Photo by Ken Hammond, USDA

U.S. Tobacco Industry Responding To New Competitors, New Challenges

Thomas C. Capehart, Jr.
thomasc@ers.usda.gov

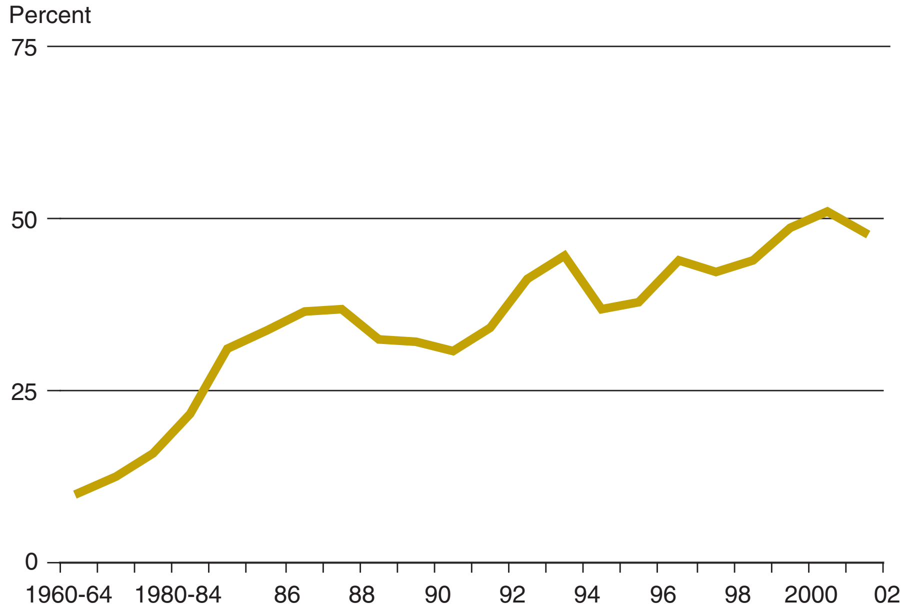
Tobacco growers are facing tough times as cigarette consumption shrinks and foreign producers edge them out of formerly lucrative markets. Not only have U.S. exports of tobacco leaf declined, but cigarettes manufactured in the United States now contain more foreign tobacco than ever before—nearly 50 percent. Why is U.S. tobacco losing ground to other countries? Price, mainly. With cheaper tobacco available on the world market, U.S. tobacco is losing global and domestic market share.

U.S. tobacco imports have significantly increased due to price competitiveness and higher leaf quality by overseas producers—the result of improved cultivation and marketing techniques. In the past, the superior quality of U.S. tobacco compensated for its higher price. But the dramatic increase in the quality of foreign leaf during the past 25 years no longer "protects" U.S. tobacco.

As the quality gap between U.S. and foreign produced leaf narrows, the price gap is increasing. In 2002, Japan, our leading and most loyal tobacco customer, purchased leaf from Brazil for the first time…and the U.S. share of world tobacco trade dropped to 8 percent, an all-time low.

Trade has always been an influential force in the global tobacco market. The U.S. is unique in that it is both a big tobacco-producing and consuming country. Countries that produce tobacco at low cost—Zimbabwe and Malawi, for example—tend to consume little tobacco and seek opportunities in lucrative markets, such as the European Union and Japan, where little tobacco is grown and production is costly. While trade policy reforms in the past decade have led to considerable shifts in trade for many commodities, tariffs on tobacco in major importing countries have always been relatively low.

Share of foreign tobacco in U.S. cigarettes



U.S. share of world tobacco trade

Tobacco Program, Now 65 Years Old, Ready for Change?

This changing global environment—and the increasing competitiveness of low-cost producing countries—is putting pressure on the U.S. flue-cured and burley tobacco program. (These two types account for 93 percent of U.S. tobacco output.) Created in 1938, the program was originally designed to provide a steady supply of high-quality leaf tobacco and to stabilize and support grower incomes through price supports and marketing quotas (see box, "The Tobacco Economy").

