The Performance of the 1998 Tobacco Master Settlement Agreement

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1. Introduction

The 1998 Master Settlement Agreement was innovative in several respects. This settlement marked the end of an unprecedented line of litigation in which the state attorneys general sued the tobacco industry for the state Medicaid-related costs associated with the alleged wrongful conduct of the cigarette industry. The nature of the financial settlement was path-breaking as well in that it did not involve a damages payment that took a conventional form but instead imposed a cigarette tax that had a settlement payment label. The settlement also imposed numerous, quite sweeping regulatory restrictions. Finally, this agreement marked the first major litigation-related payoff by the cigarette industry.

In this paper we analyze the terms of the settlement and its implications. The stakes involved were substantial—on the order of about $250 million over the first 25 years. Some states reaped these funds on an annual basis while others securitized the value of the settlement. How this money was spent is of policy interest as well in that the stated rationale for the payments was to defer health-related costs and to decrease youth smoking. The regulatory restrictions likewise were targeted at decreasing smoking, but may have had anti-competitive effects as well. Thus, the appropriate reference point for judging the settlement is how it performed as an unconventional public policy initiative.

2. The Master Settlement Agreement

The Master Settlement Agreement (MSA) of Nov. 23, 1998 marked the end of the tobacco litigation launched by the state attorneys general against the cigarette industry. This agreement settled the lawsuits initiated by 46 states. Previously, four states—Mississippi, Minnesota, Florida, and Texas—reached separate settlements with the tobacco industry.[1] Because of the national scope of many of the requirements imposed by the MSA, our main focus will be on the MSA itself rather than presenting parallel discussions of every feature of the individual state settlements.

The cases on behalf of the states involved claims for the Medicaid-related costs incurred by the states. Thus, the damages in the case did not pertain to the harms that cigarettes caused to smokers' health but rather focused on the medical costs generated by smoking behavior. The MSA settled this litigation, putting an end to the claims on behalf of the states. Not all tobacco litigation was affected, however, as individual lawsuits, class action lawsuits, and punitive damages were not restricted by the MSA despite attempts by the cigarette industry to obtain protections in these areas. The benefits reaped by the states included a variety of regulatory restrictions and payments, some of which would be made in the immediate future, but most of which would be made in perpetuity.

The first distinctive aspect of the MSA is that this settlement of the litigation did not involve settlement payments of the usual type. Financial settlements typically involve either lump sum payments or structured payments to the claimant, where in each instance the payments are being made by the defendant. For the MSA some of the minor costs were borne directly by the companies, but the primary thrust of the settlement terms was to impose the equivalent of an additional excise tax on cigarettes for which the payments would go to the states. In effect, the states used the MSA to impose additional cigarette taxes rather than obtaining the authorization of state legislatures. Thus, the preferences of the citizenry in the affected states were not reflected in the same manner as they would be if legislation were required. The decision to

[1] In 1997 and 1998 Congress considered but did not pass the Proposed Resolution of the cigarette litigation. Once these states settled individually, the prospects for federal legislation along the lines of the Proposed Resolution disappeared.

participate in the MSA and the terms of the participation were the result of a series of bargains involving representatives of the affected companies and the states, with a small group of attorneys general playing a pivotal role.[2] In addition, the financial costs of legislated taxes and litigation-imposed tax equivalents are different since the litigation imposed considerable costs, particularly in the form of the states' attorneys' fees, which were quite substantial. The imposition of a tax equivalent through litigation rather than legislation involved efficiency costs as well as possible issues of appropriateness of bypassing the usual legislative and rulemaking processes. It is noteworthy that the settlement did not emerge in the abstract but took shape only after the efforts in 1997 and 1998 to pass analogous Federal legislation called the Proposed Resolution were unsuccessful. At the time of that legislation's demise, the cigarette industry favored greater protections against other forms of litigation than would be provided by the subsequent MSA, while anti-tobacco advocates favored higher tax rates than the MSA would ultimately impose.

A natural question to ask is what relationship does a cigarette tax have to the damages sought in the case? The trigger for the payment of any damages is the alleged wrongful conduct by the companies, such as that relating to claims of deceptive advertising and concealment of the product risks. However, if this behavior was in the past and will not continue into the indefinite future, as will the per unit tax equivalent, then the penalty being levied is not directly related to the alleged wrongful conduct or even the time period in which the wrongful conduct is alleged to have occurred. If all major manufacturers were not guilty of the same wrongful conduct, then the imposition of penalties on all firms may not be warranted. The extreme case is that of potential new entrants, which did not exist during the period of wrongful conduct, but if they do

[2] None of the state legislatures were involved in ratifying the agreements, and at least in some instances, notably Massachusetts, the actions of the state attorney general conflicted with the views of the governor.

exist in the future they will nevertheless share in a variant of the penalty structure to be discussed below. The MSA did not provide for a damages payment in any real sense but rather imposed a disguised form of cigarette tax. Likewise, the total amounts of the tax were not directly linked to the damages in the cases, but emerged from the bargaining power of the respective parties. The same types of political factors also determined the relative payment shares for each of the states, as will be discussed below.

