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Implications of the 2002 Farm Bill for Commodity Markets and Trade: A California Focus

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The 2002 Farm Bill, signed into law on May 13, 2002, renews major subsidies and introduces some additional programs. The new law has implications for California commodity production and prices and may affect efforts to open international markets.

After many months of legislative negotiation, the Farm Security and Rural Investment (FSRI) Act of 2002 was signed in to law by President Bush on May 13, 2002. For more than six decades, the United States has periodically renewed and reformulated legislation authorizing domestic farm subsidy programs and related policies. The new "Farm Bill", the latest in this long history, has received wide media attention around the globe and here in California. Farm bills are typically large and complex with many separate "titles" covering a variety of farm, food and rural issues. The FSRI Act is no exception and includes titles on such diverse topics as food assistance for the poor, research and extension support, food safety and aid to rural communities. This article will focus specifically on the parts of the bill that have major implications for commodity agriculture. Even then there are simply too many complicated wrinkles in the legislation to cover them all here.

This article is a preliminary survey of some commodity market implications of the new law with a particular emphasis on California. It is too early to have definitive results; even the specifics of implementation of the law are yet to be finalized. However, we do have enough information to provide an overview of changes in the legislation and how it is likely to affect major markets. A closely related topic is how the FSRI Act relates to the U.S. commitments and negotiations in the World Trade Organization (WTO).

The FSRI Act continues the traditional farm programs by providing almost all the direct support to a relatively small handful of commodities. Most of the direct payments are provided to wheat, feed grains (mainly corn), oilseeds (mainly soybeans), cotton and rice. Dairy is also supported with payments and market regulations, and program support is also provided to some minor crops.

Most commodities in California receive relatively little direct support from farm subsidy programs. California typically produces about 15 percent of farm value in the United States and will likely receive less than five percent of the farm payments authorized in the FSRI Act (most of which go to California's rice and cotton industries). Overall, about 70 percent of farm value produced in California, including production of fruits, tree nuts, vegetables and melons, and meat animals, receive almost no direct support from Farm Bill subsidies.

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Commodity Provisions and Implications for Production and Prices

Most of the commodity provisions of the FSRI Act are familiar from previous legislation. These include: (1) "marketing loan" benefits that distribute payments per unit of output when market prices are low; and (2) fixed direct payments to owners of program crop base, even if this land is planted to other crops or no crop at all. As with previous law, no payments are allowed on program-base land that is planted to fruits, tree nuts or vegetables. Each year from 1998 to 2001, the direct payments to owners of program base were increased substantially with "Market Loss Assistance" payments that were legislated on an ad hoc basis because farm prices were generally low. The FSRI Act replaces these ad hoc payments with a new Counter-cyclical payment program. Under the new scheme, payments are made to owners of program-crop base whenever the price of the base crop falls below a specified target.

Under previous law, direct payments and market loss assistance payments were distributed in proportion to base acres and base yield that had been fixed since 1985. Under that arrangement, the payments provided little additional incentive for farmers to plant more of the program crop or attempt to increase yield to enhance payments. The new law still relies on payments distributed according to program base, but now farmers have been allowed to update their base to the recent 1998 to 2001 period if they choose. This update will allow some farmers to increase the payments they receive and may change program-induced incentives. Many farmers now will reasonably expect that the program base will be updated periodically in future legislation. This means they will expect that planting more of the program crop and using additional inputs to increase yields will enhance future program payments.

The overall projected payments under the FSRI Act are roughly equal to the payments that have been made during the 1998 to 2001 period. But, there have been some shifts among programs. The FSRI Act raised projected loan benefits, which provide a direct production incentive, for feed grains and wheat. Loan benefits were lowered for soybeans (which get new direct payments) and not changed for rice and cotton. Direct payments (those payments with the least production incentive) were reduced somewhat from recent levels. The Counter-cyclical payments were calibrated to roughly equal the magnitude of the market loss assistance payments made from 1999 to 2001. These changes, together with the updates of payments bases, are expected to shift payments away from rice towards, especially, corn and soybeans. Overall, California's share of the payments is likely to decline marginally.

There has been much international controversy about the market effects of the FSRI Act. Casual observers have simply assumed the impacts will be large and negative for commodity prices. For example, in a May 27, 2002 interview, while he was traveling in Africa with rock star Bono, a BBC reporter asked Treasury Secretary O'Neil how the U.S. could encourage more open markets and fewer subsidies in other countries when the new Farm Bill will "flood world markets with cheap U.S. commodities." Much global commentary takes a similar view, but the reality is more subtle.

