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***Looking Forward:  
A More Market-Oriented 2007 Farm Act***

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## Preface

Debate on the future direction of U.S. farm policy is intensifying in the lead up to the passage of the 2007 Farm Act. Many producers, the administration, trading partners, and other interest groups are calling for change. At the same time, current farm policies face growing competition for funding.

Much of the pressure for change reflects the fact that modern agriculture and its markets are very different to those in the 1930s when the federal government began large-scale interventions in the sector.

U.S. agriculture is no longer dominated by small-scale operations, mired in poverty, facing saturated markets with little prospect for growth. Today's farms are large, sophisticated and efficient. Operators of commercial farms enjoy average incomes more than three times the U.S. average.<sup>1</sup> The outlook for future farm prices and income is strong, primarily due to demand from the renewable fuels sector.

These structural and market changes, and the benefits that would come from concluding the Doha Round, have led to calls for U.S. farm policy reform.

The upcoming 2007 Farm Bill debate represents an important opportunity to address the sector's future challenges—to move away from policies that constrain the future of U.S. agriculture, and toward those that would place the sector in a much better position to realize its vision of growth and prosperity.

This study asks whether current U.S. farm policies best serve the interests of America's farmers and ranchers. It aims to stimulate debate on policy options to meet future economic, environmental and social needs, and describes market-oriented policies that would better support the future development and competitiveness of U.S. agriculture.

This study does not attempt to assess USDA's recently released 2007 Farm Bill proposals, as to do so would have been outside its mandate. It expands the information on possible options for achieving reform the 110<sup>th</sup> U.S. Congress has to draw upon in its deliberations on the future direction of U.S. agricultural policy.

This study was commissioned by the Government of Australia—the Chair of the Cairns Group of agricultural exporting countries.

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<sup>1</sup> Council of Economic Advisers, *Annual Report of the Council of Economic Advisers*, 2006, page 177.

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## **Executive Summary**

The 2007 Farm Bill debate will be unique in the history of U.S. farm policy development. The debate coincides with the Doha Round of WTO trade negotiations and a “market revolution” caused by the growth of the renewable fuels sector.

Global competitiveness is the key to the future prosperity of American producers since growth in foreign markets is projected to greatly exceed that in the mature domestic food and fiber markets.

In framing the 2007 Farm Bill, policy makers face critical challenges for the future of U.S. agriculture, including: how to make the sector more resilient and competitive for the long-term; how to ensure policies that are more consistent with international trade rules; and how to promote greater equity within the sector.

This study concludes that a set of market-oriented reforms would be the best way for the U.S. to meet these challenges. Such reforms would support competitiveness and market growth and minimize resulting market distortions, allowing producers to shift resources into the most profitable uses. U.S. producers would be better able to compete against foreign rivals as they would be free to make decisions based on their market expectations rather than the payments to be received from government programs.

U.S. farm policy needs to be transparent, equitable, fiscally responsible, and consistent with the international obligations of the U.S. It should also meet important goals of the wider community, including by recognizing the central role that producers play in protecting the environment.

This study envisions a 2007 Farm Act under which:

- Producers are primarily responsible for the management of their business risk and can choose from a range of tools provided by the private sector (e.g. insurance and tax effective savings products). Government based safety nets focus on market aberrations such as those caused by serious natural disasters;
- The direct payments program rewards all producers who engage in sound environmental practices;
- Rural communities are strengthened by greater emphasis on research and development, rural development, and energy; and
- Appropriate transition policies build producer support for change and provide structural support to producers as they adapt to the new policies.

By undertaking these market-oriented reforms, the U.S. would “re-arm”, rather than disarm, the agricultural sector. Important benefits would accrue to the nation as a whole.

Costs for American households and food manufacturers would fall, particularly for products using agricultural inputs that receive market price support. Taxpayers would benefit because the government would meet its environmental and social goals more efficiently in a time of projected budget deficits.

Such reforms would reduce the risk of future WTO litigation against U.S. farm policies, which if successful could lead to retaliation aimed at the wider U.S. economy. Importantly, they would reinforce U.S. leadership in international trade negotiations and significantly improve prospects for a successful conclusion to the Doha Round. This would bring benefits to the U.S. and world economies far beyond the agricultural sector. Even a one-third cut to global trade barriers would raise the average American family income by \$2,500 a year. The impact on the world's poorest farmers who are struggling to escape poverty would be substantially more.

Market-oriented reforms would address issues of equity. As noted by USDA, five crops (corn, soybeans, wheat, upland cotton, and rice) receive over 90% of commodity program payments, even though they account for only around one-fifth of agricultural sales.<sup>2</sup> The fruit, nut, vegetable, greenhouse/nursery, and livestock sectors—which account for around three-quarters of agricultural sales—receive virtually none of these payments. Structural changes in U.S. agriculture will magnify these inequities in the future. Large farms can be expected to take an even greater share of government payments as consolidation continues.

Reform of existing policies would lift industry efficiency, productivity and competitiveness. Current programs reduce efficiency by blocking market signals and constraining resource shifts to faster-growing and more profitable markets. Payments inflate farm costs, particularly for land, reducing competitiveness. They create dependency rather than support for investment, innovation, and growth. USDA data shows that, since 1980, cash receipts from supported crops have grown by less than 15% while those from unsupported crops have grown by over 185%.

Finally, strong crop prices, driven by demand from the energy sector, are expected to result in a large fall in commodity program spending even if there is an extension of the 2002 Farm Act. At the same time, net revenue for the five major program crops will rise, reducing the need for the current commodity programs.

A number of producer organizations have specifically described the need to take a new course.<sup>3</sup> The coming Farm Bill debate presents the perfect opportunity to move toward policies that support the sector's vision for growth and prosperity. Electing to go down the path of reform would represent a commitment to a strong and vibrant U.S. agricultural sector now and well into the future.

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<sup>2</sup> The sugar and dairy sectors also receive significant government support from import barriers and domestic supply controls that keep prices high.

<sup>3</sup> See American Farm Bureau Federation, *Making American Agriculture Productive and Profitable*.

## ***Looking Forward: A More Market-Oriented 2007 Farm Act***

### **I. Observations on the 2002 Farm Act**

*“Current agriculture policies are not sufficient for addressing the challenges facing farmers and the nation as a whole. Federal farm programs ... are not serving U.S. agriculture as well as in the past and are having unintended consequences ... [They] discourage producers of program commodities from switching crops as markets change and undermine the incentive to innovate and develop the specialty products that today’s consumers want.”<sup>4</sup>*

*“Farm payments appear to create dependency on even more payments, not new engines of growth.”<sup>5</sup>*

The nation’s agricultural policy objectives are frequently articulated and widely understood. They include support for small family farms and rural areas; production of adequate amounts of healthy food and fiber products; production efficiency and equitable returns; and protection of the nation’s land resources and environment.

In the context of the 2007 Farm Bill debate, many groups have been considering whether a continuation of policies like those in the 2002 Farm Act would be the best way for the U.S. to meet these objectives. In addition, they have described and evaluated a number of serious unintended consequences of current policies. This Chapter summarizes those considerations.

### **Equity Issues**

#### **Commodities Receiving Government Payments**

In calendar year 2005, total cash receipts to agriculture amounted to \$239 billion, with less than half of that attributable to crops (Chart 1). Almost 45% of crop cash receipts came from sales of fruits, vegetables, nuts, and greenhouse and nursery products (Chart 2).

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<sup>4</sup> The Chicago Council on Global Affairs, Report of the Agricultural Task Force, *Modernizing America’s Food and Farm Policy: Vision for a New Direction*, page 4.

<sup>5</sup> Mark Drabenstott, Federal Reserve Bank of Kansas City, Center for the Study of Rural America, *Do Farm Payments Promote Rural Economic Growth?*, The Main Street Economist, March 2005, page 3.

Chart 1: Cash Receipts by Commodity, 2005

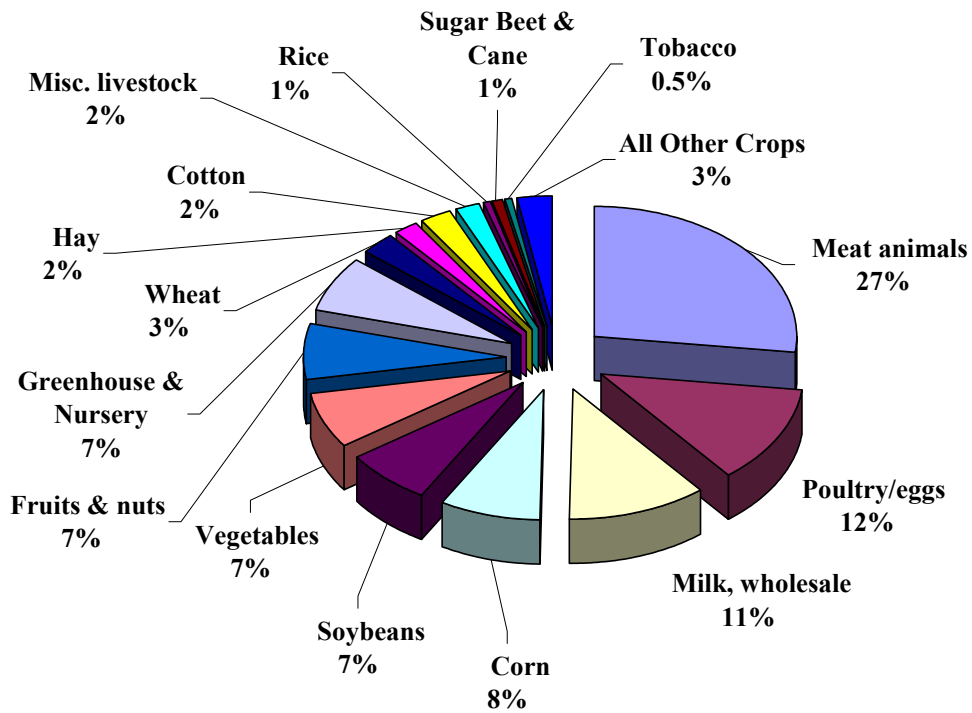
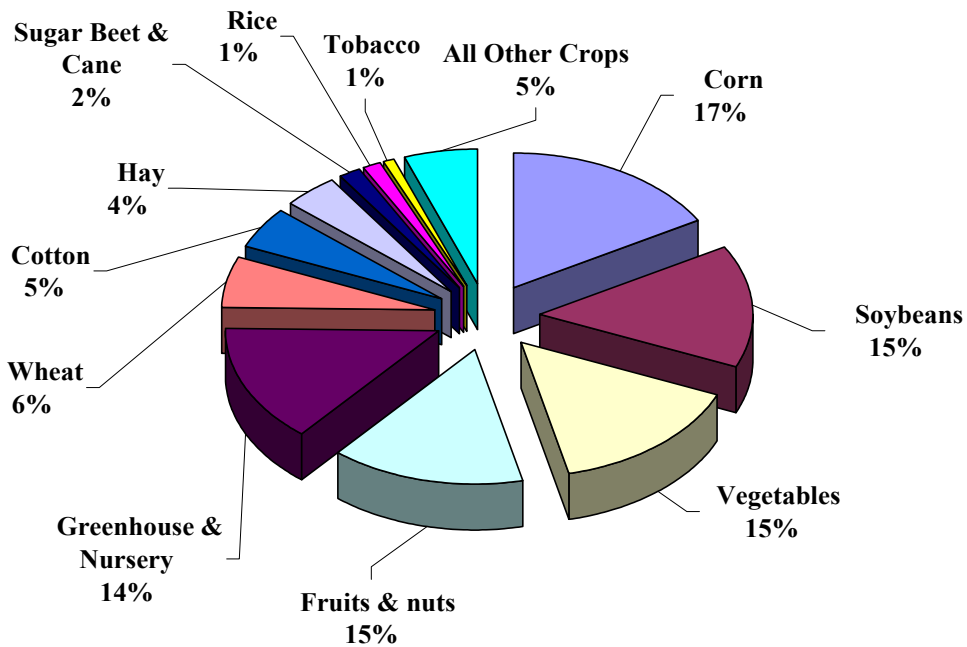


Chart 2: Cash Receipts by Crop, 2005

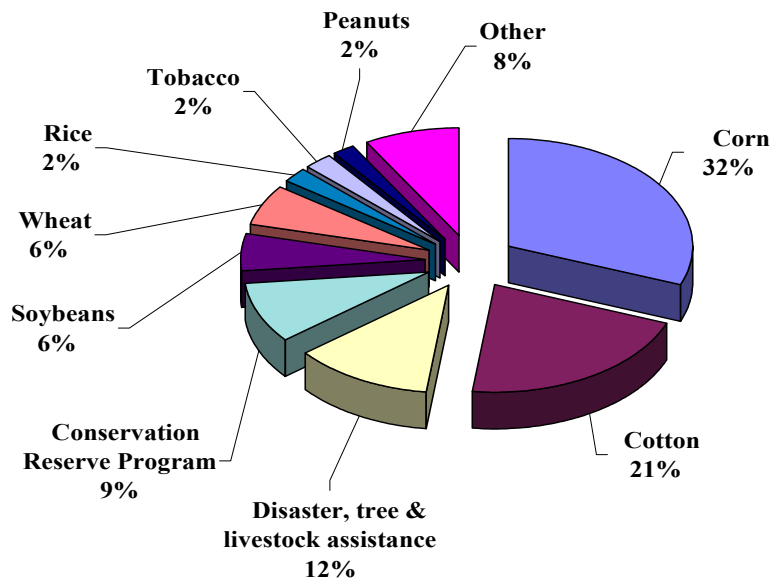


Source: USDA/ERS, Farm Cash Receipts, <http://www.ers.usda.gov/Data/FarmIncome/finfidmu.htm> (accessed December 2006).

Numerous commentators, including the Environmental Working Group<sup>6</sup> and USDA, have noted the disparity between the relative importance of U.S. agricultural sub-sectors and the distribution of government payments.

In calendar year 2005, direct federal payments to producers amounted to \$24.3 billion, over 10% of the sector's cash receipts.<sup>7</sup> Payments under the larger programs—direct payments, counter-cyclical payments, loan deficiency payments, marketing loan gains and certificate exchange gains—amounted to \$16.3 billion that year.<sup>8</sup> These programs focus mainly on five crops—wheat, rice, corn, soybeans and upland cotton—which received 93% of these payments in 2002-2005,<sup>9</sup> in spite of the fact that they account for only a relatively small portion of agriculture's cash receipts (less than 21% in 2005). Specialty crops, livestock and other important commodities receive far less, if any, support, from these programs, notwithstanding their significant contribution to cash receipts. The conservation programs and emergency and ad hoc payments, which have broader sector coverage, amounted to less than one-quarter of the payments in 2005,<sup>10</sup> and also went primarily to program crop producers.

