III. Farm Sector Policy

The farm sector and all of agriculture are vastly different today, as is much of rural America. Yet, our farm policy retains vestiges of the New Deal programs and reflects a time of greater homogeneity across American farms and farm households.

If farmers and farm families all across the country shared the same goals and faced the same challenges and opportunities, fashioning farm policy today would be straightforward. And, indeed, that's the way it must have seemed in the 1930s, when farm families depended mainly on farm earnings and grew crops and livestock on much the same acreage as their neighbors. Then, policy had a more focused objective—helping to reduce the wide income disparity between farm families and their urban counterparts—and a "one size fits all" approach was more appropriate. Supporting field crop prices provided widespread assistance, since most farmers grew some field crops, and helped stabilize the entire sector. The farm sector and all of agriculture are vastly different today, as is much of rural America. Yet, our farm policy retains vestiges of the New Deal programs and reflects a time of greater homogeneity across American farms and farm households.

Today, the farm sector is diverse beyond the imagination of those who framed the New Deal legislation. On average, farm family incomes no longer lag, but rather surpass those of other U.S. households. Most farms are run by people whose principal occupation is not farming. Markets have changed, too. Domestic demand alone is no longer sufficient to absorb what American farmers can produce. Demand by well-fed Americans grows slowly, with population growth. The promise of new, much faster growing markets lies overseas, in countries where economic prosperity is emerging for larger numbers of people.

As a result, the United States must consider its farm policy in an international setting, helping farmers stay competitive while pressing for unfettered access to global markets. At the same time, Americans' expectations with respect to food have moved well beyond assurance of adequate quantities to include quality, safety, convenience, and many more attributes. And, expectations now extend to environmental preservation and enhancement.

More than seven decades of farm policy have provided a rich, full experience upon which to draw as we contemplate appropriate 21st century policies for our industry. The view of policies and programs across their history has proved very instructive, providing invaluable lessons which at a very minimum can help us avoid the obvious mistakes of the past. History also shows that growth in farm household income was largely due to rapid improvements in productivity supported by a strong research base along with better opportunities to market products, including export markets and off-farm employment opportunities.

Many of the program approaches since the 1930s proved not to work well or not at all, produced unexpected and unwanted consequences, became far costlier than expected, and have been continually modified over time in the long succession of farm laws. Some major, and still highly relevant, lessons learned include:

- **History has shown that supporting prices is self-defeating.** Government attempts to hold prices above those determined by commercial markets have simply made matters worse time after time. Artificially higher prices encouraged even more unneeded output from the most efficient producers at the same time they discouraged utilization, consequently pushing surpluses higher and prices lower. Costs to taxpayers grew until the point was reached where something more had to be done. All too often, that turned out to be finding ways to restrict output.
- **Supply controls proved unworkable too.** These usually involved restricting the amount of land farmed in attempts to reduce output. But, the remaining land was farmed more intensively, and supply rarely was cut enough to boost prices to politically satisfactory levels. The programs were costly to taxpayers and consumers and the unused resources were a drag on overall economic performance. But, perhaps most important of all, limiting our acreage was a signal to our competitors in other countries to expand theirs, and we lost market share that is always difficult to recapture.
- **Stockholding and reserve plans distort markets enormously.** Isolating commodity stocks from the market when supplies are abundant is attractive for its short-term price stimulus. But, because such stocks eventually must be returned to the market, they limit the recovery of prices in the future. Moreover, time after time, stocks have proved costly to

Since the land charge is such an important component of farmers' total cost, sustained increases in land prices and rents have a decidedly adverse effect on the competitiveness of our farmers in the marketplace compared with those in other exporting countries, a cause of growing concern in recent years.

maintain, distorted normal marketing patterns, ceded advantage to competitors, and proved tempting targets for political tampering.

- **Program benefits invariably prove to be disparate, providing unintended (and unwanted) consequences.** The rapidly changing farm sector structure produced a wide array of farm sizes and efficiencies. Many farms were low cost and the programs were of enormous benefit, enabling them to expand their operations. Others did not receive enough benefits to remain viable and thus were absorbed along the way. That situation still remains to some extent today, even though we now have far fewer farms.

