LAO
60 YEARS OF SERVICE

March 14, 2008

Hon. Edmund G. Brown Jr.
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Krystal Paris
Initiative Coordinator

Dear Attorney General Brown:

Pursuant to Elections Code Section 9005, we have reviewed the proposed constitutional and statutory initiative entitled "The Children's Health Insurance and Youth Smoking Prevention Act of 2008" (File No. 08-0006). This measure would increase excise taxes on cigarettes and on other tobacco products. The revenues from this measure would be used to increase access to health insurance for children, curb tobacco use, fund medical research, and support various new and existing public 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:

- Fifty 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.
- Twenty-five 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 to six separate accounts that support 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.

- Ten cents per pack for the state General Fund.
- Two 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.

Revenues from current excise taxes on cigarettes and other tobacco products are estimated to be about $1 billion in 2008-09. 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.

Sales of cigarettes and other tobacco products also are subject to the sales and use tax (SUT), which is imposed on their price including excise taxes.

Existing 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 of tobacco products resulting from Proposition 10's tax increase. (Revenue reductions to Proposition 99 health care and resources programs were not backfilled under the provisions of Proposition 10.) The revenue reductions occurred because the increase in the price of cigarettes reduced cigarette sales and resulted in more sales for which taxes are not collected, such as smuggled products and out-of-state sales.

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). In general, Medi-Cal provides health services to eligible children in families with income up to 133 percent of the federal poverty level (FPL) (about $28,000 per year for a family of four), depending on the age of the child. The program is administered by the state Department of Health Care Services.

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 Medicaid matching funds for emergency services only for "nonqualified aliens," which includes undocumented persons.

Healthy Families. The Healthy Families Program (HFP) implements the federal State Children's Health Insurance Program, 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 ($53,000 per year for a family of four), 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).

Local Health Coverage Programs. Some counties have established their own health coverage programs, known as Children's Health Initiatives (CHIs), for children that are ineligible for HFP or Medi-Cal. These programs are primarily locally funded.

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 incomes between 250 percent and 300 percent of FPL. The CHIM program relies on county funds as the match required to draw down federal funds to pay for this health coverage.

PROPOSAL

New State Tobacco Tax Revenues

The average retail price of a pack of cigarettes currently is roughly $4.25 in California, including all taxes. This measure increases the existing excise tax on cigarettes by 75 cents per pack effective January 1, 2009. 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. All of the additional tobacco revenues (including those on other tobacco products) are intended to 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 be deposited in a new special fund called the Children's Health Insurance and Youth Smoking Prevention Act of 2008 Trust

Fund (hereinafter "Trust Fund"). Of the monies deposited in the Trust Fund, 75 percent would be allocated to the Children's Health Insurance Account, which could be used only to pay for health coverage authorized under this measure. (We describe these health coverage provisions below.) The remaining 25 percent would be allocated to the Tobacco Use Prevention Account (TUPA). No more than 5 percent of the funds appropriated to any account or subaccount under this measure may be used for state administration.

Backfills of Programs Funded With Tobacco Taxes

Proposition 10 and Breast Cancer Fund. An unspecified amount of the additional tobacco tax revenues generated by this measure (as determined by BOE) would be used to fully backfill the California Children and Families First Trust Fund created by Proposition 10 and the Breast Cancer Fund created by the California Breast Cancer Act of 1993. Both of these funds are supported by tobacco tax revenues, and both would likely incur a loss of funding due to decreased use of cigarettes and tobacco products resulting from the tax increases contained in this measure.

Proposition 99. An unspecified amount of these additional tobacco tax revenues generated by this measure (as determined by BOE) would be used to fully backfill the Proposition 99 Hospital Services Account, Physician Services Account, and Unallocated Account for a loss of funding that is likely to occur as a result of the tax increases contained in this measure. However the Proposition 99 Health Education Account, Research Account, and Public Resources Account would not be backfilled.

Children's Health Care Coverage

Under the measure, 75 percent of the funds that remain after providing the backfills described above would be allocated to expand eligibility for Medi-Cal and HFP to children who are now ineligible for these programs.

Expanded Eligibility for State Programs. Effective January 1, 2009, the measure expands HFP eligibility to include children from families with incomes between 250 percent and 300 percent of the FPL (between $53,000 and $64,000 per year for a family of four). Families of these children would be required to pay premiums somewhat higher than those for children currently eligible for HFP. The measure also expands eligibility for Medi-Cal and HFP to include undocumented children who are not now eligible for Medi-Cal or HFP. This measure thereby expands Medi-Cal and HFP eligibility to include children who were previously only eligible for local health coverage programs such as Healthy Kids. Funds provided by this measure could not be used to pay the costs of coverage for any children who are currently eligible for Medi-Cal or HFP but have not yet enrolled.

Additional Health Care Coverage Efforts. This measure requires the state to do the following:

- Undertake a pilot project to gather data about cost-effective strategies for increasing coverage for uninsured children in families with incomes above 300 percent of FPL.
- Convene a stakeholder group to develop outreach, enrollment, retention, and utilization processes, including simplifying paperwork requirements and verifying enrollment information only to the extent required under federal law, to ensure seamless access to coverage through Medi-Cal and HFP for all eligible children.
- Convene a stakeholder group to develop a process for the smooth transition of eligible children from local children's health initiatives to the Medi-Cal Program and HFP.

