DEPARTMENT OF HEALTH & HUMAN SERVICES

tobacco
- budget
Ew

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DPC

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Date: 1/30 Total number of pages sent: 4

Comments:

Here's my take - please call me with the final - or just fax me the chart - when you can.

Thanks.

I need it this weekend if possible - briefing DES at 830 am Mon!

200 Independence Avenue, S.W., Bldg. HHH, Room 647-D, Washington, D.C. 20201

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Q: Does the tobacco revenue you're assuming in your budget come from a cigarette tax, or penalties by the industry, or both?

A: The budget simply assumes a stream of revenue in the five-year budget window of $60 billion, roughly equal to raising the price of a pack of cigarettes gradually from --- to $1.20. [DPC to check numbers.] There are no other assumptions – it's compatible with any framework of taxes, penalties or industry payments.

Q: What exactly does this tobacco money fund?

A: It funds the following:

1) **21st Century Research Fund.** The budget includes $ ____ billion for the 21st Century Research Fund the President announced in the State of the Union. That fund includes:

   - NIH funding of $ 20 billion over five years;
   - CDC funding of $ ____ billion;
   - AHCPR funding of $ ____ billion;
   - NSF of $ ____
   - NASA of $ ____
   - Commerce programs (what are they?) of $ ____
   - DOD programs of $ ____ (Are there others?)

   The total for the 21st Century Research Fund is $____ billion over five years [DPC to add numbers]

2) **Cancer Clinical Trials.** The budget includes a 3 year $750 million demonstration that will allow Medicare patients to participate in cancer clinical trials run by the NIH.

3) **Child Care.** The HHS budget includes a $7.5 billion increase over five years in the child care block grant to states.

4) **Other HHS Programs.**

   - **Tobacco Control.** The budget includes a total of $_____ million for FDA regulatory work and enforcement and CDC tobacco control programs over the next five years.
   - **Food Safety.** Approximately $25 million of FDA's food safety increase may be funded with tobacco revenues. [Is this out now?]

5) An Education Department initiative to reduce classroom size is funded at $_____ over five years.

Q: How is this different from what you've said previously?

A: It's not. We've said all along that we expect Congress to pass tobacco legislation which will include payments and penalties from the tobacco industry that would gradually bring the price of cigarettes to about an additional $1.50 per pack over ten years. The budget document simply makes clear that we expect the revenue from that legislation to total approximately $---- in the five-year budget window.

Q: How was that amount calculated and by who?

A: The budget assumptions were calculated by OMB in conformance with the principles the President has laid out. They were done using data from the Treasury Department to calculate the effect of price hikes on consumption of tobacco.

Q: Isn't this an odd way to budget – relying on a tax that you hope will eventually deter all smoking, and end up producing no revenue?

A: No – this is a strategy that is proven, and which the Administration has supported all along. Remember, we're supporting a sound public health strategy of a combination of industry payments and penalties designed to increase the price of a pack of cigarettes by up to $1.50 in the next decade – as needed to meet youth reduction targets of 30 percent in five years, 50 percent in seven years, and 60 percent in 10 years. This budget includes a very realistic assumption of what the revenue from this approach would be in the five-year budget window.

Q: How did you choose which policy proposals will be paid for by the tobacco settlement and which ones will not?

A: In general, funding from the tobacco legislation falls into two categories. One is spending that is tied to the health consequences of tobacco use <u>and</u> uniquely suited for a separate funding stream, such as the cancer clinical trials initiative and the 21st Century Research Fund. The other category is responsibilities to assist children which the States and the Federal government share, like the child care initiative.

Q: Doesn't this mean that many of the policy proposals you've announced simply may not happen if there isn't tobacco legislation?

A: No. As we've said all along, our budget proposal makes clear that these proposals can be fully paid for within the context of a balanced budget. Our budget assumes that Congress will pass tobacco legislation, and we believe that this is a realistic assumption. The budget we are sending to Congress includes a number of proposals to pay for our new initiatives – including tax proposals and spending offsets. Of course, no offset proposed in a budget is guaranteed; the Congress can reject any proposed way of financing a program. If Congress does not pass comprehensive tobacco legislation, we will work with Congress to find other offsets. This is a high Administration priority, and we will find an effective funding mechanism.

Q: Why are some of the President's key priorities funded with tobacco money? Is this just a ploy to increase pressure on Congress to pass tobacco legislation? What are you going to do if Congress doesn't pass a bill this year?

A: First, let's remember that every initiative in our budget submission, including these, are paid for within the context of a balanced budget. The President is committed to that goal, and we'll simply find other offsets to support our key priorities if necessary. That's what happens in the budget process every year.

But we expect Congress to pass tobacco legislation -- it has bipartisan support. So does funding for the NIH, and so does child care. We believe we're going to be able to work with Congress to pass these important initiatives.

Q: Realistically, won't Congress reject tobacco legislation that includes limits on liability, given the new RJ Reynolds documents that indicate that tobacco companies targeted children as young as 14?

A: The new documents are very disturbing, but they only confirm what we've long suspected, while making the need for legislation in this area more clear than ever. Comprehensive legislation stands a far better chance of reducing youth smoking and protecting the public health than lawsuits brought by smokers against the tobacco industry. The President will focus on the legislation as a whole and ask whether it will reduce smoking and protect the public health. If it meets these objectives, he will sign it. As we've said before, limits on liability are not necessarily a dealbreaker; they should be weighed against, and viewed in light of, the public elements of the legislation.

Tobacco/Budget Q&A
~~February~~ 2, 1998

Q: In September, the President said the focus of tobacco legislation should not be about money. In the budget you are submitting today, more than 60 percent of the proposed increase in discretionary spending is paid for by tobacco legislation. Why has the President changed course?

A: The President's course has not changed -- Congress should send the President legislation that will dramatically reduce youth smoking. Experts all agree the single most important step we can take to reduce youth smoking is to raise the price of a pack of cigarettes significantly. That is why last September, and again in his State of the Union speech, the President called for Congress to pass legislation that raises cigarette prices by up to $1.50 per pack over the next ten years as necessary to reduce youth smoking. Our budget simply scores that part of the President's plan, and allocates the revenues to programs that promote public health and assist children.

Q: How can you assume revenues from tobacco legislation when it's not at all certain whether this legislation will pass?

A: It is a normal part of the budget process to account for any revenues that will be raised from proposed legislation. And we believe strongly that Congress will pass comprehensive tobacco legislation this year. If everyone who says they are committed to protecting children from tobacco rolls up their sleeves and gets to work, we will pass a significant piece of legislation.

Q: Why is it that some of the programs funded with tobacco revenues have no relation to tobacco?

A: Most of the spending is directly related to tobacco, such as health-related research and smoking cessation programs. The rest goes to programs that will assist our children. We wanted to ensure that states get a substantial share of the resources, because of the state's contribution in negotiating the original proposed settlement. It is money that goes to children's programs -- to improve child care and reduce class size -- in recognition that these are shared federal and state goals.

Q: Doesn't attaching tobacco legislation to particular spending initiatives hurt the chance of passing this legislation?

A: No. It is a normal part of the budget process to propose how to spend any revenues raised from proposed legislation. And we will work on a bipartisan basis with Congress if it has other ideas on the best way to allocate these revenues. There is no reason why allocation issues should hold up the process of comprehensive legislation.

Q: Doesn't using tobacco legislation as a funding source for important policy proposals -- such as improving child care and reducing class size -- hurt the chances of achieving those proposals?

A: No. We believe Congress will pass tobacco legislation that imposes significant financial burdens on tobacco companies. Of course, no offset proposed in a budget is guaranteed; Congress can reject any proposed way of financing a program. If Congress does not pass comprehensive tobacco legislation, we will work with Congress to find other offsets. These are high Administration priorities, and we will find effective funding mechanisms.

