

NLWJC - Kagan

DPC - Box 052 - Folder-011

Tobacco-Settlement: Price



Cynthia A. Rice

06/24/98 05:18:16 PM

Record Type: Record

To: Bruce N. Reed/OPD/EOP, Elena Kagan/OPD/EOP, Laura Emmett/WHO/EOP, Cynthia Dailard/OPD/EOP

cc:

Subject: Talking points for a Rubin call to Bible



bible.wp Treasury prepared these talking points for a Rubin return call to Bible. I think they're fine -- please let me know by tomorrow morning if you want to review them (otherwise I'll give Gruber the go ahead.)

The talking points reiterate our publicly stated position on price estimates, in response to a June 11th fax Geoffrey Bible sent Rubin of two "independent" analyses of the Treasury analysis of McCain (sent to Hatch).

June 23, 1998

MEMORANDUM TO: SECRETARY RUBIN
FROM: JONATHAN GRUBER
RE: Call to Geoffrey Bible

Action Forcing Event

Phillip Morris CEO Geoffrey Bible sent you a letter containing two critiques of the Administration's analysis of S.1415, the McCain bill. The analysis to which he refers was provided to the Senate Judiciary Committee on May 11, in response to a request from Chairman Hatch to Deputy Secretary Summers. In your return call, you reiterate the broad position that we presented in that analysis, while recognizing the uncertainties that underlie the study of this difficult topic.

Background

At his testimony before the Senate Judiciary Committee on April 30, Deputy Secretary Summers was directly challenged by Chairman Hatch to justify in detail the Administration's conclusions that the McCain bill would raise the price of cigarettes by \$1.10 per pack (in real terms) in 2003.

- Tax Policy and Economic Policy worked together to produce this analysis over the next 10 days, and it is attached as **Tab C**
- Subsequent to our analysis, the Joint Tax Committee issued an analysis which found that the price of cigarettes would actually rise by \$1.68 (constant 1998 dollars) in 2003. This difference was largely based on different assumptions about the baseline quantity of cigarettes consumed, the amount of smuggling that would arise from this legislation, the response of state taxes to this federally mandated price increase, and retail and wholesale mark-ups.
- In the wake of this news, the McCain bill was augmented by adding a "volume adjustment" which would lower the government receipts as cigarette volumes declined, to guarantee that the price would not rise by more than \$1.10 in 2003.

The letter that you received (attached as **Tab B**) contains two "independent" re-analyses of the letter that was sent to the Judiciary Committee.

- The letters contain a large amount of sharp rhetoric, but the cover note from Mr. Bible asks you to ignore this and focus on the analysis.

- Their analysis is fundamentally flawed or confused in some areas, and in others areas differ from Administration analysis because of honest scientific uncertainty. On some topics where there is some uncertainty, the administration has staked out a clear position.
- An example of the fundamental flaws in the analysis is the consideration of youth smoking. There is a clear scientific consensus that youth smoking is highly responsive to price, but this is ignored by both reviewers.
- An example of a confused point is the first reviewer's criticism of the Treasury price analysis. He argues that the analysis assumes the price elasticity falls as price rises, when the opposite is true. The price differences he attributes to differences in behavioral assumptions are actually due to his confusion between real and nominal prices.
- An example of the honest uncertainty is analyses of how the price responsiveness of smoking will change as the price rises by a large amount.
- An example of the last category is smuggling. There is some legitimate uncertainty about the impact of the McCain bill on smuggling. But we believe strongly, and have stated repeatedly in testimony, that smuggling will not be a significant problem given the impressive new enforcement regime that we are putting into place.

I attach as **Tab A** talking points for your call to Mr. Bible.

Recommendation

That you call Mr. Bible, relying on the attached talking points.

