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Trends in the Cigarette Industry After the Master Settlement Agreement

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Abstract

Since the Master Settlement Agreement (MSA) was signed in November 1998, the cigarette industry has been forced to raise prices to cover the costs associated with the settlement. The agreement between the attorneys general from 46 States and the major cigarette companies was intended primarily to reimburse States for expenses related to the treatment of smoking-related illnesses. The agreement also contained provisions to reduce smoking prevalence, especially among youth. Cigarette companies have boosted prices as a result of payments required by the settlement. Higher prices have curtailed consumption, although not as much as originally expected. The long-term decline in cigarette consumption due to non-economic factors continues as well.

Keywords: Cigarettes, tobacco, consumption, supply, use, taxes, Master Settlement Agreement, Consumer Price Index, imports, and exports.

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The Master Settlement Agreement of November 1998

Introduction

On November 16, 1998, States attorneys general and cigarette manufacturers signed an agreement to reimburse the States for the costs of treating smoking-related illnesses and to reduce underage smoking. Within a few days, all 47 States and the District of Columbia (four States settled previously) and various territories had signed on with the agreement. This tobacco settlement did not require approval by Congress.

Key elements of the pact are:

- $206 billion to be paid to States over 25 years.
- $1.5 billion over 10 years to support anti-smoking measures plus $250 million to fund research into reducing youth smoking.
- Limitations on advertising.
- Ban on cartoon characters in advertising.
- Ban on "branded" merchandise.
- Limitations on sporting event sponsorship.
- Disbanding of tobacco trade organizations.

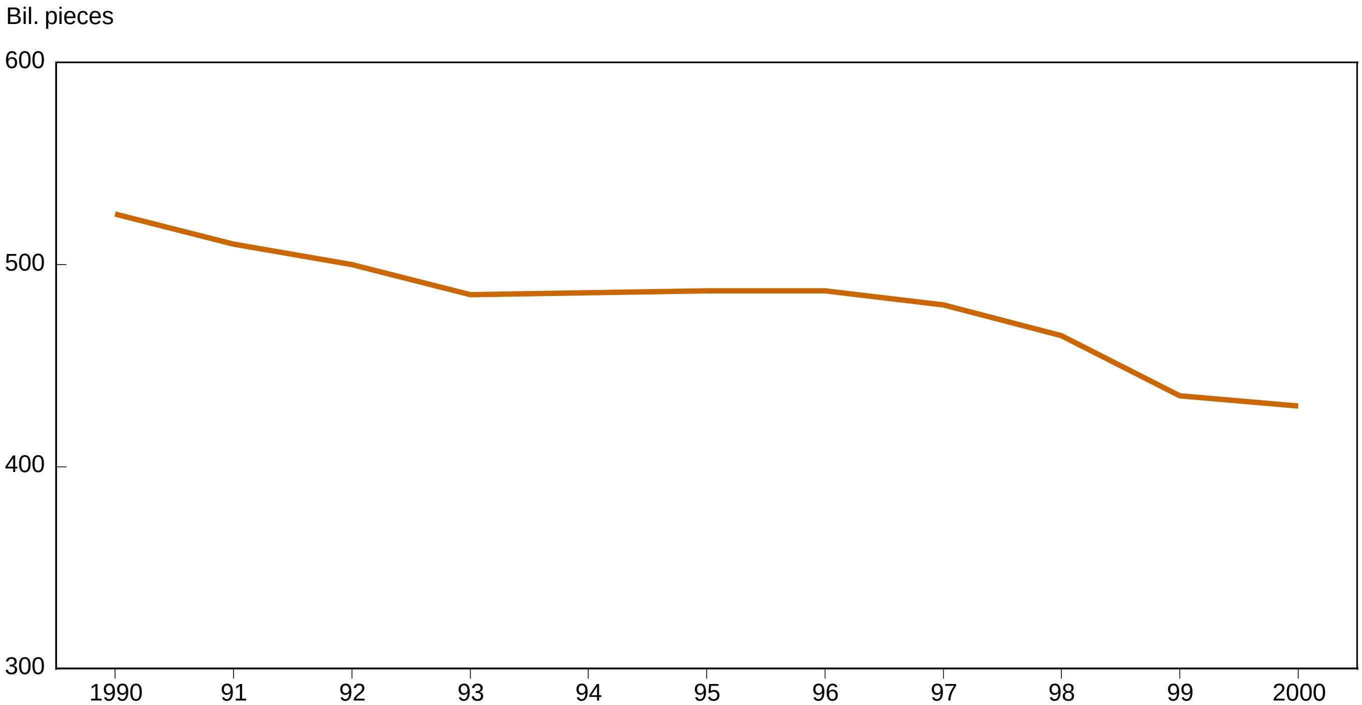
The settlement, combined with expenses from the four previous State settlements, will have an ongoing inflationary effect on the price of cigarettes.

