

The Tobacco Settlement, as Refracted through the Economics of Litigation

Richard E. Wagner
Department of Economics, 3G4
George Mason University
Fairfax, VA 22030

The immediate details of the tobacco settlement are simple. In late 1998 the Big Four tobacco companies (Philip Morris, RJ Reynolds, Lorillard, and Brown & Williamson) settled with representatives of 46 states suits that had been filed to claim compensation from the companies for what were claimed to be excess Medicaid expenses incurred by the states on behalf of smokers. When added to the earlier settlements with Florida, Minnesota, Mississippi, and Texas for \$40 billion, the tobacco companies agreed to pay some \$246 billion for the settlement of state suits throughout the land.

In filing these suits, the states claimed they were seeking to place smokers and nonsmokers on an equal footing, by imposing an added burden on smoking that was equal to the additional medical claims that smokers extracted from Medicaid. These state claims founder on one simple, incontrovertible fact that has been noted by many authors in many places: smokers do not impose any such costs on nonsmokers. If either category of citizen bears burdens for the other, it is smokers who bear costs on behalf of nonsmokers. They do this mostly through excise taxes on cigarettes. They also do it through earlier average ages of death, which reduces their claims upon public treasuries for both retirement and medical care.

If these state tobacco claims were treated at their face value, they would have been rejected out of hand. Despite this overwhelming evidence, the states pursued their suits, the federal government sought to do the same, and now is pursuing the same end through taxation, and the companies played along by settling the suits, and which led to price increases that could have been attained alternatively through taxation. Since all of this has nothing to do with any truth claims regarding damages, it must be about something else. The discourse surrounding the tobacco settlement has been a charade, where the language that is used is one of concealment and not of revelation.

In watching this charade, it is only natural to wonder what lies behind it. If the concealing language that speaks of damages is translated into a correct and revealing language, of what would it speak? At one level, the answer is easy and unexceptional: it is about power and money. But the process through which this operates also reveals important insights about the law-and-economics of suits and their settlement when the state is a plaintiff. The standard analytics of the settlement of suits cannot be applied without modification to the settlement of suits when the state is a plaintiff, because those analytics are based on the presumption that both parties to the suit are residual claimants. But the state is not a residual claimant. It is not even a person. Rather, it is a process and structure of governance. When the state becomes a plaintiff, the standard calculus of settlement must be modified to take account of this alternative institutional setting.

In this essay, I shall first review briefly the state claims about their Medicaid costs from tobacco, after which I shall review the standard economics of the settlement of suits. The remainder of the essay examines how the economics of settlement might be modified to incorporate the state as a plaintiff, and how this modification pertains to the tobacco settlement.

State Claims and their Vacuity

The published literature now contains several studies that refute resoundingly the claim that smokers impose costs on nonsmokers. One of those studies, by W. Kip Viscusi (*Regulation*, Summer 1997), reported detailed results for six individual states, in addition to national aggregates and averages. These states were Alabama, Florida, Maryland, Mississippi, New York, and Virginia. These states incurred increased costs of medical care that ranged from 1.7 cents per pack of cigarettes in Mississippi to 6.8 cents in New York. Looked at from the cost side alone, these figures might seem to provide some basis for the state claims that smokers were particularly heavy drains upon state treasuries.

The problem with this claim is that smokers are also particularly heavy contributors to state treasuries through excise taxes on cigarettes. What they pay in excise taxes dwarfs by many orders of magnitude what they receive in state-financed medical care. For instance, Mississippi imposed a tax of 36 cents per pack, which is more than 20 times the state medical cost attributed to smoking. New York imposed a tax of 56 cents per pack, which is more than eight times the state's medical cost attributed to smoking. Even in Virginia,

where the tax was only 2.5 cents per pack, the cigarette excise tax exceeded the state's costs for medical care attributed to smoking. Furthermore, excise taxes are not the only way that smokers make positive net contributions to state treasuries. On average, smokers die earlier than nonsmokers, and this reduces state outlays for pensions and nursing home care, generally in the vicinity of ten cents per pack.

To be sure, the existing literature understandably shows some range of estimates concerning the fiscal relationship between smokers and nonsmokers. What is common throughout this literature, however, is the finding that smokers more than pay their own way for any state-provided medical care that they receive, and in a big way, through excise taxes and a reduced demand for state services provided for the elderly. There is no way that any disinterested judge or jury could conclude any differently. One can only conclude that the language that speaks in terms of compensation is a diversion of attention away from the real motivations that animated the suits and their settlement.

