POLICY PENNINGS

By Daryll E. Ray

What's Ailing Tobacco?

In last week's column, we introduced you to the federal tobacco program and the role it has played in sustaining a large number of family farms in the Southeast for generations. In this column, I continue to draw upon the work of APAC economist, Dr. Kelly Tiller, to sort out the host of complexities that are forever changing tobacco production in the Southeast.

There's no shortage of issues to cover here, so we'll dive right in. First and foremost, demand for farmers' tobacco leaf, reflected in the basic quota, has fallen by about half over the last four years. Many assume that the drastic cut is due to declining cigarette consumption and fallout from the tobacco settlement. But that's only a small part of the complex picture. Domestic consumption of cigarettes has declined by about 7.5% since 1998. Some of this decline is due to health concerns but some is also due to dramatic cigarette price increases. Since 1998, the average wholesale (before the addition of state taxes) price of cigarettes has more than doubled. Some of the price increase has paid for the national tobacco settlement agreement, but economists have estimated that less than 20% of the price hikes were actually required to cover settlement costs. The rest are attributed to oligopoly market power and increased profits.

So if the settlement and declining consumption don't account for the bottoming-out of demand, what does? Domestic cigarette production is down way more than domestic cigarette consumption, indicating that multinational cigarette manufacturers are moving some of their production overseas rather than exporting U.S. cigarettes. Exports of U.S. cigarettes are down about 40% over the last 5 years. Further worsening the leaf demand situation, cigarettes still produced in the U.S. now have a lot less domestic tobacco in them than they used to. Just ten years ago, about one-third of the American blend cigarette was imported tobacco. Today, only about half of the American blend cigarette is American-produced leaf.

Historically, we have exported a significant portion of our tobacco crop. Exports have consistently fallen, primarily because our price is so far above world price. Recall that the federal tobacco program includes a minimum price guarantee. The price support formula incorporates production costs (which, of course, aren't going down) and downward movement in market price is limited by the price support structure. Thus, price supports are not very responsive when demand decreases and the program essentially stabilizes high prices by allowing supply to shift via the marketing quotas.

While tobacco growers bear the brunt of reduced demand, it has also dealt a blow to many communities that were once hotbeds of activity every fall as tobacco auction sales got underway. Declining tobacco production has also meant less tobacco passing through local auction warehouses. But the problem of declining tobacco production on warehouse activities has paled in comparison to the problems brought on by rapid transition to direct contracting with manufacturers. In just two years, about 80% of the flue-cured crop and about two-thirds of the burley crop has switched from traditional auction sales to direct contract sales. Many of the auction warehouses, once a carnival-like scene every fall, are now closed and prospects look dim for the few remaining auction warehouses.

Cigarette manufacturers have complained in recent years that they have been unable to purchase the particular stalk positions and qualities of tobacco they require through the auction system, leaving them no choice but to bypass the auction system and contract directly with growers. Farmers' response has been to speak through the market, i.e., pay sufficient premiums for desirable stalk positions and qualities. In fact, there is some evidence that farmers have received a higher average price by mixing stalk positions than by separating, defying economic logic. While this remains unexplained by the manufacturers, the benefits to manufacturers of contracting may also reflect their anticipation of FDA regulation of cigarettes and the desirability of increased control over the production and marketing process.

Not to be outdone by the billions upon billions of dollars in government aid that have flowed freely to major crops over the last few years, tobacco has also seen its share of the cash infusion. "Mailbox money" from payments related to the tobacco settlement and federal agricultural disaster programs have offset some of the income losses, but ironically, this has been another nail in the coffin of the tobacco program. The mailbox payments have contributed (along with reduced quotas) to skyrocketing quota lease rates, which have further reduced growers' profit margins. Through the 1990s, about 5 to 10 cents of the average $1.80 that a Tennessee burley grower received per pound of tobacco sold was paid to the quota owner annually in exchange for the quota rights. By 2001, that quota lease rate had gone from under 10 cents to well over 50 cents per pound, and it will likely push higher in 2002. While flue-cured lease rates have typically been higher than burley rates, they too have pushed up considerably. So growers are not only producing less, they're making much less profit on each acre they do produce.

What does the future hold for the tobacco program, tobacco production, tobacco farms, and communities dependent on tobacco income? Short of a crystal ball, there's no simple answer to this question. It is safe to say, however, that the future will not mirror the past. In the next and final column on tobacco, we'll explore some of the possible outcomes and their implications.

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