

Overview of Proposition 86: Tax on Cigarettes

LEGISLATIVE ANALYST'S OFFICE

Joint Hearing:

Assembly and Senate Revenue and Taxation,
Assembly Governmental Organization, and
Assembly and Senate Health Committees





Background: Tobacco Taxes in California

- ☑ ***Taxes on Tobacco Products.*** Excise taxes are taxes collected on selected goods and services. The state imposes excise taxes on cigarettes and other types of tobacco products, such as cigars and chewing tobacco. In addition, these products are subject to sales taxes that flow to state and local agencies.

- ☑ ***Current Level of Excise Taxes.*** The state currently imposes excise taxes of 87 cents per pack on cigarettes, with similar taxes collected on other tobacco products. The total tax consists of:
 - ***Proposition 10 Taxes.*** 50 cents to support early childhood programs enacted by Proposition 10 in 1998.
 - ***Proposition 99 Taxes.*** 25 cents to support tobacco-related programs, health care services for low-income persons, and environmental protection and recreation programs enacted by Proposition 99 in 1988.
 - ***General Fund Taxes.*** 10 cents for the state General Fund that can be used for any type of state program.
 - ***Breast Cancer Fund Taxes.*** 2 cents to support research related to breast cancer and breast cancer screening programs for uninsured women.

- ☑ ***Current Estimate of Revenues.*** The existing excise taxes on tobacco products are estimated to raise about \$1.1 billion in 2007-08.



Tax Increase Provisions of Proposition 86

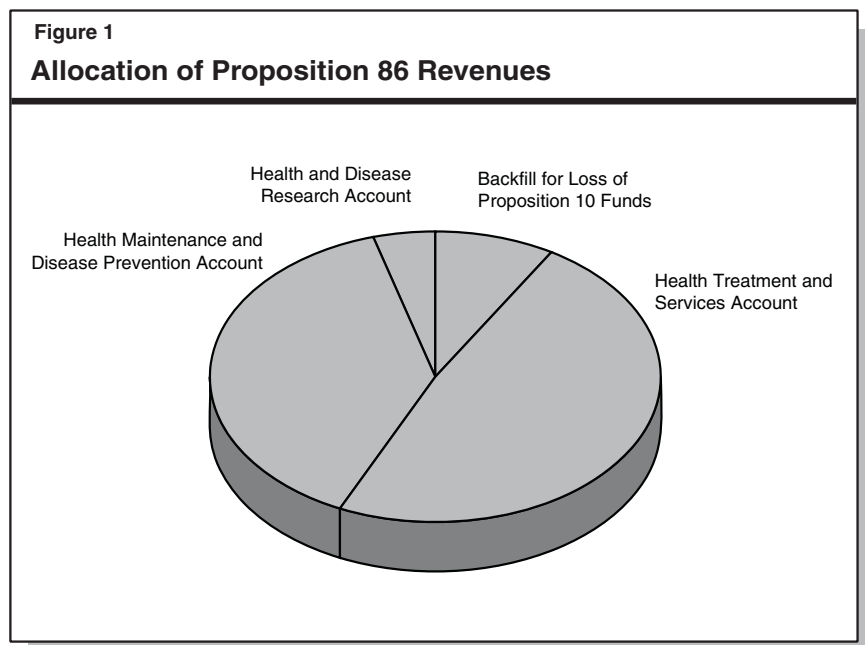
- Tax Increase on Tobacco.*** Proposition 86 increases excise taxes on cigarettes by \$2.60 per pack (and indirectly on other tobacco products) to provide additional funding for various new and expanded programs.
- Impact on Product Cost.*** A pack of cigarettes today now costs roughly \$4 per pack, including 87 cents in excise taxes. Under Proposition 86, the cost of a pack of cigarettes would go up to about \$6.60 per pack if the entire cost of the new tax were passed along to consumers.
- Other Tobacco Products Affected.*** Existing state law (part of Proposition 99) requires the Board of Equalization (BOE) to increase taxes on other tobacco products in an amount equivalent to any increase in the tax on cigarettes. Thus, the cigarette tax increase directly imposed under the terms of Proposition 86 would trigger a comparable increase in the excise taxes on other tobacco products.
- Revenues Placed in Trust Fund.*** This measure would earmark (1) the revenues from the cigarette tax increase and (2) the additional revenues from the increase in taxes triggered on other tobacco products for new and existing programs specified in this measure. These revenues would generally be deposited in a new state special fund called the Tobacco Tax of 2006 Trust Fund.



