Four major themes are included in this presentation:

1. **Tobacco production and income in Tennessee**
   This section provides information about where tobacco production stands in the state today and how tobacco production fits into the bigger agriculture pie in Tennessee.

2. **Supply and demand for U.S. tobacco**
   This section discusses factors influencing demand for U.S. leaf tobacco and the 2002 burley quota outlook.

3. **Update on tobacco settlement payment in Tennessee**
   Review of where the state stands on Phase I and Phase II payments, and the impacts of recent payments on the economy and lease prices.

4. **Summary of other tobacco issues and concerns**
   There are a number of issues and uncertainties that are of interest to the tobacco industry today. This section focuses primarily on prospects for a tobacco quota buyout and contracting issues, with brief mention of other issues.

In 2000 (the most recent data available), tobacco again led all crops in the state in cash receipts. Tobacco generated $200 million in cash receipts in 2000, which accounted for nearly one of every five dollars in crop cash receipts. Tobacco receipts in 2000 were down $17.6 million (8%) compared to 1999. Average tobacco cash receipts over the 1995-1999 period were $218 million.
Compared to the last five years, cash receipts for other major crops were also down significantly in 2000. Only nursery receipts, now that state’s third leading crop, were up slightly in 2000. Soybean receipts were down 43% compared to the last five years. As bad as soybeans were in 2000, they were actually up more than 10% compared to 1999. Low prices for major commodities – soybeans, corn, wheat, cotton – have depressed receipts over the last three years, as well as unfavorable weather conditions in West Tennessee in 1999 and 2000. Receipts from cattle and calves, the leading agricultural enterprise in the state, were up by $51 million in 2000 compared to the five-year average to $416 million. Broiler receipts were down slightly, but remain the second leading agricultural commodity in the state.

While tobacco production may be down and will not likely return to its historical levels in the near future, tobacco will continue to be an important and profitable crop for many farmers in Tennessee. This chart compares the returns above variable costs for burley and four of Tennessee’s other major row crops. Expected returns for tobacco are $1,722/acre, compared to $139 for soybeans, $132 for cotton, $117 for corn, and $29 for wheat.

The number of tobacco farms in the state has been steadily declining for decades. In this graph, a farm is considered a tobacco farm if at least half of their income is derived from tobacco production. In 1992, there were nearly 23,000 tobacco farms in the state, compared to just under 15,000 in 1997. That’s a decline of more than one third over five years. While the next comparable farm numbers won’t be available until after 2002, the pace of the decline is expected to further escalate. The expected trend is for further consolidation and exit.
Although it’s common knowledge that basic quota has fallen since 1997, it’s rather dramatic to see just how sharp the decline has been. While basic quota varied from 464 to 724 million pounds, average quota between 1980 and 1998 was 599 million pounds. It fell sharply in 1999 and again in 2000 before leveling off. Included in this chart is a projected quota level of 324.2 pounds for 2002 (a decline of 2.3% over the 2001 level). Since 1998, basic quota has averaged 339 million pounds. This is 43.4% below the average of the previous two decades. As we will discuss in more detail later, quotas are not projected to rebound to their previous levels around 600 million pounds, but are expected to stabilize around 350-400 million pounds.

This graph shows burley basic and effective quota levels in Tennessee since 1994. Through the 1990s, basic quota did not constrain tobacco production in Tennessee because of the significantly higher effective quota. Effective quota through the 1990s has averaged about 150 million pounds, far above historical production levels in the state.

As quota has plummeted, high effective quotas have cushioned the blow somewhat. But the continued sharp declines in basic quota have eroded the buffer protection that effective quota has traditionally provided. Even though basic quota in 2001 increased by more than 14 million pounds, effective quotas in 2001 continued to fall to just 74.8 million pounds. Quota has now become a constraint on tobacco production and new limits on carryforward quota will further constrain production.

As indicated by sharp declines in effective quota, harvested tobacco acreage in the state has declined sharply since 1999.

From 54,000 acres in 1990, acreage peaked at 72,000 acres in 1992 before declining to 52,000 acres in 1995. Acreage increased through 1999 when it reached 63,000 acres. Tobacco acreage has fallen from 63,000 acres in 1999 to 46,000 acres in 2000 (down 27%) and 41,000 acres in 2001 (down 35% from 1999).

