



## EFFECT OF STATE TOBACCO-TAX INCREASES ON MSA AND PHASE II PAYMENTS TO THE STATES

### Conclusions:

- I. Increases to state cigarette tax rates will not trigger the offset provision in the original Multistate Settlement Agreement (MSA) to reduce settlement payments to the state.***
- II. Increases to state cigarette tax rates will not trigger the offset provision in the Phase II settlement agreement to reduce Phase II payments to the state unless the new revenues from the tax increase are expressly used to benefit state tobacco growers or quota holders.***
- III. The state smoking declines prompted by new increases to state cigarette tax rates will slightly reduce both MSA and Phase II payments to the state -- through the "volume adjustments" made to the payment amounts -- but these relatively small reductions will be dwarfed by the new state revenues from the cigarette tax increase and from the corresponding reductions to the state's smoking-caused costs.***

### Analysis

Opponents of tobacco tax increases have charged that raising state cigarette tax rates will directly reduce state revenues from both the original Multistate Settlement Agreement and the follow-up Phase II agreement directed at providing assistance to state tobacco farmers and quota holders because of offset and volume adjustment provisions in those agreements. These claims either have absolutely no legal or factual basis or grossly exaggerate the scope and impact of the relevant provisions in the two agreements.

#### ***I. Increases to state cigarette tax rates will not trigger the offset provision in the original Multistate Settlement Agreement to reduce settlement payments to the state.***

The MSA calls for a reduction to the cigarette companies' payments to the states if the states get new revenues directly from a new federal cigarette tax increase, but there is nothing in the agreements that reduces state settlement payments because of state cigarette tax increases. The relevant language follows.

#### **X. EFFECT OF FEDERAL TOBACCO-RELATED LEGISLATION**

(a) If federal tobacco-related legislation is enacted after the MSA Execution Date and on or before November 30, 2002, and if such legislation provides for payment(s) by any Original Participating Manufacturer (whether by settlement payment, tax or any other means), all or part of which are actually made available to a Settling State ("Federal Funds"), each Original Participating Manufacturer shall receive a continuing dollar-for-dollar offset for any and all amounts that are paid by such Original Participating Manufacturer pursuant to such legislation and actually made available to such Settling State (except as described in subsections (b) and (c) below). . . .

(b) The offset described in subsection (a) shall apply only to that portion of Federal Funds, if any, that are either unrestricted as to their use, or restricted to any form of health care or to any use related to tobacco (including, but not limited to, tobacco education, cessation, control or enforcement) (other

than that portion of Federal Funds, if any, that is specifically applicable to tobacco growers or communities dependent on the production of tobacco or Tobacco Products). . . .

There is no language anywhere in the MSA that calls for offsets or payment reductions based on state cigarette tax increases.

***II. Increases to state cigarette tax rates will not trigger the offset provision in the Phase II settlement agreement to reduce Phase II payments to the state unless the new revenues from the tax increase are expressly used to benefit state tobacco growers or quota holders.***

The Phase II agreement -- which provides for annual payments from 1999 to 2010 by the cigarette companies to 14 states with tobacco farming -- calls for a reduction of the Phase II payments to any of the recipient states that raises its cigarette tax rate and uses the new revenue for the purpose of benefiting the state's tobacco farmers or quota holders. This offset provision clearly applies to new cigarette tax increases to the extent the new revenue they produce is either paid directly to state tobacco growers or quota holders or used to fund programs expressly designed to assist the tobacco growers or quota holders.<sup>1</sup>

Some have claimed that this offset provision also applies if any of the beneficiaries of any state spending or programs funded by the new cigarette tax revenues happen to be tobacco farmers or quota holders -- even if the state spending or program is specifically designed to benefit the general public or some other non-grower category of beneficiaries and has absolutely no

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<sup>1</sup> The relevant text from Phase II follows:

