UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

RESOURCES, COMMUNITY,
AND ECONOMIC DEVELOPMENT
DIVISION

December 12, 1983

B-205935

The Honorable Thomas E. Petri
House of Representatives

Dear Mr. Petri:

Subject: Cost Information on USDA's Tobacco Program (GAO/RCED-84-33)

In your April 13, 1983, letter and subsequent discussions with your office, you asked that we obtain cost information on the Department of Agriculture's (USDA's) tobacco price-support program, which is financed by the Commodity Credit Corporation (CCC). Specifically, you wanted to know (1) the costs of the tobacco program prior to passage of the No Net Cost Tobacco Program Act of 1982 (Public Law 97-218, July 20, 1982), (2) the costs incurred for the 1982 flue-cured and burley crops, and (3) the adequacy of the 1982 tobacco assessment required by the 1982 act to cover anticipated program costs, other than for administrative costs. In addition to responding to your specific questions, this report supplements our August 4, 1983, letter to you and provides general background information on the no net cost tobacco program.

In summary:

--CCC has made tobacco loans since 1938 totaling about $5 billion. Under the program, the tobacco serves as collateral for the price-support loan. A loss occurs when the sales proceeds from a crop of loan tobacco is insufficient to fully repay the loan. For those crops under loan sold through September 30, 1982, principal totaling over $58 million has not been recovered, resulting in losses to CCC.

--CCC has incurred substantial unreported interest cost expenses because of the method it allows tobacco producers to use to repay their loans. CCC borrows funds from the Department of the Treasury to meet its daily cash requirements, which includes financing for the tobacco price-support program. The Treasury charges CCC interest on the daily outstanding balance owed, which includes unpaid interest on borrowings from prior periods. In contrast,

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tobacco associations pay interest to CCC on the daily outstanding principal balances, which do not include interest from prior periods. Thus, the associations do not pay interest on interest, and as a result, a significant difference exists between the amounts of interest recorded and collected on CCC tobacco loans and the corresponding interest that CCC pays the Treasury for borrowed funds. USDA estimates these losses to range between $319 million and $591 million from the beginning of the program through September 30, 1980.

--Carrying costs (such as redrying, storage, fumigation, and overhead) and interest costs that had accrued on 1982 crop year[1] flue-cured tobacco from August 1982 through June 1983 total about $92.2 million. Carrying and interest costs through June 1983 on 1982 crop year burley tobacco total about $76.5 million.

--Under the No Net Cost Tobacco Program Act of 1982, producers pay an assessment that is deposited in a fund to be used to ensure that the government sustains no net losses after all the tobacco which came under loan has been sold (this generally takes several years). The assessment is based on, among other things, the expected volume of tobacco coming under loan and the anticipated carrying and interest costs. Because the volume of crop year 1982 tobacco coming under loan was much higher than originally projected, USDA concluded that the 1982 crop year assessment was inadequate to ensure a no net cost tobacco program for both the flue-cured and burley programs. USDA estimated in July 1983 that an additional $60.5 million for the flue-cured program and $112.5 million for the burley program[2] would be needed to recover the programs' costs. USDA plans to collect these shortages through increased assessments on subsequent crops.

TOBACCO PROGRAM DESCRIPTION

The Agricultural Adjustment Act of 1938, as amended (7 U.S.C. 1281 *et seq.*), gave USDA the authority to regulate tobacco production through acreage allotments (acres planted) and marketing quotas (pounds marketed) to help stabilize prices and support and protect farmers' income. Later, the Agricultural Act of 1949, as amended (7 U.S.C. 1421 *et seq.*), gave USDA's CCC authority to

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[1]The year that a crop is normally harvested.

[2]Approximately 115 million pounds of crop year 1982 burley tobacco were sold in September 1983, and USDA is assessing the impact of these sales on the burley program.

provide for price stabilization and support operations through price-support loans to tobacco producer associations. The associations use the funds from the loans to make cash advances to producers who are unable to sell their tobacco for at least the price-support rate assigned to the individual grades of tobacco.

