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TOBACCO: Short and Long Run Outlook

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Current Situation

With the death of the McCain Bill (Tobacco Products Control Act of 1998), tobacco farmers wonder what legislative activity to expect that may affect future demand for their tobacco. Compensation for quota owners and tobacco farmers and the future of the tobacco program under the McCain Bill were hotly debated topics. Senator Wendell Ford (D-KY) and Senator Fritz Hollings (D-SC), both members of the Commerce Committee that developed the McCain Bill, developed the farm provisions that were included in the McCain Bill. These provisions would have maintained a restructured tobacco program and would have compensated farmers at $8 per pound of quota to quota owners and a transition payment to tobacco farmers of $4 for each quota pound rented or grown as a tenant. Flue-cured growers would have had to quit growing tobacco to receive the transition payment. Senator Richard Lugar (R-IN), Chairman of the Senate Agricultural Committee, wanted to amend the McCain Bill farm provisions to eliminate the tobacco program while compensating quota owners at $8 per pound of quota with tobacco growers receiving compensation for quota owned at $4 for each pound of quota rented or grown as a tenant. Other senators said that tobacco farmers and quota owners should receive much lower levels of compensation. Caps on compensation were suggested.

While no successor to the McCain Bill has emerged, either in the Senate or House of Representatives, the issue of comprehensive tobacco legislation is not dead. Senator Orrin Hatch (R-UT) developed comprehensive tobacco settlement legislation that could be considered for introduction into the Senate. The farm provisions of the Hatch Bill are very similar to Senator Lugar's provisions that would provide compensation to tobacco growers and quota owners, but end the tobacco program. Republicans in the House of Representatives developed a proposal to combat teenage smoking and drug abuse through anti-smoking commercials and penalties for under-age smoking. The proposal currently has no funding source and House Republicans say that it will not be funded through increased cigarette prices or taxes. The bill would not contain any provisions for tobacco farmers or quota holders and would make no changes to the tobacco program. Other proposals will likely emerge. Among them could be an increase in cigarette taxes. If and when any proposal is brought to the House or Senate floor is uncertain. The chances of any comprehensive legislation being passed in 1998 seem to be little or none. Cigarette manufacturers are currently negotiating for a comprehensive settlement with the states that have filed suit for recovery of health care costs. Such an out-of-court comprehensive settlement would not likely contain any provisions for farmers. However, successful negotiation of such a settlement would likely improve future tobacco purchase intention scenarios of U.S. cigarette manufacturers over the gloomy scenarios often put forward in the last six months.

For the 1998 season, farmers can expect the tobacco program to hold average flue-cured tobacco prices at $1.70 to $1.75 per pound. A matter of some uncertainty is how much of the 1998 crop the producer cooperative (stabilization) will purchase. The producer cooperatives purchase tobacco not selling at prices above the price support level. Dry weather could potentially shorten the 1998 crop, thereby reducing coop purchases.

Outlook for 1999 Season

With little chance of comprehensive tobacco legislation being passed in 1998, tobacco farmers will likely operate under the current tobacco program in 1999. The 1999 flue-cured and burley-marketing quotas are certain to be greatly impacted by purchases of the 1998 crops by the Flue-Cured Cooperative Stabilization Corporation and the Burley Coops. The national marketing quotas for flue-cured and burley tobaccos are computed by adding the purchase intentions of cigarette manufacturers for the year in question to a 3-year average of unmanufactured

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Outlook for 1999 Season

exports. From this sum is added or subtracted an adjustment for stocks held by the burley or flue-cured coop. The secretary of agriculture then may adjust the 3-part total up or down by as much as 3 percent. Currently, the burley and flue-cured coops are holding large enough inventories so that even if they did not purchase any of the 1998 crops, the 1999 quota would likely decline. Depending on the level of purchase intentions announced by cigarette manufacturers, the potential quota decline for 1999 could range from 5 to well over 15 percent. This could place the 1999 flue-cured tobacco quota below 700 million pounds; the smallest flue-cured tobacco quota since the mid-1980s. Farmers who expanded production capacity to meet the large 1997 quota (the largest in 15 years), will find adjusting (to as much as a 30 percent decline in quota from 1997 to 1999) difficult. Excess productive capacity in 1999 will cause rental rates for quota to rise dramatically. Many farmers caught between the financial burden of previous expansions in productive capacity and escalating quota rental rates could face severe financial difficulties.

