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What Next for Farm Policy in the U.S. and EU?

This policy brief draws from the September 2011 IPC Discussion Paper "Farm Policy in the U.S. and the EU: The Status of Reform and the Choices Ahead" by David Blandford, Tim Josling, and Jean-Christophe Bureau. The authors thank IPC Chief Executive Charlotte Hebebrand for her assistance with this brief. Funding for this set of papers was provided from both sides of the Atlantic: IPC is grateful for support from the RISE Foundation (www.risefoundation.eu), and for additional support from the Farm Foundation (www.farmfoundation.org) under its Small Grants Program.

The debate over the U.S. 2012 farm bill is well underway, even though legislative proposals will not be forthcoming until 2012. Likewise, the debate over the post 2013 EU Common Agricultural Policy (CAP) has been launched, with the European Commission preparing legislative proposals likely to be formally introduced in the fall of 2011. This parallel timing allows for an interesting examination of the debates surrounding farm policy on both sides of the Atlantic, at a time of deep budgetary constraints. This policy focus provides a short overview of the evolution of U.S. and EU farm policies before examining the key objectives and constraints that are central to the policy debate, and closes with a set of recommendations for future reform.

Overview of Current Farm Policies

U.S. agricultural policies began as "temporary" measures to deal with a combined economic and environmental crisis in agriculture due to the Great Depression and the Dust Bowl. The CAP has been a key EU policy since the 1960s, when it played a significant role in economic integration and provided a stable environment for the restoration of Western European agriculture. **Both the U.S. and EU struggled for decades with trying to control the costs of acquiring surplus products to support prices.** Market intervention – maintaining high commodity prices and buying up surplus production – had become a drain on government budgets and contributed to trade friction, in particular when export subsidies were employed to draw down surpluses, leading to decreases in international prices. Moreover, artificially high prices were largely reflected in the price of land and other assets, and placed a burden on consumers (and the food processing sector). Such policies also came to be seen as decreasing farmers' responsiveness to changing market conditions.

While the U.S. no longer intervenes extensively in agricultural markets, it has maintained price support programs for major crops and milk. A series of farm bills sought to reduce the incentive to increase production of program crops and culminated in the introduction of fully decoupled payments in the 1996 Act. Following sharp declines in prices during the life of the 1996 Act, the 2002 Act saw the introduction of countercyclical payments in which support for eligible farmers varies inversely with commodity prices, though they are not linked to the current volume of production. The most recent Farm Act (2008) saw the introduction of an optional revenue stabilization program (ACRE) that was intended to offset the impact of variations in both prices and production of major program crops at the farm level. Table 1 shows a summary of the instruments presently operative in the 2008 Farm Bill.

The EU reforms of 1992 set in motion a steady movement away from the support of key cereal and livestock prices by means of market intervention and export subsidies to the use of direct payments, more or less divorced from current prices or output. Originally intended to facilitate the transition to lower support prices, the payments became viewed

Table 1: Summary of Farm Safety Net Programs Authorized Under the 2008 Farm Bill and Other Legislation

I. Commodity Programs
Field Crops
Direct payments (DP)
Counter-cyclical payments (CCPs) or Average Crop Revenue Election (ACRE)
Marketing Assistance Loan Program (MAL)
Loan deficiency payments (LDP) or Marketing loan gains (MLG)
Dairy
Dairy product price support program (DPPSP)
Milk Income Loss Program (MILC)
Sugar
Sugar price support program (SPSP)
II. Risk Management Programs
Crop Insurance
Yield-based
Revenue-based
Whole-farm
Non-insured disaster assistance (NAP)
III. Disaster Assistance
Supplemental Revenue Assistance Payments Program (SURE)
Livestock Indemnity Program (LIP)
Livestock Forage Disaster Program (LFP)
Tree Assistance Program (TAP)
Emergency Assistance for Livestock, Honey, Bees and Farmer-Raised Fish Program (ELAP)
Emergency (EM) disaster loans
Ad hoc disaster payments

Source: Based on Shields, D.A., J. Monke and R. Schepf (2010). Farm Safety Net Programs: Issues for the Next Farm Bill. Congressional Research Service, Report for Congress, R41317, Washington, DC, July 9.

