The Tobacco Settlement

It’s too bad that just 98 percent of all the trial lawyers, politicians and tobacco executives give such a bad name to all the rest. But if you look at the tobacco Master Settlement Agreement – the deal that purportedly punished Big Tobacco for its sins and compensated state governments for the burden of tobacco-related health care costs – you can see how stuff happens.

In November 1998, the executives of four major tobacco companies and the attorneys general of eight states formally settled their liability disputes. The settlement required the companies to pay fees to the states on future sales of cigarettes, in return for an end to all state claims against the companies for fraud and violations of antitrust laws as well as for smoking-related Medicaid expenses. The remaining states (other than the four that had previously made similar deals with the big cigarette makers) were given a week to decide whether to sign, and all of them did.

By Jeremy Bulow

WARNING: Negotiating with trial lawyers and cigarette companies can be dangerous to your fiscal health.
Economists estimate that about one-fifth of the 20 percent decline in smoking since 1998 is attributable to the increase in cigarette prices because the tobacco companies passed the fees on to smokers. So, as a result of the agreement, fewer people are smoking fewer cigarettes. And the states have a new multibillion-dollar source of revenue, whose burden falls only on those who choose the self-destructive behavior of smoking. As my grandmother never said, “What’s not to like?"

Well, actually, plenty. The structure of the agreement effectively forced individual states to sign on in spite of the inherently unfair formula for distributing revenues, lest their own residents bear the costs of higher cigarette prices with no offsetting revenue for the state. Under the agreement, smokers in some states (including Georgia, Kentucky, North Carolina and Virginia) are paying over $100 million per year more for tobacco than the settlement returns to their states’ coffers. Sometimes the companies and state attorneys general who negotiated the settlement say the division of revenues was based on estimate of individual state’s Medicaid costs; other times they argue it was unrelated to Medicaid. Opinions seem to vary according to the context in which they are voiced. The data show no link between payments and Medicaid costs.

Straightforward taxes on cigarettes would be fairer and have a more neutral impact on competing manufacturers. But as we shall see, more conventional taxes would be much worse for the overall financial health of the trial lawyers and the tobacco companies, as well as for a handful of the states that were at the center of the negotiations on the master agreement.

**THE (UNEASY) JUSTIFICATION FOR HIGH CIGARETTE TAXES**

Most people agree that the days when “sin” taxes can be justified on moral grounds are over. One way or another, then, high cigarette taxes must be linked to the costs that smoking imposes on others. The federal government’s Centers for Disease Control’s estimates for medical care costs and lost productivity linked to smoking from 1995 to 1999 were a whopping $157 billion per year, or $6 to $7 a pack. However, smokers and their families bear the brunt of these costs, just as the consumers of Krispy Kremes and supersized Cokes bear most of the costs of the empty calories. And to the extent that consumers already pay, there is no cost spillover that needs to be offset by taxing cigarettes more heavily.

This leaves three possible ways to justify higher cigarette taxes: Claims that smoking generates a different cost spillover through environmental or secondhand smoke; claims that the government bears a significant portion of the costs of smoking-related illness through Medicaid or Medicare programs; and claims that, because smokers are addicted and would in many cases be happier if they quit or smoked less, the current price of cigarettes is lower than the economically efficient price.

The evidence on secondhand smoke is mixed. The surgeon general recently concluded that “the scientific evidence indicates there is no risk-free level of exposure to secondhand smoke.” On the other hand, a study by two academics, James Enstrom and Geoffrey Kabat, of 118,000 people in California over a
40-year period, published in the British Medical Journal in 2003, found no measurable effect from passive smoking. A problem in such studies, which tend to focus on the health of nonsmokers who live with smokers, is that it is hard to correct for other differences in behavior that may affect health. To illustrate the pitfall of not making such corrections, consider the fact that people in Greece smoke much more and spend much less on health care than Americans do — yet still live longer. That hardly means the Greeks benefit from smoking.

Regardless of how one interprets the evidence on the effects of secondhand smoke on health, public and private enterprises seem within their rights to bar smoking on their property, if only because of the distasteful smell. But today, with such bans so prevalent, the remaining costs of secondhand smoke are overwhelmingly borne by spouses and other family members. Applying compensatory taxes to correct for cost spillovers within households is difficult at best, as those who impose the cost and those who should be compensated share family incomes.

