

BORROWING AGAINST THE FUTURE: IS SECURITIZING CALIFORNIA'S TOBACCO SETTLEMENT REVENUES THE BEST WAY TO CLOSE THE BUDGET GAP?

Governor Davis' 2002-03 Budget proposes to securitize a portion of the state's tobacco settlement revenues (TSRs) in order to provide \$2.4 billion to help balance the upcoming year's budget.¹ The state would securitize its TSRs by issuing bonds that will be repaid with this revenue stream. This paper looks at how the state's TSRs are currently spent, the issues surrounding securitization, and the Governor's proposal.

WHAT IS THE TOBACCO SETTLEMENT?

On November 23, 1998, 46 states, the District of Columbia (DC), and several territories signed a Master Settlement Agreement (MSA) with the major US tobacco companies, which settled over 40 lawsuits filed by states and localities seeking reimbursement for tobacco-related health care costs. Under the terms of the agreement, the tobacco industry will make annual payments to the states (and, in California, to localities) in perpetuity. At the time of the settlement, payments for the 25-year period beginning in 1998 were estimated to total \$206 billion, with California's 12.8 percent share expected to exceed \$25 billion. However, tobacco settlement payments fluctuate based on several factors discussed below, and more recent estimates show California's TSRs declining to \$21 billion over 25 years.²

HOW DOES CALIFORNIA SPEND TOBACCO SETTLEMENT REVENUES?

California's share of TSRs is divided between the state, all 58 counties, and four cities whose lawsuits were included as part of the settlement. A memorandum of understanding (MOU), signed by the attorneys in the affected lawsuits, outlines the allocation of the payments. The state receives 50 percent of the funds; the cities of San Francisco, Los Angeles, San Diego, and San Jose receive 5 percent of the funds (1.25 percent each); and the remaining 45 percent is divided among the counties based on population.

The state received \$515 million from the settlement in 1999-00 and \$386 million in 2000-01. These funds were deposited into the state General Fund.³ In 2001, the Legislature established the Tobacco Settlement Fund (TSF), where future TSRs would be deposited and used to fund various health programs. The Governor's Budget proposes to spend \$476.3 million in TSRs for health care programs in 2002-03, including \$64 million carried over from 2001-02 due primarily to a proposed delay for the expansion of the Healthy Families Program.⁴ The Department of Finance estimates that the state will receive \$414.8 million in TSRs in 2003-04.⁵

WHAT IS SECURITIZATION?

A state or local government securitizes its settlement payments by issuing bonds that are backed by future TSRs. These are similar to other forms of revenue bonds, which are frequently used to finance capital construction.⁶ At least 19 state and local governments, including a pool of 15 New York counties

and a pool of 24 California counties, have secured some or all of their TSRs, or are using their TSRs to repay debt on general obligation bonds.⁷ The proceeds from TSR-backed bond issues have been used to finance capital projects, fund health and anti-tobacco programs, establish endowments or trust funds, and/or balance budgets.

THE GOVERNOR'S PROPOSAL USES FUTURE REVENUES TO PAY FOR CURRENT SPENDING

The Governor proposes to securitize a share of the state's TSRs to raise \$2.4 billion in bond proceeds that will be used to bridge the 2002-03 budget gap. The Department of Finance estimates that debt service payments, which will be funded with future TSRs, will be \$62 million in 2002-03 and \$190 million annu-

Tobacco Settlement Revenues Are Subject To Change

California receives three types of settlement payments: Initial payments, which are made for the years 1998 and 2000 through 2003; Annual payments, which commence in 2000 and continue in perpetuity; and Strategic Contribution Fund (SCF) payments, which commence in 2008 and continue through 2017. The agreement does not fix the amount of the settlement payments; instead it includes a number of offsets and adjustments affecting the revenue stream including a(n):