Settlement in the form of a tax equivalent rather than a lump sum payment has two additional ramifications. First, taxes raise the price of the product, discouraging smoking behavior through the incentive effect. Second, the total present value of the payments to the states could be larger if the damages were paid in the form of a unit tax rather than a lump sum penalty. Some anti-smoking advocates had favored a lump sum damages payment to maximize the immediate harm to the industry, while others placed greater weight on the objective of discouraging smoking behavior.

The financial stakes in the tobacco litigation settlements were quite substantial. In 1997 and earlier in 1998 before the MSA was finalized, four states reached separate agreements with the cigarette industry: $3.6 billion for Mississippi, $11.3 billion for Florida, $15.3 billion for Texas, and $6.6 billion for Minnesota. These states had been the four leading states in terms of how far advanced their cases were.[3] In addition to the $36.8 billion in settlements for these four states, there was the MSA settlement in the remaining states for $206 million, or $150 billion discounted at a rate of 3%. The combined undiscounted total of payments over the first 25 years is $243 million. There were also about $7 billion in additional payments, including payments for

[3] The first state to file a lawsuit was Mississippi. The trial was about to begin in Mississippi at the time of the settlement. The amount of the settlement exceeded the damages sought in the case. The first of the state tobacco trials took place in Minnesota, but the settlement occurred before the trial was concluded. Texas and Florida had completed most of the depositions of experts before the settlement.

a foundation and anti-smoking education as well as enforcement, making the total MSA cost $213 billion and the total of all settlements about $250 billion.

While some of the payments were initial payments made in the first five years of the agreement, the bulk of the payments consisted of annual payments. The annual payment levels were set so that for the $8 billion payment amount from 2004 to 2007 the MSA agreement would impose a tax-equivalent charge of $0.33 per pack. Combined with the four separate state settlements, the total tax equivalent is $0.40 per pack. New entrants were required to pay these amounts into a fund even if they had never sold any cigarettes before 1998 and thus could not even be affected by the type of litigation that the MSA was settling. For these companies, there was no previous wrongful conduct or previous conduct of any sort. In this way the MSA provided a competitive shield so that firms that were not parties to the litigation could not have a cost advantage.[4] Payments will decline if cigarette sales decline so the agreement does function effectively as a tax.

How the settlement funds would be divided among the 46 MSA participants was determined by a political bargain, the results of which are summarized in Table 1. The first column of statistics is a calculation of the percentage share of the state's medical costs. The denominator in the calculation is the total U.S. smoking-attributable state Medicaid cost, while the numerator is the state-specific value. These estimates are the actual economic costs and are not identical to the approach used by the handful of states that undertook such calculations at the time of the settlement. With the exception of the states' calculation of the medical costs for the Commonwealth of Massachusetts, the states' calculations of the medical costs included the Federal costs share as well as the state share, and also did not account for the net incremental

[4] Potentially these new entrants could obtain reimbursement for these payments 25 years later if they could demonstrate that there was no wrongful conduct throughout the period.

costs of smoking behavior. All economic estimates reported here will follow the practice in the economics literature of isolating the net incremental costs incurred by the states where the reference point will be the nonsmoking smoker.

The second column of statistics presents the percentage share of the settlement received by the different states. Interestingly, New York received a 12.995 percent share that is almost identical to that of California's 12.997 percent share, even though New York accounted for 15.17 percent of the national smoking-related Medicaid costs as compared to 8.551 percent for California.

The best measure of how the states fared is the statistics in the final column of Table 1, which divides the payment share by the medical cost share. States with a value above 1 reaped a disproportionate share of the settlement. The state of Washington, which was represented by the lead MSA broker, then Attorney General Christine Gregoire, received a relatively high ratio of 1.396. The most prominent tobacco states fared particularly poorly, as North Carolina, Virginia, and Kentucky all had ratios in the 0.6 to 0.8 range. The state of Iowa, where the state's tobacco case had been dismissed, nevertheless had a ratio of 0.901, and the state of Alabama, where the state Attorney General refused to file a case because he did not believe such cases had validity, had a ratio of 1.08. Factors other than the state's expected damages amounts in the litigation clearly influenced the distribution of the payments.

