



COMMISSION OF THE EUROPEAN COMMUNITIES

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REPORT FROM THE COMMISSION TO THE COUNCIL

on the common organization of the market in raw tobacco

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I. THE PRODUCT

1. Origin

Tobacco is a subtropical plant that was brought to Europe from South America in the 16th century. It has numerous varieties that are adapted to a very wide range of climatic and soil conditions. As a result, tobacco is grown on all six inhabited continents and is found from Poland to Cuba and from the United States to China.

2. Terminology

Tobacco undergoes two types of post-harvest processing before becoming a finished product (cigarette, pipe tobacco, cigar or cigarillo). Indeed, there are three main phases in the processing of tobacco:

- Tobacco is first grown and harvested, then dried by tobacco farmers or planters on the farm. This is *leaf tobacco*.
- Leaf tobacco is then delivered to companies or *processors* who prepare, bale and process the leaf tobacco so that it is warehousable and usable by tobacco factories. The result of this *first processing* is called *processed* or *baled tobacco*.
- The processed tobacco then undergoes *second processing* in the *factories*, which transform it into a final product.

So, we differentiate between leaf tobacco, processed tobacco, and the finished product, which are treated by three different economic operators: the farmer, the processor and the factory. Whilst these three economic activities are distinct, they may be carried out by the same undertaking, in the legal sense of the term.

These three activities make up the *tobacco sector*, which is characterised by the interdependence of the economic sectors of tobacco production and processing.

Tobacco industry professionals also subdivide tobacco into

- aromatic tobacco, the smell of which will give the mixture used to make cigarettes its desired characteristics; and
- filler, *i.e.*, the neutral tobacco that makes up the bulk of the mixture.

Only raw tobacco (whether leaf or baled) is an agricultural commodity (Annex II to the Treaty of Rome). The finished products are industrial goods (non-Annex II).

II. ECONOMIC AND SOCIAL IMPORTANCE OF TOBACCO PRODUCTION IN EUROPE

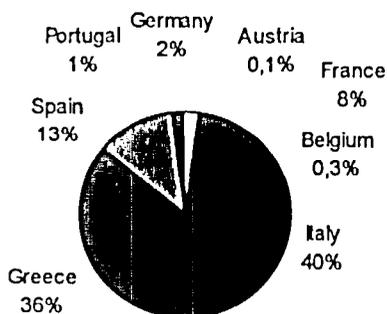
Raw leaf tobacco production in Europe ('000 tonnes)

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
EUR 12	385.2	387.5	411.2	419.9	429.7	407.8	342.7	327.9	333.2	

The European Union, with 4.6% of global tobacco production in 1994, is the world's fifth ranking producer of raw tobacco.

Community tobacco production has been declining steadily since reaching its peak in 1991. By instituting a production quota scheme, the entry into force of the new Common Organization of the Market (COM) in this sector in 1992 effectively has reduced the production of certain types of tobacco for which there was no real market.

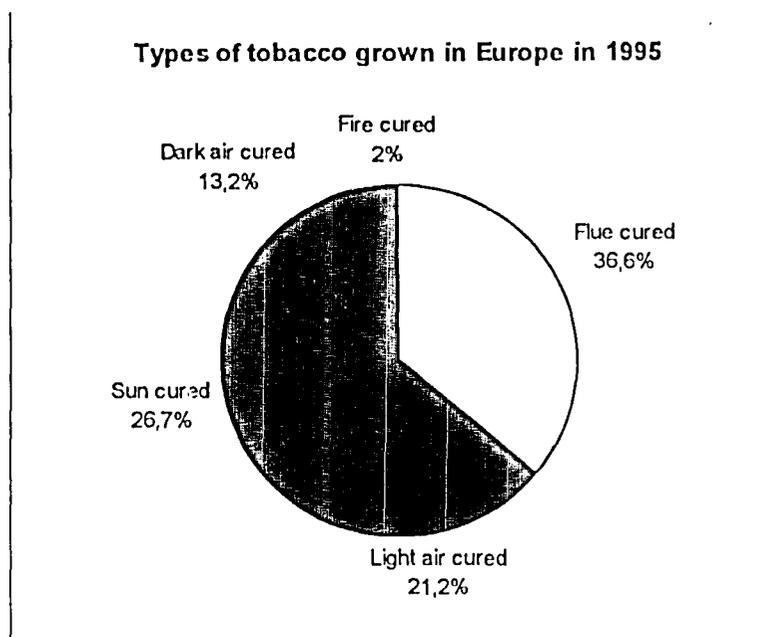
Share of each Member State in Community production of raw leaf tobacco in 1995



Italy and Greece are by far the Community's main producer countries, with 39% and 36%, respectively, of the Community's production in 1995, followed by Spain (13%) and, in decreasing order, France, Germany, Portugal, Belgium and Austria.

This report concerns tobacco production in the previous 12-member European Union, as Austria (600-tonne quota) is the only one of the new members to produce tobacco.

A. The varieties grown in Europe.



Despite their enormous diversity and specific characteristics, tobacco varieties can be grouped according to the technique used to cure (dry) their leaves. Thus, according to an internationally recognised classification, we have

Flue-cured tobacco

This is tobacco cured in ovens where ventilation, temperature and degree of humidity are controlled. This group is made up of the light tobaccos, the best-known variety of which is Virginia (called 'bright' in Italy), which is used in the manufacturing of milder cigarettes, including the mild-tasting American-style blends.

Light air-cured tobacco

These tobaccos are air-cured in sheds without being allowed to undergo fermentation. They are part of the category of light tobaccos that is represented in the Community by the Burley and Maryland varieties.

---> Provided that they are high quality, there is a great demand for flue-cured and light air-cured tobaccos, which are basic ingredients of the American-style mild-taste cigarettes, the popularity of which is tending to increase in all countries, but the competition on this market is fierce.

Sun-cured tobacco

This type of tobacco is cured in the sun, as the classification indicates. It consists of the Turkish or Oriental tobaccos, which the industry subdivides into the Oriental tobaccos *per*

se - basically, Basmás, Kaba Koulak and Katerini - the value of which hinges on the quality of their aromas, and the semi-Oriental varieties, *i.e.*, the Italian sun-cured tobaccos and most of the other Greek Oriental varieties.

---> Sun-cured tobaccos, which are used in almost every tobacco mixture because of their exceptional aromatic qualities, are in high demand on the world market. The Community varieties are of excellent quality on average.

Dark air-cured tobacco

These tobaccos are dried in similar fashion to light air-cured tobacco, except that they are allowed to undergo natural fermentation before they are sold. They consist of the raw or dark tobaccos, the main representatives of which are Paraguay, Badischer Geudertheimer, Havanna, and fermented Burley.

---> As dark air-cured tobaccos are more specifically ingredients of dark cigarettes, sales of which are falling, the global demand for dark air-cured tobacco has been dropping sharply.

Fire-cured tobacco

The main representative of fire-cured tobacco in the Community is Kentucky tobacco, which is produced and smoked primarily in Italy (Tuscan cigars).

---> Global demand for this variety has fallen off sharply.

B. Tobacco growing and use.

1. A demanding, labour-intensive crop.

1.1. *Tobacco cropping calendar.*

Although tobacco cultivation in Europe varies according to the variety and country, the main stages are as follows:

- late winter:
seedbed preparation, tilling of fields
- early spring:
soil preparation (weeding, watering, fertilizing, etc.).
- spring:

transplanting of seedlings from seedbeds to fields (by hand or with a planting machine).

- spring/summer:
crop maintenance, soil treatment, watering, hoeing, weeding and mounding.
- summer:
harvesting, basically by hand, leaf by leaf, by successive leaf stages starting from the bottom of the stem, and curing.
- autumn/winter:
tobacco sorting, baling of the harvest, and delivery.

One of the main features of tobacco cropping is that it requires very meticulous care. After starting his seedlings in a shed or under cover, the farmer will transplant the seedlings to the field, where in most cases in Europe the leaves will be harvested by hand, one by one, as they quickly reach maturity. While soil preparation, weeding and transplanting are often mechanised, tobacco is harvested and sorted basically by hand.

---> Tobacco farming is very labour intensive, especially in the transplanting and harvesting phases.

1.2. *Employment in tobacco farming.*

There are about 135 000 tobacco farmers in the Community, of whom 52% work in Greece and 31% in Italy. The number of people who earn their livings farming tobacco exceeds this figure of 135 000 producers. An estimated 170 000 full-time labourers are required. Many other jobs are also linked indirectly to tobacco farming.

Tobacco is one of the most labour-intensive crops in the European Community. On average, one hectare of tobacco calls for 2 200 hours of work a year per European tobacco farmer compared with 147 hours of work for farmers in the 'general crops' group.

For most varieties labour accounts for between 50 and 70% of the production cost, with the percentage varying with the country and variety produced. Greece's share of the employment figure exceeds its share of the production figure. This is because a large share of the tobacco grown in Greece consists of Oriental varieties, the cultivation of which requires a great amount of hand labour (labour accounts for 85% of the production costs for the Basmas variety). In Italy, in contrast, tobacco farmers grow a large amount of air- or flue-cured bright tobaccos, the cultivation of which requires less manpower (labour accounts for 45% of the production costs of flue-cured tobacco).

More than 80% of this huge manpower requirement is met by the family workforce. The entire family is often involved in growing the tobacco and - especially in Greece - harvesting and sorting the leaves.

Tobacco farmers are relying increasingly on seasonal labourers for transplanting and harvesting their crops.

