Pennsylvania Department of the Auditor General
Bureau of Special Performance Audits

Jack Wagner, Auditor General
Special Report

March 2011

Public input needed

Should tobacco settlement dollars be spent for health programs like adultBasic and tobacco cessation as intended, or should the monies go to balance the state budget?

Introduction: Why this report? Tobacco settlement monies are no longer keeping critical health initiatives afloat as intended because the funds were quietly diverted to plug holes in the state's annual budgets.

Such initiatives include adultBasic health insurance for 41,000 adults, mostly women, and efforts to prevent, control, and stop tobacco use to keep millions of people, including teens, from suffering tobacco's deadly effects.

This report discusses how tobacco settlement dollars—with little public input—have undergone a sea of change in their transformation from the intended purposes. Furthermore, there is no plan in place to cover the affected programs or to restore their funding.

We call on the Governor and the General Assembly to take immediate action regarding adultBasic, and to hold public hearings about using tobacco settlement dollars as they were originally intended.

Highlights

- There has been little or no public input about Pennsylvania's "redirection" of Tobacco Settlement Fund payments, 92 percent of which are mandated to fund *current* health programs.
- $1.34 billion has been uncoupled from the Tobacco Settlement Fund for other uses.
- The redirections mean that adultBasic health coverage for 41,000 Pennsylvanians—mostly women—was shut down on February 28.
- The redirections also mean that Pennsylvania's tobacco prevention/cessation/control programs were cut to the point where they earned failing grades from the American Lung Association.
- There has also been little or no public input regarding Pennsylvania's raiding of a separate endowment account that should receive and invest the other 8 percent of tobacco payments to use for *future* health programs.
- In one raid of the endowment account, the state took $121 million to prop up the public school employees' pension plan.
- The endowment account will be decimated by June 1, 2011.

Background: Tobacco companies agreed to pay billions of dollars to Pennsylvania.

In November 1998, Pennsylvania was among 46 states that jointly settled a lawsuit with five major tobacco companies to recover past, present, and future medical expenses for Medicaid enrollees with tobacco-related illnesses.

The joint settlement—called the Master Settlement Agreement—ended a four-year legal battle and obligated the tobacco companies to pay sums to each of the 46 states beginning in 2000. There was no end date specified, but states typically used a 25-year period to compute projections. Thus, over 25 years, the full cost to the tobacco companies was projected to be $206 billion. Of that amount, Pennsylvania was projected to receive about $11.2 billion.

The actual and projected annual payments to Pennsylvania are shown at right.

Good intentions: Make Pennsylvanians healthier.

In January 2000, then-Governor Tom Ridge issued *Pennsylvania's Health Investment Plan* that proposed initiatives to be funded by the annual settlement monies. A statement from that plan was included in the Governor's Executive Budget for 2001-02:

> Pennsylvania has positioned itself as a national leader by proposing that the use of the tobacco settlement proceeds be limited to initiatives designed to improve the health status of its citizens.

The *Health Investment Plan* contained several principles to guide the Commonwealth in

Tobacco company settlement agreement payments to Pennsylvania *(actual and projected)*

Actual payments by fiscal year[1/]	
1998-99	$142,262,000
1999-00	$464,554,000
2000-01	$345,013,000
2001-02	$433,529,000
2002-03	$416,918,000
2003-04	$370,857,000
2004-05	$366,258,000
2005-06	$336,227,000
2006-07	$351,928,000
2007-08	$382,003,000
2008-09	$419,238,000
2009-10	$349,843,000
Total actual payments	**$4,378,630,000**
Projected payments[2/]	
2011 through 2018[3/]	$370,000,000 Each year
2019 through 2025	$355,000,000 Each year
Total actual and projected payments	**$9,823,630,000**

1/ 1998-99 through 2008-09 figures are from annual Governor's Executive Budget documents. Figures for 2009-10 are from the Department of the Auditor General's audit report of the Tobacco Settlement Fund for that year. Please note that the figures for 2008-09 and 2009-10 include not just the annual settlement payments but also the strategic contribution payments (see page 6).
2/ Governor's Executive Budget for FY 2010-11.
3/ Includes $355 million for the annual settlement payments *plus* $15 million for strategic contribution payments.

using the tobacco settlement proceeds, including these two most applicable here:

- To make Pennsylvanians healthier.
- To set aside a portion of funding so that the health of future generations of Pennsylvanians can benefit, too.