Q: How much money do you expect to raise from tobacco legislation next year? What about over five years? How did you come to this figure?

A: This budget is designed to reduce youth smoking by 30% in five years and 50% in seven years, which is the President's goal. We calculate that the necessary increase in the price per pack will result in about $10 billion in revenue next year and $65 billion over five years.

Q: How much does your plan increase the cost of cigarettes?

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Q: How much money is there for states in the budget?

A: The states will receive as much money over five years as they would have received under the original settlement agreement. A large part of this money will be unrestricted; states can use it for whatever purposes they choose. The rest of the money will go to states for state-administered programs to provide child care subsidies and reduce class size. This money represents the usual federal share of Medicaid recoveries, which the Administration believes should go back to the states in recognition of the important role the states played in bringing about this legislation.

Q: Does your budget assume that the revenues from tobacco legislation will come from increased excise taxes, or from industry payments pursuant to a settlement?

A: The budget assumes that the money will come from annual industry payments pursuant to a settlement.

Q: Some of the money is listed under a category called "Other Uses." What is in this category?

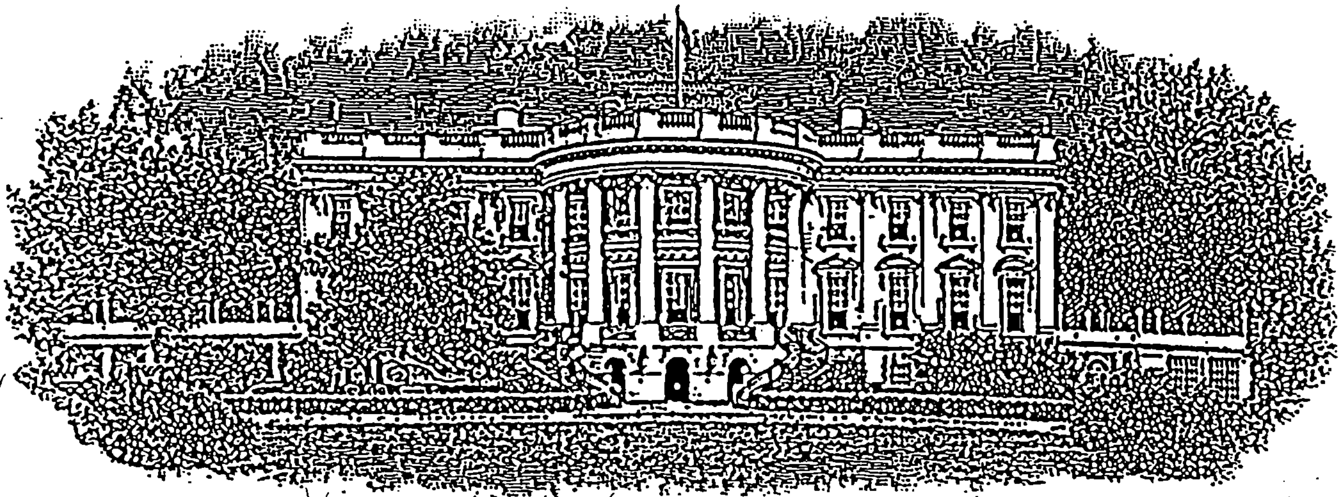
A: This category includes funds that will go to states to use as they see fit, as well as funds for tobacco farmers and for a variety of other uses. We expect final tobacco legislation to make specific allocations within this category.

Q: Last week, several Republicans came out against tobacco legislation that would grant the industry limits on liability. Many public health leaders are also saying that tobacco legislation must not include limits on liability. Does the president still favor a settlement that would include limits on industry liability?

A: The President will evaluate tobacco legislation as a whole to determine whether it protects the public health. Liability limits are not necessarily a deal-breaker for us. What's important is achieving comprehensive legislation that includes, for example, a large per-pack price increase, penalties for marketing to children, and broad restrictions on children's access to tobacco.

We hope that these kinds of statements (statements by Republican senators on liability) don't mean that some members are seeking to walk away from their responsibility to protect children by enacting comprehensive tobacco legislation.

Piecemeal legislation won't accomplish our goal. It's not enough just to say we did something if we don't pass comprehensive legislation that really accomplishes our goals.



tobacco w/ draft Q/A's TLF

DOMESTIC POLICY

FACSIMILE TRANSMISSION COVER SHEET

TO: Melissa Skolfield

FAX NUMBER:

TELEPHONE NUMBER:

FROM: Thomas Freedman

TELEPHONE NUMBER: 456-5587

PAGES (INCLUDING COVER): 4

COMMENTS: Here are draft tobacco Q's & A's.

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1/30/98

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Q: Does your budget assume that the revenues from tobacco legislation will come from increased excise taxes, or from industry payments pursuant to a settlement?

A: We are not calling for a tax increase, we are calling for annual industry payments.

Q: Some of the money is listed under a category called "Other Uses," what are these programs?

A: We have included in this category funds for issues that will ultimately be resolved in tobacco legislation, but where the specific programmatic solutions remain unsettled.

Q: Last week, several Republicans came out against tobacco legislation that would grant the industry limits on liability. Many public health leaders are also saying that tobacco legislation must not include limits on liability. Does the president still favor a settlement that would probably include some limits on industry liability?

A: The President has detailed the five principles that he believes the tobacco legislation should be based on. Liability protection for the tobacco industry is not one of them. By the same token it is not a deal-breaker for us if we are able to achieve the President's five principles. What's important is achieving those principles through comprehensive legislation that includes, for example, a large per-pack price increase, penalties for marketing to children, and broad restrictions on children's access to tobacco.

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tobacco budget — SW

Table S–7. TOBACCO LEGISLATION

(In billions of dollars)

	Estimate					Total
	1999	2000	2001	2002	2003	1999–2003
USES OF RECEIPTS FROM TOBACCO LEGISLATION						
Federally-operated Programs:						
Research Fund for America	3.6	4.6	5.0	5.7	6.3	25.3
Food and Drug Administration Enforcement Activities	0.1	0.2	0.3	0.3	0.3	1.2
Health and Human Services/Centers for Disease Control Smoking Prevention	0.1	0.1	0.1	0.1	0.1	0.4
Medicare Beneficiaries Cancer Clinical Trials Demonstration	0.2	0.2	0.3	....	....	0.8
Subtotal, Federally-operated programs	4.0	5.1	5.6	6.1	6.7	27.5
State-administered Programs:						
Child Care and Development Block Grant	1.2	1.3	1.4	1.6	2.1	7.5
Medicaid Child Outreach Reforms	0.1	0.2	0.2	0.2	0.2	0.9
Class Size Initiative	1.1	1.3	1.5	1.7	1.7	7.3
Subtotal, State-administered programs	2.4	2.7	3.1	3.5	4.0	15.7
Other Uses (Includes unrestricted funds for States, cessation programs, farmer assistance, etc.)	3.4	3.9	4.6	5.0	5.4	22.3
Total Uses	**9.8**	**11.8**	**13.3**	**14.5**	**16.1**	**65.5**
TOBACCO LEGISLATION RECEIPTS PROPOSED	**9.8**	**11.8**	**13.3**	**14.5**	**16.1**	**65.5**

Q No relation to Blocs
- Most of it is directly related (research, cess. fed. ctr.) GW Tob. budget - 9/10

Draft Tobacco/Budget Q&A

1/30/98

- But we also wanted to ensure states get $. So we ~~took~~ fed share, + give it to states for mutual priorities

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C. Care + class size are bipartisan top state priorities.

