Schumpeter, product innovation and public policy: the case of cigarettes*

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Introduction

Perhaps the most fundamental proposition advanced by Joseph Schumpeter is that competition drives innovation and innovation drives progress. Strangely, although "competition" was a key ingredient to the processes of his capitalistic world, Schumpeter was not concerned about private monopolies and evidently had little stomach for the antitrust policy practiced over the past 50 years in the United States, or for the rather aggressive policy that is emerging currently in the European Common Market.[1] At the same time, a careful reading of his writings discloses that Schumpeter's benign view of monopolies and restraints of trade was limited to **product markets**; he expressed a definite concern about monopoly and restraints of trade in **R & D-innovation markets**. Schumpeter also displayed a very prophetic insight about R & D/innovation and public policy, observing: "... *Surely nothing can be more plain or even more trite common sense than the proposition that innovation ... is at the center of practically all the phenomena, difficulties, and problems of economic life in capitalist society*."[2]

As keen a vision as Schumpeter displayed about economic processes and public policy, he could not have imagined that his theories of innovation and "creative destruction" would become a centerpiece during the 1990s for the widespread antitrust prosecutions by several states against U.S. tobacco companies alleging a conspiracy in restraint of trade and other types of unlawful conduct, and for recovery

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[1] "... There is no general case for indiscriminate 'trust busting' or for the prosecution of everything that qualifies as a restraint of trade... Pure cases of long-run monopoly must be of the rarest occurrence..." Joseph A. Schumpeter, Capitalism, Socialism, and Democracy, 3rd edn. (Harper & Bros, New York, 1950; orig. pub. 1942).

[2] Joseph A. Schumpeter, Business Cycles: A theoretical, historical, and statistical analysis of the capitalist process (McGraw Hill, New York, 1939), p. 87.

of damages resulting from health-care costs incurred. In what ranks as the largest product liability case in U.S. history, in 1998, the tobacco companies entered into a multi-billion settlement with the states for Medicaid costs attributed to treatment of tobacco-related illnesses.[3]

The complaints contend that in 1953 the tobacco companies agreed not to compete with one another on R & D covering smoking and health effects, and not to develop "safer" cigarette products.[4] To support the constrained R & D contention, plaintiff economists testified that the conspiracy resulted in lower research and development expenditures by the tobacco companies; and that, absent the conspiracy, higher levels of R & D expenditures would have been made, resulting in a much "safer," or even a completely "safe" cigarette product.[5]

This paper addresses the major hypothesis underlying the antitrust complaint, namely that the new cigarette products introduced by the tobacco companies between 1955 and 1995 do not meet the Schumpeterian standard for innovation. First, we briefly review Schumpeter's concept of innovation and creative destruction. Second, we examine findings of earlier studies on non-price competition in the cigarette industry since the 1950s *vis a vis* the "constrained R & D" contention. Third, we present data on R & D activities of the tobacco companies, on cigarette products which lowered tar and nicotine levels, and on programs promoting the sale of new products. Fourth, we discuss the nature of R & D processes generally, and the tobacco companies' role in basic medical research on tobacco-related diseases. Fifth, we examine the plaintiff experts' delineation of the product and geographic markets relevant to the antitrust complaint.

1 The meaning of innovation and "creative destruction" in Schumpeter's world

In *Capitalism, Socialism and Democracy,* Schumpeter explained that the fuel which propels capitalism is the constant injection of new innovations in the form of new consumer goods, new production techniques, new modes of transportation, and

[3] An estimated $206 billion is projected to be distributed to 46 states by 2025, unless tobacco sales decline, in which case that figure will be reduced. The other four states – Florida, Minnesota, Mississippi and Texas – entered into separate settlements with the leading tobacco companies.

[4] Our analysis of the merits of the complaint is based upon an examination of the economic reports, depositions and trial testimony of the following experts: Jeffrey M. Harris and Keith Leffler on behalf of the State of Washington; Adam B. Jaffe on behalf of the State of Minnesota, and John L. Solow on behalf of the State of Iowa. Jeffrey E. Harris, one of several economists who testified on behalf of the plaintiff states in support of these allegations contended that there was "...a conspiracy to mutually avoid health claims about cigarettes, to avoid admissions about the risks of smoking, not to develop innovative products..."Harris deposition, p. 208, State of Washington v. American Tobacco Co., and "Health-Care Spending Attributable to Cigarette Smoking and To Cigarette Manufacturers' Anti-Competitive Conduct: State of Washington Medicaid Program, 1997–2001", Damage Expert's Disclosure in: State of Washington v. American Tobacco, Inc., et al., Jeffrey E. Harris, MD PhD, November 3, 1997. See State of Texas v. American Tobacco Co., et al.; State of Washington v. American Tobacco Co., et al., 96-2-15056; State of Connecticut v. Phillip Morris, Inc., et al., CV-96-0072414-S; and State of Minnesota and Blue Cross & Blue Shield of Minnesota v. Phillip Morris, Inc., et al., C1-94-8565; State SEA.

[5] See Harris, op. cit.