

Agricultural Policy Issues for Russia

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The Russian agricultural sector has fared poorly in the transition period of the 1990s. Whether it is judged to have fared more or less poorly than the rest of the economy depends on what indicators one looks at, but it appears that in constant prices gross agricultural output has fallen about 35% since 1991.¹ According to official statistics, the share of agriculture in GDP has fallen from 16.4% in 1990 to 7.5% in 1997, but the sector's share in employment rose from 12.9% to 13.3% over the same period.² The harvests of 1998 and 1999 were poor partially because of bad weather, but the effects were exacerbated by the overall state of agriculture. The total agricultural area shrunk from 213.8 mln. ha in 1990 to 195.2 mln. ha in 1998.³ The government received massive food aid packages from the US and EU last year, and has requested another round this year, raising the serious possibility of a vicious cycle that will lead Russia to a permanent state of aid dependency.

Some of this sectoral contraction was explicable-- and even desirable—due to the highly subsidized nature of Russian agriculture in the pre-reform period. Official OECD estimates show a net PSE of 75% in 1989-91, compared to the (quite high) OECD average of about 41% in this period.⁴ Much of the support was delivered via cheap inputs, especially fertilizer and fuel, leading to its ineffective use (often over-use and waste) that did not translate into proportionate growth of production. As such subsidies declined dramatically after 1991, the use of these inputs (and productivity) plummeted. But while input use should have declined, it clearly fell too much. Gasoline use in agriculture declined from 11.3 mln. t. in 1990 to 2.4 mln. t in 1998, diesel use from 20 to 5.9 mln. t., mineral fertilizer use from 11.1 to 1.6 mln. t. By now, after almost a decade of very low fertilizer use, there is widespread agreement that soil fertility is at dangerously low levels. Successive governments have responded with attempts to reinstate input subsidies in various forms, but these efforts have been constrained by budget pressures, and have never come close to previous subsidy levels. They have also been available almost exclusively to large cooperative enterprises, not to the few private farmers.

* The findings, interpretations, and conclusions expressed in this paper are entirely those of the author and should not be attributed in any manner to the World Bank, to its affiliated organizations, or to members of its Board of Executive Directors or the countries they represent. The World Bank does not guarantee the accuracy of the data included in this paper and accepts no responsibility for any consequence of their use.

¹ See Valdes, ed., , "Chapter 5: Russia"

² Agriculture in Russia. Official issue. Goskomstat. Moscow, 1998, pp.16, 17.

³ Russian Statistical Year-Book, Moscow, Goskomstat, 1999, p.349

⁴ See V. Vitalis, "Background Paper: Russian Agriculture Support, Base Periods", mimeo., New Zealand Embassy, Moscow, December 1998. As he recognizes, the pre-reform figures must be taken with a grain of salt, not least because they were calculated at the dis-equilibrium official exchange rates. Still, the general point is valid.

Some of the other reasons for agriculture's decline, apart from the reduction of subsidies, mirrored the problems in other sectors: low aggregate demand (which hit the livestock sector hard because of the high income elasticity of demand for these products), collapse of the rural social infrastructure, an over-valued exchange rate before the August 1998 crisis (which made local production uncompetitive in domestic and foreign markets), regionalization of power and policy, disruption of trading relations, poor tax policy, and reluctance of the financial sector to lend to productive sectors. Other causes were more sector-specific and reflected the slow pace and inconsistency of reform in the sector: failure to meaningfully restructure large farms, continued grid-lock over land ownership and use rights, inappropriate treatment of private farming, failure to improve market relations and create market infrastructure, and imposition of trade barriers and administrative price controls (mostly on a regional level). The devaluation has made agroindustrial products more competitive, but it appears that this has produced a very limited supply response. Food industry production increased in 1999 compared to 1997 only by 5.6%. Agricultural output in 1999 (in current prices) was a bit higher than the very poor harvest of 1998, but was 11 percent lower than the more normal harvest of 1997 (in constant prices).

The agricultural sector has also remained mired in the non-cash economy. A major part of personal consumption comes from either household plot production or from payment of wages in kind by farm enterprises. In 1998 farm enterprises allocated 27.8% of their marketable grain to pay salaries. In addition to wages in kind, barter arrangements are also widely used to dispose of outputs through other channels. As a result, cash payments in 1998 accounted for only an estimated 40% of the marketable agricultural production. Many farm enterprises lack cash resources to cover their operating costs, let alone expand their production.