The Tobacco Economy

Flue-cured and burley tobacco make up 93 percent of the 890-million-pound U.S. tobacco crop. In 2002, the value of the crop exceeded $1.5 billion. Flue-cured tobacco is grown in North Carolina, Virginia, South Carolina, Georgia, and Florida. Burley tobacco is grown in Kentucky, Tennessee, Ohio, Indiana, Missouri, Virginia, and West Virginia. About 80,000 farmers produce these two types, using quota they own supplemented by leased quota. In addition to the 80,000 active producers, nearly all of whom own some quota, there are over 300,000 absentee tobacco quota owners. Quota, which is tied to a specific parcel of land, has economic value, so land with quota commands a substantial premium at sale.

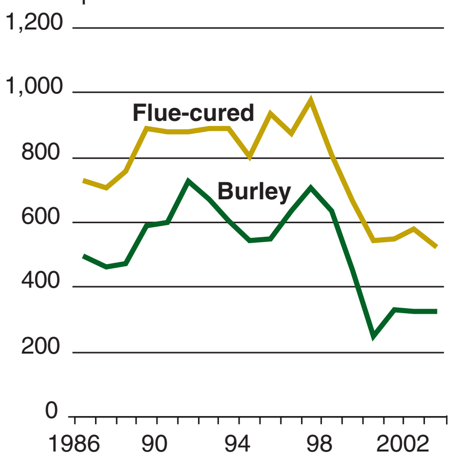
For many years, the United States was the largest tobacco leaf exporter and importer by volume. U.S. leaf has always been considered of high quality and is in demand by foreign manufacturers. However, during the past decade, Brazil has become the largest leaf exporter, with the U.S. generally second or third. The U.S. is still the largest importer of leaf, much of which is manufactured into cigarettes that are then exported. Although exports are not as high as during the mid-1990s, the United States still exports more cigarettes than any other country. Between leaf and cigarettes, tobacco makes a significant contribution to the balance of trade. In 2002, tobacco leaf and products contributed $1.7 billion to the trade balance. In the past decade, its contribution has been as high as $5.9 billion.

Quota is the amount of flue-cured or burley tobacco leaf a producer can sell during a given season and is a requirement for marketing these two types of tobacco in the United States. That is, unless a producer either owns quota or leases it from a quota owner, the producer cannot sell these types. Quota levels are revised annually according to recent demand and have declined drastically since the 1990s, as U.S. cigarette consumption has dropped and imports of tobacco leaf have risen.

The program also guarantees growers a floor price and a market for flue-cured and burley leaf. But over the years, price supports have risen and the discrepancy between U.S. and world leaf prices has become steadily larger. In 1960, grower prices in the United States averaged 60 cents per pound for flue-cured tobacco, compared with 40 cents per pound in Zimbabwe. By 2000, the difference was 60 cents per pound. Likewise, in 1960, U.S. burley prices were 25 cents per pound above prices in Malawi. In 2000, the spread was $1.40 per pound.

Because of the way the support price is calculated, the tobacco program nearly always results in annual price increases. The price depends on the average U.S. cost of producing leaf (which almost always goes up from year to year) and recent annual prices. Higher prices beget sliding demand (and greater imports), which results in smaller quotas, because expected domestic demand and export demand, significant factors in the quota calculation, are lower. The downward spiral caused by higher prices—prices rise, demand decreases, quotas shrink, but prices still continue to increase—is the cause of much of the tobacco farmers' woes…and their current interest in a buyout.

Flue-cured and burley national basic quota



The notion of quota buyouts is now more favorably received by growers at auction warehouses and country cafes in tobacco country.


Photo by Ken Hammond, USDA

In the late 1990s, legislators from tobacco-producing States proposed alternatives to the quota program. Many of these proposals included some form of buyout, in which the government would purchase the quota from the owner in order to move the tobacco industry toward a "free market" system. Quota holders would be compensated for the loss of future income from renting their quota to others or growing tobacco using their own quota.

