Frequently discussed, often misrepresented and certainly key to a successful outcome in the ongoing Doha Round, agricultural trade is arguably the most complex item on the agenda of the current trade negotiations. Controversial at the best of times and hotly contested the world over, it is one subject that has received more than its fair share of column inches over the last few months and not, sadly, simply because agricultural trade is such an important issue with so many far reaching implications. More often than not, it’s an exercise that focuses more on old and often inaccurate arguments than it does on breaking new ground.

And so we welcome you to the first issue of MAP, a new quarterly newsletter which aims to provide in-depth analysis on some of the key issues currently facing the world of agricultural trade. With the Hong Kong Ministerial meeting fast approaching and farm policy still one of the key sticking points at the WTO, MAP looks to set the story straight on agri-trade, and offer an alternative slant on some of the more controversial topics it touches on. We start this year’s series with a look at one of the most complicated farm support regimes of all – that of the U.S.

A new administration, new budget proposals and the recent rejection of the U.S. appeal against the WTO ruling on its cotton subsidies have all catapulted U.S. farm policy back into the spotlight. MAP takes this opportunity to look back at how the policy has evolved over time, attempts to unravel the meaning of some of its complex support mechanisms and looks at some of the current and future difficulties facing U.S. farm policy strategists.

We also touch on some of the similarities and differences that exist between two of farm policy’s biggest players. With much of the emphasis for a successful outcome of the Doha Round resting on U.S. and EU shoulders, we examine where the two currently stand on domestic support and provide some alternative theories to the myths that surround it and where the real problems lie.

With or without an agreement at the WTO however, 2006 will be an important year in U.S. farm policy. The current Farm Bill is due to expire in 2007, and discussions on the future policy direction will no doubt intensify over the next twelve months, and so we round off this edition of MAP with a brief look at what the future might hold.
1. A short history of U.S. Farm Policy

U.S. farm policy, many critics say, has seen little change in substance since 1933, the year that income and price support instruments, commodity programmes and production controls were first introduced under the First Agricultural Adjustment Act. Then a necessity to alleviate problems of over-production and chronically low prices in the wake of the Great Depression, many consider too little has been done since to keep farm policy in tune with the times. This first section takes a brief look back over the recent history of U.S. farm policy to see what has changed and how.

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Until the 1960s, farm policy continued to be based on a system of price support and supply controls and the changes introduced were very few and fairly minor. Surplus stocks continued to be removed from the market at government expense under the commodity loan programme (see section 2) and farmers remained eligible for a host of payments that essentially encouraged them to produce well in excess of market demand.

Overtime however, the rising cost of a policy that essentially supported artificially high prices and a declining farm population was called into question and Congress found itself under increasing pressure to introduce meaningful changes. So, with its Food and Agriculture Act of 1965, it introduced a new system of direct income support in a first attempt to boost market orientation and align world and domestic prices.

Many of the other key elements however, including the loan programme, remained the same and in reality, the 1965 Farm Act made little difference to U.S. farming other than to temporarily pacify a few of the critics.

By the 1980s, with federal budget deficits at record levels and government stocks of programme commodities ever increasing, the case against expensive government support for agricultural picked up new momentum. More half-hearted moves towards greater market orientation followed, but they did little to address what was still essentially the same old story of price support and supply controls, albeit at marginally lower levels than before.

In 1994 however, things started to change. Coupled with the growing discontent was a new post-election majority in Congress that set balancing the federal budget as its priority. It pressed the Agriculture Committees of both the Senate and the House to draft new commodity legislation that would cut farm budget outlays by $13.4 billion over a seven-year period. What resulted almost two years and many heated discussions later was the Federal Agriculture Improvement and Reform (FAIR) Act.

Considered by many as innovative and an example to be followed, it made far bolder moves towards market orientation than previous efforts had and was seen as the real turning point in U.S. farm policy. It finally moved towards a more economically efficient U.S. farm sector that was more competitive and far less trade distorting.

Target-price based deficiency payments for individual commodities were brought to an end and replaced by a more generic system of production flexibility contract (PFC) payments. These were totally decoupled from the current market situation and based instead on the amount of commodity support farmers had received in the past. They also marked the move to an entirely new way of support because, contrary to the counter-cyclical nature of previous policies they were foreseen to be fixed and declining over time.

