

# The 2002 US Farm Bill's Implications for Commodity Markets and Canada's Agri-food Sector

## SPECIAL REPORT



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### Executive Summary

This report's intent is to analyze the 2002 US "Farm Bill" to determine whether it is production and trade distorting, and how it will affect commodity markets as well as how it will affect Canadian agri-food. The objectives are to:

- To explain the producer subsidy programs and how payments under these programs will be calculated;
- To explain other provisions in the Farm Bill that are of interest to the Canadian agriculture and agri-food industry;
- To discuss the implications of the producer subsidy programs for US producers' decisions to grow the major commodities and pulses, and the likely implications of those decisions for market prices;
- To discuss the implications of other Farm Bill provisions, including trade and conservation programs, and country of origin labeling;
- To discuss the implications of the Farm Bill for the current round of WTO negotiations; and
- To provide some initial thoughts on how governments and firms in Canada and other countries might respond to the Farm Bill.

To accomplish the objectives, we provide a thorough description of the Act and its provisions. We apply it to a fictitious 1000 acre farm in the US Midwest to show its financial consequences. We also use production costs from certain regions of the US to determine the level of incentive built into the Act. The conclusions of the analysis are:

#### ***Implications of Programs for US Producer Decisions***

The direct and counter-cyclical payment components of the Act will not likely affect the production decisions of US grain farmers because they are triggered by historical acreage and production. However, the marketing loan rate component very clearly does. Our conclusions are:

- Based on USDA (or state in the case of pulses) budgets, the loan rates guarantee quite positive margins (above variable costs) per acre for all program crops except one of the pulses – using yields from 2000. They also provide an incentive to increase yields – the higher the yield, the higher the subsidy.
- Using USDA data, it would appear that the government will guarantee the highest returns to soybean production in most regions, and a combination of soy-corn or soy-cotton in all regions. The program will provide a very clear incentive for US farmers to increase their production of these two crops. The assertions to the

contrary by the US President, the Secretary of Agriculture, and the US Special Trade Representative appear to be without merit.

- While the program also provides incentives for US farmers to increase production of wheat and pulses, the incentives are lower than for soybeans and corn.
- Because of the foregoing, expect prices in the oilseed and feedgrain complex to be under pressure for the next six years, while the wheat industry will be more reflective of market conditions.
- In addition, for reasons explained in the text, we believe that the program will cause US feedgrain prices to be relatively low in the summer and early fall of the year, thereby giving an feed cost advantage to the US livestock industry.

### ***Impacts of Trade, Conservation, and Country of Origin Labeling Provisions***

The conclusions about these three elements are:

- While there is a huge amount of money in the Act for investment in conservation and environment, it does not appear to have major implications for markets or for Canadian competition.
- The trade component is much more ominous for Canada:
  - The US expanded its assistance for international market development. Hence there will be more subsidized trade promotion programs against which Canadians need to compete.
  - The US reaffirmed its intention to use food aid in poor countries. Since this program is little more than thinly veiled, institutionalized dumping that few less developed countries want, it has negative consequences for producers in those countries whose production incentives will be hurt. Moreover, it will depress prices, thereby keeping out products from Canada and other competing countries.
  - After years of reducing their export subsidies, the US elected to maintain them at the same level as in the past year. This segment defines a set of “unfair trade practices” that will be unilaterally declared by the US. This includes some practices of the Canadian Wheat Board. Implicitly, by defining these unfair trade practices, the US is declaring its intent to use export subsidies in third party markets to compete with Canada and other countries. One can easily imagine the US using export subsidies in target markets where the US perceives that the CWB is engaging in unfair trade practices, or to third party countries where the US believes it is being hurt because of European regulations about genetically engineered products. In these cases, Canada can be hurt either directly or indirectly through “sideswiping”.
- Country of Origin Labeling could have significant impacts for the Canadian beef and pork industries, from producers through to packers. Arguably, Canada has been presented with an opportunity to differentiate its product in the US market and potentially charge a premium. However, there is a significant risk that this will not happen and the US industry will take all necessary steps to reduce costs imposed by COOL. The latter alternative will be detrimental to Canada.

### ***Implications of the Act for the WTO***

The provisions of the 2002 US Act appear to fly in the face of everything the WTO is attempting to do – it imposes new trade barriers that are not justified on the basis of science; it increases domestic support to farmers with an instrument that distorts production and trade; it maintains export subsidies and targets them in an aggressive manner, and it maintains institutionalized

dumping in the form of food aid. In a round of WTO negotiations that held hopes of being the “development” round, this is a four barreled economic assault on developing and competing countries alike. One of only two alternatives can be concluded:

- The US has no intention of making trade in agricultural products more free, and plans to return to a position of isolated aggressiveness or
- The US believes that the only way to make progress toward freer world trade is to pressure and coerce the rest of the world into it.

Neither of these alternatives is attractive.

The report ends by briefly identifying a number of strategic responses that Canada could adopt and their pros and cons.

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# The 2002 US Farm Bill's Implications for Commodity Markets and Canada's Agri-food Sector

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### 1.0 Introduction

After two years of political debate, the President of the United States signed the Farm Security and Rural Investment Act (FSRI or "Farm Bill") of 2002 on May 13<sup>th</sup>, 2002. The cost of this Farm Bill is estimated by some to be US\$297 billion over 10 years, and will govern US Federal farm programs for the next 6 years.

When the President signed it, he asserted that the Act's provisions do not provide production incentives for US farmers and are, therefore, not production or trade distorting. The timing of the Act is made more interesting given that 2002 is the year in which major progress is supposed to be made in the agriculture part of the WTO negotiations. The Act brought an immediate firestorm of criticism from governments and farm groups around the world. As a result, the US Secretary of Agriculture and the US Special Trade Representative called a press conference and reasserted that it is not production or trade distorting. In fact, their spin was that the criticisms were simply everyone else's way of covering up for their own sins in agricultural subsidies and protectionism.

Who is right, the US defenders or the international critics? This report's purpose is to test the assertions that the Act is not production or trade distorting. The questions it deals with are:

- What are the major components of the 2002 Act and how will its provisions be operated?
- Are there direct or indirect production incentives for US farmers?
- What are the likely impacts of any incentives on commodity markets and on the Canadian agri-food sector, and on the WTO?

### 1.1 Objectives and Methods

The objectives of this report follow mainly from the questions above:

- To explain the producer subsidy programs and how payments under these programs will be calculated;
- To explain other provisions in the Farm Bill that are of interest to the Canadian agriculture and agri-food industry;
- To discuss the implications of the producer subsidy programs for US producers' decisions to grow the major commodities and pulses, and the likely implications of those decisions for market prices;
- To discuss the implications of other Farm Bill provisions, including trade and conservation programs, and country of origin labeling;
- To discuss the implications of the Farm Bill for the current round of WTO negotiations; and

- To provide some initial thoughts on how governments and firms in Canada and other countries might respond to the Farm Bill.

Our methods in undertaking this analysis are straight forward. Much of the paper is descriptive because it involves reading the Act and understanding its provisions. The commodity component is the part that has the possibility of providing direct production incentives to US grain farmers. To analyze the direct incentive component, it is necessary to compare the subsidy level under the Act to US producer costs. This is done using USDA budgets for various crops and regions of the US.

The remainder of the analysis is done by synthesizing the information in this study and integrating it with information from previous research to arrive at inferences and conclusions.

Section 2.0 of this report focuses on the provisions of the Act. In section 3.0 we present an analysis and its likely economic consequences. Section 3.0 and 4.0 contain a discussion of the consequences of the Act for production, market prices, and US competitors. Section 5.0 addresses the possible implications of the Act on the WTO process. Section 6.0 is a first attempt to identify potential Canadian responses to the Act.