The National Tobacco Grower Settlement Trust

In addition to the Master Settlement Agreement (sometimes known as phase I), cigarette manufacturers agreed to pay $5.15 billion to tobacco growers over a period of 12 years (phase II). The trust fund was negotiated to compensate tobacco quota owners and growers for potential reductions in their tobacco production and sales resulting from the Master Tobacco Settlement reached in 1998.

Cigarette Consumption Slips to 430 Billion Pieces in 2000

U.S. cigarette consumption, 1990-2000

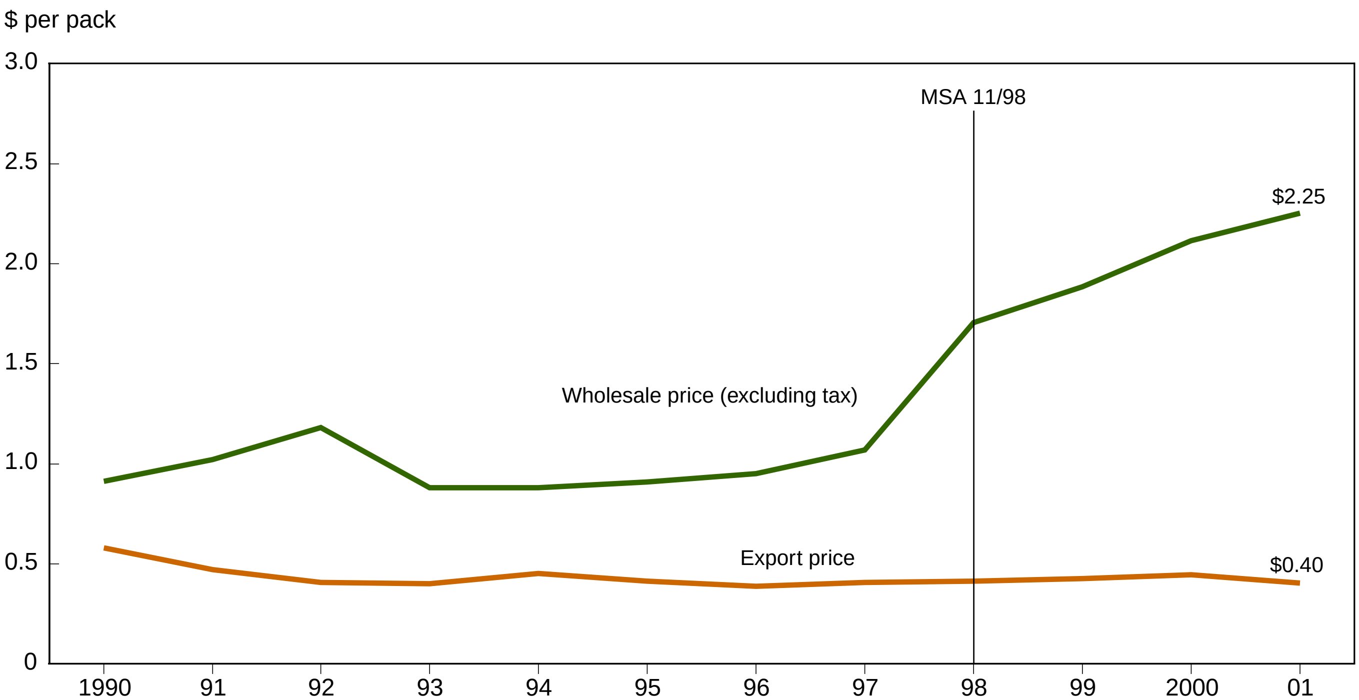


Source: *Tobacco Situation and Outlook Report*, Economic Research Service, USDA.

