Understanding the Tobacco Settlement’s Impact on State Fiscal Policy

In November of 1998, the nation’s four largest cigarette manufacturers reached a settlement agreement with representatives of 46 state governments, bringing to an end a series of lawsuits brought by the states against these manufacturers. The settlement, called the Master Settlement Agreement, gave these states an estimated $200 billion over 25 years in exchange from dropping these lawsuits. This policy brief discusses the tobacco settlement and its implications for state fiscal policy in the short term and the long run.

What was the Tobacco Settlement?

The suit was brought forward because the states alleged that the tobacco industry violated antitrust and consumer protection laws, withheld information about the impact of smoking, and manipulated nicotine levels in order to ensure that consumers stayed addicted. The settlement placed strict marketing and advertising restrictions on tobacco companies and established a national foundation to prevent youth tobacco use and tobacco related diseases.

The settlement also required tobacco companies to make payments to the states, with payments over the first 25 years estimated at $246 billion. The settlement outlines several different types of payments to the states. The largest of these payments are initial and annual payments. Initial payments are the first payments received by the state. Annual payments are payments made to the state for perpetuity. These payments are given out by “allocation percentages” which are agreed to by each state. The allocation percentage is based on two equally weighted variables:

- Smoking related Medicaid expenditures
- Smoking non-related Medicaid expenditures

Within these factors the formula also takes into account a state’s population and rates of smoking. Typically smaller states have a smaller allocation percentage than larger states. The payments are based on a fixed percentage, however they can vary based on many different factors like inflation and fluctuation in tobacco sales and market share.

There is no criteria for the way money from the tobacco settlement can be used by individual states. In response to this sudden monetary windfall several states established individual dedicated funds specifically set aside for money collected through the tobacco settlement. One of the goals of the settlement was to curb the number of youths who smoke and to promote public health. However, the General Accountability Office reports that the portion of the settlement set aside for health related programs is expected to decline from 24 percent in 2003 to 17 percent in 2004.

Up In Smoke?

Since 1998, however, the projected benefits of the tobacco settlement to the states has fallen dramatically. One estimate is that states have, so far, missed out on more than 10 percent of the
The Big Question: To Securitize or not to Securitize?

In general, securitization means giving up the right to a future stream of revenue in exchange for an immediate lump sum payment. The biggest question facing states is whether they should securitize future payments. Securitization is the process in which future payments can be sold for a set dollar amount and a single payment is received. Investment firms usually are not willing to securitize an entire state’s settlement, instead they are likely to securitize just a portion. Often securization is offered for payments over the next several years. Insuring that eventually annual payments will again be available. No matter the specific conditions of the securitization, the lump sum amount generated can be used for any purpose. Those who support securitization argue that taking the lump sum option means the state will not be susceptible to payment fluctuations caused by decreased tobacco consumption. Even if this did happen, the reduction in payments would be slight and might even grow when increases for inflation are taken into account. Others argue that securitization is a good insurance policy against tobacco companies going bankrupt. However, the chances that tobacco companies would actually go bankrupt are quite small.

While securitizing a state’s tobacco settlement may look like a really good deal, there are some important factors to weigh:

- **Future Revenue**: The securitized benefit will never be as large as the total of the annual payment. When taking this option states are being short sighted. By securitizing they are saying that they would rather take a smaller, lump sum amount than take advantage of a fairly regular stream.

- **Balancing Budgets**: The General Accountability Office found that in fiscal year 2003, states used the majority of their settlement monies for balancing their budgets. Oftentimes tobacco settlement money is used to balance shortfalls created by structural deficits. States that use a lump sum payment to balance deficits may be at risk of having their bond rating down graded.

- **Remember the Purpose**: When states take this option they are cutting off the availability of long term revenues that would otherwise be available for the purpose of the settlement - to prevent youth smoking and the promotion of public health. Taking the large payment in 2005 will likely mean that funding for health related programs is not available in 2010, whereas if the annual payments were still being received in 2010 funding would presumably still be available for these programs.

Better Options for Tobacco Settlement Money

When states get a financial windfall this large, much time and attention should be put into how to spend the money. Fiscally responsible ways to spend this money include:

- **Health Related Programs**: Spend the money on tobacco and related health care needs. After all, this is why states received the money in the first place. Studies have shown that money spent on smoking prevention actually ends up saving states money compared to the eventual health care needs of smokers.

- **Rainy Day Funds**: States should also consider putting excess funds into their Rainy Day Funds for use in times of real economic crisis.

Before entering into a securitization plan, lawmakers and the public should think more about the long term consequences of this decision, rather than the short term benefits of receiving a lump sum.
Examples of bad state uses:
NH used it for supplemental education funding.

How about a more general definition of securitization, since it’s not just limited to tobacco settlement:
Securitization is the process by which a state or local government converts an anticipated stream of future revenues into immediate revenue. In theory, this revenue can be used immediately to fund capital investments.

Notes on the original settlement:
In the mid 1990s, states started individually filing lawsuits against tobacco companies. Among the bases for the suits were that tobacco companies had deliberately tried to get people addicted to cigarettes in order to boost cigarette sales, by deliberately manipulating the nicotine levels in cigarettes.
The point of the lawsuit was to get the companies to pay states for all the expenditures they’d incurred dealing with smoking-related illnesses.
Eventually, all the states had their own lawsuits.
In March 1996, the Liggett Company (financially one of the weakest cig companies) settled. The rest of the companies followed in June of 1997.
But the agreement required some federal law changes to get put into law—in particular, the FDA would have to regulate nicotine as a drug. In 1998, Congress was unable to get legislation passed to do this, and in June of 1998 the guys threw the June 1997 agreement away.
At this point, 4 states (MS, FL, TX, MN) settled independently, and the remaining 46 states went back to the drawing board to come up with a settlement that wouldn’t require federal approval.
In November of 1998, they finished this process.
In November of 1998, the Master Settlement Agreement was agreed to. The Attorneys General of 46 states, etc signed a thing. This was 46 states, D.C. and 6 territories. This gives the states more than $200 billion over the next 25 years, in exchange for which the states agreed to drop their lawsuits against the manufacturers.
It was the 4 largest cig manufacturers who were in on the 46-state agreement.
The other four other states had already settled with the cig companies for $39.8 billion.

The settlement set specific amounts for each state for each year. But these amounts are subject to adjustment annually, depending on three factors. Inflation, # of cigs sold, and “the gain in market share by cig companies that are not participating in the agreement.

For states that haven’t securitized, these adjustments have already affected the payments states get in a negative way. A GAO report found that thru 2001, states had received $13.8B instead of the projected $15.4B, a $1.6B loss.

CSG, in a March 2002 report, has forecast that this loss will increase in future years. More people will quit smoking, so payments will go down. Need to read the CSG report to find out more.
Some of the cigarette companies were not part of the 1998 settlement. NEFF estimates that signatories were about 98% of the industry.