Removal of Government Controls Opens Peanut and Tobacco Sectors to Market Forces

Erik Dohlman
edohlman@ers.usda.gov

Linda Foreman
lfarmer@ers.usda.gov

Michelle Da Pra
mdapra@ers.usda.gov

- Landmark policy changes enacted in the early 2000s transformed the peanut and tobacco sectors by eliminating longstanding supply controls and geographic restrictions on production.
- Guided by market forces, adjustments to the new environment occurred rapidly, resulting in fewer but larger farms in the regions best adapted to production.
- Total acreage and prices for peanuts and tobacco are lower, but more efficient production, competitive prices, and other market forces have supported renewed demand growth, particularly in export markets.

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Until recently, peanuts and tobacco were among a small group of commodities in the United States regulated through the use of supply-limiting marketing quotas and price supports. Established in the 1930s, the marketing quota programs were designed to foster high and stable prices, and to support the incomes of those who possessed the rights to grow and sell peanuts and tobacco.

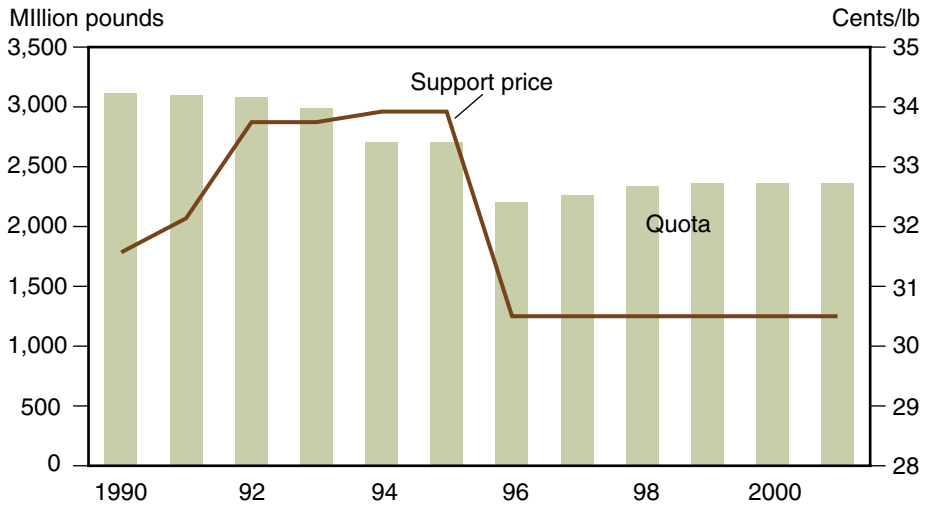
Although the quotas did provide some certainty about how much growers could sell and the price they would receive each year, rigidities in the programs made it difficult for producers to adapt to long-term market forces. Over time, a variety of economic and policy factors—primarily constraints on more efficient production and pressures from global competition—undermined the viability of the programs, which prompted legislation to eliminate the peanut program in 2002 and the tobacco program in 2004. The two laws were called "buyouts" because those who owned the rights to sell the commodity were paid for the loss of their asset (the quota).

The buyouts provided a temporary stream of payments to quota owners (convertible to a lump sum), but elimination of the quota programs suddenly exposed producers to greater market risks and brought about structural changes at the farm, regional, and marketwide levels. Key questions associated with the buyout were how producers would adapt and, in particular, what changes lower prices and greater exposure to market risk would bring to the number of farms, their scale, location, and risk-management strategies.