---> **Tobacco farming is a major source of employment, particularly in Greece and, to a lesser extent, Italy. In some areas it procures the entire population a livelihood, thereby helping to keep the rural population in work.**

2. Tobacco keeps the farms on which it is grown alive.

Farmers who grow tobacco often cultivate several crops. Thus, even if tobacco farming is, if not the only, at least the main source of employment and income for a large number of the people who grow this crop, many of them also are also engaged in sidelines that could not in themselves keep these family farms running.

Raw tobacco, which brought in about ECU 7 700 per hectare in 1995 (including Community aid, at around ECU 6 380 ha), is one of the highest-paid crops per hectare in Europe, but given the high manpower requirements the per capita income remains below the Community farming average.

Tobacco is often the financial mainstay of the farm, despite the small amount of acreage planted. On average, tobacco brings in more than half of the income of the farmers who grow this crop. What is more, it offers high margins per hectare and is a relatively stable source of income for the farmer, since he is assured of a market.

The certainty of finding buyers for the crop that results from the specific organization of the tobacco chain, with its tight links between tobacco producers and processors, enables some producers to invest in other activities. For example, the development of rural tourism in certain regions, such as Périgord in France, has been financed to a great extent by the income earned from tobacco farming.

---> **Without tobacco, practically all of the farms that grow this crop would no longer be economically viable.**

C. Tobacco is planted on small plots in Europe, hampering mechanisation.

1. Small holdings

The total acreage under tobacco in Europe was 158 954 in 1994. Planting commitments for 1995 totalled 149 578 hectares.

Tobacco type	Average area per producer		Member State	Average area per producer
Flue-cured	3.87 ha		Greece	0.92 ha
Light air-cured	0.97 ha		Italy	1.20 ha
Dark air-cured	0.83 ha		Spain	2.07 ha
Fire-cured	1.85 ha		France	1.05 ha
Sun-cured	0.67 ha		Germany	1.70 ha
Greek oriental	0.84 ha		Portugal	3.16 ha
TOTAL	1.11 ha		Belgium	1.18 ha

The mean acreage under tobacco per producer is low (about 1.11 ha). This figure varies according to the variety and country (the average acreage under Virginia tobacco per farm in Italy is 7.88 ha, compared with an average of 0.74 ha under sun-cured tobaccos in Greece). The mean production per producer is about 2.4 tonnes, but varies by a factor of from 1 to 10 between Basmás and Virginia and is five times higher in Spain than in Greece.

These statistics show that, with the help of public support, a farm devoted primarily to tobacco can be viable with a very small acreage and small production figure.

It must be added that the acreage maintained by most of the farmers practising multicropping greatly exceeds the acreage reserved for tobacco alone. Indeed, multicropping is adopted to use the land freed up by the lengthy rotation required to grow tobacco (the rotations can extend to up to seven years between two tobacco crops on the same soil so as to prevent soil depletion and specific diseases of the tobacco plant).

Moreover, the main forms of environmental pollution from tobacco farming are the effects of excessive fertilizing, over-irrigating, and unreasonable pesticide use.

---> As tobacco is generally grown on small plots, the possibilities for mechanising transplanting and harvesting operations are limited. Consequently, the mean yield per hectare has increased but slightly over the past ten years or so.

2. Intensive mechanisation does not seem feasible today.

Certain phases in the cropping of the flue-cured and light air-cured varieties of tobacco - notably harvesting and transplanting - are much more highly mechanised in the United States than in Europe. The use of machines has become feasible technically because the fields there are larger and the varieties that are grown allow mechanisation; it is economically viable because the product's added value remains very high.

Such a degree of mechanisation is not a medium-term possibility in the European Community because:

- firstly, production costs are already very high (wages for labourers, purchases of equipment necessary for curing the leaves, e.g. ovens, driers, etc.) and the profits would not be sufficient to buy new machines;
- secondly, the small size of European holdings (1.11 ha on average) makes using and recouping the cost of sophisticated machinery more difficult; and
- finally, for some varieties, such as Greek sun-cured tobaccos, readiness for harvesting may be judged only by examining the colour and texture of the leaves of each plant, which cannot be done by machines.

More intensive mechanisation can be envisioned only within the context of more cooperative farms.

---> So, tobacco is a very demanding crop. It requires a large amount of hand labour that would be difficult to replace by machinery in the medium term.

3. Employment in the tobacco processing sector.

Tobacco harvesting automatically creates jobs in the tobacco processing sector. The leaves have to be sorted, cleaned, stemmed, and finally baled for sale to the factories. The first processing is a seasonal activity that is concentrated over a five-month period.

The survival of this activity in Europe is linked directly to the continuation of tobacco farming in the Community. The transport of raw tobacco is extremely expensive, making its importation for processing in Europe unprofitable. A European processor cannot earn a living by processing imported tobacco (except for cross-border trade). Being close to the production site is thus one of the keys to the processor's success. As a result, most processing plants are located in the very regions where the tobacco is grown. Even though

a large proportion of the processing is mechanised, it continues to require a large labour force, especially for sorting the leaves.

A study carried out by a private institute¹ in 1992 estimated that some 30 000 people were employed in the first processing of tobacco in 1990 (this figure includes stable and seasonal jobs).

---> Tobacco processors, whose economic activity is directly dependent on tobacco farming in Europe, employ a large number of people.

4. Employment in the tobacco industry.

The above-mentioned study set the number of people employed directly by the tobacco industry in Europe in 1990 at 83 400. The vast majority of these jobs are in private companies that are not economically dependent on tobacco farming in Europe.

It is different when the jobs are provided by firms which are or were publicly owned, as is largely the case in France, Italy, Portugal and Spain. Undertakings of this type, which are still publicly owned except in France, have, for reasons of public service, tobacco buying policies which ensure that a major proportion of their supplies consists of tobacco grown on the territory of their Member State. They are therefore wedded to the existence of Community subsidies which support local production.

Tobacco industries are established in practically all the Member States, with some areas of specialization as in the case of cigar manufacturing in the Canary Islands.

--->The competitiveness of publicly owned or formerly publicly owned tobacco manufacturers depends directly on the continuation of tobacco growing in Europe.

D. A crop that keeps the rural fabric of regions in difficulty alive

While tobacco accounts for only 0.7% of the Community's total gross agricultural production, which is a rather small amount, tobacco farming often has major economic importance locally, in the region where the crop is grown. Tobacco farming keeps the rural fabric of the regions in which it occurs alive, for this crop calls for a large family workforce. In this way, it enables whole families to live in rural areas. By helping to keep the population in the area, tobacco generates considerable economic activity (shops, public services) and thus contributes to the survival of areas threatened by ageing and desertification.

It is striking to notice that tobacco production is very largely concentrated in Objective 1 regions. It contributes very significantly to the economies of Thrace (the mountainous

1 "L'industrie du Tabac dans la Communauté européenne 1990", Pieda, January 1992.

regions of northern Greece), Campania and Puglia (southern Italy), and Extremadura (Spain).

All the economic activity and jobs generated by the processing sector likewise depend directly on tobacco farming. Most of the time the processing activities are located in the regions where tobacco is grown. They consequently help give these regions an industrial framework.

---> **Small, low-yield farms that generate industrial activity provide jobs for a large workforce and prevent the exodus of numerous families in regions that are often characterised by developmental lags. For proof of this, note that 46% of the Community's tobacco producers are Greek farmers who grow, with their families, very promising sun-cured tobacco varieties on small farms averaging 0.8 ha under soil and climatic conditions that make all other alternative crops very difficult, and all of this occurs in Objective 1 regions. Community aid for tobacco farming contributes significantly to spatial planning in the producer countries.**

III. ANALYSIS OF THE QUALITY OF EUROPEAN TOBACCO AND ITS RANK IN WORLD PRODUCTION

Tobacco produced in Europe is low-priced compared with the same varieties obtained on other markets, such as Zimbabwe or Malawi. While the processors' mean purchase price of raw tobacco produced in Europe is low (ECU 0.6 kg for the 1995 harvest), it should be stressed that this was double the figure for the previous crop. This situation shows that the average quality of the leaf produced by certain Community varieties is very low. It also reflects a global market that is currently rising after a period in the doldrums.

A. Quantitative changes in European tobacco production.

Community production of raw tobacco rose steeply until 1991, then dropped by about 24% between 1991 and 1995. This trend is explained by two main factors:

- 'premium hunting', especially for Virginia and Badischer tobacco, under the old COM, that is, up until 1992, which led to a boom in speculative and fraudulent tobacco farming.
- the setting up in 1992 of the new COM in the tobacco sector, which makes it possible to limit production through the institution of quotas.

While the overall tendency has been one of falling production for all of the varieties produced in Europe, the major element in Community production patterns is the impressive, almost threefold rise in the production of flue-cured tobacco in the Union between 1986 and 1992. Flue-cured tobacco is now the leading type of tobacco grown in the Community, where it accounts for 36% of tobacco production. The most striking jump

took place in Greece, where production of flue-cured tobacco increased 72-fold over six years.

The developments in flue-cured tobacco production reflect global market trends on the one hand and the tendency to go for a speculative tobacco crop in the Community that was motivated, until 1992, more by 'premium hunting' than by the real needs of the Community market on the other hand.

Since 1992 the production level has been dependent for the most part on the guarantee thresholds. Thus, after peaking at 430 000 tonnes in 1991, European Union tobacco production stood at 328 000 tonnes in 1994 and rose slightly to 333 180 tonnes for the 1995 harvest.