Despite its problems, by the end of the 1990s Russia had achieved the basic elements of a market-based agricultural sector. A pluralistic economy was established in the countryside. Private farms emerged, and the role of private household plots became more important. The state monopoly on land was eliminated, leading to emergence of the beginnings of a land market. About 90% of processing and farm servicing enterprises were privatized. The pricing policy in the market of agricultural and food products was recognized to be less dependent on the state than in other sectors of the economy. Positive irreversible processes took place in the mentality of agricultural workers of various ranks. Reforms resulted in a situation where the role of the state as a basic buyer of farm products and as an agricultural input supplier has considerably diminished. While in 1993 the government procured 63% of all the cereals sold by agricultural enterprises, in 1998 this was reduced to 12%. The share of public procurement of vegetables dropped from 71% in 1993 down to 37% in 1998; of livestock and poultry – from 79% down to 41%. The inputs market also saw the emergence of numerous trade agents.

The pace of agricultural reforms has been characterized by a continuous struggle between pro-reform and conservative forces since the early nineties. The fast-changing governments have been unable to implement a consistent set of policies required to properly address the most critical reform issues. The overall performance of the sector indicates that reforms have not yet succeeded in improving efficiency and productivity. In fact, sectoral outputs, investments and the level of technology continue to deteriorate.

Poverty reduction has not happened in rural area, and social conditions have also deteriorated. Attempts to revitalize state-paternalism ideology and policy are getting more and more pressing recent months. They are mostly reflected in the measures aimed at increasing the budget financing and various privileges; state regulation of domestic agrobusiness market; introduction of protectionist policy in foreign trade; creation of new bureaucratic managerial structures. If these approaches triumph, recovery of agriculture will be considerably delayed.

To reverse the sectoral decline will require action on many fronts. Much depends on re-vitalization of aggregate demand in the overall economy. In sectoral policy, the priority issues for the reform program are the following:

Improve Subsidy and Taxation Policies

The amount of state support to the sector has always been a focal point of heated discussions. It is difficult to see a real picture because of the considerable indirect and non-transparent support, including tax privileges and debt write-offs; the large part of the sector that is in the informal economy²; and the generally poor statistics. According to some assessments, general (direct and indirect) support to agriculture amounted to Rub. 37 billion in 1999. Minister A. Gordeev states that in 1998 agribusinesses contributed about Rub. 45 billion to the consolidated budget, including Rub. 15.8 billion to the federal budget, while receiving Rub. 3.3 billion from it. According to the official statistics, in January-October 1999 consolidated budget expenditures in the agricultural and fishing sectors amounted to Rub. 23.8 billion (2.7% of the total expenditures) while tax collections and payments by the agrarian sector equaled Rub. 7.4 billion (1.1% of total revenues).

A major share of agricultural expenditures (about 2/3 of the consolidated budget in 1999) was allocated to regional budgets. Because of this, and their control over domestic trade policy, the regional authorities determine, in effect, the agrarian policy in the country.

However it is measured, the amount of state support during the years of reforms has been declining. According to the MOAF, aggregate support calculated on the basis of WTO methodology experienced almost a 9-fold decrease over the period from 1991 – 1992 to 1993 – 1995. Goskomstat figures show a drop in the share of agricultural expenditures in the consolidated budget from 13.2% in 1992 and 9% in 1993 to 2.9% in 1998 and 2.8% in 1999 (Jan.-Nov.). This trend continued through 1999, as agricultural support fell to 2.8 percent of the consolidated budget (Jan.- Nov. 1999).