___ Yes ___ No ___ Let's Discuss

Talking Points for Call to Geoffrey Bible

- Measuring the effect of comprehensive tobacco legislation on the price of cigarettes in the U.S. is an analytically difficult task that incorporates a large number of uncertainties. It is impossible to measure the effect of such legislation without making a number of assumptions and projections about an environment that is without historical parallel in the U.S.
- These types of scientific uncertainties lead to a number of the disagreements that your reviewers had with our analysis. On questions such as whether smokers are more or less responsive to small versus large price changes, there is no clear right answer. But in every such case we chose an assumption which was completely consistent with the extant scientific literature.
- In other important areas, we disagree quite strongly with your reviewers. Two such areas are the responsiveness of youth smoking to price, and the extent of smuggling that will arise from a comprehensive tobacco settlement such as the McCain bill.
- On the former, there is a clear scientific consensus that youths are very responsive to the price of cigarettes. This is confirmed by international evidence from Canada during the 1980s, where the price of cigarettes rose by 90% and youth smoking fell in half. Indeed, it is confirmed by analysis contained in internal documents from Phillip Morris and the other tobacco companies.
- On the latter, we believe quite strongly that the creation of a sound regulatory system – one that will close the distribution chain for tobacco products – will ensure that the diversion and smuggling of tobacco can be effectively controlled and will not defeat the purposes of comprehensive tobacco legislation.
- Thus, while we recognize the uncertainty that underlies this exercise, we stand by our analysis, and we would apply the same basic methodology to analyzing future bills on this topic that emerge from the Congress.
- We hope that we can work with you in trying to pass comprehensive tobacco legislation this year.

Background - Specific Topics

Volume Adjustment: In the wake of an unfavorable score of the price per pack effects of the McCain bill by JCT, the bill was augmented by adding a “volume adjustment” which would lower the government receipts as cigarette volumes declined, to guarantee that the cost per pack to the manufacturer would not rise by more than \$1.10 (1998 dollars) in 2003. This volume adjustment takes as its base 80% of 1997 volumes, which is criticized by Mr. Bible.

But the reason for this is quite simple: the payment stream included in the McCain bill already

had an “implicit” volume adjustment built in, which had the payments decline over time to reflect the fact that we expected a fall in volume. The 80% adjustment was simply picked so that, given our assumptions on volume decline, we would guarantee cost per pack increase of \$1.10 real. This is indeed the cost per pack increase “score” provided by JCT on the revised bill.

The key point is that **with this volume adjustment, the manufacturer per pack cost increment due to the base payments in the bill is guaranteed to be no greater than \$1.10 real.** This seems to be misunderstood by both the reviewers and by Bible.

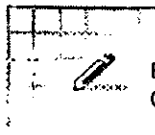
The Evolution of Price Responsiveness: Contrary to the statement by the first reviewer, our model assumes that the price responsiveness of smokers rises as the price rises. But because the model is slightly non-linear, it takes larger and larger absolute price increases to generate the same quantity reduction. It is in this sense that the model is consistent with the intuition that as the price rises, the market is composed of more and more committed smokers. Our model, moreover, is consistent with several influential empirical studies. The criticism of it offered by the first reviewer is without empirical or theoretical basis.]

Smuggling: The regulatory regime we envision has three essential elements. First, all entities in the distribution chain for tobacco products – manufacturers, wholesalers, exporters, importers, distributors and retailers – should be required to hold a license or a permit. Licensing of retailers could be done at the state level. Licenses would be issued based on certain clearly specified criteria and could be revoked or suspended for certain specified violations. Those conducting business without a license would be subject to penalties. Licensed entities should only be authorized to sell tobacco products to other licensed entities. Second, legislation should require the marking, branding and identification of packages of tobacco products intended for domestic distribution and for export so that they may not be diverted or smuggled in circumvention of the legitimate channels of distribution. Third, any regulatory proposal should include penalty and administrative provisions that will allow for effective, efficient and uniform enforcement of controls over distribution.

With the necessary regulatory provisions in place to deal with potential smuggling, we assume there will not be an increase in smuggling for several reasons. First, the “closed” distribution scheme would limit drastically smugglers’ ability to enter products into a legitimate distribution channel. Potential black marketeers will not be able to move products through legitimate wholesalers or distributors. Nor will they be able to sell products to retail consumers at the local convenience stores or other licensed retail outlets. Instead, without a way to place contraband products in the market legally, smugglers would have to sell cigarettes outside channels of legitimate distribution. This would be a risky proposition and one we do not believe will represent a significant problem. Second, U.S. cigarette manufacturers would have great incentives not to become complicit in any smuggling operation, as they would encounter enormous legal risks (such as the possibility of losing their license or, as the McCain bill provides, losing their cap on liability risk) and public opprobrium. Indeed, it is hard to imagine that large scale smuggling could occur without the manufacturers’ knowledge. Third, the U.S. Customs Service has the expertise and the experience

to deal with imported contraband products and has already made a substantial investment in the currently planned introduction of non-intrusive inspection systems and other equipment needed to detect smuggling of contraband. The organic nature of tobacco and the distinctive shape of cigarettes makes them readily detectable by equipment that Customs currently has in place.

