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COMMENTARY

D. Gale Johnson's Viewpoint

Emphasis on Subsidies Is Misplaced

The Basic Difficulty Is High Prices

The statements issued at the conclusion of the preliminary meeting for the new GATT round—held in Punta del Este, Uruguay, in September 1986—make it all too clear that there will be enormous difficulties in liberalizing trade in farm products. That there was substantial disagreement between the European Community and the United States was nothing new or unexpected.

Before the meeting, a French spokesman, trade minister Michael Noir, quite correctly stated: "We need to deal with surplus production first." This is exactly the point that President Reagan made at the Tokyo Summit.

Given this degree of agreement on the most significant issue, why was there so much conflict and argument before and during the Punta del Este meeting? One reason for misunderstanding is the emphasis on both sides of the Atlantic upon subsidies as the major culprit for the present highly disorganized state of world trade in agricultural products. This emphasis is unfortunate.

The trade disruptive effects of the Common Agricultural Policy (CAP) are not due primarily to use of export subsidies. Nor are the remarkable disruptions the U.S. created in rice and cotton markets in 1986—and the more modest but still important disruptions in the wheat and feed grain markets—caused by the much heralded export subsidies of the Export Enhancement Program.

In both the U.S. and the EC the basic difficulty starts with high prices. In the EC high threshold and intervention prices lead to excess productive capacity and agricultural output greatly in excess of EC demand. Thus, the necessity to export at almost any cost.

In the United States high target prices, supplemented until 1986 by high support prices, have been and are a major element in the current overcommitment of resources to agriculture. Thus, the emphasis given to increasing exports without regard to cost or effect upon others. Deficiency payments and marketing loans as currently used differ very little from explicit export subsidies—especially for cotton, wheat and rice, and to a modest degree for feed grains.

Emphasis on Subsidies Misleading

The emphasis upon subsidies rather than prices permits a French spokesman to mislead by comparing the amount of subsidies per farm—$20,000 in Canada, $10,000 in the United States and $2,000 in the EC as was reported in the International Herald Tribune of September 13-14, 1986. As related to the issue of surplus production, such figures are meaningless. They are almost certainly factually incorrect, but that is beside the point.

The fundamental issue is the degree of protection. The amount of subsidies, which reflect only governmental payments and entirely ignore prices paid by consumers, is a very inadequate measure of the extent of protection and the effect of domestic farm policies upon the level of production and consumption. In fact, it is possible to have a highly protectionistic farm program that encourages output expansion without a franc or a dollar of governmental subsidy.

The McNary-Haugen farm legislation of the 1920's was such a program, as is the current EC sugar program. The only significant subsidy in the EC sugar program is for the reexport of sugar that the EC committed itself to purchase from some former colonies of the European countries. If the domestic price is set high enough, and exports don't account for too large a share of domestic output (say, not more than a fourth), high rates of protection for agriculture that encourage output expansion can be achieved without the use of any governmental subsidies. So a prohibition on export subsidies need not result in market-oriented farm programs.

Reduce U.S. Protection, Too!

The rancorous debate will end, in all probability. But then the really difficult issues will emerge. These issues relate to the potential nature of any agreement that might be reached to reduce agricultural protection in the OECD countries and, even more difficult, working out within the EC, the United States and other countries the process by which protection can be reduced to an agreed-upon level. Note that the emphasis is upon protection and not upon subsidies.

The United States faces serious difficulties in negotiating reduction in agricultural protection levels. By the enactment of Section 22 of the Agricultural Adjustment Act of 1933, Congress showed its disdain for international agreements. Section 22 requires, without regard to any international agreement, that imports that adversely affect a

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domestic farm program should be restricted. This section should be repealed. Otherwise any commitment on protection levels by the United States is of little value—certainly not enough value for other countries to negotiate reductions in their protection levels.

Similarly, the U.S. needs to relinquish its 1955 GATT waiver for Article XI. The waiver permits the use of quantitative restrictions on imports without any need to justify their use. The waiver could be voided if Section 22 were repealed. Even if Section 22 is not repealed, the waiver should be ended so that U.S. failure to live by GATT principles on agricultural imports would be subject to at least the discipline of withdrawal of concessions on our exports by other countries.