At that time, the idea of a tobacco quota buyout program got mixed reviews from tobacco farmers. Many older farmers supported a buyout as a path to a secure retirement, but younger growers often preferred the stability and revenue the program guaranteed. Drastic cuts in quotas starting with the 2000 crop changed the picture. Quotas in 2003 are only 63 percent of 1999 levels. As a result, the notion of quota buyouts is now more favorably received by growers at auction warehouses and country cafes in tobacco country. This renewed interest has also united unlikely bedfellows: health advocates and tobacco grower organizations. These groups have aligned to promote legislation that couples a quota buyout with continued production controls for growers and regulation of tobacco products by the Food and Drug Administration (FDA). How did this turnabout happen, what are options for reform, and what are the consequences of a traditional U.S. cash crop "cashing out"?

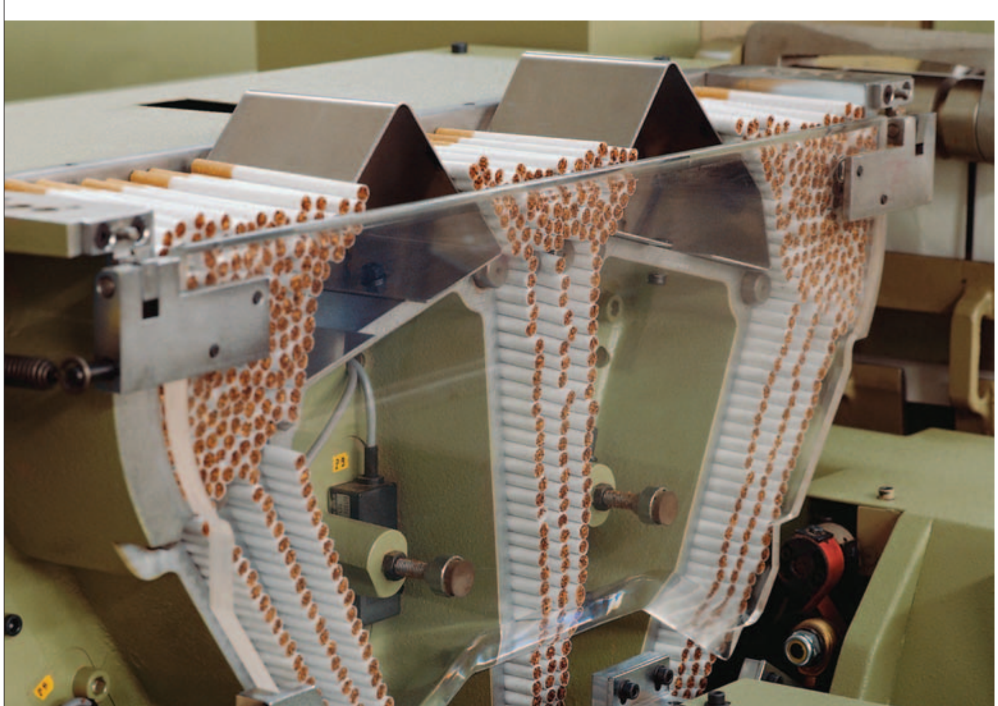
Quota Buyout Seeks To Restore U.S. Competitiveness. . .

Most tobacco leaf grown by U.S. producers follows one of three paths. It can be sold to the domestic cigarette industry for cigarette consumption here, sold to the domestic industry for manufacture and export of cigarettes, or exported in its leaf form. No matter which path the leaf follows, it faces competition from foreign sources.

Cigarettes made by domestic manufacturers contain both U.S. and foreign tobacco, with increasing amounts of the latter. High U.S. tobacco prices, competition from upstart cigarette companies making generic cigarettes, and large payments to States under the Master Settlement Agreement MSA, (see box, "Master Settlement Agreement") have made large cigarette manufacturers receptive to less expensive imported leaf—particularly given its increased quality.