The clarity of these lessons provided several emphatic turning points in national policy. The 1985 farm law proved to be one such point when, after long debate on fundamental philosophy, a more market-oriented approach was adopted. That market orientation was extended in the 1990 farm law, making a less intrusive and expensive role for government in farmer decisionmaking and in the operation of the markets.

The Federal Agriculture Improvement and Reform (FAIR) Act of 1996 proved to be historic in that it removed much of the decades-old program structure, provided unparalleled farmer decisionmaking flexibility through "decoupled" benefits, and set a new example throughout the world for providing domestic farm sector support. While that approach still is arguably the least distorting of markets and resource use, its direct payments do share some unintended effects with price support programs, namely the artificial inflation of farmland prices. The effect clearly has been exacerbated by the size of payments in recent years, some $28 billion in the last 4 years above the amount provided in the 1996 law.

While the rise in land prices creates wealth for some, it works to the disadvantage of others. Direct government transfers distort real estate markets, keeping land prices artificially high when commodity prices are low, as we are seeing today. Higher land prices from consecutive years of large program support make it more difficult for beginning farmers by increasing capital requirements. This inflation also makes it more costly for existing farms to expand to achieve size economies, either by purchasing or renting additional acreage (since land rents move in tandem with prices). Higher land values do benefit local tax authorities and the collateral base of farm lenders, but add directly to production expenses through higher interest and rental costs. Since the land charge is such an important component of farmers' total cost, sustained increases in land prices and rents have a decidedly adverse effect on the competitiveness of our farmers in the marketplace compared with those in other exporting countries, a cause of growing concern in recent years.

Squaring Today's Realities With Policies

Because of their historical evolution, current program benefits still are largely directed to specific commodity producers, resulting in only 40 percent of farms being recipients. And, there still is no direct relationship between receiving benefits and financial status of the farm. The most financially disadvantaged segment of farmers today is the low-income, low-wealth group (see appendix 1). This limited-resource group comprised about 6 percent of farms, had average household income of $9,500, but received less than 1 percent of direct government payments in 1999. In contrast, 47 percent of payments went to large commercial farms, which contributed nearly half of program commodity production and had average household income of $135,000 (figure 14).

Our current broad-scale, commodity-oriented approach to farm support does not recognize existing wide differences in production costs, marketing approaches, or overall management capabilities that delineate competitive and noncompetitive operations. It thus is impossible to provide enough income support for intermediate farms without overly stimulating production by lower cost, large-scale commercial producers (figure 15). Even though many intermediate farms and rural-residence farms receive some program benefits, only one in four generated enough revenue to cover economic costs. Even more problematic is the inability of these farms to improve their cost efficiency at the same pace as larger commercial operations, whose investment in new technologies and ability to expand are aided by program benefits.

Figure 14
Large Farms Receive the Biggest Share of Direct Government Payments (1999)

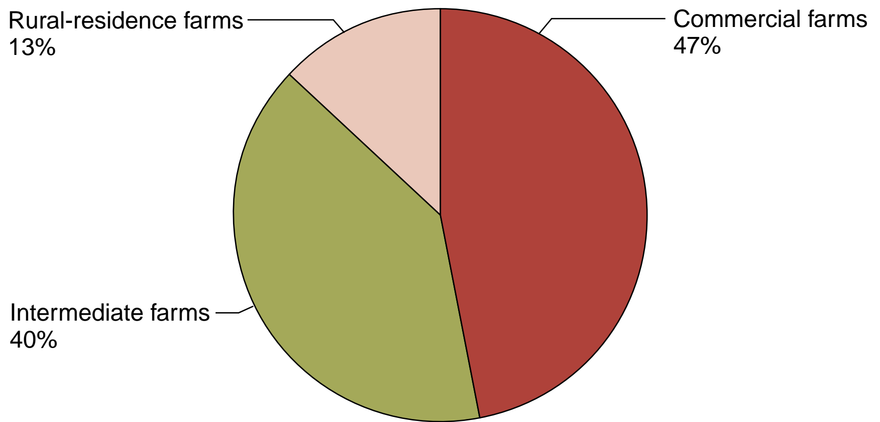
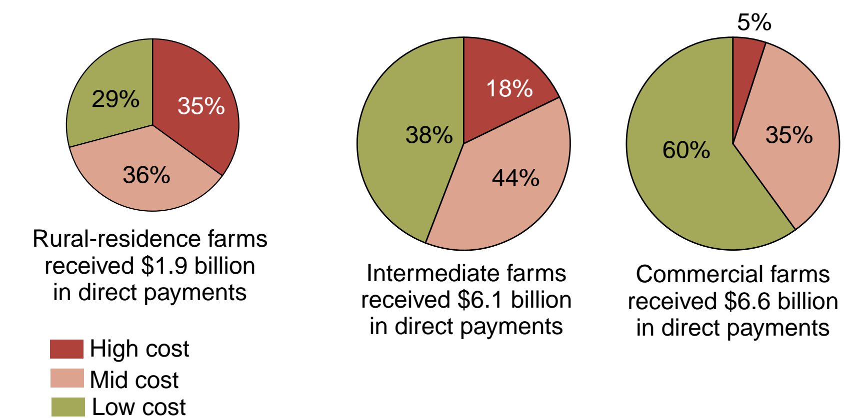


