Demonize—Then Pulverize

by Sam Kazman

Ten years ago last May, a new type of lawsuit was filed against the tobacco industry. That industry was no stranger to lawsuits; since the 1950s it had been subjected to more than eight hundred lawsuits, and it had won practically every one of them. It had never paid a penny in court-ordered damages to a smoker or to the estate of a smoker. But this suit was different. It didn't involve smokers; it involved a state—the state of Mississippi—and it involved a new legal theory. This suit was so different that within three years thirty-one other states had filed actions, and within four and a half years we had something called the Tobacco Master Settlement Agreement (MSA).

The tobacco suit circumvented voting for taxes.

The MSA was a pretty complicated document. Its first impact, practically overnight, was a huge increase in the price of cigarettes, though this turned out to be one of its less important effects. The MSA also shuffled around incredible amounts of money and political power. If you believe that taxation is theft, then this was theft by an entirely new cast of characters, many of them without any constitutional authorization. If you're suspicious of regulation through litigation, this was regulation on an entirely new scale. And if you have some regard for the constitutional separation of powers, for checks and balances, the MSA had a huge impact there as well. One of the biggest restraints on the power to impose taxes is that legislators need to cast votes for them. The attraction of new revenues is thus controlled somewhat by the political stigma of voting for taxes. That's why, in the federal Constitution, any measure to raise taxes must originate in the House of Representatives, whose members are closer to their constituents than those of the Senate.

This constitutional restraint, of having to vote for taxes, was simply demolished by the MSA, because that agreement took the form of court-approved settlements in each of forty-six states. No elected legislator anywhere had to cast a vote for it.

Mark Twain once said that first "God made idiots. This was for practice. Then he made school boards." When it comes to raising taxes and devastating industries, the main actors here—the state attorneys general and the trial lawyers they hired—first made the MSA. That was for practice. Now we're seeing similar campaigns against a host of other industries.

Tobacco and Risk

There was a basic reason why the tobacco industry had never lost a suit until now. Juries believed that when people decided to smoke, they were accepting the risks of smoking. But the industry was far from forthright about those risks. I suspect there was a period before the very first cigarette warnings were mandated in the mid-1960s when the industry knew more about the hazards of smoking than did the public. In fact, in 1954, a year after the first major epidemiological studies of smoking and cancer were published, the industry took out a full-page ad in about four hundred papers, called "A Frank Statement to Cigarette Smokers," which stated: "We accept an interest in people's health as a basic responsibility, paramount to every other consideration in our business."

Tobacco warnings put people on their own.

These are lovely words, but they're largely nonsense. If a ski slope operator were to announce that customers' health was the business's paramount concern, its customers would probably be limited to young children attracted by the bunny slopes. Skiing enthusiasts would go elsewhere. There are inherent risks in skiing, especially in adventurous skiing, and without those risks many people won't engage in it.

The tobacco industry was being disingenuous or deceitful here. Nonetheless, once those mandated warnings appeared, everyone was put on notice. From that point on, any individuals who started to smoke, or even continued to smoke, should have been barred from coming into court years later to complain that they had been deceived about the risks of smoking.

AP Photo/Gene J. Puskar

David A. Kessler, commissioner of the Food and Drug Administration (1990–97), spoke of nicotine as a pediatric disease.

A New Legal Theory, a New Cartel

So what did happen in this new suit in 1994? Mississippi came up with a recoupment theory. It claimed it was entitled to recover the huge expenses that its Medicaid program had allegedly racked up treating smoking-related illnesses. The suit was not aimed at recovering money for any individuals or groups; it was to get money for the state itself. At the same time, the head of the U.S. Food and Drug Administration (FDA), Commissioner David Kessler, M.D., announced that tobacco was subject to the FDA's jurisdiction. This claim was contrary to the position that the FDA had steadily taken for several decades. According to Kessler, smoking was a pediatric disease and cigarettes were a nicotine-delivery system. He proposed to regulate cigarettes as a therapeutic device. Of course, there's a basic question here: If tobacco is a therapy, what's the disease?

This claim of allegedly protecting children is one that you'll now find in one anti-industry campaign after another. It's a tactic that was honed to perfection in the FDA's tobacco campaign. That campaign was eventually overturned by the Supreme Court in 2000, on the ground that the FDA had no jurisdiction. By then, however, all the horses had left the stable.