PFCs were a central element of the FAIR Act’s commodity section – the Agricultural Market Transition Act (AMTA) which aimed to facilitate the move from a price to an income support based system. Under AMTA farmers could plant 100% of their total contract acreage to any crop (with limits on fruit & vegetables) and receive a full decoupled payment, provided they kept the land in good agricultural condition.
Another element in the FAIR Act legislation, that proved important only subsequently, was its safety net clause. House leadership agreed that the issue of transfers could be re-opened should the agricultural sector encounter any economic difficulties. With world market prices at record levels no-one thought much of it at the time, but only two years later the situation was significantly different.

Growing global supplies, new competition from the Southern hemisphere and the SE Asian crisis all depressed world market prices (to what in reality were much more normal levels than the unusual highs of the mid-90s), causing revenues to fall and Congress to enact the first of its relief/emergency packages to boost domestic farm incomes.

But, as ensuing baselines predicted little improvement, the ‘safety net’ soon became the norm and further pressure caused Congress to enact emergency packages in each of the four following years. As a result, the $13.4 billion saving that had been anticipated under the FAIR Act was soon exhausted, and what came next, though perhaps predictable, raised a few eyebrows.

The Farm Security and Rural Investment Act (FSRIA) was also considered a landmark policy package, only this time for very different reasons, and for those doubting that the FAIR Act had exclusively been an exercise in market orientation, FSRIA was their confirmation that other factors had come into play as well. What many considered 1996 to have got right, 2002 got wrong and instead of moving the policy forward, it seemed to revert back to a system that re-introduced many of the mechanisms previously considered to be at fault.

The FSRIA effectively made permanent many of the emergency elements that had been available under the FAIR Act, and the additional support that had become available in the emergency packages became the norm. It also provided additional support for programme commodity crops and re-introduced a counter-cyclical based support system with the one main difference being that it was extended to dairy farmers as well.

U.S. farmers found themselves once again almost entirely insulated from fluctuations in market prices. ‘Target’ prices returned, which, though slightly lower than pre-1996 levels, still translated into higher support levels against a backdrop of declining world market prices encouraging, once again, a system in which production decisions were based on policy guarantees instead of market signals. It was, in short, a far cry from what the U.S. had tried to achieve only six years earlier, and an apparent backtracking in many observers’ eyes. And so, whilst recent budget proposals have fuelled speculation as to what the next Farm Bill package might involve, history suggests it could be difficult to predict.

Graph 1. Market prices and support prices

US wheat farmers are guaranteed price support at the level of the target price. When prices fall below the loan rate, loan programme payments kick-in; when prices are above the target price no price support is provided; and when prices are between the price floor (loan rate) and price ceiling (target price), counter-cyclical payments cover the difference between the market price and what other government payments offer (see annex for more US crop prices).
2. CCPs, LDPs and MLGs – key elements of U.S. domestic farm support

Current U.S. farm policy is built on a bewildering array of complex mechanisms, described using a series of acronyms that are every bit as cryptic as the oft-criticised vocabulary that the EU and others use to describe their farm policies. ‘Counter cyclical payments’ and ‘loan deficiency programmes’ give as little away outside the States as ‘modulation’ and ‘cross-compliance’ do outside Europe. This section looks beyond the jargon at what some of the key elements of U.S. domestic support are, at the role they have to play and where they fall in terms of WTO classification.

Most trade-distorting and probably the longest-standing element of U.S. farm policy is the commodity loan programme, introduced in the 1930s to boost market prices in the arable sector and currently notified to the WTO in the amber box category. Its basic principle has remained the same throughout: to provide farmers with a guaranteed market price and/or income support. The main difference between today’s policy and the previous one is that loan programs no longer foresee the removal of surplus crops from the market when prices are low.

Historically, commodity loan programmes operated on the basis of government loans granted after harvest when prices are traditionally low, and farmers are typically less well off prior to selling the crop. Farmers then repaid the loan the following year in one of two ways: either they paid the loan back, plus the accrued interest (in years when market prices were higher than the loan rate) or they could forfeit the crop used as the loan collateral (in years when prices were low).

It was a win-win situation that offset market risks and guaranteed farmers a certain price for their goods. It is also a good example of the inherently counter-cyclical nature of American farm support.