Efficacy of Quota Programs Undermined by Trade Agreements and Market Conditions

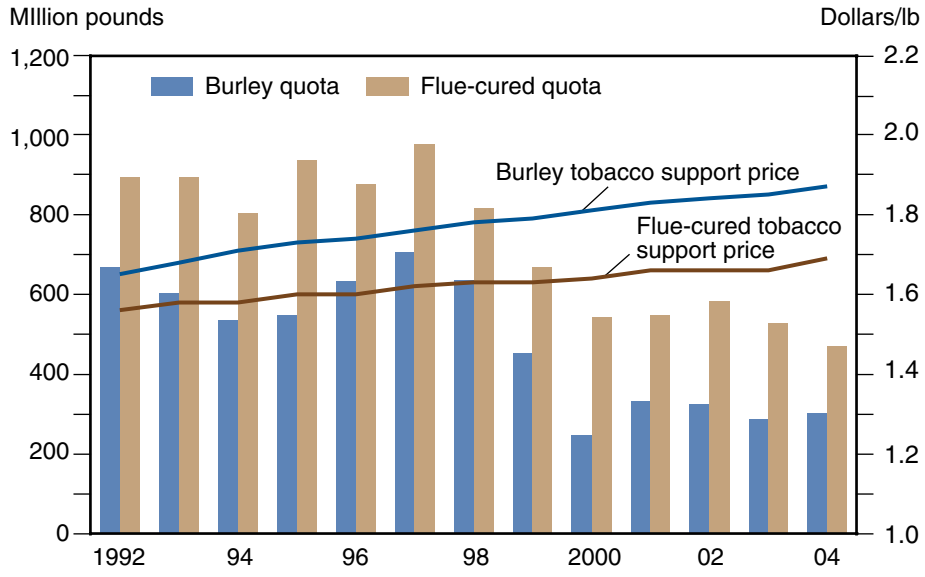
The idea of the marketing quota programs was to limit sales (marketings) to a certain quantity (quota) to keep prices higher and more stable than they would have been in a free market system. USDA could adjust the quota annually based on evaluation of demand conditions to ensure that the market-clearing price matched or exceeded an established support price, known as a quota loan rate.

Peanut support prices were lowered to hold quota steady...



Note: The quota level refers to the national poundage quota before adjustments. Year refers to marketing year (August-July). Support price refers to the quota loan rate.
Source: USDA, Economic Research Service using data from USDA's Farm Service Agency.

...while tobacco quotas were lowered to maintain high support prices



Note: The quota level refers to basic quota before adjustments.Year refers to marketing year (July-June for flue-cured and October-September for burley).
Source: USDA, Economic Research Service using data from USDA's Farm Service Agency.

Once the annual national quota level was determined, USDA distributed the marketing rights to peanut and tobacco quota owners in each region based on their historical share of quota ownership. This was done separately for tobacco and peanuts. An important distinction between the two programs was that the peanut quota applied only to peanuts destined for domestic food uses, while the tobacco quota was set to meet anticipated domestic and foreign demand for U.S. tobacco leaf.

For many years, the marketing quota systems functioned relatively smoothly, if not efficiently. Over time, however, several key market and policy changes made it clear that quota levels, support prices, or both would have to be reduced by the Government—effectively undermining the income-supporting intent of the programs (see box, "Quotas Distorted Markets and Restrained Efficiency Gains").

Separate provisions of the 1994 World Trade Organization (WTO) and North American Free Trade Agreement (NAFTA) treaties allowed more peanut imports to compete with U.S. quota holders for a share of the domestic market. U.S. tobacco growers for years had been contending with global competition from lower cost foreign producers, which led to falling foreign demand for U.S. tobacco leaf, and a rising share of foreign tobacco used in U.S. and global cigarette production. Smoking restrictions, increased health concerns, and higher cigarette taxes also dampened U.S. demand for cigarette tobacco.

With the increased competition from foreign imports, the peanut program was adjusted by lowering the support price (quota loan rate) in 1996—while keeping the quota level relatively steady. The tobacco program was adjusted by lowering the quota level by roughly 50 percent in the 8 years preceding the tobacco buyout.

These steps were required because both programs included "no-net-cost" provisions, meaning that the programs had to operate

without any direct government payments to producers. Keeping the prices and quota levels unchanged would have violated the no-net-cost provision or required quota producers to reimburse losses from selling peanuts or tobacco at a price below the quota loan rate.

Buyout Program Provides Compensation

In response to changing policies and market conditions, the 2002 Farm Act eliminated the peanut marketing quota program, beginning with the 2002 growing season. Quota owners were compensated with payments totaling $1,100 per short ton ($0.55/lb) of owned quota. The buyout payments totaled about $1.3 billion, funded entirely by the Federal Government.

The Fair and Equitable Tobacco Reform Act of 2004 subsequently ended the tobacco quota program, beginning with the 2005 growing season, and provided a combined $10 per pound payment to tobacco quota owners and producers. Payments totaling $9.6 billion are funded by assessments on tobacco product manufacturers and importers.

While the peanut buyout payments went exclusively to quota owners, the tobacco buyout payments were distributed between quota owners ($7 per pound) and those who produced and marketed quota tobacco ($3 per pound). Tobacco growers received no further government support, but peanut growers became eligible for the same type of government payments available to growers of other program crops such as wheat, corn, cotton, rice, and soybeans. These payments included direct and countercyclical payments, and a marketing loan program that provides a price guarantee of about 60 percent of what was available under the quota program.

