Virginia's
Rural Economic Analysis Program

REAP Policy Paper No. 7

Potential Changes Facing Virginia Tobacco Producers

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> **The Food and Drug Administration - declaring cigarettes a drug - released research that constitutes one of the most blistering attacks the government has ever made against an industry.**
> ***Wall Street Journal*, August 11, 1995.**

Current Issues

Tobacco producers are confronted with a number of issues that could significantly impact the tobacco industry. (See also a REAP special report: *The Virginia Tobacco Industry In a World of Change*, November, 1994.) The issues can be divided into two categories: those relating to the Tobacco Program and those relating to the demand for tobacco.

In the first category are a number of issues that may force changes to the Tobacco Program:

- *further pressures to reduce any form of government support for tobacco;*
- *implementation of the provisions of the General Agreement on Tariffs and Trade; and*
- *lack of export competitiveness.*

Significant issues that could reduce the demand for tobacco are found in the second category:

- *health concerns and health-related legislation;*
- *potential increases in taxes on cigarettes; and*
- *stronger competition with foreign producers.*

While sources of change may be coming from different directions, some changes are inter-related. The federal government has a role in many of these potential changes, often relating to the long-standing government involvement in the Tobacco Program.

Tobacco Program Policy

More than sixty years ago, Federal legislation initiated the Tobacco Program, a name commonly applied to a group of tobacco-related government programs. Since that time the program has undergone numerous revisions, but the intent of the program has remained unchanged: farm-level price and supply stability. This aim is accomplished through a combination of supply control and price support programs. Table 1 contains a chronology of selected changes to the program since its inception. The emphasis in the 1990's has been on the increasingly competitive world market.

> **The Tobacco Program provides farm-level price supports and supply stability.**

Marketing Quotas as a Supply Control

The two predominant classes of tobacco, flue-cured and burley, are part of the program. Supply control for these classes of tobacco is accomplished through quotas, which limit the number of acres that a producer can plant and the number of pounds that the producer can market. In the early years of the program, these quotas were solely acreage allotments, but the emphasis shifted to poundage allotments in the 1960's, partly in an attempt to improve quality (Mann, p.59). Most quota rights accrued to tobacco producers at the time the program started in the 1930's, although some new rights have been awarded since the inception of the program.

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Table 1: **Selected Legislative Changes in the Tobacco Program**

YEAR	LEGISLATION	IMPACT
1933	Agricultural Adjustment Act of 1933	First attempt at supply control for tobacco
1938	Agricultural Adjustment Act of 1938	Basis for current program: introduces marketing quotas in 1940 after producer referendum
1949	Agricultural Act of 1949	Current authority for price supports, continues supports at 90% of parity
1962	Public Law 87-200	Allows flue-cured lease and transfer of quota
1965	Public Law 89-12	Adopts acreage-poundage marketing quotas for flue-cured
1971	Public Law 92-10	Changes burley marketing quotas from acreage to poundage, and authorizes lease and transfer of burley quota
1982	No-Net-Cost Tobacco Program Act of 1982/ Agriculture and Food Act of 1981	Begins assessments, and allows flue-cured quota sales separate from farms
1983	Dairy and Tobacco Adjustment Act of 1983	Abolishes flue-cured quota lease and transfer beginning in 1987
1985	Omnibus Budget Reconciliation Act of 1985/ Tobacco Program Improvement Act of 1985	Changes formulas for establishing market price and quota level for burley and flue-cured
1990	Omnibus Budget Reconciliation Act of 1990	Expansion of 1985 legislation, adds additional marketing assessment
1990	Farm Poundage Quota Revisions Act of 1990	Allows burley quota sales separate from the land as long as the sale is within the same county
1993	Omnibus Budget Reconciliation Act of 1993	Requires cigarettes manufactured in the U.S. to have at least 75% domestic content
1995	General Agreement on Tariffs and Trade	Imminent replacement of domestic content rule with tariffs on imported tobacco and gradual reduction in tariff levels

Quota Transfer Restrictions

An important component of the program, the means to transfer quota rights, has undergone a number of significant legislative changes throughout the history of the program. One constant in regard to quota rights transfer remains: quota rights must stay in the county of their origin. The only exception is the burley program in Tennessee which allows lease and transfer of quota across counties within the state. Legislation allowing lease and transfer of burley quota across county borders in Virginia was rejected by producers in a recent statewide referendum (December, 1991).