In fact, simple supply and demand modeling shows that the various policy changes in the FSRI Act payment programs are likely to induce marginally more production of wheat and feed grains and thus slightly lower market prices of these crops (estimates are in the one percent range). Offsetting these impacts somewhat is three million new acres to be idled under the long-term Conservation Reserve Program. Rice and cotton production are projected to increase slightly relative to the previous program, so their projected market prices will be slightly lower. In summary, the FSRI Act likely increases the direct program crop production incentives only marginally and continues to allow planting flexibility across crops, so the production impacts across crops are modest. However, impacts may be significant for certain non-program crops in California. Even marginal increases in policy-incentives to grow program crops or payment-eligible crops may induce farmers to either not shift acreage into some relatively small-acre fruits, vegetables or tree nuts or to even shift acreage out of these crops. Thus, one impact of the FSRI Act in California is likely to be some slowing in the shift towards the crops that are not eligible for program benefits and perhaps slightly stronger market prices for these commodities compared to what would have occurred.

Finally, the FSRI Act has introduced a new dairy deficiency payment program that may have significant impacts on markets for milk and milk

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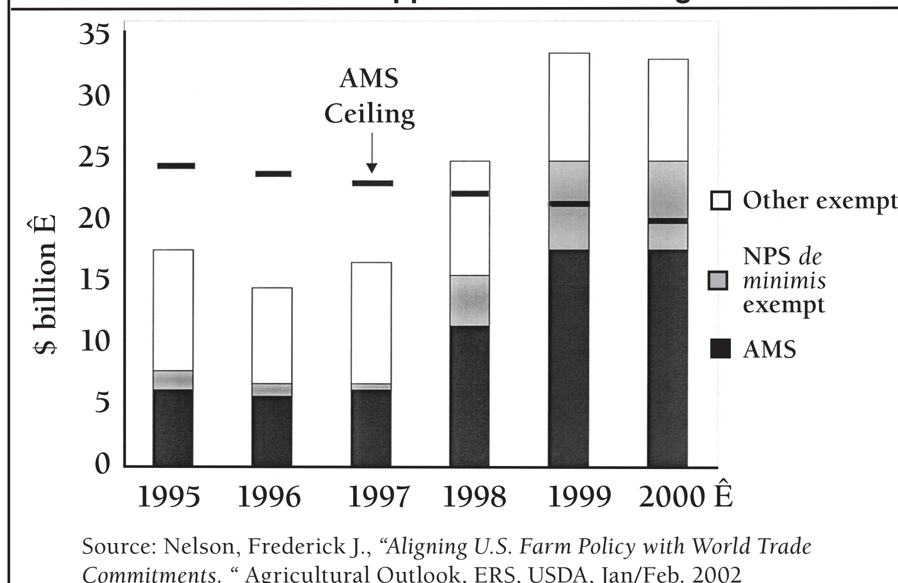
Figure 1. Total Direct Support Reported to the WTO: U.S. AMS Approaches the Ceiling



Source: Nelson, Frederick J., *"Aligning U.S. Farm Policy with World Trade Commitments.* " Agricultural Outlook, ERS, USDA, Jan/Feb. 2002

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products. This program distributes direct payments to milk producers based on the difference between a specified trigger price and a specified price of milk in the Boston market. Since market prices for dairy products are linked nationally, this program will provide an approximate floor price for eligible dairy farmers throughout the country. Overall, payments are expected to total about $1 billion per year or about five percent of milk revenue. This new program will increase milk production by about one percent nationally, which will push down milk prices by perhaps two percent. However, that is not the end of the story. The FSRI Act included a payment limit such that no further payments would be distributed to any farm when its milk output during the payment months in a year exceeded 2.4 million pounds. This limit will affect relatively few dairy farms in most of the country, but would be binding for essentially all dairy production in California. The result for California would be lower market prices and lower production because payments would fail to off-set lower market returns. Preliminary projections suggest that, even though California dairy farmers would receive payments of about $20,000 per farm, after considering the impact of lower prices, the net effect is lower diary revenue in California.

