Preface

The Commission on the Application of Payment Limitations for Agriculture (Commission) was established by the Farm Security and Rural Investment Act of 2002 (2002 Act). The purpose of the Commission was to conduct a study on the potential impacts of further payment limitations on direct payments, counter-cyclical payments, and marketing assistance loan benefits on farm income, land values, rural communities, agribusiness infrastructure, planting decisions of producers affected, and supply and prices of covered and other agricultural commodities.

The 2002 Act directed the Commission to prepare a report containing the results of the study, including such recommendations as the Commission considers appropriate. This report has been submitted in fulfillment of the 2002 Act to the President, the Committee on Agriculture of the House of Representatives, and the Committee on Agriculture, Nutrition, and Forestry of the Senate.

The Commission consists of three members appointed by the Secretary of Agriculture: Alice Devine, Vice President and General Counsel, Kansas Livestock Association, Kansas; Dr. Edward Smith, Associate Director, Agricultural and Natural Resource Sciences, Texas Cooperative Extension, Texas A&M University System; and William Spight, producer, Mississippi; three members appointed by the Committee on Agriculture, Nutrition, and Forestry of the Senate: Terry Ferguson, producer, Illinois; Ellen Linderman, producer, North Dakota; and Dr. Neil Harl, Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; three members appointed by the Committee on Agriculture of the House of Representatives: Gary Black, President, Georgia Agribusiness Council; Gary Dyer, President and Chief Executive Officer, Farm Credit Services Southwest, Arizona; and Richard Newman, producer, Texas; and the Chief Economist of the Department of Agriculture, Dr. Keith Collins.

Shortly after the appointment of all members and the Commission Chair, the Commission held its first meeting in late January 2003. The Commission met nine times since then, with the final meeting in August 2003. Written comments were solicited from the public during March 2003 on the effects of further payment limitations, and the Commission received 375 comments. Copies of the comments are available from John Jinkins, Farm Service Agency, USDA, Washington D.C. The Commission held a public workshop on June 17, 2003, in Washington, D.C., where invited experts presented analyses of the effects of further payment limitations, and the public provided written and oral comments. Copies of the papers presented by the invited experts at the workshop and a transcript of the workshop are available from John Jinkins. The Commission also invited a variety of experts to provide information to the Commission during its meetings.

The Commission extends special acknowledgement to the following individuals for their contributions to the Commission's efforts:

Dr. John Jinkins, Farm Service Agency, USDA, and Dr. Larry Salathe, Office of the Chief Economist, USDA. These two individuals served as the principal staff to the Commission, and their exceptional efforts are greatly appreciated.

Staff of the Farm Service Agency for analytical assistance, including James Little, Jim Baxa, Sandy Bryant, Kimberly Graham, Dr. Terry Hickenbotham, Brad Karmen, Dan McGlynn, and Tracey Smith.

Staff of the Farm Service Agency for administrative support, including Patty Moore, Sally Reed, Lynda Smythe, Marlene Thompson, and John Williams.

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Staff of the Economic Research Service, USDA, for analytical assistance, including Dr. Susan Offutt, Dr. Charles Barnard, Dr. Steve Crutchfield, Linda Ghelfi, Dr. Jeffrey Hopkins, Dr. David McGranahan, Dr. Mitchell Morehart, Dr. Stephen Vogel, and Paul Westcott.

Tom Sell, USDA and formerly of the staff of the House Committee on Agriculture, and Terry Van Doren of Senator Fitzgerald's staff for background on the statutory charge to the Commission.

Shirley Brown, Office of the Chief Economist, who provided administrative support to the Commission; and Raymond Bridge, Office of the Chief Economist, and the USDA Office of Communications, for assistance in publishing this report.

Invited presenters at the June 17 Workshop included: Dr. Daniel Sumner, Professor and Frank H. Buck, Jr. Chair in Agricultural Business, University of California, Davis, and Director of the Agricultural Issues Center, University of California; Dr. Bruce Gardner, Distinguished University Professor, University of Maryland; Dr. Daryll Ray, Professor and Blasingame Chair of Excellence and Director of the Agricultural Policy Analysis Center, University of Tennessee; Dr. Pat Westhoff, Food and Agricultural Policy Institute, University of Missouri; Dr. Jim Richardson, Professor, Food and Agricultural Policy Research Institute, Texas A&M University System; Dr. Mark Lange, President, National Cotton Council; Roger Johnson, Commissioner of Agriculture, North Dakota; David Stanford, Vice President, Plains Cotton Cooperative; and Richard Bell, President and Chief Executive Officer, Riceland Foods, Inc.

The Commission is also greatly indebted to the many people who made the effort to provide written and oral comments to the Commission.