One of the biggest changes to the commodity loan programme came in 1986 with the introduction of marketing loans, marking a move away from price support towards farm income support. Its purpose was effectively to continue high levels of farm support but to limit the accumulation, and cost of storing government stocks acquired through forfeit.

Marketing loans allow farmers to repay the loan at a lower rate, with any accrued interest waived when market prices are below the loan rate. It is a system designed to encourage farmers to keep the crop and sell it on the market place, rather than to the government. One of its main incentives is the potential marketing loan gain (MLG) which occurs when the loan rate falls below the market price for a certain crop. It is available to any producer who has put that crop under loan.

Another alternative, for farmers not wanting a loan but still wanting to make up the difference between the market price and the commodity programme’s floor price, is a loan deficiency payment (LDP).
Officially, these were introduced to help stabilise farm income, boost marketing opportunities and encourage a better balance between supply and demand. In reality however, they boost income stability at the expense of market stability and are an increasingly expensive method of trade-distorting support.

**Loan deficiency payments:** Introduced under the 2002 Farm Bill, these are a farm income safety net mechanism that makes up the difference between the loan rate and the actual market price, thus allowing producers to sell at a price that could be well below the per unit revenue they receive.

Expenditure on LDPs rose from negligible levels in 1997 to over $8 billion in just three years, and far from balancing supply and demand, one of their key features is that they actively provide the incentive to continue planting, even when prices fall, because of the generous levels of compensation they provide. This contributes to over-production, suppressed prices and a complete dependence on the LDP system.

As one American commentator put it, “the irony of the entire loan deficiency payment rests in itself. Low prices exist because of loan deficiency payments. It is all a sort of ‘catch 22’ that is fostered by our current farm programme. Farmers are caught in a system that is chasing its tail.”

Perhaps also guilty of creating a ‘catch 22’ situation are counter-cyclical payments (CCPs), introduced into U.S. farm policy under the 2002 Farm Bill to replace the former ad hoc Market Loss Assistance (MLA) payments. Like loan payments, they too were introduced as a safety net (or additional safety net) income stabilisation mechanism that makes up the difference between low commodity prices and target prices (which the loan programme does not cover).

CCPs are determined for each crop and the criteria used – the payment yield and the base acres – are established on the basis of a historical reference period. This makes them less trade-distorting than loan payments because they do not directly affect prices or producer returns. However, given that they are triggered by current prices, they do still influence production decisions by redressing fluctuations in market price and thus reducing revenue variability and risk.

The Milk Income Loss Contract (MILC), also introduced in 2002, operates on the same principle, compensating dairy producers when milk prices are low, and therefore enabling them, to a certain extent, to ignore market price fluctuations.

**Graph 3. Countercyclical policies**

Farm receipts coming from the market (right axis) and government payments show an almost perfect inverse relationship for the five major US crops. As market prices and consequently market receipts decline, loan programme, crop insurance and emergency payments increased up until 2002. With the FSRIA, the ex post response of emergency payments has been replaced by the ex ante presence of counter-cyclical payments. Only decoupled US support (updated with FSRIA) is independent of market developments.

Perhaps the most important detail when it comes to counter-cyclical payments however is not so much what they implicitly do, as what they explicitly acknowledge. Counter-cyclical support is an inherent element of U.S. domestic farm support, albeit a principle that actually extends far beyond this particular system and one that
Another integral part of U.S. farm policy whose significance has increased over the years is the crop insurance programme. Predominantly crop-specific, this provides insurance against either yield or price declines, or for their combined effect on revenue, and is another counter-cyclical element in US domestic support that diminishes market-related risks.

Farmer participation is encouraged by the fact that the government subsidises the cost of the insurance premium. Government expenditure on crop insurance has been steadily increasing in recent years, with the premium subsidies costing $1.7 billion in 2001 (up from $1 billion in 1996). This is expected to increase further in future as more farmers participate in the program.

Finally, there are fixed direct payments, equivalent to the EU’s decoupled payment system, under which farmers receive a set payment each year, based on a historical reference periods for each eligible crop grown. Though they are, without doubt, the minimally trade-distorting element of U.S. domestic support, they too took some backward steps under the FSRIA, regressing from the production flexibility contracts to a fixed level payment that was based on an updated reference period and effectively contributed to a higher level of support.

