California HealthCare Foundation

Insurance Markets

California Constitutional Barriers to Implementation of SB 2

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Issue Brief

Introduction

The recently enacted California Health Insurance Act of 2003 (SB 2) creates a state health coverage program for people working in large and mid-sized firms. The program will be funded by a combination of employer fees and enrollee contributions, which will cover the cost of benefits and program administration. An employer is entitled to a credit against the fee if it provides coverage to employees (and dependents in firms with 200 or more employees) with benefits and cost sharing at least as generous as those defined in the California laws governing health insurance and health care service plans or those offered by certain public, union, or other specified plans. The state's Managed Risk Medical Insurance Board will arrange for coverage of the employees (and, if they work for large firms with 200 or more employees, their dependents).

This brief provides an understanding of how the California courts have interpreted the constitution's tax provisions, which may be helpful in assessing the constitutional vulnerability of the fee imposed by SB 2.

Potential Constitutional Challenge to SB 2

Section 3 of Article 13A of the California Constitution requires the state legislature to enact a tax increase by no less than a two-thirds majority vote of both houses.[1] Opponents of SB 2 are likely to argue that the fee imposed on employers to fund the public health insurance program is a tax that, under the requirement of Section 3, required at least a two-thirds majority of both houses (SB 2 received a majority but not a two-thirds majority vote). The California Supreme Court has the final word on how to interpret the state constitution, but it has not examined a state law identical to SB 2.

Court Interpretations of Constitutional Tax Provisions

The California Supreme Court has interpreted Section 3 only once. In *Sinclair Paint v. Board of Equalization,*[2] the court considered whether a fee could be imposed on businesses whose products carried lead when the main purpose of the fee was to fund a state program to screen children for lead contamination and provide case management services to help children with lead poisoning seek treatment. Because no court had previously interpreted Section 3, the state supreme court drew principles from court decisions applying to a related section in the state constitution involving local taxes.[3] The court identified three situations in which a government-imposed fee would not be considered a tax:

- *Regulate.* The funds are used to regulate the payer (e.g., landfill use fees to reduce illegal refuse disposal or alcoholic beverage license fees to reduce public alcohol nuisances).
- *Permit/Privilege.* The funds pay for a permit (e.g., to process building, zoning, or other land use applications) or privilege (e.g., fees imposed on land developers to defray impacts on public services like parks, water service, libraries, or schools).
- *Benefit.* The funds pay for a government benefit or service that the payer receives (e.g., retail business assessments to promote shopping or landscaping maintenance or assessments for street construction).

In *Sinclair,* the court held that the lead poisoning program assessments on businesses whose products arguably contributed to childhood lead poisoning were not taxes but fell into the first category. The court held the assessments to be regulatory fees because they would have an impact on future business conduct regarding the manufacture and sale of dangerous products. The court noted that funds collected through fees must not exceed the reasonable cost of providing the services for which the fees are charged, nor could they be levied for any unrelated revenue purpose.[4]

Whether SB 2 could survive a legal challenge depends on whether it could be seen to fall into one of these categories: as a way to regulate employers in order to reduce an undesired behavior, to fund a permit or privilege, or to provide employers a benefit.

It would be difficult to argue that the fee grants employers a license or privilege (the second category). The fee might be argued to regulate employer conduct (the first category) because it will fund an employee health program (unless the employer chooses to offer one and receive a credit against the fee). However, SB 2 does not seem to regulate employers to deter undesirable effects in the same way as the fee in *Sinclair.* Furthermore, SB 2 supporters may not wish to assert this argument because that could implicate ERISA, the federal pension law, which is likely to preempt state regulation of employer health coverage.[5] It might be easier to argue that SB 2's fee falls within the third category — payment for a government benefit that the payer receives.

Assessments that the courts have held to be fees rather than taxes because they offer a benefit to the payer include residential assessments to fund parks maintenance,[6] charges to maintain landscaped medians in an industrial park,[7] a business-promotion assessment on property owners in a city business district, and landfill charges based on categories of property use (agricultural versus residential).[8] In the landfill case, the court of appeals held that the program provided a benefit to the assessed property owners, even if they did not use the landfill and did not believe the program benefited them. Some of the programs funded by assessments (such as downtown promotion, parks maintenance, landscaping and other street improvements, and landfill operations) certainly benefited the public at large. In each case, however, the courts upheld the fees on the ground that the projects they funded benefited primarily the assessed parties and therefore were assessments rather than taxes.

Application of Case Law to SB 2

Based on these court decisions, for a state assessment to be characterized as a "benefit" and avoid being labeled a tax, subject to a legislative super-majority

vote, it must primarily benefit the payer and not produce revenue greater than needed to support the program it funds. Neither the fact that persons subject to the fee would prefer not to avail themselves of the service it funds nor the incidental benefit to the public of the fee-supported program appears sufficient to classify the fee as a tax.