Proposition 86: Where Do the New Revenues Go?

- ☑ **Proposition 10 Backfill Comes “Off the Top.”** An unspecified amount of the additional excise tax revenues would be used to fully backfill Proposition 10 programs for a loss of funding that would result from Proposition 86, mainly because of reduced demand for tobacco products. The amount needed to backfill Proposition 10 would be determined by BOE.
- ☑ **Remainder Allocated to Three Main Accounts.** All remaining funding after backfill was provided to Proposition 10 would be divided as shown in Figure 1 among three main accounts, each of which has a number of subaccounts. The three main accounts are:

 - **Health Treatment and Services Account.** It would receive 52.75 percent of the remainder for (1) allocations to hospitals, (2) nursing education programs, (3) support of nonprofit community clinics, (4) physicians providing uncompensated care for the uninsured, (5) college loan repayments to encourage physicians to practice in medically underserved communities, (6) prostate cancer treatment services, and (7) services to assist persons to quit smoking.





Proposition 86: Where Do the New Revenues Go? *(Continued)*

- Health Maintenance and Disease Prevention Account.*** It would receive 42.25 percent of the remainder for (1) an expansion of children's health coverage mainly under the Healthy Families Program; (2) various tobacco-related programs, such as media advertising campaigns against smoking, education programs to prevent and reduce smoking, and state and local agency law activities to enforce regulation and taxation of tobacco products; and (3) new or existing health programs, including programs addressing colorectal, breast and cervical cancer; heart disease and stroke; obesity; and asthma.

- Health and Disease Research Account.*** It would receive 5 percent of the remainder for (1) medical research relating to cancer in general and breast and cervical cancer in particular, (2) research into tobacco-related diseases, (3) research into the effectiveness of tobacco control efforts, and (4) support of a statewide cancer registry.



Key Provisions for Children's Health Coverage Expansion

- Various Provisions Affect Children's Coverage.** As noted above, part of Proposition 86 funding would be earmarked for expanding children's health coverage. In this regard, some of the key provisions are as follows:

 - **Eligibility Expansion.** Healthy Families now provides coverage to children in families up to 250 percent of the federal poverty level (FPL) (about \$50,000 per year for a family of four) who are citizens or qualified aliens. Proposition 86 would instead provide coverage for children in families up to 300 percent of the FPL (about \$60,000 per year for a family of four) and for children who are undocumented immigrants or legal immigrants not now eligible for the program.
 - **Simplification Provisions.** State agencies administering the state's Healthy Families and Medi-Cal programs for health care for the poor would be directed to simplify the procedures for enrolling and keeping children on the rolls. One key provision says that the two programs "shall design and implement streamlined application, enrollment and retention procedures and mechanism for all benefits available under Healthy Families and Medi-Cal. From the child's perspective there shall appear to be a single program..."

- Pilot Project.** As part of the above streamlining activities, state agencies are to undertake a pilot project to test effective strategies for increasing coverage for uninsured children in families with incomes *above* 300 percent of the FPL.

- New Commission Established.** The measure creates a Healthy Kids Oversight and Accountability Commission to help ensure a smooth transition of children now covered under "local health initiatives" to Healthy Families coverage. The commission is also to help oversee other aspects of the expansion of children's coverage and the simplification provisions.