The Simple Economic Calculus of Settlement

A substantial literature has developed that seeks to explore whether a suit will be settled or will be tried. As an empirical matter, something over 90 percent of suits are settled, and this literature has sought both to explain these obviously strong tendencies to settle and to account for the failures to settle. The central point can be presented most simply by assuming, initially, that the plaintiff and the defendant agree both on the odds each party has of winning and of the

damages that would be awarded if the plaintiff wins. In this instance, both parties agree on the expected outcome of a trial. Settlement saves the expenses of litigation, and these expenses represent the gains from trade that the parties can split by reaching a settlement.

For the plaintiff, we may characterize the expected value of a suit as

$$V_p = P_p J_p - L_p , \quad (1)$$

where L_p is the plaintiff's expected litigation expenses, J_p is the judgment the plaintiff expects to receive if he wins, and P_p is the probability the plaintiff attributes to his chance of winning. Similarly, for the defendant the expected cost of a suit is

$$V_d = P_d J_d + L_d , \quad (2)$$

where the terms have the same meaning as before, save that the subscripts denote the defendant. In the event the plaintiff and defendant agree on the probable outcome and judgment, the litigation expenses are pure losses that can be saved through settlement.

For instance, suppose the plaintiff and defendant both anticipate that a verdict for the plaintiff will carry an award of \$100 million, and that the plaintiff's odds of success are 50:50. Further suppose that each party has expected litigation expenses of \$5 million. Both parties agree that the expected value of the litigation is a \$50 million award to the plaintiff. For the plaintiff, the expected net gain from litigation is

$$V_p = 0.5(\$10 \text{ million}) - \$5 \text{ million} = \$45 \text{ million}. \quad (1A)$$

For the defendant, the expected net cost from litigation is

$$V_d = 0.5(\$10 \text{ million}) + \$5 \text{ million} = \$55 \text{ million.} \quad (2A)$$

For any payment from defendant to plaintiff greater than \$45 million but less than \$55 million, both parties will gain by settling the case. The expenses of litigation provide potential gains from trade of \$10 million that can be captured by the parties through settlement.

To say that litigation expenses provide the basis for a settlement does not mean that settlements will always occur, even if the parties hold the same expectation about the outcome of a trial. The parties may be unable to resolve conflicts over the division of the gains from settlement. Settlement is an instance of bilateral monopoly, and a settlement may fail because the parties cannot agree on the distribution of the gains from settlement. Furthermore, the parties may differ in their perceptions of odds of success, as well as of the probable damages to be awarded in the event the plaintiff wins. The parties might also differ in their attitudes toward risk. To be sure, such things as rules and procedures regarding discovery operate to reduce such differences in perception. To reduce those differences, however, is not to eliminate them. If perceptions diverge sufficiently about how a trial will affect the net worth of the parties, mutual gains from settlement can vanish.

The Tobacco Settlement Described Via the Standard Calculus

The tobacco cases, however, were settled. What are we to make of this? If we follow the standard logic of settlement, we would start by saying that there was a meeting of the minds regarding the division of the settlement surplus. This

might seem to mean that both parties concurred in the expected outcome of a trial, and so decided to save the expenses of litigation. To illustrate, consider any of the several small states that settled for around \$1 billion (e.g. Hawaii, Nebraska, Nevada, New Mexico, Utah, or Vermont). An illustrative settlement calculus might find the expected value of a suit for the plaintiff to be

$$V_p = 0.4(\$2.5 \text{ billion}) - \$100 \text{ million} = \$900 \text{ million.} \quad (1B)$$

That calculus might likewise describe the expected cost of a suit to the defendant as being

$$V_d = 0.4(\$2.5 \text{ billion}) + \$100 \text{ million} = \$1.1 \text{ billion.} \quad (2B)$$

This illustration yields a settlement surplus of \$200 million for some settlement between \$900 million and \$1.1 billion. The illustrative data shown in (1B) and (2B) are consistent with an observation of settlements of between \$900 million and \$1.1 billion.

The standard approach to settlement could yield some such description as this for the observed settlement, and with similar descriptions being advanced for the larger settlements with the other states. This kind of description, however, raises some troubling questions that warrant further examination. Most significantly, this description cannot truly account for the actual terms of the settlement, at least not in terms of the typical settlement calculus. A rational plaintiff would have settled for a low amount, if not have dropped the case entirely. Similarly, a rational defendant would not have paid very much to settle the case.

