ABSTRACT

The U.S. Tobacco Program

by
Chad R. Ziepfel

The regulation of tobacco is important to many people in the United States and around the world. It affects not only the growers of tobacco but also it affects the cigarette manufacturers, the tobacco consumers, and even the foreign tobacco companies. Many new ideas have surfaced in an attempt to reform the current U.S. tobacco program. The objective of this study is to analyze possible reform programs. The analysis will begin with a look at the overall history of tobacco as it is quite important to understand the past before predicting the future. After the basis for our discussion is in place, we will then examine the current workings of the U.S. tobacco program and then the problems associated with this system. The next step will be to consider the possible reform programs. Each possibility will be fully evaluated and the pros of the system will be weighed against the cons. Finally, the future of the U.S. tobacco program will be discussed as well as the current talks in Congress regarding the system. The purpose of this discussion is not to advocate one system over another, but rather it is an attempt to take an economic perspective on each of the systems and enumerate the possible positive effects as well as the possible negative effects.
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by Chad R. Ziepfel

Approved by:

__________________________, Advisor
James W. Brock

__________________________, Reader
Gerald M. Miller

__________________________, Reader
Thomas D. Bundenthal

Accepted by:

__________________________, Director,
University Honors Program
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**Tobacco History**

In 1613, John Rolfe introduced a successful experiment of tobacco cultivation in Virginia, and since that time, tobacco has assumed major social, industrial, economic, and medical implications (Morison 52). Consequently, the regulation of tobacco, both on a commercial and on a personal basis, has been around for four centuries. Though tobacco is unmistakably detrimental to physical health, it has proved to be a substantial source of revenue to the state and federal governments of the United States. This dual nature has caused the commodity to be the center of debate. On the one hand, proponents of tobacco stress its social benefits and its economic and industrial significance. On the other hand, critics are quick to point out the apparent health hazards associated with the use of tobacco (History 1). One of the reasons that tobacco is such a debated topic is the nature of its demand. Tobacco is generally considered a price-inelastic good. This means that a change in the price of tobacco has little or no effect on the demand for tobacco (“Tobacco Price Support” 2). With this constant demand, growers of tobacco have always had a market for their product; however, the landscape surrounding the tobacco industry has changed dramatically over time. This section does not attempt to judge the worth of various regulatory schemes implemented in the tobacco industry. Rather, it will outline the ways in which regulation of the production of tobacco has affected the farmers in the United States.

In the opinion of King James I of England, tobacco was “loathsome to the eye, hateful to the nose, harmful to the brain” and “dangerous to the lungs” (Middleton 93). The King’s opinion, though far beyond his time, was irrelevant to the world in the 17th
and 18th centuries. Tobacco rapidly became the major export for many of the southern colonies. Just seven years after John Rolfe’s first experiment in 1613, tobacco became Virginia’s only export (along with very small amounts of sassafras) to England (Middleton 93). The product was so popular that tobacco leaf soon became the backbone of Maryland’s economy as well as becoming a large export of Carolina. While the tobacco exports were providing much wealth to the southern colonies, the northern colonies took a much different outlook on the crop. In Massachusetts Bay, the first general letter (April 17, 1629) prohibited the planting of tobacco except in small quantities for medicinal purposes. This order came from an official of the New England Company to the Massachusetts Bay settlers (Werner 100). However, the colonists in Connecticut attempted to rival the southern planters with a local brand of tobacco. They even went so far as to create a law stating that “no persons within this jurisdiction shall smoke any other tobacco but such as is or shall be planted within these districts, except they have license from the courte” (Tobacco Institute, Connecticut 20). England encouraged the growth of the Virginia tobacco industry in various ways including granting companies in good graces with the crown a monopoly on imported tobacco (History 2). These companies and the colonies in general prospered as a direct result of the tobacco trade. King James I even went so far as to grant an import monopoly to the Virginia and Bermuda companies and to prohibit the domestic cultivation of tobacco (Brooks 88). The booming tobacco market brought vigorous competition, which led to the application of regulation. Virginia tried to protect its tobacco growers by passing an act in 1679 that forbade the importation of North Carolina tobacco into Virginia.
Virginia also prohibited North Carolina from exporting its tobacco from Virginia ports. However, this regulation was short-lived because in 1731 the British Privy Council disallowed the law because such colonial legislation threatened the financial well being of the merchants (Middleton 114). The next form of regulatory legislation was an attempt to establish the size of the hogshead in which tobacco was packaged. Under edict from the Privy Council, Maryland was forced to pass a gauge act which set the size of the hogshead in the same dimensions as those fixed in Virginia (History 3). While regulation by Britain did create some minor problems for the tobacco growers, the colonial planters at the time were facing a much more serious problem, overproduction.

