LAO
60 YEARS OF SERVICE

January 24, 2006

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 9005, we have reviewed the proposed constitutional and statutory initiative entitled "The Tobacco Tax Act of 2006" (File No. SA2005RF0139, Amdt. No. 1-NS). This measure would increase excise taxes on cigarettes (and indirectly on other tobacco products) to provide funding for hospitals for emergency services as well as programs to increase access to health insurance for children, expand nursing education, curb tobacco use and regulate tobacco sales, and support various new and existing health and education activities.

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 and of breast cancer screening programs for uninsured women.
- 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 generally been decreasing and would likely continue to decrease slightly over time based on current law.

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 sales for which taxes are not collected, such as smuggled products and out-of-state sales.

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 Tobacco Tax Revenues

This measure increases the existing excise tax on cigarettes by $2.60 per pack effective January 2007. Existing state law requires the Board of Equalization (BOE) 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 programs specified in this measure.

How Additional Tobacco Revenues Would Be Spent

Receipts from the tobacco tax increases would generally be deposited in a new special fund called the Tobacco Tax of 2006 Trust Fund and would be allocated under the provisions of this initiative for various specified purposes.

Some of the additional tobacco tax revenues would be spent by state agencies, while others would be passed through to local government agencies, including cities, counties, and school districts. For example, county health departments would be among those receiving funds for tobacco prevention efforts, and both counties and schools would receive allocations for programs to prevent obesity. Local law enforcement agencies would likewise receive grants for training and enforcement of laws regulating the sale of tobacco products.

Backfill of Proposition 10

An unspecified amount of these additional tobacco tax revenues (as determined by BOE) would be used to fully backfill Proposition 10 programs funded with tobacco taxes for a loss of funding that is likely to occur as a result of the tax increases contained in this measure.

Health Treatment and Services Account

Under the measure, 52.75 percent of the special funds that remained after providing the Proposition 10 backfill funding would be allocated to a Health Treatment and Services Account. Funding allocated to this account would be used primarily to provide funding to hospitals, to support other medical treatment programs, and to expand nursing education.

Hospital Funding. Nearly three-fourths of the funds in this account would be allocated to hospitals 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 hospitals treat in their emergency departments and the costs to hospitals for providing charity care and health care for indigents. Private hospitals and certain public hospitals, including those operated by counties, cities, hospital districts, and the University of California, would be eligible to receive funding. Hospitals that are owned or operated by other state agencies or by the federal government would not be eligible to receive funding.

Nursing Education Programs. Part of the funding from this account would be used to expand nursing education programs in the University of California, California State University, the community colleges, and privately operated nursing education programs.

Additional Funding Allocations. Part of the funding in this account would also be allocated for the support of community clinics, to help pay for uncompensated health care for indigents provided by physicians, college loan repayments to encourage physicians to provide medical services to low-income persons in communities with insufficient physicians, to provide prostate cancer treatment services, and to provide services to assist individuals to quit smoking.

Health Maintenance and Disease Prevention Account

Under the measure, 42.25 percent of the special funds that remained after providing the Proposition 10 backfill funding would be allocated to a Health Maintenance and Disease Prevention Account. Funding allocated to this account would be used to increase access to health insurance for children, for programs to curb tobacco use and regulate tobacco sales, and to support various new and existing health and education programs.

Children's Health Coverage Expansion. Almost half of the funds in this account 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 percent 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 DHS on the implementation of these efforts.

Tobacco-Related Programs. The Health Maintenance and Disease Prevention Account would also support 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. 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. Also, some funds in this account would be set aside to evaluate the effectiveness of tobacco control programs.

Health and Education Programs. Part of the funding in the account would be set aside for the administration and operation of various new or existing health programs primarily intended to prevent or allow early detection of certain diseases. Specific allocations of funding would be provided for programs related to breast and cervical cancer, heart disease and stroke, obesity, asthma, and colorectal cancer. Certain programs would be operated by state and local health departments while others would be operated by schools. A new 13-member Oversight Committee would be established to provide advice to state agencies on obesity programs established by this measure.

Health and Disease Research Account

Under the measure, 5 percent of the special funds that remained after providing the backfill funding discussed above would be allocated to a Health and Disease Research Account. Funding allocated to this account would be used to support medical research, including specific allocations for research relating to cancer, breast cancer, lung cancer, and tobacco-related diseases. The measure also allocates funds for research on the effectiveness of tobacco control efforts and sets aside part of the funds to establish a statewide cancer registry.

Other Expenditure Rules

The funds allocated under this measure 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. 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 these new state revenues could be used to draw down additional federal funds.

Oversight and Contracting Provisions

This initiative requires DHS to prepare an annual report describing the programs that received additional tobacco tax funding generated 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 these funds would be subject to audit by the Bureau of State Audits.

In addition, this measure specifies that contracts to implement the programs funded with the additional tax revenues 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.

Existing 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.

Other Policy Changes

This measure would implement several significant policy changes relating to hospital charity care and bill collection practices and the coordination of certain medical services among hospitals.

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 350 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.) Hospitals receiving funding under this measure 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 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.