Figure 15
Distribution of Direct Payments by Farm Size and Cost Structure (1999)



Another unintended consequence of current programs stems from the increasing disconnect between land ownership and farm operation. While program benefits were intended to help farm operators, most support eventually accrues mainly to landowners, in the short run through rising rental rates and in the longer term through capitalization into land values. Land prices in recent years have been relatively robust—especially in areas producing program commodities—despite concerns about low commodity prices and the future direction of farm programs. For many farm operators, renting land is a key strategy to expand the size of the business in order to capture the size economies, as evidenced by 42 percent of farmers renting land in 1999. Clearly, operators farming mostly rented acreage may receive little benefit from the programs.

The impact of income from any source (including program benefits) on land values depends on whether that income is viewed as permanent or transitory—the degree of certainty that the income will continue in the future. Even though production flexibility contract payments were intended as transitory when authorized by the 1996 Farm Bill, subsequent emergency assistance and a 70-year history of government involvement in agriculture have reaffirmed the expectation that support will continue in the future.

The 1996 FAIR Act also continued the marketing loan program, another evolution of the old price support idea, but importantly modified to avoid government stockholding which proved so burdensome in times past. Marketing loan payments effectively provide a large countercyclical component to farm income, but distort markets by limiting the production response to falling market prices. The program guarantees a price for traditional program commodities (food grains, feed grains, and cotton) and oilseeds. As market prices have fallen below this guaranteed price, total marketing loan benefits have risen from less than $200 million for the 1997 crop to $8 billion for the 1999 and $7.3 billion to date for the 2000 crops. Since 1996, countercyclical marketing loan benefits have totaled about $20 billion.

While the current policy made large strides toward greater market orientation, a careful evaluation in

the context of today's diverse farm structure and increasingly consumer-driven marketplace still reveals severe misalignment among policy goals, program mechanisms, and outcome. Improvements could support more sustainable prosperity for farmers, agriculture, and rural communities without engendering long-term dependence on direct government support.

The Economic "Safety Net"

While strong arguments can be made for solutions for specific problems, common principles apply to all programs that support the diversity of American farms. Foremost, our strongly held view is that agricultural policy must recognize that the marketplace is the best guide for allocating resources and provides the most objective reward for efficiency and good management. But, that does not rule out helping farmers and ranchers when unexpected events beyond their control occur and cause output or income to plummet. The challenge, of course, is to provide an adequate safety net without encouraging sustained dependence on government. Safety net interventions should not obscure needed adjustments in outputs and markets that inevitably must occur, nor should they fail to reflect that the functioning of competitive markets must cover the entire food system in today's dynamic, consumer-driven agriculture.

The idea of a "safety net" is becoming much more encompassing than the traditional price and income support. This modern view has been dramatically emphasized in recent years, when we have seen the entire agriculture infrastructure placed under great stress from food safety concerns and the potentially devastating losses to producers (foot-and-mouth disease and BSE in Europe, for example). These and other events have underscored the need for protection from plant and animal diseases and pests, new research on testing, more widespread monitoring, research to maintain and improve competitiveness in world markets, buttressing the foundation for sanitary and phytosanitary measures in trade agreements, and generating more attention to food safety and the integrity of the entire food system. Arguably, the policy focus of the past 4 years has distracted us from focusing on these fundamental aspects of a safety net for the entire food system for the benefit of not only the farmer but the consuming public as well.

