



From the SelectedWorks of Andrew J. Haile

August 2009

Sin Taxes: When the State Becomes the Sinner

Contact
Author

Start Your Own
SelectedWorks

Notify Me
of New Work

Available at: http://works.bepress.com/andrew_haile/1

SIN TAXES: WHEN THE STATE BECOMES THE SINNER

ANDREW J. HAILE¹

ABSTRACT

To fill budget gaps, several state legislatures have proposed increasing existing taxes on tobacco and alcohol products. In addition, some states (as well as the federal government) are considering the enactment of new “sin taxes,” for example taxes on high-sugar drinks and internet pornography. This Article examines many of the traditional arguments for and against sin taxes. It then focuses on an argument that has previously received little attention – the conflict of interest created by a state’s dependence on sin tax revenues. When states become dependent on sin tax revenues to fund essential government services, they develop an interest in maintaining sales of the “sinful” product. Consequently, the states’ financial interest may conflict with the interest in protecting their citizens’ health.

The Article examines this conflict of interest in the context of the states’ dependence on tobacco revenues. In particular, the Article explains how the \$200 billion Master Settlement Agreement between the states and the major tobacco manufacturers aligns the states’ and the tobacco companies’ financial interests. The Article then considers two alternatives that may break, or at least mitigate, the alignment of interest between the states and the sellers of harmful, taxed products: earmarking and securitization. By earmarking or securitizing sin tax revenues, states

¹ Assistant Professor, Elon University School of Law. The author thanks Catherine Wasson, Howard Katz, Eric Fink, Marty Peters, and Dan Nash for their assistance in reviewing prior drafts of this Article.

decouple their financial interests from the interests of companies selling the “sinful” product. The Article concludes that unless states take action to address the conflict of interest that arises as a result of their dependence on sin tax revenues, the states themselves may become the “sinners” by sacrificing their citizens’ health for much-needed revenue.

I.	INTRODUCTION	1
II.	THE DEBATE OVER SIN TAXES	5
	A. <i>Common Arguments in Support of Sin Taxes</i>	6
	1. Sin Taxes Raise Revenue.....	6
	2. Sin Taxes Improve Health, Particularly Among the Most Vulnerable.....	8
	3. Sin Taxes Fairly Allocate Negative Externalities	9
	4. Sin Taxes Are More Politically Acceptable than Other Taxes.....	11
	B. <i>Common Arguments Against Sin Taxes</i>	12
	1. Sin Taxes Fail to Achieve Revenue Goals and May in Some Instances Actually Reduce Revenues	12
	2. Sin Taxes are Regressive	14
	3. Sin Taxes are Discriminatory.....	15
	4. Some Sins Actually Save the State Money.....	16
	5. Sin Taxes Open the Door to Broader Government Intervention	18
III.	A PREVIOUSLY NEGLECTED ARGUMENT: SIN TAXES CREATE CONFLICTING INCENTIVES FOR THE STATES	19
	A. <i>The States' Dependence on Tobacco Revenues</i>	20
	1. Background on the Master Settlement Agreement.....	20
	2. The States' Use of MSA Revenues	22
	B. <i>Penalty Provisions of the MSA Exacerbate the Conflict of Interest Caused by Dependence on Sin Taxes</i>	25
	1. The Volume Adjustment – A Linear Reduction in MSA Payments	26
	2. The NPM Adjustment – A Treble Threat to MSA Payments.....	28
	i. Background to the NPM Adjustment.....	29
	ii. Operation of the NPM Adjustment	30
	iii. The Current NPM Adjustment Controversy	32
	iv. Allocation of the NPM Adjustment – A Possible Total Elimination of a States' MSA Payment.....	34
IV.	BREAKING THE ALIGNMENT OF INTERESTS	36
	A. <i>Earmarking Sin Tax Revenues</i>	36
	B. <i>Securitization of Sin Tax Revenues</i>	39
V.	CONCLUSION.....	45

I. INTRODUCTION

State governments are broke.² In a desperate attempt to bridge budget deficits, state legislatures have slashed spending and are looking for sources of additional revenue. “Sin taxes” – taxes on culturally disfavored products and activities – constitute one such source. Sin taxes have historically been limited to alcohol, tobacco, and gambling.³ Several state legislatures have already increased taxes on these traditional sin tax targets, or signaled their intent to do so, to help reduce their fiscal deficits.⁴ Given the extent of current economic troubles, however, increasing taxes on these traditional targets alone will not fix the financial problems existing in many states. Consequently, some state legislatures are considering whether to expand sin taxes to cover previously untaxed products such as high-sugar drinks,⁵ internet pornography,⁶ and even marijuana.⁷

² See *New Fiscal Year Brings Painful Spending Cuts, Continued Budget Gaps in Almost Every State*, CENTER ON BUDGET AND POLICY PRIORITIES, June 29, 2009, <http://www.cbpp.org/files/6-29-09sfp-pr.pdf> (stating that “[t]he total shortfall for fiscal year 2010 — including gaps that have been addressed through budget cuts and other measures, and newly emergent gaps — now totals \$166 billion across 48 states. Total gaps through 2011 will exceed \$350 billion.”).

³ See WILLIAM F. SHUGHART II, *The Economics of the Nanny State*, in *TAXING CHOICE: THE PREDATORY POLITICS OF FISCAL DISCRIMINATION* at 20-24 (William F. Shughart II ed., 1997). Although gambling has traditionally been included as a sin tax target, this article will focus on the taxation of harmful products, particularly tobacco, rather than harmful activities such as gambling.

⁴ As of June 2009, increased tobacco taxes have already been enacted during the 2009 legislative session in Arkansas (H. 1204), Florida (S. 1840), Hawaii (H. 1175), Kentucky (H. 144), Mississippi (H. 364), Rhode Island (H. 5019), and Vermont (H. 441). Five states (Kansas, Minnesota, Utah, Virginia, and Wyoming) proposed tobacco tax increases but rejected them. Twenty-one other states still have proposed legislation to increase tobacco taxes pending.

⁵ See Sewell Chan, *A Tax on Many Soft Drinks Sets Off a Spirited Debate*, N.Y. TIMES, Dec. 16, 2008, available at <http://www.nytimes.com/2008/12/17/nyregion/17sugartax.html>. The federal government is also considering whether to tax sodas as a means of financing health care reform. See

As state legislatures debate whether or not to increase existing sin taxes, enact new ones, or both, they need to recognize that reliance on sin taxes comes with a troubling ethical issue: when a state becomes dependent on sin tax revenues to finance essential governmental programs and services, the state creates a conflict of interest between the protection of its citizens' health and the need for continued sales of harmful products.⁸ In effect, a state's dependence on sin tax revenues aligns the interests of the state with those of the producer of the "sinful" product in maintaining sales of the product. The state may itself become the sinner – seeking to maximize its revenue at the expense of its citizens' health.

This potential alignment of interest between the state and the producer of harmful products is readily illustrated by the states' dependence on tobacco revenues. States have become "addicted" to tobacco payments.

Soda Tax Proposal to Help Fund Health Care Proposal Stirs Opposition, FOX NEWS, June 3, 2009, available at <http://www.foxnews.com/politics/2009/06/03/soda-tax-proposal-help-fund-health-care-reform-stirs-opposition/>; Janet Adamy, *Soda Tax Weighed to Pay for Health Care*, WALL STREET JOURNAL, May 12, 2009, available at <http://online.wsj.com/article/SB124208505896608647.html> (stating that the Senate Finance Committee was considering a new soda tax to help fund health care reform and that health advocates were also proposing legislation to "sharply raise taxes on alcohol, move to largely eliminate artificial trans-fat from food, and reduce the sodium content in packaged and restaurant food").

⁶ Stephanie Gaskell, *Adult Download Tax Proposal Awaits Climax*, NY DAILY NEWS, Feb. 16, 2009, available at http://www.nydailynews.com/ny_local/2009/02/15/2009-02-15_adult_download_tax_proposal_awaits_clima.html.

⁷ Alison Stateman, *Can Marijuana Help Rescue California's Economy?*, TIME.COM, <http://www.time.com/time/nation/article/0,8599,1884956,00.html>. Health advocates have also previously proposed taxing fatty foods, but there have been no recent legislative proposals to implement such a tax. Kelly D. Brownell, *Get Slim with Higher Taxes*, N.Y. TIMES, Dec. 15, 1994, at A29.

⁸Whether a state has an affirmative obligation to protect its citizens' health by regulating the use of harmful products is a matter of fundamental debate. The details of that debate need not be considered in this article, however, because the moral hazard resulting from a state's dependence on sin tax revenues exists even if the state is subject only to the less controversial obligation of not profiting from the sale of harmful products to its citizens.

They depend on tobacco revenues for purposes ranging from infrastructure improvements to education.⁹ The states' reliance on tobacco revenues has been widely recognized.¹⁰ Less well known, however, is that the states' addiction to tobacco revenues and the conflict of interest it creates are exacerbated by the terms of the 1998 settlement agreement between the states and the tobacco companies, known as the "Master Settlement Agreement" or "MSA."¹¹ Under the MSA, if cigarette sales drop, not only do the states collect less revenue, they may in fact be required to pay back to the tobacco companies substantial amounts of previously-received settlement payments.

This is more than a theoretical possibility. The states and the tobacco companies are presently engaged in litigation over whether the states will be required to return to the tobacco companies as much as \$5.3 billion in previous settlement payments.¹² A decision in favor of the tobacco companies would place already cash-strapped states in an even deeper fiscal hole. Consider the perverse incentive confronting state policymakers who stand to lose up to billions of dollars if they enact legislation that reduces cigarette consumption. Perhaps this provides part

⁹ See Lisa Shames, *Tobacco Settlement: States' Allocation of Payments from Tobacco Companies for Fiscal Years 2000 through 2005* at 4, GAO, GAO-07-534T, available at <http://www.gao.gov/new.items/d07534t.pdf>. [hereinafter GAO Report].

¹⁰ See Stephanie Saul, *Government Gets Hooked on Tobacco Tax Millions*, N.Y. TIMES, Aug. 31, 2008.

¹¹ A copy of the Master Settlement Agreement is available through the National Association of Attorneys General website at http://www.naag.org/backpages/naag/tobacco/msa/msa-pdf/1109185724_1032468605_cigmsa.pdf. The Master Settlement Agreement is referred to and cited throughout this article as the "MSA".

¹² See Patricia Moltini, *NAAG Tobacco Project: 11 Years of Coordination*, NAAGAZETTE, (Nat'l Ass'n of Att'y Gens.), May 29, 2009, available at <http://www.naag.org/naag-tobacco-project-11-years-of-msa-coordination.php>.

of the explanation for why states have grossly underfunded their smoking prevention and cessation programs.¹³

Taxes on harmful products have existed almost since the country's founding, and the debate over the virtues and vices of sin taxes are just as old.¹⁴ Most of the debate has focused on whether sin taxes effectively generate revenue and motivate healthy lifestyle choices, or whether they regressively burden those individuals least able to afford them.¹⁵ These previously-debated pros and cons of sin taxes remain relevant and warrant reconsideration. That said, perhaps because states have never before relied as heavily on sin tax revenues as they do now, earlier articles have

¹³ *A Decade of Broken Promises: The 1998 State Tobacco Settlement Ten Years Later*, CAMPAIGN FOR TOBACCO FREE KIDS, at i, available at <http://www.tobaccofreekids.org/reports/settlements/2009/fullreport.pdf> [hereinafter "*Broken Promises*"] (finding that for fiscal year 2009 "no state is funding tobacco prevention programs at levels recommended by the U.S. Centers for Disease Control and Prevention"). Numerous studies have determined that smoking prevention and cessation programs are successful in reducing tobacco use. See, e.g., Institute of Medicine, *ENDING THE TOBACCO PROBLEM: A BLUEPRINT FOR THE NATION*, National Academy of Sciences (2007) at 165 (confirming the effectiveness of tobacco control programs in California and Massachusetts); Matthew C. Farrelly, *The Impact of Tobacco Control Expenditures on Adult Smoking*, 98 *AMERICAN JOURNAL OF PUBLIC HEALTH* 338 (2005) (analyzing effectiveness of smoking control programs and finding that if CDC-recommended funding had been provided there would have been 2.3 to 7.1 million fewer smokers in the U.S. in 2003).