While smokers do incur higher average annual health care expenditures, and some of these expenditures are borne by state and federal governments, there is more to this part of

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The story, too. Smokers also have a shorter life expectancy, which reduces their likelihood of collecting both Medicare benefits and Social Security payments in old age. A Harvard Law professor, W. Kip Viscusi, has estimated that smokers were already more than paying their way through taxes at both the state and federal levels before they were subjected to the settlement fees. Note, moreover, that, since the time Viscusi made those estimates, state and federal cigarette taxes have more than doubled.

It is surely true that many people who smoke would be happier if they quit, and that higher cigarette prices do inspire efforts to reduce consumption. By the same token, teenagers may be less likely to make the mistake of starting to smoke if they face higher prices. These “behavioral” arguments, while outside the mainstream of economic analysis, should be taken seriously. It is hard to argue, though, that the settlement’s fee structure is the best possible way (or even a good way) to attack nicotine addiction.

THE BYZANTINE STRUCTURE OF THE TOBACCO SETTLEMENT

The settlement and earlier similar deals with four other states (Florida, Minnesota, Mississippi and Texas) created 55 national taxes on cigarettes – one for the benefit of each participating jurisdiction. For the master settlement, a negotiating committee that included eight state attorneys general determined the fees (tax rates) and exemptions. In 2004, for example, New York collected a tax of about 45 cents for every carton of cigarettes sold anywhere in the country, regardless of whether the participating manufacturer operated in the state. Kentucky collected a national tax of 6 cents per carton sold anywhere in the country, and so on. Those 55 taxes totaled about $4.30 per carton for the original participating manufacturers (Philip Morris, Reynolds, Lorillard and Brown & Williamson) in 2004. Smaller companies that joined the agreement after it was signed by the four majors – known as “subsequent participating manufacturers” – were exempted from making any payments unless their future market shares rose to a specified level over their 1997 shares. Only one of these smaller firms, Commonwealth Brands (the maker of USA Golds), pays significant amounts into the settlement pool.

Also, in addition to the separate taxes for each state and territory under the agreement, there is a supplemental fee on sales by the original participating manufacturers that generates $500 million annually. All of this revenue goes to the trial lawyers involved in the 1998 deal. Indeed, one of the many ironies flowing from the tobacco agreement is that some of this mega-bonanza goes to lawyers who were purportedly representing smokers – the folks who pay the costs of the settlement but receive none of the proceeds.

While the settlement was the deal of a lifetime for the small tobacco companies (which collect fees under it but don’t have to pass on the money to the states as long as their market shares remain minimal) and for the trial lawyers (who receive what is effectively a tort settlement contingency fee on what by any other name is a tax increase), the results are more mixed for the states and for smokers. On the one hand, New York and California
make out like bandits on the distribution of settlements. But it is a financial millstone for states like Kentucky and Oklahoma, which would be far better off if the formula were replaced with plain-vanilla state excise taxes they could keep in entirety.

How did the settlement designers persuade the “losing” states to sign the agreement? One view is that the states were simply bamboozled: Given only a week from the time the settlement agreement became public to join in, many state attorneys general may simply not have had enough time to figure out what a bad deal they were accepting. The other (nonexclusive) possibility is that the states were coerced into signing. When a state (say, Oklahoma) was called upon to sign the agreement, it was given the following options:

1. **Don’t sign.** In this case, the agreement would have meant that Oklahomans buying cigarettes would still have paid fees (taxes) to every jurisdiction that did sign (over $4 per carton in total), but the Oklahoma state treasury wouldn’t get a penny.

2. **Sign, but do not pass the accompanying statutes designed to deter new entry to the cigarette industry.** Again, this would mean that the state’s citizens would pay all the agreement’s fees, but the state would probably not get any money.

3. **Sign, and pass the enabling statutes as written in the original agreement.** This is the option that all signers followed – though at least one had to rewrite its statute because its legislature initially used a wording that the big tobacco companies found unacceptable.

By signing the agreement and passing the required legislation, Oklahoma, for example, was entitled to collect about 4 cents for every carton the participating companies sell nationally. That meant the state would receive less than 50 cents in settlement money for every dollar paid by its smokers, leaving Oklahoma short by some $90 million a year by 2004 compared to the potential revenues from an equal-sized state excise tax on cigarettes. But that, of course, was still better than not signing, and falling short by over $150 million a year.

