ROUTING AND RECORD SHEET

SUBJECT: (Optional)
Economic Policy Council Meeting 17 December on Agriculture Competitiveness

FROM:	EXTENSION	NO.
Deane E. Hoffmann NIO/Economics		NIC 05701-86 DATE 17 December 1986

TO: (Officer designation, room number, and building)	DATE RECEIVED	DATE FORWARDED	OFFICER'S INITIALS	COMMENTS (Number each comment to show from whom to whom. Draw a line across column after each comment.)
1. EXECUTIVE REGISTRY	17 DEC 1986			
2.				25X1
3. D/Exec Staff				
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5. DDCI				5. For DDCI Meeting 17 December at 1300.
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FORM 1-79 610 USE PREVIOUS EDITIONS

1230, 17 December 1986

TALKING POINTS

The EPC background paper warns that we should be careful not to undertake policies that would jeopardize our agricultural talks in the new GATT round or reduce our leverage.

-- I would turn that around, I don't think that we can make real progress overseas without showing other countries that we are moving to get our own house in order.

-- Our agricultural policies of the last year have caused some real problems.

    -- Our wheat subsidies, problems with Canada and Australia--countries with essentially free agricultural markets.

    -- Our rice subsidies caused serious problems with Thailand and Malaysia.

We cannot solve our agriculture problems with the European Community through negotiations alone.

-- The political pressures for continuation of their subsidy programs are stronger than they are in the US.

-- Any reform ultimately is going to come as a result of budget pressures.

-- The Community Agricultural Policy sops up two-thirds of the EC budget and will be responsible for a budget overrun of up to $4 billion in 1987.

Any price changes caused by a shift in the US program within the limits Congress would allow will not significantly ease this budget problem for the EC. Indeed, by making reforms ourselves, we strengthen the hand of those in the Community that argue for change.

TALKING POINTS

A unilateral and large reduction in US agricultural subsidies would not undercut our negotiating position with the EC or Japan; indeed, it might strengthen the hand of those pushing for reform.

-- Chronic EC budget problems are the primary force for reform of the Common Agricultural Program.

-- The CAP sops up two-thirds of the EC budget and will be responsible for a budget overrun of up to $4 billion in 1987.

-- Any price changes caused by shifts in the US program will not significantly change the EC's budget problem.

-- Although a reduction in the Export Enhancement Program (EEP) would make it less expensive for the EC to compete, it would not in itself reduce the EC budget costs enough to undercut pressure for reform.

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The Director of Central Intelligence

Washington, D.C. 20505

National Intelligence Council

NIC 05701-86
17 December 1986

MEMORANDUM FOR: Deputy Director of Central Intelligence

FROM: Deane E. Hoffmann
National Intelligence Officer for Economics

SUBJECT: EPC Meeting 17 December at 1300 on Agriculture Competitiveness

1. Background: The meeting is to discuss a Department of Agriculture proposal for the domestic farm subsidy program for FY 1988. This is obviously largely a domestic issue pitting OMB and its proposal for deep cuts in agricultural loan rates (subsidies) against Agriculture with a less ambitious program. The only Agency action would be to refute a possible argument that unilateral US reductions would take pressure off the EC to implement reforms (see attached talking points). This argument was made by the USTR at the EPC last week.

2. We do not yet have a copy of the background and options paper.

3. I included a background paper on the CAP done by EURA and the agricultural program put forth at the EPC last week. I will bring back the updated proposal when I return from this morning's EPC meeting.

Deane E. Hoffmann

Deane E. Hoffmann

Attachments:
A. Memo to the EPC on Farm Program Policy Options
B. EURA Paper on EC Reaction to Reduction of Agricultural Subsidies by the US

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A.

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THE WHITE HOUSE

WASHINGTON

December 3, 1986

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: WORKING GROUP ON AGRICULTURAL COORDINATION

SUBJECT: Farm Program Policy Options

I. INTRODUCTION

The Food Security Act of 1985 was designed to make major program crops (wheat, feed grains, soybeans, cotton and rice) more competitive in the world market place and to provide a gradual transition to a more market oriented agriculture by reducing price supports (loan rates) while maintaining farm income supports (target prices).

The Act has been successful in promoting exports, particularly rice and cotton. However, because of the continuing world glut of most basic agricultural commodities, prices have declined considerably. Coupled with large U.S. crops, this has dramatically expanded the cost of those programs to the taxpayer. Program outlays for FY86 were projected at $17.2 billion, but ended up at $25.8 billion, and are likely to be in the same range for FY87 (FY80 cost was $2.8 billion). As the market returns decline, and government payments increase, participation in the programs has become an economic necessity for most commercial farmers.

Economic stress continues in the agricultural sector despite the large outlays. Many farmers borrowed against increasing land values in the late 1970's and now cannot achieve positive cash flow because of the debt, while their assets have eroded with compounded debt and declining land values. 10% to 25% of commercial farmers, depending on their region of the country, are in real financial difficulty and the commodity programs cannot save most of them.

II. THE NEED FOR REFORM

- Since farmers must produce the crops to qualify for payments, the programs artificially stimulate production, which continues at near record levels despite large acreage set-asides.

