Tobacco Stimulus

Virginia and North Carolina are among the states using money from their 1998 settlement with tobacco companies to spur economic development

BY CHARLES GERENA

Well before the federal government doled out billions of dollars to push the economy out of the 2007-2009 recession, states created their own stimulus programs using money from an unlikely source: cigarette manufacturers.

In 1998, the attorneys general of 46 states and the District of Columbia signed a master settlement agreement (MSA) to resolve lawsuits against America's four largest tobacco companies. As of April 2010, the firms have paid out more than $74 billion as part of that agreement, with the Fifth District receiving about $7 billion.

The money was intended to compensate for costs associated with smoking-related illnesses and to fund programs that improve public health and reduce tobacco use. But the MSA didn't dictate how the payments should be used. As a result, many states have used the windfall for a variety of purposes, from buying laptops for classrooms to plugging budget holes.

Those with communities that relied on tobacco farming and production to generate economic activity have used the money to offset job losses that have resulted from declines in smoking, some of which may be attributed to the MSA's restrictions on cigarette marketing. In the Fifth District, Virginia and North Carolina lawmakers devoted a significant portion of their tobacco settlement payments to stimulating development and job growth, especially in rural communities with a history of agriculture and relatively high unemployment.

As with the federal stimulus program, however, it's difficult to separate the effects of the payments from other things happening in the economy or to know what would have happened in these communities without the influx of outside funds. Since 2000, there have been two recessions and a significant expansion in between, not to mention the repercussions of globalization and technology-driven increases in productivity.

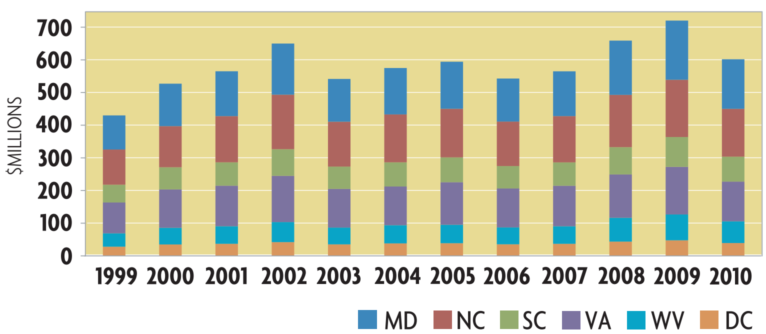
In addition, any jobs generated from investing tobacco settlement payments in economic development projects must be weighed against the costs. Will a project require the expansion of local public goods like roads and police? Will it result in the displacement or substitution of existing businesses?

An important step in such a cost-benefit analysis is tracking where the money goes. "Good public policy requires that the details of incentive packages be disclosed and that the effectiveness of incentives be measured," noted Daniel Gorin, an economist at the Federal Reserve Board of Governors, in a 2008 overview of economic development incentives. "Policymakers can then be held accountable for their decisions on the basis of evidence rather than politics."

The following charts summarize tobacco settlement payments to the Fifth District and the spending of those funds in North Carolina and Virginia, both by county and by category. A spreadsheet with more detailed information can be downloaded from the Richmond Fed's public website: www.richmondfed.org/publications

Tobacco Master Settlement Payments to Fifth District, 1999-2010

Maryland and North Carolina have been the largest beneficiaries of MSA payments in the Fifth District, each receiving about $1.7 billion between 1999 and 2010. Each state has prioritized its spending quite differently, the former supporting health care and the latter emphasizing economic development.



SOURCE: Tobacco Project website, National Association of Attorneys General

Nearly all of Maryland's payments support statewide and local efforts to reduce cancer mortality and tobacco use, as well as fund substance abuse programs and the state's Medicaid program. The rest are devoted to a program that helps southern counties transition out of their 300-year-old tradition of tobacco farming.

As part of that program, Maryland farmers were offered an annual payment of $1 for every pound of tobacco they grew in 1998 for 10 years, in return for growing something else. More than 90 percent of farmers accepted the voluntary buyout. Other parts of the program continue to fund regional agricultural development and land preservation.

In contrast, North Carolina sends half of its tobacco settlement payments to the Golden LEAF Foundation, a nonprofit organization dedicated to fostering development in economically distressed and tobacco-dependent communities. Another quarter of the payments assist tobacco producers and related businesses, while the remaining quarter support tobacco use prevention and cessation, obesity prevention, prescription drug assistance, and other health-related programs.

Virginia also splits its MSA payments three ways. Fifty percent of the payments are devoted to assisting tobacco farmers and fostering economic development, 41.5 percent support the state's Medicaid program and various healthcare initiatives, and 8.5 percent are spent by a foundation that combats youth smoking and childhood obesity.

Many states have securitized the stream of income from their future MSA payments so they could have the budgetary certainty of a lump-sum payment. Tobacco-control advocates, however, have criticized the practice. States have frequently used the one-time infusion of money to plug budget holes or finance major capital investments in the short term, not to fund health care programs over the long term as critics say the MSA originally intended.

