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Stuart J. Sweet, President **September 21, 2006**

"FARMERS WITHOUT BORDERS"

Within one year, Congress must update the laws that govern the $240 billion agricultural commodities business, passing a legislative package commonly known in Washington as "the farm bill." By tradition, the farm bill covers a significant period of time to give farmers and their bulk purchase customers adequate time to make long term plans. The current farm bill covers the period from 2002 through 2007, and its predecessor covered the time from 1996 to 2002.

The next farm bill must be considered in a world where global agricultural trade barriers are crumbling, and where the law of comparative advantage governs agricultural production – not the law of parliaments. The journey is neither straight nor smooth. Currently, the World Trade Organization talks on agriculture have broken down over how much of the globe's protectionist infrastructure can be removed now and how much can be dismantled another day.

The direction of events toward free trade in agriculture is unmistakable. For investors in U.S. securities, this global shift signals both opportunity and trouble ahead, producing "winners" and "losers."

Probable Winners:

- Milk product users, when milk products can be imported into the country at up to 20 percent to 70 percent less than domestically mandated prices
    - Dean Foods **(DF)**
    - ConAgra (**CAG**)
    - Kraft Foods (**KFT**)

- Sugar product users, when sugar can be imported at perhaps half the domestically supported price
    - Hershey Foods **(HSY)**
    - Tootsie Roll **(TR)**
- American livestock producers, who will sell more beef, pork, and chickens to hungry customers worldwide, and at higher prices when foreign tariffs on meat products are dismantled
    - Smithfield (**SFD**)
    - Hormel (**HRL**)
    - Tyson **(TSN)**
    - Pilgrim's Pride (**CHX**)

Probable Losers: Grain products users, because the prices they pay for grain will increase by up to10 percent when U.S. subsidies fall

- Corn Products International (**CPO**)
- Bunge (**BG**)
- Kellogg **(K)**

Readers can assess these conclusions by reviewing the two most comprehensive papers CAN has analyzed on the subject. The first is a June 2006 study prepared by the Congressional Budget Office, "The Effects of Liberalizing World Agricultural Trade, " available at **www.cbo.gov/ftpdocs/73xx/doc7352/06-30-Trade.pdf** . Next, we recommend reading "Boxed In," by Daniel Sumner for the CATO Institute, at **www.freetrade.org/node/23** .

WTO Talks Status: Finish By July 2007 or Wait for the 44th President to Take Office

Next July, President Bush's "fast track" trade negotiating authority runs out. This is significant because other nations will not formalize trade agreements with the U.S. when American presidents lack this authority.

Under the U.S. Constitution, Congress has primary responsibility for establishing foreign trade rules. This means that trade agreements reached by U.S. presidents have to be processed by Congress like other laws, as statutes which pass both the House and Senate in identical form before being sent to the president for his signature. Foreign countries understandably do not want to reach sweeping historic trade agreements with the U.S. President only to find that Congressional leaders demand further concessions when they write the implementing trade laws that bind the U.S. This is the purpose of "fast track authority." When such authority exists, both the House and Senate voluntarily agree that trade agreements reached by the president will be put to an up or down vote, without amendment. President Bush's "fast track" authority expires next July. Therefore, if the "Doha Round" has not been completed by then, it may be 2009 before a new president, perhaps President John McCain or President Hillary Clinton, will have fast track authority and the Doha Round can be completed.

The U.S. and European Union Offers on Agriculture in the Doha Round

Both the U.S. and the EU produce more agricultural products than they consume internally because they subsidize inefficient operators who could not survive without government help. Both compound these free trade abuses by using export subsidies to convince foreign buyers to absorb these surpluses, undercutting third world suppliers. By comparison, when third world nations misbehave, they erect tariffs walls to keep out foreign suppliers. To create farmers without borders, trade negotiators must sharply reduce all three types of agricultural protectionism. They had made slow, but significant, progress when the talks suspended. Here was the bid-ask spread when the talks broke down on July 25, 2006.

Positions of the Major Agricultural Blocs in the Doha Round

	U.S.	**European Union**	**G-20 (Third World)**
Export Financing	Eliminate by 2013	Eliminate by 2013	Not Applicable
Domestic Support	Cut by 50 percent	Cut by 40 percent	Cut by 65 percent
Tariffs	Cut by 55-90 percent	Cut by 35-50 percent	Cut by 45-75 percent

Writing the Farm Bill in 2007 as the Doha Round Talks Continue

The last farm bill was written in 2002, when federal budget surpluses made Congress generous. Congress approved plans to send $99 billion in commodity support subsidies to farmers over six years, up 61 percent from the $61 billion expected if the terms of the 1996 farm bill had continued. The days of surplus are over, and Congress appears to be in no mood to boost farm subsidies much beyond what were established in 2002. In fact, many farm trade associations are hoping that the current rules are rolled over for one or two years, fearing that a full review will lead to actual cuts.

While the final rules will be made at the Doha trade talks, until the talks conclude it is likely that farmers will hold onto the gains they made legislatively in 2002 for two reasons. First, congressional Republicans and Democrats will be competing for political support in the farm belt when the farm bill is written in 2007. Democrats remain narrow favorites to take back the House this November, but whichever party wins the House elections this fall will enjoy a precarious, modest majority that the voters can easily reverse in 2008. Control of the Senate also will be at stake in 2008. Although Republicans should hold their majority this cycle, they likely will see their 55-45 majority narrow to 52-48. However, a disproportionate number of Senate Republicans must have their contracts with the voters renewed in 2008. A fierce bidding war will help farmers, who are very well organized politically, stave off cuts.

