FAX COVER SHEET

U.S. DEPARTMENT OF AGRICULTURE
Office of the Under Secretary
Farm and Foreign Agricultural Services
14th Street and Independence Avenue, S.W.
Washington, D.C. 20250-0105

Fax No: (202) 720-8254
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Date: 3/23/98

TO: Tom Freedman

FAX NO: 456-7028

PAGES: 6
(including cover)

FROM:

- ☐ AUGUST SCHUMACHER
- ☒ DALLAS R. SMITH
- ☐ JIM SCHROEDER
- ☐ TERESA GRUBER
- ☐ JOHN WINSKI
- ☐ BUTCH MAY
- ☐ KATHY BLYTHE
- ☐ JACKIE BURRELLO

COMMENTS:

MAR 19 1998

TO: Dallas Smith, Under Secretary for Farm and Foreign Agriculture Services

FROM: Charles Hatcher, Director, Tobacco and Peanuts Division

SUBJECT: Review of Stabilization's Flue-Cured Tobacco Settlement Consideration

The following representatives from Flue-Cured Tobacco Cooperative Stabilization Corporation (Stabilization) met with the Tobacco and Peanuts Division on March 17, 1998, to discuss their Board's resolutions regarding points to be included in any tobacco settlement legislation:

Attendees: Bruce Flye, Arnold Hamm, Andy Sheppard, Kenneth Dasher, Albert Johnson, and Joe Muldoon.

Stabilization outlined their 5-points for tobacco settlement legislation and provided details about those and other issues to be addressed in settlement legislation. See copy attached.

With respect to the attached document entitled "Board Resolutions Regarding Points to be Included in any Tobacco Settlement Federal Legislation" the following clarifications, understandings or concerns are provided:

- The $8.00 per pound under item 1 for quota owners and the $4.00 per pound under item 2 for tobacco producers would be paid over a 10-year period from funds generated from the tobacco settlement. If an entity is both a quota owner and a tobacco producer, the compensation would be equal to $12.00 per pound over the 10-year period.

- The base period for items 1 and 2 are based on the average quota for the period 1995-1997.

- The quota owner in item 1 and the tobacco producer in item 2 would be determined on the date of enactment of tobacco settlement legislation. The quota owner would be the owners indicated on FSA records and all tobacco farms would need to be divided by common ownership unit for the 3-year period in order to determine the average base quota for compensation. The tobacco producer in item 2 is defined as one who shares in the risk of production. Stabilization recommends that this determination be based on FSA's acreage reports, tobacco sale bills or other records available to the county FSA committee. TPD would recommend a meeting with individual farm operators, owners and producers to ensure as accurate as possible base quota determinations.

- Under item 4, the flue-cured quota, based on the base quotas determined in item 2, would be converted to Production Limiting Permits (PLP) for only active flue-cured tobacco producers. Stabilization uses the term "active flue-cured tobacco producer" to mean the person who bears 100 percent of the risk of flue-cured tobacco production. The resolution provides that a PLP assigned to any person will be reassigned to new tobacco producers and other active tobacco producers within the same county when such person is no longer an active tobacco producers. (Note: currently FSA operates a forfeiture pool for certain tobacco quotas and this forfeited quota is reallocated to others farms in the county based on requests filed by active tobacco producers.) Stabilization recommends that the PLP holders designate the farm of production each year on FSA records.

- Item 5 recommends a purchase intention agreement between domestic cigarette manufacturers and Stabilization of 600 million pounds. A purchase requirement of 600 million pounds for domestic use is not logical or practical and may well be determined GATT inconsistent. The main purpose of payments to quota holders and tobacco producers is to compensate for lost income and equity due to reduced cigarette consumption caused by the settlement. Guaranteed purchase intentions with price support means that the negative impact on producers is mitigated. Demand for cigarettes could decline sharply, especially over a 25-year period. Surely some mechanism must permit this reduction to be reflected in purchase intentions.

- Under item 7, price support would be based on the previous 3-year average production costs for flue-cured tobacco as opposed to the current method that uses average prices received by producers and costs of production. Setting price support levels based solely on changes in costs of production raises several concerns. Several questions should be resolved: 1) What items are included in the cost calculations -- this must be spelled out precisely?; 2) What assumptions are made relative to depreciable items such as life of the investment, initial cost, and salvage value?; 3) Who is responsible for establishing the costs -- this must be spelled out precisely in legislation? Current legislation is not clear on which agency determines the cost of production figures.; and 4) Who monitors cost methods and procedures? -- experts familiar with production and marketing of tobacco should be involved in developing methods and procedures for establishing cost and monitoring the reasonableness of cost estimates.

- **Item 8 calls for these changes to be effective for the 1998 crop year which begins July 1, 1998.** Making these program changes effective July 1, 1998, is an almost impossible task even if legislation were enacted by April 1. With approval of such legislation, it is our understanding that item 8 provides that the net drop in price supports for the 1998 crop year of 24 cents per pound ($1.62 minus $1.38) would be paid to producers and an equal amount applied to the association debt with CCC to equalize loan pricing and that such monies would be in addition to any scheduled compensation or transitions payments. (Note: Stabilization recommended borrowing such funds from CCC until money was available to cover these outlays from the tobacco settlement.)

- Item 9 provides that if the compensation amounts differ from those proposed, such increase or decrease shall be reflected in the 1998 price support adjustment on an equivalent percentage basis.

- Item 10 provides no new or additional benefit to producers or the tobacco program.

- Item 11 provides for a 40 cents per pound drop from average prices received in the previous

3-years, to be effective for the 1998 crop, if their proposed program is adopted. Reducing the price support level below $1.40 per pound should cause a substitution of U.S. grown flue-cured for foreign-grown flue-cured and a gradual shift from burley to flue-cured in U.S. cigarette blends (assuming that burley price supports are not reduced). Flue-cured leaf exports would also increase.

- **Limited Resource Farmers** - Although not mentioned in Stabilization's proposal, limited resource farmers will benefit less from the quota compensation plan than other quota holders and producers since payments are based on pounds of tobacco. They own smaller quotas and produce smaller acreages. A disproportionate number of limited resource farmers are African-Americans and Native Americans. Additional assistance may be needed for quota holders who own and producers who grow less than 10,000 pounds of quota. This could be done in several ways: 1) double payments to these quota holders and tenants, 2) provide retraining assistance to quota holders and tenants and education grants to their children, and 3) provide economic assistance for building economic infrastructure and target affected individuals for training and education grants and outright monetary payments to individuals 65 and older.

- **CONCERNS:**

  - Making these program changes effective beginning July 1, 1998, will be a tremendous workload, if not an impossible effort, on our county and State FSA employees. Based on early discussions with KCMO personnel, dividing farms into separate common ownership units for determining quota holders would need to be performed at the mainframe in KCMO because of locating owners for prior year tobacco records - back to 1995 under Stabilization's proposal. Exemption from normal rule making procedures would need to be implemented and all 3 tobacco handbooks would need to be rewritten. We believe that county FSA committees would need to meet with farm operators, owners and producers to determine accurate base quota levels. At a minimum, contracts between USDA and the quota owners and tobacco producers would need to be developed and procedures for tracking these payments over 10-years set out in great detail. We estimate that the work devoted to this effort would be close to the work in the initial data load of tobacco information into the SCOAP system.

  - Additional effort would be needed to implement different tobacco settlement legislation for burley, flue-cured and other kinds of tobacco.

  - The primary reason for Stabilization wanting the program changes effective July 1 seems to be the loss in value of current loan stocks and expected loan receipts from the 1998 crop. The loss in value of loan stocks and receipts from the 1998 crop could be offset with funds dedicated to this purpose from the settlement.

Unapproved Excerpt From Flue-Cured Tobacco Cooperative Stabilization Corp. Minutes of Mar. 11, 1998 Board Meeting - **Draft & Confidential**

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2. Current flue-cured tobacco producers (producer of record on date of enactment), those who share in the risk of production, should receive $4.00 per pound in transition payments based on their share of the risk. The current producer of flue-cured tobacco quota shall receive the full payment and in the event of the producer's death the payments will continue to the producer's estate or heirs.

3. There should be a tobacco program that: (i) limits supply, (ii) places a minimum price on tobacco, and (iii) retains and encourages the health and quality standards (including pesticide and varietal standards) of US tobacco while holding imported tobacco and tobacco products accountable to the same standards.

4. The term "quota" used to describe flue-cured tobacco production controls will change to Production Limiting Permit (PLP). Only active flue-cured tobacco producers, those who bear 100% of the risk of flue-cured tobacco production, may own PLP's. PLP's will be assigned to individuals, partnerships and farming corporations based on current flue-cured tobacco production. No sale or lease of PLP's shall be authorized.

   PLP's will be re-distributed to new flue-cured tobacco producers according to current law and existing active flue-cured tobacco producers within the same county. In the case of tenants who were the primary producers of leased or rented flue-cured tobacco, credit will be given to the tenants, renters and quota owners based upon their share in the risk of current flue-cured tobacco production.

   PLP's may be transferred in the case of the death of a person to whom a PLP has been issued to the surviving spouse or if there is no surviving spouse to surviving descendants as long as the transferee is an active tobacco producer. A holder of a PLP may transfer their PLP to their spouse or descendants as long as they remain active flue-cured tobacco producers.

5. The domestic manufacturers should by private contract with Stabilization, commit to ≥600 million pounds net purchase intentions for 25 years with or without a national tobacco settlement.

   The December 1, 1994, Agreement To Purchase 1990-1993 Crops of Flue-Cured Tobacco will remain in full force and effect and be fully executed notwithstanding legislative changes to the Federal Tobacco Program.

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6. In the event any domestic manufacturer fails to purchase 100% of its purchase intentions in any marketing year, such company shall purchase from Stabilization's uncommitted inventory by the end of the same marketing year, an amount (green weight basis) of flue-cured tobacco, that when added to its current purchases, equals 100% of its purchase intentions for the marketing year.

7. Future price support adjustments shall be based solely on the previous three (3) year average production costs for flue-cured tobacco. The Secretary of Agriculture shall have no discretionary authority to adjust price supports.

8. For 1998, flue-cured tobacco producers shall be paid for all pounds marketed, an amount equal to any reduction in price support from the 1998 level. This payment shall be separate from any scheduled compensation or transition payment. Also, the same amount paid to producers on a per pound basis will be paid to CCC to reduce the loan on Stabilization's 1997 loan inventory. Funds for payments to producers and the loan shall be allocated from settlement legislation.

9. Any increase or decrease in the settlement flue-cured tobacco quota compensation, shall be reflected in the 1998 price support adjustment on an equivalent percentage basis.

10. Authorization should be granted to allow for flue-cured tobacco producer initiated referendums that would recommend to the Secretary of Agriculture needed changes to the rules and regulations that govern the Federal Tobacco Program.

11. Subject to satisfactory resolution of all the above, we recommend a 1998 price support reduction equal to a 40 cents per pound reduction in the previous three year market average to an average support price of $1.385 per pound.

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DRAFT

DRAFT
July 10, 1997

FACT SHEET
ON THE U.S. TOBACCO INDUSTRY

Production

- **The United States was the world's second largest producer of leaf tobacco** in 1995, accounting for about 9 percent of the estimated 14.0 billion pounds that were produced worldwide.

Top 10 Leaf Tobacco Producers - 1995

		Million Pounds	Share of Total (Pct.)
1.	China	5,180	37
2.	United States	1,323	9
3.	India	1,156	8
4.	Brazil	877	6
5.	Turkey	464	3
6.	Zimbabwe	463	3
7.	Indonesia	375	3
8.	Italy	292	2
9.	Greece	291	2
10.	Malawi	240	2

- **Some 124,000 farms in 16 states grow tobacco.** About three-quarters of these are actually classified as tobacco farms, meaning that tobacco comprises at least 50 percent of sales.

- **Six states account for 91 percent of production:** North Carolina and Kentucky originate 65 percent; Tennessee, Virginia, South Carolina, and Georgia produce another 26 percent.

- The U.S. **tobacco crop** in 1996 was worth $2.5 billion, representing approximately 2.4 percent of the total for all cash crops and farm commodities.

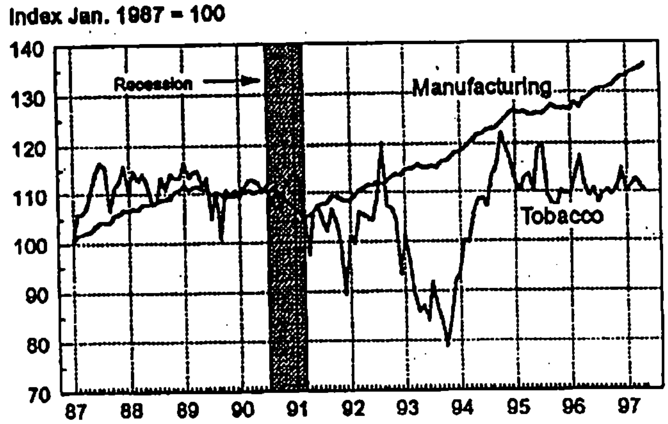
- The **manufacture of tobacco products** accounted for $16.6 billion or 0.2 percent of gross domestic product in 1994, down from 0.6 percent in the early 1960's.

- Tobacco manufacturing makes up 1.2 percent of **U.S. industrial output.**

  – **Production slid from early 1991 through most of 1993,** but by mid-1994 returned to levels that prevailed in the late 1980's.

TOBACCO PRODUCTION

Relative to All Manufacturing



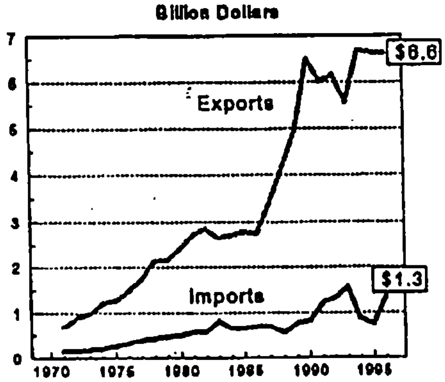
Trade

- **Exports of tobacco products** totaled $6.6 billion in 1996, $5.2 billion of which was in manufactured tobacco products and $1.4 billion in unmanufactured (leaf) tobacco. The value of **tobacco imports** was $1.3 billion last year, $1.1 billion of which was in unmanufactured products.

  – Exports rose rapidly from the mid-1980's through 1990 but have since been little changed and the trade balance has shown similar patterns.

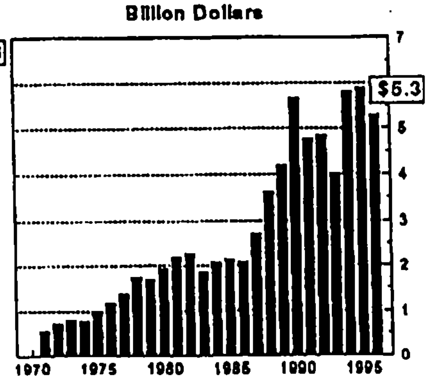
TOBACCO IMPORTS AND EXPORTS

Billion Dollars



TOBACCO TRADE BALANCE

Billion Dollars



- **U.S. factories produced** an estimated record of 760 billion cigarettes in 1996, of which about 36 percent were shipped abroad for foreign consumption.

Consumption

- **U.S. consumers spent** an estimated $50.3 billion on tobacco products in 1996, or 1.0 percent of all consumer expenditures.

Tobacco Expenditures by Type - 1996 (est.)

	Billions	Percent of Total
Total	$50.3	100
Cigarettes	47.2	94
Cigars	1.0	2
Other (smoking tobacco, chewing tobacco, and snuff)	2.1	4

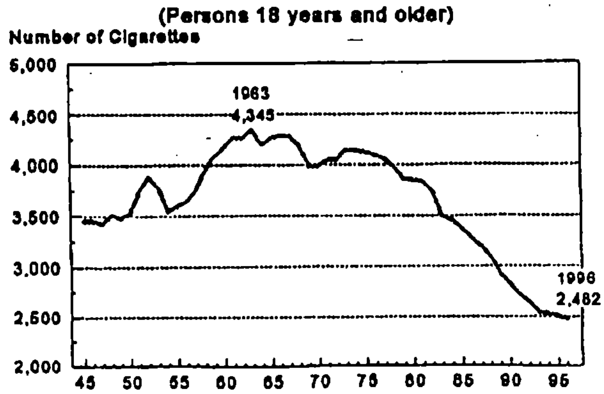
- The average household spent $269 in 1995 on tobacco products and smoking supplies, **with households in the lowest income quintiles spending more of their budget on tobacco.**

Tobacco Expenditures by Income Quintile in 1995

	Lowest 20%	Second 20%	Third 20%	Fourth 20%	Highest 20%
Tobacco	$204	$242	$327	$307	$278
Share of total expenditures	1.4%	1.1%	1.1%	0.8%	0.4%

- **Per-capita cigarette consumption has been on a long-term decline in the United States** from a record high of 4,345 in 1963 (based on the population 18 years and over) to 2,482 in 1996 -- a drop of 43 percent.

PER CAPITA U.S. CIGARETTE CONSUMPTION
(Persons 18 years and older)



- **Cigar consumption**, while a tiny part of the total, rose 19 percent last year, to 32.7 per male 18 years and over, but was only about 3 percent above the 1987 level.

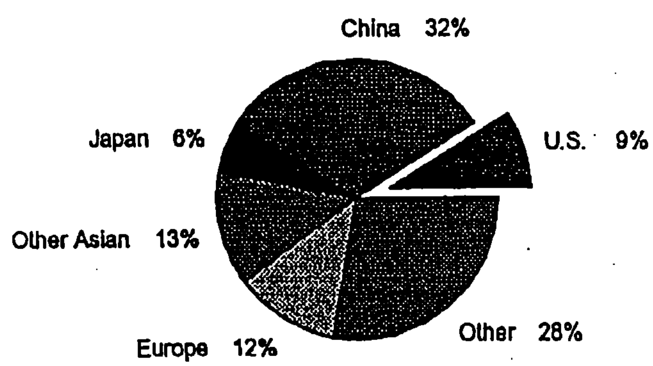
- More than offsetting the decline in the United States has been **a rise in foreign consumption of tobacco**, which has resulted in an increase in worldwide consumption of 1.2 to 1.5 percent annually.

  - **Foreign sales**, however, are said to be **much less profitable that domestic** sales.

- **China is the leading world cigarette market**, consuming 1.7 trillion cigarettes annually, or about 3-1/2 times as many as the 470 billion of the United States. (China's population is about 4-1/2 times that of the United States.)

  - **U.S. tobacco consumption is less than 10 percent of the world total.**

WORLDWIDE CIGARETTE CONSUMPTION
Total = 5.3 trillion cigarettes in 1996



Profile of Domestic Consumption

- There are estimated to be about **50.5 million adult smokers** (18 years and older) in the United States, or about 25 percent of the adult population. (See table on the next page.) These smokers consume an 18.2 cigarettes a day (almost a full pack) on average.

Adult Smoking Rates				Adult Quit Rates*
	Current	Former	Never	
Adults 18+	25.7	24.1	50.2	48.5
18-24	22.9	7.7	69.3	25.2
25-44	30.4	19.4	50.2	38.9
45-64	26.9	32.9	40.2	55.1
65+	13.3	36.4	50.3	73.3

* Percent of eversmokers who are former smokers

- There are about **3.1 million underage smokers** (younger than 18 years old). Their average consumption is about one-half a pack a day.
  - The FDA estimates that there are 1 million *new* underage smokers a year, which would roughly offset the number of 17-year-old smokers who turn 18 each year.
  - Youth smoking rates are shown below. (Note: "Daily" is used for the Lookback provisions.)

Youth Smoking Rates				
Age	Have smoked in past 30-days	Daily	Have smoked 1/2 pack or more a day	Daily users
	(------------	Percent	------------)	(Number)
8th graders	21.0	10.4	4.3	395,000
10th graders	30.4	18.3	9.4	695,000
12th graders	34.0	22.3	13.0	847,000

- **Demand Elasticities:** A consensus estimate for overall demand elasticity is -0.4, signifying that for every 1.0 percentage increase in price, demand would fall by 0.4 percent. The Surgeon General's report provides the following elasticities by age:

Demand Elasticities			
Age Group	Total	Participation	Quantity per Smoker
12-17	-1.40	-1.20	-0.25
20-25	-0.89	-0.74	-0.20
26-35	-0.47	-0.44	-0.04
36-74	-0.45	-0.15	-0.15
All Adults (20-74)	-0.42	-0.26	-0.10
All Ages (12-74)	-0.47	-0.31	-0.11

Employment and Wages

- **Tobacco manufacturing's contribution to payroll employment is minuscule.** In 1996, 41,400 workers were employed in the tobacco manufacturing industry (which includes processing of tobacco, as well as production of cigarettes, cigars, etc.), or only 0.03 percent of the 119.5 million workers on nonfarm payrolls. More than 100,000 workers (0.23 percent of nonfarm employment) had been employed in the industry in the early 1950's.

  -- **Five states and Puerto Rico account for nearly 85 percent of the jobs in tobacco manufacturing.** (Note: These are the only states that report employment separately for tobacco manufacturing and are presumably the most important for the industry.)

Jobs in Tobacco Manufacturing		
	Number of Jobs	Share of State's Payroll Jobs (percent)
North Carolina	16,830	0.47
Virginia	9,550	0.31
Kentucky	4,210	0.25
Florida	1,480	0.02
Tennessee	1,180	0.05
Puerto Rico	1,040	0.11

- **Production workers in the tobacco industry earned $19.44 an hour last year,** 52 percent more than the average worker in manufacturing. Tobacco industry wages have climbed steadily from less than 75 percent of the average factory wage in the early 1950's. Few other industries can boast comparable wages (coal mining, steel, petroleum and coal product manufacturing also have earnings that top $19 an hour).

Average Hourly Earnings in 1996	
Private nonfarm	$11.81
Manufacturing	12.77
Tobacco	19.44

Prices

- **Tobacco products have a weight of only 1.6 percent in the CPI.** Since cigarettes make up 94 percent of tobacco consumption, their weight would be 1.5 percent.

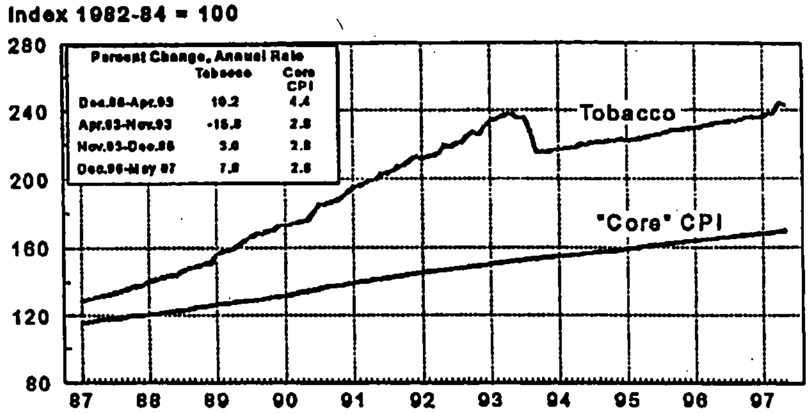
  – Current estimates of the impact of the tobacco settlement range suggest a $0.35 a pack increase in cigarette prices for 1998 and $0.62 by 2002. This amounts to a price hike between roughly 20 and 35 percent. **The impact on the CPI could be in the range of 0.3 to 0.5 percent**

- **Over the past decade, tobacco prices have risen at a 6.3 percent annual rate, compared to 3.7 percent for "core" consumer prices** (excluding food and energy). Faster growth was mainly the result of a sharp uptrend prior to 1993. (See chart on the next page.)

  – **In 1993, there was a steep downward adjustment in prices** as manufacturers of premium brands reduced prices to meet competition from the discount brands. Since 1993, tobacco prices grew at about the same pace as the core.

  – **This year, tobacco prices have sped up again,** increasing at nearly an 8 percent annual rate through May in part reflecting higher state taxes.

CONSUMER TOBACCO PRICES
Relative to the "Core" CPI



Industry Composition

- **The cigarette market is dominated by Philip Morris,** which accounts for half of cigarette sales in the United States.

The Cigarette Market in 1997 (est.)		
	Sales (Bil.Cigarettes)	Market Share (%)
Philip Morris	233.4	49.2
RJR Nabisco	114.5	24.2
BAT	76.8	16.2
Lorillard	39.9	8.4
Liggitt	8.0	1.7
TOTAL	474.1	100.0

- Philip Morris has the **widest profit margins** (45 percent of revenues per pack), followed by Lorillard (40 percent). Liggitt is estimated to have a margin of only about 3 percent this year. (See table on the next page.)