¹⁴ Alexander Hamilton cited fiscal and health benefits as justification for imposing a tax on whiskey shortly after the American Revolution. Brenda Yelvington, *Excise Taxes in Historical Perspective*, in *TAXING CHOICE: THE PREDATORY POLITICS OF FISCAL DISCRIMINATION* 33, 33 (William F. Shughart II ed., 1997) (In Hamilton's words, "the consumption of ardent spirits particularly, no doubt very much on account of their cheapness, is carried on to an extreme, which is truly to be regretted, as well in regard to the health and the morals, as to the economy of the community") (quoting Alexander Hamilton, *The Reports of Alexander Hamilton*, at 34 (Jacob E. Cooke ed., 1964)).

¹⁵ See Jendi B. Reiter, *Citizens or Sinners? – The Economic and Political Inequity of "Sin Taxes" on Tobacco and Alcohol Products*, 29 *COLUM. J.L. & SOC. PROBS.* 443, 461-68 (1996); see also Rachel E. Morse, *Resisting the Path of Least Resistance: Why the Texas "Pole Tax" and the New Class of Modern Sin Taxes are Bad Policy*, 29 *B.C. THIRD WORLD L.J.* 189 (2009).

failed to examine thoroughly the conflict of interest that results when a state becomes dependent on the continued sale of harmful products to its citizens. This article considers that conflict of interest and suggests possible ways to mitigate it.

Part I reviews the traditional arguments for and against the imposition of sin taxes. Part II examines the alignment of financial interests between the states and the sellers of products subject to sin taxes by discussing the states' dependence on tobacco revenues. After establishing the states' dependence on tobacco revenues, Part II analyzes in detail how the terms of the Master Settlement Agreement exacerbate the states' conflict of interest between protecting citizens' health and protecting revenue through continued cigarette sales. Part III discusses two alternatives that states should consider when enacting sin taxes: earmarking sin tax revenues to combat the problems caused by the taxed product and securitizing sin tax revenues. These alternatives would eliminate, or at least mitigate, the conflict of interest identified above. Part IV concludes the article.

II. THE DEBATE OVER SIN TAXES

Sin taxes engender fierce debate. Much of this debate has focused on the effectiveness and fairness of sin taxes and on whether governments should use their taxing power to modify behavior. Proponents see sin taxes as a means of raising revenue that at the same time provides financial incentives for individuals to discontinue harmful or self-destructive behaviors. Opponents contend that sin taxes unduly interfere with individual liberties and fall disproportionately on individuals least able to bear additional financial burdens. This section sets forth several of the arguments most commonly heard for and against the imposition of sin taxes. These arguments generally fail to address the ethical conflict of interest created when states become dependent on sin tax revenues.

A. *Common Arguments in Support of Sin Taxes*

Sin tax proponents typically fall into two categories: those looking to generate revenue for the state and those seeking to improve public health. Commentators have discussed which of these goals – money or health – constitutes the real motivation for sin taxes,¹⁶ but proponents of the taxes typically rely on both when arguing for their cause. Sin tax proponents also contend that they are necessary to fairly allocate the costs of using the harmful, taxed products (for example, increased health care costs and loss of productivity). Finally, sin tax advocates point to the popularity of the taxes as a justification for their enactment.

1. **Sin Taxes Raise Revenues**

Because the demand for products subject to sin taxes is relatively inelastic, taxes on those products are effective sources of revenue generation. For example, experts estimate that a 10% increase in the cost of cigarettes will cause only a 3-6% decline in consumption.¹⁷ According to these experts, even though an increase in the tobacco tax may cause some smokers to stop smoking, the overall result of the tax increase will

¹⁶ See Shughart, *supra*, note 3, at pp. 24-25 (“The fact that [sin] taxes also raise revenue is in theory of secondary importance to the promotion of virtue. But revenue is never inconsequential to government in practice.”).

¹⁷ See Badi H. Baltagi & Rajeev K. Goel, *State Tax Changes and Quasi-Experimental Price Elasticities of U.S. Cigarette Demand: An Update*, 28 J. ECON. AND FIN. 422, 427 (2004) (finding that a 10 percent increase in cigarette price would decrease the demand for cigarettes by a little over 3 percent); *Economics*, OFFICE OF TOBACCO CONTROL, <http://www.otc.ie/economics.asp> (“Because of its addictive nature the demand elasticity of tobacco products, especially cigarettes, is relatively low at about 0.4 to 0.6.”); CONGRESSIONAL BUDGET OFFICE, BUDGET OPTIONS VOLUME I, HEALTH CARE (Dec. 2008) (Option 107 - Increase the Excise Tax on Cigarettes by One Dollar Per Pack), available at <http://www.cbo.gov/ftpdocs/99xx/doc9925/12-18-HealthOptions.pdf> (“Researchers estimate that each 10 percent increase in the price of cigarettes is likely to cause their consumption to fall by 4 to 6 percent (probably more in the case of teenagers)”).

be a net gain in tax revenues.¹⁸ The relative inelasticity in the demand for cigarettes indicates that the addictive power of nicotine outweighs the increased “pain” the average smoker experiences from having to pay more for a pack of cigarettes.

Indisputably, past revenues from tobacco have been significant. The Campaign for Tobacco Free Kids estimates that between 2000 and 2009 total state tobacco revenues exceeded \$200 billion.¹⁹ One study indicates that in fiscal year 2008 alone the states reaped over \$15.6 billion in cigarette excise tax revenues and \$8.2 billion in tobacco settlement payments.²⁰

The substantial revenues raised from tobacco products has prompted many states to consider expanding sin taxes to other popular but unhealthy products. The potential revenue from those new sin tax targets appears promising. For example, the Congressional Budget Office estimates that a federal excise tax of 3 cents per 12 ounce can of “sugar sweetened” beverages would generate an estimated \$24 billion in tax revenue over the 2009-2013 period, and about \$50 billion over the 2009-2018 period.²¹ Given the prevailing economic difficulties governments currently face, revenue sources such as these constitute tempting targets for cash-poor state governments.

¹⁸ CONGRESSIONAL BUDGET OFFICE, BUDGET OPTIONS VOLUME I, HEALTH CARE (Dec. 2008) (Option 107), available at <http://www.cbo.gov/ftpdocs/99xx/doc9925/12-18-HealthOptions.pdf>.

¹⁹ *Broken Promises*, *supra*, note 13, at xi.

²⁰ William Orzechowski and R.C. Walker, *Historical Compilation*, 43 THE TAX BURDEN ON TOBACCO, 2008 at iv. The same study also estimates that the states received almost \$4 billion in general sales tax revenues from the sales of tobacco products. *Id.*

²¹ CONGRESSIONAL BUDGET OFFICE, BUDGET OPTIONS VOLUME I, HEALTH CARE (Dec. 2008) (Option 106 – Impose an Excise Tax on Sugar-Sweetened Beverages).

2. Sin Taxes Improve Health, Particularly Among the Most Vulnerable

Somewhat contrary to the first justification for sin taxes (that demand for harmful products is relatively inelastic and therefore a stable source of revenue), advocates for sin taxes also justify imposition of the taxes by arguing that the price increase caused by taxing the harmful product reduces consumption of the product and encourages a more healthy lifestyle.²² Moreover, the likelihood that a sin tax will cause a person either to cease or not to start their use of a harmful product may be higher for populations that are more sensitive to economic pressures, such as the young, the poor, and minorities.²³

Studies have found that demand elasticity for cigarettes is higher for low-income populations.²⁴ This means that as prices increase, members of

²² See *Higher Cigarette Taxes: Reduce Smoking, Save Lives, Save Money*, CAMPAIGN FOR TOBACCO-FREE KIDS, updated May 28, 2009, available at <http://www.tobaccofreekids.org/reports/prices/> (“Increasing cigarette taxes is a WIN, WIN, WIN solution for governments — a health win that reduces smoking and saves lives; a financial win that raises revenue and reduces health care costs; and a political win that is popular with the public.”); Chuck Marr & Gillian Brunet, *Taxing High-Sugar Soft Drinks Could Help Pay for Health Care Reform*, CENTER ON BUDGET AND POLICY PRIORITIES, May 27, 2009, <http://www.cbpp.org/cms/index.cfm?fa=view&id=2830> (“A tax on high-sugar soft drinks would reduce consumption of such beverages. . . . Lower consumption, in turn, would improve health outcomes.”); Kelly Brownell & Thomas Frieden, *Ounces of Prevention – The Public Policy Case for Taxes on Sugared Beverages*, 360 NEW ENG. J. MED. 1805, 1805 (2009) (“[A] tax on sugared beverages would encourage consumers to switch to more healthful beverages, which would lead to reduced caloric intake and less weight gain.”).

²³ See *Responses to Cigarette Prices By Race/Ethnicity, Income, and Age Groups – United States – 1976-1993*, 47 MORBIDITY & MORTALITY WEEKLY REPORT, 605, 605, Jul. 31, 1998, available at <http://www.cdc.gov/mmwr/preview/mmwrhtml/00054047.htm> (finding that lower-income, minority and younger populations are more likely to reduce or quit smoking in response to a price increase in cigarettes).

²⁴ *Economics*, OFFICE OF TOBACCO CONTROL, available at <http://www.otc.ie/economics.asp>, (“While elasticity [of cigarette demand] is comparatively low for higher income groups (0.2 to 0.3), it is quite high for lower income groups (0.8.). Young persons are also more sensitive to price than are adults.”).

these groups are less likely to purchase cigarettes. In addition, these groups may be more vulnerable to information asymmetries. Therefore, making it more difficult to use harmful products by increasing their cost offers additional protection to low-income individuals who might otherwise fall prey to misleading or exploitive advertising techniques.²⁵

3. Sin Taxes Fairly Allocate Negative Externalities

Proponents also argue that sin taxes help to properly allocate costs resulting from the use of harmful products, since those costs should be borne by the individuals who choose to use the products rather than by society as a whole.²⁶ The health care costs associated with smoking exemplify the potential negative externalities caused by use of a harmful product.²⁷

Measuring the cost of smoking is difficult. A study prepared by medical economists in 1993 and cited in numerous CDC publications estimated the cost of health care expenditures relating to smoking at \$50

²⁵ See Brownell, *supra*, (“In the case of sugared beverages, marketers commonly make health claims (e.g., that such beverages provide energy or vitamins) and use techniques that exploit the cognitive vulnerabilities of young children, who often cannot distinguish a television program from an advertisement.”).

²⁶ See Jeff Strnad, *Conceptualizing the “Fat Tax”: The Role of Food Taxes in Developed Economies*, 78 S. CAL. L. REV. 1221, 1240 (2005) (“An ideal Pigouvian tax would equal, for each unit of consumption, the added marginal social cost cause by the consumption of that unit.”), referring to A. C. PIGOU, *A STUDY IN PUBLIC FINANCE* (3d ed., rev. 1962). A “Pigouvian tax” is a tax on externalities designed to use market forces to achieve an efficient allocation of resources.

²⁷ See Frank J. Chaloupka & Kenneth E. Warner, *The Economics of Smoking*, in 1B HANDBOOK OF HEALTH ECON. 1539, 1579-83 (Anthony J. Culyer & Joseph P. Newhouse eds., 2000) (for a summary of issues relating to the externalities associated with smoking); Phineas Baxandall, *Taxing Habits*, REGIONAL REVIEW, Q1 2003, at 22 (stating that in 2003 healthcare costs for smokers exceeded those for non-smokers by an estimated \$12,000 over the life of the individual).

billion that year.²⁸ Another study five years later by a researcher at the University of California, Berkley concluded that smoking-related medical expenditures cost slightly over \$72 billion per year to treat.²⁹ Most recently, the Centers for Disease Control study found that from 2001-2004, the “average annual smoking-attributable health-care expenditures were \$96 billion.”³⁰

Without tobacco taxes, these costs would be spread across both smokers and non-smokers in the form of increased Medicare and Medicaid expenses.³¹ Sin tax proponents argue that spreading this cost across society generally is inequitable since non-smokers have done nothing to cause the medical problems that result from smoking. Imposing a tobacco tax makes it more likely that the government will receive money to defray smoking-related medical expenses from the same individuals who cause the government to incur those expenses, smokers.³²

²⁸ *Medical-Care Expenditures Attributable to Cigarette Smoking – United States 1993*, 43 MORBIDITY & MORTALITY WEEKLY REPORT, Jul. 8, 1994, available at <http://www.cdc.gov/mmwr/preview/mmwrhtml/00031803.htm>.