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for

The rest of the money

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go to states for

believes should go to

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We are not calling for a tax increase and not calling for an industry program

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Q: Doesn't attaching tobacco legislation to particular spending initiatives hurt the chance of passing this legislation?

A: No. It is a normal part of the budget process to propose how to spend any revenues raised from proposed legislation. And we will work on a bipartisan basis with Congress if it has other ideas on the best way to allocate these revenues. There is no reason why allocation issues should hold up the process of comprehensive legislation.

Q: How much money do you expect to raise from tobacco legislation next year? What about over five years? How did you come to this figure?

A: This budget is designed to reduce youth smoking by 30% in five years and 50% in seven years, which is the President's goal. We calculate that the necessary increase in the price per pack will result in about $10 billion in revenue next year and $65 billion over five years.

Q: How much does your plan increase the cost of cigarettes?

A: In order to reach the President's goal of reducing youth smoking by 30% in five years, and 50% in seven years, this budget projects about a $1.10 increase in the price of cigarettes over five years.

Q: What programs is tobacco money used for in the budget?

A: In general, tobacco revenues go toward protecting public health and assisting children. First, the budget provides for funds for anti-smoking activities that will help us meet the goals of reducing youth smoking rates. In addition, there are funds in the budget to support the commitment the President made when he announced his plans for tobacco legislation in September to fund a dramatic expansion of health-related research in America. Finally, in recognition of the states' role in bringing suit against tobacco companies, the budget provides for a substantial amount of money to revert to the states. Some of this money can be used for any purpose. Other funds must be used on state-administered programs to assist children (specifically, for child care, Medicaid child outreach, and class size reduction).

Q: How much money is there for states in the budget?

A: The states will receive as much money over five years as they would have received under the original settlement agreement. The rest of the money will go to states for state-administered programs for child care and class size reduction. This money represents the federal share of Medicaid recoveries, which the Administration believes should go to the states in recognition of the important role the states played in bringing about this litigation.

Q: Does your budget assume that the revenues from tobacco legislation will come from increased excise taxes, or from industry payments pursuant to a settlement?

A: We are not calling for a tax increase, we are calling for annual industry payments.

Q: Some of the money is listed under a category called "Other Uses", what are these programs?

for which a specific program has not been settled upon but

A: We have included in the budget funds for resolving issues that will be resolved in tobacco legislation, such as protecting farmers, but for which specific programs are still unsettled.

Q: **Last week, several Republicans came out against tobacco legislation that would grant the industry limits on liability. Many public health leaders are also saying that tobacco legislation must not include limits on liability. Does the president still favor a settlement that would probably include some limits on industry liability?**

A: The President has detailed the five principles that he believes the tobacco legislation should be based on. Liability protection for the tobacco industry is not one of them. By the same token it is not a deal-breaker for us if we are able to achieve the President's five principles. What's important is achieving those principles through comprehensive legislation that includes, for example, a large per-pack price increase, penalties for marketing to children, and broad restrictions on children's access to tobacco.

We hope that these kinds of statements (statements by Republican senators on liability) don't mean that some members are seeking to walk away from their responsibility to protect children by enacting comprehensive tobacco legislation.

Piecemeal legislation won't accomplish our goal. It's not enough just to say we did something if we don't pass comprehensive legislation that really accomplishes our goals.

Draft Tobacco/Budget Q&A
1/30/98

Q: In September, the President said the focus of tobacco legislation should not be about money. In the budget you are submitting today, more than 60 percent of the proposed increase in discretionary spending is paid for by tobacco legislation. Why has the President changed course?

A: The President's course has not changed -- Congress should send the President legislation that will dramatically reduce youth smoking. Experts all agree the single most important step we can take to reduce youth smoking is to raise the price of a pack of cigarettes significantly. That is why last September, and again in his State of the Union speech, the President called for Congress to pass legislation that raises cigarette prices by up to $1.50 per pack over the next ten years, as necessary to reduce youth smoking. Our budget simply scores that part of the President's plan, and allocates the revenues to programs that promote public health and assist children.

Insert 1+2 here

Q. How much money do you expect to raise from tobacco legislation next year? What about ~~O~~over five years? How did you come to this figure?

A. This budget is designed to reduce youth smoking by 30% in five years and 50% in seven years, which is the President's goal. We calculate that the necessary increase in the price per pack will result in about $10 billion in revenue next ~~year and~~ $65 billion over five years.

Q. How much does your plan increase the cost of cigarettes?

A. In order to reach the President's goal of reducing youth smoking by 30% in five years, and 50% in seven years, this budget projects about a $1.10 increase in the price of cigarettes over five years. ~~by the fifth~~

STET

Q. What programs is tobacco money used for in the budget?

In general, tobacco revenues go toward protecting public health and ~~[illegible]~~ assisting children. First, the budget provides for

A. ~~Tobacco revenues are used in the budget to fund~~ funds for anti-smoking activities that will help us meet the goals of reducing youth smoking rates. In addition, there are funds in the budget to support the commitment the President made when he announced his plans for tobacco legislation in September to fund a dramatic expansion of health-related research in America. Finally, in recognition of the states' role in bringing ~~drafting the~~ ~~[illegible]~~ suit against ~~settlement~~ tobacco companies, the budget provides for a ~~pool of funds for programs that we believe states will find mutually agreeable to help children -- such as child care initiatives.~~ substantial amount of money to revert to the states. ~~[illegible]~~ Some of this money ~~is wholly~~ ~~unrestricted. Other~~ can be used for any purpose. Other funds must be used on state-administered programs to assist children (specifically, for child care, Medicaid child outreach, and class size ~~[illegible]~~ reduction).

Q. How ~~much~~ much money is there for states in the budget?

on a bipartisan basis

Insert 2 Q: Doesn't ~~this~~ attaching tobacco legislation to particular spending initiatives hurt the ~~can~~ chance of passing this legislation?

~~A: We do not believe so.~~

A: No. ~~First~~, It is a normal part of the budget process to ~~show how~~ propose how to spend any revenues ~~received~~ raised from proposed legislation. And we ~~Second, the Budget does not like the proposed spending~~ ~~and~~ ~~we~~ will ~~forever~~ work with Congress (if it has other ideas) ~~on the~~ on the best way to allocate these revenues. ~~if there are any disagreements on that issue~~ There is no reason why allocation issues should hold up the process of comprehensive legislation.

INSERT 1 Q: How can you assume as all revenues from tobacco legislation when it's not certain whether ~~this~~ this legislation will pass?

~~The~~ It is a normal part of the budget process to ~~assume revenues from proposed legislation~~ account for ~~all~~ any revenues that will be raised from proposed legislation. ~~In any case~~ And we believe strongly that Congress will pass comprehensive tobacco legislation this year. ~~If~~ If everyone who says they are committed to protecting children from tobacco rolls up their sleeves and gets to work, we will pass a significant piece of legislation.

The states will receive as much ~~$~~ unrestricted money over five years as they would have received under the original settlement agreement ($~~[illegible]~~ __ billion). In addition, the states will receive more than $15 billion for state-administered programs to help children & important role the states played in ~~drafting the original settlement~~, bringing about this legislation.

[Bruce: Is this right?]

A. ~~The budget is consistent with the President's letter to Governors in December—we include a variety of programs that we think states will find mutually agreeable and we look forward to working with them and Congress in working on specific enacting legislation.~~ ~~This funding serves to acknowledge the critical~~

Q: **Some members have criticized the President for including spending programs in ~~your~~ his budget-- doesn't including them hurt the chances of getting legislation? Does this mean the President is not serious about getting legislation?**

A. We look forward to working with members, on a bipartisan basis, to pass legislation. The President has said this at every opportunity, most recently in his State of the Union address that he is committed to passing comprehensive bipartisan legislation. This budget simply scores the plan the President announced in September.