**Chart 3: CCC Outlays by Commodity/Function, 2005**



Source: USDA/ERS, *CCC Net Outlays by Commodity and Function*, <http://www.ers.usda.gov/publications/agoutlook/aotables/2006/10Oct/aotab35.xls> (accessed December 2006).

<sup>6</sup> See <http://www.ewg.org/farm/> (accessed January 2007).

<sup>7</sup> USDA/ERS, Income Statement for U.S. Farm Sector 2002-2006F, [http://www.ers.usda.gov/Briefing/FarmIncome/data/nf\\_t2.htm](http://www.ers.usda.gov/Briefing/FarmIncome/data/nf_t2.htm) (accessed December 2006).

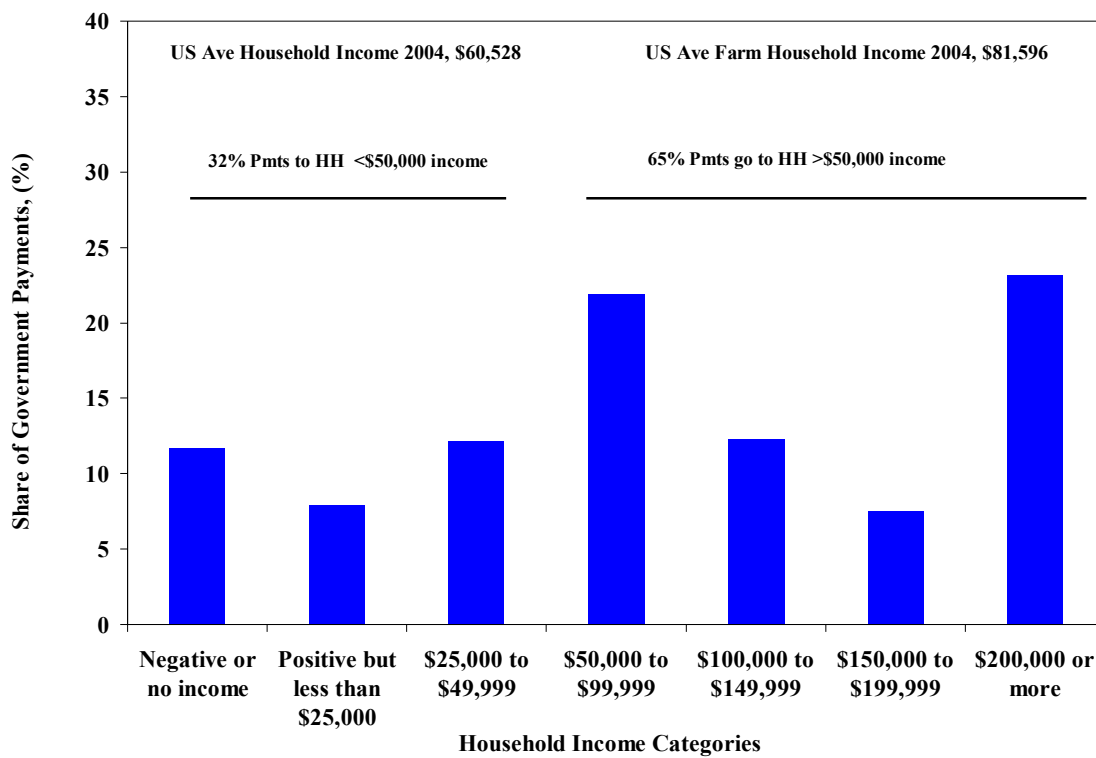
<sup>8</sup> USDA/ERS, Direct Government Payments 2002-2006F, [http://www.ers.usda.gov/Briefing/FarmIncome/Data/GP\\_t6.htm](http://www.ers.usda.gov/Briefing/FarmIncome/Data/GP_t6.htm) (accessed December 2006).

<sup>9</sup> USDA, *2007 Farm Bill Theme Paper - Risk Management*, page 9.

<sup>10</sup> USDA/ERS, Direct Government Payments 2002-2006F, [http://www.ers.usda.gov/Briefing/FarmIncome/Data/GP\\_t6.htm](http://www.ers.usda.gov/Briefing/FarmIncome/Data/GP_t6.htm) (accessed December 2006).

Furthermore, a relatively small share of government payments<sup>11</sup> goes to low-income households (Chart 4). In 2004, less than one-third of such payments went to households with operator household incomes<sup>12</sup> below \$50,000, while the 8% of farm households with operator household incomes above \$200,000 received 23% of such payments. Because the bulk of the payments go to farm households with operator household incomes above the U.S. average (\$60,528), they do not provide a primary source of assistance for low-income families.

**Chart 4: Distribution of Government Payments by Operator Household Income, 2004**



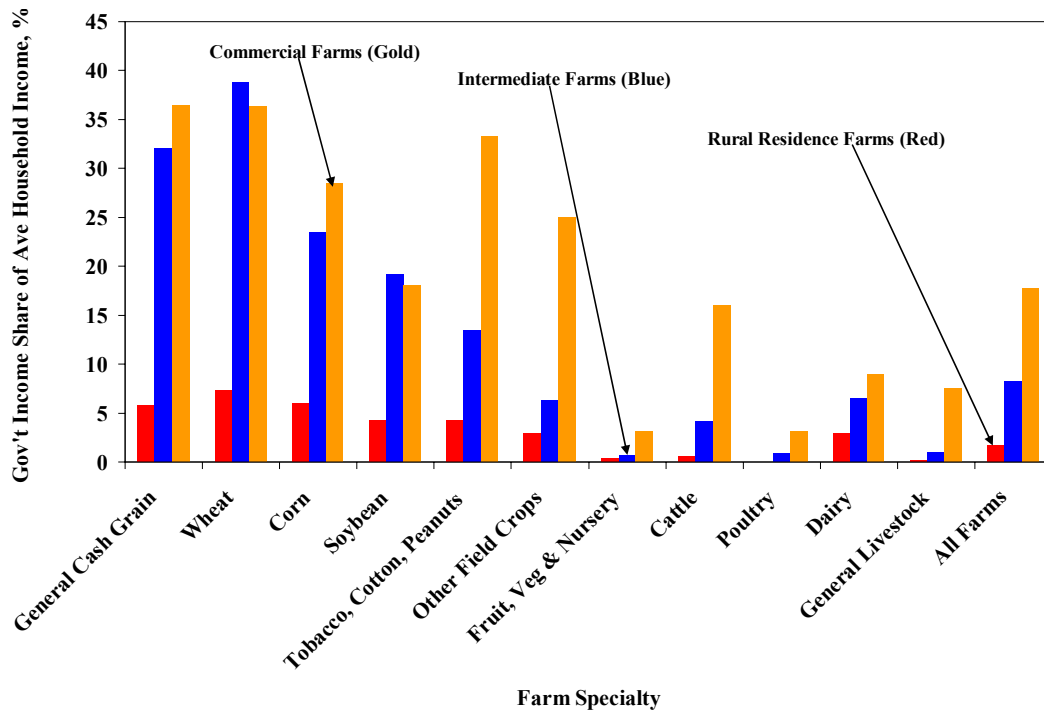
Source: USDA, 2007 Farm Bill Theme Paper - Risk Management, pages 12 and 30 and USDA/ERS data on average household incomes available at <http://www.ers.usda.gov/Briefing/WellBeing/Data/Table1FOHHIncomehistory2001-06.xls> (accessed February 2007).

<sup>11</sup> Defined to include commodity program payments, conservation payments and disaster payments.

<sup>12</sup> “Operator household income” is derived by adding net earnings from farming activities and earnings from off-farm sources. Earnings from farming activities include government payments. Off-farm earnings (which are more important to lifestyle and rural residence households than to commercial and transition households – see Chapter II) may come from a variety of sources, including wages and salaries, off-farm self-employment, interest, dividends, private pensions, Social Security, veterans' benefits, and other public programs. A detailed explanation of “operator household income” is available at [http://www.ers.usda.gov/Briefing/WellBeing/Glossary/def\\_fohi.htm](http://www.ers.usda.gov/Briefing/WellBeing/Glossary/def_fohi.htm) (accessed December 2006).

The relatively small contribution of government payments to smaller-scale producers' operator household incomes and to incomes of producers not specializing in the program crops clearly indicates the lack of any income support objective for these programs (Chart 5). The programs that are production linked—the bulk of U.S. safety net programs—tend to be concentrated as production is concentrated, in the larger commercial operations. And, for grains, soybeans, cotton and other field crops, government payments provide important shares of household income—especially for “commercial” operations. However, for fruits and vegetables, the importance of government payments is sharply lower—as it is for “rural residence” farms of all types.

**Chart 5: Government Payments as a Share of Farm Operator Household Income, by Farm Type and Size, 2004**



Source: USDA/ERS, *Agricultural Resource Management Survey, Farm Business and Household Survey Data 2004*, <http://www.ers.usda.gov/Data/ARMS/app/Farm.aspx> (accessed October 2006).

The bias in payments towards large operations specializing in the program crops is illustrated by the following examples for 2004 (the figures in brackets are the proportion of average operator household income in the form of government payments):

- Family farms specializing in corn averaged \$138,400 in payments if their sales were over \$1 million (25%), but only \$5,835 if their sales were under \$100,000 (8%);
- Family farms specializing in fruits/vegetables/nursery averaged \$16,645 in payments if their sales were over \$1 million (3%), and \$252 if their sales were under \$100,000 (0.4%); and

- Family farms specializing in poultry averaged \$6,974 in payments if their sales were over \$1 million (6%), and \$524 if their sales were between \$100,000 and \$250,000 (0.8%).<sup>13 14</sup>

The inequities of the 2002 Farm Act reflect the very structure of the support programs because payments are closely correlated to the volume of current<sup>15</sup> and past<sup>16</sup> production of a select few commodities, linkages that necessarily mean that payments go to those commodities and to larger operations. These inequities will only grow larger as the sector continues to shift towards larger farms and the relative importance of the supported crops continues to decrease.

### **Commodities Receiving Price Support**

In addition to direct income support, the government regulates a number of markets and constrains imports of some commodities to protect domestic producers.

In particular, sugar and dairy receive support in the form of direct transfers from consumers to producers and processors. In both sectors, quotas limit imports. These mechanisms, in conjunction with domestic price supports, keep domestic prices high and limit choices, for both households and food manufacturers.

Thus, while the sugar program currently operates at little or no cost to the Federal Government, the President's Council of Economic Advisers points out that consumers (including confectionary manufacturers) effectively pay a tax of \$1.5 billion per year (in the form of higher prices) that goes directly to the sugar industry.<sup>17</sup> The Department of Commerce estimates that these higher prices have resulted in the loss of nearly three confectionary manufacturing jobs for every saved sugar harvesting and growing job. In addition, consumers pay \$826,000 in higher prices each year to save each such job.<sup>18</sup>

Since the level of support provided to the sugar and dairy sectors is also linked closely to the volume of production, larger producers receive the bulk of the support – the benefits are not targeted to low income households.

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<sup>13</sup> No estimate is available of average government payments to a family farm specializing in poultry with less than \$100,000 in annual sales for 2004.

<sup>14</sup> USDA/ERS, Agricultural Resource Management Survey, Farm Business and Household Survey Data 2004, <http://www.ers.usda.gov/Data/ARMS/app/Farm.aspx> (accessed October 2006).

<sup>15</sup> In the case of the marketing loan program.

<sup>16</sup> In the case of the counter-cyclical and direct payments programs.

<sup>17</sup> Council of Economic Advisers, *Annual Report of the Council of Economic Advisers*, 2006, page 182.

<sup>18</sup> U.S. Department of Commerce, International Trade Administration, *Employment Changes in U.S. Food Manufacturing: The Impact of Sugar Prices*, page 11.

### Market Distortions

Both USDA and the Chicago Council on Global Affairs have concluded that, by blocking or masking market signals, current programs stimulate production of some commodities and limit the sector's incentive to shift resources in response to market conditions.<sup>19</sup> Additionally, they limit its capacity to compete in a number of growing markets and thereby diminish export and overall sector growth.

**Blocking Market Signals.** Low prices are normally relied upon as efficient signals to reduce production and reallocate resources. However, price-linked programs block such signals through often-large transfer payments for commodities—even when prices are only modestly below the marketing assistance loan rate. For example, in 2005/06, corn and cotton prices were slightly below the loan level but very large payments were made (Table 1). Even for soybeans, wheat and rice, whose prices were above the loan level, substantial payments were made in 2005/06.<sup>20</sup>

For each of the commodities listed in Table 1, the loan rate was well above average variable costs in 2005/6 (with the difference being especially large in the case of corn, soybeans and wheat).

**Table 1: Commodity Prices, Costs, Returns and Payments, 2005/06**

Commodity	Crop Year 2005/06						
	Price	Loan	Var Cost	Margin (per bu)		Net Returns	CCC Pmts
			\$/unit		%	\$/acre 1/	bil \$
Corn (\$/bu)	1.80	1.95	1.29	0.51	40	135.40	6.20
Soybeans (\$/bu)	5.35	5.00	2.10	3.25	155	138.69	1.14
Wheat (\$/bu)	3.40	2.75	1.89	1.51	80	63.54	1.20
Cotton (\$/lb)	0.47	0.52	0.43	0.04	10	192.03	4.20
Rice (\$/cwt)	7.90	6.50	5.97	1.93	32	154.00	0.47

Source: USDA, *USDA Agricultural Baseline Projections to 2015, February 2006*

1/ Returns minus variable costs plus any marketing loan benefits

<sup>19</sup> USDA, *2007 Farm Bill Theme Paper - Risk Management*, pages 18 and 19 and the Chicago Council on Global Affairs, Report of the Agricultural Task Force, *Modernizing America's Food and Farm Policy: Vision for a New Direction*, page 14.

<sup>20</sup> Furthermore, counter-cyclical payments can be received when prices are above the loan rate and direct payments are received regardless of the price level.

