A Critique of the Proposed National Tobacco Resolution and a Suggested Alternative

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A CRITIQUE of the proposed National Tobacco Resolution
AND A SUGGESTED ALTERNATIVE

— BY Jon D. Hanson and Kyle D. Logue

IF THE GOAL OF CIGARETTE REGULATION is either to reduce substantially the public health problem created by cigarette smoking or to allocate the costs of smoking more equitably, there are significantly better alternatives to the regulatory regime than would be created by the state attorneys general’s Proposed Tobacco Resolution. Indeed, from either perspective, we are doubtful that the current proposal represents an improvement over the status quo. Our study of the issue leads us to make two largely independent criticisms of the proposed resolution. We will only mention the first here and will focus our attention on the second.
COSTS OF CIGARETTES

The first criticism is that the proposed resolution would not require manufacturers and, in turn, consumers to pay anything approaching the true total costs of cigarettes, costs that we estimate to be at least $7 per pack, a number that is considerably higher than other estimates that have been reported in the media. Our estimate includes some, but not all, of the costs borne ultimately by smokers themselves, by smokers’ insurers, and by individuals injured by second-hand smoke. It includes only future costs and excludes many of those. So, for example, the figure includes neither the health-care costs that have previously been caused by smoking nor the future pain-and-suffering costs borne by smokers or family members of deceased smokers.

Unlike most economists who have previously attempted to measure the costs of cigarettes, we do not reduce our estimate of cigarette costs to take into account the “savings” resulting from cigarette-induced premature deaths. Those savings — measured mostly in the form of smokers’ unclaimed pension and nursing-home entitlements — may not in fact be real, and in any event, are not relevant to the questions of whether and how best to regulate the market for cigarettes.

We should make clear that the purpose of the $7 per pack figure is not to suggest that a tax of $7 per pack should be imposed or that, following the introduction of the sort of regulatory regime we suggest below, cigarette prices will rise by $7 per pack. Rather, it is meant only to suggest the magnitude of the need for some type of regulatory intervention. In fact, under the smokers’ compensation regime that we recommend, we would for a number of reasons that we cannot pursue here expect cigarette prices to rise by no more than $3 per pack.
The proposed resolution is implicitly premised on the assumption that some form of intervention in the cigarette market is necessary. In light of evidence that smokers typically begin their habits at a very early age, tend not to be well informed of the long-term health risks of smoking, often underestimate addictiveness of cigarettes, and often do not bear many of the costs associated with smoking, we agree that the market for cigarettes should not be left unregulated. Our second criticism of the proposed resolution, however, is that the regulatory regime that it would implement is almost exactly the inverse of what it should be. To understand that criticism, it is helpful to step back from the proposal itself and ask a more general question (a question that, curiously, has evaded scholars and commentators to this point): What is the best approach to regulating cigarettes?

A. Three categories of regulation

Regulatory scholars have, in broad terms, identified three general categories of regulation: command-and-control regulation; performance-based regulation; and incentive-based regulation. The distinctions we draw among the three types of regulation are not perfect and can, in some instances, begin to blur. Thus, some examples of performance-based regulation begin to look like incentive-based regulation. In fact, it is probably most accurate to understand the three categories of regulation as demarcating three points along a continuum, with command-and-control regulation at one end, incentive-based regulation at the other end, and performance-based regulation somewhere in between. Nevertheless, it is useful to maintain the conceptual distinctions among the three types of regulation to enable us to identify the costs and benefits of moving in one direction or the other along the continuum.

Under command-and-control regulation, sometimes called "input regulation," the regulator imposes specific requirements on the firm. The regulator in effect tells the regulated firm how specifically to run some aspect of its business. In regulating pollution, for example, the command-and-control regulator might prescribe specific steps that manufacturers must take, or specific technologies that they must use, in order to reduce the level of pollution that is emitted by their manufacturing processes.

There are many examples of command-and-control regulation in the proposed resolution. For example, the warning requirements and the advertising restrictions that would be imposed on manufacturers are best characterized as command-and-control regulations. Similarly, if the Food and Drug Administration exercised its limited authority under the proposed resolution to mandate particular "technically feasible," "less hazardous tobacco products," it would do so in the form of command-and-control regulations.

