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While a tobacco buyout has been considered for years, support for it among producers has grown considerably as the program has sputtered. As Kelly Tiller of the Agricultural Policy Analysis Center at the University of Tennessee has observed, the very tobacco program that made tobacco a stable and profitable crop was also responsible for its swift decline. In addition to insulating U.S. producers from the vagaries of the global market, the program also greatly limited available responses to the rise of low-cost leaf available from overseas markets. The shift to contract production, coupled with the ongoing legal and financial woes facing the tobacco industry, has contributed to the essential breakdown of the quota system.

How the Buyout Works

The tobacco buyout provision of the Jobs Creation Act pays quota owners to choose to enter into a payment contract valued at $7 per pound of basic quota they owned in 2002. Tobacco growers can enter into a contract for $3 per pound of their 2002 effective quota if they were an active producer in the 2002, 2003, or 2004 marketing year. Growers active in all three years will receive the full $3 per pound buyout. Growers active in one or two of these years will receive payments of $1 per pound or $2 per pound, respectively. For kinds of tobacco with acreage-based quotas, the pound-equivalent is derived from the quota holder or grower's 2002 allotment and the three-year (2001-2003) county average yield for that kind of tobacco for quota holders and the three-year (2001-2003) farm average for growers.

Payments to quota holders and growers are to be evenly divided into 10 annual payments, beginning in 2005. Payments to quota owners are taxable as capital gains; for producers, they are treated as ordinary income. Payments can be paid directly to financial institutions, which allow growers and quota holders to "securitize" their buyout, accepting a lump sum or accelerated payment from a bank in exchange for the full 10 years of payments. These payments are funded entirely through payments made by tobacco manufacturers and importers, with each entity paying in according to their domestic market share. The total cost of the buyout is $10.1 billion over the life of the buyout, most of which is for direct payments to growers and quota holders. Table 1 illustrates the total and annual buyout payments by state for the top six tobacco producing states. A complete listing of tobacco buyout payments by state and type of tobacco is available online at *www.slcatlanta.org/tobacco.htm*.

Total and Annual Buyout Payments by State

State	Total Buyout Payments ($ millions)			Annual Buyout Payments ($ millions)		
	Quota Owner Payments	Grower Payments	Total Buyout Payments	Quota Owner Payments	Grower Payments	Total Buyout Payments
North Carolina	2,752	1,191	3,943	275	119	394
Kentucky	1,736	733	2,469	174	73	247
Tennessee	528	240	768	53	24	77
South Carolina	508	216	725	51	22	73
Virginia	458	208	667	46	21	67
Georgia	429	183	612	43	18	61

table 1

Source: Kelly Tiller and Will Snell, Tobacco Quota Buyout: Summary Information, University of Kentucky and University of Tennessee, October 11, 2004

Because the USDA maintains a pool of tobacco as a component of the program, the buyout provides for an incremental sell-off of existing pool stocks, with a $500 million allowance in the legislation to cover any losses the USDA may incur in the sale of these pool stocks. With the 2005 season, the federal tobacco program will end, and with it, the quantity and geographic restrictions on tobacco production. Beginning with the 2005 season, growers will be able to produce as much tobacco as they wish on any land they wish. Price supports and other components of the safety net also will disappear, as will the Phase II payments made by tobacco companies to growers.

Significantly absent from the buyout legislation is any regulation of tobacco by the Food and Drug Administration (FDA). FDA regulation had been a component of several buyout proposals over the years, and was debated with the current legislation, but was dropped during the negotiations of the Congressional Conference Committee.

Impact of the Buyout

The tobacco buyout is significant for Southern states for several reasons. Tobacco is a keystone agricultural crop in a limited part of the region, but where it is a dominant crop, it has a disproportionate economic impact, supporting smaller farms on land little suited to many other forms of production agriculture. For many of these farmers, the steady erosion of quota has been particularly difficult. It is predicted that most of these farmers—between one-half and three-quarters of all tobacco producers—will exit tobacco production some time over the next 10 years. Some of these will use their buyout funds to transition to other crops or livestock. For others, the tobacco buyout payments represent a bridge to retirement. A large number of tobacco farmers, like the farming population as a whole, are either at or are approaching an age when operating a farm is difficult.

Those farmers remaining in tobacco production will find themselves in unfamiliar territory. Without the familiar price support and production control mechanism of the federal program, prices undoubtedly will begin to fluctuate downward, although the scope of the price drop is difficult to gauge. These growers will almost certainly need to grow tobacco under contract, as indeed most already do. Because contracts represent an assurance of a market, in the absence of the federal program's protections, almost all farmers will likely choose to grow under contract rather than risk the entire up-front costs for the crop without a guaranteed market at the end of the season. Banks also will expect evidence of a contract as a condition for making a loan, as is the case with the poultry industry today.