Q: **Last week, several ~~members of the~~ Republican~~leadership~~s came out ~~strongly~~ against tobacco legislation that would grant the ~~tobacco~~ industry limits on liability. ~~citing the recent disclosure of industry documents about marketing campaigns aimed at children as young as 14 as one reason for their stand.~~ Many public health leaders are also saying that tobacco legislation must not include limits on ~~industry~~ liability. Does the president still favor a settlement that would probably include some limits on industry liability?**

See answer attached - use that

A: Limiting industry liability was not among the five principles the President has said Congress must follow in writing tobacco legislation. What he has said is that some limits on industry liability as part of comprehensive tobacco legislation is not a deal-breaker. Our focus will continue to be: reducing smoking, dramatically among kids.

insert 3

Q: **The June 20th proposed settlement included $2 billion in the first year, increasing to about $3 billion per year by the 5th year, for tobacco control. How much does your budget include for tobacco control?**

A: We haven't set an exact dollar amount for tobacco control. The amount needed for tobacco control will depend on the tobacco legislation Congress passes. What is important is that final tobacco legislation must be designed to ensure that we cut youth smoking rates in half in seven years. We have left enough flexibility in the tobacco portion of our budget to pay for legislation that does that.

This money represents the federal share of state Medicaid recoveries, which the Administration has decided to return to the states ~~[illegible]~~ ~~for use in state programs~~ in recognition of the

for use in state-administered programs

GUIDANCE ON TOBACCO
JANUARY 29, 1998

INSERT 3

LIABILITY

* The President has detailed the five principles that he believes the tobacco legislation should be based on. Liability protection for the tobacco industry is not one of them. By the same token it is not a deal-breaker for us if we are able to achieve the President's five principles. What's important is achieving those principles through comprehensive legislation that includes, for example, a large per-pack price increase, penalties for marketing to children, and broad restrictions on children's access to tobacco.

* We hope that these kinds of statements (statements by Republican senators on liability) don't mean that some members are seeking to walk away from their responsibility to protect children by enacting comprehensive tobacco legislation.

* Piecemeal legislation won't accomplish our goal. It's not enough just to say we did something if we don't pass comprehensive legislation that really accomplishes our goals.

LIKELIHOOD OF COMPREHENSIVE LEGISLATION

* Now that the members of Congress are back, we're looking forward to sitting down with them to do the hard work of crafting this legislation. We've had good conversations with staff and members alike, and we believe that comprehensive legislation is not only possible but likely if everybody who says they are committed to protecting children from tobacco rolls up their sleeves and gets to work.

TOIV
Kagan

tob- farmers — EK

Thomas L. Freedman
01/30/98 10:45:05 AM

Record Type: Record

To: Jerold R. Mande/OSTP/EOP
cc:
Subject: Draft Farmers Agenda

These are the notes I sent to Bruce for farmers meeting

------------------- Forwarded by Thomas L. Freedman/OPD/EOP on 01/30/98 10:43 AM ---------------------------

Thomas L. Freedman
01/30/98 10:43:28 AM

Record Type: Record

To: Bruce N. Reed/OPD/EOP, Elena Kagan/OPD/EOP
cc: Mary L. Smith/OPD/EOP
Subject: Draft Farmers Agenda

I. Current dispute

* Ford vs. Robb

* Continue program vs. buy out

* Split between flue-cured and burley

* Ford support in Senate, Robb increase with farmers (health likes buy out)

* Action in House-- Etheridge (companies buy) Baesler (combo Ford/Robb)

II. Upcoming Events

* Subcmtee Hrng Tuesday
* Conrad bill release

III. Next Steps

* Process for choosing policy

* Hill strategy

OFFICE OF
CONGRESSIONAL RELATIONS

UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C.

To; Tom

They have requested a meeting with you Can I set it up? Is there anyone else we should Invite from the WH?

..., 1998

To: Elena Kagan
Domestic Policy Council

From: Lorraine Miller
FTC Office of Congressional Relations

Subject: Update on FTC role in Tobacco Settlement

Jodie Bernstein, the FTC Director of the Bureau of Consumer Protection, Carol Kando Pi..eda, Legislative Counsel in the Office of Congressional Relations and myself want to visit wit.. you briefly to update you on the FTC and the Tobacco Settlement.

Chris Jennings, a friend from my Clinton White House days, suggested that you might be ..e person we needed to touch base with as we continue our involvement in this matter. This meeting is informational in nature.

We have had indications from both the House and Senate Commerce Committees that the Commission may be asked to testify about the Settlement. No time frame has been set, bu.. ve thought that as we proceed, it was clear to us that the mission of the Commission would be ..est served by sharing our thoughts with the decision makers of the Settlement. You should kn..w that we met with Jerry Mande last year regarding the antitrust exemption that may be consi..red in the Tobacco Settlement.

A couple of areas we want to discuss with you are:

(1) Advertising and marketing of tobacco products and FTC's Section 5 authority.
(2) FTC/FDA jurisdiction and enforcement of permissible levels of tar and nico..ine.

We expect to be brief and if you have questions or concerns beforehand, please call me on 202/326-2468.

Thur Jan 22
at ~~2:00~~ 11:45
211

U.S. Department of Justice
Antitrust Division
Economic Analysis Group
Economic Litigation Section
FAX: (202) 307–3372

tobacco

Phone# 395-5086 Date: 7/2

TO: Chad Stone Fax# 395-6809

- ___ Atlanta F.O., (410) 331-7110
- ___ Chicago F.O., (312) 353-1046
- ___ Cleveland F.O., (216) 522-7214
- ___ Dallas F.O., (214) 880-9423
- ___ New York F.O., (212) 264-7453
- ___ Philadelphia F.O., (215) 597-8838
- ___ San Francisco F.O., (415) 436-6683
- ___ AAG, 3109 Main, 616-2645
- ___ Appellate, 514-0536
- ___ ATR Library, 514-9099
- ___ CTF, 307-9952
- ___ C&F, 616-8544
- ___ DAAG; 3113 Main, 514-0306
- ___ Fiscal, 514-6738
- ___ FOIA, 616-4529
- ___ Foreign Commerce, 514-4508
- ___ ISSG, 633-2528
- ___ Legal Policy, 514-9082
- ___ LT. I, 514-6525
- ___ LT. II, 307-6283
- ___ Merger Task, 307-5802
- ___ Operations, 514-1629
- ___ Personnel, 514-0580
- ___ PIP, 514-1517
- ___ Pre-Merger, 514-2363
- ___ Support Services, 514-2200
- ___ TEA, 307-2784
- ___ Telecommunications Task, 514-6381

FROM: Ken Heyer, Antitrust Division

Comments: Here's the memo Doug Melamed had promised you.

Total Pages Transmitted: 12 (Including Transmittal Sheet)
If you do not receive all pages, please call (202) 307-6665.

I. The settlement has 5 major goals:

(A) Prevent youth smoking;
-highest priority because most smokers start before they are legal age

(B) Get current smokers to quit or reduce smoking;

(C) Make tobacco less hazardous for those that continue to smoke;

(D) Avoid protracted litigation;
-it is expensive for all parties

(E) Reduce involuntary exposure to smoking.

II. This memorandum focusses primarily on the key portions of the proposed Act that are designed to implement the first three goals.

III. A general observation about the settlement:

A slight familiarity with the details of the settlement would lead one to believe that the cigarette companies will be paying large sums of money out of their own pockets. In reality a large portion of the settlement will be borne by consumers. To the extent that one believes that the purpose of the settlement should be to punish the cigarette manufacturers, one would be disappointed to learn that consumers will be paying a large amount of the settlement. However, to the extent that one believes the most important objective of the settlement should be to reduce youth smoking, then having consumers pay for settlement, through higher prices, is preferable to having the money come from the tobacco companies.

