

The End of the Tobacco Transition Payment Program

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November 14, 2013

With the last Tobacco Transition Payment Program (TTPP), commonly referred to as the tobacco buyout, payment scheduled for January 2014 many in agriculture are speculating what the impact might be on rural economies and, in particular, tobacco production. With about \$9.6 billion in payments to tobacco quota owners and growers over 10 years, 2005-2014, the TTPP has large impacts on rural economies in tobacco growing states. As of 2012 \$1.74 billion had been paid out by USDA directly to tobacco growers and \$4.11 billion directly to former quota owners. In addition many quota owners and growers opted to sell their stream of payments to financial institutions offering a lump-sum in return (i.e. securitizing the payment stream). \$1.79 billion had been paid to the financial institutions that purchased streams of TTPP payments.

The TTPP ended the federal tobacco price support and quota program in 2004, deregulating U.S. tobacco production and providing compensation to quota owners and tobacco farmers over a 10 year period 2005-2014. Total U.S. tobacco production had been restricted under the federal program by poundage quotas and acreage allotments set annually by USDA and allocated based on historical production dating back to 1938. For each pound of quota owned quota owners received \$7 in 10 equal annual installments. Producers received \$7 for each pound of quota owned plus \$3 for each pound of quota grown during the last three years of the tobacco program, also in 10 equal annual installments. Most producers were also quota owners. (During the tobacco program many producers rented quota from non-growers, producing tobacco with both quota owned and quota rented.) Quota owners and producers were permitted to sell the stream of payments to a third party. The \$9.6 billion cost of the TTPP is paid by USDA who recoups all the cost through annual assessments on tobacco product manufacturers.

The TTPP payments have been a significant source of revenues flowing into state economies. Tables 1 and 2 give the 2005 TTPP payments by state for quota owners and producers. The first payments made in January of 2005 reflect the magnitude in terms of both value and number of people impacted since in January, 2005 financial institutions had not yet purchased any of the payments. Over 384 thousand payments were made to quota owners in 2005. Another 182,649 payments were sent to producers, but in most cases producers were also receiving a quota owner payment. Just prior to the buyout there were over 38,000 individual flue-cured tobacco quotas and over 240,000 individual burley tobacco quotas. (Many of these quotas were owned by more than one person which may be why the total number of payments in 2005 were so large.) Around 2/3 of the flue-cured quotas were owned by non-producers. In burley the portion owned by non-producers may have been even higher. In 2005 North Carolina, the largest tobacco producing state, tobacco producer and quota owner payments totaled \$392.4 million. For comparison the next largest payout was the Master Settlement Agreement (MSA) in which tobacco manufacturers paid the state of North Carolina \$148.7 million in 2005. In the second largest tobacco state, Kentucky, producer and quota owner payments were \$221.8 million in 2005. MSA payments to Kentucky in 2005 were \$112.3 million. Figure 1 shows the 2005-2012 TTPP payments and

their breakdown between quota owners, producers and financial institutions purchasing (securitizing) payment streams.

By 2012 about 1/3 of quota owner and producer payments had been securitized, referred to as “taking a lump sum for your payments.” To do this, financial institutions paid the quota owner or producer a lump sum in return for the remaining annual TTPP payments. The financial institutions paid a lump sum that was discounted considering current and future interest rates at the time. Most discount rates were very competitive since the stream of TTPP payments were considered very “safe” in terms of certainty of payment. In the early years of the payments, a lump sum equivalent to 83% of the sum of the remaining payments was not uncommon. This equates to roughly a 4% discount rate, which in 2005, was close to the rate on 10 year Treasury bills.

The largest portion of lump sums were completed in the fall of 2005, after the first TTPP payment had been received in early 2005 and before the second TTPP payment was received in January 2006. For example if a quota owner was scheduled to receive a TTPP payment of \$1,000 per year and this quota owner sold his remaining stream of payments in fall 2005 (\$9,000 in TTPP payments over 9 years, 2006-2014) then the quota owner would have received a lump sum of \$7,470 in late 2005 in addition to the \$1,000 TTPP payment received the previous January.