- Set-asides have encouraged our competitors to expand production and reduced U.S. farm efficiency, since fixed costs are distributed over fewer acres.

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- The large subsidy element in farm programs (especially rice, where farmers are guaranteed nearly three times the world price) distresses some of our allies who compete against us in world markets without such support.
- Mandated payment limitations are weak and avoidable. Larger farmers get larger payments; some receive multi-million dollar payments.
- The cost is tremendous and budget exposure is open-ended. We do not know how much farm programs will cost the taxpayer until well into the fiscal year.
- Nonetheless, any changes will have a substantial time lag. Crop year 1987 programs are already in place which will create large FY88 outlays.

III. AVENUES FOR REFORM

A. De-coupling

Currently, farmers must produce to protect their historical production base and to qualify for payments and supports. For example, a corn farmer might now invest $135 variable costs to produce an acre of corn from which he will earn only $100 in corn sales in order to qualify for $150 in government supports. Both the taxpayer and the farmer would be better off if the farmer grew something else. De-coupling refers to making payments on an historical basis and eliminating the production requirement. This has several advantages.

- Production decisions can be based on economics instead of the need to qualify for payments.
- De-coupling would permit set-asides to be phased out so that farmers who can produce efficiently at world prices are allowed to do so on their full acreage.
- The marketplace would determine what is grown and where, enhancing U.S. competitiveness.
- Distortions such as over-intensive use of inputs (fertilizer, etc.) would diminish.
- Budget costs would largely be known in advance.
- Separating the payments from production and prices can make it possible eventually to phase them out or base them on need.
- Government's daily involvement in production agriculture would be much reduced.

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- Our trade policy negotiating position could be enhanced.
- There is Congressional interest - a Boschwitz-Boren de-coupling proposal received 42 votes in the Senate in 1985.

B. Payment Limitations

Deficiency payments, the difference between target prices and loan rates times production, are limited by statute to $50,000 per person. Congress recently added a $200,000 limit to cover most other direct payments, in particular the so-called "Findlay loan payments" (the Secretary of Agriculture has limited authority to lower loan rates to make U.S. products more competitive, but is required to make direct payments -- "Findlay loan payments" -- based on the dollar amount loan rates were lowered times production). These limits have been ineffective in holding down costs, since Findlay loan payments have been substantial and crop loan forfeitures have been exempt. In addition, a loose definition of "person" has fostered a proliferation of overlapping partnerships and other farm reconstitutions in order to qualify for multiple payment limits. More than 250,000 new farm "persons" have been created in the last two years largely to avoid the limits.

A tightening of payment limitations would reduce outlays somewhat, would curb abuse and limit payments to very large farmers while not affecting small farmers. In rice and cotton, more than half of the payments go to farmers receiving more than $50,000 each. Vigorous payment limitations would reduce the subsidy element and the incentive for over production for these crops.

IV. OTHER CONGRESSIONAL APPROACHES

A. Mandatory Controls

Some congressional leaders espouse a new program of high price supports and mandatory acreage controls. The Harkin-Gephart "Save the Family Farm Act" would allow farmers of each program crop to more than double loan rates from their current levels. In the short term, this would raise prices but it would require a combination of export subsidies and large set-asides that would devastate the farm supply industry and raise costs for the entire processing and food chain, and the consumer. It would price us out of world markets, consigning U.S. agriculture to a future of negative growth, since the domestic market is growing more slowly than farm productivity. It would require import protection, flying in the face of our commitment to freer world trade. Yet since the benefits come quickly and the damages are delayed, such proposals are politically attractive to some and should be taken seriously.

B. Marketing Loans

Marketing loans permit a farmer to use his crop as collateral for a loan at a mandated amount per bushel or pound and at maturity to pay the loan off at the then current market price, which may be much lower. This ensures U.S. prices are competitive, but results in large potential subsidies. The 1985 act included marketing loans for rice and cotton only. Some legislators are proposing extending them to wheat, soybeans and feed grains. This could drive world prices down even further and cost an additional $5-6 billion per year. Since the U.S. is already the dominant world supplier of these items, exports would increase only marginally.

V. OPTIONS FOR REFORM

The EPC Working Group on Agricultural Coordination considered and rejected options such as:

- seeking a total rewrite of the farm bill;
- seeking legislative changes in the dairy, tobacco, and peanut programs.

The Working Group has identified two potential reforms of the farm program that deserve consideration:

- Strengthening payment limitations; and
- Decoupling production decisions from Federal payment eligibility.

A. Payment Limitations

Option 1: <u>Do not enact administrative changes or seek legislative changes but support and encourage Congressional efforts on farm reconstitution.</u>

<u>Advantages</u>

- Chances of passage may be better if the initiative does not come from the administration.
- Will not be popular with farmers yet Congress seems inclined to do it; why not let them?

<u>Disadvantages</u>

- Administration would not be fully using available tools to curb the proliferation of farm entities.
- Not clear that Congress will enact the desired changes.

Option 2: Administratively tighten the definition of "person." For instance USDA can tighten rules on partnership arrangements to qualify for a separate limit.

