



Testimony of Kelly H. Tiller presented to the
**President's Commission on Improving Economic
Opportunity in Communities Dependent on
Tobacco Production While Protecting Public Health**

Louisville, Kentucky

November 10, 2000

Mr. Chairmen, thank you for the opportunity to speak before this Commission. My name is Kelly Tiller. I'm an agricultural economist with the Agricultural Policy Analysis Center at the University of Tennessee working in the areas of tobacco policy and farm-level economic analysis. In my remarks today, I would like to present some general economic data related to tobacco production and the tobacco program focused primarily on Tennessee and also summarize some of the dialogue and concerns of the Tennessee Tobacco Working Group.

Tobacco Production in Tennessee

Tobacco has played an important role in Tennessee agriculture for many generations. Tobacco remains a vital source of income in Tennessee, contributing more than one out of every ten dollars in agricultural receipts in 1999 and leading all crops in cash receipts (figure 1). Tobacco receipts in Tennessee in 1999 totaled \$218 million, accounting for 22.6 percent of all crop cash receipts.

No other major crop in Tennessee comes close to generating the level of income that tobacco does. As seen in figure 2, the average per acre value of production for tobacco in 1999 was \$3,794, compared to \$252 for cotton, \$199 for corn, and \$86 for soybeans. Net income per acre averages near \$2,000 for tobacco.

According to the 1997 Census of Agriculture, the number of tobacco farms has fallen to a new low of approximately 15,000 in Tennessee. Only one out of every four tobacco farms in 1964 remains in production today, and fewer than half of the tobacco farms in 1982 still grow tobacco. Census data indicate that the average to-

Figure 1. Percentage of Tennessee Crop Cash Receipts, 1999
(Source: Tennessee Agricultural Statistics Service, 2000)

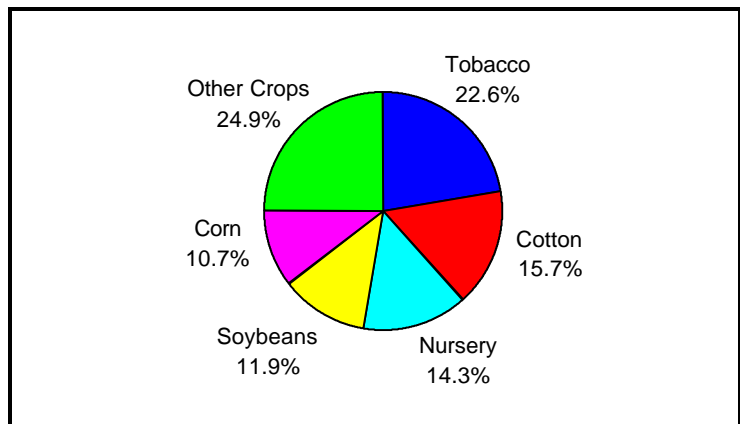
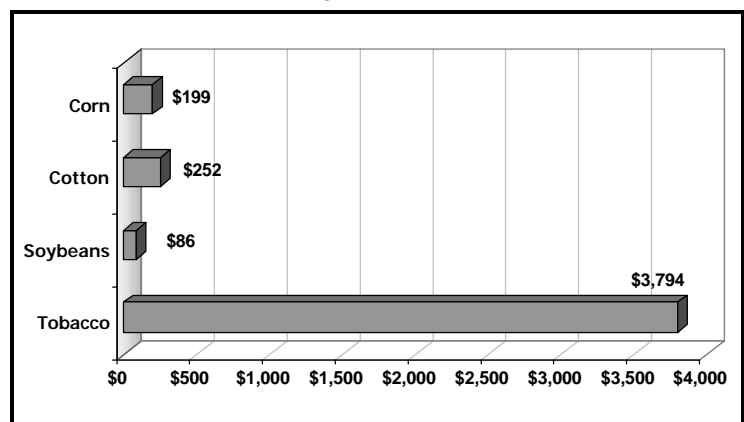


Figure 2. Per Acre Value of Tennessee Crops, 1999
(Source: Tennessee Agricultural Statistics Service, 2000)



bacco acreage per farm in the state has doubled over the last decade, from two acres per farm in 1987 to four acres in 1997.