Receipts of lump sum payments from financial institutions in late 2005 by quota owners and producers in all tobacco states are estimated to have been about \$1.16 billion. TTPP payments in January 2005 to producers and quota owners were \$287 million and \$667 million, respectively. So over \$2.1 billion in lump sum and TTPP payments flowed into tobacco states in 2005 via producers and quota owners (Figure 2). Another large portion of payments were securitized in 2006 for the 2007-2014 payments. The portion securitized in subsequent years was much smaller (Figures 1 and 2).

Where did the payments come from? Quota owner and producer payments are a transfer from tobacco product manufacturers with much the same effect as a tax. Manufacturers may have absorbed some of the assessment from profits or reductions in costs. Most likely much of the assessment was passed to tobacco product consumers in the form of higher product prices. The 2005 TTPP payments equated to about \$0.05 per pack of cigarettes sold in 2005. Financial institutions from around the US provided lump sums to TTPP recipients much in the same form as loans in return for recipients’ remaining stream of payments.

What did quota owners and producers do with their lump sums and TTPP payments? Many quota owners that were not active producers were already retirees, often former tobacco farmers, who relied on the rent from quota for retirement income. Hopefully the prevalent use of the payments for this group was that the TTPP stream or a lump sum was put in savings and then drawn on as a continuing source for retirement income. Some quota owners were heirs of former tobacco farmers who still owned the family farm but did not grow tobacco. Some non-producers had purchased land with tobacco quota. For many in these latter groups the quota rent may not have been a critical component of their income, but the buyout offered an opportunity to get a guaranteed sum over 10 years or a lump

sum. How this group used the money for consumption, investment, or savings probably varies widely depending on how dependent they were on the quota rent during the tobacco program.

Among tobacco producers many were near retirement age. Most in this group used the TTPP payment stream or lump sum to retire immediately. The exodus of tobacco farmers after the buyout was large. The number of tobacco farmers declined from about 57 thousand in the 2002 Census of Agriculture to 16,234 in the 2007 census. Part of this decline can be attributed to the way tobacco producers were defined during the tobacco program. Non-producing quota owners were counted as tobacco farmers during the program years if they shared in the risk of growing the tobacco by sharing in the cost and revenue of growing the tobacco with a grower who used the non-producing quota owner's quota. The decline is also due in part to farmers who exited tobacco production to non-farm jobs. Some farmers were part-time farmers growing tobacco, particularly burley, who dropped tobacco from their farms. But a large share of exiting farmers is attributable to farmers retiring with the end of the program.

Producers that expected to remain active farmers used their TTPP payments or lump sums in a variety of ways. Many used the payments to reduce debt. Some used the funds to diversify or expand their operations in farm enterprises other than tobacco. Some used their funds to expand their tobacco operations. Were all these investments good ones? Undoubtedly mistakes were made. Alternative enterprises were sometimes not as lucrative as they appeared. Demand for U.S. tobacco declined more dramatically than most, including this economist, could imagine due to large increases in state and federal excise taxes and comprehensive smoking bans. Consequently consolidation in tobacco farming was greater than expected and the amount contracted for by buyers smaller than expected. There were tobacco farmers that tried to expand and produce in the unregulated era after the program who were either not competitive in terms of cost of production or who decided that the profits margins were not sufficient to keep them in tobacco production. Nine years after the buyout most of these producers have exited tobacco production.

How will the end of the TTPP payments affect tobacco production? Concerns have been raised that some farmers have been using the TTPP to subsidize tobacco production and that as soon as the payments end there will be a large exodus of tobacco producers. There are probably some farmers who have done this and will exit production after 2014. But since the TTPP was not tied to any requirement to produce tobacco the only reason tobacco farmers had for continuing production was if they thought it would be profitable. The decoupling of TTPP payments from tobacco production increased the probability that decisions to continue tobacco farming were based on expected profitability, not contingent on receipt of TTPP payments.

While there is little hard data to go on and this conclusion is based on anecdotal evidence and general behavior by businesses, the end of the TTPP is likely to have little effect on tobacco production. Other factors such as the emergence of e-cigarettes, increasing regulation of tobacco products, increases in excise taxes, competition from other tobacco producing countries, exchange rates, and whether or not robust demand from Asia for tobacco continues will be much more important in determining future U.S. tobacco production levels. There are many factors, some of them quite ominous, that will have potentially large impacts on U.S. tobacco production, but the end of the TTPP is not likely one of them.