²⁹ Patricia McBroom, *\$72.7 Billion: Smoking’s Annual Health Care Cost*, BERKELEYAN, Sep. 16, 1998, available at <http://berkeley.edu/news/berkeleyan/1998/0916/smoking.html>.

³⁰ *Smoking Attributable Mortality, Years of Potential Life Lost, and Productivity Losses – United States – 2000 – 2004*, 57 MORBIDITY & MORTALITY WEEKLY REPORT 1226-1228, Nov. 14, 2008, available at <http://www.cdc.gov/mmwr/preview/mmwrhtml/mm5745a3.htm>.

³¹ See Zhang, X. et al., *Cost of Smoking to the Medicare Program, 1993*, 20(4) HEALTH CARE FINANCING REV., 1-19 (1999), available at <http://www.tcsg.org/tobacco/99SummerHCFR.pdf> (estimating the cost of smoking to the Medicare program in 1993 at \$14.2 billion); Patricia McBroom, *Impact of Cigarette Smoking on Medicaid Costs is \$322 Billion in 25 Years, Says University of California Analysis*, U.C. Berkeley, Mar. 9, 1998, available at http://berkeley.edu/news/media/releases/98legacy/03_09_98a.html (estimating the cost of smoking to Medicaid program at approximately \$12.9 billion per year).

³² See Section II.B.4, *infra*, refuting the contention that smoking imposes a net cost on society.

4. Sin Taxes Are More Politically Acceptable than Other Taxes

While political pressures may render many tax increases unfeasible, taxes on harmful products are generally more acceptable because they fall on a minority of the population, users of the harmful product who “voluntarily” elect to pay the tax when they purchase the product. Popular support for sin taxes is demonstrated by the success of ballot initiatives in numerous states to increase tobacco taxes.

In 2006, Arizona and South Dakota voters approved ballot initiatives to increase tobacco taxes by \$0.80 and \$1.00 per pack, respectively.³³ Two years earlier, voters in Colorado, Montana, and Oklahoma voted to increase their tobacco taxes substantially, with the initiatives in Colorado and Montana passing overwhelmingly.³⁴

Not all tobacco tax ballot initiatives have been successful. Ballot measures to increase tobacco taxes failed in Oregon in 2007³⁵ and California in 2006.³⁶ Even so, the California vote was extremely close, with the proposition garnering over 48% support.³⁷ Despite the defeat of

³³See *Tobacco Control Ballot Initiatives Triumph Across the U.S.*, AMERICAN CANCER SOCIETY, Nov. 8, 2006, available at http://action.acscan.org/site/DocServer/NA-News-Election_Results_Release_FINAL.pdf?docID=381.

³⁴ *Voters Increase Tobacco Taxes in Three States, Back Smoke-Free Air Measures Across the Nation*, CAMPAIGN FOR TOBACCO-FREE KIDS, Nov. 3, 2004, available at http://www.tobaccofreekids.org/Script/DisplayPressRelease.php3?Display=795&zoom_highlight=Montana; see also Mark Mellman, *Of Kids' Health Insurance and Tobacco Taxes*, THE HILL, Aug. 1, 2007, available at <http://thehill.com/mark-mellman/of--kids-health-insurance-and-tobacco-taxes-2007-08-01.html> (stating that polling showed “67% of voters favor a 75-cent increase in the federal cigarette tax, with the revenue dedicated to SCHIP, while only 28% oppose it”).

³⁵ Oregon Ballot Measure 50 (2007).

³⁶ California Proposition 86 (2006).

³⁷ State Ballot Measures, California, http://www.sos.ca.gov/elections/sov/2006_general/measures.pdf.

the proposed tax increase, the percentage of voters willing to increase taxes demonstrated the political feasibility of sin taxes.

B. Common Arguments against Sin Taxes

Opponents to sin taxes contend that the taxes are inefficient and unfair. They argue that the taxes fail to achieve their revenue-raising goals, violate standards of vertical equity by disproportionately impacting lower-income groups, and unfairly target politically unpopular minority groups (users of the taxed products). Sin tax opponents contend that users of the taxed products already bear the costs associated with using the products, and therefore increases in sin taxes are unjustified. Moreover, opponents consider the government's attempt to modify behavior by imposing taxes an unwelcomed intrusion into the realm of personal decision making. Finally, sin tax opponents argue that the health improvement justification for the taxes is often disingenuous, and that the real reason for imposing the taxes is the state's insatiable appetite for revenue.³⁸

1. Sin Taxes Fail to Achieve Revenue Goals and May in Some Instances Actually Reduce Revenues

Even with relatively inelastic demand, sin tax opponents argue that if tax levels are increased too much, demand will drop and along with it so will sales of the "sinful" product. If sales drop enough, tax revenues will actually decrease despite higher tax rates.³⁹ The "tipping point" for when taxes overburden consumers and cause a net drop in tax revenues has been reached in at least one instance. When New Jersey increased its cigarette

³⁸ Shughart, *supra*, note 3, at 24-25.

³⁹ See Tony Romm, *Recession Ushers in More Tobacco Taxes*, STATELINE.ORG, Jun. 17, 2009, <http://www.stateline.org/live/details/story?contentId=407272>.

tax by 17.5-cents-per-pack in 2007, cigarette tax revenues actually fell by \$22 million as compared to pre-tax increase levels.⁴⁰

Even if tax increases do not result in a net revenue loss, states imposing high sin taxes might not collect the full amount of tax revenue they expect because consumers find both legal and illegal alternatives to purchase the product at a lower cost. The highest total cigarette tax burden in the United States is in New York City.⁴¹ The combined state and city taxes on a pack of cigarettes sold in New York City increases the price by \$4.25 (\$2.75 in state tax; \$1.50 in city tax),⁴² and the cost for a pack of cigarettes in the city may now exceed \$10.⁴³ A 2006 study found that this high tax burden caused New York smokers to shift to lower-priced and untaxed cigarettes (purchased on-line or at Native American reservations) as ways to reduce their overall cigarette costs.⁴⁴ The study concluded that New York State lost between \$436 million and \$576

⁴⁰ See Orzechowski, *supra*, note 20, at Table 8. See also *Plan to Fund Health Reform with "Sin Taxes" Garner Minimal Support Among Lawmakers*, BNA DAILY TAX REPORT, Jun. 8, 2009.

⁴¹ *Top Combined State-Local Cigarette Tax Rates*, CAMPAIGN FOR TOBACCO-FREE KIDS, available at <http://www.tobaccofreekids.org/research/factsheets/pdf/0267.pdf>.

⁴² See *Cigarette Tax Enforcement*, N.Y.C. DEPT. FIN., available at http://www.nyc.gov/html/dof/html/services/services_fraud_cigarettes.shtml. In July 2002, New York City increased the excise tax on cigarettes from \$0.08 to \$1.50 per pack. Between 2002 and 2006 New York saw a drop of approximately 19% in smoking prevalence (meaning the number of people who smoke). See *Decline in Smoking Prevalence – New York City, 2002-2006*, 56 MORBIDITY & MORTALITY WEEKLY REPORT, 604, 604, Jun. 22, 2007, available at <http://www.cdc.gov/mmwr/preview/mmwrhtml/mm5624a4.htm>.

⁴³ David Hastie, *Pack-ing a Whallop*, N.Y. POST, Apr. 1, 2009, available at http://www.nypost.com/seven/04012009/news/regionalnews/pack_ing_a_wallop_162301.htm (stating that tax increases will push cigarette prices for even the cheapest brands to \$10 per pack in New York).

⁴⁴ Kevin Davis et. al., *Cigarette Purchasing Patterns among New York Smokers: Implications for Health, Price, and Revenue*, CENTER FOR TOBACCO CONTROL RESEARCH & ED., Mar. 1, 2006, available at <http://repositories.cdlib.org/tc/surveys/>.

million in tax revenue in 2004 as a result of consumers purchasing low-priced (mainly untaxed) cigarettes.⁴⁵ Other studies have shown the same result: increased tobacco taxes cause consumers to change their purchasing habits in ways that may ultimately result in lower tobacco tax revenues.⁴⁶

2. Sin Taxes are Regressive

In addition to arguing that sin taxes are a diminishing revenue stream (the more states tax, the less revenue they actually receive), opponents of sin taxes also deride the taxes as regressive.⁴⁷ Simply stated by one author, a “sin tax, like any flat point-of-sale tax, will consume a greater proportion of a poorer person’s income, and is thus automatically regressive.”⁴⁸ A 1994 study found that, at that time, “the cigarette tax percentage of the median income of smokers ranges from 0.4 percent for

⁴⁵ Davis, *supra*, note 44.

⁴⁶ See, e.g., Romm, *supra*, note 39 (stating that a 12-cent increase in Louisiana’s tobacco tax in 2002 resulted in “cigarette stockpiling, diminished tobacco sales, and returned less revenue than lawmakers anticipated.”); Rajeev K. Goel, *Analysis of the Impact of an Increase in the Illinois Cigarette Excise Tax*, ILLINOIS PETROLEUM MARKETERS ASSOCIATION, Mar. 6, 2009, at 2, available at <http://www.ipma-iacs.org/files/050509AnalysisoftheImpactofanIncreaseintheIllinoisCigaretteExciseTax.pdf> (suggesting that a \$1.00 increase in Illinois’ tobacco tax would result in an overall revenue loss).

⁴⁷ See Morse, *supra*, note 15, at 208-209; Jane Gravelle & Douglas Zimmerman, *Cigarette Taxes to Fund Health Care Reform*, 47 NAT’L TAX J. 575, 575 (1994) (stating that selective excise taxes “impose a heavier share of the burden on lower-income individuals than does the traditional source of federal revenue, the income tax”); *Federal Taxation of Tobacco, Alcoholic Beverages and Motor Fuels*, CONGRESSIONAL BUDGET OFFICE (1990), Table 3 at 29 available at <http://www.cbo.gov/ftpdocs/79xx/doc7951/90-CBO-039.pdf> (showing that tobacco taxes consume 4% of the poorest quintile’s post-tax income, compared to 0.5% of the wealthiest quintile’s); *Historical Effective Tax Rates, 1979–1997*, CONGRESSIONAL BUDGET OFFICE (2001), available at <http://www.cbo.gov/ftpdocs/28xx/doc2838/HistoricalTaxRates.pdf> (stating that “excise taxes claimed five times the share of income from the lowest-income households that they claimed from the highest-income households”).

⁴⁸ Morse, *supra*, note 15, at 208.

those who make \$50,000 or more to a percentage amount that is almost 13 times as great – 5.1% for those who make less than \$10,000.”⁴⁹ Based on this finding, the study’s author concluded that “cigarette taxes are strikingly regressive.”⁵⁰ A 2007 CDC study reported that a majority of all smokers in the United States come from families with incomes of less than \$35,000, while less than 20% of smokers come from families with incomes over \$75,000.⁵¹ Based on these findings, sin tax opponents argue that increases in tobacco taxes fall disproportionately on individuals from lower income homes.

Sin tax opponents reject the contention that higher prices make it more likely that lower income individuals will quit their harmful habit.⁵² Instead, they argue that “while tobacco taxes encourage people to quit smoking, those people are most likely to be from middle- and upper-income brackets . . . [which] means that an already regressive tax actually grows more regressive over time, as more middle- and upper-income people quit, while lower-income people continue to smoke.”⁵³

3. Sin Taxes are Discriminatory

As explained above,⁵⁴ sin taxes are more politically acceptable than most other tax alternatives because they significantly impact only a

⁴⁹ W. Kip Viscusi, *Cigarette Taxation and the Social Consequences of Smoking*, NAT’L BUREAU OF ECON. RESEARCH, Working Paper # 4891, Oct. 1994, at 13, available at http://www.nber.org/papers/w4891.pdf?new_window=1.

