

# Analyzing the Role of Institutions in Attaining Welfare State: A Case of Tobacco Market

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**Abstract:** *This paper tries to analyze the role of law as one of the formal institutions suggested by our classical and institutional economists. Authors in this paper try to find out the efficiency of law in achieving welfare state through government intervention. Classical economists suggested price mechanism as the best way to achieve social goal, whereas, institutional economists suggest role of legally binding rules and laws to achieve social goal where price mechanism fails. This paper studies two cases and finds out that due to the difference in the bargaining power and loopholes in laws of less powerful and developing economies, the big players can find their ways to earn huge money at the cost of the health of the poor. Law within the political boundary is more effective in curing such issues than international law.*

**Keywords:** Market Failure, Negative Externality, Welfare State, Formal Institutions, Tobacco Market

## 1. Introduction

Classical economist Adam Smith in his book „Wealth of Nation“ explores the role of market and price mechanism in achieving efficient market. According to him the invisible hand plays a rightful role in settling down the correct prices and therefore the required output for the economy. Readers and scholars emphasize more on the initial chapters and advocated that his ideologies favour laissez-faire economy. If we carefully examine the „Wealth of Nations“ we find that that Smith also has focused on the significance of government intervention in the market for improving the wealth of the economy in his later part of the book.

In the first few chapters of the Wealth of Nation, Smith has mentioned the efficiency of the market-based mechanism and therefore appears to be the promoter of market economy through invisible hand. In the later part of the book Smith focuses on the need of the government to correct the issues of market failure. He also has realised the limitations of the „invisible hand“ in situations where market fails to achieve the efficient outcome. Adam Smith expected government to take significant role and control over goods and services like defence, regulate money, enforce contract for justice, and tariffs for retaliation etc [1].

Smith against his principle of laissez faire also demonstrated that in many respects natural order may work against the general welfare of the society instead of working towards the general welfare [2]. „Wealth of nations“ may not have demonstrated the existence of externalities in the market as market failure. But his idea about restricting individual activity and individual benefits, if these benefits act as a constraint to achieve the social benefit [3], clearly illustrates that to Smith individual natural liberty is secondary to the interest of the public.

Institutional economist like Ronald Coase also talks about efficient market solution with or without formal institutions. In his article „the problem of social cost“ (1960), he discusses private bargaining better than any law and government intervention to correct market failure. That way he was in line with Adam Smith’s principle of „invisible

hand“. Just like Smith wanted government to control situations where it’s necessary to safeguard the public interest from private interest in the same manner R. Coase also wanted government and law to minimize the transaction cost and promote private bargaining. He suggested in his article that if free market doesn’t help, society must seek solutions from the state to solve the problem of market failure [4].

## 2. Problem of Negative Externality and Transaction Cost

The market of tobacco and cigarettes generates negative externalities which cannot be solved with the private bargaining and price mechanism because of the high positive transactions costs. Therefore, to solve this problem and as per the suggestions of great economists, we have laws in place across the world to remove the external cost incurred by this market on the active and passive consumers of tobacco. The following paper analyses the role of the formal institutions in correcting the issues of externalities and the loopholes in the law which are very efficiently used by the big sellers of this product.

Before discussing further we must explain the economic concepts which are being used across the paper. To begin with we must refer to the above text which speaks about the Adam Smith’s principle of „invisible hand“. Smith in his book, „wealth of nations“ argues that although entrepreneur intends only his own gain but he is led by an invisible hand which benefits others also. According to him the self interest of the individual producer or consumer leads to the collective interest of the society. In words of Frank and Bernanke “the invisible hand is about all the good things that can happen because of the incentive principle.” [5] According to Boyes and Melvin on Smith, self-interest driven by invisible hand produces the greatest social good [6].

Market failure is a situation when price mechanism doesn’t achieve efficient solution. This happens due to many reasons like lack of competition in the market, presence of externalities and social cost. Externalities are the third party

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effect of any transaction between the first and second party, specifically sellers and buyers. Externalities can be positive and negative, when any transaction between the buyers and sellers accrues external benefits to the third party, market faces positive externality. On the other hand when exchange has some external cost to the third party, market faces negative externality. In the words of Boyes and Melvin externalities are “the cost or benefits of a transaction that are borne by someone not directly involved in the transaction.” [7]

Government may attempt to correct the market failure with legally binding institutions, also known as formal institutions. The most commonly cited definition of institutions is that advanced by Douglass North: institutions “are the rules of the game in a society, or more formally, are the humanly devised constraints that shape human interaction”. Institutions include both formal rules, which are explicit and are created by the polity, written rules such as laws and constitutions, and informal constraints such as conventions and norms [8]. The law is commonly considered to be one such formal institution, and for the purposes of this paper is considered to be the only formal institution under consideration.