A most serious issue must be considered in evaluating the prospects of the GATT negotiations on agricultural trade. This issue is: Does either the United States or the European Community have the capacity to enter into a binding agreement to reduce protection to a given level by a specific date? What is to keep Congress, for example, from mandating price support or target prices that violate such an agreement?

If Section 22 is not repealed, Congress can force violations of any trade agreement. Similarly, under the current decision rules in the EC requiring unanimity, what is to keep one country from vetoing price reductions that would be required by a trade agreement?

It is important that the U.S. and EC enter into constructive discussions concerning how the farm price and income policies of each can be made more market-oriented over the next decade or so. As of the moment, there is no basis for saying that the U.S. policies are more market-oriented than the EC's or that the EC subsidizes its agriculture to a significantly greater extent than does the U.S. today. In the past EC's protection of agriculture was greater than in the U.S., but this is no longer the case.

The European Commission's price decisions for 1986 for the grains were more consistent with the long run required adjustments than the U.S. price decisions. Taking all the actions together including a levy of 3 percent, nominal returns to grain producers in France in 1986 may be as much as 10 percent below 1985. When inflation is taken into account, the decline in real producer returns for grain will be at least 10 percent for the entire community. ■

DISEQUILIBRIA

. . . when things don't fit and other thoughts

Andrew M. Novakovic on The Dairy Buyout

It May Work

The Food Security Act of 1985 (FSA) launched a new way to deal with the surplus milk production problem. Dairy farmers could bid for government payments in exchange for slaughtering or exporting their dairy cattle, retiring their dairy facilities, and ceasing the production of milk for five years.

During February and March 1986, bids were tendered by farmers and reviewed by USDA. By April 1 the farmers whose bids had been accepted were notified, and an 18-month phasein period began. Other dairy price support provisions of the FSA featured an assessment on dairy farmers and future cuts in the support price for milk.

Many think the dairy buyout will be a failure but there are good reasons to be more optimistic.

The Dairy Termination Program, or buyout, will significantly cut milk production and can help lead to balanced dairy markets in the future.

Detractors argue that the buyout is mostly a political gimmick having no long-run value in terms of reducing milk production. This reaction results in part from the experience with the 1984 and 1985 Milk Diversion Program (MDP)—also an experiment in voluntary supply control. Although the MDP cut production in the short run, it did not provide a long-run solution to surplus milk production. The buyout program need not and should not replicate the MDP experience. The buyout differs from the MDP in two important respects. First the programs have distinctly different requirements. Second, the profile of the buyout's participants could enhance its success; the type of farmers in the MDP worked against its chances of success (which wasn't good in any case).

The buyout required a total disposal of cattle and termination of milking. That is certainly "stiffer" than the partial reductions required by the MDP. The likelihood of positive long-run effects—participants staying out of business—is higher than what was expected and observed with the MDP. A production rebound after the MDP was a certainty. Some buyout participants—or their resources—may reenter dairying when their contracts expire, but with all their dairy animals and perhaps other dairy assets sold off, reentry is much less likely.

There are no specific data describing farmers who participated in the MDP or the buyout versus those who didn't; but from what information is available it appears that farmers were motivated in different ways by the two programs and that this affected the types of farmers who participated in these programs.

Two of the major factors which affected the profitability of participating in the MDP were (1) a farmer's current production relative to his base, and (2) the level of a farmer's fixed costs relative to his variable costs. The MDP invited what has come to be known as "selling air," i.e., farmers could cash in on prior reductions relative to their base, without doing anything new. Before the MDP began, its participants' annual production was already some 20 to 25 percent below their "base" marketings. Low fixed costs relative to total costs also encouraged participation. Farmers whose fixed costs were low relative to their total costs were penalized less for operating at less than full capacity; hence the attractiveness of the $10 per hundredweight diversion payment was greater for them than it was for producers with higher fixed costs.

In areas of the country where the fixed costs of milk production tend to be relatively high, such as the traditional milk producing regions of the Upper Midwest and Northeast, participation in the MDP was very low. In some areas, such as the Far West, fixed costs are relatively low but many farmers had expanded too much to be able to afford to cut back below their base period production. The single most important factor was probably the level of production relative to base production. For farmers in this category, the partial cutbacks required under the MDP were easy to achieve and the payments were substantial.

A different set of motives apply to the buyout. In the beginning most analysts

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