Completed this 30th day of August, 2003:

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Contents

Report Summary and Recommendations

Report Summary

Many objectives of farm program payments have been advanced over time, ranging from ensuring an abundant and affordable supply of food and other farm products, to conserving natural resources, to supporting the family farm. The justifications for payment limits and their implementation depend on the objectives of the payments and the effects of the limits on achieving those objectives. Payment limits are an increasing public issue today. Opinions on the objectives of farm programs are very diverse. The Federal budget deficit is record large. Although payments have declined recently, the cost of farm programs may again rise, if favorable weather increases production. This report assesses the effects of existing and further payment limitations, with the hope that the report will contribute to the continuing discussion of payment limitations for agriculture.

The Three Types of Program Payments Are Interrelated and Have Contrasting Purposes

The Commission was directed to consider three types of government payments for the program crops: food grains, feed grains, upland cotton, and oilseeds. Direct payments provide general income support through a fixed payment dependent on producers' historical acreages and yields. Counter-cyclical payments also depend on historical acreages and yields but vary depending on the level of prices. Benefits from the marketing assistance loan program are linked to current market conditions, depending on both current production and prices, with benefits increasing as production rises and prices decline. The marketing assistance loan program offers producers four possible types of benefits: loan deficiency payments, marketing loan gains, certificate exchange gains, and forfeiture gains. Certificate exchange gains and forfeiture gains are not subject to payment limits.

Each of these three payment programs has separate payment limits. The payment rates and the payment limits for each program were established in relation to one another for the program crops. This interrelationship increases the complexity of changing payment and payment limit provisions. Payment limits are uniformly applied across commodities, and regions, despite very different structural and economic situations. Further payment limits, if applied uniformly, would have very different effects across commodities and regions.

Payment Eligibility Criteria Greatly Affect the Performance of Payment Limits

"Persons" are the units to which payment limits currently apply. Persons may be human beings (individuals) or forms of business organizations, known as "entities." Current payment limit administration has two major aspects: payment eligibility criteria (recipients must be "actively engaged in farming") and payment limit implementation (payment recipients can receive payments from no more than three entities). Types of business organizations that reduce farmers' risks, such as corporations or limited partnerships, count as a single payment limit person. Types of organizations where producers pool resources but are individually liable for claims against the farm, such as general partnerships, can potentially have as many payment limit persons as there are members. In addition, an individual, as a sole proprietor or a member of a joint operation or a partnership, may also receive payments from two other entities that may be corporations or limited partnerships. As a result, the administration of payment limits creates incentives for producers to organize their farms in ways that would not occur in the absence of the payment limitations.

To be eligible for payments, persons must be "actively engaged in farming." To be actively engaged, they must contribute time (labor or management) and capital (land or equipment or operating expenses) to the farming operation. This actively engaged concept is an effort to define who is truly a farmer. The actively engaged rule is relaxed for share-rent landowners; they are considered to be actively engaged. This provision benefits operators by facilitating the sharing of production and marketing risks between operators and landowners. Determining active management is very difficult and lack of clear criteria likely facilitates the creation of persons for payment limit purposes.

Current Payments Reflect Farm Size, Are Concentrated in America's Midsection, and Account for a Sizeable Share of Farm Income

Production flexibility contract (PFC) payments, market loss assistance, and marketing loan benefits averaged $18.5 billion annually for the 1999-2001 crops. However, the President's Budget, released in February 2003, projects government payments of $8.8 billion for the 2002 crops and an average of $11.6 billion per year for the 2003-07 crops. This decline, if realized, would reduce average payments to producers and perhaps lessen payment limit issues. Budget projections, however, remain uncertain. Direct payments are projected to be the largest component of payments, averaging slightly over $5 billion per year for the life of the 2002 Act. Corn, wheat, and soybeans are expected to account for nearly three-fourths of those payments. Counter-cyclical payments are projected to average $4.4 billion, but could reach nearly $8 billion per year if market prices were to fall to each eligible crop's loan rate. Marketing assistance loan benefits are projected to average $1.6 billion per year, but could surge to over $11 billion annually, if crop prices were to return to 1999-2001 levels. Larger than anticipated marketing loan benefits would also likely increase the use of certificates above current projections. Marketing loan benefits reached a record high in 2001 at $8.2 billion, including certificate exchange gains of $2 billion, which were also record high.

The 1996 Act's payments are concentrated in the Midwest, Plains, and Delta States, areas tending to specialize in the production of program crops. Excluding conservation payments, about one-third of all farms receive government payments. In recent years, government payments have accounted for about 20 percent of gross cash income and about 100 percent of net cash income for the crops now eligible for direct and counter-cyclical payments and marketing assistance loans. The farms receiving government payments tend to have higher farm incomes and higher net worth than farms not receiving government payments. However, commercial farms (over $250,000 in sales) receiving government payments have lower farm incomes than those not receiving government payments.