The Congressional Research Service concludes that the programs effectively shield the major program commodities from market signals. It identifies substantial periods of time in which “it is only with the aid of subsidies that a substantial portion of U.S. production [was] made economically sustainable” (Table 2).<sup>21</sup>

**Table 2: Commodity Revenue and Cost Per Unit of Production, National Averages**

<b>Commodity Time Period Unit</b>	<b>Revenue per Unit from the Market (\$)</b>	<b>Revenue per Unit from Federal Subsidies (\$)</b>	<b>Share of Total Costs Covered by the Market (%)</b>	<b>Share of Total Costs Covered by Federal Subsidies (%)</b>	<b>Share of Total Costs Covered by the Market and by Federal Subsidies (%)</b>
Corn 96-04 (bu)	2.15	0.43	85	17	102
Soybeans 97-04 (bu)	5.45	0.62	91	10	101
Wheat 98-04 (bu)	2.98	1.28	61	26	87
Cotton 97-04 (bu)	0.51	0.30	63	38	101
Rice 00-04 (bu)	5.95	6.53	70	76	146

*Source: Congressional Research Service, Potential Challenges to U.S. Farm Subsidies in the WTO, page 25.*

This level of protection, or isolation from risk, significantly contributes to the separation of production decisions from market signals.

Sectors where safety net supports are de-coupled from price and production tend to respond directly to market trends, and to allocate resources to increasingly productive uses over time. Such sectors become increasingly competitive, lifting their returns and thus become more attractive to investors.

But this can only happen if there is a shift away from “low price” based protections and toward risk management and other well-designed programs that assist producers equitably without intervening directly in their markets.

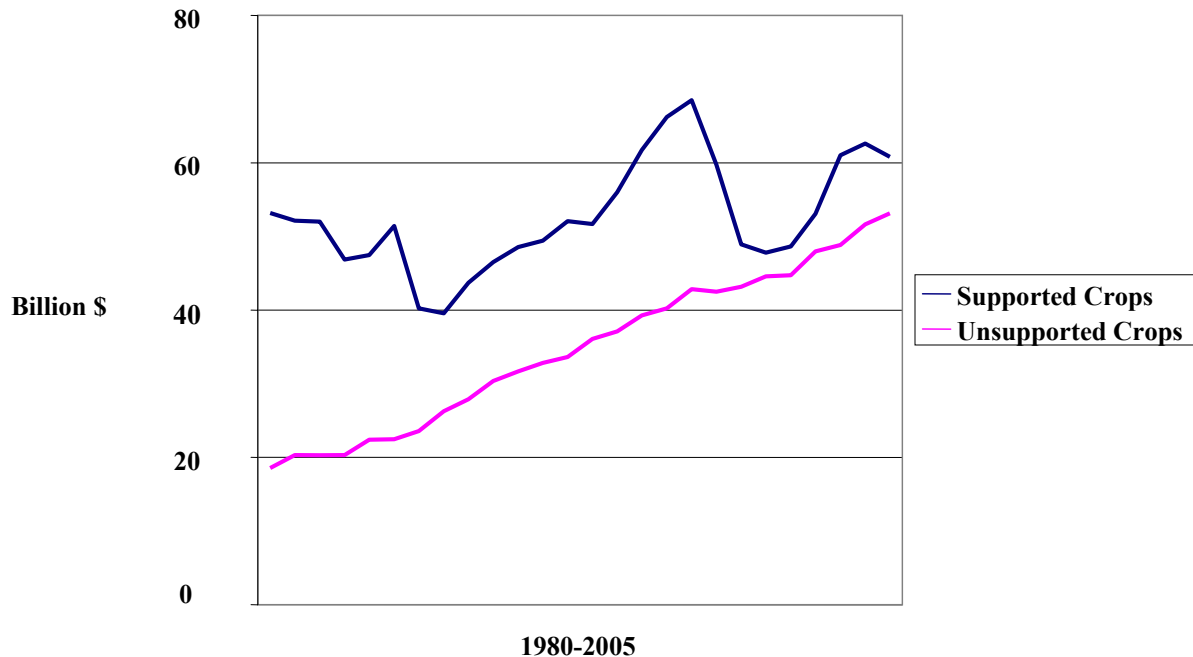
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<sup>21</sup> Congressional Research Service, *Potential Challenges to U.S. Farm Subsidies in the WTO*, page 24.

### Performance of the Supported Crops

In spite of substantial and continued government support, the overall sales performance of supported crops has been unimpressive. USDA data illustrates that cash receipts from the supported crops<sup>22</sup> reflect somewhat erratic prices and returns, and are growing only modestly—up 14% since 1980. By contrast, overall sales of unsupported crops<sup>23</sup> (most of which have been increasingly in demand due to changes in incomes, tastes and preferences), have grown steadily and rapidly during the same period, with cash receipts up by 186% (Chart 6).

**Chart 6: Cash Receipts, Supported and Unsupported Crops, 1980-2005**



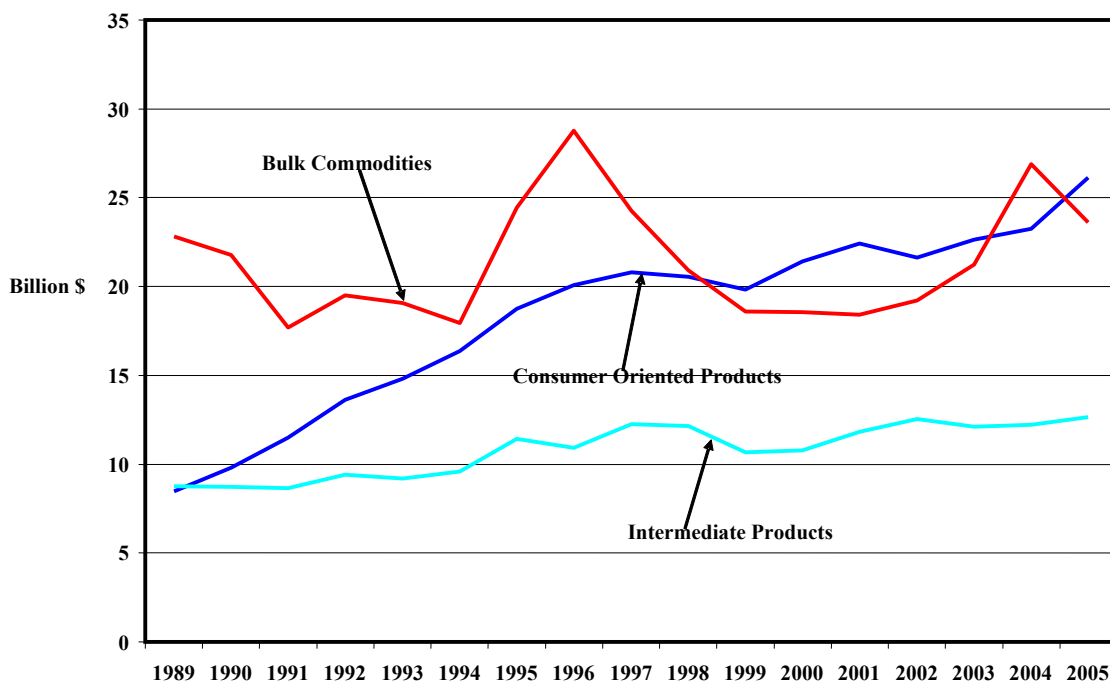
Source: USDA/ERS, *Farm Cash Receipts 1925-2005*, <http://www.ers.usda.gov/Data/FarmIncome/Finfidmu.htm#receipts> (accessed December 2006).

<sup>22</sup> Defined as food grains, feed crops, cotton, tobacco, oil crops, sugar beets, and sugar cane.

<sup>23</sup> Defined as vegetables, fruits, nuts, greenhouse, nursery, and other crops.

In terms of export performance, a similar pattern can be seen in the comparison of bulk commodities—which are dominated by those eligible for support—with those that do not receive support directly (Chart 7). For example, relatively unsupported commodities, such as fresh and processed fruit, vegetables and tree nuts, are leading U.S. export growth and have expanded exports sharply in recent years. Consumer-ready product exports are growing far more rapidly than bulk commodity exports, and now exceed bulk commodities in export value—in spite of the small support received from commodity programs.<sup>24</sup> Even the growth in the export of intermediate (partially processed) products has been faster than for bulk commodities.<sup>25</sup>

**Chart 7: U.S. Agricultural Export Performance by Product Category, 1989-2005**



Source: USDA/FAS, "BICO" reports.

While it is not clear whether the high level of support to the program crops is the cause or the result of this poor performance, it is clear that the current policies, which encourage production for many slow-growing markets rather than resource shifts to fast-growing ones, are directing taxpayer dollars to market areas of declining relative importance.

<sup>24</sup> While consumer-ready products receive no direct support from the commodity programs, they do receive modest indirect supports in some cases since they use commodities as raw supplies and benefit from abundant supplies and competitive prices.

<sup>25</sup> In USDA parlance, bulk commodities are unprocessed wheat, feed grains, food grains and other commodities. Intermediate products have been processed to some extent such as wheat flour, soybean oil and animal feeds. Consumer-oriented products include processed products such as breakfast cereals and products consumed fresh such as fruits and vegetables.

### **Rising Land Prices**

There have been numerous studies in recent years on the impact of government payments on land prices.<sup>26</sup> This impact is an unintended, and largely negative, consequence of high levels of support.

Farmland values reflect agricultural profits or rents, but they also reflect a number of other factors including non-agricultural returns (such as the demand for land for non-agricultural uses such as residential or commercial development) and farm program payments. Since many farm programs are linked to land (in the form of past participation in farm programs, for example), government payments tend to be capitalized into land values and to contribute to the sector's equity growth.

Estimates of the share of farmland values that represent capitalized government payments vary widely, ranging from 7% to 38%.

While this trend benefits landowners, high land prices (and high cash rents) can increase operating costs for many producers, particularly given that around 46% of U.S. harvested cropland is rented.<sup>27</sup> Land price inflation also increases costs for new entrants to the farming sector, speeds farm consolidation and diminishes the viability of rural communities in some areas.<sup>28</sup>

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<sup>26</sup> See, for example:

- Barnard, Whittaker, Westenbarger and Ahearn, *Evidence of Capitalization of Direct Government Payments into U.S. Cropland Values*, Amer. J. Agr. Econ. 79 (Number 5, 1997), pages 1642 to 1650.
- Barnard, Nehring, Ryan and Collender, *Higher Cropland Value from Farm Program Payments: Who Gains?*, Agricultural Outlook, Economic Research Service/USDA, November 2001.
- Ryan, Barnard and Collender, *Government Payments to Farmers Contribute to Rising Land Values*, Agricultural Outlook, Economic Research Service/USDA, June-July, 2001.
- Kastens and Dhuyvetter, *Valuing and Buying U.S. Farm Land, with a Consideration of Non-Ag Features*, Kansas State University, September 2006.

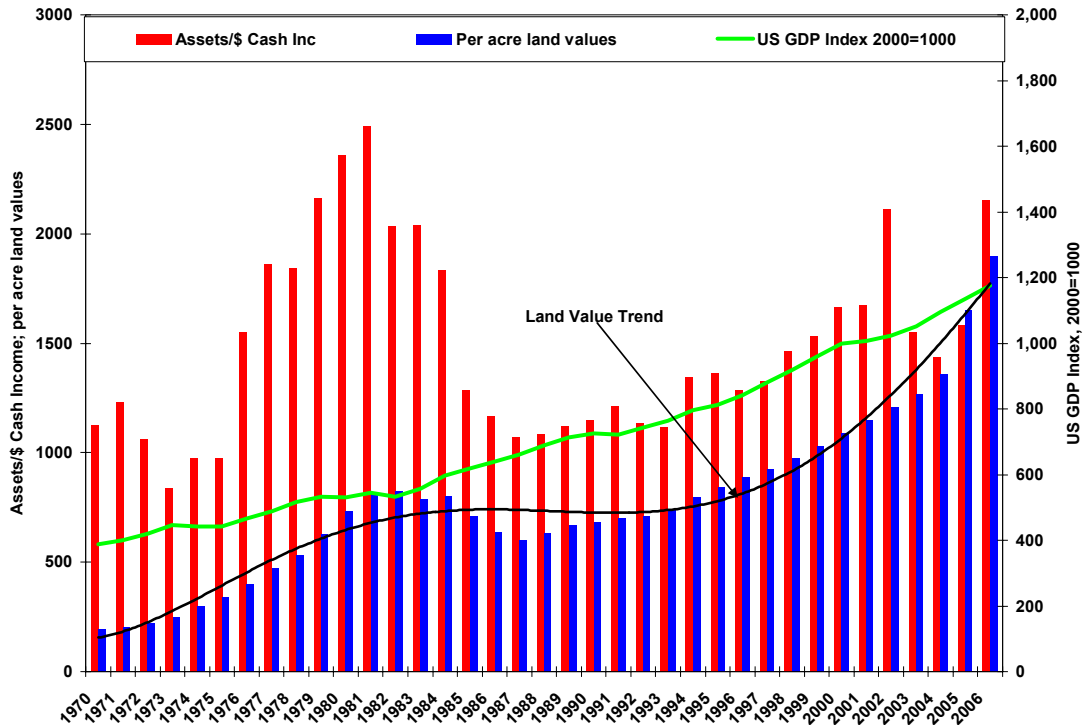
See also USDA, *2007 Farm Bill Theme Paper - Risk Management*, page 20.

<sup>27</sup> Calculated from USDA/NASS, *2002 Agricultural Census estimates*, Land Tenure tables, table 40.

<sup>28</sup> It may also result in higher prices for consumers.

The value of U.S. farm real estate grew 47% between 2000 and 2006, faster than net cash income (which grew 29%) and GDP (which grew 18%) (Chart 8). A major concern of producers (and of their bankers) is that such increases will prove unsustainable—as was the case when the sector lost 30% of its assets in the farm recession of the mid-1980s.<sup>29</sup>

**Chart 8: Farm Real Estate Value per \$ Net Cash Income and Land Prices, 1970-06**



Source: USDA/ERS, *Farm Income 2006* and USDA/NASS, *Land Values and Cash Rents, 2006 Summary, August 2006*.

<sup>29</sup> Since farm real estate is the main source of collateral for farm credit, the threat of any significant decapitalization of the sector is a major concern for producers and also for the institutions and businesses that provide inputs, credit and other resources.

### **The Effectiveness of the Programs as a Safety Net**

For economists, a safety net is a policy that ensures a minimum income, consumption, or wage level for members of a society or subgroup.<sup>30</sup>

Yet, USDA concludes that commodity programs that provide direct income support reach only about one-quarter of all farms. And while the crop insurance program covers most of the acreage of major field crops, relatively few farms purchase it. Finally, there is no broad program of income support or insurance for livestock.<sup>31</sup>

At the same time, the commodity programs tend to be heavily skewed towards those with high incomes.