Based upon the overwhelming evidence against the plaintiff's claims about smoking and excess medical costs, the expected outcome of a trial, as *based on this evidence*, would surely not look anything like what is characterized in (1B) and (2B). While the available evidence overwhelmingly shows the value for J to be zero, we might well apply a very relaxed standard of evidence in this case, as by severely discounting evidence about the taxes that smokers pay. A state legislature might even pass an act that disallows the introduction of such evidence, similar to what legislatures have done before. It is possible to imagine a sufficient relaxation of standards that might generate, say, a \$200 million figure for J. But to generate \$2.5 billion as an estimate of J would be not merely to abandon all standards, but would be to adopt outrightly fallacious and perverse standards. Alternatively, it would be to incorporate as gains from litigation something other than the recovery of excess medical claims that smokers are alleged to place upon state treasuries.

The State as a Partisan Plaintiff

The actual settlement, of course, was massive in magnitude. To reconcile this with the law-and-economics of settlement would seem to require either an abandonment of rationality or a denial that the states faced low or vanishing odds of success. I do not propose to do either of these. Rather I wish to suggest that rationality manifests itself differently when the state is a plaintiff than when the plaintiff is a private party. The standard economic analysis of settlement must be modified when the state is a plaintiff, not because rationality is abandoned but

because the substance, as distinct from the form, of rational conduct changes with the shift from private to public plaintiff.

The operation of partisan interests and ideologies must be taken into account, as must the absence of residual claimacy. To be sure, the democratic state, or attorney general, as a plaintiff faces a budget constraint just as surely as does the private citizen. The more an attorney general pursues one case, the less he can pursue other cases. This property of formal similarity, however, hides some significant substantive differences between the two types of plaintiff. Unlike a private plaintiff, an attorney general does not finance litigation on his own account. An attorney general plays with a budgetary appropriation and not his personal wealth. The relevant calculus for filing and settling suits is a calculus of political support, as these are mediated by interest groups and ideology.

At the purely formal level of argument, decisions to litigate or to settle depend on some calculus of gains and costs, just as equation (1) illustrates. A shift in institutional setting from a private to a political plaintiff, however, changes the substantive implementation of that formal calculus. To illustrate the character of this institutional impact, let me start by invoking a litigation-and-settlement calculi for the participants under the presumption that the plaintiff is a private party. For the plaintiff, the expected gain from litigation is

$$V_p = 0.3(\$200 \text{ million}) - \$6 \text{ million} = \$54 \text{ million.} \quad (1C)$$

For the defendant, the expected cost of litigation is

$$V_d = 0.3(\$200 \text{ million}) + \$6 \text{ million} = \$66 \text{ million.} \quad (2C)$$

In this setting, the settlement range would lie between \$54 and \$66 million. To be sure, this illustration violates the evidence that the relevant costs are zero or negative, as noted above. These numbers were selected to illustrate a situation where a small suit might be filed and settled. My central interest is in the process by which a shift from private to political plaintiff can generate a shift from small to large litigation. (In all of these illustrations I assume that litigation expenses are ten percent of expected recovery.)

With the state as a plaintiff, both the PJ and the L terms of the calculus illustrated by (1C) are modified. Consider first the expenses of litigation. There are at least two ways that the absence of residual claimacy reduces the cost of litigation to a political plaintiff. Most immediately, the cost of litigation is not a debit item in the attorney general's personal account. A private plaintiff may well face a \$6 million cost of litigation, as illustrated by (1C). A political plaintiff, however, will face a much lower cost. The total cost that might be borne in the aggregate by taxpayers is not relevant to judging the choices made by an attorney general. What is relevant is his personal cost, and this is not easy to determine. A lower bound to estimate of that cost would be his pro rata share in the tax bill. This would make litigation nearly a free good. An attorney general will, of course, need to maintain a coalition of supporters, and their costs would also be incorporated into his calculus. Moreover, litigation is not a free good, because choices to pursue one case more fully will require an attorney general to sacrifice whatever value he would derive from a fuller pursuit of other cases. While the cost of litigation to an attorney general will exceed zero, it will surely be

much less than it would have been had the attorney general acted as a private plaintiff.