Direct and counter-cyclical payments are paid on a farm's historical production, and marketing loan benefits are available for a farm's total production of eligible crops; consequently, farm program payments increase with farm size. In 2001, the largest 6 percent of U.S. farms received 30 percent of total PFC, market loss and disaster assistance payments, and marketing loan benefits, but these farms accounted for 48 percent of the total value of agricultural production on farms receiving government payments.

Current Payment Limits Have Little Impact on Payments, Farm Income, Farmland Values, Rural Economies, or Markets

The current $40,000 payment limit on direct payments is projected to reduce payments to producers by about 1.6 percent or $85 million per year. This conclusion is based on Farm Service Agency (FSA) payment data prior to the 2002 Act and assumes producers reaching the payment limit do not restructure from their situations prior to the 2002 Act. The $65,000 limit on counter-cyclical payments is projected to reduce payments by about 1.6 percent or $125 million per year when market prices for all crops eligible for counter-cyclical payments are at or below their respective loan rate. About 1 percent of all producers (persons) are projected to have payments reduced because of current payment limits.

A larger proportion of upland cotton and rice producers are affected by current payment limits than producers of other program crops. For cotton and rice, direct and counter-cyclical payments per acre and average acreage per farm are generally higher than for other crops eligible for direct and counter-cyclical payments. Nevertheless, many producers affected by payment limits are located outside of the traditional upland cotton and rice production areas. In 2001, producers in 43 States reached the limit on PFC payments. Furthermore, making soybeans and other oilseeds eligible for direct and counter-cyclical payments under the 2002 Act will increase the number of producers that have payments reduced because of payment limits in the Corn Belt and in other regions that dominate in the production of these crops.

Producers currently have many options to reorganize their farm businesses in ways that reduce the effect of limits on direct and counter-cyclical payments. Nationally, 88 percent of farms had 1-2 persons, 11 percent had 3-5 persons, about 1 percent had 6-10 persons, and 0.1 percent had 11 or more persons in 2002. It is likely that many of the farms with a high number of persons restructured to avoid payment limits. There were 325 farms with 21 or more persons. Ninety percent of these farms were located in 9 States—Arkansas, California, Illinois, Louisiana, Mississippi, Missouri, North Dakota, Texas, and Washington. Data for 2001 indicate these were among the leading States in terms of the number of producers having payments reduced because of the limit on PFC payments and the value of payments forgone.

Current payment limits have very little effect on land values, rural communities, and agribusiness infrastructure. That is because limits on marketing loan benefits are not effective, only a small percentage of program crop producers reach the current limits on direct and counter-cyclical payments, and many of the largest farms have either restructured or are likely to do so to lessen the extent to which the limits reduce payments. For the same reasons, current payment limits also have very limited effects on planting decisions and supplies and prices of covered commodities. In addition, direct and counter-cyclical payments are decoupled from production and consequently have little to no influence on planting decisions.

The estimated annual reduction in payments due to current payment limits, which is projected to be on the order of $85-$210 million, can be compared with the costs of administering and implementing payment limits. FSA estimates the costs for producers of filling out required forms at about $8 million annually, which does not include any legal, accounting, or other fees. The Commission was unable to estimate the cost of legal, accounting, or other fees. The Federal government spends about $16 million a year to administer regulations related to farm program payment eligibility and payment limits, including regulations that pertain to conservation and disaster programs. These costs include: employee and other expenses to see that appropriate forms are filled out and filed properly; costs to load information electronically and to develop, maintain, and refine software used to track payments; and costs to investigate, gather evidence, and prosecute instances in which producers have either violated or appear to have violated regulations on payment limits.

The use of certificates has been controversial, subject to much confusion, and often pointed to as the reason limits on marketing assistance loan benefits are ineffective. Producers can avoid the current limit on marketing loan benefits by taking out a nonrecourse marketing assistance loan, waiting until loan maturity, and then forfeiting the crops used as collateral to secure the loan. Certificates simply provide a means to obtain the marketing loan benefit without waiting for loan maturity to forfeit. As a result, prohibiting the use of commodity certificates under the current marketing loan program would likely increase loan forfeitures, which are not currently subject to payment limits.

The use of certificates under current marketing loan provisions results in little projected savings or costs to the taxpayer and only a slight increase in income for producers who would otherwise reach the payment limit and forfeit crops held as collateral for marketing assistance loans. Certificate exchanges avoid potential market disruption both during the marketing season, as stocks that would otherwise be held under loan are free to be marketed, and at the end of the season, when the government would otherwise likely sell forfeited loan stocks.

Further Limitations Could Have Substantial Regional Effects, but Modest National Effects; Much Depends on the Type of Limitations and the Ability of Producers To Adjust

Effects on Producers, Payments, and Farm Income

The effect of further payment limitations on farm income depends on the size of payments, the type of further limitations implemented, the effects on crop supplies and prices, and the extent to which affected producers may be able to restructure their farm operations.