as entitlements for EU farmers, and hence were paid to producers in new member states even though those countries had not experienced price decreases. Further reforms in 1999, 2003 and 2008 (see table 2) consolidated the shift away from market support and extended the use of direct payments. In 1999 (the Agenda 2000 reform, that included budgetary as well as agricultural policy decisions) a second "pillar" of the CAP was introduced focusing on rural development. The 2003 reform introduced a Single Farm Payment Scheme (SPS) that consolidated payments made previously on the basis of commodity output. In addition, individual commodity "common marketing organizations" were revised over the subsequent three years and eventually consolidated under a single piece of legislation. The Health Check reform in 2008 further decoupled support from production, as well as ending set-aside requirements, and placed additional limits on market intervention. It entailed the removal of most intervention prices (rice, barley, maize and in effect beef and sugar beet) and set the date of April 2015 for the phased elimination of milk quotas. These reforms have resulted in a policy that is radically different from that of the 1980s. The current policy is now consolidated around the two "pillars", the first covering programs supporting farm incomes and stabilizing markets and the second dealing with rural development, including environmental programs.[1]

1 Rural development policies focus on improving competitiveness (including payments for quality improvement and farm restructuring), improving the environment (including climate change mitigation); and improving the quality of rural life (through the renovation of villages, the diversification of production, and development of skills for local development strategies). In practice, pillar 2 support goes largely for the modernization of agriculture in new member states and for environmental objectives in old member states.

Table 2: Summary of EU reforms, 1992-2011

Date	Reform	Main changes
1992	MacSharry Reform	Reduction of cereal and some livestock prices and introduction of direct (compensation) payments
1999	Agenda 2000 reforms	Reduction of prices; introduction of second pillar (rural development); cross-compliance introduced
2003	Fischler reforms (Mid Term Review)	Introduction of SPS and SAPS, subject to national ceilings
2004-07	Reforms of specific sectors (cotton, sugar, olive-oil, tobacco, fruits and vegetables, and rice)	Incorporation of support in SPS and SAPS: funds saved allocated to national ceilings
2008	Health Check	Abolished set-asides; started phase-out of milk quotas; increased modulation; limited intervention buying

Source: Authors' compilation

Framing the Farm Policy Debate

Farm policies in both the EU and the U.S. are fixtures in their respective political landscapes. In the EU, the CAP policy influences the economic environment for 7.3 million commercial farms and over 6 million smallholdings (many of these in the most recent members, Romania and Bulgaria). Over 16 million people are employed in the agricultural sector, some 5.6 percent of the labor force (Eurostat). The average farm size is 22 hectares, and the total value of production is 304 billion euro (OECD, 2010). In the U.S. the number of farms is less (2.2 million) and the average size is larger (418 acres), and the value of output is $287 billion. Transfers under the CAP account for about 24 percent of the gross revenue from farming: in the U.S. the comparable figure is just under 10 percent (OECD, 2010). **On each side of the Atlantic, agricultural policies are entrenched and strongly supported by those that benefit from their provisions. However, the pressures on these policies in a time of budget stringency and high commodity prices are mounting.**

Farm Income Objectives

Support of farm incomes has been the traditional justification for the existence of farm programs. The Rome Treaty specified that a CAP was intended to help farmers earn a comparable income to other sectors through productivity increases and to assure consumers of a stable source of reasonably priced foods. **With EU agriculture becoming increasingly productive and modern, objectives of EU farm policy now also include improving the competitiveness of farmers and maintaining the viability of rural areas, and provision of public goods.** EU agriculture is expected to produce more than food: farmers are seen as stewards of the rural environment and contributors to aesthetic and recreational needs.

The legislation that supports farm programs in the United States does not identify any overall objectives. The current farm bill – the Food, Conservation and Energy Act of 2008 – merely states that its purpose is "to provide for the continuation of agricultural programs through fiscal year 2010, and for other purposes" (US Congress, 2008), but some specific objectives are identified in the legislation, primarily with respect to conservation and rural development programs.

Beyond income support for farmers, the need for which is less apparent given recent record farm incomes, are other objectives. Among these are the provision of public goods, and in particular protection of the environment and promotion of food security, and contributing to rural development. Such objectives are important to maintain the public support for funds for both U.S. and EU farm policy. **Among key constraints facing both U.S. and EU farm policy are the budgetary outlook and WTO implications of certain policy choices.**

Environmental Objectives

In several respects the CAP has become an environmental as well as an agricultural policy. The changes enacted in 1999 (the Agenda 2000 reform) introduced the notion of cross-compliance in which environmental rules are specified as a condition for receiving direct payments. Though one could make the case that environmental objectives could stand on their own (and apply to all farmers regardless of whether they receive payments), the political cover proved useful. How much longer the attempt to justify direct payments as a reward for environmental stewardship will last is unclear. It is not obvious that the current policy approach satisfies basic criteria for effective environmental policy, such as targeting and ensuring compliance, and some farmers have chosen to avoid the restrictions of cross-compliance by not receiving direct payments.

