BALLOT PROPOSITION # 303
Tobacco Products Tax; Health Services

Fiscal Impact Summary

Proposition 303 increases the tax on cigarettes and other tobacco related products and allocates the monies generated by the tax increase to various health care programs.

The tax increase is estimated to generate $149 million in new revenue for the state during its first full year. Because some people may stop smoking or using tobacco when the price of tobacco increases, revenue to other funds from the existing tobacco taxes may decrease. Deposits into these funds are estimated to decrease by $8 million during the first year of the tax increase.

In addition, the tax increase is estimated to save $63 million in state expenditures on health care during its first full year. The additional monies generated by the tax increase will take the place of expenditures that are currently planned.

	FISCAL YEAR		
	2003	**2004**	**2005**
STATE REVENUES			
State General Fund	$ (1,250,300)	$ (2,131,400)	$ (2,110,700)
Corrections Fund	(163,300)	(278,300)	(275,600)
Tobacco Tax and Health Care Fund	(3,119,900)	(5,301,600)	(5,222,100)
Tobacco Products Tax Fund	90,241,400	149,090,200	146,907,700
STATE EXPENDITURES			
State General Fund	$(37,901,400)	$(62,617,900)	$(61,701,200)

FISCAL ANALYSIS

Description

Proposition 303 increases the cigarette tax by $0.60 per pack and also increases the tax on other tobacco products. Proposition 303 allocates the revenue generated by the tax increase to various health care programs including a voter-approved health care coverage program, indigent health care, emergency health services, health research, and health education. The resolution also repeals the existing statute governing the Health Education Account and re-enacts the statute. It also requires the Legislature to establish a tobacco revenue, use, spending, and tracking commission.

Estimated Impact

The tobacco tax increase proposed in Proposition 303 would generate $90.2 million in FY 2003, $149.2 million in FY 2004, and $147.1 million in FY 2005 in new revenue for the Tobacco Products Tax Fund. Due to the decrease in tobacco consumption that is likely to result from the tax increase, revenue to other funds that receive monies from the existing tobacco taxes will decrease. We estimate that deposits into other state funds will decrease by $(4.5) million in FY 2003 and $(7.7) million in FY 2004 below current projections for those years.

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Estimated Impact (Cont'd)

Proposition 303 specifies that the monies generated by the new tax shall be distributed into 6 different accounts, including the Proposition 204 Protection Account. Monies in the Proposition 204 Protection Account shall be spent on the Arizona Health Care Cost Containment System (AHCCCS) expansion approved by voters prior to the expenditure of tobacco settlement monies. Because the AHCCCS expansion currently is funded from both tobacco settlement monies and General Fund monies, the additional revenue as a result of the tax increase would result in fewer General Fund monies needed for the expansion. We estimate that this results in General Fund expenditure savings of $(37.9) million in FY 2003 and $(62.6) million in FY 2004.

Analysis

Existing Tobacco Taxes

Currently, there are two distinct tobacco taxes. A.R.S. § 42-3251 levies a tax with the following distributions:

- $ 0.02 for each cigarette (which equates to about $0.40 per pack of 20 cigarettes).
- $ 0.045 per ounce for smoking tobacco, snuff, chew, and other products.
- $ 0.011 per ounce for cavendish, plug or twist tobacco.
- $ 0.089 for 20 small cigars.
- $ 0.044 for three cigars that cost less than a nickel or for one cigar costing more than a nickel.

The monies from this tax are deposited in the Tobacco Tax and Health Care Fund. In FY 2001, this tax generated about $109.1 million in revenue. Based on suggestions from the economists at DRI·WEFA, a national economic consulting firm, and based on historical consumption trends, we have assumed cigarette consumption will decline by an average of (1.5)% per year regardless of tax changes. Table 1 shows the JLBC Staff forecast for the Tobacco Tax and Health Care Fund for FY 2002 through FY 2005 prior to the proposed tax increase:

Table 1

Current Estimates of Tobacco Tax and Health Care Fund Revenue (Prior to Proposition 303)

FY 2003	$106,253,000
FY 2004	$104,695,100
FY 2005	$103,160,600

Pursuant to A.R.S. § 36-772-5, the Medically Needy Account receives 70% of fund revenues, the Health Education Account receives 23%, the Health Research Account receives 5% and the Corrections Fund Adjustment Account receives up to 2%. The Corrections Fund also receives funding from the other portion of the tobacco tax (see below) and only receives funding from the Tobacco Tax and Health Care Fund if the funding from the other tax decreases (as a result of the increase in price associated with the establishment of Tobacco Tax and Health Care Fund in FY 1994). According to the Department of Revenue (DOR), the Corrections Fund Adjustment annually receives about $200,000-$300,000 from the Tobacco Tax and Health Care Fund. The remainder of the 2% Adjustment Account is redistributed to the other Tobacco Tax and Health Care Fund accounts. In addition, DOR also receives about $350,000 per year for administrative and enforcement expenses associated with the tax.

