Domestic Agricultural Programs:

The Case for Multilateral Decoupling

By Thomas Grennes

There are two main problems of current U.S. agricultural policy: (1) large Federal Government expenditures on commodity programs, and (2) a price structure that generates commodity surpluses and makes exports uncompetitive without subsidies. The recent decreases in support prices and the depreciation of the dollar reduce the severity of these problems without solving them.

Proposals to reform agricultural policy are usually directed at either reducing government spending or promoting exports, but most proposals would solve one of the problems at the expense of the other. For example, general supply control, as proposed by Senator Harkin in the Third Quarter 1987 Issue of CHOICES, would reduce government outlays but exports would become less competitive than they are now. Proposals to increase the level and extend the coverage of export subsidies would enhance competitiveness only by increasing budgetary outlays. Both proposals are incremental reforms in the sense that they retain the main feature of agricultural policy that has been used since the 1930's, namely the manipulation of commodity prices to transfer income to farmers.

A more fundamental reform is to separate government payments from production and prices. A recent popular name for the idea is "decoupling," but it is an application of the public finance concept of a lump sum payment. The idea of decoupling payments from production is appealing because it permits exports to become more competitive without increasing budgetary outlays. Lump sum payments appear to dominate both production controls and export subsidies as an approach to current U.S. agricultural policy problems. When agricultural trade problems of other countries are also taken into account, the appeal of lump sum payments is even greater.

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The European Community and Japan have also managed agricultural prices to protect their producers from foreign competition. The result in Europe has been agricultural surpluses that cannot be exported without subsidies and budgetary expenditures that dominate all other items in the Community's budget. In Japan, domestic agricultural prices are so far above world prices that they impose enormous costs on consumers and provoke serious conflicts with trading partners.

Competitive subsidization of agricultural exports is so widespread that leaders of countries that are harmed by subsidies have found it necessary to form an organization, the Cairns Group, in order to restrict their use. Agricultural trade disputes have become so frequent and contentious that commercial relations border on trade warfare. The conversion of traditional price-based domestic policies to lump sum payments in all the major trading countries (especially the United States, the European Community, and Japan) would make a major contribution to solving these problems.

Traditional Domestic and Trade Policies Conflict

When support prices in the United States exceed prices in the rest of the world, domestic policy cannot be implemented without restricting imports and subsidizing exports. This conflict was explicitly recognized in Section 22 of the Agricultural Adjustment Act of 1933 which authorizes trade restrictions when trade interferes with the implementation of domestic programs. Another example of the conflict is the repeated request (every year since 1955) by the United States to the General Agreement on Tariffs and Trade (GATT) for an exemption from the GATT restriction on the use of import quotas. It is generally acknowledged that when goals of foreign and domestic agricultural policy conflict, the domestic goals prevail in the United States and in most other countries.

The widespread use of domestic policies that attempt to manipulate prices and the dominance of domestic policy over foreign policy have been the main barriers to liberalization of agricultural trade in the period since World War II. Agricultural products have been almost completely excluded from multilateral trade negotiations because of the close link between domestic policy and international trade. It will be impossible to achieve significant liberalization of agricultural trade in the Uruguay Round without reform of domestic policies.

Although reform of agricultural trade will be difficult to accomplish, conditions may be right for change. Traditional domestic policies have brought about commodity surpluses, budgetary problems, and trade disputes.

In the current Uruguay Round of multilateral trade negotiations, agricultural trade has been established as a high priority topic. The OECD ministers have agreed that fundamental reform of domestic policies is a prerequisite to agricultural trade liberalization. The Reagan Administration has presented a radical reform proposal to GATT that includes multilateral decoupling as a prominent feature. Thus, governments of major trading partners have a shared perception of the fundamental problem that faces them.

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Domestic Decoupling

Evidence from the past 50 years indicates strong political support in developed countries for transferring income to farmers. Traditional commodity programs that accomplish these transfers manipulate product prices and unavoidably interfere with international trade. However, the goals of income support for farmers and freer trade are not necessarily incompatible. Income transfers of any amount can be made without interfering with trade provided that payments are separated from prices and production. The idea of separating payments from production has been advocated in various forms. Senator Boschwitz has been a vigorous advocate. Rausser and Foster endorsed the approach in their CHOICES article. By making this separation, the main goal of traditional agricultural policy can be met by changing the form of government programs and the basis for entitlement to government payments.

