



# A BAD IDEA GONE TOO FAR: PROPOSITION 86, THE TOBACCO TAX

By Geoffrey F. Segal and Skaidra Smith-Heisters





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# A Bad Idea Gone Too Far: Proposition 86, The Tobacco Tax

By Geoffrey F. Segal and Skaidra Smith-Heisters

## Executive Summary

Proposition 86 seeks to expand California's health care services and medical research funds by approximately \$2 billion annually, initially through an excessive 300 percent increase in the state's tax on tobacco products.

The largest single spending items in Proposition 86 would pay for uninsured hospital and emergency trauma care costs (\$756 million annually) and children's health coverage (\$367 million), including expanding health coverage to children from families with incomes between 250 and 300 percent of the federal poverty line, or from \$50,000 to \$60,000 for a family of four. The proposal would make cigarette smokers pay part of the medical bills for obesity and people with diseases like diabetes, while less than 1 percent of the revenues generated by the new tax would actually go toward helping smokers quit. Less than 10 percent of the proposed tax funds would be spent on anti-smoking advertising and tobacco control and enforcement programs in total.

Fewer than 15 percent of California adults are smokers—the second lowest rate in the nation—but tobacco consumers constitute a relatively captive tax base, from which politicians can draw funds for a variety of programs, regardless of merit, without fear of meaningful political backlash. The tax itself and programs funded by these measures often have far-reaching consequences—such as increased tax fraud, smuggling, and diversion and waste of state funds—that are not fully appreciated by voters at the ballot box.

The proposed tobacco tax increase of \$2.60 per pack of cigarettes would make California's the highest tobacco tax (\$3.47) in the country by more than \$1.00—3.5 times the national average—and create an unprecedented incentive for legal and illegal tax avoidance. Neighboring states have far lower cigarette and sales tax rates, and there will be greater incentives to purchase cigarettes

through the Internet, by mail order, and other sales avenues. As illustrated by the nation's experience with alcohol prohibition, these types of regulations also provide unique opportunities for organized crime, which is why numerous law enforcement associations have come out against Proposition 86, including the Association of Los Angeles Deputy Sheriffs, Deputy Sheriffs Association of San Diego County, San Francisco Police Officers Association, Peace Officers Research Association of California, and the Los Angeles Police Protective League.

Tobacco tax revenues will initially cover the costs of new programs and expansion of health care benefits, but as tobacco sales continue to decline, programs founded on California's tobacco consumers will be left stranded with budgetary needs far above the dedicated revenue stream.

Meanwhile, many health care programs outlined in Proposition 86 are already funded by the state budget. Rapid growth in the state's general fund allowed for \$1.2 billion increased spending for Health and Human Services in 2006-07, bringing the total to \$73.1 billion. Last year California earned the highest grade in the nation for the State of Emergency Medicine according to the American College of Emergency Physicians. California already has one of the most generous health benefit systems for children. While there is still room for health care reforms that would lower costs and improve quality of care in California, Proposition 86 doesn't address those concerns—it only adds 38 pages of mandates, new programs, and activities that over time will develop their own bureaucracies and become long-term liabilities for the state.

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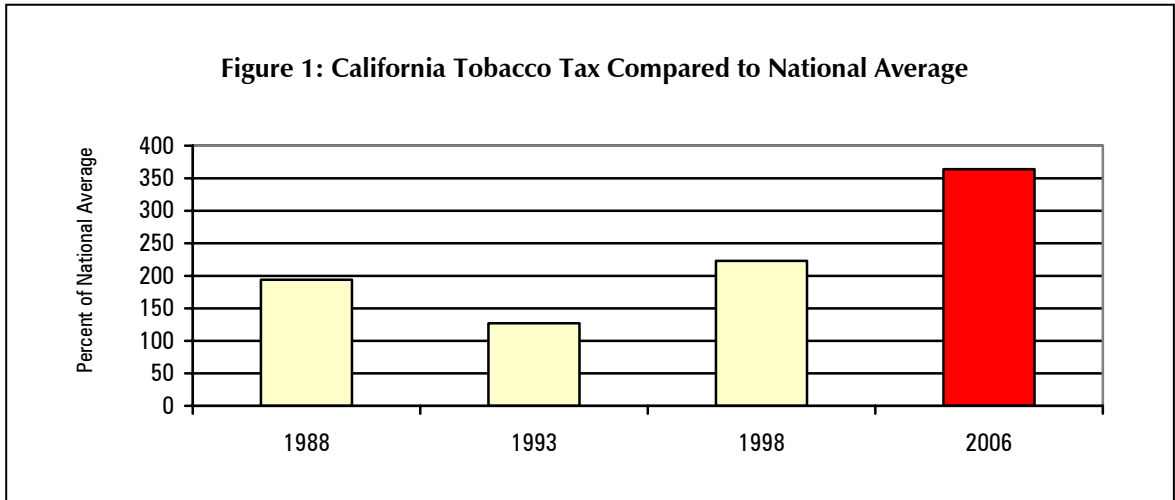
## Part I

