

UP IN *Smoke*

*Fifth District States Are
Burning Through
Tobacco Settlement Funds
to Balance Their Books*

BY KARL RHODES

North Carolina Gov. Michael Easley was the state's attorney general in 1998 when major U.S. cigarette manufacturers negotiated a master settlement agreement (MSA) with 46 states and the District of Columbia. The manufacturers agreed to pay an estimated \$206 billion to reimburse the states for health care expenses related to tobacco use. It was the largest product liability settlement ever, but Easley and several other state attorneys general demanded more.

They insisted that the manufacturers should pay an additional \$5.15 billion to tobacco farmers and quota owners in 14 tobacco-producing states over 12 years. These "Phase II" settlement payments were designed to indemnify farmers against declining demand for tobacco caused by several provisions of the MSA. Since North Carolina grows far more tobacco than any other state, its farmers receive the lion's share of these payments. But North Carolina's legislators decided to do more to help the state's struggling farmers, so they earmarked 25 percent of North Carolina's MSA payments to benefit tobacco growers and quota owners.

The tobacco farmers cheered, but their good fortune was short-lived. Easley, who had championed their cause as attorney general, moved up to the governor's office, where he was greeted by a huge deficit in 2001 and an even bigger one in 2002. To ease these financial pressures, he turned to the Tobacco Trust Fund Commission, the organization charged with using the 25 percent of North Carolina's MSA payments to help the state's tobacco farmers.

Easley intercepted a \$32 million tobacco settlement payment in April 2002; he removed \$50 million from the trust fund in June 2002; and the General

Assembly is diverting another \$38 million

from the trust fund's 2003 tobacco settlement payments.

North Carolina desperately needs the money to balance its budget, and so do the other states in the Fifth District. All of them are using tobacco settlement payments to balance their budgets

to some extent. The spectrum ranges from Maryland, which is using nearly all of its settlement payments to fund health care programs, to the District of Columbia, which securitized all of its settlement payments into one lump sum to pay down debt. Securitization

is achieved by selling bonds that are secured by payments from the MSA. In exchange for its rights to future MSA payments, D.C. got an immediate infusion of cash, and it avoided the uncertainties of receiving payments from companies in a declining industry.

Payments from the MSA are supposed to be made in perpetuity, but they will decrease if domestic tobacco consumption falls below certain benchmarks. Based on the original estimate of \$206 billion over 25 years, the Fifth District states were looking at the following projected revenue streams: North Carolina (\$4.6 billion), Maryland (\$4.4 billion), Virginia (\$4.1 billion), South Carolina (\$2.2 billion), West Virginia (\$1.7 billion), and Washington, D.C. (\$1.2 billion).

All of the states devised ambitious plans to spend this money, but as the first payments started to arrive, the stock market went into a tailspin and the national economy dipped into a recession followed by a sluggish recovery. The states are now faced with severe budget deficits, and they are struggling with the question of how much tobacco settlement money they should use to balance their budgets.

In addition to cash-strapped state governments, there are many other interests competing for the same dollars. They include smoking prevention programs, health care initiatives, economic development programs, and the tobacco farmers themselves.

In North Carolina, the intense debate over who gets what is complicated by the Phase II payments to tobacco farmers and quota holders. Are these Phase II payments enough to offset the hardship caused by the MSA? North Carolina's Tobacco Trust Fund Commission put that question to A. Blake Brown, professor of agricultural and resource economics at North Carolina State University. Brown's study, co-authored by Jonathan Perry, concluded that the present value of projected losses attributed to the MSA was \$654.9 million to \$764 million for the state's tobacco farmers and quota owners. In sharp contrast, they concluded that the present value of Phase II payments to North Carolina growers and quota owners was \$1.216 billion to \$1.223 billion.