## **2.0 Explanation of Relevant Farm Bill Provisions**

The 2002 Farm Bill is comprised of ten 'Titles', or components. Four of them have the potential to affect international markets: Commodity Programs, Conservation, Agricultural Trade and Aid, and Miscellaneous Provisions<sup>1</sup>. In this section we will describe the mechanics of the programs contained in the components that have the potential to affect Canadian producers.

### **2.1 Commodity Programs**

This is the core of the 2002 Farm Bill, and was cause for most of the debate in Congress concerning this legislation. Essentially this component is a price and income support program that has elements of previous Acts since the 1930s. Previous Acts covered primarily major field crops. Over time, different versions of commodity loan programs have been designed to provide different benefits to producers, and have addressed different policy goals. The policy goals and program benefits have included price support, income support, price stability, and short term liquidity.

There are three distinctive parts to the Commodity Programs component:

- Marketing Assistance Loans and Loan Deficiency Payments (LDPs)
- Counter-cyclical payments
- Direct payments.

Table 2.1 contains the national marketing loan rates, direct payment rates and target prices under both the new legislation and the previous Farm Bill legislation. Loan rates have increased for all the major grains, are constant for upland cotton and have decreased for soybeans. Small chickpeas, lentils and dry peas are also now eligible for this program for the first time. Direct payment rates have increased for all crops except oats, which is constant. Target prices have decreased for all commodities; soybeans and minor oilseeds have been added to this program and to the direct payment program.

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<sup>1</sup> The remaining components are Nutrition Programs, Farm Credit, Rural Development, Research, Forestry, and Energy.

**Table 2.1: Loan Rates, Direct Payment Rates and Target Prices (US\$/Unit)**

Crop	\$/Unit	Loan Rates			Direct Rates		Target Prices		
		Current	2002 Farm Bill		2002 AMTA	2002 Farm Bill	1995	2002 Farm Bill	
			(2002-2003)	(2004-2007)				(2002-2003)	(2004-2007)
Wheat	Bu.	2.58	2.80	2.75	0.46	0.52	4.00	3.86	3.92
Corn	Bu.	1.89	1.98	1.95	0.26	0.28	2.75	2.60	2.63
Sorghum	Bu.	1.71	1.98	1.95	0.31	0.35	2.61	2.54	2.57
Barley	Bu.	1.65	1.88	1.85	0.19	0.24	2.36	2.21	2.24
Oats	Bu.	1.21	1.35	1.33	0.02	0.02	1.45	1.40	1.44
Up.Cotton	Lb.	0.52	0.52	0.52	0.06	0.07	0.73	0.72	0.72
Rice	Cwt.	6.50	6.50	6.50	2.05	2.35	10.71	10.50	10.50
Soybeans	Bu.	5.26	5.00	5.00	-	0.44	-	5.80	5.80
Minor Oilseeds	Lb.	0.09	0.10	0.09	-	0.01	-	0.10	0.10
Small Chickpeas	\$/cwt.	-	7.56	7.43	-	-	-	-	-
Lentils	\$/cwt.	-	11.94	11.72	-	-	-	-	-
Dry Peas	\$/cwt.	-	6.33	6.22	-	-	-	-	-

In addition to describing the mechanics of these programs, a hypothetical farm in Iowa with 1000 cropped acres will be used to better illustrate how the programs work.

### 2.1.2 Marketing Assistance Loans and LDPs

Essentially, this program limits downside price risk by creating a price floor, while still allowing farmers to capture any potential market gains. The crops that are covered under this program are wheat, corn, soybeans, sorghum, barley, oats, rice, upland and ELS cotton, minor oilseeds (including canola, sunflowers and flax), wool, mohair, honey, dry peas, lentils and small chickpeas.

Producers of these crops receive a loan from the government at a commodity-specific loan rate per unit of production (see Table 2.1) by pledging production as loan collateral. Farmers may obtain a loan for all or part of their new commodity production after harvest. Loans can be repaid any time prior to maturity, which is nine months following the month in which the loan is made, except for cotton which matures after 10 months. These loans may be repaid in one of the following three ways:

1. At the original loan rate plus interest costs
2. By forfeiting the pledged crop to the government at loan maturity
3. At market price, if it is lower than the loan rate.

When market prices are below the original loan rate, producers are allowed to repay the loan at market price. These market price repayment rates are based on local posted county prices (PCPs) for wheat, feed grains, and oilseeds. PCPs reflect price changes in major terminal grain markets, and are corrected for the cost of transportation from the country to the terminal. Market price repayment rates for rice and upland cotton are based on the prevailing world market price<sup>2</sup>.

If the loan is repaid when the market price is lower than the loan rate, the difference between the original loan rate and the market price, called a marketing loan gain, represents a direct monetary benefit to producers. In addition, any accrued interest on the loan is waived.

<sup>2</sup> PCPs are calculated by the government every day except for minor oilseeds, which are calculated weekly. Prevailing world market prices for rice and upland cotton are also calculated on a weekly basis.



Producers who do take out loans can lock in a repayment rate for 60 days. This can only be done once over the period of the loan, and after 60 days the producer must take the market price. This option allows producers to lock in a favourable repayment rate if market prices are rising or the producer believes they will.

Alternatively, when market prices are lower than loan rates, farmers may choose to receive these marketing loan benefits through direct loan deficiency payments (LDPs). The LDP option is much simpler to administer, and allows the producer to receive the benefits of the marketing loan program without having to take out a loan and then repay it. The LDP rate is the amount by which the original loan rate exceeds market price, and is equivalent to the marketing loan gain.

Producers may also use 'generic certificates', which give producers the right to redeem commodities under loan. Certificates are purchased with cash at market price, and then used to repay a marketing loan. Marketing loan gains realized when certificates are used do not count toward the \$75,000 payment limit for this part of the program.

#### Example Farm Assumptions:

- The farm produces 500 acres each of corn and soybeans
- Farmer's soybean yield is 44 bu/acre
- Farmer's corn yield is 148 bu/acre
- Market price at loan maturity is \$1.90/bu for corn and \$4.90/bu for soybeans.

If the producer chooses the LDP option, the payment this farm would receive is as follows:

$$\text{LDP corn payment} = (\$1.98/\text{bu} - \$1.90/\text{bu}) \times 500 \text{ acres} \times 148\text{bu}/\text{acre} = \$5,920$$

$$\text{LDP soybean payment} = (\$5.00/\text{bu} - \$4.90/\text{bu}) \times 500 \text{ acres} \times 44\text{bu}/\text{acre} = \$2,200$$

$$\text{➤ Total LDP payment to farm: } \$8,040$$

The payment limit on these programs is \$75,000 per person, per crop year. Under the "three-entity rule" an individual can receive a full payment directly and up to a half payment from each of two additional entities. Producers with adjusted gross income over \$2.5 million, averaged over 3 years, are not eligible for payments, unless more than 75% of adjusted gross income comes from agriculture.

The loan rate program is clearly tied to *current* production, and since the loan rates are posted prior to seeding, producers have the opportunity to estimate the relative benefits (payments) per acre and make production decisions accordingly.

### **2.1.2 Counter-Cyclical Payments**

Counter-cyclical income support is a new program. It is intended to replace most ad hoc "emergency" market loss assistance payments paid to US farmers during 1998-2001 by providing an ongoing income "safety net". Payments are based on *historical* production and are not tied to current production. Crops eligible for counter-cyclical payments (CCPs) include wheat, corn, soybeans, sorghum, barley, oats, upland cotton, rice, other oilseeds and peanuts. Therefore, not all crops covered under the marketing loan program are eligible for counter-cyclical payments.