The Fifth District's experience with securitization of MSA payments has been a mixed bag in this regard. South Carolina was among the first states to take this route in 2001, issuing bonds that raised $934 million. About three-quarters of the bond proceeds went into a special trust fund to finance a variety of health care initiatives, including a prescription drug benefit for seniors and antismoking programs. The remainder compensated individuals for losses in tobacco production as well as funding water and wastewater system projects, car tax relief, and grants to local governments.

The same year, the District of Columbia sold $525 million in bonds against a portion of its future payments to reduce its debt and fund capital projects. A second bond issue of $245 million in 2006 financed other capital projects.

West Virginia securitized all of its future tobacco settlement payments in 2007, raising $807 million to help balance the books of the state's teacher retirement system. Initially, it had directed half of its payments into a trust fund to cover the future health-related costs of tobacco use and half for the state's health and human resources department, primarily to replace a portion of state funding for hospitals.

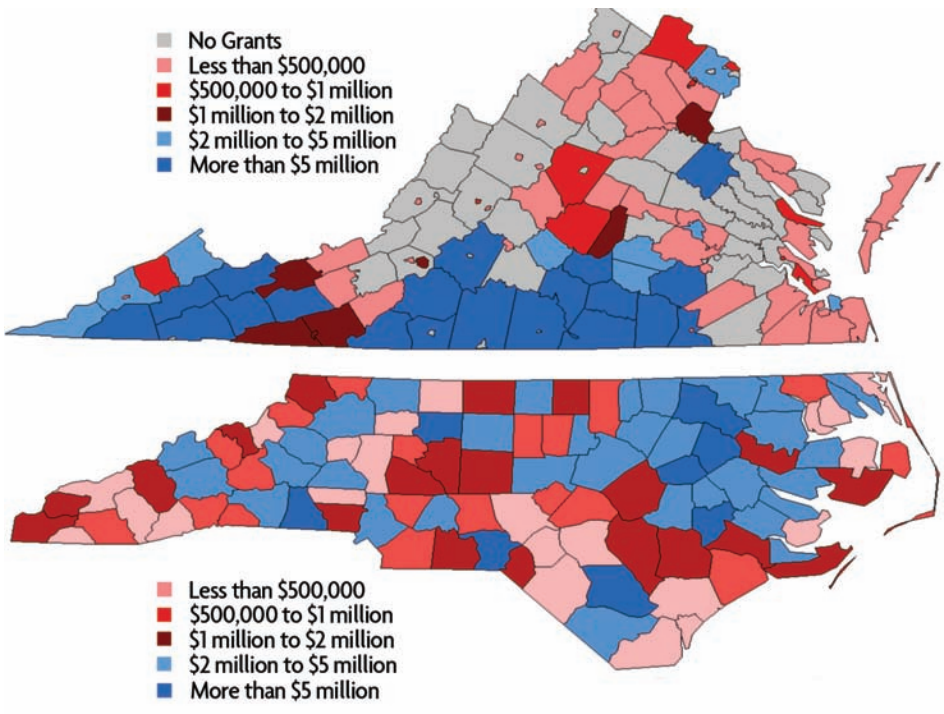
Expenditures of Tobacco Master Settlement Agreement Funds by County, 2000-2010

Lenoir County in eastern North Carolina is known as the home of the state's first governor and attracts visitors every year to its Civil War battlefields and drag strip. So why did $106 million in tobacco settlement payments flow into this rural county during the last 10 years?

A single project accounts for 95 percent of this money: the North Carolina Global TransPark, a 2,500-acre site that the state envisions as an air cargo airport surrounded by just-in-time manufacturing facilities. The airport has been developed and one anchor tenant, Spirit AeroSystems, was secured, thanks to a $100 million grant from the Golden LEAF Foundation to finance the construction of its manufacturing facility.