1996 and 1997 guarantee thresholds (in tonnes)

	I Flue cured	II Light air cured	III Dark air cured	IV Fire cured	V Sun cured	Other			TOTAL
						VI Basma	VII Katerini	VIII K. Koulak	
Italy	48 000	46 500	17 900	6 900	13 500				132 800
Greece	30 700	12 400			15 700	26 100	22 250	19 550	126 700
Spain	29 000	2 470	10 800	30					42 300
Portugal	5 500	1 200							6 700
France	9 000	6 600	12 000						27 600
Germany	3 000	4 500	4 500						12 000
Belgium		200	1 700						1 900
Austria	30	470	100						600
	125 230	74 340	47 000	6 930	29 200	26 100	22 250	19 550	350 600

---> The Community raw tobacco production picture was characterised in part by a hunt for premiums that bloated production artificially. To date, the quota scheme that has been set up has held production in check.

B. The low internal prices show that the quality of most of the varieties produced in the European Union is very low

Market prices in Europe are not high enough to cover tobacco producers' production costs.

The average price at which processors purchase Community tobacco is extremely low (ECU 0.6 kg in 1995). While the drop in European prices was greatly influenced by the drop in world prices, the level they have reached in Europe is well below the price of a kilo of tobacco quoted on the markets of Malawi, Zimbabwe and the United States.

The low prices of Community tobacco are explained first of all by the poor quality of the tobacco produced in Europe. **Although the average quality of tobacco produced in Europe is low, a finer analysis shows that most of the Greek Oriental tobaccos (Groups VI, VII and VIII) are of good quality and are sold at high prices.** In contrast, good-quality tobaccos account for but a small share of production in the other groups. This poor quality is particularly clear for most of the Greek and Italian Virginia and Burley tobacco, the production of which depends on a Community premium that is sometimes 99 times the purchase price of a kilo of tobacco. The only market for such tobacco is as filler in cheap mixtures.

This price drop has been offset by the steady prices of certain Greek Oriental varieties and, to a lesser extent, the good prices fetched by dark air-cured tobacco.

Analysis of the mean price levels in the two main producer countries shows that:

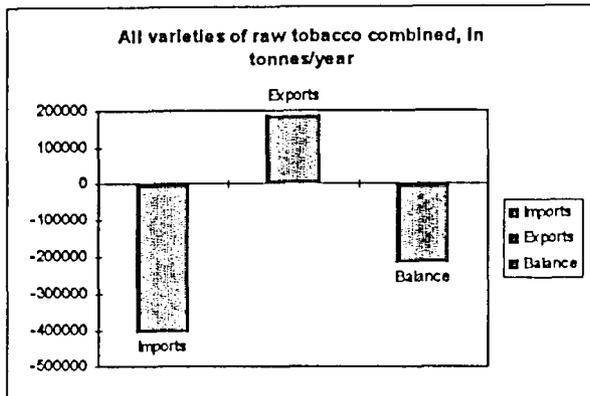
- production in Greece is marked by a strong point, namely, a specialisation in top-of-the-line products (Basma, Katerini, Kaba Koulak and 36% of sun-cured tobacco) sold at high prices that raise the national average above the Community average and offset, to a certain extent, the country's poor flue-cured tobaccos. Note should be taken of the fact that prices jumped significantly for the 1995 harvest in Greece (they doubled for Basmas and quadrupled for flue-cured tobacco).
- in Italy, unlike Greece, there is no particularly strong variety fetching well-above-average prices. On the contrary, 90% of the production of each variety fetches less than ECU 0.442 kg and more than 75% of the production of flue-cured, light, dark and sun-cured tobacco is sold at a price more or less below ECU 0.088 kg. Nevertheless, Italy produces good-quality flue-cured tobacco, especially in the north. The purchase prices of this variety were the only ones to increase in 1995 and thus take advantage of the improvement in the world market, unlike the other Italian varieties, the purchase prices of which remain extremely low.

---> With the exception of some very specific varieties (notably the Greek Oriental tobaccos), the very low purchase prices of raw tobacco in Europe testify to the generally poor quality of Community tobacco.

C. Production does not cover the Community's qualitative consumption needs.

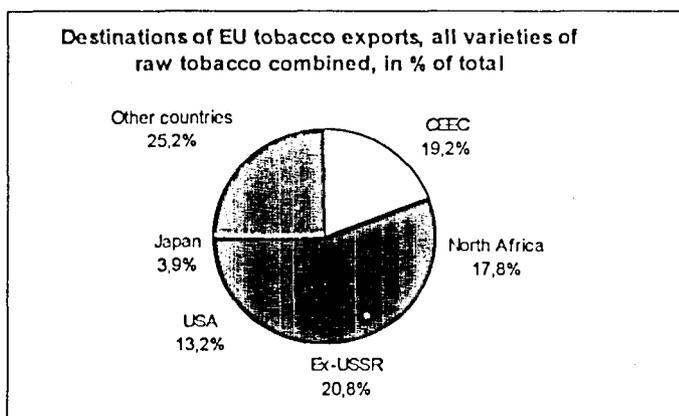
Although the level of Community tobacco production is high enough potentially to meet close to half of consumption, the tobacco that is produced in the Union covers only 23% of our consumption needs. The rest is imported.

Our production has been unable to react satisfactorily to the far-reaching changes that have occurred in Community consumption patterns over the past fifteen years. The erstwhile compartmentalised national markets that were supplied primarily by local producers have been shorn of their protection. At the same time, consumption has become more uniform and shifted towards American-type tobaccos. Some of the local producers were unable to reconvert and adapt to consumers' changing tastes. This is especially true in the case of Group V tobaccos.



Even though, to meet its consumption needs, the Community will in any event continue to have to import certain types of tobacco that it cannot produce profitably on its own soil in order to meet internal consumption needs, it must be stressed that the volume of our imports is well above the volumes of EU production and exports. The difference in value is even clearer: the value of the tobacco imported into the Community is twice that of the Community tobacco we export.

This negative balance applies across the board to all the types of tobacco grown in the Community except the Greek Oriental varieties. The problem is particularly acute in the case of flue-cured tobacco.



The main markets for the poor-quality tobacco are exports to areas (CEEC, North Africa, former USSR) where living standards are so low that the quality of the tobacco smoked is less important than its price. Attention must, however, be drawn to the one exception, sun-cured tobacco. This is the only type of tobacco for which the EU's balance of trade (in volume) is positive.

Tobacco benefits from an *ad valorem* import scheme bound under GATT. Recent developments in external market protection have not had a significant impact on the EC market.

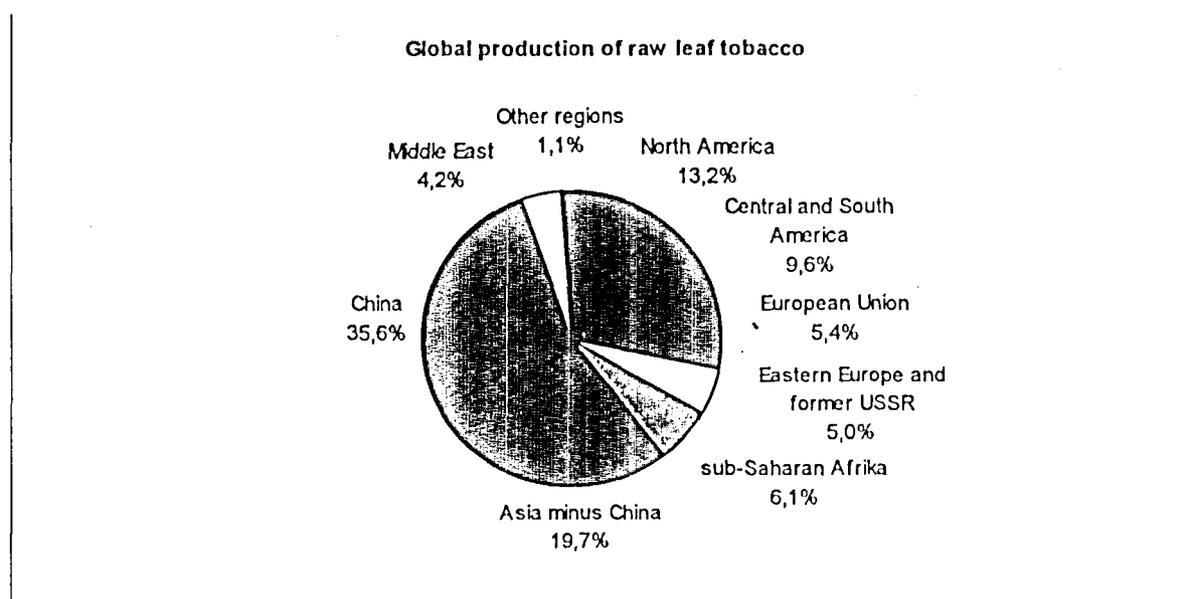
Tobacco comes under the general rule of reduced tariff protection that was revised during the Uruguay Round.

It should be pointed out that under the Lomé Convention ACP countries (for example, Zimbabwe and Malawi) may export tobacco to Europe subject to a zero duty. Special concessions are granted under the GSP agreements.

---> The poor quality of a large proportion of the production and the growth and, in certain cases, maintenance of production that is not attuned to the Community's market needs explain why the self-sufficiency rate is so low.

D. The world market.

The world market for raw tobacco is very special in that there is no world market price for the commodity and the market is dominated by four US and British multinationals - Philip Morris, BAT Industries, RJ Reynolds and Rothmans International.



China, with 42% of global production, is by far the leading producer, followed by the United States and India. The European Union ranks fifth, with 4.6% of global production in 1994. On the other hand, it is the world's leading importer of tobacco.

