

U.S. TOBACCO GROWER ISSUES

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U.S. tobacco growers continue to face a multitude and constantly growing number of challenging economic, political, social, and legal issues, causing much concern about their future and the economic outlook for their rural communities. Currently, U.S. tobacco growers are facing declining exports, increasing imports, lower cigarette production, excessive pool stocks, escalating lease prices, soaring cigarette taxes, expanding health concerns, smoking restrictions and regulations, a growing number of legal issues, a rapidly changing marketing system and much uncertainty over the future of the current tobacco program. Collectively these factors have resulted in a significant decline in demand, marketing quotas, and income in recent years. Consequently, farmers, agricultural leaders, and policy makers in tobacco states are seeking a buyout which would enable non-producing quota owners an opportunity to exit the industry, while simultaneously modifying the current tobacco policy to improve the competitiveness of U.S. leaf for those tobacco farmers who decide to continue production during a post-tobacco buyout period.

Economic Factors Affecting U.S. Tobacco Growers

The value of U.S. tobacco production averaged \$2.8 billion during the 1990s. The estimate value declined to around \$1.6 billion in 2002, and will fall even more in 2003. The recent decline in U.S. tobacco income can be attributed to a variety of factors. Historically, U.S. tobacco has garnered a significant price premium in the world market for its quality, however increasing international tobacco production, coupled with improved foreign quality, have over time narrowed the premium tobacco manufacturers are willing to pay for U.S. leaf. Furthermore, the price differential between U.S. and foreign tobaccos has generally widened in recent years, causing further erosion in the U.S. market share of world tobacco production and trade. U.S. burley producers' share of the world burley market has slipped below 20 percent in recent years (compared to over 60% in 1970), while U.S. flue-cured has fallen to less than 10% of the world flue-cured market (compared to 30% in 1970). Brazil, Zimbabwe, Malawi, and Argentina have all increased their market share of the world tobacco market relative to the United States.

In addition to losses in the world leaf market, the domestic market situation for U.S. producers has also deteriorated significantly in recent years. U.S. cigarette production has declined by more than 20% since its peak in 1996. Tobacco settlement-induced price increases for domestic cigarettes, along with higher excise taxes, and wholesale price increases have caused a noticeable drop in domestic cigarette consumption, down 13% since 1996. However, the major factor driving down U.S. cigarette output has been a significant decline in U.S. cigarette exports – down around 50% since 1996. In addition, U.S. cigarette imports, along with sales of deep discount domestically produced cigarettes, have been escalating in recent years, both of which likely contain little if any U.S. tobacco. Furthermore, cigarette tax increases were boosted in more than 20 U.S. states in 2002, which will likely result in further reductions in U.S. cigarette consumption. Consequently, all of these factors are prompting U.S. cigarette manufactures to increase their share of imported leaf to protect profit margins. Collectively these factors have resulted in U.S. burley demand falling from traditional levels in the neighborhood of 600 million pounds to around 325 to 375 million pounds annually, with U.S. flue-cured demand declining from over 900 million pounds to around 525-575 million pounds in recent years. In response to dwindling demand, tobacco marketing

quotas for both U.S. flue-cured and burley growers have been slashed by more than 50% over the past 6 years.

The decline in tobacco income has been cushioned in recent years by additional monies made available by the National Tobacco Growers Settlement Trust fund (Phase II) and by some emergency “disaster” funds made available by the U.S. Congress (T-LAP).¹ Nevertheless income generated from the production of tobacco in the United States has been reduced considerably in recent years, with a very depressed outlook for the future. Consequently, farm leaders, health officials, and policy makers in tobacco states have been working together to develop political and economic strategies to strengthen tobacco dependent economies.

U.S. Tobacco Policy Reform

The U.S. tobacco program has been a model program over the past 60 years by providing price and income support to a large number of small family farms without a significant amount of government funding. Although challenged at times in the political arena as well as by some growers, U.S. burley and flue-cured tobacco farmers have responded to the program with a more than 90% approval rating over the years. But today U.S. tobacco farmers certainly realize that the current program is clearly not working due to a variety of factors including reduced price competitiveness, declining quotas, escalating quota rental rates, and quota transfer restrictions. Consequently, much debate currently exists on whether to modify or eliminate the program. One tobacco policy option that appears to be universally accepted by quota owners and growers is a buyout of tobacco quotas, with future production decisions being made solely by active growers. Under the current U.S. tobacco program, marketing quota resides in the hands of many non-active growers who simply lease or rent these production rights to active growers. Quota reductions, along with Phase II and T-LAP funds in recent years have resulted in an escalation of quota lease rates. For example, the average quota lease rate in Kentucky has increased from around 25 cents/lb in 1997 to more than 60 cents/lb in 2002. In some cases, quota has leased for 75 cents/lb or even higher in recent years. Obviously, many Kentucky/U.S. tobacco growers feel they can no longer be competitive in the world marketplace when they have to pay over 1/3 of the U.S. market price for tobacco just for the “right” to produce. Consequently, support for a quota buyout is the major focus among growers, farm organizations, and policy makers in tobacco-producing states.

The buyout debate is not a new policy issue. This discussion originally evolved as part of U.S. Senator John McCain’s national tobacco settlement debate in 1998. At that time, support for a buyout was mixed among tobacco farmers in response to relatively high marketing quota levels, relatively low quota lease prices, and concerns over the future effects on growers and rural communities if a buyout constituted termination of the federal tobacco program. Various tobacco quota buyout bills surfaced during that debate, however the buyout was not accomplished as efforts to pass a national tobacco settlement died in the U.S. Congress. Since that period, the political, economic, and marketing environment for tobacco has changed dramatically. Quotas have declined by more than 50%, quota lease prices have soared to record levels, contracting has been introduced and now dominates the marketing of U.S. tobacco, the overall outlook for future growth in the U.S. tobacco leaf sector is not promising, and an aging tobacco farm population in general has less concern today regarding the future structure or existence of a post-tobacco buyout tobacco program. Consequently, farm leaders and policy makers recognize that significant changes must be adopted to provide compensation for those who want to exit the industry, while simultaneously creating a more favorable economic environment for those who elect to remain.

¹ U.S. tobacco companies committed \$5.15 billion over a twelve year period (1999-2010) to compensate tobacco quota owners, growers, and tenants for lost income caused by the national tobacco settlement. In addition, U.S. tobacco farmers received over \$800 million in Tobacco Loss Assistance Payments (T-LAP) for the 1999-2002 crop years as part of emergency U.S. Congressional agricultural appropriations made available for most major U.S. farm commodities.

Tobacco Quota Buyout Issues

Despite widespread support among tobacco farmers, accomplishing a buyout is a very challenging political issue. Politically for a buyout to occur, there must be some degree of unity among tobacco farm organizations, tobacco companies, and health groups over issues such as how to structure a buyout, the funding mechanism, the future U.S. tobacco policy, and future regulation of the tobacco industry. While all parties in general support the concept of a buyout, currently there exists division within the tobacco family on specific components of a potential quota buyout. Even with some ultimate degree of consensus among the tobacco family on these issues, there will certainly be a lot of risks present as the political process unfolds. For a buyout to occur it must be passed in the U.S. Congress – a body with a large and growing number of anti-tobacco members (many of which are still upset over their colleagues providing taxpayer dollars for the recent tobacco disaster (T-LAP) payments and loan forgiveness on the 1999 crop) and one that is currently facing a lot of more pressing issues such as the current budget deficit, a sluggish U.S. economy, homeland security, and the war of terrorism. Furthermore, buyout support from even some congressional members from traditional farm states outside the tobacco belt is questionable given the criticism they received over spending associated with the 2002 U.S. farm bill and the magnitude of the tobacco buyout costs relative to the benefits their farmers receive from government farm programs. Collectively, these factors present major obstacles in passing a massive quota buyout bill totalling \$15 to \$20 billion --the estimated cost of several current proposals. Although it should be pointed that the U.S. Congress did set a precedent of the federal government intervening to buyout quotas of U.S. peanut farmers as part of the 2002 farm bill.

