Revenue-based countercyclical payments

U.S policy disaster relief?

Since the March 2005 World Trade Organization Appellate Body ruling against U.S. cotton subsidies,[1] the U.S. Department of Agriculture (USDA), agribusiness lobbyists and agricultural economists have been looking for ways to make the 2007 U.S. Farm Bill "bullet proof" against WTO litigation. Agribusiness representatives have proposed that savings from cuts to price supports and direct payments could subsidize purchase of multi-commodity revenue insurance that would be safe from WTO challenge.[2] The USDA's January 31 Farm Bill proposal adapted agribusiness's revenue insurance idea, seeking to offset anxiety created by an estimated $34 billion in commodity program payment cuts from 2007-2016,[3] with a safety net for U.S. producers that would be legal under WTO rules. Because the 2002 Farm Bill expires on September 1 of this year, the U.S. Congress is now starting to recalibrate the budget[4] and rewrite or eliminate provisions of the 183-page outline proposal.

U.S. lawmakers claim the 2007 Farm Bill will not be written "in anticipation of" a WTO Doha Round agreement.[5] Nevertheless, the trade-related provisions of the USDA proposal take into account existing WTO rules and appear to anticipate adoption of rules that the U.S. has proposed in the Doha Round of negotiations. One such provision—revenue-based countercyclical payments (RCCP)—is analyzed here.

USDA characterizes RCCP as both "disaster relief"[6] and an income safety net. Both categorizations, in theory, would make the RCCP eligible for the WTO's Agreement on Agriculture (AoA) "Green Box" category[7] of domestic support payments. Spending on Green Box programs is not limited by WTO commitments. However, the complicated RCCP formula also could fit the program into the expanded Blue Box (Article 6.5 as amended by the July Framework of 2005) proposed by the United States and provisionally agreed by WTO members. This analysis outlines some of the RCCP formula elements and AoA provisions that could determine whether RCCP would be notified as Blue Box or Green Box payments.

Part or all of the RCCP proposal could be eliminated in Congress' writing of the Farm Bill, whether due to overall budget restrictions and/or conceptual objections. However, the general RCCP concept, if not its USDA formulation, is supported by influential groups with farmer and agribusiness members, including the National Corn Growers Association (NCGA) and American Farmland Trust (AFT). The NCGA is revising its initial RCCP proposal, available publicly only in summary, because "after extensive peer review, the program was found to be amber box, not green box, in World Trade Organization circles."[8] Amber box domestic support payments are subject to an annual ceiling. This analysis focuses on the USDA proposal.

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RCCPS: DISASTER RELIEF AND AN INCOME SAFETY NET

The RCCP's purpose is not just to provide WTO-compliant agricultural support but also to provide an effective "disaster relief" safety net beyond what U.S. farmers purchase in crop risk insurance. "Disaster relief" is popular among U.S. farmers, yet the scope of what is "disaster relief" is subject to differing interpretations.[9] For U.S. House of Representatives Speaker Nancy Pelosi, disaster relief is for "times of flood, drought, and other natural disasters."[10] However, the permanent "disaster relief" sought in the RCCP program includes price as a factor in the RCCP formula, so a policy-induced price depression could also trigger RCCP outlays.

For example, removing or reducing the U.S. $0.54 a gallon tariff on ethanol and releasing millions of Conservation Reserve Program acres for corn planting could decrease the demand for corn-derived ethanol, increase corn supply, depress corn prices and trigger RCCP outlays under the formula. The lack of any supply management mechanisms in the 2007 Farm Bill is projected to result in a historically low stocks-to-use ratio for corn in the USDA's econometric outlook to 2016. According to University of Tennessee Professor Daryll Ray, extremely tight corn supplies could lead to a sharp price spike for corn to as high as $6 a bushel in the event of a corn production failure, followed by a long-term low price valley of $2 per bushel of corn, as a global expansion of corn acreage chases the ethanol gold rush.[11] An upsurge of RCCP outlays would follow.