World and Chinese production of raw leaf tobacco in 1,000 tonnes

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995*
World	6000.5	6130	6710.6	7200	7053.1	7607.8	8324.9	8306.1	6515.3	7239.3
China	1707	1943	2620	2870	2627.5	3030.7	3499	3451	2320	3100

* USDA estimates

The major rise in global production of raw tobacco that occurred from the late eighties until 1993, notably for flue-cured and Burley tobacco, reflected a spurt in production in developing countries (China, India, Brazil, Zimbabwe, Malawi, Turkey, etc.) that was not absorbed by a proportionate increase in global consumption. The result was an increase in global reserves and depressed prices until 1993. Since then, lower production levels, increased global consumption, and falling reserves have led to rising prices, although they have not yet reached their 1991 levels.

The trend in developing countries is toward increasing quality. In addition, with wages accounting for the biggest share of the cost of tobacco farming, these countries have an obvious advantage. The improvement in the quality/price ratios of these countries' tobacco crops has resulted in increased competitiveness and gains in their export market shares. It is significant in this respect that in 1993 Malawi and Brazil overtook the United States as the world's leading exporters of Burley and flue-cured tobaccos.

The overall trend is one of stiffer price competition on the world market. Interestingly, the United States, which is the second world producer, does not seem to have been able to meet the challenge of increased competition, despite the excellent quality of its tobacco. US tobacco prices remain high, the United States' shares of the export market are declining, domestic market shares are following suit, and cheaper imports of flue-cured and Burley tobaccos are increasing, despite the fact that these tobaccos are grown by US farmers.

To wrap up, we must mention the uncertainty plaguing the world market due to Chinese tobacco, which alone accounts for 40% of world production. So far, the rise in Chinese tobacco production has served above all to meet the steadily rising domestic demand. However, the sharp increase in the country's stocks and sizable investments by major multinationals could prompt China to export more. Confirmation of this currently burgeoning tendency would have major impact on the world market and would be a particularly serious threat for European producers, a large share of whose production likewise is intended for use as cheap filler.

---> The world raw tobacco market is characterised by the steadily rising quality/price ratios of the tobacco produced by developing countries, the export market shares of which are increasing significantly. China is a major source of uncertainty; it could upset the world market balance seriously, especially if it exports more flue-cured tobacco.

CONCLUSIONS OF PARTS I, II AND III.

The production of some very specific varieties, such as Greek Oriental tobaccos, aside, we can say that the medium-term survival of Community tobacco is contingent on an improvement in quality.

If the quality of EU tobacco does not improve, Europe's raw tobacco production sector is doomed in the medium term.

Indeed, **the current markets for our tobacco are temporary.** The great demand from the former Eastern Bloc countries, which is currently swallowing up the bulk of our exports, is soon likely to be partially met by restructured traditional local tobacco farming. In addition, as living standards rise, these markets will demand increasing quality. **This demand for increasing quality** underlies the world market as a whole. This trend goes hand in hand with the growing popularity of cigarettes with an American taste and, more generally, the shift towards ever milder tobaccos and increasingly strict health regulations.

The EU's current specialisation in the production of cheap filler may face stiff competition from countries with very low production costs, especially China, which could well cut Europe out of the market if it gives free rein to its export impulses.

Lastly, we must underscore that the purchase prices that processors pay in Europe account for a mere 20.7% or so of the premium paid to growers. This figure shows well **how dependent the sector is on public subsidies.** The only way to weaken the sector's dependence on subsidies is to improve the crop's value and decrease the amount of the premium paid out for low-priced tobaccos.

EU tobacco production can change

Without claiming to produce tobacco of the quality produced in Zimbabwe or the United States, all of the sector's professionals agree that the European Union has the potential needed to produce a mid-range tobacco that currently sells for much higher prices on the world market, for example, more than US\$3.00/kg for baled flue-cured tobacco. Such an objective is all the more attainable in that certain types of tobacco grown in Europe, such as the Italian and Spanish sun-cured and French Burley tobaccos, never mind a large share of the Greek sun-cured tobaccos, have already reached completely acceptable prices. **The techniques and conditions for growing quality tobacco thus do exist in Europe, provided that official support is maintained.**

IV. THE COM'S FUNCTIONING AFTER THE 1992 REFORM

The 1992 reform put an end to a scheme that was highly vulnerable to fraud, to the rise in output of dubious market quality, and to budget overruns that worsened in the late eighties.

A. Budget and budget control.

1. Budget expenditure under control.

By making it possible to put a lid on budget expenditure, the 1992 reform of the tobacco COM put an end to the overruns of the former COM. This control of expenditure has first of all been a direct consequence of the proper implementation of the production quota scheme. Production (343 000 tonnes in 1993, 328 000 tonnes in 1994 and 333 180 tonnes in 1995) has been consistently lower than the quotas, which were brought down from 370 000 tonnes in 1993 to 350 000 tonnes as of 1994 following a rise in production under the old scheme that had peaked at 430 000 tonnes in 1991. Expenditure has also been held in check by the abolition of the export refund and intervention mechanisms.

Budget expenditure

(in million ECU)

EUR 12									
1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
782,2	917,9	987,1	1.138,9	1.232,1	1.329,6	1.233,1	1.165,1	1.057,4	993,0

---> The new COM set up in 1992 has stabilised, even lowered, budget expenditure by reducing production and dismantling some expensive mechanisms.

2. Fewer risks of fraud.

The risks of fraud have been greatly reduced by the new COM's entry into effect due to the following:

- the complex measures that facilitated fraud in the old COM have been abolished. Indeed, the new COM no longer provides for intervention, export refunds, factoring in of percentages of losses or reference moisture contents, nor any of the expenditure-generating events that formerly encouraged monetary speculation. On the other hand, the reform has reduced the number of groups of varieties eligible for premiums from thirty-six to eight by eliminating an unverifiable host of varieties eligible for differentiated premiums.

- the premium payment procedures have been simplified: the premium may henceforward be paid out to the producer directly without going through the processor.

In addition, monitoring procedures have been strengthened in line with the progress of the reform's implementation through

- simplification of the premium payment procedure;
- stepped-up checks of planted acreage; and
- publication of each producer's quota so as to combat the phenomenon of fictitious growers who unduly benefit from the situation without producing any tobacco.

Nevertheless, the setting up of national supervisory agencies in Italy and Greece that is provided for and encouraged by the reform has not yet been achieved for a variety of reasons.

---> The nature and scale of the irregularities ascertained after the reform are completely different compared with the previous situation. Most of them are due to the drastic changes in the rules, the complexity of managing the quota scheme, and lack of supervision (fake producers).

B. The sector's economy

While the reform has been an undeniable success from the budgetary standpoint, its results with regard to the sector's economy are more mitigated. Indeed, to the extent that the pre-1992 reform situation, which was highly opaque, can be compared with the more transparent post-reform situation, the market prices do not seem to have improved. The drops and sluggishness in market prices have been partly offset by the change in the support scheme (direct payment of premiums to producers) as well as by a few one-off increases in the premiums. However, a squeeze on the earnings of specific categories of producers, notably in northern Europe (France, Germany and Belgium), has been felt.

1. Market prices that are much too low in comparison with the premiums.

a) Pre- and post-reform prices

It is not easy to compare the situations prior to and after 1992. Prior to the 1992 reform the prices that processors paid to producers already included the premiums paid to these same processors. The processors also benefited from other types of official aid, e.g., intervention and export refunds. In addition to such aid, a mechanism for converting the premium, which was set in ecus, into the local currency was used by certain processors to reap huge speculative profits by gambling on the differences in the exchange rates in effect at the times of the premium's payment and reimbursement. Still, the above-mentioned difficulties hampering comparison of Community tobacco market prices before

and after the 1992 reform cannot hide the fact that the market prices are very low and for most varieties correspond to a tiny fraction of the premiums that are paid out (here by 'premium' we mean the total of the premium *per se*, the supplementary amount granted in the northern countries, and the aid paid to the producers' groups, to which 99% of tobacco growers belong). So, if we take the 1995 harvest, the market prices (premiums not included) are equal to only 20.7% or so of the premiums paid.

While the overall situation is not satisfactory, it does not apply uniformly across the board: there are noticeable differences from one variety or country to the next.

b) *Price/premium ratio per variety*

The lowest price/premium ratios are posted by flue-cured, light air-cured and sun-cured (Group V) tobaccos. For these types they do not reach 10%. In contrast, they consistently exceed 39% for the Greek Oriental tobaccos. The ratios for the brown and fire-cured tobaccos are 19 and 24.6%, respectively.

This ratio deserves a finer analysis. The mean Community price, which is dragged down by a large proportion of very low prices, must not camouflage a few clearly more favourable situations, even concerning the tobaccos with the lowest price/premium ratios. Thus, the top-quality flue-cured tobaccos post market prices that revolve around 50% of the premium and the best qualities of light air-cured tobacco posted market prices that were around 75% of the premium in 1993 and 1994 and above 100% of the premium in 1995.

Premiums for 1995 harvest leaf tobacco

	I Flue cured	II Light air cured	III Dark air cured	IV Fire cured	V Sun cured	VI Basmas	VII Katerini	VIII Kaba Koulak
Ecus/kg	2,70965	2,16748	2,16748	2,38362	2,16748	3,75415	3,18541	2,27615

For Belgium, France and Germany supplementary amounts ranging from ECU 0.1847 to 0.6786 are allowed for Group I, II and III varieties. These amounts are equal to half of the difference between the current year's premium and the premium applicable to the 1992 harvest.

c) *Price/premium ratio per country*

It should be pointed out that the northern countries also benefit from an additional premium that allows for their higher production costs, which are due to their markedly higher labour costs. Analysis of the price/premium ratio by country reveals that there are roughly two groups of countries, the northern countries (France, Belgium, Austria and Germany) and the southern ones, with higher market prices in the northern group. This difference is explained by the better adaptation of the northern countries' smaller growers to the industry's needs. Thus, the price/premium ratio in 1995 exceeded 20% for the

northern group (even exceeding 30% for France, Austria and Belgium) but did not reach 10% for the southern group comprising Italy, Spain and Portugal. In Greece the weight of the more expensive Oriental tobaccos raised the average price/premium ratio to 36.2%, which was one of the highest in the Community in 1995.

d) *Why such an unsatisfactory ratio?*

This situation is explained by two reasons, one structural, the other dependent on market trends.

