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Morgan: The evolution of a fraud

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I have come to believe that almost all tobacco tax compacts are hopelessly out of date and have evolved into a fraud and a tool for economic exploitation. What is worse is that most tribes and their lawyers are completely unaware of what is happening to them.

In the 1980s and early 1990s tribes all across the country ended long-running, tribal-state tax disputes by entering into various forms of tax compacts. Most of these compacts dealt with multiple tax issues, of which tobacco was just one of them. The general result of tobacco tax compacts was that the tribe and state shared the tobacco tax revenue in some form.

These compacts created a modest price advantage for cigarettes sold on the reservation and stabilized a key business for tribes. But something happened to upset this balance.

In the mid '90s, almost every state sued the major tobacco companies to get money ostensibly for health care costs related to tobacco use. In 1998, the states and tobacco companies settled their lawsuit by entering into the Master Settlement Agreement, a classic deal with the devil.

Under the MSA, the tobacco companies agreed to pay the states \$206 billion over a period of 25 years. In order to make the promised payments, tobacco companies raised the wholesale prices by approximately \$10 per carton.

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The major tobacco companies were also worried about losing market share, so the MSA required states to make tobacco manufacturers who weren't part of the MSA pay into an escrow fund, which is now about \$5 per carton.

By increasing the wholesale price of tobacco, the MSA in effect acted as a giant, hidden tobacco tax increase for states. Now there are three sources of revenue for states related to tobacco sales: the tobacco tax itself, the MSA payments, and the MSA escrow payments. Unfortunately, the pre-MSA tax compacts only anticipated one form of revenue – the tax. Tribes receive nothing from the highly lucrative MSA payments or escrow funds.

Most tax compacts also require that the tribe put some form of state tax stamp on the cigarette packs sold by the tribe. These state stamps are used to calculate the amount of payments due to the state under the MSA. So the state is using tribal sales to determine the payments due to them from the tobacco companies, but isn't sharing any of it with the tribes.

A side effect of the dramatic MSA price increase was that the embryonic tribal tobacco manufacturing industry exploded with growth. Tribal tobacco became significantly less expensive and a large number of customers started going to the reservation to buy their Native tobacco.

States have since become dependent upon these MSA and escrow payments. Some states even issued billion dollar-plus bonds based on projected MSA payments and now need to keep the money flowing. The MSA allows the tobacco companies to drop their payments to the state if the tobacco company's market share drops. So, now the states have direct financial incentives to protect the tobacco company's market share.

In order to protect the market share, nearly all the states adopted an identical law that requires tobacco companies to be on an “approved list” of manufacturers before that state tax stamp can be placed on the cigarette. Surprise, surprise. In order to be on the list, you had to be a part of the MSA or pay into the escrow fund.

This “approved list law” immediately resulted in most tribal manufactured tobacco becoming illegal in almost every state because tobacco products must have a state stamp. In order to get a state stamp, the product must be on the approved list. To get on the list, the manufacturer has to be a part of the MSA or pay into the escrow fund. Tribal manufacturers rarely participate in this system, so tribal products are now largely confined to just reservations in non-compact states.

States generally have no power to tell the tribes what they can or cannot sell on the reservation. But the states are now cleverly using the pre-MSA tax compacts as a method of enforcing the MSA by telling the tribes what tobacco products are legal on the reservation. The tax compacts’ stamp requirement was fairly benign when the compacts were entered into, but the “approved list law” has now morphed that stamp requirement into a tool for economic exploitation.

There is no way that tribes would have anticipated the tax compacts and their stamp requirement would be used to limit the tribe in such a way. Now states are in complete control of what can be sold and they are using that power to maximize their revenue and limit the tribes financially. This is the case for more than 50 tribes in Minnesota, Wisconsin, Arizona, North Dakota, Washington, Oregon and Montana.

This is not just an old compact problem. There is also a recent push by states to enter into new tobacco tax compacts. Even the notorious state of South Dakota has recently entered into a series of tobacco deals that give a percentage of the tax revenue to the tribes. But South Dakota most likely has ulterior motives. South Dakota issued a bond of \$278 million in 2003 and their projected MSA payments have been dropping over the last few years, so they need to protect and promote the MSA tobacco companies.

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A few days after a South Dakota tribe signed a recent tax compact, the state showed their hand and demanded that tribal tobacco products be removed from the tribal store because they are now illegal. So in one stroke, South Dakota got its extra MSA payments, made a competitor to its tobacco company “partners” illegal, and reduced the incentive for customers to come to the reservation to buy cigarettes. This tribe recently cancelled the tax agreement.

The tobacco compacts no longer make economic sense and have instead evolved into a tool for economic exploitation. Even worse, they are now used to dictate what a tribe can sell on its own land. I seriously doubt the states will share the MSA payments, especially since they are now so dependent on the money. I believe it is time to wake up to what is happening and to sell our own products under tribal taxes again. To be honest, I can’t believe I ever thought that outsourcing our tax system to the state was a good idea.

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