- Rising prices have caused cigarette consumption to decline 7.5 percent since 1998.
- Other factors, such as restrictions on where people can smoke and the greater knowledge of the health risks associated with smoking, also have contributed to lower cigarette consumption.
- Year-end 2000 cigarette consumption is expected to be 430 billion pieces, unchanged from earlier estimates, compared with 435 billion pieces in 1999.
- Per capita consumption continued to slip at 2,025 pieces per person (total U.S. age 16 and over population), compared with 2,067 pieces for the same group in 1999.
- Although consumption has declined by about 35 billion cigarettes since 1998, it has declined less than expected. Premium brands especially have shown a tenacious grasp on market share. The share of the market held by premium brands has continued to increase since the MSA was signed.

Cigarette Prices Have Risen Since the Master Settlement Agreement

Cigarette prices, 1990-2001



Source: *Tobacco Situation and Outlook Report*, Economic Research Service, USDA.

- 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.

- Price increases set the stage for declines in consumption in subsequent years, but increased taxes also played a role in dampening demand for cigarettes.

- The Federal excise tax has been 34 cents per pack since January 2000, when it increased from 24 cents per pack. The Federal excise tax is paid by the manufacturers, but most of the tax is passed on to consumers. In January 2002, the Federal cigarette excise tax will increase by an additional 5 cents per pack, or $2.50 per thousand cigarettes.

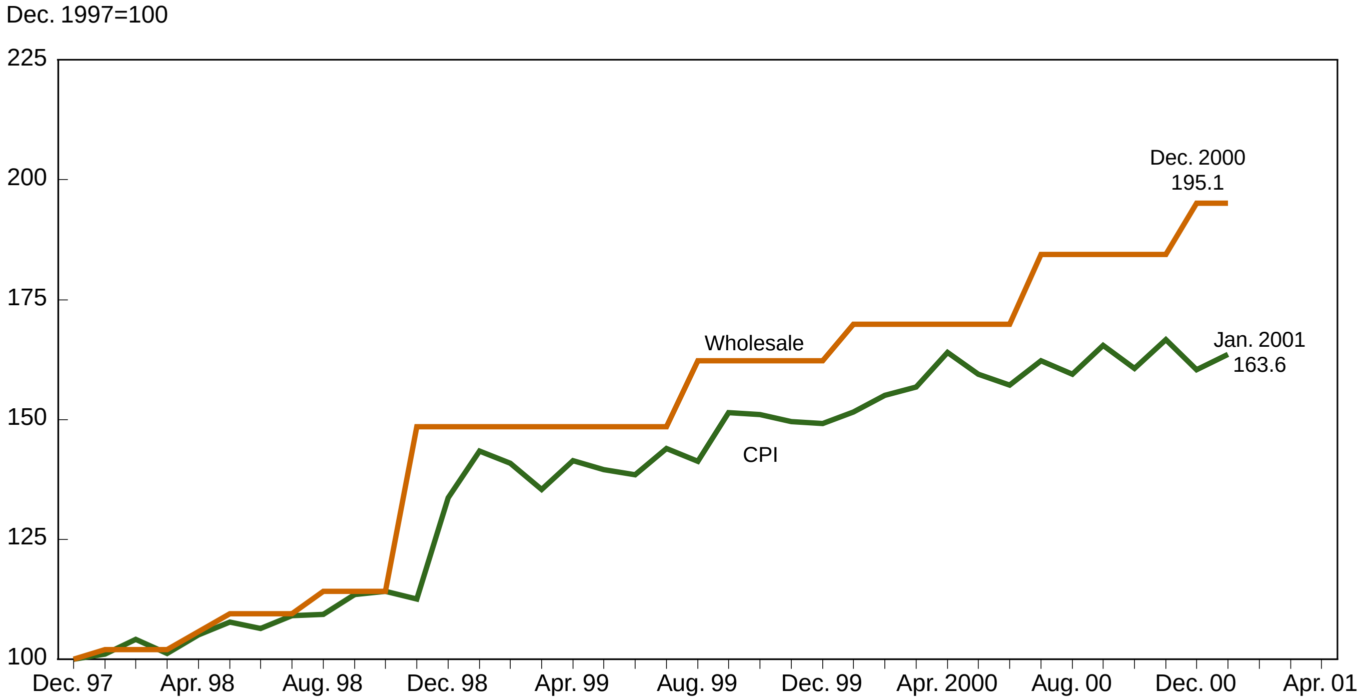
- States also collect excise taxes on cigarettes. Currently, State excise taxes range from 2.5 cents per pack in Virginia to $1.11 in New York. State excise taxes, weighted by number of packs sold, average 41 cents per pack. Most States also collect sales taxes, and some municipalities and cities collect additional taxes on cigarettes.