The basic idea is simple. Congress would determine the total value of payments per year and establish a rule for distributing payments among farmers. The most important feature of the program is that payments would *not* be related to current production. As a result, decisions by individual farmers about whether to produce another unit of output would be guided by market prices and cost of production rather than features of government programs. Prices would be determined by supply and demand, and domestic prices would move with foreign prices. Exports would be competitive without the need for subsidies. There would be no reason to restrict production, the use of land, or any other input and the payments would not affect production, consumption, or trade.

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The determination of total payments per year would be a purely political decision involving the relative importance of generosity to farmers versus budgetary saving. By expressing its policy as a fixed total expenditure, Congress would obtain greater certainty about its budgetary commitment. The traditional formulation of policy in terms of support and target price levels would place no limit on total spending.

An infinite number of rules could be devised to distribute payments among farmers. Two simple rules that have been discussed are (1) duplicate the pattern of payments that prevailed in some historical base period, and (2) make equal payments to all eligible producers. In the first case, each producer would receive the same percentage of total payments that he received in the base period. For example, in 1984, 14.5 percent of all U.S. farmers had sales of at least $100,000. These large farms received 69.4 percent of gross farm income and 66.5 percent of direct government payments. The first rule would give these same farmers about two-thirds of the total allocation made for lump sum payments. The second rule would be more favorable for smaller producers.

New farmers could enter the industry, but they would not be eligible for payments. The distribution rule chosen would have great importance for individual recipients, but it would have no effect on the total production of any product. If payments were made to farmers based on the amount of government payments received in the base year, a certificate verifying the owners' claims on future payments would become a valuable asset. Alternatively, if payments were based on previous land use or farm ownership, expected future payments would be capitalized into the market value of land or farms. In all cases, the beneficiary would have some asset that could be used as collateral for a loan. Since payments would not be related to current production, prices, or acres planted, land rent would not be affected by the program.

A major advantage of lump sum payments is their flexibility in terms of total expenditure per year, duration of payments, and the distribution of payments among recipients. An example of how a particular program could be implemented is useful. Let payments to each individual be a fixed percentage of payments received in the base year. Once the base year (1986) and the percentage (100 percent) are chosen, each individual knows his share of total payments. If Congress chooses to spend $26 billion (actual spending in 1986), a farmer who received one one-millionth of the total in 1986 would receive $26,000 in the current year. The farmers could use the money for any purpose including consumption. Moreover, the $26,000 payment will not be affected in any way by the quantity of goods produced (including zero agricultural output).

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Eligibility would be based on records of the Agricultural Stabilization and Conservation Service for 1986, and a certificate verifying the expected payment of $26,000 could be used as collateral for a loan. Certificates would be transferable and inheritable. Buyers of certificates should be willing to pay an amount based on the present value of expected future payments. The market value of a certificate would depend on the expected annual payments and the expected duration of the program. If the program were expected to last for one year only, a certificate would sell for $26,000. At the opposite extreme a certificate would sell for $260.000 (at a 10 percent discount rate) if the program were expected to last forever. Congress could increase certainty by committing itself to a fixed annual payment for a fixed number of years. Since all laws are subject to change, a more likely outcome is that Congress would change total expenditures per year in every farm bill. A virtue of decoupled payments is that fluctuations in annual payments associated with the political process would result in less economic distortion than was caused in the past by fluctuations in support prices and target prices.

Since payment shares would be based on past behavior, payment limits could be imposed without altering current behavior. Thus, the problem of subdividing farms to circumvent a payment limit per farm would not arise. In the example, a person who would otherwise receive $26,000 could not avoid a limit of $20,000 without purchasing someone else's certificate. Since the benefits of the program would accrue to the initial recipient, concentration of certificates as a result of purchase at market prices would not be objectionable. Indeed, the ability of financial institutions to buy unlimited quantities would enhance the liquidity of certificates.

Decoupled payments have a neutral effect on trade; they would not affect the competitive position of any country.

In this example, two groups of farmers would not receive benefits: (1) those producing products for which programs did not exist in the base year, and (2) those who were eligible for programs in the base year but chose not to participate. The first group includes producers of sugar, dairy products, and tobacco whose prices have been kept artificially high by import barriers or production controls. Payments could be extended to these groups, but, for a given total program cost,

less would remain for those who participated in price-related programs in the base year. Since lump sum payments have a neutral effect on production and consumption, the distribution of payments is a purely political issue.

