OUTLOOK FOR U.S. TOBACCO

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The outlook for U.S.-grown tobacco in the next 5 to 10 years is pessimistic. Since last year's Outlook Conference, unprecedented events have occurred in the tobacco industry. Foremost among those was the signing of the Global Tobacco Settlement between 40 State attorney generals and cigarette manufacturers in June. State lawsuits have been settled for billions of dollars. In addition to the Global Settlement, numerous bills have been submitted to Congress in the course of negotiating a final agreement. Many of the bills address grower concerns about declining demand for tobacco during the post-settlement era. Some form of tobacco legislation, albeit different from the original Global Settlement, is likely to be passed during the 105th Congress. The outlook for tobacco in the upcoming decade is full of uncertainties due to the fluid legal and regulatory environment the industry faces today. The only certainty is the underlying downward trend in U.S. cigarette consumption will be accelerated.

This paper examines recent trends and the near-term forecast for cigarettes and touches briefly on other tobacco products, Subsequently, the situation and outlook for flue-cured and burley tobacco leaf will be presented. Finally, some of the recent legislative initiatives and their implications for tobacco growers will be discussed.

U.S. Cigarette Output and Consumption, Falling; Exports Uncertain

U.S. cigarette consumption declined an average of about 2 percent annually during the past decade. Social acceptance of cigarette smoking is waning, concerns about smoking and health are increasing, and limits on where smoking is allowed multiply. Although the price cuts of Marlboro Monday and the upsurge of discount cigarette sales tempered price increases during the decade, State taxes rose. In the upcoming decade, cigarette prices will increase . The increases may be policy-driven, either as a result of the Global Settlement or similar legislation, higher taxes, or other forms of legislatively mandated price increases. Alternatively, they could rise because of the costs to the industry of litigation in lieu of a settlement, For whatever reason, rising cigarette prices will continue to dampen cigarette consumption.

In spite of generally declining cigarette consumption, U.S. cigarette output, propelled by exports, reached a record high in 1996. But output declined 4 percent in 1997 and is expected to continue trending downward. After increasing nearly four-fold from 1986 to 1996, cigarette exports probably reached their peak in 1996 and 1997 will commence an era of gradually declining, or at least steady, shipments. Offshore production by U.S. manufacturers contributed the decline in exports, and output, in 1997. Continued disparities between U.S. and world leaf prices, potential restrictions on cigarette production in the United States, and the possibilities for plant acquisitions and joint ventures overseas are major factors in the movement towards offshore production.

Domestic consumption peaked in 1981 and has been falling nearly every year since. Per capita cigarette consumption based on the 18 and over population group may drop by 83 cigarettes (4 packs of 20 or from 2,482 to 2,399 cigarettes) in 1997. Per capita cigarette consumption in 1988 was 3,103 pieces. Total consumption is expected to be the lowest since 1960.

Despite an increase in the smoking age population, total consumption of cigarettes is likely to decline again during the next decade and per capita consumption is also likely to fall. The major factor in continuing declines will be price. Within the past year the wholesale price of cigarettes increased by $9.25 per thousand or 19 cents per pack. Federal excise tax increases are set to take effect in 2000 and 2002, adding another $7.50 per thousand or 15 cents per pack. Although wholesale prices have not reached the levels of the early 1990's, retail prices have risen due to higher State taxes and declining share of discount brand sales. Retail prices of tobacco products were about 5 percent higher at the end of 1997 than the previous year as indicated by the Bureau of Labor Statistics Tobacco CPI.

In 1997, six states raised their excise tax on tobacco products and further increases are set for 1998. Taxes now vary from 2.5 cents per pack in Virginia to $1.00 in Alaska. Tax discrepancies have become so wide that illegal sales of cigarettes are likely to become a greater problem in the future.
Cigarettes account for most of the tobacco disappearance in the United States and other countries.