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 $2.60 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.

There is substantial evidence regarding the response of consumers to small and moderate increases in the tax on cigarettes in terms of reduced tobacco consumption. As a result, for small-to-moderate increases in price, the revenue impacts can be estimated with a reasonable degree of confidence. However, the increase in taxes proposed in this measure is substantially greater than that experienced previously. As a result, we believe that revenue estimates based on traditional assumptions regarding this consumer response would likely be overstated. Therefore, our revenue estimates below assume a somewhat greater consumer response in terms of reduced tobacco consumption to this tax increase than has traditionally been the case. These estimates are subject to uncertainty, however, given the large tax changes involved.

Revenues From Tax Increase on Tobacco Products. We estimate that the tobacco tax increase that would be enacted under this measure would raise about $1.2 billion in 2006-07 (half-year effect) and about $2.1 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.

Effects on State General Fund Revenues. The increase in the tobacco tax imposed by this measure would have effects on state General Fund revenues. Namely, as a result of the higher price and the ensuing decline in consumption of tobacco products, there would be reduced state General Fund revenues from the existing excise taxes on tobacco as well as increases in state General Fund sales tax revenues. The decreases in revenues would be approximately offset by the increases.

Effects on Local Revenues. Local governments would likely experience an annual increase in sales tax revenues in the low millions of dollars.

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. We estimate that the initial annual revenue losses are likely to be about $170 million for

Proposition 10, about $85 million for Proposition 99, and less than $10 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)
Backfill of California Children and Families First Trust Fund—Proposition 10	**Unspecified amount determined by Board of Equalization (BOE)**	$170
Health Treatment and Services Account, allocated as follows:	**52.75 percent of remaining funds**	$1,020
Hospital emergency and trauma care	74.5 percent of account	
Nursing education programs	9 percent of account	
Allocations to nonprofit community clinics	5.75 percent of account	
California Healthcare for Indigents Program—reimbursement of emergency care physicians	5.75 percent of account	
Tobacco cessation services	1.75 percent of account	
Prostate cancer treatment	1.75 percent of account	
Rural Health Services Program—reimbursement of emergency care physicians	0.75 percent of account	
College loan repayment program to encourage physicians to serve low-income areas lacking physicians	0.75 percent of account	

Continued

Purpose	Allocation	Estimate of 2007-08 Funding (Full Year)
Health Maintenance and Disease Prevention Account, allocated as follows:	**42.25 percent of remaining funds**	**$815**
Children's health coverage	45.5 percent of account	
Heart disease and stroke program	8.5 percent of account	
Breast and cervical cancer program	8 percent of account	
Obesity, diabetes, and chronic diseases programs	7.75 percent of account	
Tobacco control media campaign	6.75 percent of account	
Tobacco control competitive grants program	4.5 percent of account	
Local health department tobacco prevention program	4.25 percent of account	
Asthma program	4.25 percent of account	
Colorectal cancer program	4.25 percent of account	
Tobacco prevention education programs	3.5 percent of account	
Tobacco control enforcement activities	2.25 percent of account	
Evaluation of tobacco control programs	0.5 percent of account	
Health and Disease Research Account, allocated as follows:	**5 percent of remainder**	**$95**
Tobacco control research	34 percent of account	
Breast cancer research	25.75 percent of account	
Cancer research	14.75 percent of account	
Cancer registry	14.5 percent of account	
Lung cancer research	11 percent of account	
Total Tobacco Tax Funding Allocations		**$2,100**

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 significant increases in funding for activities comparable to those now funded through Proposition 99 accounts for health education and tobacco research, hospital services, and physician services. In the aggregate, these activities could initially experience a net gain in funding of almost $1 billion if this measure were enacted.

This measure would not provide any backfill or replacement funding for certain other activities supported through other Proposition 99 accounts. We estimate that this measure would initially result in an annual funding reduction of about $4 million for the public resources account and more than $20 million for the unallocated account.

Proposition 10. Proposition 10 would receive full backfill funding under the terms of this measure. We estimate that this backfill would initially amount to about $170 million.

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 experience a net gain of almost $80 million annually.

Revenues and Costs From Provisions Affecting Public Hospitals

Some of the funding provided under this measure for hospital emergency services could be allocated to hospitals operated by state and local agencies, such as those operated by the University of California (UC), counties, cities, and health care districts. This and certain other provisions of the measure could potentially result in increased revenues and expenditures for support of their hospital operations. The magnitude of the fiscal effects of all of these provisions is unknown, but is likely to result in a net financial gain for hospitals operated by state and local government agencies up to the low hundreds of millions of dollars annually on the statewide basis.

State Costs and County Savings From Provisions on Children's Coverage

Long-Term Increase in State Costs for Increased Enrollment. In the short term, the revenues allocated by this measure to expansion of 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.

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 incomes of more than 300 percent of FPL).

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 Public 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. 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 these 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 $2.1 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 HFP.
- 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 HFP, with unknown but potentially significant costs to the state in the long term for ongoing support of expanded HFP enrollment.
- Unknown but potentially significant savings in state and local government public 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 C. Genest
Director of Finance