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Does the Farm Bill Violate Our Trade Commitments?

Surely no farm bill has ever become so controversial so quickly. The Farm Security and Rural Investment Act (FSRIA) of 2002¹ has been called lavish, protectionist, backward-looking; it has been attacked, especially by foreign governments and industries, as a reversal of course that makes the United States a hypocrite in pressing for trade liberalization. Domestically, free-market conservatives and liberal environmentalists have found unwonted common ground in denouncing the new law.

At the same time, the new farm bill has its vigorous defenders. Farm groups, members of Congress and Bush Administration officials have pointed out that the United States remains substantially less subsidized than the European Union and other countries that criticize the new law.

The law's defenders remind their critics that the FSRIA may actually cost less than farm policies of the past few years, during which Congress mandated several rounds of ad hoc "Market Loss Assistance" payments. They have pointed out that a significant part of the new law's cost comes from higher spending on nutrition, resource conservation and other societal priorities, not from direct income subsidies to farmers. And not a few analysts have noted pointedly that what the critics mostly want – decoupled payments leading in due course to no

(Continued on page 2)

Elizabeth Haws

Crop Insurance Delivers Timely Financial Assistance

The continuing drought in much of the United States has created hardship for many farms, ranches and communities. It has contributed to an increase in prices for several commodities, particularly wheat, where hard red winter and hard red spring futures have traded well above \$4 for the first time in years. And the drought was a primary reason the Senate in September voted by 79-16 to provide disaster assistance to farmers and ranchers. Drought conditions, and the related demand for emergency aid, have prompted questions about how the federal crop insurance program is responding, after several years of good weather in which the program's actuarial performance was quite favorable.

As of October 7, 2002, the crop insurance program has responded to this year's crop losses by sending more than \$1.2 billion to producers for 2002 claims, according to a Risk Management Agency report. American Association of Crop Insurers (AACI) member companies are already disbursing crop insurance indemnity payments to farmers. On average, AACI member companies have seen a 70 percent increase in crop insurance claims this crop year – the industry loss ratio may be as high as 1.50, meaning that claims paid will exceed total premiums received by 50%. USDA estimates more than \$4 billion will be paid to farmers through crop insurance indemnities.

(Continued on page 6)

Green, from Page 1

farm programs at all – has been shown in recent years to be manifestly unsustainable and unrealistic in political terms.

We will not try to settle those arguments here. Instead, we want to focus on how the farm bill interacts with the binding international trade obligations of the United States. After all, most critics of the FSRIA have not only asserted that it is foolish domestic policy; they have also predicted that it will have dire consequences for U.S. trade policy. Embassies, economists and editorial boards have portrayed the bill as a way of perpetuating subsidies to wealthy American farmers at the direct expense of low-income producers in developing countries.

Some critics of the new farm bill have argued that it violates the spirit, rather than the letter, of the Uruguay Round Agreement on Agriculture (URAA). Again, this is not a question we will try to settle here.ⁱⁱ This article asks a more concrete question: Do provisions of the FSRIA appear to violate obligations of the United States under the URAA?

At the Border

The URAAⁱⁱⁱ imposes obligations in three areas: market access, export competition and domestic support. With respect to market access, the FSRIA does not increase tariffs or reduce quotas. It would be difficult to find a violation in this area.

Indeed, U.S. border protection remains low for most agricultural products. The average U.S. agricultural tariff is less than 12%, compared to 21% in the EU, 24% in Canada, 33% in Japan and as high as 152% in Norway.^{iv} The average for all industrial countries is 45%, and for all WTO members 62%.^v There are certainly U.S. commodities where border protection is much higher, such as sugar or peanuts – but the Bush Administration has proposed to subject these commodities and all others to substantial tariff cuts in a new multilateral trade agreement. And the farm bill does not raise tariffs or directly reduce quotas even for these products.

Export Subsidies

The FSRIA also seems innocent of any apparent violations of export subsidy commitments. The United States is no longer using the Export Enhancement Program, its primary trade weapon of the 1980s, and there is no reason to expect EEP to resume anytime soon. Again, of course, a comparison of export subsidies shows their main user to be the European Union, not the United States.

