COST BENEFIT ANALYSIS

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I. TITLE.

Fair and Equitable Tobacco Reform Act of 2004

II. Need for Action.

This rule implements provisions of Title VI of The American Jobs Creation Act of 2004 (the 2004 Act) by providing rules for assessing manufacturers and importers of tobacco products in each of the fiscal years 2005 through 2014 in order to finance quota owner and tobacco producer transitional payments and cover any costs associated with disposition of Commodity Credit Corporation (CCC) tobacco stocks.

III. Background.

The price tobacco manufacturers pay for domestic origin tobacco is higher than that for imported tobacco, owing largely to the price support program for domestic tobacco, which establishes a higher minimum price for U.S. product. With the elimination of price support for tobacco, tobacco producers stand to lose future income as domestic tobacco prices move more in line with lower-priced imported tobacco. University researchers specializing in tobacco sector analysis suggest that future tobacco prices may decline 25 per cent, or more, from their high price levels under the previous program. Over the longer term, however, remaining producers should benefit from—

- reduced production costs, as quota rent is eliminated,
- increased production, as lower domestic leaf prices compete more effectively with imported tobacco and improve competitiveness in the export market, and
- economy of scale as farms consolidate into larger and more efficient units.

Because owning tobacco quota poundage allows one to market tobacco in the higher-price domestic market, quota poundage has intrinsic value. Elimination of tobacco marketing quotas will result in a loss of future quota income to quota owners.

With lower domestic market tobacco prices, the value of CCC tobacco stocks will also decline. Since these stocks are pledged as collateral for nonrecourse marketing loans, CCC could lose significant amounts of money, due to the elimination of price support for tobacco, if subsequent tobacco prices fall below the loan value of tobacco pledged as collateral for the loan.

Compensation to tobacco producers, quota holders, and CCC is deemed an equitable remedy for loss of future tobacco income and potentially diminished value of loan collateral. The 2004 Act provides for assessments against tobacco importers and manufacturers in order to finance transitional tobacco payments for quota holders and tobacco producers and compensate CCC for any losses associated with tobacco loan stocks.

IV. Payment/Assessment Calculation.

The Act allows the CCC to enter into a contract with each eligible tobacco quota holder, or tobacco quota producer, for the purpose of providing compensation for the termination of tobacco marketing quotas and related price support. The Act also provides for assessments on manufacturers and importers of tobacco products in order to finance the payments. The Act explicitly specifies a methodology for determining assessments. Assessments will be made during 2005 through 2014 in annual amounts equal to the amounts paid to tobacco quota holders or tobacco quota producers in a calendar year, plus any reimbursements due CCC. Individual company quarterly assessments will be based upon immediately preceding quarterly sales of tobacco products, as specified in the legislation.

Quota Holder/Tobacco Producer/CCC Payment Calculation.

The total amount of contract payments due an eligible tobacco quota holder is determined by multiplying $7 per pound by the number of pounds of basic quota with respect to which the person qualifies as a tobacco quota holder, based on the 2002 quota level. The total amount of contract payments due an eligible tobacco quota producer is, in the case of flue-cured and burley tobacco, $3 per pound of effective quota established for the 2002 marketing year for quota tobacco produced on the farm and, in the case of other kinds of tobacco, $3 per pound of the basic farm acreage allotment for 2002 times the average annual yield, per acre, of quota tobacco produced on the farm for the period covering the 2001, 2002, and 2003 crop years. The total of these quota holder and tobacco producer payments is estimated at $9.6 billion, based on known payment rates per pound and 2002 acreage/poundage quotas.

CCC is to be reimbursed, with interest, for all CCC funds it uses to make payments to quota holders and tobacco producers; expenses for any net losses it may sustain under its loan agreements; and expenses incurred by using financial institutions in carrying out sections 622 and 623 of the 2004 Act. Expenses incurred by using financial institutions could include such things as the costs of mailings, advertising, and maintenance of records related to assessments and payments. While any losses to CCC can not be known precisely in advance, total payments for quota holders, tobacco producers and CCC are limited by the 2004 Act to $10.14 billion, implying a limit on reimbursement of CCC costs of about $540 million.

