

## Tobacco Policy

This section briefly discusses the most important government policies that are likely to affect the tobacco market (table 4). Most proposed measures are aimed at reducing smoking, either directly or indirectly. Tobacco policy proposals have been directed at each level of the tobacco industry: consumption, manufacturing, and farming. Restrictions on tobacco advertising and smoking in public places and excise taxes on tobacco products can reduce smoking and tobacco use directly. Other measures seek to compensate governments or other parties for the costs of smoking-related illnesses. The Federal tobacco farm program, by restricting the quantity of tobacco grown and raising its price, plays an important role in tobacco policy. The large number of individuals who benefit from the program indicates the program's importance in tobacco policy debate.

### Industry Settlement Payments

During the late 1990's, litigation against manufacturers brought by smokers and State governments seeking compensation for damages and health care costs due to smoking became an important factor influencing the tobacco industry. In 1997, tobacco manufacturers

agreed on a settlement with State attorneys general that called for payments of \$368 billion to settle claims against the industry for smokers' health costs. In exchange, the industry would have received protection from future civil suits, eliminating considerable uncertainty over future legal liabilities. Several bills were introduced in Congress to implement the settlement, but negotiations broke down in June 1998, and the 105th Congress did not pass comprehensive tobacco legislation.

Subsequently, in November 1998, tobacco manufacturers and State attorneys general agreed to a scaled-back settlement that would pay 46 States, the District of Columbia, and various territories \$206 billion over 25 years to compensate them for costs of treating smoking-related illnesses and fund antismoking programs. Four States had already reached individual settlements. The agreement called for manufacturers to pay \$1.5 billion over 10 years to support antismoking measures plus \$250 million to fund research into reducing youth smoking. Manufacturers also agreed to limitations on advertising, bans on cartoon characters in advertising and on "branded" merchandise, limits on sporting event sponsorship, and disbandment of tobacco trade organizations. Unlike the earlier settlement, this one did not require Congressional approval, since it did not

**Table 4—Tobacco policy instruments**

| Policy instrument                             | Description                                                                                                                                                        | Effect on tobacco market                                                                                                                                                                                            |
|-----------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Smoking restrictions                          | Prohibitions on smoking in workplaces, restaurants, and other places. Antismoking campaigns.                                                                       | Reduces demand for tobacco products.                                                                                                                                                                                |
| Excise taxes                                  | Tax assessments per unit of tobacco products. Federal taxes paid by manufacturers. State taxes paid by wholesalers.                                                | Manufacturers and wholesalers raise price of tobacco products to cover all or part of tax liabilities. Higher price passed on to consumers reduces demand for tobacco products.                                     |
| Settlement payments                           | Payments from manufacturers to State governments or other entities to settle legal claims.                                                                         | Manufacturers raise prices to cover all or part of settlement costs. Higher prices are passed on to consumers, reducing demand for tobacco products.                                                                |
| Food and Drug Administration (FDA) regulation | FDA could limit levels of tar and nicotine in cigarettes and issue labeling, recordkeeping, and manufacturing regulations if given authority to do so by Congress. | May force manufacturers to eliminate some products. Costs of compliance may be passed on to consumers. Could reduce overall demand and shift the mix of leaf types toward lower tar and nicotine content.           |
| Elimination of tobacco program                | Price supports and marketing quotas eliminated.                                                                                                                    | Lower leaf prices, but removal of restrictions on planting and marketing, frees up efficient producers to expand. Quota owners lose rental income. Manufacturers benefit from lower leaf prices. Leaf exports rise. |

Source: Information assembled by ERS.

place limits on private lawsuits or change FDA jurisdiction. The slightly narrower scope of the current agreement reflects its more limited goals: reimbursing States for smoking-related health costs under Medicaid and ending the uncertainty of continuing lawsuits for cigarette manufacturers. The Federal Government was not a party to the November 1998 settlement, and Congress voted in 1999 to prohibit the Federal Government from making a claim to the settlement payments. On September 22, 1999, the Department of Justice filed a wide-ranging civil suit against the three largest tobacco manufacturers, alleging that cigarette companies conspired to defraud and mislead the public about the health hazards of smoking. The suit seeks to recover expenditures made by the Federal Government to treat smoking-related illnesses of military veterans, Medicare patients, and Federal employees. The suit will also attempt to force cigarette companies to finance education and other antismoking programs.