Using this sample of 46 states, it is possible to examine a limited set of determinants in a regression analysis of the state share of the MSA payments. The first variable of interest is the state share of the medical costs, which should fully account for the division of the payments if the payments are distributed based on the rationale for the claims. The second variable that we selected as a proxy for the smoking-related policies of the state is the per pack state cigarette tax that prevailed in 1998. One would expect that states with a stronger anti-smoking sentiment would be more aggressive in waging the litigation with respect to the Medicaid claims. Each of these hypotheses is borne out. In the linear regression of the state MSA payment share, the coefficient (std. error) for the medical cost share is 0.9536 (0.0491) and is 0.0092 (0.0052) for the tax rate, with an R2 of 0.89. With all three variables in logs, the results are 0.8352 (0.0338) for the medical cost share and 0.1632 (0.0450) for the tax rate, with an R2 of 0.93. The elasticity of the payment share with respect to the medical cost share is positive, but is less than 1. The tax rate likewise has a positive effect on the payment share the state received, but the elasticity is much lower than that for medical costs.

The MSA included additional regulatory provisions as well. The MSA banned the targeting of youths in advertising and cigarette marketing, which led to subsequent debate over which publications were youth oriented and which were not.[5] Youths were no longer permitted to have access to free samples of cigarettes. In that same spirit, the MSA also banned the use of cartoons in advertising, such as the penguin that appeared in the Kool ads and Joe Camel in the Camel ads. A year before the MSA R.J. Reynolds had voluntarily retired Joe Camel, who was the most prominent cigarette cartoon character.[6] The MSA also banned outdoor advertising and cigarette advertisements, tobacco name brand merchandise, and payments for product placements in movies and television shows. The MSA imposed limits but not a ban on corporate sponsorship of events. The agreement also disbanded the two main trade associations, the Tobacco Institute and the Council for Tobacco Research, and prohibited the companies from lobbying against policies attempting to reduce youth smoking.

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[5] R.J. Reynolds in particular became embroiled in a controversy over the target age group for Rolling Stone magazine.

[6] The role of Joe Camel with respect to youth smoking had been the subject of an FTC case that the agency dropped. Joe Camel retired just before his tenth birthday.

The various restrictions on advertising and marketing raise two classes of possible concerns. First, will these restrictions impede market competition and lead to greater concentration in the industry? We will examine that hypothesis directly below. Second, will the advertising restrictions impede the introduction of new types of cigarettes, particularly those that are less hazardous to individual health? Reduced yield cigarettes such as Eclipse have not made major inroads in the market. Consumers have continued to shift into the "light" cigarette segment, but the very low tar yield cigarette share has declined. From 1998 to 2005 the market share of cigarettes with 12 mg. or less of tar rose from 56.8% to 58.4%, but there was a decline from 22.9% to 18.7% for the 9 mg. or less category, from 13.2% to 11.5% for the 6 mg. or less category, and from 1.6% to 0.6% for the 3 mg. or less category.[7] Increases in cigarette prices coupled with the rise of higher tar generic brands contributed to these trends.

A final noteworthy component of the settlements with the states involved the release of tobacco industry documents. As part of the settlement with the state of Minnesota, the tobacco industry documents obtained during the course of the litigation were posted online and made available for future private suits and class actions against the industry. This measure consequently reduced the litigation costs the plaintiffs would have to bear in future cases by making the results of the discovery process in this case a public good.

3. The Levels and Allocation of the State Payments

The MSA provided for a series of up-front payments ranging from $2.4 billion to $2.7 billion per year from 1998-2003. The annual payments continuing into perpetuity were $4.5 billion in 2000, $5 billion in 2001, and $6.5 billion in 2002 and 2003. Including the four states

[7] U.S. Federal Trade Commission (2007), Table 4A.

that settled separately, the states received $8.0 billion in payments in 2003 and a total of $37.5 billion from 2000 to 2003.[8]

Although the MSA provides for payments to the states that will continue indefinitely, some states obtained much of the future value of the funds by securitizing part of their share of the MSA payments. The principal impetus for these efforts is that many states faced budget deficits so that cashing in on future payments might shortchange future residents but had the advantage of providing immediate political benefits. Table 2 summarizes the payments to the 46 states that participated in the MSA as well as the information regarding these bond issues. Some states sold all of their future revenue, while others sold shares such as 40 to 60%. The largest amounts reaped through the bond issues were $5.5 billion for Ohio, $4.7 billion for California, and $4.6 billion for New York. Some states have had multiple bond issues as they have securitized greater portions of their payments over time.

