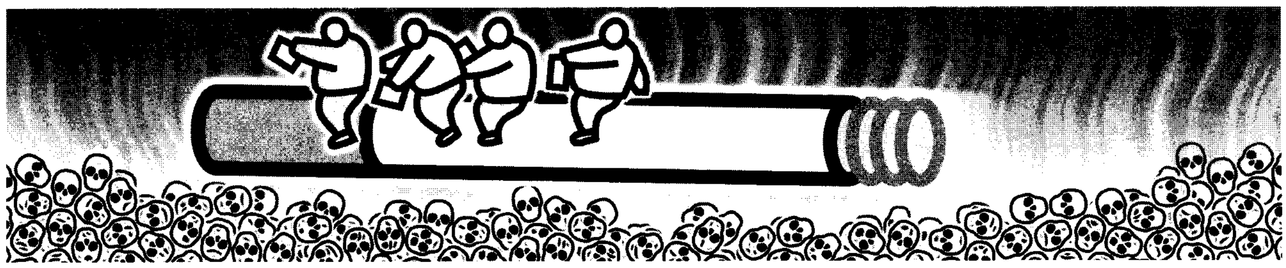

When lawyers inhale

The tobacco "settlement" reached in the United States last year offers a new way to make public policy. It is not a good way

ECONOMICS FOCUS

LAST November America's state governments and the tobacco companies salvaged what they could from their aborted settlement of lawsuits facing the industry. That first attempted deal had revolved around a central trade-off: the states would get a lot of money, and the companies would be protected from an avalanche of product-liability litigation. The proposal, which fell apart in Congress, was bad economics (though that was not of course why it failed). But the compact that has replaced it, which some people see as a model to use against makers of guns and other bad things, is in some ways worse.

The original tobacco settlement looked like a political masterpiece. The cigarette makers agreed to give the states $358 billion over 25 years, plus $10 billion upfront in lump-sum damages. The money would have come from raising cigarette prices by 35 cents a pack straight away and by 62 cents after five years, plus allowances for inflation. Various kinds of coercion were proposed to force companies that were not party to the settlement to join "voluntarily". At a stroke, class-action suits and state claims would be settled, and individual claims against the industry would be capped. The companies also agreed to some marketing and other restrictions.

Politically, the beauty of it was that it hurt nobody—except smokers (who, you may recall, are supposedly the industry's main victims). A recent paper by Jeremy Bulow, formerly of Stanford Business School and now chief economist at the Federal Trade Commission, and Paul Klemperer of Nuffield College, Oxford, explains why this is so*. On standard, plausible assumptions about the "pass-through" of higher taxes to consumers, and recalling that the demand for cigarettes is not very sensitive to price, the scheme would have reduced tobacco-company profits by the comparatively small sum of $1 billion a year (they were roughly $8 billion to begin with). Since unchecked litigation could conceivably have extracted the entire net worth of the companies, that meant they were getting off lightly. Moreover, state governments would have seen their annual revenue rise by $13 billion—by far more, that is, than the fall in profits. This is because nearly all of the new "tax" would be passed on to consumers. The people in whose name the litigation had started would be the only real losers. Brilliant.

The plan failed because congressional leaders in Washington had not been brought on board. If it was to work, they had to agree to it. (In several respects, the plan needed federal-law protection.) But they would not. The bill was swiftly recast as a company-bashing measure without such protection and the manufacturers backed out. What took its place was, first, a deal by four states modelled on the resolution and then, last November, a further scaled-down multi-state deal, not requiring co-operation in Washington. The new settlement was smaller, at $206 billion, so the tax is smaller—it is expected to settle at about 35 cents a pack. Also, there are fewer marketing restrictions. On the other hand, the companies are protected only from state cases and not from private litigation.

There is more legal wrangling to come: the story is not over yet. But suppose it were. The outcome, as Messrs Bulow and Klemperer point out, would have some troubling features. One is that the plan is not well aimed at reducing consumption of cigarettes, especially the most harmful kind. This is partly because the new scheme contains fewer marketing restrictions. Also, the tax is levied as a fixed amount per pack, rather than in proportion to tar content. And the deal specifically protects some small tobacco firms, which tend to make higher-tar cigarettes. It allows them to increase their sales substantially—and even subsidises them into the bargain, by letting them pocket the price-rise, rather than handing it over to the states. (The market value of one of these firms increased threefold when the deal was announced.)