Big Tobacco was willing to agree to the settlement’s fee system in return for five key provisions. First, the companies wanted not just relief from lawsuits by the states for any past actions, but relief from possible future actions as well. Second, they wanted their wholesalers and retailers to be exempt from future suits, ensuring that their products would continue to be ubiquitously available. Wal-Mart, supermarkets and other chain stores might decide not to sell cigarettes if they were concerned about being sued by the states. Third, the companies wanted the fees to be specific (volume-based) rather than ad valorem (a percentage of value, like a sales tax). This gave an advantage to the more expensive, more heavily marketed cigarette brands like Marlboro, Camel and Virginia Slims sold by the big companies.

Fourth, Big Tobacco wanted provisions to ensure that small cigarette companies
remained small. (More about this later.) Fifth, Big Tobacco wanted to deter entry by new manufacturers that chose not to join the settlement – the so-called “nonparticipating manufacturers” – imposing additional costs on these firms by requiring them to make hefty deposits to escrow accounts that would cover the potential costs of future liability suits. The escrow-enabling statutes and the potential litigation exposure to wholesalers and retailers who sold cigarettes from the nonparticipating manufacturers also provided a stick for getting existing small cigarette manufacturers to join, complementing the carrot of the settlement exemptions they were offered.

While the nonparticipating manufacturers are often portrayed by cartel members as outlaws unwilling to do their civic duty, their real crime is that they did not sell cigarettes prior to the settlement. These companies are not eligible for the generous subsidies provided to incumbent small companies in the form of partial exemption from the obligation to pass on the settlement fees they collect. Thus, the only way these entrants could compete effectively was to stay out of the agreement. Not surprisingly, then, in the first five years of the deal, few new firms decided to join. And those that did typically went bankrupt.

Here is roughly how the state escrow statutes worked originally: a company just beginning to sell cigarettes that chose to sign the agreement would have to pay 4 cents a carton for every carton sold anywhere in the United States to the State of Oklahoma. If the company chose not to sign the agreement, it would be classified as a non-participating manufacturer, and therefore, under the model statute passed by the Oklahoma legislature, would instead have to pay approximately the same amount into escrow – there to be held for 25 years against the possibility that the states would win legal judgments against the company.

But the treatment of participating and nonparticipating companies was not entirely parallel. While a nonparticipating manufacturer’s costs within the states that it operated in were similar to what they would have been as members of the settlement agreement, its national costs would be lower. That’s because the settlement had to be constructed around a set of individual state statutes, after Congress refused to pass enabling legislation. (The Congressional deal collapsed in part because some Republicans tried to limit the contingency fees paid to the trial lawyers.) And the nonparticipating manufacturers could therefore not be forced to open escrow accounts and make payments in states where they did not do business. By contrast, companies that joined the agreement were legally bound to pay all the states.

Thus, if a nonparticipating manufacturer only sold cigarettes in 25 percent of the country, it would have to pay those states roughly the same $1 per carton as would Big Tobacco – but nothing at all to the states in which it did not operate. This, in addition to the fact that the major cigarette companies chose to raise prices by much more than their costs under the settlement, made it possible for the nonparticipating manufacturers to grab about 8 percent of the cigarette market in terms of unit volume.

To understand how significant this 8 percent market share was (and how sensitive to price some smokers had become in choosing brands), remember that the major retailing chains were unwilling to stock nonparticipating manufacturers’ brands because it would have made them vulnerable to liability suits by the states. As a result, the only places bargain-minded smokers could find nonpartici-
parting manufacturers’ cigarettes were in mom-and-pop stores, smoke shops and other small, less-convenient outlets that don’t have the deep pockets tort plaintiffs covet.

The ability of nonparticipating manufacturers to keep their costs low (along with the inclination of a surprisingly large number of smokers to abandon brand-name cigarettes...
in favor of cheap, unadvertised generics) explains why the big exemptions granted to small participating companies by the agreement were needed to keep them within the cartel. Without the exemptions these companies might well have been better off not joining, even though joining enabled them to market their cigarettes much more widely.