Key Proposition 86 Provisions Affecting Hospitals



A significant part of Proposition 86 revenues are allocated to hospitals. Some of the key related provisions are as follows:

- **Uses of Funding.** The funding received by hospitals under Proposition 86 is to be used to pay their unreimbursed costs for emergency services and to improve or expand emergency services, facilities, or equipment.
- **Funding Allocations.** Funding would be allocated to hospitals under a formula established in the measure that is based largely on the number of persons that the hospitals treat in their emergency departments and their costs for providing health care for patients who are poor.
- **Eligible Hospitals.** Private hospitals and certain public hospitals, including those licensed to the University of California (UC), counties, and health care districts, would receive funding. Hospitals licensed to other state agencies or the federal government would not be eligible for funding.
- **Limits on Hospital Charges and Bill Collections.** Hospitals that are allocated Proposition 86 funds would be subject to limits on what they could charge to certain patients in families with incomes up to 350 percent of the FPL. These hospitals would also have to adopt written policies on their bill collection practices and, under certain circumstances, could not send unpaid bills to collection agencies, garnish wages, or place liens on the homes of patients as a means of collecting unpaid hospital bills.



Key Proposition 86 Provisions Affecting Hospitals

(Continued)

- Coordination of Medical Services by Hospitals.*** Subject to the approval of certain local officials, hospitals accepting Proposition 86 funding would be allowed to coordinate certain medical services with other hospitals. This would include emergency services. For example, hospitals would be allowed to jointly share the cost of ensuring the availability of on-call physicians who provide emergency services. The measure seeks to exempt such coordination of emergency services from antitrust laws that might otherwise limit such coordination.



Other Major Provisions of Proposition 86

- Existing Funding for Physician Payments Continued.** This measure requires that \$25 million per year in Proposition 99 funding be continued to reimburse physicians for uncompensated medical care for persons who are poor. This funding would go to the California Healthcare for Indigents Program (known as CHIP) and the Rural Health Services Program.

- Expenditure Rules.** Funds would be “continuously appropriated” outside of the legislative budget process. They would generally have to be used to expand programs and not take the place of existing state or local spending. They could be used as a match to draw down additional federal funds. Contracts to implement the new programs would be exempted from state contracting rules for the first five years.

- Oversight Provisions.** The Department of Health Services would be required to prepare an annual report describing the programs that received Proposition 86 funds and how the funding was used and put that information on its Web site for the public. Programs would be subject to audit. New state committees would oversee the expansion of children’s health coverage and antiobesity programs.



Fiscal Effects of Proposition 86— Tobacco Excise Tax Revenues

- Additional Excise Tax Revenues.** We estimate that Proposition 86 would result in an increase in excise tax revenues from cigarettes and other tobacco products of about \$1.2 billion in 2006-07 (one-half year effect because the tax increase takes effect in January 2007). In 2007-08, its first full year of implementation, we estimate a gain in revenues of about \$2.1 billion. These revenues would decline slightly thereafter.

- Key Assumptions.** Our revenue estimate is based on a number of key assumptions which are highlighted below.

 - **Tax Increase Would Be Passed Along to Consumers.** Our revenue estimate assumes that the full cost of the tax increase is passed along to consumers by the distributors of tobacco products who actually pay the excise tax and associated sales tax.
 - **Increase Would Affect Consumer Demand.** We assume that the increase in the prices of tobacco products would have a number of significant responses from consumers, including an overall reduction in the purchase of tobacco products. Some persons will reduce cigarette consumption while others will quit smoking altogether.
 - **This Increase Would Have a Greater Proportional Impact.** Our revenue estimates assume a greater consumer response for Proposition 86 than we have traditionally done for prior tobacco tax increase proposals. That is because the increase in taxes proposed in this measure is substantially greater than experienced previously. Under our forecast model, we would expect that, on average, a 7 percent decline in consumer demand would result for each additional 10 percent increase in the price of tobacco products.
 - **Significant Impact on Tobacco Consumption Likely.** Since the effective price of tobacco products would go up about 70 percent under this measure (from about \$4 to roughly \$6.80 per pack), this means overall cigarette consumption could eventually drop by over 30 percent, or roughly 350 million packs annually.