In response to the growing support for a tobacco quota buyout, nine buyout bills were introduced last year in the U.S. Congress. These bills contained some similarities, (\$8/lb for quota owners, \$4/lb for growers, 5 year compensation period), but differed in the base years for the buyout, the post-tobacco buyout program, funding mechanisms, and regulatory actions. A review of these bills, along with a discussion of issues surrounding a buyout can be assessed online by clicking on “Policy” at: <http://www.uky.edu/Agriculture/TobaccoEcon/>. Other excellent sources of information can be assessed at: <http://agpolicy.org/tobissue.html> and http://www2.ncsu.edu:8010/unity/lockers/users/a/abbrown/tobacco_econ/Buyout.html.

While a tobacco quota buyout bill was not passed in 2002, several key tobacco state lawmakers have already declared that the buyout will be major focus of their agricultural initiatives in 2003. Several of these quota buyout bills have already been reintroduced in the 108th U.S. Congress. While a lot of debate still exists in the farming community on the appropriate tobacco policy reform package to support, given current and future demand expectations under the current program, along with all the adverse effects (from the grower perspective) that Phase II funds, disaster dollars, and buyout speculation are having on quota sale and quota lease prices, the consequences of doing nothing are pretty severe. Changes are desperately needed or U.S. tobacco farmers will continue to see declining tobacco quotas and income, escalating rental rates and possible future elimination of the program with limited or no compensation – consequences that are simply not acceptable in today’s U.S. tobacco grower community. Thus, U.S. tobacco farmers will continue to put pressure on their policy makers and farm group leaders to pursue some sort of a buyout coupled with major modifications to the current program. Politically the environment for successful completion of a buyout has improved. In addition to support among the health groups, key tobacco-state lawmakers are currently in leadership positions in the U.S. Congress. The Senate majority leader, Senator Frist (TN) and the majority whip, Senator McConnell (KY) are from major burley tobacco-producing states. In addition, the chair of the House Agricultural Committee, Congressman Goodlatte, is from the tobacco state of Virginia, while the chair of the House Ag Subcommittee on Specialty Crops (which has jurisdiction over the tobacco program in

the House), Congressman Jenkins, is from Tennessee. And the current senior senator from North Carolina, John Edwards is running for President, while North Carolina's new senator, Elizabeth Dole, has recently been announced as the chairwoman of the Senate Subcommittee on Production and Price Competitiveness (which will have jurisdiction over tobacco and other ag price support programs in the Senate).

Currently, tobacco state lawmakers in U.S. Congress are meeting with tobacco companies/health groups and colleagues to assess the buyout parameters and political environment for achieving a buyout. Following this review they will likely reconvene with the various farm groups to inform them of what may be politically attainable. It is at this point that some difficult decisions and compromises will likely have to be made regarding compensation levels, base years, funding mechanisms, and regulation in order to move the process forward.

Potential Impacts of a Tobacco Quota Buyout

Undoubtedly current buyout proposals, if passed, would inject a significant amount of funds into tobacco farm economies. Most of the present tobacco buyout bills would generate well over one billion dollars annually for North Carolina and Kentucky tobacco quota owners and growers during the next five years, with significant funds being allocated to other tobacco states as well. But of concern to many farm leaders is what happens to those growers who elect to remain in the industry beyond the five year post-buyout period. If a buyout occurs, the ultimate impact on future U.S. tobacco production and prices depends greatly on whether a production control/price support program is maintained. Politically, it is questioned whether U.S. tobacco farmers can have a "buyout" and keep a program after a buyout. Program proponents argue that they are simply advocating buying out the equity in the quota and transferring those production rights to active growers. In addition, program supporters are quick to point out that U.S. peanut farmers still maintain price/income safety net provisions following their quota buyout evolving from the 2002 U.S. farm bill.

If the price support/production control program is eliminated as part of a buyout, some U.S. tobacco farmers will likely be able to survive and possibly do very well competing in the world tobacco market. By consolidating production, eliminating lease prices, and reaping the benefits of economies of scale, U.S. tobacco production costs would be significantly lower for some growers, which would induce geographical shifts in production to the most economical efficient areas. U.S. tobacco prices would still maintain a quality premium, but prices would fall closer to world tobacco prices and exhibit more volatility (i.e., be more responsive to changing world market conditions). Lower U.S. prices, coupled with anticipated increased U.S. tobacco production would have an adverse effect on foreign tobacco prices which would tend to offset some of the improved price competitiveness of U.S. leaf. Nevertheless, U.S. leaf exports would likely rebound, imports would fall, and more tobacco dollars could possibly be generated in Kentucky and North Carolina. But these tobacco dollars would be concentrated in a lot fewer farm families, and in a lot fewer rural communities, and could even move outside of traditional growing areas.

Consequently, most current U.S. buyout proposals contain provisions to provide some degree of production controls and minimum price guarantees. However, if the U.S. tobacco policy goal is to maintain a production control/price support program, then major modifications to the current program must occur if the United States is to improve its competitive position in the world market. Transferring production rights to active growers and eliminating the leasing of these production rights are being supported by program advocates as a means to minimize the future value of the production asset. Significant adjustments in the price support level will have to be adopted to improve the future

competitiveness of U.S. tobacco in domestic and international markets. Most buyout proposals that maintain a program specify a safety net price near the cost of production (currently around \$1.30/lb). A significant downward adjustment in the U.S. tobacco price support structure would result in tobacco production not being profitable in some areas that are currently producing the crop. Transfer mechanisms would then have to be implemented to quickly reallocate these production rights to other areas to provide further means to minimize the value of the production asset. While not as drastic as a free-market U.S. tobacco policy, changes of this magnitude would also result in considerable concentration of U.S. tobacco growers and have indirect implications on foreign tobacco prices, production, and trade. The ultimate impacts will eventually depend on how the post-tobacco buyout program is structured.

Diversification Strategies in the Most Tobacco-Dependent State: Kentucky

The current U.S. tobacco economy, with or without major U.S. tobacco policy reform, will not support the large number of farmers that are currently a part of the U.S. tobacco program. Consequently, many farmers and rural communities in tobacco regions are faced with an immediate need to diversify their agricultural enterprises. While certainly feeling the effects of the depressed tobacco economy, North Carolina's agricultural economy has undoubtedly been successful over the years in reducing their dependence on tobacco. Efforts to diversify Kentucky's agricultural economy have been made in the past, but with mixed results primarily due to a lack of capital and a weak marketing infrastructure for alternative enterprises. However, Kentucky policy makers seized the opportunity to provide significant investment dollars into diversifying Kentucky's agricultural economy by utilizing funding made available from the Master Settlement Agreement. The Kentucky General Assembly voted in April 2000 to allocate 50 percent of Kentucky's MSA funds to diversifying the agricultural economy, with the other 25% being allocated to early childhood development programs and 25% for smoking cessation and other health related programs. A Kentucky Agricultural Development Board was established with a goal of investing these funds in "innovative proposals that increase net farm income and effect tobacco farmers, tobacco-impacted communities and agriculture across the state by stimulating markets for Kentucky agricultural products, finding new ways to add value to Kentucky agricultural products, and exploring new opportunities for Kentucky farms." Since its inception, in 2000, the board has allocated nearly \$100 million to more than 800 projects. Major focus areas have included:

- Improving cattle genetics, cattle handling facilities, and forages
- Developing cooperatives, farmers markets, and additional improvements in marketing opportunities for Kentucky traditional, alternative, and value-added enterprises
- Expanding educational assistance for Kentucky agricultural enterprises
- Providing environmental cost share programs
- Improving access to capital

While many of these projects have concentrated on Kentucky's traditional enterprises (e.g., beef cattle, horses, dairy, poultry, hogs, corn, soybeans, wheat), special emphasis has been on alternative enterprises such as aquaculture, goats, peppers, tomatoes, sweet corn, cantaloupes, grapes, apples, peaches, nursery crops, vermaculture, and even alternative uses for tobacco (i.e. pharmaceuticals). Details on these and other diversification initiatives that are currently being undertaken in Kentucky can be assessed at <http://www.kyagpolicy.com>.²

² For other diversification efforts evolving from the tobacco settlement funding in North Carolina, and Virginia, see www.goldenleaf.org, and www.vatobaccocommission.org.

