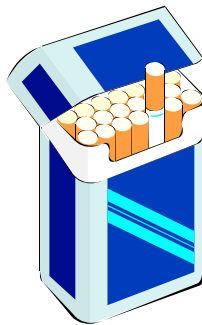


Illinois' Cigarette Tax, Tobacco Products Tax, and Tobacco Settlement Update



Commission on Government Forecasting and Accountability
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Springfield, Illinois 62706
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**Commission on Government
Forecasting and Accountability**

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EXECUTIVE SUMMARY

The State's cigarette tax and tobacco products tax are a significant source of revenue for Illinois. In FY 2006, \$640 million was generated from the taxes, \$621 million from the cigarette tax and \$19 million from the tobacco products tax. Monies from these taxes are used for schools, long-term care medical bills, and general State expenses. The FY 2006 amount is nearly \$172 million higher than what was collected in FY 2002. The reason for this increase is the 40-cent per pack increase levied on cigarettes in 2002.

Cigarettes sold in Illinois are subject to several taxes including: the State tax; the federal tax; and, in some areas, city and county taxes. Cigarettes are therefore susceptible to a number of different tax increases, which has been the case in Illinois over the past couple of years. Combining all taxes, the City of Chicago now has the highest cigarette taxes in the nation. Many feel that the cigarette tax is an ideal taxing source because it not only creates additional revenues, but also can improve the health of individuals as cigarette consumption usually declines in response to higher prices associated with the tax increases.

Recent data show that the number of packs purchased in Illinois has fallen approximately 21% since FY 2002. While the tax increases may have caused a number of people to stop smoking, it also may have prompted consumers to look elsewhere to purchase their cigarettes, such as bordering states, the Internet, or through illegal vendors. These relocated purchases result in lost revenue for State and local governments. This report takes a closer look at the impact that the various cigarette tax increases have had on Illinois and its residents. It begins with a summary of the cigarette tax and the distribution of its revenue.

The report also provides an update on the national tobacco settlement and includes background behind the multi-state agreement and summary of the amounts that have been received so far from the settlement. This section also shows where the proceeds have been distributed and where the money has been appropriated in FY 2006 and FY 2007. The report closes by showing how Illinois compares to the nation in the distribution of the settlement funds. Highlights of the report are summarized below.

- Between FY 1992 and FY 2006, total revenue from the cigarette and tobacco products tax has ranged from \$310 million in FY 1992 to \$760 million in FY 2004. Recently, however, revenues have fallen to \$640 million in FY 2006. A decline in consumption levels in reaction to the various tax increases is likely the major reason for this decrease.
- In FY 2006, of the \$640 million collected from these taxes, the money was distributed as follows: \$245 million to the General Revenue Fund; \$154 million to the Common School Fund; \$60 million to the School Infrastructure Fund; and \$181 million to the Long-Term Care Provider Fund.
- As of January 1, 2006, at \$0.98 per pack, Illinois is the 21st highest cigarette-taxing state in the nation. Rhode Island is the highest ranked taxing state at \$2.46 per pack of cigarettes, followed by New Jersey (\$2.40) and Washington (\$2.025). Missouri is currently the lowest cigarette taxing state at \$0.17 per pack.

- Chicago's combined tax total of \$4.05 per pack is the highest in the nation. Evanston is ranked 2nd in the nation with a total tax amount of \$3.69. Cicero is ranked 3rd at \$3.53 per pack and Rosemont is ranked 4th at \$3.42 per pack.
- There are several reasons cited for cigarette tax increases. These include: additional revenues; it is less controversial; cigarette tax increases tend to lead to lower cigarette consumption and therefore fewer medical problems; and, reduces bills for Illinois residents and for governments.
- In FY 2006, the Commission estimates that roughly 634 million packs of cigarettes were sold in Illinois, which is a four-year decline of 21.6%. However, this large decline is not just due to the State tax increase, but also likely due to the significant tax increases in both Cook County and the City of Chicago.
- A Chicago cigarette consumer can save \$31.05 per carton *in taxes alone* by purchasing the carton in Indiana instead of in the City of Chicago. Between CY 2004 and CY 2005, the number of packages of cigarettes taxed in Illinois dropped 4.3%. However, Indiana actually experienced an increase in packages of cigarettes taxed, albeit a slight increase, at 0.7%.
- Many are concerned with the additional tax burden that has fallen on low-income people due to these tax increases. This is because lower-income segments of the population tend to smoke in greater proportion than higher-income people.
- Since Illinois received its first tobacco settlement payment of \$115.2 million (the 1998 initial payment) in December 1999, it has since received a total of \$2.065 billion in tobacco settlement payments (thru June of 2006). The amount of \$273 million received in FY 2006 is only 84% of the \$326 million that was originally scheduled to have been received in FY 2006.
- The amount of the settlement payment fluctuates annually and is based on cigarette consumption, inflation, and the gain in market share by cigarette manufacturers that are not participating in the agreement. The latter has been the main focus of the lower-than-expected payment amounts received in recent years.
- The tobacco settlement money has been used to fund programs for the elderly, tobacco prevention control, medical research, venture-tech, and Medicaid drug programs. The funds also have been used to fund the earned-income tax credit.
- In FY 2006, the 46 states under the settlement agreement reported that they allocated the largest portion of their combined MSA payments and securitized proceeds to health-related programs (32%) and debt service (29%). Since the MSA was signed, 15 of the 46 states have securitized all or part of their payments.

Cigarette Tax – Rate and Base

The State of Illinois imposes a matching pair of taxes on cigarettes: the cigarette tax and the cigarette use tax. Wholesale distributors collect the cigarette tax from retailers, who collect the use tax from customers. Retail sellers are relieved of paying the use tax if they pay the cigarette tax to distributors. Regardless of the method of taxation, the entire cigarette tax liability ultimately falls on the consumer. Distributors are responsible for sending the money to the State. Licensed distributors prepay the cigarette tax through the purchase of stamps, which are affixed to each cigarette package.

Taxes on cigarettes were first imposed in 1941 at a rate of 2-cents per pack of 20. Rate changes since its enactment increased the tax to 9-cents per pack in 1967, 20-cents per pack in 1985, 44-cents per pack in 1993, 58-cents per pack in 1997, and to the current level of 98-cents per pack in July of 2002. A table showing the State's cigarette tax rate history is shown below.

History of Cigarette Tax Rates in Illinois
(in cents)

Year	Per Cigarette	Per Pack of 20	Year	Per Cigarette	Per Pack of 20
1941	.10	2	1969	.60	12
1947	.15	3	1985	1.0	20
1959	.20	4	1989	1.5	30
1960	.15	3	1993	2.2	44
1961	.20	4	1997	2.9	58
1965	.35	7	2002	4.9	98
1967	.45	9			

The federal government also taxes cigarettes at a rate of 39-cents per pack of 20 cigarettes. In addition, State law authorizes a municipal cigarette tax of 1-cent per package of 20, but it cannot be imposed by municipalities in which the State already collects a municipal home-rule retailers' occupation (sales) tax. State law allows home-rule units to collect their own taxes on cigarettes. Those that utilize this rule include Cook County (\$2.00 per pack), the City of Chicago (\$0.68), Cicero (\$0.16), Evanston (\$0.50) and Rosemont (\$0.05).

There is a separate tax for tobacco products other than cigarettes at a rate of 18% of wholesale price. This includes products such as cigars, snuff, chewing tobaccos, and other forms of tobacco suitable for chewing or smoking. **For the purposes of this report, revenues from the tobacco products tax are included in cigarette tax revenue totals.** In FY 2006, tobacco products revenues made up \$19 million or only 3% of total tobacco related revenues.

State Cigarette Tax Distribution

Revenues from the State cigarette taxes are distributed in the following manner:

1. Beginning in 2006, 1-cent per pack of 20 cigarettes (.05-cents per cigarette) to the General Revenue Fund.
2. \$9 million per month of the amount resulting from the increase enacted in 1985 to the Common School Fund.
3. All additional revenue from the 1997 increase of 14-cents per pack to the Common School Fund.
4. An amount that when added to the amount paid into the Common School Fund, equals \$33.3 million per month, to the General Revenue Fund. (Note: This amount lowers to \$29.2 million per month beginning in FY 2007).
5. Remainder:
 - a. Any unpaid amounts required to be paid into the General Revenue Fund for past months;
 - b. \$5 million per month to the School Infrastructure Fund beginning on April 1, 2003;
 - c. Any unpaid amounts required to be paid into the School Infrastructure Fund for past months;
 - d. Any unpaid amounts to be paid into the Long-Term Care Provider Fund.

Source: Legislative Research Unit's Tax Handbook for Legislators, 22nd edition.

To simplify, in FY 2006, the distribution of these cigarette taxes required a total of \$33.3 million per month, or nearly \$400 million per year to be distributed into the State's general funds. (In FY 2007 and thereafter, the amount distributed into the State's general funds is reduced to \$29.2 million per month or \$350 million per year). The remainder then goes into the various other non-general funds mentioned previously.