Some critics of U.S. policy have long argued that marketing loans, which maintain price protection for farmers while allowing market prices to fall as far as they will, constitute a type of export subsidy. But the argument has not gained much traction, and although marketing loans may have their disadvantages, it is difficult to view them as an export subsidy in the normal sense of that phrase.

On the Home Front

That leaves domestic support, where most attention has focused on whether the FSRIA might cause the United States to exceed maximum spending levels to which it agreed in the Uruguay Round.

Under the URAA, the United States and other countries agreed to reduce their “Total Aggregate Measure of Support” (AMS) through 2000, with that year’s level binding until a new agreement is reached. The U.S. commitments were as follows, in millions of dollars:^{vi}

1995	23,083.142
1996	22,287.173
1997	21,491.203
1998	20,695.234
1999	19,899.264
2000	19,103.294

The AMS measures trade-distorting domestic subsidies, generally calculated by comparing internal prices to world prices. Programs deemed not to distort trade are excluded from the AMS and placed in the so-called “green box,” in contrast to the AMS’s “amber box.”

Green, from Page 2

Policies can be amber and yet not count toward the Total AMS. A “product-specific” policy whose value is less than 5% of the value of the commodity to which it applies is *de minimis* and not counted. “Non-product-specific” policies are also *de minimis* and not counted if their *cumulative* value is less than 5% of the value of *all* agricultural production.^{vii}

We will consider three questions about potential violations of the AMS ceiling.

- Are Counter-Cyclical Payments (CCPs) appropriately considered to be non-product-specific subsidies?
- If CCPs were considered product-specific, would that cause the U.S. to be in violation of its AMS ceiling?
- Might the CCPs cause the overall quantity of non-product-specific subsidies to exceed the URAA’s 5% *de minimis* threshold and be counted toward the AMS ceiling?

Where Do CCPs Fit?

The new Counter-Cyclical Payments (CCPs) in the FSRFA are related to the prices of wheat, feed grains, cotton, rice, soybeans, peanuts and minor oilseeds. CCPs can be seen as taking the place of the Market Loss Assistance (MLA) payments in recent emergency bills. After a long internal debate, USDA decided that MLAs had to be included in calculating the U.S. Aggregate Measure of Support – i.e., they fell in the so-called “amber box.” The MLAs were unrelated to current production, but USDA decided they were implicitly related to current prices, since it was low prices that prompted Congress to legislate the payments. Therefore, under the terms of the URAA^{viii} they could not be placed in the green box.

However, USDA also decided that MLAs were “non-product-specific” payments, under URAA Article 6(4)(a)(ii). This was a crucial determination, because it meant that the MLAs’ value could be compared, not with the value of the commodity with which each was associated (wheat, corn, etc.), but with the total value of all

U.S. crop and livestock production. As long as the MLAs were less than 5% of that much larger number – which they were – they did not count in the calculation of the U.S. total AMS, but were considered *de minimis*.

A similar decision will need to be made about CCPs. It is clear that they do not fit in the “green box,” since they are explicitly tied to current price levels. But are they product-specific or non-product-specific?

USDA is expected to classify the payments as non-product-specific. Unlike the deficiency payments in prior farm bills, there is no requirement to plant, for example, wheat in order to receive the wheat CCP. Thus, CCPs are not associated with the production of a specific commodity.

The URAA provides little guidance about what “product-specific” and “non-product-specific” mean. But the classification of CCPs as non-product-specific is hardly cut and dried. These payments’ amount is determined solely by movements in the price of a specific commodity. The per-acre yields used to make the payments can be (at the recipient producer’s option) determined by 1998-2001 actual production of the same specific commodity. No producer will be entitled to receive a CCP for a particular commodity if he or she did not grow that commodity sometime during either 1991-95 or 1998-2001. And no doubt it could be shown that in the vast majority of cases, producers who receive the CCP for, say, corn do in fact actually grow corn, even though they are not required to do so.