While these diversification investments will likely shape the future of Kentucky agriculture, their long-term effects are difficult to assess. It has been evident over the years that there is no single ag enterprise that can replace the income generated by tobacco over a sustained period of time for a large number of farmers. But farm group leaders in Kentucky are optimistic that a large number of diversification projects spread over a large geographic area, among farmers with different production and marketing skills, coupled with an improved production and marketing infrastructure will enable Kentucky agriculture to advance in the midst of a declining tobacco income base. Economic development initiatives are also being examined in many tobacco-dependent rural communities to provide off-farm employment opportunities for those farm families that are unable to identify successful alternative ag enterprises.

Conclusions

The current political, economic, social, and legal environment within the U.S. tobacco industry has created much pessimism regarding the future outlook for U.S. tobacco farmers and tobacco-dependent rural communities. Tobacco farm income has plummeted in recent years, with no apparent opportunities for a quick rebound in the near future within the current tobacco program. Tobacco will still though, remain an important, yet smaller agricultural enterprise for North Carolina, Kentucky, and within regions of other tobacco states. But in reality, under the current demand conditions there are simply not enough tobacco dollars available to economically sustain the relatively large number of participants (i.e., quota owners and growers) remaining in the tobacco program. Consequently, support for a buyout and tobacco policy reform is almost unanimous today among tobacco farmers. Farm leaders and policymakers recognize that significant changes must be adopted to provide compensation for those who elect to exit the industry, while simultaneously creating a more favorable economic environment for those who elect to remain. Future tobacco dollars will likely be much more concentrated among farms and across geographic regions. Anticipated changes in U.S. tobacco policy will likely result in improved competitive prices for U.S. tobacco, but it remains unclear how much market share the United States can regain in today's very competitive and diminishing world market. What is clear, though, is that the current political, economic, social and legal challenges facing U.S. tobacco growers will shape a much, much different tobacco growing industry in the future than what has been experienced under the past 60 plus years of the federal tobacco program.

U.S. Tobacco Grower Issues

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Current Challenges/Issues Facing U.S. Tobacco Growers