Under performance-based regulation, by contrast, the regulator presents manufacturers with a target of some sort, which the manufacturers are encouraged to meet. That target is sometimes called a "performance standard." The manufacturers are then left to decide how best to achieve that target. One performance standard, for example, might be a maximum quantity of pollution that a firm is allowed to emit over a given period of time, such as that allowed by tradeable pollution permits. Failure to achieve the relevant target, however, would result in a fine or additional regulation. The proposed resolution contains a couple of performance-based standards. The best known example is the so-called "look-back" provision, which would set target levels of underage smoking that the industry would pay a fine for failing to meet.

Performance-based regulation, when compared to command-and-control regulation, reflects a greater degree of humility and skepticism with regard to how much the regulator can be expected to know about the cutting-edge technology in a given industry and a greater degree of reliance on the industry (or the market) to have and act on that information. Nevertheless, both types of regulation make substantial informational demands on the regulator.

If there is a performance standard or target that is assumed to be desirable, performance-based regulation can be superior to command-and-control regulation as a means of achieving that standard, for the reason already described — manufacturers have better information. In addition, if we know what the target standard is, then enforcement of such a standard is relatively easy (because of the ease of monitoring compliance) compared to enforcement of command-and-control regulation, where the regulator must constantly defer to the informational advantage of the manufacturer.

Although there is something to be said for performance-based regulation over command-and-control regulation, it is our view that they both impose roughly the same informational demands on the regulator. Although we develop that argument in considerable detail in
our Article, the general idea is captured in the following question: How is the performance-based regulator supposed to choose the appropriate target level of performance (or the appropriate fine for failing to meet that target)? For example, how does Congress or EPA determine the aggregate level of air or water pollution to permit? To answer such questions the regulator must have information about not only the level of harm caused by different levels of pollution but also the total social costs and benefits of the activities that give rise to the pollution.

Incentive-based regulation is superior to command-and-control and performance-based regulation inasmuch as it requires less information of the regulator, and it relies more on the market to generate the desired regulatory outcomes. Under incentive-based regulation, the regulator simply forces the manufacturers to pay the total costs of their manufacturing activities. The manufacturers are then left to decide what to do about those costs, if anything. Thus, incentive-based regulation does not tell manufacturers how to run their business (as command-and-control regulation does). Nor does it require the regulator to choose the ideal regulatory target (as performance-based regulation does). It simply makes the industry pay its costs, and lets the market sort things out. The general superiority of incentive-based regulation over command-and-control regulation in most settings is fairly widely accepted among scholars and is increasingly recognized by policy makers. Indeed, most of the important debates in environmental regulation seem to be over, not whether to use market forces, but how best to use market forces as a means of reducing pollution.

It is not our position that command-and-control and performance-based regulation should never be used. There are circumstances in which those types of regulation may be useful supplements to ex post incentive-based regulation. We do take the position, however, that those types of regulation, especially in the cigarette context, are not viable substitutes for ex post incentive-based regulation. Still, those regulatory alternatives can serve a complementary function. Even in the cigarette context, for example, those forms of regulation might prove helpful as a means of reducing underage smoking. In addition, in some non-cigarette situations (for example, in dealing with the problems of air pollution created by automobile emissions), either command-and-control, performance-based, or perhaps an excise tax ("ex ante incentive-based regulation") may be the only available options. This would be true if ex post incentive-based regulation (of the type we describe in greater detail in the text below) were considered impractical, perhaps because the harms associated with generalized air pollution are too widely dispersed to give rise to ex post damage claims brought by individual victims. It should be emphasized, however, that the cigarette market presents a setting in which ex post incentive-based regulation is available as a regulatory option.

