

# Tobacco Funds Building Schools in Ohio

Ohio took a bold step in 2007 and collected a lump sum of \$5.05 billion by selling bonds against an estimated \$18 billion in tobacco payments over the coming 40 years. This marks a departure from previous use of the tobacco settlement money, but given the time and place, it's a shot in the arm for a state economy in need of perking up.

## The Master Settlement Agreement

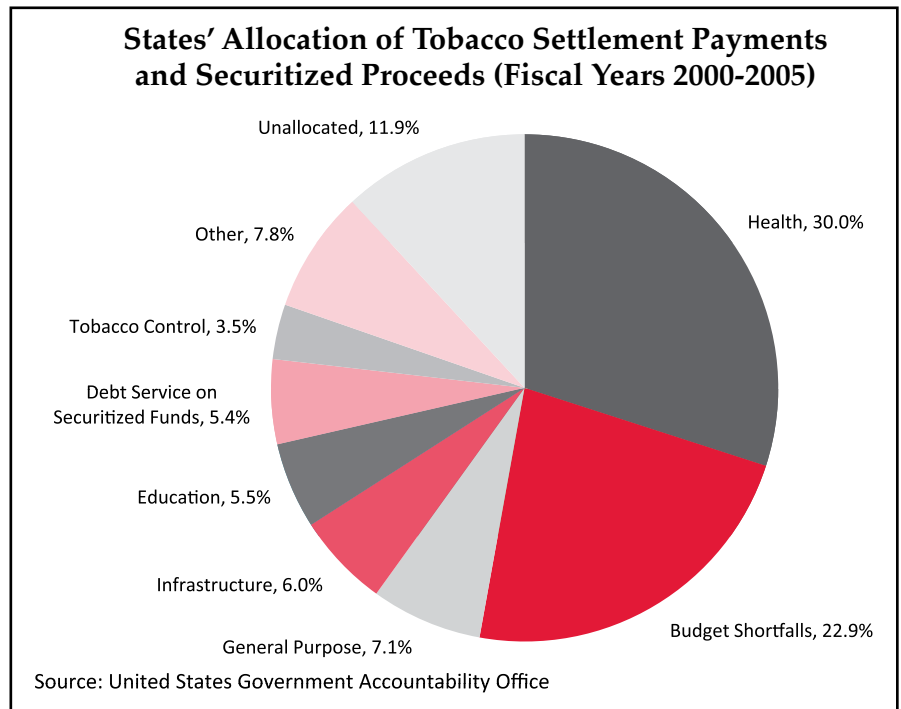
In November 1998, four<sup>1</sup> of the nation's largest tobacco companies entered into a Master Settlement Agreement (MSA) with forty-six<sup>2</sup> states to pay for past tobacco-related health care costs in the largest civil settlement in U.S. history. At the time, receipts from the settlement were estimated to be over \$200 billion over the coming 25 years. The settlement, however, called for annual payments to the states to be made in perpetuity. Each state's share of the annual payments is based upon a fixed percentage<sup>3</sup> negotiated during the settlement and identified in the MSA. These percentages were based, in part, on smoking-related health care costs for each state which in turn were based on population and smoking prevalence.

The annual payments are adjusted based upon a number of factors that include cigarette sales and inflation. Declining tobacco consumption can thus result in lower annual payments — between 1999 and 2020, consumption is estimated to decline by one-third. The payments dropped from over \$6 billion annually in 2000 through 2003 to under \$5.5 billion in 2005.<sup>4</sup>

By 2005, fifteen states had securitized a portion of their settlement by issuing bonds backed by future MSA payments. In doing this, states get the money up-front instead of waiting and they insulate themselves from risks associated with the payments from declining tobacco consumption, inflation uncertainty, and the continued profitability of tobacco companies party to the MSA. From 2000 to 2005, \$52.6 billion was received by the forty-six states with approximately \$16 billion of this amount being advanced payments from securitization.

## States Vary Widely in Use of Settlement Funds

The funds from the MSA provided an opportunity for states to take a significant inflow of capital to benefit their citizens. Since the MSA imposes no restrictions on how states spend their payments, it is not surprising that states have varied widely in how they used the money. In some cases the payments were diverted into general funds, in other cases the money was put towards one-time needs such as budget shortfalls, and in other cases state organizations were created to administer a portion of that state's payments.