In 1999, the federal budget allocated Rub. 7 billion for agricultural development (out of Rub. 8.1 billion planned), including Rub. 1.85 billion for directed subsidies, Rub. 675 million for a leasing fund, Rub. 500 million for a soft lending fund. The amount of

² According to the optimistic estimate of the State Statistics Committee (SSC), the informal hidden economy accounted for 25% of the domestic product in 1998. Most household plot production is in the informal sector. And according to SSC, “informal activities were growing more intensively in agriculture in 1999, almost half of this economic sector is “in the shadow”. (Newspaper “Izvestija”, January 6, 2000).

capital investment was limited to Rub. 233 million, and allocations for raising of soil fertility – Rub. 1.7 billion. The 2000 federal budget envisages allocation of Rub. 11.5 billion for agricultural production, including Rub. 2.3 billion for affiliated entities (salaries of bureaucrats, rent of the buildings) and expenditures of local agricultural organizations, like regional seed and vet inspections; Rub. 200 million for capital investment; Rub. 2.8 billion for raising soil fertility; and about Rub. 3.6 billion for directed subsidies³. Thus, the volume of directed subsidies is planned to be almost doubled in 2000 as compared with 1999, and their growth is the highest among all items of the 2000 budget.

More important than the volume or the trend of transfers to agriculture is the fact that the existing system of subsidizing the sector remains inefficient. Rather than being designed to create linkages between farmers and the private sector providers of credit, inputs, and services, the subsidies crowd out the private sector and preserve the old network of reliance on the state.

For example, bureaucrats decide how and where the funds to raise soil fertility are used. They are not administered in a way that takes advantage of farmers' knowledge of their own needs or gives them a choice. As a result, much of the fertilizer (as in the past) is wasted or in some cases actually counterproductive.

The Soft Lending Fund, as another example, provides credits to agriculture at a hugely subsidized rate—1/4 of the Central Bank's rate—and with little discrimination based on sound lending principles. The resources of this Fund are a basic source for seasonal lending to the agricultural sector. Despite the attempts to introduce economic criteria in allocating the funds of the Soft Lending Fund (to tie the credit to economic and financial performances of the producers) and conduct this work through the commercial banks, this mechanism remains a non-transparent administrative measure, with a significant portion of the credit in default.

Agricultural debt write-offs have been a large—but unbudgeted—source of support. Sometimes this measure has been “interpreted” as a provision of assistance to the regions that suffered from drought and other natural calamities, but this is actually a process of writing off old debts. The last time the debts written off amounted to Rub. 3.5 billion. This was implemented in accordance with Directive of the Government dated November 29, 1999 and used to write off the debts on: (i) the 1995 commodity credit (Rub. 1.3 bn.); (ii) budget loans (Rub. 1.1 bn.); (iii) centralized credits received in 1992-1994 (Rub. 730 mln.); (iv) regional bonds (Rub.415 mln.). The process of debt writing-off worsens financial discipline in the sector, undermines market principles for enterprise relations with the state and discourages the development of agricultural commercial lending. In a recent positive development, Acting President Putin refused to sign a resolution for a huge debt write-off that was prepared before an agricultural strategy

³ These are items such as (i) Subsidies to pedigree stock-breeding (Ru.289.5mln), support to domestic sheep breeding (Ru.140 mln.), subsidies to purchase mixed fodder for poultry factories and livestock conglomerates (Ru.150 mln.), subsidies for flax and hemp production (Ru. 70 mln.), elite seeds (Ru. 65 mln.), partial compensation of crop insurance expenditures (Ru. 80 mln.) and (ii) Partial compensation of expenditures for mineral fertilizers and crop protection chemicals (Ru. 2.65 bln.) which are hidden under another item of expenditures, though in the previous years they were treated as “directed subsidies” .

meeting in Krasnodar (Feb. 11, 2000). In his speech in Krasnodar he said that he is against this practice.

Agricultural production is subject to a wide array of about 10 local and federal taxes. The profit and property taxes are the main taxes at the federal level, but there are special breaks for agricultural producers. The present system, with markedly different effective rates of taxation of enterprises of various legal forms (joint stock companies, cooperatives, household plots, etc.) distorts the evolution of changes in farm organization and encourages tax evasion, thereby increasing barter transactions and weakening commercial marketing channels. The owners of household plots do not pay taxes (except land tax), and as a result, sometimes production of agricultural enterprises is “shifted” in the records to this household sector. Of special concern is that private commercial farmers are not eligible for some preferential treatment afforded others. This is reportedly an important disincentive for individuals to withdraw from the collectives and begin to farm privately. Tax legislation is cumbersome and frequently changed, and the system of tax payment to the budget is extremely complicated. In summary, the current taxation system of the agricultural sector is not transparent, efficient, or equitable relative to the treatment of other sectors of the economy.