But the USDA's outlook projections to 2016 indicate that RCCP outlays and therefore farmer benefits will be "minimal," due to anticipated higher prices for feedgrains resulting from corn use in ethanol.[12] If this outlook is accurate, and Professor Ray's price spike scenario does not come to pass, notifications of RCCP to the WTO could be similar to the USDA estimate of $1.3 billion in price contingent countercyclical payment (CCP) disbursements in FY08, down from $4.3 billion in FY06.[13] The RCCP program would supplant the CCP program in the 2002 Farm Bill and could offer the policy failure related income support that traditional crop insurance does not offer. Farmers must have purchased crop risk insurance to be eligible for ad hoc natural disaster relief payments. However, Congress has yet to decide whether farmers likewise would have to have purchased crop insurance during the entire proposed 2002-2006 base period to be eligible for RCCPs. [14]

BACKGROUND: COUNTERCYCLICAL PAYMENTS IN THE 2002 FARM BILL.

CCPs were introduced in the 2002 Farm Bill to compensate producers when prices fell. CCPs made up the difference between the target price set by Congress for a given commodity (eight major commodities are currently covered by these programs) and the higher price of either the national average market price or loan rate price (a commodity unit price according to which farmers receive interim operational financing from the government until they can sell their crops).[15] When the market price or loan rate drops below the target price, the USDA makes up the shortfall to farmers.

In the WTO cotton dispute, the U.S. argued that CCPs were disaster relief payments and therefore not subject to Aggregate Measure of Support (AMS) payment limit commitments.[16] The dispute panel and Appellate Body disagreed, contending that as price-contingent payments directed to the production of a specific commodity, the CCPs encouraged production that would not have occurred without them, thus "distorting trade." The AoA does not define "trade distortion," but according to the WTO website, "trade is distorted if prices are higher or lower than normal, and if quantities produced, bought, and sold are also higher or lower than normal—i.e. than the levels that would usually exist in a competitive market."[17] The WTO contends that any public payment that consistently affects either supply or demand—i.e., what in theory determines a "normal" price—is trade-distorting. Some distortions are allowed under the rules, but most are not.

The U.S. has yet to comply fully with the WTO cotton ruling, hoping that new rules for agriculture as part of the Doha Agenda will legitimize retroactively some of the 2002 programs such as CCPs. The USDA proposal to create a revenue-based program, meanwhile, ostensibly is designed to bring U.S. programs closer to conformity with the underlying WTO requirement that government programs be least trade-distorting.

THE RCCP PROGRAM FORMULA

In the USDA proposal, "the revenue-based payment for a [program] commodity would be triggered when the actual national revenue per acre for the commodity is less than the national target revenue per acre."[18] The national revenue per acre would be calculated by multiplying a national average yield times the higher of either a "season average market price" or the loan rate price for a commodity. ("Season average" takes into account horticulture commodities, newly eligible as program crops in the USDA's proposed 2007 Farm Bill, whose price is affected by the season in which they are grown.) The proposal does not state which crops would be eligible for RCCP payments. But in response to the WTO cotton subsidies ruling, the USDA recommends deleting the 2002 Farm Bill provision that had excluded horticultural crops and wild rice acres as eligible for CCPs and direct payments (32-33). In theory, under the USDA proposal, all crops would be eligible for RCCPs, which would result in even more intense competition among more sectors for dwindling federal dollars in the Farm Bill budget.

The national revenue target would be based on a formula derived from the target price and direct payment per commodity from the U.S. House of Representatives' version of the 2002 Farm Bill, multiplied by a national yield per acre average for the program commodity during the 2002-2006 crop years, excluding the best and worst yield years. The yield average and base acreage would remain fixed for the life of the 2007 Farm Bill. The formula for individual producer payments factors in 85 percent of the producer's historical base of acreage in a particular commodity to guard against the "moral hazard" of taking undue risks because of the RCCP program participation.[19] For example, such an undue risk might include the farmer taking the risk of planting a program commodity in a flood plain or hurricane zone because of producer eligibility for RCCPs.

The RCCP proposal fits within the U.S. WTO proposal of October 10, 2005, for an expanded Blue Box that would allow direct payments that do not require production if the following (among other) criteria are met: 1) "such payments are based on fixed and unchanging bases and yields": and 2) "such payments are made on 85 percent or less of a fixed and unchanging base level of production." [20] The fixed base acreage and yield averages and the 85 percent "moral hazard" ceiling are clearly designed to be compatible with the expanded Blue Box.

