

BALLOT PROPOSITION # 203
First Things First for Arizona's Children

FISCAL ANALYSIS

Description

Proposition 203 increases the cigarette tax by \$0.80 per pack and also increases the tax on other tobacco products. Proposition 203 allocates the revenue generated by the tax increase to programs and services provided to children prior to kindergarten and their families for the purpose of assisting child development by providing education and other support, including parent and family support programs, child care, preschool, health screenings and access to preventive health services. At least 40% of monies utilized for early childhood development must be provided to families with incomes that are less than 100% of the federal poverty level. The resolution also establishes an "Arizona early childhood development and health board" and regional partnership councils for each region of the state as determined by the board.

Estimated Impact

The tax increase is estimated to generate \$188 million in new revenue for early childhood development and health care programs during its first full year. Of this amount, at least 90% of the funds, an estimated \$169.2 million, would be used for program costs and up to 10% of the funds, an estimated \$18.8 million, would be used for administrative costs. Because some individuals may reduce their tobacco consumption when the price of tobacco increases, the state's existing tobacco tax collections may decrease. The existing tobacco tax goes for health programs, prisons and the State General Fund. The existing tobacco tax collections may decrease by \$23 million in the first full year of the tax increase.

The table below outlines the projected changes in revenues for the new Early Childhood Development and Health Fund and the funds receiving monies from the existing tobacco taxes.

	FISCAL YEAR	
	2007	2008
STATE REVENUES		
State General Fund	\$ (1,774,200)	\$ (3,041,500)
Corrections Fund	(278,000)	(476,700)
Tobacco Tax and Health Care Fund	(4,753,300)	(8,148,500)
Tobacco Products Tax Fund	(6,434,800)	(11,031,100)
Early Childhood Development and Health Fund	109,814,700	188,253,800

The proponents of this initiative have estimated increased tobacco tax revenues of \$150 million as a result of the new tax.

Analysis

New Tobacco Tax

The new tax of \$0.80 per pack of 20 cigarettes (plus other adjustments) is expected to generate an additional \$109.8 million in FY 2007 (assuming 7 months of revenue in FY 2007 after a December 1, 2006 implementation date) and \$188.3 million in FY 2008 and subsequent years. The monies will be deposited into the new Early Childhood and Health Development Fund and distributed to 2 accounts as follows: 90% to the Program Account (\$169.2 million) and 10% to the Administrative Costs Account (\$18.8 million). Language in the proposition allows for the transfer of monies from the Administrative Costs Account to the Program Account but does not allow for the transfer of monies from the Program Account to the Administrative Costs Account.

Most of the monies will be distributed to regional partnership councils on a grant process administered by a newly established Arizona Early Childhood Development and Health Board; no more than 10% in any year may be used to fund statewide grants or programs undertaken directly by the Board. In addition, the proposition specifies that the monies generated by this new tax shall supplement, not supplant, other state expenditures on, and federal monies received for, early childhood development and health programs.

Based upon the assumptions detailed above, the proposition is also expected to have the following impacts on existing recipients of tobacco tax revenue (*see Table 1*). These existing recipients are currently estimated to receive \$305 million from tobacco tax revenues in FY 2007 and FY 2008, but the proposition would reduce those amounts by \$13.2 million in FY 2007 and \$22.7 million in FY 2008. For additional details on the impact of the tax increase on the Tobacco Tax and Health Care Fund and the Tobacco Products Tax Fund, see *Tables 2 and 3*.

Existing Tobacco Taxes

Currently, there are three distinct tobacco taxes, which total approximately 5.9 cents for each cigarette, or about \$1.18 per pack of 20 cigarettes. There are also different rates on other types of tobacco products like smoking tobacco and cigars. Of the \$1.18 per pack tax on 20 cigarettes, \$0.60 is deposited in the Tobacco Products Tax Fund, \$0.40 is deposited in the Tobacco Tax and Health Care Fund, \$0.16 is deposited to the General Fund and \$0.02 is deposited to the Corrections Fund. In FY 2005, the 3 taxes generated approximately \$285.2 million in revenue (\$138.5 million from the \$0.60 tax, \$102.3 million from the \$0.40 tax and \$44.3 million from the \$0.18 tax).

Based on historical consumption trends, cigarette consumption is assumed to increase by an average of 1.5% per year in FY 2006 and FY 2007, but then remain flat from FY 2008 and onward, regardless of tax changes. While national trends have shown a decline in tobacco consumption, Arizona has actually seen an increase in tobacco tax revenues. From FY 2004 to FY 2006, for example, the state has seen an increase of 6.9% in tobacco tax collections. The higher tobacco tax revenue may be due to increased enforcement efforts by the Department of Revenue on illegal tobacco sales. Given the conflicting data, this analysis assumes that tobacco tax revenues would remain flat after FY 2007.