- The impact of taxes on the individual smoker is significant, averaging $250 per smoker in 2000 (based on Centers for Disease Control data indicating 22.7 percent of people in the United States over 16 years of age are smokers).

- Cigarettes sold for export and re-imported into the United States are known as “grey market” cigarettes. The grey market is financially feasible because the wholesale export price of U.S. cigarettes is about 20 percent of the domestic wholesale price—$.40 versus $2.25 per pack of 20 cigarettes. After paying duties, excise taxes, and transportation, cigarettes shipped abroad and then shipped back to the United States are still cheaper than those sold domestically by the manufacturers. This practice was forbidden by legislation effective January 2000.

Price Indices Show the Effect to the Consumer of Higher Cigarette Prices

Cigarette price indices, 1997-2001



Source: *Tobacco Situation and Outlook Report*, Economic Research Service, USDA.

- Retail prices, as indicated by the cigarette Consumer Price Index (CPI) (Bureau of Labor Statistics, Department of Labor), have historically tracked wholesale price increases.

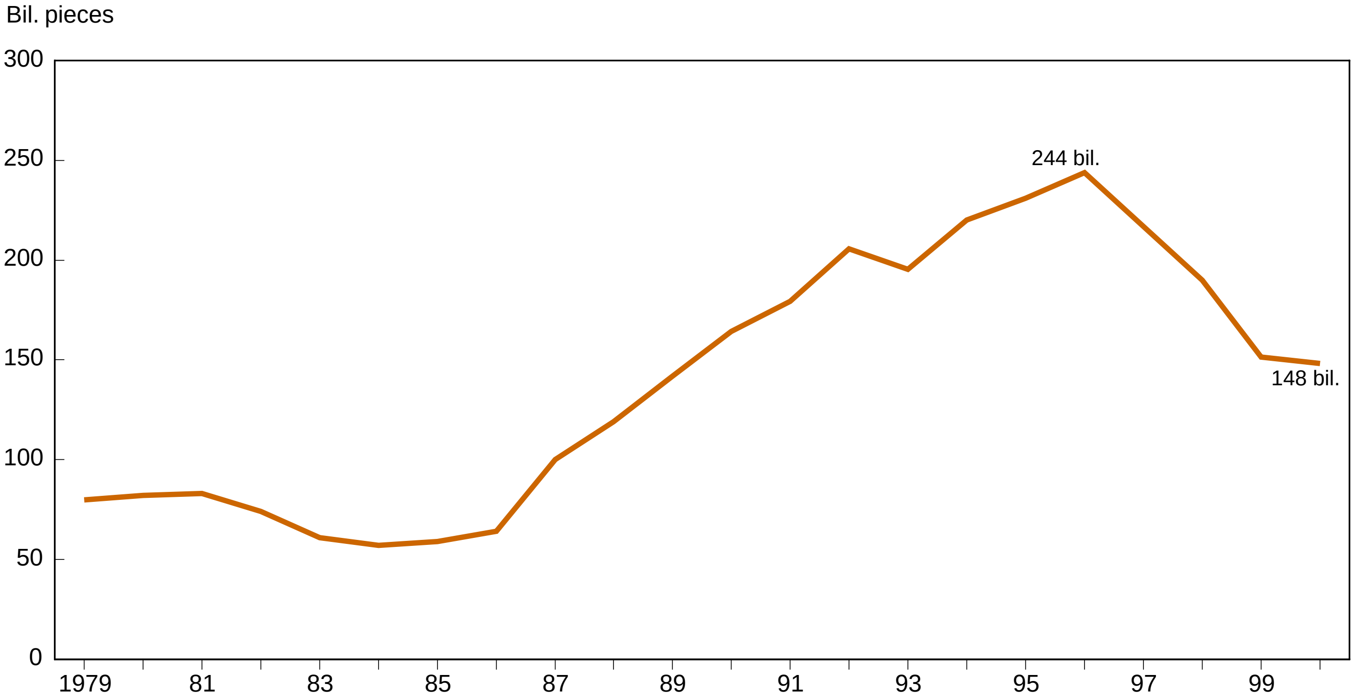
- Since the MSA, however, discounts and promotions have caused retail prices to grow at a slower rate than the wholesale prices charged by manufacturers.