Consider Liggett, which, thanks to small-manufacturer exemptions, had an average settlement cost of 37 cents per carton in 2005, saving the company over $160 million compared to what it would have had to pay without exemptions. But that still suited the big-four tobacco companies, which no longer had to worry that Liggett would chip away at their market share. After all, under the agreement, Liggett would have had to pay the full settlement fee – over $4 a carton – on incremental sales that came at the expense of the market share of the major manufacturers.

Under pressure from the participating manufacturers, who feared the rise of the non-participating manufacturers and their no-name brands, the state escrow statutes were modified in 2003. The sums that nonparticipating manufacturers must leave in escrow no longer depend on the number of states in which they sell cigarettes. Hence there is no longer much cost advantage to a strategy of staying out of the settlement agreement and operating in only a handful of states.

That puts the nonparticipating manufacturers in a financially untenable position: their settlement-related costs are now as high as those of participating manufacturers, but the large retailers are not willing to stock their products because of ongoing liability concerns. Indeed, it seems unlikely that the non-participating manufacturers will be able to remain in business – a reality that hardly upsets Big Tobacco.

Wait; it gets worse. If a nonparticipating manufacturer cries uncle and applies for membership in the settlement agreement, it must sign a pledge to pay back any money it saved by not being a participant in the past. But that just isn’t going to happen; the companies don’t have this money because they passed along the savings to cigarette buyers before the escrow rules were changed in 2003.

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To understand why the states chose to make a deal with the cigarette companies rather than just raise cigarette taxes to cover alleged cigarette-related medical costs, do as good reporters do: follow the money. Had the lawsuits that the states brought against tobacco makers been dropped and the state legislatures simply passed tax increases on cigarettes to cover their smoking-related medical costs, the lawyers working for the states would have gotten, at most, hourly fees for their services.

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Others benefited as well from this framing. First, Big Tobacco wanted a national deal that would spare it from being nicked-and-dimed in lawsuits by individual states. The only way to force all the states to join was by taxing consumers in all states and then giving money back to individual states only on the condition that they sign on the dotted line. But since one state cannot impose taxes on business transactions in other states – New York sales and excise taxes must be based on New York (not national) sales – it was in the companies’ interests to structure the payments as the costs of settling a lawsuit rather than as taxes. Second, the structure of the settlement allowed states with proactive attorneys general to set up a financial distribution schedule that reserved disproportionate shares for their own states.

The politicians involved had two extra incentives to go the settlement route. It sounds better to say you negotiated a large settlement from the death-dealers of tobacco than to say you imposed an equally large tax increase on long-suffering smokers. What’s more, by claiming that the revenues were attributable to a one-time settlement paid out over decades rather than to a tax increase, states were able to borrow against future revenues and spend the cash immediately without violating constitutional requirements to balance their budgets each year.

**THE MSA’S “SUCCESS STORIES”**

The egregious sums paid to the trial lawyers as part of the settlement – up to $92,000 an hour in some cases – have been well publicized. Perhaps less well known is that hours, as well as hourly rates, were heavily padded by reading into the record of the cases in different states the same testimony over and over again. But the subsidies that the settlement created for the small participating tobacco companies (Liggett, in particular) are equally unconscionable. After all, at its peak, Liggett sold more cigarettes than Phillip Morris. If the responsibility for smoking deaths lies...
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with the companies that addicted the smokers when they were youths, then arguably Liggett should be responsible for a significant part of the damages – certainly more than its current share of total sales.

One would expect companies that admitted to committing major torts that killed hundreds of thousands of people would be ecstatic about getting off without any sacrifice on the part of their executives or their stockholders. But Liggett wanted – and got – much more as an inducement to sign. Philip Morris was muscled into agreeing to buy four dying Liggett brands for $300 million. In addition, Liggett was given exemptions from the Master Settlement Agreement fees that save it over $125 million per year. Not bad when you consider that before the agreement was negotiated, the entire market value of Liggett stock had fallen to just $37 million.

Some of the other “success stories” spawned by the settlement are equally remarkable. With exemptions under the settlement based on the maximum of 125 percent of 1997 sales or 100 percent of 1998 sales, the little discount-cigarette maker Medallion did what was necessary to quadruple its volume from 1997 to 1998. The owner, Gary Hall, thus acquired exemptions worth over $20 million per year. He later sold his company to Liggett for $110 million. Liggett described the transaction price in its SEC filings as $107 million for the exemptions and less than $3 million for the actual business.