- **Inflation adjustment percentage.** Annual and SCF payments are increased annually by 3 percent or the prior year's Consumer Price Index, whichever is greater.
- **Volume adjustment.** This factor adjusts each type of payment to reflect increases or decreases in both the number of cigarettes shipped in or to the US and the tobacco manufacturers' operating income. In 2001, total payments to the states were reduced by 15.04 percent due to a drop in the number of cigarettes shipped, but an adjustment for an increase in operating income that year offset some of this reduction. This steep drop was due to increased cigarette prices as tobacco companies sought to recoup some of the costs imposed by the settlement, and increased taxes on cigarettes. Future volume adjustments are projected to be well below this level, with annual declines of approximately 1.7 percent, but will continue to be a risk to the settlement payment amount as efforts to reduce tobacco consumption are intensified.
- **Federal legislation offset.** Annual and SCF payments could be reduced on a dollar for dollar basis if the federal government increases tobacco taxes or requires the tobacco industry to make payments of any form on or before November 30, 2002, and any portion of the amounts raised is sent to the states either in unrestricted funds or in grants restricted to health care or tobacco-related health care. It is unlikely that this will occur as the federal government has little incentive, other than an opportunity to restrict the uses of settlement funds, to reduce settlement payments to the states merely to distribute a comparable amount back to them.
- **Litigation offset.** Annual and SCF payments are reduced in an amount equal to any settlement obtained by an agent of any state or jurisdiction (including local government entities) seeking a judgement to recover tobacco-related public health costs.
- **Overpayment or underpayment offset.** A settling state, locality, or tobacco manufacturer has the right to dispute prior payments. If successful, Initial, Annual, and SCF payments will be adjusted to offset the over- or underpayment. Currently, one of the settling tobacco companies is disputing the amount it must pay under the settlement, which could reduce California's TSRs for 2002, and may already have reduced TSRs for 2001 by \$12 million.

The financial health of the tobacco companies is another risk to future settlement payments to the state. The settlement agreement only applies to US manufacturing subsidiaries. Thus, the parent companies are not liable for payments if a US subsidiary declares bankruptcy.

Sources: State of Wisconsin Legislative Fiscal Bureau, *Discussion of Tobacco Securitization (Tobacco Settlement Securitization)*, Paper #885 (April 26, 2001); Legislative Analyst's Office, *Analysis of the 2002-03 Budget Bill* (February 20, 2002), p. C-27; and the *Master Settlement Agreement* of November 1998 between 46 states, DC, and five territories and the major tobacco companies.

ally for 22 years thereafter, for a total cost of \$4.2 billion.⁸

The interest rate on bonds is the amount of interest (or rate of return) the state must pay bond purchasers for the use of their money. The Administration assumed a 5 percent interest rate when estimating the debt service payments for the proposal. A higher interest rate would significantly increase the cost of borrowing for the state, which would result in a larger share of the state's TSRs going toward debt service in the future. The Legislative Analyst's Office (LAO) estimates, for example, that an increase in the interest rate of one percentage point, to 6 percent, would increase the state's debt service payment by \$8 million in 2002-03 and \$16 million annually for the following 22 years for a total cost of \$4.6 billion.⁹

WHY DO STATES SECURITIZE TOBACCO SETTLEMENT REVENUES?

States and localities securitize their TSRs in order to:

- Reduce the risk associated with TSRs, which can fluctuate depending on several factors. Many states make the decision to shift some of this risk to investors, thereby foregoing a portion of their TSRs in order to increase the stability of their future revenue stream.
- Distance the state from the tobacco industry. TSRs create a conflict of interest for states that have a public health interest in reducing tobacco consumption, but will lose revenues if these efforts are successful.
- Provide an immediately available sum of funds that can be used for capital outlay, to refinance existing debt, or to reduce budget deficits.
- Use the initial payment from the securitization to establish an endowment and use the investment earnings to fund health care or other programs into the future. This would allow the state to diversify its investments, as opposed to relying on the financial health of the tobacco industry.

