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Total Pages: 12

LRM ID: RJP232

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
Washington, D.C. 20503-0001

Monday, March 23, 1998

URGENT

LEGISLATIVE REFERRAL MEMORANDUM

TO: Legislative Liaison Officer - See Distribution below

Janet R. Forsgren

FROM: Janet R. Forsgren (for) Assistant Director for Legislative Reference
OMB CONTACT: Robert J. Pellicci
PHONE: (202)395-4871 FAX: (202)395-6148
SUBJECT: **TREASURY Testimony on comprehensive tobacco legislation**

DEADLINE: **3:00 p.m. Monday, March 23, 1998**

In accordance with OMB Circular A-19, OMB requests the views of your agency on the above subject before advising on its relationship to the program of the President. **Please advise us if this item will affect direct spending or receipts for purposes of the "Pay-As-You-Go" provisions of Title XIII of the Omnibus Budget Reconciliation Act of 1990.**

COMMENTS: Hearing is before the Senate Committee on Commerce, Science, and Transportation **TOMORROW** - March 24th. Treasury Deputy Secretary Summers is the witness.

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RESPONSE TO
LEGISLATIVE REFERRAL
MEMORANDUM

If your response to this request for views is short (e.g., concur/no comment), we prefer that you respond by e-mail or by faxing us this response sheet. If the response is short and you prefer to call, please call the branch-wide line shown below (NOT the analyst's line) to leave a message with a legislative assistant.

You may also respond by:
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(2) sending us a memo or letter
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TO: Robert J. Pellicci Phone: 395-4871 Fax: 395-6148
Office of Management and Budget
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The following is the response of our agency to your request for views on the above-captioned subject:

______ Concur

______ No Objection

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______ See proposed edits on pages ______

______ Other: ______________________

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March 23, 1998 DRAFT

TREASURY DEPUTY SECRETARY LAWRENCE H. SUMMERS
SENATE COMMITTEE ON COMMERCE, SCIENCE AND TRANSPORTATION
March 24, 1998

Mr Chairman, thank you for giving me this opportunity to discuss economic and financial aspects of tobacco settlement proposals presently before Congress. As you know, President Clinton strongly supports the efforts of yourselves and others in Congress to forge comprehensive legislation to protect America's children from the deadly threat of smoking that is consistent with the principles he outlined last fall.

Before I begin, let me introduce Jonathan Gruber, our Deputy Assistant Secretary for Economic Policy. We deeply regret the misunderstandings that occurred last week regarding his appearance before this committee. At Treasury and throughout the Administration we have been and will remain one hundred percent committed to working with this Committee and others in Congress to address an issue of such enormous consequence for the health of the American people and our economy.

I would like to spend my time today discussing three economic aspects of a comprehensive approach to combating tobacco use in this country: the vital role of significant price increases as part of any such approach; the scope for such increases to be achieved without imposing unfair adjustment costs on American tobacco farmers and manufacturers; and the range of tools available to address concerns relating to possible increases in smuggling as a result of such price rises.

First, however, let me say a few words about the background for this discussion: the enormous burden that smoking imposes on our nation and our economy; the need to cut teen smoking to start reducing that burden; and the need for a comprehensive settlement to achieve that goal.

I. Combating Smoking: the Need for a Comprehensive Approach

1. The Human and Economic Costs of Smoking

Smoking is by far the largest preventable cause of premature death in the U.S. As Dr. David Satcher noted in his testimony last week, over 400,000 Americans die each year of tobacco-related diseases. This toll exceeds the combined deaths from AIDS, homicide, suicide, alcohol use, illegal drug use, fires, and motor vehicle crashes. And recent estimates indicate that if current tobacco-use patterns in this nation persist, an estimated 25 million persons living today will die prematurely from a smoking related disease.