Before Brown and Perry conducted their study, Brown warned the Tobacco Trust Fund Commission that the numbers probably would shake out that way, but the commissioners insisted that

A Trip Down Tobacco Road

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| <p>1612 Jamestown colonist John Rolfe plants <i>Nicotiana Tabacum</i> seeds from the West Indies. Growing this variety of tobacco for export to England becomes the first successful industry in Virginia.</p> <p>1620s Tobacco dominates the economy of the Chesapeake Bay region for the next 150 years. It is commonly used as currency throughout the Southern colonies. People literally grow cash on their farms or in their gardens.</p> <p>1640s Looking for fresh land for tobacco production, Virginians begin migrating into the Carolinas.</p> <p>1660s A glut of tobacco in England devastates the colonial economy, but by 1700 the colonies are once again exporting a record level of the crop.</p> <p>1730 Virginia requires growers to bring tobacco to public warehouses for inspection. Maryland, North Carolina, and South Carolina eventually adopt similar systems.</p> <p>1776 Tobacco helps finance the Revolutionary War by serving as collateral on loans from France.</p> <p>1794 Congress passes the first U.S. tax on tobacco.</p> <p>1839 Stephen, a slave in Caswell County, N.C., discovers bright leaf tobacco, which is later used extensively in cigarettes.</p> <p>1850s Tobacco harvests hit record levels in Virginia, but the state's soil is nearly exhausted from growing too much tobacco.</p> <p>1865 Tobacco growers struggle to recover from the Civil War and their dependency on slave labor.</p> <p>1875 R. J. Reynolds begins to mass-produce chewing tobacco in Winston, N.C.</p> <p>1880 The first cigarette-making machine is patented.</p> <p>1890 The Duke family of Durham, N.C., consolidates the major U.S. cigarette manufacturers into the American Tobacco Co.</p> <p>1902 Philip Morris begins marketing cigarettes in the United States.</p> | <p>1911 Trust busters split the American Tobacco Co. into several of its component companies including Liggett and Myers, P. Lorillard, R. J. Reynolds, and the new American Tobacco Co.</p> <p>1913 R. J. Reynolds introduces Camels, the first cigarette brand to gain nationwide popularity.</p> <p>1914 Cigarette consumption explodes during World War I.</p> <p>1933 The Agricultural Adjustment Act of 1933 institutes price supports for tobacco — the beginning of the quota system.</p> <p>1941 American soldiers get cigarettes in their rations during World War II.</p> <p>1944 The American Cancer Society begins to warn people about the potential risks of smoking.</p> <p>1955 Philip Morris introduces the Marlboro Cowboy in advertising campaigns.</p> <p>1964 The Surgeon General issues a landmark report on "Smoking and Health."</p> <p>1966 Health warnings from the Surgeon General are required on cigarette packs.</p> <p>1971 The United States bans cigarette advertising on radio and television.</p> <p>1985 Philip Morris buys General Foods, and R. J. Reynolds buys Nabisco.</p> <p>1991 A Medical College of Georgia study shows that Joe Camel is as familiar to young children as Mickey Mouse.</p> <p>1994 Seven tobacco industry CEOs say tobacco is not addictive in testimony before Congress. Mississippi sues the major tobacco manufacturers to recover the cost of treating diseases related to tobacco use.</p> <p>1998 Major tobacco manufacturers sign a master settlement agreement that calls for payments to 46 states estimated at \$206 billion over 25 years. The other four states negotiate separate agreements.</p> |
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SOURCES: www.tobacco.org; www.historian.org; R. J. Reynolds Tobacco Co.; Facts on File; www.druglibrary.org; The Duke Homestead; North Carolina State University; Pennsylvania Tobacco Prevention Network; and Walter Reed Army Medical Center

they needed an independent analysis.

Gov. Easley used the study to further justify his raids on the tobacco trust fund. Brown notes, however, that the plight of North Carolina's tobacco farmers goes far beyond the impact of the MSA. "Total projected losses (attributable to all factors, such as MSA, excise tax increases, and declines in tobacco exports) to North Carolina burley and flue-cured tobacco growers and quota owners do exceed the projected value of Phase II payments," the study said.

But that bottom-line reality was overshadowed by the state's looming budget deficit. "Frankly, the governor was looking for an excuse to take away their funding," Brown says.