# Introduction

Californian tobacco consumers have long been among the most heavily taxed in the nation, beginning with the passage of Proposition 99, the California Tobacco Health Protection Act, in 1988. This referendum increased the state cigarette tax by 25 cents per pack and added an equivalent amount on other tobacco products. Ten years later, Proposition 10, the California Children and Families First Act of 1998, was narrowly approved by voters and imposed a new 50-cent tax on cigarettes, with an equivalent tax imposed on other tobacco products. Proposition 86, the Tobacco Tax Act of 2006, returns the question of imposing additional taxes on cigarettes to voters, just eight years after the last significant tax increase.

Proposition 86 throws the debate over tobacco taxes to a new extreme, as California voters decide whether to increase the state's tobacco tax by an unprecedented 300 percent, from the 87-cent per pack tax level established in 1998 by Proposition 10, to \$3.47 per pack—3.5 times the national average. This excise tax is in addition to the \$0.39 federal excise tax and all applicable state and local sales taxes as well.

Table 1: The History of Tobacco Tax in California						
	Date of Increase	Amount of Increase	Tax Rate After Increase	% Tax Increase	National Average	California % to National Average
Proposition 86	2006	\$2.600	\$3.470	299%	\$0.953	364%
Proposition 10	1998	\$0.500	\$0.870	135%	\$0.390	223%
Legislature	1993	\$0.020	\$0.370	6%	\$0.290	127%
Proposition 99	1988	\$0.250	\$0.350	250%	\$0.180	194%



Advocates of tobacco taxes claim that these taxes provide a net benefit because they act as both a disincentive for the consumption of tobacco products and as a revenue source for programs, such as addiction treatment and education initiatives, which mitigate some of the social effects of tobacco use. However, to many these taxes appear excessive, going far beyond any social externalities posed by personal tobacco use. Less than 15 percent of California adults are smokers—the second lowest rate in the nation—but tobacco consumers constitute a relatively captive tax base, from which politicians can draw funds for a variety of programs, regardless of merit, without fear of meaningful political backlash. The tax itself and programs funded by these measures often have far-reaching consequences—such as increased tax fraud, smuggling, and diversion and waste of state funds—that are not fully appreciated by voters at the ballot box.

## Part 2

# Proposition 86 Overview

The California Secretary of State prepared the following ballot summary for Proposition 86:

- Imposes additional 13 cent tax on each cigarette distributed (\$2.60 per pack), and indirectly increases tax on other tobacco products.
- Provides funding to qualified hospitals for emergency services, nursing education and health insurance to eligible children.
- Revenue also allocated to specified purposes including tobacco-use-prevention programs, enforcement of tobacco-related laws, and research, prevention, treatment of various conditions including cancers (breast, cervical, prostate, colorectal), heart disease, stroke, asthma and obesity.
- Exempts recipient hospitals from antitrust laws in certain circumstances.
- Revenue excluded from appropriation limits and minimum education funding (Proposition 98) calculations.

Proposition 86 would also have significant impacts on existing programs already funded with tobacco excise taxes. An increase in the price of tobacco (including taxes) reduces tobacco sales and at the same time results in more tobacco purchases online or in the black market where taxes are not collected. In 1998, Proposition 10 created tax revenues for early child development programs initiated under that measure—but because it also reduced overall tobacco sales, it resulted in decreased tax revenues for the Breast Cancer Fund and Proposition 99 programs which had been established on previous tobacco tax revenues. In response, Proposition 10 was written to “backfill,” or compensate, some losses to these other tobacco-tax programs. Proposition 86 would act similarly, allocating an amount yet to be determined (approximately \$180 million annually) to “backfill” Proposition 10 programs for early child development.

The Legislative Analyst’s Office estimates that Proposition 99-supported programs would initially see a reduction in funding of about \$5 million for public resources and another \$25 million for programs eligible for funding.<sup>1</sup> The Breast Cancer Fund would not receive backfill, however, Proposition 86 would allocate a portion of the new tax revenues for breast cancer research and other related activities.



Table 1 lists the breakdown of the allocation of Proposition 86 revenues.

More than half of the revenues would be allocated to a new Health Treatment and Services Account. Nearly three-quarters of this account would be allocated to hospitals to pay for unreimbursed emergency care costs. These funds could also be used to improve or expand emergency services, facilities, or equipment.