IV. In this section we describe the two major economic proposals of the settlement.

(A) The Base Annual Payments
-there are annual payments specified for a period of 25 years
-there is an inflation factor applied to the payments
-when tobacco sales increase, the payment increases proportionately. When tobacco sales decrease, the payment declines if adult tobacco sales have declined relative to the base year. Under these circumstances, the payment declines proportionately to adult sales.

-if there is a reduction in the base payment, if industry profits increase above the industry's base year net operating profits, then the annual payment reduction will be reduced by 25%.

(B) The Surcharge
-is a penalty if the industry fails to meet certain targets for reducing youth smoking.
-the surcharge is $80 million per percentage point the industry fails to meet the target. There is a $2 Billion cap per year for the industry.
-the $80 million may be reduced by up to 75% (the abatement) if firms meet youth marketing and other restrictions
-the $80 million number will be adjusted proportionately for percentage increases or decreases compared to base year profit.
-Each tobacco firm pays its portion of the surcharge on the basis of its market share.

V. *Problems with the Actual Settlement Terms*

(A) Here's how the base payment scheme would actually work:

(1) If total volume of smoking increases, the settlement increases proportionately. In other words, for increases in total volume the payment scheme is equivalent to an excise tax per pack.[1] [While not strictly an excise tax (in the sense that a per pack tax is not tacked on at the sales register), tobacco companies will recognize that their total payment, when they come due, will be dependent on how many packs are sold. Thus, the economic effect is as if they were faced with an excise tax].

(2) If youth smoking declines and adult volume is

---

[1]Here's an example: Suppose that total base volume is 200, 100 each for adult and youth, and the base payment is $10. This can be thought of as a 5% excise tax. If total volume increases 25% to 250, the payment increases 25%, since the formula is

(total volume/total base volume) x $10 = (250/200)x $10 = $12.50

Therefore, for increases in volume, the payment is a stable tax per pack.

unchanged, the "excise tax" per pack increases.[2]

(3) If adult smoking declines and youth smoking is unchanged, the "excise tax" per pack decreases.[3]

(4) If youth and adult smoking decline proportionately, the "excise tax" per pack is unchanged.[4]

---

[2]Here's an example that illustrates this point. Suppose that adult volume and youth volume are initially 100 each and that the base payment is $10. Suppose that youth smoking declines to 70 while adult smoking stays at 100. Using the formula for the payment in case of a decline in total volume

(actual adult volume/actual adult base volume) x $10 =

(100/100) x $10 = $10

However, since the payment is made over a smaller total volume, 170, the excise tax rate is

$10/170 = 5.9%.

That is, the excise tax increases.

[3]Here's an example that illustrates this point. Suppose as before adult and youth volume are 100 each and the payment is $10. Now suppose that youth smoking is unchanged, but that adult smoking declines to 70. Using the formula for the new payment, we have

(70/100) x $10 = $7

To convert to an excise tax rate we divide the payment by total volume

$7/170 = 4.1%

Thus, when adult smoking declines and youth smoking is unchanged, the excise tax declines.

[4]Suppose the base numbers are as before. Now, suppose both adult and youth volume decline to 70. Using the formula for the new payment, we have

(70/100) x $10 = $7

To convert to an excise tax, we divide the payment by total volume

(B) Comments on the base payment scheme:

(1) Why the asymmetry of (2) and (3) above? It's not clear from the language of the Settlement itself, however, as noted below, this could easily be rectified by having the actual payment be made equal to the base payment times actual volume over base volume.

(2) To the extent that Act is trying to reduce smoking, the fact that the base payment scheme operates as an excise tax rather than a lump sum payment is good. Excise taxes are a proven method of reducing smoking, especially for young smokers. Although true lump sum taxes penalize the tobacco companies, they do nothing to reduce smoking.

(3) Although the base payment scheme is basically an excise tax, which is good, there is an open question as to what is the correct level of the excise tax. While excise taxes can be an efficient method of forcing individuals to internalize any negative externalities produced by their behavior, a cursory view of the empirical literature on the subject is mixed on whether current cigarette prices (which already include substantial excise taxes) are high enough fully to internalize externalities from smoking.

(4) Higher taxes to reduce consumption, even if not justifiable on standard "externality" grounds, could perhaps be justified on grounds of paternalism towards addicted adults.

(C) Here's how the surcharge will actually work:

From the tobacco companies' perspective, the surcharge over and above "Base payments" due is essentially a tax per youth smoker. This is because every youth that keeps smoking costs the industry. How much? Assume there are 18 million people from ages 13 to 17 (the age groups in Apendix V, section A), of which 14.5% smoke on a daily basis [a rough, though not completely accurate, estimate taken from "Monitoring the Future"]--that's 2,520,000 teenage smokers. 1% of this number is 25,200. The tobacco companies pay 80 million for every 25,200 teenagers that do not quit - that's

---

$7/140 = 5%

The excise tax rate is unchanged.

$3,175 per youth smoker.

From the smoker's perspective the surcharge will work as an excise tax. Suppose that the industry has to pay the maximum tax: $2 Billion. Sales of cigarettes approximate 25 Billion. That's 8 cents per pack.

However, the tax per youth smoker and the excise tax due to youth smoking are likely to be appreciably smaller:

First, it is plausible that the cigarette companies will work hard to do whatever it takes to meet the "no marketing to youth" and other restrictions in order to qualify for the 75% abatement from the maximum $2 billion in surcharges. If this happens, then the tax per youth smoker drops to $794, and the excise tax due to the surcharge drops to 2 cents a pack. Second, if profits in the cigarette industry fall, then the abatement falls proportionately. Experience shows that if companies are regulated on the basis of their profits in a particular line of business, they will find ways of lowering profits, such as taking profits in other lines of business and incurring higher costs. Suppose that due to the new incentives, industry profits drop by ½. Then the per youth smoker drops to $397 and the excise tax drops to 1 cent a pack.

We do not wish to suggest that these numbers above are highly accurate estimates. However, the above rough estimates do suggest that the youth surcharge may not have much economic punch, with the exception of incentivizing the tobacco companies to comply with the minimum specified restrictions on youth marketing, etc. that would enable them to qualify for the abatement.

(D) Problems with the Surcharge

(1) The Free Rider Problem with respect to the penalty
-Recall that each firm pays for its share of the surcharge according to its market share. This allocation lead to a free rider problem because a firm that recruits an underage smoker gets the full benefit of that smoker patronage, but the surcharge is split among its competitors based on their total market share, so a firm still has an incentive to attract underage smokers.
-This may be a situation where antitrust immunity could enable the industry to overcome the free rider problem, however there are more direct ways

of dealing with this particular problem. In particular, basing each firm's surcharge on the change in its sales of cigarettes to youth

(2) Problems with using profits
-As mentioned above, there is a strong reason to suspect that if the industry payment is tied to profits, that the tobacco companies will have an incentive to allocate profits to other non-tobacco lines of business and deviate from cost minimization by converting profits to higher salaries and waste.
-The free rider problem may also be relevant here, since the Act uses industry average profit

(3) Problem with using the abatement
-rewards meeting minimum standards rather than results (but note that there is no free rider issue here, since the abatement process looks at individual firm effort)
-could be counterproductive, if all it does is encourage youth smoking by increasing the "forbidden fruit" aspect of smoking (almost certainly there must be public health studies that look at cross-state and cross-national variations of the effects of implementing laws making cigarettes more difficult for teenagers to buy and banning certain types of advertising. (Note: To the extent that cigarette advertising and marketing are simply a fight among firms for one another's existing customers, requirements to reduce these activities (and thereby qualify for the abatement) are profit-enhancing for tobacco companies, especially those that have relatively ineffective campaigns. In effect, banning certain of these activities may enhance industry profitability without much affecting total demand for their products.)