USDA's Agricultural Stabilization and Conservation Service (ASCS) is responsible for regulating the acreage allotment, marketing quota, and price-support programs; however, it does not directly administer the price-support program. Instead, it contracts with 13 producer cooperative associations for that purpose. Loans financed by CCC are made through the associations to their members.

Flue-cured and burley producers market their tobacco in auction warehouses. There it is weighed, identified by a warehouse sales ticket, and displayed in lots (baskets, sheets, or piles) on the auction floor. A USDA Agricultural Marketing Service tobacco inspector grades the tobacco in each lot and marks the grade on the warehouse sales ticket. Potential buyers then bid on the lots. If the highest bid price on any lot of tobacco is not equal to or more than the grade's price-support rate, the producer may put the tobacco under loan at the price-support rate or wait and market the tobacco at a later date hoping for a higher bid price.

The associations handle all operations related to making loan advances to producers and receiving, processing, storing, and eventually selling the tobacco under loan. CCC-financed loans to the associations cover advances to producers and the cost of receiving, processing, and storing the tobacco. Over time, the associations market the tobacco based on prices proposed by the associations and approved by CCC. Sales proceeds are applied toward repayment of the principal first and then to interest accrued on the loans.

For crop year 1981 and prior years, price support was extended through nonrecourse loans, which absolve producers from liability for any losses incurred from the sales of the tobacco by the producer associations. Net gains, if any, for those crop years, are to be distributed to the producers based on participation, whereas losses are to be absorbed by CCC.

Under the No Net Cost Tobacco Program Act of 1982, CCC will continue to make price support available to producers for crop year 1982 and subsequent years through their associations. However, the act provides that, insofar as practicable, the program be carried out at no net loss, other than for administrative expenses, and it requires tobacco producers, as a condition for eligibility for price support, to contribute to a capital fund to pay for the program's costs.

The act requires each association to establish a separate capital fund for depositing producer assessments. The fund is used to ensure that, insofar as practicable, CCC will sustain no net losses from the price-support program carried out by the association.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our objectives were to determine what the tobacco program's costs had been prior to passage of the 1982 act, what costs have accrued on the 1982 flue-cured and burley crops, and whether the assessment program is adequate to ensure that the program is carried out at no net cost to the government.

To accomplish these objectives, we reviewed applicable federal regulations and pertinent USDA policies, procedures, and program records. To obtain information on program costs, we interviewed ASCS and CCC program officials in Washington, D.C., and at ASCS state and county offices in North Carolina. Because of time constraints, we relied extensively on interviews and ASCS and CCC records and did not independently verify the data. We received agency comments on our draft report. The agency concurred in the report's factual content.

We made this review in accordance with generally accepted government auditing standards.

TOBACCO PROGRAM OPERATING LOSSES AND ADMINISTRATIVE COSTS

The government will incur a loss for crop year 1981 and prior years if sales proceeds are insufficient to fully repay the price-support loans made to the associations. Producers are responsible for losses on crop year 1982 and subsequent years. For crop year stocks already sold from 1938 through September 30, 1982, $58.2 million in loan principal was not repaid.

These losses could increase, however, considering the large amount of tobacco under loan (as of June 30, 1983, principal totaling $463.3 million and interest totaling $254.1 million was outstanding on 1976-81 crop year tobacco loans). For example, 60 percent of the 1977 flue-cured crop, on which principal and interest totaling $181 million was outstanding through June 30, 1983, has been under loan for more than 6 years. According to tobacco industry, academia, and ASCS officials, the quality of tobacco held in storage well beyond its peak aging period (approximately 3 years) slowly declines. On May 31, 1983, CCC approved a price-adjustment reduction of 7.5 percent for the 1977 flue-cured tobacco crop. The Flue-Cured Tobacco Cooperative Stabilization Corporation reported that even with the price reduction, the crop would still be sold at a profit. According to a Corporation official, however, this reduction did not stimulate sales, and should additional price reductions be necessary, losses could occur.

Public Law 98-59, enacted on July 25, 1983, amended the price-support provisions of the Agricultural Act of 1949 to keep 1983 support prices at the 1982 level. Public Law 98-180, enacted on November 29, 1983, further amended the price-support provisions to keep 1984 support prices at the 1982 level and to keep 1985 support prices, with certain restrictions, at the 1982 level.