Analysis of PFC payment data for 2000 and 2001 indicates that reducing the limit on direct payments from the current level of $40,000 to $30,000 per person, and assuming producers reaching the limit do not restructure further, could reduce direct payments by an additional $255-$275 million per year, or roughly 5 percent. With prices at the 1999-2001 levels, reducing the limit on counter-cyclical payments from $65,000 to $50,000 could lower counter-cyclical payments by an additional $400-$425 million annually, or about 5 percent. If marketing assistance loan benefits, including certificate exchanges and loan forfeitures, are limited to $75,000, and assuming no supply response, marketing loan benefits could decline by as much as $400-$500 million annually, or about 4 percent. The number of producers (persons) reaching the reduced limit on direct payments would rise from about 12,300 currently to 35,000-40,000. A similar number of producers would reach the reduced limit on counter-cyclical payments, if crop prices fall back to 1999-2001 levels.

Generally, payment limits more adversely affect the incomes of cotton and rice producers than feed grain, oilseed, and wheat producers. Further payment limitations would put financial pressure on many upland cotton and rice farms, unless they are able to restructure. Further payment limitations would also reduce payments and incomes for a lesser percentage of feed grain, wheat, and oilseed farms. Nearly every State would have some producers who would have payments and incomes reduced under further payment limits. Producers affected by payment limits have a number of options for mitigating the effects on farm income. For example, owner-operators could increase the number of persons eligible for payments, cash rent out land, or sell some or all of the acreage no longer eligible for payments. In many cases, payments would be redistributed from the producers affected to producers unaffected by further payment limits, partly negating the effects of further payment limits on total payments and aggregate farm income.

Farm operators who rent land may have fewer options to offset income reductions due to further payment limits. They would likely be less able to compete with other renters for land on which they are no longer eligible for payments. If cash renting, they could try to negotiate share rent leases but would be unlikely to succeed if that creates a payment limit problem for the landowner. Another potential difficulty for tenants is that landowners could elect not to produce on the land and collect direct and counter-cyclical payments rather than renting the land out.

Effects on Farmland Values

Some studies indicate that total government payments in recent years have increased U.S. farmland values by 15-25 percent; thus reductions in payments would be expected to have an effect on farmland values. Payment effects on farmland values vary regionally, reflecting the importance of payments and the influence of nonagricultural uses and other factors on farmland values. The benefits of higher land values accrue to landowners, with many not directly involved in agricultural production. About 41 percent of all farmland is rented out by landowners who do not operate farms, although they may share in the risk of production through crop share rental agreements. Higher farmland values increase the wealth of landowners, helping them finance the purchase of additional land. Higher farmland values also reduce the ability of limited-resource farms to purchase cropland and are of little benefit to farm operators farming mostly rented land.

In areas where competition for rented land is intense, government payments are quickly reflected in rental rates. In other areas, rental rates are slower to adjust, and tenants may retain some of the benefits of government payments. Further payment limitations, by affecting more producers, could reduce competition for land, leading to lower cash rents and land values. The effects of further payment limitations on land values, while expected to have little effect nationally, are likely to vary considerably from region to region, reflecting regional differences in land markets and the number of producers and the amount of payments affected by further limitations. In many areas, land values are heavily influenced by nonagricultural uses, program crops account for a small portion of total cropland, or further payment limitations may not affect enough producers to reduce competition materially for farmland, helping to maintain land values.

Assuming affected producers do not restructure their operations, the percentage of upland cotton and rice producers reaching the payment limit could rise sharply under further payment limitations, causing cash rents and land values to decline most in the areas that produce these crops. In Arizona and California, the percentage of upland cotton and rice producers reaching the limit on direct payments could rise to 25 percent or more if the payment limit on direct payments is reduced from $40,000 to $30,000. In these States, competition for land for production of non-program crops and nonagricultural uses may limit the decline in land values. Increasing numbers of upland cotton and rice producers in other States would also have their payments reduced under further payment limits. Cash rents and land values could be more affected in the Delta and Southern Plains than elsewhere. In these regions, government payments are an important source of income and cropland is primarily used for program crops.

Analysis conducted at the request of the Commission by the Food and Agricultural Policy Research Institute (FAPRI) estimated that land values would average about 0.4 percent lower and rental rates would average 0.8 percent lower nationally during 2004-12, if each farm was limited to receiving $40,000 in direct payments, $60,000 in counter-cyclical payments, and $175,000 in marketing loan benefits. (Farms analyzed were those meeting the Census of Agriculture definition.) The analysis assumed projected market prices above levels during 1999-2001 and that farms would restructure so that 50-75 percent of acreage affected would continue receiving payments. The largest regional declines in land values and rental rates were predicted to occur in the Delta, Southern Plains, Far West, and Southeast, with land values declining about 0.8 percent or more and rental rates declining by 1.6 percent or more in each of these regions.