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Diverse Farm Structure and the Government's Role

The highly diverse, consumer-driven food system makes flexibility imperative in matching government program design and intent with farm circumstances that vary with size, organization, and geographic location. In short, the solution should fit the problem, and benefits for one group should not disadvantage other groups. For example, highly competitive commercial farms may benefit most from trade negotiations that expand markets for their products while intermediate farms also may take advantage of newly developed market opportunities. Alternatively, investment in rural infrastructure that helps attract more and better jobs may be crucial to intermediate farms and other rural inhabitants.

Past attempts at tailoring or directing benefits to particular groups have not proved very successful where the basic economic realities of farming were misunderstood. For example, legislative efforts to ensure that farm operators rather than landlords got the benefit of government payments were easily circumvented, while payment limits to individual farmers have not proved effective. Nevertheless, developing policy improvements requires a better understanding of how the farm sector is structured and operated and the implications for a government role in the sector.

Government's Role in Assisting Commercial Farms

Commercial farms in the United States are among the most highly efficient producers of food and fiber anywhere. Their cost advantage over other farms derives largely from size economies. The bulk of their income is derived from farming and related activities and their well-being depends on the success of the farm business—on production efficiency and the managerial ability to respond to weather, pests, disease, and changes in farm input and marketing costs, as well as on prices. Federal programs that expand market opportunities, help reduce production and marketing costs, and assist with risk management are most beneficial to commercial producers.

Expand markets. In the long run, commercial farmers need new and expanded markets in which to sell their growing output to avoid suffering price declines. Government leadership in negotiating new and expanded international trade agreements and resolving trade disputes provides access to overseas customers. Support for research into alternative product uses such as renewable energy also will expand markets.

Risk management. Commercial farms, like other successful businesses, use a variety of tools to manage risks, including insurance, diversification of markets, contracting inputs and outputs to establish

prices, and using futures and options markets. Frequent exposure to natural disasters (hail, flood, drought, frost, and wind) sets agriculture apart. The potential for natural disasters to affect wide areas at the same time, as well as other factors, makes it difficult for private insurance markets for agriculture to be viable.

Insurance provides farmers with a range of choices to reduce risk, given their individual circumstances. In contrast to other payments where farmers respond to Government-determined prices and payments, insurance can be more market oriented. Market orientation extends to the provision of insurance where private companies and agents sell and service policies and the Government provides financial incentives to companies and subsidies that lower premiums paid by farmers. While insurance programs do not directly interfere with market prices, they must be expanded and managed carefully to avoid distorting markets through excessive subsidies for risk or through providing guarantees that are out of line with market conditions.

Federal involvement in agricultural insurance has grown steadily since the 1980s, in parallel with the increasing market orientation of farm policy. About three-quarters of the acreage planted to major crops (corn, wheat, soybeans, and cotton) is at least minimally insured, and insurance is available for more than 100 crops. Coverage has been expanding through the provision of coverage for more crops and through the development of new types of insurance, such as revenue coverage, which provides more risk management choices to farmers.

Concerns that farmers were purchasing too little insurance motivated reforms by Congress in the Agricultural Risk Protection Act (ARPA) of 2000. High premiums were cited as a primary cause for low participation, and the ARPA increased premium subsidies, lowering farmers' premium costs for higher coverage levels. The ARPA also increased incentives for extending coverage by increasing the role of the private sector in the development of new risk management tools. ARPA provides $8.2 billion over 5 years to lower premiums and extend coverage.

Managing conservation. Farmers and ranchers are very aware of the impact of their operations on the environment. Compliance with regulations that protect resources and the environment is consistent with farms' own objectives, but entails added cost, while competitiveness hinges on cost control. Meeting water and air quality standards, for example, can increase costs when production practices are altered to reduce nutrient loss or control erosion, just as protecting endangered species may require costly adjustments. Regulations that recognize the realities of farming operations can help minimize the costs of adopting environmentally friendly practices, and assistance in meeting additional costs also can help protect U.S. producers' competitive edge in international markets.