In the wake of Mississippi's lawsuit, state after state piled on with their own recoupment cases. The legislatures of Maryland, Florida, and Vermont actually passed laws that practically guaranteed victory by the states, abolishing the assumption-of-risk defense in Medicaid recoupment lawsuits. This defense is a well-established legal doctrine that had been the key to the industry's past legal victories. It was fully justified—at least after the cigarette warning labels were mandated. In the skiing context, for example, if you broke your leg and sued, the slope operator should be able to argue that snow is naturally and obviously slippery, and that you assumed the risk of injury from falling when you went skiing.

Lawsuit revenues are not going to health programs.

Ultimately, these cases could probably have been won by the industry, but it decided to fold instead. In November 1998, the MSA was unveiled. Under it, the companies agreed to make huge annual payments in perpetuity to the states based on cigarette sales. These payments were projected to amount to $200 billion over the first twenty-five years. (Remember, there's a huge difference between a billion and a million; an opponent of the MSA once commented that the biggest problem he runs into in Washington is that politicians don't understand that difference.) In the words of attorney Margaret A. Little, this was "the largest, privately negotiated litigation-related wealth transfer in history."

This money would be obtained by increasing the price of cigarettes. Overnight, the wholesale price of a pack of cigarettes rose from $1.25 to $1.70. But the industry signatories to the MSA, the four major cigarette producers, would face a problem in maintaining this increase, because higher prices would open the door to discount producers who did not sign the agreement. In order to prevent this, the states, as part of their agreement, made it incredibly expensive for new discount producers to enter the market. In effect, you had not just a cartel being formed—you had a state-sponsored cartel.

To ensure that the states enforced this cartel, they faced severe financial penalties if the majors lost market share. All of this was coordinated by the National Association of Attorneys General (NAAG), which received $50 million to kick off its enforcement program and which continues to oversee the MSA.

Things couldn't have been better for the states. They had all this new revenue coming in that was unencumbered by the painful process of legislatively raising taxes. If there was some irony in the fact that these states, which until now had been going after the major producers, suddenly became their partners, it didn't bother too many state officials.

As for what the states *did* with this money—that's a different story. They had said they'd be using it for smoking-abatement programs, but more than half is actually being used for general-revenue shortfalls, which mushroomed as the economic booms of the 1990s deflated. The General Accounting Office projected that, of the $11 billion that states would receive from the MSA this year, over half would go to cover budget deficits, while only 17 percent went to health-related programs of any sort (not just smoking). So, the money is being used the way politicians usually use money.

The MSA cartel, however, is not airtight. Cigarette smuggling has boomed, and the discount manufacturers have been gradually finding new ways to get into various state markets despite the MSA penalties. As a result, the major producers have been losing market share, the states have been losing revenue, and you have now directives from the NAAG urging the states to be more diligent in enforcing the cartel.

The MSA's Political Effects

While the MSA had a very quick and clear effect on cigarette prices, its less obvious political impacts were perhaps even more important. First, the state attorneys general realized that they, and the private trial attorneys whom they hired on a contingency-fee basis, were pretty good at this sort of work. And the contingency contracts meant that such projects could be undertaken without state budgetary or staff commitments.

More importantly, they could be undertaken without legislative approval as well. In some states, the requirement of legislative approval might have stopped such efforts cold. For example, the Mississippi suit that started the new wave of tobacco litigation was actually opposed by the state governor, who unsuccessfully tried to stop it in court. In Maryland, a court turned away a legislative challenge to the contingency-fee contract; in its words, requiring the contract "to be funded by the general assembly would be to hamstring the attorney general, for his efforts would likely be delayed, if not thwarted, by the cumbersome legislative process."

Greased skids, however, are the last thing you want for radical proposals. Change should be cumbersome in a democracy; you want restraints and speed bumps, rather than an attorney general unencumbered by the political process.

And what kind of public servants were involved here? You had attorneys general giving unbelievably lucrative contracts to private lawyers, which almost certainly meant that these lawyers were friends of the attorneys general. In many states, attorneys general are elected; often, the firms who got these contracts then turned around and assisted them with election-campaign contributions and other favors. Thus, for example, last February former Texas attorney general Dan Morales was sentenced to four years in prison for fraud and tax evasion relating to the state's $17 billion tobacco settlement. His parting words were that he'd been blessed to serve the public: "It is my intention and my hope to have that opportunity again." You betcha.

The trial attorneys received huge chunks of this money, often for filing what were essentially copycat cases. By one count, before the MSA there were about sixty billionaires in the United States; after the settlement, they numbered between eighty and eighty-five. Those added to the roll were trial attorneys.

Some states abolished legal defenses to win.

These trial attorneys, by the way, were generally Democrats. As one said before the 2000 presidential election: "It would be very, very horrifying to trial lawyers if Bush were elected. To combat that we want to make sure we have a Democratic president, House, and Senate. There is some serious tobacco money being spread around to ensure that."