State Cigarette Taxes Per Pack

State	Cents	Rank Among States & D.C.
Maryland	100.0	11th
District of Columbia	100.0	11th
West Virginia	17.0	44th
South Carolina	7.0	48th
North Carolina	5.0	49th
Virginia	2.5	51st

NOTE: State taxes are in addition to a federal tax of 39 cents per pack.

SOURCE: Campaign for Tobacco-Free Kids

The tobacco trust fund is one of three organizations that North Carolina created as stewards of its tobacco settlement money. Half of the payments — about \$82 million per year — go to the state's Golden LEAF Foundation, an organization that promotes economic development in North Carolina with an emphasis on regions that have been hurt the most by declines in the tobacco industry. The remaining 25 percent is supposed to bankroll the North Carolina Health & Wellness Trust Fund.

In August 2002, the Golden LEAF Foundation announced an \$85.4 million economic stimulus package designed to promote North Carolina's bio-sciences industry.

So far, the Golden LEAF's funding

has remained intact, but the Health & Wellness Trust Fund has not been as fortunate. Gov. Easley intercepted \$32 million headed for that fund in April 2002, and the General Assembly is diverting another \$40 million from the fund's 2003 tobacco settlement payments.

It's more difficult to take money from the Golden LEAF because Easley set it up as a foundation, explains William Upchurch, executive director of the Tobacco Trust Fund Commission. The trust funds, on the other hand, are full-fledged state commissions. "Our money is in a special account, but it's under state control," Upchurch says. "A couple of keystrokes and it's gone."

The diversion of dollars from North Carolina's trust funds is "unfortunate," says Carthan F. Currin, executive director of the Virginia Tobacco Indemnification and Community Revitalization Commission. "But states are independent political subdivisions, and they can make their own decisions about how to spend the funds."

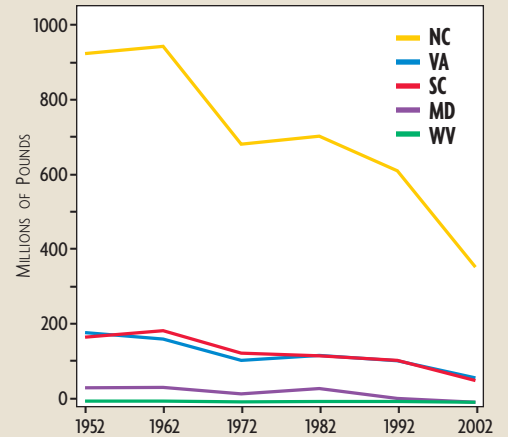
Currin's commission, which receives half of Virginia's tobacco settlement payments, has not been raided by the General Assembly, perhaps because 40 percent of Virginia's tobacco settlement payments routinely flow into the state's general fund. The remaining 10 percent goes to the Virginia Tobacco Settlement Foundation, which funds smoking-prevention programs.

Currin's commission helps Virginia's tobacco farmers, and it promotes economic development in southside and southwest Virginia, the regions of the state that are the most dependent on the tobacco industry. These areas also have been devastated by declining employment in textile manufacturing and coal mining, which were mainstays of their economies for most of the 20th century.

"Based on where the economies of these two regions are, the money is a godsend," says Currin. "I don't think it's too dramatic to compare our challenge to the Marshall Plan, which aimed to rebuild Europe after World War II."

Initially the commission focused on indemnification payments to tobacco farmers and quota holders. These pay-

Fifth District Tobacco Production



SOURCE: National Agricultural Statistics Service

ments are in addition to Virginia's Phase II settlement dollars, and they totaled \$91 million in 2001 and 2002. After the indemnification is complete, the commission plans to focus all of its resources on economic development. Last year the commission reviewed about 100 applications for economic development grants. Most of the applicants received some funding, but Currin says the review process is becoming "tighter" this year.