Long Run Outlook

Anticipated declines in U.S. cigarette consumption are already taking their toll on current purchases and purchase intentions for U.S. tobacco. A comprehensive settlement of the states' lawsuits with cigarette companies could actually cause anticipated demand for U.S. tobacco to rise because previous scenarios for future cigarette consumption and litigation costs have been so pessimistic. However, cigarette companies will still face the possibility of individual suits or class action suits from groups of individuals. Further, they face potentially adverse federal legislation or increases in cigarette excise taxes with little chance of even limited immunity from lawsuits. However, as U.S. cigarette consumption continues to decline, world cigarette consumption continues to increase. The U.S. exports around 40 percent of its tobacco in unmanufactured form. In addition, about 35 percent of all cigarettes manufactured in the U.S. are exported. Thus, developments in the export market for U.S. leaf and U.S. produced cigarettes will have a greater effect on the future of U.S. tobacco farmers than the much-publicized domestic situation.

International competition from foreign tobacco-producing countries will likely remain intense for U.S. flue-cured tobacco farmers. Brazil continues to improve the quality of its flue-cured tobacco and has surpassed the U.S. in quantity of unmanufactured exports. Zimbabwean flue-cured tobacco has traditionally been a close competitor to U.S. flue-cured tobacco. However, Zimbabwe's traditional tobacco producers are beset with internal problems. The breaking-up of tobacco plantations and their return to indigenous peoples in Zimbabwe by the Zimbabwean government could compromise both the quality and quantity of flue-cured tobacco that competes with U.S. tobacco. China's potential for either tobacco imports or exports remains highly uncertain. China produces about five times as much flue-cured tobacco as the U.S., but most of it is of lower quality and only limited amounts have been exported. China has prevented its cigarette manufacturers from using high-quality U.S. tobacco through implementation of phyto-santitary restrictions. U.S. farm groups are working with U.S. and Chinese trade officials to remove these restrictions. Removal of the restrictions could create another large export market for U.S. tobacco. U.S. burley tobacco faces much less intense international competition than flue-cured tobacco, but Argentina and Brazil are emerging as formidable competitors in both quality and quantity.

The greatest source of long-term uncertainty facing U.S. tobacco farmers is U.S. policy on smoking and cigarettes and, even more importantly, the U.S. tobacco program. The now defunct McCain bill contained provisions to restructure the tobacco program and amendments were offered to completely eliminate the program. The U.S. tobacco program limits the quantity of tobacco produced in the U.S. via the national marketing quotas. Because U.S. tobacco is differentiated from foreign tobaccos, the supply restrictions effectively raise the U.S. price above free-market levels. If the tobacco program is eliminated, the quantity of U.S. tobacco produced will increase and the price will fall. In addition, because the tobacco program limits geographic movement of tobacco production, elimination of the program will allow movement of production.

If the excise tax on cigarettes was increased and the tobacco program eliminated, then demand would fall as supply expanded. For example, if the federal cigarette tax were increased by $1.50 per pack and the tobacco program eliminated, the price per pound would fall 25 percent for flue-cured tobacco and over 20 percent for burley tobacco. Total U.S. production of flue-cured tobacco would expand between 20 and 75 percent, with the most likely scenario being expansion of 40 to 50 percent. Whether or not U.S. burley tobacco would expand or contract is difficult to predict. Forecasts of percentage changes in the

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quantity of burley tobacco produced range from a decline in production of 14 percent to an increase in production of 7 percent.

In the case of a $1.50 per pack increase in federal cigarette excise taxes and elimination of the program, forecasts of changes in gross revenues from the sale of flue-cured tobacco range from – 4 percent to + 29 percent. Gross revenues from the sale of burley tobacco would decline 20 to 30 percent. With the elimination of the tobacco program, all quota income would be transferred to cigarette manufacturers or smokers via lower tobacco prices. Consequently, the value of quota as an asset would fall to zero.