**Tax Offset Provision.** Except as expressly provided below, the amounts to be paid by the Settlers in each of the years 1999 through and including 2010 shall also be reduced upon the occurrence of any change in a law or regulation or other governmental provision that leads to a new, or an increase in an existing, federal or state excise tax on cigarettes, or any other tax, fee, assessment, or financial obligation of any kind (including without limitation a change that alters the methodology for calculating marketing assessments on the purchase of tobacco and leads to an increase in such marketing assessments) imposed by any governmental authority ("Governmental Obligation") that is based on the purchase of tobacco or tobacco products or on production of Cigarettes or use of tobacco in the manufacture of cigarettes at any stage of production or distribution that is imposed on the Settlers, to the extent that all or any portion of such Governmental Obligation is used to provide:

- (i) direct payments to Tobacco Growers or Tobacco Quota Owners;
- (ii) direct or indirect payments, grants or loans under any program designed in whole or in part for the benefit of Tobacco Growers or Tobacco Quota Owners or organizations representing Tobacco Growers or Tobacco Quota Owners . . .
- (iii) payments, grants or loans to Grower States to administer programs designed in whole or in part for the benefit of Tobacco Growers or Tobacco Quota Owners or organizations representing Tobacco Growers or Tobacco Quota Owners . . .
- (iv) payments, grants or loans to any individual, organization, or Grower State for use in activities which are designed in whole or in part to obtain commitments from, or provide compensation to, Tobacco Growers or Tobacco Quota Owners to eliminate tobacco production.

Text goes on to say that it is a dollar-for-dollar offset reduction; but if the Governmental Obligation that prompts the dollar-for-dollar reduction is passed by a single tobacco Grower state then the reduction will not, in any one year, exceed the total amount owed to that state and will be taken only against the amounts owed to that specific state. Text also says, specifically, that there will be no offset triggered by the use of any monies received by a Grower State via the MSA.

grower-specific components. This remarkably broad interpretation of the offset provision in Phase II contradicts both common sense and the most fundamental rules for interpreting legal agreements.

The key provision in Phase II states that the offset will apply if the new cigarette tax revenues are used to provide:

- (ii) direct or indirect payments, grants or loans under any program designed in whole or in part for the benefit of Tobacco Growers or Tobacco Quota Owners or organizations representing Tobacco Growers or Tobacco Quota Owners.

This language clearly means that using new cigarette tax revenues to fund programs that do not provide payments, grants, or loans does not trigger the Phase II offset. More importantly, it means that directing new cigarette tax revenues to programs that were not in any way designed to benefit growers, quota holders, or organizations that benefit them does not trigger the offset. In other words, using the new tax revenues to fund programs that were designed to help other categories of beneficiaries, with no mention of growers, cannot trigger the Phase II offset even if tobacco growers or quota holders happen to be members of the beneficiary category. The offset is triggered only if tobacco growers or quota holders are beneficiaries because they are tobacco growers or quota holders.

A broader interpretation of the text would mean that there would be little or no use of new state revenues from cigarette tax increases that would not trigger the offset since some grower or quota holder in a state is bound to benefit in some way from every state program or type of state spending. But if the states and cigarette companies who signed the Phase II agreement had meant to make the offset apply whenever new cigarette tax revenues are used for any program or purpose that ends up benefiting people who happen to be tobacco growers or quota holders, regardless of the original purpose of the program, they could have said just that. Instead, the Phase II agreement provides a list of different specific grower-related uses of the funds that will trigger the offset. At the very least, that means that the offset was not meant to be triggered by any and every use of new cigarette tax revenues but only by certain grower-related uses. And that means that the overly broad interpretation promoted by certain opponents of cigarette tax increases cannot be sustained. Any court that interprets a legal agreement must assume that each provision and sentence was put into the agreement for a reason and actually means something. But there would be no reason for the Phase II agreement to provide a list of which specific uses of new cigarette tax revenues will trigger the offset if the offset were meant to be triggered by any use of the funds that benefits growers or quota holders no matter how remotely or unintentionally.

