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# EXHIBIT 1

W. KIP VISCUSI

# SMOKE-FILLED ROOMS

## A POSTMORTEM ON THE TOBACCO DEAL

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# THE PROPOSED FEDERAL SETTLEMENT

For decades the cigarette industry had maintained a record of unblemished success in the courtroom. Withstanding a steady onslaught of lawsuits, the industry succeeded in avoiding any payoffs either in out-of-court settlements or in court-awarded damages. The dangers of settlement or unfavorable verdicts were enormous; with hundreds of thousands of smokers dying annually (a figure based on the surgeon general's estimates), a successful individual suit could trigger a wave of litigation.

By 1997, however, most states had joined in this litigation effort, in a flurry of over forty lawsuits. Cigarette policy was also an active topic for the U.S. Congress, as there continued to be support for a major increase in cigarette excise taxes. It was in this atmosphere that the cigarette industry took a surprising gamble on June 20, 1997, by offering a $368.5 billion package over twenty-five years to settle the state suits seeking reimbursement for Medicaid costs attributable to smoking. After decades of avoiding any payouts, the cigarette industry was offering to make the largest payoff in the history of the U.S. civil liability system. This effort, known as the "Proposed Resolution," was intended to be the basis for federal regulation, but Congress never adopted it.[1] Why should a policy proposal that was never even adopted be of significant interest? Because for the first time, the cigarette industry displayed a willingness to pay off in litigation. The scale of the proposed payoff in the hundreds of billions of dollars was surely a landmark event in the history of cigarette litigation and civil liability more generally. The issue was no longer whether the industry would pay off, or even whether the size of the payoff would be enormous, but what exactly the final deal would be. The Proposed Resolution also established the framework for the final state settlement of the litigation. This proposal proved to be a catastrophic error in judgment on the part of the industry and, with less dire

consequences, on the part of various political actors as well. How this resolution worked, why it failed, and what implications it had for the industry will be explored in this chapter.

Before considering the proposed settlement, it is useful to inquire whether there is any validity to the state suits at all. The foundation for any such suit must be some tortious conduct. How do cigarettes fare under the usual product liability criteria?[2]

As dozens of unsuccessful private suits against the industry have indicated, almost all juries conclude that the usual assumption-of-risk defense is pertinent. Smokers know that cigarettes are dangerous. The hazards of cigarettes are public knowledge and have been well known for decades, if not centuries.

Because of this knowledge, plaintiffs have often framed their cases in retrospective terms. Did the cigarette industry, for example, withhold risk information from the public back in the 1950s? Linking current smoking behavior to alleged transgressions in dimly remembered time periods often proves to be a formidable task for plaintiffs. But perhaps the warnings are inadequate? This claim is difficult to make, as Congress has specified the warnings language, format, and placement since the mid-1960s. Warnings legislation has given the industry substantial protections against warnings-based suits for the post-1969 period.

Could one instead base liability on a product defect? Cigarettes are surely very risky. However, this risk does not arise from manufacturing defects. Moreover, for there to be a design defect, the industry must have failed to adopt a safer design that does not compromise other benefits of the product. Safer cigarettes do exist and have been test-marketed, but these cigarettes provide less taste and a less enjoyable smoking experience.

If there is no basis for individual claims, then industry defenses would travel with such claims if the states undertook subrogation-like actions on behalf of the individuals. Alternatively, could the states seek reimbursement for costs they incur due to alleged tortious conduct by the industry? Public entities do not generally have the right to sue companies for such losses. Economic loss alone is not sufficient to justify such suits, according to previous court rulings.[3]

The tenuous nature of these suits is reflected in the only state supreme court ruling on the litigation. In 1998 the Iowa Supreme Court threw out the suit by the state of Iowa against the cigarette companies.[4] Despite this favorable ruling and the fact that no state case ever reached a jury verdict, the industry sought and eventually obtained a record-breaking settlement of the litigation, including a payoff to the state of Iowa. This settlement is the subject of this and the following chapter.