Effect of Tax Increase on Tobacco Consumption

According to Orzechowski and Walker's *Tax Burden on Tobacco* (2004) the average Arizona retail price of a pack of cigarettes for FY 2004 is \$4.30. Based on these figures, increasing the tax by \$0.80 would generate an 18.6% increase in the price of a pack of cigarettes (\$0.80/\$4.30). The US Department of Agriculture (USDA) does not expect cigarette prices to change substantially over the next few years, so the price per pack was not additionally annually adjusted.

An estimate was then developed for the price elasticity of demand for cigarettes, which measures the responsiveness of the demand for cigarettes to an increase in price (measured in the ratio of percent change in quantity demanded to the percent increase in price). The elasticity estimate was developed by examining national studies on cigarette elasticity. Although there is no general consensus on an estimate of price elasticity of demand for cigarettes, numerous estimates generally ranged from (0.2) to (0.8), with most of the estimates closer to the lower end of the range. Based on the national studies, the analysis assumed an estimate of (0.4) – that is, a 1% increase in price would result in a 0.4% decrease in quantity demanded.

Using the 18.6% average price per pack discussed above and an elasticity estimate of (0.4), it is estimated that the tax increase would result in a decrease in cigarette consumption of (7.4)% annually, which equates to about 17.5 million packs per year. According to national studies, the consumer response to the price increase would occur in the first year of the increase (in this case, December 2006 to November 2007).

Because the revenues from other tobacco products such as cigars and smokeless tobacco (which account for approximately 2% of total tobacco tax revenues) are reported in a lump sum instead of broken out by product, and because estimates of the price elasticity of demand for these other products were not available, the overall estimate assumes the change in demand for these other products matches that for cigarettes.

Local Government Impact

Some revenues into the new Early Childhood Development and Health Fund may be directed to local governments for administration of programs.

	Effect of Proposition 203 on Current Revenues		
	Current Estimated Revenue	Change in Revenue as a Result of Tax Increase	Estimated Revenue Under Proposition 203
General Fund			
FY 2007 ^{1/}	\$ 40,870,000	\$ (1,774,200)	\$ 39,095,800
FY 2008	40,870,000	(3,041,500)	37,828,500
Corrections Fund			
FY 2007 ^{1/}	\$ 6,405,000	\$ (278,100)	\$ 6,126,900
FY 2008	6,405,000	(476,700)	5,928,300
Tobacco Tax and Health Care Fund ^{2/}			
FY 2007 ^{1/}	\$109,495,000	\$(4,753,300)	\$104,741,700
FY 2008	109,495,000	(8,148,500)	101,346,500
Tobacco Products Tax Fund ^{3/}			
FY 2007 ^{1/}	\$148,230,000	\$(6,434,800)	\$141,795,200
FY 2008	148,230,000	(11,031,100)	137,198,900
Total			
FY 2007 ^{1/}	\$305,000,000	\$(13,240,400)	\$291,759,600
FY 2008	\$305,000,000	\$(22,697,800)	\$282,302,200

^{1/} Assumes tax increase will take effect December 1, 2006.
^{2/} See Table 2 for detail.
^{3/} See Table 3 for detail.

	FY 2007 Base (Without Proposition 203)	FY 2007 ^{1/2/} (Decrease Below FY 2007 Base)	FY 2008 ^{2/} (Decrease Below FY 2007 Base)
Medically Needy Account (70%)	\$ 76,646,400	\$(3,327,300)	\$(5,703,900)
Health Education Account (23%)	25,183,900	(1,093,300)	(1,874,200)
Health Research Fund (5%)	5,474,800	(237,600)	(407,400)
Transfer to DOC Corrections (2%)	2,189,900	(95,100)	(163,000)
Total	\$109,495,000	\$(4,753,300)	\$(8,148,500)

^{1/} Assumes tax increase will take effect December 1, 2006.
^{2/} Represents incremental increase associated with the tax increase above base FY 2007 funding. This does not include any other changes to the base that may occur outside of the tax increase.

	FY 2007 Base (Without Proposition 203)	FY 2007 ^{1/2/} (Decrease Below FY 2007 Base)	FY 2008 ^{2/} (Decrease Below FY 2007 Base)
Proposition 204 (42%)	\$ 62,256,600	\$(2,702,600)	\$(4,633,100)
Medically Needy Account (27%)	40,022,100	(1,737,400)	(2,978,400)
Trauma Centers/Emergency Services (20%)	29,646,000	(1,287,000)	(2,206,200)
Health Research Account Adjustment (5%)	7,411,500	(321,700)	(551,600)
Healthcare Adjustment Account (4%)	5,929,200	(257,400)	(441,200)
Health Education Account (2%)	2,964,600	(128,700)	(220,600)
Total	\$148,230,000	\$(6,434,800)	\$(11,031,100)

^{1/} Assumes tax increase will take effect December 1, 2006.
^{2/} Represents incremental increase associated with the tax increase above base FY 2007 funding. This does not include any other changes to the base that may occur outside of the tax increase.