Furthermore, the expenses of litigation can also serve as a vehicle for awarding supporting interest groups and cultivating support in a variety of forms, ranging from attempts at higher office to future commercial opportunities. For instance, the tobacco litigation involved the state attorneys general in hiring private law firms, and with many of those firms making contributions to political campaigns on behalf of their sponsor. The attorney general both faces subsidized costs of litigation and finds that some of those costs actually operate as credit items on his personal account, in that they expand his set of future opportunities. Whatever the cost of litigation might be to a private plaintiff, the same pattern of expenses will be evaluated less onerously by political a plaintiff, due simply to the change in institutional setting. A democratic state as a plaintiff may bring suits and pursue litigation when a private citizen would not.

By way of illustration, suppose the political plaintiff senses the cost of litigation to be only one-sixth as heavy as it would appear to a private plaintiff. The \$6 million cost to the private plaintiff in (1C) would be treated as though it were only \$1 million by such a political plaintiff. Even without taking interest groups and ideology into account, the cost obstacle to litigation has shrunk six-fold with the state as plaintiff, through the absence of residual claimacy. Moreover, this reduction in cost to action-takers will expand their willingness to invest in litigation. When faced with a six-fold reduction in the personal cost of litigation, supporters of the litigation will expand the resources they devote to the

litigation. If their demand for litigation were unitarily elastic, the cost of litigation would rise to \$30 million, which in turn would be evaluated personally by the plaintiff as if it were \$6 million.

Once interest groups and ideological advocacy enters within the context of a democratic state, the substance of the calculation of the PJ term in (1C) changes as well. The presence of interest groups and ideological zealots increases the returns to litigation sensed by the attorney general. We may take the \$200 million figure for J as an upper-tail estimate of damages.

Considerations pertaining to ideology and interest groups increase the perceived returns to litigation in two ways. First, the returns become some multiple of the damages. The \$200 million figure may refer to some upper bound estimate of losses to a state's treasury. What really animates pursuit of the case, however, is the plaintiff's desire to prohibit the use of tobacco and thereby to suffocate what he feels to be undesirable modes of conduct. These are not advanced in the damage claims, but are the genuine motivators of the case. Suppose these considerations operate with six times the ferocity as the beliefs about actual health care costs. In other words, \$1.2 billion signifies that the intensity of dislike of smoking and smokers, and is six times as strong as the dislike of the actual damages thought to result to the state's treasury. The plaintiff's calculus now incorporates a \$1.4 billion judgment if successful.

There are other considerations that would work to create an even more zealous plaintiff. A commercial plaintiff may well be risk neutral, but ideological zealotry surely increases the willingness to take risk for what is thought to be a

good cause. This increased willingness has the same effect on the present value calculus as an increase in the probability of success at trial. When faced with what might appear objectively to be an 0.3 chance of success, ideological zealotry will inspire greater effort than will risk neutrality. Suppose the effect of ideological zealotry is to increase the intensity with which a suit would be pursued to the same extent as would an increase in the probability of success to 0.6 affect a risk neutral plaintiff. This would render the expected gain from litigation to be \$840 million $((0.6)(\$1.4 \text{ billion}))$.

If these arguments are combined, the private calculus illustrated by (1C) is modified so as to generate a greater value for litigation. For a private plaintiff the litigation was valued at only \$54 million. For a political plaintiff, as I have described here, however, it is valued at \$1.114 billion, as summarized by (1C₁),

$$V_p = 0.8(\$1.4 \text{ billion}) - \$6 \text{ million} = \$1.114 \text{ billion.} \quad (1C_1)$$

It will be noted in (1C₁) that I have used 0.8 as the plaintiff's chance of success, when calibrated to a risk neutral calculation. Yet immediately above I used 0.6. The difference in probabilities reflects one further consideration. The litigation is expanded to the point where the cost to the plaintiff is \$6 million, but at this point total resources directed at the litigation are \$30 million. The defendant, however, spends only \$6 million, as shown in (2C). This increase in relative plaintiff spending will increase the odds of success to the plaintiff. Suppose the risk neutral probability increases from 0.3 to 0.5 by virtue of this imbalance in expenditure. If ideological zealotry is then treated as equivalent to an increase in

probability of three-tenths, the relevant figure for using a risk neutral form of calculation is 0.8.

Defending against an Interest-Driven State

What is a defendant to do when confronted with a subsidized political plaintiff driven by interests and ideological zealotry? A plaintiff described by (1C) might be a pest to a defendant, where one described by (1C₁) would be a monster. The defendants against an interest-driven state face an adversary that calculates differently than would be true with private plaintiffs. A decision to settle a suit would thus proceed differently and carry a different meaning. To be sure, a defendant faces the same formal problem regardless of the identity of the plaintiff. The substantive quality of that problem, however, differs as between private and public plaintiffs.