While there are compelling arguments in support of securitizing TSRs, there are caveats, as well. TSR-backed revenue bonds can be an expensive way to borrow due to the risk associated with this revenue stream. In addition, securitization obligates the state to use a portion of future TSRs for debt service. TSRs spent on debt service - \$190 million annually under the Governor's proposal - are funds that could be spent on health programs or other state priorities in the future. Unlike other options available to balance the budget, such as tax and fee increases or spending reductions that can be repealed later, TSR securitization creates an obligation that will continue long after the budget crisis is over.

IF CALIFORNIA PURSUES SECURITIZATION, HOW CAN IT MINIMIZE THE COST?

The state can structure a bond issue secured by TSRs in a way that minimizes its costs by:

- Giving investors the "first call" on TSRs so that investors receive the amount they are owed first, with any excess going to the state. This can reduce the interest rate on the bonds by providing some level of protection for investors in the event that TSRs decline, but it results in the state bearing most of the risk associated with a decline in the revenue stream in the future.
- Structuring the bond so that the state uses "residual" TSRs - the difference between the annual TSR payment and the annual debt service payment - to redeem the bonds before they mature. This can reduce the state's overall costs by reducing the interest it pays over time. However, investors may

demand a higher interest rate on bonds with this type of provision as it adds uncertainty with respect to the term of the investment. If the additional interest rate required by investors offsets any savings from paying off the bond before it matures, then accelerated payment will not reduce the state's costs. In addition, accelerated payment uses residual TSRs that could otherwise be used to fund programs in the future.

- “Trapping” TSRs in a rainy day fund. Placing all or some portion of any residuals into a reserve fund to guarantee future debt-service payments reduces the risk associated with TSRs, and thereby can reduce the required interest rate on the bonds. However, trapping TSRs reduces the amount of revenues available to fund other state priorities.
- Reducing the maturity of the bond issue, as investors typically demand lower interest rates for short-term bonds. There is less risk associated with a short-term bond simply because there is less time in which something can happen to reduce the revenue stream backing the bonds. However, short-term bonds require greater debt service payments in order to pay off the bonds over a short time period, thereby reducing the amount of TSRs available to fund programs.

THE GOVERNOR’S PROPOSAL RAISES SEVERAL ISSUES

Few details on the Governor’s proposal are available. As of April 9, AB 2353 simply authorizes the California Infrastructure and Economic Development Bank (CIEDB) to sell some or all of the state’s rights to future TSRs to a special purpose trust. The trust, established as a separate entity from the state, would issue bonds backed by whatever share of the state’s TSRs is required to generate \$2.4 billion. The final structure of a bond issue will be the result of negotiations between the special purpose trust and the underwriter of the bonds.

However, based on the available information, it appears that the proposal will entail all of the disadvantages of securitization, but only one, albeit not insignificant, advantage, which is to provide \$2.4 billion to help close the projected budget deficit. These funds could forestall a corresponding level of program cuts, which is the argument made by proponents of securitization.

The proposed TSR securitization raises several issues:

- It may not shift the risk of any future loss of TSRs to bondholders. The state is expected to give investors ‘first call’ on TSRs, which leaves most of the risk of future declines in the revenue stream with the state. AB 2353 establishes a special purpose trust in an effort to reduce the state’s liability for the bond repayment. However, the state is unlikely to allow the trust to default on the bonds even if future TSRs fall below debt service obligations. It would be politically costly to default, as the state will not want to give the impression of squandering bondholders’ investments. More importantly, defaulting could affect the perception of California’s creditworthiness, thereby potentially increasing the costs of future borrowing.
- By diverting revenues for debt service, it will reduce funds available for health programs dependent on the TSF in the future. Under the Governor’s proposal, securitization would reduce TSRs that could be used to fund TSF health programs by \$62 million in 2002-03, and by \$190 million annually for 22 years thereafter.¹⁰