Another drawback is the fabulous rewards bestowed on lawyers. Even the scaled-down deal proposes to pay them fees of $750m a year for five years and $500m a year indefinitely thereafter. Messrs Bulow and Klemperer calculate this as a cool $8 billion in net present value terms. According to one count, about 500 lawyers are involved: that's $16m apiece. These riches flow because the taxes levied by the states are disguised as "damages"; the lawyers therefore get their share.

The smoking gun

It would have been far better for states to impose an explicit well-designed tax, together with more marketing restrictions. Why did this not happen? First, because there would have been nothing in it for the lawyers. Second, because such taxes would have required express legislative approval state by state. The settlement was designed to get round that. Third, because an explicit tax could be levied by any particular state only on cigarettes sold within that state. The settlement in effect allows each participating state to levy a tax on cigarettes sold anywhere in America. States that do not take part will still pay the tax (ie, cigarettes will still cost more in those states) but will receive no share of the revenues—which amounts to a strong incentive for reluctant states to sign on.

In short, the lawyers have come up with a way for states to collect badly designed taxes outside as well as inside their borders, without express legislative approval—all in return for a substantial piece of the action. Many gun-control enthusiasts now hope to develop a similar strategy. After that, who knows? It is a hideous precedent. No sane system would invite lawyers to design bad taxes by stealth in exchange for a fat cut of the proceeds. Insane or not, this is the turn that American product-liability law has now taken.

* "The Tobacco Deal", CEPR Discussion Paper No. 2125, April 1999. The paper is also in the current "Microeconomics Annual" of the Brookings Institution, and can be found at www.nuff.ox.ac.uk/users/klemperer/index.htm

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Section 4, pages 1, 10.

The Ifs and Buts of the Tobacco Settlement

By SYLVIA NASAR

LAST week's $206 billion settlement between the tobacco industry and 46 states is supposed to put Big Tobacco on the run. The agreement requires cigarette makers to compensate states for the medical costs of treating smoking-related diseases. It's been hailed as a triumph of the public interest over special interests. But a closer look at the hard economics behind the agreement reveals something quite different.

The problem, economists and legal experts who have studied the deal say, isn't that the damages won by the states are too small, as leaders of the anti-smoking lobby complain.

It's that 99 percent of the total settlement is really a disguised tax hike.

Taxing cigarettes more heavily may or may not be a good idea, the critics say, but labeling as "damages" what is effectively a sales tax is misleading and will create a boondoggle for trial lawyers and a windfall for the smaller tobacco companies.

Under the deal, the Big Four tobacco producers will wind up paying direct damages of at most 1 percent of the settlement total, or $2.4 billion. That amount, calculated as a proportion of the companies' current market value, is to be paid regardless of how many packs of cigarettes they sell in the future.

The rest of the $206 billion will be paid by smokers: Cigarette prices are expected to climb by an average of about 35 cents a pack.

"Reasonable people can disagree whether increasing the cigarette tax is a good or bad idea," said Jeremy Bulow, the incoming chief economist of the Federal Trade Commission. "But the reason that the attorneys general don't want to call it a tax is so they can claim a political victory."

Clearly investors thought the deal was worth celebrating.

On Nov. 20, the day the attorneys general announced the settlement, the stock of the leading tobacco companies soared. Investors chose to disbelieve that an industry with profits of $5 billion a year would be paying $8 billion a year in damages for the next 25 years. Instead, the investors gave credence to stock analysts who believe that the profits of tobacco companies will decline by a maximum of 10 percent. And cigarette producers wasted no time in raising prices — a day after the settlement was signed on Monday, two major companies raised prices 45 cents a pack.

The higher prices represent what is essentially an old-fashioned sales tax, the very kind of tax that the Republican Congress shot down a few months back as "big government."

What makes it a tax? The fact that the amount paid is to rise and fall with the number of cigarette packs sold.

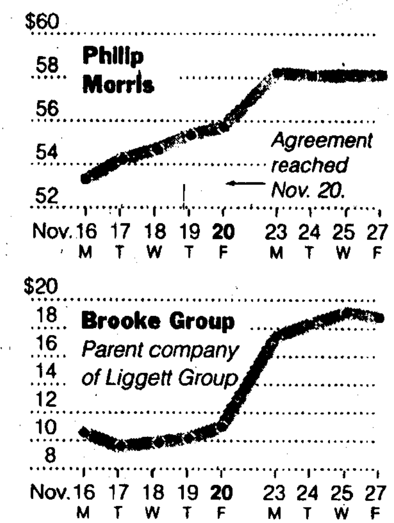
Like many sales taxes, it is borne primarily by the consumer. "Every single cigarette tax ever passed has been paid fully by the consumer," said John Gruber, an economist at the Massachusetts Institute of Technology and a former Deputy Treasury Secretary. "There's no reason to think this will be any different."

