The Burley Tobacco Farmer

Economist's Column

February 2002

by Kelly Tiller
Assistant Professor
Agricultural Policy Analysis Center
The University of Tennessee

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 only actual experience with a tobacco quota buyout has been Maryland type 32. In 1999, the state of Maryland allocated $78 million over ten years from their share of expected tobacco settlement payments to fund a tobacco buyout. Farmers participating in the voluntary buyout program are being paid $1 per pound annually for ten years, based on the average amount of tobacco produced between 1996 and 1998. In exchange for the payments, farmers must agree to permanently quit tobacco production and convert their land to other agricultural uses for at least ten years. Through 2001, 68 percent of Maryland's 990 eligible tobacco farmers were participating in the buyout, accounting for 81 percent of the state's eligible tobacco production and more farmers are expected to join the buyout program.

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 Ford and Lugar) 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 the three-year length approved in the quota referendum, 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.

- *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. 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 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.

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.

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. Despite the swarming talk, it's probably premature to start looking for a check in the mail.