  – Domestic producers devote 33 percent of revenues to marketing (advertising, promotion, selling).

Advertising and Promotional Expenditures

- U.S. domestic cigarette **advertising and promotional expenditures** averaged $4.9 billion annually over the five years ended 1994.

  – **Conventional advertising** (point-of-sale, print media and outdoor and transit) accounted for only about $1 billion, or 21 percent of the total.

    - The biggest advertising expenditures were point-of-sale ($352 million). Outdoor and magazine advertising followed at $306 million and $266 million, respectively.

  – **Coupons, buy-one-get-one free promotions,** etc accounted for $1.8 billion, or 37 percent of spending. **Promotional allowances** (volume discounts and incentives for priority shelf space) made up $1.4 billion or 28 percent of spending.

Domestic Cigarette Advertising and Promotional Spending, 1990-94 Averages

	Billion Dollars	Percent
TOTAL	$4.929	100.0
Advertising	**1.015**	**20.6**
Newspapers	0.043	0.9
Magazines	0.266	5.4
Outdoor	0.306	6.2
Transit	0.048	1.0
Point-of-sale	0.352	7.1
Other promotional	**3.915**	**79.4**
Promotional allowances	1.386	28.1
Coupons and retail value added	1.810	36.7
Other	0.719	14.6

Prepared by
Treas./Econ.Policy/K.Hendershot

The Economics of the Proposed Tobacco Settlement

How does it work?

The proposed tobacco settlement has three provisions which could have economic impacts: 1) industry payments to the settlement fund, 2) restrictions on advertising, and 3) guidelines for FDA regulation of tobacco. Of these, the payments to the settlement fund are likely to have the most significant effects.

The Settlement Payments acts like an excise tax on tobacco. The Settlement language has the effect of making the annual industry Payment proportional to cigarette sales volume or a per-pack charge.[1] From the tobacco industry perspective, the Payments required by the settlement are equivalent to an excise tax of about 35 cents in the first couple years, rising to about 65 cents by the xth year, and remaining at that level thereafter. In fact, the effects of the Settlement Payment provisions could be replicated with an excise tax at the appropriate level and divided among States, the Federal government, and individuals (and allocated to particular uses, like smoking cessation, in some cases) in the manner set forth in the Agreement.

The economics of the Settlement Payments and an excise tax are similar; however, there are some important practical differences. Most important, an excise tax is straightforward: We know exactly what it is and have a lot of experience administering and enforcing excise taxes on tobacco. The Settlement would make the tobacco companies their own tax collectors, and some mechanism for oversight would need to be established, whereas, an additional excise tax could be easily administered Treasury Department. Additionally, the Settlement Payments are made to a Fund that is to be divides among States and individuals. The bulk of the payments to States are for damages to the Medicaid system. Under Medicaid statute, each State should give the Federal government a share of the Medicaid payments based on its Medicaid matching rate (after subtracting reasonable costs of bringing the suits). Of course, a Federal excise tax would go directly to the Federal government.

The settlement also provides for an "excess profits tax" of 25 percent. Because the tobacco industry is not competitive and the Settlement would provide some anti-trust exemptions, industry could restrict output and raise prices, increasing profits. (The economics of the industry is discussed more fully below.) This provision requires the tobacco industry to pay 25 percent of any profits above 1997 profits to the Settlement Fund. (It is not clear how these would be allocated among States, individuals, and the Federal government because these payments are not specifically for Medicaid damages.) Some worry that industry could find ways of "hiding" its profits to avoid this excess profits penalty. More specific rules and oversight are could help

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[1]If cigarette sales fall, the industry's Payment to the Settlement Fund is reduced by the ratio of that year's sales to 1996 sales; if sales rise, the Payment is increased by percent increase in sales to adults. The Settlement does not make clear how "adult volume" will be measured, but estimates indicate that adults consume more than 95 percent of cigarettes produced. Thus, the use of "adult volume" for an increase -- instead of "total volume" as for declines -- is of little consequence.

prevent this. Alternatively, the penalty could be related to a measure less prone to gaming, like revenues.

The advertising restrictions attempt to eliminate advertising targeted to children. These requirements are similar to those proposed (accepted?) in a recent FDA rule. The industry spends an estimate $xx billion on advertising every year. These restrictions could save the industry billions of dollars, increasing profits (which would be subject to the excess profits provision if profits rise above 1997 levels). On the other hand, the industry could intensify advertising efforts not banned by the Agreement (advertising to adults) or look for new, creative marketing techniques such that their overall advertising budget is little affected by the Agreement. Because advertising expenses are fixed costs, these provisions are not expected to effect the per-pack price of cigarettes.

The provisions for FDA regulation limit the FDA's authority to regulate tobacco products compared to the status quo. Problems with these provisions have been widely discussed, particularly by Koop/Kessler.

How will the Settlement Effect Particular Objectives/Outcomes?

Effect on Youth Smoking and Current Smokers

Youth Smoking. Most of the "work" in reducing youth smoking is likely to happen through price increases for cigarettes. Among young people, the "participation rate" of smoking is very sensitive to price. The Settlement will increase the price of cigarettes considerably, by between x an x percent. This suggests that smoking rates for young people are expected to fall by x to x percent, or about xx to xx million 8th, 10th, and 12th graders. The number of packs that a young smoker consumes is also fairly sensitive to price, and the price increase is expected to reduce consumption for young people who do continue to smoke by about xx to xx percent. Advertising and access restrictions, as well as public health advertising, may also reduce youth smoking over the long term, although fewer studies address these issues. Some evidence suggests that access restrictions (enforcing age requirements and requiring face-to-face purchase) are effective in reducing youth smoking. Recent FDA regulations have already done a lot to strengthen access restrictions. (Is this true??) [Insert assessment of advertising restrictions and public health ads.]

The "lookback" provision does not give the tobacco industry an incentive to reduce youth smoking. The Settlement requires industry to pay a penalty if targets for the reduction in youth smoking are not met, capped at $2 billion. If the industry can show the FDA that they have made a "good faith" effort, 75 percent of the penalty would be refunded. The amount of the penalty was selected to equal the present discounted value of profits for a new smoker. In other words, the penalty is by design financially neutral from the tobacco industry perspective. (Our calculations are consistent with this.) Depending on how "a good faith effort" is interpreted, the penalty could be significantly less than the expected profits from a new smoker. Furthermore, once the $2 billion cap is met, there is no marginal penalty for addicting new smokers. If the lookback provision is really meant to punish the industry for failing to reduce youth smoking, triple damages (or more) would be a more appropriate penalty. However, most of the work in reducing youth smoking is likely to be done by other aspects of the settlement: price increases, advertising and access restriction, and FDA regulation.

Adult Smokers. Adults smokers are significantly less sensitive to increases in the price of cigarettes, so the reductions in adult smoking will be smaller. The evidence suggests that the number of adult smokers could fall by between xx and xx percent, and the packs smoker per smoker could fall by about xx to xx percent. Smokers are disproportionally lower-income, so as with a tax on cigarettes, the Settlement will be regressive. Analyses of recent cigarette tax proposals suggest that .... [insert table].

The estimates of the number of adults who quit smoking could be understated if smoking cessation techniques become better and/or cheaper. The Settlement provides some funding to subsidize smoking cessation programs. The Settlement also creates an incentive for the development of alternative nicotine delivery systems. There is essentially no evidence on the potential for this type of substitution: Any estimation of its scope would be highly speculative. The settlement also attempts to encourage the development of safer, lower-nicotine cigarettes, which would provide alternative for current adult smokers (although this may be undermined by other provisions discussed below). There is some evidence, however, that when lower-tar cigarettes were introduced, smokers often consumed more of these cigarettes. This might also be the case for lower-nicotine cigarettes.

Impact on the Tobacco and Related Industries

Does the Settlement "Punish" the Tobacco Industry? While putting the tobacco industry out of business is not the goal of this Settlement, the damages are, in part, punitive. The tobacco industry can clearly absorb the payments required by this settlement. (In fact, it is required that they be largely passed along to consumers in the form of higher prices.) [Checking into possibility that one or more smaller co's could be put out of business.]

[Insert Christian's industry paragraph.]

The impact on employment and farmers is likely to be small. [Insert Chad paragraph.]

Effects on related industries are likely to be small and temporary. [Insert Chad summary of FDA analysis.]

Potential for Side Effects and "Red Flags"

The incentive to develop safer cigarettes is greatly curtailed. The Agreement essentially eliminates intellectual property rights for tobacco-related innovations by requiring companies to notify FDA of any risk-reducing technologies that they develop or acquire and cross-licence them for a "reasonable" fee. In addition, the advertising restrictions could make it difficult to introduce a new product onto the market.

The Settlement limits industry's incentive to fight lawsuits and could encourage the government to limit lawsuits even more than the Settlement. The Agreement would eliminate class-action suits and punitive damages for past harm. Individuals could still sue for damages (just not punitive damages), and 80 percent of any awards in these suits would be paid from the Settlement Fund (subject to an annual limit, excess claims are carried over to the next year). This means that the industry has little incentive to fight these cases and that the States and the Federal government -- who are the residual claimants to the Settlement Fund -- might like to discourage lawsuits.

What this lawyers would get form the settlement is not specified in the Agreement. We do not know specifically what agreements attorney's have with States for payment, but many may have contingency agreements which could give them up to a third of the settlement. (How this would work in practice is not clear.) Similarly, under Medicaid statute, the States are allowed to deduct reasonable costs of litigation up to 50 percent of the settlement before splitting it with the Federal government. These issues should be explicitly worked out in the Settlement to ensure that payments to lawyers are not excessive.

Draft – Not for Distribution

Impact of Proposed Resolution on Cigarette Prices and Industry Profits

Can the Settlement be thought of as an excise tax?

Yes. The key to understanding the payments as effectively being an excise tax on cigarettes is the volume adjustment provision found in Title VI, B.5 of the settlement, entitled "Adjustment for Volume Decrease (Adult Volume Only) or Total Volume Increase."

For any given year, let X_0 denote the scheduled payment. Let q represent the actual unit volume of cigarette sales, and q* denote the base volume in 1996. Then the volume adjusted payment would be $X_0(q/q^*)$, which can be rewritten as $(X_0/q^*)q$. This is the same as writing the volume adjusted payment as tq, where the "tax" $t = (X_0/q^*)$. This is just like an equivalent unit tax on cigarettes. As an example consider year 10 in which the base payment X_0 = $15 billion. Since the actual number of cigarettes sold in 1996 was q* = 24.4 billion, the effective tax per pack is equal to $t = (X_0/q^*)$ = $15 / 24.4 = 61.5 cents.

What will be the impact of the effective excise tax on prices of cigarettes?

According to the economic literature and historical evidence, the price of a pack of cigarettes will probably go up by at least as much as the tax, and probably more. Prominent analysts of the cigarette industry conclude that previous excise tax increases may have served as a focal point for coordinating oligopoly price increases by sellers. As a result we expect there to be two effects, 1) a direct price response to the increase in costs due to the effective excise tax, and 2) a further price increase as a result of opportune coordination on the part of sellers. The combined effect would raise prices by more than the increase in the excise tax. The range of the price increase expected starts from a conservative 100 percent of the tax to a high of 200 percent of the tax.

Will the advertising restrictions result in windfall profits for the industry?

The restrictions on advertising and marketing imposed by the settlement (Title I, A and Appendix VII), will not increase profits very much because of the expected substitution into non-restricted forms of advertising. Moreover, marketing innovations are expected as a result of the restrictions further increasing costs. Because the most important components of current cigartte advertising and marketing, promotional allowances (28% of total advertising expenditures) and coupons and retail value added (37%), are not barred by the Proposed Resolution, we expect these to increase in intensity. Furthermore, we expect there to be an increase in conventional media advertising. The bottom line then is that advertising expenditures may fall by about $ 500 million to $1 billion. This is equivalent to savings of less than 5 cent per pack (compared to the 62 cent effective excise tax starting in year 5).

What is the impact of increased prices on the tobacco industry's profits?

Corporate profits are expected to go up as part of the settlement. There are three components to the change in corporate profits:

- Fixed cost savings of at most 5 cents per pack due to decreased advertising expenditures
- Lost revenues of 33 cents per pack on those not sold due to the reduction in cigarette sales (on the order of 2 - 6 billion)
- Increased revenues of 10 to 16 cents per pack on remaining cigarettes due to new higher price (on the order of 18 - 22 billion)

It is clear that the combination of all three components would lead to higher industry profits.

Real Net Revenue From Tobacco Settlement

Attached are preliminary estimates of the net revenue from the tobacco settlement. They include revenue effects at federal, state and local levels. One set of calculations assumes that the payments are reflected in the price of all tobacco products, while the other assumes that the payments are reflected only in the price of cigarettes. These estimates are in real terms, measured in 1996 dollars.

We find that, considering all tobacco products, the real net revenue from the tobacco settlement is likely to be about $189 billion in total, if summed over the first 25 years of the agreement. We obtain essentially the same estimate in our cigarette only calculation.

Two reasons explain why our $189 billion net revenue estimate is substantially lower than the $368.5 billion figure cited in the report. First, the $368.5 billion figure in the report ignores the sales adjustment feature of the settlement. As sales fall, whether as a result of the long-term secular trend which has historically characterized the tobacco market, or as a result of the features of this agreement, the size of the payment falls proportionately. Adjusting for the fall in sales reduces the net revenue estimate by about 19%, to $298 billion.

Second, the $368.5 billion figure does not adjust for the reduction in revenue from existing excise, income, and employment taxes. Considering federal income and employment taxes, and federal, state and local excise taxes, this adjustment can reduce net revenue by an additional $109 billion, or by 32% of the $368.5 billion cited in the report. In total, then, we estimate that the actual increase in net government receipts will be about $189 billion, or 51%, of the $368.5 billion payment cited in the report.

The $368.5 billion figure also is misleading because it is a simple sum of (real inflation adjusted) payments which flow in over time. Proper measurement of the value of the payment flow would discount to reflect the (real) time value of money. As shown in the table, discounting the payment stream by a 3.7% real discount rate will reduce its sum from $189 billion to $123 billion, or by about 18% of the original $368.5 billion dollar figure cited in the report. A higher (lower) discount rate would lower (raise) the discounted present value of the payment stream, relative to our $123 billion figure.

Our modeling focuses on the basics of the payment plan outlined in the agreement. We do not include the effects of the special penalty imposed if profits increase, nor do we model the look-back provisions that impose a penalty if sales to minors fail to fall to specified target levels. By way of justification, we note that is seems unlikely that domestic profits will increase as a result of this agreement, so neglecting the profits tax seems reasonable in this preliminary estimate. For two reasons, the look-back also seems unlikely to have a major revenue effect. First, it seems likely that the agreement will be effective in significantly reducing under-age smoking, and so any penalty would likely be much lower than the $2 billion annual maximum. Second, any assessed penalty can be reduced by 75% as along as the manufactures can show that they made a "good-faith" effort to comply with the agreement.

One detail that we do incorporate is the inflation indexation of the payments. Without such indexing, the real value of the annual proscribed payments would fall below their published level, thereby reducing the real net-revenue to the government. Our approach implicitly assumes that inflation indexing is complete, so that the real value of each year's annual payment is completely unaffected by inflation.

While this is not an official revenue estimate, our modeling approach does rely on some standard revenue estimating conventions. In particular, our estimate is based on a fixed GDP assumption, which has a number of important implications. First is an income and employment tax offset, reflecting the fact that the tobacco payments are "taken-off the top", and so reduce the base of the income and employment taxes by lowering national income. These offsets capture reductions in personal income, corporate income, and employment taxes at the federal level.

Second, some features of the agreement, which may have important effects for particular firms, or for the tobacco industry as a whole, have no effect at all in our model. In particular, the fixed GDP assumption means that the settlement's restrictions on advertising, even if effective, would have no direct effect on revenue; all else constant, the tobacco industry's reduced spending on advertising leads to a reduction in taxable income in the rest of the economy (e.g., in the advertising sector) which approximately offsets the tobacco industry's increase in taxable income.

The advertising restrictions, if effective, also might reduce net revenue indirectly by reducing tobacco sales. We have ignored this for two reasons. First, it is likely that much tobacco advertising is spent in intra-industry fights over the distribution of a fixed pool of smokers, rather than in an attempt to increase the number of smokers in the pool. Mandated reductions in this type of advertising would have no effect on industry wide sales. Second, the advertising restriction's bark may be worse than its bite because they are loosely worded, and because they do not apply to some major categories of promotional expenses.

An alternative to holding GDP fixed would be to let it rise by the full amount of the increase in the price of tobacco products. In that case, income tax receipts would not fall, so that net revenue to the government would be $252 billion over 25 years. While net revenue seemingly is higher than in the fixed GDP case, in purchasing power terms it really is the same, as the rise in GDP reduces the purchasing power of government tax revenue.

David Richardson and James Mackie
U.S. Treasury, Office of Tax Analysis
OTA
7/10/97

05:59 PM PRELIMINARY 07/10/97

Net Payments to all Governments from the Tobacco Settlement
Payment Reflected in All Products
100% Passthrough
($'s Millions)

		PDV
Base Payment	368,500	231,910
Gross Payment	284,399	182,735
Federal Excise Tax Leakage	(18,537)	(11,836)
State Excise Tax Leakage	(25,113)	(16,077)
Total Gross Excise Tax Leakage	(43,650)	(27,913)
Net Payment (Pre-Offset)	240,749	154,822
Income Tax Offset	(60,187)	(38,705)
Individual	(51,159)	(32,900)
Corporate	(9,028)	(5,806)
Net Payment including offset	180,561	116,116

Department of the Treasury
Office of Tax Analysis

05:59 PM PRELIMINARY 07/10/97

Net Yearly Payments to all Governments from the Tobacco Settlement
Payment Reflected in All Products
100% Passthrough
($'s Millions)

Year	Volume Adjusted	PDV	Volume Adjusted Fixed GDP	PDV Fixed GDP
1998	8,677	8,677	6,508	6,507
1999	6,404	6,163	4,803	4,623
2000	7,039	6,522	5,279	4,891
2001	8,288	7,392	6,216	5,544
2002	9,766	8,384	7,324	6,288
2003	10,295	8,508	7,721	6,381
2004	10,249	8,154	7,687	6,115
2005	10,207	7,817	7,655	5,863
2006	10,158	7,488	7,618	5,616
2007	10,104	7,170	7,578	5,378
2008	10,019	6,844	7,514	5,133
2009	9,925	6,526	7,444	4,895
2010	9,833	6,224	7,375	4,668
2011	9,741	5,935	7,306	4,451
2012	9,650	5,660	7,237	4,245
2013	9,560	5,397	7,170	4,048
2014	9,471	5,147	7,103	3,860
2015	9,382	4,909	7,037	3,681
2016	9,295	4,681	6,971	3,511
2017	9,208	4,464	6,906	3,348
2018	9,122	4,257	6,842	3,193
2019	9,037	4,060	6,778	3,045
2020	8,953	3,872	6,715	2,904
2021	8,870	3,692	6,652	2,769
2022	8,787	3,521	6,591	2,641
2023	8,706	3,358	6,529	2,518
Total	240,749	154,822	180,561	116,116

Department of the Treasury
Office of Tax Analysis

05:46 PM PRELIMINARY 07/10/97

Net Payments to all Governments from the Tobacco Settlement
Payment Reflected in All Products
125% Passthrough
($'s Millions)

		PDV
Base Payment	368,500	231,910
Gross Payment	274,466	176,584
Federal Excise Tax Leakage	(22,760)	(14,545)
State Excise Tax Leakage	(30,835)	(19,747)
Total Gross Excise Tax Leakage	(53,594)	(34,292)
Net Payment (Pre-Offset)	220,872	142,292
Income Tax Offset	(55,218)	(35,573)
Individual	(46,935)	(30,237)
Corporate	(8,283)	(5,336)
Net Payment including offset	165,654	106,719

Department of the Treasury
Office of Tax Analysis

05:47 PM PRELIMINARY 07/10/97

Net Yearly Payments to all Governments from the Tobacco Settlement
Payment Reflected in All Products
125% Passthrough
($'s Millions)

Year	Volume Adjusted	PDV	Volume Adjusted Fixed GDP	PDV Fixed GDP
1998	8,367	8,367	6,275	6,275
1999	5,976	5,752	4,482	4,314
2000	6,548	6,067	4,911	4,550
2001	7,662	6,833	5,746	5,125
2002	8,956	7,689	6,717	5,767
2003	9,411	7,778	7,059	5,833
2004	9,370	7,454	7,027	5,590
2005	9,331	7,146	6,998	5,359
2006	9,286	6,845	6,965	5,134
2007	9,237	6,555	6,928	4,916
2008	9,159	6,257	6,869	4,692
2009	9,074	5,966	6,805	4,475
2010	8,989	5,690	6,742	4,267
2011	8,905	5,426	6,679	4,069
2012	8,822	5,174	6,616	3,881
2013	8,740	4,934	6,555	3,701
2014	8,658	4,706	6,494	3,529
2015	8,577	4,487	6,433	3,366
2016	8,497	4,279	6,373	3,210
2017	8,418	4,081	6,314	3,061
2018	8,340	3,892	6,255	2,919
2019	8,262	3,711	6,197	2,784
2020	8,185	3,539	6,139	2,655
2021	8,109	3,375	6,082	2,532
2022	8,034	3,219	6,025	2,414
2023	7,959	3,070	5,969	2,302
Total	220,872	142,292	165,654	106,719

Department of the Treasury
Office of Tax Analysis

WALL STREET EVALUATION OF THE TOBACCO INDUSTRY AND AGREEMENT

Summary: While there is some disagreement, the weight of the Wall Street assessment of the agreement among the major tobacco companies and the states' attorneys general is quite positive.

- **Major analysts expect tobacco stocks to perform well as lifting uncertainties about litigation removes the heavy discount for risk. With the agreement, Philip Morris shares are expected to have almost the same price/earnings ratio as the market average; without the agreement, the ratio of the share price to earnings might be one quarter to one third below the average for all S&P 500 companies.**

- **Since the news that negiotiations for an agreement were underway, 18 reports by market analysts have either reconfirmed or raised recommendations to investors to BUY for tobacco stocks.**

1996: The stock market has viewed the tobacco industry as high risk for several years and in 1996 it was on a roller coaster due to shifting legal developments (see chart). On balance, over the year as a whole the market value of the major firms did not change much apart from normal movements driven by the overall stock market. However, the ratio of share prices to firms'earnings for the tobacco industry was only 59 % of the stock market average in 1996 and had ranged between 55 %and 67% of the market since 1993.

Over the course of 1996, a number of stock analysts' investment recommendations were raised, perhaps owing to the court ruling against the major Castano class action suit (May 23, 1996) and perhaps because of an assessment that tobacco stocks were oversold during their late year doldrums.

1997 before settlement talks:

In the first couple of months of this year, the stock prices for the industry advanced perhaps reflecting the same factors that analysts had been seeing a few months earlier. But the market plummeted in March on a Mississippi court ruling to allow a class action suit to go ahead and on the separate settlement of Ligget with state attorneys general.

-- One stock analyst has noted that firms traded down to a zero value of the domestic tobacco component of the business.

-- Another analyst has noted that, based on the company's fundamentals, the U.S. tobacco unit of BAT (owner of Brown Williamson) seemed to carry a negative valuation.

-- During this period, analysts' recommendations moved in a muddled fashion:

Annual Incidence of Settlement: Illustrative Example
Year 5 with -0.4 long run demand elasticity

	Year 5		
New payment	62¢/pack	62¢/pack	62¢/pack
Elasticity	-0.4	-0.4	-0.4
Pass through	100%	125%	200%
Price [1] ($1.85/pack today)	+34% $2.47	+42% $2.63	+67% $3.09
Quantity [2] (24.2 bill. pack/yr)	-13% $19.3	-17% 18.5	-27% 16.3
Total revenue ($44.7 bill/yr today)	$47.6	$48.7	$50.4
Industry profits [3] ($7.8 bill/yr today)	$7.5	$10.1	$16.6
Old tax revenue [4] ($14 bill/yr today)	$11.2	$10.8	$9.5
New govt. rev. [5] ($ billions)	$12.0	$11.5	$10.1
Incremental govt. revenue ($ bill)[6]	$10.2	$9.3	$6.6
Incremental industry profits [7]	$0.2	$2.9	$9.4
Incrm. profits as % of incrm. surplus [8]	2%	23%	59%

5 actions confirmed or raised recommendations for particular firms to BUY
4 actions confirmed or raised recommendations but left them in a mediocre range while 3 other actions CUT recommendations into this range, and
1 action confirmed a SELL recommendation.