As environmental issues have become more prominent and environmental groups have become increasingly politically active, the debate on environmental provisions in the farm bill has intensified. Farmers have largely been content to go along with environmental programs because many are based on the provision of incentives for improving environmental performance, rather than penalties to discourage environmental damage. However, strains are emerging in the environmental/commodity coalition because of the impact of higher commodity prices and bioenergy policies. Higher commodity prices make it less financially attractive for farmers to participate in key environmental programs, such as the Conservation Reserve Program (CRP). Other conservation programs, such as the Environmental Quality Incentives Program (EQIP), which provides incentives for environmental improvements on land in agricultural production, have already been the target of budget reductions since the signing of the 2008 bill. **With budgetary stringency there is likely to be less money available for incentive-based environmental programs, which have formed the cornerstone of policy in this area.**

Food Security Objectives

The high world food prices of the past four years have added another dimension to the debate on the CAP. What role does EU agriculture play in providing food security at home and abroad? The European Commission is on record as citing domestic food security as a justification for the CAP, even promoting it as a theme for the future (post-2013) policy. **It is difficult to conceive of a credible threat to food security in the EU other than through mass destruction of production capacity and infrastructure. Given the low level of risk, whether the additional cost of maintaining a high level of production is merited is for politicians to judge. The same might be said for the notion that EU productive capacity, even at high cost, should be maintained to benefit global food security. It is difficult to argue that such an insurance policy taken out in the name of food importing developing countries is worth the cost of the premium involved. The alternative would be to assist those countries with investment in their agriculture and food system infrastructure, including domestic food security programs, and avoid the high cost of producing in a region where land and water are scarce, wages are high, and environmental problems abound.** If food prices do indeed remain high then that should reduce rather than increase the need for price support for EU agriculture, including support through import tariffs. It could, however, be a reason to shift expenditure on the CAP towards research and development, rather than price and income support.

High prices since 2007 have also begun to make an impression on the Farm Bill debate. The term "food security" is being used by some to justify maintaining productive capacity in agriculture and avoiding the diversion of land to conservation uses. Few would argue that one of the world's major agricultural exporters actually runs the risk of having insufficient supplies of food to meet the physical needs of the population – although some legislators appear to suggest that this could be an issue. On the other hand, food security, in the sense of being able to satisfy the growing demand for agricultural products for food and energy use at "reasonable prices", has considerable resonance, particularly as food prices in the United States have entered a second high price period within the space of four years. It is also important to keep in mind that domestic food assistance programs are the largest element of expenditure in the farm bill. Rising food prices would require more funding for these nutrition programs, and the agricultural community may wish to emphasize the importance of production agriculture over nutrition programs, but this, would weaken the rural-urban coalitions that have kept the farm programs strong in the past. **The issue of high food prices in the United States is thus likely to become a significant factor in the debate on the 2012 farm bill**.

Budgetary Constraints

The dominant constraint on farm policy on both sides of the Atlantic at present is the availability of funds. The situation in the EU reflects decisions made in earlier times on the proportion of available funds that can be used for agriculture. Expenditure on the Common Agricultural Policy has been remarkably stable since 1991, at around 50 billion euro (in 2007 prices), in spite of an increase in the EU membership from 12 to 27 states over that period. This stability hides a significant shift in the way that the budget has been apportioned between elements of the CAP. The direct payments introduced in 1992 accounted for about 10 billion euro (in 2007 prices); by 2008 they had reached 36 billion euro. Market price support declined over that period from 23 billion euro to 4 billion euro and export subsidies fell from 13 billion to 1 billion euro. Meanwhile spending on rural development rose only modestly from 5 billion to 9 billion euro, despite the launching of the second pillar in 1999. As a consequence of the relative stability of total CAP expenditure, the share of the EU budget devoted to agriculture had fallen to 41 percent in 2011 compared to more than 70 percent in the mid-eighties. The Commission has proposed that the new 2014-2020 financial framework contain 382 billion euro for agricultural spending, though 4.7 billion euro for food safety and food assistance has been transferred to other headings (European Commission, 2011). The framework has yet to be agreed, but would set limits on the spending on the CAP.

