Tobacco Policy

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Introduction

The federal tobacco program was established under the Agricultural Adjustment Act (AAA) of 1938 as a means to raise and stabilize tobacco prices and income. Under the program, tobacco farmers agreed to restrict supply via marketing/acreage allotments (or quotas) in exchange for minimum price guarantees. If tobacco companies do not bid above predetermined price support levels, grower cooperatives purchase the surplus tobacco using Commodity Credit Corporation (CCC) funds. National marketing quotas are set each year for flue-cured and burley tobaccos based upon the domestic purchase intentions, leaf exports, and CCC loan stock levels. The marketing quotas for U.S. tobacco were initially divided among tobacco growers based on production history.

Over the years, available quota has been dispersed among heirs of tobacco farmers, non-producers who purchased farms with tobacco quota, and, of course, active tobacco farmers who inherited or purchased quota. The quota can be rented or sold under certain restrictions. Only individuals owning or renting quota can legally sell tobacco.

Since U.S. flue-cured and burley tobaccos have traditionally been differentiated from other tobaccos in the world market because of their higher quality, limiting the U.S. flue-cured and burley production results in higher prices than would occur in an unregulated market. A goal of the program is to restrict supplies at a level that causes market prices to be above preset price support levels. Price supports provide target prices to achieve in the setting of the national quotas and a safety net should the supply restrictions fail in achieving the target prices.

Price support levels are determined by a weighted average of changes in production costs and lagged market prices. The inclusion of production costs and the fact that downward movement in market prices is limited by the price support structure means that price supports are not very responsive when demand decreases. Consequently, the price stability brought about by the structure of the program often results in considerable production (i.e., quota) instability.

From the 1930s to1980, the program underwent relatively few modifications and was very successful in fulfilling the goals of the 1938 Act (providing price and income stability to a large number of small family farms without large government expenditures). However, since the early 1980s, political and economic pressures have induced several program changes, and have threatened the program's overall existence.

In 1982, the price support program was mandated to operate at no net cost to the federal government or taxpayers. Costs that arise when tobacco put under loan (tobacco taken in by the grower cooperatives) is later sold at a price lower than the loan principal plus interest are paid by an assessment on growers and buyers.[1]

In 1985, price supports were lowered and changes were made to make the quota level more responsive to current market conditions. In response to an escalating volume of imports, a domestic content law was passed in 1993, which required domestic tobacco companies to use at least 75 percent U.S. tobacco in domestically produced cigarettes. However, the law was found to be inconsistent with GATT and was later revised to a much less restrictive system using tariff rate quotas. Other tobacco program legislation over the past two decades has affected the sale and transfer of quota, and has prohibited federal expenditures on tobacco export promotion and research.

While the existence of the federal tobacco program remains uncertain, its continuation in recent years may arguably be attributable to the support of various health groups in maintaining relatively high tobacco prices and controlling production. Tobacco quota owners and growers vote every three years on whether they favor the continuation of the production control/price support program. Historically, over 90 percent of the quota owners and growers have expressed their support for the program in these referendums, which require a two-thirds vote for program continuation. However, increasing international competition, constraints on the transfer of quota, and significant changes in the marketing system towards direct contracting have caused some program participants to question the overall effectiveness of the current program. Consequently, farm leadership is currently evaluating various options to revise the program.

[1] While the program operates at no cost to taxpayers, there are some relatively low administrative costs associated with the program. In addition, as part of disaster relief legislation for agriculture, tobacco farmers received federal funds for 1999 and 2000 and a portion of existing outstanding CCC loans were forgiven on the poor quality 1999 crop.

Policy Issues and Options

The historical success of the U.S. tobacco program in garnering higher prices for U.S. tobacco than would have been obtained with unregulated tobacco production is critically dependent on the market power of U.S. tobacco in the world market. However, the U.S. market power has eroded over the years as a result of reductions in demand for U.S. tobacco resulting from: 1) declines in U.S. consumer demand due to health concerns surrounding smoking, higher cigarette excise taxes, and higher cigarette prices in response to the tobacco settlement and litigation costs, 2) shifting of U.S. cigarette exports to overseas manufacturing facilities, 3) substitution for both quality and quantity of tobacco in cigarettes as a result of technological changes in cigarette production such as filters and flavorings, and 4) substitution away from U.S. tobacco as a result of the development of cheaper tobaccos of improved quality in foreign countries.

As market power erodes, the national marketing quotas must be set at lower levels in order to maintain price. Decreasing market power makes maintenance of a tobacco program increasingly dependent on political intervention. As market power has eroded over the last 20 years, numerous options have been discussed. Since the tobacco program is permanent legislation, it is not subject to reauthorization in various farm bills. However, the farm bill does provide a vehicle to potentially alter the existing program. Several policy options for the current program situation are presented below.

- **Maintain the current tobacco program without changes in support prices.** Unmanufactured exports would likely continue their downward trend, with imports remaining at relatively high levels. Eventually, the quota could decline to a level that reflected mostly domestic purchases. Domestic purchases may recover from their current very low levels as manufacturers lower inventories to desired levels. For flue-cured tobacco, this could eventually imply a quota of between 400 and 500 million pounds and 350 to 400 million pounds for burley. Interruptions in foreign supplies, such as those caused by weather, unexpected change in exchange rates, or political unrest, could slow or interrupt the trend to lower quota levels. Furthermore, fine-tuning the quota formula components and distribution of price supports could minimize the long-term downward trends in quota. Quota return per pound (rental rates) will increase — resulting in total quota returns falling less than in the case of a price reduction. Grower earnings on management and fixed assets continue to decline.

