

CRS Report for Congress

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Tobacco Price Support: An Overview of the Program

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Summary

About 94% of U.S. tobacco production is flue-cured and burley (both being cigarette tobacco types). These crops are particularly important to the agriculture of North Carolina (where flue-cured is grown) and Kentucky (where burley is grown). Together, these two states produce 66% of the total U.S. tobacco crop. The federal tobacco price support program is designed to support and stabilize prices for farmers. It operates through a combination of mandatory marketing quotas and nonrecourse loans. Marketing quotas limit the amount of tobacco each farmer can sell, which indirectly raises market prices. The loan program establishes guaranteed minimum prices. The law requires that the loan program operate at no net cost to the federal government. Apart from year-to-year budget impacts, no-net-cost provisions of the law are intended to assure that all loan principal plus interest will be recovered.¹ This report will be updated and revised as new data become available and legislative events transpire.

Industry Profile

World production of tobacco is estimated at about 12.75 billion pounds (dry weight) for 2003. Production data are collected in more than 100 countries. However, nearly 70% of world tobacco is produced in the following six countries: China (4,904 mil. lbs.), India (1,312 mil. lbs.), Brazil (1,137 mil. lbs.), United States (801 mil. lbs.), Indonesia (319 mil. lbs.), and Turkey (313 mil. lbs.).

Fewer than 57,000 U.S. farms harvested about 831 million pounds (farm weight) of tobacco on about 416,000 acres in 2003. The estimated farm value of the 2003 crop is

¹ Data in this report, unless otherwise specified, are U.S. Department of Agriculture data from recent issues of Tobacco: World Markets and Trade, published by the Foreign Agriculture Service, and Tobacco Situation and Outlook Reports, published by the Economic Research Service.

about \$1.635 billion (\$1.967/lb.). Major U.S. tobaccos are flue-cured (produced primarily in North Carolina) and burley (produced primarily in Kentucky), which are both cigarette tobaccos. Other types of tobacco are used for cigars, chewing, and snuff.

Tobacco is grown in 16 states; North Carolina and Kentucky originate 66% of total production. Four other states (Tennessee, Virginia, South Carolina, and Georgia) produce another 29%. The high per acre value of tobacco sales (averaging about \$3,930 in 2003) makes it critical to the income of the growers and important to the economies of the major producing states. For North Carolina in 2002, tobacco constituted 9.6% of the value of all farm commodities (crops and livestock); for Kentucky, tobacco accounted for 14.4% of the value of all commodities.

The United States is the world's largest exporter of manufactured tobacco products (cigarettes) and is the second leading exporter, behind Brazil, of unmanufactured tobacco leaf. During 2003, the United States exported 353 million pounds (dry weight) of leaf tobacco, valued at \$1.031 billion (mostly to the European Union, Japan, and Switzerland). U.S. manufactured tobacco product exports could amount to about \$1.8 billion (mostly to Japan, Saudi Arabia, Israel, South Korea, European Union, United Arab Emirates, Lebanon, Hong Kong, and Singapore).

In 2003, U.S. manufacturers are expected to produce an estimated 500 billion cigarettes (exporting about 24%). American blend cigarettes are a combination of flue-cured, burley, and oriental tobaccos. All of the oriental tobacco is imported (from primarily Turkey). Consumption of cigarettes has declined nearly 36% in the United States since 1981, from 640 billion to an estimated 410 billion in 2003. However, spending for tobacco products has increased as a result of price and tax increases. In 2002, consumers spent about \$88.2 billion on tobacco products (94% for cigarettes).

Tobacco products are subject to federal excise taxes. In addition, all states and some local governments impose excise taxes. Nationally, in 2001/02, cigarette excise taxes averaged about 83¢ per pack on total consumption. Excise tax collections were an estimated \$17.032 billion (federal, \$8.284 billion; state, \$8.548 billion; local, \$200 million). On January 1, 2002, federal excise taxes increased by 5¢ per pack, to 39¢.

The Price Support Program

The tobacco price support program (first created in the 1930s along with other commodity support programs) exists only for the economic benefit of farmers. It was created for the purpose of supporting the income and stabilizing the price of tobacco received by farmers. By law, the choice of whether or not federal support will be provided is determined by growers in a referendum held every three years.

When producers approve federal price support for tobacco, they become subject to marketing quotas. A marketing quota is a supply control mechanism that indirectly increases market prices. At the same time, the federal government is required to guarantee prices at least as high as the level specified in the law.

Legislative Authority

The first commodity price support legislation was the Agricultural Adjustment Act of 1933. Various problems with this and subsequent legislation ultimately led to adoption of the Agricultural Adjustment Act of 1938 (P.L. 75-430). This permanent law established a supply control and price support program for tobacco that, even as amended, remains much the same today. The current legal authority and requirements for the federal tobacco program are contained in 7 U.S.C. 1311-1316 and 7 U.S.C. 1445.