Counter-cyclical payments: Introduced under the 2002 Farm Bill, these are another farm income safety net mechanism, triggered when the effective price of a product falls below a certain target price.

Graph 4. Farm payments and the big 5

Five US crops (wheat, corn, soybeans, cotton and rice) account for the bulk of US commodity payments under the Commodity Credit Corporation (CCC); on average, 80% of all payments go to these five crops.

The other major point we have tried to illustrate here is that there is more to U.S. domestic support than first meets the eye. The fact that it is directly and inversely related to world market prices to protect U.S. farmers from even minor market price fluctuations is one that is often missed in superficial comparisons. Similarly, many overlook the reality that U.S. production decisions are often based on a formula that is more concerned with responding to policy variables than it is with meeting market demand. It is these factors that are often more important and more relevant in the context of international discussions.
3. Oceans apart or next-door neighbours? How similar are U.S. and EU farm policies?

When it comes to domestic farm support, many commentators are undecided which of the big two it is that operates the more expensive, inefficient and trade-distorting farm policy. Both are giants in terms of agricultural production, and both, thanks to the wide geographical area they cover, are able to produce a wide range of commodities with an equal focus on crops and livestock.

Perhaps more important, is that both agree that a structured farm policy is vital to the future of their rural areas. Maintaining farm incomes, improving competitiveness and protecting the environment are high on the agenda in both the EU and the U.S. and farmers on both sides of the Atlantic are expected to carry out a whole host of other roles above and beyond the literal meaning of ‘farming’. As with everything though, the devil is in the detail. This section lays the two policies side by side to see just how similar they are.

Let us start with a comparison of the basic structure of the two farm sectors. The EU currently consists of 25 Member States, is home to around 11 million farmers (out of a total population of around 500 million), has an average holding size of about 18 hectares, and approximately 2% of farmers leave the industry each year (2000-2003 figures). The focus of the policy is largely on the production and, to some extent, the export of high quality, value-added products such as wine, cheese and processed foodstuffs. Recent reforms have concentrated on reducing the trade-distorting elements of the policy, increasing the significance of rural development and meeting the growing range of consumer demands.

The U.S. farm population on the other hand, has remained stable for the last decade, and currently numbers around 2 million (out of a total population of almost 300 million), each of whom operates on an average farm size of 180 hectares. Its structure – large farms and a low population density – lends itself more to the production and export of traditional bulk commodity products such as wheat, corn and soybeans.

More relevant however, particularly in the context of current debates is the way in which the two policies support their farms and farmers and the way in which this is viewed in terms of the WTO ‘boxes’ (amber – most trade-distorting; blue – less trade-distorting; green – non trade-distorting).

Historically, the EU’s farm policy was based on a system of price support, originally intended to guarantee farm income in the post World War II years, but over time becoming better known for generating hefty surpluses, costing two thirds of the total Community budget and being extremely trade-distorting.

Come 1992, with pressure mounting on both the domestic and international fronts with the launch of the Uruguay Round of trade talks, the EU implemented the first of its major reforms on which it has been consistently building ever since.

Guaranteed prices have been progressively cut to bring domestic prices closer to world market prices. Direct payments were introduced and have now been largely decoupled from production to encourage farmers to respond to market demand. Market support has become more or less safety net only, and the emphasis in the overall policy has shifted from supporting the product to supporting the producer.

In WTO terms, EU market price support, and the resulting intervention payments currently fall into its amber box.
These have been scaled back across the board with each reform and are now non-existent in several sectors. In its blue box are its per animal/area payments, reduced by recent reforms and considered less trade-distorting because they are within production limiting programmes. And into its green box will come the new single farm payment system, introduced under the 2004 CAP reform. This is dependent on farmers meeting their ‘cross-compliance’ – or environmental, animal welfare and food safety requirements and is calculated on the basis of fixed, historical reference period.

Consistent reform efforts have enabled the EU to significantly reduce its trade-distorting domestic support over the last ten years. And thanks to the 2004 reform, its amber and blue box measures are expected to decline further, with or without an agreement at the WTO. All of which ensures that it remains well within the AMS (Aggregate Measure of [trade-distorting] Support) domestic support limits set by the WTO and proves the undeniable progress that has been made through reform.