Differences among firms became particularly noticeable in this period:

Philip Morris is the industry leader, with 48 % of market sales, and a total market valuation of $102 billion. One third of its profits come from domestic tobacco and one third from foreign tobacco, the rest coming from a variety of mostly consumer goods lines. Its large share of the premium cigarette market is a mixed blessing because profitability is now higher there but market demand may shift to discount brands as prices are raised.

RJR Nabisco is second in size of domestic sales and has a larger share of the discount market. It is very likely in the process of separating the tobacco (Reynolds) part of the business from Nabisco, however, and is heavily debt burdened. Therefore, market valuation is specially complex.

US Tobacco is an actively traded but small firm that had attempted to stake out a position in the smokeless tobacco market (essentially snuff) and had introduced a new discount cigarette brand. These market ventures were not going well earlier this year and disproportionately many of the negative market investment recommendations were focused on UST.

BAT is a large British multinational (traded in this country in ADRs), which is involved in many product lines. Because of its product diversification, heavier role in foreign tobacco sales, and sizable presence in the discount market in the U.S. (35% of sales compared with 17% of total sales), it may be better positioned than others to cope with the agreement.

1997 since announcement of settlement talks:

On April 16, settlement talks were announced and many aspects of the agreement ultimately announced on June 20 came to be fairly accurately forecast. Tobacco industry stock prices jumped sharply (relative to the S&P) on the announcement of the settlement talks and jumped somewhat again on the rumor one day before agreement.

-- **On balance, since April 15, the market value of tobacco stocks has risen fairly modestly, by 12.4% or less than the 20.2 % increase in the S&P 500. Adjusted for the change in the S&P, the tobacco stocks have actually declined by 4.9%.**

-- **Most stock analysts, however, see the agreement as likely to be implemented and good for the market valuation of the firms.** Since April 16, 18 announcements have been to confirm or raise recommendations to BUY, while one confirmed a fairly low rating and 3 recommendations were CUT.

-- The preponderance of favorable analysts' reactions seems at variance with the net change in market valuation.

-- This discrepancy seems to be rooted in the following factors: (1) the agreement has not been enacted yet; (2) the agreement, particularly the regulatory parts, could be changed as it goes through the political process; (3) states and localities may raise their excise taxes, too; (4) foreign counties may take actions that will water down the benefits in the agreement from limiting liability for bankruptcy to the domestic part of the firm. Most major analysts seem ready to take a positive position despite these uncertainties, but investors seem more cautious as yet.

In assessing the agreement, key analysts expect earnings per share in 1998, to be *lowered* by $0.25 to $0.37 for Philip Morris and by $0.55 to $0.70 for RJR.

-- About one third, to as much as half, of these reductions come from the costs (interest) of the initial payment.

-- Other reductions in earnings come from drops in sales not fully offset by the price increases and from shifts in sales to discount (hence, lower profit) brands.

Most analysts see a decline in domestic cigarette sales of 15% to 20% by the fifth year, assuming a conventional responsiveness of sales to price and initial price increases of $0.40 to $0.60 ,rising to $0.80 or $0.90.

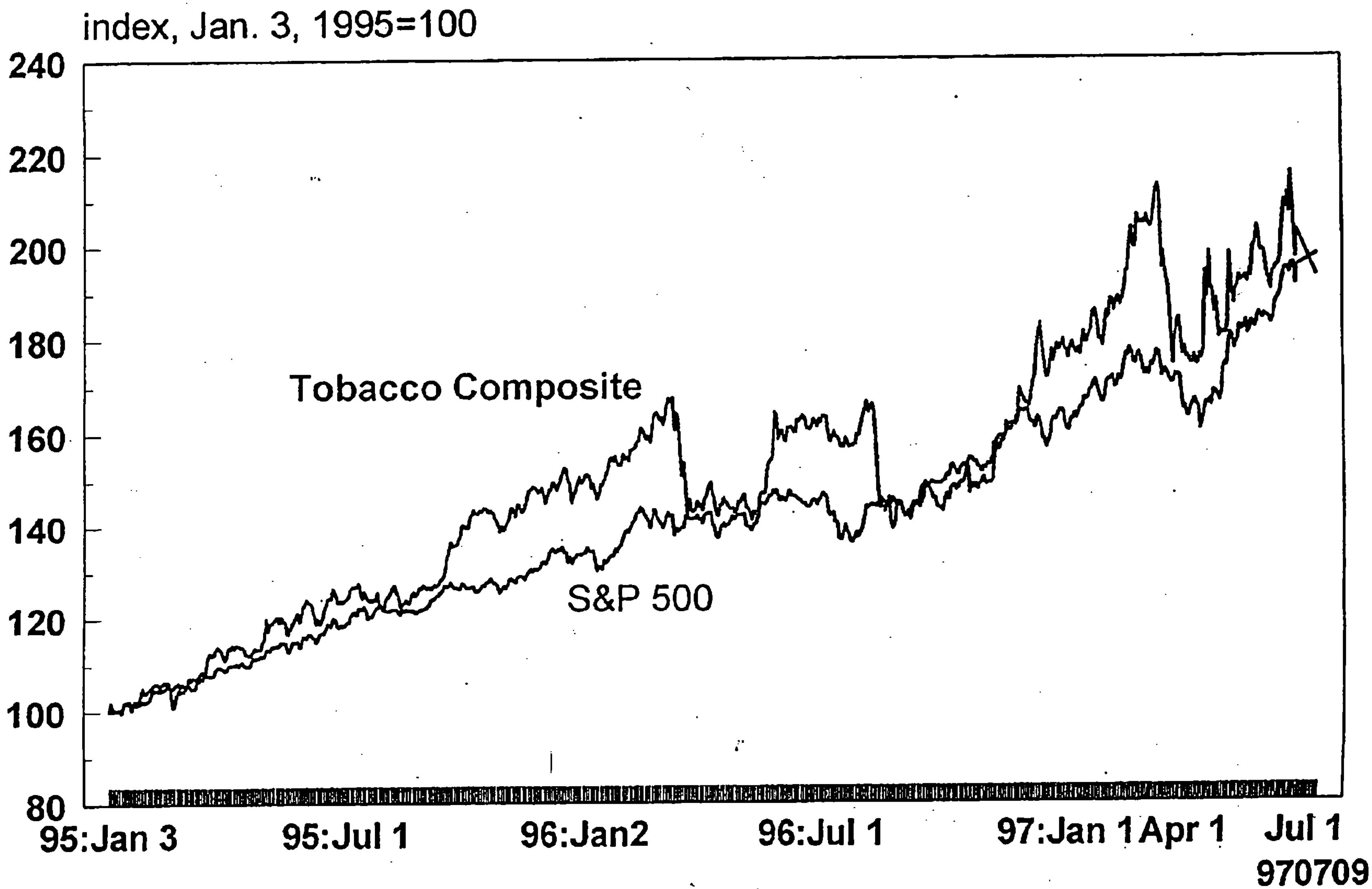
-- The analysts see a significant offset to the costs of the agreement coming from lowered advertising and marketing expenses.

-- One particularly pessimistic analyst (John Maxwell at Wheat First) sees the cut in sales coming rapidly and its effects being compounded by more regulation.

Analysts see future growth in earnings, presumably from foreign sales growth which has been very strong for the major firms such as Philip Morris and BAT.

Key analysts also see the agreement, if and when enacted in its present form, substantially reducing the risk of bankruptcy from future litigation. Primarily for this reason, analysts expect that the ratio of share price to earnings, for the bellwether Philip Morris, will become equal to the average for the equity market (Gary Black at Sanford Bernstein and Roy Burry at Oppenheimer) or show a very small discount (.95 according to Martin Feldman at Smith Barney and .9 from Mark Cohen at Goldman Sachs). This is a marked contrast to discounts of one-quarter to one third without the agreement.

Tobacco Company Stock Prices and the S&P 500 Stock Index



July 10, 1997

THE "LOOK BACK" SURCHARGE

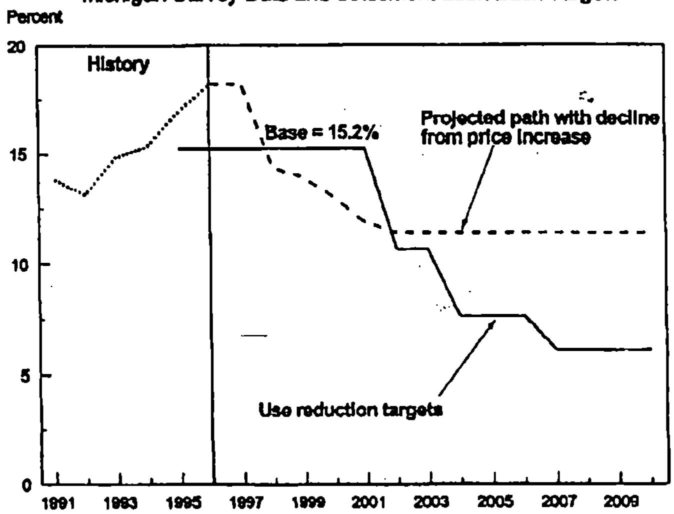
The settlement attempts to provide economic incentives to promote "dramatic and immediate reductions in the number of underage consumers of tobacco products." Manufacturers would face a surcharge if the tobacco-use reduction targets are not met. The surcharge will be imposed on the basis of a "look back" comparing actual underage teen tobacco use percentages to the targeted reduction percentages. Manufacturers could petition the FDA for partial abatement of the surcharge if they have acted in good faith and in full compliance with the Act.

<u>Will the surcharge be effective? Probably not.</u>

Our estimates indicate that the present value of the stream of profits associated with teen tobacco use in excess of the reduction targets will be larger than the cost of the surcharge. The present value of the profits is about 2 times greater than the surcharge so firms would have little economic incentive to reduce teen smoking. In fact, it appears that demand reduction from the price increases (from the "excise tax" effect of the penalty payments) will do most of the work.

Underage Daily Tobacco Use Percentages and Targets

Michigan Survey Data and Settlement Look Back Targets



- The daily tobacco use percentage for underage teens in 1996 was 18.2 % -- well above the target base of 15.2 % (calculated from data over the past 11 years).

- The surcharge would be imposed beginning in the 5th year after enactment and every year thereafter based on the difference in the actual and targeted percentage reductions in underage use -- at the rate of $80 million for each percentage point (adjusted for changes in the relevant population and industry per unit profit weighted by sales) -- subject to a $2 billion cap.

  - *The $2 billion cap is likely to be nonbinding -- it would only occur if underage smoking increased sharply to 30 % or higher or if industry profits or sales surged dramatically (by something like 100%), or some combination of the two.*

  - Our estimates indicate that higher cigarette prices (from higher excise taxes for the annual payments) will reduce industry sales about 20% and thereby also reduce the size of the surcharge in subsequent years.

Elasticity of demand estimates indicate that the higher cigarette prices alone will cause daily use by teen smokers to decline from the recent 18 percent level to about 11-1/2 percent (see chart).

- Under that estimate, the surcharge in the fifth year (30% reduction target) would be about \$52 million; the present value of the profits from the smokers above the target would be nearly *2 times higher* at \$98 million.

- In the seventh year (50% reduction target) the surcharge would be about \$230 million and the present value of profits would be nearly *2 times higher* at \$445 million.

- By the tenth year, when the full reduction of 60% is to be achieved, the surcharge would be \$170 million and the additional profit stream \$315 million, again nearly twice as large.

<u>Surcharge abatement procedures</u>

The agreement provides for potential partial abatement of surcharge payments and firms likely would make significant efforts to meet the requirements:

> "Tobacco product manufacturers could receive a partial abatement of this surcharge (up to 75%) only if they could thereafter prove to FDA that they had fully complied with the Act, had taken all reasonably available measures to reduce youth tobacco use and had not taken any action to undermine the achievement of the required reductions."

- Tobacco firms would petition the FDA for an abatement of the surcharge (after payment).

- The FDA would conduct hearings with participation of the states' attorneys general. The burden of proof would be on the manufacturers and the FDA would make the final decision (manufacturers or attorneys general could seek judicial review).

Note that the abatement rewards manufacturers for meeting the minimum standards of the Act rather than achieving underage smoking reduction results.

If we assume that firms will qualify for the full abatement, the present value of the future profit stream would end up being about 8 times higher than the abatement-adjusted surcharge – thereby rendering it ineffective.

<u>Assumptions used:</u>

Discount rate:	10 %
Profit per pack:	\$0.33
Intensity of use:	1/2 pack as teens, phased up to 1 pack a day as adults (this includes effect for teen smokers who quit as adults)
Survival probability:	taken from FDA rule in Federal Register
Probability of sustained quit:	assumption that 50% of those kept from smoking as teens (who otherwise would) eventually smoke as adult
Teen population:	Census middle series
Price elasticities:	-1.2 for # of teen smokers;-0.47 for all smokers in SR; -0.63 LR

July 10, 1997

To: Jon Gruber

From: John Hambor

Subject: Tobacco Related Entitlement Estimates

Summary

The tobacco agreement would increase long-term social security costs appreciably due to increased longevity. The ultimate effect is about a 2 percent increase in annual costs in 2070, which would be about $12 billion in today's dollars. However, the cost increases are very slow to build, and there is no measurable effect during the next ten years. Preliminary estimates indicate the net impact on Medicare is small. The important point about Medicare is that the smoking agreement appears to raise costs, on balance, because of increased life expectancies.

The estimated effects on Medicaid and SSI are more problematic. Medicaid costs will be lower, though increased expenditures on the elderly, including nursing home care, due to longer life expectancies, appear to offset much of the saving resulting from a healthier recipient population. SSI costs would be higher because of the rise in the number of eligible aged due to longer life expectancies. The effect on other entitlement programs would be small and was not estimated for this analysis.

Social Security

The Social Security Actuary has made rough long-range estimates consistent with the analysis included in the annual Trustees' Report. They estimate the effect of the agreement on teenagers will produce about a 2 percent increase in annual social security costs when they are fully retired. The actuarial deficit over the next 75 years will be increased relatively less, even if some older smokers are induced to quit as well, because the effect of reduced smoking by today's and future cohorts of adolescents will not have a substantial impact until the latter part of the projection period.

These estimates are based on the assumption that every year 250,000 of the 1 million adolescents who would start smoking will be prevented from ever smoking. This represents the estimated effect contained in the 1996 FDA analysis and is essentially the same ultimate target included in the agreement. (The lower specific target numbers in the agreement for the first seven years can be incorporated later, but are not expected to affect the results noticeably.) It is further assumed that the program will affect an additional 250,000 adolescents who would begin smoking each year after reaching 18 by the same percentage, i.e., an additional 62,500 are prevented from starting to smoke between ages 18 and 25.[1] Some older smokers are assumed to stop smoking in response to a price increase for cigarettes of about 34 percent. An average participation elasticity of about 0.4 was used to determine the number of quitters.[2]

- The net effect on the 75-year actuarial deficit is an increase of 0.1 percent of payroll. The actuarial deficit, currently 2.23 percent of payroll, is the combined employer and employee payroll tax rate increase necessary to balance the program over the next 75 years. Roughly 75 to 80 percent of the estimated increase in the actuarial deficit is attributable to reduced smoking by older smokers.

- By the end of the period, in 2070, the annual deficit, the difference between annual trust fund revenue as a percent of payroll and annual benefit outlays as a percent of payroll, would be higher by roughly 0.4 percent of payroll, about $12 billion based on today's taxable payroll. This is probably a good guess of the effect on the actuarial balance into perpetuity, i.e., a steady state effect consistent with roughly a fourth of potential new young smokers being deterred from smoking throughout their lifetimes. The cost increases are very slow to build, and there is no measurable effect during the next ten years. (See attached chart.)

- Caveats (Also apply to estimates below.)

  - The estimates make no special allowance for the effect of disability incidence on program costs. Because smokers are more likely to become disabled, reduced smoking lowers disability costs. However, this cost reduction could be offset somewhat because longer life expectancies also increase the probability of incurring a disability prior to age 65. On balance allowing for disability probably saves money, but because individuals who become disabled due to smoking are likely to be close to retirement age anyway, the effect is probably small.

  - Evidence suggests that smoking incidence is higher for those with lower income and less education. These effects are not included in the analysis.

  - A trend was not incorporated in projected smoking rates which have been

[1]The Social Security and HCFA actuaries based their estimates on these assumptions and others supplied to them by Treasury.

[2]The elasticity varied by age group and was applied to age-specific current smoking rates. Survivor probabilities for older smokers who quit were assumed to be 75 percent of same-age older smokers who had never smoked.

generally declining for all smokers since the 1970s, but have been up recently for teen-age smokers.

<u>Medicare</u> *(These estimates do not include the effects of older smokers quitting or the additional 62,500 teenagers who would not start smoking after age 18. We expect them on Monday or Tuesday.)*

Rough estimates for the impact of the agreement on Medicare were prepared by the HCFA Actuary and are based on the same assumptions as the Social Security estimates. The HCFA estimates indicate a negligible effect on the long-run balance of the HI (Medicare Part A) program and the long-run cost rate for the SMI (Medicare Part B) program.

- The 75-year HI cost rate is decreased by .015 percent of payroll because of lower lifetime costs for non-smokers and is increased by .023 percent of payroll for the additional persons who reach age 65 because they didn't smoke. The income rate is increased by .006 from additional payroll taxes paid over the longer life expectancies of the latter group. The net effect is an increase in the 75-year actuarial deficit of only .002 percent of payroll.

- The 75-year estimates for SMI were also quite small, raising the average annual cost rate over the 75-year period from 2.860 to 2.863 percent of GDP.

- The "steady state" (i.e., 75th year) estimates indicate the effect on HI is an annual cost of about .05 percent of payroll (about $1.5 billion currently). This is a net effect.

  - Costs are reduced by 0.116 percent of payroll per year because of lower health care costs for nonsmokers ($3.6 billion currently).

  - Costs are increased by 0.174 percent of payroll per year due to smokers who would have died surviving to age 65 and later. In addition, this group pays 0.009 in additional payroll taxes, so their net effect is to raise costs by 0.165 percent of payroll ($5.1 billion currently).

- On balance, SMI costs would be increased in "steady state" by 0.017 percent of GDP (currently about $1.3 billion).

- A separate internal HCFA analysis of a sample of Medicare beneficiaries in 1992-93 indicates that, on average, smokers who reach age 65 have <u>lifetime</u> Medicare costs that are about 8-9 percent higher than nonsmokers who survive to age 65. They estimated that smokers raise lifetime program costs by about 4 percent.

- However, the same analysis also indicates that program saving because of smokers who do not reach age 65 (estimated to be about 3 million in 1993) more than offsets the added health care costs of surviving smokers.

Medicaid

The effects on the Medicaid program are considerably more problematic. The HCFA Actuary has not made estimates. A very rough approach is to treat the amounts estimated in a forthcoming study[3] which estimates the effect of smoking on Medicaid spending by state, as "steady-state" saving, apply these results to current Federal spending on Medicaid, and then adjust for the expected effects of the agreement on smoking rates. A final crude adjustment is made to account for increased spending on the aged due to longer life expectancies. These additional costs could be particularly important since Medicaid covers long-term care for many of the elderly and disabled. In total, the aged population currently accounts for more than 30 percent of Medicaid costs and the disabled population accounts for almost 40 percent.

- The estimates indicate that in FY1993, about 3.9 percent of non-child federal Medicaid spending was attributable to smoking. To be consistent with the social security and Medicare estimates, the steady state should be reduced to reflect the fact that the agreement will not eliminate all smoking. We have assumed that roughly 25 percent of smokers in each teen-age cohort are deterred from ever smoking. A "steady state" estimate of Medicaid cost saving would be about a fourth of the full 1996 amount -- about $730 million.

- The net effect, after accounting for longer life expectancies, is significantly lower. The population age 65 and over is projected (by SSA) to be about 2.5 percent higher in 2070 because of the agreement. Increasing 1996 Medicaid costs for the elderly by 2.5 percent and subtracting the result from the $730 million annual saving reduces "steady state" saving to about $120 million. This offset estimate should be viewed as extremely tentative.

SSI

If the 2.5 percent increase in the population 65 and older is translated into a steady state SSI cost estimate, costs would increase by $164 million per year at 1996 program levels. The estimate accounts for both disabled recipients over age 65, who receive higher benefits, and retired recipients. This estimate is more of a conjecture than a systematic estimate by the SSA Actuary.

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[3]Preliminary data from the forthcoming study, Leonard S. Miller, et. al., "State Estimates of Medicaid Expenditures Attributable to Cigarette Smoking, Fiscal Year 1993", was provided informally by a study co-author.

PBGC

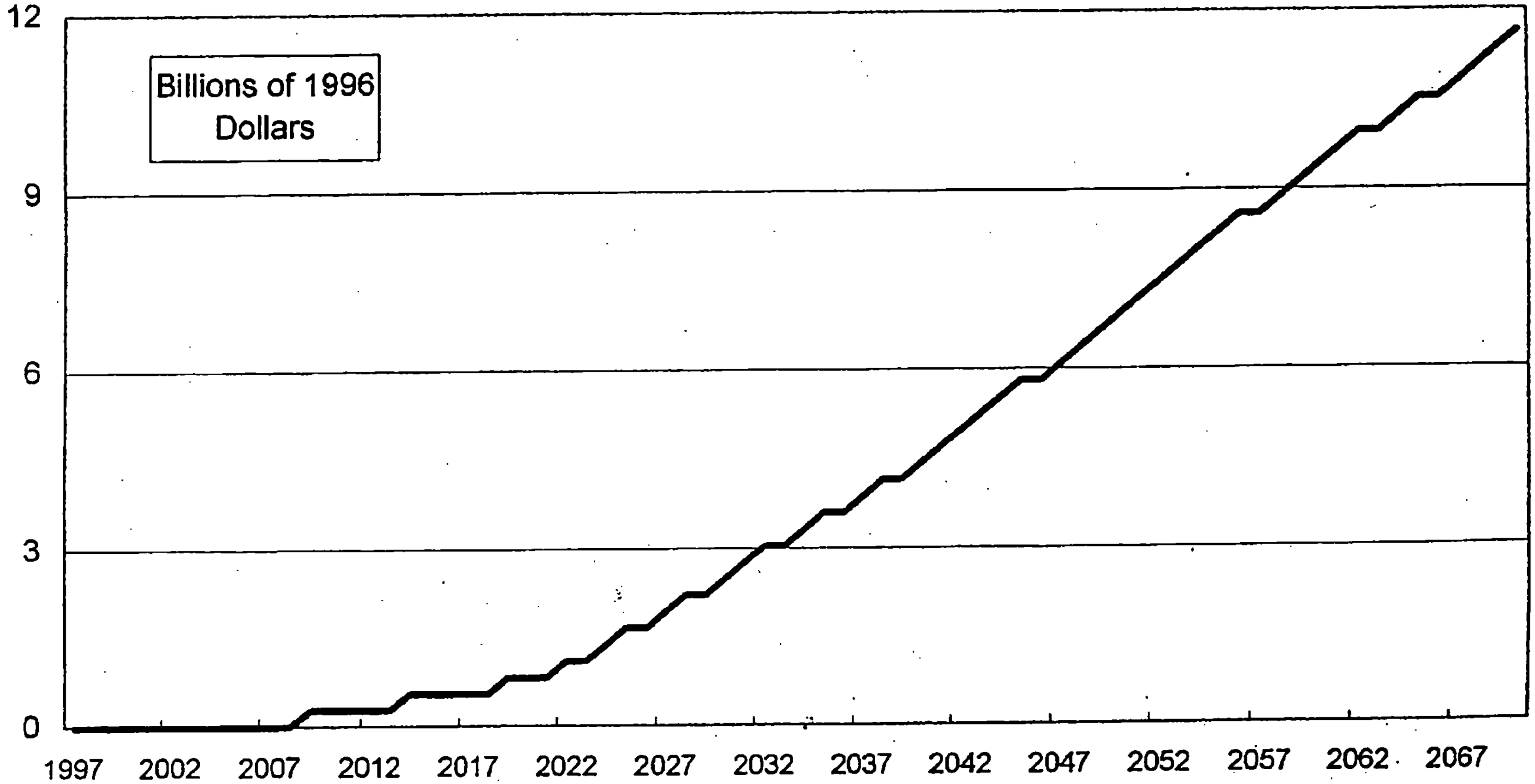
Questions have arisen about the agreement's impact on the financial viability of two of the smaller producers and the potential affect of their bankruptcy on the PBGC pension guarantee. PBGC analysts indicate that neither a Liggett nor a Lorillard bankruptcy would have a significant effect PBGC's future liabilities.