Administering Agency

Program administrative operations are carried out by the U.S. Department of Agriculture's (USDA) Farm Service Agency (FSA). Annual administrative costs are estimated at about \$22 million in FY2003 for tobacco price support operations. This cost covers primarily salaries for some headquarters personnel and staff time devoted to the tobacco program in about 600 county offices. Price support operations (nonrecourse loans) are financed by USDA's Commodity Credit Corporation (CCC). The CCC obtains needed money by borrowing from the U.S. Treasury (which must be repaid with interest).

Program Operation

The federal tobacco price support program limits and stabilizes the quantity of tobacco produced and marketed by farmers. This is achieved through marketing quotas. In addition, minimum market prices are guaranteed to farmers through CCC nonrecourse loans.²

Marketing Quotas. When farmers vote in favor of price supports, they are at the same time agreeing to accept government restrictions on the amount of tobacco they can market. The national marketing quota is the amount judged sufficient to meet domestic and export demand, but at a price above the government support price. Each farm's quota is assigned to the land. So, the right to produce and market a specified quantity of tobacco resides with the owner of the land. A farmer can only begin to grow tobacco by purchasing or renting land that has a quota. By limiting the supply of tobacco, the market price is increased. Total farm revenue is raised because consumption does not decline enough to offset the price increase. In this way, farm income is supposed to be supported through artificially high market prices, rather than through direct government payments. This differs from other commodity support programs that utilize direct payments, rather than marketing quotas, as the principal subsidy mechanism.

Loans. Marketing quotas are not always totally effective at supporting market prices, given the numerous variables that affect tobacco supply and demand. Consequently, federal support prices are guaranteed through the mechanism of nonrecourse loans available on each farmer's marketed crop. The loan price for each type of tobacco is announced each year by the USDA, using the formula specified in the law to calculate loan levels. The national loan price on 2004 crop flue-cured tobacco is \$1.69 per pound; the burley loan price is \$1.873.

² The term nonrecourse means that in cases of default no additional recourse is taken against borrowers beyond taking ownership of the collateral. The collateral is accepted as full settlement of the debt.

At the auction sale barn, each lot of tobacco goes to the highest bidder, unless that bid does not exceed the government's loan price. In such cases, the farmer is paid the loan price by a cooperative, with money borrowed from the CCC. The tobacco is consigned to the cooperative (known as a price stabilization cooperative), which redries, packs, and stores the tobacco as collateral for CCC. The cooperative, acting as an agent for the CCC, later sells the tobacco, with the proceeds going to repay the loan plus interest.

No-Net-Cost and Marketing Assessments. Under the threat of legislative dissolution of the program by its opponents, Congress passed the No-Net-Cost Tobacco Program Act in 1982 (P.L. 97-218). This legislation imposes an assessment on every pound of tobacco marketed (including imported tobacco since 1994). The no-net-cost assessment on 2004 crop flue-cured is 10¢ per pound; the burley assessment is 2¢. Growers and buyers each pay half of the no-net-cost assessment. The no-net-cost assessment funds are deposited in an escrow account that is held to reimburse the government for any financial losses resulting from tobacco loan operations. Losses occur when a cooperative sells loan collateral tobacco at a price insufficient to cover the loan principal plus interest. Until its legal authority expired, a budget deficit reduction assessment (called a marketing assessment) of 1% of the support price was collected on every pound of tobacco marketed from 1990 through 1997.

Market Loss Payments and Disaster Assistance. In response to low commodity prices in 1999, 2000, and 2001, Congress authorized market loss payments to producers of grains, cotton, oilseeds, tobacco, dairy, and several other crops (P.L. 106-78, P.L. 106-224, and P.L. 107-25). Tobacco growers were paid about \$1 per pound for diminished quotas, receiving direct payments of \$328 million in FY2000, and \$350 million plus and \$129 million in FY2001. Agricultural disaster assistance legislation in 2003 (P.L. 108-7) provided another \$51 million to tobacco producers. These payments are not constrained by the no-net-cost provisions of the tobacco loan program. Additionally, \$2.8 million was approved for tobacco on warehouse auction floors damaged by flooding from hurricane Floyd in 1999.

Experience

Passage of the No-Net-Cost Tobacco Program Act made a significant change in federal price support policy. Shifting the financial burden for tobacco program losses from the federal government to growers encouraged a reduction in support prices (which was done by legislation in 1985). Initially, this stopped the decline in U.S. tobacco leaf exports. However, the growing competitiveness of foreign tobacco has continued to erode the U.S. share of export markets. Foreign tobacco had captured 45% of the domestic cigarette manufacturing market when Congress enacted a domestic content requirement. This domestic content requirement took effect in 1994 and limited foreign tobacco to 25% of the U.S. market. Under new international trading rules, the domestic content requirement was replaced in September 1995 with a tariff-rate quota, which is less restrictive than the previous domestic content requirement. In 2002, imported tobacco constituted 55.4% of U.S.-manufactured cigarettes.

