PolicyPennings by Dr. Daryll E. Ray

Bush calls for elimination of agricultural subsidies

President George W. Bush dropped an agricultural bombshell at the G-8 Conference in Gleneagles, Scotland. At the least, it was a bombshell for U.S. agricultural producers who see the present farm program as essential to their survival. According to a July 7 Bloomberg press release, Bush "is seeking agreement with the European Union on a plan to eliminate, by 2010, the $112 billion a year that rich countries spend subsidizing their farmers." Bush's proposal goes well beyond the subsidy reductions currently being considered as a part the ongoing trade negotiations in the Doha Round of the World Trade Organization.

Of the $112 billion that Bush proposes to eliminate, one can readily assume that some $20 billion of that would come from reductions in U.S. farm program spending. For a moment, let us set aside the political improbability that the U.S. Congress would accede to such drastic cuts. Neither will we consider whether it is necessary to find replacement programs for eliminated farm-payment programs. Let's focus only on the arguments one could make to justify the elimination of various subsidies paid to U.S. farmers.

The first "subsidy" that comes to mind is the direct payments that farmers receive based on historical production figures. This type of payment is said to be decoupled because it is not tied to farmers' current production levels. And, since decoupled payments do not affect production and therefore prices, such payments do not influence quantities traded internationally. Or, to use trade negotiations lingo, decoupled payments are said to be "non trade distorting".

This type of payment, the direct decoupled payment, is a recent policy innovation. They came into being as the result of a Congressional deal during the debate on the 1996 Farm Bill. That deal allowed spending during the tenure of the 1996 Farm Bill to be based on "baseline" computations that were made more than a year earlier when farm prices were relatively low. Had the computations been made using the higher prices that existed during the later stages of the debate on the 1996 FB, agriculture would have been budgeted much less money over the life of the bill. The tactic of using the earlier, more generous, set of payment computations as the basis for determining the 1996 FB budget came to be known as "capturing the baseline."

At the time, farmgate prices were expected to remain high for the foreseeable future, so the additional "captured" money was channeled to farmers as decoupled payments, allowing farmers to get gradually diminished payments even under high-price conditions. They were called AMTA payments because the title of the 1996 Farm Bill that created them was called the "Agricultural Market Transition Act". Given that title, many believed - and some said - that the goal was to wean farmers off of federal subsidies and allow them to receive their income from an export-driven marketplace. The idea was that the payment levels would transition down to zero at some point in the future.

Guess what? Export-driven prosperity did not arrive with the implementation of the 1996 Farm Bill. Instead, total crop exports remained at the level they had been for the previous 15 years, farmgate prices fell, and federal farm subsidies more than doubled through the use of "emergency payments." By 1999, many farmers received more than 100 percent of their net farm income from government payments. AMTA payments in the 1996 Farm Bill were maintained and renamed direct payments in the 2002 Farm Bill.

In evaluating the AMTA/direct payments, we want to ask two questions: (1) Who has ultimately benefited from these payments? and (2) Do they solve or ameliorate a market failure in crop agriculture?

The AMTA/direct payments have been a boon for country bankers and landlords. On owned ground, the banker can encumber the guaranteed payment as a condition of making an operating loan for a farmer. With this payment, the banker knows that at least a portion of this year's payment on the loan will get paid no matter what the price or crop condition. For the landlord, most often the AMTA/direct payment gets bid into the cash rent rate. Farmers bid cash rent rates up because they know they can pay part of an increase in rental rate from the AMTA/direct payment. Land-owning farmers have benefited to the extent that they: (1) have access to credit, (2) can quit farming and make more off the land by renting it than if they farmed it themselves, or (3) are planning on selling the land in preparation for retirement because the payments are bid into the price of land.

While farmers benefit from the increased availability of credit made possible because of the direct payments, there are far less expensive ways of achieving that goal. One might even be tempted to call the direct payments the "Bankers Guaranteed Annual Loan Payment Program."

One of the negative consequences of assured direct payments is that it makes it more difficult for those seeking to enter farming to rent or purchase ground. They face higher land prices because much of the value of the direct payments is bid into the cost of land and annual rent payments. They must face these higher land costs at the same time that they are in the process of building up their inventory of machinery.

Precisely because the payments are decoupled from production and occur whether prices are high or low, AMTA/direct payments do not address the basic market failure in agriculture - inability to self-correct in a timely manner when faced with persistently low prices. In 1996, the direct payments were conceived as a way to use government money (that may have been forfeited otherwise) to induce farmers into accepting market reforms, and not as a corrective measure for any market failures that might be experienced by crop agriculture.

Clearly, if given the task, separate from all other considerations, credible arguments can be made for eliminating AMTA/direct payments. Next week we will consider arguments for eliminating Loan Deficiency Payments/Marketing Loan Gains, again without regard to probability of occurrence or considering other complications.

Daryll E. Ray holds the Blasingame Chair of Excellence in Agricultural Policy, Institute of Agriculture, University of Tennessee, and is the Director of UT's Agricultural Policy Analysis Center (APAC). (865) 974-7407; Fax: (865) 974-7298; dray@utk.edu; http://www.agpolicy.org. Daryll Ray's column is written with the research and assistance of Harwood D. Schaffer, Research Associate with APAC.

Originally published in *MidAmerica Farmer Grower*, Vol. 22, No. 28 July 15, 2005
Reproduction Permission Granted with 1) full attribution to Daryll E. Ray and the Agricultural Policy Analysis Center, University of Tennessee, Knoxville, TN;
2) Copy of reproduction sent to Information Specialist, Agricultural Policy Analysis Center, 310 Morgan Hall, Knoxville, TN 37996-001