The various positions of the member states in the budget debate follow with some exceptions the fault lines of national interest. States that contribute to the budget more than they receive naturally seek a small increase in the budget ceiling. Poorer members will typically request more funding for EU programs with a redistributive function. Those that have large but less productive agricultural populations tend to favor a more permissive budget allocation. Those with more efficient agricultural industries will be more concerned about ancillary services than price support and market intervention.

The current CAP budget, where the largest component (pillar 1) is 100 percent financed by the EU, while pillar 2 measures require national co-financing (between 10 to 50 percent depending on the measures and regions), encourages member states to develop a strong political preference for the first CAP pillar. This bias hampers the development of an agricultural policy that is more focused on public goods and positive externalities, i.e. the issues that are seen by economists as driving a sound public policy for the sector. In addition, the most cash strapped member states are also those where measures under pillar 2, historically weak (e.g. the low level of agri-environmental programs in Greece or Portugal), will be sacrificed even more due to the effects of the economic crisis on national budgets.

The U.S. farm bill is an amalgam of titles covering a range of issues, serving the interests of different constituencies. Food assistance programs, which are important in attracting the support of urban legislators for the farm bill, account for the largest proportion of total expenditures. There are also titles for rural development, environmental programs, and energy programs – each of which attracts its own supporters. At the time of its passage the overwhelming share (97 percent) of the estimated net outlays under the 2008 farm bill were under four titles: nutrition (67 percent); commodity support (15 percent), conservation (9 percent), and crop insurance (8 percent) (Monke and Johnson, 2010). **The passage of a farm bill requires that a "grand coalition" of interest groups with differing policy aims and objectives reach agreement on all the programs under these titles and**

their funding. In the context of extreme budget stringency, when significant trades-off may have to be made in funding across program areas, reaching such an agreement may prove to be particularly challenging.

The budget for the 2008 farm bill was required to be deficit neutral – within the spending baseline determined by the Congressional Budget Office; unless the Congress decides to change the rules this requirement will also apply to the 2012 bill. The CBO baseline provides a projection of spending under a continuation of existing legislation. Any additional spending on agriculture either has to be offset by equivalent reductions in spending for other mandatory programs, or by raising revenues. A key element in the baseline is the assumption made about future commodity prices. The expectation of stronger crop prices than those which applied to the baseline for the 2002 Act meant that the overall budgetary envelope was reduced for the 2008 farm bill. In the light of continued high commodity prices there may be a further reduction in the baseline for the 2012 bill. An additional budgetary consideration is that some existing programs do not have a baseline after the expiry of the current bill, because they are not assumed to continue. If these programs are to be funded they will have to be paid for through budget offsets from other programs. An important procedural distinction is between programs for which expenditure is mandated, such as price-linked direct payments and those for which it is authorized but subject to the annual appropriations process. This distinction leads to tension among constituencies, for example, environmentalists; some of whose programs may not be fully funded in the annual appropriations process and commodity interests, whose price support programs are usually sustained by mandatory funding.[2] In the context of the debate on future legislation under severe budget constraints, the mandatory versus non-mandatory distinction could become more significant. There may be strong pressure to limit mandatory spending in order to stay within a reduced budgetary ceiling. Conversely, non-mandatory spending may be placed at risk if future rounds of budget cutting during the life of the next farm bill influence the appropriations process.

International Trade Constraints

The 1992 CAP reform enabled the EU to agree to disciplines on domestic support and export subsidies in the Uruguay Round. Current trade constraints are a reflection of the agricultural trade system devised by the EU and the U.S. at that time. The progressive transfer of support, first to the blue box (of payments linked to supply control) and subsequently to measures notified as green box (non or minimally trade-distorting), has left the EU in a much less defensive position at the negotiating table (Josling and Swinbank, 2011). Thus the Doha Round has been the first such round where the EU can be assertive in terms of its own objectives. Though the ultimate fate of the Doha Round is still in doubt, the draft modalities of December 2008 can be used to indicate the likely impact on the CAP if agreement is reached. With respect to domestic support the latest notification to the WTO for the year 2007/08 indicates an AMS of 12.4 billion euro, well below the proposed ceiling of 21.7 billion euro for the end of the transition period (after the 70 percent reduction from the current ceiling of 72.2 billion euro). Thus the new AMS limit would appear to allow further policy changes consistent with developments since 2003. However, any major return to price supports would mean that support would rapidly approach the WTO AMS (and OTDS) limits (Blandford and Josling, 2011). **The proposed elimination of export subsidies would remove the possibility of a reversion to the practices of the past, where the EU disposed of surpluses on world markets to the detriment of competing producers.** The impact of proposed changes in market access would be more selective, and influenced by the choice of "sensitive products" that would be subject to smaller tariff cuts. Even for those products there would be some