For the tobacco products tax, 100% of its revenue goes into the Long-Term Care Provider Fund.

In FY 2006, \$621 million was collected from the State cigarette tax and \$19 million was collected from the tobacco products tax. This money was deposited into the following funds:

General Revenue Fund:	\$245.2 million
<u>Common School Fund:</u>	<u>\$154.4 million</u>
<i>Total General Funds:</i>	<i>\$399.6 million</i>
School Infrastructure Fund:	\$60.0 million
<u>Long-Term Care Provider Fund:</u>	<u>\$180.7 million</u>
TOTAL:	\$640.3 million

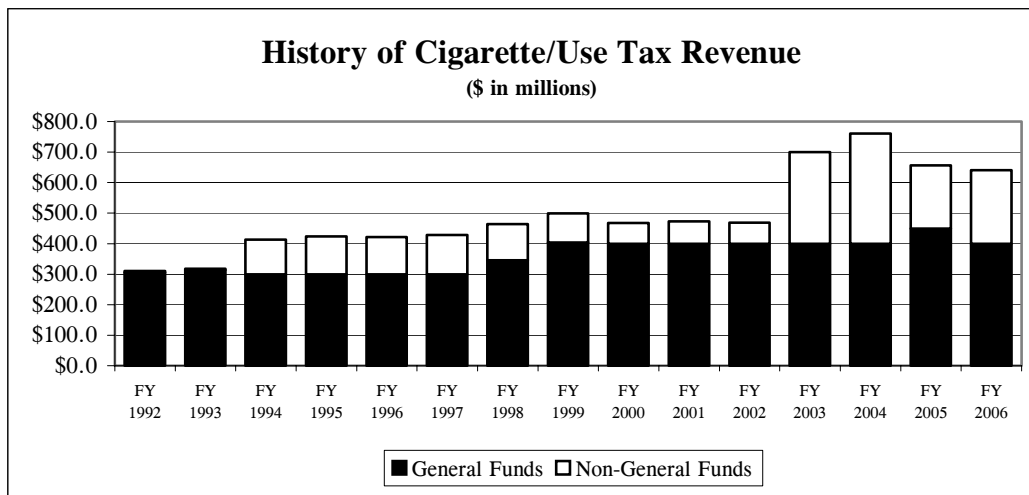
Revenue Collections History

Revenue from the State’s cigarette tax has experienced a significant amount of volatility over the last several years. Much of this volatility is due to three separate increases in the State tax rate, especially the \$0.40 increase that occurred in 2002. Between FY 1992 and FY 2006, revenue from the cigarette tax ranged from \$310 million in FY 1992 to \$760 million in FY 2004. However, revenues fell to \$640 million in FY 2006. A decline in consumption levels in reaction to the various tax increases is likely the main reason for this decrease. Below is a history of State cigarette and tobacco product tax revenue since FY 1992.

Total Cigarette and Tobacco Products Tax Revenue Annual Percentage Changes

Fiscal Year	Revenue	% Change	Fiscal Year	Revenue	% Change
1992	\$310	-2.8%	2000	\$467	-6.4%
1993	\$318	2.6%	2001	\$473	1.3%
1994	\$417	31.1%	2002	\$469	-0.8%
1995	\$424	1.7%	2003	\$700	49.3%
1996	\$422	-0.5%	2004	\$760	8.6%
1997	\$428	1.4%	2005	\$656	-13.7%
1998	\$464	8.4%	2006	\$640	-2.4%
1999	\$499	7.5%			

The amount of cigarette tax revenue deposited into the general funds reached its current monthly level on January 1, 1998, when the amount changed from \$25 million to \$33.3 million per month, or nearly \$400 million per year. In FY 2005, this amount increased to \$450 million due to a one-time distribution change. In FY 2006 the amount again was \$400 million. (Again, in FY 2007 and thereafter, the amount distributed into the State’s general funds will be reduced to \$29.2 million per month, or \$350 million per year). A chart displaying the revenue history of the general and non-general funds of the State’s cigarette tax is shown below.



How Illinois Compares to Other States

As of January 1, 2006, at \$0.98 per pack, Illinois is the 21st highest cigarette-taxing state in the nation. Rhode Island is the highest ranked taxing state at \$2.46 per pack of cigarettes, followed by New Jersey (\$2.40) and Washington (\$2.025). Missouri is currently the lowest cigarette taxing state at \$0.17 per pack. A list of all the states and their cigarette tax ranking is provided below.

STATE EXCISE TAX RATES ON CIGARETTES (January 1, 2006)

STATE	TAX RATE (¢ per pack)	RANK	STATE	TAX RATE (¢ per pack)	RANK
Alabama (1)	42.5	39	Nebraska	64	30
Alaska	160	7	Nevada	80	25
Arizona	118	16	New Hampshire	80	25
Arkansas (2)	59	32	New Jersey	240	2
California	87	23	New	91	22
Colorado	84	24	New York (1)	150	10
Connecticut	151	8	North Carolina (3)	30	45
Delaware	55	35	North Dakota	44	38
Florida	33.9	44	Ohio	125	13
Georgia	37	41	Oklahoma	103	18
Hawaii	140	11	Oregon	118	16
Idaho	57	33	Pennsylvania	135	12
Illinois (1)	98	21	Rhode Island	246	1
Indiana	55.5	34	South	7	51
Iowa	36	42	South	53	37
Kansas	79	27	Tennessee (1) (2)	20	48
Kentucky (2)	30	45	Texas	41	40
Louisiana	36	42	Utah	69.5	29
Maine	200	4	Vermont	119	15
Maryland	100	19	Virginia (1)	30	45
Massachusetts	151	8	Washington	202.5	3
Michigan	200	4	West Virginia	55	35
Minnesota (4)	123	14	Wisconsin	77	28
Mississippi	18	49	Wyoming	60	31
Missouri (1)	17	50	Dist. of	100	19
Montana	170	6			
			U. S. Median	80	

(1) Counties and cities may impose an additional tax on a pack of cigarettes in AL, 1¢ to 6¢; IL, 10¢ to 15¢; MO, 4¢ to 7¢; NYC \$1.50; TN, 1¢; and VA, 2¢ to 15¢.

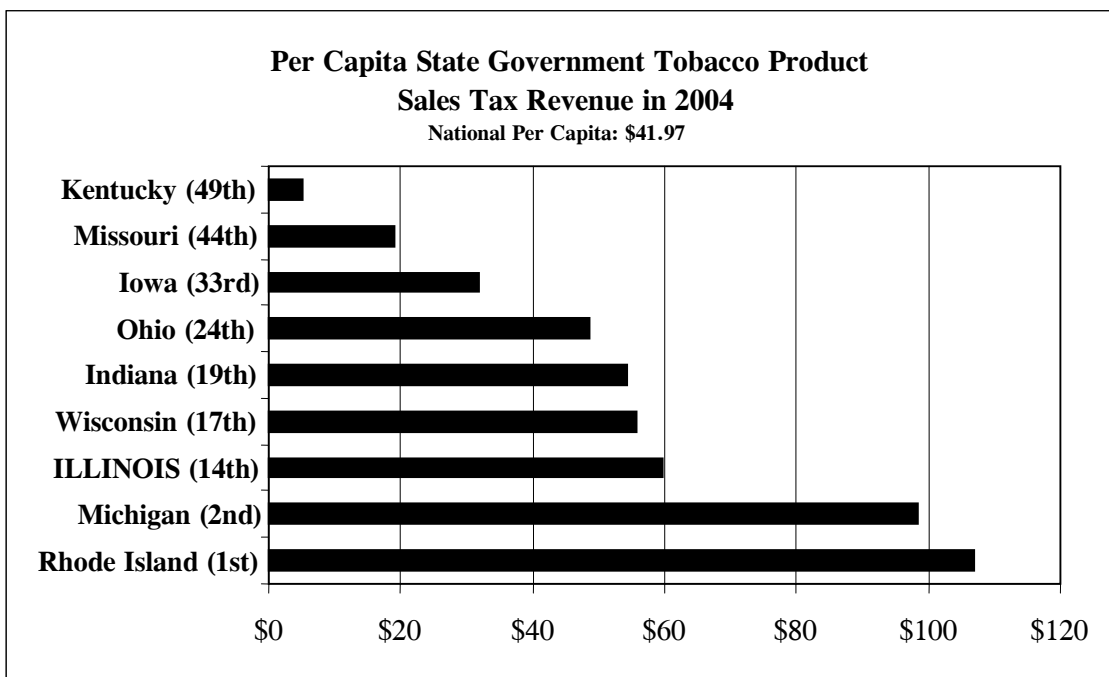
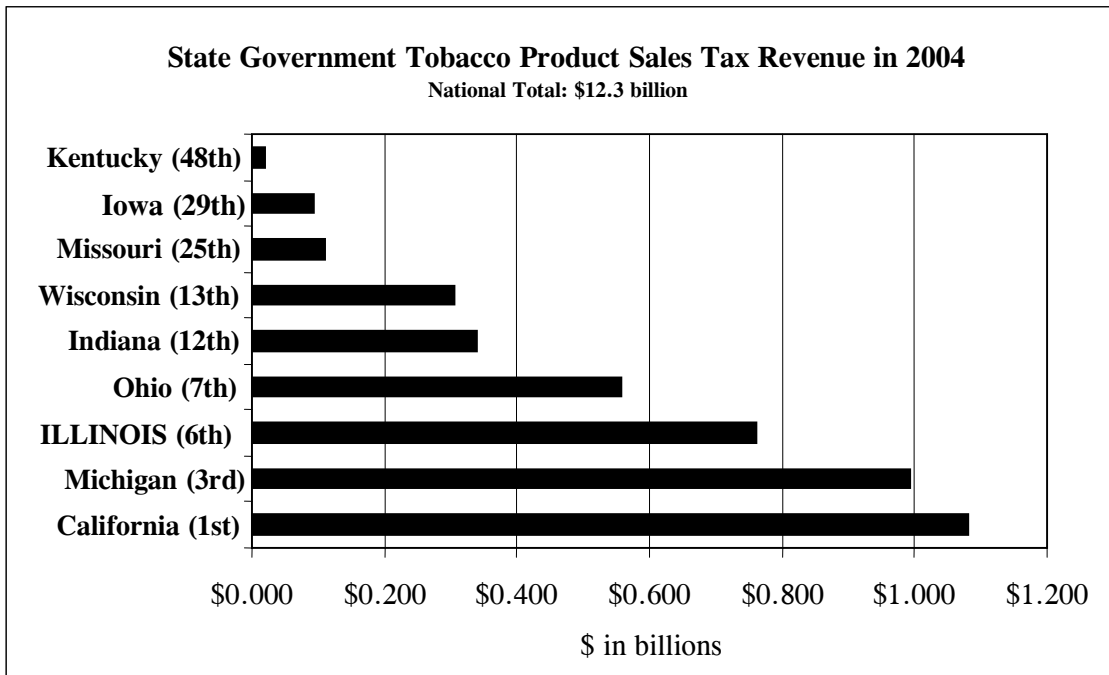
(2) Dealers pay an additional enforcement and administrative fee of 0.1¢ per pack in KY and 0.05¢ in TN. In AR, a \$1.25/1,000 cigarette fee is imposed.