⁵⁰ Viscusi, *supra*, note 49, at 13.

⁵¹ *Summary Health Statistics for U.S. Adults: National Health Interview Survey*, 2006, Table XV at 135, CDC, Dec. 2007, available at http://www.cdc.gov/nchs/data/series/sr_10/sr10_235.pdf#table24.

⁵² See text and footnotes 28-31, *supra*, in support of this position.

⁵³ Radley Balko, *Hike in Cigarette Taxes Opens Door to Other Vices*, CHICAGO SUN TIMES, Apr. 7, 2004, available at http://www.cato.org/pub_display.php?pub_id=4531.

⁵⁴ See Section II.A.4, *supra*.

minority of people: heavy users of the product subject to the tax. Economists have found that the “political support for an excise tax rises as the percent of the population consuming the base falls.”⁵⁵ As a result, sin taxes “often have great popular support” because “the majority either does not consume the product at all, or consumes such a small share that their aggregate tax price is small relative to the minority.”⁵⁶

Opponents of sin taxes contend that placing a tax burden on a minority group because it is politically feasible to do so is “exploitive” and should be avoided as a matter of fairness.⁵⁷ As stated by one group opposing an increase in federal tobacco taxes, “a politically popular and expensive program [in this case the State Children’s Health Insurance Program] should never be funded by a small, low-income, politically unpopular minority like cigarette smokers.”⁵⁸

4. Some Sins Actually Save the State Money

While sin tax proponents argue that taxes force users of harmful products to internalize the costs of those products rather than spread the cost across society more broadly,⁵⁹ opponents argue that sin tax revenue may actually exceed those health-related costs. These sin tax opponents

⁵⁵ William J. Hunter & Michael A. Nelson, *Excise Taxation and the Theory of Tax Exploitation*, 45 PUB. FIN. 268, 269 (1990).

⁵⁶ Hunter, *supra*, note 55, at 269. See also Baxandall, *supra*, note 27, at 26 (citing a poll in which 71% of Connecticut residents surveyed supported a large increase in cigarette taxes “even though a majority said the tax would be unfair to smokers”).

⁵⁷ Hunter, *supra*, note 55, at 268. See also Reiter, *supra*, note 15, at 464-65.

⁵⁸ Gerald Prante & Joseph Henchman, *Funding S-CHIP with Federal Cigarette Tax Increase is Poor Tax Policy*, TAX FOUNDATION, Jan. 15, 2009, <http://www.taxfoundation.org/news/printer/24208.html>.

⁵⁹ See Section II.A.3, *supra*, discussing the position that sin taxes properly allocate negative externalities.

find support for their position in multiple studies regarding the cost of cigarette smoking.

For example, a 1994 study by a Duke University economist concluded that “current cigarette taxes exceed the magnitude of the estimated net externalities.”⁶⁰ The study reached this conclusion based on data showing that:

[T]otal medical expenditures due to smoking are reduced by offsetting reductions in costs because of premature death. A person who dies from smoking related disease causes an increase in medical cost at the time, but medical costs are decreased in the future because that person does not suffer the illnesses otherwise suffered during a longer life. Similarly, smokers who die prematurely lose retirement benefits in the form of social security, which is a financial saving for the government (since the smokers are generally alive during the contribution period).⁶¹

Based on smokers’ early deaths, the study found savings of almost \$35 billion per year for the federal government and almost \$10 billion per year for state governments. A subsequent study of the Dutch population likewise found that smokers actually saved their government money by dying early.⁶² While being careful to acknowledge the human suffering

⁶⁰ Viscusi, *supra*. note 49, Abstract.

⁶¹ Jane G. Gravelle, *The Proposed Tobacco Settlement: Who Pays for the Health Costs of Smoking?*, CRS Report 97-1053E.

⁶² Jan J. Barendregt et al., *The Health Care Cost of Smoking*, 337 NEW ENG. J. MED. 1052 (Oct. 1997), available at <http://content.nejm.org/cgi/content/full/337/15/1052> (finding that a total cessation of smoking would result in short-term reductions of medical costs but long-term increases due to increased life expectancy).

caused by smoking-related illnesses,⁶³ opponents of tobacco taxes have cited these studies to argue against further cigarette tax increases.

5. Sin Taxes Open the Door to Broader Government Intervention

Consumption decisions are inherently personal. Opponents of sin taxes contend that each individual should have the freedom to determine whether the benefits he or she derives from the use of a product outweighs the detrimental health effects caused by the product.⁶⁴ Government intrusion into this decision-making process, through the imposition of excessive taxes on the product, amounts to an unwelcomed paternalism that infringes on personal liberties.

Those opposing sin taxes often ask, “What’s next?”⁶⁵ If sin taxes apply to cigarettes and alcohol, might they not also be extended to fatty foods or to other personal lifestyle decisions – like the decision to sit idly and watch TV? To opponents of sin taxes, the extension of government involvement into areas personal in nature such as whether one decides to eat doughnuts or watch re-runs of *The Simpsons* crosses a line into an area of individual self-determination where the government should have no part.⁶⁶

⁶³ See *Philip Morris Issues Apology for Czech Study on Smoking*, N.Y. TIMES, Jul. 27, 2001, available at <http://www.nytimes.com/2001/07/27/business/philip-morris-issues-apology-for-czech-study-on-smoking.html> (stating that a study commissioned by Philip Morris concluded that the Czech government benefited financially from the premature deaths of smokers).

⁶⁴ See Strnad, *supra*, note 26 (stating that with respect to government interference in individual choices of food consumption, “both the food industry and independent commentators have raised this issue – one that is likely to be politically salient given the American public’s strong libertarian streak”).

⁶⁵ See Reiter, *supra*, note 15, at 454 (“There is nothing about dangerous sports like hang gliding or skiing which promotes the Protestant work ethic any more than smoking, drinking or eating Big Macs.”).

⁶⁶ See Reiter, *supra*, note 15, at 453-55 (discussing the paternalism of sin taxes).

III. A PREVIOUSLY NEGLECTED ARGUMENT: SIN TAXES CREATE CONFLICTING INCENTIVES FOR THE STATES

The traditional arguments over sin taxes focus on economic and health effects, as well as government's role in influencing individual consumption decisions. They generally ignore the fact that sin taxes create an inherent conflict of interest for the state. On the one hand, states seek to protect their citizens' health.⁶⁷ On the other, once a state imposes sin taxes, it stands to profit from the continued sale of a product detrimental to its citizens' health. Any reduction in the consumption of the "sinful" product will result in a loss of revenue for the state. This conflict of interest is even more troubling if the state relies on the sin tax revenues to fund essential government services. Once such reliance occurs, the state has an interest in protecting the continued financial success of the producers of the harmful product.

Nowhere is this conflict of interest more apparent than in the states' dependence on tobacco revenues. States receive tobacco-related revenues from two sources: tobacco excise taxes and payments from tobacco companies under the 1998 Master Settlement Agreement.⁶⁸ In 2008, the states received \$15.6 billion in tobacco tax revenues.⁶⁹ They received an additional \$8.2 billion in MSA payments from the tobacco companies.⁷⁰ Given the states' use of this money for essential governmental purposes,

⁶⁷ As discussed at footnote 8, *supra*, there may be substantial debate over whether the state has an affirmative duty to protect its citizens' health, but there is less controversy over whether states should profit from harm to their citizens.

⁶⁸ Four states (Florida, Minnesota, Mississippi, and Texas) are not parties to the 1998 tobacco settlement. Instead, each of these states separately settled its claims against the tobacco companies.

⁶⁹ Orzechowski, *supra*, note 20, at iv.

⁷⁰ *Actual Tobacco Settlement Payments Received by the States*, CAMPAIGN FOR TOBACCO-FREE KIDS, available at <http://www.tobaccofreekids.org/research/factsheets/pdf/0218.pdf>.

the states have become dependent on continued tobacco revenues and therefore susceptible to a conflict of interest between protecting a necessary revenue source and protecting their citizens' health. This conflict of interest is magnified by the terms of the Master Settlement Agreement, which compounds the reduction in state tobacco revenues if the major tobacco companies lose sales volume and market share. As we shall see, if certain preconditions are met, including the loss of sales volume and market share, the states may be required to pay billions of dollars back to the companies.

A. The States' Dependence on Tobacco Revenues

Tracking how states allocate their tobacco tax revenues is difficult, since in many states those revenues are added to the general fund rather than specifically earmarked.⁷¹ In contrast, the Government Accountability Office has tracked how states spend their MSA revenues for several years.⁷² The states' allocation of MSA revenues shows their dependence on the continued receipt of payments by the tobacco companies. Before looking at that allocation, however, some background about the MSA is helpful.

1. Background on the Master Settlement Agreement

On November 23, 1998, the four largest U.S. tobacco companies and forty-six states settled lawsuits brought by the states to recover costs incurred for the treatment of tobacco-related illnesses.⁷³ The settlement,

⁷¹ According to a study undertaken by the National Conference of State Legislatures, as of fiscal year 2005, 26 states earmarked tobacco tax revenues, while the remaining 24 did not. Those states that did earmark used the revenues for, among others, the following purposes: education, state highways, health/welfare, and, debt service. *See* Arturo Perez, EARMARKING STATE TAXES, FY 2005 (Nat'l Conference of State Legislatures) (2008), available for purchase at <http://ecom.ncsl.org/bookstore/productDetail.htm?prodID=015372pdf>.

⁷² GAO Report, *supra*, note 9, at 4.

⁷³ The major tobacco companies at the time were Philip Morris Incorporated, R.J. Reynolds Tobacco Company, Brown & Williamson Tobacco Corporation, and Lorillard Tobacco Company. R.J. Reynolds and Brown & Williamson merged in 2004, leaving

known as the Master Settlement Agreement, released the states' legal claims against the companies. In exchange, the companies agreed to make substantial annual payments and to restrict certain future conduct.⁷⁴ At the time the parties entered into the MSA, experts estimated that payments from the companies to the states for the first 25 years of the agreement would exceed \$200 billion.⁷⁵

While the MSA itself is not technically an excise tax, it operates much like one in that (1) the companies subject to the MSA must make annual payments to the states;⁷⁶ (2) these payments are determined, in part, by the volume of cigarettes that the companies sell;⁷⁷ and (3) the companies have passed the cost of the settlement on to their consumers.⁷⁸ Therefore,

only three major tobacco companies in the U.S. As mentioned above in footnote 68, four states, Mississippi, Minnesota, Texas, and Florida, did not participate in the Master Settlement Agreement because they had already individually settled their claims against the tobacco companies.

⁷⁴ For example, under the MSA the companies agreed to restrict their advertising (MSA § III(d)) and their lobbying activities (MSA § III(m)) and to cease certain practice such as sponsoring athletic events (MSA § III(c)) and branding merchandise (MSA § III(f)).

⁷⁵ Summary of the Attorneys General Master Tobacco Settlement Agreement, March 1999, *available at* <http://academic.udayton.edu/health/syllabi/tobacco/summary.htm>. While this was the estimate for the amount of payments in the first 25 years of the agreement, the payments in fact extend into perpetuity.

⁷⁶ MSA § IX(c).

⁷⁷ MSA § IX(j).

⁷⁸ In 1998, prior to MSA, the national average price for a pack of premium brand cigarettes was \$2.29. The following year, after the major tobacco manufacturers entered into the MSA, the average price for the same premium brand cigarettes increased to \$3.05. Orzechowski, *supra*, note 20, at 150, 152. This 33% increase has been attributed to the companies' obligations under the MSA. See Thomas C. Capehart, Jr., *Trends in the Cigarette Industry After the Master Settlement Agreement*, UNITED STATES DEPARTMENT OF AGRICULTURE, TBS-250-01, Oct. 2001, at 5, *available at* <http://www.ers.usda.gov/publications/tbs/oct01/tbs250-01/tbs250-01.pdf> (stating that "Cigarette prices surged 45 cents per pack on November 16, 1998, the day the Master Settlement Agreement (MSA) was signed. Cigarette manufacturers raised prices to cover the cost of the settlement."); see also C. Stephen Redhead, *RL 30058: Tobacco Master*

although the MSA is a contractual agreement and not an excise tax, the lessons learned from the states' experiences with the MSA are still instructive in the excise tax context.