Behind these heavy human costs of smoking lie equally heavy economic costs for our nation:

- we spend about $60 billion each year treating smoking related illnesses. On its own, smoking during pregnancy -- which results in 2500 fetal deaths and doubles the odds of being born with low birth weight and potentially suffering problems later in life as a result -- costs the country some $3-4 billion every year;

- fires caused by smokers cost another $500 million -- and 2000 lives -- per year;

- smokers with group life insurance push up the premiums of the non-smokers in their insurance pool by about $4 billion dollars per year;

We have also to consider the enormous cost to our economy from all the premature retirements, and premature deaths of productive workers that are caused by smoking -- amounting to $60 billion or more in lost wages.

2. The Importance of Reducing Teen Smoking

There is a strong consensus on the need to reduce smoking in this country and the heavy costs that smoking brings with it. And there is an equally strong consensus on the most effective way to achieve that goal. It is to stop smoking when it starts -- in adolescence. Nine out of ten smokers start when they are in their teens. And the record shows that once they start smoking, they are unlikely to stop.

Each day, 3000 young people start smoking. Fully one third of them will have their lives cut short by it, because it causes an addiction that is very hard to shake later on. Nearly half of teen daily smokers think they will not be smoking five years later. Yet only one fifth actually manage to quit. One half of teen smokers try to quit and fail; and by age 18, two-thirds have already regretted starting. The regret is understandable: nearly half of adult smokers try to quit every year, but only about 2.5 percent succeed.

3. Why We Need a Comprehensive Approach

The Administration's efforts are guided by another lesson of experience: that preventing youth smoking demands a comprehensive attack on the problem, an approach that makes tobacco companies part of the solution. The fact is that the piecemeal approaches of past years have not worked. Youth smoking has continued to grow through the 1990s and shows no sign of declining.

What is required is a coordinated, comprehensive approach based around the five core components that the President outlined last fall.

1. A combination of annual payments and penalties on the tobacco industry designed to achieve targeted reductions in teen smoking by raising the price of a pack of cigarettes by up to $1.50 over 10 years.

A significant price increase is integral to any comprehensive plan to reduce youth smoking because, quite simply, the best way to combat youth smoking is to raise the price. Young people are much more price sensitive than adult smokers, both because they have fewer financial resources, and because they are not (yet) as addicted. Consensus estimates suggest that every 10 percent increase in the price of a pack of cigarettes can cut youth smoking by around 7 percent. And yet, despite the historic increase in federal excise taxes on cigarettes in last Summer's balanced budget agreement, there has been no increase in real terms in state and federal cigarette taxes since the Surgeon General's announcement of 1964. (*)

2. Full authority for the Food and Drug Administration to regulate tobacco products.

This is essential because the FDA needs a comprehensive set of tools to craft appropriate restrictions on access to and advertising of tobacco products and to respond to changing circumstances in supporting parents' efforts to protect would-be teen smokers. Data from a 1995 national survey indicated that more than three-quarters of young smokers were not asked to show proof of age during attempts to purchase cigarettes in the month preceding the survey.

The Administration has taken significant steps to give the FDA the authority it needs to act effectively against teen smoking but its use of that authority has been hampered by a number of recent court actions. If we are to win the battle against youth smoking we must lift this cloud of uncertainty and reaffirm the FDA's rightful position in the front line.

3. Real changes in the way the tobacco industry does business, including an end to marketing and promotion to children.

Real restrictions on youth access and marketing will likewise be integral to a successful solution. The 1994 Surgeon General's Report concluded that cigarette advertising significantly increased young people's risk of smoking by changing their perception of the extent, image, and function of smoking in our society. Studies have shown that almost as many six year olds can recognize Joe Camel (91%) as Mickey Mouse (96%), and that teens are much more likely than adults to buy the three most heavily advertised brands of cigarettes. As the Surgeon General stated recently, to have an impact on teen smoking "we need to level the playing field and allow prevention messages from parents, schools and role models to take hold without the pervasive backdrop of pro-tobacco imagery and promotional messages."