The highly diverse, consumer-driven food system makes flexibility imperative in matching government program design and intent with farm circumstances that vary with size, organization, and geographic location. In short, the solution should fit the problem and benefits for one group should not disadvantage other groups.

Needs of the Intermediate Farms

The intermediate category of farms perhaps is best characterized as businesses in transition. They may be beginning farmers or farmers nearing retirement, but a common characteristic is that keeping the farm going generally requires off-farm income sources. The path to profitability for most lies in lowering production costs—often available only by expanding their farming operations, especially if their focus is crop commodities. However, these farms increasingly have new opportunities on the demand side of the market, by increasing their revenues through direct marketing and by producing value-enhanced products. Direct markets often are specialty markets, appropriate for farmers able to move small amounts of product. Creating "virtual" economies of size through joint ventures and other value-added business enterprises also may enhance the long-term viability of these operations. Moreover, the importance of off-farm earnings clearly suggests that large benefits accrue to these farmers from efforts to expand off-farm employment opportunities and strengthen rural communities.

Strengthening competitiveness. The long-term viability of intermediate farms depends on developing strategies to access new markets and effectively manage costs. Earning profits provides the resources to adapt to all types of change, including short-term weather shocks or continual technological advances. Commercial farms have been able to do this while intermediate farms still struggle, and assistance in becoming more astute managers of their marketing and financial operations likely is critical.

Even so, intermediate farms' revenue arguably now is depressed because of the policies that encourage overproduction. These farms currently bear the unintended consequences of payments based on output, which encourage more production, primarily by commercial farms. This pushes market prices lower and makes it more difficult for intermediate farms to break even. While reducing or eliminating this market distortion would benefit these farms, it would not be sufficient to ensure their survival. That would require greater efficiency for those on the verge of becoming competitive, while recognizing the diversity of local conditions facing these farmers. A national program focusing on intermediate farms may not address all farmers' needs. For example, educational resources (to improve management), information about new markets, and natural resource conditions all vary significantly by region. This diversity has prompted discussion of new, innovative approaches such as block grants to States for programs that tailor cost efficiency to specific farms.

Risk management. Improved management extends to the sophistication with which farmers choose and employ risk management tools. Commercial farms typically use a broad range of approaches to manage adverse effects of market, financial, and natural disaster risks. Intermediate and rural-residence farms may have more limited experience. The ARPA also includes funding for partnerships with private and public entities to educate producers about risk management activities and risk reduction strategies. Federal and State Governments, often through land-grant universities, provide training to help farmers acquire or enhance risk management skills needed to thrive in today's marketplace.

Stewards of the land. Intermediate farms also must meet environmental mandates, and their smaller size may mean that they face different requirements and costs of compliance. Moreover, this group of farms controls a significant portion of the farmland (45 percent), and supporting their compliance with environmental regulations is important to the quality of the Nation's resources.

Assisting Rural-Residence Farms

Most rural-residence farms lose money on farming, subsidizing these activities with nonfarm earnings or retirement income. Objectives other than farm profitability, such as enjoyment of a rural lifestyle and farm work, keep them in agriculture. Their off-farm income, aided by favorable tax policies, permits them to subsidize farming. Also, many small farm owners may view farmland as a long-term investment that diversifies their financial portfolios.

Not surprisingly, traditional agricultural policy has very little influence on the financial well-being of these households. They are very little connected to commodity prices but much more so to wage rates, interest rates, employment levels, and tax policies. Their needs obviously are more effectively addressed by rural development and other policies that most affect them. These farms are small individually, and they account for only a small proportion of total output, but collectively they control a large proportion (29 percent) of the farmland, suggesting that their participation in appropriately designed conservation and environmental programs potentially could make important contributions to national objectives in those areas.

Other Policy Areas Increasingly Important

While policy discussion still is dominated by commodities, other areas are increasingly important for farmers of all groups. One such area is tax policy. The President's tax reform legislation eliminated the estate tax that was a longtime and growing concern to family farmers and small business owners who make up a large part of the food system. Estate tax elimination allows family farms and businesses to be passed to the next generation without dissolution of the entity or the need to sell assets in order to pay Federal taxes. Over the long haul, tax relief will encourage work and innovation and also allow farmers to save more in their pension plans or individual retirement accounts.

