

Eternal vigilance carries a high price tag  
when the state is the enemy of liberty

# Understanding the Tobacco Settlement: The State as Partisan Plaintiff

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**T**HE SALIENT FACTS OF THE TOBACCO SETTLEMENT ARE SIMPLE. In late 1998 the “big four” tobacco companies (Philip Morris, R.J. Reynolds, Lorillard, and Brown & Williamson) settled with representatives of 46 states the suits those states had filed to claim compensation for purportedly excess Medicaid expenses incurred by the states on behalf of smokers. That settlement—which followed settlements with Florida, Minnesota, Mississippi, and Texas for \$40 billion—brought to \$246 billion the amount the tobacco companies have agreed to pay all 50 states.

In filing their suits, the states claimed they were seeking to place smokers and nonsmokers on an equal footing by imposing an added burden on smoking that was equal to the additional medical claims that smokers extracted from Medicaid. But the states’ claims founder on an incontrovertible fact that has been noted by many authors in many places: smokers do not impose any such costs on nonsmokers. In fact, it is smokers who bear costs on behalf of nonsmokers. They do so mostly through the excise taxes they pay on cigarettes. They also do it by dying sooner, on average, than nonsmokers, thus reducing smokers’ claims on public treasuries for retirement and health care.

The states’ claims would have been rejected out of hand had they been treated at face value. The states nevertheless pursued their suits. The tobacco companies played along by settling the suits, which led to price increases that could just

as well have been attained through taxation.

In truth, then, the states’ pursuit of their claims—and the tobacco companies’ willingness to settle those claims—was a facade. What were the states really after? There is an easy answer: power and money. But a closer analysis of the settlement yields important insights about the states’ motives and their willingness to pursue facially groundless suits.

Everything I will say here about the groundlessness of the states’ suits and the states’ tenaciousness in the face of the facts holds equally for the Clinton administration, which has followed the states’ lead. On September 22, 1999, the U.S. Department of Justice issued a press release announcing its filing of “a civil lawsuit against the largest cigarette companies to recover the billions of dollars the federal government spends each year on smoking-related health care costs.”

Quoting Attorney General Janet Reno, the press release

continued: “Each year, American taxpayers spend billions of dollars due to the actions of the cigarette companies. Today’s suit seeks to recover those expenses. Smoking is the nation’s largest preventable cause of death and disease, and American taxpayers should not have to bear the responsibility for the staggering costs.” Specifically, the Justice Department claims that “the federal government spends more than \$20 billion per year to treat smoking-related diseases.”

### THE CLAIMS AND THEIR VACUITY

SEVERAL STUDIES REFUTE RESOUNDINGLY THE CLAIM that smokers impose costs on nonsmokers. One such study, by W. Kip Viscusi (*Regulation*, Vol. 20, No. 3), reported national aggregates and averages and gave detailed results for six states: Alabama, Florida, Maryland, Mississippi, New York, and Virginia. In those states, the costs of medical care attributed to smoking ranged from 1.7 cents a pack of cigarettes in Mississippi to 6.8 cents a pack in New York. Those figures might seem to support the states’ claims that smokers impose particularly heavy claims upon state treasuries.

The problem is that smokers are also particularly heavy contributors to state treasuries through excise taxes on cigarettes. What smokers pay in excise taxes dwarfs what they receive in state-financed medical care. For instance, at the time of Viscusi’s study, Mississippi’s tax of 18 cents a pack was more than 10 times the state’s cost of medical care attributed to smoking; New York’s tax of 56 cents a pack, more than 8 times the cost. Even Virginia, with a tax of only 2.5 cents a pack, reaped more in cigarette excise taxes than it spent on medical care attributed to smoking.

Moreover, smokers die earlier than nonsmokers do. Viscusi estimated that those earlier deaths reduce state outlays for pensions and nursing homes by an amount equivalent to an additional tax of 10 cents on a pack of cigarettes.

Although other studies have yielded estimates different than Viscusi’s, all studies have found that, through taxation and early death, smokers more than pay for the state-provided medical care they receive. No disinterested judge or jury could decide otherwise. One can only conclude that the states’ claims for compensation concealed their true motives in bringing—and settling—their suits against the tobacco companies.

### THE SIMPLE ECONOMIC CALCULUS OF SETTLEMENT

MORE THAN 90 PERCENT OF ALL SUITS ARE SETTLED. WHY is there such a strong tendency to settle, and what explains a failure to settle?