2. The States' Use of MSA Revenues

The MSA itself does not mandate how states should spend the revenues they receive under the settlement. Nevertheless, the agreement declares that the states' purposes for entering into the settlement included "reduc[ing] youth smoking" and "promot[ing] the public health."⁷⁹ In addition, at the time of the agreement, several states' attorneys general announced that their states should use the settlement funds to address the problems created by smoking.⁸⁰ For example, Washington Attorney General Christine Gregoire stated that "Washington state's proceeds from the tobacco industry settlement should be spent on public health issues or the integrity of the historic agreement will be violated."⁸¹ Iowa Attorney General Tom Miller expressed his belief about how MSA funds should be used as follows:

I believe that the funds provided in this agreement should go primarily for various health purposes, ranging

Settlement Agreement (1998): Overview, Implementation by States, and Congressional Issues, Nov. 5, 1999, available at <http://ncseonline.org/NLE/CRSreports/Agriculture/ag-55.cfm> ("Cigarette price increases have passed on [MSA] settlement costs to smokers.").

⁷⁹ MSA § I, Recitals.

⁸⁰ Governors also expressed their intention to use the tobacco settlement proceeds to remedy tobacco related ills. See NATIONAL GOVERNORS ASSOCIATION, 1999 STATE INITIATIVES ON SPENDING TOBACCO SETTLEMENT REVENUES, available at <http://www.nga.org/Files/pdf/000125TOBACCO.pdf> ("Health initiatives, including tobacco control programs, are the Governors' top priority for tobacco settlement revenues.").

⁸¹ Christine Hall, *States Spend Tobacco Settlement on Budget Shortfalls*, BUDGET & TAX NEWS, May 2004, http://www.heartland.org/policybot/results/14910/States_Spend_Tobacco_Settlement_on_Budget_Shortfalls.html.

from specific education efforts to prevent tobacco use and addiction, to providing smoking cessation programs and health care for uninsured children in our state.⁸²

The states' actual use of MSA revenues has failed to live up to these lofty intentions. In 2007, the Government Accountability Office issued a report analyzing the states' use of MSA settlement funds from fiscal year 2000 through 2005.⁸³ According to the report, for the years under review, the states received \$52.6 billion in MSA-related payments.⁸⁴ The states used the settlement proceeds for the following purposes:

<u>Category</u> ⁸⁵	<u>Dollars</u> <u>(millions)</u>	<u>Percent</u>
Health	\$16,807	30.0
Budget shortfalls	12,806	22.9
Unallocated ⁸⁶	6,639	11.9
General purposes ⁸⁷	3,955	7.1

⁸² Tom Miller, Iowa Atty. Gen., Statement of Attorney General Tom Miller (Nov. 23, 1998) (transcript available at http://www.iowa.gov/government/ag/consumer/press_releases/tob-fin.html).

⁸³ GAO Report, *supra*, note 9.

⁸⁴ GAO Report, *supra*, note 9, at 2. Of the \$52.6 billion received by the states, \$36.5 billion were payments from the tobacco companies and \$16.1 billion were advanced payments (securitized proceeds) that 15 states arranged to receive by issuing bonds backed by their future payments from the tobacco companies.

⁸⁵ GAO Report, *supra*, note 9, at 6.

⁸⁶ "Unallocated" is defined by the GAO report as "comprised of amounts not allocated for any specific purpose, such as amounts allocated to dedicated funds that have no specified purpose; amounts states chose not to allocate in the year Master Settlement Agreement payments were received that will be available for allocation in a subsequent fiscal year; interest earned from dedicated funds not yet allocated; and amounts that have not been allocated because the state had not made a decision on the use of the Master Settlement Agreement payments." GAO Report, *supra*, note 9, at 14.

⁸⁷ "General Purposes" include "amounts allocated for attorneys' fees and other items, such as law enforcement or community development, which could not be placed into a

Infrastructure	3,350	6.0
Education	3,078	5.5
Debt service on securitized funds	3,005	5.4
Tobacco control	1,943	3.5
Economic development for tobacco regions	1,490	2.7
Social Services	961	1.7
Reserves/rainy day funds	810	1.4
Tax reductions	616	1.1
Payments to tobacco growers	521	0.9
TOTAL	\$55,981⁸⁸	100.1⁸⁹

Thus, despite the promises made at the time the states signed the MSA, states have used the majority of tobacco settlement funds for purposes entirely unrelated to (i) the health problems created by cigarette smoking, or (ii) smoking cessation programs. For the period under consideration in the GAO report, only 33.5 percent was spent on health care and tobacco control.⁹⁰ Most of the funds were instead used either for general government operations (such as making up budget shortfalls, construction of infrastructure projects, and education) or were saved for unallocated purposes. Considering the severe financial challenges now faced by the states, one can only assume that the percentage of tobacco revenues going

more precise category. This category also includes amounts allocated to a state's general fund that were not earmarked for any particular purpose." GAO Report, *supra*, note 9, at 13.

⁸⁸ States' allocations do not match the payment amounts on an annual basis because states carried over funds from one year to the next and earned interest on their payments.

⁸⁹ Percentages do not total to 100 due to rounding.

⁹⁰ The spending for "health" purposes is not limited to tobacco-related health care. This category includes amounts allocated for direct health care services; health insurance, hospitals, medical technology, public health services, and health research. GAO Report, *supra*, note 9, at 13.

toward “budget shortfalls” will most likely increase over the next several years.⁹¹

Based on the amount of money received, the states’ use of that money, and the extent of the current fiscal crisis, it is fair to conclude that the states have become dependent on MSA payments to continue funding essential governmental functions. Consequently, despite the potential harm to their citizens’ health, it is in the states’ interest (at least in the short-term) to protect these payments and ensure that they continue. In essence, the states’ ability to provide certain government services depends on the continued success of the tobacco companies, creating the perverse incentive for the states to protect these companies. This incentive is further compounded by the terms of the MSA, which penalize the states if the major tobacco companies experience a decline in cigarette sales and market share.

B. Penalty Provisions of the MSA Exacerbate the Conflict of Interest Caused by Dependence on Sin Taxes

By entering into the MSA, the states sought to “reduce youth smoking” and “promote the public health.”⁹² Perhaps unwittingly, however, the states in fact aligned their financial interests with the continued success of the tobacco companies. Provisions in the MSA that reduce the amount of settlement payments if cigarette sales fall below specified levels, combined with the states’ dependence on the revenue

⁹¹ At the time of the last significant state budgetary crisis (2003), several states devoted almost all of their tobacco revenues to covering budget shortfalls. For example, California allocated approximately 75% of its MSA payments toward budget shortfalls; Wisconsin devoted almost 80%; and Idaho devoted over 90%. *See Tobacco Settlement: States’ Allocations of Fiscal Year 2003 and Expected Fiscal Year 2004*, GAO, GAO-04-518 (Mar. 2004) at 32, 36, 58, available at <http://www.gao.gov/new.items/d04518.pdf>.

⁹² MSA, Preamble, at 2.

stream from the settlement payments, have created a strong incentive for the states to avoid a significant drop in cigarette sales.⁹³

If sales of a product subject to an excise tax drop, so do tax revenues. Although the MSA technically is not an excise tax, it contains a provision, known as the Volume Adjustment, which mimics this feature. A second provision, the NPM Adjustment, actually multiplies the reduction in MSA payments if certain conditions, including a drop in nationwide cigarette sales, are met. In addition, the method of allocating the NPM Adjustment among the states creates even further incentive for the states to protect cigarette sales. Based on the NPM Adjustment's allocation method, a single state could lose its entire MSA payment, perhaps for multiple years, if the NPM Adjustment applies to it. These risks of reduced or completely eliminated MSA payments create a significant financial incentive for the states not to enact policies that could cause substantial drops in cigarette sales, such as the funding of smoking cessation and prevention programs.⁹⁴

1. The Volume Adjustment - A Linear Reduction in MSA Payments

The MSA calls for the tobacco companies that are parties to the agreement to make annual payments to the states on or before April 15 each year. The base amount of these annual payments, known as the "Base Payment Amount," is set out in the MSA as follows:

⁹³ See Robert S. Wood, *Tobacco's Tipping Point: The Master Settlement Agreement as a Focusing Event*, 34 THE POLICY STUDIES JOURNAL 419, 431 (2006) ("State governments are not spending their settlement dollars primarily on tobacco control as was anticipated, and have in fact substantially increased excise taxes to generate more revenue from cigarette sales. This has created a de facto partnership with the industry that will undermine their incentives to craft aggressive tobacco control programs as they become dependent on the revenue stream from tobacco sales.").

⁹⁴ See *Broken Promises*, *supra*, note 19, at xi (reporting that as of 2009 "no state is funding tobacco prevention programs at level recommended by the U.S. Centers for Disease Control and Prevention").

<u>Year</u>	<u>Base Payment Amount</u> ⁹⁵
2000	\$4,500,000,000
2001	\$5,000,000,000
2002-2003	\$6,500,000,000
2004-2007	\$8,000,000,000
2008-2017 ⁹⁶	\$8,139,000,000
2018 and each year thereafter	\$9,000,000,000

The amount actually paid by the companies to the states differs from the Base Payment Amount, however, because of various adjustments provided for in the MSA. One of these adjustments is the Volume Adjustment.⁹⁷ The Volume Adjustment reduces the amount owed by the companies to the states if the cigarette shipment volumes of the three largest tobacco companies drop below a specified “Base Volume,” which is set as the number of cigarettes shipped by the major tobacco companies in 1997, the year before they entered into the MSA.⁹⁸ In other words, a drop in cigarette shipments by the major tobacco companies, when compared to the Base Volume, results in a decrease in the payment owed by the tobacco companies to the states.

The amount of the payment decrease is determined by a formula set out in the MSA.⁹⁹ The formula reduces the payment amount in proportion

⁹⁵ MSA § IX(c)(1).

⁹⁶ MSA § IX(c)(1). In addition to this base payment, for years 2008-2017, the MSA calls for additional “strategic contribution payments” of \$861,000,000 from the companies to the states. *See* MSA § IX(c)(2).

⁹⁷ *See* MSA § IX(j) (listing the adjustments to the Base Payment Amount).

⁹⁸ The MSA sets the Base Volume at 475,656,000,000 cigarettes. MSA Exhibit E, Exhibit Q.

⁹⁹ The Volume Adjustment formula is:

$$(\text{Base Payment Amount}) \times (0.98) \times [1 - (\text{Actual Volume}/\text{Base Volume})]$$

to the lost volume. For example, if nationwide cigarette shipments for the year of the payment have declined 10% (as compared to the Base Volume), the amount owed by the tobacco companies under the MSA would likewise be reduced by approximately 10%.¹⁰⁰

This proportionate reduction in payments owed as a result of lower sales places the states' financial interest on the same side as the tobacco manufacturers in maintaining cigarette sales. As explained in the next section, the MSA's NPM Adjustment heightens the alignment of the interests between the states and the tobacco companies by multiplying the reduction of MSA payments.

2. The NPM Adjustment – A Treble Threat to MSA Payments

The NPM Adjustment applies on a year-by-year basis to reduce tobacco companies' annual MSA payments if certain conditions are met. The reduction can be significant. As mentioned earlier, the states and tobacco companies are presently disputing whether the tobacco companies will receive as much as \$5.3 billion of MSA payments back from the states for NPM Adjustments relating to the years 2003-2008.¹⁰¹

The NPM Adjustment is one of the more complex provisions of the MSA. To understand how it operates, some further background regarding the other basic terms of the MSA is necessary. This section gives a brief explanation of MSA terms relevant to the NPM Adjustment and then explains the operation of the NPM Adjustment.