In 1619, Virginia passed the first tobacco inspection law. This law ordered the lowest grade of tobacco to be destroyed and prohibited “second growth” tobacco and the marketing of “trash leaves” (History 3). In 1621, there was an attempt to restrict production in a more direct manner. Each cultivator was required to limit his growth to 1000 plants of nine leaves each. This act was repealed rather quickly, but in 1629 an act followed that allowed each planter to grow 3000 plants with an added stipulation allowing a planter to grow 1000 additional plants for each “non-laboring” woman and child (Brooks 96). This attempt to control production through legislation was unsuccessful and the overproduction problem persisted. Virginia made an effort to encourage the other tobacco colonies to enact similar restrictions on output, but these efforts were unsuccessful. The massive production of tobacco, which drove the price for tobacco extremely low, was beginning to ruin the economy of the tobacco colonies. In 1681, Virginia governor Culpepper stated,
that which is more to us than all other things put together, and will be the speedy and certain ruin of the colony, is the low price of tobacco. The thing is so fatal and desperate that there is no remedy; the market is overstocked and every crop overstocks it more. It is commonly said that there is tobacco enough now in London to last all England for five years....Our thriving is our undoing, and our purchase of Negroes, by increasing the supply of tobacco, has greatly contributed thereto” (Brooks 112).

The tobacco colonies refused to pass an act reducing the output of tobacco. This led the “cutters and pluckers” to take matters into their own hands. In 1682, tobacco farmers engaged in the practice of burning not only their own crops, but also the crops of their neighbors. These incidents got so troublesome that it led to legislative action in 1684, which made the destruction of tobacco a criminal offense punishable by the death penalty (Brooks 12). Since it became evident that controlling the actual growing of tobacco would be difficult to regulate, the lawmakers began to focus their efforts on quality controls. In 1713, Virginia established a warehouse system, consisting of forty public warehouses, to enforce tobacco inspection. The Privy Council originally disallowed the warehouse system, but it was re-enacted in 1730 to relieve some pressure caused by the depression of the 1720’s (Middleton 120). The Virginia system was successful in driving up the price of tobacco, leading to other tobacco colonies to propose similar legislation. Maryland, after initially rejecting the idea, adopted a similar law in 1747 with Carolina following suit in 1754. At this point in time, tobacco had become so important to the economic and social structure of society that it was actually used as money. Slaves were purchased in exchange for poundage of the “best leaf,” and tobacco was even used as payment to ministers (History 4). The law stated that “a competent and sufficient provision for the clergy will be the only means to supply this dominion with able and
faithful Ministers whereby the glory of God may be advanced, the church propagated, and the people edified” (Werner 102). In 1755, the passing of the Option Act finally gave the clergy the choice of payment in either tobacco or money for the first time. Up to this point in time, the aim of regulation on tobacco production had been securing the prosperity of the planters who dominate the economy. As tobacco regulation evolved over time, this purpose of regulation remained.

In the early 19th century, the warehouse inspection system began to give way to the sale of loose-leaf tobacco at auction (History 5). This system began to gain momentum, and in 1849, the state of Virginia legally replaced the warehouse inspection system with the new auction system. By 1865, the tobacco auction had completely replaced the previous warehouse system in the state of Virginia, with the rest of the tobacco states following suit shortly thereafter (History 5). Even though the tobacco system, up to this point, has undergone many positive changes, there were more problems, and changes, waiting in the future.