However, a $1.00 to $1.50 increase in the price of cigarettes is the goal of many of the bills submitted and under consideration in the Senate. Assuming current levels for cigarette exports continue, a 1-percent increase in the retail price of cigarettes results in a .4-percent decline in quantity consumed, and about a 3-percent decline in total cigarette output. A one-time $1.50 per pack increase in the retail price of cigarettes would lower cigarette consumption by 32 percent and lower total output, including exports, by 21 percent. It is likely such a price increase would be phased in over a period of time between 3 to 10 years, but the change in consumption would be essentially the same.

Cigar Consumption Continues Ascent

Consumption of cigars in the United States surged again in 1997 with consumption of large cigars reaching 3.6 billion, 18 percent above 1996. Cigar production surged an estimated 19 percent. As in the past few years, gains have been in the premium segment of the market. Cigar consumption is expected to continue increasing in 1998, although at a slightly slower rate. Consumption of small cigars, those weighing less than 3 pounds per 1,000, in 1997 gained 6 percent, reaching 1.6 billion cigars.

Consumption of Other Products Mixed

Smoking tobacco consumption gained slightly in 1996 reaching 15.3 million pounds, but resumed its decline in 1997, falling to 15.0 million pounds. Snuff consumption wills likely increase for 1997, continuing an upward trend that began in the mid-eighties. Chewing tobacco consumption will decline in 1997 and 1998.

U.S. Tobacco Crop Larger in 1997

U. S. leaf production in 1997 advanced 9 percent from 1996. Supplies are down about 2 percent, however, reflecting lower carryin and the shorter than expected burley crop. After rising in 1996/97, total use is expected to increase slightly in 1997/98. Lower carryin stocks offset higher production to lower supplies about 2 percent to 3.7 billion pounds.

In 1997 U.S. growers produced an estimated 1.6 billion pounds of tobacco valued at nearly $3 billion compared with 1.5 billion pounds valued at 2.9 billion in 1996.

Flue-cured

1997 flue-cured auction sales closed on November 18. Flue-cured marketings were up 13 percent at just over 1 billion pounds. Flue-cured marketings exceeded 1 billion pounds for the first time since 1981. Compared with a year earlier, flue-cured prices fell 11 cents per pound. Flue-cured production rebounded after a weather-plagued season in 1996. Prices averaged $1.724 per pound, compared with $1.837 the previous year. Although quality was better, 19 percent of the crop went under loan.
Supplies of flue-cured tobacco are up this year for the second consecutive year but are expected to fall in 1998 due to the 20 percent decline in effective quota, despite higher carryin. Flue-cured supplies represent

2.34 year's use, the highest since 1992. As of January 1, grower cooperatives held about 188 million pounds of flue-cured tobacco (farm sales weight) compared with virtually no holdings a year earlier Adequate world and domestic supplies, availability of foreign leaf, and reduced domestic use and cigarette output were reflected in lower prices and increased loan takings. Flue-cured marketings were valued at $1,749 million, 6 percent lower than 1996.

Burley

As of February 5, the burley crop is 98 percent sold and marketings are 11 percent ahead of 1996 at 605 million pounds.

Burley prices averaged 2 cents per pound lower than 1996. Early wet weather, drought during July and August, and difficult curing conditions plagued the burley crop.

U.S. leaf exports during the past several years advanced due to tighter world supplies and leaf requirements of U.S. manufacturers producing cigarettes overseas. World production is on the rebound however, and abundant global supplies in the upcoming years may result in lower exports. Brazil's recovery after years of below-normal production is a significant factor dampening U.S. leaf exports. Other producers continue to improve quality, enhancing their price-competitiveness. Technological improvements in the manufacturing process continue to reduce leaf and stem use per cigarette and permit greater use of lower-quality leaf.

Supplies of burley in 1997 are expected to increase by 5 percent to 1.5 billion pounds as lower carryin was offset by higher production. For 1997, supply is equal to 2.24 years consumption, down from 1996, reflecting shrinking burley carryin since 1994.