The no-net-cost rule muted much of the criticism that the tobacco loan program was a taxpayer subsidy for tobacco farmers. The budgetary impact of the tobacco loan program is determined primarily by loan outlays (new loans made) and loan recoveries

(repayment of old loans). In any given year, new loan outlays may be more or less than recoveries from the repayment of old loans. In FY2002, the net loan outlay recovery of \$123 million was the result of larger old loan repayments compared to new loan outlays. Since tobacco is typically stored for extended periods, it can be several years before the loan inventory is sold. The law requires that any losses of loan principal and interest be repaid from the no-net-cost account, which is funded from assessments on growers and buyers of leaf tobacco. This requirement does not apply to 1999 crop loan inventories that Congress authorized be transferred to the CCC without the action being charged against the no-net-cost program (P.L. 106-387, Sec. 844). This law cost the CCC \$625 million, for acquisition, interest, storage, and disposal. In the absence of this law, losses from the disposal of these inventories would have been covered by the no-net-cost account with funds raised from assessments on tobacco marketings.

Table 1. CCC Tobacco Outlays and Recoveries, FY2001-FY2004

| Loan Program Operation | Million \$ | | | |
|---|----------------|----------------|----------------|------------------|
| | FY01 Actual | FY02 Actual | FY03 Actual | FY04 Estimate |
| Loan outlays(+) | 115 | 110 | 220 | 147 |
| Loan recoveries(-) | -263 | -233 | -98 | -128 |
| Net loan outlays(+) or recoveries(-) | -148 | -123 | 122 | 19 |
| Market loss payments & disaster assistance(+) | 471 | 6 | 51 | 0 |
| Miscellaneous expenses(+) or receipts (-) | 63 | -20 | 6 | 1 |
| Total net expenditures(+) or receipts(-) | 386 | -137 | 179 | 20 |

Source: Data are compiled from U.S. Department of Agriculture, Commodity Credit Corporation, Commodity Estimates Book, FY2005, Washington, DC, February 2004.

There are other critics of the tobacco program. Free market advocates point to the competitive disadvantages caused by the program. Economists believe that without marketing quotas and price support loans, farmers would produce more tobacco, which would be sold at lower prices. The lower prices would lead to increased exports, and more domestic production would be used in U.S.-manufactured cigarettes — displacing some of the imported tobacco. Some health advocates say the federal government should not be supporting tobacco farm income and should get out of the tobacco business. However, elimination of the program would free producers from the production constraints of marketing quotas and result in more and lower-priced tobacco.

Elimination of the tobacco program would likely cause consolidation into fewer but larger, more mechanized tobacco farms, with reduced costs of production. Many of the smaller, higher cost farms would likely stop producing tobacco, but they would have very few alternative crops capable of such high per-acre revenues as tobacco. Economists predict that there would be a substantial adjustment cost from elimination of the program, and it would not fall solely upon those farmers, workers, and communities that would benefit from the free market efficiency gains. Several tobacco “quota buyout” bills have been introduced that would substantially alter or possibly federal tobacco support policy.

Other USDA Tobacco-Related Activities

In addition to the tobacco price support program, the USDA administers several other programs designed to assist tobacco farmers, facilitate marketing, and provide information to federal program managers and policy makers. It administers subsidized multi-peril crop insurance for tobacco (as well as for other crops), which is budgeted to cost about \$41 million in FY2005. Also, as with other crops, the Department collects, analyzes, and disseminates data on tobacco production, utilization, and prices, costing about \$1.262 million in FY2005. The USDA, using its own discretion, has discontinued all federal extension program expenditures on education and pest management related to tobacco. The Department is specifically prohibited from spending research funds on the production, processing or marketing of tobacco, and from promoting the export of tobacco or tobacco products. These prohibitions are contained in the annual USDA appropriations law.

For More Information

- USDA's Farm Service Agency (FSA) each year issues *Commodity Fact Sheets* [<http://www.fsa.usda.gov/pas/publications/facts/pubfacts.htm>] on the tobacco price support programs (as well as other commodity programs), which include eligibility information, program details, and historical data.
- The *Tobacco Situation and Outlook Report*, published by USDA's Economic Research Service (ERS), is a periodic compendium of production, trade, demand, and other current and historical data, plus special analytical articles. See the electronic *Tobacco Briefing Room* [<http://www.ers.usda.gov/Briefing/Tobacco/>] for an array of information.
- A survey and budget summary is available in CRS Report 97-417, *Tobacco Related Programs and Activities of the U.S. Department of Agriculture: Operation and Cost*.
- CRS Report RL31790, *Tobacco Quota Buyout Proposals in the 108th Congress*, examines the issues surrounding quota buyout proposals.