A welfare state is a fairly old concept in modern democracies as it was included in the Constitution of India back in the 1950's [9]. The terms basically means that a welfare state is achieved when the government subsidises the basic needs of the people, like access to food and clean water and more importantly education and healthcare. (For example – Obama-care in the USA, the food security bill in India so on and so forth) It is understood that in most cases in order to achieve a welfare state a formal institution like the law is essential and therefore it is the primary subject of this paper to examine the role played by laws in the creation of the welfare state.

### **3. Discussion: Case of Tobacco and Cigarette Market**

Law enforcement agencies around the world spend much of their budget, time and resources in locating and arresting criminals who help promote the drug trade around the world. If a person is picked at random and is asked whether he possesses knowledge as to the background of a man named Pablo Escobar, one can be rest assured that nine times out of ten, the answer will be in the affirmative. This happens mainly because of the fact that several drugs that are available for human consumption, (a number of them albeit illegally) are perceived to be dangerous and this perception is true based on the fact that these drugs are highly addictive. If addiction is the primary criterion on which the sale and consumption of these drugs is banned or regulated then it is ironic how two of the most addictive drugs which also exhibit certain harmful effects when abused are fully legal in all the countries on planet earth. These two drugs are – Tobacco and Caffeine. Leaving aside the story of caffeine, this paper seeks to trace the tobacco industry and its dangerous evolution in modern times.

Tobacco is without a doubt one of the most addictive substances in the world. In addition to its addictive nature, it is clearly proven beyond doubt that is a leading cause for

many different cancers of the body, for example – cancer of the oral cavity, oesophagus, stomach and in rare cases even leukaemia [10]. The harmful effects of tobacco rival that of even the traditional „hard“ drugs like cocaine or heroin, minus the euphoric high's usually experienced with the latter, almost leading one to believe that the only reason as to the legal status of tobacco is the lack of euphoria produced upon consumption.

However, following the spread of awareness regarding tobacco and its ill-effects in the 60's and 70's the demand for cigarettes has substantially reduced. Yet, tobacco stocks remain amongst the most profitable in the world, showcasing a record increase in recent times [11].

This clearly shows, If one considers America to be an example and the demand for cigarettes in America is falling due to the increasing awareness regarding harmful effects of tobacco consumption, yet the stock prices of cigarette manufacturing companies in the country seem to be soaring and rank themselves amongst the best performing stocks in the country. The only logical explanation for the phenomenon happens to be the fact that, these companies are making a huge profit in their overseas operations and that reflects in the stock price moving up.

These overseas operations refer to countries in Africa and in Asia, where awareness is not at a similar level as is in the States, and these cigarette companies intend to keep it that way.

In specific, this paper will deal with protection of citizens of any nation from the ill effects of smoking, as it was established above that tobacco is one of the most harmful and addictive drugs that is surprisingly legal. It will also address the faintly amusing issue of how multinational corporations are using the very same formal institution, i.e. the law in order to prevent several governments of smaller, poorer and developing nations from educating their citizens about the ill – effects of smoking in an effort to curb the same.

The specific example amongst several multinational corporations dealing in tobacco taken into consideration is Philip Morris International, one of the largest cigarette manufacturers in the world. (As of 2015, they own 7 of the top 15 brands in the world) This company has a chequered past in taking on countries and trying to prevent them from passing anti-smoking legislation and surprisingly enough, many a time succeeding in their endeavours.

Philip Morris International is a corporation that controls almost 15.6% of the global cigarette market. Up until 2008, the company was a part of the parent corporation of Altria. However, in 2008 the two entities split, with Philip Morris International emerging as an independent spinoff, with the parent company arguing that the corporate move would allow Philip Morris International more freedom, from the so called oppressive policies of the United States, in order to focus mainly on emerging economies like those in Africa and Asia, whilst the Altria group focused mainly on the US market. This spin-off also explains the dramatic rise in stock

prices of the company, even as domestic demand for cigarettes continues to drop.

Smoking tobacco has become a worldwide menace in the 21<sup>st</sup> century, because recent research shows that not only first hand smoke is carcinogenic, but second and third hand smoke to an equal extent as well [12]. In addition to this, tobacco is the most addictive legally available and sold drug in the world and has killed over one hundred million people in the 20<sup>th</sup> century, and WHO reports show that it can kill over a billion people in the 21<sup>st</sup> century [13].

In this report, it is also estimated that smoking tobacco kills over five and half million people a year and if no action is taken that number could rise to eight million by the year 2030. The most disturbing observation in the WHO reports however, happens to be that at the current rate, by 2030 almost 80% of all tobacco related deaths will occur in the developing nations. This stands in consonance with the earlier statements pertaining to the fact that most of Philip Morris International's and other cigarette companies' revenues and profits that have enabled them to stay on top of the stock market, comes from developing nations, and also with the recent and disturbing developments such as international litigation by Philip Morris International against several different (mainly small and developing) countries.