Leaf production in 1998 is likely to decrease, although burley production will rise given good growing conditions. . Manufacturer's purchase intentions for 1998 are down 15 percent for flue-cured and 11 percent for burley. The flue-cured effective quota is down 20 percent while the burley quota is up about 5 percent. Total U.S. carryin in 1998 should be up slightly. The lower flue-cured quota will result in slightly smaller supply in 1998.

For both flue-cured and burley tobacco, legislation requires that the national quota be based on:

1) Intended purchases by cigarette manufacturers;
2) Average annual exports for the 3 proceeding years;
3) The amount of tobacco needed to attain the specified reserve stock level (15 percent of the basic quota).
4.) USDA's discretion for setting the quota is limited to no more than 103 percent or less than 97 percent of the amount determined by manufacturer's needs and exports, and the reserve stock level.

Both flue-cured and burley price supports are determined by adjusting the previous year's level by:

1.) 5-year moving average of prices (two-thirds weight)
2.) Changes in the cost of production index (one-third weight)

Costs include general variable expenditures, but exclude costs of land, quota, risk, overhead, management, marketing contributions, and other costs not directly related to the production of tobacco.

The 1998 flue-cured quota was announced on December 15. The national marketing quota for the 1998 crop is 807.6 million pounds, down from the 1997 quota of 973.8 million pounds. Purchase intentions fell by 81 million pounds, exports gained nearly 29 million, and the reserve stock adjustment was -42 million pounds, reflecting the large quantity of leaf which went under loan in 1997. The USDA used its maximum discretionary adjustment to boost the quota 23.5 million pounds. The 1998 basic quota will decrease about 16.5 percent for each farm. The effective quota is expected to be about 813 million pounds, or 20 percent below 1997. The support level $1.628 cents per pound, up 2 cents from 1997. With normal yields, production should approach the effective quota.

The 1998 burley quota was announced on January 30, 1998. The national marketing quota for the 1998 crop is 637.8 million pounds, 10 percent below the 1997 quota of 704.5 million pounds. Purchase intentions were down 53 million pounds from 1997 and exports gained 25 million pounds. There was no discretionary adjustment. The effective quota for the 1998 burley crop is expected to be about 920 million pounds, about 40 million pounds above 1997. The effective quota increased because of low stocks. Price supports are set at $1.778 per pound, 1.8 cents per pound higher than 1997.

Lower purchase intentions by domestic manufacturers can be attributed in part to the secular decline in cigarette consumption; increased use of foreign leaf in U.S. manufactured cigarettes, and lower cigarette exports. Also, manufacturers are likely anticipating even sharper declines in their leaf needs after the tobacco settlement, or other regulations affecting cigarette manufacturers, are implemented. Since manufacturers store leaf for a number of years, current purchases are affected. This trend is likely to continue.

The Global Tobacco Settlement and Associated Legislative Proposals

Background

Some Congressional action to lower youth smoking will almost certainly occur before the end of 1998 and will have a spillover effect on adult consumption through price increases and restrictions on smoking. Thus the effects on the cigarette industry will be considerable. A retail price increase of $1.50 per pack over varying periods is frequently referred to as a minimum goal of many proposals. Such an increase could result in about a 32-percent decline in cigarette consumption.

Effects of Cigarette Price Increase on Tobacco Growers

A decline of this magnitude has severe implications for tobacco farmers. Assuming current proportions of cigarettes and leaf exported, a 1-percent decline in demand for cigarettes would result in a .38-percent decline in demand for leaf. A $1.50 increase in the retail price of cigarettes would cause demand for leaf to fall about 20 to 25 percent. The effects of lower demand are felt twofold: depressed grower cash receipts and in the lower value of the quota owned by growers. Owners of quota who rent or lease it out will also have reduced rental income. These effects will percolate through the communities and regions where tobacco is grown. Although communities will be affected differently depending on other economic activity that might exist, the cumulative effects are significant.