Farmers are given almost complete flexibility in deciding which crops to plant in the current year, ie they can grow any crop they want on the land, but this portion of the payment is made to what

was historically grown on the base acres. The only restriction is land that receives CCPs must be kept in agricultural uses.

CCPs are available for covered commodities whenever the effective price plus the direct payment is less than the target price (see Table 2.1 for target price levels). The effective price for a commodity is defined as the higher of the market price or the loan rate.

There are three components to the counter-cyclical payment: payment rate, payment acres, and payment yield. The amount that a producer receives is equal to the product of these three components.

The payment rate for a commodity is:

$$\text{Target price} - \text{Direct payment rate} - \text{Effective price}$$

To receive payments, a producer enters into an annual agreement. At enrollment, producers must select between two options for designating the number of base acres the payment will be based on. These options are:

1. Choose base acres equal to contract acreage for the commodity that would otherwise have been used for 2002 payments plus average oilseed plantings in 1998 to 2001, as long as base acres do not exceed available cropland.
2. Update base acres to reflect the 4-year average of acres planted, plus those acres that were not able to be planted due to weather conditions, over the 1998 to 2001 crop years.

Payment acres are equal to 85 percent of base acres for all covered crops.

Farmers have three options to determine payment yields for each individual crop:

1. Continue to use the yields that are the basis for current payment programs
2. Add to current program yields 70 percent of the difference between current program yields and the farm's average yields for the period 1998 to 2001;
3. 93.5 percent of 1998 to 2001 average yields.

CCP payments on our example farm would be as follows:

Assumptions:

- Base acreage is 500 acres each of corn and soybeans
- The 1998-01 corn average yield is 146 bu/acre
- The 1998-01 soybean average yield is 45 bu/acre
- Market prices of \$1.90/bu for corn and \$4.90/bu for soybeans

Corn:

$$\text{Payment rate} = \$2.60/\text{bu} - \$0.28/\text{bu} - \$1.98^3 = \$0.34/\text{bu}$$

$$\text{Total payment} = \$0.34/\text{bu} * (85\% * 500 \text{ acres}) * (93.5\% * 146 \text{ bu/acre}) = \$19,725.60$$

Soybeans:

$$\text{Payment rate} = \$5.80/\text{bu} - \$0.44/\text{bu} - \$5.00/\text{bu} = \$0.36/\text{bu}$$

$$\text{Total payment} = \$0.36/\text{bu} * (85\% * 500 \text{ acres}) * (93.5\% * 45 \text{ bu/acre}) = \$6,437.40$$

➤ Total counter-cyclical payment to farm: \$26,163

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<sup>3</sup> The loan rate is used here since it is higher than the market price.

Payments under this program will be made in installments. Up to 35% of the total payment is to be made in October of the year when the crop is harvested. Producers will receive a second payment of up to 70% minus the first payment after February 1, and the final payment will be received as soon as practicable after the end of the crop year.

The payment limit for this program is \$65,000 per person, per crop year. All other payment limits and restrictions that apply to the marketing loan program also apply to this program.

CCPs support and stabilize farm income when commodity prices are less than target prices. Since the payments are linked to past production, this may impact producers' current planting decisions in an expectation that current production will eventually become their historical production, and therefore the basis for future payments. However, it is not likely that this type of decision-making will have a significant impact on planting decisions, largely because base acres are now fixed for the next 6 years.

### **2.1.3 Direct Payments**

Fixed annual direct payments (DPs) replace production flexibility contract (PFC) payments (sometimes referred to as AMTA payments). This program is similar to counter-cyclical payments as it covers the same crops, is based on historical production and producers enroll on an annual basis. The amount of the payment is again equal to the product of the payment rate of the applicable base crop, the payment acres and the payment yield for the farm.

The options for designating base acres and calculating payment acres are the same as for the counter-cyclical payment. Payment yields are unchanged for those crops previously covered under the PFC program, which used the farm's average yield for period 1981-85. For soybeans and other oilseeds, which were not part of the PFC program, payment yields are the farm's average yields for 1998 to 2001, multiplied by the national average yield for 1981-85, divided by national average yield for 1998-2001. Peanut payment yields are based on the farm's average yields for 1998 to 2001.

The direct payment to our example farm is based on the same acreage and yield assumptions as for the counter-cyclical payment and the following additional assumptions:

- Farm's 1981-85 average corn yield is 114 bu/acre
- National average soybean yield for 1981-85 is 30 bu/acre
- National average soybean yield for 1998-2001 is 38.18 bu/acre

Corn:

$$\text{Total Payment} = \$0.28/\text{bu} * 114 \text{ bu/acre} * (85\% * 500 \text{ acres}) = \$13,566$$

Soybean:

$$\text{Payment yield} = (45 \text{ bu/acre} * 30 \text{ bu/acre}) / 38.18 \text{ bu acre} = 35.35 \text{ bu/acre}$$

$$\text{Total Payment} = \$0.44/\text{bu} * 35.35 \text{ bu/acre} * (85\% * 500 \text{ acres}) = \$6,610.45$$

- Total direct payments to farm: \$20,176.45

Direct payments for the 2002 crop are to be made as soon as practicable after enactment of the Farm Act. For crop years 2003-07, payments are to be made after October 1 of the year the crop is harvested. Advance payments of up to 50 percent can be made beginning December 1 of the calendar year before the year when the covered commodity is harvested.

The payment limit on direct payments is \$40,000 per person, per crop year, and all other payment limits and restrictions previously mentioned also apply here.

Fixed direct payments are not tied to production of specific crops, the amount of production, or the price of the crop. With planting flexibility farmers are not confined to producing crops for which they are receiving fixed decoupled payments. They could receive a payment for corn, but in any given year, for example, plant soybeans on the acres in which they are receiving corn payments. Thus, farmers planting decisions are based on expected market prices and variable costs of production.

The economic impacts for DPs are similar to those for production flexibility contract payments under the 1996 Farm Act. DPs increase farm income. Since PFC payments increased producer wealth and could have facilitated additional investment, PFC payments likely led to slightly higher crop production (U.S. Farm Program Benefits: Links to Planting Decisions and Agricultural Markets). However, since producers have the option of updating base payment acres in 2002 from 1996 levels, and since new crops have been added to the program, farmers may have an incentive to continue producing crops and/or to expand production in order to maintain a production history in anticipation of future opportunities to expand payment acres. However, as with prior PFC payments, impacts on production would be small.

## **2.2 Conservation Programs**

There are six categories of conservation programs: land retirement, working lands, farmland protection, conservation compliance, watershed protection and miscellaneous. Programs in the first two categories are the ones that are of interest to Canadian producers, and are described below.

### **2.2.1 Land Retirement Programs**

This category of programs includes the Conservation Reserve Program (CRP), which has been expanded under the 2002 Farm Bill to 39.2 million acres from 36.4 million acres, which represents about 1% of cropped acres in the US in 2001. The CRP pays producers in the form of rental payments and cost-share assistance to establish long-term conservation cover. Contracts under this program are for a minimum of 10 years and a maximum 15 years.

Another program in this category is the Wetlands Reserve Program (WRP). The WRP functions in the same manner as the CRP, except that agricultural land is to be restored to wetland. The maximum number of acres under the WRP has been expanded to 2.275 million acres from 1.075 million acres. These acres are part of the overall CRP acreage cap.