More than three of every four tobacco acres in the state is burley, and you can see that burley acreage has declined slightly more than dark tobacco acreage over the last two years.
This graph shows the same burley basic and effective quota that we saw before (in the blue and green bars), but overlays the level of production to point out the lag effect in production response to quota declines.

Tobacco production over the 1990s averaged 100.4 million pounds. Although basic quotas began their downward slide in 1998, higher effective quotas caused a lag response in acreage and production. Basic quota was cut 10 percent in 1998 and another 30 percent in 1999 and while the basic quota dipped below the historical production average in 1999 (down to 77.9 million pounds), effective quota remained sufficiently high so that acreage and production were not significantly affected. In fact, harvested acreage in 1999 was the highest level since 1993 and, combined with average yields, production in 1999 was up 13.5 percent over 1998 and at its highest level since 1994.

Tobacco production fell from 104 million pounds in 1999 to 71 million pounds in 2000, a decrease of one third. Tobacco production for 2001 is forecast at 68 million pounds, which would be the smallest crop since 1989. While tobacco basic quota in Tennessee increased by about one third in 2001, the effective quota further decreased by 14 percent to just under 75 million pounds, leading to further reductions in tobacco acreage. The effective quota in Tennessee in 2001 was 60 percent lower than the 1998 level and nearly one third less than the five-year average production level.

In 1997 (and through the mid 1990s), the U.S. produced more than 30% of all burley tobacco produced in the world. Since 1997, world burley production has fallen by 17%, and most of that adjustment has occurred in the United States. Over the period, U.S. burley production declined by 45% while production in the rest of the world declined on 4.5%. The U.S. share of world burley production has fallen from 30.6% in 1997 to 20.2% in 2001.
There are a number of factors that are contributing to declining demand for U.S. burley leaf. Production of the primary end product for U.S. burley, American-blend cigarettes, is down. This is due in part to declining cigarette consumption (because of health concerns and higher prices), but also due to movement of some production overseas.

At the same time, U.S. imports of foreign leaf for domestic manufacturing are up. Manufacturers are using less domestic leaf in their products, in large part because of the significant price differential between U.S. and import prices.

U.S. leaf exports are also down, contributing to lower demand. Again, the price differentials are a significant factor. U.S. leaf still provides a superior quality leaf, but the quality margin is diminishing somewhat over time.

The gap between the average U.S. burley import price and export price continues to widen. Since 1997, the average price that domestic manufacturers have paid for imported foreign burley leaf has declined more than 35%, from $1.81 to $1.35. Over the same period, the average price for exports of U.S. burley leaf has increased by $0.22, from $3.63 to $3.85. U.S. burley exports are currently priced at 185% of U.S. imports of burley tobacco.

Malawi has an auction system comparable to the U.S. system. In 2000, the average grower price in the U.S. for burley was $1.85 compared to an average grower price in Malawi of $0.46 (from USDA-FAS).

The wholesale price of a pack of 20 cigarettes in the U.S. has more than doubled since January 1998. The wholesale price was $1.31 per pack in 1998 and is now $2.64. Federal tobacco excise tax is currently at $0.39 per pack. The excise tax increased by $0.10 January 2000 and is increased another $0.05 January 2002.

Tennessee's tobacco tax, which hasn't been raised since 1969, stands at 13 cents per pack, the fifth-lowest in the country. Across all states, the average state excise tax on cigarettes is about $0.46 per pack. Five states have rates $1.00 or greater. Virginia and Kentucky remain the lowest cigarette taxing states at 2.5 and 3 cents per pack, respectively. The trend is toward increasing state excise taxes.

The average retail price of a pack of cigarettes is estimated to be $3.58/pack. This estimate includes the wholesale price and federal excise tax ($0.39/pack), state excise tax ($0.46/pack), distributor and retail margins, average state sales tax ($0.17/pack), and average discounts/promotional advertising.
This graph shows the wholesale price of cigarettes (blue line) compared to cigarette consumption levels in the U.S. (green bars). Cigarette consumption has been trending down for a number of years, falling from 525 billion pieces in 1990 to 425 in 2001. Consumption has fallen by about 19% over the period, compared to prices increasing more than 140%. Since the tobacco settlement in 1998, prices have more than doubled while consumption has fallen by less than 9%.