Almost \$100 million would be used to expand nursing education programs at state colleges and universities. Other funding would be allocated for the support of nonprofit community clinics and for uncompensated health care for uninsured persons provided by physicians. In addition, a program for physician loan repayment would be established to encourage physicians to provide services for low-income or underserved communities. Revenues would also be made available for prostate cancer treatment.

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Of the anticipated \$2.1 billion in revenues, only \$18 million, or 8 percent, would be allocated for smoking cessation programs.

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Forty-two percent of funds will be distributed to a new Health Maintenance and Disease Prevention Account, used to expand health coverage to children from families with incomes between 250 and 300 percent of the federal poverty line and children from families with incomes up to 300 percent of the federal poverty line who are undocumented immigrants or legal immigrants not now eligible for the Healthy Families Program. This means the benefits threshold would increase from \$50,000 to \$60,000 for a family of four.

The remaining 5 percent of the revenues would be deposited into the Health and Disease Research Account to support research on cancer in general and breast and lung cancer in particular. It would also support a statewide cancer registry, which would collect data on cancer cases. Of the anticipated \$2.1 billion in revenues, only \$18 million, or 8 percent, would be allocated for smoking cessation programs.

The Legislative Analyst's Office notes that revenues would initially cover the costs of new programs and the large expansion of health care benefits. Over time as revenues decline, however, the expanded program budgets would eventually exceed available resources and significant additional, long-term financing would be needed. The LAO suggests that about \$1.2 billion will be raised in 2006-07 and \$2.1 billion in 2007-08, and then revenue will decline each year after that.

<b>Table 2: How Tobacco Tax Funds Would Be Allocated</b>		
<b>Purpose</b>	<b>Allocation</b>	<b>Estimate of 2007–08 Funding (Full Year in Millions)</b>
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
<b>Total Allocations</b>		<b>\$2,100</b>

Source: California Legislative Analyst Office - [http://www.lao.ca.gov/ballot/2006/86\\_11\\_2006.htm](http://www.lao.ca.gov/ballot/2006/86_11_2006.htm)

## Part 3

# Problems with Proposition 86

## A. Increased Smuggling and Tax Avoidance

This dramatic 300 percent tax increase, combined with the significantly lower cigarette prices found in neighboring states, creates an unprecedented incentive for legal and illegal tax avoidance. The proposed tobacco tax increase of \$2.60 per pack of cigarettes would make California's the highest tobacco tax (\$3.47) in the country by more than \$1.00 (Rhode Island's tax is \$2.46). The total tax in California would be more than 3.5 times the national average of \$0.953 per pack.<sup>2</sup> Neighboring states have far lower cigarette tax rates: Arizona, \$1.18 per pack; Nevada, \$0.80; and Oregon, \$1.18, plus lower sales taxes as well.

Even in legal quantities, personal shipments of cigarettes over the Nevada border would result in savings of more than \$50 per trip based on the difference in tobacco tax rates alone. Monthly trips to Las Vegas or Phoenix would save a two-pack-a-day smoker around \$160 a month—enough to cover the round-trip ticket or gas. There is an obvious incentive and opportunity for Californian tobacco consumers to use loopholes in the California law—such as tobacco tax exemptions for sales of cigarettes to United States military exchanges and commissaries, and individual shipments of not more than 400 cigarettes personally transported into California<sup>3</sup>—if they don't just break the law altogether.

While sales of cigarettes to non-tribal members on Native American territories are technically subject to state excise taxes, enforcement of this law has been difficult if not impossible. Likewise, tobacco sales across the Mexican border and via the Internet, are notoriously hard to collect taxes on. We should expect that such purchases will increase if tobacco taxes are increased dramatically, reducing the revenue from the tax.

Estimates of the total annual tobacco tax revenues lost due to tax evasion in California range from tens to hundreds of millions of dollars. The Board of Equalization stated in its last annual report that cigarette tax evasion costs up to \$292 million per year in unpaid taxes.<sup>4</sup> The BOE estimated that a crackdown on Internet tobacco tax evasion would result in the recovery of \$33.8 million in tax revenues in 2006-07, and \$16.9 million in 2007-08—an effort that required hiring 20 additional clerks to enter a \$52 million backlog of out-of-state tobacco invoices and subpoenaed shipping

records.<sup>5,6</sup> The tax enforcement costs that will be required to calculate and further reduce these opportunities for tax evasion would be astounding, and partial enforcement of these laws unfortunately means that the most honest retailers—those obeying state law—generally suffer the greatest disadvantage in the marketplace.

According to the National Association of Convenience Stores, there are more than 43,000 retailers who sell cigarettes in California; sales of cigarettes currently account for approximately 35 percent of their sales.<sup>7</sup> When customers take their sales out-of-state, as they do under the threat of increased taxes, it has a significant impact on these retailers. For this reason, many business organizations, including more than two dozen Chambers of Commerce from around the state, oppose Proposition 86.