B. The problem with the proposed resolution

Given this consensus in favor of incentive-based regulation, one would hope that any proposal to regulate cigarettes would rely most heavily on incentive-based approaches, with little emphasis on command-and-control and performance-based regulation. In fact, however, the proposed resolution takes just the opposite approach. It is dominated by a renewed and strengthened emphasis on command-and-control regulation, including everything from new warning requirements to new FDA control over the level of nicotine and other ingredients in tobacco products. And the proposed resolution is especially remarkable for its lack of incentive-based regulatory approaches. In fact, by sharply curtailing products liability law as a means of regulating manufacturer behavior, the proposed resolution would eliminate the only existing incentive-based system with any potential for internalizing the external costs of smoking.
In addition, the settlement contains the occasional performance-based approach — such as the "look back" provision designed to achieve specific targets of underage smoking by various points in time — but those provisions, by virtually all accounts, involve penalties for failure to achieve the relevant targets that are too weak. Moreover, as we will show in the text below, even if the penalties are increased, the way in which the penalties would be apportioned among tobacco companies (essentially on a market-share basis) would undermine each company's incentives to reduce underage smoking.

To get a clearer picture of the limits of the command-and-control and performance-based regulations outlined in the proposed resolution, consider the following questions:

- What if the proposed cigarette warnings and advertising restrictions are ineffective, as they have been in the past?
- What if, in response to requirements that they must turn over to the FDA all research regarding potential alternative, potentially safer, cigarette designs, cigarette manufacturers stop conducting such research?
- What if the FDA does identify a cigarette design that appears likely to be safer than conventional designs? Should the FDA mandate it? What if smokers increase their overall consumption of cigarettes because of the new design? What if the safer cigarette is unpopular because of, say, unpleasant taste attributes? Should the FDA require that all cigarettes adopt the new design? If not, will the FDA require that cigarette manufacturers market cigarettes with the safer design as aggressively as they market their conventional brands?
- What about the look-back provision? Why is the target reduction level set at 60%? What if the look-back provision is successful in encouraging the industry to reduce underage smoking to target levels, but many individuals who do not begin as underage smokers simply pick up the habit at age 18?

C. The benefits of incentive-based regulation

Incentive-based regulation would significantly reduce the problems suggested by the preceding set of questions. It would do so by taking government regulators out of the role of trying to make complex economic and scientific determinations and by relying instead on the expertise of manufacturers and on the power of market forces.

The proposed resolution arguably includes an incentive-based component, insofar as the costs imposed on manufacturers are required to be passed through to consumers in the form of a price hike. That mandated price hike would, like an excise tax, force manufacturers to bear at least some of the costs of their products. Viewing the proposed regulation in that light, some scholars have complained that the price hike is too small. According to Jeffrey Harris, for instance, the proposed agreement would, if adopted, have the effect of a $0.62 per pack excise tax on cigarettes. In addition, some senators and the Clinton administration have recently suggested the possibility of increasing the price hike to some amount closer to $1.50 per pack. (See Jeffrey Taylor, "More Senators Seem to Back Increasing Cigarette Prices Beyond Level in Accord," Wall Street Journal, A4, Sept. 17, 1997.)

There appears to be an emerging consensus among commentators and policy makers, in other words, that the regulatory effect of the de facto excise tax needs to be enhanced and will have a greater regulatory effect than that of other aspects of the proposed resolution.

With that conclusion we agree. An excise tax probably does have certain advantages over command-and-control or performance-based regulation.

However, as an incentive-based system of regulation an excise tax has distinct disadvantages when compared with what we refer to as "ex post incentive-based regulation." By an ex post incentive-based system we mean a regime in which each cigarette manufacturer is forced to pay the external costs caused by its brand of cigarettes as those costs actually become
manifest — that is, manufacturers pay damages ex post.

An excise tax, which can be thought of as an “ex ante incentive-based” regime, has two important disadvantages when compared with an ex post incentive-based regime. First, choosing the appropriate rate of tax requires the regulator (as in the case of command-and-control and performance-based regulation) to have an enormous amount of information up front (at the time the tax rate is set) about the costs and benefits of cigarettes, including the costs and benefits of alternative cigarette designs. In contrast, under an ex post regime, costs would be imposed on cigarette manufacturers only as the external harms caused by cigarettes actually became manifest. Thus, although the regulator would be responsible for sorting out after the fact what harms had been caused by cigarettes and should be charged to manufacturers, it would be the cigarette manufacturers who would decide up front how to make and market cigarettes to minimize those costs.

