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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 was designed to support and stabilize prices for farmers. It operated through a combination of mandatory marketing quotas and nonrecourse loans. Marketing quotas limit the amount of tobacco each farmer could sell, which indirectly raised market prices. The loan program established guaranteed minimum prices. The law required 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 were intended to assure that all loan principal plus interest would be recovered.[1] The 2004 tobacco crop was the last crop eligible for federal support, as the program was terminated by P.L. 108-357, Title VI, the Fair and Equitable Tobacco Reform Act of 2004. This report will be not be updated.

Industry Profile

World production of tobacco was estimated at about 12.662 billion pounds (dry weight) for 2004. Production data are collected in more than 100 countries. However, nearly 75% of world tobacco is produced in the following seven countries: China (4,439 mil. lbs.), Brazil (1,669 mil. lbs.), India (1,318 mil. lbs.), United States (788 mil. lbs.), Indonesia (317 mil. lbs.), Malawi (304 mil. lbs.), and Turkey (281 mil. lbs.).

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[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.

Fewer than 57,000 U.S. farms marketed about 848 million pounds (farm weight) of tobacco from 408,000 acres in 2004. The estimated farm value of the 2004 crop was about $1.685 billion ($1.987/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.

Even though tobacco is grown in 21 states, North Carolina and Kentucky originate about 65% of total production and four other states (Tennessee, Virginia, South Carolina, and Georgia) produce another 25%. The high per acre value of tobacco sales (averaging about $4,130 in 2004) makes it critical to the income of the growers and important to the economies of the major producing states. For North Carolina in 2004, tobacco constituted 7.9% of the value of all farm commodities (crops and livestock); for Kentucky, tobacco accounted for 11.7% 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 2004, the United States exported 361 million pounds (dry weight) of leaf tobacco, valued at $1.044 billion (mostly to the European Union, Japan, and Russia). U.S. manufactured tobacco product exports could amount to about $1.566 billion (mostly to Japan, Saudi Arabia, Israel, Iran, Lebanon, Hong Kong, Kuwait, United Arab Emirates, and Taiwan).

In 2005, U.S. manufacturers produced an estimated 482 billion cigarettes (exporting about 23%). 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 41% in the United States since 1981, from 640 billion to an estimated 378 billion in 2005. However, spending for tobacco products has increased as a result of price and tax increases. In 2004, according to the Bureau of Economic Analysis) consumers spent about $87.6 billion on tobacco products (94% for cigarettes).

Tobacco products are subject to federal excise taxes. In addition, all states and some municipal governments impose excise taxes. Collections in July 2003-June 2004 were an estimated $20.111 billion (federal, $7.779 billion; state, $11.877 billion; municipal, $456 million). The federal cigarette excise tax was 39¢ per pack and the weighted average state-municipal tax was 62.55¢ per pack. In 2003/04, federal taxes were collected on 19.945 billion packs.

The Price Support Program

The tobacco price support program (first created in the 1930s along with other commodity support programs) existed 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 would be provided was determined by growers in a referendum held every three years.

When producers approved federal price support for tobacco, they became subject to marketing quotas. A marketing quota was a supply control mechanism that indirectly increased market prices. At the same time, the federal government was 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, remained much the same. The legal authority and requirements for the federal tobacco program were contained in 7 U.S.C. 1311-1316 and 7 U.S.C. 1445.

Administering Agency

Program administrative operations were carried out by the U.S. Department of Agriculture's (USDA) Farm Service Agency (FSA). Annual administrative costs were estimated at about $24 million in FY2004 for tobacco price support operations. This cost covered primarily salaries for some headquarters personnel and staff time devoted to the tobacco program in about 600 county offices. Price support operations (nonrecourse loans) were financed by USDA's Commodity Credit Corporation (CCC). The CCC obtained needed money by borrowing from the U.S. Treasury (which had to be repaid with interest).

Program Operation

The federal tobacco price support program limited and stabilized the quantity of tobacco produced and marketed by farmers. This was achieved through marketing quotas. In addition, minimum market prices were guaranteed to farmers through CCC nonrecourse loans.[2]

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

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[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.

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

At the auction sale barn, each lot of tobacco went to the highest bidder, unless that bid did not exceed the government's loan price. In such cases, the farmer was paid the loan price by a cooperative, with money borrowed from the CCC. The tobacco was consigned to the cooperative (known as a price stabilization cooperative), which redried, packed, and stored the tobacco as collateral for CCC. The cooperative, acting as an agent for the CCC, later sold the tobacco, with the proceeds going to repay the loan plus interest. By 2004, about 80% of tobacco was sold under contract, but leaf that did not meet specifications could be taken to auction, where it might go into the loan program.