The inability of U.S. growers to rapidly adapt volume and price to changing conditions puts them at a further disadvantage in the global market. For instance, when production in Zimbabwe plummeted due to political unrest and land reform, Brazilian producers were able to rapidly increase production and expand exports. But, because of the quota program, U.S. growers are unable to take advantage of opportunities in the world marketplace. Tobacco quota adjustments are based on past, not current or future, market conditions.

Cigarettes made by domestic manufacturers contain both U.S. and foreign tobacco, with increasing amounts of the latter.



Corbis

. . .And Boost Profitability

Despite increased foreign competition and the constraints of the quota program, American tobacco farmers still find tobacco a profitable crop—far more profitable than the alternatives. An average grower in North Carolina produced 27 acres of tobacco, about 54,000 pounds of leaf, in 1997, the latest year for which detailed production data are available. Those 27 acres yield about $100,000 of tobacco leaf. In comparison, the same 27 acres yield about $6,500 of corn. Corn isn't the only alternative, of course. Niche crops can be profitable, but often markets are limited.

At the same time, growers are faced with shrinking quota. Without access to sufficient quota, growers are unable to maintain the economies of scale needed to keep their production costs down.

For those who farm using another's quota—through leasing, for example—growing tobacco is still profitable but less so, at least on a cash basis, because they must compensate the owner of the quota. Depending on the year, renting or leasing quota can add up to 75 cents per pound, or nearly 40 percent, to a grower's expenses. The elimination of the cost of renting quota would enable these producers to maintain profits at a lower price.

Those growers who own quota do not have the expense of renting quota, but they must consider the opportunity cost to owning it—they could sell it and use the money elsewhere. As the national quota shrinks due to lower demand for leaf, competition for rental quota further inflates the cost of growing tobacco, eating into producer profits.

For all these reasons, grower interest in a buyout is at an all-time high. Quota

Master Settlement Agreement

On November 16, 1998, 46 State attorneys general and the major cigarette/smokeless tobacco product manufacturers signed a Master Settlement Agreement (MSA) to reimburse States for the cost of treating smoking-related illnesses. The companies also provided funds to reduce teen smoking. Previously, four States—Minnesota, Mississippi, Florida, and Texas—had signed separate agreements with the industry. One result of the settlement was an unprecedented increase—that very day—of 45 cents per pack in wholesale cigarette prices. Interest in the tobacco economy has broadened as States have become accustomed to payments from the MSA. Because of the size of the payments and the different ways they are used, States are now financially dependent, to varying degrees, on tobacco company payments. Key elements of the pact include:

- $206 billion to be paid to States over 25 years.
- $1.5 billion over 10 years to support anti-smoking measures, plus $250 million to fund research into reducing youth smoking.
- Limitations on advertising.
- Ban on cartoon characters in advertising.
- Ban on "branded" merchandise.
- Limitations on sporting event sponsorship.
- Disbanding of tobacco trade organizations.

In addition to the MSA, sometimes known as Phase I, cigarette manufacturers agreed to pay $5.15 billion to tobacco growers over a period of 12 years, known as Phase II. These payments were negotiated to compensate growers and quota owners for potential reductions in tobacco production resulting from the MSA.

The State of Maryland used part of its MSA payment as a tobacco buyout, by paying tobacco producers who promised not to grow tobacco. Because Maryland tobacco is a type not covered by the Federal quota program and the State program has substantively different objectives, this buyout experience is not relevant for the proposed flue-cured and burley buyout. The purpose of the Maryland buyout was to reduce tobacco production and keep land in agriculture, not to improve the viability of tobacco producers.

owners see an opportunity to exit the industry with a generous payment. Growers who are currently leasing quota anticipate a transition payment, elimination of quota rental payments if they continue growing tobacco, and the potential for lower per-acre production costs if they have greater flexibility to expand their acreage.

What Might the Policy Future Hold?