## Fundamental Components

The Proposed Resolution was not a voluntary agreement between the cigarette industry and all the state attorneys general, as was the final outcome to be discussed in chapter 3. Rather, it was a blueprint for federal legislation that would have to be passed by Congress and signed into law by the president. That is, it was a political document subject to the subsequent political process. The parties who drafted the settlement included industry representatives and some key representatives of the states' interests, such as Mississippi attorney general Mike Moore, Republican Senate majority leader Trent Lott's brother-in-law,[5] and the increasingly well publicized brother of Hillary Rodham Clinton, Hugh Rodham.[6] Thus, there was a semblance of bipartisan participation as well as possible bipartisan sharing in the spoils of the litigation. Missing were any legislators or representatives of the public health community, although they would eventually surface in the debate over the proposal. Also absent was any real effort to develop broad political support in the development of the proposal.

Public understanding of the settlement may not have extended much beyond a single number—the widely publicized $368.5 billion face value of the first twenty-five years of cigarette industry payments. The first payment, $10 billion up front, would be followed by annual payments rising from $8.5 billion the first year to $15 billion in five years. The payments would not end after twenty-five years, but would continue in perpetuity so that focusing only on the first twenty-five years understates the long-run implications of the settlement. Payments to lawyers would be in addition to this amount but would be funded separately by the cigarette industry. Side deals to compensate the attorneys would, of course, reduce the amount the states could negotiate, but the existence of a trade-off would not be as apparent. Instead, there would be the illusion that it is only the industry bearing the costs. Keeping the legal fees separate and hidden from public scrutiny would presumably boost the payoff to plaintiffs' lawyers, who might otherwise have their share diminished if there was a perceived trade-off between the payment to the state government and the payment to the lawyers. Publicizing exorbitant lawyer fees also might lead to public pressures that could kill the agreement altogether.

The timing of the payments was not inconsequential. Although payment amounts would be adjusted upward over time to reflect price increases (by 3 percent annually or the percentage increase in the consumer price index, whichever is greater), the settlement price tag of $368.5 billion was not discounted to reflect its present value. If we were

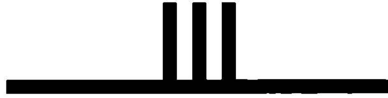
to discount the settlement payments using a 3 percent real rate of interest, the present value of the first twenty-five years of payments would be $255.6 billion, with a present value in perpetuity of $494.4 billion. Because of possible disagreements about the rate of discount, the focus of the press was on the total undiscounted package value. Not discounting also gives payments a larger and more impressive price tag.

The more important complication was that the value of the payments would vary proportionately with the unit sales volume of tobacco products. If cigarette consumption were to drop by one-fourth, the settlement payments would fall similarly. Because of the sales volume linkage, the best way to think about the proposal is in terms of the cost per pack: the payment was equivalent to an additional $0.62 per pack tax. The cigarette industry in effect agreed to an additional tax amount of $0.62 in return for reduced liability. Marketing the settlement as a damages payment by the companies rather than a tax ultimately borne almost entirely by smokers clearly boosted the public salability of the effort.[7] State and federal taxes already totaled $0.56 a pack for an annual total of more than $13 billion. The new levy would have brought the total state and federal tax per pack to $1.18.

## The Role of Taxes

A lawsuit that results in a tax rather than a damages payment in itself is a noteworthy event. What is the practical economic consequence of the settlement being tantamount to a tax? Taxes have a variety of functions, from raising money for the government, to penalizing behavior some may view as immoral, to helping align private and social incentives. While this $0.62 per pack tax increase figure nominally was related to health-care costs, in fact it had little to do with these expenses. As the calculations in chapter 5 will indicate, the gross medical cost of smoking to the states is less than a tenth of this amount for every state other than New York. Net costs of course are far less.

Although the cost of the tax would be shared by consumers and firms (for firms will lose profits as sales drop), in fact almost all of that cost would be borne by consumers. Tobacco industry payments could have been structured differently—for example, as a lump sum tax on companies rather than as a per unit tax. If the tax did not vary with cigarette sales, then from an economic standpoint the tax would be borne solely by tobacco producers. But such a tax would do nothing to discourage smoking or to align private and social incentives, which also was an objective of the settlement.



# THE SETTLEMENT OF THE STATE LAWSUITS

The settlement of the suits brought by the state attorneys general against the cigarette industry for $206 billion in 1998 resolved the impasse over the Proposed Resolution. The financial stakes dwarfed even the largest tort liability judgments and punitive damages awards in U.S. history. Moreover, the party paying the costs was the cigarette industry, which to date had been almost unscathed after decades of litigation involving the hazards of smoking.