(3) Tax rate is scheduled to increase to \$0.35 per pack on July 1, 2006.

(4) Plus an additional 25.5 cent sales tax is added to the wholesale price of a tax stamp (total \$1.485).

Source: www.taxadmin.org

In terms of state government tobacco product sales tax revenue, in 2004, Illinois was the 6th highest rated state in the nation in total revenues (\$760 million) according to the 2006 edition of *State Rankings*. (While referred to as “sales tax revenue” in this source, it pertains to the cigarette and tobacco products tax, not Illinois’ sales tax). The highest ranked state was California (\$1.082 billion). On a per-capita basis, Illinois ranked 14th in the nation at \$59.80 per capita. Rhode Island was first at \$106.96 per capita. Charts depicting these rankings are shown below. The charts identify Illinois’ ranking, along with other Midwestern states, as well as the top ranked state for each category.



In most areas throughout Illinois, the total tax that a consumer would pay for cigarettes is \$1.37 per pack (39-cent federal tax plus the 98-cent State tax). However, those areas with a county tax and/or city tax pay more than this amount. For example, cigarettes purchased in the City of Chicago consist of \$4.05 in various taxes. This total tax amount is broken out in the following manner:

Federal Rate: \$0.39 (per pack)
 State Rate: \$0.98
 Cook County Rate: \$2.00
 City of Chicago Rate: \$0.68

According to data compiled by www.tobaccofreekids.org, Chicago's combined tax total of \$4.05 per pack is the highest in the nation. The city of Evanston is ranked 2nd in the nation with a total tax amount of \$3.69 (32-cent city tax, \$2.00 Cook County Tax, 98-cent State tax, 39-cent federal tax). The town of Cicero is ranked 3rd at \$3.53 per pack and the Village of Rosemont is ranked 4th at \$3.42 per pack. New York City ranked 5th at \$3.39 per pack, with all other Cook County communities ranked 6th at \$3.37 per pack. A table depicting these rankings is shown below.

TOP COMBINED STATE-LOCAL CIGARETTE TAX RATES
 (Federal plus State plus County plus City Cigarette Tax per Pack of 20)

	Federal	State	County	City	Total
1 Chicago, Illinois	\$0.39	\$0.98	\$2.00	\$0.68	\$4.05
2 Evanston, Illinois	\$0.39	\$0.98	\$2.00	\$0.50	\$3.87
3 Cicero, Illinois	\$0.39	\$0.98	\$2.00	\$0.16	\$3.53
4 Rosemont, Illinois	\$0.39	\$0.98	\$2.00	\$0.05	\$3.42
5 New York City, New York	\$0.39	\$1.50	\$0.00	\$1.50	\$3.39
6 All Other Cook County, Illinois	\$0.39	\$0.98	\$2.00	\$0.00	\$3.37
7 Anchorage, Alaska	\$0.39	\$1.60	\$0.00	\$1.30	\$3.29
8 Rhode Island Cities	\$0.39	\$2.46	\$0.00	\$0.00	\$2.85
9 New Jersey Cities	\$0.39	\$2.40	\$0.00	\$0.00	\$2.79
10 Washington Cities	\$0.39	\$2.03	\$0.00	\$0.00	\$2.42
11 Maine Cities	\$0.39	\$2.00	\$0.00	\$0.00	\$2.39
12 Michigan Cities	\$0.39	\$2.00	\$0.00	\$0.00	\$2.39
13 Juneau, Alaska	\$0.39	\$1.60	\$0.00	\$0.30	\$2.29
14 Fairbanks, Alaska	\$0.39	\$1.60	\$0.00	\$0.20	\$2.19
15 Montana Cities	\$0.39	\$1.70	\$0.00	\$0.00	\$2.09
16 All Other Alaska Cities	\$0.39	\$1.60	\$0.00	\$0.00	\$1.99
17 Connecticut Cities	\$0.39	\$1.51	\$0.00	\$0.00	\$1.90
18 Massachusetts Cities	\$0.39	\$1.51	\$0.00	\$0.00	\$1.90
19 All Other New York Cities	\$0.39	\$1.50	\$0.00	\$0.00	\$1.89
20 Hawaii Cities	\$0.39	\$1.40	\$0.00	\$0.00	\$1.79
21 Pennsylvania Cities	\$0.39	\$1.35	\$0.00	\$0.00	\$1.74
22 Ohio Cities	\$0.39	\$1.25	\$0.00	\$0.00	\$1.64
23 Minnesota Cities	\$0.39	\$1.23	\$0.00	\$0.00	\$1.62

Source: tobaccofreekids.org with updated adjustments by the Commission

Why Increase the Tax on Cigarettes?

Over the last several years the cigarette tax has been one of the primary targets as the source for tax increases for governments throughout the nation. There are several reasons for this. The first of course is to generate additional revenue. When Illinois increased their State cigarette tax from 48-cents to 98-cents per pack in 2002, they were one of nineteen states that used this source to reduce budget gaps that evolved during the early 2000s.

These cigarette tax increases continue three years later. According to the National Conference of State Legislators, eight states increased tobacco taxes to raise revenue in 2005. Kentucky increased its cigarette tax -- which, at 3-cents per pack, had been among the lowest in the nation -- by 26-cents for \$171.7 million. Maine increased its tax by \$1 for \$51.3 million. Minnesota passed a cigarette "health impact fee" that would raise \$178.8 million. Ohio, Washington, New Hampshire and North Carolina also reported tobacco tax increases, while Idaho made permanent its 57-cents per pack cigarette tax.

A second reason that the cigarette tax has been used for tax increases is because of the notion that this tax is considered a "sin tax" and it is less controversial. The Acton Institute gives their opinion on why it is easy to choose sin taxes as the target for tax increases, "Governments often find large public support for sin taxes because the majority of the populace does not engage in whatever activity is being taxed: they themselves aren't affected by the tax, so why should they care?" The thought is the less people that are affected by a tax increase the fewer complaints that will arise once a tax increase takes place.

A third reason is the belief that high taxes on cigarettes would serve as a disincentive to smokers, meaning that fewer people would smoke and the states health care bills would go down. The National Conference of State Legislators reported that a recent national study by the Centers for Disease Control and Prevention indicated that a 50-cent tax increase would be expected to yield about a nine percent decline in consumption. If nine percent of smokers stopped smoking, or at least smoked less, the expectation is that this will result in fewer health problems, and thus fewer health care bills that governments would have to pay.

As cigarette consumption decreases, so should cigarette-related health care costs. However, some argue that this may not necessarily mean lower overall health costs. This is because of the fact that nonsmokers live longer than smokers. An article in the San Francisco Chronicle points out that as people live longer, the demand for medical products to keep people healthy, such as prescriptions, therapy, and doctor services also increases. Therefore, the longer people live, the more medical costs the State may have to endure.