🍃 Price Competitiveness in the World Market

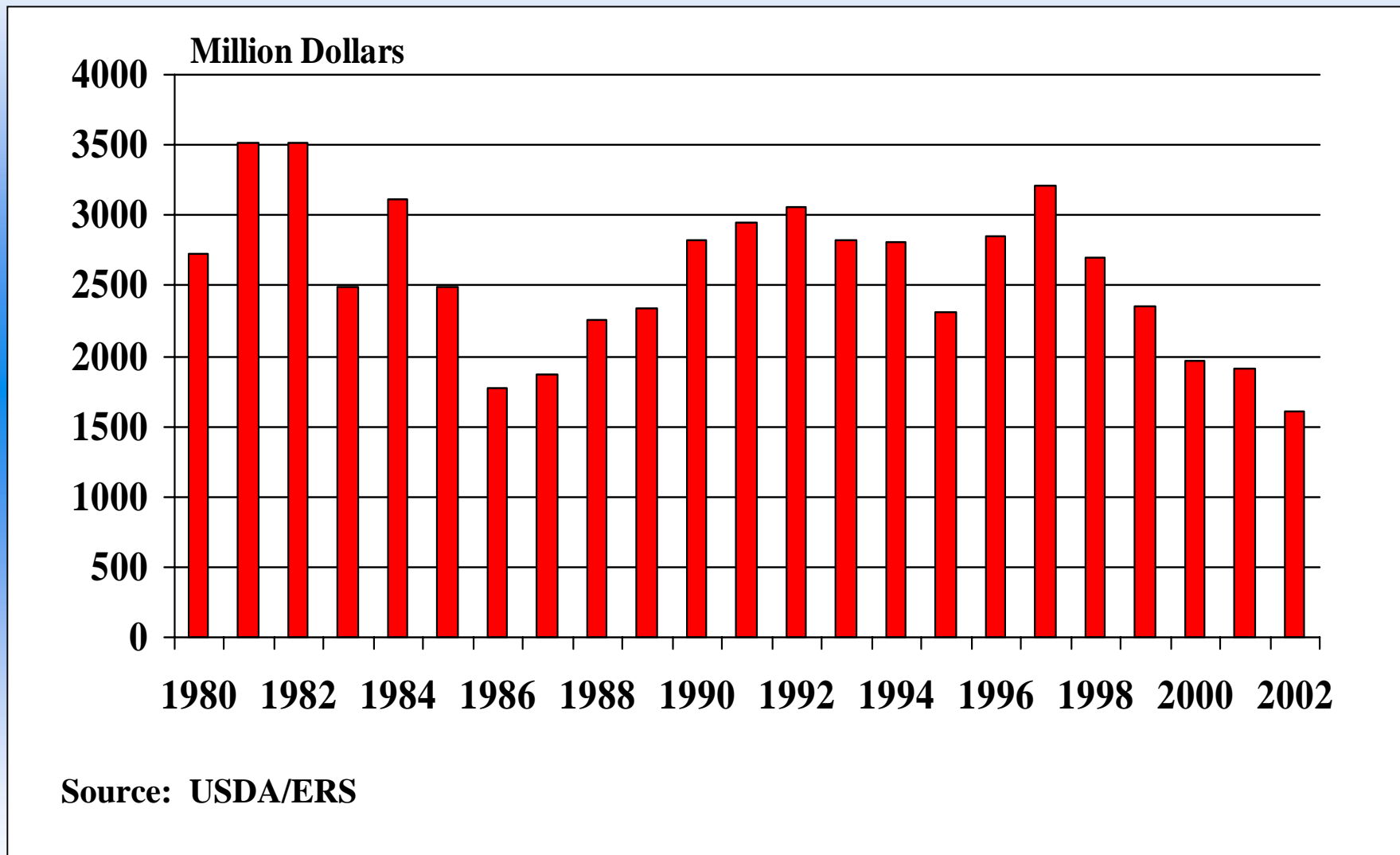
🍃 Domestic Consumption/Production



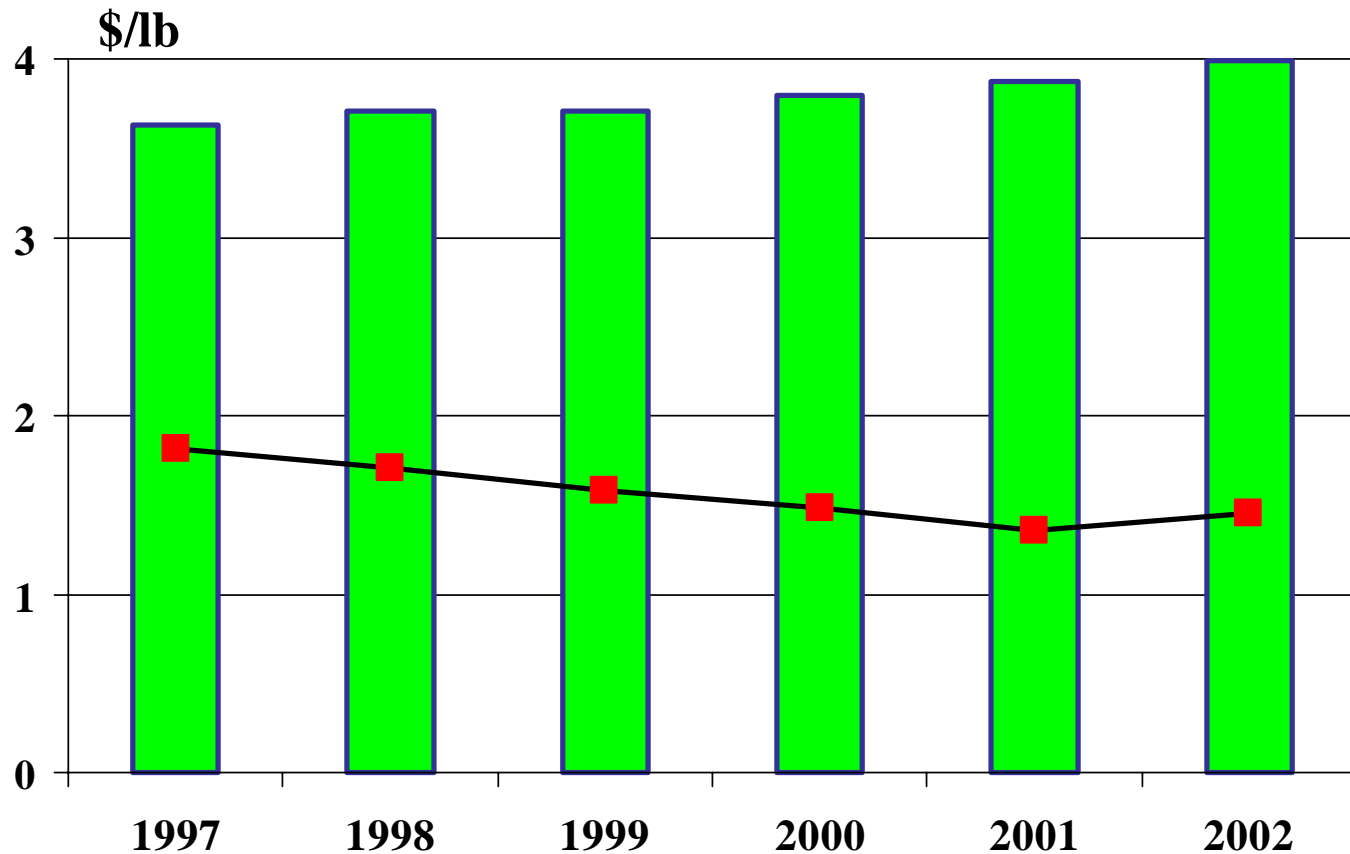
🍃 Tobacco Taxes, Regulations, and Restrictions, Lawsuits

🍃 Future Uncertainty Regarding Marketing/Policy

Value of U.S. Tobacco Production



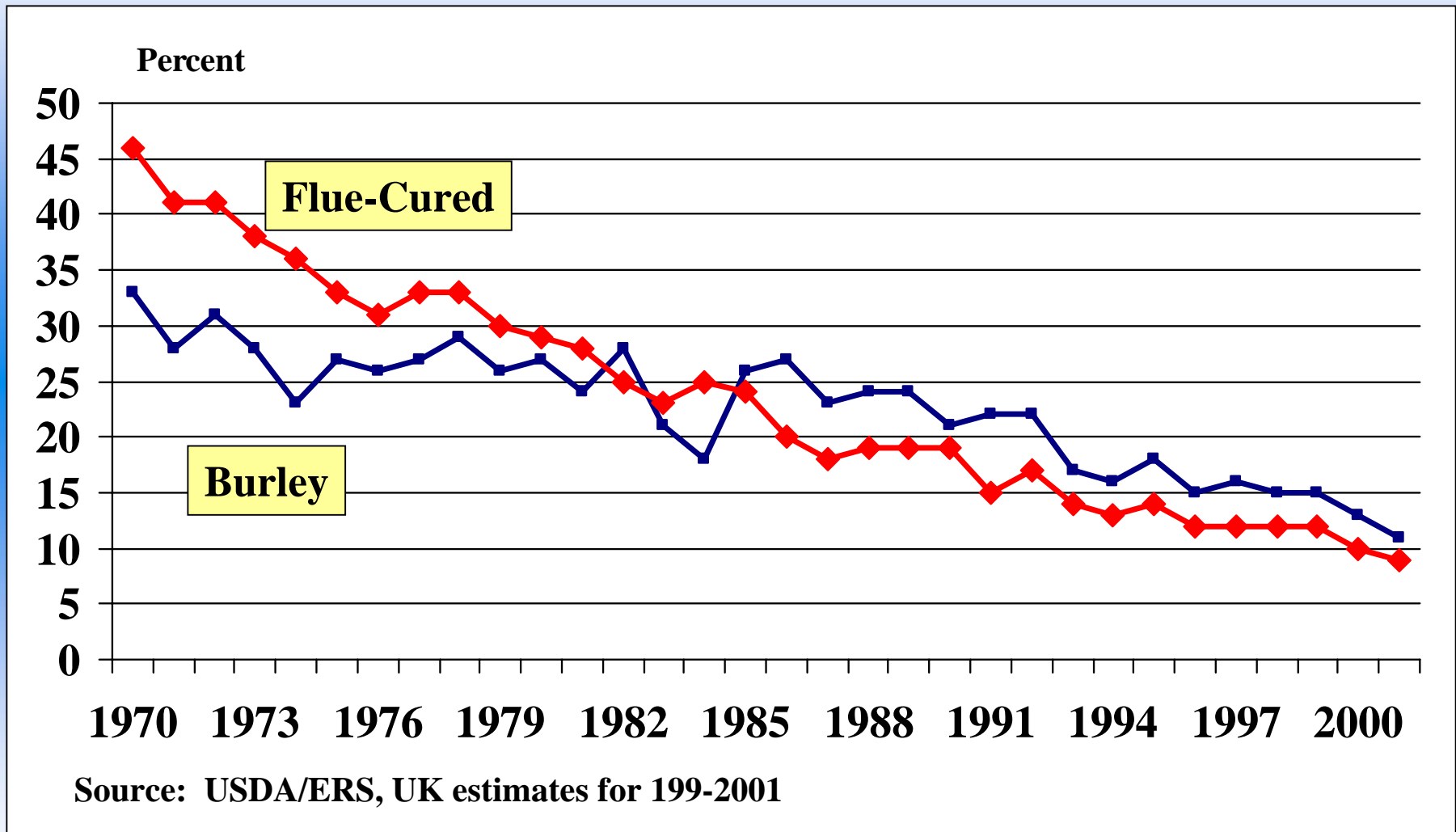
U.S. Burley Export Price vs Average U.S. Burley Import Prices