Buyouts Spurred a Rapid Exodus of Peanut and Tobacco Farmers

When the buyouts were enacted, peanut and tobacco producers faced an uncertain future. These farmers also raised other com-

Quotas Distorted Markets and Restrained Efficiency Gains

The marketing quota systems for peanuts and tobacco kept prices artificially high, which undermined the competitiveness of U.S. producers relative to foreign producers and reduced incentives to lower costs and improve efficiency. But there were other aspects of the quota programs that made it difficult for producers to improve productivity by lowering average costs and/or raising yields.

One drag on productivity was the fragmented nature of quota ownership. In the years preceding the buyouts, the number of quota owners far exceeded the number of active peanut or tobacco farmers since retired farmers typically retained their quota and rented it to others. In 2002, approximately 75,000 people owned some peanut quota, compared with 8,000 farms growing peanuts. There were more than 350,000 tobacco quota owners in 2004, but only 57,000 tobacco farms.

Most peanut and tobacco growers owned some quota, but about 60 percent of quota production for each crop was from rented quota. Producers wanting to expand the scale of their operations had to rent quota rights from quota owners, which added to their cash expenses and management time. The small size of plots also discouraged investment in specialized equipment that was economically justified only if used over a larger area. This was particularly true for tobacco farms, which typically had low tobacco acreage and relied heavily on manual labor.

In addition, administrative rules generally restricted the ability to transfer (sell or rent) quota to other States, and in some cases, counties, where more efficient production was possible due to better climate or soil conditions. Limitations on peanut production were less binding than for tobacco because a 1981 rule change allowed nonquota holders to produce peanuts wherever they chose as long as the peanuts were exported, or used for nonfood purposes (e.g., crushed to extract high-protein animal feed and vegetable oil). Nevertheless, a large share of peanut and tobacco production was confined to areas that may not have been best suited to these crops due to disease pressures or reduced soil fertility.

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Characteristics of peanut and tobacco farms changed rapidly after the quota buyouts

Item	Peanuts		Flue-cured tobacco		Burley tobacco	
	2002	2007	2004	2007	2004	2007
Number of farms	8,086	5,134	11,062	2,639	39,215	12,973
Farm size (*acres per farm*):						
Total operated	907	1,525	566	906	191	247
Peanut	137	227	NA	NA	NA	NA
Tobacco	NA	NA	33	84	5	11
Sales totaling $500,000 or more (*percent of farms*)	14	33	12	31	na	na
Percent of farms with peanut marketing contracts	40	65	NA	NA	NA	NA
Percent of farms with tobacco marketing contracts	NA	NA	47	83	31	49
Household income per farm (*1,000 dollars*)	77	111	105	140	54	60
Farm income per farm	21	65	66	110	10	9
Off-farm income per farm	55	46	39	30	43	51
Farm assets per farm (*1,000 dollars*)	938	2,129	928	1,575	465	651
Farm debt per farm (*1,000 dollars*)	162	185	88	138	37	43
Farm business net worth per farm (*1,000 dollars*)	776	1,944	840	1,437	428	608
Debt/asset ratio (*percent*)	17	9	9	9	8	7
Number of commodities per farm	3.7	4.9	3.3	4.6	2.8	4.1

NA = Not applicable. na = Data not available.
Source: USDA, Economic Research Service using data from USDA's Agricultural Resource Management Survey, 2002, 2004, and 2007.

modities, but a large share of their income—about 30 percent for peanut farms and over 40 percent for tobacco farms—came from their marketing quota crop.

In the post-buyout environment, growers had to determine whether peanut or tobacco farming could be profitable in a new, lower priced market and whether they could manage price and production risk. For producers who primarily owned quota, rather than rented, the buyout payments provided a financial cushion. However, prices immediately declined, and decisions on whether to continue production were based on whether production would be profitable at the new prices. Although farmers who rented quota received no buyout payments in the case of peanuts, and lower payments than quota owners in the case of tobacco, the impact of lower prices on farmers who had previously rented quota was softened by a reduction in expenses because they no longer needed to pay quota rental fees.

Many producers decided to quit growing peanuts and tobacco, and a substantial share of peanut and tobacco producers left farming entirely. According to data from USDA's Agricultural Resource Management Survey (ARMS), the number of producers growing the two main tobacco types—burley and flue-cured—fell by nearly 60 percent in the year after the buyout was enacted. This trend continued, but more slowly, in subsequent years, bringing the total number of burley and flue-cured tobacco farms from about 50,000 in 2004 to about 15,500 in 2007. The decline in the number of peanut farms was not as rapid or extreme as for tobacco, but even so, the number of peanut farms declined by about 3,000 (roughly a third) between 2002 and 2007.