Lastly, there was the incredible due process outrage committed by several state legislatures in abolishing established legal defenses to ensure state court victories. As the head of the Maryland senate noted regarding that state's hiring of a private lawyer: "Mr. Angelos agreed

to accept only 12.5 percent [of the award] if and only if we agreed to change tort law, which was no small feat. We changed centuries of precedent to ensure a win in this case."

Normally, you'd think this sort of travesty would stir some huge amount of public and editorial outrage. In fact, there was relatively little, indicating that this was another tactic for future use. Once an industry was sufficiently demonized, you could revoke the Constitution with no fear that the public would be up in arms.

Companies capitulate to gain economic certainty.

The NAAG did not view this as an isolated victory. It had money flooding in; it had hugely productive relationships with trial attorneys who'd gotten incredibly rich; and it began to get involved in one campaign after another, ranging from gun litigation to pharmaceutical pricing. What this means is that the deregulation that occasionally occurs under Republican administrations is now often being stopped at the state level. In the view of one state attorney general: "We're stepping in to fill the regulatory vacuum. Someone has to lead the country." So to these folks, regulation through litigation is leadership, and if Washington isn't doing it, then they're only too happy to do it.

As for the tobacco industry, its basic focus has been on calming its investors. Many analysts predicted that the industry had an excellent chance of ultimately prevailing in its legal battle. Nonetheless, it chose to settle, and one of the major factors behind that decision was the fact that its investors were incredibly nervous. These companies wanted certainty above all else; they wanted their investors to know what they were in for, even if it was going to cost a bundle. And so they folded.

Here was another lesson learned—if enough states pile on and raise the stakes high enough, you don't have to worry about the merits of the case.

Next in Line: Pharmaceuticals

While the MSA experience is still unfolding, other litigation campaigns by state and local governments have begun in its wake. One prominent example is the wave of government lawsuits against the pharmaceutical industry, based not on medical issues but on pricing. This began in 2000 with a federal suit on Medicare pricing against TAP Pharmaceutical Products. The U.S. Department of Justice utilized a new threat—if the company lost on any issue whatsoever, it would be barred from all future government dealings. As a result, the company settled, even though its allegedly secret pricing practices had previously been openly examined in congressional hearings.

This led to a wave of new pharmaceutical pricing cases by state attorneys general and trial attorneys, with unions and senior-citizen groups often joining in—in some cases under the direction of warriors from the tobacco campaigns. Treble and punitive damages have upped the financial stakes, though not yet to the level of the MSA payments.

In short, "Big Pharma" has joined Big Tobacco on the industry hit list. During the tobacco wars, the claim was that the tobacco industry was selling a drug; now, the pharmaceutical industry is purportedly selling tobacco.

The nature of the pharmaceutical industry makes it highly susceptible to political attacks. For one thing, under our third-party health insurance system, most people are not used to paying directly for medical costs. So, when something new hits them out-of-pocket, they tend to get very upset. Moreover, while new drugs have huge benefits, their benefits are difficult to demonstrate to the satisfaction of the public. Falling heart attack death rates due to new pharmaceuticals, for example, will not necessarily reduce the irritation of higher drug bills. Consumers fall into "resentful dependency"—in theory, they know these drugs may save their lives, but they hate to need them and they hate to have to pay for them.

There is also the fact that the pharmaceutical industry faces huge research-and-development costs, due in part to FDA requirements. There is a standing joke in the industry that, for any new medicine, the first pill costs $800 million, while every pill after that costs a nickel. This huge disparity between the costs involved in developing and testing a medicine and the marginal costs of producing it after the R&D is completed makes political grandstanding easy—"How dare this company sell a bottle of pills for $50, when it only costs $5 to produce?"

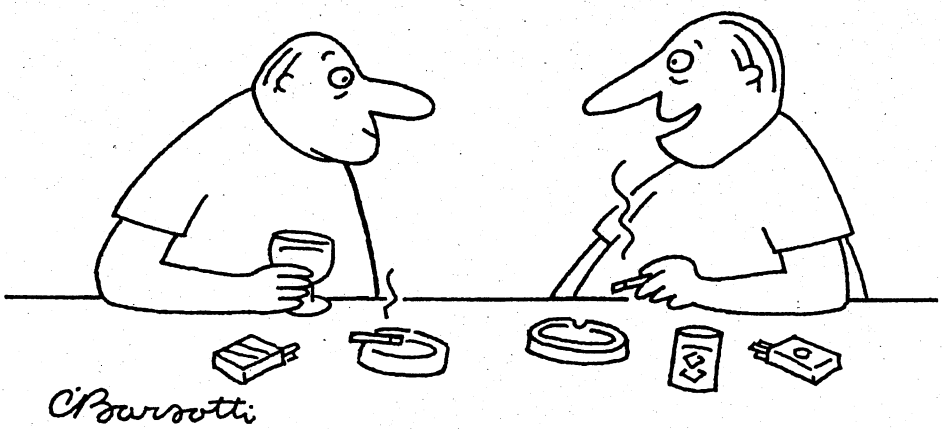
Lastly, there is the increasing shakiness of the drug patent system. Under a 2001 treaty, developing nations can break a drug patent by declaring a health emergency. The mere existence of this power has a remarkable effect on international drug price negotiations.