The value of the bond issues hinged on the ability of the cigarette companies to continue to make their MSA payments. Litigation that led to court awards that threatened the viability of the industry consequently reduced the value of the bonds so that in this domain the interests of the cigarette industry and the states were aligned. After the $10.2 billion verdict in the Illinois class action cigarette case, *Price v. Philip Morris Inc.*, Philip Morris was required to post a $12 billion bond if it wished to appeal the case. Because this amount threatened the company's ability to pay its April, 2003 MSA payments to the states, the value of the MSA tobacco bonds dropped by 20%.[9] California cancelled the sale of its bonds, and New York proceeded with its $4.2 billion sale but only after pledging to make up any shortfall in the tobacco companies'

[8] See p. 3 of Andrew McKinley et al. (2003), NCSL.
[9] Ibid, NCSL (2003), p. 26.

payments with the state's general revenue funds.[10] Although the Illinois Supreme Court subsequently overturned the verdict in the *Price* case, this incident highlights the continued financial stake that the states have in the financial well-being of the cigarette industry.

The allocation of the payments by the states bore little relation to the avowed objective of decreasing tobacco smoking, particularly among underagesmokers. Table 3 summarizes the spending distribution of both the payments and the securitized proceeds. Note that these allocations are gross allocations, not net, so they may not necessarily indicate an increase in state spending in particular areas. Almost one-third of the funds were designated for health programs. While Medicaid is included among the targeted efforts, other funded programs included cancer prevention programs generally, drug addiction programs, and the provision of adult health insurance, medical assistance for the disabled, and pharmaceutical assistance for the elderly.[11] As Table 3 indicates, most of the funds were for deficit reduction, unallocated general revenues, general purposes, and other categories unrelated to smoking and health. Many states had quite targeted allocations, as Tennessee allocated all the funds to general revenues to balance the budget and Kentucky allocated 50% of the funds for economic assistance to tobacco farmers.[12] Tobacco control efforts received only 3.5% of the funds, and this categorization is sufficiently broad that it overstates the amount actually targeted at anti-smoking efforts.[13] With rare exceptions, the funds obtained from securitization were targeted to deficit reduction, economic

[10] NCSL (2003), p. 18.
[11] GAO-07-534T, pp. 8-9.
[12] NCSL (2003), pp. 59 and 37.
[13] The relatively ambitious efforts by the state of Illinois in FY 2004 included "$1 million for the American Lung Association, $2.3 million for school-based health clinics, $5 million for grants to local health departments, $1.2 million to the Liquor Control commission for age enforcement, $0.5 million for MSA enforcement, $1 million for tobacco control research, and $5 million for tobacco-use prevention." NCSL (2003), p. 34.

development, education, capital projects, and other matters unrelated to smoking or health. Louisiana and South Carolina included health care among the purposes of the securitized funds.[14]

As a result, the anti-smoking groups have expressed dissatisfaction with how the funds have been allocated. The Centers for Disease Control established funding guidelines for tobacco-use prevention that few states have been able to meet. In 2000 the only state that met the guidelines was Mississippi, which was not part of the MSA. The three states that met the guidelines in the subsequent years were Hawaii, Indiana, and Maine in 2001, Maine, Massachusetts, and Mississippi in 2002, and Arkansas, Maine, and Mississippi in 2003. With the exception of Maine and Mississippi, there are no repeat players in meeting the minimum guidelines established by the CDC. The MSA funds have proven to be quite fungible, bearing little relation to the intended purpose of the funds.

4. The Effects of Advertising Restrictions

A particularly visible consequence of the MSA is that it bolstered the already stringent restrictions on the advertising and marketing of cigarettes. Coupled with the increase in product prices due to the MSA and subsequent state cigarette tax increases, the advertising restrictions led to a substantial shift in the marketing efforts for cigarettes. Constrained forms of marketing and advertising declined, while unconstrained forms often increased. Chief among these marketing effects that increased is the role of price discounts, which by their very nature are targeted to legal purchasers of cigarettes and are also responsive to the demand effects arising from the increased cost of cigarettes.

Table 4 summarizes the trends in different expenditure categories from 1998 to 2005 based on data compiled by the U.S. Federal Trade Commission (2007). All data have been

[14] Johnson (2004).

converted to $2005. The final two columns report the regression coefficient (standard error) from a regression of the expenditure category against a simple time trend variable and a 0-1 dummy variable for the post-MSA period. In most instances, data used for the regressions are available from 1970-2005 so that there are 36 observations per expenditure category.