Some of the most dramatic changes with elimination of the tobacco program would be changes in location of tobacco production and changes in numbers of tobacco farmers. Burley production would exit the Appalachian region due to high production costs, but could expand in central Kentucky and central Tennessee. Burley expansion in central Kentucky and Tennessee could be limited if the piedmont of North Carolina and Virginia began producing burley tobacco instead of flue-cured. Flue-cured production would decline in the piedmont of North Carolina and Virginia, but expand in the coastal plain of North and South Carolina, as well as in south Georgia and north Florida. While highly uncertain, tobacco production could expand to areas not currently producing tobacco. The current tobacco program limits consolidation of farms and tends to preserve small farms because quota (and thus tobacco production) can not be sold or rented across county lines (Tennessee is the exception). Elimination of the tobacco program would result in much greater consolidation of tobacco farms and a large net exit of tobacco farmers despite a possible expansion of overall production. The reduction in number of farms would be particularly notable in regions where farm size is smallest, such as the Appalachian region in burley production and the piedmont of North Carolina and Virginia in flue-cured production.

Of course, congress could also retain the tobacco program while at the same time increasing cigarette taxes or smoking regulations. Some anti-smoking groups now support the continuation of a tobacco program because it restricts production of U.S. tobacco and maintains a higher tobacco price to cigarette manufacturers than would exist in the absence of a program. If, for example, cigarette taxes were increased $1.50 per pack, tobacco prices would be held near their current levels by decreasing the marketing quotas in response to the decline in demand. Total annual sales quantities of flue-cured tobacco would be expected to decline between 9 and 19 percent. Total annual sales quantities of burley tobacco would be expected to decline between 11 and 23 percent. All of the decline would result from purchase declines of U.S. tobacco by U.S. cigarette manufacturers of 15 to 33 percent. Unmanufactured exports of U.S. tobacco would be unaffected by the tax increase since the price of U.S. tobacco would not change under the current tobacco program.

Under the current program, as with annual sales quantities, gross farm revenues from tobacco sales would fall 9 to 19 percent for flue-cured tobacco and between 11 and 23 percent for burley tobacco in response to a $1.50 per-pack increase in cigarette taxes. Quota income on a pound of tobacco is the difference between the price received for the tobacco and the total economic cost of producing a pound of tobacco (less the cost of quota). Since the tobacco program elevates the price of U.S. tobacco in the world market by restricting production and sales of U.S. tobacco via marketing quotas, quota is an income-producing asset. Under the current tobacco program, a $1.50 per-pack increase in cigarette taxes would be expected to reduce income from quota by 2 to 6 percent for flue-cured tobacco, but no reduction is expected for burley. The reason quota-income declines less than gross revenues and sales quantities is that the annual return per pound of quota increases as quota declines and becomes scarcer.

Elimination of the tobacco program in the face of declining demand would lead to higher total farm revenues from flue-cured tobacco than maintenance of a tobacco program. However, burley would experience lower total farm revenues in the case of elimination of a program, despite an expansion in burley tobacco production. In both cases, elimination of the tobacco program leads to about $500 million in quota income being transferred from quota owners to cigarette manufacturers and smokers. Maintenance of a tobacco program preserves the current geographic location of production, protecting farm revenues in some areas, but preventing growth in farm revenues from tobacco sales in other areas. Most burley production areas fair better under a scenario of maintaining a program, while the results are mixed for flue-cured areas. Individuals that own considerable quantities of quota, including tobacco farmers that own quota for most of their production, clearly fair better under program maintenance. However, farmers that rent quota for most of their production and farm in low cost-of-production areas might fair better without a program.

Currently the national marketing quota for flue-cured tobacco is around 800 million pounds yielding annual gross farm revenues of about $1.4 billion. The national marketing quota for burley tobacco is around 550 million pounds yielding gross farm revenues of about $1 billion.

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Regardless of the status of a tobacco settlement or comprehensive smoking legislation, the debate about what to do with the tobacco program will likely continue with uncertain resolution.

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