III. Emerging Challenges for U.S. Tobacco Farmers

Based on current trends, U.S. cigarette production is expected to decline further during the next few years as U.S. cigarette consumption continues to decline slowly and steadily and cigarette exports continue their sharper decline. Whether leaf exports will decline further or leaf imports rise is more difficult to predict, but flue-cured and burley quotas are, at best, expected to remain close to the sharply reduced 2000 levels. It is also clear that U.S. tobacco farmers face challenges other than reduced demand, including the increase in direct contracting between farmers and cigarette companies and the possible termination of the U.S. tobacco program.

"We're very concerned about the price support system. We're very concerned about contracting and we're also very concerned about the buyout program ."

Billy Ray Smith,
Kentucky Commissioner of Agriculture

Contracting and the Tobacco Price Support Program

Historically, essentially all flue-cured and burley tobacco has been sold at a government-sanctioned auction. However, in 2000 over one-fourth of U.S. burley leaf sales bypassed auction warehouses via contract sales directly to the largest cigarette manufacturer. That percentage is expected to grow, and contracting is also expected to extend to flue-cured tobacco sales in 2001.

At the Commission's hearings and elsewhere, many tobacco farmers expressed serious concerns about the impact of contracting on their future well being. One concern is that contracting will end up leaving out many of the smaller tobacco farms because it is simply too much trouble for the cigarette companies to contract directly with a large number of small-scale farmers. A related problem is that smaller farms with limited financial resources may not be able to comply with the cigarette companies' demands for adopting various new technologies; and smaller farms may not be able to provide large enough sale lots of the kind of quality-segregated leaf the companies now say they want. Additionally, with only small amounts of tobacco available for auction sales, exports would likely decline even more.

In addition, many tobacco farmers worry about losing their independence and autonomy if they enter into direct contracts and lose their ability to sell their leaf through auctions. Many believe that through contracting tobacco farmers risk becoming, in effect, employees of the companies. Because of the unequal bargaining power of tobacco farmers and the large cigarette companies, many farmers also fear that the companies will ultimately demand significant concessions from the contracting farmers, such as lower prices. Similar shifts to direct contracting in the U.S. poultry and pork markets, for example, have resulted in sharp price reductions, among other problems for farmers.

The U.S. tobacco program currently guarantees minimum prices for tobacco leaf sold in the United States. Contracting could either require farmers to sell at lower prices *(rather than exercise their option of selling through the auction at the program-guaranteed minimum price)* or could even lead to the end of the tobacco program. For example, if farmers holding a majority of all flue-cured or burley quota were under contract to the cigarette companies, they might vote to end the tobacco program so that they could escape its production and sales limits and sell more leaf to the companies through their contracts *(thereby* *reducing the demand for non-contract tobacco)*.

In an analysis of tobacco contracting, University of Kentucky tobacco economist William Snell found that contracting would not only lower prices and favor large growers, but would likely reduce grower independence while increasing the cigarette companies' control, thereby creating a greater risk of market power abuses by the companies. He also concluded that direct contracting could reduce the amount of public information on prices, quantities sold, and quality and grade that the current auction system provides, and which the price support program requires.

Because of these concerns, the Commission has received proposals that Federal legislation is needed to make sure that tobacco contracting does not put existing U.S. tobacco farmers in an even worse position than they are in today. Related comments were also received expressing the view that tobacco sold under contract should still be inspected for quality and safety both to ensure fair competition with non-contract leaf and to address public health concerns.

Possible Termination of the Tobacco Program

Beyond the rise of contracting, the recent sharp reductions in tobacco quotas coupled with stagnant prices and large increases in quota rental rates are also jeopardizing the future of the U.S. tobacco program. Finding it increasingly hard to survive under the tobacco program, farmers might simply vote to end it. But eliminating the tobacco program would create major hardships for most tobacco farms, particularly small family-run operations. While overall U.S. tobacco production and sales would probably increase, prices would drop considerably – and many farmers would not be able to make up for the price cuts through increased sales. In addition, virtually all flue-cured and burley tobacco would soon be grown under contract, with the potential problems described above, and the number of active tobacco farms would decline sharply.

"We believe that 2 components of the tobacco program, the price support and the quota systems, help keep the small farmer in business ."