As illustrated by the nation's experience with alcohol prohibition, these types of regulations also provide unique opportunities for organized crime. In February 2006, a California resident was charged in connection with the operation of a smuggling ring from North Carolina to California. It's believed that almost 500,000 cartons of cigarettes were smuggled, with a tax avoidance of \$4.35 million and a hit to legitimate California retailers of \$20 million.<sup>8</sup>

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Monthly trips to Las Vegas or Phoenix would save a two-pack-a-day smoker around \$160 a month—enough to cover the round-trip ticket or gas.

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New York recently uncovered a smuggling ring that netted defendants millions in profits, according to the Suffolk County District Attorney Thomas Spota.<sup>9</sup> The smugglers purchased large quantities of untaxed cigarettes at Indian reservations and resold them with counterfeit tax stamps.

The federal Bureau of Alcohol, Tobacco, Firearms and Explosives has more than 450 active investigations into trafficking schemes—where groups organize cigarette shipments from low-tax states to high-tax states.<sup>10</sup> If the ballot initiative in California passes, the excise tax difference between California and South Carolina would grow to \$3.40 per pack. Passage of the proposition will result in ripe conditions for more smuggling and black market activity. Increased black market sales should be a concern not just because of the loss of tax revenues to the state, but because of associated criminal activities, which may include increased sales of tobacco products to minors and incidence of violence. Valuable public safety resources will be spent needlessly in attempts to stem these efforts. If history is any lesson, we will not win this war. For these reasons, at least 15 different law enforcement associations have all come out against Proposition 86. These groups include the Association of Los Angeles Deputy Sheriffs, Deputy Sheriffs Association of San Diego County, San Francisco Police Officers Association, Peace Officers Research Association of California, and the Los Angeles Police Protective League.

## B. Misrepresentation of Tax Goals

Advocates of Proposition 86 describe it as a smoking cessation measure, however, only a small fraction of revenues goes to smoking-related programs. In fact, less than one percent of the revenues generated would actually go toward helping smokers quit. If you add in spending on anti-smoking advertising and tobacco control and enforcement programs to help keep children from starting it is still less than 10 percent. Over 90 percent goes to fund existing health care programs mostly unrelated to smoking.

A common justification of tobacco taxes is that these taxes help to recover the social costs of personal tobacco use—that is, costs beyond those that the consumer pays in the price of the product. Many of these social costs, ranging anywhere from cleaning fees on real estate property to insured medical expenses, are paid for privately. A consumption tax is supposed to cover other costs—such as medical expenses paid for under public programs like Medicaid or the costs of responding to fires caused by cigarettes—called “external” costs because they are not fully paid by the consumer, either directly or indirectly. Proposition 86 goes much further than that, however.

A recent Duke University study estimated the per-pack costs of cigarette smoking (over the smoker’s lifetime) borne by society to be \$1.44.<sup>11</sup> The proposed tax would bring California’s per pack tax to \$3.47—more than twice what smoking is estimated to cost the public, and then smokers pay federal taxes, or state or local sales taxes on top of that. According to the California Department of Health Services, the everyday smoker in California smokes an average of 14 cigarettes per day.<sup>12</sup> Under the proposed tax increase, these consumers would pay approximately \$887 per year in state cigarette taxes, more than \$500 a year in excess of what might be justified by the “externalities” argument. While these figures are only approximations, they should be important considerations.

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**It is clear that the real goal of Proposition 86 is to raise money for a wide variety of new and ongoing health programs that have little or no relationship to tobacco use.**

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Tax proponents have not attempted to justify the arbitrary and disproportionate nature of their proposal.

It is clear that the real goal of Proposition 86 is to raise money for a wide variety of new and ongoing health programs that have little or no relationship to tobacco use. Ironically, far from recovering the social costs of tobacco use, the proposal would make cigarette smokers pay part of the medical bills for obesity and people with diseases like diabetes. The proposal is not just unfair, it is unwise, because the expansion of health services and research proposed under Proposition 86 is not subject to a thorough review, as these programs would be if they were proposed under the normal budgeting process. Moreover, these programs will depend on a declining source of

revenue—as fewer people smoke and more people evade the taxes, revenues from Proposition 86 will fall and the programs will be back clamoring for more funding.

Certainly many of the programs are worthwhile. Funding \$179 million annually for cancer research and treatment programs or \$756 million for hospital emergency and trauma care might well make perfect sense. If so, why is this funding not allocated out of the fast-growing state budget? Clearly the legislature did not find these programs to be enough of a priority to provide these funds.

