POLICY brief

Washington Research Council

BRIEFLY

Initiative 773 would raise Washington state cigarette taxes to $1.425 per pack, the highest in the nation.

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Initiative 773 – Fiscal Smoke and Mirrors

Ballot box budgeting has plagued legislators for years. Most recently, passage of two initiatives last November – one dedicating property tax revenues to an off-budget education account, the other mandating pay hikes for teacher – handcuffed lawmakers and prolonged budget deliberations into the early summer.

This year's entry, Initiative 773, would increase tobacco taxes and dedicate the money to health care and "tobacco prevention" programs. The new money raised by the tax hike, however, would only sustain the program expansion for a little over five years, after which programs would have to be cut or new revenues found.

Overview

I-773 mandates a cigarette tax hike of sixty cents per pack and imposes a 129.4 percent surtax, up from the current 74.9 percent, on the wholesale price of other tobacco products (e.g., cigars, chewing and pipe tobacco). The increases are designated to fund additional slots in the Basic Health Plan and pay for efforts to discourage tobacco use. In addition, proponents argue that the higher taxes will lead some current smokers to quit and discourage nonsmokers, particularly young people, from starting.

Washington's 82.5-cent cigarette tax is currently seventh highest in the nation, trailing New York ($1.11), Alaska, Hawaii, Maine, Rhode Island ($1.00 each), and California ($0.87). Bumping the tax to $1.425 would place Washington at the top of the list by a considerable margin. While similar comparisons of taxes on other tobacco products are complicated by different taxing strategies among the states, it's generally recognized that, here too, Washington's tax is already among the highest.

Increasing the statutory tax burden by 73 percent will not increase tax revenues by a like amount. First, there will be some reduction in consumption. Second, as the Senate Ways and Means analysis acknowledges, "purchase of untaxed cigarettes increases" as the tax burden is hiked.

Following the money. All of the money raised from the increased taxes is deposited in the Health Services Account (HSA). The initiative earmarks spending from the new revenues in four ways.

First, existing designated accounts relying on tobacco taxes are compensated for losses resulting from decreased consumption. Remember, tobacco taxes are already earmarked. The higher tax rate will generate more revenue overall, but reduced taxable consumption will lower the take from the existing 82.5-cent tax, some of which flows into the Water Quality Account and the Violence Reduction and Drug Education (VRDE) Account. The initiative designates enough money from tax increase to offset losses in those two

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accounts, but provides no such backfill for the General Fund, which also receives money from tobacco taxes.

Second, $5 million a year is earmarked for "programs that effectively improve the health of low-income persons, including efforts to reduce diseases and illnesses that harm low-income persons." The initiative charges the health department with responsibility for evaluating the cost-effectiveness of such programs and recommending how the money should be spent.

Third, ten percent of the funds in the HSA are to be transferred to the tobacco prevention and control account for use in combating tobacco use. After July 1, 2002, at least $26.2 4 million should be spent to implement the Washington state tobacco prevention and control plan (TPCP).

Fourth, the bulk of the money is to be spent to increase Basic Health Plan enrollment. The money must supplement enrollment of 125,000 in the BHP. The initiative directs the health care authority to add 20,000 enrollees in the 2001-2003 biennium, bringing the total to 145,000. In the 2003-2005 biennium, enrollment should reach 175,000 and in each biennium thereafter, at least 175,000 persons should be enrolled.

The following chart, Figure 1, shows the Department of Revenue's estimates of changes in the anticipated annual revenue stream should the initiative pass.

FIGURE 1

Fiscal Impact of I-773

Dollars in millions

	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007
General Fund-State	-$2.2	-$5.1	-$4.7	-$4.3	-$3.9	-$3.6
Water Quality	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
VRDE	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
HSA	$84.4	$135.1	$135.1	$135.1	$135.2	$135.3
Total State Impact	**$82.2**	**$130.0**	**$130.4**	**$130.8**	**$131.3**	**$131.7**

Source: Department of Revenue

Fiscal Considerations

Earmarking, Generally. In our 1996 report, *Too Much Earmarking, Dedicating Funds*, the Research Council cited some common justifications for earmarking, as evaluated by the National Conference of State Legislatures. Three of them are relevant here.

1) The benefit principle: those who benefit should pay. This argument makes the most sense when government is providing a specific service to a clearly identified population. Using gas taxes for transportation purposes is a good example. In such instances, the earmarked tax is essentially a user fee.