Current Proposals Compensating Tobacco Farmers for Losses

The following proposals have been made to alleviate the economic impacts of declining cigarette consumption on producers and quota owners. These proposals are separate from, but generally assume, the passage of the global tobacco settlement or similar legislation.

Senators Ford and McCain submitted bills (S1310 and S1414 respectively) which compensating quota owners at a rate of $4 per pound per year for reductions in quota based on quota owned from 1994 to 1996. Quota lessees would receive $2 per year with a limit of $8 per pound on half the base quota. The estimated cost of quota compensation is $15.8 billion. Economic development grants of $300 to 500 billion are also provided for tobacco growing regions, at a total cost of $8.3 billion. Industry workers would receive assistance and higher education grants would be available for tobacco farm families. Total cost of the bill is $28.5 billion. The tobacco program is left intact.

Senator Lugar's proposal (S1313) terminates the tobacco quotas in 1999 and phases out the price support program in 3 years. Quota owners would receive $8.00 per pound, while lessees would receive $1.20 per pound. Tobacco-growing states would receive $300 million in block grants for agricultural diversification and rural economic development programs. The total cast of the bill is estimated at $15 billion.

Senator Kennedy's proposal (S 1492) is a comprehensive tobacco manufacturing, marketing, distribution, and public health policy proposal. The tobacco program would continue intact but farmers, quota owners and lessees could sell their quota to the Government at a rate of ($4.pound for quota owners and lessees). Community economic development block grants are included in the bill. A Trust Fund paid for by higher excise taxes would spend $13 billion on farmers and rural development.

Senator Hatch (S 1530) has proposed a comprehensive tobacco manufacturing, marketing, distribution, and public health policy proposal. Assistance is available for tobacco farmers, industry workers, and tobacco dependent communities. The tobacco program is terminated; quota owners are offered $8.00 per pound and lessors are offered $4.00 per pound. Assistance is available to displaced industry workers, and economic development grants for tobacco dependent communities. Community development and education grants are similar to the Ford bill.

Senator Robb (S 1582) has introduced a bill to compensate quota holders for loss of tobacco quota asset value and privatize the tobacco program. Tobacco growers would receive annual nontransferable tobacco marketing licenses. Current quota owners would be compensated $8 per pound for lost quota. Transition payments of $2.00 per pound would be made to lessees and tenants. Block grants for economic development of $250 million for 5 years are included. Total cost of the bill is $22.8 billion. Leaf prices would fall by the value of the quota rent rate since licenses would not be transferable.

Senator Conrad's bill (S 1638) is the most recent submission. This bill provides $10 billion for tobacco farmer compensation and transition assistance for five years, without specifying how the money would be spent.

These proposals affect tobacco producers differently. The following is a rough guide to estimated effects compared with the USDA baseline after 10 years:

The current USDA tobacco baseline projects declines in flue-cured and burley production of about 20 percent, each in the decade following 1997. However, the Global Tobacco Settlement, additional taxes and price increases, and new legislation will affect the baseline

The Ford proposal (LEAF) would result in little change to production levels, and prices, grower revenue or costs of production. Grower incomes would be maintained. Proposals such as the Senators Lugar's and Hatch's would have significant effects on production levels prices by eliminating the tobacco program. Without the tobacco price support and production quota program tobacco production would be unrestricted. Production would increase, prices fall, and less efficient growers would not produce tobacco. Increases in production could be as much as 40 percent compared with continuation of the program. Given declining U.S. consumption, any production increases would likely be exported. The Robb bill would result in little change to production levels or grower welfare. Lower prices resulting from elimination of quota ownership or lease costs would likely cause leaf prices to become more competitive on the world market.

The U.S. tobacco industry is facing unprecedented changes in the next few years. Resolution of the issues raised by the Global Tobacco Settlement will yield a new playing field for the tobacco industry. Increased regulation by the FDA of tobacco products will in a large part determine the rules of play. The 124,000 tobacco farmers who supply the bulk of the tobacco used by the industry will face major challenges no matter which, if any of the grower-related proposals take effect.