In spite of the strong protections that the marketing loan and counter-cyclical payments programs provide against low prices, commentators have noted that they can either under-compensate or over-compensate eligible producers as price and production circumstances change.<sup>32</sup> For example:

- When yields are low and prices are high, payments are low—even though producer returns may be relatively low because of the poor yields;
- When yields are high and prices are low, payments are high—even though producer returns may be relatively high because of large production;
- If producers plant different crops than in the base period, and the prices of the crops being grown are low but the prices of those in the base are high, the producer is under-compensated; and
- If producers plant different crops than in the base period, and the prices of the crops being grown are high but the prices of those in the base are low, the producer is over-compensated.

Because the marketing loan program is linked to both prices and yields, producers can be under-compensated if yields are so low that producers have little or no products which qualify (e.g. the marketing loan program will provide no benefit in a year of total crop failure).

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<sup>30</sup> Gundersen, Morehart, Whitener, Ghelfi, Johnson, Kassel, Kuhn, Mishra, Offutt, and Tiehen, USDA/ERS, *A Safety Net for Farm Households*, page 1.

<sup>31</sup> Dismukes and Durst, USDA/ERS, *Whole-Farm Approaches to a Safety Net*, page 1.

<sup>32</sup> This argument is being made by a number of academics, but also by USDA. See, for example, USDA, *2007 Farm Bill Theme Paper - Risk Management*, page 17.

## II. Context of the 2007 Debate

*“The structure of agriculture is moving away from the middle.”<sup>33</sup>*

*“For many agricultural products, the main opportunity for future growth in demand has been in export markets. Continued growth in output will require maintaining and increasing access to foreign markets.”<sup>34</sup>*

*“If prices move higher ... current farm programs will provide little stabilization during the next farm bill period.”<sup>35</sup>*

The 2007 Farm Bill debate is expected to take place in the first half of 2007, so that the new legislation can be in place as the old law expires with the 2007 crops. The new legislation likely will apply to the 2008-12 crops.

In several important ways, the debate will be different from those in the past, and will take place in the context of challenges from several directions.

This Chapter sets out a number of those challenges and their implications for the 2007 Farm Act.

### Budget Concerns

In contrast to the budget surpluses expected when the 2002 Farm Act was written, the outlook for the life of the 2007 Farm Act is for large budget deficits and rapidly increasing claims for resources from social programs, national defense, and many others.

Given the expected tight budgetary situation, it is worthwhile noting that the increase in biofuels production from grains (discussed in more detail below) likely will raise crop prices. Such trends could significantly reduce demands on current safety-net programs—particularly the counter cyclical and marketing loan programs—but only if no changes are made to the rates used to calculate the benefits paid under these programs (i.e. there is a simple extension of the 2002 Farm Act).

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<sup>33</sup> American Farm Bureau Federation, *Making American Agriculture Productive and Profitable*, Executive Summary, page viii.

<sup>34</sup> USDA, *2007 Farm Bill Theme Paper – Strengthening the Foundation for Future Growth in U.S. Agriculture*, page 9.

<sup>35</sup> Public Policy Action Team, National Corn Growers’ Association, *Forging a New Direction for Farm Policy*, page 25.

As a result of improved prices, it is projected that spending on the marketing loan program will decline—from \$6 billion for 2005 to \$0.60 billion for 2015—with cotton and rice growers being the main recipients. Corn and soybean prices during 2006 to 2015 are projected to be high enough to prevent their participation in the marketing loan program.<sup>36</sup>

These trends are widely anticipated by agricultural groups, and are raising concerns about levels of future benefits. For example, in a December 2006 letter to the President and others, the American Farm Bureau Federation reportedly stated that “the increase in ethanol and biofuels production—and the impact on corn and soybean prices—[is expected] to reduce the [CBO] commodity baseline to about \$57 billion over six years, ... barely more than half of the \$99 billion Congress was willing to spend on commodity programs over the last six years”. Furthermore, “the stronger ethanol demand scenario ... could drive commodity program spending to less than \$8 billion annually ... If \$5.2 billion in direct payments is continued, less than \$3 billion would remain in the commodity program baseline to focus on price risk via the marketing loan program or the counter-cyclical program”.<sup>37</sup>

The American Farm Bureau Federation has called for funding for the 2007 Farm Act to be set at the levels authorized in the 2002 Farm Act (with an adjustment for inflation).<sup>38</sup> This implies changes to the rates used to calculate benefits under the marketing loan, counter-cyclical payments, and (perhaps) direct payments programs.

### **Restiveness in the Farm Sector**

In conjunction with the American Farm Bureau Federation’s call for funding for the commodity programs to be increased, additional claims for support are emerging.

**Specialty crops producers**, recognizing their significant contribution to total cash receipts for agriculture and fearing increased competition from the possible removal of the planting flexibility limitations on direct payments, are working actively against a simple extension of the 2002 Farm Act. They have not proposed direct subsidies but do want greater investment in programs to support their industries (e.g. federal nutrition programs, research and development, conservation programs, State block grants).<sup>39</sup>

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<sup>36</sup> Of course, the absence of participation in the marketing loan program does not mean that corn and soybean growers will be worse off. Rather, it implies that they will be receiving more of their returns from the market and less from the government.

<sup>37</sup> See text of letter available at <http://images.meredith.com/ag/pdf/120706budgetletter.pdf> (accessed December 2006).

<sup>38</sup> See text of letter available at <http://images.meredith.com/ag/pdf/120706budgetletter.pdf> (accessed December 2006).

<sup>39</sup> See discussion of the goals of the Specialty Crop Farm Bill Alliance at <http://www.competitiveagriculture.org/> (accessed December 2006).

**Livestock producers** are likely to seek increased support if it appears they will face higher feed costs due to the effect of ethanol demand on corn and soybean prices.<sup>40</sup>

**Conservation groups**, such as the American Farmland Trust, are seeking greater conservation funding.<sup>41</sup> This reflects broad community support for programs that assist producers based on how well they protect the land, air and water. The Chairmen of the House and Senate Agriculture Committees also wish to boost conservation spending.

**Energy interests.** Growth in renewable fuels markets driven by a desire to reduce U.S. dependency on foreign petroleum products is leading to re-structuring of the agricultural sector. It is affecting commodity markets and pricing patterns, allocation of agricultural resources, investment needs for grain handling, shipping and storage facilities, the structure and location of livestock feeding, and other sector characteristics. Policies are being called for that give attention to both the positive and negative impacts of this growth. The Chairmen of the House and Senate Agriculture Committees also wish to boost spending on the development of biofuels from new agricultural sources.<sup>42</sup>

The question facing the drafters of the 2007 Farm Act is how to address these new demands<sup>43</sup> in light of the call by the American Farm Bureau Federation for increased spending on the traditional commodity programs.

### **Future Commodity Prices and Outlook**

This section discusses the outlook for program crops assuming a continuation of current policies (i.e. a simple extension of the 2002 Farm Act). That is, it assumes no changes to the rates used to calculate benefits under the marketing loan, counter-cyclical payments, and direct payments programs.

Notwithstanding the sharp decline in spending on these programs caused by higher crop prices, the sum of sales revenue and government payments for the program crops is projected to increase by more than \$11 billion between 2005 and 2015, with the increase in sales revenue significantly exceeding the decline in government payments (Chart 9).

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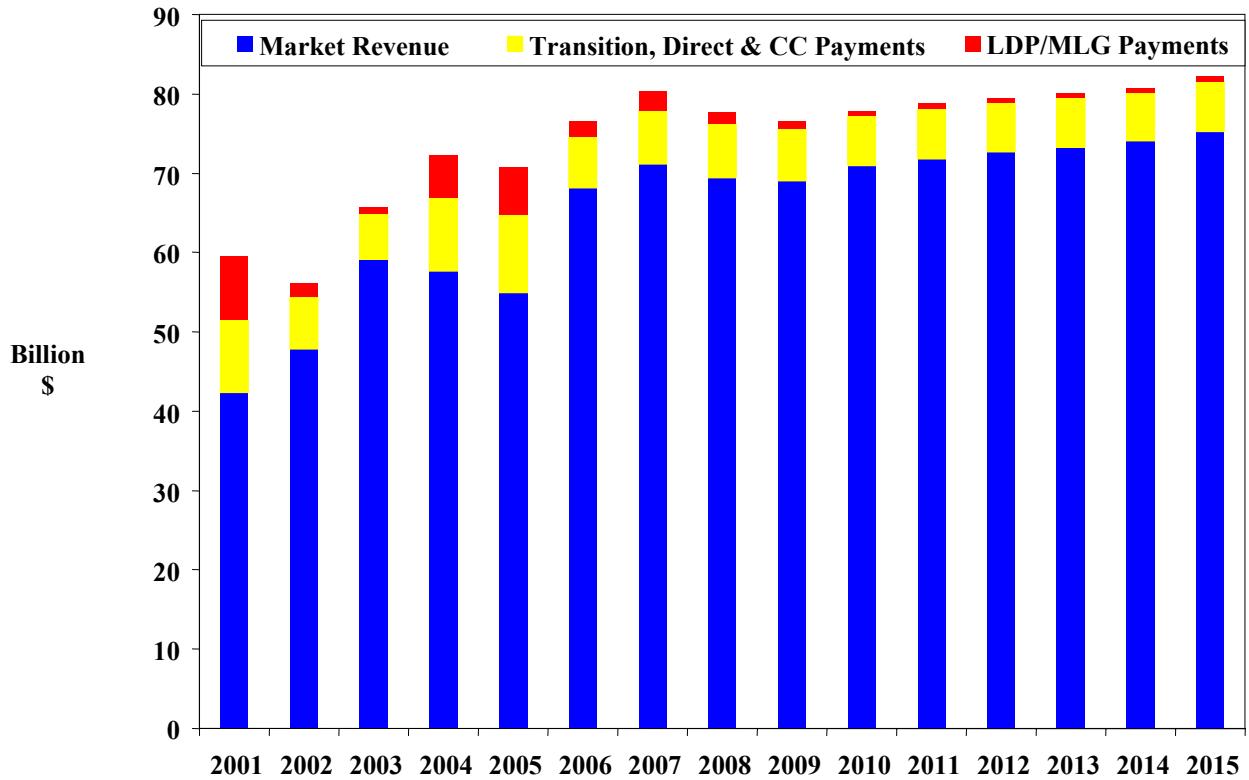
<sup>40</sup> See, for example, the testimony of Ms. Joy Philippi, President, National Pork Producers' Council, before the House Agriculture Committee on 20 September 2006, available at <http://agriculture.house.gov/hearings/109/10938.pdf> (accessed December 2006).

<sup>41</sup> See, for example, American Farmland Trust, *Agenda 2007: A New Framework and Direction for U.S. Farm Policy*, available at <http://www.farmland.org/programs/campaign/newpolicyrecommendations.asp> (accessed December 2006).

<sup>42</sup> DesMoinesRegister.com, *Farm Bill to back money for biofuels, leader says*, <http://www.desmoinesregister.com/apps/pbcs.dll/article?AID=/20061209/BUSINESS01/612090322/-1/LIFE04> (accessed January 2007).

<sup>43</sup> And others, such as the permanent disaster assistance program favored by Chairman Peterson.

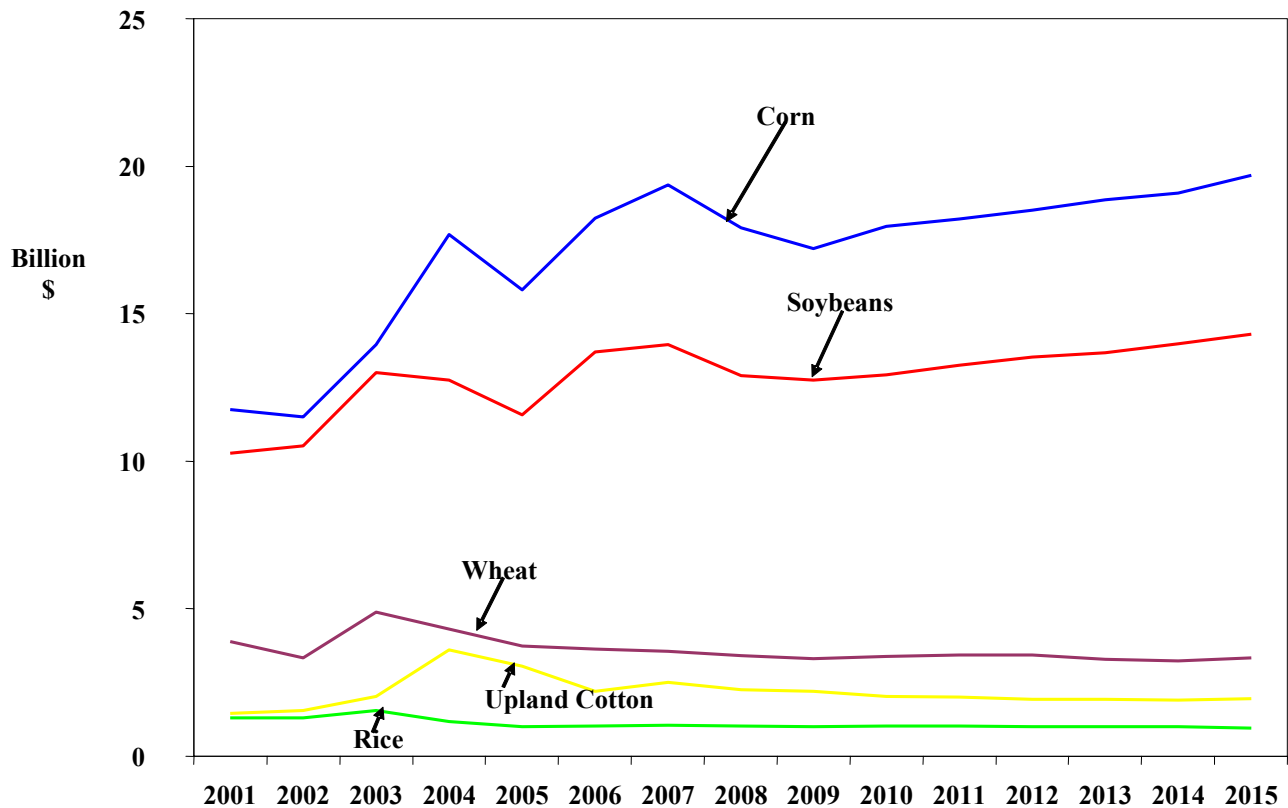
Chart 9: Commodity Sales and Government Payments, Crop Years 2002-15, Corn and Other Feed Grains, Wheat, Rice, Soybeans and Upland Cotton



Source: Informa Economics projections, December 2006.

Overall net revenue (which includes government payments but deducts variable production costs) is also projected to increase. Corn is projected to see a significant increase in net revenue. A large increase is also projected for soybeans, while cotton and wheat are projected to remain at or above 2002 levels (Chart 10).