U.S. farm policy on the other hand, as we’ve discussed, has been more a question of policy ping-pong. The idea of phasing-out many of its more trade-distorting policies was, well, phased out under FSRIA and expenditure on them has actually increased in the last few years. Recent evolution has rather focussed on moving away from a safety net policy and back to an umbrella support structure that is primarily geared to protecting farmers from the potential income loss that could result from any number of factors.

The real problem for the U.S. however, is not so much that third countries frown upon its recent policy about-turn. It is more the pressure it is putting on itself by allowing its trade-distorting domestic support to increase indiscriminately. Like the EU, it has always, historically at least, scrupulously observed its amber box/AMS ceilings, but following the changes implemented by FSRIA, it now finds itself in real danger of overshooting its limits.

U.S. AMS levels (falling under WTO reduction commitments) fluctuate from year to year because of their counter-cyclical nature, and reached their peak of around $16 billion in 2001 - $3.1 billion below its annual AMS ceiling. Now, with market support for dairy and sugar at $5.8 billion and predicted to slightly increase, loan programme payments likely to exceed $7 billion per year in years of low market prices, and counter-cyclical payments, which must remain under product-specific AMS in the absence of a WTO agreement to reclassify the blue box, likely to top $4 billion in low price years, the U.S. is going to struggle to stay within its boundaries (see graph 10 for details).

And this is without taking into account the fact that roughly $1.5 billion issued under the crop insurance scheme is currently exempt from AMS restrictions because of its doubtful classification (as non-product specific) under the amber box’s de minimis clause. In fact almost all U.S. crop insurance is product specific and 85% of it is for products that fall under the loan programme. (Of course, crop insurance can actually be classified as green box, providing it meets certain criteria – which the U.S. policy does not.)

Unlike in the EU, where successive reforms have addressed both domestic and international commitments, anticipated much needed change, and moved steadily away from a trade-distorting support based policy, U.S. farm policy, under the 2002 Farm Bill at least, seems to have done the opposite. This means that with or without an agreement in the WTO (that will reduce trade-distorting support and potentially also AMS ceilings), U.S. farm policy is in danger of imploding from the pressure it is putting on itself.

And despite the fact that farm policy is featuring high on the agenda of budget discussions on both sides of the Atlantic (in the U.S. following the 2006 budget proposals and in the EU in talks over the 2007-2013 financial perspectives), this is one factor that seems to have been overlooked so far in Congress. Where the policy moves from here – which it seems it must – will be watched with interest.

What comes next? A million, or even billion dollar question, and one that seems appropriate to round off this edition of MAP. Logic would suggest that U.S. farm policy will have to introduce some fairly drastic changes in the next farm bill to curb its current domestic support spending, even if nothing were to come from the Doha Round. And anything that does come out of the Hong Kong Ministerial later in the year is only likely to complicate matters further.

Recent publication of the President’s 2006 budget proposals have added more coal to the fire implying with his mention of “budget cuts”, if not a reopening of the 2002 Farm Bill, then certainly the direction future farm bill discussions could take. However, what he proposes – a reduction in total Farm Bill outlays of $5.7 billion over five years (which is neither as significant nor as severe as previous estimations had suggested), was met with the predictable resistance from both farmers’ organisations and Congress.

Farm spending is currently under budget, the critics say, it is unfair to undermine the safety net potential in times of low prices and naïve to unilaterally disarm on domestic support prior to an agreement in the WTO. And such a move would, one commentator said, “weaken the position of U.S. trade negotiators who do not even know what obligations the U.S. may be expected to assume as part of the overall WTO trade agreement.”

How much difference would the proposed cuts make (see insert, p10), even if they were accepted as they are? Very little in fact, and certainly no changes to the basic structure of commodity support. They would mainly affect the farming population in two sectors – cotton and rice, which though recipients of the largest subsidies, are also fewest in number. And a reduction of half a billion dollars – which are the cuts foreseen for commodity programme expenditure would have little impact on commodity net outlays that are estimated to top $24 billion in 2005.