A wide range of policy options exists. On one end of the policy continuum is the total dissolution of the program—letting market forces determine the location, volume, and price of tobacco production. In this scenario (and others discussed below), total U.S. acreage and acreage per farm would likely increase. Prices would drop, imports would likely decline, and the U.S. share of both domestic and global markets would increase. Land values formerly propped up by the value of quota would decline during the adjustment to a free market.

At various points between the free-market end of the continuum and the restrictive end lie the buyout proposals currently being debated in Congress. Many of these proposals originate from the principles outlined in a 2001 Presidential Commission Report, *Tobacco at a Crossroad: A Call for Action*. Under such proposals, quota holders (owners) would typically receive a fixed payment per pound for their quota, paid over a period of years. Currently, there are about 400,000 quota owners, and they range from large, business-oriented holders to former tobacco farmers and retired people. Producers who do not own quota would be paid a transition payment to help them adjust to a free-market environment and to encourage diversification into other enterprises. During the mid-1990s, the 80,000 farmers who grew flue-cured and burley tobacco planted 60 percent of their tobacco using others' quota (see box, "How a Buyout Proposal Might Operate").

Some proposals include licenses as a substitute for quotas, in order to continue some form of control over production. Licenses would differ from quotas in several ways. Licenses would be issued to individuals and would stay with those individuals until the license holder dies and passes the license on to someone else. Licenses would not be bought, sold, or rented, and, therefore, would not add to the cost of growing tobacco. As such, licenses would negatively affect competitiveness less than quotas. Licenses would also carry geographic restrictions to prevent production from leaving traditional areas.

Price support at some level has also been proposed for a revised tobacco program—with or without licensing. Lower levels of price support would move policy along the continuum of policy options toward a free-market orientation, while

How a Buyout Proposal Might Operate

While the various buyout proposals being considered carry different features, all of them include some sort of buyout of quota. At the time of this writing, all the proposals contain similar payment structures, in terms of the amounts that would be paid to quota holders and to producers.

The national flue-cured and burley tobacco quotas are determined, according to statute, by a formula that accounts for domestic and foreign demand for U.S. leaf. An adjustment in the national quota is then applied to each quota holder. For the purposes of a buyout, payments to individual quota owners are prorated by the share of each in the national quota poundage for the base period, multiplied by \$8. (The present value of the future income stream from a pound of quota is roughly \$8.) An active producer/renter would receive a transition payment of \$4 per pound of tobacco, determined by varying base periods depending on the proposal. (One proposal pays an additional \$2 a pound to those who stop growing tobacco.) A quota owner who also produces his or her tobacco would therefore be entitled to \$12 per pound.

Growers would receive payments that vary according to the proportion of quota they own or rent. In 1997, the last year for which we have detailed data, growers in North Carolina, the major flue-cured producing State, each produced an average of 27 acres of tobacco, about 54,000 pounds of leaf. During the 2002 season, that was about \$100,000 worth of leaf. To put it in perspective, the same 27 acres would have produced about \$6,500 worth of corn. Since North Carolina tobacco growers typically own about 33 percent of their quota and lease the remaining 67 percent, a grower would ultimately receive \$142,560 in quota payments and \$216,000 in transition payments, or \$358,560. The owner of the leased quota would receive \$289,440 in quota buyout payments. Quota was high in 1997, so payments may differ from this example.

A burley tobacco grower in Kentucky, where farms average about 6 acres of tobacco production, produces about 12,000 pounds of leaf. Based on an average quota rental of 56 percent, a grower would receive \$42,240 in quota buyout payments and \$96,000 in transition payments for a total of \$138,240. The owner of the leased quota would receive \$53,760.

Peanut quota buyout

Similar to the current tobacco program, the peanut program was, until last year, a system that relied on production limitations (quotas) to support prices of peanuts (destined for domestic food consumption) at levels generally well above those in international markets. The 2002 Farm Act eliminated the quota system—allowing domestic marketing of peanuts by any producer—and compensated the former quota owners with a quota buyout. Under the peanut quota buyout, peanut quota owners were compensated with 55 cents per pound for the loss of their quota rights—about \$37,000 for an average North Carolina peanut grower using 27 acres to produce his/her peanut quota.