The playing field for contract tobacco production likely will be altered. Heretofore, contract terms have been negotiated with growers against a backdrop of a minimum price set by the federal government. Going forward, tobacco contracts will reflect the world price for tobacco as well as the total global production. This will make it much more difficult for growers to pressure tobacco dealers on contract terms. Furthermore, tobacco dealers will be able to stipulate cultivation, varietal selection and handling more so than previously. On the other hand, as prices for U.S. tobacco drop, the quantity of domestic leaf manufacturers are likely to buy will increase, which will be good news for those producers remaining in the market with room to expand production.

Of course, with the lifting of the geographic restriction on production, tobacco manufacturers may choose to offer contracts to producers in new areas. However, such a move would involve significant capital investments for the new producers, as well as a steep learning curve for new growers on the peculiarities of the crop. These hurdles are not insurmountable, of course, and the advantages of locating production closer to points of export to markets in which tobacco consumption is increasing (such as Latin America and Asia) are likely to offer a leg up for some growers.

Over time, tobacco production will shift within the tobacco belt, and it is almost inevitable that it will shift to regions outside it as well. Georgia, Florida and Alabama will see some of this expansion as lower prices spur greater domestic leaf purchases and farmers with larger land holdings (who are mostly in these states) shift more land into tobacco production. Smaller farmers in the Appalachian region will be more likely to drop out of production entirely, particularly in face of competition from larger operations in surrounding states. Sunbelt states in the Southwest, particularly Arizona, Texas and New Mexico, as well as California, could all initiate large scale tobacco production, although the expansion may be limited by a combination of climate, costs, and the elasticity of the market to absorb large quantities of tobacco. The labor costs associated with tobacco, and the patterns of migrant labor that are long-established along the Eastern seaboard, also may impede the expansion of tobacco production to the West.

What's Ahead?

For tobacco as an American commodity, the buyout reflects the end of an era. With this era will go many of the smaller farms in the Appalachian region which have been supported for the past 70 years by the profits from this unique crop. Many of these farms are owned and operated by older individuals, for whom the buyout will provide a soft landing into retirement. Quota cuts in recent years have been particularly hard on these farmers, as their allotments shrank and the price of leasing quota rose. For this group, 10 years of buyout payments represents the cashing-out of the equity they have built up over a lifetime of farming.

As has already been noted, in addition to older producers choosing to leave production, the buyout provides an opportunity for farmers with smaller holdings to exit production and for those with more land to increase the size of their tobacco crop. The payments for larger producers will provide capital necessary for expansion as well as cushion the blow that lower prices will have on their farm profitability. Finally, tobacco will extend beyond its historic region, although the extent to which this happens depends in large part on tobacco dealers. With so much of the tobacco infrastructure—including receiving stations, manufacturing facilities, exporters and, of course, farmers—located in the South, it is highly unlikely that the region will see a mass exodus of the crop. A measured transition to a more geographically diverse production pattern, offering greater variety, economic opportunities and varied harvest and marketing patterns, seems likely.

In the near term, payments to tobacco farmers will mean an infusion of cash into many rural communities that have been hard hit economically over the past several years. North Carolina, Kentucky, Tennessee and South Carolina all stand to reap more than $500 million from the buyout, with the buyout pumping nearly $ 9.4 billion into the economies of states in the SLC region. This will have an enormous impact on the region, generating new economic activity and jobs in parts of the region where economic prosperity has recently been scarce. Using the IMPLAN input-output model, Kelly Tiller of the University of Tennessee projected that the total economic activity in the region generated from the buyout in its first year will be $801.1 million, creating nearly 8,000 new jobs. Over the life of the buyout, the total economic impact will be nearly $8 billion. It is worth noting that this impact is less than the total value of the buyout because growers lose an estimated $2.3 billion in Phase II payments (which are thus a liability in terms of this economic model), which offset the buyout payments to growers. An additional component of this impact will be on state and federal tax rolls. Buyout payments are taxable as either capital gains (for quota owners) or ordinary income (for quota growers). As the University of Tennessee analysis indicates, tax receipts should increase appreciably at both the state and federal level. Table 2 illustrates this for the states in the SLC.