4. Progress toward other public health goals, including biomedical and cancer research, a reduction of second hand smoke, promotion of smoking cessation programs, and other urgent priorities

We need to marshal the combined resources and expertise at the national, state and community level to expand our knowledge of the causes and effects of smoking and use what we already know to better effect. Across the country, experiments in second hand smoke reduction and smoking cessation programs have been yielding important lessons on what works and what doesn't. But we need to find out more. And we need to make sure that those lessons are being applied nationally and globally. (*???*)

5. Protection for tobacco farmers and their communities

A comprehensive approach to reducing youth smoking can and must take account of the legitimate concerns of the 124,000 farmers who are involved in tobacco production and the families who depend on them. As I will discuss in a moment, a commitment to compensating these communities for a new nationwide approach to tobacco is integral to our search for a comprehensive solution.

We believe that all five of these components are critical to a solution because they are all mutually reinforcing: the effectiveness of any one is substantially increased by the presence of the others. In particular, studies in Massachusetts and California suggest that while increasing the price of cigarettes is one of the most cost-effective short-term strategies for reducing tobacco consumption among all age groups, the ability to sustain that reduction is significantly increased when the price increase comes with a comprehensive anti-smoking campaign along the lines outlined above. And the more we are able to coordinate our efforts across state and county lines, the more effective such an approach will be.

II. The Economic Implications of a Comprehensive Approach

Let me now turn to three aspects of the tobacco proposals of particular relevance to Treasury and this committee: the implications of these proposals for the pricing of cigarettes and the amount of youth smoking; the implications for the tobacco farmers and manufacturers; and the scope for addressing the potential risk of increased smuggling as a result of these proposals.

1. The Need to Increase Prices

As I have said, increasing the price of cigarettes is universally recognized to be a critical first step to reducing smoking by young people. Thus, to measure the impact of any tobacco legislation on youth smoking we need to measure the impact on the price of cigarettes to consumers. Here there are two important distinctions to be borne in mind.

The first is the distinction between nominal price increases and constant dollar, or real, price increases. All of the figures that we have used in our discussions of price effects are constant dollar figures. Because the goal of price increases is to get youth to stop smoking, and they will only have this effect if the price increases are real.

The second distinction to remember is between price increases that are due to tobacco legislation and those increases that are due to underlying changes in the environment that would have occurred anyway, such as the increase in federal excise taxes last summer or the growth in state excise taxation. Let me be clear: the President's call for substantial price increases referred to real, settlement-induced price increases. It would be inappropriate for any of us in reaching this agreement to claim credit for underlying price increases that would have occurred in the absence of legislation in meeting the President's goal. Only those price increases directly attributable to the legislation should count.

This second distinction is important for evaluating the testimony that Martin Feldman provided to this committee last week, evaluating the pricing effects of S. 1414, which are identical to those of the June 20 AG settlement. Mr. Feldman stated that if this bill was passed, cigarette prices would rise by $2.42 in nominal terms -- and by $1.63 in real terms -- by 2007. But his carefully worded statement referred to what the price would be if this legislation was passed, not the effect of the legislation per se. In fact, using his methodology but separating out the effect of the legislation on its own, the real increase in prices would be only 90 cents. [check that this is for 2007]

In fact, even this figure is a substantial over-estimate, for embedded in Mr Feldman's analysis are a number of misplaced assumptions. Most important, he assumes that wholesalers and retailers will add their existing mark-ups -- of upwards of 25 percent -- to the settlement costs passed on by manufacturers. Yet virtually all of the relevant empirical evidence suggests that there will be very little "pyramiding" of this kind. That is why the FTC, in their analysis of the original AG settlement, assume in their baseline that there would be not be this kind of mark-up of the payments made by manufacturers in the prices paid by consumers.