To improve the efficiency of the system of subsidies and fiscal policy as a whole requires the following steps:

- Change the principles for identifying the amounts and areas of support. Programs financed through the federal budget should have social objectives or address clearly identified market failures or externalities. This could include development of rural social infrastructure, to reduce the burden of maintaining social infrastructure by agricultural enterprises. State support could also be aimed at expanding the sales of agribusiness production, including exports [exports credits] and Food Stamps Programs to help low income groups of people. Other subsidies should be designed to resolve externalities or market imperfections and targeted/channeled to viable agricultural enterprises.
- Revisit the mechanism of the Leasing and the Soft Loan Funds (since at this stage it is not possible to eliminate altogether the soft lending or state leasing), in order to develop private sector credit and service providers, rather than crowding them out;
- Increase substantially federal budget allocations to support private farms, and ensure that they are eligible for any subsidies accorded to other farms;
- Design a system of measures to legalize the revenues received from the informal economy by both cutting the tax rates and the number of different taxes, and by more clear and accurate identification of the household plots.
- Limit tax exemptions and privileges, and ensure that they do not discriminate against private farmers.

Reduce State Interventions and Encourage Competition in Input and Output Markets

The state monopoly has been replaced with the monopolistic behavior of local processing entities and dictate of regional officials. Russia's regions have in place a number of measures aimed at controlling food trade and prices, which are expressly forbidden under WTO rules. These include price controls, additional standards and certification requirements, re-establishment of monopoly purchasing, uneven enforcement of customs regulations, and other direct or indirect non-tariff barriers to trade, either among regions or with the outside world⁴. Sales of cereals in many regions are controlled by oblast administrations through "commodity credits". In the spring, they allocate financial resources from their local budgets for sowing purposes (in most cases, providing inputs in kind through barter deals) and in the fall they demand debt repayment using cereals and ban free sales outside the oblast. Regional (and, in fact, federal) food corporations set up as a vehicle for market regulations have, in effect, turned into some sort of oblast administration offices used for signature of the contracts that are hard bargains for the peasants. There are also attempts to revitalize the commodity credit system on the Federal level⁵.

In the sale of many other farm products, since alternative sale options are not available, the producer is forced to sell meat, milk, vegetables, and other perishables to the nearest processing enterprise at unfavorable prices. Only a small number of the large farm enterprises have been able to expand the scope of their operation, improve their production efficiency through the construction of their own warehouse, refrigeration and processing facilities or integrate their production and business with those of the agroprocessing and trade enterprises.

Policy here should be aimed at development of new private channels for supplying farm products and inputs (wholesale markets, exchanges, fairs, marketing and supplying cooperatives, revival of the procurement function of the consumers' cooperatives); liquidation of the local monopolies and regional food separatism; expansion of agri-industrial integration; improvements in operation of market information services; and a cardinal change in the line of activities of the food corporations by making them a tool for regulation of —not intervention in— the agricultural market. These changes, combined with improvements in the general business environment and reduction of barriers to entry, should increase competition in these markets.

The law "On Parity of Prices for Agricultural and Industrial Products (Services) Used in Agriculture and Compensation of Losses Caused by Its Offense" approved by the Duma (but not yet signed by President) should be revoked. This Law authorizes annual calculations of the difference between growth of agricultural input and output prices, and mandates that agriculture's "losses" from this be transferred back from the state budget.

⁴ See V. Vitalis, "Second Level Regional Policies in the Russia Federation and the Multilateral Trade Rules Affecting Such Policies", mimeo., New Zealand Embassy, Moscow, September, 1999.

⁵ A governmental Resolution dated January 27, 2000 ("On measures to regulate grain market by the state") envisages introduction of a commodity credit mechanism.

This law also authorizes reduced prices for agricultural inputs (fuel, energy, fertilizers) and various forms of state control over prices in agribusiness.

New regulations should be aimed at state regulation of agribusiness consistent with the conditions of the market economy. This new system needs to include:

- A new system for government procurement and sale interventions under clearly delineated conditions (e.g., emergencies);
- Mechanisms to pledge or provide advance payments to procure farm products;
- Prohibition of the establishment by federal or local governments of ultimate consumer prices or a level for trade mark-ups or indicative coefficients for wholesale/procurement, retail/procurement price ratios;
- Liquidation of any trade barriers; liquidation of the monopoly of RosAgrosnab and other state companies dominating some product markets;
- Establishment of conditions to improve leasing operations by attracting credits of the commercial banks, investment companies, other private investors, and to use modern guarantee arrangements.