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We have passed initiatives before to fund smoking-reduction programs, and the money is being diverted and abused.

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### C. Creating More Problems Than it Solves

Tobacco tax monies above and beyond those needed to mitigate the actual societal cost of tobacco use have been used for a variety of special-interest programs through the years. In many cases, the funds have simply been abused.

The University of California, San Francisco, found that, “Despite clear language in the initiative regarding the use of funds, the Proposition 99-funded tobacco control programs have been under attack by both the Legislature, which consistently failed to allocate 20 percent of the revenues to the Health Education Account, and by interest groups, particularly the California Medical Association and California Association of Hospitals and Health Care Systems, and the Western Center for Law and Poverty...accelerating diversions of funds out of legitimate tobacco control activities.”<sup>13</sup> In 1998, Proposition 10 created the “California Children and Families First Commission,” which is now under investigation by the state auditor for the misappropriation of \$23 million in 2005. In other words, we have passed initiatives before to fund smoking-reduction programs, and the money is being diverted and abused. And now Proposition 86 includes more funding for the same old problems, including the Commission under investigation.

Proposition 86 is written expressly for the benefit of some of the same interests that have abused California’s tobacco tax funds in the past. Further, Proposition 86 includes some 38 pages of mandates—new programs and activities that do not receive their appropriations through the annual state budget process. Thus, they are not subject to oversight or change from the legislature or governor. Perhaps most troubling is that contracts to implement some of the new programs would be exempted from state contracting rules, enabling further waste and corruption. Proposition 86 does not contain traditional public accounting safeguards to ensure that tax revenues are spent in the public’s best interest—and without a new proposition, there is nothing taxpayers could do about it.

Authors of Proposition 86 also wrote a clause exempting hospital corporations from antitrust laws. If hospital antitrust laws need reform, that issue should be addressed on its own merit, not buried in a ballot proposition on an unrelated subject.

Finally, the proposition represents a massive expansion of the welfare system (i.e., expansion of SCHIP—the State Children’s Health Insurance Program) in California that will have long-term costs that will not be covered by tobacco taxes. As was the case with Proposition 99 programs after the approval of Proposition 10, and as is predicted with the passage of Proposition 86, while tobacco tax rates increase, tobacco sales rates decrease, and programs founded on California’s tobacco consumers will be left stranded with budgetary needs far above the dedicated revenue stream. As noted earlier, the opinion of the Legislative Analyst’s Office is that tobacco tax revenues will initially cover the costs of new programs and expansion of health care benefits. It is difficult to calculate how long that will be the case. The LAO has stated that while their revenue estimates “assume a somewhat greater consumer response in terms of reduced tobacco consumption...[revenue] estimates are subject to uncertainty, however, given the large tax changes involved.”<sup>14</sup>

## Part 4

# Alternatives to Proposition 86

As shown above, tobacco smoking cessation and prevention are not the real objectives of Proposition 86. If they were, the authors of the proposition would have dedicated more of the funds toward programs that work to educate and support Californians in making healthy choices about the use of tobacco products. Rather, the proposition aims to create revenue for a wide variety of health programs through heavy taxation of a small minority. Do these ends justify the means?

### A. California Already Receives Highest Grade for “State of Emergency Medicine”

If Proposition 86 passes, some \$750 million of the new revenue will annually be sent to hospitals to offset emergency and trauma care costs. The authors of Proposition 86 want you to believe that California’s health care system is in crisis and that billions in new tax dollars are needed to shore up our states’ emergency and trauma care. However, California earned the highest grade in the nation for the State of Emergency Medicine according to the American College of Emergency Physicians.<sup>15</sup> Further, the report card ranked California near the top for Public Health and Injury Prevention as well as the Medical Liability Environment. While the report card did point out some problem areas, it does not suggest that more than three-quarters of a billion dollars needs to be spent. In fact, California almost has as many emergency room doctors as the next three most populous states (New York, Texas, and Florida), combined.<sup>16</sup>