Does SB 2 Benefit Employers? It might be argued that the fee funds a program that benefits employers who pay it because access to coverage could to result in healthier and more productive employees, but the evidence in support of this assertion is weak and ambiguous. It also could be asserted that the state's purchasing power might lower the per-employee cost of health coverage, reducing the cost (or rate of increase) that employers who offer coverage or pay the fee would face in the absence of the state program, though public programs have not always achieved these efficiencies. Finally, some spouses covered by an employer's dependent coverage work for firms that do not offer coverage. A program that requires all businesses with at least 50 employees to pay the fee if they do not offer coverage arguably distributes the responsibility to fund health coverage more equitably across all large and medium-sized employers and thereby benefits those who have borne this burden and experienced the competitive disadvantage it causes.

Does SB 2 Benefit Employees? SB 2 supporters also might argue that the real payers of the fee are not employers but their employees, whose wages are reduced by the value of fringe benefits. Economists generally agree that employee compensation is a total package comprising wages and fringe benefits and that the existence of fringe benefits reduces wages for the average worker.[9] While employers typically write the check for employee health coverage, employees pay for this benefit by lower wages than they could demand in its absence.[10] Under this line of reasoning, it is employees (and their dependents) who actually bear the cost of the fee, but also benefit directly from access to the state's health insurance program. It might have been easier to assert this argument if the fee had been characterized as an employee fee and imposed directly on employees rather than employers.

Conclusion

The California Supreme Court has not considered a case with a fee that funds a program like the health insurance program in SB 2. To overcome a constitutional challenge, the assessment imposed by SB 2 will need to fall within one of the *Sinclair* categories. Because the health insurance program is not designed to deter undesirable employer behavior in the same way as the lead poisoning treatment program at issue in *Sinclair,* SB 2 might be more likely to survive if a court holds that the fee funds a program that benefits employers or employees. Because the alleged benefits to employers or employees are quite different from the benefits that property owners received in the other cases interpreting the state constitution's tax provisions, courts considering whether SB 2's assessment is a tax or a fee will be breaking new ground.

AUTHOR

Patricia A. Butler, J.D., Dr. P.H.

ENDNOTES

1. Section 3 provides: "From and after the effective date of this article, any changes in state taxes enacted for the purpose of increasing revenues collected pursuant thereto whether by increased rates or changes in methods of computation must be imposed by an Act passed by not less than two-thirds of all members of the legislature, except that no new ad valorem taxes on real property or sales or transaction taxes on the sales of real property may be imposed."

2. 15 Cal. 3d 866, 64 Cal. Rptr. 2d 447, 937 P. 2d 1350 (1997).

3. Article 13A Section 4 (enacted at the same time as Section 3) requires a two-thirds vote by local voters before local governments (such as counties and cities) and special districts may impose new taxes. The court in *Sinclair* said that, in view of the similar objectives of these laws, reasoning in cases involving local assessments under Section 4 might apply to state assessments under Section 3.

4. 15 Cal. 3d at 876, 64 Cal. Rptr. at 453.

5. ERISA implications of SB 2 are discussed in a separate California HealthCare Foundation issue brief **www.chcf.org/topics/sb2/index.cfm?itemID=21740**.

6. *Knox v. City of Orland,* 4 Cal. 4th 137, 14 Cal. Rptr. 2d 159 (1992). This case involved section 4 — local government assessment.

7. *City Council v. South,* 146 Cal. App. 3d 320, 194 Cal. Rptr. 2d 111 (1983) (impact proportionate to the estimated benefits to each property); *Evans v. City of San Jose,* 3 Cal. App. 4th 728, 3 Cal. Rptr. 2d 601 (1992) (fee accrued to a discrete group subject to the assessment); *Kern County Farm Bureau v. County of Kern,* 19 Cal. App. 4th 1423, 23 Cal. Rptr. 2d 910 (1993) (also characterized as a service/user fee that served a regulatory purpose).

8. The Court of Appeals cited *Pennell v. City of San Jose,* 2 Cal. 3d 365, 228 Cal. Rptr. 726 (1986), where the state supreme court upheld a fee imposed on landlords to fund a rental dispute mediation process. In *City of Glendale v. Trondsen,* 48 Cal. 2d 93, 308 P.2d 1 (1957), a case preceding the Jarvis-Gann tax limitation amendments but involving the nature of a rubbish collection fee, the supreme court held the fee was valid despite a property owner's claim he did not use the service.

9. Blumberg, L.J. 1999. "Who Pays for Employer-Sponsored Health Insurance?" *Health Affairs* 18(6): 58–61; Blumberg, L.J. and L. M. Nichols. 2004. "Why are so many Americans uninsured?" in Health Policy and the Uninsured (C. McLaughlin, ed.) Washington, D.C.: Urban Institute Press (in press).

10. Nichols and Blumberg *(ibid)* note that economic research generally supports the hypothesis that workers bear most of the cost of health coverage through lower wages, despite evidence that neither workers nor their employers believe fringe benefits have such a wage impact. The authors conclude that this "wage incidence" is experienced by the overall employee group, not individual workers, and its effects are observable over time (not immediately after a change in fringe benefits).