Big Pharma is now on the industry hit list.

Underlying all this is the growing notion that it is somehow immoral to make money from people's illnesses. But if we rule out the profit motive, then what's left as far as a business model for pharmaceutical innovation? I can think of only one—that of the Post Office. And under that model, I suspect, we can kiss innovation goodbye.

Fast Food

The food industry is also beginning to attract a new wave of lawsuits. Fast foods and fatty foods are accused of being unhealthy, addictive products whose sales are spurred by deceptive



"And my lawyer says we have a hell of a case against La-Z-Boy."

advertising aimed especially at children. Common sense suggests that eating one Big Mac after another is not the ideal diet. That common sense, however, is nowhere to be found in the critical acclaim heaped on the documentary *Super Size Me*, whose narrator spends a full month consuming vast amounts of McDonald's food and then bemoans how he's fallen out of shape.

Fast food is attracting lawsuits.

To date there have been two private suits filed against McDonald's by consumers blaming it for their obesity. An advisor on these cases, John Banzhaf, was one of the leading lawyers in the tobacco war. Both suits were unsuccessful, but the growing number of legal seminars on nutritional litigation suggests that this field is in its infancy. And there are already signs of industry accommodation—McDonald's is phasing out its supersized fries and drinks, and Kraft Foods is limiting the size of its single-serve packages. Kraft claims that it's doing so as a public service, but some might wonder whether this isn't just an excuse to increase unit prices.

At the same time, there is a growing number of proposals to impose "fat taxes" and soda bottle taxes, all premised on the thought that, like smoking, obesity and other nutritional ills carry social costs that we need to reduce. Not surprisingly, food advertising aimed at children is also under attack.

Big Oil, Big Auto

The oil and automobile industries are another area facing a grim litigation future. For starters, in the last decade a whole new body of literature has arisen on what is called the "social costing" of cars—the claim that, when you fill up at the pump, you do not pay the full cost to society of your driving. There are supposedly air pollution costs, military defense costs, and, most recently and most ominously, global warming costs. (Global warming is, I think, an issue where the more we learn about the earth's climate, the less reason there is to believe that we're on the verge of any human-produced catastrophe. At a minimum, the environmentalist claim that there is no remaining scientific debate over this issue is simply false. Nonetheless, global warming alarmists love to portray skeptics as being engaged in "tobacco science.")

If you accept that driving imposes a social cost, then it's not that much of a leap for some enterprising state attorney general to argue that society is entitled to recoup that cost. Higher gas taxes are one approach, but those would stir up some formidable opposition from the public. Litigation against Big Oil and Big Auto, on the other hand, would avoid such nettlesome problems.

Another ripe area is that of corporate accounting. Environmentalists are demanding that corporations begin to list such "environmental liabilities" as global-warming emissions in annual reports, even though there have been no successful suits to date on such claims. They argue that this is necessary for investor awareness, but in fact investors may end up being hurt. When totally speculative risks find their way into company reports, they arguably become less speculative. Once a firm acknowledges such risks, it can be more easily faulted for its failure to reduce them. So, what begins as a measure to supposedly increase shareholder awareness ends up becoming a rope by which to hang the company.

Network economics (also known as path dependence) is another argument that is being introduced into these controversies. There is a choice between several different technologies, but once enough people choose one of them, the alternatives disappear, even though they may be superior. This supposedly illustrates a market failure.

Litigation may obviate passing gasoline taxes.

One example of this was the competition between VHS and Beta videocassette recorders several decades ago. Beta recorders were supposedly technologically superior, but they lost to VHS models just because so many people chose the latter.

In fact, VHS won because, back then, it could record more material on a cassette. That was a perfectly good reason for it to have won. This was simple competition.