Further, Mr. Feldman fails to take account of the "double-counting" provisions of the youth lookback penalties in the AG settlement and as a result substantially over-estimates those penalties. He also adds additional legal fees -- which he then assumes will be marked up -- when, if anything, as I shall discuss in a moment, the legal costs facing tobacco companies should decrease as a result of the settlement.

Our own analysis of the impact of the AG settlement, correcting for these features of Mr Feldman's analysis, suggests that it will have a much more modest effect on cigarette prices than he predicts. We find that the AG settlement, and S. 1414, would lead to an incremental, constant-dollar, price increase of only 62-66 cents by 2007 [to check against Tax Policy numbers], with the range of uncertainty arising from year-to-year variation in the amount of the youth lookback penalties. This finding is very similar to the FTC analysis of the settlement produced this summer. And like the FTC analysis, it suggests that this type of financial arrangement falls far short of producing the significant price increase the President has called for

Consequently, the Administration's budget contemplates measures to achieve a much larger increase in the price of tobacco products. We have proposed that any tobacco legislation provide for annual lump sum payments by tobacco manufacturers, with the amounts paid by each determined by formula. The budget assumes net Federal receipts from this legislation that will total at least $10 billion in 1999, rising each subsequent year for a total of $65 billion between 1999 and 2003. These amounts are consistent with the President's call for an increase in the price of a pack of cigarettes of up to $1.50, in constant dollars, over 10 years as necessary to meet the targets set to reduce youth smoking.

Translating this budget stream into an implied price increase per pack raises even greater difficulties than in the case of the AG settlement. In particular, in the case of the AG settlement the payment stream is "volume adjusted", meaning that, as domestic sales falls, the required payments by the tobacco industry will fall correspondingly. As a result, one can estimate the impact on cigarette prices without regard to the many additional factors that will affect the volume of cigarette demand: for example, the ultimate share of payments that are passed on to prices because they are distributed based on market share, relative to the share that are not likely to be passed on because they are fixed regardless of sales; or the degree to which companies pass on the cost of the agreement to domestic purchasers as opposed to foreign ones; and the extent of black and gray market activity.

There is another important area of uncertainty. We have assumed in our calculations that the major change in tobacco pricing nationwide would come as a consequence of federal action in the context of a comprehensive settlement and without significant tax increases on the part of the states. If states take action to increase their own cigarette tax rates this, of course, would lead to a different set of consequences.

Applying the same set of principles to the revenue stream described in the Budget suggests that it would generate price increases rising from 62 cents in 1999 to $1.10 in 2003, in constant dollars. This is a much larger price increment that is contemplated by the settlement, and provides a serious step towards meeting our youth smoking reduction goals.

As I noted earlier, the impact of any given price increase on youth smoking will be significantly increased by other elements of the comprehensive approach the President has called for -- notably, a crackdown on youth marketing and advertising by tobacco companies and more effective enforcement of legal restrictions on tobacco sales to young people.

Studies have found a 69 percent decline in daily use by seventh and eighth graders in Woodridge, Illinois following legislation and enforcement of restrictions on cigarette sales to minors, and a 44 percent decline in junior high school students' smoking in Leominster, Massachusetts as a result of strictly enforced sales restrictions. For our own estimates, we use a conservative assumption that experts have recommended -- that comprehensive sales and marketing restrictions will reduce youth smoking by about 15%.

The combination of the price increase noted above and the tighter restrictions on youth access and marketing leads to dramatic reductions in youth smoking. We estimate that our plan will:

- lower youth smoking by 42% by 2003

- reduce the number of youths smoking each year by as many as 1.9 million by 2003
- reduce the cumulative number of youths who smoke between now and 2003 by 3 million
- and, as result, avoid roughly 1 million premature deaths as a result

These estimates suggest the value of such a comprehensive approach to combatting teen smoking. But we cannot and will not let our success in this effort depend on the accuracy of today's best estimates. The many uncertainties involved in making these predictions only underline the importance of incorporating in any legislation the Administration's concrete targets for reducing youth smoking. These aim to cut youth smoking by 30% after 5 years, 50% after 7 years, and 60% after 10 years. And in the strong youth lookback penalties that the President has proposed we have additional insurance that these targets will be met. These penalties should apply to both the industry as a whole, and to individual companies as well, to hold those companies accountable for their actions in selling tobacco products to youth.