Sixty years later, during the so-called “roaring twenties,” the farmers of America once again were in a vicious struggle for prosperity. The farmers were once more producing far too much crop for the American market, and with Western Europe a market that was effectively closed due to the high tariffs, the price for tobacco crops was plummeting. The terrible conditions forced mid-west farmers to sell their crops to whoever would offer a price, no matter how low that price might be. In January 1933, things started to get out of hand. The combination of the Hoover administration promising prosperity in the near future and the never-ending line of bankruptcies and
foreclosures led the state of Iowa to be put under martial law in April 1933. The government had to devise a plan to ease the suffering of an entire industry. In May 1933, Congress passed the Agricultural Adjustment Act (AAA). This New Deal initiative was a comprehensive effort to raise and stabilize farm prices and income. This program covered tobacco as well as other agricultural goods such as cotton, wheat, corn, rice, hogs, and milk. The program had the purpose of gaining parity in agricultural prices, and it included voluntary agreements with both producers and processors to reduce production and regulate the markets (Leer 3). The major downfall of the Agricultural Adjustment Act of 1933 was that program costs were offset by taxes on the processing of the farm goods. This led the Supreme Court, under Hoosac Mills’ decision in 1936, to rule the program unconstitutional on the grounds that it was illegal to levy a tax on one group (the processors) in order to pay it to another (the farmers), and that the program allowed the federal government to interfere in the running of state issues.

On February 16, 1938, Congress enacted the Agricultural Adjustment Act (AAA) of 1938 as an alternative and replacement for the farm subsidy policies found unworkable in the AAA legislation of 1933. The 1938 Act introduced comprehensive price support programs and combined these price supports with non-recourse loans and marketing quotas in order to keep supply in line with market demand (Leer 4). Thus, the modern-day federal tobacco program was born in an effort to raise and stabilize tobacco prices to, in turn, raise and stabilize the income of the tobacco growers (“Tobacco Price Support” 2).

It is important to note that the creation and continued effects of the federal
tobacco program exists for the economic benefit of the tobacco farmers. The program’s inception was solely for the purpose of supporting the income and stabilizing the price of tobacco received by farmers. A major aspect of the program is that the farmers themselves determine the continued operation of the federal support program in a referendum held every three years (“Tobacco Price Support” 2).

The program was quite successful and underwent relatively few modifications from inception in 1938 until about 1980. The price support program was accomplishing the goals set forth by the 1938 Act in that it was providing price and income stability to a large number of small family farms without extensive governmental expenditures. However, beginning in the early 1980’s, the program has come under attack, invoking several program changes (Brown 1). These changes mainly stemmed from political and economic pressure to cut the federal budget.

One large change occurred in 1982 when the federal price support system was mandated to “operate at no net cost to the federal government” or to the taxpayers (Brown 2). This created an assessment charge that is paid by the growers and buyers of tobacco. This assessment covers the costs that occur when tobacco put under loan (tobacco taken in by the grower cooperatives) is subsequently sold at a price that is too low to cover the loan principal plus interest (Brown 2). Continued pressure to cut the federal budget caused the lowering of price supports and changes to the quota levels in 1985. In the early 1990’s, the United States tobacco farmers faced a new challenge: the level of tobacco imported into the country was growing rapidly. The federal government noticed this possible threat to the livelihood of the small farmer, so in 1993, the federal
government passed a domestic content law, which required domestic tobacco companies to use at least 75 percent U.S. tobacco in the domestic production of cigarettes. However, the international community viewed the strict tariffs as a violation of GATT. The government revised the domestic content law into a much less restrictive system using tariff rate quotas in place of the original hard quotas.