Effects on Rural Communities and Agribusiness Infrastructure

Farming's role in the Nation's rural economies has declined over time, as growth in the nonfarm economy exceeded that in farming. Out of 2,450 rural U.S. counties, the number of farm-dependent counties—those where farming accounts for 20 percent or more of county personal income—has declined, falling from 556 in 1989 to 316 in the mid-1990s. While the farm share of rural economic activity and the farm population have declined, the rural population has grown, and average farm household income has risen to the point where it is on a par with average urban household income and exceeds average nonfarm rural household income. Despite the long-term decline in farming in the rural economy, agriculture—more broadly defined as farming plus input-supplying industries and processing, distribution, and delivery to consumers—remains a crucial part of the rural and national economy, accounting for 17 percent of U.S. employment and 12 percent of U.S. gross domestic product in 2001. Many rural counties that are farming dependent also continue to depend heavily on government payments.

The greatest effects of further payment limitations on rural communities and agribusiness infrastructure potentially occur in counties where payments are most concentrated, farm income is most dependent on payments, and the likelihood of producers being affected by further payment limits is highest. Such areas are found in: the Delta States of Arkansas, Louisiana, and Mississippi; in west Texas; and in rural areas of Arizona and California, where rice and cotton payments are concentrated. If payment limits were tightened significantly, thereby increasing the portion of producers affected, farm-dependent counties in western Kansas, central and eastern Nebraska and South Dakota, western Iowa, and a few other areas could potentially be affected as well.

Short-term effects of further payment limitations are likely to be negative for rural communities and their agribusiness infrastructure. This conclusion depends on the assumption that payments are important, which occurs when farm prices are low, and it depends on how producers adjust to reaching the payment limit. If producers reduce planted acreage, which several economic studies suggest, then in the most affected counties, there would be declines in farm income, farm input use, purchases of agribusiness services (such as specialized infrastructure like cotton ginning, warehousing, and rice milling), and farmland values. The largest negative effects are expected to be for counties where production of cotton and rice is concentrated. Producers may also shift to other crops, but such shifting is expected to be modest nationally but more pronounced regionally. Positive short-term effects include higher prices of the commodities whose acreage is reduced and lower production costs to the extent cash rents decline. These effects would partially offset the contractionary effects on the rural economies caused by the lower production and farm incomes of those directly affected by the further limits.

The long-run effects on rural economies of further payment limits are generally unknown. The short-run effects on the farm sector, just described, are likely to diminish over time, as producers adjust in a variety of ways to the payment limits. While the competitive position of small farms relative to large farms may be enhanced, little is known as to whether that would translate into positive rural community and agribusiness effects over time. Instead, most studies suggest factors other than farm structure are more important, ranging from nonfarm technology developments (from roads to telecommunications), to economic diversity, to natural amenities, to human capital investment.

Effects on Crop Planted Area, Supply, Demand, and Price

Various studies indicate that government payments over time have increased crop production from 1 to nearly 6 percent. The estimates depend on the period analyzed, as government payments have much less effect on crop production and markets when prices are high. Decoupled payments affect planting decisions much less than payments that are directly linked to current production. Consequently, further limitations that reduce direct and counter-cyclical payments would likely have considerably less impact on crop supplies and prices than equivalent further limitations that reduce marketing loan benefits.

Analysis of eliminating marketing loan benefits provides an upper bound on the effects on acreage and price that could occur under further payment limits that appreciably affect marketing loans. One USDA study estimated the elimination of marketing loan benefits could have reduced plantings of major crops by 2 to 4 million acres, with cotton acreage down 1.5 million acres in 2000, or over 10 percent, the largest percentage decline for all major crops. In response, cotton prices were projected to rise 5 cents per pound and rice prices, 10 to 20 cents per hundredweight. Another USDA study estimated that the unusually low prices of 2001/2002 would have reduced cotton acreage by 2.5 to 3.0 million acres and rice by 300,000 acres in the absence of the marketing assistance loan program.

The FAPRI analysis of a specific payment limitation scenario, cited earlier, estimated that further payment limitations could reduce the area planted to cotton by about 500,000 acres and the area planted to rice by about 250,000 acres in 2004. Cotton prices were projected to increase by 2 percent and rice prices by 8 percent in 2004, while prices for other major crops do not change significantly. FAPRI also pointed out that these effects depend on the existing program benefit levels. If cotton prices were to average below 40 cents per pound, as they did during the 2001 crop year, FAPRI projects cotton acreage could decline by 1.2 million acres in 2004, up from their estimate of 0.5 million acres under the higher baseline price of 40-50 cents per pound. Alternatively, if cotton prices were to average over 50 cents per pound, cotton acreage could fall by only 0.2 million acres.

