

**PHILIP MORRIS**

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*The document
from the
ABC story*

PHILIP MORRIS U. S. A.

INTER-OFFICE CORRESPONDENCE

Richmond, Virginia

To: . Mr. Jon Zoler Date: September 3, 1987
From: . Myron Johnston
Subject: . Handling an excise tax increase

I have been asked for my views as to how we should pass on the price increase in the event of an increase in the excise tax. My choice is to do what I suggested to Wally McDowell in 1982: Pass on the increase in one fell swoop and make it clear to smokers that the government is solely responsible for the price increase, advertise to that effect, suggest that people stock up to avoid the price increase, and recommend that they refrigerate their cigarettes "to preserve their freshness." (It would be necessary to emphasize that point or we would get a lot of bottle complaints.) Then when people exhaust their supply and go to the store to buy more, they will be less likely to remember what they last paid and will be less likely to suffer from "sticker shock." As a result, they should be less likely to use the price increase as an incentive to stop smoking or reduce their consumption.

Last time, of course, we increased prices five times between February of 1982 and January of 1983. In less than a year the price went from \$20.20 to \$26.90 per thousand (\$2.70 more than the tax), and this fact was not lost on consumers, who could legitimately blame the manufacturers for the price increases. While price increases of this magnitude might have been tolerated during the rapid escalation in the overall inflation rate between 1977 and 1981, the increase in the price of cigarettes in 1982-83 was made even more dramatic by the fact that the overall rate of inflation was slowing considerably. You may recall from the article I sent you that Jeffery Harris of HII calculated, on the basis of the Lewin and Coate data, that the 1982-83 round of price increases caused two million adults to quit smoking and prevented 600,000 teenagers from starting to smoke. Those teenagers are now 18-21 years old, and since about 70 percent of 18-21 year-olds and 35 percent of older smokers smoke a PM brand, this means that 700,000 of those adult quitters had been PM smokers and 420,000 of the non-starters would have been PM smokers. Thus, if Harris is right, we were hit disproportionately hard. We don't need to have that happen again.

I think it is reasonable to assume that wholesalers and retailers will behave pretty much as they did in 1982. The wholesalers liquidated their inventories to avoid paying the floor tax, consumers did not stockpile to any great extent (probably in part because the price increase did not occur suddenly), and the retailers, who faced no floor tax, stocked up because of the profit potential. They stocked up on everything, that is, except Philip Morris brands. B&W loaded in November, Reynolds in December, and we did not load, with the result that, in Richmond at least, the shelves were virtually bare of PM brands. I remember one irate 7-Eleven manager, who knew that I worked at PM, holding up

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a pack of Marlboro Lights and telling me that that was his entire stock of Marlboro Lights, and that he was not due for another delivery for two days. He was losing sales, and we may very well have lost some smokers. We certainly incurred the wrath of retailers who lost sales because they were out of our brands. We don't need to have that happen again either.

Thus my recommendation is to take the increase all at once; advertise, blaming it on the feds and encouraging smokers to stockpile; increase prices only to the extent of the tax; and make sure that the cigarettes that the retailers stockpile are our brands this time. We might also take the opportunity to again point out the regressive nature of the tax and tell smokers what percent of the price of a pack of cigarettes in their state is due to taxes.

The only problem I can see with this approach is that we might not have enough production capacity to fill the orders if smokers do stockpile heavily.

MEJ:f

cc: Ed Gee
Art Goldfarb
Ken Houghton
Carolyn Levy
Leo Mayer
Karen Miller
John Tindall
Central File

W. S. J.

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PHILIP MORRIS U. S. A.
INTER-OFFICE CORRESPONDENCE
RICHMOND, VIRGINIA

Mr. Harry G. Daniel

September 17, 1981

Myron Johnston

Subject: Teenage Smoking and the Federal Excise Tax on Cigarettes

I have just finished studying a National Bureau of Economic Research (NBER) working paper entitled "The Effect of Government Regulation on Teenage Smoking." In the paper the authors examine the impact on teenage smoking of (1) the excise tax on cigarettes, (2) the FCC Fairness Doctrine (i.e. the anti-smoking commercials), and (3) the cigarette advertising ban. This is by far the best study I have read concerning the effects of the anti-smoking commercials, and the only study I know of that attempts to determine the price elasticity of cigarettes among different groups.