Tobacco Manufacturer/Importer Assessment Calculation.

Tobacco manufacturer and importer assessments are based on their shares of sales volume for 6 major tobacco product classes: cigarettes, cigars, pipe tobacco, snuff, chewing tobacco, and roll-your-own tobacco. Of these product classes, the first 2 are measured in number of units of product, whereas those remaining are measured in pounds of product. Each category of product is assigned a percentage of the total market, based on its share of sales during a prescribed period and, within that product class, each manufacturer and importer of that product is assigned a share of that percentage based on its pro rata share of the total sales of that product.

The 2004 Act specifies that cigarettes' proportion of the FY 2005 assessment, based upon its share of the market over a specified period, is 96.331 percent. Based on this share, total assessments on cigarette manufacturers and importers during FY 2005 are estimated at about $975 million. In 2003, total taxable removal of cigarettes was about 400 billion, or about 20 billion packs of 20 each. The assessment per pack of cigarettes would be about 4.8 cents. In order to cover their share of the product class's assessment, cigarette manufacturers and importers would likely raise the price of cigarettes by a similar amount.

Cigars' proportion of the FY 2005 assessment is 2.783 percent, about $28.2 million. This implies a potential price increase of about 0.4 cents per cigar, based on 2003 removals of 7.0 billion units. Other products' share of the assessment in million dollars, and the implied increase in product price in cents per pound, in parenthesis, are: snuff--$5.5 (7.3), chewing tobacco--$1.1 (2.4), pipe tobacco--$.7 (13.8), and roll-your-own--$1.7 (13.8).

CCC must calculate an individual manufacturer's or importer's share of each product class and associated assessment, before sending them notice of their assessment and providing each an opportunity to contest or question the assessment. The manufacturers and importers are required to provide data to enable CCC to determine their respective shares of product classes. The data to be provided is the same as is currently required to be provided to other U.S. agencies charged with collecting taxes on tobacco products. The number of manufacturers and importers providing data for assessments can be estimated, based on the number of reports currently required to be provided to other government entities. On August 18, 2004, there were 158 product manufacturers and 666 product importers providing data on tobacco product sales.

V. Expected Impacts.

Impact on Manufacturers and Importers.

The expected result of these regulations is the procurement of approximately $10.14

billion dollars in assessments from tobacco manufacturers and importers over a 10-year period, or about $1.014 billion annually. Manufacturers and importers are expected to ultimately pass the majority of these costs on to consumers of tobacco products through small increases in sales prices, since demand tends to be much more inelastic than supply. While no specific estimates of the supply elasticity are available, most studies assume supply to be perfectly elastic.

The additional burden of providing information on sales volume to CCC is deemed negligible inasmuch as these data are already provided to other government agencies.

Impact on Consumers.

Consumers are expected to pay marginally higher prices for tobacco products than they would in the absence of the assessments, as manufacturers pass on most of the cost of assessments through higher product sales prices. The recent national average retail price of cigarettes is calculated to be $3.8066 per pack. A 4.8-cent-per-pack increase in the price would equate to a 1.3-percent rise in the retail price. Numerous studies have calculated the price elasticity of demand for cigarettes to be quite inelastic, ranging from a low of -0.4 to a high of -0.75. The range of estimates for youth smoking is wider, ranging from 0 to -1.44. Based on these estimates, a 1-percent rise in the price of cigarettes would be expected to reduce overall consumption by 0.4 percent to 0.75 percent. However, among youth, the expected impact may range from no decline to as much as a 1.44-percent decline. Nonetheless, consumers in aggregate, are not expected to significantly reduce consumption of tobacco products due to the expected increases in tobacco prices attributable to the assessments, alone.

Impact on USDA and CCC Outlays.

CCC will likely incur modest additional staffing requirements associated with the ongoing administration of the assessment provisions described herein. The likelihood of heavy dependence on automated processes will limit staff requirements. CCC loan operation net expenses are covered by the assessments collected under these regulations. However, since the tobacco program has been administered at no-net-cost for years, the assessment provisions described here are expected to have no significant impact on CCC loan operation expenses.