- In the case of Lorillard, their unfunded pension liability is estimated to be $3.5 million, which is a little more than 1 percent of the unfunded pension liability of their parent company, Lowes Corp.
- In the case of Liggett, which is part of the Brook Group, PBGC is aware that Brook is having financial difficulties. Brook is primarily Liggett, i.e., it is not a diversified holding company, and its unfunded pension liability is $35 million. Brook is on a list of companies monitored by PBGC as "reasonably possible" candidates to add to PBGC liabilities. These companies have under funded pension liabilities and generally are rated at junk bond status.

Other Programs

- The effect on Veteran's programs and the Federal Civil Service Retirement system was considered to be too small for inclusion.

Projected Increase in Annual Cost of OASDI Program due to Tobacco Agreement



July 8, 1997

MEMORANDUM TO CHAD STONE, SARAH REBER

FROM: CRISTIAN SANTESTEBAN

SUBJECT: Extension of Harris' model

In an extension of the analysis done by Jeff Harris, I have calculated the present discounted value of the stream of payments by the tobacco industry. I examine four key scenarios in which the pass-through rates of the effective excise tax are 75, 100, 125, and 200 percent.

Demand elasticity is assumed to be -0.4, and there's a background real decline of smoking of about 0.6 percentage points. I also assume, as does Harris, that advertising expenditures will only fall by $500 million per year, not affecting operating profits very much. In addition, I assume that the demand curve will not shift inward as a result of the slightly lower advertising expenditures.

Assuming the following pass-through rates, the present discounted value of payments will be:

75%	$205.7 billion
100%	$200.2 billion
125%	$194.9 billion
200%	$179.8 billion

Assumptions:

Base Price of Pack of Cigarettes 1.85	
CPI Growth	1.03
Discount Rate	1.07
Pass Through	0.75
1996 Sales	24.400
Surcharge per year	0.0
1996 Profits	8.4
Elasticity of demand	-0.4
Real Natural Decline	-0.6

Year	Base	Effective Real Tax	Real Price	Consumption (Harris Model)	Real Volume Adjusted Payments	PDV
0	10.0	0.41	2.16	23.7	10.0	10
1	8.5	0.35	2.11	23.7	8.3	8.0
2	9.5	0.39	2.14	23.5	9.1	8.5
3	11.5	0.47	2.20	23.0	10.9	9.7
4	14.0	0.57	2.28	22.6	12.9	11.1
5	15.0	0.61	2.31	22.3	13.7	11.3
6	15.0	0.61	2.31	22.2	13.6	10.8
7	15.0	0.61	2.31	22.0	13.5	10.4
8	15.0	0.61	2.31	21.9	13.5	9.9
9	15.0	0.61	2.31	21.8	13.4	9.5
10	15.0	0.61	2.31	21.6	13.3	9.1
11	15.0	0.61	2.31	21.5	13.2	8.7
12	15.0	0.61	2.31	21.4	13.1	8.3
13	15.0	0.61	2.31	21.2	13.1	8.0
14	15.0	0.61	2.31	21.1	13.0	7.6
15	15.0	0.61	2.31	21.0	12.9	7.3
16	15.0	0.61	2.31	20.9	12.8	7.0
17	15.0	0.61	2.31	20.7	12.7	6.7
18	15.0	0.61	2.31	20.6	12.7	6.4
19	15.0	0.61	2.31	20.5	12.6	6.1
20	15.0	0.61	2.31	20.4	12.5	5.8
21	15.0	0.61	2.31	20.2	12.4	5.6
22	15.0	0.61	2.31	20.1	12.4	5.4
23	15.0	0.61	2.31	20.0	12.3	5.1
24	15.0	0.61	2.31	19.9	12.2	4.9
25	15.0	0.61	2.31	19.8	12.2	4.7
Total	368.5				322.3	205.7

Assumptions:

Base Price of Pack of Cigarettes 1.85	
CPI Growth	1.03
Discount Rate	1.07
Pass Through	1.00
1996 Sales	24.400
Surcharge per year	0.0
1996 Profits	8.4
Elasticity of demand	-0.4
Real Natural Decline	-0.6

Year	Base	Effective Real Tax	Real Price	Consumption (Harris Model)	Real Volume Adjusted Payments	PDV
0	10.0	0.41	2.26	23.2	10.0	10
1	8.5	0.35	2.20	23.3	8.1	7.8
2	9.5	0.39	2.24	23.0	9.0	8.3
3	11.5	0.47	2.32	22.5	10.6	9.5
4	14.0	0.57	2.42	21.9	12.6	10.8
5	15.0	0.61	2.46	21.6	13.3	11.0
6	15.0	0.61	2.46	21.5	13.2	10.5
7	15.0	0.61	2.46	21.4	13.1	10.1
8	15.0	0.61	2.46	21.2	13.1	9.6
9	15.0	0.61	2.46	21.1	13.0	9.2
10	15.0	0.61	2.46	21.0	12.9	8.8
11	15.0	0.61	2.46	20.9	12.8	8.4
12	15.0	0.61	2.46	20.7	12.7	8.1
13	15.0	0.61	2.46	20.6	12.7	7.7
14	15.0	0.61	2.46	20.5	12.6	7.4
15	15.0	0.61	2.46	20.4	12.5	7.1
16	15.0	0.61	2.46	20.2	12.4	6.8
17	15.0	0.61	2.46	20.1	12.4	6.5
18	15.0	0.61	2.46	20.0	12.3	6.2
19	15.0	0.61	2.46	19.9	12.2	5.9
20	15.0	0.61	2.46	19.8	12.2	5.7
21	15.0	0.61	2.46	19.6	12.1	5.4
22	15.0	0.61	2.46	19.5	12.0	5.2
23	15.0	0.61	2.46	19.4	11.9	5.0
24	15.0	0.61	2.46	19.3	11.9	4.8
25	15.0	0.61	2.46	19.2	11.8	4.5
Total	368.5				313.4	200.2

Assumptions:

Base Price of Pack of Cigarettes
1.85

CPI Growth	1.03
Discount Rate	1.07
Pass Through	1.25
1996 Sales	24.400
Surcharge per year	0.0
1996 Profits	8.4
Elasticity of demand	-0.4
Real Natural Decline	-0.6

Year	Base	Effective Real Tax	Real Price	Consumption (Harris Model)	Real Volume Adjusted Payments	PDV
0	10.0	0.41	2.36	22.7	10.0	10
1	8.5	0.35	2.29	22.9	8.0	7.7
2	9.5	0.39	2.34	22.6	8.8	8.1
3	11.5	0.47	2.44	22.0	10.4	9.2
4	14.0	0.57	2.57	21.3	12.2	10.5
5	15.0	0.61	2.62	21.0	12.9	10.7
6	15.0	0.61	2.62	20.9	12.8	10.2
7	15.0	0.61	2.62	20.7	12.7	9.8
8	15.0	0.61	2.62	20.6	12.7	9.3
9	15.0	0.61	2.62	20.5	12.6	8.9
10	15.0	0.61	2.62	20.4	12.5	8.6
11	15.0	0.61	2.62	20.2	12.4	8.2
12	15.0	0.61	2.62	20.1	12.4	7.8
13	15.0	0.61	2.62	20.0	12.3	7.5
14	15.0	0.61	2.62	19.9	12.2	7.2
15	15.0	0.61	2.62	19.8	12.2	6.9
16	15.0	0.61	2.62	19.6	12.1	6.6
17	15.0	0.61	2.62	19.5	12.0	6.3
18	15.0	0.61	2.62	19.4	11.9	6.0
19	15.0	0.61	2.62	19.3	11.9	5.8
20	15.0	0.61	2.62	19.2	11.8	5.5
21	15.0	0.61	2.62	19.1	11.7	5.3
22	15.0	0.61	2.62	19.0	11.7	5.0
23	15.0	0.61	2.62	18.8	11.6	4.8
24	15.0	0.61	2.62	18.7	11.5	4.6
25	15.0	0.61	2.62	18.6	11.4	4.4
Total	368.5				304.8	194.9

Assumptions:

Base Price of Pack of Cigarettes 1.85	
CPI Growth	1.03
Discount Rate	1.07
Pass Through	2.00
1996 Sales	24.400
Surcharge per year	0.0
1996 Profits	8.4
Elasticity of demand	-0.4
Real Natural Decline	-0.6

Year	Base	Effective Real Tax	Real Price	Consumption (Harris Model)	Real Volume Adjusted Payments	PDV
0	10.0	0.41	2.67	21.4	10.0	10
1	8.5	0.35	2.55	21.8	7.6	7.3
2	9.5	0.39	2.63	21.3	8.3	7.7
3	11.5	0.47	2.79	20.5	9.7	8.6
4	14.0	0.57	3.00	19.6	11.3	9.7
5	15.0	0.61	3.08	19.2	11.8	9.7
6	15.0	0.61	3.08	19.1	11.7	9.3
7	15.0	0.61	3.08	19.0	11.7	8.9
8	15.0	0.61	3.08	18.8	11.6	8.5
9	15.0	0.61	3.08	18.7	11.5	8.2
10	15.0	0.61	3.08	18.6	11.4	7.8
11	15.0	0.61	3.08	18.5	11.4	7.5
12	15.0	0.61	3.08	18.4	11.3	7.2
13	15.0	0.61	3.08	18.3	11.2	6.9
14	15.0	0.61	3.08	18.2	11.2	6.6
15	15.0	0.61	3.08	18.1	11.1	6.3
16	15.0	0.61	3.08	18.0	11.0	6.0
17	15.0	0.61	3.08	17.9	11.0	5.7
18	15.0	0.61	3.08	17.7	10.9	5.5
19	15.0	0.61	3.08	17.6	10.8	5.3
20	15.0	0.61	3.08	17.5	10.8	5.0
21	15.0	0.61	3.08	17.4	10.7	4.8
22	15.0	0.61	3.08	17.3	10.6	4.6
23	15.0	0.61	3.08	17.2	10.6	4.4
24	15.0	0.61	3.08	17.1	10.5	4.2
25	15.0	0.61	3.08	17.0	10.5	4.0
Total	368.5				280.2	179.8

Preliminary Observations on Proposed Tobacco Settlement[1]
July 9, 1997

I. Incidence of payments

highlight significance of the effect of the settlement on industry competition

A. Some assumptions

1. industry demand relatively inelastic

- estimated elasticity for adults = -0.4 in short run, -0.7 in long run

- international evidence does not suggest industry demand elasticity will change markedly with large price increases

2. more than 100% pass through of industry-wide cost increases in higher prices

- settlement encourages at least 100% pass-through

- empirical estimates of pass-through are in the 100% to 125% range, holding constant the oligopoly solution concept

- no reason to modify this figure based on curvature of demand given evidence favoring constant elasticity over large range

- a settlement that leads to less competitive behavior as well as imposing a cost increase will likely exhibit greater pass through of the cost increase than historical estimates suggest

  - small reductions in the degree of industry competition can lead to large price increases with inelastic demand

  - the settlement incorporates provisions that may facilitate cooperative price fixing, discourage entry, discourage producer substitution to lower priced products, and raise the costs of output expansion

3. industry supply function relatively elastic

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[1]Prepared as an aid to discussion by the staff of the Bureau of Economics, Federal Trade Commission. These comments are not necessarily those of the Federal Trade Commission or any individual Commissioner.

B. Implications [see table]

1 smoking will likely decline substantially

- the price increase is the primary mechanism

- caveat: out of sample predictions have large uncertainty; international evidence suggests quantity declines may be overstated

- health benefits will go to those who quit or choose never to start; if those who continue to smoke reduce consumption, the health benefits will depend on the extent to which they compensate by smoking more intensively

2. tobacco industry profits will likely rise, even before accounting for the benefit of reduced exposure to legal liability

- if the pass-through rate is high, reflecting reductions in competition, industry profits will likely rise substantially

3. incidence depends on intensity of post-settlement industry competition (built into 125% vs. 200% pass-through assumption)

II. Some other incentive effects of settlement proposal

A. youth smoking will likely decline substantially [see table]

- youth responsiveness to price is higher than adults
  (estimated youth demand elasticity = -1.3)

- access restrictions may also discourage youth smoking substantially (notwithstanding some potential for evasion)

- recall earlier caveat; quantity declines may be overstated

B. R&D to develop safer cigarettes may be eliminated

- mandated cross-licensing of innovations and FDA authority to mandate introduction of less hazardous products that are technologically feasible undermine private appropriability (notwithstanding guarantee of reasonable rate)

- FDA's technology-forcing mandate is limited, as FDA may not require modifications that will create demand for contraband

- developers of safer cigarettes may find it difficult or impossible to advertise such products, limiting the potential private return to R&D

- some R&D incentives may remain if can market safer products abroad

Annual Incidence of Settlement

	Year 1		Year 5	
New payment	35¢/pack	35¢/pack	62¢/pack	62¢/pack
Elasticity	-0.4	-0.4	-0.[redacted]7	-0.[redacted]7
Pass through	125%	200%	125%	200%
Price [1] ($1.85/pack today)	+24% $2.29	+38% $2.55	+42% $2.63	+67% $3.09
Quantity [2] (24.2 bill. pack/yr)	-9% 21.5	-15% 20.2	-29% 15.7	-47% 11.8
Total revenue ($44.7 bill/yr today)	$49.2	$51.4	$41.3	$36.5
Industry profits [3] ($7.8 bill/yr today)	$10.1	$14.8	$8.8	$12.4
Old tax revenue [4] ($14 bill/yr today)	$12.5	$11.7	$9.1	$6.9
New govt. rev. [5] ($ billions)	$7.5	$7.1	$9.1	$7.3
Total govt. revenue ($ bill)[6]	$9.0	$6.8	$8.7	$1.4
Incremental industry profits [7]	$2.4	$7.1	$1.5	$5.1
Incrm. profits as % of incrm. surplus [8]	21%	51%	15%	78%

Notes

[1] All figures in 1997 dollars. Product mix (fraction low priced products sold) held constant.

[2] Adjusted for declining trend in sales (-1.6%/yr). Does not adjust trend to reflect new disclosures, public education, and advertising restrictions in settlement that might increase exogenous rate of sales decline.

[3] Components of change in profits
   a. fixed costs savings of 5¢/pack on current advt + legal (approx 50%, $1 bill.)
   b. lost contribution of 33¢/pack on reduced quantity
   c. increased contribution from price increase on remaining quantity

   Does not include expected value of reduced risk of large legal liability

[4] Direct federal, state and local taxes combined; does not include corporate profits tax

[5] Does not include possible excess profits adjustment or possible surcharge in settlement

[6] Old tax revenue + new govt. revenue less old tax revenue in but-for world of no settlement. (But-for world assumes constant real prices, quantity declining at current trend rate.)

[7] Profits less profits in but-for world of no settlement

[8] Incremental surplus = incremental govt. revenue + incremental profits

Preliminary Observations on Proposed Tobacco Settlement[1]
July 10, 1997

I. Incidence of payments

highlight significance of the effect of the settlement on industry competition for distribution of benefits between governmental revenues and industry profits

A. Some assumptions

1. industry demand relatively inelastic

   - estimated elasticity for adults = -0.4 in short run, -0.7 in long run
   - international evidence does not suggest industry demand elasticity will change markedly with large price increases

2. more than 100% pass through of industry-wide cost increases in higher prices

   - settlement encourages at least 100% pass-through
   - empirical estimates of pass-through are in the 100% to 125% range, holding constant the oligopoly solution concept
   - no reason to modify this figure based on curvature of demand given evidence favoring constant elasticity over large range
   - a settlement that leads to less competitive behavior as well as imposing a cost increase will likely exhibit greater pass through of the cost increase than historical estimates suggest
     - small reductions in the degree of industry competition can lead to large price increases with inelastic demand
     - the settlement incorporates provisions that may facilitate cooperative price fixing, discourage entry, discourage producer substitution to lower priced products, and raise the costs of output expansion

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[1]Prepared as an aid to discussion by the staff of the Bureau of Economics, Federal Trade Commission. These comments are not necessarily those of the Federal Trade Commission or any individual Commissioner.

3. industry supply function relatively elastic

B. Implications [see table]

1 smoking will likely decline substantially

- the price increase is the primary mechanism
- caveat: out of sample predictions have large uncertainty; international evidence suggests quantity declines may be overstated
- health benefits will go to those who quit or choose never to start; if those who continue to smoke reduce consumption, the health benefits will depend on the extent to which they compensate by smoking more intensively

2. tobacco industry profits will likely rise, even before accounting for the benefit of reduced exposure to legal liability

- if the pass-through rate is high, reflecting reductions in competition, industry profits will likely rise substantially

3. incidence depends on intensity of post-settlement industry competition (built into 125% vs. 200% pass-through assumption)

II. Some other incentive effects of settlement proposal

A. youth smoking will likely decline substantially

- youth responsiveness to price is higher than adults (estimated youth demand elasticity = -1.3)
- access restrictions may also discourage youth smoking substantially (notwithstanding some potential for evasion)
- recall earlier caveat; quantity declines may be overstated

B. R&D to develop safer cigarettes may be reduced or even eliminated

- mandated cross-licensing of innovations and FDA authority to mandate introduction of less hazardous products that are technologically feasible undermine private appropriability (notwithstanding guarantee of reasonable rate)

- FDA's technology-forcing mandate is limited, as FDA may not require modifications that will create demand for contraband

- developers of safer cigarettes may find it difficult or impossible to advertise such products, limiting the potential private return to R&D

- some R&D incentives may remain if can market safer products abroad

Annual Incidence of Settlement: Illustrative Example

	Year 1		Year 5	
New payment	35¢/pack	35¢/pack	62¢/pack	62¢/pack
Elasticity	-0.4	-0.4	-0.7	-0.7
Pass through	125%	200%	125%	200%
Price [1]	+24%	+38%	+42%	+67%
($1.85/pack today)	$2.29	$2.55	$2.63	$3.09
Quantity [2]	-9%	-15%	-29%	-47%
(24.2 bill. pack/yr)	21.5	20.2	15.7	11.8
Total revenue ($44.7 bill/yr today)	$49.2	$51.4	$41.3	$36.5
Industry profits [3] ($7.8 bill/yr today)	$10.1	$14.8	$8.8	$12.4
Old tax revenue [4] ($14 bill/yr today)	$12.5	$11.7	$9.1	$6.9
New govt. rev. [5] ($ billions)	$7.5	$7.1	$9.8	$7.3
Incremental govt. revenue ($ bill)[6]	$6.2	$5.0	$6.0	$1.3
Incremental industry profits [7]	$2.4	$7.1	$1.5	$5.1
Incrm. profits as % of incrm. surplus [8]	27%	59%	20%	80%

Notes

[1] All figures in 1997 dollars. Product mix (fraction low priced products sold) held constant.

[2] Adjusted for declining trend in sales (-1.6%/yr). Does not adjust trend to reflect new disclosures, public education, and advertising restrictions in settlement that might increase exogenous rate of sales decline.

[3] Components of change in profits:
  a. fixed costs savings equivalent to 5¢/pack at 1997 quantities on current advertising + legal expenses (approx 50% or $1.2 bill.)
  b. lost contribution of 33¢/pack on reduced quantity
  c. increased contribution from price increase on remaining quantity

  Does not include expected value of reduced risk of large legal liability.

[4] Direct federal, state and local taxes combined; does not include corporate profits tax.

[5] Reflects new payments. Does not include possible excess profits adjustment or possible surcharge in settlement.

[6] Old tax revenue + new govt. revenue less old tax revenue in the but-for world of no settlement. (The but-for world assumes constant real prices, quantity declining at current trend rate.)

[7] Profits less profits in the but-for world of no settlement.

[8] Incremental surplus = incremental govt. revenue + incremental profits.

Annual Incidence of Settlement: Illustrative Example
with 10% pass through

	Year 1	Year 5
New payment	35¢/pack	62¢/pack
Elasticity	-0.4	-0.7
Pass through	100%	100%
Price [1] ($1.85/pack today)	+19% $2.20	+34% $2.47
Quantity [2] (24.2 bill. pack/yr)	-8% 22.0	-23% 17.0
Total revenue ($44.7 bill/yr today)	$48.3	$42.0
Industry profits [3] ($7.8 bill/yr today)	$8.3	$6.7
Old tax revenue [4] ($14 bill/yr today)	$12.7	$9.9
New govt. rev. [5] ($ billions)	$7.7	$10.6
Incremental govt. revenue ($ bill)[6]	$6.6	$7.5
Incremental industry profits [7]	$0.6	-$0.5
Incrm. profits as % of incrm. surplus [8]	8%	-7%

Annual Incidence of Settlement: Illustrative Example
Year 5 with -0.4 long run demand elasticity

	Year 5		
New payment	62¢/pack	62¢/pack	62¢/pack
Elasticity	-0.4	-0.4	-0.4
Pass through	100%	125%	200%
Price [1]	+34%	+42%	+67%
($1.85/pack today)	$2.47	$2.63	$3.09
Quantity [2]	-13%	-17%	-27%
(24.2 bill. pack/yr)	$19.3	18.5	16.3
Total revenue ($44.7 bill/yr today)	$47.6	$48.7	$50.4
Industry profits [3] ($7.8 bill/yr today)	$7.5	$10.1	$16.6
Old tax revenue [4] ($14 bill/yr today)	$11.2	$10.8	$9.5
New govt. rev. [5] ($ billions)	$12.0	$11.5	$10.1
Incremental govt. revenue ($ bill)[6]	$10.2	$9.3	$6.6
Incremental industry profits [7]	$0.2	$2.9	$9.4
Incrm. profits as % of incrm. surplus [8]	2%	23%	59%

DRAFT

EFFECTS OF THE PROPOSED SETTLEMENT ON TOBACCO PRODUCERS

Background

Total U.S. cigarette output was a record 760 billion cigarettes in 1996 (figure 1). Cigarette output rose steadily throughout most of this century and reflected the steady increase in domestic cigarette consumption. Domestic cigarette disappearance peaked at 640 billion cigarettes in 1981 (figure 2). Between 1981 and 1996, domestic cigarette consumption fell by over 150 billion cigarettes. U.S. cigarette output initially reflected this decline, but by the early 1990s output had rebounded reflecting the increase in cigarette exports. In 1996, the United States exported a record 260 billion cigarettes, with the European Union and Japan accounting for over half of the U.S. export market.

Tobacco is produced in 21 states, with 65 percent of the acreage in Kentucky and North Carolina. Several different types and kinds of tobacco are grown, but flue-cured and barley--the primary cigarette tobaccos--account for about 94 percent of total production. Tobacco is usually the sixth largest cash crop, behind corn, soybeans, wheat, hay and cotton. There were an estimated 124,000 farms that grew tobacco in 1992. The average farm grew about 6.7 acres of tobacco.

Cigarettes account for about 90 percent of the tobacco used in the United States. U.S. cigarette manufacturers used an estimated 1.44 billion pounds of tobacco in cigarettes in 1995. Domestic burley accounted for about 27 percent of the tobacco used in cigarettes; domestic flue-cured, 37 percent; Maryland, 1 percent; and imported, the remaining 35 percent. Since the mid-1970s, the shares of both U.S. flue-cured and burley have declined. U.S. tobacco production and marketings have declined as a result (figures 3, 4, and 5).

The decline has been offset by a shift to an increasing share of imported tobacco in U.S. cigarettes (figure 6). U.S. leaf imports for consumption climbed from 413 million pounds in 1990 to more than 1 billion pounds in 1993. The main reason for this surge was the rising popularity in the United States and abroad for low and mid-priced brands. To meet this demand, manufactures imported an increasing amount of lower cost foreign tobacco. In response to surging tobacco imports, Congress enacted a provision in the Omnibus Budget Reconciliation Act of 1993 which required U.S.-manufactured cigarettes to contain 75 percent U.S.-grown tobacco. As part of the Uruguay Round implementing legislation, domestic content provisions were replaced by the establishment of a tariff rate quota for certain imported tobacco, primarily flue-cured and burley. Imports of cigarette leaf tobaccos (excluding Oriental) which exceed predetermined quota are now subject to an import duty of 350 percent ad valorem, although a draw-back provision allows most of the duty to be refunded if the imported leaf is re-exported in the form of manufactured tobacco or cigarettes.