It is worth noting here that a collateral benefit of the large price increases that we are supporting to limit youth smoking will be revenues that will support the other integral element of a comprehensive approach -- the pursuit of other major public health goals, including biomedical and cancer research, a reduction in second hand smoke, promotion of smoking cessation programs, and other urgent national priorities (*). It will also help go toward reimbursing the Medicaid costs of the states that brought the original class action suits.

2. The Implications For the Tobacco Industry

There has been understandable concern, in recent months, that a comprehensive approach to reduce smoking might impose unfair adjustment costs on tobacco manufacturers or their suppliers and inflict collateral damage on our economy. Yet we are confident that the changes in pricing and behavior that we are seeking can be achieved without putting producers' livelihoods or the health of the broader economy at risk.

Tobacco farmers

There are more than 124,000 (*Economist says this, rather than 125,000*) farms engaged in the production of tobacco, and we recognize that a significant reduction in smoking in the United States could curtail an important source of income for these farms. That is why one of the President's principles is protection for tobacco farmers and their communities. And we have supported, in this context, the efforts of the many Senators and House members who have been working to provide for this protection.

A good many commentators in this debate have implied that combating teen smoking involved a zero-sum choice -- between protecting the health of children, on the one hand, and protecting the economic well being of farmers and their communities on the other. The President has explicitly rejected this false choice. So have the coalition for public health and tobacco farming organizations that last week endorsed a set of principles with which both groups could agree. Let there be no doubt: we are determined that one important use of the funds raised by higher prices on cigarettes will be the provision of funds to protect the economic well-being of all America's tobacco farmers and their communities.

Tobacco manufacturers

Turning now to the companies involved in the production of tobacco, let me outline briefly why we do not believe that either the Administration's budget, or the other relevant legislation pending before congress would impose an undue burden on these companies or their employees.

A central feature of both the settlement and all of the legislation that has been proposed to date is an expectation -- indeed, the express desire -- that companies will pass the settlement costs on to the price of tobacco products. To the extent that prices are indeed passed on the impact on the profitability of these companies will be less than many have perhaps imagined and certainly insufficient to create major disturbance to the economy. The FTC analysis of the June 20 AG settlement suggested that the total impact of the settlement would lead to, at most, a 15 percent reduction in tobacco industry profits. (WHAT ABOUT THE ADDITIONAL EFFECT OF FED TAX INCREASES?) Indeed, on certain scenarios, the FTC even estimated that industry profits could rise, if the industry followed some past examples and passed more than 100 percent of the settlement payment on to the price of cigarettes.

Even the more likely, 15 percent impact on the industry's profitability must be considered alongside the relevant counterfactual: namely a world without comprehensive tobacco legislation. This would be a world of continued and potentially crippling legal uncertainty for the industry . The extent to which alternative legislative approaches resolve that uncertainty will vary depending on the particular features of the legislation. But any legislation that involves some resolution of a portion of the outstanding suits from states or other parties will provide enormously valuable insurance against risks that are, quite simply, incalculable in the present climate.

The high value placed on certainty -- even the certainty of heavy future penalties -- has been amply demonstrated by the response of the stock market and Wall Street analysts to the prospect of a settlement. The announcement of settlement talks on April 16 of last year led to a sharp rise in tobacco stocks. And in the months immediately following the news, Wall Street analysts' recommendations regarding the industry were uniformly positive, with the vast majority recommending that their clients purchase tobacco stocks.