Since recovering health care costs was a prime issue underlying the settlement, it is not surprising that states allocated more MSA funds to health-related programs than to any other single category. From 2000 to 2005, 30.0% of the payments went to states' health-related programs. Some states have emphasized this need much more than

<sup>1</sup> Though only a handful of tobacco companies originally signed the agreement, over 40 other tobacco companies have since signed on.

<sup>2</sup> The four states that were not part of the settlement — Florida, Minnesota, Mississippi, and Texas — settled separately.

<sup>3</sup> Ohio's percentage is about 5%.

<sup>4</sup> *States' Allocations of Payments from Tobacco Companies for Fiscal Years 2000 through 2005*, United States Government Accountability Office.

others: in 2005 and 2006, 100% of Arizona's payments were slated for health programs and in the same years Pennsylvania earmarked close to 90% of its payments for the same purpose.<sup>5</sup> Even in these states, however, the MSA funds do not cover all of the states' ongoing smoking-related health care costs. In Arizona, for example, the state's annual share of smoking-related health care costs is estimated to be \$316 million<sup>6</sup> while in 2005 and 2006 the state averaged only \$92 million in MSA payments.

Some states viewed the settlement as an opportunity to fund needs that could not be funded previously due to the high cost of health care. Using the money against budget shortfalls was popular, especially early on. From 2000 to 2005, 22.9% of the settlement money was put towards state budget shortfalls. On a side-note, the incentive was strong to use these funds to fix an immediate problem because the U.S. economy was in recession from March to November 2001 and the ensuing recovery was associated with slow employment growth that dampened state revenues. Using MSA funds for budget shortfalls peaked in 2004 when 44% of MSA receipts were applied to budget shortfalls. In 2005, however, this activity fell to 4% and expectations for 2006 were for a mere 2%.

The Master Settlement Agreement also included a set of restrictions on tobacco marketing and advertising. In line with this, most states allocated at least some of the money to tobacco control programs because they saw the benefit of using some of the funds to deter citizens from smoking. Overall, from 2000 to 2005, 3.5% of the state payments were used for tobacco control initiatives. Of the forty-six states party to the MSA, six allocated 20% or more of their payments in 2005 towards tobacco control. According to the U.S. Centers for Disease Control and Prevention (CDC), however, this type of funding should be increased. As of the 2007 fiscal year, only three states — Colorado, Delaware, and Maine — met the CDC's minimum recommendation of tobacco prevention funding.<sup>7</sup> In fiscal year 2006, Ohio spent \$45 million on tobacco prevention, ranking it 13<sup>th</sup> among the states in meeting the CDC's recommended expenditures.<sup>8</sup>

The category "debt service on securitized funds" represents the portions of annual payments made against bonds that were sold.<sup>9</sup> In a sense, this "slice of the pie" somewhat skews the representation of the allocation of payments since debt service represents funds previously received and allocated elsewhere. In 2002, only 2% of payments went towards debt service, but by 2005 this percentage increased to 24% with expectations to climb higher.

## Ohio's Use of MSA Funds

In 2005, Ohio allocated \$112 million in tobacco settlement funds with the two largest amounts designated for health (\$37.3 million) and tobacco prevention (\$37.1 million). During the same year, \$15.6 million went to economic development for tobacco regions — "programs to increase the variety, quantity, and value of nontobacco agricultural products, strategic investment in communities adversely impacted by a reduction in tobacco demand, [and] education and training for tobacco growers."<sup>10</sup> (In 2002, Ohio had 1,845 tobacco farms containing 1.3% of the tobacco acreage in the nation.)<sup>11</sup> The state also allocated some money to education in 2005, \$9.3 million for technology enhancements in schools.<sup>12</sup>