The second disadvantage of an excise tax, compared with an ex post approach, is that an excise tax does not create incentives for cigarette manufacturers to compete over safety. This is a very basic point, but it is extremely important and is central to our argument for an ex post regime (and to our critique of the proposed resolution). At best, an excise tax (and the de facto excise tax contemplated in the proposed resolution) would impose on each manufacturer the average per pack external costs for the whole industry. Such a tax, however, provides no incentive for manufacturers to make investments in developing and manufacturing safer cigarette designs (such as nicotine-free cigarettes or low-carcinogen cigarettes) or in identifying relatively low-risk smokers (people who are least likely to suffer harmful effects
Any such innovations would cost a manufacturer money—the research and development costs among others—but would provide essentially zero benefit to that manufacturer given that the taxes are fixed (or, if variable, are assessed on a market share basis).

If the taxes are fixed, then, of course, nothing that a manufacturer does can lower them. Even if the taxes vary to reflect the changes in the average costs of cigarettes, however, manufacturers will not invest to lower those costs, because the benefit of such investments would be shared with the whole industry in the form of a reduced industry-wide excise tax. Again, each manufacturer would have a strong incentive to make no such safety-enhancing investments. This phenomenon is a special case of what policy scholars call the “common pool” or “free rider” problem. We sometimes refer to it as the “unraveling problem,” because, under such a scenario, the market for safety improvements may unravel, as each manufacturer realizes that making investments in safety enhancements is not in its financial best interest.

D. The smokers’ compensation alternative

An ex post incentive-based regime can, at least in theory, overcome the unraveling problem associated with an excise tax and can thereby create the market incentives for manufacturers to compete over safety. Such an ex post regime can force each manufacturer to bear the harms caused by its brand of cigarettes specifically and not just the average harm caused by the industry as a whole. To achieve that goal, one of the essential elements of any ex post incentive-based regime would be an ability, even if imperfect, to trace harms to specific brands.

The specific form of ex post incentive-based regulation that we will emphasize here is a regime that we call “smokers’ compensation.” One of many possible versions of such a system would rely on a newly created administrative board with authority to adjudicate the compensation claims. Someone suffering from a smoking-related illness would bring a claim to that board and present evidence regarding his or her injury and smoking history. If necessary causal links were established, the board would award compensation to the claimant and then charge the manufacturer or manufacturers for the amount paid out. But, whatever form it might take, a smokers’ compensation system is distinguishable from an excise tax in the following ways:

- Fact finding with regard to harms caused by cigarettes would be based on evidence of actual harms after they have occurred rather than on speculation regarding possible future harms.
- Manufacturers, rather than regulators, would conduct the ex ante cost-benefit analysis regarding what safety investments to make, what product design changes to consider, and how those changes will affect product demand.
- Costs would be imposed on manufacturers on a brand-specific, rather than on a fixed, industry-wide, or market share basis.
- Incentives to compete over increased safety would be created, rather than dulled or eliminated.
- Victims of smoking-caused harm themselves would voluntarily come forward with information regarding harms caused by cigarettes, thereby providing useful information regarding brand-specific risks.

The smokers’ compensation system can also be distinguished from products liability law—another ex post incentive-based regime. Under the current rules, products liability law is the only existing ex post incentive-based regulation of cigarettes. Some commentators complain, however, that that regime has been wholly ineffective, a complaint we challenge below. Other commentators and industry officials may worry that products liability law, in its current form, presents the tobacco industry with an unacceptable level of uncertainty as to what the industry’s overall liability for smoking-caused harm will be. It is also sometimes argued that the tort system entails relatively high administrative costs compared to other systems of deterrence.

In response to such concerns, consider the following ways in which the proposed smokers’ compensation model might be cheaper, simpler, and more certain than its tort law alternative:

- The fact finding determination would be conducted by an administrative board or an administrative law judge rather than by a lay jury.
- This fact finder could be specially trained in dealing with scientific evidence, or could be authorized to solicit advice from experts or a blue-ribbon panel of scientists.
The damages for each type of smoking-caused harm could be predetermined based on some type of grid system, whereby a given harm produces a given (i.e., certain) level of damage payment from the manufacturer.

