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Tobacco Quota Buyout

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Summary

Tobacco quota buyout legislation (Title VI of P.L. 108-357 (H.R. 4520)) terminated U.S. tobacco farm price support (nonrecourse loans) and domestic production controls (marketing quotas) after the 2004 crop year. An assessment on tobacco product manufacturers and importers will generate about $9.6 billion over 10 years for compensatory payments to tobacco quota owners and active tobacco producers. Beginning with the 2005 crop, there are no restrictions on who can grow and market tobacco, where it can be grown, and the amount that can be grown and marketed. (This report will not be updated.)

Tobacco quota buyout legislation (P.L. 108-357, Title VI, Fair and Equitable Tobacco Reform Act of 2004) eliminated federal farm price support for tobacco at the end of the 2004 crop year. Tobacco quota owners and active producers will be paid about $9.6 billion as compensation for lost rents and to aid in the transition to a free market system. The payment rate to quota owners is $7/lb. on 2002 basic quota; the payment rate to active producers is $3/lb. on 2002 effective quota. Payments will be made in equal annual installments for 10 years. Farmers wanting faster payouts can assign their quota buyout contracts to private financial institutions and receive discounted lump sum payments. Money to pay for the buyout comes from new assessments on tobacco product manufacturers and importers.

After about 65 years of supply control and price support, farmers are no longer constrained as to who can produce tobacco, where it can be grown, how much can be marketed, or how low the farm price can go. In their pre-buyout analyses, tobacco economists anticipated a rapid consolidation of tobacco production onto substantially fewer but larger farms located in the most economical regions. Total U.S. tobacco production was expected to increase.[1]

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[1] Paul L. Hollis, *Tobacco Buyout Affects Outlook for 2005 Crops*, Southeast Farm Press, December 29, 2004.

The tobacco quota buyout campaign gained momentum after farmers were joined by some anti-smoking and public health advocates, as well as the Philip Morris USA cigarette manufacturing company, seeking new authority for the Food and Drug Administration (FDA) to regulate tobacco products. The FDA authority was introduced as S. 2461 (DeWine-Kennedy) and H.R. 4433 (Tom Davis-Waxman) in the 108th Congress. Legislative conferees on H.R. 4520 did not adopt the FDA provisions, though the provisions had been included in the Senate version of the bill. There was opposition from some cigarette manufacturers to the FDA provisions, and from those in Congress opposed to giving the federal government expanded regulatory authority over private businesses.

Payments to Tobacco Quota Holders

A tobacco quota holder was defined as the owner (as of October 22, 2004) of a farm with a basic tobacco marketing quota or tobacco acreage allotment for the 2004 marketing year. Each quota holder received a contract obligating the USDA's Commodity Credit Corporation (CCC) Tobacco Trust Fund to pay $7/lb. on the basic quota level established for the farm for the 2002 marketing year. The payments would be made in 10 equal annual installments of $0.70/lb. For those kinds of tobacco where the farm quota was specified in acres, a 2002 poundage equivalent was calculated using the county average yield for the 2001-2003 crop years.

In 2002 the national basic quota amounted to about 959 million pounds. So, payments to quota owners could amount to $6.7 billion. According to USDA's Farm Service Agency (FSA) data, there were about 415,750 tobacco quota owners in 1999. There were 56,977 farms producing tobacco in 2002, according to the Census of Agriculture, and almost all of these farm operators also were owners of quota. Thus, approximately 358,000 nonoperator landlords could receive quota buyout payments along with the nearly 57,000 farm operators.

Payments to Producers of Quota Tobacco

Active tobacco producers received a contract obligating the CCC to pay $3/lb. on the effective farm marketing quota for the 2002 marketing year. For those kinds of tobacco where the effective farm quota was specified in acres, a 2002 poundage equivalent was calculated using the average yield on the farm for the 2001-2003 crop years. A farmer who produced quota tobacco in each of the 2002-2004 marketing years would receive the full $3/lb. payment. The payments would be made in 10 equal annual installments of $0.30/lb. For each of the three base years the farmer did not produce tobacco, the payment is reduced by one-third.

In 2002, the national effective quota amounted to about 970 million pounds. Hence, payments to quota owners could amount to $2.9 billion, which could be divided among approximately 57,000 producers.

Obtaining Lump Sum Payments

Provisions were made in the law allowing contract payment recipients to assign the annual payments to financial institutions (called successor-in-interest transfers by FSA).