A.R.S. § 42-3052 also levies the following taxes:

- $0.009 for each cigarette (which equates to about $0.18 per pack of 20 cigarettes)
- $ 0.02 per ounce for smoking tobacco, snuff, chew, and other products.
- $ 0.005 per ounce for cavendish, plug or twist tobacco.
- $ 0.04 for 20 small cigars.
- $ 0.02 for three cigars that cost less than a nickel or for one cigar costing more than a nickel.

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Analysis (Cont'd)

Of the amounts collected, 11.11% is deposited in the Corrections Fund. The remaining collections are deposited in the General Fund. Table 2 shows the JLBC forecast for the tobacco tax collections for the Corrections Fund and the General Fund prior to the proposed tax increase:

Table 2

Current Revenue Estimates (Prior to Proposition 303)

	Corrections Fund	General Fund
FY 2003	$6,005,500	$42,405,600
FY 2004	$5,953,600	$42,007,800
FY 2005	$5,902,100	$41,613,900

Effect of Tax Increase on Tobacco Consumption

Proposition 303 levies an additional tax of 1.5 times the rates levied under A.R.S. § 42-3251, which equates to an additional $0.60 per pack of 20 cigarettes. The monies will be deposited into the new Tobacco Products Tax Fund and distributed to 6 accounts as follows: 42% to the Proposition 204 Protection Account (to be spent prior to the expenditure of tobacco settlement monies on the AHCCCS expansion approved by voters), 27% to the Medically Needy Account, 20% to the Emergency Health Services account for reimbursement of uncompensated care and trauma readiness costs, 5% to the Health Research Account, 2% to the Health Education Account for early detection programs for the 4 leading causes of death in Arizona, and 4% to the Health Care Adjustment Account to compensate the Tobacco Tax and Health Care Fund accounts for loss of revenue as a result of the decrease in consumption resulting from the new tax.

We first estimated the tobacco tax revenue for FY 2002 through FY 2005 that would be generated by tobacco purchases at the current tax rates. We discussed potential changes in cigarette consumption with the economists at DRI·WEFA, a national economic consulting firm. Based on suggestions from DRI·WEFA, we projected that cigarette consumption would decline by (1.5)% per year regardless of tax changes. Actual cigarette consumption in Arizona has declined at a slightly higher average rate from FY 1996 to FY 2001 than (1.5)%. Looking at the annual rates of decline, however, we believe that the large increase in cigarette prices from 1999 to 2000 associated with the Tobacco Litigation Master Settlement resulted in a larger decrease in consumption for FY 2000 than in other years. This generated a higher average rate than we would otherwise expect. Therefore, we used the DRI·WEFA rate, which controls for this recent price increase. Revenue 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 do not display a discernible trend in consumption. Therefore, we assumed no growth or decline in other tobacco product revenue.

After using these average rates of decline in consumption to estimate the FY 2002 - FY 2005 tobacco tax revenue at the current tax rate, we then calculated the impact of the tax increases. We assumed that the tax increase would take effect on December 1, 2002.

According to the Arizona Department of Health Services the national average pre-tax price per pack of cigarettes for FY 2002 is $3.56. We applied the $0.40 per pack tax associated with the Tobacco Tax and Health Care Fund and the $0.18 per pack tax associated with the Corrections Fund and the General Fund, and estimated that the average price per pack of cigarettes in Arizona is $4.14. It is possible that, because we used national statistics, the average price per pack of cigarettes in Arizona is slightly higher or lower than our estimate. We were not, however, able to obtain reliable state-specific information on the price per pack.

Based on these figures, we determined that increasing the tax one and one-half times would generate a 14.49% price increase in a pack of cigarettes ($0.60/$4.14). DRI·WEFA indicated that they did not expect cigarette prices to change substantially over the next few years, so we did not annually adjust the price per pack.

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Analysis (Cont'd)

We then developed an estimate 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). In this case, we estimated how the increase in price due to the tax increase would affect the demand for cigarettes. We were not able to obtain firm state-specific estimates of this elasticity. Therefore, we developed the estimate by examining national studies on cigarette elasticity. Although there is no general consensus on an estimate of price elasticity of demand for cigarettes, we did find numerous estimates that generally ranged from (0.2) to (0.5), with most of the estimates closer to the lower end of the range. We also consulted with DRI·WEFA. Based on the national studies and our discussions with DRI·WEFA, we developed an estimate of (0.35) – that is, a 1% increase in price would result in a 0.35% decrease in demand.

We used our calculations of the percentage increase in price associated with the various tax rates to estimate the potential reductions in demand that would result from the tax increases. Using the 14.49% average price per pack discussed above and an elasticity estimate of (0.35), we estimate that the tax increase would result in a decrease in cigarette consumption of (5.1)%, which equates to about 13 million packs per year. According to national studies and DRI·WEFA, the consumer response to the price increase would occur in the first year of the increase (in this case, December 2002 to November 2003). This decrease is in addition to the general (1.5)% decrease in consumption. After the drop in demand in FY 2003 and FY 2004, we assumed demand would continue to decline at the average rate of (1.5)% per year.