**Chart 10: Net Revenue, Selected Commodities, 2002-15**



Source: Informa Economics projections, December 2006.

### Observations

This projected increase in net revenues despite the significant fall in commodity program payments suggests that money could be available to fund less trade distorting programs and to help address the demands of the additional claimants discussed above. It represents an opportunity for program crop growers to secure a greater share of their returns from the market and to become less reliant on government payments.

### **Biofuels—New Competitor for Production Resources**

Biofuel market growth has been rapid and important in recent years and promises to dominate the grain and oilseed sector's economic outlook for the intermediate term. The emergence of this new market, in which agriculture is an important player facing huge demands, means fundamental changes for the sector, including stronger future prices and greater volatility—very different conditions than those that led to the design of the current commodity programs.

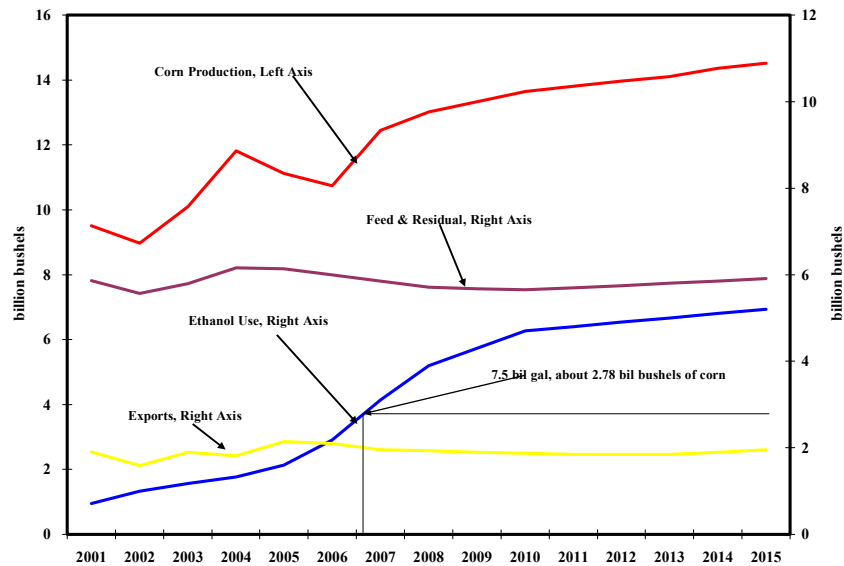
These new realities provide an opportunity, and a need, to design agricultural programs that can effectively support the sector in the future.

Initially driven by federal policies aimed at reducing air and water pollution, biofuels are now being promoted to reduce dependence on foreign oil and reduce greenhouse gas emissions. Policies with the clear intent of stimulating ethanol and biodiesel production are being implemented and are rapidly diverting growing shares of corn and soybean production. Investment in research and development is attempting to create efficient processes to produce ethanol from materials other than grain, but those also can be expected to require the use of land resources, including those now used for food and fiber crops.

Key drivers of ethanol production are government subsidies and support, the price of ethanol, the price of competing petroleum products, and the prices of ethanol production inputs and by-products. Extremely attractive ethanol margins mean that the 7.5 billion gallon production mandate is likely to be surpassed in 2007, five years in advance of the target date specified in the Energy Policy Act.

In fact, current investment trends suggest that at least 15 billion gallons of renewable fuels will be produced annually by 2015, largely ethanol from corn. This would imply corn production of 14.5 billion bushels on 87 million acres (with a yield of 181.5 bushels per acre), much greater amounts than are produced today. Such fundamental changes in outlook clearly imply stronger returns for the sector, and greater volatility as well (Chart 11 and Table 3).

**Chart 11: Corn Requirements for Renewable Fuels**  
*15 Billion Gallon Renewable Fuel Production Levels*



*Source: Informa Economics projections, December 2006.*

Increases in corn production of this size will require significant shifts for the sector. For example, it will mean an additional 8.4 million acres cultivated for corn by 2015, primarily shifted from land previously used for soybean (3.6 million acres) and wheat (3.3 million acres). Because the growth of corn productivity has been extraordinarily great, shifts of this magnitude appear possible without severe price shocks or market disruptions, assuming no adverse weather conditions and a continuation of productivity growth (Table 3).

**Table 3: Corn and Soybean Fundamentals, 2006-2015**

	2006	2015	<i>Change</i>	
	<i>Planted Area</i>		<i>units</i>	<i>%</i>
Corn	78.6	87	8.4	10.7
All wheat	57.3	54	-3.3	-5.8
Soybeans	75.6	72	-3.6	-4.8
Cotton	15	12.2	-2.8	-18.7
Total planted	312.1	310	-2.1	-0.7
	<i>Corn subsector fundamentals</i>			
Production, mil bu	10,745	14,520	3775	35.1
Use for ethanol, mil bu	2,175	5,200	3025	139.1
Exports, mil bu	2,100	1,950	-150	-7.1
Use for feed, mil bu	6,000	5,910	-90	-1.5
Total use, mil bu	11,665	14,540	2875	24.6
	<i>Soybean subsector fundamentals</i>			
Production, mil bu	3,204	3,290	86	2.7
Crush, mil bu	1,785	2,000	215	12.0
Exports, mil bu	1,100	1,125	25	2.3
Total use, mil bu	3,052	3,310	258	8.5

*Source: Informa Economics projections, December 2006.*

## **Observations**

The primary federal incentive for ethanol production is a \$0.51 per gallon subsidy. By 2015, this subsidy will cost \$7.1 billion per year (based on production of 15 billion gallons of renewable fuels, including 14.2 billion gallons of ethanol). Thus, assuming a continuation of the policies in the 2002 Farm Act (i.e. a simple extension of the 2002 Farm Act), the projected *decrease* in commodity program payments over the life of the 2007 Farm Act will (at least) be partially compensated for by the projected *increase* in ethanol subsidies.

## **Other Sources of Future Demand**

The agricultural sector's domestic food and fiber markets are mature and respond very little as incomes grow. This is not true for most of the world's people, who significantly increase their food consumption as their incomes grow—so, future food market growth depends on the sector's ability to compete globally.

Domestic demand for primary commodities can also be expanded by the development of innovative products and the addition of value through the supply chain—areas in which the U.S. food and fiber system holds a demonstrated advantage. Increasingly, this system is being driven by the consumer. Producer sensitivity to these changing needs is critical to remaining viable in the marketplace.

Policies designed to protect producers from the risks of yesterday limit their capacity to respond to these market opportunities and to compete in increasingly global markets.

## **Structural Implications for Policy<sup>44</sup>**

**Producer Needs Vary Widely.** Even though there are only about one-third as many farms as in 1940,<sup>45</sup> the sector has continued to expand its volume and sales, meet virtually all U.S. food and fiber needs, and supply major markets overseas. As farm numbers have declined, the dominance of “commercial” operations has grown, with many operating on a very large scale. In addition, farms have become more specialized in their operation and far more diverse in their organization.

For more than 30 years, U.S. agriculture has been tri-modal in structure—commercial operations with sales of over \$250,000 each; small, “lifestyle” farms with annual sales of less than \$100,000 each (and usually with negative net farm income); and a “transition” group with annual sales of between \$100,000 and \$250,000 each.

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<sup>44</sup> This section depends heavily on data and calculations based on USDA/NASS, *2002 Census of Agriculture*.

<sup>45</sup> From around 6 million in 1940 to around 2 million in 2005—USDA/ERS, Number of Farms 1850-2006, <http://www.ers.usda.gov/data/farmincome/finfidmu.htm> (accessed October 2006).

There have been significant changes in the relative importance of each group to the sector, even since the mid-1990s (Table 4).

**Table 4: Number of Farms and Value of Sales by Sales Class, 1996-2004**

Type of Farm	By Value of Sales	1996	2004	1996	2004	% Chng 96-2004
		<i>Number of Farms</i>		<i>Percent of Total</i>		
Lifestyle Farms	Less than \$100,000	1,639,075	1,771,907	81.6	84	+8.1
Transition Farms	\$100,000 to \$249,999	206,469	167,948	10.3	8	-18.7
Comm'l Farms	\$250,000 & Greater	163,351	168,071	8.1	8	+2.9
Mega Farms	\$1 million & Over	22,398	34,408	1.1	1.6	+53.6
All Farms	Total	2,008,896	2,107,925			
<i>Value of Sales in \$1000</i>						
Lifestyle Farms	Less than \$100,000	26,484,133	25,962,306	14.7	11.7	-2
Transition Farms	\$100,000 to \$249,000	37,730,159	29,595,175	21	13.3	-21.6
Comm'l Farms	\$250,000 & Greater	115,558,715	166,767,853	64.3	75	+44.3
Mega Farms	\$1 million & Over	50,758,683	99,847,279	28.2	44.9	+96.7
All Farms	Total Value of Sales	179,773,007	222,325,335			

*Source: USDA/ERS, Agricultural Resource Management Survey, Farm Business and Household Survey Data, 1996 and 2004, <http://www.ers.usda.gov/Data/ARMS/app/Farm.aspx> (accessed October 2006).*

### **Lifestyle Farms**

These are the most numerous farms. Their numbers continue to grow (up 8% between 1996 and 2004), although their contribution to total sales is small and falling.

These farms tend to be relatively prosperous and very diverse, and depend on agriculture for less than one-half of their income. Their income levels are significantly above those of the average American, and have been since the early 1980s. Many of these farmers are retired, while others are fully employed in non-agricultural jobs but enjoy rural living (barely half of all operators count farming as their primary occupation). The group's well-being tends to reflect trends in the national economy rather than in agriculture.

Most lifestyle farmers lose money on farming, an activity they subsidize with non-farm earnings, retirement income or by land speculation. This suggests that the group is at least as concerned with interest rates, tax policies and stock market trends as it is in commodity prices. Their concerns also include rural development and environmental issues, among many others.

The group is an enigma for farm policy. The image of the struggling small farmer that was created long ago—perhaps in pre-Civil War days—is no longer true. This group fits the small farmer image to the extent that it tends to include relatively small operations. However, there is no reasonable indication that farm programs are required to help it achieve its goals—especially its numerous goals that do not concern agriculture. Nor, in truth, do they have any reasonable capacity to do so—each of the 1.8 million farms with annual sales of under \$100,000 received, on average, just over \$1,400 in government payments in 2004 (at a total cost to taxpayers of almost \$2.6 billion).<sup>46</sup>

### **Commercial Farms**

Commercial farmers depend heavily on agriculture—63% get more than 75% of their income from farming and over 90% count farming as their primary occupation. They account for the bulk of the production of food and fiber—more than three-quarters of agricultural sales in 2004—even though they only constitute 8% of farms.

Commercial farms are generally moderate sized businesses readily able to attract capital and growing steadily larger, especially in the livestock and other high-value sectors. They tend to have strong interests in expanding their sales, especially in adding value to raw commodities close to production areas, but also in expanding their international sales. They are interested in improving productivity through a number of avenues including better production cost control; new technology and better management techniques; commodity marketing and price management; risk management; and engaging in conservation.

### **Transition Farms**

Transition farmers depend heavily on farming—52% get more than 75% of their income from farming, while more than 80% count farming as their primary occupation.

These producers tend to have many of the same interests as commercial farmers, but their needs are often more critical and their management capacity lower. They are strongly interested in becoming more competitive; primarily by accessing new markets; by adding resources; and by building better management techniques.

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<sup>46</sup> USDA/ERS, Agricultural Resource Management Survey, Farm Business and Household Survey Data, 2004, <http://www.ers.usda.gov/Data/ARMS/app/Farm.aspx> (accessed October 2006) and USDA, *2007 Farm Bill Theme Paper - Risk Management*, page 30.

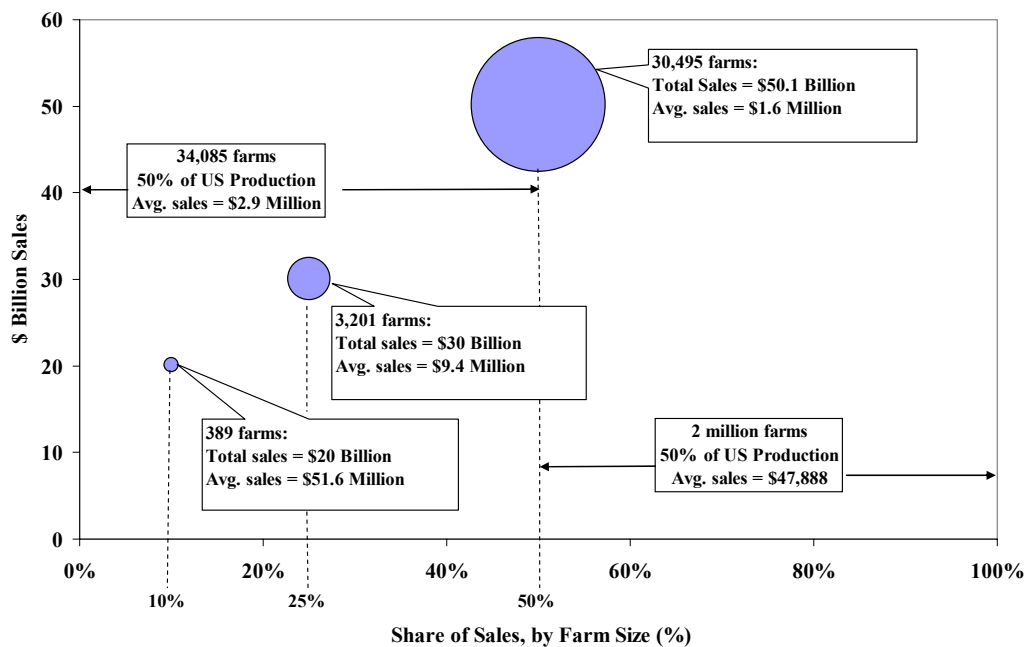
Transition farmers bear much of the burden of competing disadvantageously with larger scale, more efficient producers. As a result, they are interested in both technical assistance and cost-share assistance (including to help offset regulatory requirements). In addition, many of these producers may be interested in programs that help them shift out of farming—in fact, the number of farms in this category declined almost 19% between 1996 and 2004, while sales were down almost 22%.

Transition farmers also are an enigma for farm policy. Because they are often less efficient than larger-scale farmers, programs designed to help them may be even more helpful for larger-scale operators, who may then be stimulated to expand and consolidate, a trend many transition farmers oppose. Similarly, programs designed to help larger commercial producers may not be adequate to help the smaller transition farmers.