Burley tobacco quotas in Tennessee have been cut nearly two thirds since 1997. Figure 3 shows the state's basic and effective quota since 1994 and projections for 2001. The 2000 basic burley tobacco quota in Tennessee was set at 42.4 million pounds. Assuming that manufacturer purchase intentions change little over the 2000 level, export levels and forfeited 1999 burley pool stocks indicate that the 2001 quota could increase 30 to 40 percent. While this projection is considerably more optimistic than the outlook appeared only a short time ago (prior to forfeiture of 250 million pounds of 1999 burley pool stocks to the CCC and forgiveness of loans on the forfeited poundage), a 30 percent increase in the 2001 basic quota still only results in a basic quota of about 55 million pounds in Tennessee next year. Tennessee has historically marketed less tobacco than the annual quota, allowing significantly higher effective quotas to buffer the impacts of recent quota reductions.

Figure 4 shows the same burley basic and effective quota in Tennessee as well as the pounds produced and marketed. During the 1990s, tobacco production in Tennessee has averaged 100.4 million pounds. 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. Projections for the 2000 marketing year are for production of 94.5 million pounds. Effective quota for 2000 is 87 million pounds, indicating that declining basic quotas have now eroded the buffer

Figure 3. Tennessee Burley Tobacco Basic and Effective Quota, 1994-2000 (2001 Projections).

(Source: Tennessee Farm Services Agency)

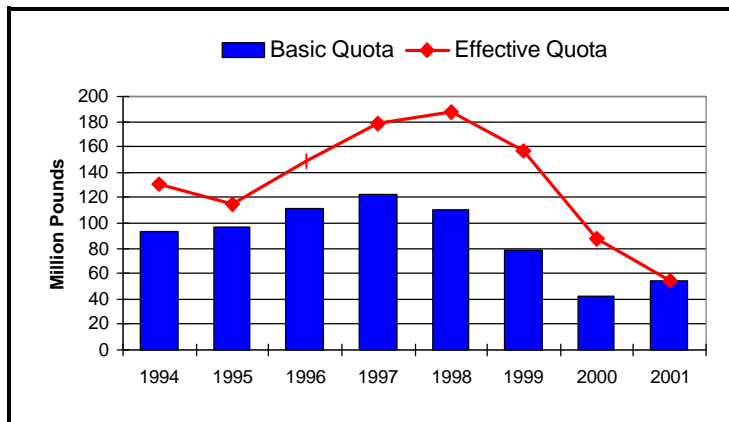


Figure 4. Tennessee Burley Tobacco Quotas, Production and Marketings, 1994-2000 (2001 Projections).

(Source: Tennessee Agricultural Statistics Service; FSA)

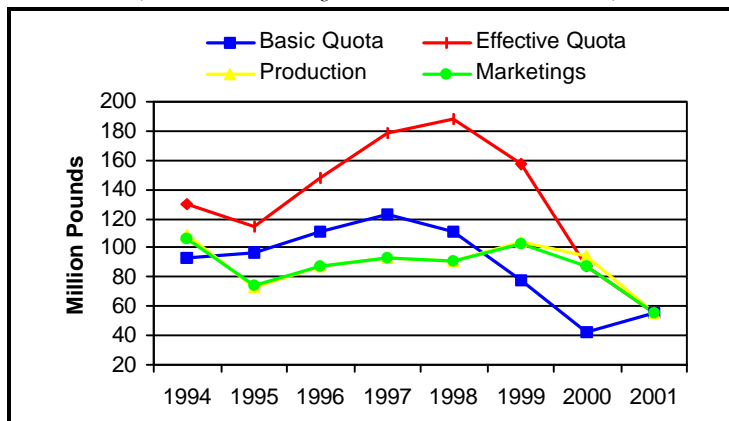
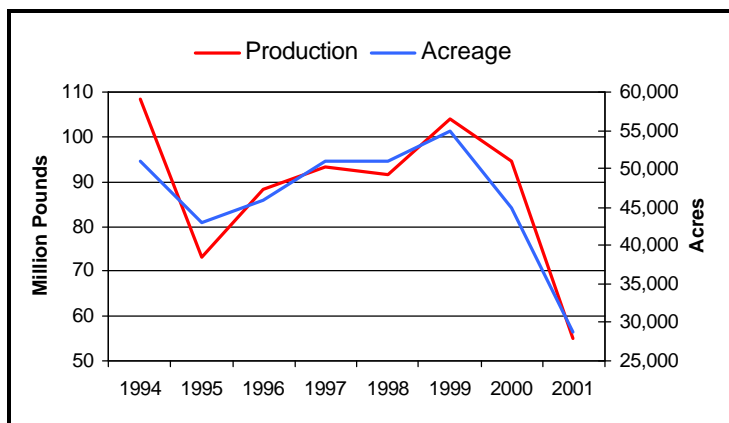


Figure 5. Tennessee Burley Tobacco Production and Harvested Acreage, 1994-2000 (2001 Projections).