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 we were not able to obtain estimates of the price elasticity of demand for these other products, we did not adjust the estimated revenue for the demand reduction that may result from the increase in price.

State Revenue and Expenditure Impact

Based upon the assumptions detailed above, we developed estimates for the impact of Proposition 303 on existing recipients of tobacco tax revenue (see Table 3) as well as the recipients of the tax increase (see Table 4).

As an existing recipient, the Corrections Fund receives monies from the adjustment account based on the decrease in revenue associated with the enactment of the tobacco tax associated with the Tobacco Tax and Health Care Fund. Because the resolution does not specify that an additional adjustment be made to the Corrections Fund to account for a decrease in revenue as a result of the proposed tobacco tax, we have assumed the Corrections Fund Adjustment Account would continue to receive about $300,000 per year and have proportionally distributed the remaining portion associated with the Corrections Fund to the other accounts.

Table 3

Effect of Proposition on Current Revenues

	Current Estimated Revenue	**Change in Revenue as a Result of Tax Increase**	**Estimated Revenue Under Proposition 303**
General Fund			
FY 2003 [1/]	$42,405,600	$(1,250,300)	$41,155,300
FY 2004	42,007,800	(2,131,400)	39,876,400
FY 2005	41,613,900	(2,110,700)	39,503,200
Corrections Fund			
FY 2003 [1/]	$6,005,500	$(163,300)	$5,842,200
FY 2004	5,953,600	(278,300)	5,675,300
FY 2005	5,902,100	(275,600)	5,626,500
Tobacco Tax and Health Care Fund			
FY 2003 [1/]	$106,253,000	$(3,119,900)	$103,133,100
FY 2004	104,695,100	(5,301,600)	99,393,500
FY 2005	103,160,600	(5,222,100)	97,938,500

1/ Assumes tax increase will take effect December 1, 2002.

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Analysis (Cont'd)

We also assumed the administrative and enforcement expenses for DOR would grow at an average annual rate of 4.9% (based on the average growth for FY 1996 to FY 2001) but that DOR would not need additional monies for administration and enforcement as a result of the tax increase.

Table 4 summarizes the estimated distribution of the proposed tax increase. With the exception of the Proposition 204 Protection Account and the Emergency Services Account, the other accounts receive existing tobacco tax revenues.

Table 4

Distribution of New Tax Revenue

	FY 2003 Base (Without Proposition 303)	**FY 2003 1/2/ (Increase Above FY 2003 Base)**	**FY 2004 2/ (Increase Above FY 2003 Base)**
Proposition 204 Protection Account (42%)	$ 0	$ 37,901,400	$ 62,617,900
Medically Needy Account (27%)	73,118,400	24,365,200	40,254,300
Emergency Services Account (20%)	0	18,048,300	29,818,000
Health Research Fund (5%)	5,223,500	4,512,100	7,454,500
Health Education Account (2%)	24,021,500	1,804,800	2,981,800
Health Care Adjustment Account (4%)	0	3,609,700	5,963,600
Total	**$102,363,400**	**$90,241,400**	**$149,090,200**

1/ Assumes tax increase will take effect December 1, 2002.
2/ Represents incremental increase associated with the tax increase above base FY 2003 funding. This does not include any other changes to the base that may occur outside of the tax increase.

Monies in the Proposition 204 Protection Account will be spent on the AHCCCS expansion approved by voters prior to the expenditure of tobacco settlement monies. The AHCCCS expansion is currently funded from both tobacco settlement monies and General Fund monies. In FY 2003, $111,585,700 was appropriated from the General Fund for Proposition 204. Generally, the tobacco settlement monies are spent before monies from the General Fund are used. Because Proposition 303 requires that monies in the Proposition 204 Protection Account be spent before Tobacco Settlement monies, the additional revenue as a result of the tax increase would result in fewer General Fund monies needed for the expansion. We estimate that this reduces General Fund expenditures by $37.9 million in FY 2003 and $62.6 million in FY 2004.

Proposition 204 requires the state to continue General Fund spending on the expansion population at a specified level (about $47 million). This is known as a "maintenance of effort" requirement. Even with the General Fund savings achieved under Proposition 303, General Fund spending on the expansion population will still exceed $47 million. Therefore, we do not believe Proposition 303 affects the maintenance of effort requirements of Proposition 204.

The repeal and reenactment of the Health Education Account of the Tobacco Tax and Health Care Fund has no fiscal impact. We assume that the staff responsibilities for the legislative Tobacco Revenue Use, Spending, and Tracking Commission will be absorbed by existing legislative staff, with no fiscal impact.

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This estimate was prepared by Beth Kohler (602-542-5491).