

DATE: July 26, 2016
TO: Interested Parties
FROM: Kyle I. Jen, Deputy Director
RE: Tobacco Settlement Funds

This memorandum provides an update on tobacco settlement revenue received by the State of Michigan and the expenditures made from that revenue. An attached table shows estimated revenue and expenditures for the period of FY 2014-15 to FY 2015-19.

Settlement Receipts

The Master Settlement Agreement (MSA) providing for tobacco manufacturer payments to states was originally reached between 46 states and the four largest U.S. tobacco manufacturers in 1998. (A number of smaller manufacturers have since joined the agreement. Payments began in 2000 and are due in perpetuity. Annual payment amounts due from the manufacturers to the State of Michigan have declined from over \$300 million in the early years of the agreement to \$290 million in FY 2014-15. Under the MSA, annual adjustments are made to account for both inflation and cigarette sales levels.

As part of a dispute regarding state enforcement of provisions of the settlement related to non-participating manufacturers, participating manufacturers withheld payment amounts totaling roughly \$200 million from FY 2005-06 to FY 2011-2012. An arbitration settlement between the manufacturers and a number of states, including Michigan, was reached in 2013 that resulted in the following:

- Net receipts of an additional \$129 million for the manufacturers to the state in FY 2012-13 on a one-time basis.
- Ongoing credits from the state to the manufacturers of \$23 to \$25 million per year in FYs 2013-14 through FY 2016-17, with an additional negative adjustment for the state of \$7 million per year in FYs 2013-14 and 2014-15.
- Agreement that the manufacturers would not dispute payment amounts through FY 2014-15.

For FY 2015-16, manufacturers withheld \$16 million from the total payment of \$290 million due to Michigan, beyond the \$23 million due them under the arbitration settlement terms described above.

Automatic Payments

Four types of payments are made each year from tobacco settlement revenue prior to discretionary appropriations by the Legislature.

Securitization payments: Michigan has securitized a portion of its tobacco settlement revenues on two occasions, receiving an up-front payment of revenue in return for annual debt service payments to bond-holders.

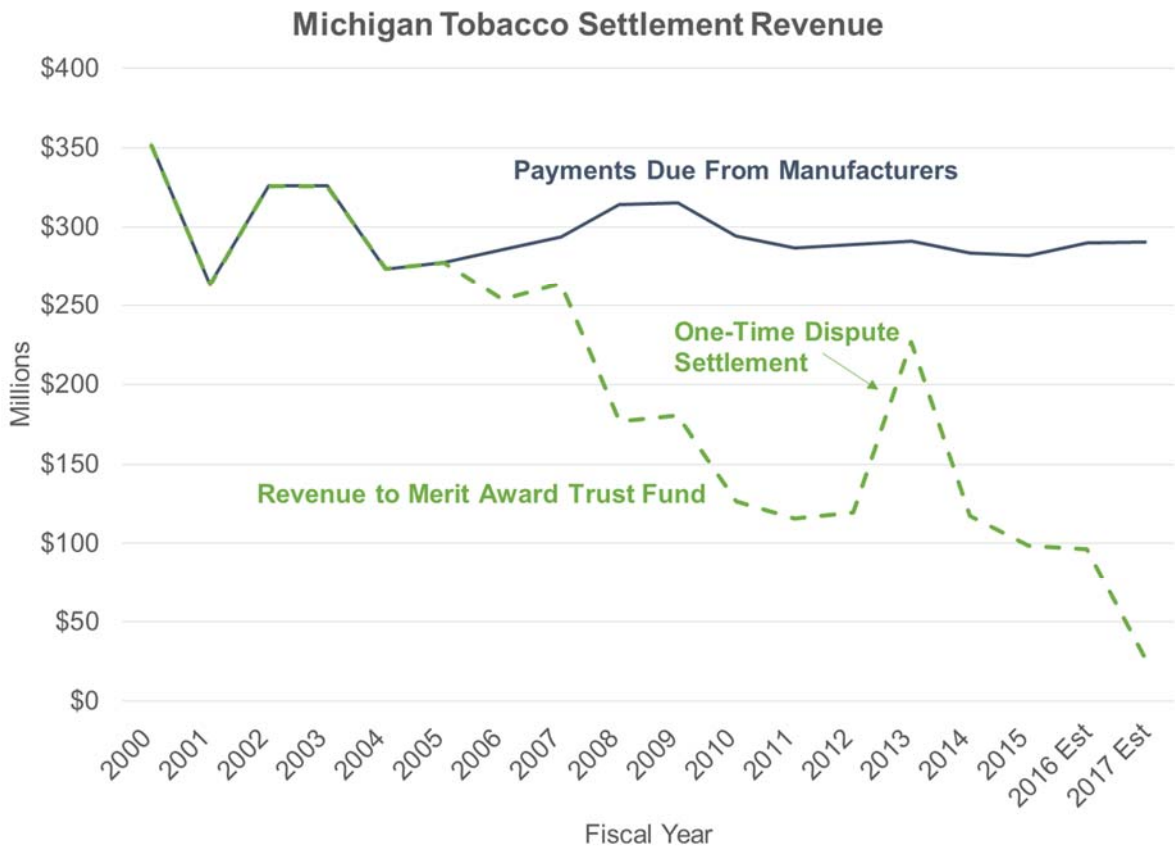
- In 2005, \$400 million was securitized to fund the starting balance of the 21st Century Jobs Fund, an economic development program administered by the Michigan Strategic Fund (MSF).
- In 2007, \$415 million was securitized to help balance the FY 2006-07 state budget.