### **2.2.2 Working Lands Programs**

The Environmental Quality Incentives Program (EQIP) provides producers with technical assistance, cost-share payments and incentive payments to assist with environmental and conservation improvements on the farm. EQIP applies to both livestock and crop producers, and in addition to an increase in funding (\$5.8B from \$1.3B), other changes to this program will impact large livestock operations in particular. The previous cap on the size of livestock operation eligible for this program has been removed, and large operations will now be eligible for cost-sharing assistance to construct waste management facilities. To be eligible for this program, intensive livestock operations must prepare a comprehensive nutrient management plan, and all producers seeking funding must prepare a conservation plan. Total funding available to a producer is now \$450,000 over the period 2002 to 2007.

A new program called the Conservation Security Program has been added to this category. This is an incentive program for adopting or maintaining structural practices that address at least one

resource of concern (e.g. water, soil, wildlife habitat). The greater the conservation effort, the higher the payment producers will receive. All agricultural land is eligible for this program, however there is an annual payment cap.

### **2.2.3 Other Conservation Programs**

Some of the other changes to the conservation programs include:

- An increase in funding for the Farmland Protection Program, which provides funds to various levels of government (other than Federal) to help purchase easements against development of productive farmland. Total funding over FY 2002-07 is \$472M.
- A new program, the Grassland Reserve Program, that will assist land owners in restoring grassland and conserving virgin grassland through long-term contracts or easements. Easement purchases will be based on fair market value, and annual contract payments will equal 75% of grazing value. Funding is \$254M over FY 2003-07.

## **2.3 Agricultural Trade and Aid**

The Agricultural Trade and Aid provisions of the 2002 Farm Bill include changes to existing programs and some new programs. The trade programs are intended to either develop foreign markets for US products, or to maintain existing markets.

### **2.3.1 Export Credit Programs**

The export credit guarantee program, which facilitates commercial sales of US agricultural products, has been extended through 2007. This program covers short-term (up to 3 years) and intermediate term (up to 7 years) private credit, and is mandated to provide \$5.5 billion annually – the same amount as in the 1996 Farm Bill. At least 35% of this funding must be applied to processed and high-value products. The most significant difference in the new legislation is that repayment terms have been extended from 180 to 360 days.

A similar program, the Emerging Markets Program, makes available a minimum of \$1 billion for direct credit or credit guarantees to emerging markets<sup>4</sup>. The funds from this program can be used to establish or provide facilities, services, or US products to improve handling, marketing, processing, storage, or distribution of imported agricultural products. This program was part of the previous Farm Bill legislation, and has been reauthorized at the same funding level through 2007.

### **2.3.2 Export Enhancement Program**

The Export Enhancement Program (EEP) is an export subsidy that permits USDA to provide “bonuses to make US commodities more competitive, offsetting adverse effects of unfair trade practices or subsidies.” Funding for EEP has been renewed at the current level of \$478M annually. The most significant change to EEP is an expansion of the definition of ‘unfair trade practices’ to include the following:

- practices of state trading enterprises that "are not consistent with sound commercial practices conducted in the ordinary course of trade;"
- rules that unfairly restrict imports of U.S. products in the administration of tariff-rate quotas;

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<sup>4</sup> An emerging market is a country that “is taking steps toward a market-oriented economy, through the food, agriculture or rural business sectors of the economy of the country, and; has the potential to provide a viable and significant market for United States agricultural commodities or products of United States agricultural commodities.”

- unjustified trade restrictions or commercial requirements, such as labeling, that affect new technologies, including biotechnology;
- unjustified sanitary or phytosanitary restrictions;
- subsidies that decrease market opportunities for U.S. exports or unfairly distort agricultural markets to the detriment of the U.S.;
- other unjustified technical barriers to trade; and
- failure of a country to adhere to already existing trade agreements with the U.S.

### **2.3.2 Market Development Programs**

The Market Access Program provides funding for public/private partnerships in the form of cost sharing for overseas marketing and promotional activities that create, maintain and expand foreign markets for US agricultural, forestry and fishery products. Funding for this program will increase from the current \$90M annually to \$200M in FY 2006 and 2007.

A similar program, the Foreign Market Development Cooperator Program, provides cost sharing assistance to non-profit agricultural trade organizations to conduct certain international market development activities. The emphasis in this program is on exporting value-added products to emerging markets. Funding for this program has also been increased, from \$27.5 million to \$34.5 million annually.

The Dairy Export Incentive Program (DEIP) has been renewed to 2007. The DEIP subsidizes exports of US dairy products, with the goal of exporting the maximum volume of dairy products allowed under the AoA, and subject to the limit on export subsidies in the same agreement. The program operates on a bid bonus system with cash bonus payments to entities exporting US dairy products. The focus of the program is market development.

A new program in this area of the 2002 Farm Bill is the Exporter Assistance Initiative. Although no funds were allocated to this program, USDA is authorized to set up and maintain a website that will provide relevant legal and regulatory information to US exporters and potential exporters of agricultural commodities. The Biotechnology and Agricultural Trade program is also a new program. Its' purpose is two-fold: 1) provide quick response intervention on biotechnology, food safety, disease, and SPS issues; and 2) develop protocols on animal health, grain quality and GMOs through bilateral negotiations. This program has been allocated \$6M annually.

## **2.4 Miscellaneous Provisions**

The last Title of the 2002 Farm Bill is entitled 'Miscellaneous Provisions'. However, one of the most contentious issues of the Bill is included in this part - Country of Origin Labeling (COOL). This provision states that all fresh produce, fish, peanuts, livestock and meat products must carry a country of origin label at the retail level. The program does not apply to food service establishments (e.g. restaurants, bars, etc.). Guidelines for voluntary COOL are to be issued by September 30, 2002 and the program will be mandatory after September 30, 2004. Only those commodities that are produced (in the case of produce and peanuts) or born, raised and slaughtered (in the case of fish, livestock and meat products) in the United States can be designated as having a United States country of origin.

The Secretary of Agriculture is not permitted to establish a mandatory identification system to verify the country of origin. Instead, existing (as of May, 2002) certification programs such as the carcass grading and certification system must be used. However, suppliers of commodities

covered under COOL will be required to provide retailers with information regarding their products' country of origin.

Other provisions in the section include:

- \$5M to establish a national organic certification cost-share program to assist producers and handlers of agricultural products in obtaining certification under the Organic Food Production Act of 1990.
- Producers who produce and market 100% organic products will be exempt from commodity promotion check-offs.
- A minimum of \$200M must be spent each year to purchase fruits, vegetables and other specialty food crops. \$50M of this is to be used to purchase fruits and vegetables for distribution to schools and service institutions.
- Dairy importers must pay an assessment (check-off) equivalent to domestic producers. They will also be eligible to vote in referenda and be represented on the National Dairy Promotion and Research Board.

### 3.0 Implications of the Commodity Programs

In this section we will discuss the implications of the commodity programs for the major commodities of interest to Canadian producers – corn, soybeans, wheat and pulse crops. The most important implication will be the supply response that arises from the financial incentives and disincentives created by these programs to plant or not plant certain crops. That is the focus of this section.