The FSRI Act of 2002 and the WTO

By signing the WTO agreement of 1994, the United States and other nations accepted some complex limits on farm subsidy programs. The agreement specified that programs with payments that did not encourage additional production and were not tied to prices were exempt from limits. For other subsidies, the U.S agreed that by 2001, "trade distorting subsidy" including payments, prices supports, input subsidies and others, would be limited to an Aggregate Measure of Support (AMS) of $19.1 billion dollars. In making that calculation, countries were allowed to exclude *de minimis* product specific subsidy that remained below five percent of gross revenue of that product. Furthermore, subsidies that were not product specific were excluded if they totaled less than five percent of the whole value of aggregate agricultural production— about $10 billion for the United States. The question is, therefore, will the FSRI Act cause the U.S. to violate these limits?

Figure 1 shows the direct farm support of the United States in categories used by the WTO. Figure 1 documents that, starting in 1998, the U.S support levels jumped and the AMS jumped as well. By 2000, the U.S. AMS was nearing the limits agreed to in the WTO and the Non-Product-Specific (NPS) support was also nearing its $10 billion cap. The FSRI Act will likely put upward pressure on the AMS and the NPS subsidy measures, but four factors suggest that the U.S. will not violate its WTO obligations in this area. First, the rules for reporting the various aggregates allow considerable flexibility and, for example, some subsidies now reported as NPS may be shifted to the AMS category and vice versa. Second, the AMS is tied to product prices and it is likely that commodity prices will gradually rise from the historical lows experienced recently, taking some pressure off the AMS. Third, about $5 billion of the reported AMS is tied to dairy, sugar and peanut price supports. The peanut program has already been modified and the dairy and sugar price support schemes provide relatively little real support for their large contribution to the AMS. These programs could be modified to provide equal benefit to producers and reduce the computed AMS dramatically, leaving room for more direct payments

in times of low market prices. Finally, the FSRI Act includes a "circuit breaker" provision requiring the Secretary of Agriculture to modify payments if WTO limits would otherwise be violated by USDA projects.

More important than the compliance with the Uruguay Round Agreement Acts (URAA), are the effects of the FSRI Act of 2002 on the prospects for successful trade liberalization in the current WTO negotiations and elsewhere. The United States negotiators remain committed to reducing trade barriers and opening markets through the WTO negotiation, in the discussions for free trade in the Americas, and elsewhere. The new farm bill will likely have several implications for these efforts. First, the U.S. negotiators will now have less opportunity to agree to lower domestic supports in exchange for additional market opening or lower export subsidies. Second, some other countries now see the United States as a main source of distortion in world markets, rather than a supporter of liberalization, and will focus attention on negotiating lower U.S. subsidies while devoting less effort to opening markets in places such as Korea, Japan or Europe. Third, negotiating attention from the world community will be diverted from the most trade distorting policies, typically border measures. None of these implications make it easier to achieve more open world markets for agricultural trade.

Comments from around the world indicate the difficult position of U.S. trade negotiators. Brazilian Agricultural Minister Marcus Vinicius Pratini de Moraes, stated that the 2002 Act will not help the negotiations on a new world trade agreement and could also slow the pace of discussions in creating the Free Trade Area of the Americas. China's vice minister of trade Long Yongtu asked, "After the U.S. Congress adopted such a bill, why can we not do similar things?" Pascal Lamy, EU trade commissioner, told the *Financial Times* of London, "For those people who want to see the [EU farm policy] evolving in a reasonable way to make it more trade-friendly, [the U.S. Farm Bill] is not good news. We'll be confronted by people saying: 'These guys are extremely naive if they start undressing at a time when others are buying new pullovers.'" The large farm lobby group in the European Union, COPA/COGECA, stated the U.S. Farm Bill proves that Europe's CAP should be maintained. *Financial Times* of London summarized much sentiment in its editorial on May 29, 2002. "With its new, grotesque farm subsidies, the U.S. has let the European Union off the hook … having surrendered to protectionism, Washington is in no position to fight." And, "Washington's reversion to huge subsidies tied to production … leaves the international campaign for agricultural reform with little hope."

While the comments are partly self-serving, most of the world evidently finds it hard to take seriously the U.S. efforts to lower border barriers into their markets when many U.S. farmers are protected from market forces at home. The label "cynical hypocrite" does not make negotiation easier.

California agriculture is a large net exporter of many commodities that gain relatively little from Farm Bill subsidies in the 2002 Act. For the longer term, if the FSRI Act makes progress in global market opening more difficult, that is not good news for farmers here in California.

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