As a result of these transactions, 24.1% of annual tobacco settlement receipts are now paid as debt service. In FY 2015-16, this debt service amount is \$60 million.

Transfer to 21st Century Jobs Fund: Originally, an additional \$600 million was statutorily earmarked for the 21st Century Jobs Fund through ongoing annual transfers, to bring the total cumulative amount of tobacco settlement funds dedicated to the fund to \$1.0 billion. This was originally to be accomplished through an earmark of \$75 million per year for six years, from FY 2007-08 through FY 2014-15. Due to temporary reductions in the earmark as part of budget balancing efforts, an additional earmark of \$72 million was subsequently created for FY 2015-16. In 2014, the full \$75 million earmark for the 21st Century Jobs Fund was extended through FY 2018-19.

Repayment to Budget Stabilization Fund: In FY 2013-14, a payment of \$195 million was made from the state’s Budget Stabilization Fund (BSF) toward the City of Detroit bankruptcy settlement. In conjunction with this payment, the Michigan Trust Fund Act was amended to provide that \$17.5 million per year in tobacco settlement revenue will be paid back into the BSF over a period of 20 years. (The \$195 million payment out of the BSF was calculated based on the net present value of \$350 million in payments to Detroit over 20 years.)

Transfer to Community District Education Trust Fund: As part of the plan to restructure the Detroit Public Schools (DPS) recently enacted by the Legislature, the Michigan Trust Fund Act was amended to provide that \$72 million per year in tobacco settlement revenue will be transferred to the new Community District Education Trust Fund beginning in FY 2016-17. Total transfers cannot exceed \$617 million, which would allow for the transfer to occur for roughly eight and a half years. These funds will then be utilized in the annual School Aid budget to backfill revenue from the local 18-mill property tax levy that currently supports the foundation allowance for DPS but will instead be diverted to pay off the accumulated debt of the district.



Merit Award Trust Fund

The Michigan Trust Fund Act provides that net tobacco settlement revenue available to the state after withheld payments, arbitration settlement-related adjustments, and the automatic payments described above have been made are to be deposited in the Merit Award Trust Fund (MATF). Under statute, expenditures can be made for the following purposes:

- The Merit Award scholarship program and associated administrative costs. This program was subsequently replaced with the Promise Grant Program, which was then defunded beginning in FY 2009-10.
- The Tuition Incentive Program, a financial aid program targeted at students from low-income families. This program is now funded primarily with federal TANF funds in conjunction with adjustments made to the state's TANF maintenance-of-effort (MOE) plan.
- The Michigan Nursing Scholarship Program, which was defunded beginning in FY 2009-10.
- "Other expenditures as determined by law."

In recent years, available tobacco settlement funds have been used similarly to General Fund/General Purpose (GF/GP) revenue under the final provision cited above. (In some prior years, funds were transferred directly to the state's General Fund to help deal with state budget imbalances.) The two largest uses of the revenue in recent years have been for the state's Medicaid and Family Independence (cash assistance) Programs in the Health and Human Services (DHHS) budget.