But there are other implications, mainly for US farmers. They include:

- Land values will increase in the US because the subsidies will be capitalized into them. As a result of the programs, the worst market/policy conditions are known with certainty: if one plants soybeans, no worse outcome will occur than that beans will be worth \$5.80/bu, and, as we will see, the actual return will likely be higher depending on how one elects to operate the loan rate provision. Thus the asset that produces this result (an acre of land) can be worth no less than the \$5.80 multiplied by the number of bu it will produce, less the direct cost of producing them. Inflated land values will be a major obstacle for US taxpayers when they decide in a few years that the subsidies are too rich. The argument will be made that “taxpayers, through the subsidies, encouraged me to pay too much for land, now they need to compensate me when they reduce the subsidies”.
- US producers will not have incentive to understand and use modern marketing tools. All they need to do is to be able to interpret the government programs to ensure an income. They will learn to “farm the government”. This too will be a problem if and when the US wants to reduce subsidies in the future because it will have created a generation of people with few skills to exist in a modern market place.
- The Act will likely discourage many young people from farming. While it may provide a moderate income with assurance, it will also make it difficult to increase incomes because the supply response to the program will mean an upper limit to market prices – there’s no better way to encourage a cheap food policy than to give enough subsidies to over produce and keep market prices down. In essence, farmers become wards of the state. Most young people with skills and drive don’t want to be on welfare, and they will seek alternative employment.

#### 3.1 Soybeans, Corn and Wheat

The Marketing Assistance Loan/LDP is expected to have the most significant impact on farmers’ planting decisions since it is based on current production and current market prices, and producers know what the loan rates are before they plant their crop. The Counter Cyclical Payments and Direct Payments are based on historical acres and yields that will stay fixed for the next six years. These programs follow very closely the WTO definition of a program that is decoupled and therefore ‘exempt’ from the accounting of a country’s Aggregate Measurement of Support (AMS). Consequently, although these programs will increase farmer’s income they are not anticipated to have an effect on planting decisions.

The primary methodology used in calculating the financial incentives that will affect producers’ planting decisions is to subtract total variable costs from the loan rate, on a per acre basis, to arrive at a “loan rate contribution margin” per acre. The loan rate margin, therefore, represents the guaranteed amount producers will receive from the government after paying their variable costs (or below variable costs if the margin value is negative). These margins are shown in



Table 3.1 for the US and four major agricultural regions<sup>5</sup>. Variable costs were calculated on a regional basis using USDA data for 2000. They include only those costs specific to growing each crop, and do not include general overhead, land rent, management labour costs, property taxes, depreciation, insurance, etc. Yields per acre are also regionally based, however the loan rate used is the national rate, not a regional rate.

**Table 3.1: National and Regional Loan Rate Margins, US \$/acre**

Region	Corn		Soybean		Wheat		Cotton	
	\$/acre		\$/acre		\$/acre		\$/acre	
	2002-03	2004-07	2002-03	2004-07	2002-03	2004-07	2002-03	2004-07
US	111.73	107.59	<b>127.88</b>	127.88	46.90	45.02	35.78	35.78
Heartland	131.97	127.53	<b>150.62</b>	150.62	91.45	88.50	122.71	122.71
Northern Great Plains	58.68	55.77	<b>123.99</b>	123.99	42.31	40.63		
Prairie Gateway	<b>64.05</b>	60.24	47.62	47.62	30.31	28.89	-10.65	-10.65
Southern Seaboard	53.95	50.77	<b>103.74</b>	103.74	21.74	19.61	75.28	75.28

Source: Authors' calculations, <http://www.ers.usda.gov/data/costsandreturns/data/current/>.

Comparing loan rate margins between crops in each region reveals where the greatest financial incentives are, and consequently what the supply response is anticipated to be. The numbers in bold in Table 3.1 are the highest loan rate margins for each region. For all regions except Prairie Gateway, soybeans have the highest loan rate margin (even though the loan rate is lower than in the previous Farm Bill), and therefore the greatest production incentive. For this reason, we would expect to see an increase in soybean acreage in the major soybean-producing areas of the United States. Since soybeans must be grown in rotation with another crop, preferably a grass, the likely rotation candidate is corn, except perhaps in the southeast where cotton has the second highest margin. The other major potential rotation crop would be wheat, however the loan rate margin is higher for corn than it is for wheat in all regions.

In the Prairie Gateway region, the highest loan rate margin is in corn, and it is double that of the wheat loan rate margin. Producers who can grow either corn or wheat (agronomically) therefore have a significant incentive to produce corn. Soybeans have the second highest loan rate in this region, making them the primary choice for a rotational crop from both a financial and an agronomic perspective.

Although wheat returns a positive loan rate margin in all regions, it is the lowest margin value in the Heartland, Prairie Gateway and Southern Seaboard regions and the second lowest in the US and Northern Great Plains. This means that the incentive to grow wheat is not as significant as it is for soybeans and corn, so in some areas wheat acres may be moved into soybeans.

The marketing loan program provides not only a financial incentive to move acres into soybeans and corn where possible but also a financial incentive to increase yield, since payments are made on a per bushel basis. Together, these incentives are likely to result in increased production of corn and soybeans. This will put downward pressure on soybean and corn prices, and since corn is the major feedgrain in the US, lower corn prices would be an incentive to increase livestock production.

<sup>5</sup> These are USDA regions, and do not necessarily follow state borders. We used state averages for each region. The states are Heartland – Iowa; Northern Great Plains – North Dakota; Prairie Gateway – Kansas; Southern Seaboard – North Carolina.

The implications for Canadian producers therefore are:

- We would expect soybean, canola and feedgrain prices to be under pressure during the life of the 2002 Act because of the very substantial incentives to produce soybeans and corn in the US.
- Interestingly, the program may give some upside potential to wheat prices because of the incentive to produce soybeans and wheat in the US.

A further implication for Canadian producers is related to the nine-month maturity of marketing loans. The 1996 Farm Bill first introduced the nine-month maturity period and since then there has been an effect on feedgrain prices in the summer months – i.e. US prices have declined in the summer. Loans that are taken out close to harvest mature in the summer, at which time a significant amount of grain is moved onto the market, driving prices down. Therefore, there is a net advantage to US livestock producers because of relatively low feedgrain prices during these months.

This is likely to have a negative impact on livestock production in Canada during the summer months, especially in finishing. We expect that with the continuation of the nine-month maturity period, this effect on summer feedgrain prices will also continue. Because of the feeding advantage, this will likely continue the trend toward producing weanling pigs and feeder cattle in Canada, and shipping them to the US for finishing<sup>6</sup>. This is even without the effects of drought that western Canada is currently facing.

Direct payments and counter-cyclical payments are shown in Tables 3.2 and 3.3. Note that these tables show the maximum payment per acre, i.e. if market prices fall below the loan rate. Counter-cyclical and direct payments are also paid on 85% of base acres, so the values per acre are again intended primarily to show the differences between crops in each region. Direct payment calculations are based on USDA NASS yield data for a representative state in each region<sup>7</sup>, for the applicable period. Yield calculations for counter-cyclical payments are based on 93.5% of the 1998-2001 average USDA NASS yield for the same representative states.

**Table 3.2: Direct Payments, US \$/acre**

	Corn	Soybean	Wheat	Cotton
Region	\$/acre	\$/acre	\$/acre	\$/acre
US	29.56	13.20	19.31	38.21
Heartland	31.92	15.58	19.86	35.66
Northern Great Plains	19.82	11.51	16.22	n/a
Prairie Gateway	32.93	9.61	18.51	16.14
Southern Seaboard	22.68	9.95	17.97	38.06

Source: Authors' calculations, <http://www.nass.usda.gov:81/ipedb/>.

<sup>6</sup> Below we will argue that the country of origin labeling provision will have just the opposite implication for Canada.

<sup>7</sup> Representative states used are: Iowa (Heartland), North Dakota (Northern Great Plains), Kansas (Prairie Gateway), and North Carolina (Southern Seaboard).