The “Total” figures at the bottom of Table 4 indicate an overall rise in advertising and marketing expenditures from 1998 to 2005. This increase is reflective of an overall positive time trend in which total expenditures are rising by $271 million per year in addition to the $3.9 billion jump in expenditures in the post-MSA period, which is almost 50% of the 1998 base.[15]

This jump in total advertising and marketing expenditures is frequently cited in the literature but is a quite misleading measure of the temporal shifts. By far the three largest component categories in Table 4 involve pricing effects rather than advertising. The largest component is promotional allowances and price discounts, which rose from $3.4 billion in 1998 to $10.6 billion in 2005. The long term time trend is positive and quite substantial, and the upward post-MSA shift term reflects an increase in allowances of $4.8 billion, which exceeds the overall post-MSA jump for the Total advertising and marketing expenditure category. The second largest category in 2005 is coupons, which likewise represent a form of price discount. The use of coupons displays no significant time trend or response to the MSA. The third price-related component is the retail-value-added category. The pattern for this component reflects a negative time trend coupled with a positive post-MSA effect linked to the increased price of cigarettes after the MSA. Almost all of the retail-value-added component, or 99% in 2005, is from offers such as buy one pack, get one pack free. The remainder involves bonus items such as a T-shirt given away when the customer purchases three packs of cigarettes. The retail value

[15] Total expenditures peaked in 2003 at a level of $15,145,998,000, which is reported here in nominal terms. See the U.S. FTC (2007), Table 2C.

added component has a strong negative time trend coupled with a positive post-MSA shift, but the net effect is that this component is an order of magnitude smaller than the value of promotional allowances and price discounts. Together the three price-related marketing practices involve total expenditures in 2005 of $12.2 billion, which is 93% of all advertising and marketing expenditures.

The relative role of the advertising components was more substantial before the MSA as these categories accounted for 25% of all advertising and marketing expenditures. While some advertising efforts involved a mixture of time trends and post-MSA shifts that are opposite in sign, the net effects over the 1998-2005 period involve substantial declines, with the exception of the modest internet marketing that increased and sampling distributions which were quite stable. Advertising in newspapers, magazines, outdoor ads, and transit ads plummeted.

The three largest advertising categories in 2005 were specialty item distribution, public entertainment, and point-of-sale advertising, each of which accounted for about $200 million in expenditures. The overwhelming share of specialty items distributed were non-branded items such as lighters and sporting goods distributed with cigarettes. Distribution of these items had been rising over time, but the MSA had a dramatic negative effect on the category.[16] Public entertainment expenses were rising over time, with no significant MSA effect. Sponsorships of events in adults-only facilities such as a bar night and sponsorships of general-audience entertainment such as fishing tournaments comprise this category. Point-of-sale advertising had been on the rise over time, but declined post-MSA. This advertising consists of ads posted at the retail location not including outdoor ads posted on the property.

[16] This decline arises in part because specialty items distributed in conjunction with cigarettes were designated as retail-value-added expenses beginning in 1988.

5. Market Structure[17]

In addition to the aforementioned effects of advertising on introducing new lower risk products, there might also be effects of advertising restrictions on market structure. To the extent that the MSA restrained market competition, one might expect there to be a rise in market concentration, which in turn would boost price-cost margins and diminish the consumer surplus received by purchasers of cigarettes. An alternative hypothesis is that advertising limitations would freeze market shares at their current levels, which is also anti-competitive in that new entrants with more desirable products would not be able to gain a foothold in the market. That there might be anti-competitive effects of the advertising restrictions is a concern that was raised after the fact by some economists, though was not a prominent part of the policy debate, perhaps in part because the agreement was never debated in a public forum.[18] It is noteworthy that a classic textbook case of where industry collusion would be desirable is with respect to advertising expenditures, which tend to have a Prisoners' Dilemma type of structure.[19] While industry collusion to restrict advertising is illegal, a legal form of collusion is through the mechanism of the MSA in which the restrictions are instituted under the guise of decreasing smoking rather than reducing advertising costs to the industry. Whether this was in fact collusion is less important than whether it led to the anti-competitive effects associated with collusion.

The data reported in Table 5 suggest that the most extreme fears of the effects of the advertising restrictions were not well founded. Table 5 summarizes the market shares for the major tobacco companies from 1997 through 2005. Philip Morris, the clear market leader, has a

[17] Data discussed in this section are drawn from The Maxwell Consumer Report, Martch 16, 1999, and The Maxwell Report dated March 9, 2000; March 3, 2001; February, 2002; March, 2003; February, 2004; and February, 2006. These are the year end and fourth quarter sales estimates for the cigarette industry in the respective preceding years. Reports include data for multiple years.
[18] Discussion of the possible anti-competitive effects appears in Viscusi (2002) and in the Expert Report of Joseph Stiglitz in *Schwab et. al. v. Philip Morris*.
[19] See Viscusi, Harrington, and Vernon (2005), p. 102.