No-Net-Cost and Marketing Assessments. Under the threat of a 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 imposed an assessment on every pound of tobacco marketed (including imported tobacco since 1994). The no-net-cost assessment on 2004 crop flue-cured was 10¢ per pound; the burley assessment was 2¢. Growers and buyers each paid half of the no-net-cost assessment. The no-net-cost assessment funds were deposited in an escrow account that was held to reimburse the government for any financial losses resulting from tobacco loan operations. Losses occurred when a cooperative sold 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 in FY2000, and $340 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 were 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 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 cigarettes to 25% foreign content. Under new international trading rules, the domestic content requirement was replaced in September 1995 with a tariff-rate quota, which was less restrictive than the previous domestic content requirement. In 2004, imported tobacco constituted 61.3% of U.S.-manufactured cigarettes.

Tobacco-Related CCC Net Outlays, and FSA Administrative Expenses, by Fiscal Year, 1980-2004

(in millions of dollars)

Fiscal Year	CCC Net Outlays	FSA Administrative Expenses	Fiscal Year	CCC Net Outlays	FSA Administrative Expenses
1980	(87.8)	13.9	1993	235.4	15.3
1981	(51.2)	13.1	1994	692.7	14.7
1982	103.0	13.3	1995	(298.2)	15.3
1983	879.8	12.3	1996	(495.9)	14.3
1984	346.4	13.4	1997	(156.2)	14.8
1985	455.4	11.5	1998	376.5	16.1
1986	253.4	10.8	1999	112.7	12.8
1987	(346.0)	10.0	2000	657.1	14.1
1988	(453.3)	8.4	2001	385.8	17.6
1989	(367.0)	10.8	2002	(137.2)	18.1
1990	(307.3)	11.7	2003	179.3	21.4
1991	(143.4)	14.8	2004	18.5	24.1
1992	29.2	13.4	Sum FY 80-04	1,881.7	356.0

Source: U.S. Department of Agriculture. Farm Service Agency. History of Budgetary Expenditures of the Commodity Credit Corporation, annual issues. And, Office of Management and Finance, internal document titled Program-by-Program Summary, Estimated Costs Related to Tobacco Activities, annual issues.

Note: Negative numbers indicate negative net outlays (i.e., gains or receipts). Included in the tabulations are revenues generated by the deficit reduction fees assessed on all tobacco marketings from 1990 through 1998, averaging about $30 million per year. Also included are congressionally mandated farm assistance payments of in FY2000, FY2001, FY2002, and FY2003 of respectively $328 million, $469 million, $6 million, and $51 million.

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 was determined primarily by loan outlays (new loans made) and loan recoveries (repayment of old loans). In any given year, new loan outlays might be more or less than recoveries from the repayment of old loans. Since tobacco is typically stored for extended periods, it could be several years before the loan inventory was sold. The law required that any losses of loan principal and interest be repaid from the no-net-cost account, which was funded from assessments on growers and buyers of leaf tobacco. This requirement did 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. However, and in spite of no-net-cost legislation, the continuing net CCC outlays brought criticism.

There were other critics of the tobacco program. Free market advocates pointed to the competitive disadvantages caused by the program. Economists believed 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 said the federal government should not be supporting tobacco farm income and should get out of the tobacco business.

The Fair and Equitable Tobacco Reform Act of 2004 (P.L. 108-357, Title VI) was signed into law October 22, 2004. It eliminated the tobacco program after the 2004 crop. This "quota buyout" bill paid quota owners $7/lb. on 2002 basic quota and active producers $3/lb. on 2002 effective quota. The $9.6 billion cost of payments, plus another $540 million for expected losses on CCC loan inventories is to be paid from assessments on cigarette manufacturers and importers over a 10-year period (FY2005-14).

Other USDA Tobacco-Related Activities

The USDA continues to administer several other programs designed to assist tobacco farmers, facilitate marketing, and provide information to federal policy makers. It administers subsidized multi-peril crop insurance for tobacco (as well as for other crops), which was 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 was 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

- CRS Report RS22046, *Tobacco Quota Buyout*.
- CRS Report RL31790, *Tobacco Quota Buyout Proposals in the 108th Congress*.
- CRS Report 97-417, *Tobacco Related Programs and Activities of the U.S. Department of Agriculture: Operation and Cost*.