Premier International Holdings more than doubled its cigarette sales in 1998, thereby acquiring exemptions worth $19 million per year. Premier then proceeded to sell more cigarettes than were covered by its exemption. But the company sharply underreported sales, claiming it owed $287,000 for 1999 to 2002 but ultimately admitting that it owed $46.5 million. While Premier was unable to pay off all this debt at once, it was able to provide what the state attorneys general regarded as sufficiently good collateral to allow it to repay over time and thereby avoid being shut down. Just what was that collateral? The company’s ongoing settlement subsidy.

Commonwealth Tobacco, at the time controlled by Brian M. Kelly, received the second largest bundle of MSA fee exemptions. Its market share was largely based on lesser brands that it had acquired from Brown & Williamson in 1995. Kelly went on to sell the company, and last year was the only Kentuckian to make the Forbes 400. He may also have been the only person on the list to create a fortune by starting a company in a low-tech, declining manufacturing industry in the
1990s and building a modest market share in the commodity end of his business.

Finally, since 1997, the big tobacco companies have been able to raise prices by about $2 per carton above and beyond all cost increases linked to tax increases and settlement payments. For perspective, that increase was about equal to the entire cost of producing the cigarettes. While it is impossible to say whether these startling increases in profit margins in a business with significant overcapacity were solely attributable to market power created by the settlement, it is certainly the case that the big companies would have done much worse had the states imposed conventional ad valorem tax increases on cigarettes.

**PUBLIC HEALTH CONSEQUENCES OF MSA TAXATION**

The core provision of the settlement agreement gives participating cigarette makers and their distributors broad protection from legal liability linked to smoking in exchange for collecting huge sums of money from smokers and passing it on to the states. Was this deal with the devil a good one in terms of public policy?

The legal protection ensured that cigarettes would continue to be widely available. Without freedom from lawsuits, it is at least possible that the big retailers like Wal-Mart, which do not touch nonparticipating manufacturers’ cigarettes today because of the potential liability, would have decided that selling brand-name cigarettes was not worth the risk, either. Consumers would then find cigarettes much less convenient to buy.

Hence it is possible that the agreement took us in exactly the wrong direction. As the economists Douglas Bernheim of Stanford and Antonio Rangel of Cal Tech have argued, we can think of the purchase of addictive products as falling broadly into two categories: irrational impulse purchases, and more rational purchases where the consumer weighs the costs and benefits of his decisions. There is a consensus on banning cigarette purchases by minors because everyone agrees they lack the maturity to make good decisions about risking addiction. We also ban certain kinds of cigarette marketing, both to reduce the appeal of cigarettes to young people and to reduce the likelihood of triggering impulse consumption in already-addicted adults.

By helping ensure that cigarettes continue to be sold ubiquitously, the agreement makes it that much harder for addicts to avoid impulse purchases.

On the other hand, there is no political pressure for banning smoking by adults in private. All told, these policies are consistent with the principle that deterrence should focus on impulse purchases rather than on calculated purchases by adults.

The easy availability of cigarettes (or lack thereof) is an important factor in controlling impulse purchases. This rings true, for example, to people who do not buy ice cream because they will inevitably eat it in one sitting. Without the settlement’s legal protections, smokers might no longer be able to find cigarettes at the major stores where they do most of their shopping. Thus, by helping ensure that cigarettes continue to be sold ubiquitously, the agreement makes it that much harder for
addicts to avoid impulse purchases.

Price, on the other hand, is probably a significant factor in reducing calculated purchases, but probably has less impact on impulse purchases. Indeed, much of economics is based on the notion that higher prices tend to curb purchases by rational consumers. So higher prices should lead to a decline in smoking by those making considered calculations.

By contrast, a smoker carrying a nicotine jones is unlikely to be sensitive to price. Indeed, the fact that smoking is fairly insensitive to price – a 10 percent price increase typically causes only a 3 to 4 percent reduction in consumption – is consistent with the idea that we might do better to attack smoking by making it inconvenient to buy cigarettes or by restricting marketing activities, than by raising prices with taxes or fees.