More generally, it is clear that the offset provision was meant to block duplicated payments by the cigarette companies for the benefit of state tobacco growers and quota holders. Since they were agreeing to make substantial annual payments to the states for twelve years for the benefit of the states' growers and quota holders, the cigarette companies wanted to make sure that the Phase II agreement also blocked the states from forcing them to make additional payments to benefit the states' growers and quota holders. In fact, the offset provisions that list the grower-related uses of new cigarette tax revenues that will trigger the offset provision roughly parallel the permitted grower-related uses of Phase II payments by the states. Just as the states cannot use Phase II payments for programs designed to help the general public or other non-grower categories of beneficiaries (even if those categories happen to include growers or quota holders), the states cannot use any new revenues from cigarette tax increases for Phase-II-type purposes without triggering the offset provision. But the states are left completely free to use new cigarette tax revenues for non-Phase-II purposes.

**III. The state smoking declines prompted by new increases to state cigarette tax rates will slightly reduce both MSA and Phase II payments to the state -- through the "volume adjustments" made to the payment amounts -- but these relatively small reductions will be dwarfed by the new state revenues from the cigarette tax increase and from the corresponding reductions to the state's smoking-caused costs.**

Both the MSA and Phase II have "volume adjustment" provisions that call for reductions to the payments to the states based on nationwide declines in the cigarette sales of the four cigarette manufacturers that were the original signers of the MSA and Phase II. While a state's cigarette tax increase can substantially reduce smoking within its own borders, its effect on nationwide cigarette sales -- and on the volume adjustments -- will inevitably be much weaker.<sup>2</sup> In fact, Kentucky, Virginia and North Carolina (the three biggest tobacco-farming states) respectively account for only 2.9, 3.1, and 3.7 percent of total U.S. cigarette sales.<sup>3</sup> Even a 50-cent or \$1.00 increase to any one of the tobacco state's cigarette tax rates would, at most, reduce nationwide cigarette sales (and the state's MSA and Phase II payments) by less than one percent.

On the other hand, such increases to the state's cigarette tax rates would bring in enormous amounts of new state revenue because the increased amount of tax per pack will bring in much more new revenue that is lost by fewer packs being sold. In every case, these new tax revenues would be much larger than any related volume-adjustment reductions to the states MSA and Phase II payments.

It is also well established that reducing state smoking rates (through state cigarette tax increases or other means) will not only reduce the amount of smoking caused illness and suffering in the state and save lives but will also reduce a wide range of smoking-caused costs in the state (including smoking-caused state Medicaid program expenditures) and will reduce the amount of money required from taxpayers in the state to cover the smoking-caused costs of both the state and federal governments.<sup>4</sup>

*National Center for Tobacco-Free Kids, May 7, 2002 / Eric Lindblom*

**For additional information on the new revenues, public health benefits, and cost savings from raising state cigarette taxes, please see the Campaign's website at:**

<http://tobaccofreekids.org/reports/prices>

or

<http://tobaccofreekids.org/research/factsheets/index.php?CategoryID=18>

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<sup>2</sup> Numerous studies have established that for every ten percent a state tax increase raises the average price of a pack of cigarettes in the state it will also reduce overall cigarette consumption in the state by about four percent. See, e.g., Chaloupka, F. J., "Macro-Social Influences: The Effects of Prices and Tobacco Control Policies on the Demand for Tobacco Products," *Nicotine & Tobacco Research* (2000), and other price studies at <http://tigger.uic.edu/~fjc>. See, also, Campaign for Tobacco-Free Kids factsheet, *Raising Cigarette Taxes Reduces Smoking, Especially Among Kids (and the Cigarette Companies Know It)*, <http://tobaccofreekids.org/research/factsheets/pdf/0146.pdf>.

<sup>3</sup> The portions of total U.S. cigarette sales for other tobacco states follow: Tennessee (2.7%), Georgia (3.3%), South Carolina (1.8%), Florida (5.8%), Ohio (5.3%), Indiana (3.4%), Connecticut (1.1%), Maryland (1.4%), Pennsylvania (5%). Orzechowski & Walker, *Tax Burden on Tobacco* (2002).

<sup>4</sup> See, e.g., Campaign for Tobacco-Free Kids factsheets, *State Cigarette Tax Rates and Projected Benefits from Increasing Them*, <http://tobaccofreekids.org/research/factsheets/pdf/0148.pdf>, & *Comprehensive State Tobacco-Control Programs Save Money*, <http://tobaccofreekids.org/research/factsheets/pdf/0168.pdf>.