Fiscal Effects of Proposition 86— Tobacco Excise Tax Revenues

(Continued)

- ☑ ***Other Factors Could Increase or Reduce Excise Tax Revenues.*** We recognize that other factors could increase or decrease the level of tobacco excise tax revenues we have projected. Some consumers could shift their purchases so that taxes could not be collected on tobacco products, such as through Internet purchases or purchases of smuggled products. Programs funded by Proposition 86 to deter and reduce smoking could also eventually further reduce tobacco excise tax revenues. On the other hand, funding allocated in the measure for tobacco-related state and local law enforcement activities could result in increased tax collections. The magnitude of these specific fiscal effects is unknown.



Fiscal Effects of Proposition 86— Other Effects on State and Local Revenues

- ☑ ***Effects on State General Fund Revenues.*** The decline in tobacco consumption that would be expected to result from the increase in tobacco excise taxes provided in Proposition 86 would reduce revenues from the existing part of the excise taxes (10 cents per pack) that now goes into the state General Fund. On the other hand, state General Fund sales tax revenues would increase because the sales tax is based on the price of the tobacco product plus the excise tax. These decreases in revenues would roughly equal the increases in revenues.
- ☑ ***Effects on Local Revenues.*** Local governments would likely experience an annual increase in sales tax revenues of as much as \$10 million.
- ☑ ***Effects on Existing Tobacco Excise Tax Revenues.*** The decline in tobacco consumption that would be expected to result from Proposition 86 would reduce the excise taxes now being collected for Proposition 10, Proposition 99, and the Breast Cancer Fund. We estimate that the initial annual revenue loss would be about \$180 million for Proposition 10, about \$90 million for Proposition 99, and less than \$10 million for the Breast Cancer Fund. However, these losses would be more than offset with new money from Proposition 86, as we will discuss later in this presentation.



Fiscal Effects of Proposition 86— New Spending for State and Local Programs

Figure 2

How Tobacco Tax Funds Would Be Allocated^a

Purpose	Allocation	Estimate of 2007-08 Funding (Full Year in Millions)
Backfill of California Children and Families First Trust Fund—Proposition 10	Unspecified amount determined by Board of Equalization	\$180
<i>Health Treatment and Services Account</i>	52.75 percent of remaining funds	\$1,015
Hospital emergency and trauma care	74.50 percent of account	\$756
Nursing education programs	9.00 percent	91
Nonprofit community clinics	5.75 percent	58
California Healthcare for Indigents Program—reimbursement of emergency care physicians	5.75 percent	58
Tobacco cessation services	1.75 percent	18
Prostate cancer treatment	1.75 percent	18
Rural Health Services Program—reimbursement of emergency care physicians	0.75 percent	8
College loan repayment program to encourage physicians to serve low-income areas lacking physicians	0.75 percent	8
<i>Health Maintenance and Disease Prevention Account</i>	42.25 percent of remaining funds	\$810
Children's health coverage	45.50 percent of account	\$367
Heart disease and stroke program	8.50 percent	69
Breast and cervical cancer program	8.00 percent	65
Obesity, diabetes, and chronic diseases programs	7.75 percent	63
Tobacco control media campaign	6.75 percent	55
Tobacco control competitive grants program	4.50 percent	36
Local health department tobacco prevention program	4.25 percent	34
Asthma program	4.25 percent	34
Colorectal cancer program	4.25 percent	34
Tobacco prevention education programs	3.50 percent	28
Tobacco control enforcement activities	2.25 percent	18
Evaluation of tobacco control programs	0.50 percent	4
<i>Health and Disease Research Account</i>	5.00 percent of remaining funds	\$95
Tobacco control research	34.00 percent of account	\$32
Breast cancer research	25.75 percent	24
Cancer research	14.75 percent	14
Cancer registry	14.50 percent	14
Lung cancer research	11.00 percent	10
Total Allocations		\$2,100

^a Because the overall revenues from the tobacco tax increase are subject to uncertainty, the actual allocations to programs could be greater or less than the amounts shown here.
Totals may not add due to rounding.