Because of the quality of the work, the prestige (and objectivity) of the NBER, and the fact that the excise tax on cigarettes has not changed in nearly 30 years, I think we need to take seriously their statement that "...if future reductions in youth smoking are desired, an increase in the Federal excise tax is a potent policy to accomplish this goal." Given that a further reduction in youth smoking is the goal of many pressure groups and Federal agencies, and that the goal of balancing the Federal budget through budget cuts seems increasingly elusive, I think we can expect an increase in the excise tax on cigarettes, probably within a year.

There are other things that lead me to believe that there will be increases in the Federal excise taxes on both cigarettes and alcoholic beverages: (1) It can be argued that excise taxes are "voluntary" taxes in that payment of them can be avoided by refraining from purchasing the product, and that therefore increasing excise taxes does not reduce discretionary incomes. (2) Both cigarettes and alcoholic beverages have low price elasticities, so the additional taxes can be passed on to the consumer with little adverse effect on the industries. (3) Prices of cigarettes and alcoholic beverages (as measured by the Consumer Price Index) have increased more slowly than prices generally. (4) Excise taxes contributed only 5.0 percent to total Federal revenues in 1980, down from 8.1 percent in 1970 and 12.5 percent in 1960. (5) A 25 percent increase in the excise taxes on cigarettes and alcoholic beverages would reduce the Federal deficit by over two billion dollars, yet have a minimal effect on the Consumer Price Index. Given the current price of gasoline and the state of the automobile industry, I do not think it would be politically feasible to raise excise taxes on cars or gasoline, but I think cigarettes and alcoholic beverages are fair game for increased taxes.

*The paper is a part of the NBER's research program in Health Economics and was supported by grants from the National Science Foundation to the NBER and from the National Center for Health Services to the New Jersey Medical School. The authors are Eugene M. Levit, Office of Primary Health Care Education, New Jersey Medical School; Douglas Coate, Department of Economics, Newark College of Arts and Sciences, Rutgers University; and Michael Grossman, Department of Economics, City University of New York Graduate School.

TRIAL EXHIBIT
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Some of the findings reported in the paper are as follows:

Most researchers, myself included, have calculated that the best estimate of the price elasticity of cigarettes is about -0.4, i.e. that a ten percent increase in the retail price of cigarettes will cause a decline of about four percent in cigarette sales. Many of us have hypothesized that price elasticities are different for different demographic or socio-economic groups, e.g., that price increases would have less effect on the higher income groups and on the older and therefore more habituated smokers, than on other smokers. Because of the lack of any reliable data, this has remained until now strictly a hypothesis. The authors of this paper, however, have used the results of the 1966-1970 Health Examination Survey of the National Center for Health Statistics, and have constructed an elegant longitudinal and cross-sectional model of teenage smoking behavior. This has made it possible for them to calculate the price elasticity for teenagers and compare it with the generally accepted price elasticity of cigarettes for the total smoking population.

The authors conclude that the anti-smoking commercials represented a shock to the underlying upward trend in teenage smoking in the mid-1960's and early 1970's, particularly in the first year in which they were aired, but that the trend reasserted itself the following year, although teenage smoking remained at a lower level than would have been the case in the absence of the anti-smoking commercials. This is consistent with my findings that random shocks, such as the report of the Royal College of Physicians and Surgeons, the Readers Digest articles, and the reports of the Surgeon General, have brief effects, and that sales subsequently resume the upward trend, but more slowly and from a lower base. The authors also conclude that the cigarette advertising ban had a relatively minor effect in discouraging teenage smoking.