Growers who left peanut and tobacco production were primarily older farmers who likely owned, rather than rented, quota. The subsequent growth of average farm size also indicates that operators of smaller farms did not have the resources or inclination to risk continued production in a more competitive and uncertain environment. The rapid decline in farm numbers, particularly for tobacco, also may reflect decisions by many farmers to defer retirement or other changes in farming activities until the buyouts were enacted.

The tobacco buyout was widely anticipated, and producers did not want to forgo the opportunity to collect the additional buyout transition payments that were made to active tobacco producers. The slower pace of exits among peanut farmers may also be tied to the availability of new forms of government support which, in contrast to tobacco, continued to provide a (lower) floor to the revenue received for their output.

Consolidation Boosts Average Farm Size

While farm numbers declined at a different pace for tobacco and peanuts, the ensuing consolidation produced a similar outcome—fewer, but larger, farms for each crop. Exits of small farms accounted for much of the increase in average farm size, at least initially, rather than the entry of larger new farms or an increase in acreage among existing farmers. Average peanut acres increased from 137 per farm in 2002, to 227 in 2007. Total average operated acres per farm expanded to 1,525, compared with 907 in 2002.

Tobacco farms were much smaller, on average, than peanut farms, both before and after the tobacco buyout. Even so, average burley acres per farm doubled from 5 to 11 acres between 2004 and 2007, and average flue-cured acreage more than doubled from 33 to 84 acres per farm. As with peanuts, total operated acres per farm also grew.

The financial condition of the remaining peanut and tobacco farms appears, on average, to be as good as, if not better than, such farms' typical financial condition in the years the buyouts were enacted. Total farm and off-farm household income, total farm business net worth, and the percentage of farms falling into the higher sales class were all comparable or higher in 2007 than in 2002 for peanuts and in 2004 for tobacco, while debt-to-asset ratios were the same or lower.

While data are not conclusive and are highly variable, total household incomes increased for a sample of peanut and tobacco farms surveyed by ARMS, with increases coming mostly from farm activities rather than off-farm income. This finding is consistent with the observation that operators of larger farms tend to devote most of their time to farming activities and rely less on off-farm work to supplement their incomes. While the debt-asset ratio declined significantly only for peanut farms, total farm business net worth and the share of farms operating in the largest sales class—farm sales over $500,000 annually—rose substantially for both peanut and flue-cured tobacco farms.

Peanut and Tobacco Producers Increase Use of Marketing Contracts

Tobacco and peanut producers approached their risk management strategies similarly following the buyouts—by increasing their use of marketing contracts to lock in prices and by maintaining a diversified commodity mix to spread risk. The use of contracts to set terms on prices, output, and other conditions has been a growing trend throughout agriculture, but contracts were not widely used for peanuts and tobacco until the 2000s because the marketing quota system and other institutions (e.g., tobacco auctions and farmer cooperatives) served a similar purpose.

Some tobacco and peanut producers used contracts prior to the buyouts. Tobacco contracts sometimes offered higher prices than auctions. Peanut producers growing nonquota peanuts for export or crushing—about one-quarter of production— relied mostly on marketing contracts. Nevertheless, the percentage of farms using marketing contracts increased significantly following the buyouts. By 2007, 65 percent of peanut farms used marketing contracts, compared with 40 percent in 2002.

Less than 10 percent of tobacco farms used tobacco marketing contracts in 2000, but this percentage rose in the years leading up to the tobacco buyout. By 2007, 83 percent of flue-cured tobacco farms and 49 percent of burley tobacco farms used tobacco marketing contracts. Since peanut and tobacco farms are larger following the buyouts, they also tend to be more diversified in their commodity mix and better able to spread risk.