Virginia also is in the process of securitizing its funding for the Tobacco Indemnification and Community Revitalization Commission. This bond deal would convert the commission's estimated 25-year revenue stream of \$2 billion into a present-day endowment of \$600 million to \$700 million. Securitization will insulate the commission from potential reductions in tobacco settlement payments, and it will make the commission's funding "not bullet-proof, but harder for future General Assemblies to raid," Currin says.

That seems to be the case in South Carolina, a state that securitized all of its tobacco settlement payments in the spring of 2001. South Carolina issued bonds that converted its projected revenue stream of \$2.2 billion into a lump sum of \$791 million. The state put \$101 million of that sum into its Medicaid program to balance its current budget, but the structure of the bond deal will all but eliminate South Carolina's ability to use the funds to cover future deficits, says Les Boles,



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director of the Office of State Budget.

Of the original \$791 million, South Carolina spent 15 percent to help indemnify its tobacco farmers, quota owners, and warehouse operators. It allocated 12 percent for economic development initiatives, with an emphasis on the state's tobacco-producing region, and it used 73 percent to create the Healthcare Tobacco Settlement Trust Fund. Most of the indemnification and economic development money has already been spent or spoken for, and the health care trust fund is down to about \$400 million, Boles says.

All of South Carolina's budget-balancing Medicaid money came out of the health care trust fund, leaving just enough to endow a new prescription drug plan for senior citizens and a

modest tobacco-prevention program.

An attempt to securitize West Virginia's tobacco settlement payments failed in last year's legislature, and now the state is facing a \$200 million budget deficit for the coming year, says Bruce W. Adkins, acting director of the West Virginia Division of Tobacco Prevention.

To help close that gap, Gov. Bob Wise has proposed using \$20 million from the state's medical trust fund to alleviate a medical malpractice insurance crisis, says John Law, a spokesman for the state's Department of Health and Human Resources. This would mark the first time West Virginia has touched its medical trust fund, which was set aside by the legislature to cover future health-related costs of tobacco use.

Half of West Virginia's tobacco settlement payments flow into this trust fund, while the other half goes to the state's Department of Health and Human Resources, primarily to help fund state-supported hospitals. This money has been a budget-balancing tool all along because it merely replaces dollars that were already allocated to the hospitals before the tobacco settlement. The new funds have solidified the department's budget, but they have not boosted it, Law says.

One exception to this rule has been the department's Division of Tobacco Prevention, which has received \$5.8 million annually since the tobacco money started flowing. Adkins says he's fairly confident that West Virginia will maintain that funding level. It's significantly below the minimum amount of \$14 million recommended by the U.S. Centers for Disease Control and Prevention, but it's far more than the state used to spend.

A report produced by the Campaign for Tobacco-Free Kids puts West Virginia in the middle of the pack among Fifth District states when it comes to spending money on smoking prevention. The report blasts all but a few U.S. states for failing to keep their promise "to use a significant portion of the settlement funds ... to attack the enormous public health problem posed by tobacco use."

How Fifth District States Allocated Master Settlement Agreement Money

State	Original Estimated Revenue Stream ^a	Securitized?	Health Care ^b	Economic Development	Tobacco Farmers ^c	General Fund	Debt Reduction ^d
North Carolina	\$4.6 billion	No	25%*	50%	25%*	None	None
Maryland	4.4 billion	No	94%*	None	6%	None	None
Virginia	4.1 billion	Pending	10%		50%**	40%*	None
South Carolina	2.2 billion	Yes	73%*	12%	15%	None	None
West Virginia	1.7 billion	No	100%*	None	None	None	None
District of Columbia	1.2 billion	Yes	None ^d	None	None	None	100%*

* These funds have been used for budget-balancing to some extent

** Fifty percent split between economic development and tobacco farmers

^a Based on 25-year projections made in 1998

^b Includes funding of tobacco-prevention programs

^c Does not include any Phase II payments

^d Washington's debt-service savings are earmarked for Medicaid and other health care programs in fiscal 2003 and 2004