The USDA forecast is for cigarette consumption to continue to decline between 1% and 3% per year through 2005. This would result in consumption near 380-400 billion pieces by 2005.

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This graph compares cigarette production, consumption, and exports in 1996 with the levels in 2000. Since 1996, cigarette production in the U.S. has fallen by 21%. But only part of the decline is due to reduced consumption due to health concerns and higher prices. Consumption over the same period fell by only 12%, while U.S. cigarette exports fell by 40%.

Since 1997, U.S. exports of burley leaf tobacco have declined by 64 million pounds, of 34%. Exports in 2000 were down to 125 million pounds, their lowest level in more than a decade. U.S. prices significantly above the world price are a contributing factor.
These pie charts show the share by country of world tobacco production, exports and imports. In 2000, the U.S. produced only 7% of the world’s tobacco. The U.S. produced 86% of world burley in 1950, and 18% in 2000. Nearly half of all tobacco was produced in China and India.

The U.S. contributed only 9% of world tobacco exports in 2000, about the same amount as Zimbabwe, but far below the export leader Brazil’s 19%.

The U.S. was also the third leading tobacco importer, responsible for 11% of world imports, behind the Russian Federation and Germany.

A new reality that U.S. tobacco growers are now facing is that the U.S. has little influence over the world tobacco situation and outlook. Our role today is one of several dominant players. More than ever before, the future of tobacco in the U.S. depends on a complex global tobacco market.

From 1990 to 1998, U.S. manufacturer purchase intentions averaged 416 million pounds. Since 1998, they have fallen by 45% to 227.4 million pounds for 2002. As we just saw, exports have continued to decline, down nearly 25% compared to 1998. A major factor affecting last year’s 2001 quota was the reserve stock adjustment. In the fall of 2000, it appeared that large inventories would again push basic quota in 2001 well below the historically low 2000 quota. But a last-hour federal bailout forgiving 1999 pool stock loans eased the burden of excessive pool stocks, allowing quota to ease upward, despite continued declines in purchase intentions and exports. Without any adjustments by the Secretary of Agriculture, the 2002 quota will be 324.2 million pounds, or 2.3% lower than 2001. Effective quota in 2001 was the basic quota (332 million pounds) plus undermarketings of 35 million pounds, or 367 million pounds. Carryforward in 2002 is limited to 10% of basic quota (33 million pounds). With limited pool intake this year, effective quota will move even closer to basic quota in 2002.
Tobacco Settlement Review

- Major manufacturers settled states’ class action suits in 1998 for $206 billion over 25 years
- Master Settlement Agreement (MSA) payments: no strings attached, states’ discretion (legislature)
- A separate agreement signed in 1999 (Phase II) providing growers and quota owners direct compensation for reduced incomes, $5.15 billion over 12 years
- Phase II payments based on each state’s 1998 share of basic quota, up to state Phase II boards to allocate

Tennessee Tobacco Settlement Update

Just to review, there are two aspects of the tobacco settlement that are of primary interest to growers and quota owners. The Master Settlement Agreement (MSA) reached in 1998 between manufacturers and states directs payments (according to a schedule and adjustments) to states’ general funds. In most states, the legislature is responsible for determining uses of the money.

Then in 1999, manufacturers reached a separate agreement with tobacco-growing states, the National Tobacco Growers Trust, where manufacturers make direct payments to tobacco growers and quota owners, according to parameters established by state certification boards.

TN Tobacco Settlement Spending

- Expect to receive $4.8 billion over 25 years, payments average about $195 million per year
- Payments go to state’s general fund, legislature determines annual use
- State has received over $550 million to date (FY02)
- General interest in spending half on agriculture and half on tobacco health issues
- All payments through FY02 committed to general budget to cover budget deficit

Tennessee expects to receive about $4.8 billion from the MSA over 25 years. So far, Tennessee has received over $550 million, and will continue to receive somewhere around $195 million per year.

Initially, the legislature expressed interest in using half of the settlement money for agriculture and half for health issues. There was pretty widespread support for these uses and committees were formed to make specific spending recommendations.