Regardless of the reason for cigarette tax increases, these increases have had an impact on Illinois and its residents. The following section looks at these impacts.

The Impact of Cigarette Tax Increases

Two of the main reasons for increasing cigarette taxes are to generate additional revenues and lower cigarette consumption. It appears that the State cigarette tax increase in 2002 did just that. After Illinois increased its cigarette tax from 58-cents to 98-cents per pack in 2002, the State saw overall cigarette and tobacco products tax revenues increase from \$469 million to as high as \$760 million in FY 2004, an increase of 62%. Not surprisingly, from a consumption standpoint, the number of packs of cigarettes sold dropped. Before the tax increase, roughly 809 million packs were sold in Illinois. In FY 2004, it is estimated that approximately 757 million packs of cigarettes were sold, a decline of 6.4%.

In FY 2006, the Commission estimates that roughly 634 million packs of cigarettes were taxed in Illinois, which is a four-year decline of 21.6%. However, this large decline is not due entirely to the State tax increase, but also due to the significant tax increases in both Cook County and the City of Chicago. On April 1, 2004, Cook County increased their cigarette tax rate from \$0.18 to \$1.00 per pack and then to \$2.00 per pack on March 1, 2006. On January 1, 2005, the City of Chicago increased their cigarette tax from \$0.16 to \$0.48 and then to \$0.68 per pack on January 10, 2006. Therefore, over the last couple of years, the total amount that a consumer would pay in taxes alone for cigarettes purchased in the City of Chicago increased from \$1.71 per pack to \$4.05 per pack.

It would appear that these multiple tax increases are having an effect on State revenues. Total cigarette and tobacco products tax revenues fell from \$760 million in FY 2004 to \$656 million in FY 2005 and to \$640 million in FY 2006. However, even with the declining figures it must be pointed out that the revenue collected in FY 2006 is still well above the levels experienced before the State tax increase in 2002. Therefore, it appears that the rationale behind the cigarette tax increases has been substantiated: revenues are higher while cigarette consumption has declined.

The declining number of packages sold would suggest that many cigarette smokers who are looking to stop smoking appear to use tax increases as a final incentive to do so. Contributing to this incentive is the smoking ban that many communities throughout Illinois are imposing. Cities such as Chicago, Bloomington, Normal, Springfield, and De Kalb have voted to ban smoking in their indoor public locations. Lawmakers recently enacted a provision allowing counties to institute smoking bans in unincorporated areas as well. Cook County will join the City of Chicago in February 2007 in the smoking ban. As more and more Illinois communities ban smoking in public locations there will be fewer opportunities to smoke, which will likely mean additional drops in cigarettes sales in the future.

While recent statistics show a decline in Illinois cigarette sales, this may not be just due to a decline in cigarette consumption, but may also be due to cigarette consumers looking elsewhere to purchase their cigarettes. For example, because of the recent tax increases, according to a spokesman for the Illinois Association of Tobacco and Candy Distributors, cigarette distributors have seen a noticeable decline in the number of cigarette stamps sold in Cook County. The spokesman emphasized that this is because of lower tax rates in surrounding areas.

For example, smokers who live in Cook County can easily drive a short distance to surrounding suburb counties such as DuPage or Will County and save \$2.68 per package of cigarettes in taxes alone compared to the cost of buying a pack of cigarettes in the City of Chicago. (This is over \$26 for a carton of 10 packs). While this has an adverse affect on Cook County tax revenues, from a State revenue perspective, this is not a concern as long as the purchase is made in Illinois. However, what *is* a concern is the fact that Cook County smokers can also easily drive the short distance to Indiana and take advantage of Indiana's lower cigarette tax rates.

To understand this more clearly, using Indiana's state cigarette tax rate of 55.5-cents per pack and adding in the federal tax rate, purchasing a pack of cigarettes in Indiana would cost \$0.945 in taxes, or \$9.45 for a carton of 10 packs of cigarettes. As stated earlier, a pack of cigarettes purchased in the city of Chicago costs \$4.05 in taxes alone, which equates to \$40.50 for a carton of 10 packs of cigarettes. Therefore, a Chicago cigarette consumer would save \$31.05 per carton *in taxes alone* by purchasing the carton in Indiana instead of in the City of Chicago.

Recent data suggest that Indiana may be benefiting from Illinois' higher tax rates. As shown below, according to monthly reports issued by Orzechowski and Walker, the average change in packages taxed in the United States was -3.2% between CY 2004 and CY 2005. During that period, the number of packages of cigarettes taxed in Illinois dropped 4.3%. However, Indiana actually experienced an increase in packages of cigarettes taxed, albeit a slight increase, at 0.7%. Once the impact of the 2006 tax increases in Cook County and the City of Chicago take effect, the difference between Illinois and Indiana may appear even more dramatic. Again, this information would suggest that the decline in Illinois cigarette sales might not mean that all Illinois residents are quitting smoking, but rather are heading elsewhere, such as Indiana, to purchase their cigarettes at a cheaper price.

Packages of Cigarettes Taxed

	Illinois	Indiana		Illinois	Indiana
Jan-04	49,830,000	43,437,000	Jan-05	43,450,000	42,434,000
Feb-04	53,940,000	42,811,000	Feb-05	46,149,000	44,912,000
Mar-04	68,882,000	50,967,000	Mar-05	52,719,000	49,644,000
Apr-04	53,280,000	51,638,000	Apr-05	55,389,000	50,459,000
May-04	51,294,000	52,289,000	May-05	54,790,000	50,536,000
Jun-04	60,110,000	57,805,000	Jun-05	63,704,000	56,442,000
Jul-04	59,954,000	52,421,000	Jul-05	57,755,000	50,730,000
Aug-04	55,699,000	51,129,000	Aug-05	61,669,000	60,533,000
Sep-04	63,914,000	59,602,000	Sep-05	58,804,000	60,528,000
Oct-04	49,459,000	41,671,000	Oct-05	50,400,000	41,150,000
Nov-04	57,374,000	48,838,000	Nov-05	53,580,000	49,773,000
Dec-04	60,643,000	50,646,000	Dec-05	56,488,000	50,268,000
CY 2004 Total:	684,379,000	603,254,000	CY 2005 Total:	654,897,000	607,409,000
Nationwide Average % Change in CY 2005: -3.2%			% Change:	-4.3%	0.7%

Source: Orzechowski and Walker Monthly Report

Every state bordering Illinois has a lower cigarette tax than Illinois. Therefore, Indiana is likely not the only state benefiting from Illinois' higher tax rates. Currently, Missouri has the lowest tax rate in the nation at 17-cents per pack. Because of this 81-cent difference in price, an Illinois resident who lives on the Missouri border can save \$8.10 per carton of cigarettes by simply crossing the border to purchase cigarettes.

The Department of Revenue has indicated in the past that they will step up enforcement of improperly tax stamped purchases being brought back into Illinois. By law, anyone possessing between 10 and 99 packs of cigarettes that are improperly tax stamped is liable for a penalty of \$10 for each such package unless reasonable cause can be established. Those possessing 100 or more improperly tax stamped packs are liable for a penalty of \$15 per cigarette package. However, even with the law in place, this provision is very difficult to enforce.

There has been concern that Illinois' higher cigarette tax rates may be enticing Illinois smokers to use the Internet as a place to purchase their cigarettes. Internet sales offer smokers a way to evade tobacco and sales taxes. This has been the concern for not only Illinois, but also states throughout the nation. One study, according to a Prudential Securities report, indicated that Internet tobacco sales accounted for 14% of the total U.S. market in 2005. Governments are concerned with Internet sales not only because of the avoidance of taxes, but also because selling tobacco products online makes it easier and cheaper for kids to buy cigarettes.

In an effort to limit the amount of cigarettes sold on the Internet, the federal government made an agreement in March 2005 with major credit card companies. According to detnews.com, "The result is that virtually all credit cards will no longer participate with Web sites based in the United States and abroad that sell cigarettes and tobacco products in every state.... (and) agreed to take action against Internet sellers that authorities identify as violating state and federal laws regulating cigarettes sales."

In addition, in February 2006, FedEx joined DHL and UPS in the agreement to prohibit deliveries of cigarettes to individual consumers nationwide. According to a FedEx press release, "Internet and mail order cigarette retailers operate in violation of numerous federal, state and local laws, including tax laws, age verification laws, delivery restrictions, reporting requirements, and federal wire fraud and mail fraud statutes. As a result, a coalition of federal, state and local law enforcement agencies has been working on several initiatives to stop these illegal sales, including federal and state criminal indictments of cigarette sellers, seizures of contraband cigarettes, and efforts to strengthen cigarette trafficking prohibitions."