### B. Proposition 86 Programs Already Receive State Support

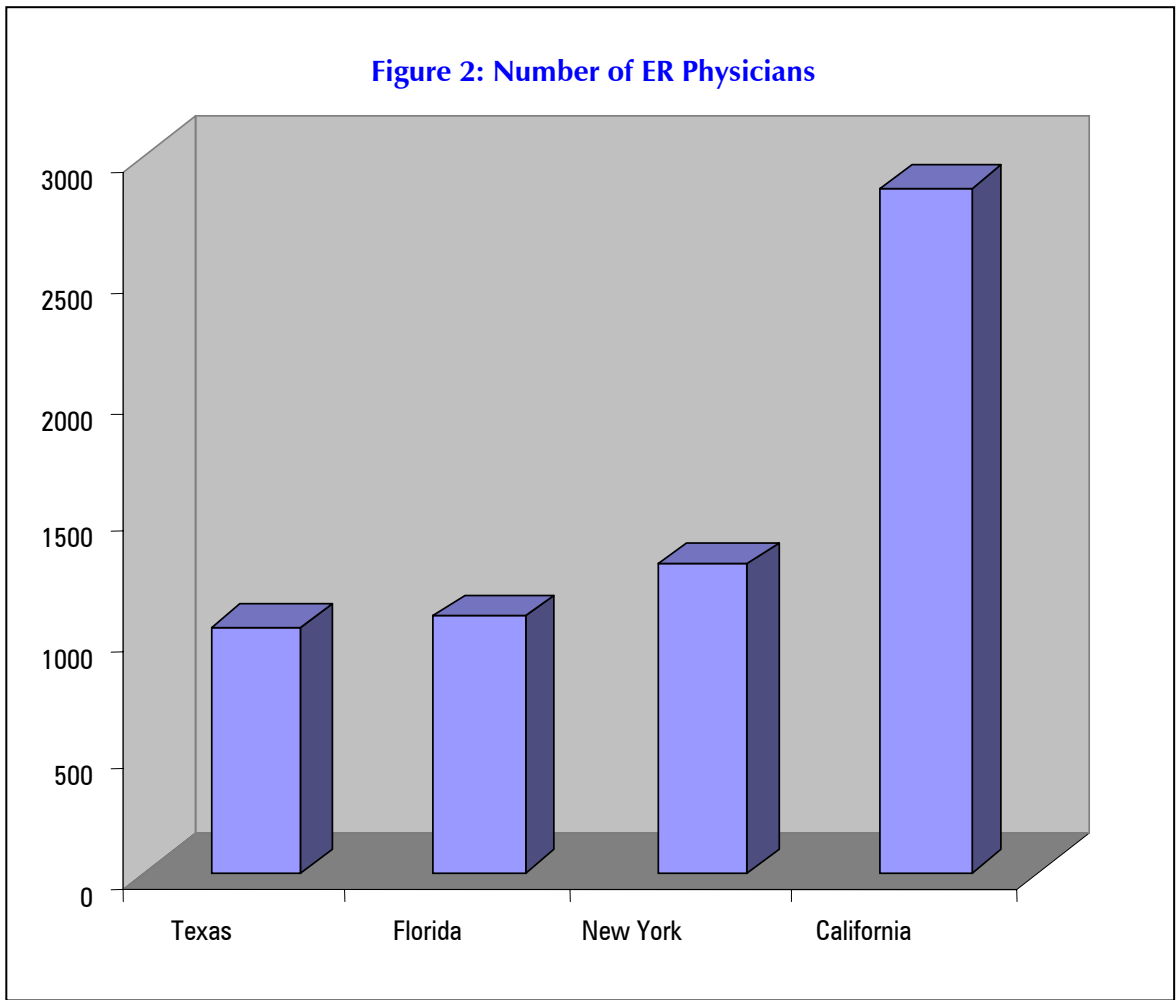
California already spends billions of dollars on health care services. The total proposed budget for Health and Human Services (HHS) in 2006-07 is \$73.1 billion. This represents a \$1.8 billion increase over the previous year with two-thirds (\$1.2 billion) of that increase coming from rapid growth in the general fund.

Many health care programs outlined in Proposition 86 are already funded by the state budget. It can be assumed that additional investments in these programs are not as high a priority as other programs within HHS, otherwise more existing revenues would be allocated to them. Funding for the 11 central program areas of Proposition 86 represents about a half percent (0.5 percent) of the



total annual state budget of HHS. Each of these programs has merit; where each sits relative to other spending priorities is debated each year during the budget process. It is clear that lawmakers do not see these programs as high priority relative to other spending.

Perhaps more troubling with the spending plans is that programs to reduce smoking rates among adults and children, one of the initiative’s key goals, receive less than 10 percent of revenues. Tobacco control, cessation, and education programs are already funded with other cigarette tax dollars. Proposition 86 adds very few new dollars to these activities.