2 Mandatory funding can be reduced in the annual appropriations process or by the House and Senate Agriculture Committees. However, mandatory spending tends to be more stable and consistent compared to that through the annual appropriations process (Monke and Stubbs, 2010).

market opening through expanded TRQs. Sectors that might be affected include suckler cows and sheep, poultry, fruits and vegetables.[3]

The current WTO agreement on agriculture (including rules on domestic support, market access and export competition) imposes relatively few constraints on U.S. agricultural policies. The domestic support disciplines impose a maximum on the total support provided under market price support programs for dairy and sugar, non-exempt payments for commodities and non-product-specific support (amber box). Direct payments have been notified under a category exempt from limitations (green box), as have payments under food assistance and environmental programs. The green box status of U.S. direct payments has been called into question as a result of a dispute settlement case on cotton brought by Brazil. If those payments were to be included in the amber box, the U.S. would have exceeded its amber box maximum in certain years. This is not currently an issue with relatively high commodity prices. The 2008 Act made some definitional changes to the dairy price support program that has allowed the United States to reduce notified support for that commodity.[4]

If a new agreement on agriculture is eventually concluded in the current Doha round of WTO negotiations, disciplines would be tightened on U.S. domestic support, various forms of export assistance would either be eliminated or more tightly constrained, and there would be some reductions in tariffs and increases in tariff-rate quotas (TRQs) for those products claimed as "sensitive". These changes could place some pressure on existing commodity programs (dairy and sugar, in particular) in terms of meeting WTO commitments on domestic support. Should prices fall and significant price-linked payments be triggered, there could also be issues for major field crops. There is some flexibility in the WTO commitments (particularly on the legal definition of support prices) that might allow the United States to reduce notified market price support, although this could require some legislative changes for existing programs. **It is rather more challenging to alter the current programs for crops to avoid the possibility of exceeding WTO support bindings, particularly if market prices fall. The ACRE program, introduced in the current Farm Act, has added an additional layer of complexity to meeting future commitments because of its ability to pay production-linked subsidies to farmers when prices are relatively high.**[5] Significant changes in the crop insurance program would have to be made to allow the U.S. to notify the government subsidy element in this program as "green box" support.

Key Issues in the Farm Policy Debate

A fundamental issue facing EU policy makers is how to manage the two-pillar structure of the CAP in the face of competing demands for available funds. Is the farm support pillar a permanent feature, devoted to maintaining capacity in EU agriculture, stimulating productivity and stabilizing markets? Or is it a relic of past intervention in commodity markets that proved costly and ineffective? Is the rural development pillar to be the main focus for the future, combining environmental and climate change policy with social cohesion and rural viability? Or is this primarily a vehicle for shifting some funds to poorer areas of the EU27, particularly to the twelve new members?

Radical changes to the CAP seem unlikely, given the relative success of reforms to date and their political acceptance. The demands from farmers' organization to go back to guaranteed prices now appear as largely unrealistic and are not seriously on the agenda. Proposals for making direct pay-

3 The market for suckler cows could be affected even if beef tariff lines are treated as sensitive products. Two-thirds of EU beef consumption is from the (very inelastic) supply of byproduct of the dairy herd. So it could be the suckler cow market that will take all the shock from a Doha (or a MERCOSUR agreement).

4 Further detail on these issues is contained in Blandford and Josling (2011), Blandford and Orden (2011) and Bureau and Witzke, (2011).

5 Participation in ACRE would become more attractive if current direct payments were reduced substantially or even eliminated. In that case, the likelihood that the program would create problems for meeting Doha domestic support commitments would be increased.

ments countercyclical have met a more favorable echo from some farmers' organizations, cooperatives and some member states, but these present difficulties given their inter-annual variations and the EU's WTO obligations. The use of more market regulation in the CAP, in order to avoid the large price fluctuations that have been observed over the last five years, has also been proposed. However, in practice it is unlikely that any ambitious policy in this area will be included in the CAP. A major reason is that no one has yet found satisfactory, and even realistic, ways to stabilize agricultural prices without getting back into either a public intervention system or a quota system, and earlier experience with the CAP has shown the many unwanted effects of such mechanisms. Some member states have argued for an ambitious EU policy regarding income insurance, but this has been opposed by other member states. In its November 2010 proposal, the Commission safely proposes to have insurance schemes within Pillar 2, i.e., with co-financing (EC, 2010).