Consensus: The General Assembly agreed with the plan to make health care the priority. By passing the Tobacco Settlement Act (Act 77 of 2001), Pennsylvania's General Assembly signified its agreement with the principles outlined in the *Health Investment Plan*, including making Pennsylvanians healthier and setting aside funds for future generations.

The state heralded its plan as a bipartisan effort focused solely on improving the health of Pennsylvanians. In contrast, other states did not focus solely on health-related uses and/or chose to use settlement monies to boost their general funds.

Administration: Who and what. The Act created the Tobacco Settlement Investment Board to manage and invest the monies. The Act also created the *Tobacco Settlement Fund* as the account to receive and disburse the annual settlement payments.

Also created was the forward-looking *Health Endowment Account for Long-Term Hope.* This visionary endowment account was created to receive a portion of the annual Master Settlement Agreement payments for investment, thus providing a means to keep health programs going in the future if the annual settlement payments decreased or stopped.

Mandate: The settlement agreement specified how to divide the annual payments. The Tobacco Settlement Act mandated that the annual Master Settlement Agreement payments should be used according to these percentages:

8% to be put aside for future health programs
- Deposit into Health Endowment Account

92% to be used for current health programs
- 30% to share between adultBasic insurance and Medicaid for workers with disabilities
- 18% for health research
- 13% for home- and community-based services for the elderly
- 12% for tobacco use prevention and cessation programs
- 10% to reimburse hospitals for the uncompensated care they provide
- 8% to expand PACENET, the Pharmaceutical Assistance Contract for the Elderly (PACE) Needs Enhancement Tier
- 1% for cancer-specific health research

Implementation: Is health care still the priority? Even though the Tobacco Settlement Act specifically mandated how settlement payments should be appropriated to cover various health initiatives, Pennsylvania chose to "redirect" many of the monies beginning in fiscal year 2005-06 and continuing every year thereafter through fiscal year 2010-11.

The redirections were authorized by mandates in annual budget acts, thus superseding the original Tobacco Settlement Act mandates.

A direct result of the redirections was a dramatic funding cut for two critical initiatives — the tobacco use prevention and cessation program and the adultBasic health insurance program, both discussed next.

Up in smoke: Tobacco use prevention and cessation program. We noted on page 3 that, of the funds mandated to support current health initiatives, 12 percent was intended to pay for programs that would prevent, decrease, or stop tobacco use. But that 12 percent share didn't last long before the state lowered it, first to 8 percent (years 2005-06 through 2008-09) and then to 5 percent (years 2009-10 and 2010-11).