Most U.S. tobacco production has been under a price support and supply control program since the 1930s. Producers are guaranteed higher than market equilibrium prices in exchange for limiting marketings through marketing quotas. Support prices for burly and flue-cured tobacco are set annually based on the previous year's level, adjusted by changes in the 5-year moving average of prices and in the cost of production index (figure 7). Flue-cured and burley marketing quotas are based on 1) intended purchases by cigarette manufactures, 2) average annual exports for the 3 previous years, and 3) the amount of tobacco needed to attain a specified reserve level. Quota levels have generally trended downward since the mid-1970s, following the decline in marketings (figure 8). Quota levels are up for both flue-cured and burley tobacco in 1997, reflecting increased marketings and reduced stock levels in 1996.

The higher tobacco prices resulting from the program have created values for marketing quota rights. Because rules governing quota transfer are highly restrictive, these values have been capitalized into land values. Currently, quota rents are approximately 50 to 60 cents per pound. A 1991 survey of farms showed that only 7 percent of the flue-cured operators owned the entire tobacco quota they produced, about 21 percent rented all their quota, and the remaining 72 percent owned and rented quota. The percent of burley quota owners who produce all of their quota is typically higher reflecting the more restrictive rules governing burley transfer and leasing.

The "No-Net-Cost Tobacco Program Act of 1982" required that to be eligible for price support, producers of all kinds of tobacco, beginning with the 1982 crop, had to contribute to a fund or pay assessments to an account established by the cooperative association that makes Federal support loans available to producers. The funds are collected to cover potential losses in operating the price support program. Further changes in tobacco legislation in 1986 extended the no-net-cost provisions to tobacco purchasers.

Estimated Effects of the Settlement on Cigarette Consumption

The settlement between cigarette manufacturers and the State Attorneys General will likely result in an increase in the retail price of cigarettes on the order of 25 to 50 cents per pack of 20 cigarettes. This price increase stems from the lump-sum and penalty payments which will be made by cigarette manufacturers as part of the agreement. The effects of the penalties will be lessened somewhat by rebates based on declining adult consumption. If the price increases result in lower adult consumption compared with 1996, a rebate is paid. The payment to be made is equal to the ratio of that year's adult consumption to 1996 adult consumption times the penalty. For example, a 100 million decline in cigarette consumption would result in a penalty of $6.7 billion instead of $8.5 billion for the first year.

The following analysis assume a one-time change in price and estimates the effect of the price change on cigarette consumption. The effects of the price change on cigarette consumption are additive with the long-term downward trend in domestic cigarette consumption. Demand effects are based on a short-run elasticity of domestic demand for cigarettes of -0.4.

The total per-pack-equivalent of the $18.5 billion penalty to be paid the first year (1997) is estimated to be about 75-80 cents per pack. It is unlikely, however, that the full penalty will be transmitted to domestic consumers in the form of a price increase. Cigarette manufacturers have shown in the past they are capable of absorbing relatively large price decreases. For example, in November 1993, wholesale premium cigarette prices declined 30 percent as manufacturers moved to regain market share from discount brands. The penalty payments are tax-deductible expenses, so the cigarette manufacturers will not have to bear the full burden. In addition, manufacturers will receive a partial rebate of the penalty for any decline in adult consumption from the 1996 level (as described above). For the purposes of this analysis, 25 and 50 cent per pack price increases are evaluated.

A 25-cent increase in the price of a pack of cigarettes would raise the price from the current $1.91 per pack to $2.16 per pack, a 13.1 percent increase. A 50-cent increase in the price of cigarettes would raise the retail price to $2.41 cents per pack, an increase of 26.2 percent. The price increases are assumed to be a one-time event, even though it is likely that the increases would be gradually phased in.

Based on a short run elasticity of -0.4, a 13.1-percent gain (25 cents per pack) in the retail price of cigarettes would likely result in a 5.2 percent decline in volume consumed. Likewise, a 50 cent rise in the retail price would lead to a 10.5 percent decline in volume.

Cigarette exports are not restricted by the settlement and will likely continue their upward trend. Cigarette exports could increase above baseline levels, particularly if U.S. manufacturers seek to maintain near-current production levels to efficiently utilize manufacturing capacity. Assuming the agreement would enter into effect in 1997 and prices rose 25 cents per pack, total 1998 disappearance (domestic consumption plus exports) of U.S.-produced cigarettes would decline 2.5 percent--from 731 billion to 713 billion pieces. Under the 50-cent increase scenario, 1998 disappearance would fall 6 percent to 689 billion pieces. By 2006, disappearance of U.S. produced cigarettes would fall to about 600 billion cigarettes with a 25-cent increase, about 9 percent below expected disappearance of 660 billion pieces in the current baseline. With a 50-cent increase, consumption in 2006 is expected to be 580 billion cigarettes, 12 percent less than the level of cigarette disappearance expected in 2006 without the settlement.

Implications for Tobacco Producers

Decreases in cigarette disappearance will primarily affect domestic tobacco production. First, the duty draw-back provisions of the tariff rate quota will mean that any growth in cigarette exports will likely increase imports of lower-cost foreign tobacco. Second, U.S. tobacco leaf exports are not likely to be affected because prices for domestic tobacco will remain above the support price.

A 25-cent increase in cigarette prices is estimated to result in a decline in the use of flue-cured and burley tobacco for domestic cigarette consumption of 10 percent and 8.4 percent, respectively, by 2006. Some of the decline will be offset by the use of domestic tobacco for increased cigarette production for export. Total flue-cured and burley marketings will likely fall by 6.4 percent and

7.5 percent, respectively, by 2006 (figures 9 and 10). A 50-cent increase in cigarette prices is estimated to result in a decline in total flue-cured and burley marketings of 8.1 percent and 9.8 percent, respectively, by 2006.

Because of the relatively high tobacco loan rates, decreases in flue-cured and burley use will likely lead to a small decrease in market prices, at least in the short term. Over the long run, support prices will fall, reflecting the adjustment factors based on the 5-year moving average market price. By 2006, average prices paid to flue-cured and burley growers are expected to drop by about 1 percent assuming a 25 cent increase in cigarette price and by about 3 percent assuming a 50-cent increase (figures 11 and 12). Assuming no changes in the tobacco program, 2006 quota levels for flue-cured tobacco will likely fall below baseline levels by about 6 percent assuming a 25-cent increase in cigarette prices and by 8 percent assuming a 50-cent increase. Quota levels for burley are estimated to fall by 7.5 percent for a 25-cent per pack increase and almost 10 percent for a 50-cent per pack increase.