The distribution of direct payments among member states is perhaps the most contentious aspect of the budget debate. New member states argue that they reap much less benefit per hectare from the CAP than does the EU15. Many of the older member states argue against a complete leveling of payments across the EU27 in order to avoid large transfers to the new members. As a result, it is likely that negotiations will end up with a compromise, with significant redistribution of pillar 1 payments between member states, but without a full harmonization of the level of payments per hectare.

There is a further debate on how to make the distribution of direct payments more equitable among farms. Because direct payments were originally designed to compensate farmers for the lowering of guaranteed prices, they were proportional to previous levels of cereals and oilseeds production, and to some extent to beef and sheep production. **The perpetuation, some 20 years later, of the same reference levels in some member states means that decoupled payments tend to go to larger and more productive farms, which are often involved in intensive agriculture.** The inequity of the distribution of pillar 1 payments has led the Commission to propose a move away from historical references for individual payments. However, in practice, the post "health check" CAP grants member states a considerable degree of flexibility in allocating pillar 1 payments. If the Commission pushes for a more even distribution it will put pressure on member states that have maintained the historical allocation, and whose governments have not been able to confront vested interests by making use of existing flexibilities.

Finally, **an important issue is the simplification of the CAP**. The administrative burden placed on farmers as well as on national administrations, has been growing in many member states, even though the decoupling and the creation of a "single" farm payment was supposed to make things simpler. **The need for simplification is stressed by all farm organizations. It is however regarded with caution by many environmental organizations, whose proposals for encouraging the delivery of public goods tend to lead to more complex policy measures.** The issue of simplification could be a major force against the greening of the CAP, given that limited availability of efficient and simple measures that can be applied throughout the EU and which need little inspection.

The current agricultural policy debate in the U.S. focuses primarily on the nature of the "safety net" for U.S. farmers, and the reinstrumentation of programs to live within budget constraints. Much of the discussion centers on the cost to the federal government of farm programs. The budgetary debate for agriculture is made more relevant by the political imperative of reducing the deficit in the federal budget, currently averaging around 9 percent of GDP, and by the fact that net farm income is at record levels. Estimates from the Economic Research Service of USDA are that net farm income will be around $95 billion in 2011 – 20 percent higher than in 2010. Adjusted for inflation, that would be the second highest value in the last 35 years, being surpassed only during the commodity boom of 1974. **With high prices for agricultural commodities there will be con-**

siderable pressure on legislators to reduce the level of support or to realign expenditures to meet changing priorities.

Current U.S. commodity programs are comprised of a mixture of instruments, including direct income supports, price supports, and price-linked payments, in addition to various insurance schemes. While the complete elimination of many of these programs is unlikely – once introduced, farm programs tend to have remarkable staying power – the debate centers on the balance of emphasis among them. A divergence of opinion is already apparent on whether reductions in direct payments would go towards accommodating a reduction in the overall budget for commodity support, or whether funds should be reallocated to other programs. A shift in funding away from price and income support towards insurance programs, would clearly place the emphasis on the safety net as a risk management concept.

The main issues in the current policy debate in the U.S. and the EU revolve around the future direction of direct payments. Will the EU continue to use direct payments to influence farm decisions by emphasizing compliance with environmental and other practices? Or will the emphasis stay on income support and be a proxy for risk management? And will the U.S. maintain the direct payments that provide income support in both good years and bad, or move towards programs that aim to help only when incomes and prices are low? The answer to these questions will determine the future of farm policy in the EU and the US.[6]

The Path for Future Reform

What marks the current policy reform discussions in the EU is the need to craft an agricultural policy that places farming in the context of rural development, the provision of scenic and recreational public goods, the stewardship of the environment, and the maintenance of a tradition of quality regional foods. Of course the "bottom line" is the transfer of considerable amounts of public funds to farmers, which makes it difficult to distinguish between objectives and rationalizations. But if the EU farming community is just going along with the rhetoric to keep urban support they may have overplayed their hand and lost control of the process. **By contrast, the issues in the U.S. are more clear-cut. The agricultural programs are under the threat of significant cuts in the budget. The agricultural community appears to be taking the view that their best option is to emphasize the importance of production agriculture (although not necessarily the research and development that will underpin its future competitiveness) and sacrifice the trappings of conservation and rural development and funds devoted to nutrition programs.** This has the effect of weakening the rural-urban coalitions that have kept the farm programs strong in the past. **Whether the U.S. strategy of defending entitlements at a time of budget stringency is more successful than the EU approach of building a coalition based on the provision of environmental goods and services remains to be seen.**

EU reform has reached a stage where the CAP in effect relies on direct payments to satisfy demands for income support and at the same time seeks to change farmers' environmental practices. Relatively high tariff barriers give a measure of protection from international competition. But the stability of this policy depends, as noted earlier, on the political acceptability of the payments and their economic effectiveness in achieving objectives.