Accelerate Land Reform and the Development of an Agricultural Land Market

Land reform is under way, but far from complete. There are now nearly 12 million owners of land shares. About 10 per cent of agricultural lands are clear private property of physical or legal bodies, with another 56 percent in collective enterprises in which workers own land shares⁶. Every owner of a land share is also entitled to get a household plot on a free basis, thus becoming an owner of this plot. Land registration and cadastre is progressing. A land market comprising mainly urban land and household plots has appeared, with about 420,000 transactions in 1998, but very few of these are sales of private agricultural land. These household plots have played a very positive role under the economic crisis environment, when they have become the main suppliers of food for a significant part of the population and for some even the main source of income.

According to the Russian Constitution (1993), the right for private land ownership is one of the main constitutional rights of citizens. Subjects of FR (regions) have no right to turn down or vote down this right from their local legislature. Land relations are recognized as property relations. Nevertheless, only a few regions (among them Saratov, Samara, Tatarstan) have introduced progressive Land Codes. A new Federal Land Code has been discussed in the parliament since 1994 (the old Land Code was approved in 1991). Though sale is permitted by Presidential Decrees (and by law in some oblasts), it has no firm legal basis. Federal law directly bans mortgage of agricultural lands and even

⁶ Currently the structure of land ownership is as follows: state land – 34% (reserves – 9%, state land used by population – 9%, state land used by agricultural enterprises – 16%); private land – 10% (private farmers – 6%, household plots – 3%, other – 1%); collective ownership – 56%.

of household plots. Leasing based on the general articles of the Civil Code or on the laws of the subjects of Federation is extremely limited.

Under these circumstances, the priorities should be:

- Pass a federal land law affirming rights to buy , sell and mortgage agricultural land ;
- Evaluate state farms remaining on ‘the federal property’ list (unprivatized agricultural enterprises). Reduce the number remaining in public sector;
- Include registration of land shares in the system of land registration, and elaborate a legal basis for land share leasing;
- Speed up land survey, registration and titling service as a priority to developing a fully functional land market. (Law on Land Cadastre recently passed.)
- Establish and disseminate procedures for land transactions, including leasing as well as purchase and sale.
- Improve the system of land taxation;
- Establish a framework for the dissemination of land market information.

Implement a New Approach in the Reorganization of Agricultural Enterprises

In the process of agrarian restructuring the majority of agricultural enterprises have faced the problem of insolvency. As of November 1, 1999, 24.3 thousand agricultural enterprises (out of 27.3 thous. large and middle farms) had outstanding arrears (not including defaults on bank loans) totalling Ru. 117.8 bln. Many enterprises have debts which exceed their annual sales volume. In the agribusiness sector, as of beginning of 2000, the total debt was Ru. 189 bln.; this amount exceeds the sector’s annual sales value. This situation has actually paralyzed the system of payments for some agricultural enterprises, and resulted in the chaotic process of creating new legal entities which inherit the old debts. Although these procedures are contrary to the legislation, local administrations in practice ignore this. From 5 to 10 percent of agricultural enterprises are in the process of self liquidation without having appropriate legal successors or processing legal documents. The problem is complicated by the fact that these enterprises own many social assets and provide the corresponding social services for employees. (The total estimated expenditures of agricultural enterprises for social infrastructure are Ru. 10 bln.). The passage of the Federal law on insolvency (bankruptcy) as of January 1998 has provided a serious basis to solve this problem. However, the mechanisms proposed in the law do not consider the specific character of an agricultural enterprise and relations of land and property owners. There is a need for a comprehensive treatment of farm debt linked to the restructuring of farms and the real liquidation of the worst

components of the system. So far, only about 10 percent of the agricultural enterprises have been truly re-organized, though many more have changed their formal title.

The main task here is to establish implementable procedures for restructuring and/or liquidation of insolvent farm enterprises, so that resulting enterprises have incentives and capacity to engage in commercial activities. Debt work-out procedures should split off legitimate social services and place them with the public sector.

