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Washington Research Council

BRIEFLY

Legislators have proposed selling the anticipated revenues from the tobacco settlement to bridge the gap between spending and revenues in the state general fund. The practice, called securitization, should be viewed with skepticism in the current budget context.

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An Insecure Plan for Tobacco Fund Securitization

To bridge the gap between revenues and expenses, state legislators propose selling the anticipated future revenues from the 1998 settlement negotiated between major tobacco companies and state governments, a financial transaction known as securitization. Bonds, backed by the tobacco settlement money, would be sold and the proceeds would be used to cover the budget shortfall.

The revenue stream is substantial. According to the state attorney general, Washington will receive about $4 billion over the next 25 years, plus an additional $500 million over a 10-year period.

Senator Lisa Brown, who announced the plan Monday, proposes selling up to 25 percent of the annual revenues to raise $525 million for use in the state budget. Of that money, $105 million would be paid into the Health Services Account. The remaining $420 million would be transferred to the state general fund to help plug the $1.6 billion hole.

The proposal is controversial, opposed by Attorney General Christine Gregoire and Treasurer Michael Murphy, both Democrats, as well as by key legislative Republicans. Governor Gary Locke has indicated his support of securitization. The House budget proposal makes similar use of the technique, although for a lesser amount.

Sen. Brown says, is that securitization allows a government to convert "a long-term stream of money ... into a one-time lump-sum payment."

Gregoire cites four arguments against the proposal, saying it is a) too expensive, returning just 25 - 30 cents on the dollar; b) just a "one-time budget fix" that will increase problems in the future, c) is extremely complex, with debt limit and bond rating implications, and likely to invite legal challenges; and d) diverts the money from the "critical goals" of the settlement that linked smoking to health care costs.

Murphy likens securitization to mortgaging the house to pay for groceries.

Six states – Alabama, Alaska, Arkansas, Iowa, Louisiana, and South Carolina - and several local governments, including New York City, securitized some part of their tobacco settlement. Wisconsin is expected to securitize its settlement money in the next few months, for as much as $1.2 billion.

In presenting their budget proposal, Senate Democrats acknowledged that securitization is not in itself a long-term solution, but they say it is a bridge to one because they are putting efficiencies in place that will reduce costs in the future. Further, they believe the legislature cannot pass a general tax increase this session, unless a referendum clause is attached. The uncertainty of voter approval makes a tax increase an irresponsible proposition, they contend.

Securitization, then, represents an opportunity to get money into the general fund without raising taxes.

Considerations

Four questions should be considered:

- Is the state giving up too much to get too little?
- Is the diversion of settlement money to the general fund appropriate?
- Would securitization make sense if we were not facing a $1.6 billion budget deficit?
- Will the proposed use of the funds lead to a more severe budget problem next year, or will securitization contribute to long-term budget stability?

Too much for too little?

Critics have charged that securitization is too expensive.

There will be substantial transactions costs associated with the creation of a new state entity to issue the securitized bonds, brokerage and legal fees, and, if Attorney General Gregoire is correct, the additional risk of litigation. As well, questions have been raised about the impact of the sale on the state debt limit and bond rating.

Beyond these transactions costs, many of which attend even the routine issuance of state bonds, there is the larger issue of the discount rate, which, like an interest rate, is the rate applied to future revenue streams to determine their present value. As Sen. Brown has pointed out, securitization simply recognizes the time value of money. One hundred dollars today is worth more than $100 to be received thirty years from now. The 25 cents on the dollar comment, of course, also applies to any bond issue, as debt service payments over the life of the bonds represent a multiple of the borrowed amount.

The Technical Assistance Legal Center associated with the California-based Public Health Institute points out that there are two factors to be considered. First, the investors' required return on investment must be taken into account. And, second, there will be an additional cost associated with the risk of buying tobacco bonds. That risk, however, is not great, according to most observers.

The costs need not be prohibitive, although exact information is not yet available. And, as in the bond markets, changing interest rates will make a substantial difference.

Appropriate Use of the Money?

Many critics of this securitization aim their fire at the diversion of settlement funds from tobacco cessation and health programs to more general purposes. In their press conference, Senate Democrats attempted to address this argument by saying that the tobacco money was intended to pay for health care and that rising medical costs have contributed substantially to the current pressure on the state budget.

How the settlement money is spent is clearly a policy issue, subject to legislative discretion. Although the states linked the settlement to the social and public health costs associated with tobacco use, many states have chosen to spend the money for other purposes. With passage last year of Initiative 773, increasing the state cigarette tax by sixty cents with the money dedicated to health and smoking cessation programs, Washington clearly has not stinted when it comes to earmarking revenues for these limited purposes. One reason the state faces the budget challenge it does is that legislative control over the budget has been reduced over time by fund dedications.