The significant increase in the state’s debt service payment in future years will leave the TSF with insufficient resources to pay for the programs currently supported by the fund. The LAO estimates that the TSF could be short approximately \$340 million in 2003-04, which will require either reduc-

tions in TSF-funded programs or an increase in General Fund support for these programs.¹¹

- The proposed 23-year maturity of the bonds may increase the interest rate or require an agreement to ‘trap’ revenues in a reserve, both of which would reduce the amount of TSRs available to fund programs. AB 2353 authorizes the CIEDB to establish a reserve fund as well as other actions necessary to minimize the debt service costs.
- The LAO estimates that there will be an ongoing General Fund imbalance between revenues and expenditures leading to operating deficits in the range of \$7 billion in 2003-04 and 2004-05.¹² TSR securitization is a one-time solution to the deficit in the current and budget years that does not reduce the ongoing structural deficit and, in fact, would exacerbate the problem by reducing resources available in future years.

CONCLUSION

Proponents of the Governor’s securitization proposal argue that the magnitude of cuts needed to balance the 2002-03 Budget are so severe that borrowing is warranted. However, securitizing the state’s TSRs would worsen future years’ budget problems. The Legislature should:

- *Borrow against future TSRs to balance the budget only as a last resort.* Securitizing the state’s TSRs to fund current spending does not increase the state’s long-term resources, reduces future revenues for meeting the state’s needs and priorities, and does not address the structural deficit in the General Fund. Before such an action is taken, all other options, including increasing taxes and fees, should be considered.
- *Eliminate the TSF if TSR securitization goes forward.* This should be done to ensure that TSF-funded programs do not disproportionately bear the costs of balancing the budget. Securitization is expected to reduce future revenues below the point sufficient to fully fund these programs. Therefore, in order to avoid reductions to TSF-funded programs in future budget years, the state will have to decide between reducing or eliminating other General Fund programs or increasing revenues. The decision to fund TSF-funded programs should be made based on a comprehensive assessment of the state’s needs and priorities rather than on the amount of residual TSRs the state receives after meeting its debt service obligations. To consider these programs separately from other state expenditures could result in the latter.

The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. Support for the CBP comes from foundation grants, publications and individual contributions. Delaine McCullough prepared this Brief with assistance from Jean Ross. Please visit the CBP’s web site at www.cbp.org.

ENDNOTES

¹ AB 2353 (Migden) contains the legislative authorization needed to implement the Governor's proposal. AB 2353 would authorize the California Infrastructure and Economic Development Bank (CIEDB) to sell the state's TSRs to a special purpose trust, which will issue revenue bonds backed by some or all of the state's TSRs.

² Legislative Analyst's Office, *Analysis of the 2002-03 Budget Bill* (February 20, 2002), p. C-27.

³ Personal communication with Department of Finance staff on March 5, 2002.

⁴ Legislative Analyst's Office, *Analysis of the 2002-03 Budget Bill* (February 20, 2002), p. C-36-C-37.

⁵ Personal communication with Department of Finance staff on March 5, 2002.

⁶ A revenue bond is a bond backed by a dedicated revenue stream. General Obligation bonds, in contrast, are backed by the state's General Fund.

⁷ National Conference of State Legislatures, *State Management and Allocation of Tobacco Settlement Revenue 1999-2001* (August 2001).

⁸ Department of Finance, *Governor's Budget Summary 2002-03* (January 10, 2002), p. 10.

⁹ Legislative Analyst's Office, *Analysis of the 2002-03 Budget Bill* (February 20, 2002), p. C-32.

¹⁰ Department of Finance, *Governor's Budget Summary 2002-03* (January 10, 2002), p. 10.

¹¹ Legislative Analyst's Office, *Analysis of the 2002-03 Budget Bill* (February 20, 2002), p. C-27. On April 2, the Governor dropped his proposal to eliminate the Child Health and Disability Prevention Program (CHDP), which may change this amount.

¹² Legislative Analyst's Office, *The 2002-03 Budget: Perspectives and Issues* (February 2002).