The above-mentioned "Phase I" settlement did not address the impacts that the settlement would have on growers and owners of tobacco quota. Subsequently, cigarette manufacturers agreed to a "Phase II" settlement, in which they would pay growers of cigarette tobaccos \$5.15 billion to compensate them for losses due to declining cigarette demand. Payments are to be distributed between States based on relative quota or, for nonquota States, production. At the writing of this report, States were determining how the payments would be distributed to individual farmers. Several States set up boards that include farm representatives to oversee disbursement of the funds.

Industry payments have an effect similar to that of an excise tax. Manufacturers generally raise prices to cover the payments, passing on the costs to smokers. During 1998, for example, cigarette manufacturers raised wholesale prices 14 percent, motivated largely by anticipated multibillion-dollar settlements of lawsuits. A 45-cent-per-pack increase was announced immediately following the November 1998 settlement. Higher cigarette prices could cause consumption to slide as much as 25 percent in 10 years compared with 17 percent at the current rate of decline. Lower cigarette consumption will dampen demand for tobacco leaf.

### **Antismoking Measures**

Restrictions on advertising and mandatory warning labels on packaging and advertisements were adopted following the 1964 Surgeon General's *Tobacco and*

*Health* report. There has been discussion about broadening restrictions on cigarette advertising and strengthening warning labels to further reduce smoking. The 1998 global settlement between State attorneys general and manufacturers placed further restrictions on advertising. Restrictions on smoking in public buildings and workplaces have been expanded in recent years.

The effects of antismoking programs and smoking restrictions are likely to further reduce the demand for tobacco products. In response to shrinking domestic demand, manufacturers will reduce the scale of their domestic operations and their purchases of tobacco leaf and other inputs. If overseas markets grow, manufacturers would probably increase export sales, partially offsetting the impact of reduced domestic demand. However, overseas growth is uncertain since other countries are also instituting antismoking measures. As antismoking measures reduce demand for cigarettes, a proportional decrease in demand for tobacco leaf is also expected. According to Brown's (1995) estimates, a significant increase in smoking restrictions (such as banning smoking in all workplaces) could result in a 4-percent reduction in manufacturers' purchases of tobacco leaf. Gross income to tobacco farmers would fall 2 percent, assuming that the current tobacco program is maintained.

Antismoking efforts have contributed to the decline in smoking in recent years, but an array of other factors have also contributed, including demographic trends and price increases. Over the decade from 1988 to 1998, U.S. consumption fell from 563 billion pieces to an estimated 470 billion. Declining demand brings about a gradual shrinkage of the industry; movement of workers, land, capital, and other resources out of the industry; and consolidation of remaining businesses and farms.

### **Excise Taxes**

Tobacco has been taxed throughout most of the history of the United States, and individual States have taxed cigarettes since the 1920's and 1930's. Manufacturers (in the case of Federal excise taxes) and wholesalers (State taxes) pay these taxes. The Federal tax is currently \$17 per thousand cigarettes (34 cents per pack of 20). State taxes vary considerably from 2.5 cents per pack in Virginia to \$1.00 per pack in Alaska and Hawaii, with a weighted average of 34 cents per pack. Local taxes are in force in some places, and sales taxes are assessed on cigarettes in most States. Excise taxes

are largely passed on to consumers by raising the retail price of cigarettes. Tobacco consumers bear most of the incidence of excise taxes because their demand for cigarettes is relatively insensitive to price. Federal excise taxes increased from 24 cents per pack to 34 cents in year 2000, and are slated to increase again to 39 cents in 2002. Various States also have excise tax increases before their legislatures. Large Federal excise tax increases of \$1.50 per pack or more have been considered.