A spokesman for the Illinois Association of Tobacco and Candy Distributors is also concerned that the high cigarette taxes will cause many smokers to turn to the "black market" to obtain their cigarettes. He states that there are several cases of individuals illegally selling unstamped packs of cigarettes in Cook County at non-taxed rates on street corners to take advantage of Cook County's high cigarette tax rates. These illegal vendors can sell their cigarettes at cheaper rates than retailers because they don't pay and collect taxes. While law enforcement is necessary to put an end to this illegal activity, police

departments often do not have the time or the manpower to do so. The Association points out that the illegal selling of cigarettes not only hurts Illinois tobacco companies and retailers but the revenue collections of State and local governments as well. The spokesman summarizes by saying, “We (the tobacco industry) can survive in a legitimate atmosphere, but we cannot survive in an illegitimate atmosphere.”

As stated earlier, Illinois’ cigarette sales have declined 21% over the last four years. However, even with this large decline, the vast majority of Illinois smokers continue to purchase cigarettes in the State, despite the recent tax increases. Many are concerned with the additional tax burden that has fallen on low-income people due to these tax increases. This is because lower-income segments of the population have a tendency to smoke in greater proportion than higher-income people. According to National Center for Chronic Disease Prevention and Health Promotion, “Cigarette smoking is more common among adults who live below the poverty level (29.1 percent) than among those living at or above the poverty level (20.6 percent).” This and other related statistics are shown on the following page.

An article from the Center on Budget and Policy Priorities points out that cigarette taxes are regressive, in that, they represent a greater proportion of the income of poorer households than they do of wealthier households. The article states, “expenditures on cigarettes amount to 3.2 percent of the income of people in the bottom fourth of the income distribution, but only 0.4 percent of the income of people in the top fourth. Thus, increases in cigarette taxes particularly burden the poor.”

However, others argue that cigarette tax increases actually help the poor. An article from tobaccofreekids.com contends that, “higher smoking rates among lower-income groups means they are now suffering the most from smoking and will, consequently, benefit the most from any effective new measures to reduce smoking, including increased state tobacco taxes.” The article points out that increases in cigarette tax rates are more likely to cause lower-income people to quit smoking or reduce cigarette consumption than those at higher incomes. They contend that tobacco-tax increases improve the health of low-income smokers and their families and significantly reduce their related costs.

From a government standpoint, it appears that if the tax increases cause people to stop smoking, this is considered a positive step because people are likely to be healthier, which will save the State in health-related costs. On the other hand, if smokers continue to smoke and purchase their cigarettes in Illinois, this is perceived to be positive as tax revenue will be generated for deposit into various funds, such as the General Revenue Fund, the Common School Fund, and the Long-Term Care Provider Fund. The hope of Illinois leaders is that these cigarette tax increases are not making a situation worse for low-income smokers who choose not to quit or cannot quit because this may lead to additional financial and health-related problems down the road.

TABLE. Percentage of persons aged ≥ 18 years who were current smokers,* by sex and selected characteristics — National Health Interview Survey, United States, 2004

Characteristic	Men	Women	Total
	(n = 13,903) % (95% CI) [†]	(n = 17,423) % (95% CI)	(n = 31,326) % (95% CI)
Race/Ethnicity[§]			
White, non-Hispanic	24.1 (±1.1)	20.4 (±0.9)	22.2 (±0.8)
Black, non-Hispanic	23.9 (±2.4)	17.2 (±2.1)	20.2 (±1.7)
Hispanic	18.9 (±1.9)	10.9 (±1.3)	15.0 (±1.2)
American Indian/ Alaska Native [¶]	37.3 (±12.1)	28.5 (±11.4)	33.4 (±8.3)
Asian**	17.8 (±4.4)	4.8 (±2.1)	11.3 (±2.4)
Education^{††}			
0–12 yrs (no diploma)	31.5 (±2.4)	21.2 (±2.0)	26.2 (±1.6)
<8 yrs	23.5 (±3.2)	10.5 (±2.0)	16.7 (±2.0)
9–11 yrs	38.3 (±3.7)	29.8 (±3.1)	34.0 (±2.4)
12 yrs (no diploma)	29.9 (±6.5)	21.9 (±4.6)	25.5 (±3.8)
GED ^{§§} diploma	42.1 (±5.9)	36.6 (±5.9)	39.6 (±4.4)
High school graduate	27.2 (±1.8)	21.1 (±1.4)	24.0 (±1.1)
Associate degree	24.6 (±3.1)	18.0 (±2.1)	20.9 (±1.9)
Some college	24.6 (±1.8)	20.3 (±1.3)	22.2 (±1.1)
Undergraduate degree	13.5 (±1.7)	10.1 (±1.4)	11.7 (±1.1)
Graduate degree	7.9 (±1.5)	8.1 (±1.5)	8.0 (±1.0)
Age group (yrs)			
18–24	25.6 (±2.9)	21.5 (±2.3)	23.6 (±2.0)
25–44	26.3 (±1.5)	21.4 (±1.2)	23.8 (±1.0)
45–64	25.0 (±1.6)	19.8 (±1.2)	22.4 (±1.0)
≥ 65	9.8 (±1.4)	8.1 (±1.0)	8.8 (±0.8)
Poverty status^{¶¶}			
At or above	23.5 (±1.1)	17.7 (±0.9)	20.6 (±0.7)
Below	31.9 (±3.3)	27.1 (±2.2)	29.1 (±2.0)
Unknown	20.8 (±1.6)	17.4 (±1.4)	19.0 (±1.1)
Total	23.4 (±0.9)	18.5 (±0.7)	20.9 (±0.6)

* Persons who reported smoking ≥ 100 cigarettes during their lifetime and at the time of interview reported smoking every day or some days. Excludes 349 respondents whose smoking status was unknown.

[†] Confidence interval.

[§] Excludes 332 respondents of unknown or multiple racial/ethnic category or whose racial/ethnic category was unknown.

[¶] Wide variances in estimates reflect small sample sizes.

** Does not include native Hawaiians or other Pacific Islanders.

^{††} Among persons aged ≥ 25 years. Excludes 345 persons whose education level was unknown.

^{§§} General Educational Development.

^{¶¶} Based on family income reported by respondents and 2003 poverty thresholds published by the U.S. Census Bureau.

Tobacco Settlement Issues

In November 1998, 46 states, including Illinois, along with the District of Columbia, and six territories entered into an agreement with the four largest cigarette manufacturers to recoup health care costs attributed to smoking-related illnesses. This Master Settlement Agreement provided states with settlement payments totaling more than \$200 billion over the next 25 years. In exchange, the states agreed to drop their lawsuits against the manufacturers.

It has now been nearly eight years since the settlement. This section takes a look at the amount of money that Illinois has received so far from the Master Settlement Agreement and how that money has been spent. It discusses why tobacco settlement deposits have been less than expected. It then details how Illinois's tobacco settlement spending compares to other states throughout the nation. Before that begins, a basic summary of the Master Settlement Agreement is provided along with original projections of tobacco settlement payments.

What is the Tobacco Settlement?

In the 1990s, in order to obtain reimbursement for health impairments caused by the public's use of tobacco, several states sued the major tobacco companies. In 1997 and 1998, four states, Florida, Minnesota, Mississippi, and Texas came to an agreement with the tobacco companies to pay \$40 billion over 25 years. In lieu of future lawsuits, the nation's largest tobacco companies, Phillip Morris, USA; R.J. Reynolds Tobacco Company; Brown & Williamson Tobacco Corporation; and Lorillard Tobacco Company negotiated and signed an agreement with the remaining 46 states, as well as the District of Columbia, and the five U.S. territories. The settlement of several lawsuits led to an agreement known as the Master Settlement Agreement (MSA).

Under the MSA, each state receives a share of payments based on a fixed percentage agreed upon in the MSA. The percentage was based loosely on the smoking-related health care costs for each state. The total payments were originally estimated at over \$200 billion paid out between 1999 and 2025. However, the total payment fluctuates annually and is based on a formula that considers participating manufacturers' annual U.S. shipments of tobacco as compared with those of 1997. Other factors also can affect this payment amount, such as inflation and the gain in market share by cigarette manufacturers that are not participating in the agreement.

Tobacco Settlement Receipts

Before receiving these payments, states had to achieve State Specific Finality, which occurred when each state court gave final approval to that state's settlement and consent decree. Illinois achieved this status on January 26, 1999. On June 30, 1999, SB 1183 was signed into law (P.A. 91-0041), enacting the model statute. After waiting for a requisite number of states to achieve State Specific Finality, payments were made available to the

states. Since Illinois received its first payment of \$115.2 million (the 1998 initial payment) in December 1999, it has since received a total of \$2.065 billion in tobacco settlement payments (thru June of 2006).

There have been other settlement monies that the State has received in addition to the \$2.065 billion. In FY 2003, approximately \$88 million, which had been held in escrow pending agreement over a legal dispute, was released and deposited into the General Revenue Fund. In addition, in FY 2003 thru FY 2005, a total of \$67.5 million (\$22.5 million per year) was set aside to pay lawyer fees and was not included in the \$2.065 billion total.

Under the original payment schedule, Illinois was scheduled to have received \$2.488 billion thru FY 2006. Even when including the \$88 million and \$67.5 million in settlement monies not deposited into the Tobacco Settlement Recovery Fund, the State's total of \$2.221 billion in settlement funds is only 89% of what was originally scheduled to have been received by this time. A list of the payments received thru FY 2006 is provided on page 16.