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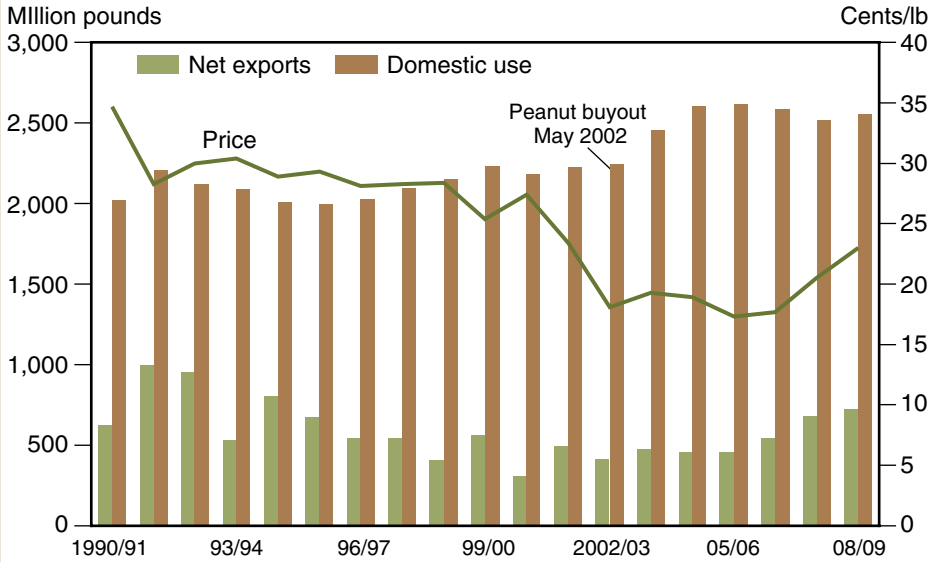
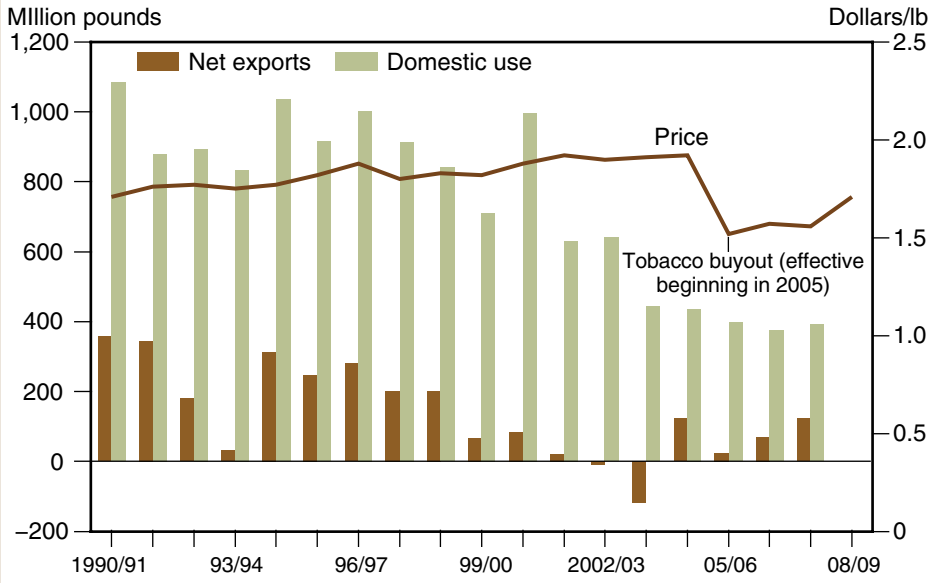
Domestic and foreign peanut demand strengthen after buyout



Note: Net exports refers to exports minus imports. Domestic use refers to food use. Years are marketing years (August-July).

Sources: USDA, Economic Research Service using USDA, National Agricultural Statistics Service, *Crop Production, Quick Stats*, and *Peanut Stocks and Processing*; and U.S. Department of Commerce, Census Bureau.

Domestic use of U.S.-grown tobacco stabilizes at lower level, but net exports rise



Note: Net exports refers to exports minus imports. Prices are a simple average of flue-cured and burley tobacco prices.Years are marketing years (July-June for flue-cured and October-September for burley).

Sources: USDA, Economic Research Service using USDA, National Agricultural Statistics Service, *Crop Production* and *Quick Stats*; and U.S. Department of Commerce, Census Bureau. Factors for converting tobacco stocks to farm weight taken from USDA, Agricultural Marketing Service, *Tobacco Quarterly Stock Report*, various years.

Production Migrates to Different Areas

With the elimination of marketing quotas, geographic restrictions ended, resulting in significant shifts in production area between counties and States as some traditional production regions declined and others expanded. Lower, post-buyout prices no longer supported profitable production in areas where net returns from production were relatively low. This trend was most notable for peanuts, where production migrated away from the Southwest and Mid-Atlantic but remained strong in the Southeast. Many counties in the Southeast saw increased plantings, and production spread to some Southeastern counties with no previous production history. The Southeast's share of national peanut acreage grew from about half before the buyout to nearly three-quarters.