The current system used to regulate the price and quantity of tobacco is quite complicated. Many of the farmers who operate under this system do not have a full understanding of how the intricacies of the program work. With so many Americans relying on this system for their livelihood, it is important to gain a full understanding of how the tobacco program works before analyzing proposed changes.
Current Tobacco Program

The current U.S. tobacco program affects nearly 350,000 farms located in 17 states. Despite its major impact on a large portion of the agricultural industry, the operations and costs associated with the tobacco program are often misunderstood. The tobacco price support program is designed for the distinct purpose of raising and stabilizing farm tobacco prices at a higher level than would otherwise be possible. This is accomplished through a combination of two program features, marketing quotas and nonrecourse commodity loans. The program guarantees minimum tobacco prices to the U.S. farmers in exchange for the restriction of production (Snell 1). The program operates at no net cost using the Commodity Credit Corporation (CCC), which makes loans to the grower cooperatives for the purchase of tobacco that has not been sold at auction. The U.S. Department of Agriculture (USDA) Farm Service Agency (FSA) is responsible for carrying out the program’s administrative operations. Annual administrative costs are estimated at $15 million for price support operations. An assessment levied on both tobacco producers and tobacco purchasers is used to fund these relatively small administrative and non-operating costs associated with the program.

When the tobacco farmers consent to price supports, they are, at the same time, agreeing to accept government restrictions on the amount of tobacco they can market. The national marketing quota is the amount of tobacco determined sufficient to meet annual domestic and export demand, but at a price at least as high as the legally mandated support price (“Tobacco-Related Programs” 1). The marketing quotas are assigned to each individual piece of farmland, and the privilege to produce and market a specified
quantity of tobacco resides with the owner of that land ("Tobacco-Related Programs" 3). The only way a person can grow tobacco is to either purchase or rent land that has a tobacco marketing quota. This means that the production of tobacco is effectively held below what it would naturally be, and this limited supply of tobacco causes the market price to increase, as can be seen in figure 1 below.

![Graph showing supply curves and price and quantity changes](image)

Figure 1

As the government restricts the output produced by the farmers, the supply curve shifts from $S_0$ to $S_1$. This causes the equilibrium price to be much higher ($P_0$ to $P_1$), as well as the equilibrium quantity to be lower ($Q_0$ to $Q_1$). However, the shift in price is more dramatic than the shift in quantity because of the inelastic demand (rather vertical demand curve). This drives up the farmer’s income. The demand for tobacco is inelastic and the decline in consumption is not enough to offset the increase in price. The government, in setting the minimum price level for tobacco, attempts to target $P_1$ as the
minimum selling price; they attempt to restrict the supply so that all of the tobacco is sold at or above the minimum price, P1. The long-run price elasticity of demand for cigarettes (the world’s primary tobacco product) is approximately -.228 (Giles 6). Therefore, a 10% increase in the price of cigarettes will only result in a 2.28% decrease in consumption of cigarettes. This means that artificially high market prices are supporting farm income, instead of income being supported through direct payments by the government. Essentially, the buyers of tobacco (and eventually the consumers) are bearing the cost of the price support program. However, given the fact that several variables affect the supply and demand of tobacco, marketing quotas alone are not always an effective means of supporting market price (“Tobacco-Related Programs” 3).

In conjunction with marketing quotas, nonrecourse loans are available on each farmer’s marketed crop through the Commodity Credit Corporation (CCC) to guarantee minimum selling prices (“Tobacco-Related Programs” 3). When the tobacco grower brings his tobacco to auction, he/she sells the tobacco to the highest bidder. However, if the bid does not exceed the minimum loan price set by the government (P1 from the above graph), then a cooperative using money borrowed from the CCC purchases the tobacco. The cooperative that purchases the tobacco is called a “price stabilization cooperative” (“Tobacco-Related Programs” 3). This cooperative then redries, packs, and stores the tobacco as collateral on the loan from the CCC. When the market for tobacco gets better, the cooperative sells the tobacco and repays the CCC loan, including interest (“Tobacco-Related Programs” 2).
The tobacco loan program acts as a financing mechanism that allows tobacco to be stored for long periods, in order to allow the supply and demand for tobacco to balance. It is important to point out that it is possible for the tobacco price support program to produce a net revenue to the federal government. In any given year, the budgetary impact of the loan program is determined as the difference between loan outlays and loan recoveries. Therefore, the revenue or cost of the program depends on the new loans made and the old loans repaid in a given year. In years where the loan repayments exceed the new loan requests, the CCC experiences net revenues. For FY2004, the loan activities of the CCC are expected to result in net revenues of approximately $101 million ("Tobacco-Related Programs" 2). Despite these positive numbers for FY2004, the CCC does not always experience net revenues. In some years, the new loan outlays outweigh the old loan repayments. In such years, the CCC experiences net losses.
In order to comply with the current tobacco program, the net revenue years must offset the net expenditure years over time. This is the most outstanding aspect of the no-net-cost program. Though there is no set timetable over which the program must balance, the general goal of the program is to ensure that the federal government is not directly subsidizing tobacco farmers on a consistent basis. However, some costs, in addition to administration, do arise in the application of this program.