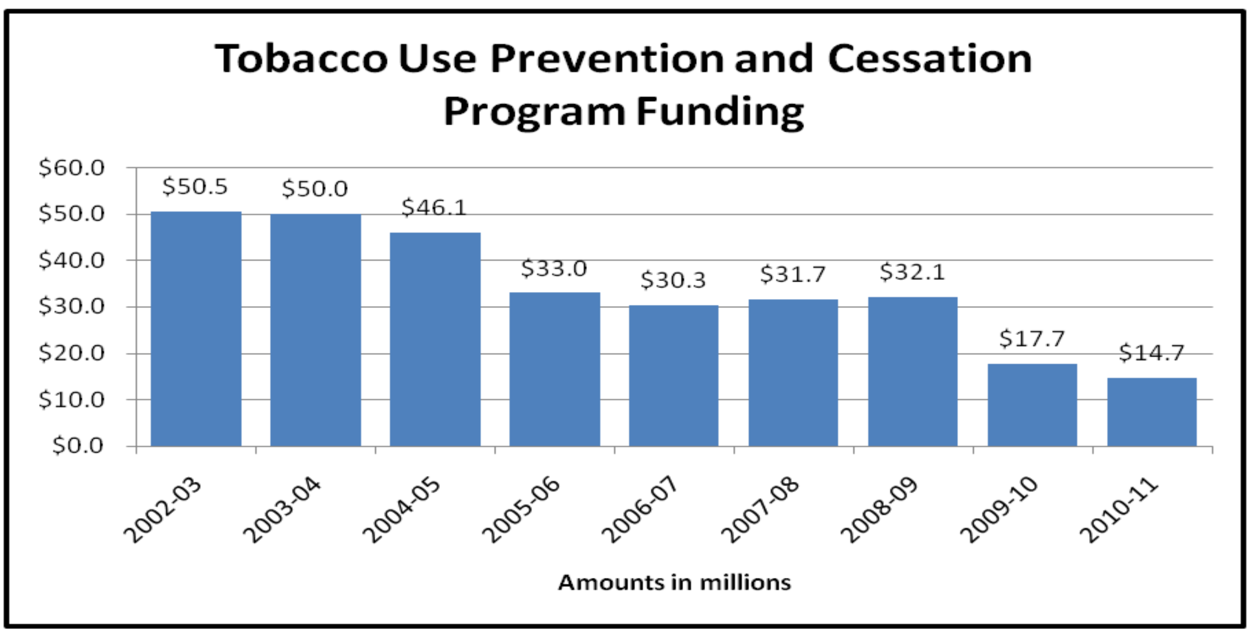
In dollar amounts, the funding dropped from a high of $50.5 million in 2002-03 to a low of $14.7 million (2010-11).

Used by the state Department of Health both locally and statewide, the funds went for tobacco education and awareness, including media campaigns. In fact, television advertising generated most of the calls to the state's quit-smoking hotline (1-800-784-8669), according to Health officials. But the severe funding cuts in recent years allowed only a single statewide media campaign annually.

Also cut back were local programs, including those focused on educating children about the dangers of smoking. Those programs received only a quarter of the annual funding they needed.

Funding was so meager that the American Lung Association in 2010 gave Pennsylvania grades of "F" for tobacco prevention and control *and* for cessation efforts, saying "Thumbs down to Pennsylvania for cutting state funding for its tobacco control program by close to 55 percent over the past two years."

Unfortunately, Pennsylvania was not alone in receiving failing grades. In fact, the American Lung Association's report cited four major trends nationwide, including this one: "States continued to turn to tobacco taxes to balance budgets and then failed to help smokers quit."



Each year, more than 20,000 Pennsylvanians die from the effects of smoking. Each year, too, Pennsylvanians spend more than $5 billion to treat smoking-related illnesses.

These statistics cannot improve if the state is unable to counterbalance the sophisticated marketing efforts of tobacco companies.