Last year, the legislature decided to use all of the settlement money in the state through June 2002 to cover a state budget deficit. While the state still faces serious budget shortages, I want to point out that the legislature will have to continually revisit the settlement allocation question.
The separate National Tobacco Growers Trust, commonly called Phase II, expects to pay Tennessee growers and quota owners about $390 million through 2010. Payments must be made directly to growers or quota owners of cigarette tobaccos (burley, but not dark tobaccos), according to a state certifying board.

In 1999 and 2000, the board allocated 80% of the payments to tobacco growers and 20% to quota owners, based on production and quota in the previous crop year. For 2001, the ratio was changed to 90/10, although the payment year was again rolled forward.

Phase II payments in Tennessee totaled about $29 million in 1999, $17.5 million in 2000, and $26 million in 2001. According to the payment schedule, payments are expected to increase to about $38 million/year for the next 7 years before declining to $22 million in 2009 and 2010.

In addition to Phase II direct payments, growers and quota owners have also received payments over the last two years under the Tobacco Loss Assistance Program, or TLAP payments. In addition to Phase II payments, Tennessee received about $32 million in TLAP payments in 1999 and about $33 million in TLAP payments in 2000. These payments have significantly increased the “mailbox value” of tobacco over the last few years.

The output multiplier for the tobacco sector in Tennessee is 1.85 (which includes direct, indirect, and induced effects). The aggregate household output multiplier for Tennessee is 1.59.

A tobacco grower in Tennessee with 10 acres of production and average yields would generate about $40,000 in tobacco sales at average prices. $40,000 in tobacco cash receipts would yield the grower about $20,000 in net income. That $20,000 in net income is associated with $40,000 in direct effects (direct agricultural sales), $19,000 in indirect effects (tobacco-related sales such as input supplies), and $15,000 in induced effects (household expenditures due to tobacco-related income) for a total economic activity impact of $74,000.

If you just gave the same grower $20,000 instead of having him earn it through tobacco production and sales activities, the total economic activity impact is $32,000, where $20,000 is the direct effect, $3,500 is the indirect effect, and $8,500 is the induced (household) effect.
The green bar graph shows average quota lease prices in Kentucky over the last ten years. Quota lease price data are collected annually in Kentucky through a county-level Extension survey of growers. We do not have any comparable data in Tennessee. The blue line for Tennessee’s quota lease price is entirely a “best guess” estimate. In general, quota in Tennessee leased from $0.00 to $0.10 per pound for most of the 1990s and has risen sharply since 1998. The range of quota lease prices is wide, but my best “guess” is that quota lease prices averaged about $0.15 in 1999, $0.35 in 2000, and $0.45 in 2001.

In many ways, the impact of higher quota lease prices has hit Tennessee even harder than Kentucky. For most of the last decade, quota lease costs in Kentucky averaged just under $0.40 per pound. This compares to average lease prices in Tennessee of under $0.10 per pound, so Kentucky has been paying about four times the Tennessee rate for quota poundage, primarily due cross-county leasing in Tennessee and the large portion of the crop grown under share-cropping arrangements in Kentucky. Since 1998, average quota lease prices in Kentucky have gone up about 50% while they have gone up nearly 500% in Tennessee.

This steep increase in quota lease costs has made a significant difference in net income from tobacco in Tennessee. A $0.35 average increase in a primary cost of production, quota, takes a big chunk out of the net profit per pound of tobacco.

While considerable support for some kind of a “buyout” exists, prospects are uncertain at best. A large number of questions remain to be addressed—not the least of which is a buyout funding source—and a successful buyout proposal will likely require considerable input from all stakeholder groups including tobacco growers, quota owners, tobacco companies, public health interests, farm organizations, and government entities.