Fiscal Effects of Proposition 86— Impacts on Other Tobacco Tax Programs

- Proposition 10.** As noted earlier, the measure requires that the Proposition 10 program receive a full backfill of any losses that result from the decline in tobacco consumption caused by Proposition 10. We estimate that this annual loss, and the resulting backfill, would be about \$180 million initially.
- Proposition 99.** Proposition 99 does not directly receive a backfill allocation to offset the loss of funding we believe would result if Proposition 86 were enacted. As a result, the public resources account would lose about \$5 million per year initially and the unallocated account, which can be used for any program eligible for Proposition 99 funding, would lose about \$25 million annually. Proposition 86 would also cause a loss to other Proposition 99 accounts, but would also provide significant additional new funding for activities comparable to those now funded under Proposition 99. This includes health education and tobacco research, hospital services, and physician services. In the aggregate, we estimate these activities would initially have an annual net gain of almost \$950 million.
- Breast Cancer Fund.** Again, no backfill funding is provided directly to the Breast Cancer Fund under Proposition 86. However, Proposition 86 allocates significant new funding for comparable purposes, with the result that these activities would likely experience a net gain of \$80 million a year initially.



Fiscal Effects of Proposition 86— Effects on Public Hospitals

- ☑ ***Various Public Hospitals Would Gain Funding.*** Some of the funding provided under Proposition 86 to hospitals would go to publicly operated hospitals—mainly those run by UC, counties, cities, and health care districts. Other provisions of the measure, such as those limiting hospital charges to lower-income persons and bill collections, will also have fiscal effects on these public hospitals. In the end, hospitals operated by state and local agencies are likely to have a net financial gain up to the low hundreds of millions of dollars annually on a statewide basis.



Fiscal Effects of Proposition 86— Provisions for Children’s Coverage

- Long-Term Effects of Increased Healthy Families Coverage.*** In the short term, the revenues earmarked in Proposition 86 to expand Healthy Families would be more than sufficient to pay the costs of gradually increasing enrollment. Over time, as excise tax revenues declined and enrollment grew, the costs of the expansion could exceed the new Proposition 86 revenues. If actions were not taken to limit program costs, additional state support would be needed to support the Healthy Families Program. These potential costs are unknown but could be significant.
- State and County Savings From Shift in Children’s Coverage.*** Counties would likely receive unknown but significant savings as children now enrolled in local health coverage initiatives were shifted to Healthy Families. The state could also experience savings in Medi-Cal for emergency services if these children instead received health coverage through the expanded Healthy Families Program.
- Net Increase in State Costs From Pilot Projects and Simplified Enrollment.*** Depending on what specific steps were taken to implement these provisions, the state could save on some administrative costs for enrollment activities in Medi-Cal and Healthy Families. But it would also likely experience increases in administrative and caseload costs. We estimate that the net fiscal effect would be an increase in state costs that could exceed \$100 million annually after a few years.



Fiscal Effects of Proposition 86— Potential State and Local Health Savings

- Lower Costs for Health Care for Poor and Public Employees.*** The state and local governments incur costs for providing health care for low-income persons and public employees. The decrease in tobacco consumption likely to result from Proposition 86 would probably reduce state and local health care costs in the long term. In addition, lower costs for government could result from some of the new and expanded health care programs funded in the measure. The magnitude of these savings are unknown but would likely be significant.