Because these acts freeze the tobacco price-support level for the next several years, the federal government could experience difficulty in disposing of tobacco that is already under loan, and it may incur additional losses. The associations adjust the price of tobacco under loan to reflect additional carrying and interest costs as they accrue; consequently, the price of tobacco under loan continually rises. In past years, the program has relied on an escalation in the selling price from year to year, brought about by the price-support formula, to help make tobacco under loan competitively priced with the current year's crop. The price freeze would make tobacco from 1982 and subsequent crop years more marketable while making stocks under government loan from crop year 1981 and prior years (which could be higher priced due to carrying and interest costs) less marketable.

USDA's Office of Budget and Program Analysis (OBPA) estimated administrative and other service costs to operate the tobacco price-support program to be $116.5 million for the 4-year period 1981 through 1984. Estimated administrative costs of $54.6 million during the period are based on the time it takes for a sample of county employees to oversee the program's day-to-day operation. In addition to administrative costs, other service costs such as inspection, grading, research, and crop insurance premium subsidies are incurred but not reported as supporting the program. OBPA has estimated the costs for these services to be about $61.9 million for the 4-year period. The following table shows estimated administrative and other service costs.

	1981	1982	1983	1984	Total 1981-84
	(millions)				
Administration of price-support program	$13.1	$13.3	$13.6	$14.6	$ 54.6
Inspection and grading[a]	7.3	0.1	0.1	0.1	7.6
Market news reporting	0.5	0.6	0.6	0.6	2.3
Research and extension	8.0	8.5	8.8	8.8	34.1
Crop insurance premium subsidy[b]	0	5.8	6.0	6.1	17.9
Total	$28.9	$28.3	$29.1	$30.2	$116.5

[a]User fees paid by producers for inspection and grading were adopted for 1982 and future crops. The remaining federal expenditure for 1982 through 1984 is only for developing and maintaining grading standards.

[b]Crop insurance premium subsidies began with the 1982 crop.

INTEREST COSTS UNDERSTATED

In three prior reports[3] we discussed how CCC-approved repayment practices understate interest costs on tobacco loans. Cash received from loan repayments is applied first to loan principal and then, after the principal is liquidated, to interest receivable. However, under CCC's procedures for repaying its Treasury borrowings, CCC pays interest on the daily outstanding balance owed, which includes unpaid interest.

Using the existing method of computing interest, ASCS reported that for those years in which the tobacco was sold during the period from 1940 to 1981, interest on tobacco loans totaling $152.7 million has yet to be repaid. However, CCC's repayment practices are inconsistent with its practices for repaying Treasury borrowings; therefore, interest losses actually have been much greater than those reported. The Treasury charges CCC interest on the daily outstanding balance owed, which includes unpaid

[3]Collection and Accounting for Accrued Interest on Commodity Credit Corporation Producer Loans, AFMD-82-40, Jan. 11, 1982; Tobacco Program's Production Rights and Effects on Competition, CED-82-70, Apr. 23, 1982; and Information on Commodity Credit Corporation Loan Repayment Practices, CED-82-106, June 16, 1982.

interest on borrowings from prior periods. In contrast, CCC charges the tobacco producer associations interest on the daily outstanding principal balances and does not charge any interest on the still unpaid interest from prior periods. Thus, the associations pay interest at substantially reduced amounts because their loan principal balances are more rapidly reduced as they apply sale proceeds first to loan principal, until liquidated, and then to accrued interest. As a result, a significant difference exists between the amounts of interest recorded and collected on CCC tobacco loans and the corresponding interest which CCC pays the Treasury for borrowed funds.

As stated in our April 23, 1982, report, ASCS and CCC officials calculated that the amount of interest CCC has paid to the Treasury from the beginning of the program through September 30, 1980, could total about $845 million. Meanwhile, CCC records indicated that it had collected $254 million in interest income, or a net loss to the government of about $591 million. CCC's Comptroller said that interest expense was based on yearly beginning and ending average loan balances and the interest income was probably based on incomplete documents. In a letter dated April 11, 1983, to Representative Larry J. Hopkins, the Acting Administrator, ASCS, projected interest losses on tobacco loans to be about $319 million. This amount includes $153 million in unpaid interest plus an amount resulting from the differing interest rates used by the Treasury and CCC.