By establishing the link to cross compliance, the EU has stressed the "public goods" aspect of direct payments, with a particular focus on the environment. In order to further strengthen this link, funds should be moved to pillar 2 since these programs are oriented to the provision of public goods. This, however, will be resisted by member states given the need to co-finance pillar 2 measures, but also by the farm lobby, which prefers less constrained and cumbersome pillar 1 payments. Efforts to further "green" pillar 1 are therefore also likely.

Further reform should do more than simplify and improve the conditionality of the direct payments. It should work towards a distribution of the payments

6 See IPC Policy Focus "The Future of Direct Payments." September 2011. http://www.agritrade.org/Publications/FarmPolicyintheUSandEU.html.

that is both equitable and rational. **The case for continued direct payments needs to be made in a way that is convincing to the public. If this is not possible they should be phased out.**

Reform should limit other aspects of the CAP to improving competitiveness and encouraging open markets. The international environment is such that the EU will, at some point, need to make concessions regarding agricultural border protection. Either a WTO agreement will be reached, or the EU will have to sign ambitious bilateral or regional agreements with large entities that are now the main locations for economic growth, i.e., MERCOSUR, India, Russia, and the Ukraine, and in many cases these countries will demand greater access to the EU market for their agricultural products. The EU arable crop sector faces limited risks from such agreements (with the exception of sugar), but the livestock sector, in particular, may need some assistance. This could be done in a way that is more targeted, for instance using a redefined Least Favored Area payments program to help hill farmers transition to more competitive activities.

It is unclear how much reform of agricultural policies will be possible in the 2012 farm bill. In view of severe budgetary constraints, there could be a major reconsideration of policy direction, although the likelihood that this will be possible in a presidential election year is not high. Nevertheless, on the assumption that a serious reconsideration will be possible, this paper suggests elements of a new, more effective and less expensive safety net for U.S. agriculture.

With the U.S. likely to reduce or eliminate direct payments, it should channel remaining funds into a safety net program that would provide incentives for active risk management and self-insurance by farmers. There is little evidence that farmers would in fact choose to buy insurance if they had to pay "commercial" levels of premiums: the question is whether if traditional programs were not available, the attraction of risk-management aspects of the safety net would increase. Crop insurance would continue to be a key element for short-term risk management and help to leverage increasingly scarce public resources, although a central issue to be addressed is how much public subsidy to provide. For the crop insurance programs to be consistent with WTO rules for green box payments, the level of subsidy given by the government must be strictly controlled. Reduction or elimination of direct payments would be one step in the development of actuarially sound and widely used insurance schemes.

Current U.S. programs do not require farmers to take an active part in managing systemic business risk; in fact they may actually discourage it. A co-responsibility (public-private partnership) approach for limiting the impact of fluctuations in prices on farmers' net income would change this situation. One option would be to create individual farm income stabilization accounts (FISAs). Part of the funds currently authorized for direct payments and for price support payments could be reallocated to provide for the accumulation of stabilization accounts based on public contributions and contributions from farmers themselves. Initial accounts could be created by a non-matching start up payment, financed from the phase-out of existing direct payments and other entitlements, with subsequent contributions from public funds made on a matching basis (the match could be 50/50 or some other ratio to be decided with capping of the total size of accounts, possibly based upon gross farm sales).

A disaster relief program should cover uninsurable catastrophic risk. **But if a risk management approach to the safety net is to prove successful, the potential for ad hoc support measures must be limited.** A major challenge is how to ensure that "disaster relief" is exactly that, i.e., limited to addressing non-insurable risks that generate significant losses, rather than a convenient tool for politicians to win votes by providing additional transfers to their constituents. It would be necessary to establish rules that will constrain this tendency and place the focus on non-insurable risk with major consequences for the future viability of farming in affected areas.