At this point in time, a few of the instances of litigation that PMI has taken up against countries will be considered – Firstly, the case of Philip Morris International v. State of Uruguay can be considered [14]. The case began in 2010 when Philip Morris International filed an official claim for compensation before an international court of arbitration stating that the competitive value of the trademarks, investments and holdings in the country of Uruguay had been reduced by the policies of the government, and the above mentioned policies were violative of the bilateral treaty of trade and friendship that exists between Uruguay and Switzerland, [15] where PMI is headquartered.

It is especially dismaying to note that, a country like Uruguay that has received recognition and several mentions of praise from organizations like the WHO, for its path – breaking efforts to boost awareness regarding the ill effects of smoking tobacco, by increasing the size of the cancer warning on the cigarette packs and banning smoking in public places. This policy was initiated by the president of Uruguay, Tabaré Vázquez an oncologist by profession. Through this legislation, Uruguay became the first Latin American country to ban smoking in public places.

However, PMI alleged in its formal complaint against the small Latin American country before the International Centre for Settlement of Investment Disputes (ICSID) a subsidiary of the World Bank that this policy of banning smoking in public places proves detrimental to profits of the company which is in direct violation of the bilateral treaty of trade between Switzerland and Uruguay. In 2013, after consideration of all the documents submitted by the two parties the court decided that it has the jurisdiction to hear the case, and currently the proceedings of the case are underway.

At this point time, it must be noted that the litigation has been underway for three years in order decide whether the court has jurisdiction in the matter, and is likely to stretch on for many more years before a verdict can be delivered. For a small, relatively poor and developing economic like Uruguay; maintenance of the lawsuit and litigation expenses over the years proves harsh on the already taxed economy. In a way, that is the objective of Philip Morris International, to bleed the government dry such that they accede to its demands and at the same time create what can be termed as an „instrument of deterrence“ that has the potential to deter other small and developing countries from passing anti – smoking legislation.

What is interesting to note is the fact that, Philip Morris International has not restricted its law suits to just emerging economies, but has also surprisingly taken on developed nations as well, in order to prevent their anti – smoking legislations from being implemented. A landmark case and subsequent judgement in this matter is Philip Morris International v. The State of Norway [16], wherein, PMI challenged the validity of the tobacco visual ban that was imposed by Norway, on all tobacco products in 2010. This measure, PMI alleged would not prove useful in curbing the use of tobacco products, but would rather only serve to restrict competition and prove damaging to the profits of not just PMI but rather all cigarette companies and that would in turn be violative of the EEA agreement.

The case was first filed before an Oslo district court, which later on decided to seek an advisory opinion for the EFTA court regarding the validity of the ban imposed by the Norwegian state with the EEA agreement, that extends several pieces of EU legislation on non – EU members like Norway, and the EFTA court being competent to provide an advisory opinion regarding the interpretation of the EEA rules decided and ruled on the matter. The decision of the EFTA court in the matter of PMI v. State of Norway, is landmark in the sense that it lays down the groundwork for several other countries within the EU that have proposed anti-smoking legislation like the UK, Iceland and others to go ahead with their plans without being derailed by law suits from cigarette companies like PMI.

The court held in its decision that, the ban on the visual display of product names by Norway was carried out in pursuance to the principle of preserving public health which can be justified as a fair reason to create restrictions under Article 13, the article under contention which provides for a free distribution of good in Europe under the relevant agreements. The logic of the court in arriving at such a conclusion is of great interest. The court applied the „precautionary principle“, albeit in a very unorthodox fashion. The precautionary principle is usually applied when there is scientific doubt or uncertainty regarding the possibility of a particular hazard; however the court in this particular case applied the principle to the presence of an uncertainty regarding a policy used to combat or curb a public hazard.

The court was of the opinion, that hard, empirical proof that a particular policy (In this case, the visual ban on cigarettes by Norway) is effective in curbing a hazard such as smoking

is immaterial, as the principle of preserving public health is a primary responsibility of the state and must be discharged with the highest priority. It can be reasonably inferred that this opinion of the EFTA court will go a long way in creating an EU – wide ban on visual display on cigarette packs and preserve public health in the long run.

#### 4. Conclusion

The entire discussion again takes us back to the problem of market failure and presence of negative externalities. Smith, Coase, Keynes and many other economists suggested seeking help of the government and formal institutions to solve the issue of social cost when price mechanism doesn't correct the failure. It is disheartening to note that while developed nations might have the resources to take on cigarette companies like Philip Morris International, and emerge victorious. The same cannot be said for developing economies, considering how most of the cigarette manufacturing giant's revenue is generated in developing economies. The „instrument of deterrence“ in the hands of these companies only put the lives of countless citizens at stake. It is also ironic to note, how after consideration of all the facts presented, it is the law (the formal institution) that vests in legislators the authority to pass laws that might contribute positively towards spreading of awareness regarding the ill effects of smoking. It is also the very same law that allows cigarette companies like Philip Morris International to sue countries in international courts and prevent them from going ahead with trying to save their people. Lady Justice truly must be blind. This article poses a question to the academicians and social scientist to find out the solutions of this power game, while bridging the inequality gap of power and strength between the developed and the developing nations.

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