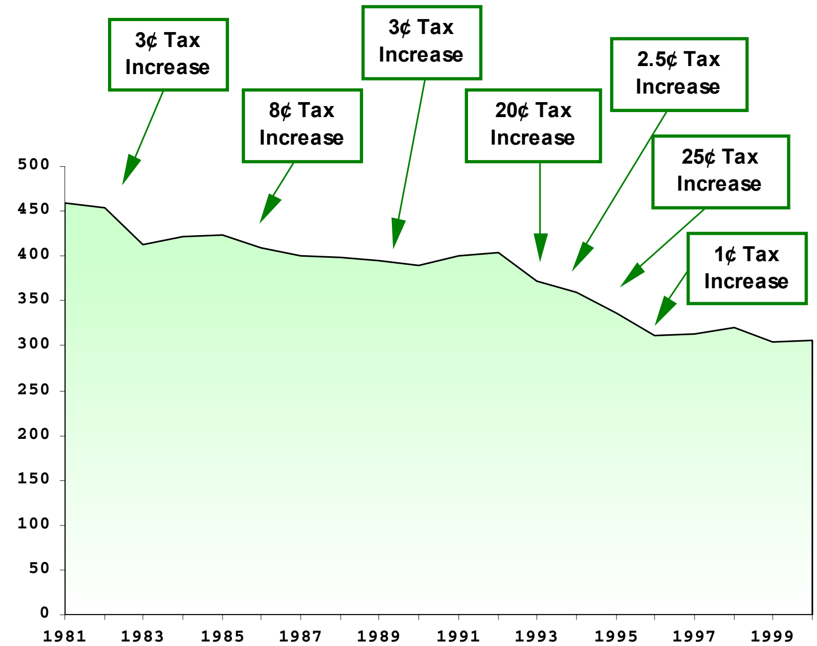
2) Assured funding: This oft-cited rationale is rarely achieved. Frequently, as one expert cited by NCSL points out, "earmarking often ties spending needs moving in one direction, such as indigent health care …, with a revenue source moving in another, such as taxes on tobacco products." For verification of the point, see Figure 2, which shows the continuing decline in taxable cigarette sales, particularly in the wake of tax increases. Remember, also, that this decline occurred during a period of substantial population growth in the state.

3) To secure public support for new or higher taxes. Earmarking does have popular appeal. The first tax referred to the voters under Initiative 601 dedicated funding for VRDE and passed handily. At the time, the Research Council argued that it was "bad budget policy."

FIGURE 2

Annual Sales of Cigarettes in Washington State, 1981-2000

(Millions of Packs)



Source: Office of the Forecast Council

General Fund-State. Most years, a $5-10 million loss to the state general fund would be a matter of little concern. With the state facing the potential of a billion dollar budget shortfall, this small cut looms a bit larger. Some might suggest that the diversion is minor relative to the magnitude of the state's budget challenge, and therefore shouldn't be a factor in evaluating I-773. Conversely, others will point out that every dollar matters and, in fact, a couple of million dollars is still a lot of money.

Typically, advocates of earmarking justify the practice by saying the diversion is for a good cause and will not cause any harm to the general fund budget. They then point out that earmarking is a good way to protect a vulnerable program, one that might suffer in competition with other priorities.

The legislature is properly charged with responsibility for weighing competing budget priorities. As budget decisions are taken out of the hands of lawmakers, the challenges increase dramatically. The cumulative effect of earmarked revenues and dedicated funding — even relatively small nicks — reduces discretion. When budgets have to be pared, as during an economic downturn, it is clearly desirable to have the full range of options available to lawmakers.

Tobacco Prevention and Control. The initiative would shift about $13 million a year to the Tobacco Prevention and Control Account (TPCA) established in 2000 with the first $100 million the state received under the national settlement with the major tobacco firms. According to the Economic Opportunity Institute, which backs the initiative, the $26.2 million earmarked for the TPCP is based on the budget recommended by a council appointed by the health department. The 2001-2003 legislative appropriation amounts to $17.5 million a year.

An analysis by the Senate Ways and Means Committee concludes that the difference between the $26.2 million funding mandated by the initiative and the $13 million provided by it could be made up from the $100 million in the account through 2009. After that, Senate analysts point out, "approximately $13 million per year of additional revenues would need to be raised for or diverted" to the account to meet the mandated expenditure.

As well, there is no provision for adjusting expenditures based on evaluation of the various programs. One of the problems with fund dedication has long been that budgets are based on available revenues, rather than program assessment or need.

VRDE and Water Quality. There is no direct fiscal impact on these programs, as the initiative would compensate them for revenue losses as resulting from the projected reduction in taxable purchases.

Basic Health Plan. Under I-773, the BHP would receive about $62.4 million in FY 2002, rising to $91.4 million in 2003, increasing annually to about $100 million in FY 2007. The BHP offers health insurance to the working poor, with family incomes below 200 percent of the federal poverty level. While dental and vision care are not covered, the plan pays for hospital care, prescription drugs, doctor visits, and the like, requiring participants to make co-payments and pay premiums, which vary based on income. What the enrollee cannot afford, the state picks up.