In a June 27, 1983, report, which quoted extensively from a prior GAO report, USDA's Office of Inspector General (OIG) also objected to CCC repayment practices. The report stated that CCC permits all 13 associations to apply repayments to loan principal until all principal is repaid and then to interest. It noted that CCC repays the Treasury Department for funds borrowed to make the loans, first by applying repayments to accumulated interest and then to unpaid loan principal.

The OIG estimated that CCC would lose at least $95 million on the 1982 crop of flue-cured tobacco under loan. The OIG recommended that the method of computing interest be changed to prevent losses to CCC or that CCC be reimbursed for losses from the associations' no net cost funds or accounts. This recommendation is similar to the one made in our January 11, 1982, report--that CCC bring its loan repayment practices more in line with the method it follows for Treasury borrowings.

In a letter dated December 1, 1983, to Senator Thomas F. Eagleton, the Administrator, ASCS, provided the agency's response to the recommendation. He stated that:

> ". . . We do not believe that the no net cost provisions of the 1982 Act require any change in the procedures which are utilized by the Corporation with respect to the

charging of and crediting interest under the tobacco price support program. In our view, a substantive change in these procedures would fundamentally alter the structure of the tobacco price support program in a manner which is not contemplated by the provisions of the Act.

"For example, the full recovery of CCC costs for interest would require a 160 percent increase in the assessments which are paid by producers under the provisions of the 1982 Act. The effect of an increase of this magnitude would result in the destruction of the tobacco price support program.

"However, we have decided that, beginning January 1, 1984, any repayments which are made with respect to tobacco loans will be applied against any outstanding principal and interest."

The Department did not state how the repayments are to be allocated between principal and interest. The allocation will not, however, result in full recovery of interest costs under the tobacco program. We have referred the issue of whether the No Net Cost Tobacco Program Act of 1982 requires CCC to change its procedures for charging and crediting interest under the tobacco price-support program to our Office of General Counsel for its advice. We will provide the opinion when it is finalized.

COST OF THE 1982 CROP

We obtained cost data from ASCS and CCC to determine the cost of the flue-cured and burley tobacco programs for crop year 1982. According to the data, flue-cured tobacco valued at $437.4 million and burley tobacco valued at $498.1 million were under loan with the associations. Table 1 provides a monthly tabulation for each of these loan amounts.

Table 1

Monthly Advances to Growers for Crop Year 1982 Tobacco

Month	Flue-cured	Burley[a]
July 1982	$ 12,261,581	$ -
August 1982	162,336,235	-
September 1982	109,534,558	-
October 1982	146,568,380	-
November 1982	6,613,237	53,235,013
December 1982	93,408	210,148,685
January 1983	8,637	169,349,303
February 1983	9,257	52,180,037
March 1983	2,677	12,720,226
April 1983	-	411,199
May 1983	-	26,405
	$437,427,970	$498,070,868

[a]Market opened in Nov. 1982.

Carrying costs totaling $52.3 million and interest costs totaling $39.9 million had accrued on crop year 1982 flue-cured tobacco during July 1982 through June 1983. On crop year 1982 burley tobacco, for which the market opened in November 1982, carrying charges totaling $52.7 million and interest charges totaling $23.9 million had accrued during the 8-month period ending June 1983. Table 2 lists the specific carrying costs and table 3 shows the amounts of interest that have accrued on the 1982 crops of flue-cured and burley tobacco.

Table 2

Crop Year 1982 Tobacco Carrying Charges

Charge	Flue-cured[a]	Burley[b]
Redrying charges	$41,782,006	$ -
Sheeting and loading	3,135,603	-
Green freight	1,071,672	3,122,745
Dry freight	791,804	-
Innage	454,656	440,559
Storage	1,058,185	463,133
Commercial insurance	126,398	67,268
Fumigation	207,892	-
Grading service	332,251	568,744
Overhead	1,758,923	543,474
Reweighing	179	-
Inspection and sampling	23,388	-
Processing charges	1,506,921	44,041,626
Outage	176	-
Green prizing (packing)	-	3,427,316
Total	$52,250,054	$52,674,865

[a]Accrued from Aug. 1982 through June 1983.