The only fact finding question would be causation. Hence there would be no need for expensive fact finding on such questions as product defect, industry standards, assumption of risk, and the like.

Although the need for litigation in hard cases would not be eliminated, the claims adjustment process could become more routinized than is the case with current product liability claims, thereby reducing administrative costs.

If the above-listed aspects of the proposal do not provide enough certainty, it might be possible to impose an overall cap or budget on the amount of damages that can be paid by the cigarette industry in a given year, so long as the damage payments within that cap are allocated among manufacturers according to each company's relative causal share of the harm, and not just according to market share.

This has been a necessarily sketchy outline of a smokers' compensation approach to regulating cigarettes. We have made no effort here to work out all the details of such a program, nor do we expect that that task will prove easy. Still, there are a variety of ways in which such a regulatory regime might be adjusted or tailored without eliminating its beneficial effects. We would note, moreover, that there are existing regulatory regimes to which policy makers may usefully look for guidance regarding how to implement a smokers' compensation regime. The most obvious analogy, given the name we have chosen, is workers' compensation. Another analogy would be no-fault automobile insurance. The smokers' compensation regime that we have in mind, after all, is essentially a no-fault system with the cigarette companies acting as the insurers of smoking-caused harms.
possible OBJECTIONS

There are two possible objections to an ex post incentive-based system, such as a smokers' compensation system, as compared to an ex ante incentive-based system of regulation, such as an excise tax.

A. Strategic avoidance of regulatory incentives

First, an excise tax might be presumed superior because it would be charged as the cigarette is sold rather than when the injury occurs. Because, under a smokers' compensation system, manufacturers would be liable for the harms of cigarettes sold many years earlier, a smokers' compensation system would arguably create opportunities for cigarette manufacturers to evade the regulator's incentive-creating sanctions. For example, after profiting for twenty years or so, a new entrant to the cigarette market might simply distribute its assets to its shareholders, rendering itself largely immune to the threat of smokers' compensation claims. To be sure, the manufacturer would then be bankrupted by the smokers' compensation claims, but only after many years of profiting substantially and distributing those profits to shareholders. Legal scholars sometimes describe this as a "judgment-proofing" or "hit and run" strategy.

There are several reasons why such judgment-proofing strategies are unlikely to be adopted by manufacturers. For example, sophisticated long-term creditors would — and, in other industries, do — include covenants prohibiting (or, more generally, increasing the costliness of) such strategies. Also, opportunities for strategic avoidance of regulatory incentives exist for virtually all forms of regulation. For instance, manufacturers could avoid the effect of an excise tax by directly or indirectly selling their brands on black markets, as may be common in other countries that have substantial cigarette tariffs. That evasion strategy would be less effective under a smokers' compensation system because manufacturers would have to pay for the harms caused by all of their cigarettes, even those purchased on black markets. Indeed, for that reason, manufacturers would have a strong incentive to discourage the emergence of black markets in their own cigarettes. Finally, there are regulatory policies that could be adopted that would prevent manufacturers from evading the threat of future liability. For instance, as is provided for under the proposed resolution, manufacturers might be required to put up a substantial bond, to ensure that some assets are available in the future. Similarly, as is the case for virtually all European corporations, manufacturers might be required to meet minimum capitalization requirements, which would serve the same purpose as a bond. Finally, as is true of automobile drivers in most of the states in this country, cigarette manufacturers could be required to purchase a minimum amount of liability insurance which would cover the costs of future potential liability.

B. The personal responsibility question

Others might object to a smokers' compensation system (or to any other type of victim-initiated ex post incentive-based system) on the ground that it compensates smokers for the harms caused by cigarettes and thus removes from them any responsibility for their own decisions. The goal of a smokers' compensation system is to enhance public health. But if the goal were to force individuals to own up to, or take responsibility for, their actions, we are aware of no policy response that would be superior to a smokers' compensation system. That's true for several reasons.