(Source: Tennessee Agricultural Statistics Service)



protection of the effective quota. The result is that despite a more optimistic outlook for quota next year, Tennessee growers will still be forced to reduce tobacco acreage drastically in 2001 as effective quota continues to decline sharply.

Over the 1990s, tobacco acreage in Tennessee has averaged 52,000 acres. As effective quota in 2000 dipped below recent production levels, Tennessee farmers significantly reduced their tobacco acreage, as seen in figure 5. Preliminary estimates put the 2000 tobacco acreage at 45,000 acres, which is 18 percent below the 1999 harvested acreage of 55,000. In spite of a 10,000 acre reduction in tobacco acreage, production did not fall proportionately due to high yields estimated to be near 2,100 pounds per acre. Projections are for the 2000 effective quota (87 million pounds) to actually constrain marketings of the 2000 crop (projected to be about 94.5 million pounds), which means that effective quota in 2001 is likely to be at or slightly below basic quota. Thus, the brunt of the quota reduction of recent years will be felt in the state in 2001 when effective quota will limit production to a level significantly below the production levels of the last decade.

If basic quota in Tennessee increases by 30 percent in 2001 to 55 million pounds, assuming the 1990-99 average yield of 1,920 pounds, tobacco acreage could decline to under 29,000. This would be a reduction of more than one third over the 2000 acreage and a 47 percent reduction from the 1999 acreage. So while the prospect of increasing quotas in 2001 is certainly positive for the tobacco industry, Tennessee burley production is not expected to rebound to the levels of the last decade over the next few years.

The Tobacco Program

Because U.S. tobacco is differentiated from foreign tobaccos (implying a downward-sloping demand curve), supply restrictions are effective in elevating U.S. prices — the premise for the federal tobacco program. Quota, or the right to produce and market tobacco, then becomes an asset with value where quota owners

exercise cartel power via the program. The program allows economic rents to be transferred from purchasers and producers to quota owners (which may or may not grow the quota). The difference between the program price and the marginal cost of producing the tobacco is the rental rate for quota, the mechanism for transferring rents from purchasers and producers to quota owners.

By design, the tobacco program stabilizes prices by inducing quota volatility. When demand for tobacco declines, prices remain relatively fixed and quota declines to accommodate the shrinking market. Price supports are not very responsive when demand declines because they are determined by a weighted average of changes in production costs and historical market prices. The effective result is that prices remain relatively constant and supply is shifted downward via a reduction in the quota restriction. When demand declines and quota declines without reducing price, the rental rate for the quota increases.

The policy of cutting quotas while maintaining relatively stable prices tends to place more of the burden of reduced market demand on growers than on quota holders. As demand shifts downward, quotas decline and price remains relatively fixed. Adjustment in the market comes through the rental rate, which increases. Thus, quota owners recover some of the value of lost quota by increasing the value of the remaining quota. The growers leasing a significant portion of the quota he grows bears the brunt of the downward adjustment through higher quota lease rates, though still benefiting from the reduced risk afforded by stable prices.

Quota and income losses for U.S. producers are not expected to recover in the near future. The industry demand curve for U.S. burley tobacco has been shifting downward over the last few years and the forces responsible for the shift are not expected to reverse the trend in the near future. The downward pressure on industry demand stems from a number of sources including

increasing imports of foreign leaf, declining exports of U.S. leaf, declining domestic consumption of cigarettes, movement of cigarette production overseas, and legal and political uncertainty. Relatively high, stable U.S. prices (compared to world leaf prices) and projections for continued declines in domestic consumption of manufactured tobacco products and continued movement of U.S. production overseas suggest that total demand for U.S. burley is likely to be about a third lower over the next few years, compared to historical levels.

Tennessee Tobacco Working Group

For nearly three years, I have been working with a diverse group of tobacco stakeholders in Tennessee through the Tennessee Tobacco Working Group. This group is a state-level tobacco dialogue modeled after the Southern Tobacco Communities Project. The goal of the group is to use the *Core Principles of Agreement Between the Tobacco Producer Community and the Public Health Community* to identify areas of common ground among participants and work together to strengthen the economic vitality of Tennessee's tobacco producing communities while protecting public health. About 75 individuals have participated in this dialogue representing the interests of growers and quota holders, producer organizations, public health organizations, warehouse operators, academic researchers (public health, tobacco production, public policy, economic development), state agencies (public health and agriculture), and elected officials (governor, state legislators, and U.S. senators and representatives). Following is a summary of some of the key issues and concerns of this group.