[b]Accrued from Nov. 1982 through June 1983.

Table 3

Interest Due on Crop Year 1982 Tobacco Loans[a]

Month	Flue-cured	Burley[b]
July 1982	$ 16,400	$ -
August 1982	1,230,815	-
September 1982	2,777,584	-
October 1982	4,288,191	-
November 1982	4,887,541	56,234
December 1982	5,074,480	1,478,916
January 1983	3,697,739	2,659,084
February 1983	3,346,136	3,424,666
March 1983	3,697,314	4,058,195
April 1983	3,581,235	3,968,714
May 1983	3,721,368	4,185,754
June 1983	3,599,993	4,029,436
Total	$39,918,796	$23,860,999

[a]Simple interest computed monthly on outstanding principal balance due.

[b]Market opened in Nov. 1982.

ADEQUACY OF THE ASSESSMENT PROGRAM

The No Net Cost Tobacco Program Act of 1982 provides that, insofar as practicable, the tobacco program be carried out at no net loss and requires that producers pay for the program's cost. Under the act, each association is required to establish a separate capital fund to which producers, as a condition for their eligibility to receive price supports, are required to contribute. The fund is used to ensure that, insofar as practicable, CCC will sustain no net losses from the price-support program. The amount to contribute to the fund is determined by the associations, subject to approval by the Secretary of Agriculture. The Secretary may approve the contributions only if the proposed amounts are sufficient to reimburse CCC for any losses sustained under its loan agreements with the associations.

As of September 16, 1983, assessments had been made on the 1982 and 1983 flue-cured and burley crops. (Because not all of the 1983 crop had been harvested and marketed, only a portion of the flue-cured assessments and none of the burley assessments had been collected as of Sept. 16, 1983.) These assessments have generated funds to be used to cover some of the anticipated losses on the crops under loan.

According to a July 27, 1983, report from the Director, Tobacco and Peanuts Division, to the Board of Directors, CCC, ASCS estimated that the initial assessments placed on the 1982 flue-cured and burley tobacco crops would be inadequate to cover anticipated losses on these crops.

For 1982 the flue-cured assessment was 3 cents per pound and the burley assessment was 1 cent per pound. These assessments, which are based on, among other things, the expected volume of tobacco coming under loan and the anticipated carrying and interest costs, generated $29.5 million and $7.5 million for the respective flue-cured and burley programs to be used to cover anticipated losses on the crops. According to the ASCS report, the initial assessments that USDA approved were inadequate to ensure a no net cost tobacco program for the 1982 crop year, and an additional $60.5 million for the flue-cured program and $112.5 million for the burley program would be needed to recover the program's cost.

According to the report, a record volume of 1982 tobacco came under loan which was partly due to economic recession here and overseas, tax increases on cigarettes, and price increases. This caused the companies to reduce purchases because consumers bought less cigarettes. The report stated that the larger than expected loan volumes would result in larger projected losses than had been earlier indicated for the 1982 crop. ASCS plans to collect the shortages through increased assessments on the 1983 through 1986 crops.

Past experience has shown that it generally takes 4 to 8 years to sell an entire flue-cured crop taken under loan. Also, the marketability of tobacco under loan is affected by various other factors such as inflation, interest rates, demand for tobacco, weather conditions, production quotas, and selling prices. Therefore, it will be several years before it is known whether the assessment on the 1982 flue-cured crop is sufficient to cover the crop's disposal at no net cost to the government.

According to the Deputy Director, Tobacco and Peanuts Division, approximately 115 million pounds of crop year 1982 burley tobacco (or about one-half of the 1982 burley crop under loan) was sold in September 1983. USDA is assessing the impact of these sales on the burley program.

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We are sending copies of this report to the Director, Office of Management and Budget; the Secretary of Agriculture; various

Senate and House committees; members of Congress; and other interested parties. We will also make copies available to others upon request.

Sincerely yours,

J. Dexter Peach
Director