Figure 1

U.S. cigarette output

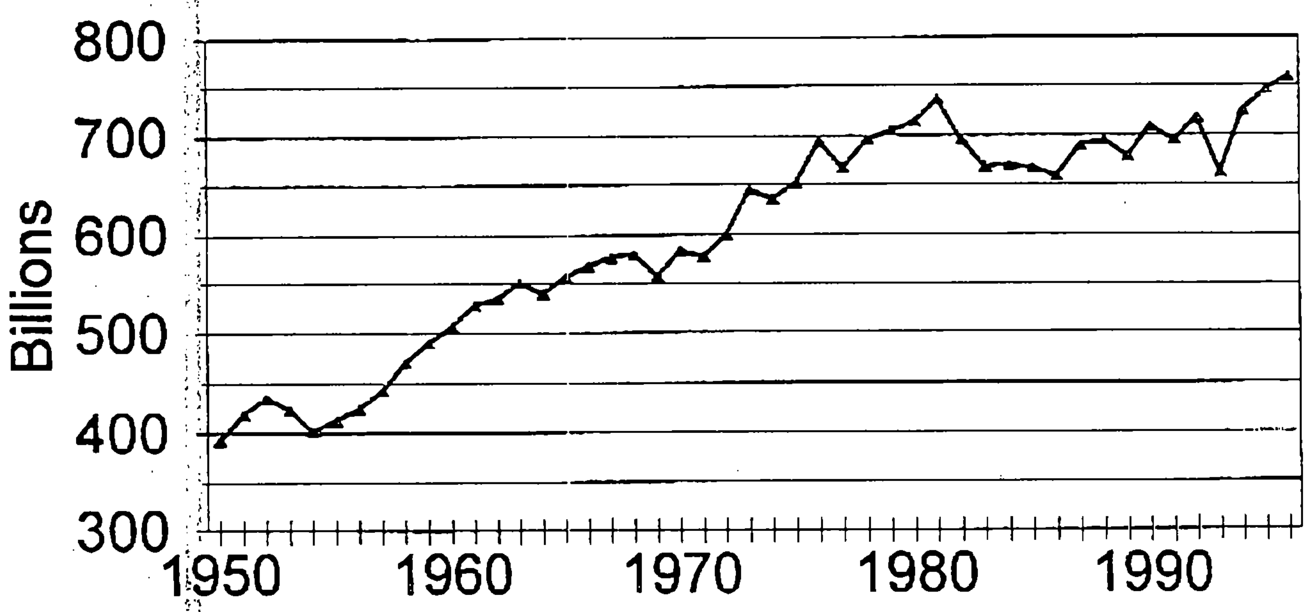


Figure 2

U.S. cigarette disappearance

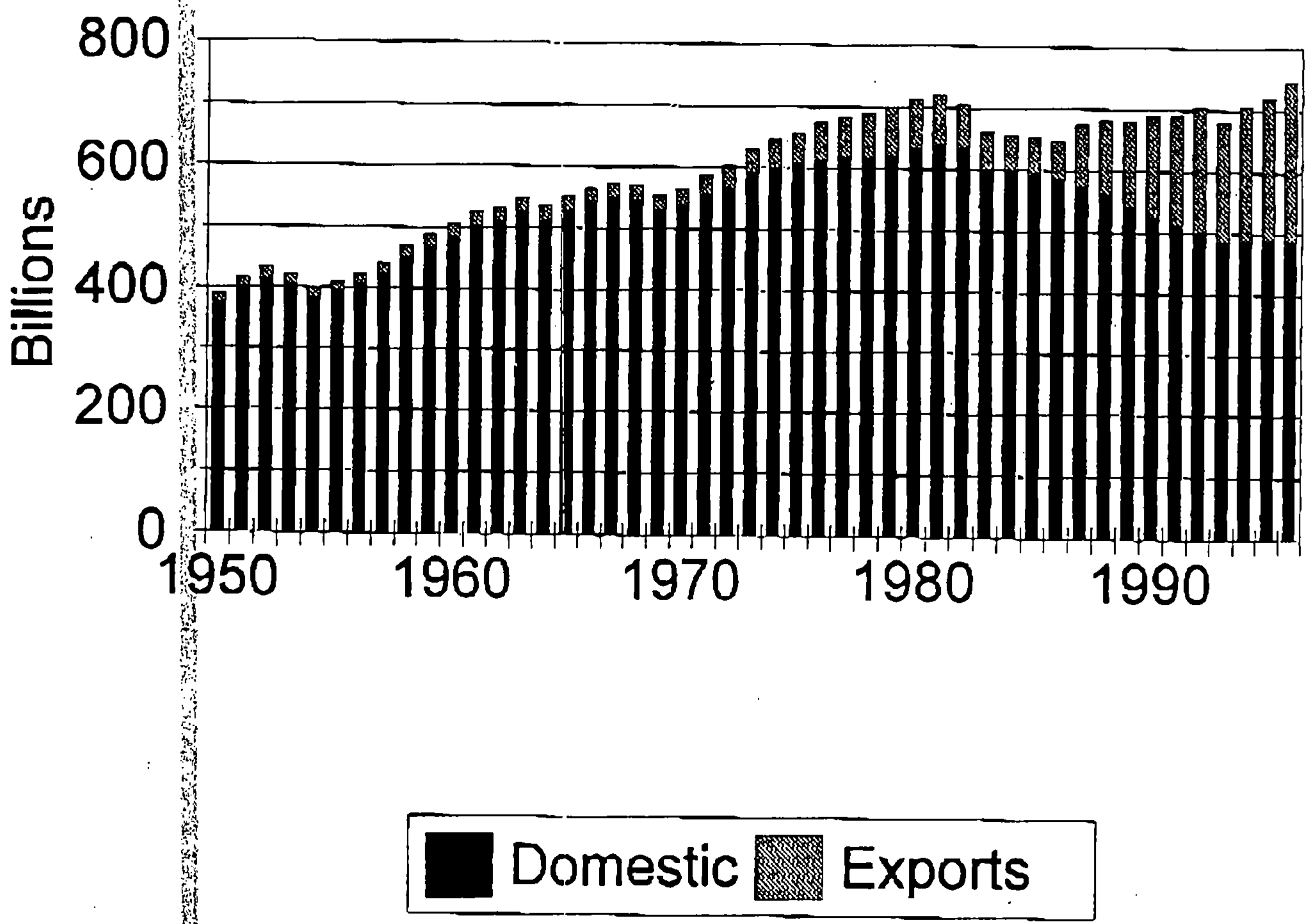


Figure 3

U.S. tobacco production

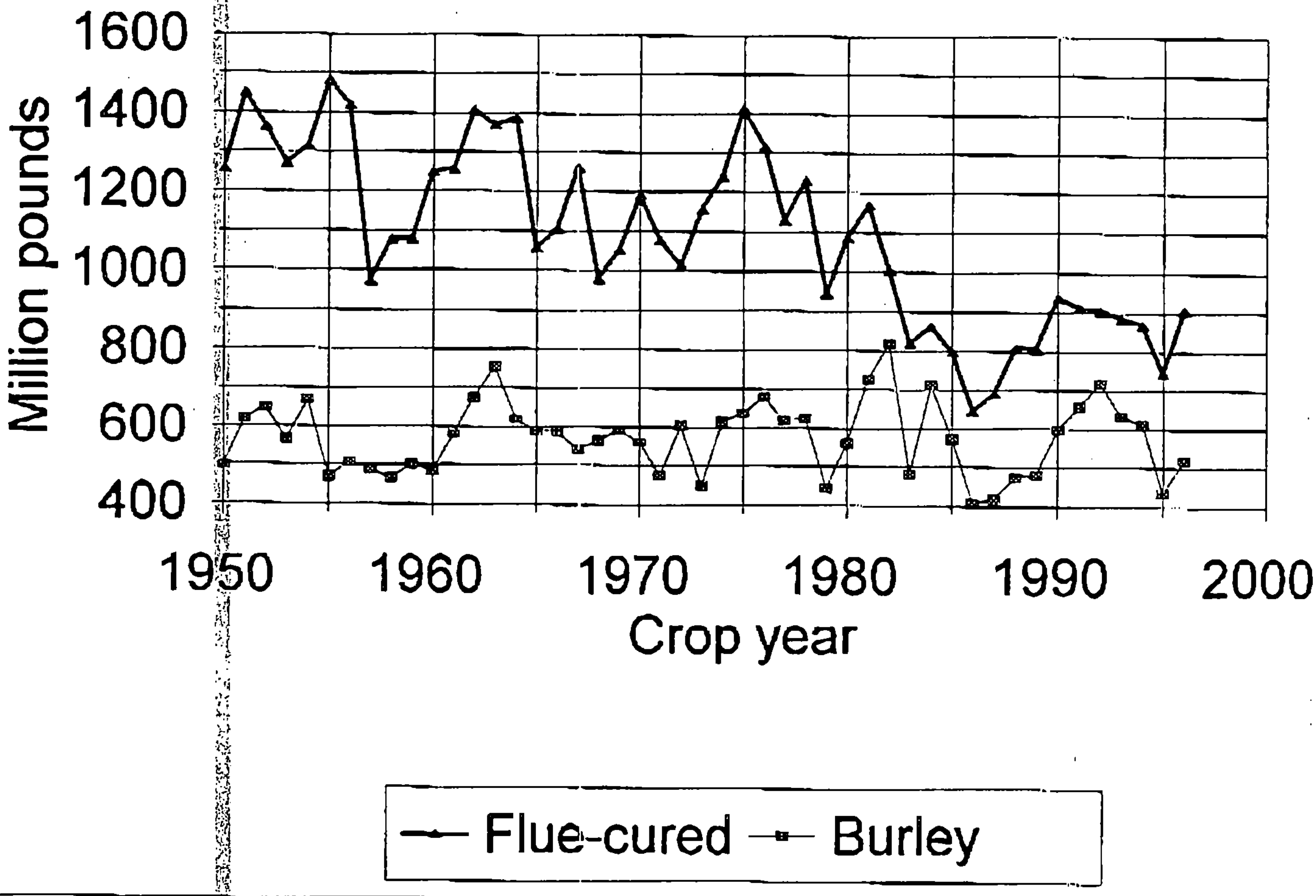


Figure 4

Flue-cured tobacco disappearance

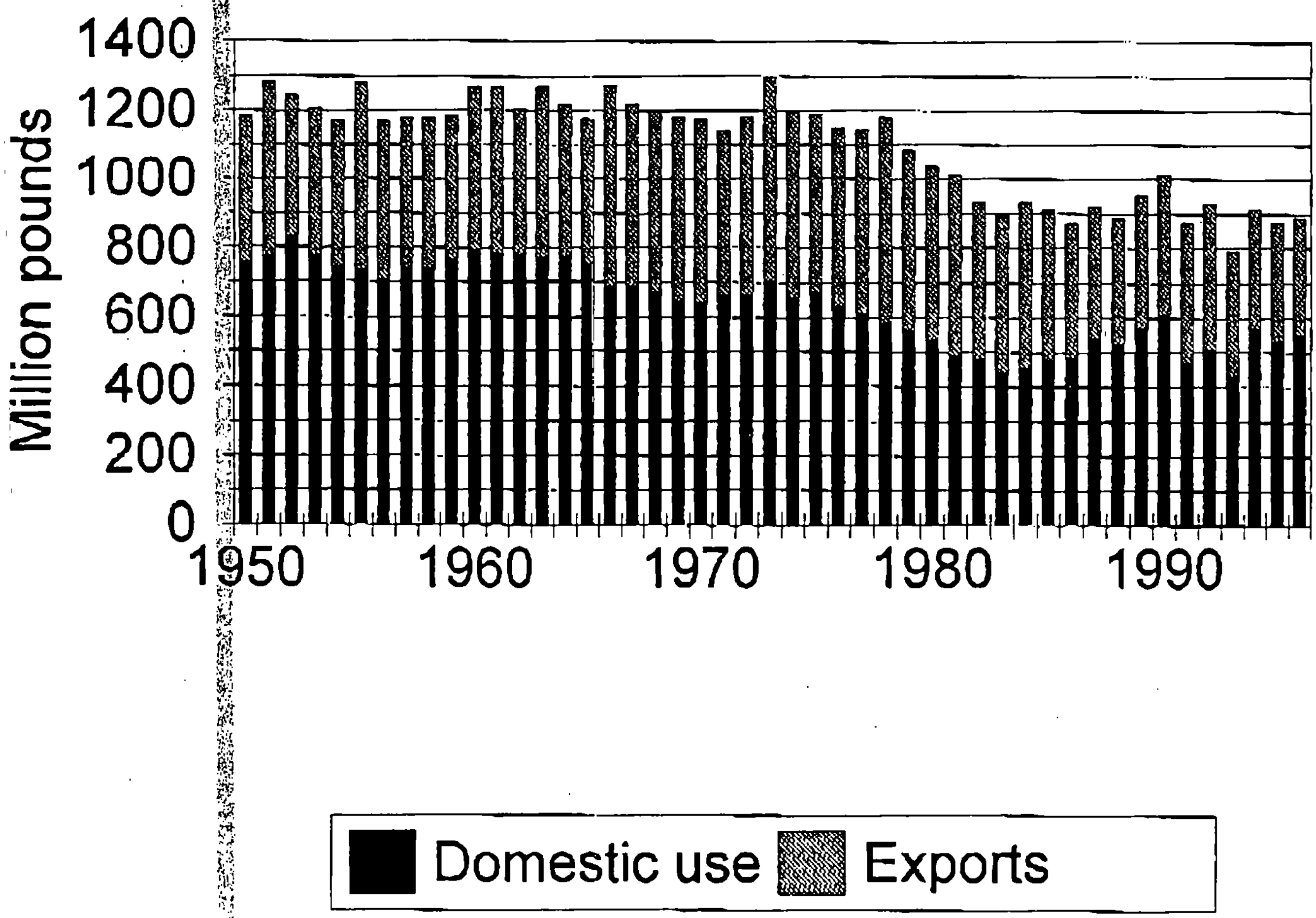


Figure 5

Burley tobacco disappearance

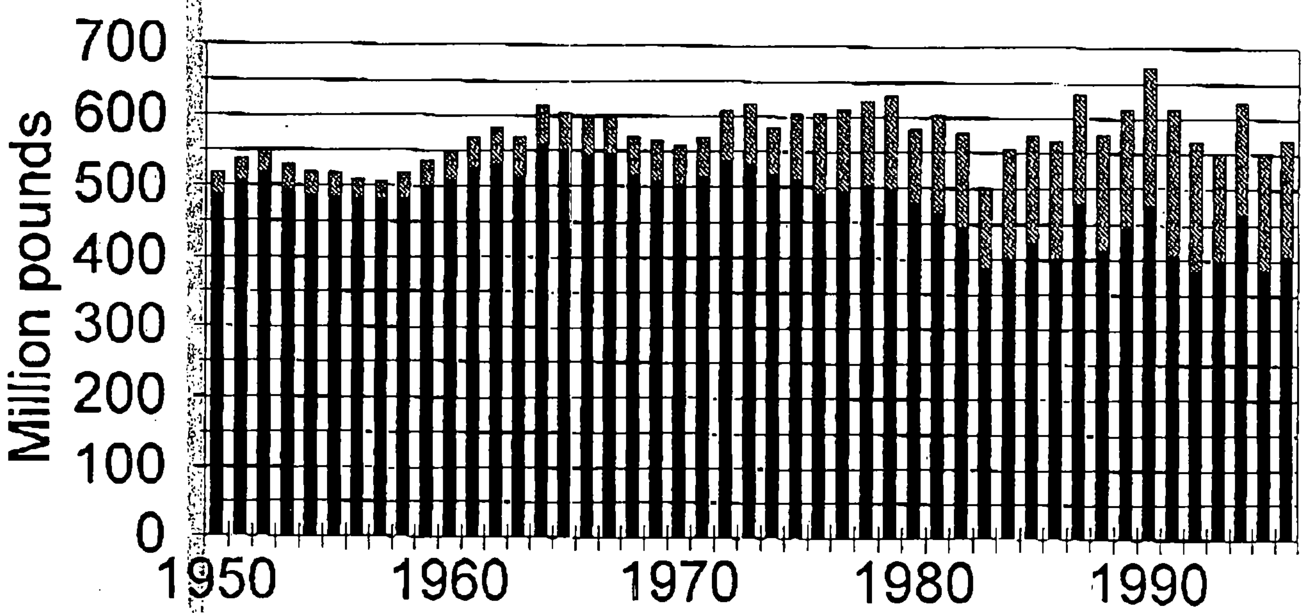


Figure 6

U.S. tobacco imports

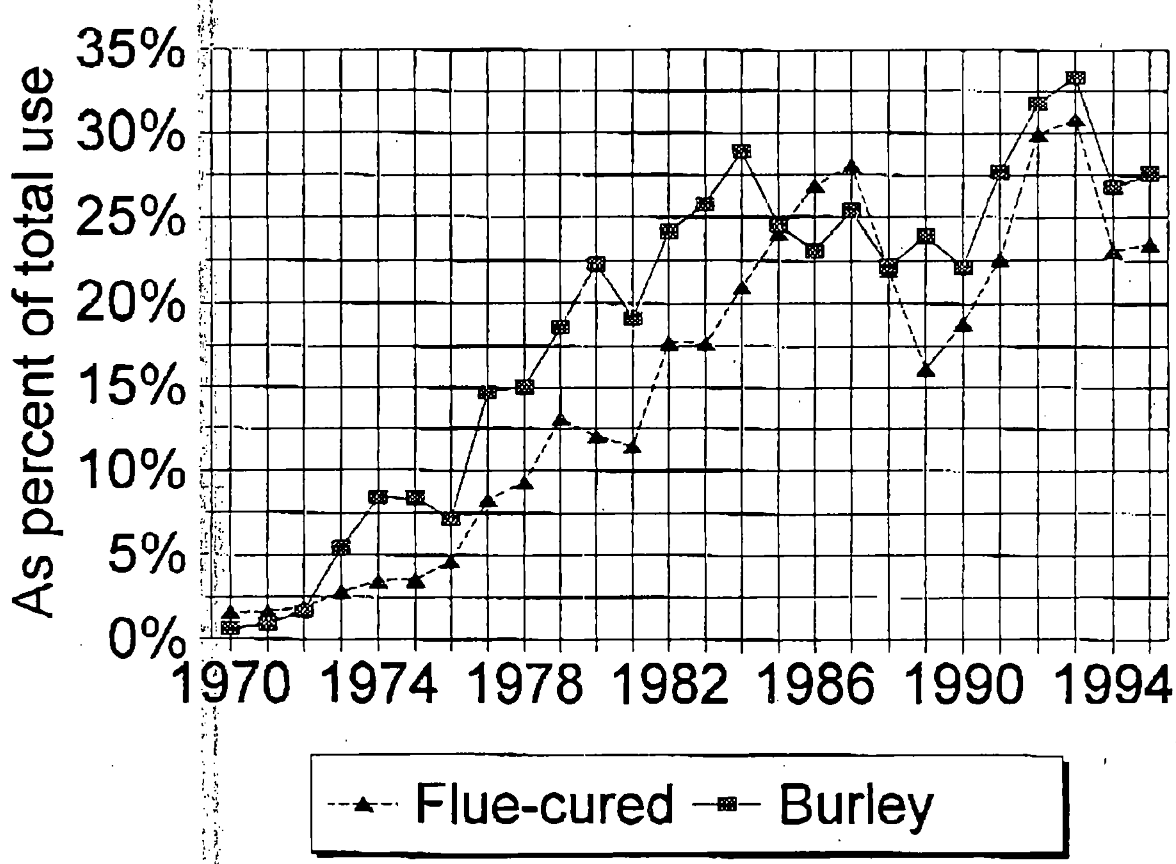


Figure 7

Tobacco support rates

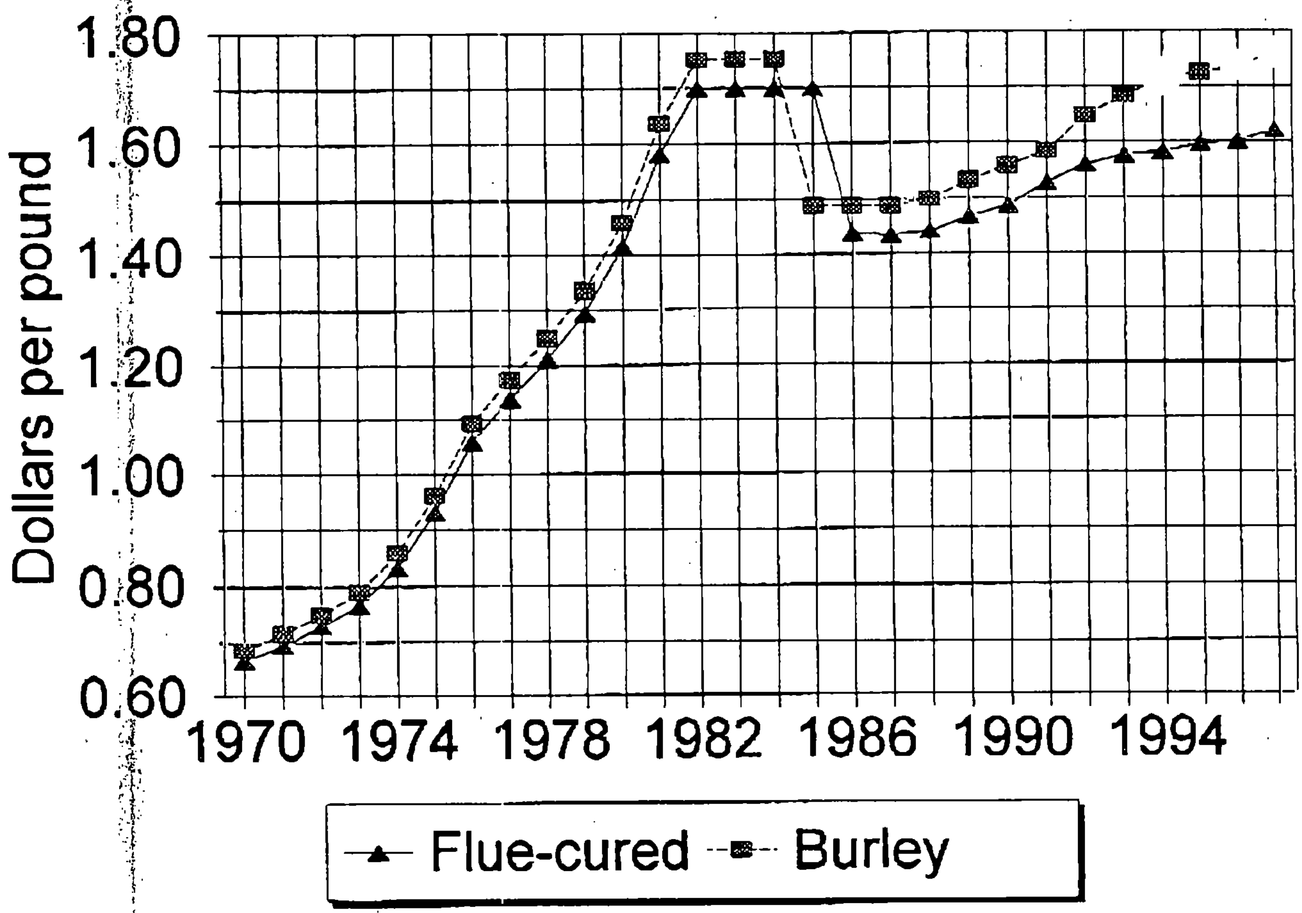


Figure 8

Tobacco marketing quotas

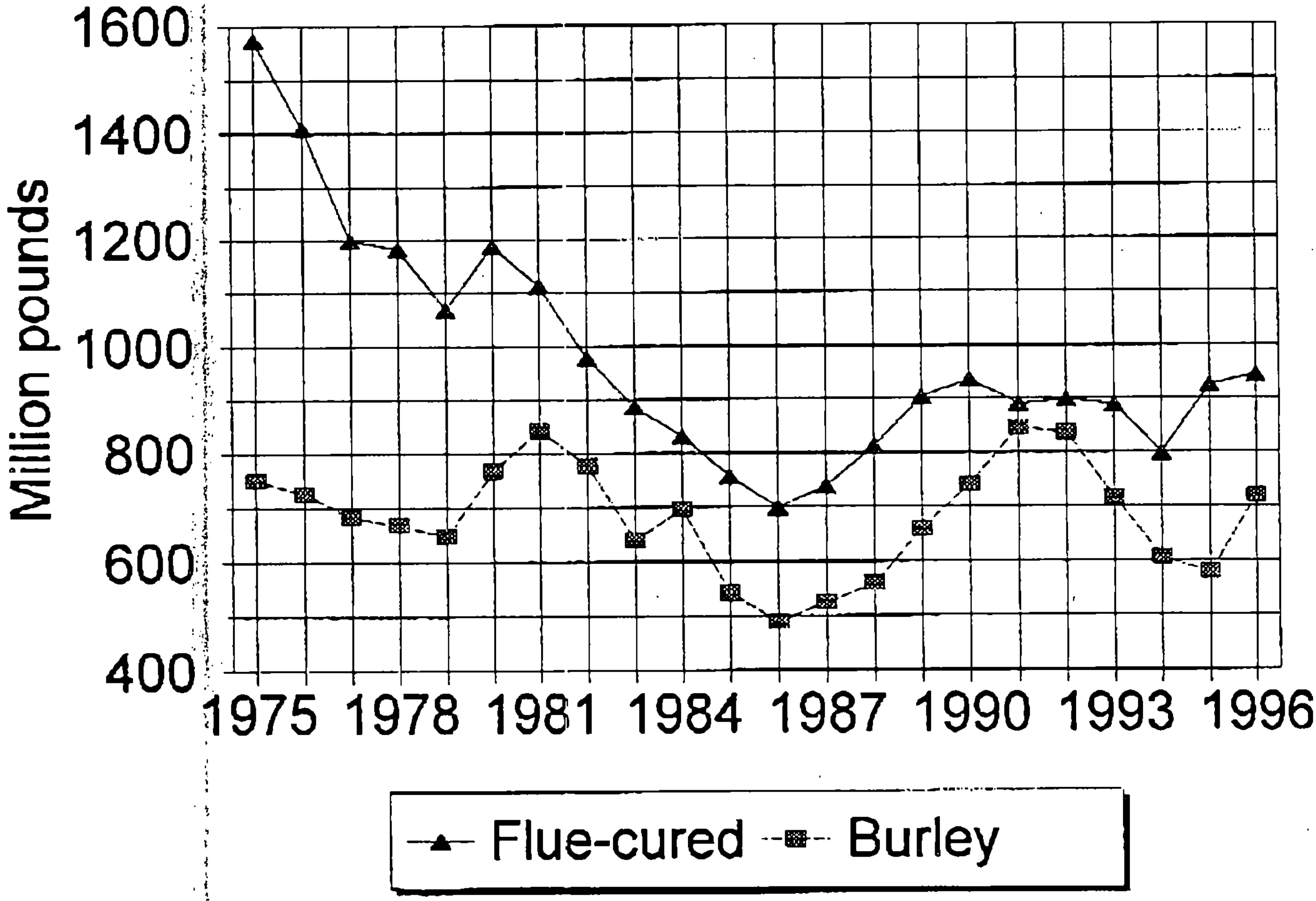


Figure 9

Effects on flue-cured marketings

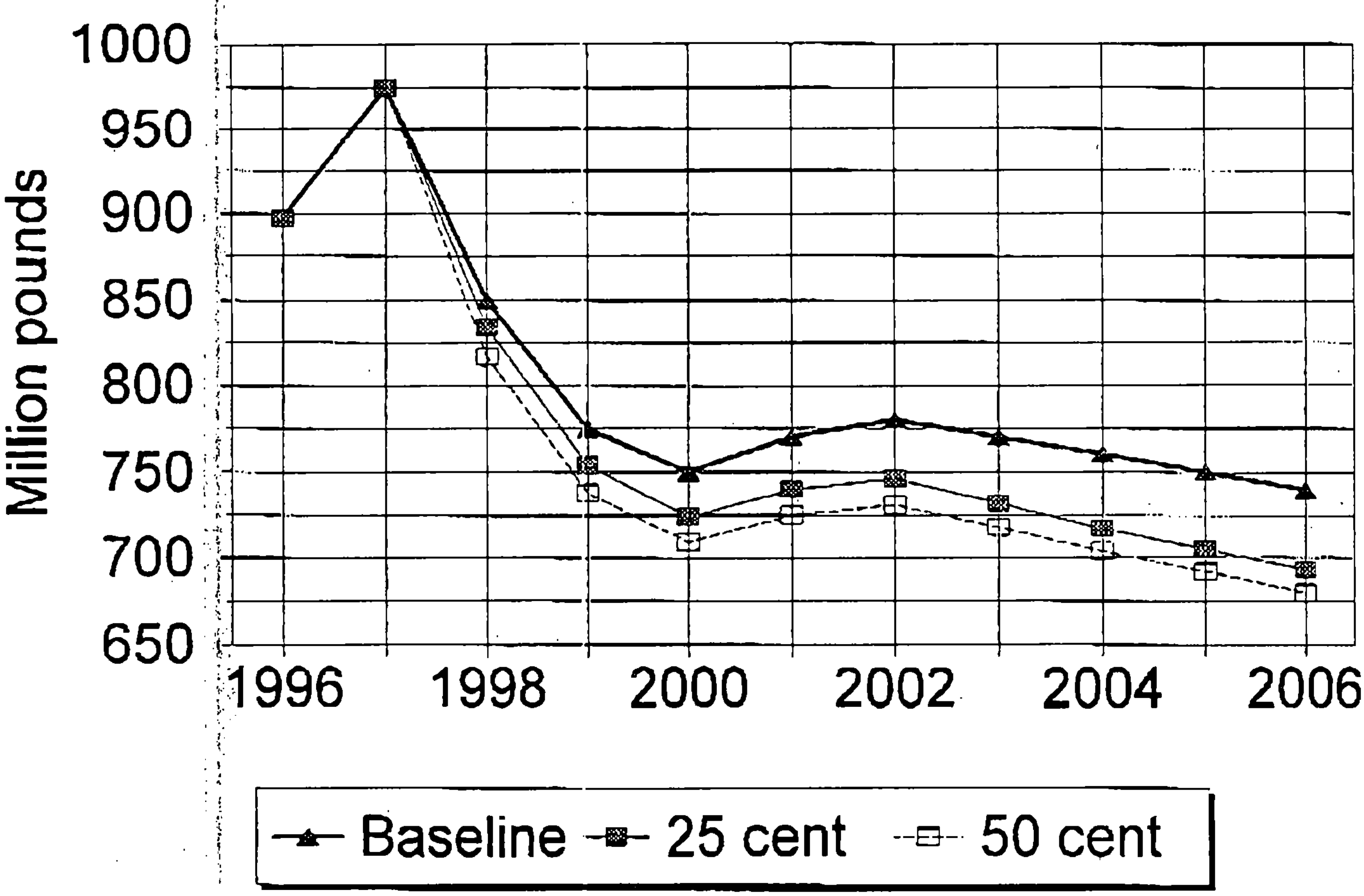


Figure 10

Effects on burley marketings

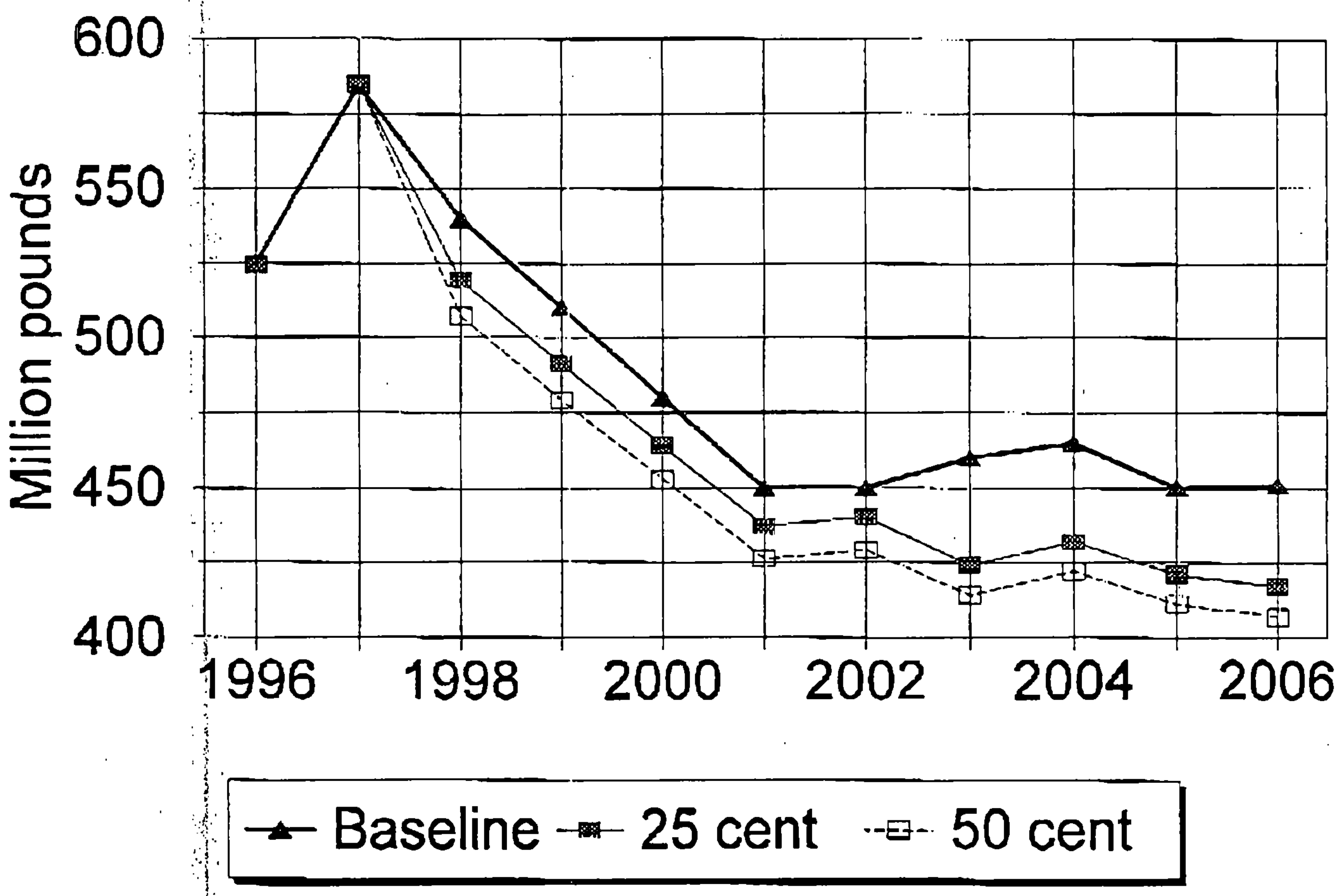


Figure 11
Effects on flue-cured prices

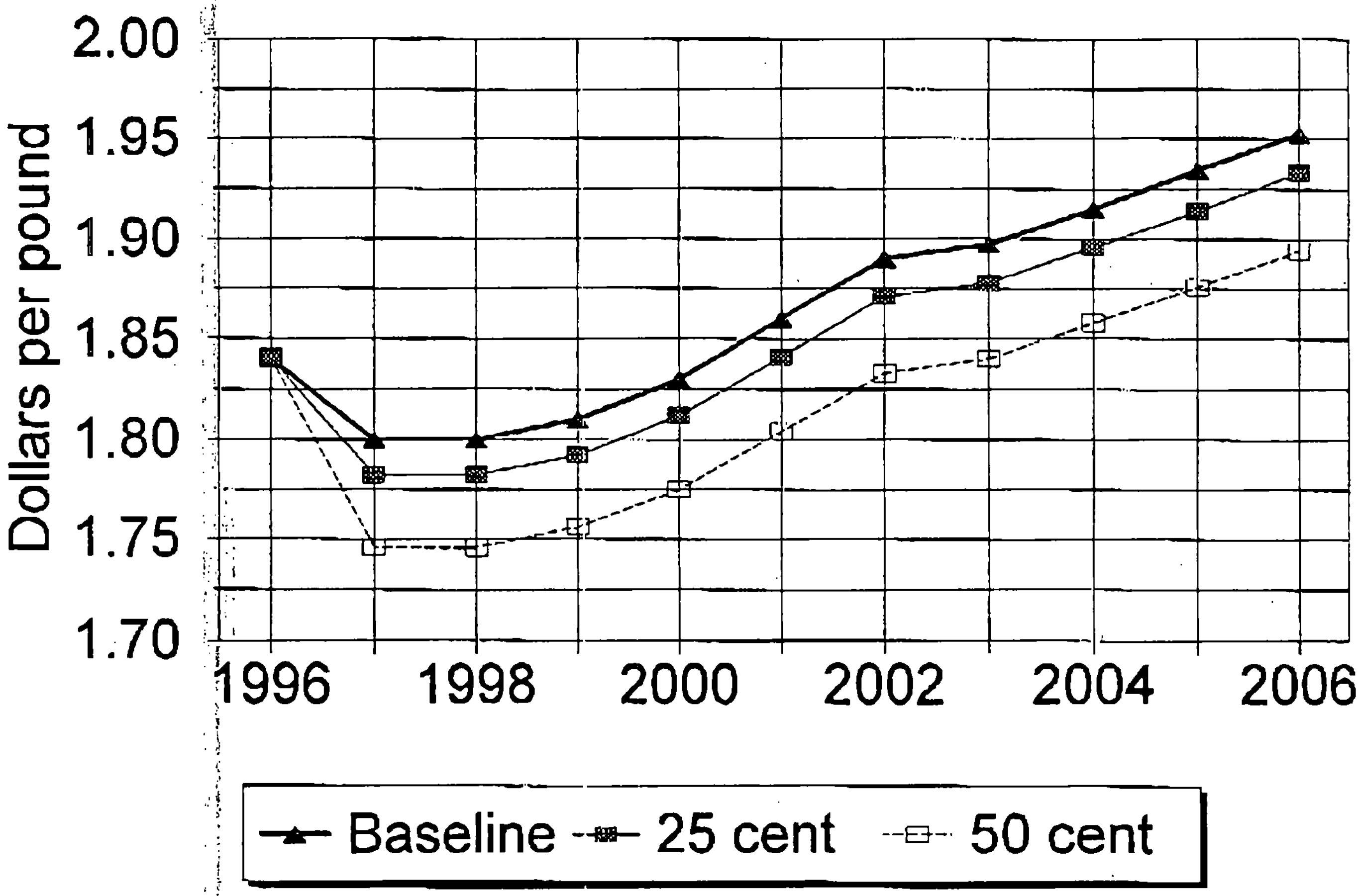
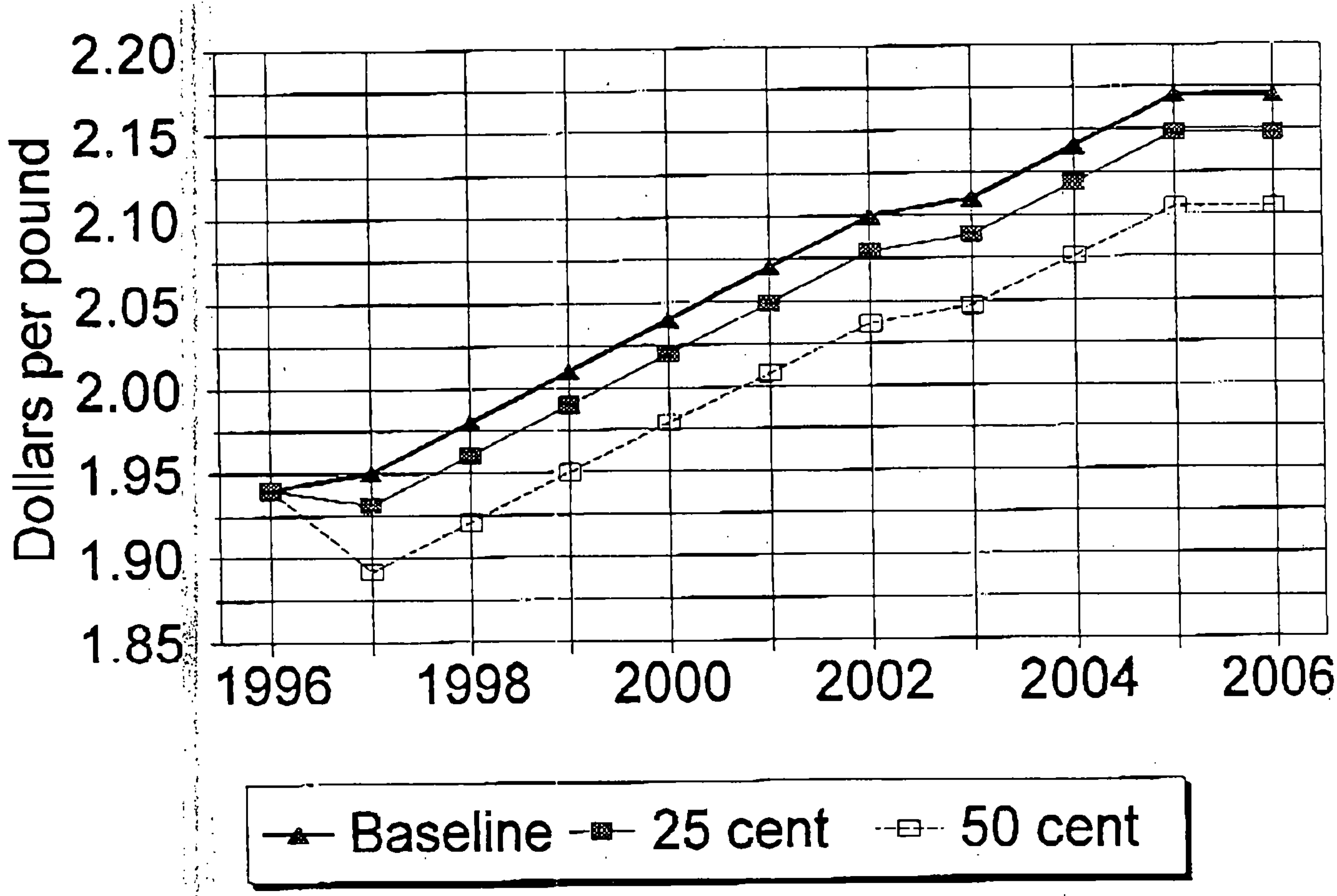


Figure 12

Effects on burley prices



Facrney

The Tobacco Program—A Summary and Update

by

Tom Capehart

Abstract: Most tobacco production in the United States has been under a price support-production control program since the early 1930's. A number of changes have been made in the program, especially during the last 15 years. Changes in the program from the early 1930's are summarized and more recent changes evaluated in this article.