Assume that the plaintiff and the defendant agree on each party’s odds of winning and on the damages that would be awarded if the plaintiff won. Suppose, for example, both the plaintiff and defendant anticipate that the plaintiff has a 50-percent chance of winning and that a verdict for the plaintiff would carry an award of \$100 million; that is, the expected outcome of the litigation is a \$50 million award to the plaintiff. Suppose further that each party anticipates litigation expenses of \$5 million.

Therefore, in this example, the plaintiff’s expected gain from litigation is \$45 million and the defendant’s expected loss is \$55 million. Both parties will gain by settling the case for any payment from defendant to plaintiff greater than \$45 million but less than \$55 million. That is, in the case where the parties agree on the expected value of the award, they will settle by sharing the settlement surplus (the sum of their anticipated litigation expenses).

The prospect of avoiding litigation expenses does not

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always lead to a settlement, however. Even if the parties hold the same expectation about the outcome of a trial, they may be unable to agree on the division of the settlement surplus. Furthermore, the parties may have different assessments of the odds of success or the damages to be awarded. The parties might also differ in their attitudes toward risk. To be sure, such things as rules and procedures regarding discovery tend to reduce such differences, but to reduce those differences is not to eliminate them. If perceptions diverge sufficiently, one or both parties may conclude that they have nothing to gain by settling.

### THE TOBACCO SETTLEMENT AND THE STANDARD CALCULUS

THE STATES’ SUITS AGAINST THE TOBACCO COMPANIES were settled. What are we to make of the settlement? By the standard calculus of settlement, we would say that both parties concurred in the expected outcome of a trial, that they decided to save the expenses of litigation, and that there was a meeting of minds about the division of the settlement surplus.

Consider, for example, any of the several small states that settled for around \$1 billion, namely, Hawaii, Nebraska, Nevada, New Mexico, and Vermont. Suppose the following: Hawaii thought it had a 40-percent chance of winning; the

tobacco companies thought Hawaii had a 40-percent chance of winning; both parties expected an award to Hawaii of \$2.5 billion if it won; and each party estimated its litigation expenses at \$100 million.

The standard economics of settlement might therefore explain the actual outcome: a \$1 billion settlement. That is, if Hawaii's expected value of winning was \$1 billion (40 percent of \$2.5 billion), but it would have spent \$100 million to litigate, it stood to gain \$900 million. And if the tobacco companies' expected value of losing was the same \$1 billion, but they would have spent \$100 million to litigate, they stood to lose \$1.1 billion. It would seem that the \$1 billion settlement neatly divided a \$200 million surplus between the two parties.

But such an analysis cannot explain the settlement with Hawaii—or any other state. Based on the overwhelming evidence against the claim that smoking leads to excess medical costs, the states should have settled for far less than \$246 billion or dropped their cases entirely. By the same token, the tobacco companies should have paid far less than \$246 billion to settle the cases.

### THE STATE AS PARTISAN PLAINTIFF

RECONCILING THE ACTUAL SETTLEMENT WITH THE STANDARD economic calculus would seem to require an assumption that either the parties acted irrationally or the states did *not* face low-to-vanishing odds of success.

I propose a third explanation: rationality manifests itself differently when the plaintiff is the state rather than a private party. When the state takes over, the operation of partisan interests and ideologies must be taken into account, as must indifference to the costs of litigation.

To illustrate the political calculus, I will begin with an example of a settlement in which the plaintiff is a private party. Suppose plaintiff and defendant agree on the plaintiff's chances of winning (30 percent) and on the award if the plaintiff wins (\$200 million). That is, they agree that the expected value of the award is \$60 million. Further, suppose each party faces litigation costs of \$6 million. The resulting settlement range is \$54 million to \$66 million.

But the entry of the state as plaintiff changes both the expected value of the award and the assessment of litigation expenses. Consider litigation expenses. An attorney general faced with a case costing \$6 million to litigate would assess that cost differently than would a private plaintiff. He could assess the cost as his personal share of the tax bill, which would make the litigation nearly a free good to him. (He might also include the tax burden on his coalition of political allies, which could still result in a relatively low assessment of the cost.) More to the point, a decision to pursue one case more fully would require an attorney

general to sacrifice whatever value he would derive from the fuller pursuit of other cases. Whatever that value might be, however, an attorney general is unlikely to assess it at \$6 million—or even in terms of money. The cases he chooses to pursue are, by definition, more valuable politically than the cases he must forgo.