48-51% market share throughout the period and a 49% share both in 1998 and 2005. Lorillard likewise maintained a 9-10% share throughout this period, and Liggett remained an insignificant player in the market in the 1-3% range.

This considerable stability is not shared by the performance of the other firms. R.J. Reynolds experienced a modest decline in market share from 24% in 1998 to 22% in 2005, but the company with which it merged, Brown & Williamson, dropped from a 15% market share in 1998 to 11% in 2003. The two growth categories were the "Others" grouping of generic cigarettes and Commonwealth Brands, which marketed six discount brands that it purchased from Brown & Williamson.[20] Overall, there appears to be sufficient volatility in the market shares to indicate that market shares were not locked in by the MSA.

The effects on market concentration likewise are modest. The bottom row of Table 5 reports the HHI index values based on the cigarette industry categories shown in the table. While the HHI values are relatively high, which would certainly be expected given that a single firm accounts for half the market, there is no evidence of an anti-competitive increase in concentration. The HHI index in 1998 is 3327, which is a bit larger than the 2003 pre-merger value of 3222. After the R.J. Reynolds-Brown &Williamson merger, the HHI index rises modestly to 3271 and continues to increase to 3336 in 2005.

An additional instructive reference point is to ask what the pattern of HHI index values would have been if R.J. Reynolds and Brown & Williamson were treated as a single entity throughout the 1997-2005 period. If that industry structure had prevailed, the HHI index would have exhibited a decline from 4066 in 1997 to 3336 in 2005, indicating a substantial decrease in market concentration.

[20] The brands were Tuscany, which Commonwealth Brands calls its "premium" brand, and the generic brands USA Gold, Montclair, Malibu, Sonoma, and Riviera.

6. Legal Fees and Subsequent Litigation

The MSA had four principal ramifications for subsequent litigation against the cigarette industry. First, because the attorneys representing the states received billions of dollars in payments associated with the settlement, the financial resources of the plaintiffs' bar were enhanced, thus providing the potential financial backing for additional litigation. Second, the publicity that the tobacco industry was willing to pay a record breaking amount of $250 billion to settle lawsuits launched by the states potentially indicated to jurors that the companies were guilty of record breaking wrongful conduct. Third, the settlement of the lawsuits in the billions gave jurors a new anchor value for damages in the billions rather than the millions.[21] Fourth, the Minnesota settlement provided for the public disclosure of the tobacco industry documents obtained during the discovery process, reducing litigation costs in future lawsuits.

The states contracted out the tobacco cases on a contingency fee basis. Because these deals were not put out for open competitive bids, there is a strong possibility of using the process to reward political allies with excessively lucrative arrangements that are not in the public interest. The attorneys representing Mississippi received 35% of the total settlement amount, or $1.43 billion.[22] The attorney share in Florida was 26%, leading to a payout of $3.43 billion. The attorneys representing Texas in the litigation received 19% of the settlement amount, or $3.3 billion. Attorney fees were $111 million for the state of Missouri and $265 million for Ohio. Although no comprehensive tally of the amount of the fees is available, the U.S. Chamber of

[21] Some observers have hypothesized that the subsequent large verdicts against other companies, such as GM, were also influenced by the anchoring effect of the MSA.
[22] The state-specific figures discussed here are from Viscusi (2002), p. 51. References are provided therein.

Commerce's quite partial tally in 2001 identified $11 billion in fees that had been received by attorneys.[23]

Until the MSA the tobacco industry had a record of never having paid out an individual smoker liability claim. After the MSA the companies did not fare as well. Table 6 summarizes the results of the five largest verdicts against the industry. Three of the cases were individual smoker cases but nevertheless involved enormous verdicts, chiefly in the punitive damages component. The level of punitive damages awarded is $150 million in *Schwarz v. Philip Morris Inc.*, $3 billion in *Boeken v. Philip Morris Inc.*, and $28 billion in *Bullock v. Philip Morris Inc.* The Florida cigarette class action *Engle v. R.J. Reynolds* had punitive damages of $145 billion, while the Illinois "light" cigarettes class action *Price v. Philip Morris* had punitive damages of $3.1 billion and compensatory damages of $7.1 billion. The *Price* case verdict had broad ramification with respect to the market for securitizing the MSA payments. While these decisions were all appealed, the litigation landscape of the cigarette industry had undergone a dramatic shift. Rather than putting an end to litigation against the industry, the MSA increased it. The protections against punitive damages and class actions that were part of the draft Proposed Resolution were not included in the MSA but would have proven to be valuable to the industry.