For Virginia tobacco producers, changes to the Tobacco Program quota transfer restrictions could create unique problems. The within-county transfer restrictions have prevented movement of participating tobacco classes to new areas of production since the inception of the program in the 1930's. What had been an on-going southeasterly shift of flue-cured tobacco production halted at that time. Some current production areas in Virginia may have higher production costs than other areas. If so, production in these locations could be jeopardized if quota transfer restrictions are lifted.

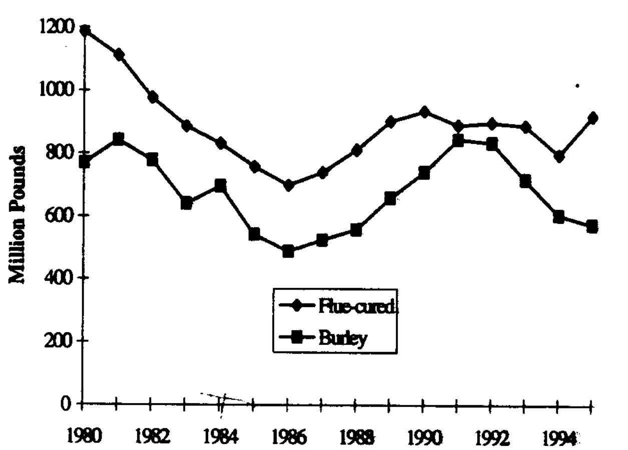
Under current legislation, quota rights must stay in the county of their origin. If quota restrictions are lifted, production in higher cost production areas in Virginia could be jeopardized.

How the Quota is Established

Annual marketing quotas for each participating class of tobacco are announced by the USDA. By law, the quotas are based on an estimate of the supply needed by manufacturers. A combination of intended purchases provided by cigarette manufacturers plus tobacco exports estimated from the prior three years' average exports, adjusted by quantities required to maintain reserve stocks at specified levels, generates the supply estimate. The Secretary of Agriculture can alter the estimate at his discretion. The resulting basic quota becomes an effective quota after adjusting for marketings under or over quota for the prior year. Producers are allowed the latter adjustment to accommodate a range of seasonable variability in production quantities.

The preliminary figures for the effective marketing quotas for 1995 are 922 million pounds for flue-cured and 576 million pounds for burley. Virginia's share is approximately 82 and 23 million pounds, respectively (Consolidated Farm Service Agency). Figure 1 provides a history of the effective national marketing quotas since 1980, with preliminary levels for 1995.

Figure 1. Effective Quotas Since 1980 for Burley and Flue-cured Tobacco



Mechanics of Price Supports

Growers of the participating classes of tobacco that adhere to the marketing quotas are eligible for price supports. Prices are established for various types and grades of tobacco before the production year. After harvest, tobacco is taken to tobacco warehouses where it is graded and then sold by auction. If cigarette manufacturers are not willing to bid an amount higher than the support price, the tobacco goes under loan. That is, producer-owned cooperatives "purchase" the tobacco at the support price, store it, and attempt to avoid losses by selling it at a higher price in the future. The USDA's Commodity Credit Corporation lends the purchasing funds needed at current U.S. Treasury borrowing costs (Grise, 1995, p. 12).

The support price calculation has changed over time. In 1995, the support price adjusts the 1994 price based upon the change in the 5-year moving average of prices and the change in the cost of production index. To establish the final support price, the Secretary of Agriculture can adopt from 65 to 100% of the formula-calculated change. In 1994, the Secretary opted for 65% of the calculated change in determining both the burley and flue-cured support prices.