Serious reform of the commodity program provisions in U.S. farm policy would require betterfocused programs that impose a lower burden on the budget. The safety net instruments used should provide a measure of stability to farm incomes without significant budget outlays over time. A crop insurance scheme that was actuarially sound would be less expensive and more in line with international rules (i.e. eligible for the WTO green box). Budget reductions will require both program changes and modifications in the way that funds are administered. More comprehensive insurance coverage would eliminate much of the need for the counter-cyclical price or revenue linked payments that are at the heart of current programs, though some disaster payments may be necessary as a supplement to insurance in cases where losses are catastrophic. Marketing loans could be phased out over time, as the private capital market absorbed the task of evening-out income among and within crop years. In addition, the ACRE program, would be eliminated since its function would be replaced by the individual income stabilization accounts.

The farm bill, as currently structured, contains several titles covering areas such as environmental objectives and rural development that involve public good components. These parts of the legislation, although smaller in terms of public expenditure, may be under particular threat during a period of severe budget constraint. A number of changes can be made to current programs in order to reduce their costs and to improve their efficiency.

In terms of farm bill provisions relating to public goods, one important change would be to make greater use of auction-based approaches for the allocation of funds under environmental programs. This approach is already used for the Conservation Reserve Program where bids by farmers for payments for retiring land parcels are compared to an index of environmental benefits to determine those to be accepted. The approach could be adopted more generally, for example, in the allocation of funds under EQIP. This would mean that increasingly scarce funds could be targeted to those uses and regions where the environmental benefits are greatest. A second important change would be to expand the use of cost-sharing and performance-based payments in environmental, rural development and other programs. Tighter expenditure limits could be achieved through greater reliance on loan guarantees rather than grants and through the expanded use of public-private partnerships to leverage available federal funds. A third important change would be to assign a higher priority to the use of scarce public funds for investment in research and development and to employ greater targeting in the use of these funds. **U.S. agriculture faces enormous challenges due to increasing global demand for food and raw materials, including bioenergy, and greater climatic instability. The evidence of the need for expanded investment in R&D across the food system to meet these challenges is overwhelming.** An increase in the real price of food and agricultural commodities is likely to stimulate more private investment in the food system, but most basic research (that which does not offer a rapid return investment) is unlikely to be funded privately.[7]

7 See forthcoming IPC Policy Focus: "Research and Development: The Future of Agriculture." This Policy Focus will be available in October 2011 at http://www.agritrade.org/Publications/FarmPolicyintheUSandEU.html.

Key Recommendations for the EU:

- The constructive elements of the CAP reform process, the elimination of price support policies, should be continued in any future legislation.
- To the extent that the EU continues to rely on direct payments as its main farm policy instrument, it must work towards a distribution of the payments that is both equitable and rational.
- The EU should also provide a sound rationale to EU taxpayers for continuing support to agricultural producers. A minor improvement to the conditionality of direct payments would not be sufficient to make this rationale credible.
- Public goods provision may be a plausible reason for some part of the direct payments but these should be carefully targeted and in some cases provided at the member state level.
- Research into productivity increases and cost reductions should become a more significant part of the CAP funding, as that will in the long run enable the EU to maintain competitiveness. Groundless objections to new technologies will hinder the EU in achieving this aim.
- The EU should also prepare for a further lowering of border protection both to help consumers and the food processing industry and to direct resources into socially profitable types of production. Participation in bilateral and multilateral trade negotiations can be a useful way of stimulating a competitive EU agricultural sector.

Key Recommendations for the U.S.:

- The U.S. should provide incentives for active risk management and self-insurance by farmers.
- Farm policy should enable farmers to manage short-term risk in prices and output, primarily through crop insurance and private price risk management mechanisms (forward contracting, futures, and options).
- Policy instruments should also be developed that enable farmers to manage longer-term business risks associated with periods of low prices.
- In addition, it may continue to be necessary to provide a means of addressing uninsurable catastrophic risk through a disaster relief mechanism.
- Public goods provisions and rural development programs must be less costly and more targeted.
- Increased R&D funding should be a priority to help farmers meet growing global demand and maintain the competitiveness built up over the past few decades.

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The International Food & Agricultural Trade Policy Council promotes the role of trade in creating a more open, equitable, productive and sustainable global food & agricultural system. IPC makes pragmatic trade policy recommendations to help solve the major challenges facing the global food & agricultural system in the 21st century—the need to promote global food security, to sustainably increase productivity, and to contribute to economic growth and development.

IPC convenes influential policymakers, agribusiness executives, farm and civil society leaders, and academics from around the world in order to clarify complex issues, foster broad stakeholder participation in policy deliberations, and build consensus around pragmatic policy recommendations. More information about the organization and its membership can be found on our website: www.agritrade.org.