7. Conclusion

The MSA served as a negotiated form of tax equivalents and regulation that emerged from an out-of-court settlement rather than legislative initiatives. The stakes involved have proven to be enormous, and the structure of the payments has established a commonality of

[23] U.S. Chamber of Commerce, "Chamber Targets Excessive Legal Fees: Files 21 FOIA Requests on Tobacco Settlements," March 14, 2001.

financial interests between the tobacco industry and the states. Bypassing the usual legislative process, or in the case of regulations the usual rulemaking process, is not simply a matter of adhering to the good government principles of elementary civics books. Bargains in which the key parties are the attorneys general and the cigarette industry may not be reflective of the kinds of taxes and regulations that are in society's best interests. Chief among the criticisms to date is that the MSA might have anti-competitive effects by imposing per pack financial penalties on new entrants that were not party to the litigation and by limits on advertising and marketing, which would impede entry and the introduction of new products. Thus far, there is no firm evidence of significant adverse anti-competitive effects.

The other major critique has been with respect to the allocation of the funds, as much less has gone to health and tobacco-related efforts than was anticipated. As with tax revenues generally, states have treated these funds as being fungible so that there has not been the substantial increase in the allocation of funds to health and tobacco programs that many expected to result from the MSA. Whether such a targeting of funds should have been the appropriate policy objective is a different matter that involves comparison of the efficacy of such expenditures with other uses of the resources. Even though the states reaped the funds windfall because of the tobacco litigation, the allocation that best advances the interests of the citizenry may not be closely tied to tobacco-related initiatives.

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Table 1

Ratio of the State Settlement Payment Share to the State Medical Care Cost Share for States Participating in the Settlement[a]

State	Percentage Share of Medical Cost	Percentage Share of Settlement	Settlement Share Divided by Medical Cost Share
Alabama	1.520	1.650	1.080
Alaska	0.280	0.350	1.263
Arizona	0.530	1.500	2.850
Arkansas	1.020	0.840	0.828
California	8.551	12.997	1.520
Colorado	1.229	1.396	1.136
Connecticut	1.948	1.890	0.970
Delaware	0.513	0.403	0.784
Georgia	3.154	2.499	0.792
Hawaii	0.212	0.613	2.886
Idaho	0.229	0.370	1.615
Illinois	5.609	4.739	0.845
Indiana	3.587	2.077	0.579
Iowa	0.983	0.886	0.901
Kansas	0.830	0.849	1.023
Kentucky	2.806	1.793	0.639
Louisiana	2.424	2.296	0.947
Maine	0.724	0.783	1.082
Maryland	2.048	2.302	1.124
Massachusetts	3.170	4.113	1.297
Michigan	3.326	4.431	1.332
Missouri	2.722	2.316	0.851
Montana	0.244	0.432	1.774
Nebraska	0.569	0.606	1.065
Nevada	0.521	0.621	1.191
New Hampshire	0.894	0.678	0.759
New Jersey	4.262	3.937	0.924
New Mexico	0.351	0.607	1.729
New York	15.170	12.995	0.857
North Carolina	3.491	2.375	0.680

North Dakota	0.211	0.373	1.764
Ohio	6.148	5.129	0.834
Oklahoma	1.199	1.055	0.880
Oregon	1.003	1.169	1.165
Pennsylvania	5.298	5.853	1.105
Rhode Island	0.736	0.732	0.995
South Carolina	1.422	1.198	0.842
South Dakota	0.256	0.355	1.389
Tennessee	2.874	2.485	0.865
Utah	0.220	0.453	2.058
Vermont	0.321	0.419	1.306
Virginia	2.766	2.082	0.753
Washington	1.498	2.091	1.396
West Virginia	0.978	0.903	0.923
Wisconsin	1.983	2.110	1.064
Wyoming	0.178	0.253	1.420

[a] Source: Viscusi, W. Kip. (2002). *Smoke-Filled Rooms*. Chicago: University of Chicago Press. Medical cost externality figures assume a 3% discount rate and cost levels for 1995.

Table 2

Master Settlement Agreement Payments and Securitized Proceeds Received by the 46 States
(Fiscal Years 2000-2005)

Fiscal Year	**Payments**	**Securitized Proceeds**	**Total**
2000-2001	$13,200,000,000	$928,900,000	$14,128,900,000
2002	6,238,393,496	3,838,376,465	10,076,769,961
2003	6,306,329,459	6,482,764,469	12,789,093,928
2004	5,340,128,223	4,374,698,723	9,714,826,946
2005	5,453,132,303	389,977,667	5,843,109,970
Total	**$36,537,983,481**	**$16,014,717,324**	**$52,552,700,805**

Source: GAO-07-534T.