For 1994, the average support price was $1.583 per pound for flue-cured and $1.714 per pound for burley. The 1995 support prices are slightly higher, at $1.597 and $1.725. Loan rates for the individual grades of tobacco (which are based on quality, color, leaf length, and leaf positioning on the stalk) are established so that their weighted average is equal to the base support prices.

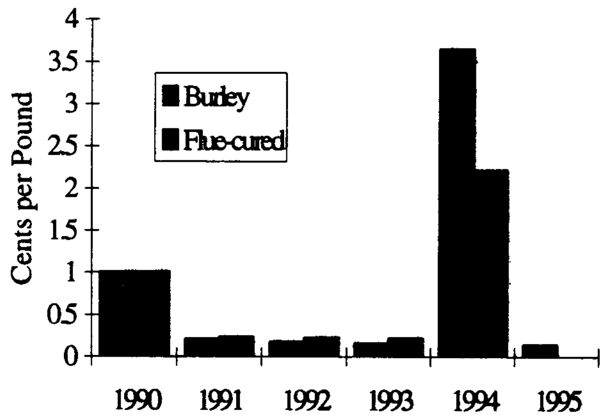
No-Net-Cost Assessments

In the 1980's, the government made changes to reduce its expenditures on the program. Previously, cooperative losses on sales during periods of falling prices were paid by the government. The No-Net-Cost Tobacco Program Act of 1982 requires producers to pay for the losses through per-pound assessments which are paid into a fund established for this purpose. Any profits from cooperative sales are also placed in the fund. Subsequent legislation requires purchasers of tobacco to pay an assessment into this fund, including assessments on purchases of imported tobacco. The amount of the assessment varies with the quantity of tobacco under loan and with estimates of funds required to cover carrying costs and losses.

In addition to the no-net-cost assessment, a marketing assessment of 1% of the support price was levied, starting in 1991. This assessment is divided equally between the producers and purchasers of tobacco.

Instability in the no-net-cost assessment has plagued tobacco producers (see Figure 2). In 1994, this assessment was 3.643 cents per pound for burley and 2.2085 cents per pound for flue-cured, their highest levels since 1984. Increasing levels of loan stocks contributed to the need for a higher no-net-cost assessment in 1994. The assessment fell substantially in 1995 to 0.1375 and 0.0015 cents per pound for burley and flue-cured, respectively.

Figure 2. Producer No-Net-Cost Assessments in the 1990's, Marketing Assessments Excluded



Note: 1995 flue-cured assessment is $.0015

Remaining Government Expenditures

Changes made to the Tobacco Program in the 1980's were partly in response to criticisms by various health groups of Federal government financial support of the tobacco industry. Currently, the no-net-cost and marketing assessments cover most of the costs of the program, leaving the government with administrative costs of $15-$18 million per year (Grise, 1995, p.12). In 1993, total government expenditures for program administrative costs plus research and other efforts were approximately $46 million (U.S. Department of Agriculture, June, 1994). Criticism of such government expenditures continues.

Renewed Stability in 1995

Current questions about the Tobacco Program center on the establishment of the quota and price support levels. The 1994 burley and flue-cured quota levels were the lowest since 1988. Many tobacco growers feared this trend would continue in 1995. However, an agreement reached at the end of 1994 between the manufacturers and producer cooperatives, with assistance from members of Congress, brings some improvement in quota levels and program stability. The 1995 effective quota level for flue-cured actually exceeds the 1994 level. The effective quota for burley declined slightly, because the basic quota increase did not cover the prior year's over-marketings.

Because manufacturers agreed to purchase the 1990-1993 loan stocks over the next seven years, no-net-cost assessments dropped substantially for both burley and flue-cured tobacco in 1995. Terms of the buy-out agreement allow the purchase of the tobacco at a discount, with the discounts covered by no-net-cost funds. An important part of this agreement is the announced purchase intentions of the manufacturers for the next six years. Manufacturers are encouraged to purchase at least 90% of these intentions (adjusted annually for some agreed upon factors), because they will then be eligible for additional discounts on the purchase of the loan stocks. In the absence of large shocks to the tobacco market, this agreement should bring stability to the quota level for the near future, provided the federal program remains unchanged.