For starters, smokers would have to pay when purchasing each pack of cigarettes, in the form of higher product prices, for their right to make a claim later, when a smoking-caused illness occurs. The arrangement is no different from that between insureds and their first-party insurers. Thus, smokers would not be getting something for nothing and would not be evading responsibility. Indeed, the whole goal of this type of incentive-based system is not to let smokers off the hook but to force smokers to take responsibility by forcing each smoker to place his money where his mouth is. Absent such a price increase, smokers would continue to disregard the substantial costs that their smoking poses to themselves and to others; and smokers would continue to have to "take responsibility" for risks that they were not fully aware of. Moreover, the harms caused by cigarettes are, of course, often quite serious. And even to the extent smokers or their families receive compensation for some of the costs of cigarette-caused harms, it is difficult to say that the dead or seriously ill smoker ever fully evades the ultimate responsibility for her smoking decisions. Finally, of course, smokers are not the only actors who should be accountable for their actions. Under an ex post incentive-based regime, tobacco manufacturers, too, would be forced to bear responsibility for their actions.
Is it really now

or never;

this or nothing?
Those who are interested in the cigarette problem might ask questions such as: “Doesn’t the proposed resolution represent a step in the right direction?” and “In light of the fact that the apparent momentum in Washington to enact a comprehensive federal regulatory response to the cigarette problem might die, shouldn’t we embrace the proposed resolution or something substantially similar to it while we have the chance, rather than be returned to the status quo?”

In our view, the answer to both questions is “no.” Taking public health as the overriding goal, we would, if forced to choose, pick the status quo. To understand why, it is necessary first to understand that critics and supporters of the proposed settlement share two flawed premises, which nevertheless seem to be dictating the terms of the policy debate. First, both sides assume that the primary purpose of products liability law in this context is, not to serve public health goals, but simply to compensate those injured by smoking. Second, both sides seem to agree that civil liability laws have, to date, failed to serve that or any other worthwhile goal. Consequently, most participants in the debate have indicated in one way or another that the elimination of tort law would be no big loss, even for smoking plaintiffs. The proponents of the proposed resolution, for instance, point out that, even if $368.5 billion does not cover all the harms, past and future, caused by cigarettes, it is a lot more than nothing, which is what manufacturers have paid in tort damages to date. Critics of the proposed resolution are typically less explicit. They make their views known either by not mentioning the effect of the proposed resolution on tort law or by indicating that they would not challenge that effect if only the proposed resolution could be adjusted to better serve public health goals.

Arguably, however, the principal goal of products liability law is, broadly speaking, public health, not compensation. In the cigarette context in particular, the question then becomes whether the public-health goal is better achieved through products liability law or through the types of regulation envisaged in the proposed resolution. Those who would sacrifice products liability law to accept the proposed resolution implicitly assume that the public health benefits of the latter would outpace the public health benefits of the former. But, perhaps because of the general anti-tort sentiment in this country, that presumption has been largely unexamined and is, for several reasons, highly questionable.

First, products liability law comes far closer, at least in theory, to providing an ex post incentive-based type of regulation than any alternative form of regulation now being considered (other than the smokers’ compensation regime we are proposing). Moreover, products liability law could have more than just a theoretical impact. It is true that no substantial product liability judgments have been won against the tobacco industry. Nevertheless, products liability law is currently in a state of flux or disequilibrium; and the growing likelihood of many large civil judgments against the industry is a big part of what pushed the industry to the negotiating table and thus what made the $368.5 billion settlement offer possible. In other words, to say that the settlement agreement would produce $368.5 billion while product liability law has produced nothing is to misunderstand what motivated the agreement in the first place.

It would be more accurate to claim that administrative regulation, not tort law, has failed those who have been harmed by cigarette smoking. The FDA has long declined to exercise its authority in this area, presumably because of the political power of the cigarette industry and because of the FDA’s lack of expertise regarding how best to regulate. Furthermore, it has been administrative regulation that has effectively derailed otherwise viable products liability claims against cigarette manufacturers. For example, the FTC-promulgated warning labels have given rise to the preemption defense and greatly strengthened the assumption-of-risk defense in tort law. Those defenses have until very recently proved an insurmountable barrier to tort recovery. Thus, in light of this past experience with administrative regulation, it is not clear that we should have much confidence in the expanded role for administrative regulation contemplated in the proposed resolution.
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IN CONTEXT

That brings us to our final observation. The history of tobacco regulation makes clear one very disturbing fact. The cigarette industry has, using a variety of strategies, successfully managed to protect itself throughout this century against any form of meaningful regulation. By far, its most successful strategy has been to meet the threat of tough regulations with preemptive, command-and-control-style, anemic regulations. The experience with FTC warning requirements is a case in point. But there are many others. Within the last several years, that practice has been especially evident at the local level, where the industry has supported some state tobacco control legislation in an effort to preempt the authority of city, town, and county governments to control the sale and use of tobacco.  