**Table 3.3: Maximum Counter-cyclical Payments, US\$/acre**

Region	Corn		Soybean		Wheat		Cotton	
	\$/acre		\$/acre		\$/acre		\$/acre	
	2002-03	2004-07	2002-03	2004-07	2002-03	2004-07	2002-03	2004-07
US	43.18	50.80	12.97	12.97	21.22	25.54	81.33	81.33
Heartland	46.41	54.60	15.15	15.15	23.73	28.56	82.61	82.61
Northern Great Plains	35.84	42.17	11.19	11.19	15.89	19.13	n/a	n/a
Prairie Gateway	43.31	50.96	9.34	9.34	21.84	26.29	47.31	47.31
Southern Seaboard	31.07	36.56	9.68	9.68	22.59	27.20	88.19	88.19

Source: Authors' calculations, <http://www.nass.usda.gov:81/ipedb/>.

### 3.2 Pulse Crops

Three pulse crops (dry peas, small chickpeas and lentils) were added to the marketing loan program for the first time in the 2002 Farm Bill. To assess the implications for these crops, we have used the same loan rate margin concept and methodology as in the previous section. The variable costs and yields were taken from crop production budgets developed by the University of Idaho for chickpeas<sup>8</sup>, and the University of North Dakota for peas and lentils. The loan rate margins for pulse crops are shown in Table 3.4.

**Table 3.4: Loan Rate Margins for Pulse Crops, US\$/acre**

	2002-2003	2004-2007
	\$/acre	
Chickpeas	-42.52	-44.08
Peas	79.00	76.69
Lentils	91.71	89.07

The negative loan rate margin for chickpeas indicates that the marketing loan program does not provide a production incentive. There is, however, a production incentive for peas and lentils due to the relatively high loan rate margin. There are other factors that should be taken into consideration in determining the impact of the marketing loan program on these crops. US production is relatively small compared to Canadian production, and the largest pulse crop in the US, dry beans, is not included in the program. Production of the pulse crops under the marketing loan program and dry beans for the US and Canada are shown in Table 3.5.

**Table 3.5: US and Canadian Pulse Crop Production, 2001**

	Canada		US	
	2000	2001	2000	2001
	000 mt			
Chickpeas	388	447	59	73
Lentils	914	568	137	131
Peas	2864	2030	158	159
Edible Beans	268	279	1138	815

<sup>8</sup> The chickpea budget was for large chickpeas; it has been adjusted for small chickpeas.

Although acreage planted to these crops in the US has declined over the past few years, due largely to disease problems (notably chickpeas in Idaho) and a decline in prices, they were never major crops. This can be attributed to a combination of factors, including agronomic and climatic considerations, a lack of good varieties and a lack of useful pesticides. With the possible exception of pesticide registration, none of these factors have materially changed. Therefore, although there is now a guaranteed margin in growing peas and lentils, there are still several important limiting factors. For this reason, we do not expect to see a sudden significant increase in pulse acres in the US.

The loan rate margin for peas and lentils, however, is second only to soybeans in the Northern Great Plains region and comparable to wheat in the Heartland region. This could provide the incentive for producers to increase acres planted to these crops over time, if better varieties are developed and if the climatic and agronomic conditions are found to be suitable. The implications for Canadian pulse producers of increased pulse crop production in the US would be negative pressure on world prices, and would also likely mean greater competition for Canadian producers in foreign markets, as a significant proportion of these crops are exported. The potential effect on Canadian producers of these crops, however, is more likely to be felt in the mid to long-term, rather than in the short-term.

## **4.0 Implications of Conservation, Trade and COOL Programs**

The commodity programs have the greatest potential to affect producers' yearly planting decisions, however the programs in the Conservation, Trade and Aid and Miscellaneous sections of the Farm Bill also have implications for Canadian producers.

### **4.1 Conservation Programs**

In general, the Working Lands programs will benefit from a larger increase in funding than the land retirement programs, indicating a change in conservation program emphasis. EQIP and the new Conservation Security Program will receive new funding of \$11 billion over 10 years, compared with a combined increase of \$3 billion for CRP and WRP over the same period. This is an indication of the growing importance of conservation practices and environmentally friendly agricultural production practices in the United States, which has in part been prompted by consumer concerns and demands.

The changes to the EQIP hold the most potential for economic implications both in the US and Canada. In Canada, nutrient management legislation is either in place or being developed in several provinces, but producers do not have access to government funding to help them comply with this legislation. It appears that the US is taking a different route to the same end by providing subsidies to encourage the same type of action. The EQIP is now clearly geared toward assisting intensive livestock operations in becoming more environmentally friendly through more advanced manure management facilities and farm environmental plans. The amount of money available is significant enough to be an incentive for such operations to invest in developing a nutrient management plan and the capital required to implement such a plan. What the legislation does not indicate, however, is whether there are standards that must be met for nutrient management and conservation plans. Without baseline standards these plans will not be as meaningful as they could be in addressing environmental issues over the long term.

### **4.2 Export Trade and Aid Programs**

The expansion of the definition of unfair trade practices is the most significant change in this part of the Farm Bill. It is an acknowledgement of the proliferation of non-tariff trade barriers over the past few years, and of the restrictions these barriers have placed on US exports of agricultural commodities. By declaring these additional to be 'unfair trade practices', the US has a more immediate retaliatory threat and/or action at its disposal than filing a formal complaint through the WTO or NAFTA.

The new part of the definition regarding state trading enterprises appears to be aimed at the Canadian Wheat Board (CWB). The US has stated that it wants to see the exclusive export rights of state trading enterprise ended in the current round of WTO negotiations, and this clearly reinforces that position. The wording of this point is very similar to that used in the US initial WTO negotiating proposal, and follows closely the reasons behind the many US trade investigations of the CWB. In particular, the US believes that the CWB's lack of transparency regarding export pricing, the absence of acquisition costs of the grain it sells and government guarantees of initial prices are not 'sound commercial practices'. Inclusion of this point in the definition of unfair trade practices means, therefore, that the US could declare the CWB an unfair trade practice and use EEP funds to subsidize the sale of US wheat and barley into markets the CWB sells into.

The points in the expanded definition that address commercial and sanitary and phytosanitary (SPS) restrictions also seem to be aimed at recent irritants to the export of US commodities. Regulations concerning the importation and/or tolerance levels of genetically modified (GM) grain and oilseed crops have come into effect or are being considered by several countries, including China, Japan, the Philippines and India. Such regulations are largely considered to be a non-tariff barrier. For example, new rules took effect in China in March 2002 that stipulate all imported GM products must be certified harmless to humans, animals or the environment by the Chinese. These rules, however, were initially very vague and caused significant disruption to soybean trade between the US and China, worth \$1B annually.

GM labeling regulations have also negatively affected US grain and oilseed exports, especially in Europe. The European Parliament has passed legislation<sup>9</sup> that requires food and feed derived from genetically modified organisms (GMOs) to be traced and labeled as such. The legislation allows for a 1% tolerance level of GMOs in imported food and feed, and imports will have to carry a label declaring the possible GMOs they might contain. These proposed regulations are seen by the US as a non-tariff trade barrier and a threat to their \$4B annual exports of soy meal and other products. It was reported late in 2001 that the US was considering filing a formal complaint at the WTO on this issue.

The commitment to export development programs, in terms of both increased funding for existing programs and the inception of new programs, indicate that the US is committed to further penetrating existing export markets and developing new markets either through cost sharing promotional activities with private sector and trade organizations, or through resolving non-tariff trade barriers such as SPS issues. The issue of GMOs is specifically addressed in several areas. These crops were not grown when the last Farm Bill was passed and now represent a significant proportion of the acreage planted to the major crops (soybeans, corn and cotton). Since GM crops are not segregated from non-GM crops, the acceptance of GM crops in export markets is becoming more and more important in developing and maintaining export markets.