As mentioned previously, all payments scheduled by the Master Tobacco Settlement Agreement are subject to adjustments that may increase or decrease the payments to each state. Adjustments are applied to each annual payment before a state receives a payment. According to the Bond Buyer, "After the 2006 payments were tallied, states received MSA payments totaling \$5.7 billion, compared with the \$6.5 billion they would have received had tobacco companies not taken the (MSA) adjustments." This means that states received only 87.7% of what was originally expected. (Illinois received only 83.6% of anticipated settlement monies in FY 2006). The article states that the reason for the adjustments is because tobacco companies under the MSA are citing market share losses to those non-participating MSA tobacco companies.

The major tobacco companies argue that states are not enforcing model statutes that require companies that did not participate in the MSA to make payments into state-overseen escrow accounts. According to the Bond Buyer, "The accounts are meant to be tapped if sick smokers were to sue any (non-participating manufacturer) in the future. In addition, they are meant to level the playing field with those companies that signed the agreement by pushing the (non-participating manufacturers') costs of doing business to about the same level they would have been had they signed the MSA." By claiming market share loss, 10 participating manufacturers opted to place a portion of their 2006 MSA settlement into escrow funds instead of making payments to states. A few small companies decided to withhold their portion altogether. Fifteen companies opted to make full payments in 2006, but stated that they are due an adjustment.

There continues to be debate on whether the adjustments that some of these companies took are warranted. In response, all of the MSA states, including Illinois, have sued tobacco companies for their full 2006 payments. At the time of this report, no ruling had been made. Tobacco companies already have warned states that they plan on seeking additional reductions in the future, citing market share losses and enforcement issues.

As shown below, Illinois was originally scheduled to receive over \$9.1 billion from the Master Tobacco Settlement Agreement through 2025, which was the fifth largest payout from the MSA. If payments continue to come in at less-than-expected levels, the State will receive much less than this amount. The table on page 17 provides a list of the payment amounts that the State was originally expected to receive, along with a list of payments that Illinois would receive if it stayed at its current decreasing trend.

Originally Projected Annual Payment Scheduled to Each State through 2025 (Only Top 10 States are Shown)	
California	\$25,006,972,511
New York	25,003,202,243
Pennsylvania	11,259,169,603
Ohio	9,869,422,449
Illinois	9,118,539,559
Michigan	8,526,278,034
Massachusetts	7,913,114,213
New Jersey	7,576,167,918
Georgia	4,808,740,669
<u>Tennessee</u>	<u>4,782,168,127</u>
TOTAL	\$113,863,775,325

TOBACCO SETTLEMENT PAYMENTS TO ILLINOIS THRU FY 2006
(\$ in millions)

Payment Type	Unadjusted Payment Scheduled	Actual Payment Received
Initial (12/99)		\$115.3
Initial (1/00)		\$100.1
Annual (4/00)		\$134.1
Other Payments		\$0.0
FY 2000 TOTAL	\$410.1	\$349.5

Initial (1/01)		\$96.3
Annual (4/01)		\$171.3
Other Payments		\$0.4
FY 2001 TOTAL	\$322.2	\$268.0

Initial (12/01)		\$84.9
Annual (4/02)		\$225.2
Other Payments		\$2.1
FY 2002 TOTAL	\$386.9	\$312.3

Initial (12/02)		\$74.6
Annual (4/03)		\$215.5
Other Payments		\$28.8
FY 2003 TOTAL*	\$390.6	\$319.0

Initial		\$0.0
Annual (4/04)		\$266.8
Other Payments		\$2.9
FY 2004 TOTAL*	\$326.0	\$269.8

Initial		\$0.0
Annual (4/05)		\$270.9
Other Payments		\$3.2
FY 2005 TOTAL*	\$326.0	\$274.1

Initial		\$0.0
Annual (4/06)		\$269.0
Other Payments		\$3.6
FY 2006 TOTAL	\$326.0	\$272.6

TOTAL THRU FY 2006 (Escrow Amounts Not Included)	\$2,487.8	\$2,065.3
% of Scheduled Payment Received:		83%

TOTAL THRU FY 2006* (Escrowed Amounts Included)	\$2,487.8	\$2,220.8
% of Scheduled Payment Received:		89%

* The FY 2003 total of \$319 M figure shown above does not include \$88 M in settlement monies that was transferred from an escrow account to the General Revenue Fund. The actual amount in FY 2003 attributed to tobacco settlement receipts was \$407 M. In FY 2003 - FY 2005, a total of \$67.5 million (\$22.5 per year) was set aside to pay lawyer fees. In FY 2006 and thereafter, similar adjustments are not anticipated.

**ILLINOIS' Share of
Tobacco Settlement Payments**

FY	Scheduled Payment	Estimated Total Payment	% of Scheduled Payment	Estimated Amount to Escrow	Actual Payment Received	% of Scheduled Payment
					actual	
2000	\$410.2 *	\$377.0	91.9%	\$27.5	\$349.5	85.2%
2001	322.2	\$289.1	89.7%	\$21.1	\$268.0	83.2%
2002	386.9	\$336.8	87.1%	\$24.6	\$312.3	80.7%
2003	390.6	\$341.5	87.4%	\$22.5	\$319.0 **	81.7%
2004	326.0	\$292.3	89.6%	\$22.5	\$269.8	82.7%
2005	326.0	\$296.6	91.0%	\$22.5	\$274.1	84.1%
2006	326.0	\$272.6	83.6%	\$0.0	\$272.6	83.6%
					estimated	
2007	326.0			\$0.0	\$270.6	83.0%
2008	332.5			\$0.0	\$274.3	82.5%
2009	332.5			\$0.0	\$272.7	82.0%
2010	332.5			\$0.0	\$271.0	81.5%
2011	332.5			\$0.0	\$269.3	81.0%
2012	332.5			\$0.0	\$267.7	80.5%
2013	332.5			\$0.0	\$266.0	80.0%
2014	332.5			\$0.0	\$264.3	79.5%
2015	332.5			\$0.0	\$262.7	79.0%
2016	332.5			\$0.0	\$261.0	78.5%
2017	332.5			\$0.0	\$259.4	78.0%
2018	372.5			\$0.0	\$288.7	77.5%
2019	372.5			\$0.0	\$286.8	77.0%
2020	372.5			\$0.0	\$285.0	76.5%
2021	372.5			\$0.0	\$283.1	76.0%
2022	372.5			\$0.0	\$281.2	75.5%
2023	372.5			\$0.0	\$279.4	75.0%
2024	372.5			\$0.0	\$277.5	74.5%
2025	372.5			\$0.0	\$275.7	74.0%
TOTAL	\$9,118.9				\$7,261.5	79.6%

* Year 2000 annual payment of \$410.1 M includes 1998 initial payment of \$111.7 million.

FY 2000 - FY 2003 also include initial payments.

** The FY 2003 total of \$319 M figure does not include \$88 M that was transferred from an escrow account to the General Revenue Fund. The actual amount in FY 2003 was \$407 M.

Note: In FY 2003 - FY 2005, a total of \$67.5 million (\$22.5 per year) was set aside to pay lawyer fees. In FY 2006 and thereafter, similar adjustments are not anticipated.

Tobacco Settlement Distribution

After the tobacco settlement money is received, it is distributed to various departments throughout the State which, in turn, fund a wide range of areas. According to the U.S. Government Accountability Office, the MSA has no requirement on how states spend their payments. Programs that have benefited from tobacco settlement funds in Illinois include programs for the elderly, tobacco prevention/control, medical research, and venture-tech. The majority of tobacco settlement funds in Illinois are used for the Medicaid drug program where 50% of the amount is covered by the federal government through federal matching funds. The funds also have been used to finance the earned income tax credit. A list of where the tobacco settlement money has been distributed between FY 2000 and FY 2006 (by agency) is provided on the following page. A list of the FY 2006 and FY 2007 appropriations from the Tobacco Settlement Recovery Fund is provided below.