Perhaps the most fundamental puzzle is not why the settlement amount was so large, but why the companies paid off the states at all. Evidence to be examined in subsequent chapters indicates that cigarettes are self-financing at both the national level and the state level. If cigarettes in effect pay their own way and there are no net costs to society, why is it that the states reaped what would appear to be a windfall gain? Which costs count and how cigarette costs are tallied will, however, affect the assessment of the costs of cigarettes to the states. Cigarettes do in fact increase expected health-care costs. Whether the courts would conclude that cigarettes were on balance self-financing consequently depended on which other cost effects the courts would recognize in determining the economic loss to the states. The potential for punitive damages and runaway juries also presented the industry with a potentially unfavorable lottery outcome.

The settlement led to an enormous payoff to the states. The unprecedented size and scope of the settlement alone make it of considerable interest. The settlement also raises other intriguing issues regarding the structure of the payments and their disposition. To what extent is the settlement tantamount to an excise tax, as was the formula in the Proposed Resolution? Which states have gained the most from the settlement, based on estimates of the underlying medical costs that gave rise to the claims? How have the lawyers representing the states fared as a

result of the settlement provision for attorneys' fees? Addressing these issues is pertinent not only to the cigarette litigation but also to all future litigation of this type.

### Litigation versus Taxes

For market outcomes to be efficient, all costs associated with the use of a product must be borne by the consumer. If, for example, consumers impose costs on others that are not reflected in the price of a particular consumer good, they will consume "too much" of that good. Economists call such costs inflicted on others outside of the market transaction "externalities." A conventional solution to such externalities is to impose an appropriate tax. If, for example, consumption of a product imposes 25 cents per unit cost on others, then a tax of 25 cents per unit will create efficient incentives for the "correct" amount of product use. The tax may lead the consumers to generate an efficient amount of harm, but there is also the task of getting the 25 cent penalty to the party who is harmed. Such compensation for any loss in welfare is needed to ensure that the outcome is equitable. Even without such targeting of the payments, the penalty level itself will be sufficient to promote efficient levels of risk. For example, a properly set penalty on heavily polluting vehicles will lead consumers to recognize the costs of their pollution, which must be offset by some other valuable car attribute if the product is to remain attractive for purchase.

The lawsuits filed by the state attorneys general have similar economic underpinnings. The fundamental concern is with the financial cost smoking imposes on the states. The chief economic cost is that cigarettes have an adverse effect on individual health, boosting health-care costs and the associated financial burden on the states.

A key question raised by the litigation is why the states pursued a litigation strategy at all rather than following the economic textbook prescription of levying excise taxes. Unlike externality taxes in general, this tax would present no problem in directing the payment to the injured party because it is the state government itself that has suffered the financial harm. Thus, the state could tax the product at the time of sale rather than suing the cigarette industry after the fact for these costs. Were the states truly ignorant of the smoking–health cost linkage? Moreover, even if the states just learned of cigarette risks, they could impose a tax in the future, which is what the settlement primarily did.

Taxes have advantages over legal action. They create incentives at the time of sale for efficient use of the product. In contrast, unanticipated liability costs will not affect product prices. If, for example, the purpose

of these suits is to recoup net costs incurred over the previous decades of cigarette consumption, then the prices consumers paid in the past for cigarettes did not reflect these costs, and people smoked too much given the costs of smoking. Appropriate taxes reflecting the social harm of current consumption will lead to correct consumption choices now. They cannot correct for past errors. However, is it really credible that the states were unaware of the adverse health effects of smoking until now and consequently did not foresee a potential role for taxes?

It is noteworthy that both the Proposed Resolution and the Master Settlement Agreement of the state attorneys general case each ultimately had a tax-like structure for collecting the settlement amount, insofar as payment is linked to the number of cigarette packs sold. If state legislatures impose excise taxes directly, they avoid the considerable litigation costs and attorneys' fees associated with the state suits. These costs are in the billions and represent a loss from what could have been paid to the states. Providing attorneys with billion-dollar legal bounties also creates incentives for more speculative litigation efforts.