Will the end of the TTPP be felt in rural communities in tobacco producing states? The answer is certainly yes. The TTPP brought unprecedented funds to a large number of citizens in rural tobacco producing communities. But even this situation should not be a crisis scenario. All involved in the tobacco buyout have known with certainty that the payments would end after 10 years. Again in every situation where funds are received there are some who spend irresponsibly and others who make honest mistakes in investment and consumption decisions. However most have likely consumed, invested, or saved the payments with the end in mind. All will bemoan the end of the payments, but the end should not be a surprise.

One final “fly in the ointment” has arisen as this article is written. The Office of Management and Budget decided that the final TTPP payment should be subject to sequestration and be reduced by up to 7.2%. This decision was completely unexpected by all involved since the TTPP payments are backed and completely funded from a trust fund of assessments on the tobacco industry (i.e. at no cost, not even administrative, to the government). All involved including the financial institutions buying payment streams viewed the TTPP payments with the certainty of Treasury Bills. While the end of the TTPP payments should not be disruptive because the end was expected, an unexpected reduction in the last TTPP payment is disruptive. A reduction of 7.2% would be over \$68 million dollars not flowing to quota owners, producers and financial institutions. Congressional offices involved in bringing resolution to this unexpected problem seemed confident that the reduction will be restored...stay tuned.

Table 1. 2005 TTPP Payments to Quota Owners by State

State	Number of Payments	Total for State of 2005 Payments	Total for State Implied Over 10 years	Average 2005 Payment	Total Average Payments Implied Over 10 Years
AL	71	\$ 347,306	\$ 3,473,064	\$ 4,892	\$ 48,916
FL	502	\$ 8,378,140	\$ 83,781,404	\$ 16,690	\$ 166,895
GA	5,876	\$ 42,854,888	\$ 428,548,883	\$ 7,293	\$ 72,932
IN	7,859	\$ 5,981,167	\$ 59,811,668	\$ 761	\$ 7,611
KA	26	\$ 24,144	\$ 241,437	\$ 929	\$ 9,286
KY	141,264	\$ 173,276,502	\$1,732,765,020	\$ 1,227	\$ 12,266
MN	28	\$ 26,755	\$ 267,554	\$ 956	\$ 9,556
MO	1,455	\$ 2,225,371	\$ 22,253,714	\$ 1,529	\$ 15,295
NC	94,678	\$ 274,253,512	\$2,742,535,117	\$ 2,897	\$ 28,967
OH	8,558	\$ 7,473,636	\$ 74,736,361	\$ 873	\$ 8,733
OK	1	\$ 713	\$ 7,133	\$ 713	\$ 7,133
SC	17,874	\$ 50,381,675	\$ 503,816,754	\$ 2,819	\$ 28,187
TN	74,355	\$ 50,472,183	\$ 504,721,826	\$ 679	\$ 6,788
VA	25,677	\$ 45,340,891	\$ 453,408,907	\$ 1,766	\$ 17,658
WV	2,944	\$ 1,385,493	\$ 13,854,925	\$ 471	\$ 4,706
WI	3,162	\$ 4,691,981	\$ 46,919,810	\$ 1,484	\$ 14,839
US	384,330	\$ 667,114,358	\$6,671,143,577	\$ 1,736	\$ 17,358