Other issues that raise lots of questions, but not always a lot of answers, include the long term effects of contracting, the future of the federal production control and price support program, the impact of new production technologies and biotechnology, and legal uncertainties.
Talk of a tobacco quota buyout is not anything new. But over the last few years, buyout talk has reached a crescendo level. The most recent round of interest was sparked by the release of the President’s Tobacco Commission report in May 2001, which recommended, among other things, a quota buyout. The Commission recommended that quota owners be compensated $8/lb for quota owned, to be paid out over five years. The grower of the quota would be compensated an additional $4/lb of quota if they agree to exit tobacco production or $2/lb if they elect to continue tobacco production under a new tobacco production permit system. The program was projected to cost about $15 billion and the Commission recommended an increase in the federal cigarette excise tax of about $0.17/pack to fund the program.

Status of the Commission Report

- Presently, the Commission’s recommendations are still a “report”
- No legislation has been introduced
- Funding a buyout with a federal cigarette excise tax would be difficult, at best
- Other buyout/funding proposals are being discussed

Buyout Questions to Address

- Appropriate payment rate(s)
- Payment basis
- Payment period
- Tax treatment, payment limits
- Program provisions (if any)
- Paying for a buyout

While there seems to be general support in the farming community for a quota buyout, the devil is in the details. Outlined here are several questions that would have to be addressed before any buyout proposal can move forward.

- What is an appropriate payment rate(s) — the most common numbers that have been tossed about have been payments of $8/lb for the owner of the quota and $2-$4/lb for the grower of the quota. These rates first surfaced in early 1998 as tobacco buyout plans (dominated by those from Senators Lugar and Ford) were included in proposed tobacco settlement legislation. The $8 figure was arrived at using a quota rental rate of $0.40/lb, a 5% discount rate, and assuming that the quota asset would maintain that value forever. Given the current state of the tobacco program and outlook, assuming that quota will provide the owner income into perpetuity may be a stretch, yet this is a
driving factor in the $8/lb figure. By comparison, if you bump the quota rental value to $0.60/lb, keep the discount rate conservative at 5%, but reduce the life of the quota to three years, the present value falls to just $1.67/lb. Even if you assume a quota asset life of ten years, a $0.60/lb rental rate, and a 5% discount rate, the present value of quota is still under $5/lb. Another way to look at the $8/lb figure is to note that if you expect to receive quota income for 10 years (instead of forever), using the same 5% discount rate, the quota rental rate each year would have to be over $1/lb to equal a present value of $8/lb. Table 1 shows the present value of two rental rates, $0.40 and $0.60 per pound, at three discount rates (5%, 6%, 10%) and over six time horizons (3, 5, 10, 20, 50 years, and into perpetuity). It also shows the various rental rates that would be required to achieve a present value of $8 and $6 per pound under the alternative discount rates and time horizons.

- **Payment basis** — quota compensation would likely be tied to some base year or, more likely, average of years. Payments could be made based upon the level of basic quota, effective quota, actual marketings, or some combination.

- **Payment period** — payments would likely be spread over three to ten years. Lump sum payments may also be offered below a designated level or a discounted payment may be offered up front.

- **Tax treatment** — Strategies to lessen the impact of taxes on buyout payments could include 401K-type retirement plans, capital gains treatment of payments, or tax incentives for reinvesting buyout payments in agricultural enterprises.

- **Program provisions (if any)** — most buyout plans include elimination of the current federal tobacco program. Some kind of an income safety net program for those who want to continue tobacco production post-buyout is desirable, although designing one that can achieve federal approval and funding may be a challenge.

- **Paying for a buyout** — regardless of the details, a quota buyout will be expensive and will require a secure, sustainable source of funding.

In addition to coming up with workable answers to each of these questions, there are other potential obstacles a buyout proposal must overcome. It is likely that any federally-funded buyout would be subject to payment limitations relevant for other agricultural programs. Public perception is another potential stumbling block. A large number of quota owners aren’t actually involved in tobacco production. In fact, a large number don’t even live in the same state where the quota is grown and some live outside the country. While it is understandable that quotas, a tradable asset distributed generations ago, are scattered far and wide, writing large checks to New Yorkers who couldn’t distinguish a tobacco plant from a weed may be a difficult pill for legislators and taxpayers to swallow, especially beyond the tobacco-growing region.

<table>
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<td>1.81 1.36</td>
<td>1.85 1.39</td>
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Table 1. Present Value of Alternative Quota Rental Rates, Discount Rates, and Time Horizons.