The most important finding, and the one of greatest significance to the company, is their calculation of the price elasticity of cigarettes among teenagers. They calculate that the smoking participation elasticity is -1.2, which means that a ten percent increase in the price of cigarettes would lead to a decline of 12 percent in the number of teenagers who would otherwise begin to smoke. Their calculation of the quantity smoked elasticity for teenagers is -1.4, which means that a ten percent increase in price would lead to a 14 percent decline in cigarette consumption by teenagers. This is in contrast to the aforementioned -0.4 elasticity for the total smoking population. In another paper, two of these authors, Lewit and Coate, found that smoking by young adults 20 to 24 is much more responsive to price than smoking by older adults, which again is consistent with the hypothesis mentioned above.

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The authors concede that one reason for the large price elasticities they found among teenagers is that the elasticities incorporate income effects and substitution effects, i.e., cross-elasticities. This, of course, is true of virtually all calculations of price elasticities. As a result of some of the relationships I discovered while working on my report on teenage smoking,* I am inclined to believe that cross-elasticities are particularly important in the case of teenagers. Among teenagers the prevalence of cigarette smoking is highly correlated with income (from either allowances or working) while there is no similar correlation between smoking prevalence and income among adults. Teenage smoking prevalence appears to have begun to decline among boys at about the time of the high teenage unemployment rates of the early 1970's, at which time the smoking prevalence among girls was still increasing, and it is the males who would be most likely to feel the impact of unemployment. Furthermore, it was among the older boys that the decline was greatest, and, again, one would expect that the older boys would feel the impact of unemployment more than the younger ones.

With regard to the substitution effects, or cross-elasticities, I think the most important substitution effect is with gasoline. In my study, I found that the cumulative smoking incidence among boys in 1976 was about the same as in 1979 up to the age of 16, but past the age of 16 (the age at which many of them would have access to a car), the 1979 incidence was substantially below that of 1976. Consider also that in 1967, for one dollar, a teenager could buy two gallons of gasoline and a pack of cigarettes. As recently as 1978, if teenage incomes kept pace with inflation, the same purchasing power would still buy a pack of cigarettes and two gallons of gasoline. With income continuing to increase with inflation, this was no longer possible for the 1979 teenager, and the 1980 teenager could not even afford the two gallons of gasoline. I think it is more than coincidental that the sharpest declines in smoking prevalence among teenage males occurred in 1979 and 1980, the years in which the price of gasoline rose most sharply. When it comes to a choice between smoking cigarettes or cruising around in his car, the average teenage male would probably choose the latter. If this cross-elasticity between cigarettes and gasoline is, indeed, related to the decline in smoking prevalence among teenagers, we would expect to see some moderation in the rate of decline in smoking among boys when the 1981 data become available.

In any event, and for whatever reason, it is clear that price has a pronounced effect on the smoking prevalence of teenagers, and that the goals of reducing teenage smoking and balancing the budget would both be served by increasing the Federal excise tax on cigarettes. It is worth quoting the authors somewhat extensively on one point: "Such a policy [increasing the Federal excise tax] may also be an effective way to curb the detrimental (sic) health effects of smoking in the long run without substantially harming the cigarette industry in the short run. Since youth and young adult price elasticities are much larger than adult price elasticities while adult smokers account for the bulk of cigarette sales, a substantial excise tax increase would substantially

*"Young Smokers: Prevalence, Trends, Implications, and Related Demographics."
March 31, 1981

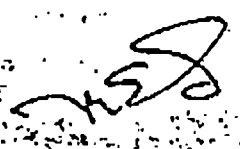
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reduce smoking participation by young new smokers but leave industry sales largely unchanged. Given the evidence that individuals are considerably less likely to initiate smoking after age 25, it is quite possible that the cohort of young smokers who never begin to smoke as a result of the tax increase would never become regular smokers. As a consequence, over a period of several decades, aggregate smoking and its associated detrimental health effects would decline substantially."

It is worth noting that government actions designed to reduce smoking in the late 1960's and early 1970's served to moderate an underlying upward trend in teenage smoking, while any government action taken now will accelerate its present downward trend. Given a price elasticity of -0.4 for total cigarette sales and -1.2 for teenage smoking participation, a 25 percent increase in the excise tax could be expected to reduce industry sales to about 1.2 percent below what would be expected in the absence of such an increase, and to reduce the number of teenage smokers to 3.5 to 4.0 percent below the number that would otherwise be expected. The almost certainty of improved economic conditions, lower inflation rates, and increasing discretionary incomes over the next few years, however, should serve to moderate the adverse effect on sales of an excise tax increase. We can never look with equanimity on increases in the excise tax, but because of demographic trends and the improved economic outlook an increase at this time would probably be less harmful than it would have been at any other time in the past decade.

MEJ:f

cc: R. N. Thomson
J. M. Zoller
T. T. Goodale
C. H. Rowe
L. F. Meyer



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September 27, 1982

TO: Mr. P. E. Calyan
FROM: Ms. D. S. Burrows
RE: MARKETING IMPLICATIONS OF THE NBER MODELS

The attached memo summarizes the findings of the National Bureau of Economic Research on the relative price sensitivity of age/sex groups, per your request.

A key finding is that younger adult males are highly sensitive to price. This suggests that the steep rise in prices expected in the coming months could threaten the long term vitality of the industry, by drying up the supply of new/younger adult smokers entering the market. It could also undermine the long range growth potential of brands which rely on new/younger smokers, including Marlboro and Newport.

There is no reason to assume that price makes the idea of smoking less appealing to younger adults. But price may create a barrier which prevents that appeal from developing into an ongoing choice to become a smoker.

RJR has an opportunity to break this price barrier with a brand targeted to younger adult males, the most sensitive group. Three approaches are possible:

1. A new younger adult male brand which offers imagery combined with lower price.
2. A larger, economy size pack of a new or existing brand.
3. Marketing "half-packs" (10's or 12's) of a new or existing younger adult male brand, in addition to 20's.

I recommend marketing "half-packs" because:

- Half-packs are a logical size for beginner smokers. As mature smokers, their rate will double (or more). Brand loyalty would carry this gain over to the brand's 20's.
- Younger smokers seem more sensitive to cash outlay than cost per cigarette. (Otherwise they would buy cartons, not packs.) Half-packs could reduce consumers' cash outlay by 30-40% versus branded 20's. Generic 20's only offer a 16% lower outlay.
- Low price would not imply a "cheap brand" nor require sacrifices in unit profit, marketing support, or quality.
- Newport 10's are showing up in regular outlets (not just vending), suggesting Lorillard may also be aware of this younger adult price sensitivity.

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Code: 5.21

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Half-packs targeted to younger adults are not likely to achieve a large market share themselves: new smokers account for perhaps 1% of the market in a given year. But this is the percent Marlboro has compounded for 25 years. RJR's long term investment could pay off as handsomely.

Perhaps the half-pack idea could also be explored as a way to address the price sensitivity among older adults. The young and the old have two things in common: they have lower incomes and are light smokers.

Diane

Diane S. Burrows
MARKETING DEVELOPMENT DEPARTMENT

DSB/ch

cc: Mr. J. R. Moore
Mr. J. R. Hribar
Mr. W. W. Doten
Mr. R. A. Davis
MDIC

DSB/ch - 9/28/82
Code: 5.21

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APPENDIX IGENERAL COMMENTS ON SMOKING AND HEALTH

In thinking about smoking and health, the first thing that comes to mind is product liability. Yet, internationally, this has not yet become the issue that is has here and, frankly, I don't see that there is much we can add to a discussion of this point. Clearly, it is of the gravest concern to all of us since it poses a potential threat to the entire industry in most places. As I see it, the best help we can offer is to make doubly certain that we do nothing overseas that jeopardizes what is going on here.

There are, though, other smoking and health issues that we can, and do, work on. Here I am referring to the impact that the smoking and health debate is having on taxation, on marketing freedoms, on public smoking, and more recently on passive smoking. We are working on all these issues somewhere in the world and our approaches depend on the specifics of each place.

✓ Of all the concerns, there is one - taxation - that alarms us the most. While marketing restrictions and public and passive smoking do depress volume, in our experience taxation depresses it much more severely. Our concern for taxation is, therefore, central to our thinking about smoking and health. It has historically been the area to which we have devoted most resources and for the foreseeable future, I think things will stay that way almost everywhere.

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