More significant, and certainly more substantial than the proposed cuts, is the fact that 2004 commodity programme expenditure marked a $13 billion increase on the previous year, largely because the various countercyclical instruments kicked in when exceptionally high yields caused prices to fall. Half a billion dollars is therefore going to have little effect on the problem of the U.S’s burgeoning AMS discussed in section 3. And anyway, expenditure on commodity programmes is anticipated to fall by this amount next year when there will be less need for the safety net mechanisms. So if farm lobbies thought these proposals were bad, there could be worse to come.

Also compounding the problem is the way in which the U.S. institutional system works. Firstly, the way in which the Senate is composed (2 Senators from each State) means that a significant component – over a third – has direct rural interests and very strong alliances with rural groups, which is reflected in any votes on farm policy and rural affairs issues.

Secondly, unlike in the EU where farm legislation is fixed until (if and when) the European Commission proposes legislative change, each U.S. Farm Bill exists for a finite period, after which it must either be replaced by new law or it returns to the original legislation (in this case the First Food and Agriculture Act of 1933). And so in 2007, when the current Farm Bill expires U.S. farm policy either lapses back to 1933 modes and methods (which most certainly won’t happen). Or, what is far more probable is that an entirely new Farm Bill will be voted into legislation, failing which FSRIA will be prolonged for one or two years.

For the moment, Congress is preoccupied with the budget proposal prior to presenting a new draft, currently foreseen for June. After this much of the focus will presumably return to the sequence of events evolving in the WTO. Perhaps Hong Kong will present a clearer picture, but regardless of whether it does or not, 2006 is likely to be another decisive year for U.S. farm policy in which some key decisions will have to be taken.
The 2006 budget proposal in brief

How the USDA budget works:

Only 30% - $24.3 billion - of the total USDA budget is specifically spent on supporting production agriculture. A far larger proportion – 50% - goes on food and nutrition programmes, while 9% goes on natural resource and environmental schemes and 11% on rural development, research and education, marketing and regulatory activities and administration. Overall USDA outlays currently stand at $94.9 billion (up from $71.7 billion in 2004) and is predicted to fall by $300 million in 2006 when the safety net mechanisms will be required less.

The USDA budget is split between mandatory (which occurs outside of annual appropriations and for which the rules and parameters are controlled by Congress) and discretionary spending (which is determined by funding allocations in the annual appropriations acts, set by the 13 sub-committees of the Senate and the House). Approximately ¾ of total USDA spending is classified as mandatory, a significant percentage of which is accounted for by domestic farm support programs and the crop insurance program.

Key domestic support provisions under President Bush’s proposal:

1) A 5% reduction in crop and dairy support program payments to be achieved via:
   - a $250 000 per person payment limitation to the cumulative total of direct payments, down from $360 000 under the current system, a cut that would mainly affect cotton and rice producers.
   - an end to the existing ‘three entity rule’ which sets independent ceilings for each type of payment - $40 000 for direct payments, $65 000 for CCPs, and 75 000 on MLPs.
2) A prolongation of the MILC program, due to end in 2005, for the duration of the current Farm Bill.
3) Improvements in crop insurance coverage to increase participation in the program and minimise the demand for ad hoc disaster assistance.
4) The introduction of a sugar marketing assessment, to be paid by producers on all domestically produced cane and beet sugar at 1.2% of the sugar loan rate.

Next steps:

Congress is currently working on a variety of options to try and accommodate the different demands. As it stands, both the Senate and House Agriculture Committees favour equal cuts across the board for commodity, conservation and nutrition programs, though the magnitude of the cuts varies between the two - $4.2 billion over 5 years in the House and $2.8 in the Senate. The discussion will continue in a conference process, with the aim of reaching a compromise between both chambers by June 2005. All that seems likely at this stage is that the term ‘budget cuts’ will be replaced by the more modest phrase ‘budget savings’.

In the next issue of MAP:

Africa’s agricultural economy: Its position in the world and its relations with the EU.
5. Graphical Annex:

Graph 5. US Corn prices

Graph 6. US Soybeans prices
Graph 7. US Cotton prices

$/mt

Graph 8. EU wheat policy evolution

€/metric tonne

Direct payment | Farm price | Intervention price
Then price | Farm price | World price (€/mt) | World price ($/mt)
Note 1: Crop disaster payments notified under the green box; $ 577 million in 1998 were notified and are included in the de minimis.