By making all commodities eligible for the payments, the USDA seeks to avoid the "trade distortion" in a specific crop that was ruled illegal in the WTO cotton subsidies case and presumably would run afoul of a future WTO dispute settlement panel. If the USDA disburses RCCPs as a total payment for all program commodities affected by natural disasters or income loss, it may be difficult to verify all the claimed losses. A USDA review of farmer tax records showed that it would be difficult to verify the documentation for a whole farm income insurance plan.[21]

The document that the USDA's Farm Services Administration (FSA) would use to verify revenue would be farmer tax records. In theory, these tax records could be reviewed by other farmers on the FSA county committee. The FSA regulations for direct and countercyclical payments eligibility and compliance in the 2002 Farm bill ran to 690 pp. and presumably RCCP regulations would be similarly complex.[22] The complexity of RCCP rules, together with farmer reluctance to let other farmers review their accounting books, could make revenue verification and RCCP administration very difficult. Verifying U.S. notification of RCCPs to the WTO could be even more difficult.

GREEN BOX OR BLUE BOX?

The USDA seems to be pursuing a two-part strategy with RCCPs. It hopes that WTO members will accept RCCP notifications as Green Box eligible, but will shift the payment to the Blue Box if the members insist. Above all, the RCCP is designed to avoid classification as Amber Box, where the new payment constraints expected from the Doha Round are likely to bite.

The Green Box allows disaster assistance payments (AoA Annex 2, paragraph 8) and income safety net programs (paragraph 7). The income insurance payments "shall not relate to the prices, domestic or international, applying to such production" (paragraph 7c) nor to volume of production *in years following the base period* (paragraph (6 b-d; our emphasis). The AoA definition of a five-year base period, with the best and worst income years excluded from income support payment calculation (7a), coincides with the RCCP formula definition. Thus far the RCCP program would appear to conform to Green Box requirements.

Where the RCCP Green Box notifications could be challenged as WTO illegal is at the juncture of payments claimed as relief from officially declared natural disasters (8a) and income support payments to mitigate an income collapse resulting from policy decisions (e.g., removal of the ethanol tariff). WTO members are allowed to subsidize crop risk insurance premiums for producers "for relief from natural disasters" (8) and to make payments for "income safety nets" (7). But it would be difficult to verify, and hence to notify, to the WTO what part of RCCPs corresponded to natural disaster relief payment and what corresponded to an income loss that could result from a policy or neglect to administer a policy. An imprecise or incomplete notification could eventually lead to the formation of a dispute settlement panel and perhaps even a ruling against the RCCP program.

HOW MUCH ASSISTANCE WILL RCCPS PROVIDE FARMERS?

Let us assume that the U.S. has designed income insurance and disaster relief in a package that would be safe from a successful challenge at the WTO. Let us further assume that USDA's optimistic outlook to 2016 prevails and that persistently higher corn prices boost other row crop prices.[23] (USDA estimates corn prices paid by county elevators to remain above $3.30 a bushel from now until 2016.[24]) Under the RCCP formula and given the USDA's 2007-2016 outlook, to what extent are farmers likely to benefit from the RCCP program? To answer the question, we consider just one component of the RCCP calculation.

The major factor limiting the effectiveness of the RCCP for individual farmers is the national average yield per acre calculation by commodity. Private crops insurance plans reinsured by the USDA calculate yield on a county trend (historical) basis because both yield factors and disasters that diminish yield are assumed to be fairly localized.[25] If gale force winds destroy crops in a county, the resulting yield decrease, compared to the historical yield trend, is easy to measure. The resulting insurance payment for the covered acreage will take into account the costs of production for the covered crops in that county.

By contrast, the RCCP payment is calculated by a national yield per acre average. A county-wide (in some cases even state-wide) calamity would not make much difference to national yields and prices. Absent a catastrophe affecting a large part of the national acreage for a program crop, the resulting RCCP to farmers is unlikely to compensate for the lost value of the crop. The area damaged is too small to reduce the national yield average to the point where it is an important factor in the overall RCCP calculation.

Furthermore, because the worst and best yield average years from the 2002-2006 base period are thrown out of the RCCP calculation, an RCCP payment on the basis of the other three-year yield average may not compensate enough for loss incurred during a year of widespread calamity, say a climate change–induced drought. To mitigate this coverage shortcoming, the USDA proposal offers the possibility of compensation through a government crop insurance program. The "Crop Insurance Supplemental Deductible Coverage" proposal would be activated if " a county-wide loss is 10 percent or more."(Title X, 152)

One of the strong proponents of an RCCP program, the National Corn Growers Association (NCGA), has recognized the RCCP coverage shortcoming. In March, NCGA members ap-

proved a resolution calling for a county-based rather than national average-based RCCP program. They further proposed that the RCCP program apply to planted acres, rather than historical base acres, which would make it impossible to notify RCCPs as Green Box.[26] Similarly, the American Farmland Trust (AFT) wants revenue protection "compatible with global trading rules" against "unexpected losses in revenue based on actual market conditions, rather than pay farmers based on historical production."[27] The revenue protection AFT prefers would violate the historical production basis requirement for Green Box eligibility.