MSA Exhibit E, § B(ii).

¹⁰⁰ The Volume Adjustment would in fact reduce the payment amount by 9.8% if shipment volumes dropped 10%. This is because the Volume Adjustment formula contains a constant factor of 0.98.

¹⁰¹ See Moltini, *supra*, note 12.

i. Background to the NPM Adjustment

The MSA separates domestic tobacco manufacturers into two broad categories: Participating Manufacturers and Non-Participating Manufacturers. Participating Manufacturers are those tobacco companies that are signatories to the agreement.¹⁰² They have agreed to be bound by the settlement's conduct restrictions and payment obligations. In exchange, these companies received a release with respect to any claims by the states relating to the use, sale, distribution, manufacture, development, advertizing, marketing, or health effects of tobacco products.¹⁰³

Non-Participating Manufacturers are defined by the MSA as any tobacco companies that are not Participating Manufacturers.¹⁰⁴ They remain subject to potential claims by the states relating to their tobacco products. The Non-Participating Manufacturers are not bound, however, by the settlement agreement's payment provisions or other obligations.¹⁰⁵

¹⁰² MSA § II(jj). The Participating Manufacturers are further divided between Original Participating Manufacturers ("OPMs") and Subsequent Participating Manufacturers ("SPMs"). The OPMs are the largest domestic tobacco companies (Philip Morris, RJR, and Lorillard), which were the initial companies to settle with the states. MSA § II(hh). The SPMs are approximately 40 smaller tobacco manufacturers that joined the MSA after the OPMs. MSA § II(tt). A list of Participating Manufacturers at available at http://www.naag.org/backpages/naag/tobacco/msa/participating_manu/.

¹⁰³ MSA §§ II(nn), XII(a).

¹⁰⁴ MSA § II(cc).

¹⁰⁵ Even though Non-Participating Manufacturers ("NPMs") do not have to make MSA payments, they are subject in all 46 MSA states to legislation requiring them to pay into a 25-year escrow amounts comparable to the MSA payments imposed on Participating Manufacturers. These funds are available to the states in the event that the states elect to pursue claims against the NPMs for the damages caused by their cigarettes, including any health care costs for treating smoking-related illnesses. *See* MSA Exhibit T.

At the time of the MSA, Participating Manufacturers held approximately 99.6% of the domestic cigarette market share.¹⁰⁶ The NPM Adjustment was intended to compensate Participating Manufacturers if they lost market share to Non-Participating Manufacturers as a result of the competitive disadvantages caused by the MSA's payment obligations and marketing restrictions.¹⁰⁷

ii. Operation of the NPM Adjustment

The NPM Adjustment applies to the Participating Manufacturers' annual payment obligations for any year in which the following conditions are met:

- (1) the Participating Manufacturers, in the aggregate, lose at least 2% of their pre-MSA market share to Non-Participating Manufacturers;¹⁰⁸
- (2) the aggregate number of cigarettes shipped by certain Participating Manufacturers for the year in question is less than the number of cigarettes shipped by those same companies for the year before they entered into the MSA;¹⁰⁹ and

¹⁰⁶ See *The High Cost of Nicotine Withdrawal*, BUSINESSWEEK, May 25, 2003, available at http://www.businessweek.com/magazine/content/05_21/b3934051_mz011.htm. The original four OPMs held approximately 97% of the cigarette market in 1997, the base year for determining whether the PMs suffer a market share loss for purposes of the NPM Adjustment. See *Who Owns What: The Companies at a Glance*, FRONTLINE ONLINE, <http://www.pbs.org/wgbh/pages/frontline/shows/settlement/big/owns.html>.

¹⁰⁷ The MSA literally states that the purpose of the NPM Adjustment is "to protect public health gains achieved by this Agreement." MSA § IX(d)(1).

¹⁰⁸ MSA § IX(d)(1)(A).

¹⁰⁹ MSA § IX(d)(1)(D).

- (3) a “nationally recognized firm of economic consultants” determines that the MSA was a “significant factor” in causing the Participating Manufacturers’ market share loss for the year in question.¹¹⁰

The first two criteria not only create an incentive for the states to maintain cigarette sales, but could also motivate the states to enact policies favoring Participating Manufacturers over Non-Participating Manufacturers.¹¹¹ Despite those incentives, the Participating Manufacturers’ market share has been at least 2% below their pre-MSA market share for every year since 2000.¹¹² In addition, the number of cigarettes shipped by the Participating Manufacturers has declined as compared to their pre-MSA shipment volumes every year since the MSA became effective.¹¹³

The percentage of “Market Share Loss”¹¹⁴ by the Participating Manufacturers’ determines the amount of the NPM Adjustment. If the Participating Manufacturers suffer up to a 16 2/3% market share loss, the NPM Adjustment trebles the reduction in MSA payments.¹¹⁵ To illustrate,

¹¹⁰ MSA § IX(d)(1)(C).

¹¹¹ Non-Participating Manufacturers have filed several lawsuits challenging aspects of the MSA based on their position that the MSA violates federal antitrust statutes. *See, e.g.*, *Tritent Int’l Corp. v. Kentucky*, 467 F.3d 547 (6th Cir. 2006); *S&M Brands, Inc. v. Summers*, 393 F.Supp.2d 605 (M.D. Tenn. 2005), *aff’d*, 228 Fed. Appx. 560 (6th Cir. 2007) (unpublished); *Grand River Enters. Six Nations, Ltd. v. Pryor*, 2006 WL 1517603 (S.D.N.Y. May 31, 2006), *aff’d*, 481 F.3d 60 (2d Cir. 2007); *Freedom Holdings, Inc. v. Spitzer*, 447 F.Supp.2d 230 (S.D.N.Y. 2004), *aff’d* 408 F.3d 112 (2d Cir. 2005); *Xcaliber Int’l Ltd., LLC v. Foti*, 2006 WL 2990126 (E.D. La. Oct 18, 2006).

¹¹² *Final Determination pursuant to NPM Procedures Agreement § 19 in the 2003 NPM Adjustment Proceeding Pursuant to Master Settlement Agreement § IX(d)(1)(C)*, THE BRATTLE GROUP, available at <http://www.affwa.org/pdfs/msa1.pdf>.

¹¹³ Orzechowski, *supra*, note 20, at Table 3, p. 6.

¹¹⁴ “Market Share Loss” is defined in the MSA as the Participating Manufacturer’s actual market share loss less 2%.

¹¹⁵ MSA § IX(d)(1)(A)(ii).

for a year in which the Participating Manufacturers' Market Share Loss equals 5%, the NPM Adjustment will reduce their MSA payments by 15%. If the Market Share Loss exceeds 16 2/3%, then the amount of the NPM Adjustment is determined according to a more complicated formula found in the MSA.¹¹⁶ This formula results in less than a treble reduction, but still more than the proportional reduction of the Volume Adjustment.¹¹⁷ Thus, while the Volume Reduction motivates the states to protect cigarette sales, the NPM Adjustment substantially increases that motivation because of the multiplying effect of the NPM Adjustment formula.

iii. The Current NPM Adjustment Controversy

Based on a report from the National Association of Attorneys General, the Participating Manufacturers lost market share and shipment volume for years 2003 through 2008 in amounts sufficient to render them eligible for up to \$5.3 billion of NPM Adjustments.¹¹⁸ Before receiving those adjustments, however, the prerequisite of a "significant factor determination" must be made.

¹¹⁶ MSA § IX(d)(1)(A)(iii).

¹¹⁷ The table below shows the NPM Adjustment Percentage resulting from various assumed Market Share Losses:

<u>Market Share Loss</u>	<u>NPM Adjustment Percentage</u>
5%	15%
10%	30%
15%	45%
20%	52%
25%	55%
30%	58%
35%	61%

¹¹⁸ See Moltini, *supra*, note 12.

The MSA states that “a nationally recognized firm of economic consultants (the ‘Firm’) shall determine whether the disadvantages experienced as a result of the provisions of this Agreement were a significant factor contributing to the Market Share Loss for the year in question.”¹¹⁹ In May 2004 the Participating Manufacturers and the states jointly selected The Brattle Group, an economic consulting firm headed by Nobel laureate Daniel McFadden, to make the “significant factor determination” for payment years 2003, 2004, and 2005.¹²⁰ The Brattle Group has determined that in each of the three years in question, the MSA in fact played a “significant factor” in the Participating Manufacturers’ Market Share Loss.¹²¹ Consequently, the criteria for the NPM Adjustment have been met with respect to years 2003-2005. The aggregate amount of the NPM Adjustment for these three years is approximately \$3 billion.¹²²

Despite satisfying all three criteria for the NPM Adjustment to apply to payments made by the Participating Manufacturers for the years 2003 through 2005, however, the Participating Manufacturers have not yet received any refund for the payments they made in those years. This is because the states contend that they are immune from the NPM Adjustment for those years based on a provision in the MSA known as the “diligent enforcement” provision.¹²³ In short, under the diligent enforcement provision an individual state’s MSA payment “shall not be subject to the NPM Adjustment” if that state “diligently enforced” a particular state statute, known as a “Qualifying Statute,” for the years in question. The MSA required the states to pass Qualifying Statutes in

¹¹⁹ MSA § IX(d)(1)(C).

¹²⁰ Michigan Tobacco Settlement Finance Authority Offering Circular, Jun. 26, 2008, at 22 (hereinafter “Michigan Circular”) (on file with author).

¹²¹ Michigan Circular at 23-25.

¹²² Michigan Circular at 25.

¹²³ MSA § IX(d)(2)(B).

order to level the competitive playing field between Participating Manufacturers and Non-Participating Manufacturers.¹²⁴ The diligent enforcement defense applies on a state-by-state basis. In other words, some states may have diligently enforced their Qualifying Statutes, while others may not have. Only those states that diligently enforced their Qualifying Statutes will benefit from the protection of the diligent enforcement provision.

The states and Participating Manufacturers have been ordered to arbitrate the question of whether the states diligently enforced their Qualifying Statutes.¹²⁵ The outcome of the arbitration proceedings will determine whether the states have to repay billions of previous MSA payments to the Participating Manufacturers.¹²⁶

iv. Allocation of the NPM Adjustment – A Possible Total Elimination of a State’s MSA Payment

Because of the diligent enforcement provision, the MSA does not necessarily allocate the NPM Adjustment among the states in a pro rata fashion. In other words, if the NPM Adjustment reduces the Participating Manufacturers’ MSA payments by 15%, that does not mean that every state will necessarily see a 15% reduction in its MSA revenues. Some states might suffer no reduction, while others could lose their entire MSA payment. This is because if a state has diligently enforced its Qualifying

¹²⁴ MSA § IX(d)(2)(B).

¹²⁵ Michigan Circular at 25 (stating that “[a]s of March 5, 2008, 47 of 48 state courts that have thus far considered the issue of whether a diligent enforcement dispute should be resolved in state courts or through arbitration have held in favor of the arbitration process”).

¹²⁶ See Dan Seymour, *Tobacco Firms Free \$540M: Temporary Deal Ahead of Arbitration*, BOND BUYER, Mar. 3, 2009 (reporting that Lorillard Tobacco Company and R.J. Reynolds Tobacco Co. released \$540 million of disputed funds to the states in order to avoid further appeals by the states over the issue of whether the diligent enforcement issue is subject to arbitration).

Statute, its share of the NPM Adjustment is reallocated among the other states.¹²⁷ This reallocation could result in the total elimination of some states' MSA payments, at least for the year in which the NPM Adjustment applies and possibly longer.