SOURCE: Individual states

State Funding for Tobacco Prevention

State	Annual Funding ^a	CDC Recommendation ^b	Percent of Recommendation
Maryland	\$30.0 million	\$30.3 million	99
Virginia	22.2 million	38.9 million	57
West Virginia	5.8 million	14.2 million	41
North Carolina	6.2 million	42.6 million	15
South Carolina	2.0 million	23.9 million	8
District of Columbia	None	7.5 million	0

^aFor fiscal 2003

^bMinimum amount recommended for each state by the Centers for Disease Control and Prevention

SOURCE: Campaign for Tobacco-Free Kids

Maryland was the only Fifth District state to win praise in the report for raising its smoking-prevention program to the minimum level recommended by the Centers for Disease Control. Maryland and three other states have “heeded the evidence that tobacco prevention is both good public health policy that will reduce smoking and save lives and good fiscal policy that will help solve their budgetary challenges by reducing the tremendous amounts they spend to treat smoking-caused disease under Medicaid and other state-funded health care programs.”

While praising smoking prevention as a worthy goal, some economists disagree with the idea that smoking prevention saves states money — particularly states that have high cigarette taxes.

People who smoke don’t live as long and, as a result, aren’t as much of a burden on state finances as one might think. “On balance, all the states make money” from tobacco use, says W. Kip Viscusi, professor of law and economics at Harvard University.

Viscusi — author of *Smoke-Filled Rooms: A Postmortem on the Tobacco Deal* — also suggests that the effectiveness of smoking-prevention campaigns may be overstated. “Most of the states where they claim great success also have ratcheted up cigarette taxes as well,” he says. “I’ve not seen a study that separates the two.”

Viscusi agrees, however, that the states have broken their promise to use tobacco settlement money to improve public

health. “The main rationale for getting all that money was to save the kids,” he says. “Now that they have the money, no one’s talking about the kids much.”

Brown, the professor of agricultural economics at N.C. State, sees it the same way. “Smoking prevention is not the priority right now. The priorities are budget balancing and other things,” he says. “States have a huge incentive to keep people smoking. If people stop smoking, the states would have no [tobacco] money.”

If the states and the tobacco manufacturers were winking at each other all along, Maryland Gov. Parris Glendening must have missed the signal. In June 1999, he put out a press release outlining what Maryland would do with its tobacco settlement proceeds.

“I see this as an opportunity to take the tobacco industry’s blood money and make Maryland a healthier state for everyone,” he said.

That’s pretty much what Maryland has done, says Carlessia Hussein, director of the state’s Cigarette Restitution Fund Program. Forty percent of the state’s settlement money has gone to cancer prevention, treatment, and research, while 31 percent is being spent on tobacco-prevention programs. Most of these dollars go to local coalitions that decide how to use them most effectively in their individual cities and counties.

Maryland has put 18 percent of its settlement money into substance-abuse programs, and 3 percent has been earmarked to treat tobacco-related dis-

eases such as emphysema. Another 2 percent has flowed into a health care foundation that serves uninsured and underinsured residents.

Maryland is using 6 percent of the money to buy out tobacco farmers who agree to pursue other agricultural endeavors and legally encumber their land so that no one will ever be allowed to grow tobacco on it. Based on their average tobacco output between 1997 and 1999, Maryland pays participating farmers \$1 per pound per year for 10 years.

Before the buyout, Maryland had 1,200 to 1,250 eligible tobacco farmers, and most of them have accepted the offer, says Pat McMillan, special assistant to Maryland’s secretary of agriculture. The main exception has been the state’s Amish farmers, who “have opted out of the program for religious reasons.”

Maryland has used some of its tobacco settlement funds for Medicaid, and that helps balance the budget, Hussein admits. “But some would say that all the money should go back to Medicaid. Fortunately, our state hasn’t seen it that way.”

Not yet, but Maryland swore in a new governor in January, and he’s facing a \$1.6 billion budget deficit for 2004. And so far, he has played his tobacco cards very close to the vest.

“Certainly we’re going to have some cuts,” Hussein says, “but I feel sure that the new administration will see the value in what we are doing.” **RF**

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