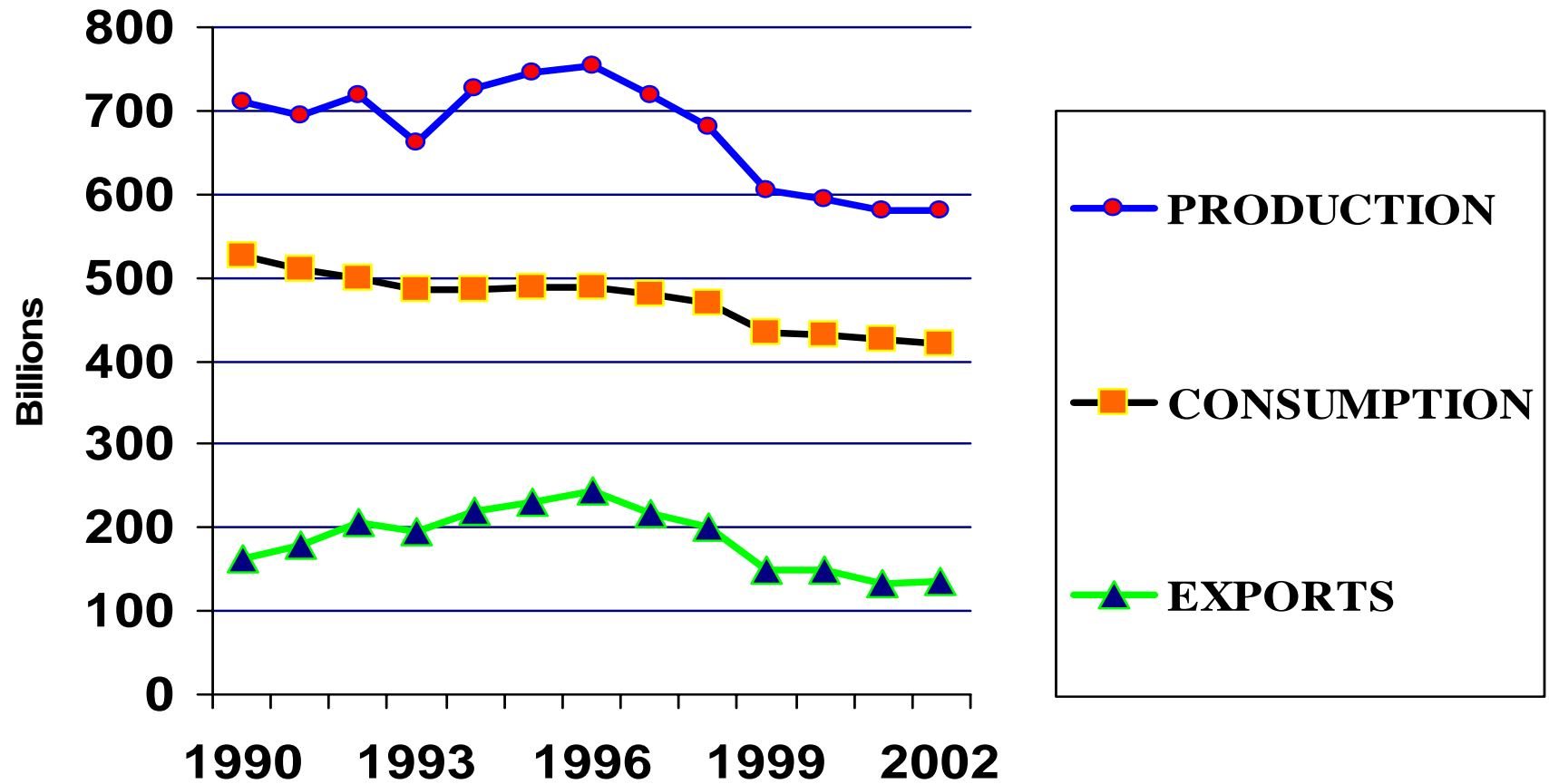
Source: USDA/FAS

■ U.S. ■ Import

U.S. Market Share of World Flue-Cured and Burley Exports

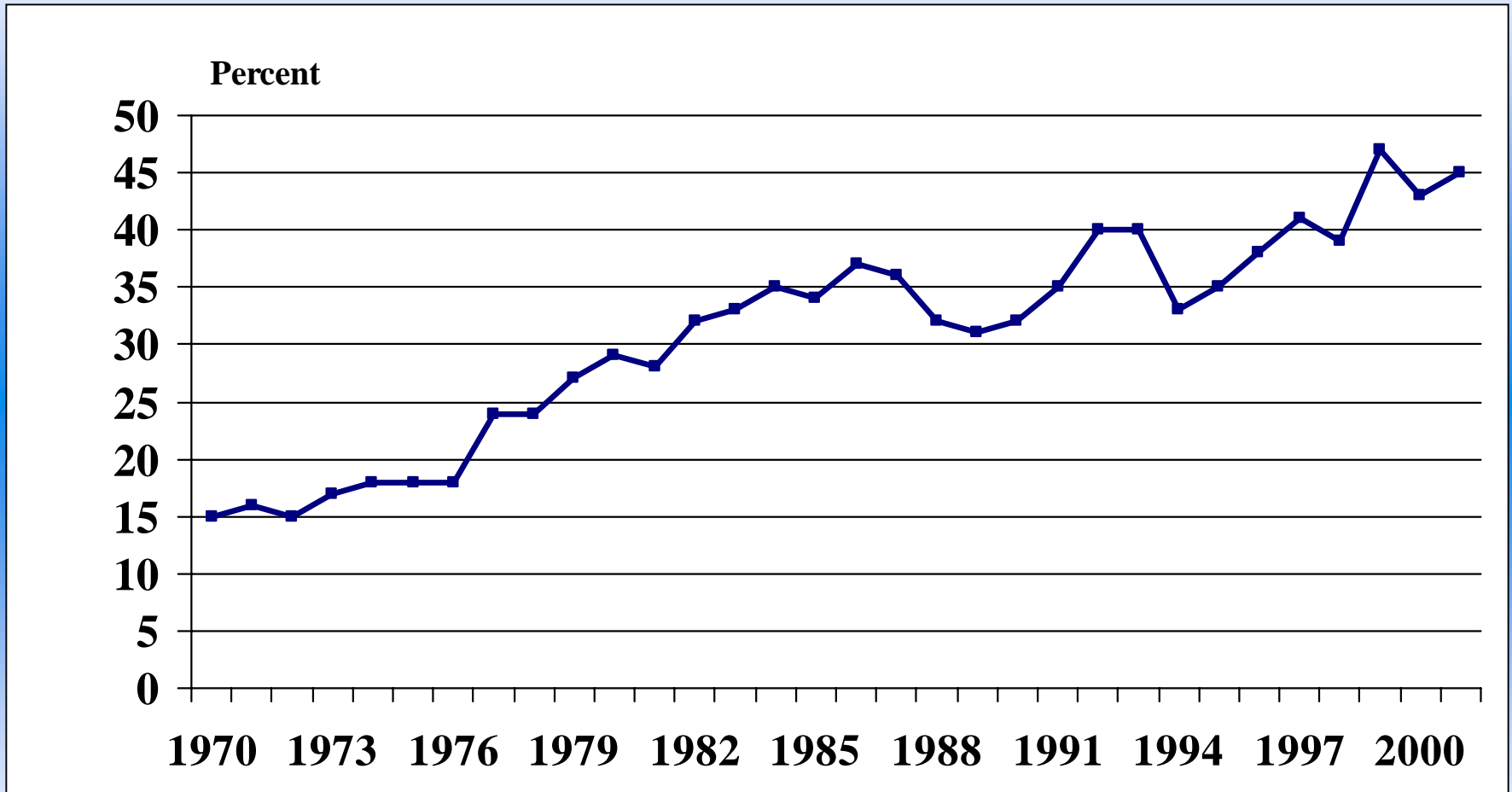


U.S. Cigarette Production, Consumption and Exports



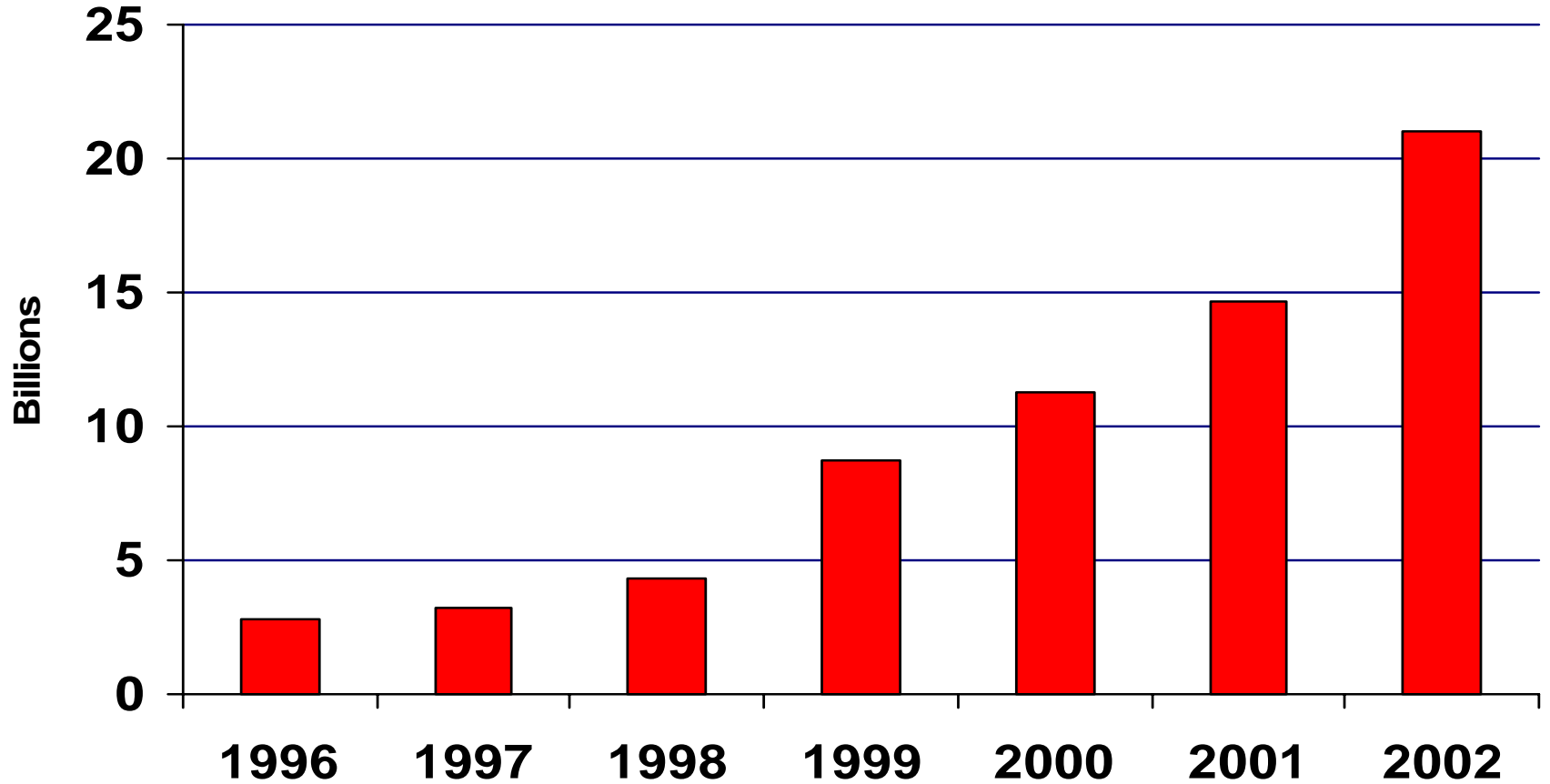
Source: USDA/ERS

Market Share of Imported Tobacco



Source: USDA/ERS

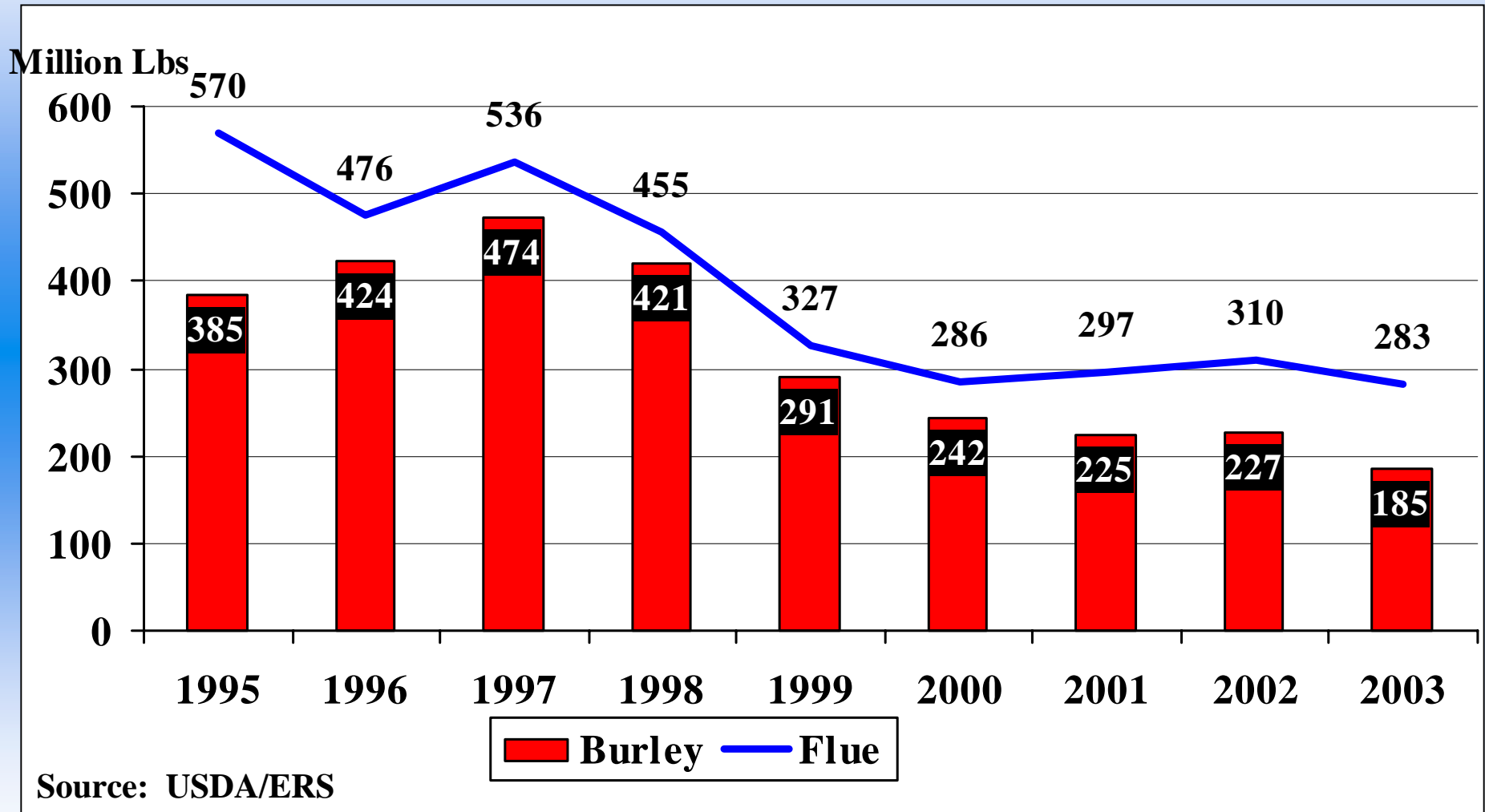
U.S. Cigarette Imports



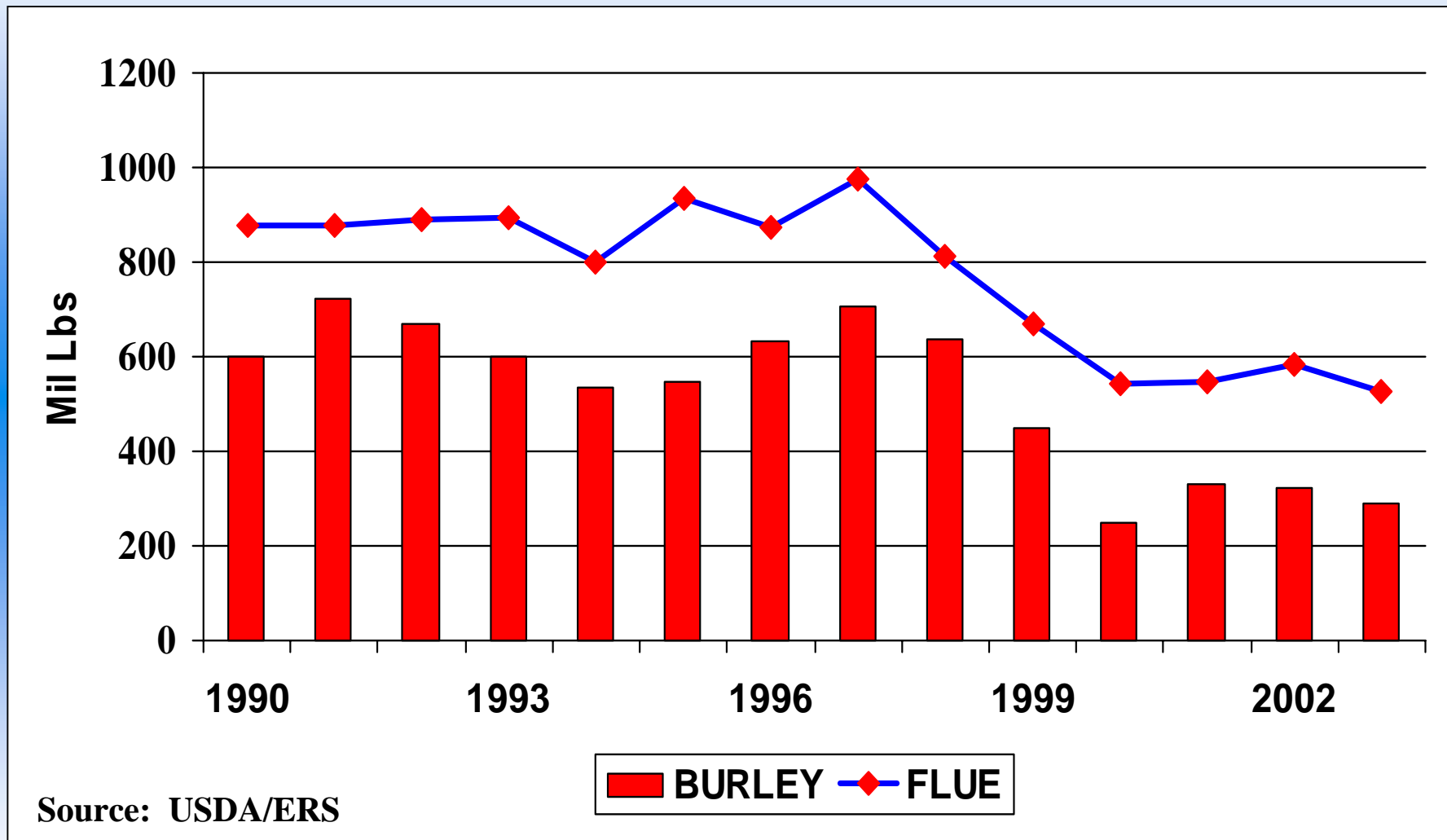
Source: USDA/FAS

U.S. Manufacturer

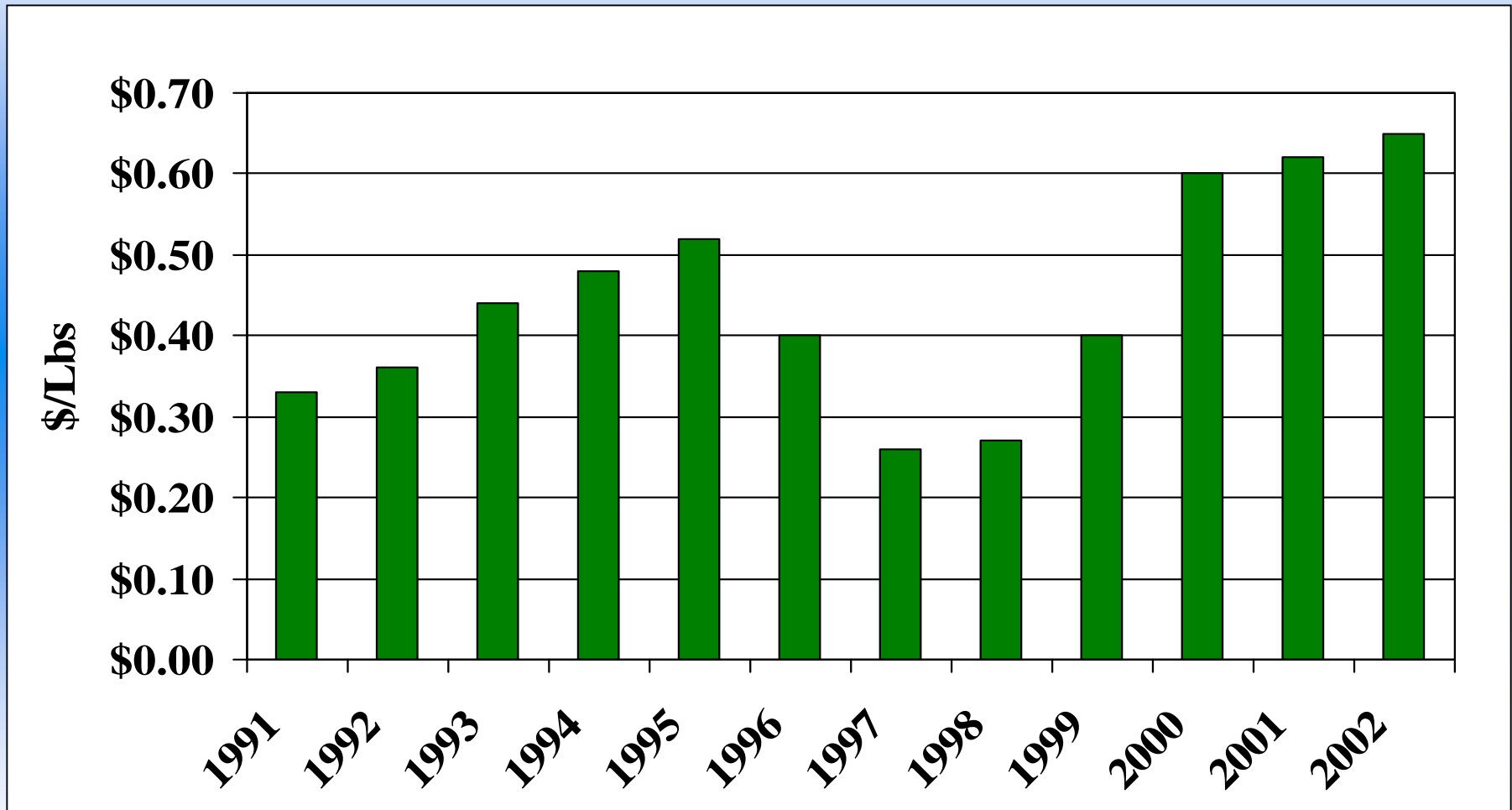
Purchase Intentions: Flue vs Burley



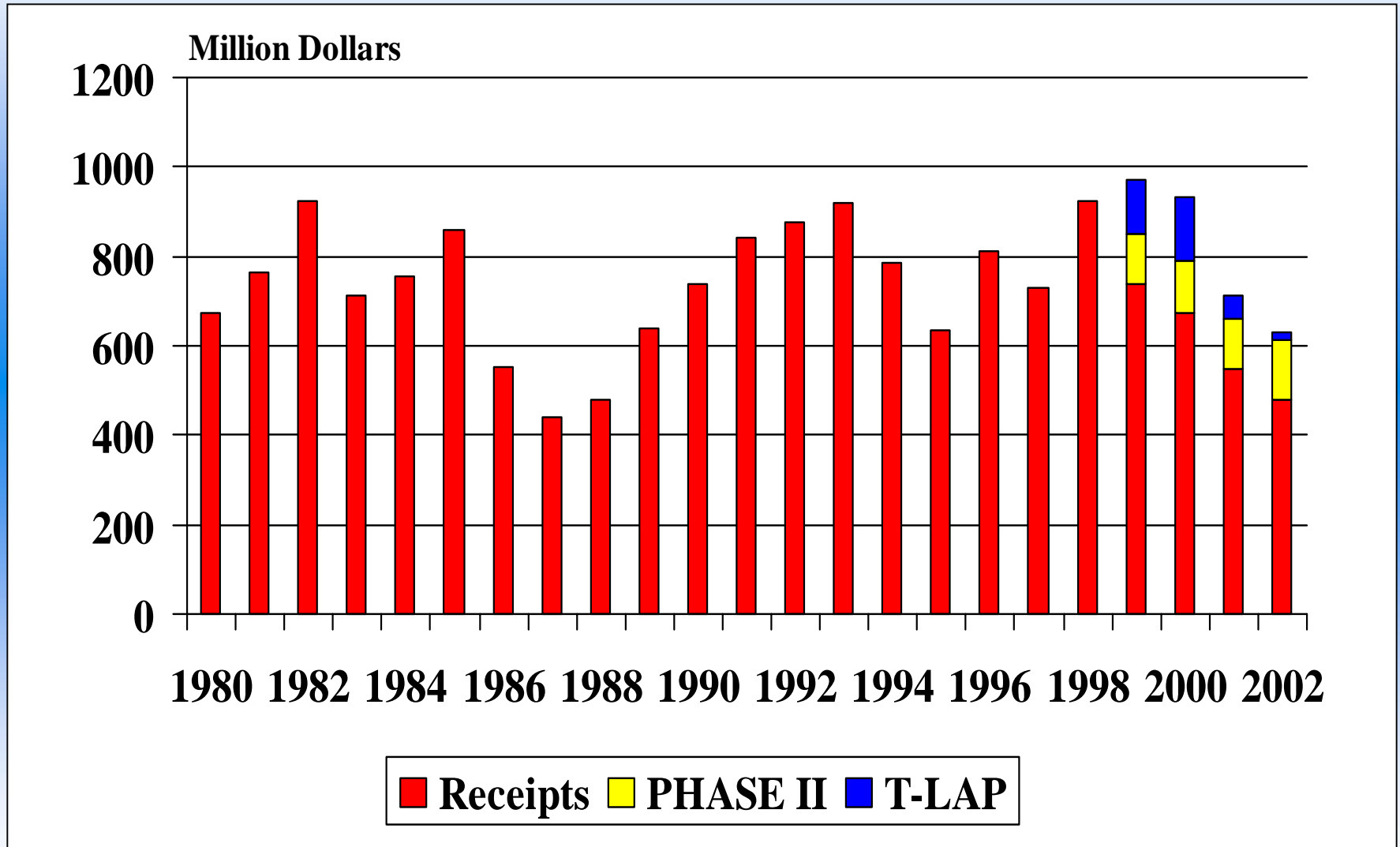
U.S. Burley and Flue-Cured Marketing Quotas



Average Kentucky Burley Quota Lease Prices



Kentucky Tobacco Cash Receipts/Mailbox \$



Distribution of KY Tobacco Income



\$500,000,000

160,000 Individuals



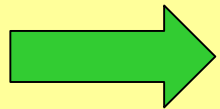
\$3,125/Person



Buyout/Policy Reform

Buyout Environment

- **> 50% Drop In Quotas**
- **Record Lease Prices**