- First of all, the scheme of relatively high premiums that are independent of the quality and yield does not provide any incentives for increasing the quality of the production and thus market prices in a context of relatively low market prices overall. At the current stage, a producer does better if he grows a low-quality high-yielding variety, such as flue-cured tobacco, that entails less cost and effort.
- Secondly, the global bear market since 1991 has forced prices in the European Community down. The turnaround in prices in the Community, which lag one year behind world market prices, was not felt until the 1995 harvest, which posted significant price rises, especially in Greece.

2. A processing industry in the midst of restructuring

Although less detailed information is available concerning the situation of the processing industry in Europe, it can nevertheless be said that this sector is currently being revamped. Europe's processors no longer benefit from the support granted under the old scheme (intervention and export refunds), production has fallen by some 15%, and even though processors have been able to pass the lower market prices on to producers, their economic situation today is precarious.

Processing overcapacity, which is particularly clear in certain regions and for certain groups of tobacco varieties, is leading to and will lead to even further rationalisation of the industry's capacity. This rationalisation, which has begun without too much strife, has also made it possible to eliminate some rather parasitic undertakings. This can only be beneficial for the sector's overall economy.

The ongoing rationalisation of industrial capacity may enable tobacco growers to adapt better to market demand. It may also lower average processing costs, which should have favourable repercussions on the prices paid to producers.

3. The processors continue to be solidly implanted in the European Community

As far as the processors are concerned, the large multinationals' direct dependence on changes in Community tobacco production is weak, for their supply strategies are global. However, having stable qualities of tobacco at competitive prices is in their interest, too. Community production can interest them in this respect. That being said, their presence

in the Community is marked by stability, whether with regard to purchases of Community tobacco or industrial production.

In contrast, Europe's modern and old State-owned factories are in the throes of a more delicate process of privatisation and severe rationalisation of production facilities.

---> Except for some very specific tobaccos, market prices are very low compared with the premiums being paid out.

C. Management

1. The current scheme is characterised by a certain inflexibility

A quota scheme is always characterised by a certain inflexibility and administrative complexity. The COM in tobacco is no exception to the rule. The possibilities for transferring quotas are very limited. To protect traditional producers - a praiseworthy objective in itself - all definitive transfers of quotas are practically ruled out unless the grower ceases operation. This being so, measures were adopted in 1996 to allow temporary, annual transfers of the unused portions of certified quotas.

This inflexibility is also seen in the varietal group quotas' failure to adapt to changing demand and meteorological conditions. While setting quotas for one year or more gives growers a stable framework, changes in demand and the weather do not heed administrative orders. This simple truth has moreover led the Community to adopt arrangements for transferring quotas between groups of varieties and production carry-over in order to cope with such above-mentioned fluctuations.

2. The scheme is also somewhat complex

The complexity of the scheme's administration is linked above all to the calculation and distribution of individual quotas and registration of cultivation contracts. Despite the fact that growers are strongly encouraged to band together, the quotas are still distributed to individual growers. Now, this multiplies the various administrative operations required by several hundred.

The individual quotas are calculated each year on the basis of actual deliveries over the previous three years. In addition to these thousands of annual operations, the unused part of each quota certificate must be sent back to the respective national administration, which then proceeds with a second distribution of the available quantities. It must be stressed that each distribution of quota certificates is followed by a period for concluding the cultivation contracts, which must obligatorily be registered.

Up until the 1996 harvest the complexity of these administrative procedures was exacerbated by the existence of cultivation certificates, which replaced quota certificates in the case of tobacco producing and processing cooperatives.

All this has been compounded by the normal difficulties of transition from the old to the new scheme, the exclusion of 1992 as a reference year for calculating quotas, and the taking of new producers into account.

The current quota system is too restrictive, for

- it does not facilitate adapting production to the market's needs, and
- given its complexity, it is cumbersome for the administrations to manage.

3. Transitional period

For a transitional period running from the 1992 reform to the end of 1994 it was still possible to sell tobacco grown prior to the 1993 crop to intervention agencies or be eligible for export refunds. As this transitional period has come to a close, only a small amount of tobacco remains in the intervention stock. It should be sold in the course of the 1996 fiscal year.

4. Reconversion programmes

Growers of the Mavra and Tsebelia varieties in Greece and the Forchheimer Havanna IIc variety and Geudertheimer hybrids in Italy have been given the possibility of switching to other varieties or agricultural crops. A particularly large number of growers have signed up for these programmes in Greece. Given the market problems plaguing these varieties, the reconversion programmes must nonetheless be backed up by appropriate measures described later in this report.

CONCLUSIONS OF PART IV

First of all the analysis shows that the overall situation is positive. The reformed COM has worked well, budget expenditure has been held in check, frauds limited to a great extent, and, despite its complexity, the administrations involved have managed, albeit with delays, to overcome the various barriers to its implementation.

Secondly, weaknesses calling for appropriate corrective measures have emerged. These are, firstly, the low market price-to-premium ratio, which is liable to jeopardise the efficacy of public support for growers; secondly, the scheme's lack of flexibility, making access to the sector, transfers of production quotas and adaptation of the guarantee thresholds to market demand difficult; and thirdly, the complexity of its management, given the host of operations involved in calculating and distributing individual quotas.

If official support for producers is maintained, the future will hinge on improving the sector's economic situation by raising the quality and consequently the market prices of the tobacco that is produced, by rendering management more flexible by allowing definitive transfers of quotas and broadening the possibilities for transferring guarantee thresholds between varieties, and by simplifying the administrative procedures so as to free the operators and national administrations from excessive red tape.

V. PROPOSALS FOR THE FUTURE OF THE COM IN TOBACCO.

A. The Commission's choices

---> *A prior political decision*

Tobacco farming is no different from any other agricultural activity. However, one has to admit that tobacco consumption has harmful effects on human health. The fifteen Member States of the European Union are in the forefront of the countries that encourage smoking prevention campaigns and restrict the advertising of tobacco products.

Article 129 of the Treaty provides that health protection requirements shall form a constituent part of the Community's other policies.

The anti-smoking campaigns sometimes elicit a certain amount of puzzlement over the fact that the Community is continuing to help tobacco producers While participating in the promotion of anti-smoking measures. The Commission has always stressed the fact that aid to tobacco growers has no impact on the level of tobacco consumption in the European Union and the 'only' real effect of ending support for tobacco growers would be an increase in tobacco imports, as virtually the entire EU tobacco crop would be doomed if support were withdrawn.

The great majority of these tobacco farmers live in disadvantaged rural areas where alternatives to traditional occupations are rare. The reason for organizing the tobacco market is to support these farmers. On no account must it be considered support for smoking. While this distinction has clearly been made by the Commission, it is no less true that certain segments of public opinion and political circles have a negative perception of this Community aid.

---> *involving a choice between two scenarios*

First scenario

In this scenario, the decision would be gradually to disengage the Community from this sector. Specific measures would then have to be taken to ease the growers' switching to other activities or ceasing their activity and to lessen the impact of such disengagement on the processing industry farther down the chain and on the local economies in general.

Commission proposal:

Since the decision is to continue supporting tobacco farmers, then the future of the COM in tobacco must be decided on the basis of past experience and the Community's market forecasts.

Sticking to the *status quo* must be rejected, for, despite the overall positive effects of the 1992 reform, official funds still are not used very effectively if one considers the mean

value of Community tobacco. Measures that include a share of continuity and a share of reform so as to shore up the positive aspects of the 1992 reform and correct its weaknesses are justified.

The aim should be to enhance the sector's economic productivity by increasing the final value of the output. This calls for higher-quality as demanded by the market. This is the only way to increase both growers' incomes and the effectiveness of official aid for the sector without budget overruns.

It is also necessary to make it easier to leave the sector voluntarily.

B. Scenarios for the future

1. Scenario 1 - Gradual disengagement

To analyse the consequences of the Community's gradual disengagement from the market it is necessary both to assess the economic and social impact of such a measure and to study the possible alternatives. In addition, it must be stressed that this would be the first time the Community dismantled a COM.

a) Social and economic impact.

Cutting off aid to the growers, whose incomes as a rule are highly dependent on the Community's budget, would doom most of the Community's tobacco production to disappear in the short run, with the possible exception of a few pockets of high-value tobacco (Oriental varieties) in northern Greece. Downstream, the processing industry would also be doomed, for processing imported leaf tobacco in the Community is not economic. As a reminder, some 135 000 jobs in tobacco production and 18 000 jobs in the processing sector (likewise concentrated in the tobacco-growing regions) would be affected. To this must be added the impact of losing the indirect economic effects of these activities. On the other hand, a segment of the manufacturing industry might be less affected. The multinationals would be able to change their global sources of raw material without too much difficulty and continue operating in the Community. In contrast, the old State undertakings (Monopoli di Stato, SEITA, Tabacalera and Tabaqueira) would be affected, for they traditionally get a large proportion of their supplies from their domestic markets.

The first question to ask is therefore what would be the alternatives to tobacco farming and processing.

b) Alternatives to tobacco farming.

First of all, one must realise that, as a rule, tobacco is grown on soil that is suitable for growing other crops. The Greek Oriental (and, to a lesser extent, Italian semi-Oriental) varieties are exceptions to this rule, for they are grown on poorer, dry, hillside plots where growing other crops is riskier.

