The Tobacco-Quota Buyout: More Legal Plunder

BY E. C. PASOUR, JR.

Critics of tobacco use (and others) have been calling for an end to all government support to the industry for several decades. Now, under the corporate-tax bill passed by Congress last October, owners of tobacco quotas and farmers who produce the crop in the United States will receive cash payments totaling $10.1 billion as a quid pro quo for accepting an end to the tobacco price-support program. This linking of compensation to termination of the tobacco production cartel created buyout fever in North Carolina, Kentucky, and other major tobacco-producing states.

What was the purpose of the tobacco program and why was it in trouble? What was a tobacco-marketing quota and why did it have market value? Does the buyout make sense—economically or ethically? First, consider a brief overview of the federal price-support program for tobacco and how it operated.

The U.S. Department of Agriculture had operated a tobacco-production cartel since the early 1930s during the New Deal. The price of tobacco was raised above the market level to the “support price” by restricting production through the use of government-assigned producer poundage quotas. The national tobacco-marketing quota was the quantity (in pounds) of tobacco all domestic producers were permitted to market each year.1 The national quota was allocated among individual farms based proportionally on their history of producing tobacco. The federal government each year adjusted the amount of quotas based on estimates of buyer purchases for the coming season.

The market for the “right” to produce and sell tobacco was tightly controlled. Tobacco had to be grown in the county to which the quota was assigned. If a farmer wished to grow tobacco but did not own a quota, he had to purchase or lease it from someone who did. If renting a quota from someone else, he had to produce tobacco on the farm to which the quota was attached—a quota could not be leased or sold across county or state lines. Thus less-efficient producers continued to grow tobacco because the program distorted the pattern of production, as restrictions on selling and renting quotas prevented production from moving to lower-cost regions. When the program ended, there were about 430,000 quota owners and about 60,000 active producers of tobacco in the United States.2

Quota holdings repeatedly were divided by inheritances, land sales, or other transactions and disconnected from tobacco-farming operations, giving rise to widespread absentee ownership. Although tobacco was grown under quota in only 21 states, the quota owners were scattered across all 50 states, the District of Columbia, four U.S. territories, and even 16 foreign countries.3

What determined the quota price?4 In economic terms, the value of the price-support program was incorporated into quota prices. Annual lease rates for quotas reflected the difference between the govern-

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ment-supported price of tobacco and non-quota costs of production, primarily land, labor, fertilizer, and pesticides. If the support price for tobacco was, say, $2 per pound and non-quota costs of production were $1.50 per pound, the quota rental value would have been about 50 cents per pound. Quota prices varied over time with changes in the amount of quotas and the supply and demand for tobacco. If, for example, the amount of quotas was reduced and economic conditions remained unchanged, the annual rental rate for quota increased.

The capital value of the quota reflected the present value of the expected future annual rents. For example, if quota could be rented for one year at 50 cents per pound and the tobacco program was expected to last indefinitely, the capital value of quota would have been $10 per pound if the discount rate—the interest rate at which money can be invested—was 5 percent. That is, a quota sale price of $10 ($.50 divided by 5 percent) per pound would provide an annual income of 50 cents per pound in perpetuity.

Recently, tobacco-marketing quotas were renting for 50–60 cents per pound, while the sale or capital values were as much as $6 per pound amid buyout speculation. Rental rates and sales values varied from county to county because of differences in costs of production and restrictions on the transfer of quotas.

Who Benefited?

The farmers who were assigned production rights when the tobacco program was initiated received a once-and-for-all windfall gain. Once the program began, farmers producing tobacco either had to own a tobacco allotment or rent it from someone who did. Thus producers in later years received little benefit from the price-support program because the higher product prices were largely offset by higher production costs.

Individuals who later bought marketing quotas had to pay the market value—the estimated present value of estimated future annual quota rents. Had the program been abolished without a buyout, all quota owners would have suffered losses—including many who had never received windfall gains. This "transitional gains trap" is similar to that affecting owners of taxi medallions and other grants of government privilege.

As it stands, the tobacco-quota buyout rewards those who received windfall gains along with those who didn’t.

Once begun, some of the fully predictable (but unintended) consequences of the price-support program soon became manifest. The tobacco program led to increased costs of production for all producers because a prospective tobacco farmer either had to own or rent a quota. If a farmer rented a quota for, say, 50 cents per pound, production outlays were increased by that amount. If a tobacco farmer used his own quota, the rental income forgone represented an implicit cost—the opportunity cost of what was lost by not renting the quota to another farmer. Higher tobacco prices meant higher quota prices and increased costs of production.