Source: USDA-Farm Service Agency

Table 2. 2005 TTPP Payments to Producers by State

State	Number of Payments	Total for State of 2005 Payments	Total for State Implied for 10 Payments	Average 2005 Payment per Recipient	Average Total per Recipient of 10 Payments
AL	24	\$ 148,956	\$ 1,489,561	\$ 6,207	\$ 62,065
FL	334	\$ 3,598,760	\$ 35,987,601	\$ 10,775	\$ 107,747
GA	3,688	\$ 18,291,371	\$ 182,913,706	\$ 4,960	\$ 49,597
IN	2,683	\$ 2,594,548	\$ 25,945,480	\$ 967	\$ 9,670
KA	19	\$ 10,548	\$ 105,481	\$ 555	\$ 5,552
KY	80,498	\$ 74,002,167	\$ 740,021,668	\$ 919	\$ 9,193
MO	901	\$ 952,103	\$ 9,521,033	\$ 1,057	\$ 10,567
NC	45,347	\$ 118,136,768	\$1,181,367,679	\$ 2,605	\$ 26,052
OH	4,365	\$ 3,068,833	\$ 30,688,331	\$ 703	\$ 7,031
OK	4	\$ 257	\$ 2,573	\$ 64	\$ 643
SC	7,368	\$ 21,653,935	\$ 216,539,352	\$ 2,939	\$ 29,389
TN	22,656	\$ 22,737,052	\$ 227,370,516	\$ 1,004	\$ 10,036
VA	12,496	\$ 19,819,039	\$ 198,190,386	\$ 1,586	\$ 15,860
WV	990	\$ 708,562	\$ 7,085,617	\$ 716	\$ 7,157
WI	1,276	\$ 1,282,308	\$ 12,823,081	\$ 1,005	\$ 10,049
US	182,649	\$ 287,005,206	\$2,870,052,064	\$ 1,571	\$ 15,713

Source: USDA-Farm Service Agency

Figure 1: Tobacco Transition Payment Program: Quota Owner Payments, Producer Payments, and Portions Securitized

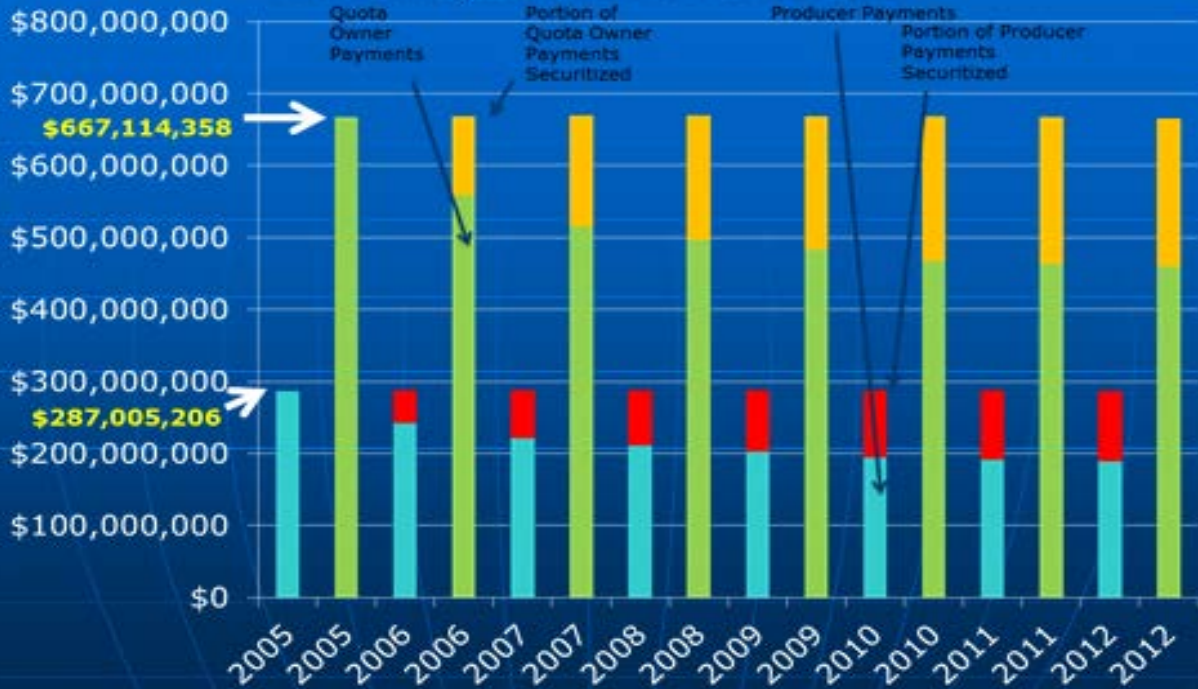


Figure 2. Total Funds to Producers and Quota Owners: TTPP Payments and Estimated Lump Sum Receipts