It may be granted that an ideologically-oriented, interest-driven state may pursue particular cases more vigorously than an individual, commercial plaintiff. But why should this evoke any change in conduct by the defendant? It might seem to be irrelevant that the state becomes a more eager plaintiff through such things as placing a good part of the cost of litigation upon nonsupporters of the suit, of deriving ideological value from the suit, and being a zealot. Why would not the defendants continue to operate according to the calculus described by (2C)? In this case they would litigate rather than settle, and bear an expected cost of \$55 million rather than bending to a settlement with a plaintiff who values

the suit at \$1.114 billion. After all, there is simply no settlement range in the world represented by (1C₁) and (2C).

There is, however, something wrong with this picture of a plaintiff valuing litigation at \$1.114 billion while the defendant treats it as worth only \$55 million. One party to a suit cannot truly expect to gain \$1.114 billion while the other truly expects to lose just \$55 million. There are many reasons to think that the defendant's view of the world described by (2C) will give way to the plaintiff's view described by (1C₁).

First of all, the calculus described by (2C) has been rendered obsolete by the increased expenditure on litigation that accompanies the subsidization of political litigation. The defendant's presumption that the plaintiff has a 0.3 chance of success is based on the presumption that each spends \$6 million on the litigation. The increase in plaintiff's spending to \$30 million increases the chance that the plaintiff will be successful to 0.5, as I explained above. The expected loss to the defendant will thus rise from the \$60 million shown in (2C) to \$100 million, which in turn will evoke an increase in the defendant's spending on the litigation.

More than this, however, is the dramatic clash in world views represented by a comparison of the J terms. The defendant described by (2C) is thinking in terms of possible excess medical costs imposed by smokers on state treasuries. The plaintiff described by (1C₁) regards those claims as secondary, and is animated by a vision of a smoke-free America. The wide gap between the J terms in the calculi of the plaintiff and defendant is not some quantum of

imaginary money, but rather reflects the extent of the plaintiff's hoped for degradation of the commercial value of tobacco companies.

The tobacco settlement thus represents a capitulation by the companies to the plaintiff's world view. A man sitting on an ice burg in the North Atlantic as it floats south will recognize his ultimate fate, and yet be thankful when clouds obscure the sun. It is perhaps no different with the tobacco companies. In a fair game of chance, the player with the smaller fortune will eventually be ruined by the player with the larger fortune if the play continues long enough. In ordinary games, of course, play is voluntary, and either party can terminate the play at will. But the state can command participation, and it can exhaust the fortune of anyone against whom it plays. We may note that the claims about the costs of medical care are specious, but they are also irrelevant as motivators in the actions against tobacco. A wise person would not continuously play a fair game of chance against a much wealthier adversary, and similarly would not want to play continuously against a zealous, interest-driven political plaintiff. Settlement is like that welcome cloud in the North Atlantic. It gives respite to a weary soul, but it doesn't bring peace of mind.

What Price Eternal Vigilance?

The particular numbers I have used here are, of course, hypothetical constructs that were created to illustrate a theme, and to do so within the general analytical context supplied by the economics of litigation and settlement. The general theme illustrated by the tobacco settlement is the danger of being on the

opposite side of the partisan use of state power to advance a private interest agenda at public expense. Eternal vigilance is the price of liberty, as Patrick Henry noted. And the state is potentially the biggest threat of all. We may well fault the tobacco companies for capitulating against the onslaught of state power. For if everyone did this liberty would perish. Yet the state as a partisan plaintiff can pursue a strategy of divide-and-conquer against its potential defendants, which renders some such capitulation understandable, even if it can never render it admirable.

Selected References

Epstein, Richard A. *Bargaining with the State*. Princeton: Princeton University Press, 1993.

De Jasay, Anthony. *The State*. Oxford: Basil Blackwell, 1985.

McChesney, Fred S. *Money for Nothing: Politicians, Rent Extraction, and Political Extortion*. Cambridge: Harvard University Press, 1997.

Tollison, Robert D. and Wagner, Richard E. *The Economics of Smoking*. Boston: Kluwer Academic Publishers, 1992.

Viscusi, W. Kip. *Smoking: Making the Risky Decision*. New York: Oxford University Press, 1992.