An increase in the Federal excise tax on cigarettes induces manufacturers to raise wholesale prices to pass on the tax. Studies of cigarette demand find that consumption is inelastic with respect to price—a 10-percent increase in cigarette prices will reduce demand by only 4 to 5 percent. Consequently, manufacturers lose relatively little volume when they raise prices. The oligopolistic nature of the cigarette industry also gives firms considerable power in setting prices. This means that manufacturers can pass on cost increases, such as excise taxes or settlement payments, to consumers through higher prices. In a 1999 study published by the North Carolina Rural Development Center, the authors assumed that 70 percent of cost increases are passed through in price increases. Recent trends in prices seem to bear this out. Cigarette prices have risen rapidly since 1980, faster than costs of materials and excise taxes (Howard, Congelio, and Yatsko). After agreeing to a legal settlement with 46 States in November 1998, manufacturers immediately announced a price increase of \$0.45 per pack to offset expected costs of the settlement. This suggests that manufacturers pass on most, if not all, of an excise tax increase to consumers. It should be noted, however, that cigarette manufacturers have sometimes cut prices in the past for strategic reasons to gain market share and to compete with off-price brands. Nevertheless, it seems likely that excise tax increases will result in longrun increases in wholesale and retail cigarette prices. The Federal excise tax increase in 2000 (10 cents) and that scheduled for 2002 (5 cents) are likely to speed up the expected decline in domestic cigarette consumption.

### **FDA Regulation of Tobacco Products**

Another measure that has been the subject of discussion, legislation, and litigation is the Food and Drug Administration's (FDA) assertion of authority to regulate the manufacture and distribution of tobacco products. Regulations issued by FDA in August 1996 asserted jurisdiction over cigarettes as medical devices,

and would require companies to comply with a wide range of labeling, reporting, recordkeeping, manufacturing, and other requirements. Under these regulations, FDA could force manufacturers to reduce levels of tar and nicotine in cigarettes, and, possibly, ban nicotine altogether. However, in a February 2000 decision, the U.S. Supreme Court ruled that existing law does not grant FDA the power to regulate tobacco. Thus, FDA will not have regulatory authority over tobacco unless Congress passes legislation that specifically grants such authority.

Some public health advocates and policymakers have recommended controls on exports of cigarettes. Advocates of export controls are concerned that restrictions on smoking in the United States will induce manufacturers to sell more cigarettes abroad, thus, in effect, "exporting" public health problems. A bill proposed by Senator John McCain in 1998, but never passed, contained requirements that cigarettes made for overseas markets comply with U.S. warning label provisions, and would have barred export of tobacco products not complying with FDA standards. Opponents of export controls argue that manufacturers would respond by moving their operations overseas.

### **Tobacco Farm Program**

The Tobacco Farm Program is probably the most complex intervention in tobacco markets (see Appendix 1, "The Tobacco Farm Program"). The program determines how changes in tobacco demand are transmitted to the farm sector. It also has an important impact on the structure of the industry and preserves historical production patterns. The program has been the subject of considerable controversy, and its elimination is a serious policy option.

The program limits the quantity of tobacco grown in the United States by assigning marketing quotas to holders of tobacco allotments. Supply is managed by setting annual quotas in line with expected demand for leaf. Quotas are apportioned to allotment holders based on historical production patterns that existed in the 1930's at the program's inception. Since the 1960's, tobacco quota owners have been allowed to rent or lease quota to others, so that today many owners of quota do not grow tobacco. About half of the tobacco quota is used by the people who own it. The other half is rented to farmers for either cash payments or shares. Without the supply limits mandated by the program, producers would grow considerably more