- Discounts and promotions have also enabled manufacturers to maintain market share for premium cigarettes.

- The cigarette CPI increased much faster than the CPI for all consumer items. Between 1998 and 2000, the overall CPI grew by 6 percent while the cigarette CPI grew by 60 percent.

After Peaking in 1996, Cigarette Exports Fell Rapidly Until 1999, Then Stabilized

U.S. cigarette exports, 1979-2000



Source: *Tobacco Situation and Outlook Report*, Economic Research Service, USDA.

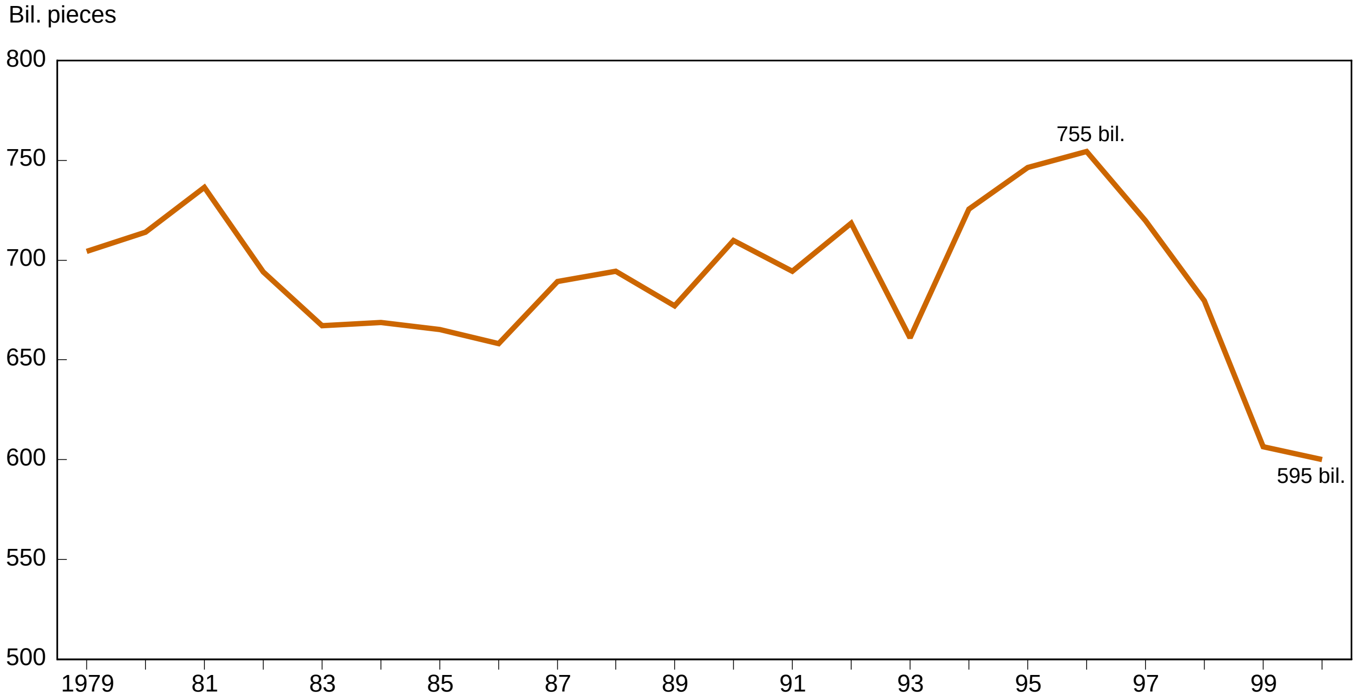
- Since 1996, cigarette exports have fallen by about 100 billion pieces.