Develop a Working Rural Finance System

Problems in rural financial markets have become even more acute following the financial crisis. As a result of reforms, the state has stopped providing “direct credits” (centralized disbursement of budget funds) to agriculture; specialized financial institutions are now used for this work, but the credit volumes are only a fraction of previous levels. At the same time, credit through normal commercial channels has not increased. This has resulted in a severe liquidity crunch.

The issue of agricultural credit in Russia has some particularities determined by the current economic situation in agriculture and the banking sector. On the agricultural side, these include low profitability and creditworthiness of agricultural enterprises; collapse of agricultural financial institutions, including “SBS-Agro” bank; high loan delinquency; and poor and corrupt management of some enterprises. The Russian banking sector remains unreformed. At the beginning of 2000 there were 1,349 credit institutions out of which only 295 (21.9%) had more than \$1.4 million in share capital. Massive closures of weak banks did not happen, and little was done by the ARKO, the agency created March 1999 to oversee the banking restructuring. ARKO failed to restructure the biggest agricultural bank SBS-Agro, which is being kept afloat through various artificial means. Some regional banks remained viable during the August crisis and show considerable growth of activity now. Nevertheless, in spite of a slow recovery of the banking sector, regular loans are not available to agriculture and will not be available on large scale in near future.

A draft Governmental Resolution on creation of “Rossel’khozbank” (a former part of the SBS-Agro) is being submitted for the final approval in the government, and a draft law has been prepared in the Duma. Some 51% of this bank’s shares would be owned by the Government. It would serve as the main channel of providing budget money—all funds from the Soft Loan Fund and the Leasing Fund-- to agriculture. If adopted and funded, this would represent a huge step backward, as it would more or less permanently cement the state’s role as virtually the only provider of credit to the sector and would ensure that lending is done on non-economic criteria.

Use of subsidized credit through the Soft Loan Fund is inevitable at this point, but it should be done in such a way as to attract commercial lending and to facilitate its phase-out in the future. The efforts should be focused at elimination of three major factors associated with the commercial banks reluctance to lend to agricultural enterprises: high risk, lack of adequate collateral; and high transactional costs. Reduction of these deterrents is crucial.

To begin to develop a functioning rural financial market, the main tasks are the following:

- Introduce a new mechanism for the Soft Loan Fund. This would include stopping the practice of administrative distribution of credits (by which the MOAF identifies the amount for each region and regional authorities clear the bank's selection of borrowers) and using only a small number of authorized commercial banks to disburse low-interest farm credits; this work should be done through a system of open and comprehensive competition of all interested banks (subject only to prudential requirements) and borrowers. An independent Banking Board (not the MOAF) should manage the activity, including audit (to assure appropriate use of loan proceeds). Funds of the Soft Loan Fund should be used to provide partial guarantees and partial coverage of the regular interest rate. Under these conditions, any agricultural producer would have a chance to apply to any commercial bank using the normal interest rate. ;
- Abandon the idea of creating a state agricultural bank. This would monopolize financial flows to agriculture and crowd out private lenders.;
- Phase in requirements by the Loan Fund for risk sharing by participating commercial banks. This could include various schemes, including: (i) a partial credit guarantee scheme to cover business loans for working or fixed capital investment (this scheme was designed for bankable Nizhny Novgorod agricultural producers who lack sufficient collateral to assist them to get credit from commercial banks); (ii) a partial export credit guarantee which covers pre-shipment risks on a transaction; (iii) a crop insurance program which deals with agricultural risks such as adverse climate⁷; and also (iv) "non-commercial" loan guarantees which protect lenders against political risks;
- Pass a law on mortgage crediting in agriculture and use of land as collateral;
- Develop the system of non-bank agricultural credit unions, cooperatives and collective borrowing organizations to help small agricultural producers; support various mutual lending and leasing arrangements. The law on credit cooperatives should be finally approved by the Parliament. Creation of credit cooperatives should be initiated through the Special Governmental Program for Cooperation in this area. Ideas of cooperative credit should be widely discussed among rural population to explain the benefits of their application for private farmers and household plots owners; and
- Widely introduce the system of warehouse receipts and grain mortgage transactions. The specific normative basis for using warehouse receipts should be approved.

⁷ Such a scheme should be based on sound insurance principles to avoid adverse selection and moral hazard, including payments determined by objectively measurable variables outside the control of individual producers, such as area rainfall or hail.