VI. Other Potential Problems with the Settlement

A. Disincentives for Desirable Innovations

--Mandatory cross-licensing could lessen the incentives of participating companies' to innovate reduced risk tobacco products.

One goal of the proposed legislation is to foster production of reduced risk tobacco products. The proposed legislation contains several elements designed to prompt such innovation by the participating companies. We strongly suspect, however, that at least some of these claimed incentives to innovate may end up having precisely the opposite result. In particular,

Title I (E)(4) provides that:

The manufacturers will be required to notify FDA of any technology that they develop or acquire and that reduces the risk from tobacco products and, for a commercially reasonable fee, to cross license all such technology, but only to those companies also covered by the same obligations.

Title I (E)(4), Proposal at 14. Requiring cross-licensing of this technology may reduce research and development competition among tobacco companies because a firm with leading technology would not be able to benefit from its innovations to the exclusion of other firms with less valuable innovations. A rough, but useful, analogy might be to proposing a repeal of the patent laws (or property rights generally) and requiring mandatory licensing by firms or individuals that develop valuable innovations. The primary economic rationale for patent protection is, however, that rights to one's innovation provide the prospect of economic reward to the innovator, without which investment and innovation are far less likely to occur in the first place. If the participating tobacco companies are, in fact, the most likely source for new reduced risk technology, this cross-licensing mandate would seem to lessen the likelihood that the companies will allocate the research and development funds necessary to develop these reduced risk tobacco products, and therefore that they will not be developed at all. It therefore seems likely that incentives to innovate reduced risk tobacco technology would be increased--and the public heath better served--if this provision were deleted from the proposed legislation.

B. Unclear Scope of Antitrust Exemption

Beyond the proposal to, in effect, raise cigarette prices through imposition of what would essentially be an additional "excise tax," the agreement goes further by proposing an exemption to the antitrust laws. The proposed antitrust exemption broadly states:

In order to achieve the goals of this agreement and the Act relating to tobacco use by children and adolescents, the tobacco product manufacturers may, notwithstanding the provisions of the Sherman Act, the Clayton Act, or any other federal or state antitrust law, act unilaterally, or may jointly confer, coordinate or act in concert, for this limited purpose.

Appendix IV (C)(2), Proposal at 50.

The agreement goes on to provide that the Department must approve any such "process or plan" that is to be exempt from the antitrust laws:

> **Manufacturers must obtain prior approval from the Department of Justice of any plan or process for taking action pursuant to this section; however, no approval shall be required for specific actions taken in accordance with an approved plan.**

Appendix IV (C)(2), Proposal at 50. This draft provision provides no procedural guidance to the Department or to the participating companies regarding such approvals. The draft provision sets no standard for granting such approvals; it does not set a time limit for Departmental approval; and it does not provide for any remedy if companies act before the Department approves proposed activity. Most fundamentally, this proposal raises policy questions regarding the extent to whether tobacco companies ought to be permitted to act in concert to raise prices. If (as seems likely) the monopoly price for cigarettes is above the price that would be produced by the annual payments-generated "excise tax," antitrust immunity would lead to a) higher prices (largely, one would expect, to already addicted (i.e., inelastic) smokers), b) reduced cigarette consumption (the precise reduction would depend on the demand elasticity for cigarettes in the relevant range), and c) higher profits to the cigarette companies.

One could make an economic case for raising prices and cutting cigarette consumption by the amounts implied by this proposal if there is good reason to believe that, at pre-collusion prices, cigarette smoking produces a combination of a) strong negative externalities (an issue on which, as noted below, the evidence seems to be mixed), and/or b) still too much smoking by youths who are probably too immature to make intelligent decisions about whether or not to smoke, c) paternalistic motives towards those who are already hooked[5]. Otherwise, the usual deadweight loss arguments for antitrust scrutiny of collusive behavior would seem to apply. If one were to expressly authorize monopoly pricing, there is an additional issue of who gets to keep the monopoly profits. The large

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[5]It is worth noting an obvious tension between, on the one hand, seeking to help addicted smokers by getting them to cut back on cigarettes while at the same time charging them more money in the process. Insofar as a smoker quits, you may have done him a favor. Insofar as a smoker remains hooked, he is now not only suffering from cigarettes, he is poorer as well.

transfer of consumer surplus to tobacco companies could, if society wishes, be taxed away in some lump-sum fashion. One possibility might be to estimate in advance the profitability to the tobacco companies of colluding under the provisions of this settlement and impose a lump-sum tax of that size up front. Alternatively, one might adjust the terms of the settlement so as to raise the "excise tax" closer to that which would generate closer to monopoly pricing in the industry. This way more (though not necessarily all) of the monopoly rents would be handed back to the government.

VII. What might an "Ideal" settlement look like?

The answer depends on just what goals we are trying to achieve. The following identifies some of the goals implicit (or explicit) in the settlement, and describes very briefly proposed ways of achieving them most efficiently.

Goal(A): Reduce smoking generally

(1) insofar as smokers do not consider the costs of secondhand smoke and the higher expected health care costs they impose on society (assuming those costs exceed the pension benefits they lose due to their early deaths), they tend to smoke too much (i.e., the full cost of smoking includes those costs that smokers don't pay for, inosfar as their smoking decisions do not take them fully into account, they smoke too much)

(2) solved by excise tax = costs they impose on society (with such a tax, a decision to smoke based only on the price of cigarettes and factors internal to the smoker would reflect the full costs of smoking)

(3) recent externality estimates range from 19 cents a pack to $4.80 a pack (a range that's too broad to be of much use since it runs from a fraction of the current excise tax to a multiple of it and thus leaves us uncertain as to whether smokers impose costs on society or subsidize non-smokers)

(4) paternalism could be yet another appropriate motive for raising excise taxes by more than estimated negative externalities

Goal(B): reduce underage smoking

(1) underage smokers seem to act relatively myopically (Chaloupka JPE 1991 pp. 722-42 finds that smoking by older smokers supports the Becker-Murphy model for rational consumption of addictive goods, but smoking by younger smokers

does not)

(2) solved by an excise tax on underage smoking with each firm's tax based on number of kids smoking its brands

Goal(C): punish tobacco firms for fraud/deception

optimal fines are lump sum (otherwise cost passes through)

Goal(D): Get companies to accept settlement. This may require not punishing them severely.

VIII. Practical improvements in the settlement

(A) Have the base payment adjustment be more purely an excise tax. Instead of the formula described and critiqued above, make the payment equal to sales times a constant tax rate (i.e., make it simple and straightforward with incentives pointing in the right direction)

(B) Calculate each firm's surcharge on the basis of the change in *its* sales to kids to eliminate the free rider problem

(C) Base adjustments in the surcharge not on profits (which are hard to observe and easy to distort) but on revenue. This would help ensure that the surcharge is not avoided by accounting gimmicks and tobacco firms would have every incentive to minimize their costs.

(D) The 75% surcharge abatement makes the settlement for underage smoking 75% regulatory command and control and only 25% market incentives. Consider reducing the extent to which companies can get around the full surcharge by meeting criteria other than performance targets (i.e., reductions in number of kids hooked).

(E) If the externality evidence for adult smokers is weak, consider trading off some of the base payment for more surcharge

(F) Greater guidance needed on just what types of "industry cooperation" the antitrust authorities are to be approving. One possibility would be to have antitrust immunity attach only in certain limited circumstances; for example where, in the view of the antitrust authorities, the joint conduct of the participating companies will be primarily to reduce the sale to children and adolescents in the United States of tobacco products produced by the parties. No blanket exemption for cartel behavior across the board.