This enables financial institutions to make lump sum payments to the quota holders and active producers. The financial institutions are allowed to discount the contracts to cover their costs of borrowing as well as administrative overhead. By regulation, the maximum allowable discount rate is the prime rate on the first workday of each money plus 2% rounded to the nearest number. CCC then makes the annual payments to the financial institutions to which the contracts have been assigned.

Assessments on Tobacco Product Manufacturers and Importers

The cost of the tobacco buyout is covered by assessments on tobacco product manufacturers and tobacco product importers. The assessments will be collected by the CCC on a quarterly basis during each of the 10 fiscal years from FY2005 through FY2014. The assessments began with the calendar quarter ending December 31, 2004. The amount to be collected each fiscal year is the amount needed to cover the year's expenditures associated with the quota buyout program — about $1 billion per year.

The assessments are apportioned according to the gross domestic volume share of the market held by each class of tobacco product. By law, the initial shares for FY2005 were as follows: cigarettes, 96.331%; cigars, 2.783%; snuff, 0.539%; roll-your-own tobacco, 0.171%; chewing tobacco, 0.111%; pipe tobacco, 0.066%. Each year the allocation will be changed to mirror shifts in market shares. Each manufacturer and importer's *pro rata* share of the domestic market becomes its contribution to the total collection. Assessments and collections are done quarterly. If domestic cigarette sales remain constant at the 2004 level of 19.4 billion packs, the annual buyout program cost will amount to about 5¢ per pack.

Subsequent to the 1998 Master Settlement Agreement between the major cigarette manufacturers and the State Attorneys General, the manufacturers signed a Phase II agreement to pay $5.15 billion to the tobacco producing states. The payments were to be made over a 12-year period corresponding to a declining scale from 1999 through 2010. An estimated $2.0 billion in remaining Phase II obligations are now offset by the tobacco quota buyout assessments. The states most adversely affected by the loss of Phase II payments will be Pennsylvania and Maryland (at about $9.3 million and $13.5 million respectively) because these states will not receive quota buyout payments. They receive no buyout payments because many years ago the tobacco producers decided to forgo the federal tobacco subsidy program.

Disposal of Loan Pool Stocks

Farm market prices for U.S.-grown tobacco in 2005 and subsequent years are expected to fall below the mandatory support levels that applied to 2004 and previous crops. Therefore, tobacco previously put under price support loan (called loan pool stocks) likely will not be sold at prices high enough to cover the loan principal plus interest. It also is possible that no-net-cost funds previously collected from producers and leaf buyers will not be adequate to cover the losses. The buyout legislation anticipates this development and specifies that such losses in excess of funds previously set aside in the no-net-cost accounts are to be covered by money from the Tobacco Trust Fund. (A detailed explanation of the previous support program is in CRS Report 95-129, *Tobacco Price Support: An Overview of the Program*.)

Administration of the Tobacco Quota Buyout Program

The tobacco quota buyout program is administered by the FSA through the same network of county offices that administered the tobacco price support program and the emergency Tobacco Loss Payments. The records in these county offices are used to determine the distribution of payments. Also, quota holders and producers were required to complete applications with sufficient information to demonstrate each applicant's rightful claim to payments.

The CCC established a revolving Tobacco Trust Fund to receive tobacco product assessments and to make quota owner and producer payments. The Tobacco Trust Fund also will reimburse the CCC for losses associated with the disposal of existing association loan pool stocks and inventories connected to prior price support activities. Total expenditures from the Trust Fund are limited to $10.14 billion and must be completed by January 1, 2015.

Tobacco Quota Holder and Producer Transition Payment Estimates, by State

(million $)

State	Quota Holder Payments	Producer Transition Payments	Total Quota Buyout Payments
North Carolina	$2,751.9	$1,190.9	$3,942.8
Kentucky	$1,735.9	$733.1	$2,469.0
Tennessee	$527.9	$239.6	$767.5
South Carolina	$508.3	$216.4	$724.7
Virginia	$458.3	$208.4	$666.6
Georgia	$429.4	$182.9	$612.3
Florida	$83.9	$35.7	$119.6
Ohio	$74.1	$34.0	$108.1
Indiana	$60.5	$27.0	$87.6
Wisconsin	$44.3	$19.0	$63.2
Missouri	$22.3	$9.7	$31.9
West Virginia	$14.2	$10.5	$24.8
Alabama	$3.3	$1.4	$4.6
Total	**$6,714.1**	**$2,908.6**	**$9,622.7**

Note: Based on basic and effective quota data from USDA's Farm Service Agency.