1995 Farm Bill

Ongoing debates in Congress will lead to farm bill legislation that replaces the expiring Food, Agriculture, Conservation, and Trade Act of 1990. (See also *Are You Ready for the 1995 Farm Bill*, REAP Horizons, Vol. 6, No. 4, July/August 1994.) Although the Tobacco Program exists under continuing legislation from 1938 and 1949, program changes or amendments could be debated as a part of the larger farm bill legislative process. At the time of publication of this policy paper, Congress had just returned from recess. They are expected to take up debate on the proposed "Freedom to Farm Act of 1995" that could shape the new farm bill. It is difficult to speculate on the fate of this proposal, and it may not reflect the final farm bill legislation that goes into law. To date, it has centered on commodities other than tobacco, although the Tobacco Program could enter into future debate. Changes for the Tobacco Program in current or future legislation may be influenced by a number of demand factors.

In the absence of large shocks to tobacco demand or substantial changes to the federal Tobacco Program, the manufacturers' agreement to purchase 1990-1993 loan stocks should bring stability to the quota level in the near future.

Demand Factors Influencing the Tobacco Program

Programs and policies for tobacco will increasingly be forced to consider a volatile demand for tobacco and tobacco products. Price support policies will inevitably be in conflict with the marketplace if demand for tobacco declines significantly.

If demand for tobacco declines significantly, price support policies will inevitably be in conflict with the marketplace.

Health-Related Matters and Tobacco Demand

Linkage of cigarette smoking to health concerns has been a public issue for quite some time, the initial impetus being a Surgeon General's report in 1964. Such concerns have encouraged many smokers to quit or to reduce their consumption, while encouraging other potential smokers not to start. Domestic consumption of tobacco has experienced a long-term decline. Cigarettes, the most significant use of tobacco, lead the decline in consumption. In 1994, consumption remained unchanged, mostly due to lower retail cigarette prices. However, current attitudes toward smoking, plus enacted and pending legislation restricting smoking, are likely to restore the decline in demand in 1995 (U.S. Department of Agriculture, April, 1995).

Both attitudes and legislation are making it more difficult to smoke freely everywhere, partly due to worries about second-hand smoke. Smoking regulations for the workplace are being considered by the U.S. Department of Labor. Regulations would require employers to either provide separate adequately ventilated smoking areas or prohibit smoking. Many state and local governments have enacted or are considering smoking restriction legislation, while others are expanding existing regulations.

There are reports alleging that nicotine levels ingested while smoking some cigarettes can lead to addiction to nicotine and cigarettes. The previous Congress held highly visible committee hearings in the House of Representatives that included testimony by executives of the largest companies in the tobacco industry. These executives testified that they were unaware of any attempts by their companies to manipulate the nicotine content of cigarettes. This contentious issue has surfaced in numerous lawsuits, and has recently resurfaced in Congress with new disclosures about alleged industry knowledge of the nicotine issue. Congress has also held public hearings with the Commissioner of the Food and Drug Administration (FDA) in regard to regulating nicotine as an addictive drug and, thus, regulating cigarettes containing nicotine.

Very recently, the FDA declared nicotine a drug. By doing so, the FDA can propose regulations on tobacco products, such as cigarettes, now considered "drug-delivery devices" (Lambert, p. B6). The President instructed the FDA to propose regulations that are intended to curtail smoking by minors. Accordingly, numerous advertising and distribution regulations have been proposed.

These regulations will not take immediate effect. It is likely that Congress will deliberate on these regulations and perhaps propose alternative legislation. In the meantime, the tobacco industry is taking action, including lawsuits against the proposed regulations. Nevertheless, many industry observers believe that the FDA actions could have an impact on the tobacco industry beyond the proposed regulations. In addition to opening up the possibility of stronger regulations in the future, it is possible that the intensity of legal actions against the tobacco industry will increase. New and pending legal suits against manufacturers of tobacco products could have profound effects on the industry.