As noted earlier, Congress passed the No-Net-Cost Tobacco Program Act in 1982. This law states that the tobacco price support program should create no cost to the general taxpayers ("Tobacco Related Programs" 2). As with all federal programs, there are some administrative costs associated with the tobacco program. These costs include: market news/analysis, extension and research activities, crop insurance subsidies, and the administration of the program by Farm Service Agency personnel (Snell 2). These administrative costs are partially offset by an assessment called the "budget deficit
This is 1% of the support price assessment that is paid on every pound of tobacco marketed. The producers and buyers split this assessment cost evenly. This assessment is directly applied to reducing the federal budget deficit, which is where the tobacco program administration costs surface. This is how the tobacco program funds its own administrative costs. Other costs arise in the tobacco price support program when tobacco that is purchased by the price stabilization cooperative is later sold at a price that is insufficient to repay the CCC loan with interest. In order to cover these costs, the program charges an assessment on sellers and buyers at the wholesale level on every pound of leaf tobacco marketed. The assessment rate is determined by the administration and the revenue is deposited in an off-budget account that is held to reimburse the CCC for any financial losses that may result from tobacco loan operations ("Tobacco-Related Programs" 4). This no-net-cost rule has curbed much of the criticism of the federal government subsidizing the tobacco industry. However, the no-net-cost program does not always work perfectly. As noted earlier, the net revenues and net costs of the program even out because in some years the CCC collects on more loans than it gives out and in other years it gives out more loans than it collects. However, in 1986 and again in 2000, the financial solvency of the no-net-cost fund was threatened by massive accumulating loan inventories ("Tobacco-Related Programs" 2). In order to ensure the existence of the program, Congress transferred the rights to the tobacco to the CCC and ignored the no-net-cost requirement. The CCC was then forced to dispose of these tobacco crops costing the CCC approximately $376 million in 1986 and $661 million in 2000. Though this has only happened twice, the major losses associated with ignoring
the no-net-cost rule sparks much criticism about the entire tobacco price support program. In fact, the program has not been performing well recently, and its entire existence has now come under question. When trying to determine the appropriate course of action regarding the tobacco price support program, it is important to understand the circumstances surrounding the debate. Why are people calling for a change?
Current Problems