While there are no purely agronomic obstacles to reorienting tobacco farms toward different crops, such conversion raises problems of economic viability.

Today, converting some 150 000 ha of a highly labour-intensive crop that generates high gross profit margins per hectare without endangering the economic equilibria of the replacement crops, especially of market garden crops, which have similar agricultural and labour requirements to those of tobacco, does not appear to be feasible.

There are no real alternative crops which would make such small farms economically viable.

Switching to other crops, such as field crops, or livestock would also come up against market equilibria or quantitative restrictions on Community support as in the milk, livestock and field crop sectors. Moreover, as field crops demand much less manpower, they would never be able to absorb the labour surpluses generated by the cessation of tobacco farming. Unemployment would consequently rise.

Forestry would offer some advantages from this point of view, for market forecasts are for demand exceeding supply. However, given the small size and high labour-intensiveness of the typical tobacco farm, afforestation would be economically inefficient and in any event unable to absorb the lost jobs.

Consequently, wholesale compulsory conversion would entail more far-reaching and faster adjustment than voluntary departure and therefore any real alternative to tobacco farming would have to be sought outside agriculture in the broad sense, that is, in other areas of economic activity. The same applies to the processing industry, which would have to undergo radical conversion.

This assessment highlights the need for well-integrated accompanying measures if economic depression and its possible social consequences are to be avoided. Consequently, the Community's disengagement should be accompanied, during a transitional period, by support measures for the economic conversion of tobacco farms and processing.

Once the problem is stated in these terms, the more dynamic and economically developed the tobacco-farming areas are, the easier their economic conversion. Unfortunately, this is but rarely the case - quite the contrary - for some 80% of production is in Objective 1 regions and often the least developed of the Objective 1 group (Thrace and Central Greece, Puglia and Campania in Italy, and Extremadura and Andalusia in Spain).

The Commission rejected this scenario for the following reasons:

- Community disengagement from the sector would have no effect on tobacco consumption;
- the economic and social consequences would be likely to be very serious in regions already experiencing major economic problems;
- the Community market organization might be replaced by national ones.

2. Other rejected scenarios

The above analysis of the tobacco sector and functioning of the COM shows that the scheme set up after the 1992 reform can be given an overall positive assessment, especially as regards controlling the budget, creating a sounder market, and combating fraud. On the other hand, economic incentives to encourage the production of higher-value varieties more in line with the market's needs and ways to render the COM's management simpler and more flexible must be instituted.

a) Alternatives to the current support model

- (i) The first alternative would be to replace the production quota and aid system with a system of aid per hectare.

Such a system applied to the tobacco sector would be very difficult to monitor and would be likely to attract "premium hunters".

The introduction of a per-hectare aid scheme would require accurate checking of areas, which would be very difficult to achieve on account of the small areas involved (1.1 ha on average per holding, with much smaller plots), the number of holdings (over 135 000) and the rotation between plots.

Community aid accounts on average for 80% of growers' income from tobacco (over 95% in the case of some varieties in some Member States). In these circumstances a per hectare aid scheme carries a real risk that growers will plant tobacco without actually harvesting it. In order to deal with this problem it would be necessary to keep a check on deliveries in addition to accurately monitoring areas, which would make the scheme more complex and cumbersome to administer.

- (ii) The other alternative model would consist in paying tobacco farmers direct income support equivalent to their mean net income.

According to the Court of Auditors, which suggested such a scheme in its 1994 report, this would halve the current budget for the sector.

The Court calculated that if every farmer who pulled out of tobacco farming had received over the three-year period running from 1988 through 1990 compensatory aid from the Community instead of the above-mentioned mean net income per hectare, *i.e.*, ECU 2 655, the total cost for the Community budget would have been ECU 595 m and the Community could have thus saved ECU 520 m under this scheme. In addition, it contended that such a scheme would have had the merit of cutting tobacco production, which would have been in line with the Community's efforts to reduce smoking for health reasons.

There are, however, two major flaws in this analysis:

- First of all, the Court of Auditors made a methodological mistake in calculating the mean net incomes. This mistake is very simple but has huge consequences, for the Court did not weight the FADN's income data. As a result, the lowest income figures in two small producer countries totally skewed the mean. Tobacco growers' mean net income over the three years analysed by the Court was actually ECU 4 275 ha, not ECU 2 655 ha. The compensatory aid would accordingly total ECU 954 m, which is fairly close to the current expenditure.
 - Next, claiming, as the Court does in its 1994 report, that the reduction in Community tobacco production would make a positive contribution to the war on smoking is tantamount to saying that imports from the rest of the world would not fill the gap or that the level of smoking depends on the place where tobacco is grown. Such claims do not appear to be founded. The true consequences of a drop in Community tobacco production would be an increase in imports from outside the EU and a negative impact on the economies of the EU's tobacco-growing regions.
 - In addition, paying direct income support, as the Court suggests, to farmers who gave up growing tobacco would create an extraordinary situation in which farmers would be financed by public funds provided that they did not farm. This would go well beyond set-aside payments. The social and political acceptability of such a situation is doubtful.
- (iii) Another alternative would be to lower the premiums significantly to encourage farmers to improve the quality of their crops, as they would then be much more dependent on market prices.

In this case, however, the incomes of a large number of producers would plummet, forcing many of them out of the sector without any other compensation, for they would not be able to increase the value of their crops and would find themselves much worse off financially. This would be even truer in some regions that are currently producing very low market value varieties and would not have any support to switch to better quality tobaccos. This alternative would reduce support for the sector along two avenues, first by lowering the premiums, then by reducing the number of growers.

---> The solutions examined by the Court of Auditors in its 1994 report are not realistic, lasting responses to the economic and social problems confronting the tobacco-growing sector in Europe.

- (iv) Retaining the scheme in its present form must clearly be ruled out for the reasons set out in the conclusions of Part IV.

Firstly, the low market price-to-premium ratio is liable to jeopardise the efficacy of public support for growers; secondly, the scheme's inflexibility makes access to the sector, transfers of production quotas and adaptation of the guarantee thresholds to market demand difficult; and thirdly, the complexity of its management must be borne in mind, given the host of operations involved in calculating and distributing individual quotas.

b) Scenario 2 - Commission proposals : fundamental reform of the sector

The continuation of support for tobacco farmers should be based on the current COM with some substantial improvements. The modifications required would, however, go further than the arrangements provided for in the basic regulation and which concerned Titles I - Premium System and II - System of Production Limitation.

(1) Modifying the premium scheme to improve the quality of the tobacco produced - a major challenge

(a) Why change the current scheme of premiums?

The changes made to the way the premium system currently operates must be equal to the criticism levied against it.

The main criticism is that the Community is financing a low-quality product - in the case of the bulk of the tobacco - for which there is no true demand inside the Community. Consequently, financing tobacco farming is a waste of public monies. While this criticism is not justified for certain products (Greek Oriental tobaccos), it is founded, on the contrary, where a good proportion of the tobacco produced is of very low quality and value. Having said this, we must nevertheless point out that there is currently a market for even this tobacco, as proven by exports without refunds to the CEEC and North Africa in 1993, 1994 and 1995.

Analysis of the current situation shows that measures must be taken to improve the quality and value of the tobacco produced in Europe so as better to meet the internal market's needs and increase the sector's added value. Such an approach is all the more necessary as the current outlets for the Community's low-quality tobacco do not have long-term prospects, consumers are becoming fussier, and growers will face stiffer competition from the low-end tobaccos produced by less developed countries.

As already explained in this report, paying a set price regardless of the tobacco's quality in a context in which the other part of the producer's earnings, *i.e.*, the market price, is generally marginal compared with the premium, does not create any incentives to grow tobacco with a better quality/price ratio.

Thus, while improving the quality of the tobacco produced is the main aim of the proposed amendments, it also presents us with a major challenge. Old habits die hard, and the changes sought can only come about gradually.

---> **The proposed changes are intended to improve the economic situation of the sector, to render the quota scheme more flexible and simplify its administrative management, to step up supervision, to take account of environmental protection, and, finally, to organize a system for getting out of the sector.**

We must stress in particular that the success of these proposals is an indispensable condition for continuing to provide support for tobacco growers.

(b) Proposal: Modulate Community aid according to tobacco quality so as to encourage better quality

(b1) The principle of modulated Community aid

The Council of Ministers, being aware of this situation, asked the Commission to study the possibility of modulating support for tobacco according to quality (conclusions of the June 1995 Council).

The Court of Auditors had already raised this question, which is the key to the good functioning of the sector's economy, in its 1983 and 1987 reports, claiming that if the premiums varied according to the tobacco's quality, growers and processors would have an incentive to raise quality. Given the advantages that might be gained from implementing differentiated, quality-dependent premiums, the Court of Auditors felt that the generalised or selective institution of such a system deserved serious examination.

Modulating support means linking the payment of part of the premium to the value of the tobacco produced. The modulation system would thus comprise a **fixed portion** and a **variable portion** so as to combine the social function of Community aid, which is to give tobacco farmers a minimum income, and its economic function, which is to encourage the production of quality tobacco better suited to the internal market's needs. Any modulation that linked part of the premium to subjective assessment of the tobacco's quality (experts' appraisals or administrative classification) must be ruled out, for such a system would be extremely complex and very difficult to oversee. The Commission thus proposes **modulating the Community aid according to the raw tobacco's purchase price**, since this is the only objective datum in our possession that indicates the product's quality.

---> What part of the support should be modulated?

