Business Scene | Louis Uchitelle

The Soaring Cost Of Cigarettes

WHEN the Labor Department releases its monthly reports on inflation, they often include this sort of sentence: "Tobacco products (mainly cigarettes) were among the items that rose most sharply in price." Fewer and fewer Americans smoke. And the danger to health is a huge disincentive. But in the last decade, no other single item in the Consumer Price Index has gone up as much as cigarettes.

Clearly the cigarette industry, despite the endless anti-smoking campaigns, is achieving price increases that many other industries can only dream of. Even health care did not keep up with the 154.3 percent rise in cigarette prices between 1980 and 1990, although the cost of hospital rooms and prescription drugs ran a very close second and third, respectively.

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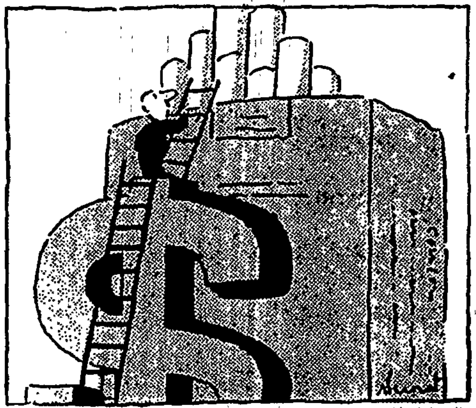
What has made cigarette prices go up so much? Rising Federal, state and local sales taxes have contributed smartly to cigarette inflation. But the biggest contribution has come from the nation's six major cigarette manufacturers, the Labor Department says. Their factory markups are passed along at the retail level, where cigarettes today average $1.67 a pack, up from 63 cents in 1980.

"Like clockwork, the industry raises prices twice a year, in the November-December period and in May-June," said Patrick Jackman, chief of the Consumer Price Division at the Labor Department's Bureau of Labor Statistics.

The impact of these uniform increases goes beyond the nation's smokers. Even in the recession, cigarette prices (and also the cost of chewing and pipe tobacco, cigars and snuff) rose 12.9 percent, at an annual rate, from January through June. That jump, when many other costs barely rose, gave cigarettes a disproportionate influence on the overall inflation rate. Of the 2.7 percent rate of increase in the Consumer Price Index in the first six



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months, cigarette inflation contributed two-tenths of a percent, Mr. Jackman said.

Cigarette manufacturers decline to discuss pricing. But interviews with industry analysts, trade association officials, economists and one representative of a manufacturing company (off the record) offer a lesson in the economics of cigarette pricing.

First, the cigarette industry concedes that consumption will continue to decline at the present rate of 2 percent a year or so, because cigarettes are so widely viewed as unhealthy. Lower prices simply cannot reverse this trend. "If you have a shrinking market and you want to make money, you have no choice but to raise prices," said Emanuel Goldman, a tobacco analyst at Paine Webber Inc.

Helping the industry achieve that goal are the smokers themselves. They accept price increases more than people who buy cereal or neckties. The smoking habit — many say addiction — is not easily given up, particularly when the price increases come in small doses: 5 or 6 cents a pack every few months.

There is some level at which sticker price shock does act as an incentive to quit smoking, "but we don't know what it is," said John C. Maxwell Jr., a tobacco analyst at Wheat First Securities. Probably it is well over $2 a pack and less than $4.50. The latter is roughly what cigarettes cost in Canada, where sharply higher sales taxes and a vociferous anti-smoking campaign have been accompanied by a steep drop in smoking.

The American cigarette industry, in fact, is sensitive to price resistance. Five years ago, the manufacturers offered only premium brand cigarettes, such as Marlboro (Philip Morris). These sold, and still sell, at a generally uniform price, which averages $1.75 a pack today. But two less expensive categories were introduced in the late 1980's: generics, such as Doral (R. J. Reynolds), and sub-generics, such as Montclair (American Brands). Each uses different quality tobacco.

As prices have risen, 20 percent of all smokers have dropped down to these lower-priced brands, testimony that even smokers run short of pocket money. But lately the manufacturers have been increasing the prices of the generics much more than those of the premiums. So the spread between the most and least costly categories of cigarettes is narrowing, to about 50 cents a pack.

The constant price increases are a huge source of profits for the manufacturers. Phillip Morris, for example, gets 64 percent of its operating income from cigarettes, more than twice the profit margin of its food and beer lines. The other companies — Reynolds, American Brands, Liggett, Brown & Williamson and Lorillard — report similar results.

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How long can this cash machine function? American cigarette manufacturers are enjoying strong export growth. They have cracked Japan and other overseas markets in recent years, and exports are expanding faster than domestic consumption is shrinking. So total production is rising, which facilitates price increases at home and helps to hold down the cost of producing each cigarette.

More important, in a world of smokers partial to American low-tar cigarettes, exports could rise for years. "Cigarette production in the United States does not have to drop in our lifetime," Mr. Maxwell declares. Unless the price gets to $4.50 a pack.

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