During the summer of 2000, the Tennessee legislature decided to use their initial tobacco settlement payments (totaling over \$200 million) to establish two funds — one for public health, the other for agriculture — with each receiving half of the current payments. Legislators did not determine any specific uses for the funds. Two legislative committees have recently been estab-

lished — a nine-member health legislative committee and a ten-member agriculture legislative committee — to make recommendations for specific use of the funds. Allocations will require the approval of the full legislature during the next legislative session.

Tobacco stakeholders in Tennessee are very concerned about potential uses for these funds. Participants feel it's important that tobacco settlement dollars be used to address tobacco-related needs, including preventing and solving tobacco-related health problems and ensuring economic vitality for growers and communities that have depended on tobacco income. The public health community has recently completed a comprehensive tobacco use reduction and prevention plan for the state. Lack of adequate funding has severely limited implementation of the plan to date, and participants in the TTWG are interested in using a portion of the settlement payments dedicated to health uses to fund the state's plan. Participants are also interested in using the agriculture portion of the settlement funds to provide economic assistance to tobacco growers through development of alternative and supplemental enterprises, market assistance, education, and addressing long-term transition to changing tobacco markets.

Participants recognize that it seems likely that the use of contracts in tobacco purchasing will increase, exacerbating the trend toward consolidation of tobacco farms and tobacco warehouses. Growers are particularly concerned about the ability of the tobacco program to accommodate a significant portion of contract-produced leaf. Although by no means specific to tobacco, contracts in general impose some risks on producers (especially in a market with a very small number of buyers) but also have some producer benefits. Growers are concerned that movement toward extensive contracting without modifications of the tobacco program will result in eventual elimination of the program, leading to sharp declines in prices, movement of production out of many communities currently dependent on tobacco income, and asset losses for quota

owners without compensation.

A shrinking market cannot sustain the historical production level, forcing some growers to exit production. While a number of factors besides production costs affect a farm's potential to remain viable in the market, economic theory suggests that over time, lower-cost producers will remain in tobacco production. In Tennessee, the Appalachian region will likely be most heavily impacted by the declining market. The socioeconomic and cultural status, environmental and soil characteristics, infrastructure, and lack of off-farm employment opportunities which typify the Appalachian region exacerbate the difficulties for small Appalachian farmers and rural communities to respond and adapt. Declining incomes in this region are also a public health concern.

The economic impact of the significant quota cuts has been cushioned somewhat by recent federal disaster assistance (TLAP) and tobacco settlement (Phase II) payments. In calendar year 2000, Tennessee burley tobacco growers received approximately \$95 million in direct payments: \$28.5 million in Phase II payments, \$32 million in 1999 TLAP payments, and \$35 million (expected) in 2000 TLAP payments. Tobacco growers received 80 percent of each payment based on pounds marketed in 1998. The remaining 20 percent was paid to quota holders based on 1998 basic quota. While growers and quota owners have benefited from this assistance, they are concerned that the amounts are still relatively small compared to potential losses, similar future payments (with the exception of 10 more years of Phase II payments at a lower level) are unlikely, and the amount of the payments does not allow growers to address the long-term problems and uncertainty they face.

Conclusions

Changing tobacco markets and persistent uncertainty are resulting in a number of unanswered questions. How can extensive contracting in tobacco marketing co-exist with a supply

control and price support program? How could the asset value of quota be equitably eliminated or transferred to growers? What is the value of quota? How might a supply/marketing licensing program be structured? In the absence of a supply control and price support program, how could contract growers be protected from price and contract risks associated with a market characterized by very few buyers? To what extent and how quickly would U.S. exports adjust to downward movement in prices? As markets adjust to lower levels of industry demand, how will production move geographically? How would geographical movement of production differ in the absence of a supply control and price support program? How quickly will any market transitions occur? How will communication in the future market be facilitated? These are just a few of the many questions being asked. There are few easy answers.

I commend this Committee for addressing such formidable questions, often characterized by polarized views. Approaching many of these pressing issues will require careful examination and analysis of available data, but also additional research and data collection efforts. Estimation of regional costs of production, regional identification of additional grower and quota owner demographic and economic characteristics, estimation of price responsiveness under alternative market scenarios, and regional evaluation of available economic and agricultural development resources will all be important in addressing the myriad of questions on the table.