The variable portion of the premium should be larger for the varieties that currently have low price/premium ratios. Consequently, the modulation would not necessarily be of the same magnitude for all the groups of varieties. The amount of the fixed portion of the premium should be close to the old intervention price in the case of low-quality tobaccos,

as this amount has already proven valid as a minimum income. The aim is to avoid encouraging the production of low-quality tobacco. The combination of all these criteria leads us to propose a modulatable fraction ranging from 35 to 45% of the total amount of support, compared with today's ineffectual 9 to 10% figure.

(b2) Implementation: modulation through increasing aid to producers' groups

The instrument would consist of the specific aid instituted under the current COM, whereby a supplemental premium is paid by the producers' group to its members. The proposal consists in increasing this aid, which must henceforward be paid by the group to its members as a function of the prices at which their individual crops were sold. The increase in this specific aid would be financed by a decrease in the premium set in ECU/kg and paid out regardless of the quality of the product.

This solution nevertheless has various specific advantages and drawbacks:

(b3) Advantages/disadvantages of modulation via aid to producers' groups

It must be pointed out right from the start that the only risks of fraud presented by the modulation system concern the assignment of the Community aid amongst the producers and would not have any impact on the amount of the budget expenditure. While it may be tempting for a producer, in league with a processor, to raise the purchase price of his crop artificially in order to collect a larger premium, such fraud would deflect Community aid away from other producers. This type of behaviour would thus constitute a zero sum game in which the producers would be cheating each other. The system's proper implementation thus depends on the veracity of the prices as well as the administration's and producers' abilities to check them.

Advantages

This system has the advantage of being easier to check. Indeed, each producers' group is responsible for paying the specific aid out to each of its members and based on the average market price obtained by each member (and for each variety) compared with the mean of the prices obtained by the other members. This market price is already known today, for it results from the procedure of delivering and putting the tobacco under supervision. Moreover, as all payments of aid and market prices must obligatorily be effected by bank or postal transfer, it is easy to check the facts. The only way to get around the system is for all the group's members and the processor to engage in an entente under which the quality of all the producers' deliveries would be said to be identical.

In terms of management, this alternative obviously has the advantage of being simpler for the administration to manage, because it would be up to each producers' group to perform the calculations necessary for modulating the specific aid.

Simpler to set up: the specific aid is already part of the current scheme, in which it is set at 10% of the premium.

Disadvantages

Experience has shown that the specific aid as it currently exists has failed to improve quality. It should already be paying for quality, as this is the purpose of between 90 and 100% of the specific aid. However, we are forced to acknowledge that no positive effect on quality has emerged. The reason is that the current specific aid contains two flaws: the amount of the aid is too small truly to encourage higher-grade varieties, and the criteria for valuing quality are too lax, making it possible to pay well for tobacco of too low a quality. By changing both the amount and the aid allocation criteria, the proposed reform would correct the weaknesses in the current system.

This system compares the value of the tobacco produced within a given group of growers only. So, the amount of the specific aid received by each producer will depend on the mean price calculated for his own group. Consequently, a grower who produces a cheaper tobacco than that of another grower belonging to another group could have higher total earnings.

However, there are ways to increase the efficacy of this system. They consist in setting stricter conditions for recognising growers' groups by increasing the minimum number of members and the minimum quota amounts for eligibility.

(b4) Setting up this modulation does not entail changing the current levels of premiums and quotas

We propose **not changing the premiums' current levels**, for experience shows that the current distribution of the premiums by group of varieties is equitable on the whole. The varieties for which the demand is highest are being produced and no significant overproduction has been ascertained. On the contrary, only some 95% of the 350 000-tonne quota is used.

The volume of the quota can also remain at its current level. The most important aim, without spilling over the current budget, is to increase the economic efficacy of the Community aid by modulating the premium. The apportionment of the quota by country and by group of varieties is generally correct.

However, something must be done to boost the quotas for the best varieties, *i.e.*, those that have sure markets and fetch high market prices, to the detriment of the quotas for varieties that are hard to dispose of and have intolerably low market prices. In particular, the volume of the quota for Group V - sun-cured - tobaccos must be decreased and the corresponding quantities transferred to other groups, such as Groups VI and VII, in observance of the principle of budget neutrality.

(2) Making it easier to leave the sector voluntarily

The Commission has ruled out compulsory, wholesale disengagement. Since the real opportunities for conversion are limited, this scenario, which would involve finding some 190 000 jobs in other sectors, could only be implemented at extremely high social cost.

On the other hand, it is possible to assist the conversion of tobacco growers on an individual, voluntary basis, or even to organize the conversion of all producers on a local scale.

In addition, the fundamental reform, and in particular the modulation of the premium, will face the sector with a major challenge resulting in the consolidation of holdings and inciting growers who are unable to improve the quality of their production to leave the sector.

In order to facilitate conversion, it would be appropriate to adopt accompanying measures such as local development aid and a permanent scheme for buying back quotas with a corresponding reduction in the size of the overall quota.

Possible conversion measures.

The key element of these accompanying measures should be the promotion of strategic local development plans that reorient growers towards other activities. These plans should be drawn up at the level closest to the areas concerned. They should involve closely all those who are directly affected, starting with the producers' groups. These plans should have an integrated approach to development such as is found currently in the development programmes for Objective 1 and 5(b) regions that are financed by the EU's Structural Funds. They could include a range of information, advisory, training and organizational measures focussed on possible local alternatives. They should help to mobilise available resources, notably those of the structural and other programmes co-financed by the Community, such as early retirement schemes.

Several measures could be taken :

- to ensure the viability of the farms and processing facilities likely to weather the transition (e.g. aid for investment and environmental conservation).
In this context, the programmes for switching to other crops, which have been particularly successful in Greece (see point IV.4), could be taken as a model provided that there is a corresponding reduction in the overall quota volume. Aid was paid for three years to tobacco growers who wished to give up tobacco growing and switch to other crops.
- to facilitate abandoning non-viable tobacco farming by means of measures aimed at the individual and the community.

(a) individual aid

This aid could take the form of buying up quotas over a sufficiently long timespan (7-10 years) coupled with a degressive payment mechanism or, alternatively, issuing the affected tobacco farmers bonds, on the basis of which the Community would pay out annual annuities until the bond's maturity (7-10 years). The tobacco farmers would be free either to keep the bonds and collect the corresponding annuities or sell them on the private market.

Early retirement, set-aside and afforestation aids are additional possibilities. Attention should be paid to the question of how to make the early retirement measures provided for in Regulation 2079/92 more attractive to producers, particularly by assessing the reasons why the measures have not yet had any success.

(b) Community (regional/local) aid

- * information, training, advice and technical assistance to ease the transition;
- * economic development measures designed to offer alternative occupational activities.

This entire set of measures should be part of a strategic local development plan that would rely on various legal bases and sources of financing, depending on the nature of the measures involved:

- certain measures needed to draw up the plan (information, analysis, technical assistance), intended to facilitate its implementation (training, advice, publicity), or that are integral parts of the operational phase (for example, quota buy-back) could be financed by the EAGGF Guarantee Section;
- in other cases the authorities responsible for implementing the various programmes should examine the possibility of assigning part of the budgets allocated to them to the following measures:
 - * other measures would have their legal basis and thus be financed within the framework of Structural Funds Objectives 1 and 5(b) assistance (most of the regions involved are in this category). The mid-term review planned for 1997 provides an opportunity to examine which specific measures could be adopted in the coming years to help tobacco growers switch to other economic activities. Suggestions along these lines could be made to the Member States and monitoring committees involved.
 - * still other measures, such as early retirement, afforestation and agro-environmental measures, and Objective 5(a) measures, can rely on an already established legal and financial framework.

If these measures are applied over a sufficiently long period they should facilitate the search for alternative activities and support the local social and economic fabric.

Special attention should also be paid to the processing industry's reconversion so as to cushion any major negative impacts on the local economies.

(3) Making the quota and guarantee threshold scheme more flexible

The other aspect of the current COM that must be perfected is the management of the stabilizer scheme, especially its lack of flexibility.

Flexibility must be enhanced on various levels.

- First of all, the volumes of the quotas by country and group of varieties must not be fixed, for it must always be possible to adjust the supply to meet the demand. To do this, the possibilities of transferring quotas between groups of varieties without increasing the budget must be boosted. Such transfers are already allowed for quotas that are not bound to cultivation contracts. Organizing such transfers prior to the quotas' allocation and, to this end, encouraging the sector to forecast market needs more accurately, would be an important positive achievement.
- As mentioned earlier, transfers from cheaper varieties with more precarious markets to more valuable varieties for which there is a greater market demand must also be encouraged.
- Finally, transfers of quotas, whether they be annual or permanent, within a group of varieties should be facilitated. Market mechanisms should be chosen to achieve this end. **The definitive transfer of quotas between traditional producers** should be facilitated, as such transfers would be appropriate solutions for a host of individual situations and would encourage the most motivated operators to build economically viable undertakings.

Besides this, special provisions must be adopted to allow the creation of a national quota reserve. This would also make the scheme more flexible.

Making the quota scheme more flexible and modulating the premium will thus give growers a powerful incentive to consolidate holdings, the average size of which is set to rise while the number of growers will continue to fall, as the current pattern of fragmented holdings is difficult to sustain.

(4) Simplifying the scheme's administrative management

Simplifying the scheme's management is also a concern of the public authorities. The degree of complexity reached by the tobacco production management scheme leads us to propose the revision of a series of procedures with the aim of streamlining the scheme's administration.