If the only criterion for product specificity is whether a payment is conditioned on, and made in proportion to, current production, then CCPs are non-product-specific. But a different interpretation seems at least plausible.

So What?

If CCPs *were* deemed product-specific, they would generally exceed 5% of the value of production for the relevant crop, at least in years of low prices. In that case, they would count toward the U.S. AMS.

Green, from Page 3

CBO estimates CCPs in FY 2003 at \$4.573 billion^{ix}, and assumes similar payments in succeeding years. Counting this amount toward the AMS would significantly increase the chances that the U.S. could violate its WTO commitments.

Generally, the AMS^x comprises about \$4.5 billion for dairy price supports, onto which must be added under the new farm bill about \$250 million in dairy payments. The value of the sugar program is about \$1 billion. The peanut program will no longer be a pure price support, but about \$150 million in new loan deficiency payments for peanut producers will count toward the AMS. Then there are the existing marketing loan gains and loan deficiency payments (MLGs/LDPs) for other commodities, which are forecast by CBO for 2003 at approximately \$7.8 billion, once the provisions of the FSRIA are added to baseline assumptions.^{xi}

Although there remain a few items we have not counted, toting up the major items brings us to about \$13.7 billion, still far below the U.S. AMS ceiling of \$19.1 billion. The United States has, by this reckoning, perhaps \$5 billion in what USDA sometimes calls “unused AMS.”

If CBO is right about the eventual amount of CCPs and MLGs/LDPs, then even if CCPs were counted toward the Total AMS, there is probably no WTO violation -- \$4.6 billion in CCPs is less than \$5 billion or so in “unused AMS”.

On the other hand, suppose prices had turned out lower than expected. Admittedly, at the moment the reverse is more likely – the price projections used in CBO’s estimates earlier in the year are now too low, so counter-cyclical spending will be less than projected. However, experience teaches that sometime during the lifetime of this farm bill, prices may be significantly lower than CBO projects today. What if that had happened this year?

Suppose corn prices had been 10 cents lower than CBO thought in March, wheat prices

15 cents lower and soybean prices 20 cents lower. Using USDA’s mid-summer estimates of 2002 crops^{xii} as proxies for the amount of production affected, and assuming that almost every unit of production gets a MLG/LDP one way or another, the government would face unexpected amber-box spending on MLGs/LDPs of \$965 million for corn, \$273 million for wheat and \$574 million for soybeans. The \$7.8 billion in MLGs/LDPs would become about \$9.6 billion. Then the total AMS would be at least \$15.5 billion *without* counting CCPs, and if they were counted, the United States would violate its \$19.1 billion ceiling by nearly a billion dollars.

This example is illustrative rather than predictive. It does point out, though, that a counter-cyclical program – despite numerous advantages – makes it more difficult to have confidence that our nation will comply with the obligations it undertook in the URAA.

The *De Minimis* Category

It is also conceivable, though unlikely, that larger-than-expected spending for CCPs and other policies might cause the United States to exceed the *de minimis* level for non-product-specific supports. This category regularly includes about \$450 million for irrigation, livestock grazing subsidies and state credit programs. It also includes a measure of crop insurance subsidies, which have varied widely in formal U.S. notifications to the WTO, from \$120 million in 1997 to \$906 million in 1995.^{xiii} Crop insurance legislation in 2000 increased the amount of premium subsidies, potentially increasing the amount to be notified to the WTO, though this also depends on indemnities paid out, where the actuarial experience of recent years has been favorable. It is hard to know what to assume about this number, but for purposes of this illustration, we will suppose that the string of good years may have come to an end and that the U.S. notification is close to \$1 billion.

Even so, we are only at about \$1.5 billion, and the 5% *de minimis* threshold is around \$10 billion. With CCPs estimated at \$4.6 billion, but in reality probably less than

Green, from Page 4

that, the possibility of breaching the threshold seems remote. If that level were exceeded, though, the value of non-product-specific support would count toward the Total AMS, which it presently does not.