<b>Table 3: Proposed Programs Spending Under Proposition 86</b>	
	<b>Cost (\$M)</b>
California Healthcare for Indigents Program—reimbursement of emergency care physicians	58
Prostate cancer treatment	18
Rural Health Services Program—reimbursement of emergency care physicians	8
Heart disease and stroke program	69
Breast and cervical cancer program	65
Obesity, diabetes, and chronic diseases programs	63
Asthma program	34
Colorectal cancer program	34
Breast cancer research	24
Cancer research	14
Lung cancer research	10
<b>Total</b>	<b>\$397</b>

### C. California's SCHIP is Already Generous

The second most costly spending proposal under Proposition 86 is a massive expansion of the State Children's Health Insurance Program. California already has one of the most generous benefit systems for children. In fact, we currently have the third highest income limit for what families can earn and still be eligible—250 percent of the federal poverty level,<sup>17</sup> or \$50,000 for a family of four<sup>18</sup>. Proposition 86 would take the limit up to 300 percent of the federal poverty level, who are undocumented immigrants or legal immigrants not now eligible for the Healthy Families Program. In addition, according to the Legislative Analysts' Office it could include children of families with incomes up to 300 percent of the federal poverty level who are not now eligible for the Healthy Families Program.

The long-term implications are not fully known, however, a benefit increase of this size would certainly increase the liabilities and costs of the system.

### D. Long-Term Reforms for More Affordable Healthcare

Improving our health care system is a worthy goal. Proposition 86 is not the best mechanism to achieve that end.

Sadly, it is often public policy itself that drives the costs of health care up, particularly excessive regulatory intervention. Again, California is in relatively good shape. Our health insurance market is considered by many to be competitive and fairly market-driven. However, there are some policy

mandates and regulations that add to the cost. A review of existing coverage requirements may reveal costly measures that, if amended, would lower the cost of coverage.

Further, the introduction of Health Savings Accounts (HSAs) would result in significant long-term benefits for Californians and their health care system. Simply defined, HSAs incorporate a tax-free savings account with a high-deductible health insurance plan. A major goal of HSAs is to give enrollees incentives to lower their utilization of medical services. Under an HSA an enrollee or his or her employer makes tax-free payments into the HSA and joins a high-deductible health insurance plan (with costs significantly less than low-deductible plans). The HSA uses those funds for preventative and routine care during the year. Any money left in the savings plan at the end of the year belongs to the individual. Either way, the individual is protected. The high-deductible plan protects the individual in the event of a major illness, injury or accident, while most of the healthcare expenses are paid from the savings.

This presents a major opportunity because under the current insurance scheme, there is no incentive to control health care costs or spending. An HSA is one of the best ways to improve coverage while changing the incentive structure to get patients to think about costs and value when spending their health care dollars.

While this shift doesn't address immediate concerns, it does free up some resources that can be reallocated to meet these needs. Again, in the long run, HSAs promise to lower costs and improve quality of care—both things Proposition 86 cannot promise to do.

Finally, those who are concerned about the cost effects of pooling smokers' and non-smokers' health care costs in programs such as Medicaid and group life insurance should examine regulatory changes needed in these instances—again, something Proposition 86 ignores.

## Part 5

# Conclusion

The authors of Proposition 86 are sending California taxpayers a mixed message. They argue that the new tax is meant to get smokers to stop. However, the authors of Proposition 86 are addicted to the promise of new revenues that can be spent on 38 pages of new and expanded programs. Further, less than 10 percent of the new revenues would go to smoking cessation or education programs.

If approved, the Proposition 86 programs will develop their own constituencies and demands for increased funding. As tax revenues decline over time, as we know they will, Proposition 86 programs will compete for funding with other important programs like education, transportation, and law enforcement. This could lead to worsening deficits, cuts in programs, or further tax increases. What's worse, there aren't any controls on how the money is spent—funds would be distributed outside the normal budgeting process, leaving taxpayers without any oversight.

A tax this high will create a new profitable enterprise for criminal activities. Smuggling and stolen cigarettes are already profitable; however, with Proposition 86 in place, taxes in a single truckload of cigarettes would be worth \$2 million or more. The high cost of enforcement and the negative impacts of criminal activity are tremendous, and far outweigh any benefits of Proposition 86 programs.

In addition, California's small businesses will suffer as legitimate sales of cigarettes are diverted to legal and illegal channels including the Internet and neighboring states. California has been losing tax dollars and taxpayers to neighboring states for the last few years. We can't afford to continue this trend and continually send consumers fleeing from the state.

On top of that the tax is unfair. Only a small percentage of Californians are smokers, yet they're asked to pay for programs and services that have no benefit to them.

The bottom line is that special interests win and taxpayers lose.

## About the Authors

**Geoffrey F. Segal** is the director of privatization and government reform at Reason Foundation. Mr. Segal recently served as an advisor to Florida Gov. Jeb Bush's Center for Efficient Government. In addition, his counsel has recently been sought out by Gov. Mark Sanford and Indiana Gov. Mitch Daniels, where he is working with the Government Efficiency and Financial Planning group inside the Office of Management and Budget. Segal is also an advisor to the Cost Cutting Caucus in the Virginia House of Delegates.