The export credit programs have been reauthorized with only change of interest – the extension of repayment terms to one year from six months. These programs make it easier for US exporters to sell their products into countries that otherwise would not be able to purchase these products. The European Union feels that these programs potentially constitute a subsidy, since companies may sell to countries that they otherwise would not if there was no government credit guarantee.

### **4.3 Country of Origin Labeling**

This provision of the 2002 Farm Bill was essentially sought by northern-tier state lawmakers looking to impede imports of livestock and meat products from Canada. Many US livestock producers and their organizations have been seeking such non-tariff protection for over twenty years.

However, not all in the US meat and livestock industry are pleased with this new provision. The American Meat Institute estimates that complying with COOL will add \$1 billion additional annual costs to the livestock, red meat and supermarket industries in the US, and will cost USDA \$60 million in annual oversight costs. The AMI also recognizes that the program will be a trade irritant with the US' major produce and livestock trading partners. In the US, the potential impacts of COOL include reduced competitiveness in the meat production chain, less capital

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<sup>9</sup> The legislation must also be passed by member country parliaments in order for it to take effect.

investment in these industries, some smaller operations going out of business, more expensive produce and meat at the grocery store.

This provision could have significant impacts for Canada. On one hand, if the US wishes to impose costs on themselves, arguably that could be Canada's gain. On the other, the US industry will take all necessary steps to reduce costs imposed by COOL, and that will be detrimental to Canada. Last year a total of 1.193 million slaughter cattle and 161,500 feeder cattle and more than 5.1 million feeder and slaughter hogs were exported to the US in 2001. Under COOL, these cattle and hogs will have to be individually identified and segregated either in feedlots, finishing barns or packing plants prior to processing. In addition, there is the issue of meat exports. Last year for example, Canada exported over 40% of its total beef production and about three-quarters of that went to the US. Country of origin labeling also requires that meat will have to be labeled as such in the meat case.

One potential scenario would be US packers and retailers deciding that Canadian livestock and meat are an unworkable proposition and will simply choose not to import product. Alternatively, since the industry is based on margins, the extra costs of handling and labeling Canadian livestock and meat will be bid into the price offered to Canadian farmers and processors. Either way it means lower prices for the Canadian industry and Canadian producers.

## 5.0 Implications for WTO Negotiations

The Doha Ministerial Declaration of November 2001 was a significant step forward for the overall WTO negotiations and especially for the agriculture negotiations, as consensus was reached on the overall objectives with respect to the three 'pillars' of the agriculture negotiations. These pillars are: market access, domestic support and export subsidies. The stated objectives of the agriculture negotiations are: "substantial improvements in market access; reductions of, with a view to phasing out, all forms of export subsidies; and substantial reductions in trade-distorting domestic support". The negotiations are currently focused on generating a comprehensive proposal, taking into account the 45 proposals that have already been submitted by 126 member governments.

The US' initial WTO negotiating position says it wants to 'reduce substantially trade-distorting domestic support'. The Farm Bill, however, has increased the value of defined US subsidies. This contradiction has heightened the level of cynicism and pessimism regarding a successful outcome of these negotiations, as it is a perceived reversal of past US position of promoting free and fair global trade in agricultural commodities. This leaves the US in a weaker bargaining position at the WTO table, as they will have a difficult time convincing other countries, especially the EU, to reduce their domestic and export subsidies. This has already begun, as the US Deputy Trade Representative stated in July at the WTO that the US is "fully committed to achieve an ambitious outcome on agriculture in the Doha negotiations", and will continue to "assert leadership" at the WTO. This was viewed as a public relations exercise by many other countries, including the EU.

The Doha round has been named the 'Development Round', as there is a commitment to fully involve developing countries in the negotiations, and a commitment to achieving an outcome that they will see serious benefits from. The Farm Bill then also has implications for developing countries and their desire for a successful outcome of the Doha negotiations<sup>10</sup>. By putting downward pressure on world export prices and restricting access to its domestic market, the US is essentially putting developing countries in a position where their prospects for export gains are significantly reduced.

According to the work program set out by the WTO agriculture negotiations committee, the key negotiating principles for each pillar are to be set out by March 1, 2003 so that member governments can complete their first offers or comprehensive draft commitments by the 5<sup>th</sup> Ministerial Conference later in 2003. In order to meet this deadline, negotiating meetings have been scheduled for each pillar starting in June 2002. The Doha Ministerial Declaration set the deadline for reaching a final agreement in the agriculture negotiations (and all other negotiations in the WTO) of January 1, 2005. At this time, neither the agriculture committee deadline of March 1, 2003 nor the overall deadline of January 1, 2005 is in jeopardy. Given the importance of US commitments to subsidy reduction and the support of developing countries to the negotiations, the US Farm Bill certainly has the potential to cripple this round of negotiations.

The Farm Bill has further implications beyond the issue of subsidy reduction. The US would like to see the EU's genetically modified labeling plans declared a non-tariff trade barrier. However the Farm Bill's country of origin labeling requirements make it much harder to achieve this, as the US is instituting its own labeling non-tariff barrier.

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<sup>10</sup> See *The 2002 US Farm Bill and International Agri-Food Trade: Dusting Off the Prebisch Thesis*, a Special Report by the George Morris Centre. June 2002.



## 6.0 Conclusions and Potential Strategic Responses

This report started out with several objectives:

- To explain the producer subsidy programs and how payments under these programs will be calculated;
- To explain other provisions in the Farm Bill that are of interest to the Canadian agriculture and agri-food industry;
- To discuss the implications of the producer subsidy programs for US producers' decisions to grow the major commodities and pulses, and the likely implications of those decisions for market prices;
- To discuss the implications of other Farm Bill provisions, including trade and conservation programs, and country of origin labeling;
- To discuss the implications of the Farm Bill for the current round of WTO negotiations; and
- To provide some initial thoughts on how governments and firms in Canada and other countries might respond to the Farm Bill.

In section 6.1, we provide a brief overview of the conclusions about the objectives. In 6.2, potential strategic responses are addressed.

### 6.1 Conclusions

#### *Explaining provisions*

There are no conclusions about the first two objectives because they are procedural in nature. The provisions were explained in section 2.0.

#### *Implications of Programs for US Producer Decisions*

The direct and counter-cyclical payment components of the Act will not likely affect the production decisions of US grain farmers because they are triggered by historical acreage and production. However, the marketing loan rate component very clearly does. Our conclusions are:

- Based on USDA (or state in the case of pulses) budgets, the loan rates guarantee quite positive margins (above variable costs) per acre for all program crops except one of the pulses – using yields from 2001. They also provide an incentive to increase yields – the higher the yield, the higher the subsidy.
- Using USDA data, it would appear that the government will guarantee the highest returns to soybean production in most regions, and a combination of soy-corn or soy-cotton in all regions. The program will provide a very clear incentive for US farmers to increase their production of these two crops. The assertions to the contrary by the US President, the Secretary of Agriculture, and the US Special Trade Representative appear to be without merit.
- While the program also provides incentives for US farmers to increase production of wheat and pulses, the incentives are lower than for soybeans and corn.
- Because of the foregoing, expect prices in the oilseed and feedgrain complex to be under pressure for the next six years, while the wheat industry will be more reflective of market conditions.

In addition, for reasons explained in the text, we believe that the program will cause US feedgrain prices to be relatively low in the summer and early fall of the year, thereby giving an feed cost advantage to the US livestock industry.