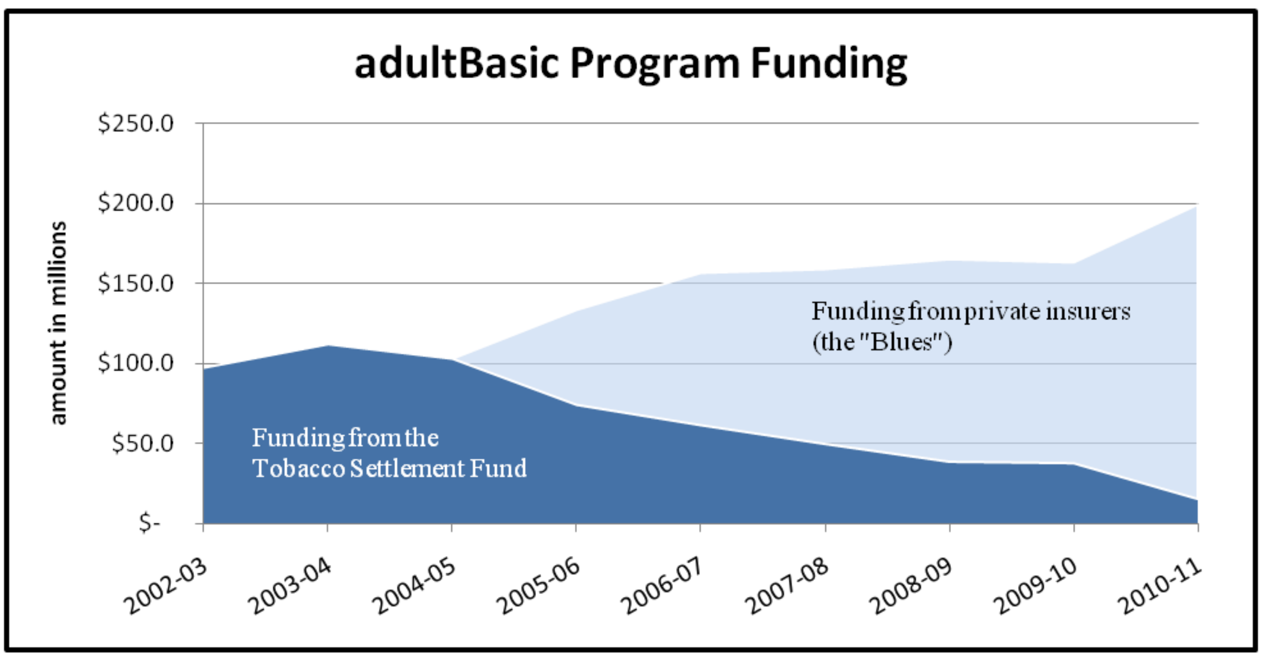
Gone: adultBasic health insurance. For thousands of people who earn too much to qualify for Medicaid but not enough to buy health insurance, the state's adultBasic health insurance program filled a critical need. Tobacco monies allowed the state to subsidize this basic coverage so that enrollees paid just $36 a month. At its highest, adultBasic had 54,000 enrollees.

Most enrollees—63 percent—were women. But coverage ended on February 28. There were 41,000 enrollees when coverage ended, along with a waiting list of 505,000. That's half a million people who needed this coverage but never had a chance to get it. The state originally paid for adultBasic with annual tobacco settlement monies, $98 million in fiscal year 2002-03, $112 million in fiscal year 2003-04, and $103 million in fiscal year 2004-05. But over the next six years, Pennsylvania cut its portion from $74 million to less than $22 million by counting on agreements with health insurers Capital Blue Cross, Highmark, Independence Blue Cross, and Blue Cross of Northeastern Pennsylvania, to make up the difference.

The tobacco monies that formerly paid for adultBasic were redirected elsewhere, even as health care costs increased and even as the waiting list for adultBasic grew.

The four health insurers, collectively known as the "Blues," fulfilled their original agreement to pay into adultBasic until December 31, 2010, after which the state had no plan in place to restore funding. The Blues again provided funds for coverage that lasted through the end of February 2011. But now, as before, the state has no plan to use incoming tobacco settlement dollars to pick up where it left off before the Blues stepped in on the state's behalf.

It's important to emphasize that adultBasic was *not* an entitlement. Again, enrollees



paid premiums of $36 a month and qualified for the program only if they were not eligible for Medicaid or were otherwise uninsured. Most enrollees were women—many with jobs where health coverage is not a benefit.

There have been calls for health insurers, including for-profit insurers, to pick up the funding, but these calls distract the public from recalling that it was tobacco settlement monies that were intended to pay for adultBasic from the start.

Future funding: Where does it stand? As we stated earlier in this report, the Health Endowment Account for Long-term Hope was created to set aside funds for future use. The Tobacco Settlement Act also provided that the endowment account could be used for health care needs in certain situations. Specifically, the law states this:

> Whenever the Governor determines that money from the Health [Endowment] Account is necessary to meet the extraordinary or emergency health care needs of the citizens of this Commonwealth...the General Assembly may...appropriate money from the Health [Endowment] Account to meet the needs identified in the Governor's request.

The lack of funding for the 41,000 adultBasic enrollees could be considered an extraordinary health care need. Now, however, even the Health Endowment Account will be wiped out by June 1, 2011.

The decimation of the endowment account results from the same annual budget acts that directed money away from tobacco prevention and cessation programs and adultBasic. The state simply sent the intended endowment monies elsewhere.