Pass-Through to Price: The second reviewer disputes our assumption that these payments will be passed-through to prices. But this assumption is supported by a large empirical literature, and is commonly employed in outside analyses of this legislation, including those by CBO and JCT.



Bruce N. Reed
05/22/98 03:20:34 PM

Record Type: Record

To: Cynthia A. Rice/OPD/EOP, Mary L. Smith/OPD/EOP, Cynthia Dailard/OPD/EOP, Elena Kagan/OPD/EOP

cc:

Subject: Price Quote

There's a very good quote in one of the Philip Morris documents Mary found on teen smoking and price. It's from Sept 17, 1981 (p.3): "It is clear that price has a pronounced effect on the smoking prevalence of teenagers." The document also suggests a price elasticity of -1.2 for teens, considerably higher than we assume. We should try to use the quote in our defensive talking points (and find out what the author of the memo did for PM).

Tob-ser-new documents
and
Tob-ser-price

Here is a transcript of an ABC News story from last night, May 19, that mentioned two Philip Morris documents demonstrating that the tobacco industry knows that raising prices will cause a decline in youth smoking. A Philip Morris strategic planning document from the early 1990s states: "There is no question that increasing taxes will cause a decrease in smoking. This point is best illustrated by the present situation in Canada." In another document from five years earlier, a Philip Morris analysis of price increases concluded: "Price increases prevented 600,000 teenagers from starting to smoke. We don't need to have that happen again." We are trying to get the actual documents.

Tob - rrr - new documents
and

Tob - rrr - price

5TH STORY of Level 1 printed in FULL format.

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ABC NEWS

SHOW: WORLD NEWS TONIGHT WITH PETER JENNINGS (6:30 pm ET)

MAY 19, 1998

Transcript # 98051905-j04

TYPE: PACKAGE

SECTION: NEWS

LENGTH: 633 words

HEADLINE: WILL PRICE INCREASE DETER TEEN SMOKERS?

BYLINE: AARON BROWN, PETER JENNINGS

HIGHLIGHT:

DEBATE OVER RAISING PRICE PER PACK BY \$1.50

BODY:

THIS IS A RUSH TRANSCRIPT. THIS COPY MAY NOT BE IN ITS FINAL FORM AND MAY BE UPDATED.

PETER JENNINGS: In Washington, there has been another round of testy debate in the Senate about a bill to regulate tobacco.

(voice-over) This one that would raise the price of cigarettes by \$1.50 a pack. Those in favor, including that senator, say that if cigarettes are more expensive, teenagers would buy fewer.

(on camera) The tobacco companies say that price is not a factor. Mind you, that's not what they've always said. Here's ABC's Aaron Brown.

AARON BROWN, ABC News: (voice-over) The industry argues that where underage smoking is concerned, the most basic law of economics does not apply -- charging more will not mean selling less.

STEVEN GOLDSTONE, Chairman & CEO, RJR Nabisco: As parents, we know that the reasons kids smoke aren't related to price.

AARON BROWN: (voice-over) In fact, industry ads argue, steep price increases will only make the problem worse.

WORLD NEWS TONIGHT WITH PETER JENNINGS, MAY 19, 1998

NARRATOR (Tobacco Industry TV Ad): There will be a black market in cigarettes with unregulated access to kids.

AARON BROWN: (voice-over) The industry cites Canada as proof. In the early '80s, when Canada increased cigarette prices, a black market did emerge. But something else happened in Canada the tobacco industry does not mention.

DAVID SWEANOR, Non-Smokers' Rights-Canada: The price went up in Canada, consumption among teenagers plummeted.

AARON BROWN: (voice-over) The number of kids who smoked every day dropped by 60 percent in little more than a decade.

(on camera) The tobacco companies know this. The evidence of their knowledge is contained in their own files. This Philip Morris strategic planning document from the early '90s states it simply.

(voice-over) "There is no question that increasing taxes will cause a decrease in smoking. This point is best illustrated by the present situation in Canada." Five years earlier, a Philip Morris analysis of price increases concluded, "Price increases prevented 600,000 teenagers from starting to smoke. We don't need to have that happen again."