Tax Matters and Demand

With a four cent per pack increase on January 1, 1993, the U.S. Federal cigarette excise tax currently stands at 24 cents per pack of 20. The excise tax of 8 cents per pack in 1951 after adjusting for inflation would have been 42 cents per pack in 1993 (Grossman, p. 212). Some parties use this 42-cent estimate to support a higher excise tax.

During 1994, a number of legislative proposals for significant increases in the tax rate were proposed. These proposed tax increases would provide part of the funding required for proposed federal health care plans. Excise taxes above $2.00 per pack were discussed, but as the various plans developed, the tax tended to range from 45 cents to $1.00, often with phase-in periods of several years. According to one estimate, an optimal revenue raising excise tax would be $1.26 per pack (Grossman, p. 214). Total revenue from an excise tax would decline at rates above $1.26 due to larger offsetting declines in consumption. The new Congress has not eliminated consideration of higher tobacco excise taxes to pay for new health care legislation, although this may not be deliberated until next year (U.S. Department of Agriculture, June, 1995).

Aggressive taxes on cigarettes are not only in the realm of the Federal government. For example, the State of Michigan raised their tax on cigarettes from 25 to 75 cents per pack in 1994. On July 1, the state of Washington raised their tax by 25 cents to 81.5 cents per pack (U.S. Department of Agriculture, June, 1995). While Washington now has the highest state tax on cigarettes, Virginia has the lowest at 2.5 cents per pack. According to the U.S. Department of Agriculture, the weighted average of state taxes on cigarettes was 31.3 cents per pack in July, 1994 (December, 1994).

A substantial increase in the excise tax will reduce cigarette consumption. However, estimates of the response to an increase in price vary. Demand for cigarettes is less price sensitive (more inelastic) than many other commodities, but large price increases could reach thresholds of greater price sensitivity. Excise tax increases in the ranges discussed are larger than any previous increases, making estimation difficult. One forecast prepared for Congress states that a 75-cent increase in the tax will cause cigarette consumption to fall by over 15 percent (Womach, p. 4). Other industry observers predict that excise tax increases currently being discussed could reduce domestic consumption by one-third (Grise 1993, p. 2).

General Agreement on Tariffs and Trade

Congress ratified the Uruguay Round agreement of the General Agreement on Tariffs and Trade (GATT) in December of 1994. Conforming with the general principles of GATT will lead to changes in tobacco market competition. In general, GATT works to encourage world trade. Reducing protection of domestic markets from imports provides one means to do this. Usually the process converts non-tariff import barriers into tariffs, with subsequent reduction of these tariffs over time. (See also *GATT and Agriculture: Gains and Promise!*, REAP Policy Paper No. 5.)

For U.S. tobacco producers, equitable GATT implementation should impact both exports and imports. It will help encourage exports of tobacco as barriers in other countries are lowered. Imports will be impacted because the U.S. will probably not be allowed to continue the domestic content restriction, which prevents domestically produced cigarettes from containing more than 25% imported tobaccos. The cigarette content regulations will be converted into equivalent tariffs. A Presidential proclamation of a Tariff Rate Quota will culminate this process. At the time of publication of this report, negotiation of tariff rate equivalents was complete, but the Presidential proclamation has not been publicly announced (U.S. International Trade Commission).

Kirk Wayne, President of Tobacco Associates, expresses one reflection of industry concern about the current quota rate negotiations. He is concerned that the import quota levels will be too low to "...truly protect the U.S. tobacco price support program..." (Wayne, p.3).

The fact that these tariffs will be reduced over time should cause the tobacco industry further concern. Given continued reduction of tariff levels over time, it becomes likely that the present U.S. support prices will be jeopardized. Without a decrease in the support price, lower-priced imports will cause more domestic production to go under loan. In such a scenario, the no-net-cost assessments supporting the loan prices will become prohibitive. Eventually, the price support arm of the Tobacco Program will have to undergo significant revision or face erosion of price support levels from increased world trade competitiveness under GATT.