Producers may increase production of other crops, depending on relative returns, the additional investment and machinery needed, and agronomic considerations. For many producers, alternative crops may not be feasible because of climatic conditions. Some producers or landowners may opt not to produce a crop on acreage subject to further payment limitations, particularly when market prices are considerably below the loan rate. This option is generally less desirable than renting out the land not qualifying for payments to another producer who is not affected by further payment limitations, but may be the option of choice, especially if many potential renters have payments reduced under further payment limitations.

Many of the producers affected by further payment limitations would be located in States that also produce a variety of fruits and vegetables. The 2002 Act's limitations on planting fruits and vegetables along with other factors, such as the increase in investment and equipment, availability of market outlets, including the need for contracts for many perishable crops, and volatility in prices and returns, may prevent many producers affected by further payment limitations from shifting additional acreage into fruits and vegetables. Nevertheless, small shifts in acreage into fruits and vegetables could have negative price effects on some fruit and vegetable crops. Forage crops, such as alfalfa, may represent the best alternative for many western growers, and increased production of such crops would likely occur.

Acreage and price effects are likely to be greatest in the short term. Over time, producers affected by further payment limits are likely to adjust their operations, including reorganizations that permit the receipt of more payments or changes in landownership and rental arrangements that allow other producers to farm the program crop acreage and receive the payments associated with the acreage and production. Consequently, over the long term, changes in acreage, price, and total payments (and therefore land value and rural economy effects) are expected to be substantially lower than in the short term.

Recommendations

Section 1605 of the 2002 Act directs the Commission to study specific issues addressed in this report. In addition, the report may include "such recommendations as the Commission considers appropriate." The focus of the Commission has been on reviewing data and analysis on the effects of further payment limits as reported in Chapters 1 through 5 of this report. In addition, the Commission believes this work has provided information that could guide future legislative and regulatory efforts that address administration, effectiveness, and integrity of payment limits. This guidance is presented in this section of the report.

Timing of Changes in the Levels and Application of Payment Limits

- **Any substantial changes should take place with reauthorization of the next Farm Bill.** The 2002 Farm Bill establishes farm payment programs, including payment limits, through the 2007 crop year. While farm bills can be changed, their multiyear nature provides stability for production agriculture. Producers, their lenders, and other agribusiness firms make long-term investment decisions based on this multiyear legislation. Consequently, if substantial changes are to be made in payment limits, payment eligibility criteria, or regulations administering payment limits, such changes should be part of the reauthorization of the next Farm Bill.

- **If substantial changes are made, there should be an adequate phase-in period.** If any substantial changes in payment limits were to be made, they should be phased in over a sufficient period of time to avoid unnecessary disruptions in production, marketing, and business organization, including landowner-tenant lease arrangements.

General Administration of Payment Limits

- **More resources should be allocated for payment limit administration in USDA's Farm Service Agency (FSA) and Office of Inspector General (OIG).**
  As a result of considerable interaction with those administering and auditing the payment limit program, the Commission believes that USDA staff implement payment limits with integrity and determination. Nevertheless, FSA county office staff have considerable workloads, and more resources could augment current efforts to train staff on payment limits and monitor compliance. Similarly, OIG has limited staff available for compliance and enforcement. The vast majority of farmers adhere to the rules that limit payments. Additional resources could be used to develop a targeted, strategic approach for addressing the most questionable cases of payment limit abuse. Consideration could also be given to developing a system of graduated penalties for intentional violations of regulations that would make the penalty commensurate with the degree of the infraction.

- **Payment eligibility and limitation statutes and regulations should not create incentives that lead producers to choose one form of business organization over another.**
  Farmers may organize their businesses as corporations, limited liability companies, or other types of entities to limit their personal liability for farm business debts, estate planning, and other business reasons. Under current payment limits, there are organizational structures, such as a corporation, that are treated as a single "person," while in other business structures, where liability is not limited, such as a general partnership, each partner is a separate "person" with a separate payment limit. Payment limits should not induce a producer to choose one form of business organization over another.

- **Payment eligibility and limitation statutes and regulations should not cause producers to take on production and marketing risks that they would not otherwise undertake.**
  Share lease arrangements are important risk-sharing mechanisms for producers. Changes in payment limits could provide an incentive to shift from cash to share rent or vice versa for the purpose of redistributing payments. Payment limit statutes and regulations should strive to minimize the effect on the preferred risk-sharing arrangements between landowners and tenants. Continuing to treat share rent landowners as actively engaged in agriculture helps facilitate risk sharing for producers.

- **Efforts to change payment limit policies should strive to make the policies meaningful, transparent, and simple.**
  These objectives are difficult to achieve but worthy, and potential changes in payment limit policies and regulations should be tested against these objectives.

- **Changes in payment limits should be sensitive to differences in commodities, regions, and existing agribusiness infrastructure.**

  Uniform changes in payment limit policies may have very disparate and substantial regional and local effects. Potential changes in payment limit policies and regulations should recognize these impacts.