Table 3

Amount and Percentage of States' Allocations of Master Settlement Agreement Payments and Securitized Proceeds by Category, Fiscal Years 2000-2005

Category	**Dollars (millions)**	**Percent**
Health	$16,807	30.0
Budget shortfalls	12,806	22.9
Unallocated	6,639	11.9
General purposes	3,955	7.1
Infrastructure	3,350	6.0
Education	3,078	5.5
Debt service on securitized funds	3,005	5.4
Tobacco control	1,943	3.5
Economic development for tobacco regions	1,490	2.7
Social services	961	1.7
Reserves/rainy day funds	810	1.4
Tax reductions	616	1.1
Payments to tobacco growers	521	0.9
Total	**$55,981**	**100.1**

Source: GAO-07-534T.

Table 4

Cigarette Advertising and Marketing Trends[a]

Expenditure Category	Expenditures (thousands of dollars) 1998	2005	Coefficient (Std. Error) Time Trend	Post-MSA
Promotional allowances and price discounts	3,447,864	10,623,750	+163,087* (50,740)	4,765,949* (1,085,423)
Retail value added	1,862,774	732,536	-612,552* (243,067)	+3,448,025* (1,509,589)
Coupons	747,556	870,137	+26,769 (17,309)	-117,310 (107,502)
Newspapers	35,263	1,589	-31,419* (3,222)	223,350* (68,930)
Magazines	336,887	44,777	-16,498* (3434)	-65,262 (73,457)
Outdoor	352,965	9,821	-2399 (2435)	-386,357* (52,091)
Transit	48,094	0	-489 (434)	-49,203* (9,275)
Point-of-sale	348,196	182,193	+12,284* (2,594)	-226,509* (55,486)
Sampling distribution	17,277	17,199	-7,296* (1,731)	+12,064 (37,019)
Specialty item distribution	426,157	230,534	+30,769* (5,132)	-579,425* (109,787)
Public entertainment	297,653	214,227	+7,494* (1,597)	+25,518 (34,171)
Direct mail	69,189	51,844	-16,702* (4,489)	+171,093* (54,264)
Endorsement	0	0	-59* (19)	393 (229)
Internet	150	2,675	+273* (116)	-119 (724)
Total	8,063,793	13,111,000	+271,275* (28,120)	3,860,075* (601,535)

[a] A constant is included in the regressions but is not reported. Expenditure categories not reported in the table are price discounts, sponsorships, and telephone. All data converted to 2005$ using the CPI.

* statistically significant at 0.05 level, two-tailed test.

Table 5

Year-End Market Shares and HHI

	1997	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Philip Morris	0.487	0.494	0.496	0.505	0.510	0.490	0.504	0.475	0.487
RJ Reynolds	0.242	0.240	0.230	0.230	0.223	0.231	0.215	0.288	0.282
Brown & Williamson	0.160	0.150	0.134	0.117	0.109	0.112	0.105	.	.
Lorillard	0.087	0.091	0.104	0.096	0.093	0.091	0.093	0.088	0.092
Commonwealth Brands	.	.	0.011	0.018	0.022	0.030	0.031	0.029	0.035
Liggett	0.013	0.013	0.012	0.015	0.022	0.024	0.026	0.023	0.022
Others	0.010	0.012	0.023	0.019	0.021	0.023	0.025	0.097	0.082
HHI	3291.71	3327.30	3284.82	3317.40	3317.68	3162.91	3221.77	3270.92	3335.90

The data on year-end market shares are obtained from the Maxwell Consumer Reports issued in March 1999, March 2000, March 2001, February 2002, March 2003, February 2004, and February 2006. The year-end market shares are reported in each Maxwell Consumer Report under the table entitled “Company Volume and Market Share.”

Table 6

Largest Cigarette Case Verdicts

Case Name	Award ($ millions)		
	Compensatory Damages	Punitive Damages	Total
Boeken v. Philip Morris Inc. (2001)	5.54	3,000.0	3,005.54
Bullock v. Philip Morris Inc. (2002)	0.65	28,000.0	28,000.65
Engle v. R.J. Reynolds Tobacco Co. (2000)	12.7	145,000.0	145,012.7
Price v. Philip Morris Inc. (2003)	7,100.0	3,100.0	10,200.0
Schwarz v. Philip Morris Inc. (2002)	0.17	150.0	150.17