The only real threat that non-product-specific *de minimis* support might exceed the threshold – and it seems a small one – might arise if the new direct payments' status as green were called into question.

At first glance, these payments appear perfectly compliant with the URAA strictures. Clearly, they are unrelated to current prices. They also seem to fulfill the requirement that they “not be related to, or based on, the type or volume of production ... undertaken by the producer in any year after the base period.”^{xiv}

If “the base period” means the various periods used to establish producers' payment entitlements for the direct payments which commence in 2002, the FSRIA is compliant to the same degree the FAIR Act was compliant. Producers' planting flexibility means that their payments are not reduced because they grew, or did not grow, a particular crop. (Of course, this flexibility is not complete, since most fruit and vegetable production is disallowed, but that stricture is simply carried forward from the FAIR Act and went unchallenged there.)

On the other hand, it is possible to argue that the direct payments are, in fact, simply the FAIR Act payments by a different name. They are comparable in size, made in the same manner to basically the same group of people and predicated on the same set of qualifications (e. g., conservation compliance, not planting fruits and vegetables). If the program is really the same as the one enacted in 1996, simply extended with minor modifications, perhaps the “base period” for purposes of ascertaining URAA compliance should actually be the same as the base period for the FAIR Act payments, i. e., the set of acreage bases calculated for 1996.

But under the FSRIA, producers are allowed to update their payment bases for the

various commodities by virtue of what they actually produced in 1998-2001. This option is clearly written into the new law. If 1996 were considered still to be the “base period,” then the ability to update payment bases now, though a one-time option, would violate the requirement that payments “not be related to ... production ... in any year after the base period.” The payments would, in fact, be related to production in 1998-2001.

We do not assert that this argument is especially persuasive. However, if foreign governments are as upset as they claim to be over the new farm bill, it is no longer inconceivable that the U.S. could face a challenge from these countries on such an issue. Indeed, perhaps the fruit-and-vegetable restrictions are not completely safe either.

Failing such a (perhaps dubious) challenge, the United States seems unlikely to be out of compliance with its Total AMS requirements unless market prices fall substantially below expected levels. But of course, that has happened before.

Conclusion

Most analyses of the FSRIA have found a low-level probability that it will put the United States in violation of its trade commitments. That is a reasonable conclusion – but is also implies that on balance, the U.S. is more likely *not* to run afoul of these commitments.

No provision of the FSRIA appears to be in blatant violation of the URAA. The interaction of some provisions *could* cause the United States to violate its Total AMS ceiling under some circumstances. Those circumstances would include low prices for most major crops over a sustained period.

Even in that case, though, the likelihood of a violation seems remote if the United States government can successfully classify Counter-Cyclical Payments (CCPs) as non-product-specific payments. Even if the CCPs should be considered product-specific, there would still be a good chance that the resulting tabula-

Green, from Page 1

tions would find the U.S. to be compliant with the rules.

We have tried to answer a relatively narrow question – Does the farm bill violate the URAA? – rather than the broader one of whether the farm bill makes U.S. trade negotiators' task more difficult. In some ways, it undoubtedly has already done so. But that does not prove the farm bill was a mistake. And a clear-eyed look at both the farm bill and the URAA should at least make us take some of the wilder and more emotional criticisms of the new law with a grain of salt. The bill is imperfect, but it is hardly the protectionist behemoth of rapidly-emerging myth.

NOTES:

ⁱ P.L. 107-171, May 13, 2002, 116 Stat. 134 et seq.

ⁱⁱ We have, however, tried to address this and other questions in a paper presented to a symposium of the American Agricultural Economics Association. See Randy Green, "The New Farm Bill and Trade Policy: Bargaining Chip or Time Bomb?", July 29, 2002, available upon request from rgreen@mwmlaw.com.