Tax-deferred Farm and Ranch Risk Management (FARRM) accounts, as variously have been proposed, would allow farmers to reserve a substantial percentage of their net farm income in a tax-deferred account, which could be drawn on during downturns. These funds could be held in the account for several years to help farmers in times of reduced income to offset operating expenses and purchase inputs for the next production cycle. Such accounts, appropriately designed to be countercyclical, could be an important part of the economic safety net.

Farm Policy and International Trade

It has been clear for some time that the long-term economic health and prosperity of the farm sector, and indeed of the entire food system, depend upon the ability to gain greater access to customers in foreign markets. The reasons are obvious. We have far more capacity, in our natural resources and infrastructure investments, than needed to meet domestic food needs and our market is now mature. In fact, new technology expands this capacity faster than the growth in domestic demand, which is at the slow pace of our Nation's population growth. Assets increasingly out of place, underutilized, and declining in value would result without growing access to the 96 percent of the world's consumers who are outside the United States.

This increased reliance on foreign markets and trade now means that we must pay greater attention to the compatible development of domestic farm support policy and our international undertakings and activities. Today, choices made in our domestic policy have a direct bearing upon

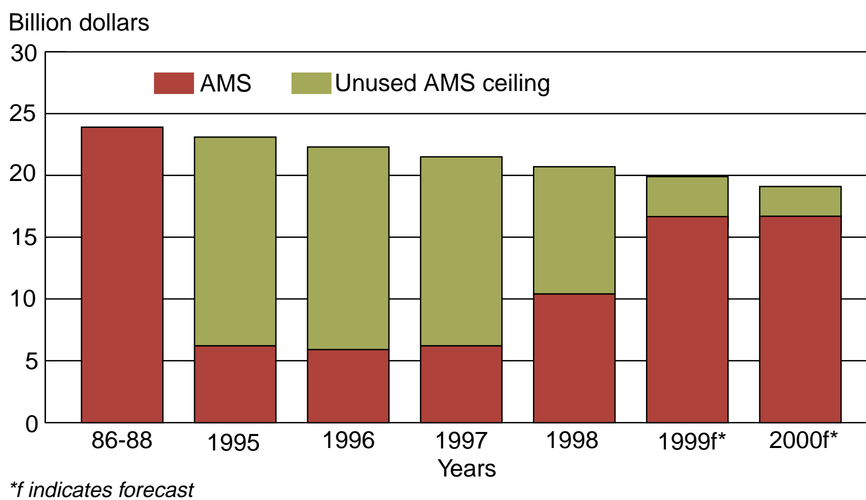
international agreements already in force as well as upon the latitude we have in negotiating new agreements to bring even more benefits.

We must ensure that we fulfill our existing WTO commitment on domestic support while providing room for negotiations. The "three pillars" of the Uruguay Round Agreement on Agriculture (URAA)—market access, domestic support, and export subsidies—recognize the interdependence between domestic and trade policies. Reaching a consensus among WTO members on further trade liberalization will require reductions across all three pillars.

Current policies, particularly spending for marketing loan payments, approach WTO limits and leave little room for negotiating further reductions (figure 16). Amber box spending rose from $6.2 billion in 1997 to $10.4 billion in 1998, largely from increased marketing loan payments. Payments in 1999 and 2000 brought the United States closer to its limits. Other large expenditures in the amber box are market price supports for dairy, sugar, and peanuts valued at $5.8 billion in 1998 and subsidies for crop insurance at $747 million.

Noncommodity-specific payments also have increased and potentially could exceed the ceiling of 5 percent of the value of domestic production. If this happens, the full value of the expenditures then must be included in the Aggregate Measure of Support (AMS) and would push us well above our WTO commitments. Market loss assistance payments (MLAs) of $2.9 billion, combined with other expenditures, used about one-half of the available 1998 "de minimus" exemption. Increased crop insurance subsidies in 1999 and 2000, combined with MLAs of $5.5 billion, will push our total much closer to the "de minimus" ceiling.