Attempting to price smokers out of the market has another drawback: taxes on cigarettes are highly regressive, because smokers disproportionately have lower incomes. Cigarette taxes could be made a bit less regressive by making taxes proportional to the price of the cigarettes, rather than the volume of tobacco sales since the poor disproportionately smoke deep-discount cigarettes. But Big Tobacco would bitterly oppose such changes because most of the cigarettes it sells are higher priced branded products.

Finally, if the focus of cigarette taxes is to deter young smokers, taxes in proportion to value make much more sense. The public health community long ago concluded that young smokers overwhelmingly bought premium brands because kids are particularly susceptible to image marketing. So for any given tax rate on cigarettes, a tax in proportion to value will tax the cigarettes that kids smoke more heavily. Imposing the same per-carton tax on both the cheap, generic cigarettes and the expensive, heavily marketed cigarettes is like exempting the marketing component of the cigarette price from tax, and may explain why a Justice Department report concluded that the agreement has failed to reduce the big companies’ marketing expenditures.

Ideally, then, cigarette sales should be restricted to outlets that are experts in making their services inaccessible and unappealing. My own Swiftian fix would be to turn over sales to the nice folks who run the Immigration and Naturalization Service. A more practical alternative, perhaps, would be to restrict
retail transactions to state-owned stores that have little incentive to generate volume, as a number of states (among them Idaho, Montana, North Carolina, Ohio, Pennsylvania, Utah and Washington) do with liquor.

**WILL WE EVER BE RID OF THE MSA?**

Few people trust tobacco companies, trial lawyers or politicians. But somehow when the three groups got together and spoke with one voice they were able to convince most people – particularly nonsmokers who benefit from higher cigarette tax revenue – that the settlement had achieved a noble public health goal.

In reality, the settlement preserved tobacco companies’ profits, while it gave the trial lawyers an incredibly large ongoing source of income gouged from the hides of smokers and handed state politicians bragging rights as Davids to Big Tobacco’s Goliath.

While some states came out ahead financially compared to the sums they would have garnered from equivalent state excise taxes, the states lost as a group because they were forced to share the windfall with the trial lawyers and a handful of smaller settlement-favored companies like Liggett.

The confluence of such muscular special
interests that benefit from the agreement has made it difficult to challenge the agreement in court or in legislatures. Smokers don’t have the financial resources or the organization. And while the nonparticipating manufacturers are challenging the settlement agreement because the new structure of the escrow statutes is putting them out of business, the financial squeeze makes it tough for them to spend seriously on court fights.

So is there any hope that the master settlement agreement can be undone? I see three possible avenues to this end.

First, the structure of the settlement, which creates what must be considered either a set of national taxes implemented by states or a set of collusive cost-sharing agreements that raise prices for consumers, would almost certainly fall afoul of the courts if the product in question was anything other than tobacco. And it is possible that court challenges by the nonparticipating manufacturers will prove successful.

Second, the big tobacco companies are now suing to have $1.3 billion returned to them by the states. They are invoking a provision of the agreement that requires states to compensate them if they lose market share as a result of ineffective enforcement of the escrow provisions designed to undermine the competitive edge of the nonparticipating manufacturers. If the companies win these claims, the states may finally come to realize that Big Tobacco is not a docile ally and decide they would be better off with legally bulletproof excise taxes than with the settlement. Before it comes to that, however, the manufacturers will likely offer a deal foregoing all or part of these rebates in return for even tougher measures to keep newcomers out of the cigarette business.

The third and best hope is that legislators in the states whose smokers pay more in fees than the states get back from the settlement will come to realize how badly they were taken in 1998 and devise ways to undermine the agreement. For example, Oklahoma could pass a tax equal to the minimum of the national settlement payment per carton for sales in the state and the state payment under the settlement for every carton sold anywhere in the country.

Since the state’s settlement payment is so low, the effective tax would be the state payment times national sales for virtually every company, and would effectively double Oklahoma’s share.

Alternatively, Oklahoma could sue to prevent the companies that signed the agreement from basing payments to other states on sales within Oklahoma, arguing that each state should get back all the fees paid by its own smokers. The state would have a very strong economic case and, with the home court advantage, an excellent chance of winning before state-elected judges. Indeed, once losing states realize that they have a significant financial interest in dumping the agreement or changing the distribution formula, they should be able to rid themselves of it.