ⁱⁱⁱ The various agreements reached in the Uruguay Round of multilateral trade negotiations are published in 103d Congress, 2d Session, House Report 103-316, Vol. 1, "Uruguay Round Trade Agreements, Texts of Agreements, Implementing Bill, Statement of Administrative Action, and Required Supporting Statements," U. S. Government Printing Office, Washington: 1994. The Agreement on Agriculture (URAA) appears beginning at p. 1355. References in subsequent footnotes are to Articles of the URAA.

^{iv} Mary E. Burfisher, Ed., "The Road Ahead: Agricultural Policy Reform in the WTO – Summary Report," USDA/ERS, Agricultural Economic Report No 797, January 2001, p. 10.

^v House Committee on Agriculture, "The Facts on U.S. Farm Policy," Summer 2002.

^{vi} Personal correspondence with Economic Research Service, June 2002.

^{vii} URAA, Article 6(4)(a).

^{viii} URAA, Annex 2(6)(c).

^{ix} Congressional Budget Office, "H.R. 2646: Farm Security and Rural Investment Act of 2002 – CBO Estimate of Budget Authority," attached to letter from Dan L. Crippen, Director, to Honorable Tom Harkin, May 6, 2002. A current-conditions estimate of the

bill's impact shows CCP outlays to be substantially less.

^x World Trade Organization, Committee on Agriculture, "Notification: Domestic Support: United States," various years (G/AG/N/USA/10, 12 June 1997; G/AG/N/USA/17, 15 June 1998; G/AG/N/USA/27, 28 June 1999; G/AG/N/USA/36, 26 June 2001.)

^{xi} CBO, *op. cit.*

^{xii} USDA/WAOB, *World Agricultural Supply and Demand Estimates*, June 2002.

^{xiii} World Trade Organization, *op. cit.*

^{xiv} URAA, Annex 2(6)(b).

^{xv} Cf. Food and Agricultural Policy Research Institute, "Farm Security and Rural Improvement Act of 2002: Preliminary FAPRI Analysis," FAPRI-UMC Report #05-02 (May 6, 2002).

Haws, from Page 1

Nationally from 1998 to 2001, the crop insurance program distributed almost \$9.6 billion in indemnity payments. The national average Farmer Benefit/Cost Ratio for 2001 was 2.27. That means on average, producers received \$2.27 in benefits for each dollar of premium paid.

Rapid Response by AACI Members to Settle 2002 Crop Losses

On average, AACI member companies are mailing the indemnity payment to the producer in 14 days or less from the time the farmer submits the claim. Presently, AACI member companies on average are paying \$3-5 million per day for 2002 crop loss claims. These payments will likely escalate to \$8-10 million per day when harvest peaks in a few weeks. Within the AACI companies, an average of more than 300 loss adjusters per company are working producers' claims daily. To prevent delay in processing claims this fall, AACI member companies are developing strategies to deal with the increased demand for the loss adjusters when harvest gets fully underway.

Crop Insurance – Important Risk Management Tool

Crop insurance provides farmers with a flexible risk management tool. For many crops, farmers have the ability to insure up to 85 percent of their historical production. Producers and their lenders and suppliers recognize that crop insurance is an important component of each farm's overall risk management program.

Crop insurance allows producers to lock in a level of income that can provide the necessary cash flow to obtain an operating loan and forward market their crops to take advantage of higher market prices. Producers cannot reliably manage risk with ad hoc disaster assistance because they do not know if or when in any given year they will receive payment for their losses. As important as many producers would say disaster aid is, it cannot provide a farmer

Haws, from Page 6

with the confidence to sell forward and lock in a better price, nor can the possibility of future Congressional action be used to obtain an operating loan.

The federal crop insurance program allows producers to choose a level of insurance that matches their particular tolerance for risk. Some producers can tolerate an exposure of 50 percent, while others who may be more leveraged might require 75 percent coverage.