Figure 16
U.S. Aggregate Measure of Support (AMS) Approaches WTO Ceiling



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WTO Domestic Support Categories

The URAA differentiates domestic support policies according to their effects on production and trade. "Amber box" policies that directly subsidize production and influence the decision to produce are included in the calculation of an Aggregate Measure of Support (AMS) and made subject to reductions. Amber box policies are further divided according to whether they provide commodity-specific or noncommodity-specific support. "Green box" policies, those that cause only minimal trade distortions, are exempt from any expenditure limits. "Blue box" policies are distorting farm subsidies that are linked with supply limitations.

WTO members agreed to reduce commodity-specific, trade-distorting domestic support by 20 percent (13 percent for developing countries). Noncommodity-specific support is not included when calculating the AMS as long as it does not exceed 5 percent of the value of agricultural production (developing countries have a 10 percent ceiling). These amber box payments are referred to as "de minimus." Our limit on spending on amber box policies is $19.1 billion. "Blue box" policies are exempt from reductions because the supply limits partially offset the subsidies' incentives to overproduce and thus disrupt global trade.

Principles for Farm Policy

- **Pay heed to lessons learned.** Above all, effective farm policies for the new century must build upon the lessons learned from over seven decades of rich experience with the farm programs. Even the most carefully designed government intervention distorts markets and resource allocation, produces unintended consequences, and spreads benefits unevenly. We cannot afford to keep relearning the lessons of the past.

- **Recognize our new operating environment.** Our farm sector and food system operate today in a new and evolving business and social environment. It is a competitive, consumer-driven environment, global and rapidly changing with enormous implications for the place and role of the farm sector in the overall food system. It is highly inter-dependent, blending the efforts of many industries to add value to farm sector products.

- **Continually expand our commitment to open markets.** The United States is thoroughly committed to market-oriented policies, well understood to serve the best long-term interests of all stakeholders in the food system and society at large. Markets have continually demonstrated their superiority to other alternatives in guiding allocation of resources, investment, and production in patterns that are most beneficial to society at large. Still, this commitment needs to be renewed and expanded.

- **Commit even more fully to future growth of the farm and food system.** There is a long-standing, national economic commitment to open markets in support of the Nation's market-oriented policies. For the agriculture industry, development of foreign markets is essential to support future investment, growth, and the long-term health of the sector. Our agricultural production capacity today not only exceeds domestic demand but is growing faster as well. Thus, future asset values, incomes, growth, and general prosperity depend upon gaining greater access to the global

growth markets. New and expanded trade agreements hold the best promise for our competitive producers to expand sales and gain market share and generate economic activity across rural America.

- **Ensure that farm and trade policies are fully compatible.** Domestic farm support and international trade policies must be consistent and mutually reinforcing. It makes no sense to have trade policies and programs promoting farm exports at the same time domestic support programs inadvertently reduce competitiveness. Our domestic and export policy must support our existing international obligations and at the same time give us ample latitude in pursuing ambitious goals in ongoing and future negotiations.
- **Strengthen U.S. global leadership.** The world looks to U.S. leadership in policy formulation and program design for both domestic agriculture support and international trade. U.S. policymakers must be cognizant that our actions set examples and help persuade others to our positions.
- **Accommodate and build on the farm sector's wide diversity.** Effective agricultural policies must recognize the wide diversity in the farm sector itself, in terms of size, location, financial status, crop and livestock products produced, managerial abilities, income sources, and goals and aspirations. The problems faced by these groups are widely different and require solutions tailored effectively to address particular needs. Failure to do so only exacerbates the problems and postpones the day of reckoning.
- **Provide a market-oriented economic safety net for farmers.** The national recognition that the farm sector is both unique and essential is long standing and widely held. The result is a parallel commitment to policies that support open markets and those that prevent precipitate downturns in the farm sector. Thus, these programs must conform to basic public policy principles including effectiveness, transparency, equity, consistency, and comprehensiveness. Current policies now take several forms, including countercyclical loans, crop and revenue insurance, and direct payments, but they could be constructed with other programs (such as tax-deferred income accounts) that fully comply with such principles.
- **Focus on a broader infrastructure.** Provide a longer term view of the requirements for a healthy and prosperous farm and food system to ensure that it continues to enjoy widespread consumer confidence and support. This entails refocusing institutions and continuing judicious investment for the entire system, including refurbishing and modernizing the infrastructure that underpins the farm, food, and trading system.