Advantages

- Some large payments would be reduced, with potential budget savings of $100 million to $200 million annually.
- Proliferation of farm entities would be curbed.
- Promotes fairness.

Disadvantages:

- Not as far reaching as option 3.
- New rules would undoubtedly affect some legitimate partnerships and corporations.
- Strong Congressional objections could be expected as the new rules are implemented.

Option 3: Seek legislation for a $50,000 payment limitation that includes all direct payments, with a separate $100,000 (or $200,000) limitation on non-recourse loans. Tighten "person" definition through administrative and legislative actions.

Advantages

- Very large payments such as those received by some rice and cotton growers, would be eliminated.
- Outlays would be reduced by at least one billion per year.
- Production incentives would be reduced on large farms.

Disadvantages

- Congress has recently rejected making the $50,000 limit all-inclusive and is likely to do so again.
- Most farm groups will strongly oppose such limits. Those representing rice and cotton, especially, will use everything they have to kill a tight limit.
- Not economically correct signal; treats small farms better than large farms.

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B. Decoupling

Option 1: Seek legislation to reduce target prices by an additional ten percent (10%) per year through 1990 and to permit farmers to qualify for deficiency payments with no requirement to grow the program crop. Farmers would be allowed to grow what they wished on the acreage base for that crop.

Advantages

- Is a significant step toward farm program reform.
- Reduces production incentive in marginal production areas.
- Reduces budget exposure by an estimated $10 billion over four years.

Disadvantages

- Other direct payments and loans (especially marketing loans) still provide substantial production incentive.
- Not as dramatic a step toward policy reform as option 3.
- Would be opposed by specialty crops growers.
- Paying farmers for growing nothing will generate some negative publicity.

Option 2: Seek legislation to replace existing direct payments with a transition payment that approximates a farmer's 1987 direct payments. Phase transition payment out over five years, and increase the limit on loan rate reductions from 5% to 10% per year.

Advantages

- Moves rapidly to market oriented production and allows for an eventual end to government involvement.
- Budget exposure would largely be known in advance; outlays reduced yearly.
- Subsidy element would be clearly identified (this can be a disadvantage with farm groups who do not want to be considered "on welfare").

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Disadvantages

- Many farmers and their representatives would object to having their price guarantee removed.

- The total phase-out of payments would raise fears that farmers would be "abandoned."

- May be viewed in Congress as too radical an alternative in the face of a battle over mandatory controls.

- Pays some farmers for growing nothing.

An alternative approach to decoupling, is to simply continue our policy of 1985 and accelerate the reduction of target prices.

Option 3: Seek legislation to reduce target prices by an additional ten percent per year through 1990.

Advantages

- Reduces budget exposure by an estimated $10 billion over four years.

- Reduces production incentives over time thereby gaining greater market orientation.

Disadvantages

- Does not by itself achieve any policy reforms.

- Unlikely to pass and would be used to criticize the Administration for "insensitivity to the farm crisis."

B.

EC Reaction to a Unilateral Reduction of Agricultural Subsidies by the US

--EC leaders would almost certainly reserve any substantive reaction to such a US move until all the details of the US plan were revealed, its exact ramifications understood, and its prospects for adoption gauged. The EC would look to see whether the plan was a bona fide reform effort with domestic political backing, or a cosmetic tinkering with agricultural policy. Of prime importance to the EC would be the effect of the plan on US production and stockpiles of grain and other surplus commodities that compete with EC exports. 25X1

--US moves to cut its own agricultural subsidies probably would have little direct impact on the long-raging debate in the Community on reform of the Common Agricultural Policy (CAP). The need for reform is increasingly recognized, yet the political will to agree on specific actions has been lacking. Foreign pressure would probably play a minor role in the debate, which has been overwhelmingly dominated by member state domestic political interests and EC institutional questions.

> -Strong farm lobbies have made the CAP an important political issue in many member states. With elections scheduled over the next two years in West Germany, the UK, France, Italy, and Denmark, many of these governments are unlikely to want to take on this issue.

 25X1

-The most powerful force for CAP reform has been the chronic EC budget crisis. The CAP is likely to come under unprecedented pressure in 1987 because the EC is expected to overrun its budget by up to $4 billion with no additional financial resources available. The CAP sops up over two-thirds of the budget and is increasingly resented by the Commission and some members. 25X1

25X1

--Still, a US move to cut its own direct and indirect agricultural subsidies would strengthen the hand of those forces pushing for reform in the EC: primarily the EC Commission, and to a lesser extent, the UK. It would help keep the international limelight on the subject, and increase pressure on the EC to take comparable action. Those dragging their feet on reform might not be able to hide behind the argument that the US currently spends more subsidzing its farmers than the EC does. 25X1

--On the specific issue of export subsidies, the EC would enthusiastically welcome a reduction in the US program but almost certainly would not follow a unilateral US lead and reduce its own subsidies. The Community contends its own subsidies merely serve to meet the gap between high internal EC prices and lower world prices. In fact, highly dependent on exports to keep surpluses of grain from becoming even more unmanageable, the EC would view cuts in US subsidies as an opportunity to expand its share of world grain markets. 25X1

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