Keywords: Tobacco, tobacco program, price support.

1930 to 1981

The Federal Government has operated programs to support and stabilize tobacco prices since the early 1930's. As a result, risks to growers from seasonal and cyclical price changes have been lessened in the face of weather, production, and use variations.

The Agricultural Adjustment Act of 1933 designated tobacco as a basic (storable) commodity, and cash payments were made to tobacco growers who restricted production (1933-35). After the 1933 legislation was declared unconstitutional, substitute legislation authorized payments for carrying out soil conservation practices (1936-37).

The Agricultural Act of 1938 authorized marketing quotas, with a penalty for growers exceeding them. With two-thirds or more of tobacco growers voting approval of marketing quotas for their kind of tobacco, growers received price support up to 75 percent of parity. Parity price calculations used 1910-14 as the base period for most commodities, but August 1919-July 1929 was designated for tobacco.

Despite many legislative changes since 1938, the authority to provide an adequate and balanced flow of tobacco through the marketing quota continues. The program is available for all kinds of tobacco except shade-grown wrapper and Perique. Excluding the 1939 crops, marketing quotas have been approved and in effect since 1938 for each crop of flue-cured, burley, and dark tobacco. Cigar binder and Ohio filler crops first came under quotas in 1951. Price supports have never applied to Pennsylvania filler and last applied to the Maryland crop in 1965 and the Connecticut-Massachusetts binder crop in 1983.

In October 1942, Congress raised the support level to 90 percent of parity, which continued through 1948. The Agricultural Act of 1949 continued the 90 percent parity level and has been the authority for tobacco price support since 1950.

Because of sharply increasing price supports, an amendment to the 1949 Act set crop support prices for 1960 at the previous year's level. The amendment also provided for subsequent price support changes to be based on the average parity index for the 3 previous calendar years compared with 1959 indexes.

Under the loan program, a support price (loan rate) is established for each grade of tobacco. If the buyers are not willing to bid above the Government loan rate for any lot of tobacco, an eligible grower may receive the lot's designated loan rate less any overhead deduction to cover the loan association's administrative costs. The tobacco is then taken by a cooperative association. Under an agreement with the Commodity Credit Corporation (CCC), the association arranges for receiving, redrying, packing, storing, and eventually selling the tobacco under loan.

Grade loan rates are based on recent trends in market prices, loan holdings, and the shares of particular grades received under loan. The weighted average of various loan rates must equal the overall support level for each kind of tobacco.

Lease and transfer of flue-cured tobacco was permitted from 1962 to 1986 (leasing was discontinued in 1987, but reinstated only for natural disasters beginning in 1988). Acreage-poundage quotas for flue-cured tobacco were implemented in 1965. Lease and transfer of quotas and poundage quotas became effective for burley in 1971. Producers of flue-cured and burley were allowed to sell an amount up to 110 percent of their quota without penalty (changed to 103 percent in 1986), with marketings the following year to be reduced by the amount of any overmarketings.

An administrative rule in 1974 provided relief at congested warehouses early in the marketing season by requiring each flue-cured producer, as a condition of eligibility for price support, to designate in advance the warehouse desired for selling. The warehouse had to be within 100 miles of the county seat where the farm was located.

1982 to 1985

Three laws were enacted in 1982 and 1983 that substantially changed the program. Their adoption was impelled by a number of pressing concerns. Health groups and some members of Congress were concerned that the U.S. Treasury made outlays on a commodity statistically associated with various illnesses. Another concern among some growers and others was that many of the owners of tobacco quotas did not grow tobacco. Still another concern was that price supports were so high that U.S. tobacco was losing its competitiveness in world markets.

The first law was termed the "No-Net-Cost Tobacco Program Act of 1982." The law, mandated by the 1981 Agriculture and Food Act, required that to be eligible for price support, producers of all kinds of tobacco, beginning with the 1982 crop, had to contribute to a fund or pay assessments to an account established by the cooperative association that makes Federal support loans available to producers. The funds are collected to cover potential losses in operating the price support program.

The no-net-cost law was the first to authorize owners of flue-cured allotments and quotas to sell these rights separately from the farms to which the allotments were attached. The allotments and quotas had to be sold to actual active producers for use on other farms in the same county. The legislation also required corporations, utilities, educational and religious institutions, and other entities owning tobacco allotments, but not significantly involved in farming, to sell their allotments or forfeit them.

The second law froze 1983 tobacco supports at their 1982 levels. The law also permitted the Secretary of Agriculture to reduce burley quotas as much as 10 percent in any year, if necessary, to control overproduction; previously, the maximum reduction permitted was 5 percent.

The third law made further changes in the tobacco program, as follows:

- Flue-cured supports for 1984 were again frozen at the 1982 level. In 1984, the support price for burley and other types was set so as not to narrow the normal price support differential between them and flue-cured. Procedures were established for calculating supports for each kind of tobacco in the future.
- The lease and transfer of flue-cured tobacco quota was abolished beginning in 1987.
- Imported tobacco, except for Oriental and cigar tobacco, must be inspected for grade and quality to the extent feasible. An amendment to the Food Security Act of 1985 required that imported tobacco be tested for pesticide residues similar to testing required for domestically grown leaf.
- Beginning in 1986, the law required forfeiture of any flue-cured quotas assigned to a farm on which tobacco had not been planted (or considered planted) during at least 2 of the 3 previous years.
- The last permitted announcement date for flue-cured tobacco quota was changed from December 1 to December 15.

1986 to 1987

Although three significant pieces of legislation were enacted in 1982 and 1983, major problems still existed in the tobacco program. These problems were addressed by the Consolidated Omnibus Budget Reconciliation Act of 1985. The Act, enacted in April 1986, affected the tobacco control programs as follows:

- Beginning in 1987, after being lowered in 1985 for burley and 1986 for flue-cured, the annual flue-cured and burley price support was the level for the preceding year adjusted by changes in the 5-year moving average of prices (two-thirds weight) and in the cost of production index (one-third weight). Costs include general variable costs, but exclude costs of land, quota, risk, overhead, management, marketing contributions or assessments, and other costs not directly related to tobacco production. The Secretary can set the price support between 65 and 100 percent of the calculated adjusted change from the previous year. The procedure for setting price supports for any kind of tobacco other than flue-cured and burley was unchanged.
- Flue-cured and burley quotas are now based on 1) intended purchases by cigarette manufacturers, 2) average annual exports for the 3 preceding years, and 3) the amount of tobacco needed to attain a specified reserve stock level (15 percent of the effective quota or a minimum of 100 million pounds of flue-cured and 50 million pounds of burley). Quota reductions were limited from 1986 to 1993. (The limit was extended to 1996 in subsequent legislation.)
- USDA's discretion for setting flue-cured and burley quotas is limited to not more than 103 percent or less than 97 percent of the amount determined by manufacturers' needs and exports, and the reserve stock level.
- The amount of flue-cured and burley tobacco that can be marketed without penalty was reduced from 110 to 103 percent of the farm marketing quota.
- The latest announcement date for marketing quotas for any kind of tobacco, other than flue-cured and burley, w[as] changed from February 1 to March 1.
- Cigarette manufacturers are required to submit estimates to USDA of their flue-cured and burley purchases for th[e] upcoming marketing year 15 days before the quota announcements are due. Any manufacturer that fails to pur[-]chase at least 90 percent of the tobacco it said it would purchase is subject to penalties.
- Purchasers of flue-cured and burley tobacco pay the same amount to the associations as producers, to the extent practicable.
- Loan stocks of 1976-84 crops were sold at discount pric[es] over a 5-year period for burley and 8 years for flue-cur[ed]

The Agricultural Reconciliation Act of 1987 made further changes in the tobacco program. The most important change permitted limited lease and transfer of flue-cured tobacco quotas under disaster conditions. The law also reduced effective price support levels in 1988 and 1989.

1988 to 1994

The Drought Assistance Act of 1988 provided assistance to tobacco producers if their crop was lowered more than 35 percent by drought, hail, excessive moisture, or related conditions. The Disaster Assistance Act of 1989 provided payments if tobacco production was reduced more than 40 percent because of damaging weather or related conditions. For producers who obtained crop insurance in 1989 under the Federal Crop Insurance Act, disaster payments were available for losses exceeding 35 percent of expected production with average yields.

Three pieces of legislation affecting tobacco were enacted in November 1990. Under the Omnibus Budget Reconciliation Act of 1990 for 1991-95 crop years, tobacco growers and purchasers of tobacco under marketing quota will annually be assessed 1 percent of the national loan rate on all marketings (0.5 percent each for growers and purchasers). The assessment is targeted to reduce the budget deficit. The marketing assessment has been extended through 1998.

The Food, Agriculture, Conservation, and Trade Act of 1990 included the following provisions:

- The Act authorizes the Secretary of Agriculture to invest trust fund reserves from the imported-tobacco inspection account in insured, or fully collateralized, interest bearing accounts, or authorize the Secretary of the Treasury to invest these funds in U.S. Government debt instruments. Fees, charges, and interest earned from the investment of such funds is added to the applicable appropriation account and available without fiscal year limitation. Interest earned is used to offset imported tobacco inspection fees.

The Farm Poundage Quota Revisions Act of 1990 was designed to increase utilization of burley quota. Major features of the law are:

- The sales of burley tobacco quota within counties was permitted beginning with the 1991 crop year. The buyer must be an active burley grower and the purchase is annually limited to no more than 30 percent of the existing quota of the buyer's farm, or 20,000 pounds, whichever is greater. Sales of poundage quotas have been permitted for flue-cured tobacco since 1982.

- A farm that purchases quota is not permitted to sell any quota within 3 years of the last year of purchase. The total tobacco acreage permitted on a receiving farm cannot exceed 50 percent of the cropland in the farm.

- Quota holders are required to lease, or attempt to grow, their quota 2 out of 3 years or forfeit the quota. This replaces the 1- out of 5-year plan.

- Divisions of farm quota cannot be less than 1,000 pounds (except when the division is among family members or pursuant to probate proceedings).

- The amount that could be leased to a receiving farm was increased from 15,000 to 30,000 pounds, thereby permitting individual farms to lease in the larger amount.

- Lease and transfer across county lines was authorized in Tennessee. Tennessee burley producers approved such transfer in a Statewide referendum in January 1991.

In December 1991, legislation was enacted to correct technical errors and clarify various provisions of the 1990 Food, Agriculture, Conservation, and Trade Act. It contained a number of provisions, including the repeal of the Tobacco Seed and Plant Exportation Act. This repeal lifted constraints on U.S. export of tobacco seeds and plants. Another provision permits lease and transfer of burley quota across county lines in Virginia. However, growers did not approve State lease and transfer in a Statewide referendum. Finally, the Tobacco Adjustment Act of 1983 was amended to exempt reporting requirements for tobacco used in cigars, pipes, and chewing tobacco and snuff in retail packages.

In October 1992, an amendment to the Agricultural Adjustment Act of 1938 required that sale or lease of allotments between farms by producers of fire-cured, dark air-cured, and Virginia sun-cured tobacco be approved on an acre-for-acre basis. Previously, the law required a reduction in the allotment transferred when the normal yield for the farm getting the allotment exceeded by more than 10 percent the normal yield of the farm releasing the allotment.

The Omnibus Budget Reconciliation Act (OBRA) of 1993 (P.L. 103-66) contained a provision that required U.S. manufactured cigarettes to contain at least 75 percent domestically grown tobacco during each calendar year, whether for domestic consumption or export. Penalties were assessed manufacturers that exceeded the maximum allowed foreign content. The limit and penalties could be waived during natural disasters or because of low reserve stocks.

In addition to the minimum content requirement, the OBRA of 1993 legislation imposes budget-deficit and no-net-cost assessments on importers. The rate for the budget deficit assessment is the same as for purchasers of domestic leaf, and the rate for the no-net-cost assessment is equal to the combined rates of fees collected from producers and purchasers of U.S.-grown flue-cured and burley leaf. Also, fees for inspecting all imported tobacco will be comparable with fees and charges fixed and collected for services provided in connection with tobacco produced in the United States.

U.S. growers and purchasers of domestic leaf have paid special assessments equal to 1 percent of the average price support since 1991 to help reduce the Federal budget deficit. The new budget deficit assessment on importers applies to the 1994-98 crops and applies to all tobacco imported, including Oriental. Failure to remit the budget deficit fee will result in a penalty equal to 37.5 percent of the sum of the average price of flue-cured and burley tobacco for the immediately preceding year on the quantity of tobacco on which the failure occurs.

The no-net-cost assessments cover projected losses in operating the tobacco price-support program. U.S. flue-cured and burley growers have paid no-net-cost fees since 1982, while purchasers have paid fees on U.S.-grown tobacco since 1986. Beginning in 1994, no-net-cost assessments are being levied on importers of flue-cured and burley tobacco. Noncompliance by importers to no-net-cost assessments results in a penalty equal to the average price of the tobacco involved for the preceding year times the quantity of tobacco which the failure occurs.

The new act extended to 1996 a provision in previous law that limited the reduction in the national marketing quota for flue-cured and burley tobacco to no more than 10 percent of the amount of each quota in the preceding year. When determining the marketing quota for the 1995 and 1996 crop years, the Secretary of Agriculture can waive the 10 percent quota reduction limit if loan stocks exceed 150 percent of the reserve stock level.

1995 to Present

President Clinton proclaimed a tariff-rate quota (TRQ), effective September 13, 1995, for certain imported tobacco, primarily flue-cured and burley. The proclamation also eliminated duties on cigar wrapper, binder, filler, and Oriental tobacco. The TRQ replaced the domestic content rule (OBRA) of 1993, which was determined to be inconsistent with the General Agreement on Tariffs and Trade (GATT). GATT implementing legislation contained provisions ending the domestic content provisions once the President proclaimed a TRQ on certain types of tobaccos. The TRQ is the result of negotiations which conform to existing GATT requirements. Negotiations with supplier countries established a tariff-rate quota for imported flue-cured and burley tobacco as a GATT/WTO-consistent alternative.

The TRQ places limitations on the quantities imported for consumption. Because of superseding agreements, Canada, Mexico, and Israel are not included under the quantitative restrictions. Imports above quota levels are subject to a 350-percent ad valorem duty. However, most of the duty may be refunded if the same tobacco imported is used to manufacture cigarettes that are exported. Imports under nine harmonized tariff subheadings during the period September 13 to September 12 of any year are limited to the following quantities:

	Million pounds (declared weight)
Argentina[1]	26.5
Brazil	176.8
Chile	6.1
Guatemala[2]	19.6
EU-15	22.0
Malawi	26.5
Philippines	6.8
Thailand	15.4
Zimbabwe	26.5
Other	6.6
Total	332.6

Summary and Conclusions

Many changes have been made to the Federal tobacco price support production control program—especially during the last 15 years. Changes have been made to increase the U.S. competitive position in world markets and significantly lower potential taxpayer costs for operating the program. Even though taxpayer costs are relatively small, the association between use of tobacco products and various diseases has spawned the introduction in Congress of several bills to eliminate the price support program.

The implementation of the tariff-rate quota has brought the United States in line with the GATT/Uruguay Round accord. Imports have increased under the less restrictive TRQ and are expected to continue at higher levels than were under the domestic content rule. However, U.S. growers may benefit from increased exports of leaf, and cigarette companies will not have the incentive to move production offshore that existed under the domestic content rule.

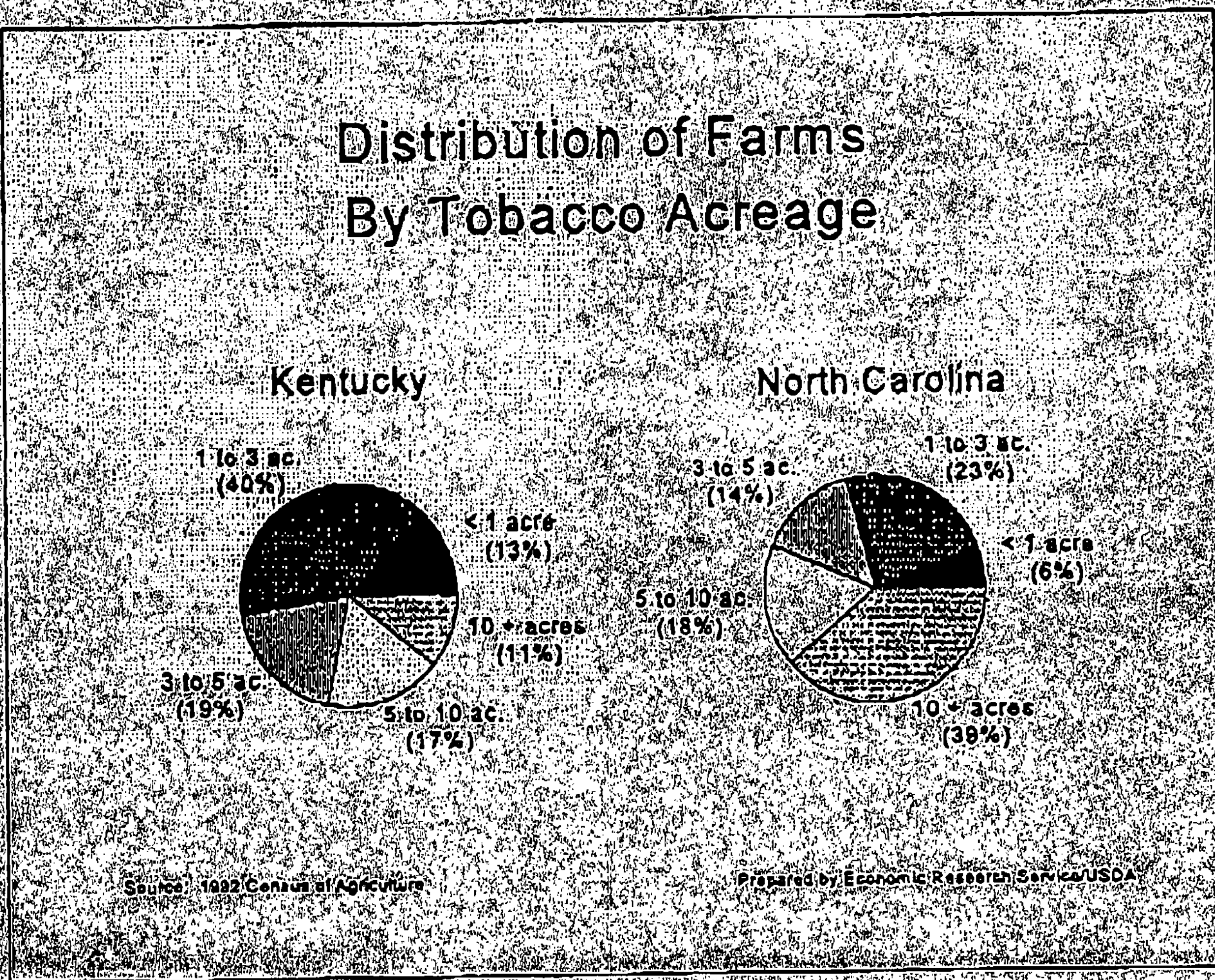
[1]Argentina's quota will decline to 24.3 million pounds on September 1 1998 and to 23.7 million pounds on September 13, 1999.

[2]Guatemala's quota will increase annually beginning September 13, 1996 19.6 million, 20.4 million, 21.2 million, and 22 million pounds by Septemb 13, 1999.

Financial Structure of Tobacco Farms In Kentucky and North Carolina

U.S. tobacco production is primarily concentrated in Kentucky/Tennessee (burley) and the southeastern States (flue-cured), although other States grow small amounts. The 1992 Census of Agriculture reported 59,373 farms in Kentucky (268,140 tobacco acres) and 17,625 farms in North Carolina (283,900 tobacco acres) growing of tobacco.

Tobacco acreage on Kentucky and North Carolina farms differs dramatically in size of plantings. Over 50 percent of farms with tobacco in Kentucky have less than 3 acres planted to the crop, compared with just under 30 percent in North Carolina. In Kentucky, the largest number of farms (40 percent) plant 1-3 acres, while in North Carolina the largest number of farms (39 percent) plant 10 or more acres to tobacco.



Importance of Tobacco

According to USDA's 1994 Farm Costs and Returns Survey (FCRS), tobacco accounts for an average 51.2 percent of total farm value of production on Kentucky farms growing tobacco. This compares with 57.3 percent in North Carolina. In Kentucky cattle were ranked second while in North Carolina hogs ranked second.

With farms defined as SIC tobacco farms (more than 50 percent of total farm value of production comes from tobacco), the importance of tobacco grows. SIC tobacco farms in Kentucky had an average 81.4 percent of total value of production from tobacco, compared with 80.0 percent in North Carolina. For Kentucky SIC tobacco farms, crops played only a minor role in the farms' commodity mix, but cattle were still important. In North Carolina, however, hogs were a minor enterprise but soybeans and corn remained important.

The FCRS showed an average farm size of 124 acres in Kentucky and 156 acres in North Carolina. Tobacco acreage accounted for an average 3.7 acres and 12.7 acres in the 2 States, respectively.

Value of selected farm products for farms with tobacco, 1994

	Kentucky		North Carolina	
	All farms with tobacco	SIC tobacco farms 1/	All farms with tobacco	SIC tobacco farms 1/
Number of farms	35,937	25,576	16,878	14,535
	Average dollars per farm			
Farm value of production	33,476	22,632	86,811	64,811
Crop value of production	21,951	19,929	64,096	64,105
Tobacco value of production	17,134	18,417	49,747	51,830
Corn value of production	2,406	427	2,243	1,594
Soybean value of production	1,461	575	7,561	7,781
Cotton value of production	0	0	1,692	501
Wheat value of production	257	110	1,315	1,019
Livestock value of production	11,525	2,703	22,715	706
Hogs value of production	1,858	68	16,678	99
Cattle value of production	4,622	2,484	1,310	607
Poultry value of production	20	0	4,727	0

Source: Farm Costs and Returns Survey, ERS/USDA.
1/ Tobacco accounts for over 50 percent of farm total value of agricultural production.

Farm Income

The 1994 income statements for Kentucky and North Carolina farms with tobacco show an average net cash income of $6,409 in Kentucky and $3,523 in North Carolina. For SIC tobacco farms, these levels rise to $18,783 and $16,383 for Kentucky and North Carolina, respectively. Regardless of the State or the level of specialization in tobacco, direct Government payments (deficiency payments) played a small role in determining the level of farm income. However, the Government tobacco programs are designed as an indirect control mechanism. Tobacco production is regulated by a Federal poundage quota price support program. Growers are guaranteed a minimum price through supports in exchange for their limiting production. Therefore, tobacco program support is reflected in tobacco receipts rather than in Government payments.

On the expense side, chemicals and hired labor accounted for the greatest expense. Equipment-related expenses for fuels and repairs also ranked high. For farms with livestock, feed expenses became important.

Income statements for farms with tobacco, 1994

	Kentucky		North Carolina	
	All farms with tobacco	SIC tobacco farms 1/	All farms with tobacco	SIC tobacco farms 1/
	Average dollars per farm			
Gross cash income	25,668	59,011	16,551	54,412
Crop sales	14,168	53,434	13,150	52,244
Livestock sales	10,165	1,663	2,437	706
Government payments	172	526	70	292
Other farm-related income	1,163	3,389	894	1,170
Less: Cash expenses	19,259	40,229	13,029	38,030
Variable	15,093	32,110	9,964	31,049
Livestock purchases	249	149	60	34
Feed	3,392	223	1,198	164
Other livestock expenses	394	33	272	26
Seed and plants	698	1,693	520	1,514
Fertilizer and chemicals	3,177	9,131	2,498	8,938
Labor	2,347	7,916	2,108	7,424
Fuels and oils	1,032	5,364	685	5,512
Repairs and maintenance	1,903	3,833	1,323	3,851
Machine-hire and custom work	419	859	159	927
Utilities	635	1,656	557	1,507
Other variable expenses	847	1,254	584	1,152
Fixed	4,165	8,118	3,064	6,981
Real estate, property taxes	505	817	337	789
Interest	1,856	1,914	1,335	1,372
Insurance premiums	993	2,081	840	2,015
Rent and lease payments	811	3,306	553	2,805
Equals: Net cash farm income	6,409	18,783	3,523	16,383
Less:				
Depreciation	2,412	3,128	1,359	2,953
Labor, non-cash benefits	125	199	128	184
Plus:				
Value of inventory change	-574	3,644	-236	4,016
Nonmoney income	4,282	4,563	4,255	4,375
Equals: Net farm income	7,580	25,463	6,054	21,637

Source: Farm Costs and Returns Survey, ERS/USDA.
1/ Tobacco accounts for over 50 percent of farm total value of agricultural production

Tobacco Costs of Production

Estimates of the costs of producing the 1994 tobacco crop are available at the national level only. These estimates show average per-planted-acre variable cash costs of $2,446.04 for burley and $1,884.68 for flue-cured. While fuel and curing expenses are much higher for flue-cured tobacco, burley's high post-harvest labor costs are more than offsetting. Net returns over variable cash costs averaged $1,847.86 per acre for burley tobacco and $2,205.12 for flue-cured tobacco. When all costs are included, net returns averaged negative $468.89 for burley and positive $415.42 for flue-cured.

negative?