Unlike tobacco producers, however, peanut producers, whether former quota owners or not, now may also be eligible for other types of support (such as direct payments, marketing assistance loans, counter-cyclical payments) and are protected by high import tariffs.

higher support levels would be more protective. Price support could be continued indefinitely, could provide a period of time for growers to acclimate to the new economic environment, or could terminate altogether at a sunset date. Price supports could be in effect for a producer's historical level of production, but not protect production above that level.

Some policy proposals toward the restrictive area of the continuum combine price supports and licensing with FDA regulation. These proposals combine goals dear to both tobacco growers and health advocates. From a health promotion perspective, a program that enhances quality control and health and safety standards for tobacco leaf is in the interest of the health community. Inspections for pesticides and other chemicals at all levels of the production chain is a goal that health advocates say would reduce harm from tobacco products. Health advocates also want future tobacco crops to be grown in traditional areas, where monitoring can be carried out by knowledgeable people.

The status quo—the program that currently exists—is at the most restrictive end of the continuum, where market forces are constrained by various types of interventions. Current levels of price supports are not competitive in world markets. Costs are higher, because some production rights are controlled by nonproducing quota owners. And, U.S. growers are increasingly noncompetitive as imports increase, quota levels shrink, and the price support level rises. Preservation of the status quo all but guarantees continued decline in quota levels to the point where the U.S. tobacco industry could become a minor supplier of tobacco.

Many Scenarios Are Possible

Tobacco continues to be an important U.S. crop, but recent world market pressures on tobacco producers and continuing concern about the health effects of cig-

Photo by Ken Hammond, USDA

arettes have renewed interest in proposed buyout programs for tobacco quota holders. A buyout would eliminate quota restrictions on tobacco production, but in most proposals, some form of production control and price support would continue. Eliminating quota rental costs, which inflate the price of U.S. versus foreign leaf, would enhance U.S. competitiveness in domestic and foreign markets.

Part of the impetus for a buyout is to increase the competitiveness of U.S. tobacco by narrowing the gap between its price and that of other countries. In a post-buyout environment, as the U.S. price falls, purchases of U.S. tobacco would increase both domestically and by foreign customers. Growers would respond to this increase in demand as much as possible within the limits of the post-buyout program. In a free-market, no-program environment, production would increase rapidly. If constraints exist because of continued market intervention, any increase would be slower.

Although health groups do not necessarily want tobacco production to increase, they may accept smokers' consuming U.S. tobacco produced under a stringent regulatory environment with careful inspections for banned chemicals. Linking the goals of a tobacco quota buyout and FDA regulation of tobacco products has advantages for both producers and health interests. Tobacco buyout advocates can garner widespread support for an issue that affects only a handful of States, and health regulation watchdogs get support in States traditionally opposed to tobacco product regulation.

A post-program regime without geographical restrictions on tobacco production could upend the structure of the U.S. tobacco industry. Production may move to areas where larger, more efficient units could be assembled. Production in areas such as the Piedmont or hilly regions in Kentucky, where tract size is traditionally smaller, likely would decline. Tobacco farms would grow bigger and the number of growers would drop. And, some production would likely shift to States that have never grown tobacco, along with attendant economic consequences. W

This article is drawn from…

Trends in the Cigarette Industry After the Master Settlement Agreement, by Thomas C. Capehart, Jr., TBS-250-01, USDA/ERS, October 2001, available at: www.ers.usda.gov/publications/tbs/oct01/tbs250-01

Tobacco Quota Buyout Proposals in the 107th Congress, by Jasper Womack, Congressional Research Service, Library of Congress, August 2002.

Tobacco at a Crossroad: A Call for Action, by the President's Commission on Improving Economic Opportunity in Communities Dependent on Tobacco Production While Protecting Public Health, 2001, available at: www.fsa.usda.gov/tobcom/reports.htm

See also the ERS Tobacco Briefing Room at www.ers.usda.gov/briefing/tobacco