Export Situation and Prices

GATT may provide the additional impetus needed for changes to the formula for determining the Tobacco Program support prices. Some analysts argue that the support prices are once again too high, thereby discouraging exports. The program has undergone changes in the past in answer to similar charges. For example, the significant formula change in the 1980's was partly in response to competitiveness issues. Given the current formula for determining quota production levels, producers seeking to maintain or increase quota levels look to increased exports in the face of declining domestic consumption. The current support price levels are an issue when increases in exports are needed to maintain production levels.

While an increasing share of tobacco production goes to exports, the U.S.'s total share of the world export market is declining. Despite this decline in share of exports, higher foreign incomes and an increased preference for blends containing higher quality U.S. tobacco have helped to offset losses to U.S. tobacco producers. The calculation of the 1994 flue-cured quota illustrates the importance of exports to U.S. production: the export contribution was greater than domestic purchase intentions. Although 1994 had an unusually low level of domestic purchase intentions, export significance cannot be downplayed.

Conclusion

Tobacco producers faced extremely negative external pressures in 1994, only to find mostly improved conditions for 1995. This outcome is largely the result of an agreement with manufacturers that increases domestic buying intentions and provides terms for the buyout of excess loan stocks. The increase in domestic buying intentions should be viewed as a one-time occurrence, rather than an increase that will be sustained. Quotas are expected to be fairly stable or declining over the next few years.

The entire tobacco industry was relieved that the federal excise tax for cigarettes did not increase in 1994 as feared; however, that possibility remains for the future. Given the many other issues facing the industry, changes to the Tobacco Program are highly likely. Tobacco producers have heard pessimistic warnings in the past, without the forecasted consequences coming true. The number of potential issues that are present at this time raises the stakes. Current trends increase the likelihood that, over time, one or more of these issues will come to bear.

Given the many other issues facing the industry, changes to the Tobacco Program are highly likely.

Who May be Impacted

Not all changes will impact everyone equally. Many of the possible sources of change would impact both manufacturers and producers negatively. Health concerns and their related restrictions, excise tax increases, and stronger foreign competition each impact the entire industry negatively by reducing demand and prices. Any of these reductions in demand, lower tariffs over time with GATT, or pressures to reduce government support for tobacco increase the chance that the Tobacco Program will be changed. Changes to the Tobacco Program may impact producers differently than manufacturers. In the extreme case, absence of the program could hurt some producers by lowering tobacco prices still further.

Regions can also be impacted differently. For example, tobacco production could shift to other areas, changing the regional economies. This can only happen with a change to the Tobacco Program. Although the Tobacco Program does not need to be authorized in the new farm bill, it is possible that empowering legislation can be discussed and changed in conjunction with the farm bill deliberations. Alternatively, new legislation changing the program could be enacted separately.

Many changes to the Tobacco Program have been advocated. Increasing the price competitiveness of tobacco in the world market suggests changes in the price support program. Some industry experts are advocating different forms of a two-tiered price system (Tarczy, p. 4). Changes to the support price determination may create a need for an accompanying change to the marketing quota formula.

There has also been discussion of elimination of the program altogether. Concerns about the regional impact of such a change have encouraged a number of suggestions for reducing the impact. One suggestion is a buy-out of the quota program (Womach, p. 10). While this compensates quota owners, it does not compensate the locality for the changes that could occur.

Sumner and Alston (1985) estimated that, in the absence of any Tobacco Program, the price level of tobacco would fall by approximately 25% (p. 19). Such a price decline could lead to a 50% increase in tobacco sales (p. 27), lead by a doubling of exports (p. 26). Under this scenario, tobacco sales revenues would increase, but that does not necessarily translate into higher profits for producers. Thus, individual producers may not be better off.

Future Considerations

It is unlikely that the Tobacco Program will be eliminated unless large shocks to the industry, such as substantial federal excise tax increases, create the need. In the near term, continual moderate changes to the program similar to those faced by the industry in the 1980's and 1990's are likely. Changes to the program and a decline in the general conditions for the tobacco industry could negatively impact tobacco-producing regions in the Commonwealth. A future report will look at the impact of a potential decline in tobacco production on local communities, with emphasis on the general agribusiness sector, as well as on producers.

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