First of all, one must recognise that calculating and distributing the quota certificates each year to tens of thousands of farmers, sometimes followed up by a second allocation in the course of the year, is a cumbersome managerial task. The obvious solution is to **manage the quotas through the producers' groups**, rather than dealing directly with the

individual producers. This would slash the administrative work from tens of thousands to only a few dozen operations, even in the largest producer countries. The group itself would then be responsible for distributing the individual quotas and performing, under the administration's supervision and as required by the Community's regulations, all of the relevant calculations. We must underscore in this respect that managing the scheme via the producers' groups would not invalidate the existence of unaffiliated, individual producers (their existence, however, is already marginal, given, amongst other things, the incentive of benefitting from specific aid), nor would it cancel each group's obligation to register the deliveries of each of its members, thereby enabling them to leave the group as well, if they so desire.

Next, calculating each producer's quota annual is no longer justified, given the quota system's stability. The quotas could thus be revised every three years, without prejudice to possible annual adjustments following transfers between groups of varieties.

Delivery inspections would also benefit from being simplified. The systematic measurement of the moisture content of each batch of tobacco delivered has proved ineffective and difficult to achieve. This stipulation should be dropped, with the inspector resorting to measuring moisture content only in the event of doubts as to the quality of the tobacco delivered.

Having **two quota distributions** (one of which is residual) and consequently two periods for filing cultivation contracts in the same year no longer seems necessary, given that allowing producers to transfer quota certificates amongst themselves would create enough flexibility for the guarantee thresholds to be used fully.

The proposed simplifications would thus eliminate several thousand operations (calculations of quotas, duplicate mailing of quota certificates to individual producers, and systematic measurement of moisture content upon delivery), which would lighten the administrative load substantially.

(5) Encouraging better remuneration for quality

The cultivation contract should be maintained, given the security it offers the sector and the fact that it can be used as a lever to improve the match between supply and demand. However, the cultivation contract does blur market signals, as the prices are sometimes set a year before the actual sale. A well-supervised system of bidding for contracts could offer a solution by increasing competition between processors and, consequently, the market prices paid to the growers.

(6) Taking account of environmental protection

The main forms of environmental pollution from tobacco farming are the effects of excessive fertilising, over-irrigating, and unreasonable pesticide use.

It must be stressed that an economic system that encourages better quality produce will be beneficial for the environment, for the quality of the tobacco leaf is linked to reasonable

fertiliser applications. Pesticides, for their part, are still indispensable to ensure a good-quality leaf. However, the use of integrated pest management (IPM) techniques should be strongly encouraged. So should the practice of picking up waste, starting with the plastic sheets used in the fields.

To achieve this, the **portion of the specific aid intended for technical assistance should also be used to promote environmental protection measures**, *e.g.*, rational fertiliser applications, integrated pest management, waste pick-up, and more efficient irrigation techniques.

The promotion of these environmental protection measures should be monitored periodically at the regional, national and Community level. To ensure that they form part of a coherent policy, they should be carried out in a framework defined by the Member States and approved by the Commission.

Training and information sessions should be organized with the help of specialists in the various fields.

Finally, a system for assessing these measures should be set up so as to learn from the necessarily diverse experiences of their application in the field.

(7) Less harmful varieties on the market

The Tobacco Research and Information Fund, which is financed by a percentage of the growers' premiums, should be maintained. One of its tasks is to search for varieties and cultivation methods which are less harmful to human health and in this field the Fund can assist in the production of tobacco containing less tar, heavy metals or nicotine. Research in the field of environmental protection should also be included.

It is planned not only to continue the Fund's activities in the field of supplying information on the harmful effects of tobacco consumption but to provide it with increased resources for this purpose by raising the percentage withheld from the premium to 2%. It is in the tobacco producers' interest to show that they understand the health problem, which is quite separate from the continuation of tobacco growing, which will continue on a world scale as long as there are tobacco consumers.

(8) Stepping up supervision

Supervising the COM must remain a key concern. Chapter II of this report drew the clear conclusion that the level of fraud that prevailed prior to the 1992 reform had fallen sharply. Indeed, the more vulnerable support mechanisms were dismantled (end of intervention and export refunds) and the current stability of budget outlays corroborates this analysis.

Experience has nevertheless shown that risks of fraud, linked notably to the existence of phony producers (involved in a black market in tobacco), subsist. Although the risks of

fraud are markedly lower than they were in the past, they still exist. That is why **acreage checks** have been stepped up and **local publicity** of quota beneficiaries has been instituted.

There is an additional need to give a precise legal definition of the term 'tobacco processor' so as to prevent broad interpretations of Community regulations that would currently allow middlemen to take advantage of the system.

As far as the supervisory agencies are concerned, we are forced to admit that the Commission's efforts have not yet succeeded. The two countries concerned, namely, Italy and Greece, have been unable to set up the new supervisory agencies called for in the Regulation. This being the case, the monitoring has been done by the already existing bodies, AIMA and EOK. In future, the key elements of the current supervisory system should be kept. These are checking the areas to weed out bogus producers, inspecting deliveries to verify the tobacco's eligibility for the premium, and inspecting processing plants' warehouses to prevent the payment of several premiums for the same tobacco. The field inspections could be stepped up efficiently by using the **integrated area control** system that already exists for other crops. The mandatory nature of delivery checks must be upheld (mandatory presence of inspectors for all deliveries, written permission for the delivery and transfer of the tobacco under the supervisory agency's supervision) and that of **warehouse inspections** on the processor's premises **stepped up** (mandatory minimum sampling). It would also be worthwhile to **check the stocks leaving the processing plants** so as to make certain that the tobacco has actually been processed.

The essential aim of monitoring the COM in tobacco must always be to control expenditure. To do this, all poorly designed economic mechanisms must be corrected or eliminated. This has already been done to a great extent by the 1992 reform. Next, there must be a guarantee that the appropriate checks are actually carried out, notably by taking the necessary action in the clearance of accounts.

For the Commission, the main issue is defining the types and frequency of the checks to conduct. It will then be up to the national authorities to choose the best way to organize such checks in line with each country's particularities. In this respect and given the experience of the past few years, the Commission feels that the choice of the administrative framework (specific supervisory agency or organization of inspections by pre-existing bodies) should be made by the Member States.

C. Other elements

As for the rest, the 1992 reform has proven well-founded. **Reinstituting intervention and export refunds is out of the question.**

Intervention is not justified in a sector with a relatively low degree of self-sufficiency and relatively high aid for producers. Moreover, it was difficult to monitor.

Export refunds are not justified, either. The best qualities are exported without problems or sold on the internal market. The lowest qualities fetch such low prices that refunds

make no economic sense. Moreover, just as in the case of intervention, the refunds were also too difficult to monitor.

The changes proposed, which are aimed at increasing the quality of the tobacco produced, will also raise the quality of the tobacco the Community exports on the world market.

The **inter-branch approach** initiated by the 1992 reform should be bolstered and deserves encouragement. In this respect the Commission considers it important that the entire sector take concerted action, that is, that growers, processors and factories consult each other more in order to strengthen their efforts to improve the quality of their products and the supply's responsiveness to demand. The rise in quality must be market-driven. In this context, the market's needs will definitely be expressed by prices, but they can also be reinforced to good effect by contractual means, notably by setting minimal qualities and quality grades. In addition, the contractual approach will also make the industry's needs more transparent and in this way facilitate efforts to adapt the supply to the demand.

The reformed COM should also undergo **assessment** four years after its adoption. On this occasion an analysis of the changes in the tobacco crop's value versus the support granted to this sector would be indispensable.

CONCLUSIONS OF PART V.

The future of the COM in tobacco was made contingent on choosing first whether to continue the Community's involvement in this sector.

1. The Community's **disengagement** from this sector, which would doom most of the Community's tobacco industry in the medium term, has been ruled out. Such a scenario would mean compulsorily converting some 190 000 jobs and would have an extremely high social cost without producing any effect on tobacco consumption.

The Commission has therefore chosen to propose that Community support to producers be continued, provided the COM undergoes fundamental reform.

2. Continuing the Community's involvement would also involve a choice concerning the best model to follow. At all events, Community aid must always benefit only producers.

- a) Setting up a **hectare-based aid system** or a scheme of **direct income support** for tobacco growers would not solve the serious economic problems plaguing the sector. The budgetary costs of these alternatives would likewise be comparable to those of the current system.

Lowering the Community premium significantly would have the drawback of immediately sounding the death knell of a large proportion of Community tobacco without allowing it to shift towards higher quality.

- b) **Keeping the current scheme unchanged** would have the disadvantage of perpetuating the current situation, that is, one in which the farmer stands to gain more from producing a low-quality crop by reducing his production costs than from investing in better quality. In the current COM the low market price-to-premium ratio is liable to jeopardise the efficacy of public support for growers; secondly, the scheme's inflexibility makes access to the sector, transfers of production quotas and adaptation of the guarantee thresholds to market demand difficult; and thirdly, the complexity of its management must be borne in mind, given the host of operations involved in calculating and distributing individual quotas.

3. The solutions to consider must, on the contrary, reverse this trend and offer incentives for producing better quality. If Community involvement is continued, it would be advisable to **modulate part of the Community aid in line with the tobacco's quality** as determined by its market price.

This modulation of Community aid must be backed up by measures that **facilitate withdrawal from the sector, in particular by buying up individual quotas.**

The combination of these reforms would have the effect of improving the quality of the tobacco produced in the Community and drastically reducing exports of poor-quality tobacco.

The financial resources would be redistributed within the overall budget allocated to the sector, thus making it possible to increase the proportion of expenditure on measures to facilitate structural adjustment, in particular voluntary departure from the sector.

The **supervisory measures** that exist under the current Regulation, especially those affecting the first processors, must be reinforced.

Finally, the proposed reform aims to **simplify the sector's management and pay more attention to environmental protection.**

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