### ***Impacts of Trade, Conservation, and Country of Origin Labeling Provisions***

The conclusions about these three elements are:

- While there is a huge amount of money in the Act for investment in conservation and environment, it does not appear to have major implications for markets or for Canadian competition.
- The trade component is much more ominous for Canada:
  - The US expanded its assistance for international market development. Hence there will be more subsidized trade promotion programs against which Canadians need to compete.
  - The US reaffirmed its intention to use food aid in poor countries. Since this program is little more than thinly veiled, institutionalized dumping that few less developed countries want, it has negative consequences for producers in those countries whose production incentives will be hurt. Moreover, it will depress prices, thereby keeping out products from Canada and other competing countries.
  - After years of reducing their export subsidies, the US elected to maintain them at the same level as in the past year. This segment defines a set of “unfair trade practices” that will be unilaterally declared by the US. This includes some practices of the Canadian Wheat Board. Implicitly, by defining these unfair trade practices, the US is declaring its intent to use export subsidies in third party markets to compete with Canada and other countries. One can easily imagine the US using export subsidies in target markets where the US perceives that the CWB is engaging in unfair trade practices, or to third party countries where the US believes it is being hurt because of European regulations about genetically engineered products. In these cases, Canada can be hurt either directly or indirectly through “sideswiping”.
- Country of Origin Labeling could have significant negative impacts for the Canadian beef and pork industries, from producers through to packers. Arguably, Canada has been presented with an opportunity to differentiate its product in the US market and potentially charge a premium. However, there is a significant risk that this will not happen and the US industry will take all necessary steps to reduce costs imposed by COOL. The latter alternative will be detrimental to Canada.

### ***Implications of the Act for the WTO***

The provisions of the 2002 US Act appear to fly in the face of everything the WTO is attempting to do – it imposes new trade barriers that are not justified on the basis of science; it increases domestic support to farmers with an instrument that distorts production and trade; it maintains export subsidies and targets them in an aggressive manner, and it maintains institutionalized dumping in the form of food aid. In a round of WTO negotiations that held hopes of being the “development” round, this is a four barreled economic assault on developing and competing countries alike. One of only two alternatives can be concluded:

- The US has no intention of making trade in agricultural products more free, and plans to return to a position of isolated aggressiveness or
- The US believes that the only way to make progress toward freer world trade is to pressure and coerce the rest of the world into it.

Neither of these alternatives is attractive.

## 6.2 Canada's Potential Responses

This small section is an initial attempt to explore potential responses to the Farm Bill in which Canada could participate. We make no recommendations because we do not believe we know what is the right course at this time. Rather, our intent is to begin to identify alternatives and explore their pros and cons before interacting with our members and others in search of an appropriate set of responses.

On the surface, it would appear that the alternatives fall into three categories. The first is dispute settlement mechanisms that exist under WTO or NAFTA. The second is unilateral responses – courses of action Canada could take by itself to try to change the US approach. The third is actions taken in concert with other countries to bring pressure to the US.

### ***Dispute Settlement.***

At least two alternatives are possible here. The first is to bring countervail action against the US for its marketing loan program, as we have done in the past for corn. Two major problems are associated with this. First, under the 1995 WTO agreement, the US is allowed \$19.1 bil in aggregate support. As we already saw, the direct and counter-cyclical payment components are exempt from the limit and from countervail action. But the problem with the loan rate component is that it would have to be done after Canadian agriculture has already been injured.

The second problem is that the cure may be worse than the disease. Bringing countervail action is a good solution when a country is a net importer of a product and/or of the product it is used to produce. Canada tends to be a net exporter of feed grains and oilseeds, and a net exporter of livestock. A countervailing duty against US grain will either have no effect in Canada if we remain on a net export basis, or would devastate Canadian livestock producers if we do not. Given weather conditions in western Canada at the moment, there is a high probability that we will not be on an export basis for feedgrains. So, if Canadian livestock producers have to pay US prices for feedgrains, plus the cost of freight to move them to Canada, and a countervail, it would likely put them out of business since their cattle and hogs have to compete with those produced in the US. This could be worse with country or origin labeling added on top.

Another alternative is to bring action on COOL in a WTO dispute. This may be a good alternative, but it likely can't be pursued until after the labeling rules have been put into place and made mandatory. This may not happen for several years, thereby ensuring political uncertainty in Canada meanwhile. Political uncertainty is always a good way to discourage investment. The entire process the US has introduced creates uncertainty in Canada and elsewhere (including the US), thereby discouraging new investment.

### ***Unilateral Actions***

Canada has a range of unilateral actions it can take. The most obvious is to use the public purse to offset the effects of the US program by compensating farmers and others in Canada. This alternative brings a major dilemma. While it may be effective in assisting those who are hurt, it is a poor public investment in large part because most of it is likely to end up capitalized into land values, and it could lead to further trade retaliation by the US and/or other countries.

Other types of unilateral action include things like requiring country of origin labeling on a products like fresh beef. This is an interesting situation because Eastern Canada is deficit in beef and imports from the US, while Western Canada is a surplus producer and exports to the US. The reasons for this two-way flow are obvious when one looks at a map and a schedule of

freight rates. Imposing COOL on the US would alter the economics, raise beef prices in Eastern Canada, and make it a more attractive destination for beef from Western Canada.

The downsides of this are three fold. Obviously, it adds costs to the system and reduces overall efficiency. Second, Canada is a relatively small player, and we doubt it would have much effect on the direction of US policy. Third, it invites another round of retaliation from the US.

### ***Coordinated Multi-lateral Retaliation***

Under this alternative, Canada and other trading nations would coordinate efforts to negotiate with and retaliate against the US to bring it back in line with the move toward a more global economy. The latter could include concerted efforts at WTO dispute tribunals, passage of COOL and other similar tactics around the world, refusal to allow the US-based firms to do work in various countries, unilaterally imposing import duties on US products so that pressure will be brought on the US government by US exporters to back off on the areas of protection it is pursuing. In other words, this would not be a response just to the Farm Bill, but also to other US actions such as the steel tariffs, softwood lumber, etc.

With enough cooperation, this could be effective at changing US policy. But it is clearly dangerous. First, it contains the danger that protectionism could get out of hand in all countries, thereby returning the world to the economic disaster of the 1920's. Second, it could easily backfire, and cause retaliation, thereby getting to the 1920's more quickly.

### ***Closing Comment***

There may be more and better responses to the US drift toward protectionism and isolation than we have identified in this brief discussion. But reviewing the ones discussed above, one can't avoid being pessimistic because none are very attractive. After more than a decade of freer trade in North America and almost a decade of slightly freer trade around the world because of the 1995 WTO accord, most of the results were positive. Where results were not positive, it was usually in areas where trade restrictions or government subsidies were still in place. What ever the warts of the international system that was emerging during the 1990's, they could have been treated and managed by continuing down the path of more global market access.

In a muddled and confusing way, the US has expressed frustration with the pace of change toward more global trade, especially given the pace of change in information, transportation, and manufacturing technology that causes the world to cry out for more economic integration. Moreover, all the evidence to date is that a move to more global access adds to prosperity, peace and the development of the human spirit, despite assertions by some to the contrary.

The only partially rational explanation for this sudden shift in US policy toward protectionism and isolationism is that the pace of change in world trade policy is too slow. So, because of its economic might, the US may be rationalizing that it can bully the world to better policy by enacting the opposite.

As we consider the implications of this Act and the implications of the possible reactions to it, we have to conclude that the US is taking a huge risk and likely making a huge mistake. The potential consequences of the path that the world seems now to be taking in terms of protectionism and regionalism can only be disastrous. And the country that fancies itself as the leader of the free world is leading it into the disaster.