Certainly, an argument can be made in favor of using tobacco money to support the general fund. At any rate, such discussions are a legitimate part of legislative deliberations.

Does securitization make sense absent the crisis?

Removed from the current budget crisis, there are several reasons securitization may be good fiscal policy.

Sale of the revenue stream has been described as being analogous to portfolio diversification. A lump sum settlement from securitization could be used to establish an endowment fund, invested in a variety of assets, reducing the state's exposure to reductions in settlement proceeds. Bondholders would assume some of the risk associated with reliance on tobacco settlement dollars.

The Wisconsin Legislative Bureau acknowledged that the question of the state's liability to bondholders "has yet to be legally tested." They go on to state that "... even if the state would have no legal responsibility, having bonds in default that are effectively tied to the state's rights to tobacco settlement payments could be perceived as harmful to the state's financial reputation ... it is conceivable that states would be politically compelled to repay bondholders regardless of whether the state is legally committed to do so." (Wisconsin Legislative Fiscal Bureau, Paper #885, "Discussion of Tobacco Securitization," April 26, 2001)

The lump sum payment also could be used to support capital spending, matching one-time revenues to one-time expenses. The securitized funding would reduce the need for the state to incur long-term debt.

Ease or Increase the State Budget Problem?

This is the most critical question with respect to the legislative budget proposals. Using windfall revenues to balance the state budget is more analogous to drawing down reserves than it is to mortgaging the house. Our current budget problem results in part from a failure to control spending as the economy slowed. While the events of September 11 had a major impact on the state budget, the Research Council and others warned last spring that the budgets being considered by the legislature were not sustainable. Although the magnitude of the current shortfall could not be foreseen, there was a clear and foreseeable likelihood that the state would face a serious deficit in 2002 or 2003.

The Center on Budget and Policy Priorities (CBPP) makes a useful distinction between *cyclical* and *structural* deficits. (Kevin Carey, Liz McNichol and Iris Lav, "State Responses to Tight Fiscal Conditions," Center on Budget and Policy Priorities, August, 2001.) Cyclical deficits are "*temporary* imbalances between revenues and expenditures caused by fluctuation in the business cycle." On the other hand, structural deficits represent "*permanent* imbalances caused by a long-term gap between the projected increase in revenues and the projected cost of government services."

If the state is experiencing a cyclical deficit, lawmakers could justify using reserves, securitized tobacco funds, and other such short-term tactics to buy time until the tax revenues recovered enough to support the operating budget. On the other hand, if the budget problems reveal a structural deficit, stronger measures will be required. If so, they should be taken sooner rather than later.

As the CBPP points out states can simultaneously experience deficits that are both structural and cyclical. Washington would appear to be in that unpleasant situation.

Several factors suggest that the present budget shortfall has a substantial structural dimension.

First, recent ballot initiatives have reduced general fund revenues while increasing spending pressure. Diverting property tax money into a restricted education account, eliminating the Motor Vehicle Excise Tax, and limiting property tax revenues has significantly narrowed the general fund tax base, and the impact will compound in future years. Nonetheless, state spending, until recently, has been relatively unaffected, as surpluses and reserves were used to sustain expenditure levels.

Second, while population growth has contributed to increasing demand for public services (e.g., school enrollments, social service caseloads, and inmate populations) state government has expanded beyond the level required just to keep pace with increased demand. (For more on demand pressures see Washington Research Council *Policy Brief*, "Caseload Increases Drive Up State Costs", March 4, 2002.) Further, the governor and legislature have been reluctant to adopt the efficiencies and cost-containment strategies of the private sector, including outsourcing for services, requiring employees to pay a higher share of the cost of health care insurance, and shedding unproductive or unnecessary programs and activities.

Third, several critical sectors of our economy show no signs of rapid recovery. The future of the airplane industry in our state remains in doubt, with future investment dependent on both global and local conditions – in the latter case, including changes in the state business climate. The aluminum industry contracted dramatically in the last eighteen months. And the tech boom of the late Nineties, which artificially inflated state coffers, has returned to a more normal course.

Faced with a structural deficit, lawmakers must do more than buy time.

Conclusion.

The issue facing the legislature has much to do with whether or not securitization is responsible fiscal policy. The answer to that question is, it depends. It depends on how the money is to be used. Securitization to avoid tough fiscal decisions will exacerbate the financial problems confronting lawmakers in the next biennium. It's clear from the plans unveiled so far, lawmakers appear have more restructuring to do.

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