- **Pessimistic Outlook**
- **Aging Farmers**



**Support for
A Buyout**

Buyout Issues

- **Structure**
 - Price/lb
 - Base years
- **Program**
 - Modified or Eliminated?
- **Funding**
 - Excise Taxes
 - User Fee
 - Other Assessments
- **FDA Regulation**

2002 U.S. Congress: 9 Tobacco Quota Buyout Bills Introduced

Senate

- Helms (NC)
- Hollings (SC)
- Miller (GA)
- Cleland (GA)

House

- McIntyre (NC)
- Fletcher (KY)
- Goode (VA)
- Chambliss (GA)
- Hill (IN)

Similarities/Differences in Tobacco Quota Buyout Bills

Similarities

- \$8/lb for Quota Owners
- \$4/lb for Growers
- Cost \$15-20 Billion
- 5 Year Period

Differences

- Base Year
- Post-Buyout Program?
- Funding
- FDA Regulation

Political Challenges

- **Unity among tobacco farmers, companies and health groups**
 - **Structure of the buyout**
 - **Post-buyout policy**
 - **Funding mechanism**
 - **FDA**

Political Challenges

- **Unity among tobacco farmers, companies and health groups**
- **Congressional challenges**
 - **Maintaining compensation levels of \$8/\$4**
 - **Achieving both a buyout and a program**
 - **Agreeable FDA regulation**
 - **Other more pressing issues such as homeland security, war on terrorism, prescription drugs, budget deficit, weak economy**

Opportunities for a Buyout

- **Farm groups committed to a consensus**
- **Peanut quota buyout sets a precedence**
- **Support from health groups/tobacco companies**
- **Non-taxpayer funds used to finance most bills**
- **Current political leadership in U.S. Congress**

Political Leadership in the U.S. Congress Relevant to a Tobacco Buyout

- **Senate Majority Leader – Frist (R-TN)**
- **Senate Majority Whip – McConnell (R-KY)**
- **House Ag Committee Chair – Goodlate (R-VA)**
- **House Ag Specialty Crops Subcommittee Chair – Jenkins (R-TN)**
- **Senate Ag Subcommittee on Production and Price Competitiveness Chair – Dole (R-NC)**
- **Edwards (D-NC), candidate for Democratic nomination for U.S. President**

So What Happens Next?

- **Tobacco state lawmakers in U.S. Congress meeting to assess buyout parameters and political environment**
- **Farm groups will have to assess the quota owner/grower support of various compromises and potential future political risk that will likely evolve as the process unfolds**

Post-Tobacco Buyout Environment

- **Structure of most current buyout bills would inject over 1 billion dollars into KY and NC ag economies annually for the next 5 years**
- **Concentration of farms/tobacco dollars**
- **More competitive prices/demand expansion ???**
- **Will we maintain a safety net, production control program???**
- **Marketing system adjustments will continue**
- **More regulation**
- **Introduction of reduced risk tobacco products which may call for specialized tobacco production characteristics**

http://www.uky.edu/Agriculture/TobaccoEcon

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Please send questions, comments, or suggestions to [William Snell](#).