Tobacco production did not increase substantially in any production location. However, it became more concentrated in parts of the two largest tobacco-producing States—North Carolina for flue-cured tobacco and Kentucky for burley tobacco. In North Carolina, acreage has shifted toward the coast, closer to ports.

The impacts of greater planting flexibility and market orientation, and the regional shifts in production, appear to have contributed to increased efficiency and improved yields, particularly for peanuts. Since the buyout, areas with a history of stronger yields have been gaining acreage at the expense of areas with poorer yields, and national peanut yields averaged 17 percent higher during 2003-08 than during 1996-2002. This could be the result of better growing conditions in the new areas, and perhaps different crop management practices employed by the larger operations, such as longer crop rotations and better use of inputs. Tobacco yields have shown little if any discernible upward trend since the tobacco buyout, but ARMS data indicate that areas that have retained the most acreage historically have higher and less variable yields than those that have lost acreage.

Buyouts Disrupted Production, But Heightened Producers' Competitiveness

The peanut and tobacco buyouts marked the beginning of a major transition for producers and other stakeholders in the marketing quota system. Producers faced lower prices, more risk, and pressures to contain costs and improve productivity. Prices initially declined—30 percent for peanuts and 20 percent for tobacco—and production immediately fell. At the same time, the buyouts forced restructuring in both sectors that left producers better poised to respond to and take advantage of market opportunities. Several years after the buyouts, total acreage and prices remain below pre-buyout levels, but more efficient production and competitive prices have established some of the conditions for demand growth, particularly in export markets.

Peanut acreage has been somewhat volatile, but higher yields have boosted production—including a record crop in 2008—and domestic demand is stronger than before the buyout (see "In the Long Run" on page 48). U.S. peanuts have also become more competitive both in the domestic market and abroad. Before the buyout, U.S. peanut imports had been on a steady upward path due to market access agreements that were part of the 1994 NAFTA and WTO treaties. However, lower post-buyout prices caused imports to taper off. Lower prices reinforced by a generally weaker dollar since 2002 reversed the decline in peanut exports that preceded the buyout, and exports reached a 13-year high in 2008. Prospects for higher sales in the next year or two may be dimmed somewhat by the global recession and a possible strengthening of the dollar from current levels.

Tobacco export demand also has gained momentum with a weakened dollar and a narrowing of the traditionally large gap between U.S. and foreign tobacco leaf prices. However, domestic demand for U.S. tobacco leaf continues to drop, but more slowly than prior to the tobacco buyout. The continued drop reflects the ongoing decline in domestic per capita smoking rates, relatively steady tobacco leaf imports, and reduced exports of U.S. cigarettes. Even with lower U.S. tobacco leaf prices, domestic demand has been constrained by high retail cigarette prices that largely reflect costs other than tobacco leaf (e.g., manufacturing, promotion, and taxes). Only in some specialized categories—such as dark tobacco used in snuff and smokeless tobacco—has increased demand led to higher acreage.

Although not all recent changes in the peanut and tobacco sectors can be attributed to the buyouts, they clearly represented landmark events that influenced many of the structural changes that followed. Decisions on whether to increase, continue, reduce, or drop out of production—or even to begin production for the first time—are now based more on market-determined net returns from alternative crop choices, and are no longer affected by geographic restrictions on production. Regional production shifts, farm consolidation, and increased exports suggest that the buyouts and planting flexibility have enhanced overall economic efficiency and responsiveness to market developments.

This article is drawn from . . .

The Post-Buyout Experience: Peanut and Tobacco Sectors Adapt to Policy Reform, by Erik Dohlman, Linda Foreman, and Michelle Da Pra, EIB-60, USDA, Economic Research Service, November 2009, available at: www.ers.usda.gov/publications/eib60/

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Peanut Backgrounder, by Erik Dohlman and Janet Livezey, OCS-05i-01, USDA, Economic Research Service, October 2005, available at: www.ers.usda.gov/publications/ocs/oct05/ocs05i01/

Peanut Policy Change and Adjustment Under the 2002 Farm Act, by Erik Dohlman, Linwood Hoffman, Edwin Young, and William McBride, OCS-04G-01, USDA, Economic Research Service, July 2004, available at: www.ers.usda.gov/publications/ocs/jul04/ocs04g01/

Economic Research Service, *Data and Reports,* available at: www.ers.usda.gov/browse/crops/tobacco.htm