- **Modest reductions in price supports while keeping the current tobacco program.** If historical relationships between price and quantity sold are still valid, quotas would be expected to rebound over three to five years after the price support reduction as exports increase and imports fall. U.S. flue-cured quota would likely be more responsive than burley quotas. Return per pound (rental rates) and total returns to quota would decline. Grower earnings on management and fixed assets would increase as the quota increased. Some degree of market power is still required for this option to have the desired effect of increasing quotas. Without significant price adjustments, market power would continue to erode with the likely results being additional program modification after a number of years.

- **Lower price support to close to the free market price of tobacco, with significant modification of the tobacco program**. Lowering price supports to below the price that U.S. tobacco would sell for with unregulated production would likely cause exports to rebound and domestic cigarette manufacturers to increase use of U.S. tobacco — even if U.S. tobacco has little remaining power in the world tobacco market. Price would decline to the free market price for tobacco, perhaps in the range of $1.10 to $1.30 per pound for U.S. flue-cured tobacco, and $1.25 to $1.50 per pound for U.S. burley. U.S. tobacco production and sales, especially flue-cured, would increase significantly, with little effect on total tobacco consumption. Maintaining price supports at some level below the expected market price would provide a safety net for farmers when world tobacco prices fall unexpectedly. This would be an important feature of this option, since world tobacco prices can be very volatile. Marketing loan payments equaling support price minus market price could be made to tobacco farmers during periods when the market price drops below support prices. Tobacco would be allowed to clear the market at world prices. No cooperative would be needed to purchase tobacco not bringing the support price.

  This option is similar to the loan deficiency payment feature of government programs for cotton, soybeans, and grains, and it is also similar to the European Union's program for tobacco farmers. Some level of production controls might be desirable under such an option. If the support price is set too high or production costs fall due to rapid technological change, then production and, consequently, farmer payments could become large. Production controls would prevent production from expanding more than is desirable by policy makers concerned about program costs, and by health advocates concerned about expanding U.S. tobacco production.

  Under such a program, the economic return to quota would be eliminated and the right to produce tobacco would only be held by active tobacco growers. Total grower earnings on management and fixed assets would increase as production increased. Depending on how much price declined and how production rights were allocated under this option, considerable structural change could occur at the farm level — including significant consolidation of farms and changes in location of production and rural economies.

- **Segment tobacco sales into export and domestic markets with different prices.** Theoretically, returns to quota owners could be maximized by enforcing a quota on domestic sales of tobacco to force a higher price in the less price sensitive market for U.S. consumption, and allowing greater sales and a lower price in the more price sensitive export market. The U.S. peanut program has operated in such a manner for over 20 years. The problems associated with such an option are that strict import controls on tobacco must be enforced to prevent lower priced export tobacco or products made from export tobacco from reentering the United States. Strict import controls are difficult to enforce and may be impossible to implement under the current rules of the World Trade Organization.

- **Elimination of the tobacco program.** Eliminating the tobacco program would result in substantial structural change in tobacco farming and in many rural economies. Tobacco prices would fall toward the world price, making U.S. tobacco more competitive. While tobacco production would increase, many smaller tobacco farmers, particularly those in geographical regions with the highest production costs, would exit tobacco farming. The end result would be fewer but larger tobacco farms producing more tobacco at lower and more volatile prices. Because of the growth in tobacco sales, cash farm sales from tobacco (more likely for flue-cured than burley) might grow, despite lower prices and lower net returns per acre. Kentucky, Tennessee, and Virginia would likely produce less tobacco, while North Carolina, South Carolina, and Georgia would likely produce more tobacco.

Compensation for changes in the tobacco program. There are many arguments for and against compensation to stake holders in the tobacco program if program changes are made. If the current program is maintained, grower earnings on management and fixed assets suffer. If price is reduced or the program is eliminated, then the value of quota is reduced or eliminated. Cigarette manufacturers and their customers are the beneficiaries of price reductions. If the value of quota disappears, some farm groups and legislators argue that since the tobacco is permanent legislation, quota owners should be compensated for all potential future lost income from quota where quota is assumed to generate income into perpetuity. Others argue that compensation should only be for a set time horizon of lost quota income, or that market values of quota should be used. Finally, some groups may argue that market prices paid for quota reflect the risk of program elimination and, consequently, no compensation for quota is warranted. Besides the level of potential compensation, many other policy questions arise under this option, including: where will the funds originate, how will the funds be distributed among the individual program participants, what will the time frame be, and will the program be modified or eliminated?

References and Suggested Readings

Brown, A. Blake. *Report to the Presidential Commission on Tobacco*. Agricultural and Resource Economics, North Carolina State University, December 1, 2000.

Snell, William B. and Daniel Green. *Policy Issues and Options Surrounding a Buyout of U.S. Tobacco Quotas*. Department of Agricultural Economics, University of Kentucky, December 2000.