Tobacco Settlement Recovery Fund FY 2006 and FY 2007 Appropriations (\$000s)			
Agency Name	FY06 Approp	FY 07 Budget	Program
Attorney General	\$ 750.0	\$ 870.0	Expenses Incurred in Enforcement of the MSA
DoA	\$ 8,890.9	\$ 8,890.9	Circuit Breaker/Pharmaceutical Assistance
DoA	\$ 1,100.0	\$ 1,100.0	For Grants to Senior Health Assistance Programs
DCEO	\$ 2,000.0	\$ -	Administration, Grant, and Investment Expenses of Technology Initiatives
DCEO	\$ 1,500.0	\$ -	Illinois Technology Enterprise Corporation
DHS	\$ 2,000.0	\$ 2,500.0	For Children's Health Programs
DHS	\$ 250.0	\$ 250.0	Coalition For Technical Assistance and Training
DHFS	\$ 13,800.0	\$ 13,800.0	Academic Excellence
DHFS	\$ 508,029.1	\$ 375,152.9	Medicaid Drugs ¹
DPH	\$ 3,000.0	\$ 3,000.0	Grants for the Community Health Center Expansion Program
DPH	\$ 5,000.0	\$ 5,000.0	Local Health Protection Grants for Health Anti -Smoking Programs
DPH	\$ 1,000.0	\$ 1,000.0	Grant to the American Lung Association for Operations of the Quitline
DPH	\$ 3,000.0	\$ 5,000.0	Grants for the Tobacco Use Prevention Program, BAHUAH, and Asthma Prevention (includes \$2.0 m for BASUAH program below)
DPH	\$ 2,000.0	\$ -	Grants for AIDS/HIV outreach/BASUAH (included in \$5.0 m above for FY 07)
DPH	\$ 1,900.0	\$ 1,900.0	Grant for the U of I for Sickle Cell Research
DPH	\$ -	\$ 1,500.0	Grants for the Community Health Center Expansion Program
DPH	\$ -	\$ 1,500.0	Grants for the Community Health Center and Dental Expansion Program
Revenue	\$ 167.9	\$ 165.5	Tobacco Enforcement Grants - Operations
Revenue	\$ 1,000.0	\$ 1,000.0	Grants to Local Governments for Tobacco Enforcement
	\$ 555,387.9	\$ 422,629.3	NEW APPROPRIATIONS
Agency Name	555,387.9	FY 07 Reapprop (est)	Program
CDB	\$ 7,602.7	\$ 3,865.0	CDB Statewide Capital Maintenance Projects ²
	\$ 7,602.7	\$ 3,865.0	REAPPROPRIATIONS

¹ 50% of this amount is covered by the federal government through federal matching funds

² Estimated amount. Actual reappropriation will be based on spending through 6/30.

Source: Governor's Office of Management and Budget

Tobacco Settlement Receipts and Distribution

Thru June 2006

\$ in millions

	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006**
BEGINNING BALANCE	\$0.0	\$355.1	\$230.5	\$46.3	\$20.3	\$28.7	\$19.5
TOTAL RECEIPTS*	\$355.1	\$276.6	\$393.8	\$459.5	\$494.3	\$476.2	\$379.4
DISTRIBUTION							
Aging		\$1.60	\$1.00	\$0.00	\$1.03	\$9.32	\$3.97
Attorney General		\$0.40	\$0.80	\$0.63	\$0.45	\$0.65	\$0.66
Board of Higher Ed		\$2.50	\$4.00	\$4.50	\$4.41	\$0.00	\$0.00
Capital Development Board		\$2.60	\$17.90	\$7.75	\$2.96	\$1.82	\$1.46
Commerce and Economic Opportunity		\$2.40	\$6.60	\$3.02	\$2.57	\$3.51	\$2.82
Comptroller		\$0.70	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
Court of Claims		\$0.00	\$0.00	\$0.30	\$0.00	\$1.07	\$0.03
Human Services		\$1.10	\$2.20	\$2.20	\$2.21	\$2.21	\$2.19
Liquor Control Commission		\$1.10	\$1.10	\$1.12	\$0.00	\$0.00	\$0.00
Public Health		\$18.40	\$53.80	\$14.20	\$10.91	\$10.59	\$10.53
Healthcare & Family Services		\$11.80	\$13.80	\$236.39	\$312.45	\$386.72	\$341.99
Revenue		\$34.20	\$136.70	\$138.42	\$83.08	\$1.10	\$1.09
State Board of Education		\$9.60	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
Statutory Transfers		\$315.00	\$340.00	\$76.01	\$64.88	\$68.40	\$0.02
University of Illinois		\$0.00	\$0.00	\$1.00	\$1.00	\$0.00	\$0.00
Total Expenditures		\$401.2	\$578.0	\$485.6	\$485.9	\$485.4	\$364.8
ENDING BALANCE	\$355.1	\$230.5	\$46.3	\$20.3	\$28.7	\$19.5	\$34.2

*Total receipts include tobacco settlement proceeds, as well as transfers, investment income, etc.

** FY 2006 totals do not include lapse period spending.

<i>Proceeds Only (Does not include investment income, etc)</i>							
	FY 2000 Receipts	FY 2001 Receipts	FY 2002 Receipts	FY 2003 Receipts	FY 2004 Receipts	FY 2005 Receipts	FY 2006 Receipts
	\$ in millions	\$ in millions	\$ in millions	\$ in millions	\$ in millions	\$ in millions	\$ in millions
	\$115.3 D	\$0.1 J	\$2.1 N	\$74.6 N	\$2.9 O	\$3.2 A	\$3.3
	\$100.1 J	\$0.0 A	\$84.9 D	\$24.9 D	\$266.8 A	\$270.9 A	\$0.3
	\$134.1 A	\$96.3 J	\$0.0 J	\$215.5 J			\$269.0
	\$0.0 M	\$171.3 A	\$225.2 A	\$3.9 A			
		\$0.3 J					
	\$349.5	\$268.0	\$312.3	\$319.0	\$269.8	\$274.1	\$272.6

<i>IEFC estimate of Tobacco Settlement Proceeds</i>	
	\$ in millions
FY 2007	\$271.0

Distribution of Tobacco Settlement Proceeds in Other States

In April 2006, the United States Government Accountability Office (GAO), in accordance with the Farm Security and Rural Investment Act of 2002, released a report on how states use MSA payments made by tobacco companies. In addition, the report included information about states' receipt and allocation of securitized tobacco proceeds. Highlights of the report are discussed below.

The GAO surveyed state budget offices in each of the 46 states under the MSA to obtain payment and allocation information for their report. The states were asked to categorize their MSA payment allocations for FY 2005 and their expected allocations for FY 2006 using 13 categories. In addition, the states were asked if they securitized their payments and, if so, the amount of proceeds they received from securitization and the categories to which they allocated the securitized proceeds. (Securitization is the process by which states receive substantial advance proceeds based on the amounts that tobacco companies owe by issuing bonds backed by payments to be made in the future).

The states under the MSA received over \$5.8 billion in FY 2005 and expect to receive \$5.4 billion in FY 2006. These amounts are significantly less than those of previous years, when total proceeds and payments averaged around \$9.3 billion annually. According to the report, "The decreases occurred because only one state, Virginia, chose to issue a bond and receive securitized payments (\$390 million) in 2005, and none plan to do so in 2006." Since the MSA was signed, 15 of the 46 states have securitized all or part of their payments. The GAO report adds that, "Of the \$46.7 billion states reported receiving over the first five years, about \$31 billion were MSA payments from the tobacco companies and about \$15.6 billion were securitized proceeds."

Of the FY 2005 tobacco settlement funds received, states allocated the largest portions to health-related programs (32%) and debt service on securitized proceeds (24%). In FY 2006, it is expected that health programs will remain at 32% while debt service is expected to increase to 29%. The report states that while these two categories' percentage of the total has increased from levels experience in the past (in 2004 the breakout was health programs 20% and debt service 9%), "the dollars allocated to these categories decreased because of the nearly \$4 billion decrease in securitized proceeds from fiscal year 2004 to 2005."

When securitized proceeds are included in the totals, the 46 states under the MSA reported receiving around \$5.5 billion in MSA payments in FY 2005 and approximately \$390 million in securitized proceeds (Virginia). FY 2006 is expected to receive similar amounts of MSA payments with no states expected to receive securitized proceeds. The MSA payments in these years are similar to FY 2004, however, the amount of securitized proceeds for FY 2005 and FY 2006 are about \$4 billion and \$4.4 billion less than FY 2004, respectively. This is due to the large number of states that have securitized their proceeds in the past. The table on the following page identifies those states that have decided to securitize their tobacco payments and the amount of those proceeds for fiscal years 2000-2005.

**Total Amount of Securitized Proceeds Received by States
Fiscal Years 2000-2005**

State	Total Securitized Proceeds
Alabama	\$153,760,000
Arkansas	\$58,268,549
Alaska	\$203,000,000
California	\$2,485,000,000
Iowa	\$643,108,448
Louisiana	\$1,069,510,894
New Jersey	\$2,751,814,469
New York	\$4,200,000,000
Oregon	\$657,565,000 *
Rhode Island	\$545,859,897
South Carolina	\$785,900,000
South Dakota	\$278,045,000
Washington	\$517,905,000
Virginia	\$389,977,667
Wisconsin	\$1,275,002,400
Total	\$16,014,717,324

* Oregon issued bonds, but did not securitize them with tobacco settlement payments.

Source: United States Government Accountability Office

In FY 2005, the 46 states reported that they allocated the largest portion of their combined MSA payments and securitized proceeds to health-related programs (32%) and to debt service on securitized proceeds (24%). In FY 2006 the largest portion of these payments and proceeds are again expected to go to health-related programs (32%) and debt service (29%). A summary of how these payments and proceeds have been allocated between FY 2000 and FY 2006 are shown in the below table.