The $498 million in the budget for the current, 2001-2003, biennium is expected to subsidize an enrollment of about 125,000. The initiative intends for the increased revenue from the tobacco tax hike to fund enrollments above that 125,000 base. Whether the initiative requires the legislature to fund 125,000 slots is a matter of some dispute. Clearly, the initiative intends that the legislature continue to maintain baseline support.

As Senate analysts note, the number of additional enrollments that could be supported by the new money will depend on a variety of factors, including: a) health care cost increases (for the past four years premiums have increased an average of 10 percent a year), b) the rate at which new enrollees join the program, c) the age and income mix of new enrollees (older and poorer enrollees are more expensive), and d) future state appropriations.

They construct three scenarios for estimating when new costs would exceed the revenues from higher tobacco taxes. Assuming 8 percent annual premium cost increases and that the state meets the enrollment targets set by I-773 relatively quickly, annual costs would begin to exceed annual revenues in FY 2005 and cumulative costs would exceed cumulative revenues in late FY 2008. If premium costs continue to grow at the current 10 percent rate, but enrollment targets are met more slowly, the program runs into an annual deficit in FY 2005 and a cumulative deficit in early FY 2008. In their final scenario, they assumed 10 percent annual premium increases and very gradual growth in enrollments; under those assumptions, annual costs exceeded annual revenues in FY 2007 and cumulative costs exceeded cumulative revenues in early FY 2014.

In two of the three scenarios, then, the increase in enrollment would only be sustained by the I-773 tax increases for five years. After that, either enrollment would have to be cut or other revenues found.

Comments

Evasion and Smuggling. The higher tobacco tax will increase the buyer's incentive to evade the tax and lead to higher rates of cigarette smuggling. In late 1997, the head of the Federal Bureau of Alcohol, Tobacco and Firearms (BATF) told Congress that cigarette smuggling was on the increase. In FY 1998, the state revenue department estimated that cigarette tax evasion cost the state $120 million, including sales and B&O taxes. The wide disparity in state excise taxes makes smuggling profitable and evasion enticing.

Passage of I-773 would give Washington State the highest cigarette tax in the nation, considerably higher than neighboring states.

An October 16, 2001 story in the Washington Times reported on the arrest of two men accused of smuggling 4,660 packs of untaxed cigarettes worth $16,962 into Maryland from Virginia. A spokesman says the state is concerned with links to terrorist groups. “Cigarette smuggling is getting bigger than illegal drugs,” he said. “The cigarettes can be bought legally and sold illegally.”

Last year federal officials indicted 18 people for allegedly smuggling cigarettes from North Carolina to Michigan, according to a Cato Institute report. Each truckload of cigarettes netted $10,000 in profits, money that prosecutors say went to terrorist organizations.

Internet sales of tobacco products are also increasing despite efforts to discourage them. For example, a web site operated in the Western New York State on the Allegany Indian Reservation boasts of “regulatory advantages that allow us to sell cigarettes at discounted prices.” Further, they assure purchasers that “we do not ever share your personal information with any other company or government agency!”

According to the National Center for Policy Analysis (NCPA) New York’s cigarette tax increase “led to a “massive increase in cigarette smuggling, which is putting many legitimate cigarette sellers out of business and undermining efforts to reduce teen smoking.” Here, convenience store operators and distributors anticipate the same outcome if I-773 passes.

Inappropriate earmarking. Consider again the three arguments for earmarking: the benefit principle, assured funding and gaining support for tax increases.

First, Initiative 773 fails to merit support on the strength of the benefit principle. Although there are linkages between tobacco consumption and health problems, to say smokers will benefit from expansion in the BHP strains credulity. There’s simply no clear relationship.

Second, the tax increase fails to provide assured funding. BHP costs continue to rise rapidly, with no easing in sight. Before simply increasing enrollment, policy makers should take a close look at the program’s benefits package, pricing, and eligibility criteria. In less than a decade, the BHP has become an important part of the state’s efforts to extend health care coverage. The program, however, has always been on shaky financial footing. At best, I-773 provides stopgap funding when a thorough program analysis is required.

Third, and here’s the key, I-773 clearly hopes to secure support for a tax increase on an unpopular product to support popular programs. Most supporters of the initiative will not pay the tax, which will be borne primarily by cigarette smokers, disproportionately lower income people. No major tax has as regressive an impact as tobacco taxes.

Unacceptable budget consequences. Despite its worthy goals, Initiative 773 follows the same tired route of past efforts to circumvent the budget process by taking a direct path to the ballot box. There’s rarely a good time to carve away at the state general fund by earmarking taxes and dedicating expenditures, but it is hard to imagine a worse time.

I-773 will compound the state’s growing budget crisis. This is not the exception to the rule – earmarking remains bad fiscal policy.

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