, the state is likely to have an initial 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 tobacco products caused by this measure would similarly reduce the tobacco tax revenues that would be generated under Propositions 99 and 10 and for the Breast Cancer Fund. The annual revenue losses could initially amount to as much as $90 million for Proposition 10, $45 million for Proposition 99, and $4 million for the Breast Cancer Fund. As we discuss below, this measure would partly or fully offset these losses with additional tax revenues generated by this measure.

Increased State and Local Expenditures for Health and Tobacco-Related Programs

State and local government expenditures for the administration and operation of various health and tobacco-related programs and children's health coverage would generally increase in line with the proposed increase in tobacco 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 allocations to these accounts was reached, allocations for these purposes would probably decline in subsequent years in keeping with an anticipated overall decline in tobacco tax revenues.

The state administrative costs associated with the tax provisions of this measure would be minor.

Figure 1

How Tobacco Tax Funds Would Be Allocated

(Dollars in Millions)

Purpose	Allocation	Estimate of 2007-08 Funding (Full Year)
Disease Prevention, Treatment and Research Account, allocated as follows:	**33 percent**	**$462**
Heart disease and stroke program	20 percent of account	($92)
Breast and cervical cancer services	19 percent of account	(89)
Obesity, diabetes, and chronic diseases programs, consisting of:	18 percent of account	(83)
— Media advertising and public relations, grants, research, and other activities	70 percent of subaccount	(58)
— School programs	30 percent of subaccount	(25)
Asthma program, consisting of:	10 percent of account	(46)
— Community programs, research, media and public relations campaigns, other activities	60 percent of subaccount	(28)
— School programs	40 percent of subaccount	(19)
Colorectal cancer program	10 percent of account	(46)
Breast cancer research program	7 percent of account	(32)
Prostate cancer treatment services	5 percent of account	(23)
Statewide cancer registry	4 percent of account	(19)
Cancer research program	4 percent of account	(19)
Lung disease research	3 percent of account	(14)
California Healthy Kids Account	**32 percent**	**$448**
Tobacco Use Prevention, Education and Enforcement Account, allocated as follows:	**20 percent**	**$280**
Media advertisements and public relations programs	24 percent of account	($67)
Competitive grants program	16 percent of account	(45)
Local health department-based programs	15 percent of account	(42)
Research programs	14 percent of account	(39)
School education programs	13 percent of account	(36)

Continued

Purpose	Allocation	Estimate of 2007-08 Funding (Full Year)
Tobacco cessation services	8 percent of account	(22)
Tobacco control enforcement activities, consisting of:	8 percent of account	(22)
— Programs to reduce illegal sales of tobacco products to minors, local grants	50 percent of subaccount	(11)
— Board of Equalization activities	25 percent of subaccount	(6)
— Department of Justice activities	25 percent of subaccount	(6)
Evaluation of tobacco control programs	2 percent of account	(6)
Community Clinics Uninsured Account	**6 percent**	**$84**
California Children and Families First Trust Fund—Proposition 10	**5 percent**	**$70**
Nursing Education, Student Health and Public Health Account, allocated as follows:	**4 percent**	**$56**
Registered nurse scholarship	50 percent of account	($28)
Registered nurse education	20 percent of account	(11)
School nurses	15 percent of account	(8)
Public health safety net clinics	15 percent of account	(8)
Total Tobacco Tax Funding Allocations		**$1,400**

Detail may not total due to rounding.

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 Fund.

Proposition 99. This measure does not backfill any Proposition 99 accounts for the loss of revenues that would be likely to occur as a result of the tobacco tax increase proposed in this measure. However, this measure would initially provide about $280 million annually in new funding for various tobacco-related programs, some of which are similar to the activities now funded through Proposition 99 accounts for health education and tobacco research. Thus, these activities would have a significant net gain in funding if this measure were enacted.

This measure would not provide any backfill or replacement funding for activities supported through other Proposition 99 accounts. We estimate that this measure would initially result in an annual funding reduction of $16 million for the Proposition 99 hospital services account, $5 million for the physician services account, $2 million for the public resources account, and $11 million for the unallocated account.

Proposition 10. As noted earlier, we estimate that the available Proposition 10 funding would initially decrease as a result of the tobacco tax increase proposed in this measure. The provision in this measure allocating 5 percent of the new tax revenues for the fund would not completely backfill this funding loss. Thus, we estimate that this measure is likely to initially result in a net loss of $20 million annually in Proposition 10 funding.