Under a policy of decoupled payments, U.S. exports would be more competitive. However, the effect of the policy on the total value of exports depends on the relative importance of lower prices and greater export volume. The response of exports depends on many variables, including the length of the time period considered; domestic restrictions on prices, production, and inputs; and the completeness of price transmission to other countries. By eliminating domestic restrictions, a program of decoupled payments would increase export response. If decoupling were also adopted by trading partners, there would be an additional stimulus to export response as prices would be more completely transmitted abroad. In the presence of these complementary policies at home and abroad, it is likely that after one year the increase in export volume would exceed the decrease in prices for all U.S. agricultural exports.

For More Information

For other writings related to decoupling, trade conditions and negotiations see:

The articles in the Third Quarter 1987 issue of CHOICES by the three U. S. Senators: Cochran, Boschwitz and Harkin.

The American Enterprise Institute (Washington, DC) March 1987 Working Paper "Domestic Commodity Programs, The Value of the Dollar, and U.S. Agricultural Exports" by Thomas Grennes.

The Institute for International Economics (Washington DC) September 1987 book, Agriculture and the GATT: Rewriting the Rules by Dale E. Hathaway.

The September 1987 *World Economy* article, "Multilateral Negotiations on Farm-Support Levels" by Stefan Tangermann, T. E. Josling, and Scott Pearson.

Importance of Multilateral Decoupling

A case can be made in favor of unilateral decoupling of payments, but benefits will be greater if the major countries act in unison. The resource adjustment problem in each country would be smaller than if the countries acted on their own. A disadvantage of unilateral decoupling is that protectionist rivals would gain a competitive advantage. For example, unilateral decoupling by the United States would make it possible for European exporters to obtain a given share of the world grain market at a lower subsidy cost.

The simultaneous adoption of decoupled payments by the major trading countries would greatly improve the world trading system. The use of lump sum payments would permit countries to continue income transfers to their farmers without incurring the unintended side effects of commodity surpluses and trade controls. The opportunity to compensate farmers whose income would otherwise fall should enhance the political acceptability of trade liberalization. Agricultural trade disputes would become less common and less severe. By eliminating the need for controls on commodity prices, production, and inputs, a policy of decoupled payments could reduce the remaining forms of agricultural protection to tariffs and import quotas. Changing protection to these more conventional forms would make it easier to agree on the measurement of protection and easier to carry out successful multilateral trade negotiation.

Since lump sum payments to producers do not distort trade, it would be useful to provide countries an incentive to adopt this form of income support. As Tangermann, Josling, and Pearson point out, lump sum payments could be excluded from the measures of protection used in multilateral trade negotiation. For countries converting traditional commodity programs to decoupled payments, the measured rate of protection would decline, and these countries would be entitled to receive trade concessions from other participating countries. Since decoupled payments have a neutral effect on trade, they would not affect the competitive position of any country. Each country would be free to choose its own total outlay on farm income support and its own rule for distributing payments.

Lump sum payments to producers combined with market determined prices would make it possible to apply the same set of GATT rules to agricultural trade as to general trade. Hathaway describes the two major current exceptions that allow import quotas and export subsidies. Import quotas on agricultural products are permitted if production of the import substitute is restricted (Article XI). Export subsidies on primary products are permitted (Article XVI) if the resulting share of the world market is not "inequitable." Since import quotas and export subsidies are not necessary to implement decoupled income payments, there is no justification for a more permissive set of GATT rules for agricultural products. The more general set of rules is clearer and easier to implement. Adoption of uniform rules for both agricultural and nonagricultural trade has also been advocated by the Cairns Group.

The Right Time

The time is right for major reform of domestic agricultural policy. Separating income payments from production would stimulate United States exports without increasing budgetary outlays. Multilateral adoption of decoupled payments would allow countries to continue to support incomes of farmers at desired levels without interfering with international trade. This fundamental reform of domestic agricultural policies would reduce the frequency and magnitude of trade disputes and eliminate the major barrier to successful trade negotiations.

Have you read...

An Economic Analysis of Agricultural Land Loss and Its Impact on Family Farms in North Carolina

...a report on an examination of farmland transfers in North Carolina in the three years beginning in 1982. The study found that nearly two-thirds of farmland involved in transfers was converted to nonagricultural uses.

Practically all farmers (96.7 percent) surveyed believe that there will be a shortage of farmland by the year 2000. And nearly as many said that all levels of government should take measures to protect farmland.

But close to 99 percent believe that individual owners should be able to sell their farmland even if it is converted to nonfarm use.

For a copy of the final report, write to Anwar Saeed Khan, North Carolina Agricultural & Technical State University, Department of Economics, Greensboro, NC, 27411.