EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

CC: Chris

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MEMORANDUM

To: The Director
From: Dan Mendelson
Re: Using Budget Savings for the Medicare Reform Package
Date: April 13, 1999

This memo seeks your guidance on whether the Administration should use some of the Medicare savings proposals and the tobacco excise tax increases proposed in the FY 2000 Budget to finance the President's Medicare reform plan (e.g., prescription drug benefit). This topic has been raised repeatedly by DPC, NEC, OVP, and HHS, and I expect that it will be raised at an upcoming Medicare principal's meeting. As I noted to you yesterday, I expect that Senator Kennedy's bill will finance virtually the entire drug benefit through tobacco taxes and use of surplus revenues.

Recall that the Budget proposed $7.7 billion in net Medicare savings over FY 2000-04 ($3.9 billion of this amount is the inpatient hospital freeze that has been extremely controversial). In addition, the Budget proposed a $0.55 increase in the tobacco excise tax and accelerated the BBA's $0.15 tobacco excise tax increase, generating $34.5 billion in savings over five years. The FY 2000 Budget uses most of the Medicare savings and all of the tobacco tax increases to offset FY 2000 discretionary spending.

A prescription drug benefit could cost in the range of $50 to $90 billion over five years. While we are developing options that would generate revenues by extending BBA policies, there is mounting criticism against extending many of the BBA savings policies (as proposed by the Medicare Commission), and a desire by some authorizers to undo selected BBA policies in the short term. And while we will also have some options that generate revenues by modestly increasing beneficiary payments (e.g., through an income-related premium), none of the principals will advocate for heavy reliance on such savings.

Below we give the pros and cons of using Medicare and tobacco savings for Medicare reform. Of course, we could temper this policy by only using a portion of such revenues for this purpose, or by proposing additional tobacco revenues that are not contained in the budget. Addendum I below gives more detail on our FY 2000 tobacco tax policies. Addendum II below summarizes revenue available from different tobacco tax policies.

We should meet briefly to discuss this issue before the upcoming principal's meeting.

Pros:

- Helps the Administration avoid using BBA extenders that have been the subject of recent criticism. It is likely that the authorizers will reverse or curb some of the Medicare BBA savings policies as opposed to extending them as envisioned by the Commission and in the Administration's current Medicare reform base package.

- Could generate new momentum for the Administration's tobacco policies by linking a tobacco tax increase to a popular prescription drug benefit initiative. Similarly, the BBA CHIP program was partially financed through an increase in the Federal tobacco excise tax.

- The President has already established a link between tobacco and Medicare by announcing that some of the proceeds from a Federal lawsuit against the tobacco industry would help shore up the Medicare trust funds.

- Would use Medicare savings for Medicare reform, as opposed to funding discretionary programs proposed in the Budget.

Cons:

- It could create a $9.1 billion shortfall in FY 2000 on the discretionary side of the Budget. Using these offsets for Medicare reform could make it much more difficult to reach agreement this year with the Congress on FY 2000 appropriations.

- Because the President's Medicare plan must be released soon, the timing of such a decision would likely conflict with your ongoing negotiations on the Supplemental.

- The tobacco tax is an uncertain revenue source should smokers quit more rapidly than expected. Many states also have acted recently to increase their taxes, which could leave less available revenue for the Federal government to finance prescription drugs and other Medicare reforms in the years ahead.

- The Congress has shown little interest in enacting tobacco price increases as proposed by the Administration in the FY 1999 and FY 2000 Budgets. Linking a popular initiative like Medicare prescription drugs to a tax increase opposed by many in Congress could hinder the motion of a drug benefit.

Addendum I: The FY 2000 Budget Policy on Tobacco Excise Taxes

The Budget included two major tobacco excise policies that provide savings of roughly $35 billion over FY 2000 to FY 2004 (see table below):

(1) A 55 cents per-pack increase to be collected through tobacco excise taxes.
FY 2004-04 Savings: $32.2 billion.

(2) Acceleration of the BBA's 15 cents excise tax. The 1997 Balanced Budget Agreement (BBA) raised the excise tax 10 cents per-pack effective January 1, 2000 and another 5 cents effective January 1, 2002, for a cumulative 15 cents increase. The FY 2000 Budget accelerates the effective date of this entire tax by one year, effective October 1, 1999.
FY 2000-04 Savings: $1.9 billion.

Federal Receipts Raised From Tobacco Excise Taxes (in billions)

Year	1999	2000	2001	2002	2003	2004	00-04
55 cents	.165	6.525	6.426	6.426	6.418	6.400	32.195
BBA 15 cent	.139	1.081	0.679	0.163	-----	-----	1.923
Shift BATF[1]	-.381	.381	----	----	-----	-----	.381
Net Receipts	-.077	7.987	7.105	6.589	6.418	6.400	34.499

The FY 2000 Budget attributed these revenues to tobacco-related health care costs in the following Federal programs.

Federal Program	FY 2000 Tobacco-Related Costs (in billions)
Veterans' Affairs	4.0
OPM FEHB[2]	2.2
Department of Defense	1.6
Indian Health Service	0.3
TOTAL	**$8.0**

[1] This policy is the Bureau on Alcohol, Tobacco and Firearms (BATF) excise shift. Treasury assumes that revenues will be lower than we estimated in 2000 because smokers will stock up in FY 1999, before the 70 cents total price increase takes effect. The stocking up effect reduces 2000 revenues, but increases 1999 revenues by $304 million. To capture the 1999 revenues for use in 2000, Treasury came up with an excise tax shift. The shift loses money in 1999 and gains in 2000, more or less canceling out the stocking up effect. Note that the shift applies to all excise taxes collected by BATF, not just tobacco.

[2] OPM Federal Employee Health Benefits Program figure includes the total premium costs, and is not broken down by enrollee share (28%) and Federal share (72%).

Addendum II.Potential Net Revenues from a Federal Tobacco Tax Increase

The following table estimates revenue that could be derived from various levels of an excise tax increase.

($ in Billions)

Increase in Tax	2000[3]	2001	2002	2003	2004	2000-04
55 cents per pack	8.0	7.1	6.6	6.4	6.4	34.5
75 cents per pack	10.3	9.0	8.3	8.1	8.3	43.9
$1.00 per pack	12.8	11.1	10.3	10.1	10.5	54.8
$1.25 per pack	15.1	12.8	12.1	11.9	12.3	64.2
$1.50 per pack	17.1	14.4	13.6	13.4	14.0	72.4

Note: The year-by-year estimates may differ somewhat from Treasury-generated estimates, but the totals from 2000-04 should be close. Treasury is likely to include additional assumptions, such as increased smuggling due to higher per-pack costs, that would drive down the demand and, therefore, reduce the total revenue generated from the tax.

cc: Sylvia Mathews
Josh Gotbaum
Chuck Kieffer
Dick Emery

[3] Includes impact of speeding up BBA97 15 cents tax increase