Breast Cancer Fund. No backfill funding would be provided for the Breast Cancer Fund to offset the loss of revenues resulting from the tax increases proposed in this measure. However, this measure would allocate a set portion of the new tax revenues for breast cancer research and breast cancer early detection services, with the result that these activities would be likely to initially have a net gain of annual funding of about $30 million for breast cancer research and $87 million for breast cancer and cervical cancer early detection services.

Other Tobacco Tax Initiatives. This measure provides that any other tobacco tax initiative approved by the voters in 2006 shall not go into effect until July 2010.

Long-Term Increase in State Health Costs for Eligibility Expansion

Healthy Families. In the short term, the revenues allocated by this measure to HFP would probably exceed the costs to expand HFP eligibility. This would particularly be the case in the early years of the program expansion as enrollment gradually increased. However, over time, as the tobacco tax revenues allocated for this eligibility expansion declined (for the reasons mentioned above) and the number of children eligible for HFP grew, these costs could exceed the available revenues. (Also, the future availability of federal funds to support the enrollment of additional children in HFP is unknown at this time.) If actions were not taken to offset program costs at that point, additional state financial support for the program would be necessary. These potential long-term state costs are unknown but potentially significant.

Net Increase in State Costs From Streamlining Enrollment

As noted earlier, this measure would require that Medi-Cal and HFP be modified to simplify paperwork requirements to enroll children and to retain them in coverage. For example, among other changes, these provisions could allow applicants to "self-certify" their income and assets on their applications for coverage without immediately providing employer or tax documents to verify their financial status. Other provisions to streamline enrollment would require that other health and social services programs, such as the food stamp program, become a "gateway" or point of entry into Medi-Cal and HFP; ensure there are no gaps in coverage whenever children transfer between children's health coverage programs; ensure that "from a child's perspective" that Medi-Cal and HFP "operate as a single program;" and establish the pilot projects for covering children in families with incomes above 300 percent of the FPL.

These changes are likely to increase caseload and, therefore, medical benefit costs. For example, families whose income levels are too high to qualify for Medi-Cal or HFP may nonetheless apply for health care coverage for their children. In addition, although some simplification of enrollment and reenrollment procedures would reduce the state costs of processing each case, various other changes in procedures and an increase in the caseload of the two programs would likely result in a net increase in state administrative costs. Thus, the net fiscal effect of the provisions for streamlining enrollment could be an increase in General Fund costs of up to the low hundreds of millions of dollars annually after a few years. Some implementation costs could be paid for using the new tobacco tax revenues generated under this measure.

Potential State and Local Savings on Health Costs

County Savings From Shift in Children's Coverage. The use of new tobacco tax revenues for the expansion of HFP eligibility included in this measure could result in unknown but potentially significant savings on a statewide basis to those local governments which participate in CHIM or have developed their own health coverage programs for children ineligible for HFP. This is because, as mentioned earlier, those children covered by the CHIM program and some of the children covered by the local health coverage programs would now be eligible for the state's HFP. The extent of the savings is unknown given that some local health coverage programs would continue to serve those still ineligible for HFP (such as children in families with income up to 400 percent of FPL).

Other Reductions in Public Health Program 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. Also, some of the health programs funded in this measure are intended to prevent individuals from experiencing serious health problems that could be costly to treat. To the extent that these changes affect publicly funded health care programs, they are likely to reduce state and local government health care costs over time. In addition, the proposed expansion of state health programs could reduce county costs for providing health care for indigents. The magnitude of savings from these factors is unknown but would likely be significant.

Summary

The measure would have the following major impacts:

- Increase in new state tobacco tax revenues of about $1.4 billion annually by 2007-08, declining slightly annually thereafter. Those revenues would be used for various health and tobacco-related programs and for children's health coverage.
- Unknown net state costs potentially reaching the low hundreds of millions annually after a few years due to provisions for streamlining enrollment in the Medi-Cal and Healthy Families programs.
- Unknown but potentially significant savings to counties on a statewide basis beginning in the near term for a shift of children from county health coverage to the Healthy Families Program, with unknown but potentially significant costs to the state in the long term for ongoing support of expanded Healthy Families enrollment.
- Unknown but probably significant savings in state and local government health care costs over time due to expected reduction in consumption of tobacco products and due to other factors.

Sincerely,

Elizabeth G. Hill
Legislative Analyst

Michael Genest
Acting Director of Finance