Historically, the success of the U.S. tobacco program in collecting higher prices for U.S. tobacco than would have been obtained if tobacco production were unregulated is significantly dependent on the market power of U.S. tobacco in the world market (Brown 2). The worldwide production of tobacco has risen since 1991. This increase in production has resulted in a massive surplus of tobacco in worldwide markets, which has driven down the world price of tobacco. This is not a completely recent occurrence. Historically, the U.S. price support system has generally prevented the collapse of the U.S. tobacco prices during these periods of excess supply. U.S. tobacco has recently garnered two to three times the average price of foreign tobacco. While U.S. tobacco still commands a quality price premium in the world tobacco market, the gap between U.S. prices and the world prices is declining (Brown 3). There are several reasons for the U.S. tobacco’s loss of market power. First, worldwide tobacco production continues to increase at steady rates. The major difference now is that the foreign tobacco is of a much better quality. The producers of tobacco products are substituting away from U.S. tobacco because of the development of cheaper foreign tobacco with improved quality (Brown 2). Second, manufacturing of cigarette exports is being moved to overseas facilities. The cigarette companies are producing their cigarettes for export in the foreign countries where they use primarily foreign tobacco. Third, the cigarette producers are replacing premium tobacco with filters and flavorings. Recent technological changes have allowed the cigarette producers to use lower quality (and cheaper) foreign tobacco and still maintain a quality cigarette by using the new filters and flavorings. Finally, and
most importantly, the U.S. tobacco market power has eroded because of declines in U.S. consumer demand. Worldwide tobacco consumption continues to increase to record levels, but the demand for U.S. tobacco in the domestic market has declined significantly. Even though the demand for cigarettes is inelastic, the increase in health concerns, higher cigarette excise taxes, and higher cigarette prices in response to the tobacco settlement and litigation costs have driven down considerably the demand for U.S. tobacco. As you can see in Figure 4 below, as the worldwide supply of tobacco continues to rise and the demand for U.S. tobacco continues to fall, the price garnered by U.S. tobacco is continuing to drop.

All of these forces are eroding the market power of U.S. tobacco in world markets. As market power erodes, the national marketing quotas must be set at lower levels in order to maintain a higher-than-equilibrium market price (Brown 2). The table
below shows how the production of tobacco has decreased over the years while the price for tobacco has risen in an effort to keep constant the value of production.

Table 59--U.S. tobacco, acreage, yield per acre, production, price, and value

<table>
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<tr>
<th>Crop year</th>
<th>Acres harvested</th>
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<th>Production per acre</th>
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</tbody>
</table>
As you can see in Figure 5 below, supply has gone up (due to worldwide production replacing domestic production) and demand has gone down (because of eroding market control) taking us to the equilibrium price of $P_1$. However, for the government to even just maintain the price level $P_o$ (let alone raise the price level), the marketing quota must be set at a substantially lower level in order to bring the supply curve ($S_2$) back up to intersect with the new demand curve at the old fixed price level.

![Figure 5](image)

Decreasing market power makes political intervention increasingly important for the maintenance of a tobacco program (Brown 2). The situation of U.S. tobacco is changing,
and the legislation must change accordingly to provide U.S. farmers with the best opportunity to succeed. The legislation must take into account the forces of change in the tobacco industry and should take aim at compensating for the decline in demand for domestic tobacco.
**Options For Change**

As the landscape of the tobacco industry changes, the government is being forced to propose some legislative changes to ensure the survival of American tobacco farms. The current tobacco price support system may not be able to replicate its historical success at raising and stabilizing the income of tobacco farmers. The market power of American tobacco has decreased significantly over the past several years, leading to the discussion of several new options. Since the tobacco program is permanent legislation, it is not subject to reauthorization in various farm bills (Brown 2). However, the existing program does provide a vehicle for alterations. It is important that these decisions be made as quickly as possible because import restrictions on foreign tobacco are only going to help raise domestic tobacco prices for a short time due to an imminent response by foreign countries to decrease the purchase of U.S. tobacco. There are various groups who have a significant interest in how the tobacco price support system operates. These groups have different objectives, and, therefore, they have different ideas as to how the program should be altered. For example, non-producing quota owners, as well as growers who own a majority of their quota, would most likely be in favor of maintaining the current price levels but with a reduction in production levels (creating higher lease rates). On the other hand, large-scale growers renting a large portion of their quota would most likely be in favor of lower price supports accompanied by higher production levels (creating lower lease rates) (Brown 4). Depending on their current situation, many different groups of people have often conflicting ideas as to the best way to correct the
system. Before a superior solution can be chosen, all possible options must be explored and the consequences of these options must be enumerated.