As noted above, command-and-control is the least effective form of regulation in this type of setting. It requires the regulator to have an enormous amount of information about the product, information that the regulator often must rely on the industry to provide. Insofar as the industry is the source of the regulator's information, it becomes relatively easy for the industry to manipulate the process and avoid really having to bear the costs of its actions. Furthermore, the regulations themselves are severely limited by the inability of the regulator to anticipate every counter-move that the industry might make in its attempt to thwart the regulator — or, more accurately, to save the money that would otherwise have to be spent in complying with the spirit of the regulation. As we have argued, those criticisms certainly apply to the settlement's numerous command-and-control regulations. To be sure, the agreement also contains some elements of performance-based regulations, which, in theory, might pose somewhat of a regulatory threat to the cigarette industry. As other critics have noted and our research shows, however, the performance-based aspects of the settlement are rendered quite anemic by the substantial ex ante and ex post loopholes and the relatively minor surcharges for failing to meet performance targets.

CONCLUSION

The proposed resolution states that "[a] key element in achieving the Act's goals will be forcing a fundamental change in the way the tobacco industry does business." With that assessment we completely agree. The proposed resolution also claims that it would "provide for means to ensure that the industry will not only comply with the letter of the law but will also have powerful incentives to prevent underage usage of tobacco products and to strive to develop and market less hazardous tobacco products." As our analysis has indicated, however, that claim is unfounded.

Indeed, as already emphasized, the mix of regulatory regimes chosen by the proposed resolution — mostly command-and-control; some qualified performance-based, and virtually zero ex post incentive-based regulation — is precisely the reverse of what most policy-oriented scholarship would recommend. Moreover, it is, from the tobacco industry's perspective, ideal. In light of the industry's track record, therefore, the choice of that mix of regulatory regimes was probably no accident.

As noted above, command-and-control is the least effective form of regulation in this type of setting. It requires the regulator to have an enormous amount of information about the product, information that the regulator often must rely on the industry to provide. Insofar as the industry is the source of the regulator's information, it becomes relatively easy for the industry to manipulate the process and avoid really having to bear the costs of its actions. Furthermore, the regulations themselves are severely limited by the inability of the regulator to anticipate every counter-move that the industry might make in its attempt to thwart the regulator — or, more accurately, to save the money that would otherwise have to be spent in complying with the spirit of the regulation. As we have argued, those criticisms certainly apply to the settlement's numerous command-and-control regulations. To be sure, the agreement also contains some elements of performance-based regulations, which, in theory, might pose somewhat of a regulatory threat to the cigarette industry. As other critics have noted and our research shows, however, the performance-based aspects of the settlement are rendered quite anemic by the substantial ex ante and ex post loopholes and the relatively minor surcharges for failing to meet performance targets.

Considering the big picture, therefore, we have no trouble rejecting the suggestion that the proposed settlement would somehow substantially alter the culture or incentives of the tobacco industry. To the contrary, the basic incentives of manufacturers would remain. They would still seek to find and to create loopholes in the regulations. They would still seek to misrepresent the risks to consumers and regulators.

Our very strong sense at the end of the day is that the proposed resolution would accomplish precisely what previous efforts to regulate the cigarette industry have accomplished. Specifically, the proposal would create the illusion of regulation (at least initially) while simultaneously protecting the industry and smokers from having to bear the costs of cigarettes.

Based on our analysis, we would recommend that Congress reject the proposed resolution and start over from scratch, this time beginning with the following question in mind: How can we design an effective ex post incentive-based response to the cigarette problem? In our forthcoming Yale Law Journal article (cited above), we discuss the framework for beginning that analysis, although much work on the details remains to be done.

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