Big Changes for Regional Manufacturing and Tobacco Sectors

BY CHARLES GERENA

President Bush signed the American Jobs Creation Act on the eve of his 2004 re-election. Among other things, the legislation contains accounting changes and tax breaks intended to benefit various sectors of the national economy, from restaurant owners to producers of biodiesel fuel. It may even stave off a trade war by repealing a tax break on the export income of manufacturers called an extraterritorial income exclusion (ETI). The ETI had angered the European Union enough to impose tariffs on U.S. exports last March.

The Jobs Creation Act will affect two bedrocks of the Fifth District regional economy: manufacturing and tobacco.

Hello, Tax Deduction

While some manufacturers lose the ETI, many more will gain from the cornucopia of provisions in the Jobs Creation Act. For one thing, they will receive more than $8 billion of tax breaks over the next three years to offset the impact of the ETI repeal.

In addition, manufacturers will be able to deduct 9 percent of gross income generated by "domestic production activities," minus certain items. The deduction phases in over the next five years.

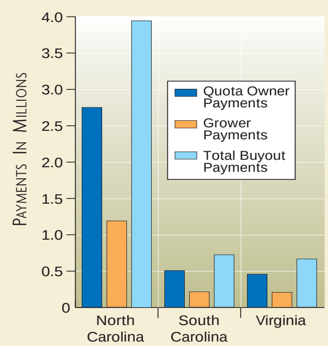
The bill's definition of "domestic production activities" includes commodities that aren't traditionally considered manufactured goods, including construction projects, television shows, and electricity. While this broad description is meant to spread the benefits of the deduction widely, it also adds confusion to an already convoluted tax code.

"You are going to create incentives to label activities within the firm as production that may or may not be production. That's going to lead to a lot of paperwork for the IRS and the accountants," says Kimberly Clausing, an economist and tax policy expert at Reed College who has closely studied the provisions of the Jobs Creation Act. Indeed, PricewaterhouseCoopers expressed its concerns about the uncertainties surrounding the deduction in a recent report to its clients.

Clausing thinks it makes little sense to stimulate the economy by creating yet another deduction. Instead, tax simplification and a reduction in corporate tax rates would be better, she says. "You wouldn't be handing well-connected people windfalls. You would generate economic activity because the marginal incentive to do things is going to be higher when our rate is lower relative to our foreign counterparts."

The Big Tobacco Payoff

North Carolina will get the biggest chunk of the federal tobacco buyout: 41 percent of the $9.6 billion total payout over the next 10 years. Maryland wasn't included in the buyout, while West Virginia received very little money.



NOTE: Adding owner payments and grower payments may not equal total buyout payments due to rounding.
SOURCE: Agricultural Policy Analysis Center, University of Tennessee

Bye-Bye, Price Supports

In the Fifth District, the provision of the Jobs Creation Act that has garnered the most attention has been the "Fair and Equitable Tobacco Reform Act," which eliminates federal price supports and the quota system that controls tobacco leaf production. To soften the blow, quota holders and tobacco growers will receive annual payments over the next 10 years, up to a maximum of $9.6 billion.

The tobacco subsidy program began during the Great Depression to help farmers cope with falling prices. Since then, it has succeeded in keeping domestic tobacco prices up and domestic production down, says economist Richard Ault at Auburn University. That hasn't been good for tobacco product manufacturers because they want greater flexibility and more stability in their supply.

Higher tobacco prices also "created an incentive and an opportunity for imported tobacco to come into the market," Ault says. "In the last 20 years, other countries have developed tobacco that is a very good substitute for high-quality American tobacco, particularly Brazil." As U.S. tobacco production has fallen and quotas have been lowered, quota holders have watched their assets diminish in value. Ault says that is why they have been anxious to be bought out by Uncle Sam.

As for farmers, those who hold quotas will immediately benefit from the annual payments they will receive. Also, they will no longer have to buy or rent quotas to increase production. But some may see the value of their land drop because plots with tobacco quotas associated with them commanded a premium that no longer exists. Eliminating tobacco subsidies will also remove a major justification for the warehouse-based auction system, which offers farmers an alternative to direct contracts with manufacturers. Only tobacco sold at auction is eligible for price supports, not tobacco sold under contract.

The transition might be painful for some, but economists like Ault believe that agricultural subsidies can't work in a global economy. "All countries are finding that, in the face of foreign competition, subsidy programs are becoming more and more burdensome," he says. **RF**