**Sector Concentration**

The sector’s trend toward concentration can be seen in the importance of commercial farms, but also in the (declining) number of large operations necessary to account for 50% of sector sales. The importance of the larger farms is startling. In 2002, a mere 389 farms accounted for 10% of sales and averaged \$51.6 million in sales each. Another 3,201 farms accounted for an additional 15% of sales and averaged \$9.4 million in sales each, while 30,495 farms accounted for an additional 25% of sales and averaged \$1.6 million in sales each. Two million other farms shared the remaining 50% of sales, averaging only \$47,888 each (Chart 12).

**Chart 12: Agricultural Sales Concentration, 2002**



Source: USDA/NASS, 2002 Census of Agriculture.

As set out in Table 4, mega-farms (those with annual sales over \$1 million) almost doubled their sales between 1996 and 2004—in fact, this 1.6% of farms provided almost 45% of the total value of farm production in 2004.

## **Observations**

U.S. agriculture has generally opposed program design or eligibility based on farm structure.<sup>47</sup> Producers' interests and needs, however, differ widely—depending heavily on the size of their operation—disparities in structure and needs that have grown sharply over the seven decades since government intervention began.

The price-linked support system now has very little impact on the most often invoked target of agricultural policy, the smaller operator. In any event, since smaller operators produce relatively little and are only loosely linked to the agricultural economy, there is no indication that government payments are required to help them achieve their goals.

As a result of the push towards consolidation, an ever-increasing portion of government payments is being provided to large, commercial operations who are in the best position to look after themselves. In 2004, over \$5.5bn (over 54% of total government payments) was paid to farms with annual sales of over \$250,000,<sup>48</sup> notwithstanding that the average operator household income of family farms in that category was over \$190,000,<sup>49</sup> more than three times the U.S. average.

The transition farms, those arguably in most need of assistance, received the least funding of the three groups—\$2.1 billion in 2004.<sup>50</sup>

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<sup>47</sup> Although social considerations have led to efforts to limit payment totals.

<sup>48</sup> USDA, *2007 Farm Bill Theme Paper - Risk Management*, page 30.

<sup>49</sup> USDA, Economic Research Service, Agricultural Resource Management Survey, Farm Business and Household Survey Data, 2004, <http://www.ers.usda.gov/Data/ARMS/app/Farm.aspx> (accessed January 2007).

<sup>50</sup> USDA, *2007 Farm Bill Theme Paper - Risk Management*, page 30.

### **Potential Collapse of the Sugar Program?**

Under current U.S. sugar policy, processors are guaranteed a minimum sugar price. Processors pledge the sugar they are going to produce as collateral for government loans. If market prices fall below the minimum price, processors simply forfeit the sugar to the government.

The 2002 Farm Act requires that the sugar program be administered, to the maximum extent practicable, at no budgetary cost. In order to do this, USDA attempts to control the supply of sugar to keep the price high enough above the legislated loan rate to prevent the forfeiture of sugar. It controls the domestic supply of sugar through marketing allotments (which limit the volume of sugar that each processor can sell) and controls the foreign supply of sugar through quotas.

The tools now used to manage the program will become ineffective once NAFTA is fully implemented (to allow free trade in sweeteners) on 1 January 2008.<sup>51</sup> This is because USDA's authority to issue marketing allotments is linked to an import trigger that could be exceeded if imports from Mexico increase as expected. A study prepared for the American Sugar Alliance estimates that free trade in sugar under NAFTA will "spur additional exports to the United States [from Mexico] on the order of one-half million to one million metric tons" per year and forfeitures (and thus government stocks) "on the order of one million short tons, raw value".<sup>52</sup> It would be impossible to administer the program at no budgetary cost with forfeitures of this magnitude—in fact, the CBO January 2007 baseline estimates of outlays show spending for the sugar program of almost \$1.4 billion during FY2008-17.

Put simply, it is impossible to operate a supply control program if, in fact, the government cannot control the supply.

The 2007 Farm Act presents an opportunity for a thorough restructuring of the sugar program. Removing barriers to imported sweeteners would lower prices for consumers, stem the loss of confectionary manufacturing jobs, and concentrate beet and cane production on the most efficient producers.

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<sup>51</sup> See testimony of former USDA Under Secretary Dr. J.B. Penn before the Senate Agriculture Committee in May 2006, available at [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109\\_senate\\_hearings&docid=f:30239.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_senate_hearings&docid=f:30239.pdf) (accessed January 2007).

<sup>52</sup> McKeany-Flavell Company, Inc., *The Future of U.S. Sugar Policy*, pages 8 and 10.

**Trade Policy—The WTO Cotton Dispute<sup>53</sup>**

U.S. trading partners have long asserted that they are damaged by U.S. policies.<sup>54</sup> In 2003, Brazil brought a WTO case against U.S. cotton (and other) programs and won. The dispute settlement panel and subsequent Appellate Body deciding the case concluded that subsidies provided to U.S. cotton growers caused “serious prejudice” to Brazil’s interests by causing significant price suppression in the world market for cotton.<sup>55</sup>

The WTO’s ruling on price suppression focused on subsidies directly linked to world prices, including counter-cyclical payments, the marketing loan program and Step 2 payments (paid to domestic users of U.S. cotton to compensate for high prices for U.S. cotton and paid to exporters of U.S. cotton to compensate for low world cotton prices). The U.S. eliminated its Step 2 payments effective 1 August 2006, but has not proposed any modifications to the marketing loan program or the counter-cyclical payments program, which paid out significantly more than the Step 2 program in the period considered by the WTO in the dispute (Table 5).

**Table 5: Spending on U.S. Support Found to Cause Price-Suppression, Marketing Years 1999-02, Cotton**

<b>\$ million</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
Marketing loan program	1,761	636	2,609	897.8
Step 2 payments (domestic users & exporters)	279.3	445.3	235.7	177.8
MLA payments	432.8	438.3	452.3	0
CCP payments	0	0	0	864.9
<b>Total</b>	<b>2473.1</b>	<b>1519.6</b>	<b>3297</b>	<b>1940.5</b>

*Source: United States – Subsidies on Upland Cotton, Appellate Body Report, WT/DS267/AB/R, page 301.*

<sup>53</sup> United States – Subsidies on Upland Cotton, DS267.

<sup>54</sup> Even the President’s Council of Economic Advisers notes that “domestic commodity policies ... as used by the United States and other countries, reduce farm income in poor countries” (Council of Economic Advisers, *Annual Report of the Council of Economic Advisers*, 2006, page 192).

<sup>55</sup> For the rest of this paper, the decisions of the panel and Appellate Body will be referred to as the WTO’s decision.

U.S. officials, including Secretary of Agriculture Mike Johanns, are openly concerned about future challenges based on “serious prejudice” for other major commodities that receive support under the same programs as cotton (e.g. corn, rice, wheat and soybeans, which all receive support under the marketing loan and counter-cyclical payments programs).<sup>56</sup> The Congressional Research Service concludes that “economic studies ... support the idea that U.S. ... agricultural support programs negatively influence international market prices and tend to disadvantage third-country trade of non-subsidized “like” products”.<sup>57</sup>

Professor Daniel Sumner, a consultant to Brazil during the Cotton dispute, estimates that U.S. subsidies suppress world corn prices by 9% to 10%, world wheat prices by 6% to 8%, and world rice prices by 4% to 6%.<sup>58</sup>

The stakes in potential litigation against U.S. programs are extremely high. For example, the non-U.S. level of world trade in wheat, corn, rice, soybeans and cotton was just under \$42 billion in 2004.<sup>59</sup> Even if the overall suppression of world prices due to U.S. subsidies is as low as 3%, losses by competing exporters would amount to more than \$1.25 billion annually.<sup>60</sup>

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<sup>56</sup> See, for example, his remarks at the Cato Institute, 31 August 2006.

<sup>57</sup> Congressional Research Service, *Potential Challenges to U.S. Farm Subsidies in the WTO*, page 38.

<sup>58</sup> Sumner, *Boxed In: Conflicts between U.S. Farm Policies and WTO Obligations*, CATO Institute, Center for Trade Policy Studies, No. 32, 5 December 2005, page 21.

<sup>59</sup> FAOSTAT, <http://faostat.fao.org/site/412/DesktopDefault.aspx?pageID=412>. The estimated value of world trade for the five selected commodities was just over \$65 billion in 2004, with the United States accounting for \$23.4 billion of the total.

<sup>60</sup> The concept of “serious prejudice” under Article 6.3 of the WTO Agreement on Subsidies and Countervailing Measures extends beyond significant suppression of world prices. “Serious prejudice” would also be found if U.S. subsidies to a commodity were found to have:

- displaced or impeded the imports of a like product of another WTO Member into the U.S. market;
- displaced or impeded the exports of a like product of another WTO Member from a third country market;
- caused significant price undercutting by the subsidized product as compared with the price of a like product of another WTO Member in the same market or lost sales in the same market; or
- caused an increase in the world market share of the U.S. in that commodity as compared to the average share it had during the previous period of three years and this increase followed a consistent trend over a period when the subsidies had been granted.

In addition to findings of “serious prejudice” against the cotton programs, the WTO ruled on several other aspects of U.S. farm policies. These include:

- **Direct Payments and the Green Box.** The WTO found that U.S. direct payments are not fully decoupled from production as required for classification as Green Box. This was due to the restrictions on planting specialty crops on program crop base acreage.<sup>61 62</sup>

Had direct payments been notified as Amber Box, the U.S. would have exceeded its \$19.1 billion Aggregate Measurement of Support (“AMS”) cap in several recent years.<sup>63</sup> Trading partners could be expected to challenge the U.S. on this basis, forcing it to come into compliance by cutting its Amber Box spending (which includes the marketing loan program, dairy and sugar price supports, and others).<sup>64</sup>

- **Export Credit Guarantees for Other Commodities.** The WTO found three U.S. export credit guarantee programs<sup>65</sup> to be export subsidies applied in a manner that breaches U.S. export subsidy commitments for a number of products.

To comply with this aspect of the WTO’s ruling, the U.S. has changed the fee structure of the GSM-102 and SCGP programs to more closely match the underlying risk—and, it has effectively discontinued the GSM-103 program.<sup>66</sup> Brazil maintains that these actions have been insufficient to bring the U.S. into compliance with WTO rules.

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<sup>61</sup> Removing specialty crop planting restrictions on base acreage would not necessarily place direct payments as beyond challenge, since the WTO did not decide on Brazil’s other claim – that updating acreage bases (as was done in the 2002 Farm Act) would also make direct payments Amber Box.

<sup>62</sup> As Congress considers removing the planting flexibility limitations on program acreage, the claim of specialty crop producers for more equitable treatment likely will intensify, since removal of the limitations would mean they would face competition from farmers receiving generous direct payments.

<sup>63</sup> Hart, *The WTO Picture After the Cotton Ruling*, Iowa Ag Review, Spring 2005 and Summer, *Boxed In: Conflicts between U.S. Farm Policies and WTO Obligations*, CATO Institute, Center for Trade Policy Studies, No. 32, 5 December 2005.

<sup>64</sup> The WTO further concluded that a number of crop insurance programs and the counter-cyclical payments program “provide support to a specific commodity,” which could mean that they must be counted towards the U.S.’ AMS limit. If the U.S. included counter-cyclical payments and crop insurance outlays as product-specific Amber Box outlays this could also raise the U.S.’ AMS above the \$19.1 billion cap.

<sup>65</sup> The GSM 102, GSM 103 and SCGP programs.

<sup>66</sup> In addition, no export credit guarantees have been issued under the SCGP program since 1 October 2005 (see figures available at <http://ffas.usda.gov/excredits/monthly/ecg.html> (accessed January 2007)).

## Observations

Brazil's success in challenging U.S. farm programs has stimulated wide interest among other WTO Members.<sup>67</sup> For example, Canada has requested WTO consultations in respect of U.S. farm subsidies and Uruguay has undertaken a series of discussions with the U.S. on the effect of U.S. rice programs.<sup>68</sup> There are a number of aspects of the WTO's decision that deserve careful consideration:

- It raises very significant questions about the impact of central U.S. safety net programs on trading partners that appear to be difficult to defend—not only for cotton, but for all of the major program commodities since they receive payments under the very same programs applicable to the cotton sector;
- The threats of further litigation raise the prospect of farm programs being dismantled rather than redesigned with vision by Congress.<sup>69</sup> In such a situation, the U.S. would not only forego gains in market access in return for those policy reforms, but could face trade retaliation as well;
- If the U.S. chooses not to change its programs in response to successful WTO litigation against it, then Brazil (or any other successful litigant) will have the right to retaliate. It is likely that such retaliation would be aimed at the non-agricultural sector of the U.S. economy, causing angst in Congress and the resultant possibility of a reduction of Congressional support for agriculture;
- Some trading partners may come to believe that they can achieve major concessions (reductions in U.S. domestic support) by litigation rather than by negotiation. Thus, a failure to reform may diminish U.S. prospects of gains in market access in the Doha Round;
- The projected future reduction in spending on the marketing loan program and counter-cyclical payments program due to strong commodity prices would be likely to reduce the adverse effects of those subsidies on U.S. trading partners (and thus reduce the chances of successful litigation). However, moves to restore spending on those programs to 2002 Farm Act levels (by changing the loan rates and the target prices) would also act to restore the adverse effects; and
- Less trade distorting forms of support appear to be less likely to be successfully challenged as causing “serious prejudice” to U.S. trading partners.

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<sup>67</sup> Brazil itself is now pursuing two actions before the WTO – one to determine whether or not the U.S. has fully implemented the original WTO rulings and another seeking compensation if it is found that the U.S. has not so implemented.

<sup>68</sup> Inside U.S. Trade, *U.S. Says WTO Talks Remove Need for Uruguay Rice Challenge*, 28 October 2005; and Inside U.S. Trade, *Uruguay Seeks Compensation from U.S. for Effects of Rice Subsidies*, 10 March 2006.

<sup>69</sup> Secretary of Agriculture Johanns, remarks at the Cato Institute, 31 August 2006.

### Trade Policy—The WTO Doha Round

At the time of writing, the Doha Round of WTO trade negotiations are once again showing modest signs of life after being stalled for much of 2006.

One of the key sticking points is the high level of U.S. trade-distorting domestic support.<sup>70</sup> Most of this support is provided by the marketing loan program, the counter-cyclical payments program, the sugar program, and the dairy program.<sup>71</sup> The failure of the U.S. to agree to sufficient cuts to these programs is often cited as a primary reason for the failure of U.S. trading partners to agree to provide meaningful agricultural market access in the Doha Round. And it is such market access that is the key to future growth in U.S. agriculture.

