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The U.S. Tobacco Program:
How It Works and Who Pays For It

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The operation of the U.S. tobacco program and its costs are often misunderstood. The program guarantees U.S. tobacco farmers minimum prices in exchange for restricting production. By law, the tobacco program operates at a zero cost to U.S. taxpayers. In years of abundant production, the Commodity Credit Corporation (CCC) — a funding agency of the federal government — makes loans to grower cooperatives to purchase tobacco passed over at auction by tobacco buyers. But law requires that the principal and interest on these federal loans be fully guaranteed by marketing assessments paid by U.S. tobacco producers and purchasers.

There are some relatively small administrative and other non-operating costs associated with the program. However, these costs are partially offset by an additional assessment levied on tobacco producers and purchasers.

How the U.S. Tobacco Program Works

The U.S. tobacco program consists of marketing quotas and price supports. Marketing quotas establish the maximum amount of tobacco U.S. farmers can sell in a given marketing year. A national quota is initially determined by a formula accounting for domestic demand, export demand, and reserve stock levels. The national quota is allocated to nearly 350,000 U.S. farms located in 17 states. Price supports establish minimum prices farmers may receive for their tobacco. The average price support level is influenced by changes in the previous years' market prices and farmers' costs of production.

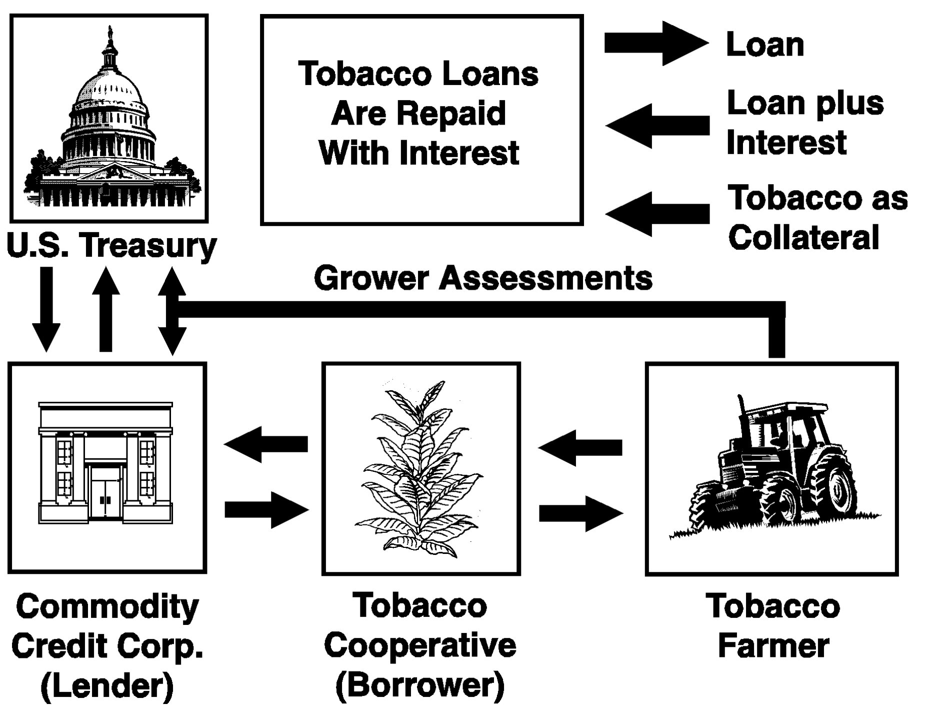
Farmers deliver their tobacco to auction warehouses where government graders (financed by the farmers) place a grade on each sales lot of tobacco. This grade refers to a specific price support (loan) level. If tobacco companies do not bid one cent per pound above the government-established price support level, the tobacco is purchased by a grower-financed/grower-operated cooperative. The cooperative pays the farmer using money borrowed from the CCC. The tobacco represents collateral on the government-backed loan.

The cooperative processes and stores the tobacco for future sale. Following the sale of the surplus tobacco, the cooperative repays the CCC loans in full with interest.

Costs and Assessments Associated With the Tobacco Program

The No-Net-Cost Tobacco Program Act of 1982 mandated that the U.S. tobacco program operate at no expense to U.S. taxpayers. To carry out this mandate, tobacco producers and purchasers are assessed a no-net-cost fee on each pound of tobacco sold.