In FY 2015-16, a payment of \$48.7 million is being made to DPS for short-term operational costs, prior to the full restructuring plan taking effect. These funds were available from a one-time balance resulting from the arbitration settlement.

Beginning in FY 2016-17, revenue available in the MATF will be quite limited. Only \$26 million is available for appropriation in FY 2016-17. Appropriations have been made for five purposes:

- \$19.7 million for the Medicaid program, effectively offsetting GF/GP funds.
- \$4.1 million for the Aging Respite Care program in the DHHS budget, which provides grants to regional Area Agencies on Aging for respite care services to assist family caregivers providing care to an elderly person in need of constant supervision.
- \$1.2 million for administration of student financial aid programs in the Treasury budget. This appropriation dates back to the Tuition Incentive Program being funded from the MATF, rather than from federal TANF funds.
- \$805,500 for criminal investigation in the State Police budget related to cigarette sales.
- \$495,700 for Attorney General operations, tied to ongoing legal work related to the MSA.

In FY 2017-18, available MATF revenue is expected to increase by about \$25 million per year (to a total of about \$50 million), due to the expiration of arbitration settlement-related credits. The possibility of continued, or increased, withheld payments by the tobacco manufacturers, however, creates uncertainty regarding the precise amount of revenue that will be available for appropriation by the Legislature in future budgets.

Tobacco Settlement Revenue and Expenditure Projections

Based on FY 2016-17 Enacted Budget

Millions of \$

	FY 2014-15 Final	FY 2015-16 YTD	FY 2016-17 Enacted	FY 2017-18 Projected	FY 2018-19 Projected
Tobacco Settlement Receipts					
Payment due from manufacturers	\$281.8	\$290.0	\$290.3	\$301.9	\$300.4
Arbitration settlement-related credits to manufacturers	(30.2)	(24.9)	(23.0)	0.0	0.0
Withheld payments	<u>0.0</u>	<u>(16.1)</u>	<u>(16.0)</u>	<u>(16.6)</u>	<u>(16.5)</u>
Net Receipts	\$251.6	\$249.1	\$251.4	\$285.3	\$283.9
Automatic Payments					
Securitization debt service payments (24.11% of net receipts)	(\$60.7)	(\$60.1)	(\$60.6)	(\$68.8)	(\$68.4)
Transfer to 21st Century Jobs Fund (sunsets after FY 2018-19)	(75.0)	(75.0)	(75.0)	(75.0)	(75.0)
Repayment to Budget Stabilization Fund for City of Detroit settlement payment	(17.5)	(17.5)	(17.5)	(17.5)	(17.5)
Transfer to Community District Education Trust Fund (DPS backfill)	<u>0.0</u>	<u>0.0</u>	<u>(72.0)</u>	<u>(72.0)</u>	<u>(72.0)</u>
Net Revenue to Merit Award Trust Fund	\$98.4	\$96.5	\$26.3	\$52.0	\$50.9
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Merit Award Trust Fund (MATF)					
MATF Beginning Balance	\$75.2	\$61.2	\$0.0	\$0.0	\$25.8
Interest	<u>0.1</u>	<u>0.1</u>	<u>0.0</u>	<u>0.0</u>	<u>0.0</u>
MATF Resources Available	\$173.7	\$157.8	\$26.3	\$52.1	\$76.7
MATF Expenditures					
Medicaid (DHHS)	\$64.3	\$60.6	\$19.7	\$19.7	\$19.7
Family Independence Program (DHHS)	30.1	30.1	0.0	0.0	0.0
Aging Respite Care (DHHS)	4.1	4.1	4.1	4.1	4.1
Financial aid administration (Treasury)	0.9	1.1	1.2	1.2	1.2
Criminal investigations/IT (State Police)	0.8	0.8	0.8	0.8	0.8
Operations (Attorney General)	0.5	0.5	0.5	0.5	0.5
Venture Michigan Fund tax voucher repurchase (DTMB)	11.9	11.9	0.0	0.0	0.0
Payment to Detroit Public Schools for short-term operations (Treasury)	<u>0.0</u>	<u>48.7</u>	<u>0.0</u>	<u>0.0</u>	<u>0.0</u>
TOTAL	\$112.5	\$157.8	\$26.3	\$26.3	\$26.3
MATF Ending Balance	\$61.2	\$0.0	\$0.0	\$25.8	\$50.5