Second, farm groups will credibly argue that the U.S. should not unilaterally disarm by slashing domestic commodity support subsidies before the Doha Round concludes. It has proven difficult to move the EU as far as the U.S. would like. If anything, farm groups argue that subsidies should go *up* to pressure the Europeans as the talks continue, just as President Reagan did when he boosted spending on nuclear weapons, ultimately leading to an agreement with the Soviet Union to cut them sharply. Congress apparently agrees that unilateral cuts are misguided. While Doha talks were moving forward in 2006, Congress rebuffed the Bush Administration's budget proposals to cut support subsidies by 5 percent.

Investors can conclude that farm income will remain healthy, courtesy of Washington subsidies in 2007 and 2008. Until the Doha Round forces agricultural trade barriers to tumble, there is unlikely to be major change in farm price support rules.

How the Subsidy System Operates

It surprises some to learn that the price support system concentrates its benefits on a small segment of American agriculture. Specifically, 21 percent of the agricultural commodity industry by revenue walks off with 93 percent of the commodity support subsidies. The five big winners are corn, soybeans, wheat, cotton, and rice.

There are three major support programs available to select commercial crop farmers. The first is a "loan program" for specified crops, including the five big winners. Under current law, these farmers can take out non-recourse loans offering "loan commodity" crops as collateral.

The collateral is calculated on a per bushel basis established by Congress. If a corn farmer takes out a $1,000,000 loan, he must put up 513,000 bushels as collateral because the "loan rate" is $1.95 per bushel. If the market price of corn drops below $1.95 per bushel when the loan becomes due nine months later, he transfers title to the 513,000 bushels of corn he has raised to the government, and the loan is considered paid in full.

Additional benefits flow to producers of "covered" commodities, a select group comprised principally of the five winners. Every year, they receive a "direct payment" based on the acres they own, whether they produce a crop or not! Every "covered" crop farmer has been assigned "base acreage" and also has established "historic yield" levels on his farm. The corn farmer above, for example, may be known by the Department of Agriculture to have a 1,000 acre farm that historically yields 110 bushels of corn per acre. Under the 2002 farm bill, the "direct payment" for corn is 28 cents per bushel. Every registered corn farmer is entitled to 85 percent of the direct payment. This corn farmer with his1,000 acre farm that historically produces 110 bushels of corn per acre is entitled to (1,000 acres) * (110 bushels/ per acre) * (28 cents per corn bushel) * 85% or $26,180 annually.

In years when commodity prices are low, farmers qualifying for direct payments receive "counter-cyclical payments" as well, based on a "target price" per bushel for their crop and the direct payment price per bushel. In the case of a corn farmer, the target price now is $2.63 per bushel and the "direct payment" is 28 cents per bushel. If the market price is less than $2.35 ($2.63 target price-$0.28 direct payment), then he qualifies for a counter-cyclical payment equal to 85 percent of the difference between $2.35 and the market price for corn. In bad years, when the price falls to $1.90 per bushel, for example, this farmer would receive a counter-cyclical payment that year equal to $42,075, ($2.35 - $1.90) * (1000 acres) * (110 bushels/acre) * 85%.

The three subsidies – non-recourse loans, counter-cyclical payments, and direct payments – are so generous that many qualifying growers consistently sell their crops for less than it costs to grow them, but collect a "profit" because of federal subsidies (**www.freetrade.org/node/23** on p. 19). When the Doha Round is implemented, at least half of these subsidies should be gone.

Milk and Sugar Farmers May Have to Leave the Land of Milk and Honey

If you like milkshakes, better times may be ahead. Under the global trade talks, import quotas for sugar and dairy products are considered the most serious form of international trade distortion. If trade negotiators decide that half of domestic production subsidies must go, more foreign sugar and dairy products will come into the U.S. when the Doha Round is implemented. Their lobbyists will work hard to be treated as "sensitive industries," which would mean grain farmers would have to take deeper subsidy cuts so that they can take less.

Meat Packers May Face Trouble

At what point in a consolidating industry do "economies of scale" turn into "oligopoly power"? Shareholders of Smithfield (**SFD**) and Tyson (**TSN**) hope Congress views them as

adding to productivity, not injuring farmers, when the farm bill is written. There is no question that consolidation has occurred in the meat packing industry. Here are the top packers in 2004, according to the Library of Congress' Congressional Research Service:

Cattle Slaughter		**Hog Slaughter**	
Company	**Market Share**	**Company**	**Market Share**
Tyson	25.6%	Smithfield	26.1%
Cargill	20.5%	Tyson	18.5%
Swift	15.3%	Swift	10.8%
National	9.5%	Cargill	8.9%

Federal trust busters like to use a measurement known as the Herfindahl-Hirschman Index (HHI) to calculate when industry concentration becomes worrisome when evaluating market shares of industry leaders. An industry is considered "highly concentrated" when the HHI hits 1,800. The index for beef packers was 1,842 in 2003.

Some believe the way to restore competitive balance or, put another way, to create a mechanism that will raise the prices packers must pay, is to limit the size of the herds that meat packers control before slaughter. Packing plants idled because there are no animals to slaughter are unprofitable, and their owners will "pay up" to avoid this. To help their voters, Senators Chuck Grassley (R-IA) and Tim Johnson (D-SD), want to allow packers to own animals only within 14 days of slaughter. Hog packers might find this especially painful since they own approximately 25 percent of all hogs, and raising hogs for slaughter may be more profitable than being in the slaughter business. Their shareholders would not enjoy forced divestiture.

On Dec. 13, 2001, during debate on the last farm bill, advocates of divestiture prevailed on the Senate floor by a vote of 51 to 46. The matter was dropped during House-Senate negotiations to produce the final farm bill, under pressure from the House GOP. Industry leaders may not have such protection this cycle, especially if the Democrats capture the House in November.

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