Potentially superior policy routes could have been taken, but were not. What is the government failure that did not produce efficient taxation before the litigation? Why did not state legislatures levy the appropriate tax in the past to cover the costs of smoking? Or perhaps previous tax levels were already appropriate. Prospectively, why didn't the state legislatures simply tax cigarettes now in recognition of whatever the perceived costs of cigarettes are? The cigarette settlement will prove to be largely tantamount to an excise tax on future packs of cigarettes. State tax levies could have accomplished the same objective without incurring the enormous litigation costs and attorneys' fees. What was the market failure in the political arena?

Moreover, whatever tax was levied would have been the result of open legislative bargaining rather than a backroom deal involving state attorneys general eager for self-promotion. Mississippi attorney general Michael Moore intended to use the success of the settlement as a springboard to the governorship. Other attorneys general, such as Scott Harshbarger from Massachusetts and Skip Humphrey from Minnesota, featured their antismoking efforts in their unsuccessful 1998 gubernatorial campaigns. Senator McCain used the visibility from the tobacco in his unsuccessful bid for the Republican nomination for the presidency. It is not coincidental that the broad settlement agreement was reached shortly after the 1998 elections. Governors in liberal strongholds such as Massachusetts waited until after the election before signing on because they did not wish to risk the ire of the extreme anti-smoking forces who opposed any settlement.

Cigarette executives likewise may have been subject to a variety of incentives other than the national interest. Because tobacco company stock prices jumped whenever the prospects of a settlement appeared likely, there was a strong financial rationale for ending the litigation. Indeed, Philip Morris stock continues to perform quite strongly in the postsettlement period. If, however, the companies had beaten market expectations and won these suits, then that would have been an even better financial outcome that would also have affected the firms' fortunes favorably. Cigarette executives did not take any of these cases to a verdict, as they were perhaps fearful of the legal uncertainties.

A settlement agreement whereby in effect the industry agrees to a higher excise tax to end the litigation has an additional advantage as well. If the industry was likely to face political pressures to incur a higher excise tax, then a settlement that imposes a virtual tax may dampen the political impetus for even higher actual taxes.

Another reason for imposing a cigarette tax through the guise of a complex legal settlement is that legislators would not have to suffer the political fallout from having imposed a tax. Rather, the attorneys general seem to be punishing the cigarette companies, whereas it is the smokers who will bear the preponderance of the tax.[1] Although cigarette companies nominally pay the penalty, its linkage to sales ensures a tax-like structure.

The question nevertheless remains as to why the damages payment was in the form of a tax. This is not the norm for damages. The more typical form would be in the form of a lump sum payment equal to the value of the damages award. In some instances, parties may agree to a structured settlement, such as an annuity for an accident victim. Phasing payments over time also does reduce the size of the immediate financial effect.

However, the Master Settlement Agreement does not simply spread the payments out over time. It also links these payments directly to cigarette sales. Doing so is of tremendous economic importance. Tax-like structures alter future incentives to buy the product and will be largely borne by consumers. Such a structure is only appropriate if one believes that cigarette prices continue to be too low given their true social costs. Estimates in the next two chapters do not indicate that this was the case. Moreover, from the standpoint of the litigation, only the portion of costs due to wrongful conduct should be counted in setting the tax. However, the estimates by the states did not single out only a part of the costs due to wrongful conduct as being bad. Smoking more generally was viewed as being costly and harmful.

Would it have been preferable to simply levy a lump sum penalty

on cigarette companies? Taxes that are invariant with respect to cigarette sales would fall on the company and its shareholders, not the consumers. Some antismoking forces favored this structure as a means of punishing the companies. However, this penalty approach does not raise the cost of cigarettes to smokers and does not discourage smoking. If we act under the assumption that the penalty is related to prospective harm cigarettes inflict on the states, then the tax-equivalent form of penalties is preferable because it provides appropriate economic incentives to smokers to discourage their smoking behavior. It also will be more lucrative for the states than having the industry make a fixed damages payment now.

### The Resolution of the State Attorneys General Suits

Because of the substantial litigation costs and legal uncertainties associated with litigating these suits in a variety of state jurisdictions, the cigarette industry sought a negotiated settlement of this litigation in 1997. As the previous chapter indicated, the Proposed Resolution of the tobacco litigation would have provided for $368.5 billion in payments over twenty-five years, substantial regulatory changes, and shielding of the companies from litigation by the states, class actions, and punitive damages claims. After this agreement failed to receive approval from Congress, the industry negotiated an agreement directly with the states. How did the industry fare and in what way did this outcome differ from the Proposed Resolution?