Assuming that a quota rental rate of $0.40, at a 5% discount rate, will generate the quota owner that rental income forever, the present value of the quota is $8. If a discount rate of 10% is assumed, that same quota’s present value is $4. If you want to achieve a present value of $8, assuming a 5% discount rate and a 10-year time horizon, the annual quota rental rate would have to be $1.02/lb.
The buyout plan recommended in the President’s Tobacco Commission report is projected to cost around $15 billion over five years. For perspective, that is roughly one-third of the total spending that was authorized for all farm programs over seven years in the 1996 Farm Bill. Granted, they have actually spent much more than they initially authorized, but it is still a very large price tag for spending on one regionalized commodity. Suggested funding sources have included federal funding through the new farm bill (unlikely); a new federal cigarette excise tax (unpopular and difficult at best); re-directing some or all of the two recent federal cigarette excise tax increases ($0.10 and $0.05); using no-net-cost funds (comparatively a small amount); directing remaining Phase II funds and some of Phase I settlement funds (may be difficult to coordinate multi-state effort); and tobacco manufacturer contributions.

Maryland’s Buyout Experience

- Voluntary buyout of Maryland type 32
- Funded by $78 million from state’s tobacco settlement over 10 years
- Participants paid $1/lb annually for 10 years, based on 1996-1998 average production
- Must permanently quit tobacco and convert land to other agricultural uses for 10 years
- Through 2001, 66% of Maryland’s 981 eligible producers participating, accounting for 81% of production

New Buyout “Calculator” Tool

- Excel spreadsheet created by Daniel Green and Will Snell at the University of Kentucky
- Allows you to put in your own specific farm data
- Allows you to play around with different buyout payment scenarios
- Allows you to compare expected returns
- Available for download at the UK Tobacco Economics Online website in early February
  - http://www.uky.edu/Agriculture/TobaccoEcon/
Sample input screens are shown here, where the user enters information about the buyout scenario they want to examine and also their particular farm situation.

Once the user puts in desired farm and buyout data, one click returns a summary of the expected returns under two scenarios: (1) stay in production, keep the program as is, and continue receiving Phase II payments and (2) participate in a quota buyout, eliminating Phase II payments, and either continue or quit tobacco production.

Over the entire burley belt, about 63% of tobacco was contracted in 2001, compared to about 26% last year. Contracting was more prevalent in Tennessee, with about 80% of pounds contracted. In the flue-cured region, about 80% of the crop was under contract. Contract prices have been about $0.04 higher.

A number of questions about contracting remain unanswered, especially related to the evolution of contracts over time. There are still a number of grower concerns about contracting prospects in the absence of a federal price support program. Uncertainty about the ability to fulfill export demands under a contract system also exists.

A referendum is scheduled before April on the question of mandatory federal grading of tobacco. Passage of the referendum requires a simple majority, unlike the program continuation referendum.

- 63.3% of all 2001 burley pounds contracted, compared to 26.3% in 2000
- About 80% of TN burley contracted in 2001
- About 80% of the 2001 flue-cured crop contracted
- What will be the impact of contracting on demand for U.S. burley exports?
- How will contracting evolve?
- Federal grading referendum this spring
The Future of the Tobacco Program

- Can the issue of international price competitiveness be addressed within the current program?
- How will contracting affect the future of the program?
- What will happen to tobacco removed from pool stocks last year and existing loan stocks?
- Has quota stabilized around a new equilibrium range?
- What will happen to tobacco production if we don't have a program?

Additional uncertainty stems from recent and anticipated technologies in tobacco production. Progress continues on curing research to reduce TSNAs and other carcinogens and also on genetically modified tobaccos that may produce a reduced-risk tobacco product.

At least one major manufacturer has indicated interest in FDA regulation of manufactured tobacco products. While other companies have not followed suit, questions remain about the long-term impacts of FDA regulations on the production of the leaf input.

Work continues on new uses for tobaccos, including biopharmaceuticals and industrial uses. While these demands are still very minor, they still may play a more significant role in the future.

Litigation against tobacco manufacturers, for health as well as anti-trust claims, adds uncertainty.

For More Information ... www.agpolicy.org

All presentations and papers, as well as additional tobacco resources, are available from the Ag Policy Analysis Center’s website: