The Future of the U.S. Tobacco Economy

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Agricultural Outlook Forum
February 23, 1999

Last November's tobacco settlement was followed by an immediate boost in wholesale cigarette prices on top of earlier increases that brought the cumulative price increase for 1998 to 50 percent. In recent months growers were hit with substantial cuts in tobacco quotas for the second year in a row, due to the double whammy of a deteriorating domestic market outlook and falling exports due to economic crisis in Asia and other overseas markets. ERS expects that higher cigarette prices and other factors could cut U.S. cigarette consumption by as much as 25 percent over the next 10 years.

The tobacco industry, with roughly $50 billion in annual sales, accounts for an important chunk of the U.S. economy, so loss of tobacco sales can be expected to cause significant economic hardship and dislocation. Tracing the shares of the tobacco dollar and where those dollars go shows that most of the impact will be felt beyond the farm gate, by retail stores, manufacturers, wholesale establishments, transportation industries, and other businesses that supply materials and services to the industry. U.S. farms receive less than 3 cents of every retail dollar spent on cigarettes, but tobacco farmers and their communities are probably most vulnerable to declining tobacco sales.

Tobacco Farms and Rural Communities Are Most Vulnerable

Manufacturing, wholesale, retail trade, transportation industries, their employees, and businesses that supply them will feel economic pain, but most of those activities occur in urban areas where alternative opportunities are plentiful, especially in today's booming economy. Tobacco farms and their operators, on the other hand, have invested considerable amounts of capital, time, and other resources in tobacco-specific resources: equipment, greenhouses, curing barns, land, and expertise that cannot be easily redeployed to other uses. Tobacco farmers, who have an average of 20 years experience on their present farm, have accumulated considerable expertise in tobacco growing. With an average age of 54 years old, retraining doesn't make sense for most. In many tobacco-growing areas, profitable alternative farm enterprises are not available. On tobacco farms, tobacco outstrips all competing enterprises in returns per acre, especially on small farms. Tobacco communities may be vulnerable if they cannot replace lost tobacco spending at farm supply and equipment dealers, warehouses, and retail stores.

Declining tobacco sales will mean real economic hardship for thousands of people and dozens of communities, but this is a manageable problem. The number of people and communities who will be seriously impacted and the dollar value of their losses are relatively small, especially in comparison to the dollars that will flow to tobacco States through the recent tobacco settlement and the recently established growers' trust fund. The economic dislocation can be managed, but there are at least four tasks that must be completed to ensure that this happens.

- Identify the people and communities that will be hurt the most.
- Understand the various strategies that farmers and communities might pursue in response to declining tobacco income.

- Target assistance where it is most needed.
- Make sure assistance dollars are used wisely.

Growers and Communities are Diverse

Tobacco farmers and quota owners are a very diverse group. They vary in the size of their operations, the productivity of their land, and the nontobacco alternatives (both on- and off-farm) available to them. Characteristics are also strongly correlated with geographic location and tobacco type. Flue-cured farms on the coastal plain tend to be large, averaging 400 acres or more. They are relatively diversified, full-time farms with potential for expanding tobacco acreage. On the other hand, flue-cured farms in the Piedmont region of North Carolina-Virginia and most burley farms are smaller, more numerous, more dependent on off-farm employment, have little potential for expanding tobacco acreage. They are less likely to have a profitable nontobacco enterprise and more likely to have beef cattle. Various farms are likely to have differing strategies and objectives in response to changes in the tobacco market. A "one size fits all" approach to addressing tobacco farmers' needs is potentially wasteful and ineffective.

Many tobacco-growing communities have experienced strong economic growth. Over the past several decades, the nonfarm economy in the tobacco region has grown steadily while tobacco (and farming in general) has remained stagnant, or declined. That means tobacco has decreased in economic importance. The ratio of gross tobacco sales to total personal income is less than 5 percent in most counties where tobacco is grown. But there are 88 counties with ratios over 5 percent, and 33 with ratios over 10 percent. These counties are the most vulnerable to loss of tobacco income, and many have few jobs, an aging population, and high poverty rates. The most

vulnerable communities also tend to be the most likely to lose tobacco production--where productivity is low and farms are small. They are clustered in central and eastern Kentucky and in the North Carolina-Virginia Piedmont with a number in the Coastal Plain region.

Sharp Decline in Number of Growers is Likely

Tobacco growers and tobacco-dependent communities will choose various strategies to respond to the declining tobacco market. Some will stay in tobacco and try to increase productivity and acreage. Growers who have large efficient farms are the most likely to stay in the tobacco business. Many will try to expand acreage their acreage, especially if the program should be eliminated, to take advantage of economies of size and mechanization.

It seems inevitable, however, that a lot of people will quit tobacco growing in the coming decade. "Fewer, larger farms" has been the watchword in most types of farming and we've seen a lot of consolidation already in tobacco. The number of tobacco growers declined by two-thirds over the last 30 years while tobacco production stayed roughly constant at about 1.7 billion pounds. The number of tobacco growers fell about 30 percent between 1992 and 1997 alone. About one-fourth of tobacco farmers are 65 years old or older. The consolidation process will speed up if the tobacco program is eliminated. About 60 percent of tobacco growers harvested less than 5 acres of tobacco in 1997. Many of these very small operations may become nonviable with shrinking quotas and/or lower per-acre returns.

The 1997 Census of Agriculture counted 90,000 farms that grew tobacco, and 65,000 farms where tobacco was the primary crop. It is likely that at least half of these farms will no longer be

growing tobacco in 10 years. Those who are able to will retire. Some may stay in farming and pursue alternative farm enterprises. Some will pursue nonfarm employment or start a business. Each group will have different goals and needs. As States manage the funds flowing through the settlement and grower trust funds, they need to give attention to how they can aid the large number of growers making a transition out of tobacco.

Different Needs For Different Strategies

Growers who stay in the tobacco business will be interested in research and extension that could develop and disseminate new technologies and improved management and find alternative uses for tobacco. Marketing is another area where tobacco growers may need assistance in the long run. Some people anticipate an increase in contracting between growers and tobacco companies if the tobacco program is eliminated at some point. Contracting could also become more prevalent if industrial or pharmaceutical uses for tobacco are found. As we have seen in the poultry and hog sectors, contracting opens a range of issues for farmers. Growers may need advice on evaluating contracts and help in collecting market and price information.

Tobacco growers may try to develop on-farm alternative crops, livestock, or value-added enterprises. This strategy may be successful for some, but it is well known that other crops cannot match tobacco's per-acre returns. A few labor-intensive high-value commodities, including vegetables, some fruits, and exotic specialty crops can bring high returns, but the market for many of these is limited and widespread adoption pushes down prices. Tobacco

growers need good, well-considered advice on the technical, marketing, and financing aspects of starting up new farm enterprises.

Many members of tobacco-growing households will seek to replace lost tobacco income with off-farm employment. This can be addressed through both supply- and demand-side measures: training and skill development and rural job creation. However, the average age of tobacco growers is 53 and 35 percent are at least 60 years old, so retraining for a nonfarm career is not always realistic. Many older farmers may continue to operate their farms, while those who are financially able to do so may retire. Older farmers need help with financial planning. Those who are not in a position to retire are the group most severely affected by declining tobacco demand and in need of income support.

Communities Need to Plan Carefully

Towns, cities, and counties in tobacco-dependent areas will also need to plan carefully to adjust to the loss of tobacco income. Some communities may seek to develop and encourage new agricultural enterprises. This could include encouraging agricultural tourism, opening a farmers' market, attracting a food processing plant, or promoting purchases of local produce by retailers and restaurants. Communities may need assistance in market evaluation, grants or loans for facility construction, advice on advertising and promotion. Regional collaboration among communities may be an effective way to pool resources.