Summary of the Tobacco Quota Buyout Legislation

Fair and Equitable Tobacco Reform Act of 2004, Title VI of P.L. 108-357 Adopted by Congress as Title VI of H.R. 4520, signed into law October 22, 2004.
Total Payments and Other Spending Total payments to quota owners and producers, as well as costs related to disposition of loan pool stocks, are limited to $10.14 billion. There is no additional spending for community assistance or other activities. [Sec. 627]
Funding Sources Payments to quota owners and active producers, and expenses related to disposal of existing price support loan stocks, are from a Tobacco Trust Fund created in the CCC. Trust Fund revenues are from quarterly assessments on tobacco product manufacturers and importers. Cigarettes pay 96.331% in the first year, other tobacco products share the remainder. [Sec. 625] Cigarette manufacturer Phase II producer payment obligations of about $2.6 billion for 2005-2010 end under provisions of the Phase II agreement.
Payment Timing Payments to quota owners and producers are made in 10 equal annual installments from FY2005 through FY2014. [Sec. 622(e) and 623(d)] Advance payment options likely will be available to owners and producers from financial institutions to which they assign their contracts. [Sec. 624(e)]
Quota Owner Payments Quota owners (numbering about 416,000, including about 57,000 active producers and 359,000 landlords) as of the date of enactment are to be paid $7 per lb. on marketing year 2002 basic quota, divided into 10 equal payments of 70¢ per pound. [Sec. 622] (Estimated cost = $6.7 billion)
Active Producer Payments Active producers (numbering about 57,000), who raised tobacco in 2002, 2003, or 2004, are to be paid $3 per lb. on 2002 marketing year effective quota, divided into 10 annual installments of 30¢ per pound. Payments are reduced by 1/3 for each year tobacco was not grown by the producer. [Sec. 623] (Estimated cost = $2.9 billion. Nearly all producers own some quota.)
Assignment of Payments Holders of contracts to receive payments may assign them to financial institutions. The CCC will then make annual payments to the financial institutions. [Sec. 624(e)]
Production Controls and Restrictions Marketing quotas and acreage allotments are terminated. [Sec. 611 and 612] There will be no restrictions on who can produce tobacco in 2005 and future years, or where it can be produced. Production likely will be consolidated onto fewer and larger farms in the most economical regions. Total production is expected to increase.

Price Support Price support loans and no-net-cost assessments are terminated. [Sec. 612] Market prices are expected to decline by 20-30%.
Disposal of Loan Pool Stocks Loan pool stocks acquired under previous price support operations will be sold by price stabilization cooperatives and the CCC. Losses in excess of no-net-cost account funds are to be reimbursed from the Tobacco Trust Fund. [Sec. 641] An estimated $517 million should be available for this purpose from the Trust Fund after subtracting buyout expenditures from total funds.
Tobacco Inspection and Grading Mandatory inspection and grading of imported tobacco is eliminated. [Sec. 611(b)] Inspection and grading of domestic tobacco will continue at designated auction markets as long as 2/3 of the growers selling at the market the previous year vote their approval.

CRS Reports

CRS Report RS20802, *Tobacco Farmer Assistance*.
CRS Report 95-129, *Tobacco Price Support: An Overview of the Program*.
CRS Report RL31790, *Tobacco Quota Buyout Proposals in the 108th Congress*.

Other Resources

"Tobacco Transition Assessments; Final Rule." *Federal Register*, vol. 70, no. 27 (February 10, 2005), pp. 7007-7014.
"Tobacco Transition Payment Program; Final Rule." *Federal Register*, vol. 70, no. 63 (April 4, 2005), pp. 17150-17165.
North Carolina State University, Tobacco Economics, [http://www.ces.ncsu.edu/depts/agecon/tobacco_econ/].
University of Kentucky, Tobacco Economics Online, [http://www.uky.edu/Agriculture/TobaccoEcon/].
University of Tennessee, Tobacco Policy and Economics, [http://www.agpolicy.org/tobacco.html].
USDA, Economic Research Service, Tobacco Briefing Room, [http://www.ers.usda.gov/Briefing/Tobacco/].
USDA, Farm Service Agency (FSA), Tobacco Information, [http://www.fsa.usda.gov/tobacco/].