Today, Philip Morris tells a different story.

STEVEN PARRISH, Senior, Vice President, Philip Morris: There are a lot of things that have an impact on whether a kid is going to smoke. Price is not the only thing.

AARON BROWN: (voice-over) And no one on the anti-tobacco side claims it is. But they do say this...

DAVID SWEANOR: If there is anything more effective at reducing smoking among kids than price, we haven't found it yet.

AARON BROWN: (voice-over) And neither has anyone else. Aaron Brown, ABC News, New York.

PETER JENNINGS: Some other news today. The government has released its first study on the safety...

(voice-over) ...of those so-called personal watercraft, including things like jet skis and waverunners. They represent now a third of all new boats sold. To cut down on accidents, the government recommends the Coast Guard establish safety standards. The vast majority of people who have accidents had no safety instruction.

(on camera) Overseas in Belfast today, rock 'n' roll to promote peace.

BONO, U2: (singing) Just give peace a chance.

PETER JENNINGS: (voice-over) The familiar sounds of U2, including Bono, from Dublin sharing the stage with Protestant and Catholic politicians to encourage support for an historic referendum to be held Friday on the Northern Ireland

WORLD NEWS TONIGHT WITH PETER JENNINGS, MAY 19, 1998

peace agreements that were negotiated with American help in April.

(on camera) In just a moment, is the government doing enough to make sure the drugs we take are safe? We have an ABC News investigation.

(Commercial Break)

LANGUAGE: ENGLISH

LOAD-DATE: May 20, 1998

Legislative Price Increases Will Not Be Marked Up by Wholesalers and Retailers

Some have claimed that the \$1.10 per pack price increase in the McCain bill will increase prices further at the retail and wholesale level, as retailers and wholesalers "mark-up" the price increase. While retailers and wholesalers currently do have a markup that they add to the manufacturer's price of a pack of cigarettes, virtually all relevant evidence and expert advice demonstrate that these markups will not increase in the face of a legislative price increase.

Why won't retailers and wholesalers increase their markup if there is a legislative price increase?

Wholesalers and retailers set their markup as an absolute dollar amount above their costs of business. The competitive nature of the wholesale and retail sectors make it impossible for these groups to increase this set amount when the prices of cigarettes rise because of legislative action. In these competitive sectors, any retailer or wholesaler that tried to increase their margins would soon be undercut by a neighboring store or another wholesaler.

One Wall Street analyst, Martin Feldman, claimed that there will be markups of the legislated price increases at the retail and wholesale level. But this view is neither held by his colleagues nor supported by the relevant empirical evidence. For example, the FTC, in their objective analysis of the original Attorney's General settlement, assume in their baseline that there would not be any mark-up at the wholesale or retail level of the payments made by manufacturers.

Additionally, a large number of economic studies have examined the impact of cigarette tax increases on the retail price of cigarettes, and they have uniformly concluded that there is no appreciable markup. For example, Barnett, Keeler, and Hu's 1995 study estimated a pass-through rate from federal taxes to retail prices of about 102 percent over the 1955 to 1990 period (in other words, a 10 cent per pack tax increase resulted in a retail price increase of 10.002 cents, or a markup increase of only 0.002 cents). Sumner's 1981 study of state tax increases over the 1954-1978 period found a pass-through rate of 103 to 107 percent, and Merriman's 1994 study estimated a rate of 106 percent.

Will retailers raise their markups to make up for the reduced tobacco sales volume under a legislated price increase?

While tobacco sales volumes will fall due to a \$1.10 per pack price increase, this will have a negligible effect on the earnings of retailers. On average, accounting for the relative sales of tobacco products at different locations, retailers that sell tobacco products derive only 7 percent of their revenues from tobacco. Even a one-quarter reduction in sales volume would mean at most a 1.5 percent reduction in retail income. And, once again, any retailer that attempted to make up for this lost income by raising prices would quickly be undercut by his competitors.

Don't some states have laws that require a markup?

A number of states do have laws which try to limit predatory pricing by regulating that retailers cannot sell at below cost. But this is irrelevant for the question of whether additional federal payments will be marked up at the retail level. So long as there is some markup, there will be no predatory pricing finding - so that these laws provide no reason to hold markups constant in percentage terms.