Key analysts have stated that the June 20 Attorney General agreement would substantially reduce the risk of bankruptcy in this industry from future litigation. For example, Gary Black, a tobacco analyst at Sanford C. Bernstein, estimates that the domestic tobacco businesses of Phillip Morris and RJR Nabisco are currently valued by the market at just *one-third* what they would be worth in the absence of uncertainty about future litigation and regulation. And most analysts agree that the AG settlement would raise the price of Phillip Morris stock, relative to its earnings, by about one-third. At its current market value, this increase in market capitalization alone would be worth $35 billion to the company -- a sum equivalent to 7 years' operating earnings net of settlement payments and 21 years of domestic tobacco earnings.

In the months since the AG settlement was announced, tobacco stocks have underperformed the general stock market, reflecting pessimism about the likelihood of a settlement as generous as that contemplated on June 20. Yet there remains a keen interest in the possibility of a legislative solution to the tobacco industry's legal problems -- as we saw, only last week, when the news that this committee was delaying its markup of tobacco legislation led to a fall in the value of domestic tobacco stocks of some 2 percent.

3. The Potential Implications for Smuggling

Of the many uncertainties involved in gauging the impact of the tobacco proposals presently under consideration one of the more troubling is the possibility that a substantial increase in the price of cigarettes could trigger a rise in tobacco smuggling into the United States. Clearly, any large increase in smuggling would reduce the effectiveness of the strategy and raise broader concerns for our society. However, wider international experience of countries in comparable situations suggests that the risk of increased smuggling, while real, is manageable if the right regulatory frameworks are put in place to address it.

Let me stress: a core feature of the approach we are envisioning will be to put in place enforcement mechanisms and other strong measure combat the risk of smuggling, however negligible it may turn out to be, and to ensure that the central goal of reducing youth smoking is not in any way compromised by such activity.

In order to control the diversion of tobacco and prevent smuggling, the Administration supports a system of licensing and registration that would close the distribution chain for tobacco products. Under this system, only manufacturers, importers, exporters and distributors of tobacco products that are licensed would be allowed to engage in those businesses. Those conducting business without a license would be subject to criminal and civil penalties, as well as seizure and forfeiture of property. Licenses would be issued based on certain specified criteria and could be revoked or suspended for certain specified violations.

In addition, only registered retailers would be allowed to purchase tobacco products from licensed entities. Each licensee would be required to have a system of records, creating an audit trail that will allow for the detection of persons responsible for diverting tobacco from legitimate channels of distribution. The proposal would also require that all tobacco products intended for export would be specially marked. These markings will help prevent such tobacco products from entering the legitimate domestic chain of distribution.

Under our proposal, a tobacco retailer's registration could be suspended or revoked for certain specified violations and could be voided upon a determination by HHS that FDA's restrictions on sales to minors had been violated. Once a registration is voided, a retailer would be unable to purchase tobacco products through the legitimate chain of distribution. This registration system, therefore, would also help discourage illegal sales to minors.

These measures[, together with additional resources dedicated to prevent trafficking in contraband tobacco products,] will help ensure that tobacco smuggling is minimized and youth smoking is reduced.

III. Concluding Remarks

Members of the Committee, as the President has said: "we stand on the verge of one of the greatest public health achievements in history -- an historic triumph in our fight to protect America's children from the deadly threat of tobacco." The opportunity is there for the taking: in the comprehensive, five-part approach that the President has called for and so many in Congress are striving to achieve.

The stakes are high. Every day that we do not take action means that another 3,000 young people will become regular smokers. Just in the time that I have been speaking to you, 20 children have started smoking, and 7 of them will die prematurely as a result. We cannot afford to delay one child longer. If we pass comprehensive legislation that meets the targets laid out in our budget, in five years' time around 40 percent fewer American children will be smokers; in 10 years time, the number will have halved. I look forward to working closely with you, Mr Chairman, with the other members of this committee and with others in Congress as we work to take this historic step forward for the future of our nation and the future of our economy. I would now welcome any questions.