Finally, consider fixing certain drafting problems in the proposed resolution. For example,

1) change p. 8 to a ban on tobacco companies distributing non-tobacco merchandise. (rather than a ban on possession of such merchandise).
(2) p. 19 should exempt cigarette papers from the ban on use of non-tobacco ingredients (since otherwise it would likely ban all manufacture of cigarettes).
(3) p. 30 should exempt homes and private apartments from the ban on smoking (i.e., 10 people can be a big family or a weekly party).

Effects of the Tobacco Settlement on Tobacco Farmers and the USDA Price Support Program

The Tobacco Settlement between numerous States' Attorneys General and the Tobacco Industry on Friday June 20 is aimed at resolving issues relating to underage smoking and reimbursements to States for Medicaid expenditures related to tobacco-related illnesses. The Settlement also sets national standards controlling the manufacture of tobacco products, restricts advertising alternatives, and mandates a nationwide smoking cessation program. There are no immediate and direct implications for tobacco farmers or the USDA price support program. Nonetheless, there will be indirect effects resulting from the Settlement as the industry restructures in compliance with the 9 titles included in the Settlement.

Agriculture as Addressed by the Settlement

Direct mention of the USDA or tobacco farming occur in two instances within the agreement. The first simply states that tobacco farmers will not be subject to additional regulations over and above those existing for other producers of raw products. "Tobacco farmers will face no greater regulatory burden than the producers of other raw products regulated by the federal government." [Title I, Subtitle E. (See appendix)]

The second mention of agriculture addresses the issue of limitations on FDA regulatory jurisdiction and states: "-- Grower Limitation: FDA jurisdiction does not extend to the growing, cultivation or curing of raw tobacco (USDA has exclusive authority)." [Title V, Subtitle A. (See appendix)]

Indirect Implications of the Settlement for farmers

The primary implication of the Settlement for tobacco growers is added impetus to discourage consumption of tobacco products, reducing the demand for leaf tobacco used in domestic manufacturing.

Declining consumption due to reduced underage smoking

Currently, the proportion of total consumption attributable to underage smokers is not known with certainty. Estimates range from 3 to 5 percent. U.S. consumption in 1996 was 487 billion cigarettes of which between 15 to 24 billion could have been consumed by underage smokers. The Settlement seeks to reduce underage smoking significantly over the next decade and maintain the reduction thereafter:

> Underage use of cigarette products must decline by at least 30% from estimated levels over the last decade by the fifth year after the legislation takes effect, by at least 50% from estimated levels over the last decade by the seventh year after the legislation

takes effect, by at least 60% from estimated levels over the last decade by the tenth year after the legislation takes effect, and remain at such reduced levels or below thereafter. [Title II]

If the Settlement reduces underage consumption by 30 percent by the fifth year, consumption will decline between 5 to 8 billion pieces, assuming underage consumption of 15 to 24 billion cigarettes annually. This is the equivalent of 5.7 to 9.2 million pounds of tobacco (farm sales weight), based on current domestic leaf use per cigarette. U.S. tobacco production in 1996 was 1,517 million pounds.

The Settlement also covers smokless tobacco products in much the same terms as cigarettes. This increases the number of leaf types that may be affected.

Declining adult consumption may result if prices rise because of the Settlement.

At this point, it is difficult to tell how the Settlement will affect retail cigarette prices. Cigarette companies are liable for huge payments under the agreement, beginning with an up-front payment of $10 billion at signing and $8.5 billion due at the end of the first full calendar year following signing. The up-front penalty equals approximately 41 cents per pack (20 cigarettes) based on 1996 U.S. consumption and 26 cents per pack based on total output (including exports). Adding the first annual payment raises the amount to 76 cents per pack for domestic sales and 49 cents for total output. Retail cigarette prices averaged $1.91 nationwide in 1996. Wholesale prices were 99 cents per pack for premium cigarettes, which make up about 72 percent of total output.

Given the imperfectly competitive structure of the cigarette industry and inelastic consumer demand, we would expect much of the additional costs to be transferred to consumers. However, in the past, the cigarette industry has reduced wholesale prices, such as in 1993 when the prices for premium cigarettes were slashed to regain market share from discount brands.

Some respected Wall Street analysts are forecasting a 50-cent per pack increase at the wholesale level, combined with a consumption decline of about 11 percent.

Using a commonly accepted price elasticity of demand for cigarettes, the following table illustrates potential changes in cigarette consumption with 4 levels of retail price increases. The change in cigarette consumption is converted to change in domestic leaf use for each price change. These estimates assume no change in the proportion of imported tobacco leaf used in U.S. manufactured cigarettes. A $1.00 increase in the retail price of a pack of cigarettes results in a 20.9 percent decrease in cigarette consumption and a 116.7 million pound decrease in domestic leaf use, about 8 percent of U.S. production in 1996. Likewise, a 25 cent increase in the retail price results in a 5.2 percent decline in cigarette consumption and a 29.2 million pound decline in domestic tobacco use, about 2 percent of 1996 U.S. production.

Estimated effects of cigarette price increases

1996 average price per pack ($)	1.91
1996 total U.S. consumption (billion cigarettes)	487
Price elasticity of demand	-0.40

price change cents	pct chng price percent	pct chng vol percent	quantity billions	domestic use per 1,000 cigarettes lbs.	domestic use mil. lbs.	pct chng	est chng mil. lbs.
25	13.1	-5.2	462	1.144	528	-5.2	-29.2
50	26.2	-10.5	436	1.144	499	-10.5	-58.3
75	39.3	-15.7	411	1.144	470	-15.7	-87.5
100	52.4	-20.9	385	1.144	440	-20.9	-116.7

The cigarette industry uses both domestically grown and imported tobacco leaf to manufacture cigarettes. In 1995, the most recent data available, U.S.-manufactured cigarettes contained about 35 percent foreign tobacco leaf. U.S. tobacco growers likewise supply both domestic cigarette manufacturers and the export market. In 1996, leaf exports accounted for about 33 percent of U.S. production. U.S.-manufactured cigarettes are consumed domestically and exported. In 1996, 32 percent of the cigarettes manufactured in the United States were shipped overseas.

The effects of changes in domestic consumption of cigarettes on tobacco growers are tempered by prospects for foreign demand for U.S. cigarettes and the proportion of foreign tobacco used by U.S. cigarette manufacturers. The impact of the Settlement and associated price changes on the mix of domestic and foreign leaf used by manufacturers, and the level of leaf imports, is difficult to determine. As manufacturers attempt to cut costs, use of lower-priced imported leaf may rise, accentuating downward price pressures on U.S. tobacco leaf. If, however, facing declining domestic consumption, manufacturers export more cigarettes, that could temper any downward price pressure on U.S. tobacco leaf. Currently tobacco leaf imports are limited by a tariff rate quota; however, in the past year, only about 68 percent of the quota was utilized. In addition, imported leaf which is used to manufacture cigarettes subsequently exported is subject to a duty drawback. If domestic consumption is relatively stable, manufacturers will likely continue using the same proportions of domestic and foreign leaf.

The increase in retail cigarette prices may be less than indicated by the size of the penalties to be paid by the manufacturers. The Settlement contains a provision [Title VI B. 5. (See appendix)] which rebates part of the penalty paid by manufacturers if adult consumption falls below the 1996 level. This provision should negate some of the price effect of the penalty by enabling manufacturers to use the rebate to lower prices and thus regain sales. In addition, the penalties are paid using pre-tax dollars, further lessening the financial burden of cigarette manufacturers and reducing amount prices might be increased. Advertising expenditures, which total about $6 billion annually for the industry, are likely to decline also.