- This is due to offshore manufacturing by U.S. makers of cigarettes, primarily in Europe and Eastern Europe, declining consumption in some major buying countries in Europe and Asia, and economic troubles in many Asian nations.

- U.S. cigarette imports are rising, but are a small factor in overall consumption.

Declining Domestic Demand and Exports Shrink U.S. Cigarette Production

U.S. cigarette output, 1979-2000

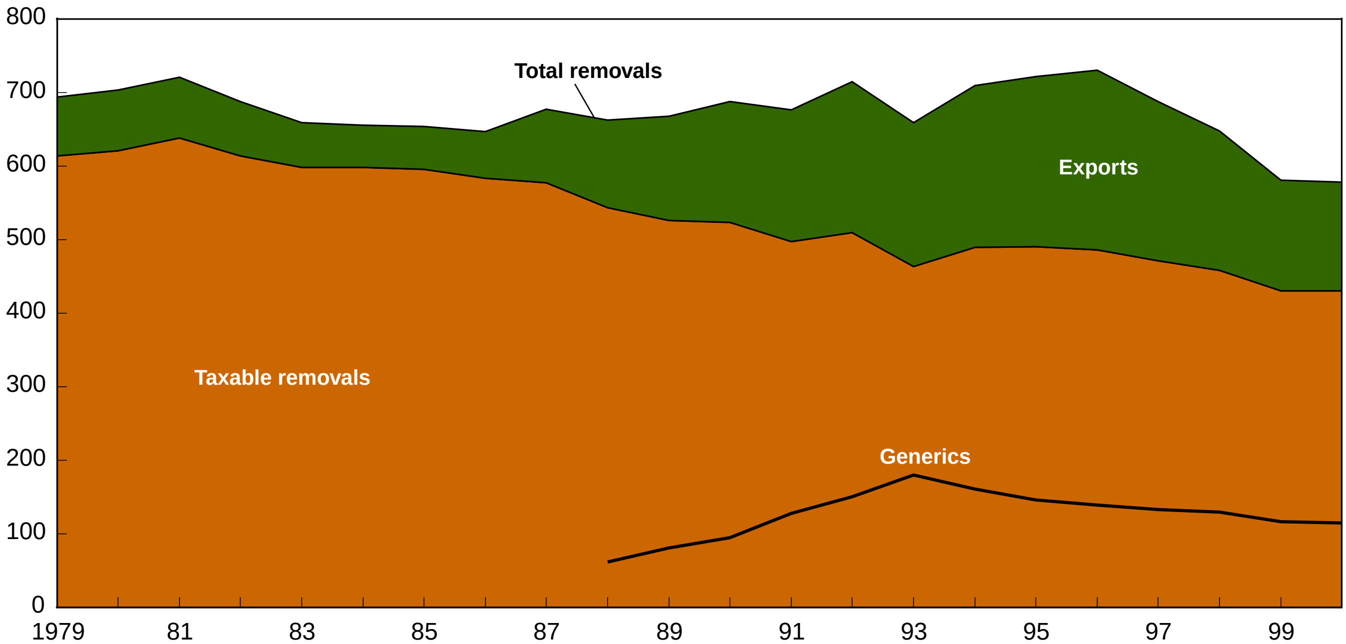


Source: *Tobacco Situation and Outlook Report*, Economic Research Service, USDA.

- Declining domestic consumption and lower exports have reduced the number of cigarettes produced in the United States.
- After peaking in 1996, cigarette output has fallen every year since. Cigarette output in 2000 is about 595 billion pieces.
- In 2000, exports were virtually unchanged and domestic consumption fell slightly. With output falling relatively faster than consumption, stocks are declining.

The Components of U.S. Cigarette Use Show Declines Are Long Term

U.S. cigarette disappearance, 1979-2000



Source: *Tobacco Situation and Outlook Report*, Economic Research Service, USDA.

- Discount (generic) brand market share continued to slip in 2000, falling to 26.7 percent of sales, compared with 37.0 percent in 1993. This is mostly due to increased price competitiveness of premium brands due to promotions and discounts.