"If it looks like a duck, quacks like a duck . . .," Mr. Gruber added. "It's a tax because it's a set of payments made by tobacco companies that depend on how many packs they sell."

Still, most economists think it makes sense to use taxes to have the price of cigarettes reflect their true social cost,

Feeling No Pain

Judging from the stock price of these two companies, investors do not think tobacco profits are likely to decline substantially as a result of the industry's $206 billion settlement with 46 states.



Source: Bloomberg Financial Markets

The New York Times

though some, like Mr. Bulow, have reservations because the taxes fall heavily on the poor. And as tobacco companies have known for years, the evidence is compelling that raising prices leads some smokers to cut back and deters teen-agers from picking up the habit.

But by disguising a de facto sales tax as damages, the critics maintain, the states have agreed to a deal with unintended consequences that are just hinted at in the joint news release describing the 100-page settlement. By calling taxes damages, the critics say, the states wound up agreeing to provisions that Congress would never dream of if it passed a tax increase.

For example, economists cite the huge contingency fees that the 200 or so trial lawyers who helped produce the agreement will collect. Under the deal, the lawyers will divide $1.25 billion initially and about $500 million a year thereafter. That's an $8 billion payout, or 20 times the biggest contingency fee ever paid, the $400 million collected by a lawyer in the 1985 Texaco-Pennzoil case.

Mr. Gruber calls the legal fees "huge, gross and disgusting." Mr. Bulow estimates that had the fees been calculated only on the basis of actual damages, each lawyer would receive an average of about $1 million apiece, versus the $40 million apiece that the lawyers will actually collect.

"By calling the settlement 'damages' it makes it seem reasonable to pay the lawyers a lot," said Paul Klemperer, an economist at Oxford University. "If you called it taxes, you wouldn't expect to give lawyers a fraction of the tax."

The lawyers maintain they are being paid fairly for taking a huge gamble. But for one thing, some states hadn't even got around to filing suits against the tobacco companies, so the lawyers in those states haven't done much of anything yet. And those lawyers who have put in time did most of their work in the past year — after it became clear that a broad settlement was a near-certain bet.

A second consequence of calling taxes damages is that the deal, far from in-

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The Ifs And Buts

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flicting pain on all cigarette producers, actually enriches a few of them. Take Liggett & Myers, which until recently was valued at about $120 million and which hadn't turned a profit in several years. Under the deal, Liggett will actually collect an annual subsidy of about $100 million, courtesy of taxpayers.

Here's how. A tax hike applies to all cigarette producers, big and small, current and future. But the states can only collect damages from the companies they are suing: in this case, the Big Four: Philip Morris, R. J. Reynolds Tobacco, Lorillard Tobacco and Brown & Williamson Tobacco.

But by limiting damages to the largest companies, the states would be handing smaller tobacco producers like Liggett a cost advantage of 35 cents a pack, since the Big Four would have to raise their prices, while the little guys would not. Given that it costs just 20 cents to manufacture a pack of cigarettes, that's a huge advantage.

HOW did the states solve the problem? In effect, they told the small companies that if they agreed to be "taxed" they would be allowed — up to a limit higher than their current sales — to keep the revenue they collected instead of turning them in to the states. Thus, Liggett can match the higher prices charged by the Big Four companies but doesn't have to hand over any of the extra income except in the unlikely event that its sales exceed 400 million packs, or 125 percent of its current sales.

Even assuming that Liggett loses some sales when it raises its prices, Mr. Klemperer said, the subsidy it will collect still amounts to $100 million a year, an amount equal to its recent market value.

Actually, Liggett gained even more from the tobacco agreement. Because of agreements reached earlier with some states, Liggett wasn't as vulnerable as the other companies to states' threats to pass punitive legislation if it failed to climb aboard. To induce Liggett to sign on, Philip Morris, eager to dispel the threat of a firm that could potentially produce cigarettes at a 35-cent cost advantage, paid three times the value of the entire company for 3 of Liggett's 14 brands. The contract stipulated that Philip Morris would pay Liggett $150 million even if the Federal Trade Commission shoots down the deal.

Ian Ayres, a professor at the Yale Law School, is among those worried about the precedent set by the settlement. "It's scary." he said.