Patrick Jennings,
Legislative Director,
Kentucky Farm Bureau,
Louisville, KY

While it is difficult to predict exactly how much U.S. leaf prices would drop and sales would increase if the tobacco program were eliminated, various tobacco economists and researchers have developed estimates based on an analysis of historical data and existing circumstances. For example, studies suggest that 25 percent price reductions would increase overall U.S. tobacco leaf sales by about 36 to 62 percent, although the most recent study supports the lower figure. In a 1999 study, which took into account the different domestic and global markets for burley and flue-cured tobacco, agricultural economists and tobacco specialists Blake Brown, William Snell, and Kelly Tiller calculated that the end of the tobacco program would reduce burley prices by more than twenty percent, but burley sales would increase by only 13 to 16 percent. In contrast, they project that flue-cured prices would drop by about 27 percent, but flue-cured sales would increase by 84 to 89 percent.[3] However, some observers believe the calculated flue-cured sales figures are too high because of the likelihood that offsetting price reductions and other adjustments would occur in competitor countries.

These calculations suggest that burley growers would, as a whole, suffer more from the end of the tobacco program because the overall increased demand for burley would not compensate for the price drop. Total U.S. burley revenues would decline. Because the demand

3 These changes in U.S. leaf prices and sales would also reduce foreign leaf prices and sales.

for flue-cured leaf would increase relatively more than its price would drop, flue-cured growers, as a group, would do better than the burley growers. Nonetheless, many individual flue-cured growers would still be unable to expand their own production sufficiently, or at a low enough cost, to make up for the reduced prices, and many smaller-scale flue-cured growers would not be able to compete successfully against larger farms with lower production costs. It is also important to note that there are many more burley farmers than flue-cured farmers in the United States.

Initially, production of flue-cured tobacco would likely move to larger farms that could produce the tobacco most cheaply, with shifts away from the Piedmont areas of North Carolina and Virginia to eastern North Carolina, South Carolina and Georgia. Similarly, burley production would likely move out of the Appalachian regions and concentrate in the Bluegrass and South Central areas of Kentucky. Eventually, production could also move to non-traditional growing areas, including non-tobacco states, and be grown on much larger, more mechanized farms than exist today, under more direct control of the cigarette companies.

Besides putting many existing tobacco farmers out of business, these shifts would create considerable additional hardships for tobacco-dependent local economies and input suppliers that are already suffering. Tobacco auction warehouses would likely disappear. Moreover, the end of the tobacco program would also eliminate existing quota rights with no compensation, which would be a serious economic loss for many quota holders, especially those who rely on income from renting or leasing their quota. The value of existing tobacco farmland, which would no longer have an exclusive right to grow tobacco, would also decline sharply. In Kentucky, for example, farmland values would probably drop by about 10 percent and could reduce the value of the land owned by current tobacco farm owners, or their landlords by as much as $7 billion.

The end of the tobacco support program would also prompt a substantial shift of income and profits from current U.S. tobacco growers and quota holders to the U.S. cigarette companies. Tobacco economists Brown, Snell and Tiller calculate that the loss of quota value alone caused by the end of the tobacco program would transfer over $500 million per year in yearly income from quota holders to the cigarette companies. Based on the cost savings caused by the declines in U.S. and foreign tobacco leaf prices, others have estimated that the end of the tobacco program would transfer $800 million or more per year to the cigarette companies from tobacco farmers.

Because of these concerns, the Commission does not support ending the U.S. tobacco program without continuing some kind of system for limiting U.S. tobacco production to existing farming areas, maintaining minimum prices, and promoting public health and safety concerns. There are many ways that the current tobacco program could be modified, including some form of quota buyout which is discussed in the next section of this Preliminary Report. Accordingly, the Commission requests additional comments and proposals from all interested parties to guide its efforts to develop the most constructive ways possible to modify the tobacco program and address the many concerns related to the rise of contracting and the possible termination of the tobacco program, while protecting family farmers and the public health.

For more information on contracting, the future viability of the U.S. tobacco program, and the possible consequences from its elimination, see Working Draft, Policy Issues and Options Surrounding a Buyout of U.S. Tobacco Quotas by Will Snell and Daniel Green, December 2000 and Report to the Presidential Commission on Tobacco by A. Blake Brown, December 1, 2000 which may be found on the Commission's website at http://www.fsa.usda.gov/tobcom; and Contracting in Tobacco? By Carolyn Dimitri and Edward Jaenicke on the Economic Research Service's website at http://www.ers.usda.gov/briefing/tobacco.