

Caltaxletter

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FOULING THE TOBACCO SETTLEMENT STREAM: HIGHER TAXES MEAN FEWER DOLLARS

The budget-balancing strategy of borrowing \$4.5 billion from the California's share of the tobacco industry's Master Settlement Agreement (MSA) is short-sighted and ill-advised, akin to getting a mortgage on a house to pay for groceries.

That's how the Washington (State) Research Bureau described what states are doing to deal with their budget problems, and Cal-Tax couldn't agree more. To get the \$4.5 billion up front, California must commit to pay private investors big bucks. The state may be getting no more than 40 cents on the dollar.

This "securitization deal" has many rough edges. To wit:

- Increasing cigarette excise taxes will undoubtedly reduce the size of the MSA payments states expect to receive from the tobacco industry. Already, these MSA payments have slipped badly: In 2001, total MSA payments made to the states were \$5.9 billion, 15 percent smaller than the scheduled \$6.8 billion states were expecting to receive.
- In California this slippage translates into big dollars. In 2001 the Golden State was projected to receive about \$884 million, but actual payments made were \$125 million short at \$759 million. In 2002, California was supposed to receive \$1.06 billion, but received \$884.1 million – a shortfall of \$176 million. In just two years California has lost \$301 million in MSA payments.
- The drop off in MSA payments is due to falling cigarette volume. As cigarette taxes go up and prices are increased to account for the settlement payments, consumers have economized. One way consumers have economized is by purchasing so-called "fourth tier" cigarettes, cut rate cigarettes from small companies that are not part of the MSA regime. By replacing volume that would have otherwise been sold by MSA parties, the "fourth tier" ends up causing the MSA payments to shrink.
- These trends are likely to get worse because of a massive wave of large state cigarette tax hikes that will go into effect this year. Twelve states have already adopted large tax hikes in 2002. California's excise tax could soar by 63 cents a pack in August, if [AB 433](#) is adopted, bringing the tax to \$1.50 per pack. (Such a tax rate in New York City has hiked the price of a pack of smokes to \$7, according to a *USA Today* report. Effective July 1, the city's tax went from 8 cents to \$1.50 a pack, which, when matched by the state's \$1.50 tax, requires New Yorkers to pay almost double the national average for cigarettes.)
- California's 2003 MSA payment was originally projected to be \$1.071 billion. Based on the trend of the MSA payments to date, the actual payment would likely be no more than \$892 million or \$179 million less than projected. And logic would say that is an optimistic estimate since the volume declines that will result from the state excise tax increases already passed in 2002 are not factored into the projection.

- It is projected that MSA cigarette volume could go down by another 3 percent due to these tax hikes alone. If that occurs, California would lose another \$27 million in 2003 or a total of \$206 million less than the original projection. These losses will continue in perpetuity.
- California will only exacerbate the shrinking MSA pool by raising its own cigarette tax. A 50-cent tax hike could drop California cigarette sales by 15 percent, thereby shrinking national MSA payments by millions of dollars.
- California hopes to sell bonds on the basis of its MSA revenue stream. Yet California recently has lost hundreds of millions of dollars in MSA payments. California needs to lead the way in resisting the tidal wave of tax increases lest financiers take an unfavorable view of the state's shrinking MSA payment stream.

(Eight states have gone to the bond market for budget-balancing funds with MSA payments as security. They include Rhode Island, taking a lump sum of \$685.4 million, while giving private investors \$1.2 billion over 20 years, reported *The Associated Press* on June 21. California's use of MSA money drew criticism from the *San Francisco Chronicle*. A July 3 editorial called it "shortsighted to tap into money designed to save lives and save the state money in the long run – by preventing and treating smoking-related illnesses.")