While not reflected in the 2005 figures, periodic allocations of tobacco settlement funds in Ohio were put towards school construction.<sup>13</sup> This funding increased dramatically as school construction was a major goal underlying the massive sell-off in 2007 of forty years worth of MSA payments for \$5.05 billion. The resultant money will be put towards a school construction program along with a real-estate tax break for seniors and disabled residents. The plan was approved nearly unanimously by the state legislature with reduced risk being one factor in the decision. Commenting on the action, State Treasurer Richard Cordray said, "We have shed the risk for the state of Ohio that tobacco companies will be profitable well into the future, which is a speculative point at this juncture."<sup>14</sup>

Another factor in the decision was the opportunity to give a jolt to the economy. Governor Strickland said, "This will create a construction boom in Ohio at a time

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<sup>5</sup> *States' Allocations of Fiscal Year 2005 and Expected Fiscal Year 2006 Payments*, United States Government Accountability Office.

<sup>6</sup> Source: <http://tobaccofreekids.org/reports/settlements/toll.php?StateID=AZ>. The annual health care costs in Arizona directly caused by smoking are estimated to be \$1.28 billion while \$316 million represents the portion covered by the state Medicaid program.

<sup>7</sup> *A Broken Promise to Our Children: The 1998 State Tobacco Settlement Eight Years Later*, The Campaign for Tobacco-Free Kids, December 2006.

<sup>8</sup> Source: tobaccofreekids.org.

<sup>9</sup> In selling bonds to investors, states receive money up front while in return the investors receive future MSA payments to those states.

<sup>10</sup> *States' Allocations of Fiscal Year 2005 and Expected Fiscal Year 2006 Payments*, United States Government Accountability Office.

<sup>11</sup> *Trends in U.S. Tobacco Farming*, November, 2004, <http://www.ers.usda.gov>.

<sup>12</sup> *States' Allocations of Fiscal Year 2005 and Expected Fiscal Year 2006 Payments*, United States Government Accountability Office.

<sup>13</sup> *2006 Annual Report*, Ohio School Facilities Commission.

<sup>14</sup> *Cleveland Plain Dealer*, October 30, 2007.

when we need job creation.”<sup>15</sup> As shown elsewhere in this publication, the construction industry is in decline in the state and in several of the large metro areas. Residential building construction especially has struggled — not surprising given the current state of the housing market — contracting by 3,000 jobs from the fourth quarter of 2004 to the fourth quarter of 2006. A boost to nonresidential building construction will help alleviate job loss in residential construction as the two industries have similar occupation structures. As shown in the table here, the three most common occupations in each industry are the same. The top fifteen occupations in nonresidential building construction account for 73% of that sector’s employment and 76%<sup>16</sup> of employment in residential building construction.

From Ohio’s Tobacco Securitization program, \$4.1 billion will be available to the Ohio School Facilities Commis-

sion (OSFC) in the 2009 to 2011 fiscal years. Over 140 school systems will benefit from this program with new construction or renovations designed using the LEED (Leadership in Energy and Environmental Design) for Schools rating system. LEED is a benchmark for the design and construction of energy efficient and environmentally friendly buildings. According to OSFC Executive Director Michael Shoemaker, in addition to energy savings, these design principals “have a positive effect on student health, attendance, and performance.”<sup>19</sup>

<sup>15</sup> Ibid.

<sup>16</sup> This figure does not sum directly from the figures on the table due to rounding.

<sup>17</sup> SOC stands for the Standard Occupational Classification system.

<sup>18</sup> NAICS stands for the North American Industry Classification System.

<sup>19</sup> “School Facilities Commission Approves First Round of Funding from Tobacco Securitization,” November 29, 2007, <http://www.osfc.state.oh.us>.

### Occupation Mix in Building Construction Industries

SOC Code <sup>17</sup>	Title	Nonresidential Building Construction (NAICS <sup>18</sup> 2362)	Residential Building Construction (NAICS 2361)
47-2031	Carpenters	20%	30%
47-2061	Construction Laborers	14%	12%
47-1011	First-Line Supervisors/Managers of Construction Trades and Extraction Workers	10%	9%
11-9021	Construction Managers	6%	4%
47-2051	Cement Masons and Concrete Finishers	3%	1%
13-1051	Cost Estimators	2%	2%
11-1021	General and Operations Managers	2%	2%
47-3012	Helpers--Carpenters	2%	5%
43-9061	Office Clerks, General	2%	4%
47-2073	Operating Engineers and Other Construction Equipment Operators	2%	1%
43-3031	Bookkeeping, Accounting, and Auditing Clerks	2%	3%
47-2152	Plumbers, Pipefitters, and Steamfitters	2%	< 1%
43-6011	Executive Secretaries and Administrative Assistants	2%	2%
47-2221	Structural Iron and Steel Workers	2%	< 1%
43-6014	Secretaries, Except Legal, Medical, and Executive	2%	3%