To illustrate, consider an example in which a single state, New York, fails to prove that it diligently enforced its Qualifying Statute for the year in which an NPM Adjustment applies. Assume that for the year in question the amount of the MSA payment before application of the NPM Adjustment is \$8 billion, and the Market Share Loss for that year is 5%. As explained above, assuming that the other requirements for the NPM Adjustment are met, the NPM Adjustment for that year would be 15%. This means that the NPM Adjustment would reduce the MSA payments going to the states for that year by \$1.2 billion (15% of \$8 billion). New York usually receives 12.76% of the annual MSA payments.¹²⁸ Absent application of the NPM Adjustment, New York would receive \$1,020,800,000 of the \$8 billion payment. With the reallocation of the NPM Adjustment based on the determination that all states other than New York diligently enforced their NPM escrow statutes, however, the entire NPM Adjustment for the year in question would fall solely on New York. New York's total MSA payment for that year would be wiped out; rather than receiving \$1,020,800,000, New York would receive \$0.¹²⁹

This extreme result obviously provides a strong incentive for the states to diligently enforce their Qualifying Statutes. It also heightens the alignment of interests between the states and the tobacco companies to

¹²⁷ MSA § IX(d)(2)(C).

¹²⁸ See MSA Exhibit A, setting forth the "Allocable Share" of MSA payments that each state receives.

¹²⁹ The MSA is silent as to whether the "excess" NPM Adjustment for the year in question (in this example the remaining \$179,200,000 (= \$1,200,000,000 – 1,020,800,000)) would be applied against New York's MSA payment in subsequent years until the excess is fully used or whether the excess "expires" unused. See MSA § IX(d)(2)(D).

prevent the prerequisites to the NPM Adjustment – Market Share Loss by Participating Manufacturers and reduced cigarette volume shipments – from occurring in the first place.

IV. BREAKING THE ALIGNMENT OF INTERESTS

The extent of the states' incentive to continue the sale of harmful products is amplified in the tobacco context because of the multiplier effect and allocation method of the NPM Adjustment. To a lesser degree, however, that incentive exists in all sin tax contexts. That is because, as with the Volume Adjustment under the MSA, a reduction in the sales of a product subject to a sin tax necessarily means a reduction in state revenues. This is the case whether the taxed product is cigarettes or sodas. Once a state has become dependent on sin tax revenues generated from the sale of the harmful product, the state has intertwined its financial interests with the product's manufacturers in continuing sales of the harmful product.

There are at least two means of breaking this alignment of interests that state legislatures should consider when enacting or increasing sin taxes. One is to earmark the revenues from sin taxes so that those revenues are limited to combating the harmful effects caused by the taxed product. The second is to securitize the sin tax revenue stream.

A. Earmarking Sin Tax Revenues

Earmarking means “designating some or all of the collections from a specific tax or revenue source for a specific expenditure, with the intent that the designation will continue into the future.”¹³⁰ Earmarking sin tax revenues so that they are used to address the harmful effects of the taxed product would break the connection between the states' and the manufacturers' financial interests. This is because if tax revenues are so earmarked and use of the harmful product declines due to prevention

¹³⁰ Perez, *supra*, note 71, at 2.

programs, for example, the state's need for the revenue generated by the sale of the product would also decline. In effect, earmarking prevents states from becoming dependent on sin tax revenues to fund government activities unrelated to the use of the taxed product.

For example, if cigarette taxes and MSA revenues were earmarked primarily to fund smoking cessation and prevention programs, and to pay for the treatment of health care problems associated with tobacco use, then a decline in smoking could be absorbed more readily by the state because the need for those funds would naturally decline as cigarette sales decreased. With less smoking, there would be fewer smoking-related illnesses and therefore less need for cigarette tax revenues to fund cessation and health programs. Similarly, if a newly enacted tax on high-sugar drinks were spent on health care issues such as obesity, diabetes, and other harms caused by consumption of the drinks, then a decline in consumption of high-sugar drinks would not adversely affect the state's financial interests since the need for the tax revenue would also decline. By devoting the use of sin tax funds in this way, states would decouple their financial interests from those of the producer of the taxed product. Policymakers could pursue policies to reduce use of the harmful product, like the funding of cessation and prevention programs, without a concern over the impact of such policies to the state's fiscal health.

The prevalence of earmarking varies from state to state. As of 2005, all states earmarked some percentage of their total tax collections to various government programs, ranging from a low of 4.4% in Rhode Island to a high of 84.0% in Alabama.¹³¹ With respect to tobacco taxes specifically, twenty-six states earmarked some or all of their tax revenues.¹³² The amount and use of the earmarked tobacco taxes varied greatly from state to state. For example, Vermont earmarked 100% of its

¹³¹ Perez, *supra*, note 71, at 2.

¹³² Perez, *supra*, note 71, at Appendix B.

tobacco tax revenue toward indigent health care.¹³³ Arkansas, on the other hand, earmarked only 2.5% of its cigarette tax revenue, which went entirely to its Meals on Wheels and elderly transportation programs.¹³⁴

To break the alignment of financial interests between the states and the producers of the taxed product, legislatures should earmark sin tax revenues to programs that address the use of and problems caused by the product. Earmarking revenues for even worthy programs unrelated to the taxed product may create or exacerbate the conflict of interest between the state's desire to protect its citizens' health and its need to maintain tax revenues. For example, using tobacco tax revenues to finance school construction is a worthy use of the funds, but keeps the state dependent on their continued receipt.

Of course, with respect to the existing sin tax on tobacco, it may be unrealistic to expect earmarking alone to address the conflict of interest since so many states have already become dependent on revenues from the sales of tobacco products to fund a broad range of government services and programs. Moreover, even if sin taxes are enacted on previously untaxed products, the proponents have proposed these taxes less for their ameliorative health effects and more for the much-needed money that they can bring to the states.¹³⁵ Earmarking sin taxes exclusively to combat the

¹³³ Perez, *supra*, note 71, at 104.

¹³⁴ Perez, *supra*, note 71, at 18.

¹³⁵ See, e.g., Derek Thompson, *In Praise of Sin Taxes for Cigarettes, Soda, Marijuana . . .*, THE ATLANTIC, May 21, 2009, available at http://business.theatlantic.com/2009/05/cigarette_tax_soda_tax_marijuana_tax_levy_it_on_me.php ("At the end of the day, we might as well tax the things we're only going to have to pay for later."). Perhaps at no time was the focus on revenue rather than health more apparent than in the debate over whether to repeal Prohibition. Desperately in need of tax revenue, the Democratic party's platform has been characterized as supporting the theme that "if only given a chance, Americans might drink themselves into a balanced budget." Brenda Yelvington, *Excise Taxes in Historical Perspective*, in TAXING CHOICE: THE PREDATORY POLITICS OF FISCAL DISCRIMINATION 33, 33 (William F. Shughart II ed., 1997).

problems created by the taxed product would be ideal, but it may not be realistic given the states' pressing financial needs. Recognizing this reality, the next section discusses an alternative means that some states might use to at least mitigate the conflict of interest created by dependence on sin tax revenue: securitization.

B. Securitization of Sin Tax Revenues

“Securitization” means selling the expected cash flows from an asset in exchange for a large, single, upfront payment.¹³⁶ Some states have securitized their MSA payments by issuing bonds backed by future MSA payments.¹³⁷ While securitization has been subject to substantial criticism from health advocates, it can serve to break the alignment of interests between the states and the tobacco companies by shifting the risk of a decline in cigarette sales away from the states and to bondholders.

New York City became the first government entity to securitize its MSA payments in 1999.¹³⁸ Since then at least 20 states (and numerous counties in New York and California) have securitized some or all of their

¹³⁶ Craig L. Johnson, *The State of the Tobacco Settlement: Are Settlement Funds Being Used to Finance State Government Budget Deficits? A Research Note*, J. PUB. BUDGETING & FIN., 113, 121 (Spring 2004); *see also* Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1374-75 (1991).

¹³⁷ Securitization of MSA payments has been likened to the decision confronted by a lottery winner over whether to take a smaller lump sum payment up front or an aggregate larger amount paid out periodically over a lengthy period of time. *See* Joni James & David Milstead, *States Mull Whether to Sell Stream of Tobacco Dollars*, WALL ST. J., Aug. 2, 2000, at F1.

¹³⁸ *Tobacco Bonds Timeline*, BOND BUYER, Apr. 25, 2007 (2007 WLNR 8223714). Under a New York consent decree, New York City and each of the state's 57 counties receive a portion of the state's MSA payments directly. *See Tobacco Settlement: States' Use of Master Settlement Agreement Payments* at 13-14, GAO, GAO-01-851 (June 2001). Under a memorandum of understanding among the state of California, its 58 counties, and 4 major cities, the state sends a portion of its MSA payments to the counties and cities. *Id.*

MSA payments.¹³⁹ Bond issuances backed by MSA payments have ranged in size from a low of \$60 million (Arkansas)¹⁴⁰ up to \$5.5 billion (Ohio).¹⁴¹ States have used the cash infusion from the sale of MSA-backed tobacco bonds for various purposes, including to fund health care, education, and infrastructure projects, as well as to cover budget deficits.¹⁴²

The decision to securitize MSA payments has been controversial. Critics argue that the states get far too little money in exchange for the stream of future MSA payments that they sell, with investors and investment bankers getting the benefit of the deal.¹⁴³ Opponents of securitization contend that in most instances the lump sum payments received by the states have been used for short-term fiscal needs, like dealing with immediate budget shortfalls, rather than longer-term investments aimed at improving health, like smoking prevention programs and medical care.¹⁴⁴ Critics also rail against the significant transaction

¹³⁹ These states are: Alabama, Alaska, Arkansas, California, Iowa, Louisiana, Michigan, Missouri, New Jersey, New York, North Dakota, Ohio, Oregon, Rhode Island, South Carolina, South Dakota, Virginia, Washington, West Virginia, and Wisconsin. See *Tobacco Settlement: States' Allocation of Fiscal Year 2005 and Expected Fiscal Year 2006 Payments* at 12, GAO, GAO-06-502 (Apr. 2006).

¹⁴⁰ *Tobacco Settlement: States' Allocation of Fiscal Year 2005 and Expected Fiscal Year 2006 Payments* at 7-8, GAO, GAO-06-502 (Apr. 2006).

¹⁴¹ *Largest Tobacco Settlement Bond Sales*, BOND BUYER, Oct. 5, 2007.

¹⁴² GAO-06-502, *supra*, note 139, at 10-11.

¹⁴³ See *Securitization – Breaking the Promise*, AMERICAN LUNG ASSOCIATION, available at <http://www.lungusa.org/atf/cf/%7B7A8D42C2-FCCA-4604-8ADE-7F5D5E762256%7D/SECURITIZATION.PDF> [hereinafter “ALA Securitization”] (stating that “securitization will only give the states 30 to 40 cents on the dollar”); *Securitizing State Tobacco Settlement Payments: Myths vs. Facts*, CAMPAIGN FOR TOBACCO-FREE KIDS, available at <http://www.tobaccofreekids.org/research/factsheets/pdf/0132.pdf> (stating that “[s]tates will receive only pennies for every future dollar of settlement revenues they securitize”).

¹⁴⁴ ALA Securitization, *supra*, note 143, at 3-5.

costs associated with securitization.¹⁴⁵ Finally, they argue that it is poor public policy to sell a long-term income stream to fix a short-term problem like a budget shortfall.¹⁴⁶

Proponents of tobacco bonds have argued that securitization is a way to eliminate, or at least reduce, the risk states otherwise face that MSA payments may decline or altogether cease in the future.¹⁴⁷ Due to the various adjustments in the MSA, such as the Volume Adjustment and the NPM Adjustment, the amount of MSA payments could drop sharply if cigarette sales continue to decrease and Non-Participating Manufacturers gain more market share.¹⁴⁸ In addition, various risk factors – including significant litigation exposure – could drive one or more of the major Participating Manufacturers into bankruptcy, thereby rendering it unable to make future MSA payments.¹⁴⁹ Advocates for securitization argue that by securitizing MSA payments the states can reallocate these risks to the bondholders.¹⁵⁰ Securitization also allows the states to receive a substantial lump-sum of cash at one time, which may open up otherwise unavailable policy options such as financing capital improvements or undertaking other capital-intensive projects.

¹⁴⁵ The average transaction cost for an issuance is 2.82% of par value of the bonds sold. See Johnson, *supra*, note 136, at 123.

¹⁴⁶ See Johnson, *supra*, note 136, at 125.