Tobacco Use Prevention Efforts

Under the measure, 25 percent of the funds that remain after providing backfills described above would be allocated to TUPA to be allocated as follows:

- Twenty-five percent to the Anti-Tobacco Media Subaccount for media advertisements and public relations programs to prevent and reduce the use of tobacco products.
- Twenty percent to the Competitive Grants Subaccount for programs directed at the prevention of tobacco-related diseases.
- Twenty percent to the Local Health Departments Subaccount for programs to prevent tobacco use at the local level.
- Thirteen percent to the Disease Research Subaccount to be used by the University of California for tobacco related disease research and the establishment of a lung cancer detection and treatment research program.
- Ten percent to the Education and Prevention Subaccount for programs to reduce the use of tobacco products.
- Ten percent to the Tobacco Cessation Subaccount to be used to provide tobacco cessation programs and services to children, youth, and adult tobacco users.
- Two percent to the Evaluation Subaccount to be used by the Department of Public Health for evaluation of tobacco control programs.

Other Expenditure Rules

The funds allocated under this measure would not be subject to appropriation by the Legislature 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 obtain additional federal matching funds.

FISCAL EFFECTS

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

Impacts on State and Local Revenues

Revenues Will Be Affected by Consumer Response. Our revenue estimates assume that the distributors of tobacco products, who actually remit the excise tax, largely pass along the excise tax increase of 75 cents per pack to consumers. In other words, we assume that the prices of tobacco products would be raised to include the excise tax increase. This would result in various consumer responses. The price increase is likely to result in consumers reducing the quantity of taxable tobacco products that they purchase. Consumers could also change the way they acquire tobacco products so that fewer transactions are taxed, such as through Internet purchases or purchases of smuggled products.

The magnitude of these consumer responses is uncertain given the size of the proposed tax increase. There is substantial evidence regarding the response of consumers to small and moderate tax increases on tobacco products in terms of reduced tobacco consumption. However, the increase in taxes proposed in this measure is greater than experienced previously. A reasonable projection of consumer response is incorporated into our revenue estimates, but these estimates are still subject to uncertainty given a variety of factors, including the large tax change involved.

New Excise Tax Revenues. We estimate that the increase in excise taxes would raise about $420 million in 2008-09 (half-year effect from January 2009 through June 2009) and about $750 million in 2009-10 (first full-year impact). The excise tax increase would raise slightly declining amounts of revenues thereafter, due to the well-established trend of declining per-capita cigarette consumption in the state.

Effects on State General Fund Revenues. The measure's increase in the excise tax would have offsetting effects on state General Fund revenues. On the one hand, the higher price and the ensuing decline in consumption of tobacco products would reduce state General Fund revenues from the existing tobacco excise taxes by about $10 million annually. On the other hand, the state's General Fund SUT revenues would increase by about $20 million annually because the price of each pack of cigarettes will be more once the new excise tax is added. The net effect would be a net increase in General Fund revenues of about $10 million annually.

Effects on Local Revenues. Local governments would likely experience an annual increase in SUT revenues of approximately $10 million.

Effects on Existing Tobacco Excise Tax Revenues. The decline in consumption of tobacco products caused by this measure would similarly reduce the excise tax revenues that would be generated for Proposition 99 and Proposition 10 programs and for the Breast Cancer Fund. We estimate that the initial annual revenue losses are likely to be about $45 million for Proposition 10, about $25 million for Proposition 99, and less than $2 million for the Breast Cancer Fund. However, the measure provides that both Proposition 10 and the Breast Cancer fund would receive full backfill funding. As regards Proposition 99, this measure does not backfill some of the Proposition 99 health accounts for the loss of revenues that would be likely to occur as a result of the tobacco tax increase proposed in this measure. Accordingly, we estimate that this measure would initially result in an annual funding reduction of about $5 million for the Health Education Account, about $1 million for the Research Account, and about $1 million for the Public Resources Account.

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 for the eligibility expansion of HFP and Medi-Cal could meet or exceed the costs. This is because enrollment in the HFP and Medi-Cal would gradually increase during the early years of the expansion. However, over time, as the tobacco tax revenues allocated for the expansion declined (for the reasons mentioned above) and the number of children eligible for HFP and Medi-Cal grew (due to the expansion and increases in population), 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 state costs are unknown but potentially significant, and could be up to the low hundreds of millions of dollars annually in the long term.

County Savings From Shift in Children's Coverage. The use of new tobacco tax revenues for the expansion of HFP and Medi-Cal eligibility included in this measure could result in unknown but potentially significant savings on a statewide basis to those local governments that operate CHIs or other health coverage programs for children ineligible for HFP and Medi-Cal. This is because, as mentioned earlier, many of these children would now be eligible for the state HFP and Medi-Cal Program. The extent of the savings is unknown given that some local health coverage programs may 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 and Pilot Projects. As noted above, this measure would require that Medi-Cal and HFP convene a stakeholder group to develop improved outreach, enrollment, and retention processes including simplifying paperwork requirements and verifying enrollment information only to the extent required under federal law. To the extent that the Legislature and Governor approved these changes, they would likely result in additional persons enrolling in the programs and a corresponding increase in program costs. The amount of the increased costs from improved outreach, enrollment, and retention is unknown, but potentially significant.

Also as described above, this measure directs the state to establish a pilot project to test coverage methods for uninsured children in families with incomes above 300 percent of FPL. Depending upon how this pilot project was implemented, it could increase state costs to an unknown extent.

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 $750 million annually by 2009-10, declining slightly annually thereafter. These revenues would be used for children's health coverage and for various health and tobacco-related programs.
- Unknown but potentially significant costs to the state of up to the low hundreds of millions of dollars annually in the long term for ongoing support of

the expanded HFP and Medi-Cal Program as tobacco revenues decline and enrollment in these programs increases.

- 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 HFP and Medi-Cal.
- 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