TOBACCO SUBSIDIES: AN ECONOMIC PERSPECTIVE

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Carl Zulauf and Allan Lines, Ag Economists, Ohio State University
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PUBLIC SUBSIDIES: ECONOMIC DEFINITION

- An economic definition of a public subsidy is any government policy (action) which increases the annual return to a factor of production (land, labor, capital, management) above the return that the factor of production would receive if there was no government intervention (often called the free market).
- Annual return is the focus because it is well known that government subsidies are bid into the acquisition cost of resources. For example, the annual income deficiency payments to farmers is bid into the price of land. The reason is that the annual payment from the government makes the land more valuable to its owner. Hence he/she is willing to pay more for the land. To generalize, a public subsidy increases annual returns which in turn results in a higher acquisition cost for the asset. As a result, the long-term rate of return to the asset remains approximately the same whether the public subsidy exists or not.

PUBLIC SUBSIDIES: TYPES

- **Direct Government Payments**: These are direct public outlays paid to the producer or owner of a resource. Income deficiency payments to producers of corn and wheat are examples.
- **Tax Exemptions or Credits**: Reducing the tax rate on income generated by a resource increases the return to the resource above the return which occurs if the tax exemption did not exist. An example is the investment tax credit which was discontinued in 1986. Investment tax credit reduced the cost of buying equipment and buildings, thereby increasing their return, and making it more profitable to buy them. Other examples of public subsidies via the tax system include tax abatements for new or expanding businesses and the exemption of municipal bonds from federal income tax.
- **Supply Restrictions**: Numerous public policies effectively reduce the supply in the market, thereby increasing the good's price above the price that would exist if there were no supply restriction. A common example is high tariffs or quotas on imports. For example, quotas on sugar imports raise the price of U.S. sugar. Another common example is a patent. For 17 years no one can make the identical product without paying the patent holder. This reduces the supply of the patented good and increases its price. A third example is restrictions on crop acreage or marketings. These reduce supply, thereby increasing price above the market price that would exist without such restrictions.
- Note, a public subsidy may be paid by taxpayers, as in the case of direct government payments, or consumers, as in the case of supply restrictions.

CURRENT TOBACCO PROGRAM

- Statutory authority for the tobacco marketing quota and price support programs is the *Agricultural Adjustment Act of 1938*, as amended, and the *Agricultural Adjustment Act of 1949*, as amended. The Secretary of Agriculture proclaims a quota on marketings of a particular kind of tobacco in order to be eligible for the support price. Marketing quota must be approved in a referendum by tobacco producers. About 98% of U.S.-produced tobacco is under a price support program. For

1995, the effective marketing quota for flue-cured tobacco (types no. 11-14) is 924.9 million pounds and for burley tobacco (type no. 31) is 577.9 million pounds. The 1995 support price is $1.597/pound for flue-cured tobacco and $1.725/pound for burley tobacco. Tobacco program costs, except for administrative costs (approximately $15 million in 1994), are borne by growers and purchasers through per-pound assessments. Hence, tobacco often is referred to as a "no net cost" program.

HOW TOBACCO IS SUBSIDIZED

- **Tobacco is subsidized by the restrictions (quotas) on marketings.** The quotas reduce domestic supply, thereby increasing the price received by U.S. tobacco producers.
- Evidence that price is indeed above the free market price comes from the leasing, renting, and sale of marketing quotas by those holders of quotas who do not wish to grow tobacco.
- Flue-cured and burley quotas can be sold only within county boundaries. Flue-cured quotas generally cannot be leased but burley quotas can be leased within county lines except that in Tennessee they can be leased across county boundaries. In 1993, county average rental rates for flue-cured tobacco in North Carolina varied from 25-42¢/pound, with a median of 35¢/pound. Burley lease costs in Kentucky averaged about 48¢/pound in 1994 and 44¢/pound in 1993. Current evidence for Ohio suggests burley quotas are being leased for approximately 50¢/pound.
- Marketing quotas exist because the government program exists. The fact that producers are willing to pay for the quota suggests that the quota has value because it increases return, i.e. price, above what would exist without the program (i.e., in the free market). Furthermore, the quota value is an indicator of how much the price may decline if the tobacco program is eliminated.
- In recent years, Ohio has produced approximately 18 million pounds of burley tobacco. Given the 50¢/pound subsidy, the tobacco program translates into $9 million in additional income to Ohio's tobacco production activity.
- (Except for the information on Ohio, which comes from Ohio contacts, information on the tobacco program in the last two sections are from Verner N. Grise, *Tobacco: Background for 1995 Farm Legislation*, U.S. Department of Agriculture (USDA), Economic Research Service (ERS), Commercial Agriculture Division (CAD) Agricultural Economic Report 709, April 1995; and USDA, ERS, CAD, *Tobacco Situation and Outlook*, TBS-232, September 1995.)

FINAL NOTES

- Currently the word "subsidy" has a negative connotation with the general public. However, to an economist, subsidy is a word which defines a state of the world in which the return to a factor of production exceeds the return the factor would receive in a free market. No value judgment is attached to the word. A subsidy is good or bad only relative to one's value set.
- While it is true that the tobacco program does not involve direct government expenditures, except for administrative costs; tobacco is a subsidized crop under the conventional economic definition of the term.
- Editorial comment: Among Ohio farmers that we talk to, the only ones who privately believe that tobacco is not subsidized are tobacco farmers. This observation should raise a red flag -- continued use of the no-subsidy argument is likely to unnecessarily bring public ridicule upon the tobacco industry. They would be better off to simply state that, except for administrative costs, the tobacco program is not a budget cost to the U.S. taxpayer and leave the argument at that.