U.S. costs of production for tobacco, 1994

	Burley		Flue-cured
	Dollars per acre		
Cash receipts	4,293.90		4,089.80
Variable Costs:			
Labor	1,409.06		705.17
Noncash benefits	15.31		23.79
Fertilizer and lime	243.89		296.27
Plant bed materials	76.28		45.49
Chemicals	92.78		212.80
Custom operations	10.86		7.81
Fuel and lubrication	101.63		55.26
Curing and heating fuel	7.19		274.97
Repairs	103.62	2446	140.33
Marketing (burley) & warehousing (flue-cured)	225.43		108.38
No-net-cost & marketing assessment	105.30	808	72.60
Inspection and grading fee	16.38		16.94
Interest	17.08	425	21.13
Other	21.23		3.74
Total, variable costs	2,446.04	1384	1,884.68
Machinery and barn ownership costs:			
Capital replacement	273.31	4753	289.72
Return to nonland capital	109.81	4293	98.78
Taxes and insurance	125.06		134.22
Total ownership costs	508.18	3379	522.72
Other Costs:			
General farm overhead	425.10	1383	289.72
Land and quota charge	1,383.47	1762	977.26
Total excluding land and quota	3,379.32	1374 4293	2,697.12
Returns:		4773	
Receipts less variable cash costs	1,847.86	46	2,205.12
Receipts less total costs	-468.89		415.42
Yield (lbs/acre)	2,108		2,420

Costs and Returns for Selected Vegetables and Field Crops

Tobacco growers are currently growing a mix of other field and specialty crops such as corn, soybeans, cotton, and wheat. Between 1 and 2 percent of FCRS farms with tobacco reported harvesting vegetables. Data from North Carolina are available that allow comparisons among costs and returns for major vegetable crops. Kentucky data were not available.

Except for tomatoes, other vegetable crops are more likely to be grown in flue-cured tobacco areas than in burley areas. Returns vary widely from year to year, depending on growing conditions and market conditions in a specific season.

The gross returns are based on yields and prices reported by NASS for 1994. Cash variable costs are based on enterprise budget estimates developed at the North Carolina State University and have been adjusted to represent average production practices for 1994. The net returns represent earnings to land, labor, capital, machinery, overhead, and management.

Although some tobacco producers could produce vegetables on tobacco acreage, the majority of any displaced tobacco land would likely go into field crops. The demand for vegetables is relatively inelastic, meaning that even small increases in the quantity results in relatively large price declines. Because the vegetable acreage is so small relative to tobacco, a small percentage shift of tobacco land would represent a substantial increase in vegetable acreage. This would lower prices and reduce vegetable returns.

In contrast, tobacco acreage represents a relative small percentage of field crop acreage. Consequently, a relative large shift could occur from tobacco to field crops without having a noticeable impact on either field crop prices or returns.

Estimated average costs and returns for selected vegetable and field crops in North Carolina, 1994

Crop	Gross revenue[1]	Cash variable expenses[2]	Net above cash variable expenses
	Dollars per acre		
Sweet potatoes	1,627.50	1,118.92	508.58
Cucumbers, Processing	992.00	1,041.62	95.63
Cucumbers, Fresh market	440.00	466.61	-26.61
Bell peppers, Fresh market	717.50	864.81	-62.56
Snap beans, Fresh market	983.50	600.06	383.44
Watermelon	675.00	485.86	190.63
Cabbage, Fresh market	1,900.00	1,016.36	883.64
Tomatoes, Fresh market	4,332.00	3,735.50	596.50
Corn (Southeast region)	278.20	157.86	120.34
Soybeans (Southeast region)	170.91	95.10	75.81
Cotton (Southeast region)	623.60	291.70	331.90
Flue-cured tobacco	4,089.80	1,884.68	2,205.12

[1] Average price times average yield per acre. Source: USDA, NASS.

[2] Vegetable expenses are based on Extension enterprise budgets from North Carolina State University. Budgets modified to represent average production practices for 1994. Field crop expenses are from USDA's costs-of-production accounts.

ANALYSIS OF S. 1415 - UNIVERSAL TOBACCO SETTLEMENT ACT

A bill (S.1415) entitled "Universal Tobacco Settlement Act" was introduced on November 7, 1997 "to reform and restructure the processes by which tobacco products are manufactured, marketed, and distributed; to prevent the use of tobacco products by minors: to redress the adverse health effects of tobacco uses; and for other purposes." Although not specified in the bill, it has been estimated that the equivalent of a 62 cent per pack of 20 cigarettes increase in Federal excise taxes would be needed to cover payments agreed to in the June 20, 1997, proposed Tobacco Settlement.

In addition to the hike in cigarette prices, S.1415 would place additional prohibitions on advertising, would require stronger warning labels and would ban smoking in most public places. Although most of the impact on consumption would result from higher cigarette retail prices, these additional measures could also be a factor in reduced cigarette consumption.

An increase in cigarette prices of 62 cents per pack over about 8 years would cause consumption to decline 8 to 12 percent, assuming a price elasticity of -.25 to -.4. U.S. consumption would decline by about 50 billion cigarettes solely because of the settlement costs. A decline of this magnitude would drop both flue-cured and burley quotas by about 50 million pounds below baseline levels annually by 2006. Lost income to flue-cured and burley producers would total around $180 million annually. In addition, quota owners would lose about $40 million, warehouse operators might lose $8 million and other input suppliers and hired farm workers could lose $50 million or more in income annually.

The original provisions of S. 1415 incorporated the farm component of what is commonly referred to as the "Ford Bill". Under this provision, the tobacco price support-production control program would remain intact. Price supports, quota levels, and assessments would be calculated the same as they are now. However, beginning in 1999, compensation would be made to eligible quota owners, quota lessees, and quota tenants for lost tobacco quota resulting from a decline in demand for domestically produced tobacco.

Annual payments for lost quota would be $4.00 per pound times the amount by which quota falls below the 1994-1996 base quota average. Quota lessee and quota tenant payments are calculated by formula to equal about one-half the amount paid the quota owner.

In addition to funds earmarked specifically for tobacco farmers, the Ford Bill would create the "Tobacco Community Revitalization Trust Fund" for tobacco producers and growing communities for the purpose of adjusting to the impact of the legislation. The proposal would earmark $2.1 billion per year for the Fund for years 1 through 10; $500 million per year for years 10 through 25; and amounts sufficient to cover tobacco program costs, as calculated annually by the USDA for years 26 and after.

The USDA would administer the Fund, which would be used for payments for lost tobacco quota and other costs. Payments for lost tobacco quota cannot exceed $1.6 billion in any calendar year. By 2001, quotas would decline to the point that the $1.6 billion cap would become effective. By 2009, cumulative payments could total more than $15 billion.

Based on what we have been able to determine, there is still a lack of agreement on how the farm component of the Tobacco Settlement will be structured. However, the tobacco farm leadership appears to be nearing a compromise on parts of the Ford and Robb Bills. The problems in flue-cured tobacco, our largest quota kind of tobacco, seem to be in two main areas: 1) whether there will be price support reductions for flue-cured tobacco - - there appears to be strong resistance to this among some groups and individuals, including Senator Helms, and 2) finding an agreeable procedure for getting flue-cured tobacco quota transferred to actual producers. We also understand that the burley tobacco leadership will basically push for the "Ford Bill".

Based on a conversation with personnel at the Flue-Cured Tobacco Cooperative Stabilization Corporation on March 12, they, along with the burley tobacco leadership, plan to meet with Senator Ford's staff on March 16 to review their recommendations for the farm component of the Tobacco Settlement. If recommendations are delivered to Senator Ford's office on March 16, it may well be March 19-20 before recommendations are converted to bill language.

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The Tobacco Program—A Summary and Update

by

Tom Capehart

Abstract: Most tobacco production in the United States has been under a price support-production control program since the early 1930's. A number of changes have been made in the program, especially during the last 15 years. Changes in the program from the early 1930's are summarized and more recent changes evaluated in this article.

Keywords: Tobacco, tobacco program, price support.

1930 to 1981

The Federal Government has operated programs to support and stabilize tobacco prices since the early 1930's. As a result, risks to growers from seasonal and cyclical price changes have been lessened in the face of weather, production, and use variations.

The Agricultural Adjustment Act of 1933 designated tobacco as a basic (storable) commodity, and cash payments were made to tobacco growers who restricted production (1933-35). After the 1933 legislation was declared unconstitutional, substitute legislation authorized payments for carrying out soil conservation practices (1936-37).

The Agricultural Act of 1938 authorized marketing quotas, with a penalty for growers exceeding them. With two-thirds or more of tobacco growers voting approval of marketing quotas for their kind of tobacco, growers received price support up to 75 percent of parity. Parity price calculations used 1910-14 as the base period for most commodities, but August 1919-July 1929 was designated for tobacco.

Despite many legislative changes since 1938, the authority to provide an adequate and balanced flow of tobacco through the marketing quota continues. The program is available for all kinds of tobacco except shade-grown wrapper and Perique. Excluding the 1939 crops, marketing quotas have been approved and in effect since 1938 for each crop of flue-cured, burley, and dark tobacco. Cigar binder and Ohio filler crops first came under quotas in 1951. Price supports have never applied to Pennsylvania filler and last applied to the Maryland crop in 1965 and the Connecticut-Massachusetts binder crop in 1983.

In October 1942, Congress raised the support level to 90 percent of parity, which continued through 1948. The Agricultural Act of 1949 continued the 90 percent parity level and has been the authority for tobacco price support since 1950.

Because of sharply increasing price supports, an amendment to the 1949 Act set crop support prices for 1960 at the previous year's level. The amendment also provided for subsequent price support changes to be based on the average parity index for the 3 previous calendar years compared with 1959 indexes.

Under the loan program, a support price (loan rate) is established for each grade of tobacco. If the buyers are not willing to bid above the Government loan rate for any lot of tobacco, an eligible grower may receive the lot's designated loan rate less any overhead deduction to cover the loan association's administrative costs. The tobacco is then taken by a cooperative association. Under an agreement with the Commodity Credit Corporation (CCC), the association arranges for receiving, redrying, packing, storing, and eventually selling the tobacco under loan.

Grade loan rates are based on recent trends in market prices, loan holdings, and the shares of particular grades received under loan. The weighted average of various loan rates must equal the overall support level for each kind of tobacco.

Lease and transfer of flue-cured tobacco was permitted from 1962 to 1986 (leasing was discontinued in 1987, but reinstated only for natural disasters beginning in 1988). Acreage-poundage quotas for flue-cured tobacco were implemented in 1965. Lease and transfer of quotas and poundage quotas became effective for burley in 1971. Producers of flue-cured and burley were allowed to sell an amount up to 110 percent of their quota without penalty (changed to 103 percent in 1986), with marketings the following year to be reduced by the amount of any overmarketings.

An administrative rule in 1974 provided relief at congested warehouses early in the marketing season by requiring each flue-cured producer, as a condition of eligibility for price support, to designate in advance the warehouse desired for selling. The warehouse had to be within 100 miles of the county seat where the farm was located.

1982 to 1985

Three laws were enacted in 1982 and 1983 that substantially changed the program. Their adoption was impelled by a number of pressing concerns. Health groups and some members of Congress were concerned that the U.S. Treasury made outlays on a commodity statistically associated with various illnesses. Another concern among some growers and others was that many of the owners of tobacco quotas did not grow tobacco. Still another concern was that price supports were so high that U.S. tobacco was losing its competitiveness in world markets.

The first law was termed the "No-Net-Cost Tobacco Program Act of 1982." The law, mandated by the 1981 Agriculture and Food Act, required that to be eligible for price support, producers of all kinds of tobacco, beginning with the 1982 crop, had to contribute to a fund or pay assessments to an account established by the cooperative association that makes Federal support loans available to producers. The funds are collected to cover potential losses in operating the price support program.

The no-net-cost law was the first to authorize owners of flue-cured allotments and quotas to sell these rights separately from the farms to which the allotments were attached. The allotments and quotas had to be sold to actual active producers for use on other farms in the same county. The legislation also required corporations, utilities, educational and religious institutions, and other entities owning tobacco allotments, but not significantly involved in farming, to sell their allotments or forfeit them.

The second law froze 1983 tobacco supports at their 1982 levels. The law also permitted the Secretary of Agriculture to reduce burley quotas as much as 10 percent in any year, if necessary, to control overproduction; previously, the maximum reduction permitted was 5 percent.

The third law made further changes in the tobacco program, as follows:

- Flue-cured supports for 1984 were again frozen at the 1982 level. In 1984, the support price for burley and other types was set so as not to narrow the normal price support differential between them and flue-cured. Procedures were established for calculating supports for each kind of tobacco in the future.
- The lease and transfer of flue-cured tobacco quota was abolished beginning in 1987.
- Imported tobacco, except for Oriental and cigar tobacco, must be inspected for grade and quality to the extent feasible. An amendment to the Food Security Act of 1985 required that imported tobacco be tested for pesticide residues similar to testing required for domestically grown leaf.
- Beginning in 1986, the law required forfeiture of any flue-cured quotas assigned to a farm on which tobacco had not been planted (or considered planted) during at least 2 of the 3 previous years.
- The last permitted announcement date for flue-cured tobacco quota was changed from December 1 to December 15.

1986 to 1987

Although three significant pieces of legislation were enacted in 1982 and 1983, major problems still existed in the tobacco program. These problems were addressed by the Consolidated Omnibus Budget Reconciliation Act of 1985. The Act, enacted in April 1986, affected the tobacco control programs as follows:

- Beginning in 1987, after being lowered in 1985 for burley and 1986 for flue-cured, the annual flue-cured and burley price support was the level for the preceding year adjustec by changes in the 5-year moving average of prices (two-thirds weight) and in the cost of production index (one-third weight). Costs include general variable costs, but exclude costs of land, quota, risk, overhead, management marketing contributions or assessments, and other costs not directly related to tobacco production. The Secretary can set the price support between 65 and 100 percent of the calculated adjusted change from the previous year. The procedure for setting price supports for any kind of t bacco other than flue-cured and burley was unchanged.
- Flue-cured and burley quotas are now based on 1) intended purchases by cigarette manufacturers, 2) average annual exports for the 3 preceding years, and 3) the amount of tobacco needed to attain a specified reserve stock level (15 percent of the effective quota or a minimum of 100 million pounds of flue-cured and 50 million pounds of burley). Quota reductions were limited from 1986 to 1993. (The limit was extended to 1996 in subsequent legislation.)
- USDA's discretion for setting flue-cured and burley quo tas is limited to not more than 103 percent or less than 9 percent of the amount determined by manufacturers' needs and exports, and the reserve stock level.
- The amount of flue-cured and burley tobacco that can b marketed without penalty was reduced from 110 to 103 percent of the farm marketing quota.
- The latest announcement date for marketing quotas for any kind of tobacco, other than flue-cured and burley, w changed from February 1 to March 1.
- Cigarette manufacturers are required to submit estimate to USDA of their flue-cured and burley purchases for t upcoming marketing year 15 days before the quota announcements are due. Any manufacturer that fails to pu chase at least 90 percent of the tobacco it said it would purchase is subject to penalties.
- Purchasers of flue-cured and burley tobacco pay the same amount to the associations as producers, to the extent practicable.
- Loan stocks of 1976-84 crops were sold at discount pri over a 5-year period for burley and 8 years for flue-cur

The Agricultural Reconciliation Act of 1987 made further changes in the tobacco program. The most important change permitted limited lease and transfer of flue-cured tobacco quotas under disaster conditions. The law also reduced effective price support levels in 1988 and 1989.

1988 to 1994

The Drought Assistance Act of 1988 provided assistance to tobacco producers if their crop was lowered more than 35 percent by drought, hail, excessive moisture, or related conditions. The Disaster Assistance Act of 1989 provided payments if tobacco production was reduced more than 40 percent because of damaging weather or related conditions. For producers who obtained crop insurance in 1989 under the Federal Crop Insurance Act, disaster payments were available for losses exceeding 35 percent of expected production with average yields.

Three pieces of legislation affecting tobacco were enacted in November 1990. Under the Omnibus Budget Reconciliation Act of 1990 for 1991-95 crop years, tobacco growers and purchasers of tobacco under marketing quota will annually be assessed 1 percent of the national loan rate on all marketings (0.5 percent each for growers and purchasers). The assessment is targeted to reduce the budget deficit. The marketing assessment has been extended through 1998.

done

The Food, Agriculture, Conservation, and Trade Act of 1990 included the following provisions:

- The Act authorizes the Secretary of Agriculture to invest trust fund reserves from the imported-tobacco inspection account in insured, or fully collateralized, interest bearing accounts, or authorize the Secretary of the Treasury to invest these funds in U.S. Government debt instruments. Fees, charges, and interest earned from the investment of such funds is added to the applicable appropriation account and available without fiscal year limitation. Interest earned is used to offset imported tobacco inspection fees.

The Farm Poundage Quota Revisions Act of 1990 was designed to increase utilization of burley quota. Major features of the law are:

- The sales of burley tobacco quota within counties was permitted beginning with the 1991 crop year. The buyer must be an active burley grower and the purchase is annually limited to no more than 30 percent of the existing quota of the buyer's farm, or 20,000 pounds, whichever is greater. Sales of poundage quotas have been permitted for flue-cured tobacco since 1982.

- A farm that purchases quota is not permitted to sell any quota within 3 years of the last year of purchase. The total tobacco acreage permitted on a receiving farm cannot exceed 50 percent of the cropland in the farm.

- Quota holders are required to lease, or attempt to grow, their quota 2 out of 3 years or forfeit the quota. This replaces the 1- out of 5-year plan.

- Divisions of farm quota cannot be less than 1,000 pounds (except when the division is among family members or pursuant to probate proceedings).

- The amount that could be leased to a receiving farm was increased from 15,000 to 30,000 pounds, thereby permitting individual farms to lease in the larger amount.

- Lease and transfer across county lines was authorized in Tennessee. Tennessee burley producers approved such transfer in a Statewide referendum in January 1991.

In December 1991, legislation was enacted to correct technical errors and clarify various provisions of the 1990 Food, Agriculture, Conservation, and Trade Act. It contained a number of provisions, including the repeal of the Tobacco Seed and Plant Exportation Act. This repeal lifted constraints on U.S. export of tobacco seeds and plants. Another provision permits lease and transfer of burley quota across county lines in Virginia. However, growers did not approve State lease and transfer in a Statewide referendum. Finally, the Tobacco Adjustment Act of 1983 was amended to exempt reporting requirements for tobacco used in cigars, pipes, and chewing tobacco and snuff in retail packages.

In October 1992, an amendment to the Agricultural Adjustment Act of 1938 required that sale or lease of allotments between farms by producers of fire-cured, dark air-cured, and Virginia sun-cured tobacco be approved on an acre-for-acre basis. Previously, the law required a reduction in the allotment transferred when the normal yield for the farm getting the allotment exceeded by more than 10 percent the normal yield of the farm releasing the allotment.

The Omnibus Budget Reconciliation Act (OBRA) of 1993 (P.L. 103-66) contained a provision that required U.S. manufactured cigarettes to contain at least 75 percent domestically grown tobacco during each calendar year, whether for domestic consumption or export. Penalties were assessed manufacturers that exceeded the maximum allowed foreign content. The limit and penalties could be waived during natural disasters or because of low reserve stocks.

In addition to the minimum content requirement, the OBRA of 1993 legislation imposes budget-deficit and no-net-cost assessments on importers. The rate for the budget deficit assessment is the same as for purchasers of domestic leaf, and the rate for the no-net-cost assessment is equal to the combined rates of fees collected from producers and purchasers of U.S.-grown flue-cured and burley leaf. Also, fees for inspecting all imported tobacco will be comparable with fees and charges fixed and collected for services provided in connection with tobacco produced in the United States.

U.S. growers and purchasers of domestic leaf have paid special assessments equal to 1 percent of the average price support since 1991 to help reduce the Federal budget deficit. The new budget deficit assessment on importers applies to the 1994-98 crops and applies to all tobacco imported, including Oriental. Failure to remit the budget deficit fee will result in a penalty equal to 37.5 percent of the sum of the average price of flue-cured and burley tobacco for the immediately preceding year on the quantity of tobacco on which the failure occurs.

The no-net-cost assessments cover projected losses in operating the tobacco price-support program. U.S. flue-cured and burley growers have paid no-net-cost fees since 1982, while purchasers have paid fees on U.S.-grown tobacco since 1986. Beginning in 1994, no-net-cost assessments are being levied on importers of flue-cured and burley tobacco. Noncompliance by importers to no-net-cost assessments results in a penalty equal to the average price of the tobacco involved for the preceding year times the quantity of tobacco which the failure occurs.

The new act extended to 1996 a provision in previous law that limited the reduction in the national marketing quota for flue-cured and burley tobacco to no more than 10 percent of the amount of each quota in the preceding year. When determining the marketing quota for the 1995 and 1996 crop years, the Secretary of Agriculture can waive the 10 percent quota reduction limit if loan stocks exceed 150 percent of the reserve stock level.

1995 to Present

President Clinton proclaimed a tariff-rate quota (TRQ), effective September 13, 1995, for certain imported tobacco, primarily flue-cured and burley. The proclamation also eliminated duties on cigar wrapper, binder, filler, and Oriental tobacco. The TRQ replaced the domestic content rule (OBRA) of 1993, which was determined to be inconsistent with the General Agreement on Tariffs and Trade (GATT). GATT implementing legislation contained provisions ending the domestic content provisions once the President proclaimed a TRQ on certain types of tobaccos. The TRQ is the result of negotiations which conform to existing GATT requirements. Negotiations with supplier countries established a tariff-rate quota for imported flue-cured and burley tobacco as a GATT/WTO-consistent alternative.

The TRQ places limitations on the quantities imported for consumption. Because of superseding agreements, Canada, Mexico, and Israel are not included under the quantitative restrictions. Imports above quota levels are subject to a 350-percent ad valorem duty. However, most of the duty may be refunded if the same tobacco imported is used to manufacture cigarettes that are exported. Imports under nine harmonized tariff subheadings during the period September 13 to September 12 of any year are limited to the following quantities:

	Million pounds (declared weight)
Argentina[1]	26.5
Brazil	176.8
Chile	6.1
Guatemala[2]	19.6
EU-15	22.0
Malawi	26.5
Philippines	6.8
Thailand	15.4
Zimbabwe	26.5
Other	6.6
Total	332.6

Summary and Conclusions

Many changes have been made to the Federal tobacco price support production control program—especially during the last 15 years. Changes have been made to increase the U.S. competitive position in world markets and significantly lower potential taxpayer costs for operating the program. Even though taxpayer costs are relatively small, the association between use of tobacco products and various diseases has spawned the introduction in Congress of several bills to eliminate the price support program.

The implementation of the tariff-rate quota has brought the United States in line with the GATT/Uruguay Round accord. Imports have increased under the less restrictive TRQ and are expected to continue at higher levels than were under the domestic content rule. However, U.S. growers may benefit from increased exports of leaf, and cigarette companies will not have the incentive to move production offshore that existed under the domestic content rule.

[1]Argentina's quota will decline to 24.3 million pounds on September 1998 and to 23.7 million pounds on September 13, 1999.

[2]Guatemala's quota will increase annually beginning September 13, 19[illegible] 19.6 million, 20.4 million, 21.2 million, and 22 million pounds by September 13, 1999.