Moreover, litigation affords an attorney general opportunities to reward supporting interests and to cultivate his advancement in politics or the private sector. State attorneys general in the tobacco litigation, for instance, were involved in hiring private law firms, and many of those firms made contributions to political campaigns on behalf of the attorneys general.

Thus, an attorney general not only faces subsidized litigation expenses but also finds that some of those expenses may actually advance his career. Whatever the cost of litigation might be to a private plaintiff, the same cost will be given less weight by a political plaintiff. A state will therefore choose to bring suit where a private plaintiff would not; it will spend more to pursue a suit than a private plaintiff would spend; and it will continue to pursue a suit beyond the point at which a private plaintiff would settle it.

Special interests and ideological zealotry give a state an even greater incentive to pursue a suit and to resist settlement. An attorney general who is sympathetic (or beholden) to anti-tobacco zealots, for instance, is driven not just by the prospect of a monetary award but by the

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desire to prohibit the use of tobacco and thereby to stifle what he considers undesirable conduct. That desire will not be stated in a state's damage claims, but it is what truly motivates the state's case. Because of its true motivation—and its zealousness—a state will place a higher value on a prospective monetary award than would a private plaintiff. Moreover, a zealous plaintiff will be less inhibited than a risk-neutral plaintiff will when both face the same situation; a zealous plaintiff will act as if the odds of success are higher than an objective, risk-neutral appraisal would show them to be.

Let us now view the private plaintiff's calculus through the eyes of an attorney general driven by anti-smoking zeal. Suppose he acts as if he has an 80-percent chance of winning and that he assesses the prospective award at \$1.4

billion. The expected value of the award would be \$1.12 billion to him, whereas it would be only \$60 million to a private plaintiff. And the attorney general would be willing to settle for nothing less than \$1.114 billion even if he were to

To change the metaphor, the tobacco industry is like a man on a southward-drifting iceberg in the North Atlantic. The tobacco companies recognize their ultimate fate (or the fate wished on them by the states), but they are glad to take the respite offered by a few clouds (the tobacco settlement).

Think of tobacco litigation as a game of chance. A wise person would not continue to play a game of chance against a much wealthier, obsessive adversary. But the tobacco companies have no choice in the matter.

#### WHERE IS ETERNAL VIGILANCE?

THE NUMERICAL EXAMPLES I HAVE used here are, of course, hypothetical constructs, created to illustrate a theme and to do so in the context of the economics of litigation and settlement. That theme, illustrated by the tobacco settlement, is the danger of being opposed by a government—federal or state—that uses its power to advance a private agenda at public expense.

value his litigation expenses (say \$30 million) at the private plaintiff's figure of \$6 million.

Thus can a private "pest" willing to settle for \$54 million become a public "monster" demanding 20 times as much.

#### DEFENDING AGAINST AN INTEREST-DRIVEN STATE

WHAT IS A DEFENDANT TO DO WHEN CONFRONTED WITH a subsidized political plaintiff driven by interest groups and ideology? An ideologically oriented, interest-driven state may pursue a particular case more vigorously than a commercial plaintiff does. But why should that evoke any change in conduct by the defendant? If a defendant would settle with a private plaintiff for no more than \$66 million, why should it settle with the state for more than \$1 billion?

There are good reasons to think that the defendant's view of the world will give way to the plaintiff's view when the plaintiff is the state. First, there is the state's greater willingness to spend money on litigation, which increases the plaintiff's chances of winning. If the state is willing to spend \$30 million where a private plaintiff would spend \$6 million, an objective defendant will raise its estimate of the plaintiff's chances of winning the case. Second, an objective defendant will recognize that what is at stake is not just (imaginary) excess medical costs but the commercial value of its business.

The tobacco settlement thus represents the tobacco companies' capitulation to the states' worldview. Think of tobacco litigation as a game of chance. In a fair game, the player with the larger fortune eventually will ruin the player with the smaller fortune if play continues long enough. In ordinary games, of course, play is voluntary and either party can terminate play at will. But the state can command participation, and it can exhaust the fortune of anyone against whom it plays. A wise person would not continue to play a game of chance against a much wealthier, obsessive adversary. But the tobacco companies have no choice in the matter.

We may fault the tobacco companies for capitulating to the onslaught of governmental power, for if everyone did so liberty would perish. But because government has the wherewithal to pursue a divide-and-conquer strategy in the political pursuit of defendants, some capitulation is understandable—even if it is not admirable.

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