Here's where the endowment account *should have* received its deposits, according to the Tobacco Settlement Act:

- ✓ The *initial/jurisdictional* payments received by the Commonwealth, as required by the Master Settlement Agreement.
- ✓ Eight percent of each *subsequent* annual Master Settlement Agreement payments received by the Commonwealth.
- ✓ Each of ten strategic contribution payments (these are payments made to states that incurred litigation costs related to the settlement) from 2008 to 2017, as required by the Master Settlement Agreement.
- ✓ Investment/interest earnings of the Tobacco Settlement Fund after deduction of investment expenses.
- ✓ Investment/interest earnings of the endowment account itself after deduction of investment expenses and other approved expenses of the Tobacco Settlement Investment Board.
- ✓ Investment/interest earnings of the *Health Venture Investment Account*, another Tobacco Settlement Fund account.
- ✓ Income that will be shared, once certain thresholds have been met, from the *Life Science Greenhouse* program, a self-sustaining investment vehicle started by the Tobacco Settlement Fund.
- ✓ Lapses (monies appropriated but not spent by year end) from certain programs that are funded by annual tobacco payments.

By continually adding to the endowment account and investing the monies within it as originally intended, the state planned to accumulate and grow funds that would be available to extend health initiatives if tobacco companies stopped making payments. But **with virtually no public input,** Pennsylvania took the account in a different direction from the original plan beginning as early as 2002-03, only one year after the endowment account was created. At that time, the state started transforming the endowment account from a long-term investment vehicle to a short-term checking account to plug holes in the state budget.

Such actions continued nearly every subsequent year, likely fueled by the lack of attention the shifts generated.

The annual budget acts discussed earlier (i.e., those that directed Tobacco Settlement Fund monies elsewhere) were also used to legitimize the demise of the endowment account. In fact, the first redirection of endowment funds in fiscal year 2002-03 resulted when the annual budget act

Demise of the Health Endowment Account for Long-Term Hope

Fiscal year	Ending balance	Factors leading to the declining balance
FY 2007-08	**$658,580,000**	✓ Interest in Tobacco Settlement Fund remains there instead of being transferred to Health Endowment Account ✓ Interest from Health Endowment Account is transferred to Tobacco Settlement Fund and not kept in endowment account
FY 2008-09	**$531,973,000**	✓ $15 million of interest in Tobacco Settlement Fund remains there instead of going to Health Endowment Account ✓ $50 million of interest in Health Endowment Account is shifted to Tobacco Settlement Fund ✓ Strategic contribution payment is deposited into Tobacco Settlement Fund rather than Health Endowment Account
FY 2009-10	**$432,711,922**	✓ $15 million of interest in Tobacco Settlement Fund remains there instead of going to Health Endowment Acct. ✓ $10 million of interest in Health Endowment Account is transferred to Tobacco Settlement Fund ✓ Strategic contribution payment is deposited into Tobacco Settlement Fund rather than Health Endowment Account ✓ 8% of Master Settlement Agreement payment goes to Tobacco Settlement Fund, not Health Endowment Account ✓ $150 million is transferred to General Fund
FY 2010-11 (pursuant to Act 46 of 2010)	**$0**	✓ $15 million of interest in Tobacco Settlement fund remains there instead of going to Health Endowment Account ✓ Strategic contribution payment is deposited into Tobacco Settlement Fund rather than Health Endowment Account ✓ 8% of Master Settlement Agreement payment goes to Tobacco Settlement Fund, not Health Endowment Account ✓ $121 million is used to make payment to Public School Employees' Retirement System on behalf of General Fund ✓ Any remaining $$ get transferred out of Health Endowment Account to Tobacco Settlement Fund by June 1, 2011

mandated that the endowment account would *not* get the interest earned on the Tobacco Settlement Fund as originally required. Instead, the Tobacco Settlement Fund kept the interest for itself.

In fiscal years 2005-06 through 2007-08, Pennsylvania's annual budget acts mandated that interest earned on the Tobacco Settlement Fund would again remain there rather than helping to build the endowment account. Another mandate made even the endowment account give its interest to the Tobacco Settlement Fund.