States' Allocations of Combined MSA Payments and Securitized Proceeds for Fiscal Years 2000 through 2006

Category	2000-2001		2002		2003		2004		2005		Expected 2006	
	Allocation	Percent	Allocation	Percent	Allocation	Percent	Allocation	Percent	Allocation	Percent	Allocation	Percent
Budget shortfalls	*	*	\$2,448	20%	\$5,038	36%	\$5,059	44%	\$261	4%	\$85	1%
Debt service on securitized funds	*	*	\$271	2%	\$339	2%	\$998	9%	\$1,397	24%	\$1,662	29%
Economic development for tobacco regions	\$466	4%	\$218	2%	\$285	2%	\$291	3%	\$230	4%	\$217	4%
Education	\$848	7%	\$1,132	9%	\$531	4%	\$280	2%	\$287	5%	\$330	6%
General purposes	\$623	5%	\$684	6%	\$1,111	8%	\$747	7%	\$790	13%	\$761	13%
Health	\$4,788	38%	\$4,434	37%	\$3,455	24%	\$2,263	20%	\$1,867	32%	\$1,850	32%
Infrastructure	\$294	2%	\$1,222	10%	\$1,044	7%	\$759	7%	\$31	1%	\$313	5%
Payments to tobacco growers	\$235	2%	\$192	2%	\$43	0%	\$25	0%	\$26	0%	\$20	0%
Reserves/Rainy day funds	\$603	5%	\$124	1%	\$24	0%	\$14	0%	\$45	1%	\$17	0%
Social services	\$231	2%	\$278	2%	\$160	1%	\$142	1%	\$150	3%	\$154	3%
Tax reductions	\$416	3%	\$35	0%	\$109	1%	\$56	1%	\$0	0%	\$0	0%
Tobacco control	\$790	6%	\$375	3%	\$276	2%	\$223	2%	\$279	5%	\$272	5%
Unallocated	\$3,217	26%	\$584	5%	\$1,720	12%	\$575	5%	\$543	9%	\$86	2%
Total	\$12,511	100%	\$11,998	99%	\$14,135	99%	\$11,432	101%	\$5,907	101%	\$5,767	100%

Note: Percentages may not add up to 100 percent and allocations may not add up to total allocations due to rounding. The amounts for each year are in the current year dollars for that year. Percentages across years may be compared but not dollars across years because the dollars are not adjusted to a constant base year.

* No information was obtained on allocations for budget shortfalls and debt service on securitized funds in fiscal years 2000 and 2001

Source: United States Government Accountability Office, April 2006

Using the categories and data provided in the GAO report, Illinois also allocated the largest portion of their MSA payments to health-related programs (71%) in FY 2005. This was followed by general purposes (17%) and education (5%). A table depicting how Illinois compares to the nation in its allocation of MSA payments is shown below.

**Percentage Breakout of Allocation of MSA Payments and Securitized Proceeds
FY 2005**

	Nationwide	Illinois
Budget shortfalls	4%	0%
Debt service on securitized funds	24%	0%
Economic development for tobacco regions	4%	0%
Education	5%	5%
General purposes	13%	17%
Health	32%	71%
Social services	3%	3%
Tobacco control	5%	3%
Unallocated	9%	0%
Other	2%	1%

One of the main differences in the allocation of tobacco settlement related funds between Illinois and the nation is that Illinois has no debt service on securitized funds. Although Illinois is not one of the fifteen states that decided to securitize tobacco settlement proceeds, it came close to doing so. During the budget process of FY 2002, there were many discussions of Illinois utilizing its tobacco settlement funds to assist in reducing the State's budget gap. In order for this to occur, the State had to create legislation that would allow portions of the tobacco settlement funds to be securitized and/or bonded. This legislation came in the form of Public Act 92-0596, which was enacted in July of 2002.

Public Act 92-0596 authorized \$750 million in General Obligation Tobacco Securitization bonds to be issued only during FY 2003 for the making of deposits as follows: 50% to the General Revenue Fund to build the fiscal year ending general funds cash balance and to meet the ordinary and contingent expenses of the State, and 50% to the Budget Stabilization Fund. The public act also authorized the transfers from the Tobacco Settlement Recovery Fund to the General Revenue Fund to pay the aggregate of the principal of, interest on, and premium, if any, on the Tobacco Securitization General Obligation bonds. The State decided against utilizing this provision. Because the provisions under Public Act 92-0596 were only for FY 2003, the State would have to reauthorize the use of tobacco settlement monies for bonding for future fiscal years.

CONCLUSION

The State cigarette tax increase of 2002 has affected Illinois in a variety of ways. Fiscally, it has generated millions of dollars in additional revenue. The last fiscal year before the tax increase, total cigarette tax collections totaled \$469 million. Since then, revenues from the cigarette and tobacco products tax have been as high as \$760 million in FY 2004. While the latest figures show that revenues have fallen to \$640 million in FY 2006, this amount is still significantly higher than before the tax increase.

The fact that cigarette tax revenues are falling is not that surprising. Throughout the nation, cigarettes tax increases are generally accompanied by declines in tobacco consumption. This is one of the main reasons that the cigarette tax is used as a source for tax increases: to gain revenues while at the same time lowering cigarette consumption which would likely result in fewer health problems and tobacco related healthcare bills. Lower healthcare bills likely means savings for Illinois residents and for the State.

There is a concern, however, that while the number of cigarette stamps sold in Illinois has declined, consumption may not be falling at the same rate. This is because smokers may be looking elsewhere to buy cigarettes, such as the Internet, illegal vendors, or to other states. This may especially be the case in Chicago, which now has the highest combined cigarette tax in the nation at \$4.05 cents per pack due to recent local cigarette tax increases for both the City of Chicago and for Cook County. Any further tax increases, either State or local, could jeopardize Illinois losing more cigarette tax revenues to other states because of Illinois' higher cigarette tax rates.

For those that continue to purchase cigarettes in the State, there is concern over the impact that higher tax rates are having on the budgets of Illinois residents, especially those living below the poverty line. Critics point out that because cigarette taxes represent a greater proportion of the income of poorer households than they do of wealthier households, cigarette tax increases are particularly hard on this segment of the population. Others argue that cigarette tax increases are actually good for the poor as cigarette tax rates are more likely to cause lower-income people to reduce cigarette consumption than those at higher incomes.

It has now been over six years since Illinois received its first payment from the Master Tobacco Settlement Agreement. Thru June 2006, the State has received a total of \$2.221 billion in tobacco settlement payments, including proceeds deposited into escrow accounts. These proceeds are used to fund programs for the elderly, tobacco prevention, medical research, and venture-tech, with the majority used to fund the Medicaid drug program. However, the State has received only 89% of the \$2.488 billion that was originally scheduled to have been received by this time (84% in FY 2006). The amount of the settlement payment fluctuates annually and is based on cigarette consumption, inflation, and the gain in market share by cigarette manufacturers that are not participating in the agreement. The latter has been the main contributor to the lower-than-expected payment amounts received in recent years. This trend is expected to continue in the future, which means Illinois will likely receive well short of the \$9.1 billion it originally expected to receive after the payment schedule is completed in 2025.

BACKGROUND

The Commission on Government Forecasting and Accountability (CGFA), a bipartisan, joint legislative commission, provides the General Assembly with information relevant to the Illinois economy, taxes and other sources of revenue and debt obligations of the State. The Commission's specific responsibilities include:

- 1) Preparation of annual revenue estimates with periodic updates;
- 2) Analysis of the fiscal impact of revenue bills;
- 3) Preparation of "State Debt Impact Notes" on legislation which would appropriate bond funds or increase bond authorization;
- 4) Periodic assessment of capital facility plans;
- 5) Annual estimates of public pension funding requirements and preparation of pension impact notes;
- 6) Annual estimates of the liabilities of the State's group health insurance program and approval of contract renewals promulgated by the Department of Central Management Services;
- 7) Administration of the State Facility Closure Act.

The Commission also has a mandate to report to the General Assembly ". . . on economic trends in relation to long-range planning and budgeting; and to study and make such recommendations as it deems appropriate on local and regional economic and fiscal policies and on federal fiscal policy as it may affect Illinois. . . ." This results in several reports on various economic issues throughout the year.

The Commission publishes several reports each year. In addition to a Monthly Briefing, the Commission publishes the "Revenue Estimate and Economic Outlook" which describes and projects economic conditions and their impact on State revenues. The "Bonded Indebtedness Report" examines the State's debt position as well as other issues directly related to conditions in the financial markets. The "Financial Conditions of the Illinois Public Retirement Systems" provides an overview of the funding condition of the State's retirement systems. Also published are an Annual Fiscal Year Budget Summary; Report on the Liabilities of the State Employees' Group Insurance Program; and Report of the Cost and Savings of the State Employees' Early Retirement Incentive Program. The Commission also publishes each year special topic reports that have or could have an impact on the economic well being of Illinois. All reports are available on the Commission's website.

These reports are available from:

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703 Stratton Office Building
Springfield, Illinois 62706
(217) 782-5320
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http://www.ilga.gov/commission/cgfa/cgfa_home.html