One option is to maintain the current tobacco program without changes in tobacco support prices. This option would likely cause the continued decline of unmanufactured exports, while at the same time allowing imports of foreign tobacco to remain at relatively high levels. The short-comings of the current system would continue to be exposed. The quotas would have to be reduced again and again in order to maintain the price level (because of increased worldwide production and decreasing U.S. domestic demand). As the demand goes down (from Do to D1) and the supply goes up (from So to S1), the government must reduce domestic supply (from S1 to S2) in order to maintain a higher equilibrium price (Po) as can be seen in Figure 6.
This declining quota will result in decreased overall revenues for the tobacco farmers. However, domestic purchases may improve from their current extremely low levels as manufacturers decrease inventories to desired levels. In addition, any interruption in foreign supplies of tobacco, such as those caused by weather, unexpected change in exchange rates, or political unrest, could slow the process of declining quotas. This is because if the imported supply of tobacco is less (S3), then the shift back up to the equilibrium price will not be as drastic (from S3 to S2 as compared to S1 to S2 on Figure 7).

Figure 7

Nonetheless, this option seems doomed to failure. The worldwide production of high quality tobacco is going to continue, and unless the price support system is changed, farmers will continue to face decreased revenues and tough times.

Another possibility is to reduce the price supports while keeping the current tobacco program. This would entail setting the price support at P2, which is less than the
original equilibrium price (Po), but higher than the current equilibrium price (P1). By doing this, the quantity demanded for U.S. tobacco would be less (Q1) than the quantity supplied (Q2). However, if historical relationships between price and quantity hold true, quotas would be expected to rebound rather quickly as exports would increase and imports would decrease (because of the cheaper U.S. tobacco). Research has shown that in the previous 40 to 50 years, a 1 percent decrease in U.S. tobacco prices has led to a 1 percent increase in domestic purchases and a 2 to 2.5 percent rise in unmanufactured exports (Brown 6). This reduction in price supports would likely lead to increases in sales. The lower price support would lead to lower manufacturing costs for tobacco products, which would allow for increased production and increased purchases of tobacco. This would cause the demand curve to shift back to the right and the supply curve to shift back to the left (allowing for a more expansive quota) until the equilibrium price is equal to the price support (P2).

Figure 8
This decrease in the price support would cause a decrease in revenues until the quota level began to rise. This option would likely raise concentration in tobacco production because the high-cost producers would likely sell their quotas to the larger, low-cost producing farms. This option would likely be harmful to the areas where there are many small farms. This also assumes that some degree of market power still exists with U.S. tobacco. The price of foreign tobacco would still be lower than the price of U.S. tobacco. The only way that this plan can work is if consumers prefer U.S. tobacco. Without significant price adjustments, the market power of U.S. tobacco would continue to erode and the program would again need modification.

A further option for reform of the tobacco price support system is to segment tobacco sales into export and domestic markets with different prices. Theoretically, the revenue of the tobacco growing industry could be maximized by enforcing a quota on domestic sales of tobacco to force a higher price in the less price sensitive market for U.S. consumption, and allowing greater sales and a lower price in the more price sensitive export market. In order to successfully implement a two-tiered system, the domestic and export markets must be effectively segmented. This means that control over the movement of tobacco between the domestic and export markets, as well as control over imports, is necessary. The restriction on imports is very important because they prevent lower priced export tobacco or products made from export tobacco from reentering the U.S. This option would obviously increase the domestic demand for U.S. tobacco (because of the limit on imports), but it would drastically decrease the export
demand for U.S. tobacco because foreign countries would retaliate against our import restrictions. They would not buy our tobacco because we would not buy theirs. This program would allow for the U.S. farmers to stabilize their income and allow for quotas to remain relatively high, but it is unlikely that this much control over the tobacco industry could be achieved due to the trend toward free trade between the U.S. and other countries.

The final alternative for reform is to completely eliminate the tobacco program. This would lead to essentially the same outcomes as lowering the price supports, but in a more dramatic fashion. The supply of tobacco from the U.S. would increase dramatically, while the price paid for U.S. tobacco would decrease. This would lead to higher sales (Qo to Q1) at a lower price (Po to P1).