In a February 2009 special performance audit report of the Tobacco Settlement Investment Board, we calculated that the above shifts caused the endowment account alone to miss out on at least $112.1 million since fiscal year 2002-03 through fiscal year 2007-08, plus whatever interest could have been earned on that $112.1 million.

The redirection was more severe starting in 2008-09 as more endowment revenues went to the Tobacco Settlement Fund and the General Fund. The table on the previous page illustrates the falling balances.

Covering budget shortfalls: The right decision? Just like the endowment account gave $150 million to the state's General Fund in fiscal year 2009-10 and $121 million to fulfill a General Fund obligation for making a required contribution to PSERS (Public School Employees' Retirement System) in fiscal year 2010-11, now the Tobacco Settlement Fund itself is being used to plug state budget holes.

Specifically, since fiscal year 2002-03, $795.3 million of Tobacco Settlement Fund monies were allocated to long-term care costs traditionally paid with General Fund monies.

In other words, the state used monies intended for adultBasic, tobacco prevention, and the Health Endowment Account to pay for—on behalf of the General Fund—Medicaid long-term care for seniors and persons with disabilities, thus freeing up the General Fund for other purposes.

What legislator could argue against helping Pennsylvania seniors and persons with disabilities? Using the information available, legislators decided to pay for *current* long-term care costs for hundreds of thousands of *known* beneficiaries versus putting money into an endowment account for *future* beneficiaries as yet *unknown* and *unnumbered*. But with no public hearings or floor debates, legislators would not have heard the following questions:

- **?** What happened to the **traditional** funding that paid for the costs of long-term care services for seniors and persons with disabilities? ***Unknown***
- **?** Why did the traditional long-term care funding need to be "offset" by health endowment monies? ***See next question***
- **?** Was the offset needed so the traditional sources of long-term care funding could be used to plug holes elsewhere in the state's budget? ***Yes***

Another $32.4 million was transferred from the Tobacco Settlement Fund to the General Fund for unspecified purposes when Pennsylvania reduced the tobacco prevention program in fiscal years 2009-10 and 2010-11. Finally, a diversion of $250 million to the General Fund will occur by June 1, 2011, again for unspecified purposes.

$1.34 billion in quiet "redirections" *Where did they go?*	
To the General Fund for unspecified purposes: ✓ $150 million from Health Endowment Account ✓ $32.4 million from Tobacco Settlement Fund ✓ $250 million from Tobacco Settlement Fund	$ 432.4 million
✓ To the General Fund for a Commonwealth-required contribution to the Public School Employees' Retirement System	$ 121.0 million
✓ To fund Medicaid long-term care for seniors and persons with disabilities	$ 795.3 million

More consequences: Now what? With 41,000 Pennsylvanians who lost their adultBasic health insurance benefits, with Pennsylvania receiving an F grade for its tobacco use prevention and cessation program, and with the Health Endowment Account emptied by June 1, 2011, it is unknown where the state will go from here in deciding how to use its remaining annual Master Settlement Agreement payments as they arrive.

In short, with the potential of $5.4 billion in tobacco settlement monies coming to Pennsylvania in the next 15 years, the state must decide if it will continue to allow the funds to plug the state budget, or if they should pay for critical health programs as the General Assembly originally intended.

Recommendations: Immediate action and public input needed. The Governor and the General Assembly should be open and fully transparent regarding the use of Tobacco Settlement monies. Thus, we recommend the following:

1. The Governor and the General Assembly should use incoming tobacco settlement dollars for adultBasic to bridge the gap until health insurance becomes widely available on January 1, 2014, under federal health care reform. If more dollars are needed, other sources of funding—both public and private—should be explored.

2. The Governor and the General Assembly should hold immediate public hearings throughout the Commonwealth to discuss the use of incoming tobacco settlement dollars long-term. The following questions should be answered:

   - Whether tobacco settlement dollars should be used according to the original intentions, including funding critically important tobacco prevention and cessation programs.
   - If new/different priorities should be established.
   - If and how the Health Endowment Account should be restored.

Questions about this report? Contact the Pennsylvania Department of the Auditor General, Office of Communications, 318 Finance Building, Harrisburg, Pa., 17120, 717-787-1381. Or visit online at www.auditorgen.state.pa.us.