tobacco, pushing down market prices and returns. Zhang, Husten, and Giovino estimate that the tobacco program raised the price of tobacco by 32 to 40 cents per pound (18-23 percent) above what it would have been without the program in the early 1990's. Because tobacco returns are so attractive, a tobacco quota (the right to grow and market tobacco) is a valuable capital asset. Economic theory suggests that a quota for a pound of tobacco is worth the difference between the price and the economic cost of producing it.<sup>5</sup> Farmers who own quota earn higher returns than they could from other crops. Net returns from tobacco over cash expenses are about \$2,000 per acre in most years, and farmers pay roughly 35 cents per pound to rent quota. On a farm with yields of 2,000 lbs. per acre, the quota rental would be \$700 per acre. At a lease rate of 35 cents, the average flue-cured allotment of 24,250 pounds would bring an annual rental income of \$8,487.50 to its owner, and an average burley allotment of 3,500 pounds would be worth \$1,225. Quota rental rates tend to rise and fall with tobacco prices. As higher prices increase the anticipated profitability of the tobacco crop, growers are willing to pay more for quota. Therefore, growers who rent their quota may not benefit very much through direct income enhancement since their quota rental payments rise with tobacco prices. The benefits accrue largely to those who own tobacco quota. Growers do benefit from the program's effect of stabilizing year-to-year fluctuations in prices, which reduces their risk and helps them obtain financing.

International trade in tobacco leaf has important effects on, and is affected by, tobacco policy. The price enhancement due to the program induces manufacturers to substitute imported for domestic tobacco and makes U.S. leaf less competitive on world markets. As discussed earlier, U.S. tobacco has maintained a surprisingly large world market share, despite its high price. However, manufacturers have been increasing their use of imported tobacco due to the price differential, the improving quality of foreign leaf, and increasing preference for low-tar and generic brand cigarettes, which use imported leaf more heavily. In 1993,

<sup>5</sup>The economic cost includes the opportunity cost, or the income that could have been earned by devoting the farm's land, labor, and capital to the best alternative activity (for example, growing another crop or working off the farm).

Congress passed a domestic content law that required manufacturers to use at least 75 percent domestic leaf in U.S.-manufactured cigarettes. That law was found to be inconsistent with the General Agreement on Tariffs and Trade. The domestic content law was replaced with a tariff rate quota (TRQ), which assesses a 350-percent duty on imports beyond a fixed quota and has a duty drawback for re-exported products. By 1998, the TRQ had never been reached. Beghin, Brown, and Zaini conclude that leaf import restrictions raise domestic use and price of U.S. tobacco, reduce U.S. cigarette output by a small amount (less than 1 percent), and may play a minor role in pushing cigarette manufacturers to relocate production offshore.

The Tobacco Farm Program increases the political complexity of tobacco policy by increasing the number of individuals who benefit from tobacco production. Without the program, there would be far fewer tobacco farms than the nearly 90,000 counted in 1997. There are about 325,000 owners of tobacco allotments/quotas, many of whom are included in the 90,000 growers, but most quota owners rent their quota to others. The income enhancement of the tobacco program amounts to an income transfer to owners of quota from tobacco manufacturers (by reducing their profits), smokers (by raising the price of cigarettes), and foreign buyers of tobacco (Johnson, p. 28). For growers who do not own quota, much of the program's benefit is bid away in the rent they must pay to obtain quota.

The increasing sentiment for antismoking measures and deregulation of farming in the late 1990's led to serious proposals to privatize or eliminate the tobacco program during debate over the tobacco settlement in 1998. Growers of each type of tobacco vote to participate in the program. Several types of tobacco (Maryland, Pennsylvania filler, and Connecticut binder) are already grown without price supports because growers voted against quotas. While continuation of the tobacco program is uncertain, it has survived a number of challenges over the years. Its no-net-cost provisions have muted criticism of the program as an unnecessary subsidy. Many public health advocates, once among its chief critics, now support the program, having recognized that the program limits tobacco production and raises its cost—effects that are consistent with public health goals.