PolicyPennings by Dr. Daryll E. Ray

Tobacco quota buyout is just the beginning

Most tobacco quota owners and growers—concentrated in the Carolinas, Kentucky, Tennessee, the Virginias and Georgia—are still in shock over passage of the much-anticipated tobacco quota buyout. But it's a good kind of shock.

As we described in last week's column, the tobacco quota buyout is designed to fix problems in tobacco production and marketing that didn't have any easy fixes within the confines of the federal tobacco quota and price support program. It was a 7-year roller coaster ride to the realization of a tobacco quota buyout.

But now that the shock over the realization of an odds-defying buyout is beginning to wane, a whole new wave of shock is rippling through tobacco country. And this time it is not the good kind of shock. Farmers who are planning or considering a future in tobacco production are quickly recognizing that they are in uncharted waters. And these uncharted waters are murky at best, with all the makings of a perfect storm on the horizon.

The first level of buyout impact analysis is relatively simple. The federal tobacco program ends in exchange for compensation/transition payments for quota owners and growers. To fill in a few more details, the federal tobacco quota and price support programs are fully terminated, beginning with the 2005 crop. For the next ten years, tobacco product manufacturers and importers will be required to make payments into a government trust fund—to the tune of about $10 billion over 10 years—that will be used to make compensation and transition payments to tobacco quota owners and growers and dispose of existing pool stocks. And that's pretty much the whole buyout in a nutshell.

For the one-half to three-quarters of all tobacco program participants today who will likely take the buyout and run, the second level of analysis extends to questions like: Should I take a discounted lump sum payment or a full ten-year payout? How can I minimize the tax impacts of the buyout payments? Should I buy a new red truck or a new blue truck?

For the remaining quarter or more of tobacco farmers who want to be post-buyout tobacco farmers, there's a third level of analysis that gets complex quickly: Now what? We have just witnessed the most dramatic change in tobacco policy in more than 65 years, perhaps even the most dramatic change in *any agricultural policy* in the last half century with tobacco's new distinction as the only government supported crop to move cold turkey to a totally free market.

A number of the unanswered questions can be lumped under the contract uncertainty heading. U.S. tobacco manufacturers began bypassing the program-backed auction market system several years ago in favor of direct contracts with producers. While the rise of direct contracting in tobacco was swift and prevalent, contract terms were undoubtedly influenced by the mere presence of the safety net of the program's minimum support price guarantee for all domestic tobacco production. In a post-program free tobacco market, it's difficult to imagine a tobacco farmer bearing the significant up-front costs of raising a tobacco crop without a contract in place. Perhaps more relevant, it's harder still to imagine a lender allowing a farmer to bear the up-front production costs without at least a one-year contract in place.

While a contract will be a necessity, tobacco growers will have limited market power to influence contract offers or terms. Contracting manufacturers or leaf dealers will hold all the cards determining which growers will be offered contracts and where they will be located (now that tobacco production is free to move out of the previously restricted tobacco belt).

While future price declines from the high price levels under the previous program are inevitable, where will contract prices settle? Price declines of around 25% or more over three years are expected. Ultimately, contractors will also determine the quantity of U.S. tobacco production as the free tobacco market responds to shifts and adjustments in world tobacco markets.

Although these questions remain unanswered, growers are quickly approaching the narrow window of opportunity for production decisions for next year. Growers are already contemplating reasonable lease and share arrangements for next year absent the value of the quotas, but with little or no market certainties to depend on. And of course their lenders are keenly interested in learning more specific details about future grower contracts.

These unanswered questions only scratch the surface for those making life-altering decisions over the next several months and years. While most quota owners and growers who have seriously analyzed the buyout have concluded that it was the best possible outcome that was politically feasible, they would probably also warn other farmers to be careful of what you ask for. You just might get it.

This column was written by Kelly Tiller, Assistant Professor with the Agricultural Policy Analysis Center. More detailed information about the tobacco quota buyout is available from the Tobacco Buyout section of APAC's website:http://www.agpolicy.org/tobquota.html. Daryll E. Ray holds the Blasingame Chair of Excellence in Agricultural Policy, Institute of Agriculture, University of Tennessee, and is the Director of the UT's Agricultural Policy Analysis Center. (865) 974-7407; Fax: (865) 974-7298; dray@utk.edu; http://agpolicy.org.

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