At the end of 1998 the industry did reach a separate settlement agreement with the group of forty-six attorneys general who had not yet settled. It had already settled with four states in separate agreements in 1997 and earlier in 1998. Mississippi received $3.6 billion, Florida $11.3 billion, Texas $15.3 billion, and Minnesota $6.6 billion.[2] Most of these settlements occurred after the prospects of the June 1997 Proposed Resolution effort began to dim, as the tobacco industry sought to resolve the litigation with each individual state. The industry's settlement efforts were baffling to those involved in the tobacco litigation. The first such settlement was for the Mississippi case where, as in all other state cases, I was serving as an expert witness for the industry on whether smokers were aware of the risks of cigarettes. This case was just going to trial, and the lawyers litigating the case were optimistic. However, the negotiation decisions were being made at the corporate level, not by the litigators. Not only was the decision to settle surprising, but the amount of the settlement exceeded the damages that Mississippi sought in the case. All that seemed to matter was that Wall Street continued to regard such settle-

ments favorably—irrespective of the wisdom of such deals. Indeed, no state suit ever made it to a court verdict as a result of this rush to settle the litigation.

The $36.8 billion in settlements for the four separate state settlements are not included in the overall announced price tag of $206 billion, which was the most highly publicized figure from the Master Settlement Agreement. Thus, the total settlement value with all fifty states is $243 billion.

The Master Settlement Agreement included substantial regulatory reforms. Whereas ideally one might want these reforms to emerge from a national policy discussion and federal legislation, these reforms are the result of the decentralized bargains by the state attorneys general. Unlike the Proposed Resolution, the settlement did not include a new set of rotating cigarette warnings or broad FDA authority to regulate cigarettes. The regulations in the settlement included prohibition of targeting youths in cigarette marketing, a ban on the use of cartoons (e.g., Joe Camel, who had already been retired voluntarily by R. J. Reynolds in 1997), limitations on corporate sponsorships of events, elimination of outdoor advertising and advertisements, no payments for product placements, ban on tobacco brand name merchandise, ban on youth access to free samples, and lobbying limits. Cigarette companies are, for example, not permitted to lobby against measures to reduce youth smoking. It is difficult to envision situations in which this restriction would be necessary, because of the broadly based public consensus against underage smoking. The industry also had to dissolve the Tobacco Institute and the Council for Tobacco Research—U.S.A. as well as the Center for Indoor Air Research, but it had the freedom to form new trade associations so that this lobbying limit may be largely symbolic.[3]

Limiting advertising may not be in society's interest. If the primary effect of advertising is to influence brand choice rather than consumption of a broad class of products, as a considerable economic literature suggests, then banning advertising or restricting it in important domains has the effect of locking in the current market shares to the extent that firms cannot advertise new brands. Firms with a high market share at the present time, notably Philip Morris, will presumably tend to benefit more from advertising restrictions than firms with a more modest market share. New market introductions by these firms will be more difficult, so that it will be harder to get smokers to switch brands or to switch to different types of cigarettes by making consumers aware of the properties of these new products.

This disadvantage is troublesome for two reasons. Restricting advertising decreases market competition, leading to increased concentra-