Mr. Segal is a highly skilled policy analyst with a strong, diversified background in policy research and project analysis focusing on public-private partnerships, competition, government efficiency, government spending and waste, transparency, accountability, and government performance.

He has worked closely with legislators in California, New York, Florida, Virginia, Pennsylvania, Oregon, Kentucky, Indiana, Ohio, Washington D.C., Colorado, Minnesota, Maryland, Maine, North and South Carolina, Hawaii, Arizona, and Texas in efforts to reduce government spending, improve government performance, and enhance accountability in government programs.

Mr. Segal has testified to the United States Senate and numerous state legislatures and agencies. He has written dozens of articles for leading publications including *Investor's Business Daily*, *Atlanta Journal-Constitution*, *Indianapolis Star*, *Orange County Register*, *Los Angeles Daily News*, and *New York Sun*. Segal is also a contributing editor to *Budget & Tax News*.

He earned a B.A. in Political Science at Arizona State University and a Masters of Public Policy from Pepperdine University.

**Skaidra Smith-Heisters** is a policy analyst at Reason Foundation. Her research is part of Reason's New Environmentalism program, launched by Lynn Scarlett, which develops innovative solutions to environmental problems and emphasizes the benefits of local decisions over Washington's command-and-control regulations.

Smith-Heisters is a graduate of the University of California at Davis program in Nature and Culture. Prior to joining Reason, she worked in habitat restoration, endangered species management and natural resources planning with the California State Parks system.

# Endnotes

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  - <sup>2</sup> Campaign for Tobacco-Free Kids, State Cigarette Excise Tax Rates and Rankings, <http://www.tobaccofreekids.org/research/factsheets/pdf/0097.pdf>, September 25, 2006.
  - <sup>3</sup> Rev. & Tax Code §30102 and §30106
  - <sup>4</sup> State Board of Equalization, *2004-05 Annual Report*, (Sacramento, CA, 2006) <http://134.186.44.198/annual/pdf/2005/5-special05.pdf>, p. 48
  - <sup>5</sup> Andrew McIntosh, "State Chasing Taxes from Cigarettes Bought Online," *Contra Costa Times*, July 23, 2006.
  - <sup>6</sup> California State Assembly, *2006-2007 State Budget Act: Floor Report*, (Sacramento, CA) <http://democrats.assembly.ca.gov/members/a27/pdf/FloorReport2006-07.pdf>, June 27, 2006, p. 57-58
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  - <sup>10</sup> U.S. Bureau of Alcohol, Tobacco, Firearms and Explosives, *2005 Annual Report* (Washington D.C.), p. 32.
  - <sup>11</sup> Duke University, *Smoking's Real Cost Reaches \$40 Per Pack Over Lifetime, Duke Study Concludes*, [http://dukenews.duke.edu/2004/11/costofsmoking\\_1104.html](http://dukenews.duke.edu/2004/11/costofsmoking_1104.html)
  - <sup>12</sup> California Department of Health Services, *Cigarette Consumption*, (Sacramento, CA, 2005), <http://www.dhs.ca.gov/tobacco/documents/pubs/Consumption.pdf>
  - <sup>13</sup> University of California, San Francisco, *Implementation of Proposition 99: 1994-1995 and 1995-1996 Fiscal Years: Assembly Bill 816*, <http://www.ucsf.edu/campus/schmed/ihs/Prop99.html>.
  - <sup>14</sup> California Legislative Analyst's Office, *California Voter Information Guide* (Sacramento, CA, 2006), p. 6,
  - <sup>15</sup> American College of Emergency Physicians, *National Report Card on the State of Emergency Medicine* <http://my.acep.org/site/DocServer/2006-NationalReportCard.pdf?docID=221>, January 2006, pg. 7.

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- <sup>16</sup> American Board of Medical Specialties, *Annual Report and Reference Handbook*, (Evanston, IL: 2005), pp. 86-89 - <http://www.abms.org/downloads/statistics/table7.pdf>. Note: California 2,874; Texas 1,023; Florida 1,070; New York 1,289
- <sup>17</sup> U.S. Department of Health and Human Services, *2006 Federal Poverty Guidelines*, (Washington D.C.), <http://aspe.hhs.gov/poverty/06poverty.shtml> -- In addition, add \$3,400 for each additional child i.e., a family of 5 would have a FPL of \$23,400.
- <sup>18</sup> The Henry J. Kaiser Family Foundation, *State Health Facts*, [www.StateHealthFacts.org](http://www.StateHealthFacts.org).



## CALIFORNIA GENERAL ELECTION



*Reason*

Reason Foundation  
3415 S. Sepulveda Blvd., Suite 400  
Los Angeles, CA 90034  
310/391-2245  
310/391-4395 (fax)  
[www.reason.org](http://www.reason.org)