The tobacco buyout, while historic and significant, is only part of the massive changes that have occurred in tobacco during the past decade. The rise in contracting shifts in production methods, the decline of the auction system, and the continued graying of tobacco farmers all signal a seismic shift in a crop that is intrinsically tied to the history of the United States and to the culture of much of the South. The quota buyout in one manner ensures that tobacco will continue to be a viable commodity for American farmers for years to come, even as it signals the end of a cultural period in America's agricultural history.

Economic Impact of the Tobacco Quota Buyout in the SLC

State	First Year Buyout ($ millions)					Total Over 10 Years ($ millions)			
	Total Buyout Payments	Total Economic Activity Impact	Employment Impact (jobs)	Federal Tax Impact	Total Tax Impact	Total Buyout Payments	Total Economic Activity Impact	Federal Tax Impact	Total Tax Impact
Alabama	0.5	0.4	4	0.1	0.1	5	4	1	1
Florida	12	11.6	127	1.7	2.3	120	116	17	23
Georgia	61.2	58	537	8.5	10.8	612	580	85	108
Kentucky	246.9	179.1	1818	26.8	33.9	2,469	1,791	268	339
Missouri	3.2	2.4	23	0.4	0.5	32	24	4	5
North Carolina	394.3	356.1	3441	51.8	65.1	3,943	3,561	518	651
South Carolina	72.5	61.6	634	8.5	11	725	616	85	110
Tennessee	76.7	71.4	704	9.9	12.5	767	714	99	125
Virginia	66.7	60.5	573	9.1	11.3	667	605	91	113
Total	934.0	801.1	7861	116.8	147.5	9,340	8,011	1,168	1,475

table 2

Source: Economic Impacts of the Tobacco Quota Buyout, University of Tennessee, November 2004

Phase II and the Buyout: Timing is Everything

In 1999, the four major tobacco companies agreed to make $5.15 billion in payments over 12 years as compensation for losses experienced by tobacco growers and quota holders due to decreases in demand as a result of the multistate tobacco settlement reached a year earlier. This "Phase II" settlement included a clause providing for reduction in the payments by the amount of any tax or assessment on the companies by the government for grower compensation.

The quota buyout essentially eliminates the Phase II payments, but there is disagreement over when they are to be eliminated. The tobacco industry maintains that they do not need to make these payments for 2004 because of the enactment of legislation assessing them for the costs of the buyout. Growers insist that the Phase II buyouts are not affected by the signing of the legislation but by the actual making of payments to the federal government, which will not occur until 2005. This is far from a minor semantic discussion. At stake is roughly $424 million in payments to growers for 2004. The case is currently in court in North Carolina.

This ***Regional Resource*** was prepared for the Agriculture and Rural Development Committee of the Southern Legislative Conference (SLC) by Jonathan Watts Hull, SLC Senior Policy Analyst.

The SLC is a non-partisan, non-profit organization serving Southern state legislators and their staffs. First organized in 1947, the SLC is a regional component of The Council of State Governments, a national organization which has represented state governments since 1933. The SLC is headquartered in Atlanta, Georgia.

[The Tobacco Buyout]

By Jonathan Watts Hull
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On October 22, 2004, the American Jobs Creation Act of 2004 was signed into law. The Act, which includes a range of corporate tax cuts, began as a repeal of an export tax break for U.S. corporations that had been deemed to be in violation of the rules of the World Trade Organization in 2003. The final Act became a vehicle for a range of business tax relief along with simplifying international tax law. Tucked away in the legislation is quite possibly the most historically significant part of the bill. Along with reducing the tax rate on corporations repatriating income from overseas operations, the Act contains a buyout for tobacco quota owners and growers.

A tobacco buyout has been an item of considerable discussion for years. Tobacco growers and their communities have waited as legislation has been presented and subsequently languished in Congress since 1998 after the completion of the Master Settlement Agreement. Outside tobacco communities, however, the issue seems of little relevance. In essence, the tobacco buyout provides quota holders and tobacco farmers with a payment in exchange for their tobacco allotment. In this manner, the quota system can be eliminated, while providing compensation to those who would stand to lose from the change. (For a basic overview of the tobacco program, please see the SLC Special Series Report *Tobacco in Transition*).

The concept of a buyout is not an effort to eliminate tobacco production in the United States, but to shift the U.S. market toward a more global model, with the price of tobacco allowed to rise and fall with global stocks. Currently, U.S. tobacco is marketed above the global price, with domestic leaf earning a premium due to scarcity and quality. During the past decade, tobacco quota amounts have been reduced dramatically, a result of the declining amount of U.S. leaf demanded by tobacco manufacturers. Competition from overseas producers and a decline in domestic tobacco consumption have compounded domestic producers' difficulties.

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