The Agricultural Risk Protection Act of 2000 (ARPA) increased the federal premium subsidy to farmers for all levels of coverage on all insurance products. The premium subsidy permits producers to obtain higher levels of coverage at more affordable prices. The crop insurance program provides a financial safety net for farmers while operating within the parameters of the federal budget. ARPA provides the following premium subsidy for the stated coverage levels:

Coverage Levels %	50	55	60	65	70	75	80	85
Premium Subsidy %	67	64	64	59	59	55	48	38

The 50 percent coverage level means coverage at 50 percent of the producer's normal yield and 100 percent of the established price. This coverage should not be confused with Catastrophic (CAT) coverage, which is a multi-peril program that provides 50 percent yield coverage at 50 percent of the price. Farmers may purchase this bare-bones level of coverage for \$100 per policy.

Today, because ARPA made the higher levels of coverage more affordable, most producers purchase coverage at the 70 percent level. This means that the farmer carries the equivalent of a 30 percent deductible, which in some instances can be significant. Crop insurance provides a stable financial safety net that in many cases more than covers the farmers operating costs for the crop.

Regardless of the amount of indemnity payments made to farmers through the crop insurance program, if there is a significant crop loss during an election year there will be a political push to send additional money back to the Congressional districts. Unfortunately, as the Congressional Budget tightens, many may begin to think that the short term benefits of ad hoc disaster assistance is better than an established insurance product program that allow producers a dependable level of income if they suffer crop losses.

To understand the rationale behind the "deductible," one must understand that crop insurance is much different from homeowners insurance or other types of property-casualty insurance. When a person purchases insurance coverage for a home, the exact size and value of the property is known. Crop insurance cannot cover 100 percent of historical production, because many factors that are not weather-related affect crop production, such as farming practices. If the crop was insured at 100 percent of its value, the insurance program could create a moral hazard – an incentive to farm not for the market but rather for the insurance payment.

ARPA Increased Participation and Coverage Levels

Enrollment in the crop insurance program rose from 182 million acres in 1998 to almost 212 million acres in 2001, a 17 percent increase. This level of voluntary participation in the program is approximately equal to the 85 percent of eligible acreage that was insured in 1995, when enrollment was mandatory. Additionally, in 2001, 81 percent of the eligible acres were insured with buy-up coverage. Buy-up coverage is any level of insurance greater than that provided by CAT, i.e., 50 percent coverage on both yield and price.

In 1998, fewer than 10 percent of acres in the four major crops (corn, cotton, soybeans and wheat) were insured at levels over 65 percent. In 2001, more than 50 percent of these crops were insured above the 65 percent level.

Haws, from Page 7

ARPA also encouraged the development of a variety of crop insurance plans. Now crop insurance is available for more than 60 crops. The crop insurance program also expanded the number of revenue insurance products available to address farmers' financial needs: Crop Revenue Coverage (CRC), Income Protection Coverage (IP), Revenue Assurance (RA), and Adjusted Gross Revenue (AGR) to provide yield loss and price protection. The revenue products provide additional protection with a "harvest price election" which will raise the guaranteed price if the harvest price is higher than the base price established earlier in the season. Therefore, the price guarantee reflects current market conditions for the commodity. In 2001 revenue insurance products covered 35,170,813 acres of corn, 2,114,020 acres of cotton, 21,658,010 acres of soybeans and 28,689,878 acres of wheat.

Other crop insurance plans include the Group Risk Plan (GRP) and Group Risk Income Protection Plans (GRIP) that provide protection based on yield or revenue fluctuations on a countywide basis.

New insurance products are being developed to address a wider variety of producers' needs, such as pasture and rangeland risk management, fresh vegetable insurance and cost of production insurance for other commodities.

The crop insurance program has gone through two major legislative reforms: the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994 and ARPA in 2000. The 1994 legislation did increase participation, but the bulk of the growth was at the 50 percent coverage level. By contrast, ARPA appears to be encouraging farmers to insure at higher levels of coverage, offering them more financial stability and a more complete risk management package.

Conclusion

ARPA is providing a sound financial risk management tool for farmers, which allows them to lock in guaranteed level of income each year. Without the passage of ARPA, many farmers would be in a more tenuous financial situation this year because they would either not have crop insurance or have coverage at much lower levels.

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