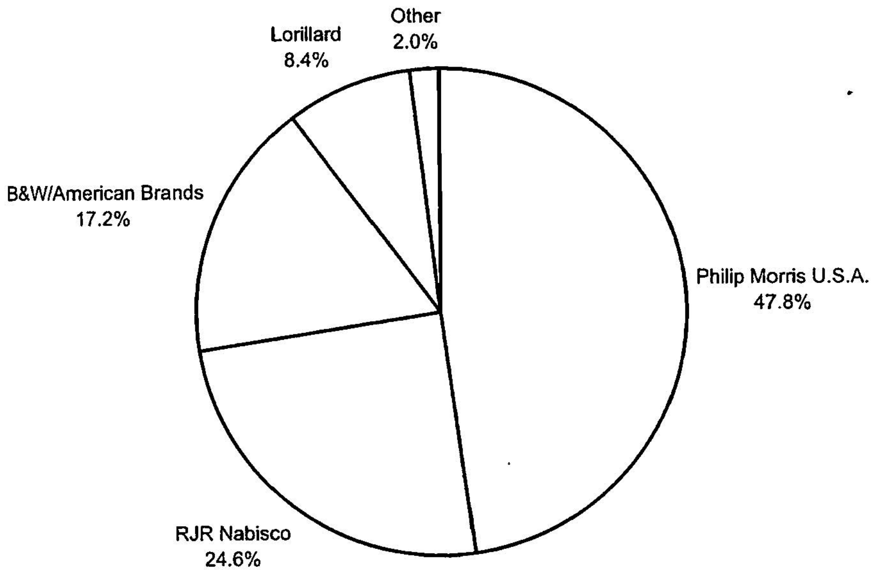



*Figure 1 Tobacco industry market share: top 7 multinational tobacco companies. Source:* Philip Morris Companies Inc. 1996 Year End Financial Fact Sheet.

tion and higher prices. It is anticompetitive. Second, advertising is a mechanism for providing information to consumers about safer cigarettes that may be developed in the future. In an environment with stringent restrictions on advertising, an alternative mechanism must be found if consumers are to be alerted to the changing safety characteristics of cigarettes.

Even before the settlement agreement and its likely anticompetitive effects, the U.S. tobacco industry was becoming increasingly concentrated. Figure 1 summarizes the market shares. By 1996 Philip Morris U.S.A. controlled 47.8 percent of the domestic tobacco market.[4] R. J. Reynolds was next, with 24.6 percent market share. The two largest firms consequently controlled almost three-fourths of this major industry, which reflects a high degree of concentration. Brown and Williamson/ American Brands controlled much of the remainder with 17.2 percent market share, and Lorillard (8.4 percent) and other brands (2.0 percent) made up the rest.

The antismoking objective is consequently at odds with the usual antitrust norms to foster market competition. If the companies had colluded on their own to eliminate wasteful advertising expenditures so as to lock in current market shares and save billions in marketing costs, there would have been immediate legal actions by the government to

prevent it. Once these restraints were specified as part of the Proposed Resolution and the Master Settlement Agreement, government officials lauded them as an effort that will stop smoking, ignoring their consequences for market competition. Anticompetitive efforts are not the exclusive concern, just as decreasing smoking is not the only avowed policy objective. However, if advertising primarily affects brand choice rather than cigarette consumption, the anticompetitive consequences will loom larger in terms of the social costs.

The imposition of a cigarette tax through the settlement leaves existing companies vulnerable to new entrants. If the tax is intended to discourage smoking and prospective harms, it should be borne by new entrants as well. If the tax is truly only for past harms, as was claimed in the lawsuits against the cigarette companies, then more conventional damages payment rather than a tax would have been warranted.

To prevent existing companies from being undercut by new entrants, the Master Settlement Agreement also included provisions that would reduce the payments by the company if existing sales went down. The states that did not adopt so-called Qualifying Statutes would incur the reduced value of these payments. Such Qualifying Statutes would require new entrants to post pro rata damages based on cigarette sales. New entrants for whom there are no allegations of past wrongful conduct consequently would have to make payments into a damages fund. Whether one views this approach as anticompetitive in nature depends on how one views the appropriateness of the tax-like structure. If a cigarette tax mechanism is appropriate and actually pertains to future harms, all cigarettes of comparable riskiness should bear the tax. However, the cigarette tax is not linked in any way to cigarette safety. Should cigarettes free of nicotine and all cancer risks ever be marketed, they would be subject to the same tax as other cigarettes. Thus, even if the tax is viewed as a prospective penalty on a risky product, it is not structured appropriately.

Legal challenges to the agreement that were under way in 2001 sought to strike the portion of the agreement that imposed penalties on new entrants. These firms were not parties to the original settlement, which was purportedly for past harms. Ultimately, the failure of the financial structure of the settlement can be traced to the fact that it imposes an excise tax, and such taxes are the appropriate province of the legislature.

The original participating manufacturers in the settlement included the four major producers: Philip Morris Incorporated, R. J. Reynolds Tobacco Company, Brown and Williamson Tobacco Company, and Lorillard Tobacco Company. As a result of the settlement, these firms were released of all claims relating to the state suits. In particular, they

were released of all claims for past conduct targeted in the state suits, where these claims were based on sale, research, and statements regarding tobacco products. Similarly, the firms were released of state suit claims for future conduct, and monetary claims relating to tobacco product exposure. Unlike the Proposed Settlement, this agreement included no restrictions on private tort actions or punitive damages. Suits by other entities, such as labor unions, insurance companies, and Native American tribes, were also unaffected. Each of these groups has since filed lawsuits based on the briefs prepared for the state cases.[5] Companies thus received less shielding from litigation than under the Proposed Resolution.