The Need for Additional Information

- **USDA should increase efforts to provide more complete data on farm program benefits.**

  More information is needed on the relationships between socioeconomic data based on farm operator households and payment data based on persons. Current databases on payments per person provide no economic or other information on the farm operation. Operation data provide incomplete information on a farm's person structure. As a result, there is no direct information available on how farms would be affected by further payment limitations. The Commission also believes that USDA needs to make a meaningful commitment to implementing section 1614 of the 2002 Act, which requires tracking of benefits provided directly or indirectly to individuals and entities. The Commission had difficulty obtaining data tracking all benefits to individuals and recommends that FSA track all benefits through entities to individuals.

- **Alternative ways of addressing payment limits, payment eligibility, and payment limit implementation need more analysis.**

  Academic research on the effects of payment limits is very sparse, partly because the data are limited. Changes in payment limits should not be made without an understanding of the costs and benefits of the changes. The social costs might include reduced production efficiency for U.S. agriculture and the social benefits might include some socioeconomic effects on rural areas. Current academic research provides very limited estimates of efficiency costs and no consensus on socioeconomic benefits. These effects are likely to depend on the types of changes in limits that are made and merit additional study. In addition, most of the results of this report were based on average or deterministic prices, yields, and acreage. The consequences of changing risk-mitigating farm payment programs are better understood using probabilistic risk analysis. Such an approach would provide probability distributions of different outcomes and would make a valuable contribution to the public discussion of payment limitations.

Payment Limit Implementation and Eligibility Criteria

During preparation of this report, the Commission reviewed payment eligibility criteria and payment limit implementation. This review and public comments received identified several issues and alternative ways to address them. The Commission did not evaluate in detail the effects of the many options that became apparent, and therefore provides only conceptual guidance on these issues. Several of the many issues identified and options to address them appear central to the debate about further payment limitations. Development of these concepts into precise proposals would require greater specificity and analysis.

- **Attributing payments directly to individuals (human beings) could improve program transparency, program administration, and farm business efficiency.** Currently, payments are attributed to persons, which may be individuals or entities, such as corporations. This treatment raised two concerns with the Commission. First, the flow of payments from the government to and through all entities to individuals receiving the payments is not identified and therefore not transparent. Second, differential treatment of the various forms of business organizations creates incentives for producers to choose business organizations based on payments rather than risk or other business considerations. Attributing payments directly to the individual would reduce these concerns.

  The Commission identified two alternatives for implementing direct attribution:

  1. All payments would be attributed directly to individuals and subject to the payment limits on individuals. Entities could still qualify for and receive payments. The individual would have to be actively engaged in agriculture for the individual, or the individual's share of an entity, to receive payments. Payments to an entity would be limited by the number of individuals actively engaged in agriculture in the entity. A landowner, as well as trusts, nonprofit organizations, corporations, or other entities that own and share rent land would continue to be considered actively engaged and be eligible to receive payments.

     As an example, an actively engaged individual could receive up to $40,000 in direct payments made straight from the government to the individual. If the individual also has interest in any number of entities and is actively engaged in agriculture in these entities, the individual could receive up to an additional $40,000 in direct payments made to the entities and attributed through them to the individual.

  2. All payments would be attributed directly to an individual, but the individual would not have separate limits for payments received directly from the government and from payments received through entities. The existing limits, $40,000 for the individual and $40,000 from other entities, would be combined into one limit per individual. As in the alternative above, landowners, as well as trusts, nonprofit organizations, corporations, and other entities that own and share rent land would continue to be eligible and receive payments. All payments to entities would be tracked through the entities and attributed to the individuals in the entity who are actively engaged in agriculture. For both of these approaches to direct attribution, the uniqueness of pooling commodities for sale, such as by marketing cooperatives, may have to be addressed.

- **Strengthening the current criteria for determining eligibility of persons for payments could improve program integrity.** Eligibility for payments currently requires that a person provide operating capital, equipment or land and active personal labor or management (see Chapter II). The Commission is concerned that some individuals may become eligible for payments even when their active personal management is not contributing in a meaningful way to the farming operation. This may occur because of the difficulty of measuring management and determining compliance. Hence, the criterion of providing management may present a very low threshold for qualifying for payments, thus facilitating creation of persons for payment limit purposes. This concern could be addressed by combining the active personal labor or management requirement into a single criterion: active labor and management. The Commission did not develop explicit criteria and believes USDA should define active personal labor and management through rulemaking to ensure the individual's contribution to the operation is meaningful and measurable.

Payment Limits on Marketing Loan Benefits

Currently, there is a $75,000 limit per person on marketing assistance loan gains (MLGs) and loan deficiency payments (LDPs), but marketing loans are nonrecourse loans, and there is no limit on loan forfeiture gains. When the $75,000 limit is reached, a producer may continue to receive marketing loan benefits by using certificates to settle the loan or by forfeiting loan collateral to the government. While the use of certificates expedites the process by which a producer receives marketing loan benefits in excess of the $75,000 limit, it is the nonrecourse feature of the marketing loan that makes receipt of these benefits possible.