Indirect Implications for the USDA Tobacco Program

The indirect implications for the USDA program are mainly political in nature. Congressional attention focused on the Settlement has already spawned tangential tobacco-related legislative proposals, such as the bill introduced by Senator Mitch McConnell to have cigarette manufacturers cover the costs of the Tobacco Program. In recent sessions of Congress, the Tobacco Program has come under attack and narrowly survived.

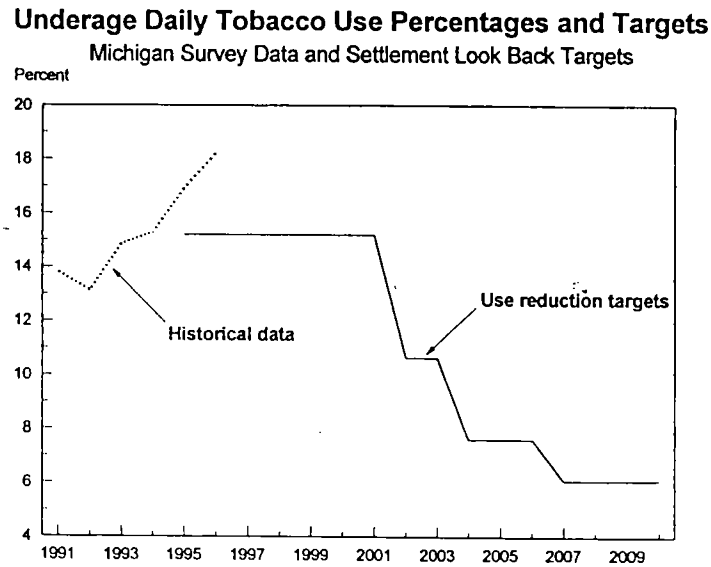
(Preliminary -- NOT final)

THE "LOOK BACK" SURCHARGE

The settlement attempts to provide economic incentives to promote "dramatic and immediate reductions in the number of underage consumers of tobacco products." Manufacturers would face surcharges if the tobacco-use reduction targets are not met. Surcharges will be imposed on the basis of a "look back" comparing actual teen tobacco use percentages to the targeted reduction percentages.

<u>**Will the surcharge be effective? No.**</u>

Our initial calculations indicate that the present value of the stream of profits from a higher percentage of teen tobacco use exceeds the cost of the surcharge by a factor in the range of 3 to 6 -- hence, the economic incentive to firms to reduce teen smoking will not be effective.



- The daily tobacco use percentage for underage teens in 1996 was 18.2 % -- well above the target base of 15.2 % (calculated from data over the past 11 years).

- The surcharge would be imposed beginning in the 5th year after enactment and every year thereafter based on the difference in the actual and targeted percentage reductions in underage use -- at the rate of \$80 million for each percentage point (adjusted for changes in the size of the relevant population and industry profits).

- For the case of no change in the level of teen daily use (staying at 18.2 %), the surcharge for the fifth year would be about \$660 million (in 1997 dollars). The present value of the future profit stream from the additional smokers above the target would be much higher at about \$3.6 billion -- *5-1/2 times greater than the cost of the surcharge*. (After-tax comparisons would yield the same ratio under the assumption that the profits tax rate remains unchanged through time.) Similar ratios apply to the surcharges in other years.

- If we assume that teen use declines because of higher cigarette prices from higher excise taxes, the use percentage falls to about 13-1/2 percent and the surcharge in the fifth year would be about \$400 billion and the present value of profits would be about \$1.4 billion for a ratio of about 3-1/2.

These results indicate that to be effective, the surcharge would have to be increased by a factor of about 3-1/2 to 5-1/2, or somewhere in the range of $280 million to $440 million per percentage point.

Some Assumptions:

Discount rate:	4.0 %	
Profit per pack:	$0.30	
Intensity of use:	1 pack a day	
Survival probability:	taken from FDA rule in Federal Register	
Teen population:	Census middle series	
Teen price elasticity:	-1.0	(second scenario assumes that % decline in use translates in to % decline in users)

THE TOBACCO SETTLEMENT PAYMENT MAZE

($ Billions)	Upon Enactment	12/31 of: Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11	Years 12+
Lump Sum Cash Payment	10.0	—	—	—	—	—	—	—	—	—	—	—	—
Public Health Funds													
Smoking Cessation	—	1.0	1.0	1.0	1.0	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
HHS smoking initiative	—	0.125	0.125	0.125	0.225	0.225	0.225	0.225	0.225	0.225	0.225	0.225	0.225
FDA enforcement	—	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
State and Local ASSIST	—	0.075	0.075	0.1	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125
Research	—	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
NASCAR, Rodeo	—	—	0.075	0.075	0.075	0.075	0.075	0.075	0.075	0.075	0.075	0.075	—
Counter-Advertising	—	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Unallocated	—	—	—	—	—	0.175	0.175	0.175	0.175	0.175	0.175	0.175	0.25
SUBTOTAL	—	2.1*	2.175	2.2	2.325	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Tort Fund	—	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	
"Public Health Trust"	—	2.5	2.5	3.5	4.0	5.0	2.5	2.5	2.5	—	—	—	—
Medicaid Payments to States	—	—	0.825	1.8	3.675	3.0	5.5	5.5	5.5	8.0	8.0	8.0	8.0
TOTAL	10.0	8.5	9.5	11.5	14.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0

*First Year number for Public Health Funds is supposed to be capped at 2.0

Amounts do not include: (1) additional liability payments not covered by tort fund (up to an additional $1 billion per year),
(2) youth smoking reduction penalties (up to $2 billion per year); or
(3) attorneys fees

Tobacco

CDC's Proposed Public Health Initiative

Resources potentially resulting from the tobacco settlement should be used for unmet public health needs. We propose using the settlement dollars in three high priority areas:

I. Implement Known and Effective Prevention Strategies for Youth ($550 million)

- **School-based Health Education:** This initiative would implement comprehensive school health programs in every State in the Nation and develop and disseminate model policies and programs through national partners. ($100 million)

- **Tobacco:** The initiative would implement a comprehensive approach to tobacco use prevention and substantially strengthen state-based tobacco efforts. ($230 million)

- **Other important youth priorities** ($220 million)
  - Safe America: Through Injury Prevention and Control
  - Healthy Homes, Healthy Children
  - Hazardous Chemical Exposures in Children
  - Prevention of STD-related infertility in youth

II. Develop and Address Unmet Opportunities for Prevention ($290 million)

- **Cardiovascular Disease:** No national public health program addresses this major cause of tobacco-related death. This initiative would establish that capacity in all States. ($100 million)

- **Monitor the Health of the Nation:** It is vital to have in place adequate health information systems to monitor the impact of public health efforts. CDC and the States do not have the capacity to do this. This initiative would build it. ($120 million)

- **Other Priorities** ($70 million)
  - Asthma prevention
  - Capacity for Occupational Safety and Health
  - Folic Acid for Healthy Babies and Adults

III. Protect Public Health: Repair Past Damage and Prepare for Urgent Threats ($520 million)

- **Prevention Block Grant:** Public health has eroded over the last two decades, as reported by the IOM. Doubling the prevention block grant would repair that erosion and direct resources to States to use as they see fit to address public health needs. ($150 million)

- **Infectious Diseases: Emerging and Reemerging Threats:** Infectious diseases are the third leading cause of death in the United States. This initiative would implement "A Prevention Strategy for the United States." ($120 million)

- **Other Priorities** ($250 million)
  - Vaccine-preventable Diseases
  - Emergency Preparedness
  - Preventing Environmental Disease