Many communities may seek to develop or attract nonfarm industry as a job creation strategy. Tobacco communities have been very active in economic development and many have been

successful. Southern communities have long relied on attracting manufacturing facilities, and this will be an important component of development efforts for many tobacco communities. However, many experts argue that encouraging start-up of locally-owned businesses is a more effective approach to economic development.

This brings us to the concerns growers have about how funds earmarked for tobacco communities will be spent. Careful attention must be given to planning and overseeing use of settlement and growers' trust funds targeted to growers and their communities. States are taking steps to form commissions to advise governors on this process, but more needs to be done. Cooperation among States, alliances among tobacco communities, and cooperation among various Federal and State agencies that provide economic development assistance could bring more synergy to the adjustment process. There are several models of regional issue-specific development initiatives that could be followed, including the Northwest Timber Initiative, the Mississippi Delta Compact, and the Colonias Initiative, which addressed economic development needs in the United States' southern border region.

Conclusion

In summary, the tobacco industry faces momentous changes in the coming decade. There will be considerable economic pain and dislocation. The problem is a manageable one, however. The entities who have control over settlement and growers' trust funds need to give attention not only to the current economic pain tobacco growers are experiencing, but also plan ahead for the transition to a smaller, highly productive and efficient tobacco industry.

There are some 300,000 quota owners and 90,000 tobacco growers. Some of the quota owners are also growers, but we don't know how many. For the majority of people involved in tobacco, their income from tobacco is an important component of their household income, but not their sole source of support. For example, at a lease rate of 35 cents per pound the average owner of a flue-cured quota allotment would receive rental income of $8,500 per year and the average burley allotment would bring $1,225 per year. In 1997 more than half of principal operators of tobacco farms said farming was not their principal occupation and 38 percent worked essentially full time (200 days per year) off-farm.

While economic losses facing tobacco farmers and their communities are substantial, they are often overstated. While there are several hundred thousand people likely to be adversely affected by the loss of income from tobacco growing or quota rental, most of those people are only partially dependent on tobacco income. Similarly, many tobacco-growing communities happen to be adjacent to rapidly-growing sunbelt cities, which has reduced the local dependence on tobacco dollars.

It has been over thirty years since the government's initial warnings about tobacco's detrimental effects on health and restrictions on cigarette advertising, so weak demand for tobacco is no surprise. People have been sending out warnings about tobacco's poor prospects since the 1960's. Tobacco has had its ups and downs over the past thirty years, but the trend has generally been down. The newly released 1997 Census of Agriculture shows that the number of tobacco

growers declined 28 percent between 1992 and 1997. In 1997 there were less than 90,000 farms growing tobacco, about one-third the number of growers 30 years ago.

Consolidation is one of the major trends in tobacco production that will continue into the next century. "Fewer, larger farms" has been the watchword in most types of farming and we've seen a lot of consolidation already in tobacco. While the number of tobacco growers declined by two-thirds over 30 years, tobacco production was about the same, at 1.7 billion pounds. Without the Federal tobacco program, consolidation would have been even more dramatic. The tobacco program essentially froze in place historical patterns of tobacco production by preventing transfers of quota across county lines, boosting the profitability of an acre of tobacco, and keeping small tobacco holdings viable. Without the program there would have been regional shifts in production and thousands of small growers could not have stayed in the business without the program's price supports. That means there is even more room for consolidation in tobacco growing.

The recent decline in quotas may speed up consolidation. As each grower's quota (and therefore his or her gross income) shrinks, those who have large fixed obligations to pay, such as interest payments on machinery or land purchases, will be looking to acquire more quota. This will push up quota rental rates, and more growers, especially smaller operators, will probably rent out their quota. The consequence is fewer, larger tobacco growers. If the tobacco program and its quota system were eliminated, consolidation and regional shifts in production would occur, bringing about dramatic changes in the structure of the industry. Flue-cured acreage would tend to move

from piedmont to low-cost coastal plain areas where growers can expand acreage and take advantage of size economies. Burley acreage would move out of high-cost mountain regions and extremely small holdings would decline in number.