Source: JobsEQ.com

If performance benefits are attained, the school construction initiative will have a positive long-term impact on the state economy, since the educational attainment of the workforce is associated with higher wages. As Governor Strickland acknowledged in a speech in April 2007, “Whether for the state or its people, there is an unbreakable link between education and economic opportunity....We must build an education system set to enable our young people to win in the Global economy.”<sup>20</sup>

## Other States’ MSA Fund Usage

North Carolina created a foundation to administer one-half of its MSA funds, the Golden LEAF Foundation, which was charged with helping North Carolina citizens by advancing and transforming the state economy. The Foundation accepts grant applications from all communities in the state but gives preference to those benefitting its “priority counties,” those that are tobacco-dependent or economically stressed. The Golden LEAF Foundation takes a long-term view to its funding with its philosophy that “to the greatest degree possible grants should be funded from income on investments.”<sup>21</sup> In fiscal year 2005, for example, the Foundation had \$24.5 million in expenses compared to \$36.8 million in investment income and \$74.3 million from its annual MSA revenue. Projects the Foundation has supported include a \$60 million biotech initiative and an aerospace initiative funded by almost \$11 million in grants.

Like Ohio, South Carolina also cashed in future payments. In 2000, the state securitized payments expected over the next twenty-five years for a lump payment of \$912 million. This money was divided into four trust funds: 73% into a health care trust fund, 15% for assistance to tobacco farmers, 10% for economic development in rural areas of the state, and 2% for local water and sewer projects. In the health care fund, also meant to fund tobacco prevention programs, only interest was intended to be available for spending. In fiscal year 2003, however, the state bypassed this restriction and withdrew \$100 million from the fund to help offset the state’s budget deficit and to fund Medicaid. Furthermore, since fiscal year 2003, no MSA settlement funds have been spent on tobacco prevention.<sup>22</sup>

Kentucky, a leading tobacco-producing state, created the Kentucky Agriculture Development Board in 2000 to distribute 50% of the state’s MSA money. The remaining portions of the payments are used primarily for health care and education — especially early childhood education. In 2005, the state put 34.3% of its MSA funds towards health care, 9.7% into education, and 4.4% into tobacco control.<sup>23</sup> The Agriculture Development Board, as its name implies, is focused on agricultural concerns: “...to increase net farm income and effect tobacco farmers, tobacco-impacted communities, and agriculture across the state through stimulating markets for Kentucky agricultural products, finding new ways to add value to Kentucky agricultural products, and exploring new opportunities for Kentucky farms and farm products.”<sup>24</sup> Programs supported by the Agriculture Development Board range from marketing programs to computer literacy programs for farmers to support for more traditional agricultural needs through such programs as the Farm Livestock Fencing Improvement Program.<sup>25</sup>



Photo courtesy of Richard Fleischman & Partners Architects

<sup>20</sup> Knowledgeworks Leadership Institute speech, April 27, 2007, <http://governor2.ohio.gov>.

<sup>21</sup> Golden LEAF Foundation 2005 Annual Report.

<sup>22</sup> <http://tobaccofreekids.org/reports/settlements/state.php?stateID=SC>

<sup>23</sup> States’ Allocations of Fiscal Year 2005 and Expected Fiscal Year 2006 Payments, United States Government Accountability Office.

<sup>24</sup> [http://www.kyagpolicy.com/board/documents/guiding\\_principles.pdf](http://www.kyagpolicy.com/board/documents/guiding_principles.pdf)

<sup>25</sup> Annual Report July 2005-June 2006, Kentucky Agricultural Development Fund.