CONCLUSION

This analysis suggests the USDA design of the RCCP has some probability of being ruled consistent with the AoA Green Box and/or the Blue Box, if the proposed expansion of Blue Box criteria adopted by WTO members in July 2005 is included in the Doha Agenda ultimately adopted. WTO member acceptance of RCCP would presuppose that the USDA can verify the basis for payments and notify RCCP accurately, completely and on time.

But the RCCP formula and its use of national averages, if adopted by Congress as proposed by the USDA, is unlikely to protect income much beyond what is offered by crop risk insurance programs, except in years of widespread income or yield calamity. According to one analysis, "over 80% of insurable crop acreage was enrolled in the [crop insurance] program in 2005 and more than half of those acres were insured at coverage levels of 70% or higher."[28] To achieve this rate of program participation, the USDA provided government payments to entice farmers to pay the additional insurance premiums, thereby indirectly subsidizing the private crop insurance industry.

According to the Food and Agriculture Policy Research Institute, government net outlays for federal crop insurance, averaging about $3 billion a year since FY 2002, will increase to $4.6 billion by 2015. The summary of the revised NCGA proposal for RCCPs quotes a $5.5 billion anticipated outlay for federal crop insurance by 2012, a figure that is not in the USDA projections to 2016.[29] The NCGA wants to "integrate" further the RCCP with the crop insurance program. As the government share of premium subsidies, loss-sharing and benefit delivery costs increases, the WTO consistency of the USDA's crop insurance program, could be challenged.[30]

Though the RCCP formula offers opportunity for relief from a widely distributed natural disaster, the USDA outlook does not foresee the likelihood of large RCCP disbursements due to the relatively high prices anticipated for feed grains, especially corn, over the next ten years. If the formula is changed to the traditional county basis for calculating yield average, the RCCP program could provide greater benefits to producers, but at the political and fiscal cost of breaking overall Bush Administration and Congressional budget goals. Senator Tom Harkin, the chair of the U.S. Senate Agriculture Committee, has already indicated his opposition to USDA, EU and Brazilian proposals to put a ceiling on domestic support payments to specific crops, particularly corn,[31] so the potential for commodity program payments to exceed USDA outlook estimates remains strong.

Nothing in the USDA's 2007 Farm Bill proposal would prepare farmers to face the aforementioned scenario of a short-lived corn price spike, brought about by very tight supplies and a production failure, followed by a price collapse as global corn acreage expands to catch the tail end of the price spike. The National Farmers Union (NFU) is therefore calling for "countercyclical payments indexed to the cost of production to support family farmers during periods of low commodity prices."[32] The NFU has also proposed a "strategic renewable energy reserve" that would provide a critical margin of hold-over stock and reduce the likelihood of a price collapse, which would trigger RCCP, just as the 1996 Farm Bill set the stage for massive CCP outlays. The NFU wants a "permanent disaster program" that would be separate from and prevent accounting conflation with income safety net programs. The National Family Farm Coalition has called for a tiered approach to crop insurance with payments capped at $90,000 and supplemented by farmer-owned and other strategic grain reserves for food and energy security purposes.[33] Others have proposed strategic working lands crop acreage reserves for sustainably grown bioenergy feedstocks. [34]

These proposals jointly offer greater likelihood that farm incomes will be derived from cost of production plus prices, rather than from government payments to compensate for market or policy failures. The proposal for a permanent disaster relief fund would simplify the management and accounting that the RCCP formula complicates.

Furthermore, the complex RCCP formula seems calculated to offer little benefit to farmers, based on the USDA forecast of high prices and low program payouts. However, the RCCP is designed to ensure that if low prices were to resume, the U.S. would be allowed again, under WTO rules, to continue spending the billions of dollars it has needed to mitigate market and policy failures most years since the signing of the Uruguay Round.

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