According to the Congressional Budget Office,<sup>72</sup> the annual global economic benefit resulting from the abolition of policies that distort agricultural trade would be in the range of \$50 billion to \$185 billion.<sup>73</sup> The CBO also found that almost all studies show that the U.S. would gain from such full liberalisation and that U.S. agriculture as a whole would benefit. Cato estimates that comprehensive global and agricultural trade reform would result in an additional \$88 billion in annual U.S. farm exports, with only a \$28 billion increase in imports.<sup>74</sup>

Thus, programs for the benefit of commodities that contribute only around one-third of U.S. agricultural cash receipts<sup>75</sup> are standing in the way of a Doha Round outcome that would benefit all of U.S. agriculture.

Agreement on agricultural domestic support and market access is widely acknowledged to be the key to a successful conclusion of all aspects of the Doha Round negotiations. Such a successful conclusion would bring benefits to the U.S. economy far beyond the agricultural sector. Even a one-third cut to global trade barriers would raise the income of the average American family by \$2,500 a year.<sup>76</sup>

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<sup>70</sup> Along with the EU's failure to offer sufficient market access.

<sup>71</sup> The dairy price support program contributes around \$4.5 billion to the U.S.' AMS. The U.S.' October 2005 WTO proposal would cut the U.S.' AMS to \$7.6 billion. Thus, dairy policy reform may be essential to the U.S. meeting even its current offer in the Doha Round.

<sup>72</sup> Congressional Budget Office, Economic and Budget Issue Brief, *Agricultural Trade Liberalization*.

<sup>73</sup> In studies that include the effects of liberalisation on the rate of productivity growth, the benefits are 50 percent to more than 100 percent larger.

<sup>74</sup> Griswold, Slivinski and Preble, *Ripe for Reform-Six Good Reasons to Reduce U.S. Farm Subsidies and Trade Barriers*, CATO Institute, Center for Trade Policy Studies, No. 30, 14 September 2005, page 10.

<sup>75</sup> See the combined contribution of rice, wheat, corn, cotton, soybeans, sugar beet, sugar cane, and milk to total cash receipts in Chart 1.

<sup>76</sup> Business Roundtable, *World Trade Organization (WTO) and the Future*, available at [http://trade.businessroundtable.org/trade\\_2006/wto/future.html](http://trade.businessroundtable.org/trade_2006/wto/future.html) (accessed December 2006).

### III. Options for a More Market-Oriented 2007 Farm Act

*“Put simply, the more a policy pays to a farmer without affecting his/her production decisions, the greater the share of income retained by the household and the smaller the impact on production and trade.”<sup>77</sup>*

*“I believe we owe it to our farmers and ranchers to do more than just rubber-stamp policies of the past. We owe it to them to thoughtfully consider how U.S. farm policy can help to set the future course of America's first industry.”<sup>78</sup>*

#### Policy Objectives and Principles

As previously set out, the nation's **agricultural policy objectives** are frequently articulated and widely understood. They include support for small family farms and rural areas; production of adequate amounts of healthy food and fiber products; production efficiency and equitable returns; and protection of the nation's land resources and environment.

Consistent with the vision of future growth and prosperity for the sector articulated by the American Farm Bureau Federation<sup>79</sup> and others, this study suggests that the following “**policy principles**” should guide the 2007 Farm Act in the pursuit of such objectives:

- **Market-oriented, innovative and forward looking.** Programs should encourage, rather than discourage, producers from investing in growth areas, such as new export markets and energy demand. They should ensure that producers can compete globally, develop innovative products, and add value through the supply chain. Future investment, growth and development in the sector will depend significantly on policies that anticipate and respond to future needs, rather than attempt to protect against market changes;
- **Minimally market-distorting.** The current programs distort markets due to their links to production and price. Agriculture's expanding and increasingly dynamic markets require producers to be free to produce any crop, including energy crops, based on their market expectations, rather than on a government list of “basic” commodities. Reducing trade-domestic support will decrease the chance that programs will be subject to successful WTO litigation, increase the odds of a successful conclusion to the Doha Round, and thus lay the groundwork for the improved market access that would benefit the whole U.S. economy;

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<sup>77</sup> OECD, Joint Working Party on Agriculture and Trade, *Agricultural Policies in OECD Countries: A Positive Reform Agenda*, COM/AGR/TD/WP(2002)19/FINAL, page 30.

<sup>78</sup> Secretary of Agriculture Mike Johanns, Remarks at the Cato Institute, 31 August 2006.

<sup>79</sup> See American Farm Bureau Federation, *Making American Agriculture Productive and Profitable*, Vision Statement.

- **Serve better-defined social purposes.** Agricultural policies should service the broader needs of producers, rural communities, food, feed, and energy consumers, and taxpayers. They should recognize the important role that producers can play in protecting the environment. The concentration of current program benefits on a few commodities and higher-income households makes them difficult to justify;
- **Private, not public, risk management.** Individual producers should have access to a range of risk management tools provided by the private sector and should be free to choose the level of business risk they wish to cover. As set out below, there are numerous ways in which producers can minimize risk without having to rely on market-distorting government programs;
- **Reflect structure-based needs.** U.S. agriculture is commercial in nature, supported by modern technologies, able management and abundant capital. It includes at least three categories of producers, each with substantially different policy needs. These range from better access to growing markets for “commercial” farmers, adequate finance and technical assistance for “transition” farmers, and stronger rural development policies for “lifestyle” farmers;
- **Transparency, equity and simplicity.** Farm policies should be more transparent, equitable and should be simple for producers (and tax-payers) to understand. Current programs, particularly those for sugar and dairy, are complex. Their costs are sometimes hidden and their beneficiaries are often not the small family farms that society generally considers most worthy of assistance;
- **Consistency with international trade obligations.** Producers should not be faced with the uncertainty arising from possible WTO litigation against U.S. farm policies. The wider U.S. economy should not be at risk from retaliation from trading partners;
- **Transition assistance.** Government assistance should be available to producers for a limited time to ensure a smooth transition to new policies. A positive climate for change is more likely to develop when prices are high and the outlook strong (as it is now) and if assistance is provided by the government; and
- **Fiscal prudence.** U.S. agricultural policy should deliver better value-for-money for producers and tax payers, and will need to “do more with less” given the competing needs for resources in this period of budget deficits.

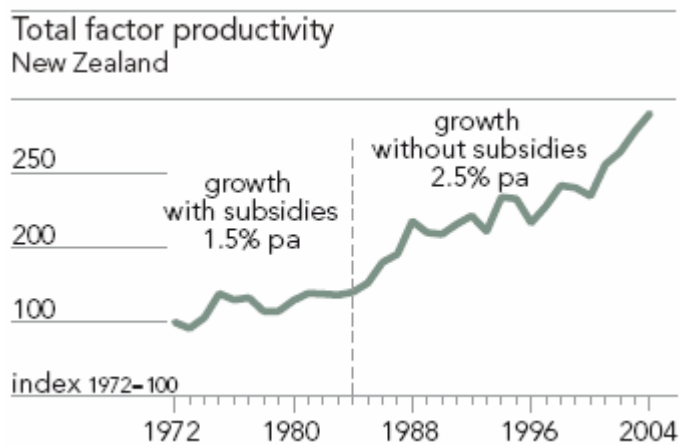
### Reform—The New Zealand Experience

Before 1984, agriculture in New Zealand was protected by a variety of subsidies. Major policy changes were made during 1984-87, with others negotiated with industry over an extended period.

The reforms are widely credited with having stimulated economic growth and development. For example:

- The number of commercial farms grew from 77,000 in 1983-84 to 80,000 by 1992-03. These are now being consolidated, and number about 66,000;
- Land area for livestock and arable farming declined from 14 million ha to about 12 million ha in 1992-93, but land productivity increased by 85%;
- Farmland prices fell at the time of the reform, but immediately began to recover; and
- The agricultural sector has become more responsive, more efficient and more productive. Total factor productivity for the sector, which grew at about 1.5% per year between 1972 and 1984, increased rapidly to average 2.5% per year since the mid-1980s. As a result, the industry competes very successfully in global markets, especially for livestock and dairy products.

**Chart 13: Total Factor Productivity Growth in New Zealand Agriculture Before and After the Removal of Subsidies**



As a study into the reforms concluded: “... farm incomes and farmland prices do recover after reform and can go on to make significant gains. The sooner that efficient farmers regain a viable commercial position following reform, the sooner they are able to make essential new investments and the faster the recovery will be.”

*Source: Australian Bureau of Agricultural and Resource Economics and the New Zealand Ministry of Agriculture and Forestry, Agriculture in New Zealand – Past, Present and Future.*

## **Options for Reform**

The policies put in place in the 2002 Farm Act reflect the past more than they do the future. Many of them were designed in response to the depression-era needs of the 1930s while others were aimed at ameliorating the effects of the most recent farm recession of the 1980s. Policies offered to protect small, struggling farmers against persistently low prices and incomes are increasingly ill-suited to the needs of today's modern, commercial agricultural sector in an era of stronger but more volatile markets. The result is that policies increasingly constrain, rather than support, the sector's future development.

The following is an example of the sort of policy options that would more closely follow the policy principles outlined above.<sup>80</sup>

### **Risk Management**

The main responsibility for risk management in agriculture clearly lies with producers themselves and with private industry that can provide market based tools including insurance, savings tools, and futures and options contracts. For the increasingly commercial agricultural sector, the use of instruments provided by the private sector should be encouraged to address those price fluctuations and bad seasons that are a normal part of farming.

To an important extent, past federal actions have discouraged such private risk management by providing disaster payments and other support when crops or livestock are damaged, a fact producers say they consider when choosing risk management programs. The direct payments program also provides a type of risk management in that it guarantees eligible producers a minimum income in times of bad weather or markets.

Government programs, particularly those that are sector-specific and have direct links to prices and production, create market distortions, encourage over production and disadvantage producers elsewhere. Government programs that are sector-wide, that avoid direct links to prices and production, and that cover only a limited share of losses would be less market distorting than current programs and thus more likely to meet WTO Green Box criteria.

As a general principle, direct government involvement in risk management should focus primarily on protecting producers against sharp drops in income caused by serious disasters (e.g. severe drought, floods and hurricanes). Rationalizing the support provided by government against risk in this way would free resources that could be devoted to programs more specifically tailored to the separate needs of different categories of producers, as discussed in Chapter II.

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<sup>80</sup> On 31 January 2007, USDA released its proposals for the 2007 Farm Bill that included heavier reliance on direct payments, enhanced conservation programs, a re-structured counter-cyclical payments program, and a re-structured marketing loan program, among many other suggested changes. These proposals will be debated in detail by the Congress in the coming months.

Over a period of many years, the U.S. has developed a combination of public and private approaches to risk management, and frequently offers these in tandem to assist producers in managing agricultural risks. There is now growing producer interest in the need to gradually shift risk from the public to the private sector. Programs that shift the focus from price protection and toward risk management are in wide use now, with still more products under development. Many of the current instruments have been used successfully for some time in the U.S. and in many other parts of the world. Several examples of such programs are described below.

### **Revenue and Income Protection**

**Revenue Insurance.** USDA's Risk Management Agency already provides (and, subsidizes) a number of revenue insurance products, which pay out when revenue falls below a guaranteed level:

- **Revenue Assurance.** The producer selects a dollar amount of target revenue from a range of 65-75% of expected revenue;
- **Income Protection Policies.** Producers are protected against reductions in gross income caused by a decline in price or yield from early-season expectations; and
- **Group Risk Income Protection (GRIP) Policies.** These are based on the average county revenue for an insured crop, with indemnity payments occurring when the average county revenue for the insured crop falls below the revenue coverage limit selected. The Illinois Farm Bureau's Farm Policy Task Force has proposed a modified GRIP to replace marketing loans and counter-cyclical payments. It suggests that the cost of GRIP would be about the same as the programs it would replace, but it could operate with greater transparency and be simpler to administer.

**Adjusted Gross Revenue Policies.** These policies address revenue for the entire farm rather than an individual crop by guaranteeing a percentage of average gross farm revenue, based on each producer's tax information and expected farm revenue. Because the program is farm-based (rather than individual crop based), it could satisfy WTO Green Box requirements if coverage and payment levels were restricted to no more than 70%.<sup>81</sup>

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<sup>81</sup> See paragraph 7(a) of Annex 2 to the WTO Agreement on Agriculture.

Other organizations are suggesting that revenue insurance products replace the marketing loan program and counter-cyclical payments program:

- **The Chicago Council on Global Affairs** backs “whole farm” revenue insurance that is available to all producers because it “does not keep producers tied to specific commodities year after year [and therefore] encourages entrepreneurship”;<sup>82</sup>
- **The American Farmland Trust** backs a national revenue deficiency program together with private individual revenue insurance;<sup>83</sup> and
- **Other groups** are looking into revenue insurance options.

**Farm Savings Accounts.** Programs in Canada and Australia have been offered to allow producers to build tax-deferred accounts that they draw upon when farm income is abnormally low. Similar programs have been suggested for the U.S.:

- **Canadian Agricultural Income Stabilization Program.** This program combines income stabilization and disaster protection. Participants select their desired level of protection and then make payments to a participating financial institution. At least 70% of the producer’s expected profit is covered in the event of a catastrophic loss (defined as a profit of zero or below). Sixty percent of funding is provided by the Federal Government and 40% is provided by the Provincial Governments;
- **Australian Farm Management Deposits.** Since 1999, Australia has offered a Farm Management Deposits (FMD) program in which farmers deposit pre-tax dollars that are taxed only upon withdrawal. This allows deposits to be made in years when the marginal tax rate on the money would otherwise be high and for withdrawals to be made in low income years when the marginal tax rate on the money will be lower. All primary agricultural producers are eligible;
- **U.S. Farm and Ranch Risk Management Account Proposal.** Similar to Australia’s FMD program, the FARRM concept has been discussed in the U.S. and would allow farmers to contribute a portion of their income to tax-deferred accounts for withdrawal at their discretion—but with a penalty if they are held more than five years. The maximum amount of the deposit would be 20% of taxable net farm income plus capital gains from farm business. Interest earnings on the deposits would be taxed as normal income; and

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<sup>82</sup> The Chicago Council on Global Affairs, Report of the Agricultural Task Force, *Modernizing America’s Food and Farm Policy: Vision for a New Direction*, page 39.

<sup>83</sup> American Farmland Trust, *Agenda 2007: A New Framework and Direction for U.S. Farm Policy*, pages 16 and 17.

- **Individual Risk Management Accounts.** Individual Risk Management Accounts were discussed in the 2002 Farm Bill debate as a farm revenue insurance program. The scheme would provide matching government funds for farmer deposits of 2% of gross farm income annually in IRMA accounts. Participating farmers would not be allowed to purchase subsidized crop insurance. Withdrawals would be triggered when gross farm income fell below 80% of the three-year average and would be limited to amounts necessary to bring income up to the 80% level.