As a result, sales of U.S.-grown tobacco have declined sharply in recent years. Domestic and, especially, foreign buyers of tobacco increasingly turned to non-U.S. exporters like Brazil, Malawi, and Argentina, as the harmful effect of the program intensified. Exports of U.S. tobacco and tobacco products decreased by more than 75 percent from 1992 to 2003. Because of the dramatic decrease in use of domestically produced tobacco, the amount of marketing quotas for the 2004 crop year was only half as large as it was in 1997. With rapidly declining quotas, tobacco producers were increasingly willing to forgo the tobacco program—and increased their efforts to get a buyout.

Under the last October’s buyout bill, quota owners will receive $7 per pound of quota owned and active producers $3 per pound of quota on tobacco produced. Most active producers also owned quota, and they will get both payments! The money will come from assessments on manufacturers and importers of tobacco products.
marketed in the United States—that is, ultimately, from smokers primarily.

As with most farm subsidies, most of the payments will mainly go to a small percentage of the recipients. The top 1 percent of recipients will receive more than one-fourth of the payments, averaging almost $600,000, over ten years. On the other hand, the bottom 80 percent of buyout recipients will each receive about $5,000 over ten years.

**Did a Buyout Make Sense?**

Before tapping taxpayers, manufacturers, or smokers for a quota buyout, one should have asked whether a buyout made sense—legally, economically, or ethically. It had been argued that if government action reduced the value of quotas, the loss to quota holders constituted a “taking,” which under the Constitution’s Fifth Amendment is to be compensated by the government. But such a reduction in value does not meet the legal requirements of a “taking.” Numerous restrictions and regulations affecting property rights in land, air, and water have been imposed in recent decades. Economic losses incurred by private citizens in connection with such restrictions are generally not compensable—such losses are held to be a mere incident of lawful regulations. And while environmental regulations reduce the value of legitimate assets, the value of tobacco quotas was created by government fiat. In other words, in a free market, there would have been no quotas to which value could be attached.

Moreover, there is little evidence that Congress intended to convey the character of property to holders of tobacco allotments in the original New Deal legislation. The emphasis was on restricting production as a means of increasing the price. The situation is closely analogous to that of grazing permits to ranchers on public-domain lands. Here, too, the use represented by the permit is a valuable asset, and it is common for that value to be capitalized either into the value of the permit itself or, in some cases, into the sales price of the ranch to which it was assigned. However, the government has always maintained that grazing on the public lands is a “privilege,” not a “right,” and grazing permits are explicitly subject to withdrawal by the federal government without compensation.

In short, the fact that tobacco-marketing quotas had economic value does not indicate that their owners had a legally protected property right in them. If tobacco-quota owners had no legally protected property rights, there is no economic or legal basis for a buyout.

What about the ethical case for the buyout? The quota buyout was similar to all other government redistribution schemes—it was wrong in principle.

Whenever coercive government goes beyond its proper, limited scope and taxes the incomes of some citizens in order to give the proceeds to others, it is taking what does not belong to it. As Frédéric Bastiat, the nineteenth-century French pamphleteer-economist emphasized, the mission of the law is to protect persons and property, but once the state exceeds this proper limit “you will then be lost in an uncharted territory. . . . Once started where will you stop?” Madison and other framers of the Constitution supported Bastiat’s position. They held that justice was obtained in the process of protection of private property and destroyed in the process of forced transfers. In this view, individuals have no legal obligation to help others because this would imply that potential recipients have a right to take what is not theirs, which is inconsistent with the laws of justice. Individuals acting on their own are free to help the less fortunate, of course, and indeed, as moral persons ought to do so.

With increasing foreign competition and declining smoking rates, tobacco farmers became more willing to take their chances in the free market. But, not surprisingly, they wanted to be compensated for giving up the cartel. “You’ve got farmers and quota holders who have been going along with this program for 60 years,” said
the executive director of the National Tobacco Growers Association. “It’s just not right to take away the quota value and leave these people stranded.”

There is no economic, legal, or ethical reason, however, to force anyone to compensate those who have benefited from a government-enforced cartel.

What then explains the momentum for the tobacco quota buyout—why did it pass? The tobacco quota buyout is a prime example of favor seeking—“the term used by economists when referring to actions taken by individuals and groups seeking to use the political process to plunder the wealth of others.”

2. Ibid.
7. Womach.
9. Ibid., p. 22.
10. Pasour and Rucker, Ch. 6.