Prior to 1982, the stored tobacco owned by producer cooperatives was



the only recourse for CCC loans. The government did incur some relatively small financial losses associated with the pre-1982 crops. In addition, taxpayers assumed some losses on the sale of the 1983 crop which (like other agricultural crops) was declared a federal disaster. Total losses of principal since the program originated in the 1930s are less than $700 million on loans exceeding $10 billion. Over 60 percent of the losses were associated with the 1983 drought-disaster crop. However, since the 1982 law, no-net-cost assessments have ensured that taxpayers are not subsidizing loans under the tobacco program.

Because of USDA accounting procedures, some years may indicate a net expenditure associated with the tobacco program, while in other years the tobacco program generates revenue for the government. Loans covering each year are considered an expense until fully repaid sometimes years later. Then when demand outpaces production, tobacco under loan is sold and the loans are repaid with interest, creating revenue for the government. Over time, however, all no-net-cost assessments must cover all current and projected losses on the tobacco loan program operation.

As with all federal programs, there are some administrative and other non-operating costs associated with the tobacco program. These include market news/analysis, extension and research activities, crop insurance subsidies, and the administration of the program by Farm Service Agency personnel. Adverse weather conditions and diseases in 1995 abnormally increased crop insurance outlays, resulting in larger than normal expenditure for the tobacco program in fiscal year 1996. Administrative and other non-operating expenditures associated with the tobacco program are projected to fall to more normal levels of around $50 million for fiscal year 1997.

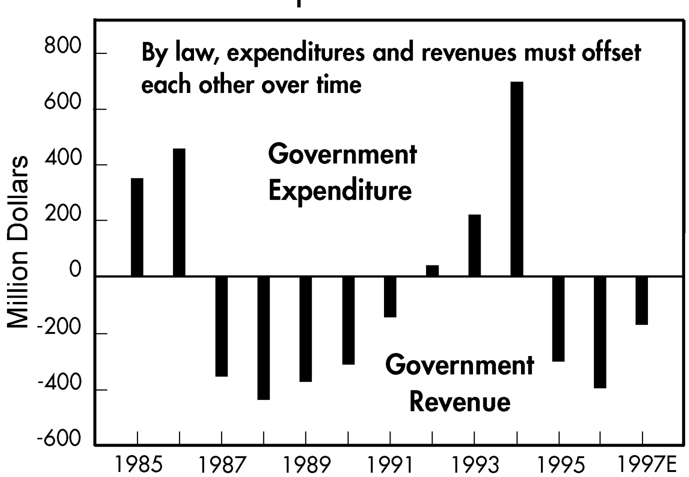
These administrative and other non-operating costs are partially offset by another assessment called the "budget deficit assessment" that tobacco producers and purchasers pay. This assessment, totalling around $30 million in recent years, is directly applied toward reducing the federal budget deficit. Abolishing the U.S. tobacco program would eliminate this source of U.S. government revenue, but would not necessarily totally eliminate other non-operating costs associated with the program. Also, the government would be subject to financial liability on any remaining tobacco loan inventories if the program were eliminated.

The Program's Impact on Farm Income and Tobacco Consumption

Unlike other agricultural programs, the tobacco program has accomplished many of the basic initial goals of farm programs of providing price and income support for a large number of small family farms without incurring large government expenditures. Despite increased consolidation during the past decade, the average tobacco farm grows fewer than seven acres of tobacco annually, with individual farm quotas being much smaller.

Eliminating the U.S. tobacco program would significantly increase price volatility and cause prices to fall by 20 percent or more. A price decline of this magnitude would likely reduce the number of family farms growing tobacco by more than 50 percent and would be devastating to many communities which experience high production costs and which depend on tobacco income, but lack off-farm employment opportunities. Even with lower and more volatile prices, U.S. tobacco production without a tobacco program would increase in concentrated areas that experience low production costs. The elimination of the program would also have adverse effects on land values, property tax bases, and the sale of agribusiness goods and services in certain rural areas. Without a program, tobacco companies would have access to lower cost domestic and foreign leaf, resulting in slightly lower cigarette prices (and thus slightly higher cigarette sales) and/or higher tobacco company profits.

CCC Net Expenditures For Tobacco



Source: USDA, Note Negative Expenditures Are Govt. Revenues

USDA Tobacco Industry and Program Data

U.S. Tobacco Farm Quotas (1995)	**347,000**
U.S. Tobacco Farms (1992 Census)	**124,000**
Avg. Tobacco Per Farm (1992 Census)	**6.7 acres**
Value of U.S. Tobacco Prod. (1992-95 Avg.)	**$2.7 billion**
Gross Value Per Acre of Tobacco (1992-95 Avg.)	**$3,833**
Taxes Collected on Tobacco Products (1995)	**$15 billion**
U.S. Tobacco Trade Surplus (1995)	**+$5.9 billion**

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