¹⁴⁷ Walter Henry Clay Mckay, *Reaping the Tobacco Settlement Windfall: The Viability of Future Settlement Payment Securitization as an Option for State Legislatures*, 52 ALA. L. REV. 705, 706-13 (2001).

¹⁴⁸ See Gary Ellis, *Analysis of Tobacco Revenue Settlement Bonds: Assessing Cigarette Consumption Decline Estimates*, J. STRUCTURED FIN., 60, 62 (Winter 2008) (showing an annualized decline rate in cigarette consumption of 2.68% from 1996-2006 and exceeding 3% from 2003 forward).

¹⁴⁹ See Section V, *infra*, discussing the case of *Price v. Philip Morris* and concerns in 2003 over a possible bankruptcy for Philip Morris, the nation's largest cigarette manufacturer.

¹⁵⁰ Mckay, *supra*, note 147, at 715.

In order to securitize their MSA payments, states typically establish a special purpose entity, sell the rights to future MSA payments to the entity, and then have the entity issue the bonds to investors.¹⁵¹ The cash received from the investors is then paid by the special purpose entity to the state in consideration for the entity's acquisition of the MSA payment rights from the state.¹⁵² This arrangement helps to insulate the states from liability in the event that the tobacco companies fail to make their MSA payments, causing a default on bond payments. In addition, the bond indenture documents typically contain an express disclaimer of any liability for the state if the tobacco companies fail to make their MSA payments for any reason. For example, the Offering Circular for a 2008 tobacco bond issuance by the State of Michigan provides:

The Series 2008 Bonds are special revenue obligations of the Authority [the special purpose corporation set up by Michigan to issue the bonds] secured solely by and payable solely from the [stream of future MSA payments being sold] and the other collateral pledged under the Indenture. **The Series 2008 Bonds do not directly or indirectly, or contingently, obligate the State or any political subdivision of the State to pay any amounts to the Authority or to the Bondholders, or levy or pledge any form of taxation whatsoever for the Series 2008 Bonds.** The Bonds are not a debt or liability of the State or any agency or instrumentality of the State, other than the Authority, either legal, moral, or otherwise, and nothing contained in the Act or the indenture is to be construed to

¹⁵¹ Ellis, *supra*, note 148, at 61. For example, when California issued its tobacco bonds it established a special purpose corporation called Golden State Tobacco Securitization Corp. The state then sold its right to future MSA payments to the special purpose corporation, which issued the bonds.

¹⁵² Tobacco Settlement Financing Corporation (New York) Offering Circular, Jun. 12, 2003, at S-3, S-7 (hereinafter "New York Circular") (on file with author).

authorize the Authority to incur any indebtedness on behalf of, or in any way obligate the State or any political subdivision of the State.¹⁵³

Thus, with rare exception,¹⁵⁴ states that have issued bonds secured by MSA payments have shifted the risk of default by the tobacco companies on their MSA payments away from the states and to the bondholders.¹⁵⁵ This allows the states to have securitized their payments to pursue policies aimed at reducing smoking without as much concern over the loss of needed revenues.

Extending securitization beyond the MSA to other sin taxes revenues would help address the conflict of interest created by states' increasing dependence on sin taxes as a source for financing government operations and programs. Like MSA payments, sin taxes provide an annual revenue stream. This revenue stream can be valued and securitized.¹⁵⁶

¹⁵³ Michigan Circular at S-4 through S-5 (emphasis added).

¹⁵⁴ In at least two instances, market conditions at the time of bond issuances required states to include in their offerings an assurance to bondholders that if MSA payments by the tobacco companies were insufficient to satisfy the bond obligations, the governor would request that the states' legislative bodies allocate money necessary to pay the bonds. See New York Circular at S-2; Golden State Tobacco Securitization Corporation (California) Offering Circular, September 25, 2003, at 3. See Richard Briffault, *The Disfavored Constitution: State Fiscal Limits and State Constitutional Law*, 34 RUTGERS L.J. 907, 920-925 (discussing states' use of "subject-to-appropriation" debt to avoid constitutional limitations on debt issuance).

¹⁵⁵ While the legal documents relating to the tobacco bond issuances usually place the risk of default on the bondholders, at least one author suggests that states may elect to make bond payments in the event of default in order to avoid a lower credit rating and higher borrowing costs in the future. See Teresa Dondlinger Trissell, *Derivative Use in Tax-Exempt Financing*, 48 TAX LAW. 1021, 1028 (1995).

¹⁵⁶ There may be procedural requirements to securitizing sin tax revenues in some states. More than three quarters of the states have debt limitations in their constitutions. Stewart E. Sterk & Elizabeth S. Goldman, *Controlling Legislative Shortsightedness: The Effectiveness of Constitutional Debt Limitations*, 1991 WIS. L. REV. 1301, 1315-16. These limitations require state debt to be approved by a supermajority of the legislature, by voter referendum, or by both. See Briffault, *supra*, note 154, at 916. Bonds secured

Admittedly, future sin tax revenues may be somewhat more difficult to predict than MSA payments, because sin tax revenues are based on consumer decisions whether to purchase the taxed product rather than a contractual obligation (as with the MSA). As previously discussed, however, sin taxes typically apply to products with relatively inelastic demand and therefore relatively stable revenue streams.¹⁵⁷ Moreover, MSA payments have been successfully securitized despite the fact that the amount actually paid each year may differ significantly from the annual Base Payment Amount due to the numerous potential adjustments, including the Volume and NPM Adjustments. Therefore, the existence of some uncertainty over the exact amount of future revenues for a particular sin tax should not prevent a state from securitizing at least a portion of the tax's projected revenues.

To decouple a state's financial interests from the interests of manufacturers of the taxed product, the bond indenture securitizing sin tax revenues should specify that the bond is a revenue bond backed solely by receipts from the securitized sin tax, and not a general obligation bond.¹⁵⁸ States can successfully protect themselves from liability by expressly limiting the source of recovery for bond payments to a specified revenue

by a single tax revenue stream, such as a sin tax, may need to meet such procedural requirements, though some cases indicate otherwise. *See, e.g., In re: Okla. Capitol Improvement Auth.*, 958 P.2d 759 (Okla. 1998) (finding that bonds to finance highway construction were exempt from debt limitations if they were backed by taxes on motor fuels and vehicle license fees); *Convention Ctr. Auth. v. Anzai*, 890 P.2d 1197 (Haw. 1995) (a bond issued to finance a convention center might not be "debt" within the meaning of the constitutional constraint if it was backed by a new tax on hotel occupancy).

¹⁵⁷ *See* Section II.A.1, *supra*, discussing the demand elasticity of cigarettes.

¹⁵⁸ *See* Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035, 1046-55 (explaining various forms of municipal financing); Robert S. Amdursky, *The 1988 Municipal Bond Amendments: History, Purpose, and Effects*, 22 URB. LAW. 1, 2 n.4 (1990) (explaining that a "general obligation" bond is backed by the full faith and credit of the issuing government entity, whereas a "revenue" bond (also known as a "special" or "limited" obligation bond) is backed solely by a specified revenue stream).

stream.¹⁵⁹ By issuing bonds backed solely by a sin tax revenue stream, states can shift the risk of reduced sin tax receipts away from themselves and to their bondholders. In this manner, the states would break (or at least reduce) the alignment of interest with the producers of the “sinful” product, and allow for the pursuit of policies consistent with their citizens’ interests rather than policies tied to the financial welfare of the product manufacturer.

V. CONCLUSION

A state’s dependence on sin tax revenues creates a perverse incentive for the state to protect the continued sale of harmful products to its citizens. Perhaps this was most starkly illustrated in April 2003, after a state court judge in Madison County, Illinois ruled against Philip Morris in a consumer fraud case and ordered the tobacco giant to pay \$10 billion in damages.¹⁶⁰ The court required the company to post a \$12 billion bond to appeal the damage award.¹⁶¹ Philip Morris responded by notifying state attorneys general that the bond requirement created uncertainty over whether the company would be able to make its \$2.6 billion MSA payment obligation due on April 15, 2003.¹⁶²

Fearing a possible disruption in their MSA payments, the attorneys general from thirty-seven states and territories joined together to submit an

¹⁵⁹ See *Chemical Bank v. Washington Public Power Supply System*, 99 Wash.2d 772, 666 P.2d 329 (1983) (concurrence by Justice Williams) (stating that “the bonds in question are ‘revenue’ bonds, not general obligation bonds, and payable solely out of any revenues to be generated by the projects. . . . There is no obligation to pay revenue bonds where there are no revenues.”). Several states limit their liability on revenue bonds as a matter of statute. See, e.g., Wash. Rev. Code Ann. § 28B.07.320(9).

¹⁶⁰ *Addicted to Tobacco*, WALL ST. J., Apr. 4, 2003 at p. A8.

¹⁶¹ *Id.*

¹⁶² Letter from Denise F. Keane, General Counsel of Philip Morris, to Christine O. Gregoire, Attorney General of Washington (Mar. 27, 2003) (attached to Amicus Brief in *Price v. Philip Morris, Inc.*).

amicus brief requesting the Illinois court to reduce the bond requirement.¹⁶³ The attorneys general argued that “many State programs, including vital public health programs, depend on MSA payments for their support” and urged the court “to exercise its discretion to set an appeal bond that does not interfere with the States’ vital interests.”¹⁶⁴ The brief also stated that “if Philip Morris fails to make its \$2.6 billion payment to the States on April 15, 2003, the States face a substantial, immediate, and unexpected revenue shortfall.”¹⁶⁵ The Illinois court subsequently lowered the bond requirement to \$800 cash and a \$6 billion note.¹⁶⁶ Following this scare over a possible default on MSA payments, several states enacted statutes capping the maximum amount for an appeal bond in tobacco-related cases.¹⁶⁷ The states’ dependence on tobacco revenues had caused them to join sides with the nation’s largest tobacco company in an effort to protect their joint financial interests.

This would not have happened if the states had done what they promised at the outset of the MSA – used the settlement revenues for tobacco control programs. Instead, the states’ reliance on MSA payments to fund general government programs and operations forced the states to advocate on behalf of the nation’s largest cigarette producer. Moreover, if

¹⁶³ The attorneys general were joined on the amicus brief by the National Conference of States Legislatures, a bipartisan organization led by state legislators from across the country.

¹⁶⁴ Brief of Attorneys General as Amicus Curiae Supporting Respondents, Philip Morris Incorporated, at 2-3, (Third Judicial Circuit, Madison County, Illinois Claim No. 00-L-112) (hereinafter “AG Amicus Brief”), *available at* http://www.atg.wa.gov/uploadedFiles/Home/News/Press_Releases/2003/Amicus_brief040803.pdf.

¹⁶⁵ AG Amicus Brief, *supra*, note 164, at 11.

¹⁶⁶ See Elizabeth Albanese, *Philip Morris’ Bond Lowered*, BOND BUYER, Apr. 15, 2003.

¹⁶⁷ See, e.g., ALA. CODE § 6-12-4 (capping bond at \$125 million); CAL. HEALTH & SAFETY CODE § 104558 (\$150 million cap); HAW. REV. STAT. § 328L-7(\$150 million cap); KAN. ST. § 50-6a05 (\$25 million cap).

all of the states had securitized their MSA revenues and shifted the risk of non-payment to bondholders, the states could have avoided the immediate budget and ethical crises that the Illinois ruling created.¹⁶⁸

The risk that the states will become more dependent on new or increased sin taxes is particularly acute given the unprecedented economic circumstances presently affecting many states. Before state legislatures turn to sin taxes as an easy source of revenue, however, they should reconsider the traditional arguments both for and against the taxes. They should also consider the conflict of interest that increasing dependence on sin tax revenues creates. Earmarking and securitization provide two means of avoiding, or at least mitigating, this conflict of interest. Unless the states take action to protect against the moral hazards associated with sin taxes, they might just find that they themselves become the sinners, protecting tax revenues at the expense of their citizens' health.

¹⁶⁸ Tellingly, seven of the states that did not join the amicus brief (Alabama, California, Connecticut, Illinois, Missouri, Wisconsin, and New York) had securitized some or all of their MSA payments at the time of the Illinois court's ruling.