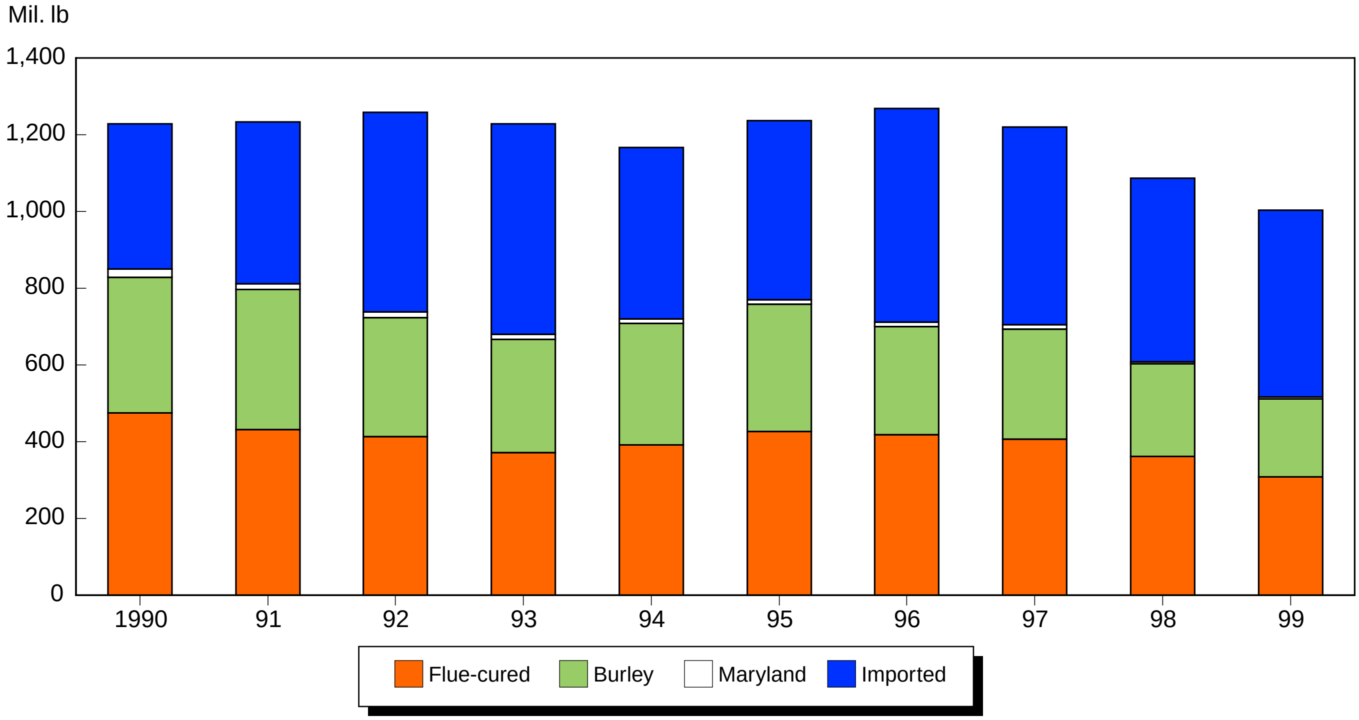
- Output for calendar 2000 is expected to be around 595 billion pieces.

- Taxable removals (the amount upon which Federal tax was paid) in 2000 reached 423 billion pieces and exports totaled 148.3 billion pieces (12 months of data). Federal excise taxes are collected from cigarette manufacturers.

- Exports stabilized, slipping by only 2.8 billion cigarettes compared with declines of 50 billion pieces during both 1998 and 1999.

Overall Leaf Use Has Declined, but the Domestic Component Has Shrunk Even Faster

Tobacco used for cigarettes, 1990-1999



Source: *Tobacco Situation and Outlook Report*, Economic Research Service, USDA.

- Lower cigarette output has caused demand for tobacco leaf to decline.