Imposing a fixed payment limit on marketing loan benefits would require that all four methods of realizing loan program benefits—LDPs, MLGs, certificate exchange gains, and forfeiture gains—be made subject to payment limitations. Making forfeiture gains subject to the payment limit would require that access to the nonrecourse loan be limited. If the nonrecourse loan program with the option to forfeit continues, the Commission concludes there is no clear benefit to eliminating certificates and there are apparent costs (see Chapter 4).

- **Potential changes in the implementation of payment limits on marketing loan benefits must address a fundamental policy choice about who should benefit from farm program payments.**

  The Commission was divided on this choice and simply offers the essence of the debate:

  View I—Continue the current nonrecourse marketing loan program.
  Some Commissioners believe the nonrecourse loan program is a fundamental component of the farm safety net and should remain in its current form. This long-standing program, tracing to the 1930s, guarantees a minimum effective price for all of a producer's eligible production. These Commissioners view the program as essential to income stability and risk management. It is a mechanism to promote orderly marketing by helping producers finance temporary storage, providing them more flexibility to market at the appropriate time over the course of the season. This flexibility is also an important feature for the many producers who must sell into concentrated markets.

  Limiting the forfeiture provision of loans is expected to reduce income and production, particularly for rice and cotton, but also for many grain and oilseed producers, and adversely affect related infrastructure for rice and cotton. The modern commercial family-size farm is large and heavily capitalized, and the current marketing loan payment limit fails to reflect this contemporary and evolving structure of today's farms. Limiting forfeiture to achieve some uniform payment limit on marketing loan benefits for all commodities and all regions would produce inequitable income risk coverage across commodities. For example, production costs for cotton and rice equal a higher portion of the loan rate than for grains and oilseeds.

These Commissioners believe it is notable that marketing loan benefits are large only when prices are extraordinarily low, such as in 2001/2002 for cotton and rice. Removing the safety net at such a time would lead to very adverse consequences for affected producers. The FAPRI analysis conducted for the Commission demonstrated that, under a strict marketing loan limit, acreage cutbacks become quite substantial as market prices decline. These acreage cutbacks result from large income reductions for these family-size farms as well as denial of credit from their lenders because of higher financial risks.

These Commissioners believe that the consequence of a limitation on loan forfeiture would be highly disruptive to production agriculture, agribusiness infrastructure, and local economies in many areas. As affected producers reduce production or their lands are farmed by other, less efficient producers, the efficiency of American agriculture would decline. This reduction in efficiency could raise prices and make U.S. agriculture less competitive in the world.

View II—The payment limit for marketing loan benefits should apply to all four types of marketing loan benefits: LDPs, MLGs, certificate exchange gains, and forfeiture gains. Some Commissioners believe that marketing loans should be nonrecourse up to the payment limit and recourse thereafter. The loan program should not be an entitlement for all producers and for all production, regardless of farm size. Payments should be maintained as far as possible for family-size operations. These Commissioners believe that there is no public interest in providing benefits in excess of a reasonable level of income support for family-size operations. They believe that at a time of low margins in agriculture, a modest population of large, lower cost operators in a regional land market could affect farmland values and rental rates. They question whether it is in the public interest to allow large operators to influence farmland values and rental rates with the use of government payments. There is evidence in economic theory that the gains from efficiency of the larger operations are used to bid up the most limiting factor of production, which is usually land. This is accomplished by bidding up rental rates, some of which are then capitalized into land values.

These Commissioners believe the FAPRI estimates conducted for the Commission on the effects of further payment limitations demonstrate that the effects on acreage for rice and cotton would likely be modest under baseline price projections. Market prices would rise and there would be a small decline in national farmland values. If producers affected by the marketing loan limits have substantial economies of scale, then further limits could be absorbed with little restructuring. Because some affected producers may not have substantial economies of scale, a 3- to 5-year phase-in period for the marketing loan limitation should be utilized. Producers could also mitigate risks by using hedging and other risk management tools to protect against the effects of low prices, which occur periodically and did in 2001.

These Commissioners believe farm consolidation would be slowed somewhat with further marketing loan limits, and that would be beneficial to rural communities, even though empirical data are lacking on this point. They also believe that marketing loan limits would have little effect on overall farm efficiency, as the primary effect would be on reducing the economic rents of large producers. Effective payment limits on marketing loan benefits, after a reasonable adjustment period, would allow labor and capital markets to function and returns to labor and capital would be re-established near present levels. The ultimate major impact would be on farmland values and rents.

These Commissioners would consider the establishment of different loan payment limits by crop or region, although they doubt such differential limits are justified.