The notion of network economics as a rationale for government intrusion rests on the view that people are stupid while government is smart, and so we need a state technology czar to send us down the right path. But when it comes to choosing between competing technologies, government has a relatively poor track record. Its decision-making is infected by politics, by arrogance, and by unlimited funding. Individuals, on the other hand, at least pay for their mistakes, and that's a great incentive to learn from those mistakes.

What does network economics have to do with Big Oil and Big Auto? Well, one argument against sport utility vehicles is that people buy them because other people have bought them. SUVs are a collision hazard, and the only way to protect yourself from this hazard is to buy one yourself. That, of course, only increases your neighbor's incentive to do the same.

There is a bit of logic to this, since the higher bumpers of SUVs make them incompatible, to a degree, with passenger cars. But there are many other things that, from a safety standpoint, are "incompatible" with cars, ranging from trees to bridge abutments to other cars. If safety is the prime criterion in choosing a car, then you'd never have a snazzy little model such as the Mini Cooper. If safety compatibility were the touchstone of automotive regulatory policy, then how can you justify the federal fuel economy standards, whose downsizing effect on vehicles is responsible for thousands of traffic deaths? (Actually, you can't justify those standards, yet they're espoused by many of the same groups that protest SUVs.)

In short, network economics is simply one of many arguments against SUVs raised by those who object to how people live their lives. If you listen to enough of those arguments, you realize that SUV really stands for "scapegoat utility vehicle."

Lessons Learned

So, what tobacco-campaign tactics are now being used elsewhere?

First—claim that everything under attack is like tobacco. The term "addictive," for example, has probably been used more in the past decade than in the entire preceding century—our "addiction" to cars, to "cheap" oil, to food; gambling addicts, sex addicts, chocolate addicts. Neurological research seems to indicate that many things are similar to tobacco, in the sense that certain repetitive actions aimed at low-level rewards, such as chewing food or playing a slot machine, produce chemical changes that are somewhat similar to those of smoking. But if anything,

this suggests that the term should not be an automatic justification for regulation.

Second—whenever possible, claim that you're protecting children. This tactic has been most fruitfully employed in attacking product advertising on the ground that it "targets" minors. The concept, however, has been vastly expanded. Rather than referring to ad campaigns that deliberately go after children, it now means any ads to which minors are simply exposed. An ad in *Sports Illustrated* or on a billboard is suddenly fair game. "Big Booze" is one of the latest industries to be hit with such charges.

This is a huge First Amendment threat. If exposure becomes the criterion for denying constitutional protection, then any public advertising is risky. However enticing Joe Camel may have been, he was far less a threat to our children than a gutted First Amendment.

There may be an attractive innocence to the biblical notion that "a child shall lead" us. Being led by politicians who claim to be protecting our children, however, is another matter entirely.

Third—medicalize individual behavior. Everything is put into a public health model, from smoking to getting fat (the "obesity epidemic") to driving cars. This model has several insidious effects. It tempts people to surrender their individual judgment; they view themselves as less responsible for both the choices they make and the consequences of those choices. After all, if the surgeon general says it's a sickness, who am I to argue? As one commentator put it: "Everything bad that happens to me is a disease, and someone else gave it to me." "The surgeon general says it's a disease, so there are people in white coats who'll take care of it."

Fourth—subject whatever offends you to social costing. If everything you do is society's fiscal responsibility, then it's much easier to argue that everything you do is society's business.

Despite its technical-sounding name, social costing is an incredibly ambiguous technique. In the case of smoking, the social costing analyses were deeply flawed, invariably omitting the fact that smoking kills. A two-pack-a-day smoker, for example, tends to live six to eight years less than a nonsmoker and will tend to die of diseases that kill relatively quickly. One result of this is that smokers draw far less out of Social Security and pension funds. Yet the anti-tobacco activists, whose tirades focused on the risks of smoking, suddenly shied away from doing a fiscal accounting of these risks. Analyses that took those risks into account found that smokers more than pay their own way, especially given the cigarette taxes paid on their habit.

The automobile debate illustrates how social-cost numbers get lost in the drive to expand government. Social costers argue that society subsidizes driving, but they then go on to advocate mass transit, a transportation mode that is even more heavily subsidized.

The Tab

Tobacco can be a very tough habit to quit. That, however, is an issue that we face as individuals. Once smoking became a political matter, it turned out that tobacco revenues were far more addictive to politicians than smoking was to consumers. The price paid by smokers for the MSA was a steep one. But when it comes to the price that we may all pay for the political consequences of the MSA...well, to borrow from an old rock classic, baby, you ain't seen nothing yet. N

Sam Kazman is general counsel of the Competitive Enterprise Institute and heads CEI's Death By Regulation Project.