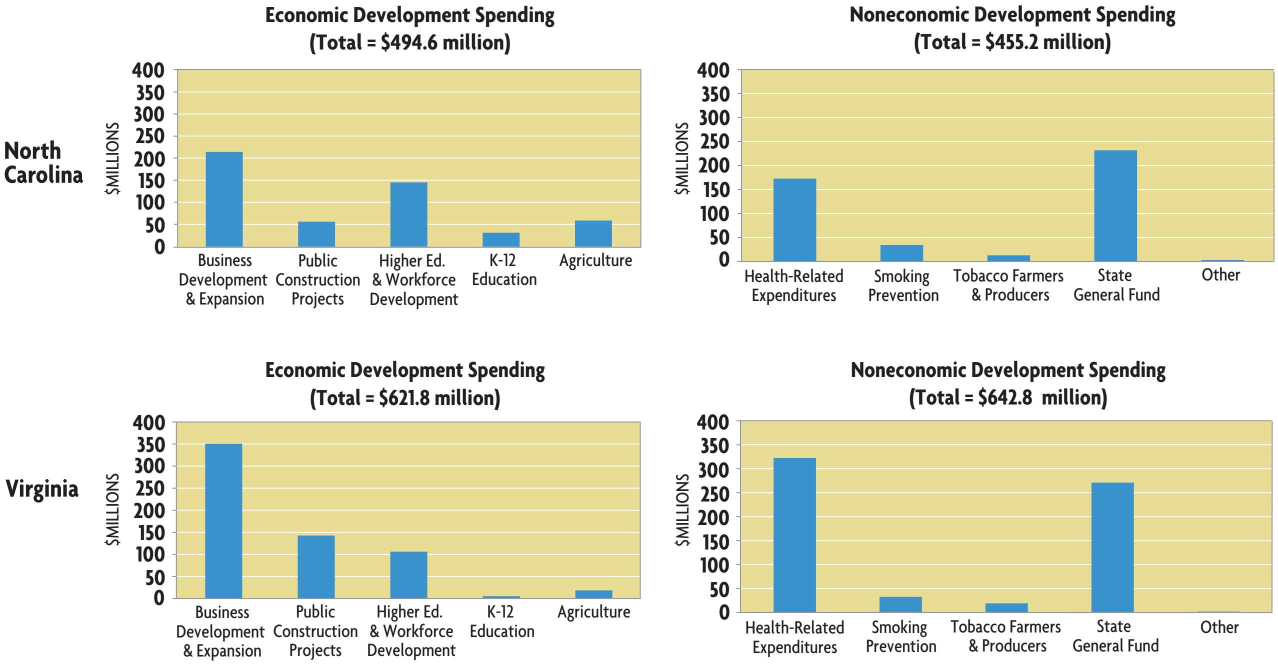
A single project also accounts for Pittsylvania County receiving the largest amount of payments — $92 million — in Virginia. About $26 million has been awarded to the county and the city of Danville to develop the Institute for Advanced Learning and Research into a high-tech hub for southern and Southwest Virginia. The institute partners with Virginia Tech to conduct research and development in horticulture and forestry, motorsports, and other areas, as well as commercialize technologies in those fields.

Aside from these outliers, Virginia and North Carolina have invested their tobacco settlement payments over a wide geographic area. Virginia has favored the southern and southwestern counties where farmers produce most of the state's tobacco, while North Carolina has spread its investments to economically-challenged rural counties in general, not just tobacco-growing centers.



SOURCES: Virginia Tobacco Indemnification and Community Revitalization Commission, Virginia Foundation for Health Youth, Golden LEAF Foundation, North Carolina Tobacco Trust Fund Commission, and North Carolina Healthy and Wellness Trust Fund Commission

Expenditures of Tobacco Master Settlement Agreement Funds by Category of Spending, 2000-2010



NOTES: Data represents grants awarded and program funds committed by a state-designated organization during the specified fiscal year. It does not include nongrant or non-program expenditures, such as an organization's administrative and marketing expenses, or direct compensation to tobacco farmers. Actual disbursements may occur in subsequent years, and end up being smaller than the original grants due to grantees discontinuing the funded program or the organization cutting off funding. Data for Virginia includes the 40 percent of the state's MSA payment set aside for the general fund from 2000 to 2004 and for the Virginia Health Care Fund from 2005 to 2010.

SOURCES: Virginia Tobacco Indemnification and Community Revitalization Commission, Virginia Foundation for Healthy Youth, Golden LEAF Foundation, North Carolina Tobacco Trust Fund Commission, and North Carolina Health and Wellness Trust Fund Commission

When tobacco settlement payments are used to develop certain sectors of a regional economy or support specific businesses, states are placing bets on economic winners. Lawmakers, along with the assortment of commissions they have created to spend the money, may try to reinvigorate declining industries or jump-start new ones.

The problem is that empirical research hasn't been able to conclusively prove whether such "industrial policy" in general pays off significantly. "The standard justifications given … by state and local officials, politicians, and many academics are, at best, poorly supported by the evidence," noted Alan Peters and Peter Fisher, both professors of urban and regional planning at the University of Iowa, in a 2004 journal article. Consequently, Peters, Fisher, and other researchers of economic development incentives advocate improving education, simplifying the taxation and regulation of businesses, and doing other things to encourage economic growth rather than trying to choose winners.

Virginia and North Carolina have tried both approaches with the tobacco settlement funds they have devoted to economic development. From 2000 to 2010, the states awarded $35 million in grants for K-12 education, funding after-school programs for at-risk youth and purchases of laptops, iPod Touches and other technology for classrooms. A larger chunk of money — $247 million — went into higher education and workforce development. In many cases, the money paid for new equipment at community colleges so that students can be trained to use the latest technology.

The biggest portion of Virginia and North Carolina's economic development dollars — about $561 million — funded business development and expansion on the local, regional, and statewide level. Often, the money helped existing businesses to acquire capital equipment or financed improvements to business parks and municipal infrastructure to attract new businesses. Targeted industries included biotechnology, manufacturing, and tourism.

Budget pressures, however, have competed with efforts to spur economic development. More than $233 million in tobacco settlement payments have been directed by North Carolina lawmakers into the state's general fund during the last 10 years. About $273 million of Virginia's payments went into the state's general fund, largely because 40 percent of payments were automatically counted as general revenue from 2000 to 2004. **RF**