Because the Master Settlement Agreement and the settlement of the Minnesota case led to the release of voluminous tobacco industry documents, there also would be more information available for future plaintiffs' cases. Plaintiffs' attorneys armed with these internal company documents would claim that companies had withheld vital risk information. Whether such claims are true or not, the use of formerly secret internal documents gives such evidence a cloak-and-dagger mystique that enhances its impact on a jury. Moreover, the fact that the industry was vulnerable and had paid damages in the billions raised the expectations of potential plaintiffs and perhaps juror perceptions of liability as well. The multibillion-dollar payoff also may influence juror attitudes as well by establishing an anchor for future award levels.

The payments to be made under the agreement function very much like a tax per pack. Costs are to be based on the firm's market share, and in particular will be linked to the total number of individual packs sold. If, for example, the payment level were $8 billion annually, as it will be from 2004 to 2007, there would be a $0.33 per pack tax-equivalent charge associated with the agreement. Costs for the four states that reached separate agreements are in addition to that amount, bringing the total tax equivalent to about $0.40 per pack. The actual increase in the price per pack will be more due to the costs generated by attorneys' fees, wholesaler markup, and related expenses. This tax level bears no reasonable relationship to any of the estimated costs of cigarettes calculated in the next two chapters. Even if only medical costs incurred by the states enter the tally, and one excludes any cost savings due to cigarettes, the industry overpaid.

The focal point of the public discussion has been the publicized figure of $206 billion for the Master Settlement Agreement rather than on the per pack equivalent. In fact, the actual cost levels are much more complex than either a lump sum damages award or a simple payment per pack. The scope of the settlement with the states was quite broad and

involved more than cash transfers. Many of the financial outlays also were targeted for specific purposes related to antismoking efforts. The lion's share of the money, however, goes to the states for unrestricted uses.

First, the cigarette industry will be funding a foundation to reduce youth smoking. The base payments were $25 million in 1999 and in the subsequent nine years for a ten-year total of $250 million.

Second, the cigarette industry will also fund a more broadly based national public education fund. The amount of funds going to this effort were set at $250 million in 1999, and $300 million beginning in the year 2000 and continuing for every year through 2003, for a total amount of $1.45 billion. Whereas there will be no inflation adjustments for the youth smoking payments, the national public education fund payments will be subject both to an inflation adjustment and to a volume adjustment based on the level of cigarette sales by the particular firm. Total allocations for the antismoking foundation and the national public education fund are under 1 percent of the total settlement price tag for the first twenty-five years. These measures are not the main point of the settlement, which is simply to transfer money to the states.

The third component of financial payments is for enforcement efforts related to the settlement agreement. In particular, the four major tobacco firms must contribute $150,000 annually to fund an executive committee to supervise the agreement, or $1.5 million over ten years. Moreover, the firms had to pay $50 million in 1999 for enforcement of the agreement. These payments are subject both to inflation adjustments and to volume adjustments.

Table 1 summarizes the payments the firms must make for the settlement agreement, not counting their payments for the various educational efforts mentioned earlier. The first column of payments lists the initial payment amounts for the years 1999–2003. These initial payments range from $2.4 billion to $2.7 billion. The next column of payments pertains to annual payments, and these begin at $4.5 billion in the year 2000 and rise to $9 billion in the years 2018 into perpetuity. Note that whereas the press has focused on payments over the initial twenty-five years, these annual payments do not stop in 2023 but continue forever. The final set of payments, which are designated additional payments, are for $0.861 billion from the years 2008 through 2017. These payments are distinguished in different categories in part because different kinds of volume and inflation adjustments pertain to them. The final column in table 1 lists the total payment amounts, which begin at $2.4 billion in 1999 and rise to a total of $9 billion by 2008 and remain at that level in perpetuity.

Table 1 also lists the twenty-five-year payment totals for each column of costs, where I take 1999 as the starting point. These amounts are