![Figure 9](image)

However, the price for U.S. tobacco would not always stay so low. As the price for U.S. tobacco drops, the amount of foreign tobacco imports would decrease. This would shift
the supply curve back to the left (from S1 to S2), which would drive the price for tobacco back up slightly.

However, it is still to be seen whether the demand for tobacco will continue to decline, which would shift the demand curve back to the left pushing the price for tobacco back down. Without the price supports in place, the high-cost producers would have essentially no chance to compete with the large, low-cost producing farms. Many of the small farmers would go out of business and be forced to find a new way to make a living. The lower prices would allow the U.S. tobacco industry to increase exports and to possibly increase domestic demand, but price and income variability would also increase. This would certainly result in a sudden increase in supply of tobacco and a definite decrease in the price of tobacco. The viability of this option lies in whether the increase in the quantity supplied is enough to offset the decrease in price. This option would
certainly allow exports of U.S. tobacco to increase as well as considerably driving up domestic sales, but it remains to be seen whether the increase in sales (both domestically and overseas) would be large enough to offset the decrease in price.
The Future of U.S. Tobacco

The U.S. tobacco industry is faced with the problem of decreased domestic demand as well as increased worldwide production. The rest of the world is finally catching up to the quality of U.S. tobacco. The current system used to restrict the output of domestic tobacco and guarantee the price received by tobacco farmers is no longer achieving its goal of raising and stabilizing farmer’s incomes. Various alternatives have been proposed in an attempt to revamp the system. All of these possible options have a downside. It is impossible to find a solution to the U.S. tobacco problem that will please everyone. Nonetheless, some type of change must be made in order to ensure the survival of the U.S. tobacco industry. The system has reached a point where drastic changes may be necessary, even if these changes could result in a loss of jobs or decreased revenue to tobacco growers. Something must be done to save a system that has been failing for the past 15 years. As the pressure mounts, it seems that many of the farmers are leaning more towards the complete elimination of the tobacco program. However, these farmers are not willing to give up their quota values without a significant payoff. The idea is to pay the current quota owners for the value of their quota, and then the quota system and price supports will be removed. Once this occurs, the production of tobacco will be moved primarily to large farms that can operate at low production costs. Many growers are in favor of this buyout, but the problem of where the payoff money will come from is still looming. There are currently two proposed plans for the $12 billion buyout. The proposed plan in the Senate calls for the buyout to be financed by the cigarette makers, but the actual costs would be passed on to the consumers of tobacco.
The plan initiated in the House of Representatives involves a payment by the U.S. treasury of nearly $10 billion. This would essentially mean that the taxpayers are paying for the buyout. Obviously, the Senate bill would be an easier political sell, but the viability of both plans is still in question. Another issue corresponding to the proposed buyout is the FDA regulation of tobacco. Phillip Morris, the parent company for the number one selling cigarette brand Marlboro, is attempting to persuade the tobacco growers to agree to eliminate the current tobacco system while also allowing FDA regulation of cigarettes (O’Connell 1). This desire for FDA regulation surfaces in the Senate version of the buyout plan, while the House version has no provision for FDA regulation. Phillip Morris has ensured the farmers that under their proposed bill the FDA will stay off the actual tobacco farms and will merely regulate the manufacturing of cigarettes. Phillip Morris is the only cigarette manufacturer in favor of regulation of tobacco products (Brogan 1). Regulating the manufacture of cigarettes would allow Phillip Morris to fend off rivals and hold onto its Marlboro brand’s number one position because low price upstarts will be forced to comply with strict regulations. All of these issues create strong emotional reactions from those who have the most at stake. If a buyout plan does get approved (whether or not FDA regulation is included), many people far from the tobacco farms will stand to benefit mightily. People who own tobacco quotas and simply lease the rights to grow tobacco to sharecroppers on the land would receive the majority of the buyout money. It remains to be seen whether the tobacco program will be eliminated, but even if the program is retained, it is quite probable that some significant changes will be made to the system. As the demand for tobacco
declines and the foreign production of tobacco continues to rise, a decision must be made soon to address the economic livelihood of small tobacco farmers throughout the U.S.