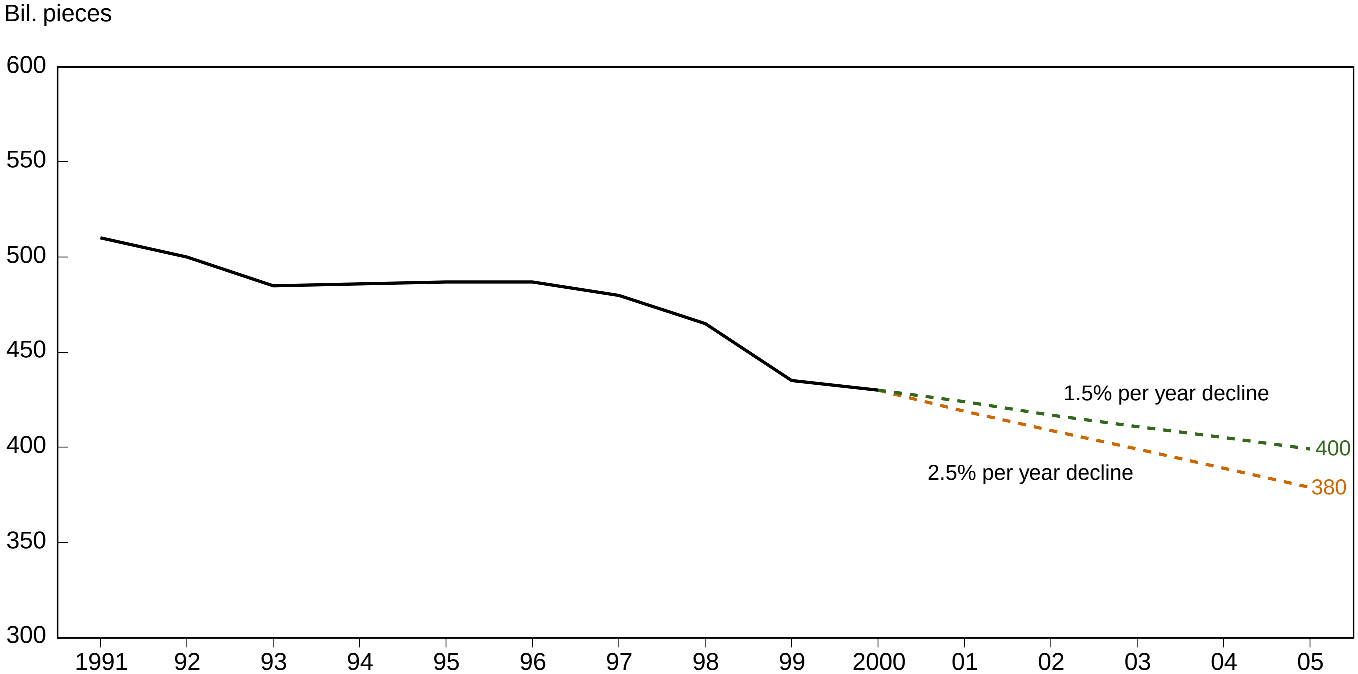
- U.S. leaf prices are higher than world leaf prices, making U.S. leaf less competitive. The price support component of the U.S. tobacco program inflates U.S. leaf prices. Without the program, U.S. prices would be closer to those of other leaf-producing countries. Furthermore, improved quality of foreign-grown leaf has boosted leaf import levels. (See the Policy section of the Tobacco Briefing Room, http://www.ers.usda.gov/briefing/tobacco/policy.htm, for details of the USDA Tobacco Program.)

- U.S. leaf has been displaced to a greater extent by foreign leaf than by declines in cigarette consumption.

Upcoming Trends in the U.S. Cigarette Industry

U.S. cigarette consumption, 1991-2005

2001-05 forecast with 1.5% and 2.5% per annum decline



Source: *Tobacco Situation and Outlook Report*, Economic Research Service, USDA.

- Cigarette consumption in the United States will likely continue to decline between 1 and 3 percent per year, assuming price increases similar to those of the past 2 years.

- Additional taxes or price increases will dampen consumption further.

- Cigarette exports will likely continue at about current levels for at least 5 years, as demand for U.S.-manufactured cigarettes has stabilized in major importing countries and movement of production offshore has stopped.

- Demand for U.S. leaf will continue to slide. Competition from foreign leaf in both domestic and foreign markets will dampen U.S. leaf use.

- Any major changes in the U.S. tobacco program will cause significant changes in these forecasts. For instance, elimination of the price support and marketing quota would cause U.S. leaf production to rise and prices to fall.