**Table 6: Farm Savings Accounts Programs Compared**

	<b>Eligibility</b>	<b>Farm Deposits Tax Deferred?</b>	<b>Maximum Yearly Deposit</b>	<b>Withdrawal Restrictions</b>	<b>Government Matches Contributions?</b>	<b>Comments</b>
NISA	Positive net farm income	No	20% eligible net sales	Net income falls below 5 year average or \$35k	Yes, up to 3% of gross farm sales, 3% "interest bonus"	
CAIS	Positive net farm income	No	14% of reference margin	Production margin less than reference margin	Yes, upon withdrawal	Based on net income
IRMA	Positive gross farm income	Yes	2% gross farm income	Gross farm income less than three year average	Yes, 2% gross farm income	
FARRM	Positive net farm income	Yes	20% net farm income	None	No	10% penalty if not withdrawn in 5 years
FMD	Primary commodity producer	Yes	\$A300,000	None	No	Off-farm income must be less than \$A50,000.

**Other Ways of Reducing Risk.** Several other private forms of revenue/income risk management may well have been crowded out by the availability of federal programs. These include:

- **Diversification of production**, whereby low returns from one commodity are offset by high returns from another commodity grown in the same year;
- **Vertical integration** of successive production stages;
- **Forward contracts**, under which a producer's expected production is sold in advance at a guaranteed price; and
- **Use of futures or options contracts** to reduce losses from price falls that might occur in the future.

### **Marketing Credit—An Alternative to Marketing Assistance Loans**

The current marketing assistance loan program is completely linked to prices and production. It is among the most interventionist of current policies because it both blocks market signals for U.S. producers and suppresses international prices for competing exporters. In addition, its effectiveness as a risk management tool is being increasingly questioned because, while it provides substantial support for selected producers when prices are low in response to high production, it provides much less support in most other circumstances.<sup>84</sup> Finally, there is little evidence to suggest that transition and commercial farmers have difficulty in obtaining credit from private sources.

The program could be made much less market distorting by removing its non-recourse feature. In this way, it could be redesigned from a price-guarantee program to one that merely provides short-term credit, where loans (including interest and storage costs) must be repaid regardless of prices, with interest at commercial rates. Except in cases of market failure when government sources of short term finance are required, such loans should be provided by private financial institutions.

### **Environmental/Conservation Programs**

The direct payments program has been in place in the U.S. since the 1996 FAIR Act (when it was offered as “compensation” for the termination of the earlier target price program, with declining annual payments). However, the program was expanded to include additional commodities in 2002. The program’s payments are based on each producer’s individual history (acreage and yields) and reflect neither current production<sup>85</sup> nor prices.

While direct payments are less market-distorting than programs coupled to prices or production,<sup>86</sup> they still constitute a government intrusion, particularly as they are only available to those producers with a history of producing certain commodities.

As we have seen, there is broad community support for programs that assist producers based on how well they protect the land, air and water. Direct payments could be modified to serve the social purpose of rewarding producers for sound environmental practices, at the same time as supplementing revenues. Such a program would be available to all producers who manage land and provide environmental benefits, regardless of the crops produced or geographic location.

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<sup>84</sup> See Chapter I.

<sup>85</sup> Except for the planting flexibility limitations previously discussed.

<sup>86</sup> Ash, *Agricultural Policies in Selected OECD Countries: Prospects for Reform*, page 3.

Thus, all producers could have access to “environmental payments” under which they would “sell” environmental services much as they sell agricultural products (such environmental services could include controlling floodwaters, providing wildlife habitat, recharging groundwater, increasing biodiversity, and providing open space and cleaner air and water).<sup>87</sup>

The proposed program could supplement programs providing grants to producers to undertake specific environmental activities. In recognition of the potential for interest in such programs to exceed available resources, producers could compete to participate. This would maximize the return on public investment.

### **Research and Development**

Agricultural research has been a central area of emphasis since USDA’s organization almost 150 years ago. USDA spent nearly \$2.6 billion on its research, education and economics programs in FY 2005.<sup>88</sup> Public investment in agricultural research by the federal and state governments is widely credited with the sector’s rapid and sustained productivity growth—trends that have become increasingly important with the growth in importance of global markets.

In today’s environment, private capital sponsors a growing share of the sector’s R&D efforts, but very important areas remain that will be important to the future competitiveness of U.S. products in global markets.

To retain its historic competitive advantage in production technology, U.S. agriculture should expand its future investment in R&D. There is scope to improve farm performance by strengthening the coordination and collaboration of publicly and privately funded research and by placing more emphasis on technology adoption.

There is also scope to provide government resources to assist the development of innovative products and the addition of value through the supply chain. This will raise demand for primary commodities.

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<sup>87</sup> Current recipients of direct payments could be guaranteed a minimum payment, which would decline over time—at the same time, all agricultural producers would be eligible to participate in the new program.

<sup>88</sup> USDA, Budget Summary FY2007, available at <http://www.obpa.usda.gov/budsum/2007/fy07budsum.pdf> (accessed December 2006).

## **Rural Development**

Although agriculture is no longer the dominant economic activity in rural areas, it continues to be important and to depend heavily on rural infrastructure and facilities. USDA manages about \$3 billion in rural development programs focused on support for rural utilities, housing and rural businesses, including cooperatives.<sup>89</sup> These programs have been especially important as farm families have become increasingly dependant on off-farm jobs for income—a trend likely to continue in the future. USDA’s programs for electricity and telecommunications have benefited many rural communities.

Several development programs have particular promise for rural areas. Modern communications effectively prevent isolation and remove distance as a barrier to efficiency, and can provide a major benefit to rural areas. However, to achieve such efficiency, a combination of better land-based communication facilities and better access to satellite technology is required—both require access to substantial amounts of capital.

Other policy areas that affect rural development and could impact on the future ability of U.S. agriculture to compete globally are: immigration policy, particularly possible impacts on the availability of unskilled agricultural labor; and taxation policy that can influence investment shifts to or away from agriculture and the transfer of farm enterprises between generations.

In addition, many rural areas are benefiting from the production, processing and handling of renewable fuels—and from a number of technology applications, including the development of wind and water power, among others. Investment in these areas could be expanded.

To remain competitive and better position itself to take full advantage of new market opportunities, U.S. agriculture will need to increase its capacity to adopt innovation. Building capacity through education and training in areas beyond traditional agribusiness business skills such as agronomy and animal husbandry into areas such as business planning, risk management, and conservation and land management will be important in this regard.

There is also a role for the government to develop programs to assist in the long-term growth within the U.S. agricultural sector. Programs aimed at assisting transition, for example to assist those “transition” producers seeking to move into the “commercial” producer category, need to be considered.

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<sup>89</sup> USDA, Budget Summary FY2007, available at <http://www.obpa.usda.gov/budsum/2007/fy07budsum.pdf> (accessed December 2006).

### **Energy Policy**

As the foregoing sections have shown, the production, handling and distribution of renewable fuels are increasingly important to agriculture, as are the policies that help stimulate investment in these activities. The markets for grains are strengthening producer income and reducing reliance on current programs.

As a result, energy policy is increasingly important to producers, even though it is the responsibility of the Department of Energy rather than USDA and includes a number of energy policy concerns at both the federal and state levels. As energy policies have become an increasingly important factor in agricultural markets, and as producers have become increasingly important investors in energy production facilities, there will be pressure for a special title concerning energy policy in the 2007 Farm Act.

At the same time as energy market growth and energy policies have the capacity to strengthen the agricultural economy, these trends can be expected to have both positive and negative impacts across the sector—with important differences for livestock and grain producers, among many others. A federal energy policy and plan—with longer-term goals, well specified incentives and tools, and attention to both positive and negative impacts across the sector—should be developed.

### **Transition Assistance**

The shift to less market distorting policies will require structural support from government during the transition period. Other countries, such as Australia and Canada, have recognized this important policy tenet in achieving major policy change. A smooth transition is important not only for the affected producers but also for the agricultural financial sector given that current programs are capitalized into land values and other forms of producer assets.

Transition arrangements require careful design. They must recognize that policy needs differ between the various producer and commodity groups. Transition arrangements should help producers make decisions for the future based on their own circumstances. Producers should be allowed to decide how they intend to respond to market forces and be allowed to shift their resources into the most profitable uses, including being allowed to leave farming if they wish. Arrangements should not distort production decisions or market prices, and they should be temporary with a clearly defined end-point.

**Building Producer Support.** On several occasions in the past, payments have been made to producers to compensate them where programs have been withdrawn or changed. For example, the 1996 FAIR Act that terminated the price deficiency program authorized payments to producers totaling \$35.6 billion over seven years, with payments specifically allocated to the program commodities.<sup>90</sup>

More recently, Congress authorized the purchase of producers' "quota rights" for both peanuts and tobacco. The 2002 peanut program restructuring included both a buyout of production quota rights and the offer of a new direct and counter-cyclical payment program. The 2004 tobacco buyout ended quotas and eliminated the loan rate program, without implementing new payment mechanisms. In the aftermath of both programs, acreage shifted from high-cost to low-cost areas, and producers in areas losing acreage shifted to production of other crops with adjustments facilitated by the recent strength in markets for a broad range of crops.

The concept of "buying" producer equity in a beneficial program is widely considered to face two important drawbacks. The first is potential cost, which likely would be substantial for the program commodities. The second is the potential for subsequent reintroductions of programs if economic circumstances change—as happened in 1997-2002 following the 1996 transition payments program.

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<sup>90</sup> Orden, *Presentation at USDA's 2005 Outlook Conference*, February 2005.

### **Transition—The Australian Dairy Experience**

The Australian dairy industry had a long history of price support and marketing regulation until reforms were implemented in the mid-1980s, first in the export sector and then, in mid-2000, for the sector as a whole through the elimination of all price support mechanisms.

Changes required to adapt to the new policy were both sudden and substantial. The new policy was announced nine months before implementation, giving producers limited time to prepare. All producers were affected, especially those that focused on the market for fluid milk. This market faced an immediate and substantial decline in prices, although producers of products for export had two years of unusually strong market prices.

The Australian Government provided A\$2 billion in restructuring assistance, primarily direct assistance to farmers funded by a tax on milk consumption. The *Dairy Structural Adjustment Program* offered transition payments to producers based on their individual exposure to the changes, while the *Supplementary Dairy Assistance* scheme provided extra targeted assistance to those facing the greatest adjustment pressures. The aid was fully decoupled from current or future production decisions - there were no conditions on how farmers could use the assistance or any requirement to exit the industry. Most farmers who remained in the industry used their transition funds for financial and on-farm restructuring.

An Australian government agency, the Rural Industries Research and Development Corporation (RIRDC), reviewed the industry experience with dairy reform and concluded that the Australian experiences with policy reform have shown that farmers can adapt to new market environments. While there was a farm level adjustment response, its impacts were often not as severe as initially feared - but the RIRDC also recognized that restructuring assistance that helped farmers make the transition was very important. A number of producers left the industry, but there was no major industry contraction as some had feared. Most producers elected to continue farming and make changes to off-set the decline in farm income. Following the adjustment period, production recovered and export performance has been maintained.

*Source: Rural Industries Research and Development Corporation, Industry Adjustment to Policy Reform: A Case Study of the Australian Dairy Industry, 2005.*

#### **IV. Conclusion—Leadership Rather than Disarmament**

*“Meaningful, sectorwide reform focused on ensuring the long-term competitiveness and sustainability of the U.S. agriculture and food system ... will benefit not just U.S. agriculture, but American consumers, rural communities, the environment, our nation, and the world as a whole.”<sup>91</sup>*

The coming 2007 Farm Bill debate is a unique opportunity to prepare the farm sector for future growth and development. The alternative is to maintain policies that protect and isolate and face growing criticism for their limited coverage, unintended consequences, and failure to provide effective support for sector development.

A frequent political argument against farm policy reform is that it would constitute “unilateral disarmament”—giving up policy tools without adequate compensation—and should therefore be avoided. However, market-oriented reform would simply change for the better programs that are inequitable, that provide an imperfect safety-net, and that do not provide the tools required to improve the sector’s competitiveness in global markets. Such reform would be, in essence, a “re-arming”, rather than a disarming, of the sector.

Furthermore, U.S. reforms would follow—not anticipate—those of competing agricultural exporters who either have fully, or partially ended their domestic supports, or are in the process of doing so. These include New Zealand, Australia, and Canada.<sup>92</sup> Even the EU is shifting away from domestic price support and toward decoupled direct payments.

Thus, the more relevant issues concern the benefits and costs of policy changes—would policy reforms be beneficial in their own right? A large body of evidence in the form of experience by competitors, as well as accepted economic studies, shows that they would.<sup>93</sup>

The benefits of such reforms would be expected from several directions. The U.S. would retain its leadership in support of economic development for developing and least-developed countries, re-align its policies with its international obligations, and encourage broader trade liberalization. It would avoid the possible consequences flowing from further WTO litigation.

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<sup>91</sup> The Chicago Council on Global Affairs, Report of the Agricultural Task Force, *Modernizing America’s Food and Farm Policy: Vision for a New Direction*, pages 1 and 2.

<sup>92</sup> With its grain and oilseed reforms of the 1990s.

<sup>93</sup> See, for example, OECD, Joint Working Party on Agriculture and Trade, *Agriculture Policies in OECD Countries: A Positive Reform Agenda*, COM/AGR/TD/WP(2002)19/FINAL.

And, not least, such reforms would have widespread and positive economic effects.

These include lower food prices for American households, especially low-income families that spend a large share of their income on food, and for U.S. food manufacturers, making them more efficient and increasing their competitiveness.

Market-oriented reforms would stimulate investments in those areas where sales opportunities already exist and place producers in a much better position to take advantage of those market access gains that would result from a successful conclusion to the Doha Round, at the same time as increasing the odds of such a successful conclusion.

Most importantly, such reforms would benefit farmers by supporting the production of those products that are in greatest demand and in which the U.S. has a comparative advantage, rather than those protected by government programs. Producers would be free to make decisions and investments based on the greatest return from the market, rather than the greatest return from the government. It is no coincidence that farmers operating in undistorted markets have reported the greatest sales growth in recent years—a pattern as well established in the U.S. as it is abroad.

The U.S. faces a “policy crossroad” in the coming 2007 Farm Bill debate. It must choose among competing visions—one focused on growing and changing markets, and a developing, more prosperous sector; and a second focused on policies that protect and isolate.

Farm policy should ultimately be about improving farm productivity, competitiveness and farm returns. Only by looking forward, rather than backward, can U.S. agriculture realize its full potential and achieve the development it envisions.