PolicyPennings by Dr. Daryll E. Ray

In the agricultural "whodunit," subsidies may not be the prime suspect

In our last column we began looking at the possibility that the US corn, wheat, rice, and soybean programs could be subject to WTO challenges using similar arguments to those used in the cotton case in which Brazil challenged US farm payments to cotton producers.

One of the most gripping story lines of recent years is the one in which after a crime is committed, law enforcement officials become so focused on "the obvious suspect" that they ignore evidence that may point them toward other suspects. After the suspect is convicted, it has often taken decades before new forensic tools free "the obvious suspect" and identify someone else as responsible for the crime.

A similar story line is being played out in the debate over trade and the US farm program. Many of those looking for the reason for low commodity prices are so focused on "the obvious suspect" (increased production resulting from US subsidies) that they ignore evidence that may lead them to consider other causes for the low prices.

The argument asserts that US subsidies have stimulated US farmers to produce a considerably greater crop volume than they would have without the subsidies. The result of this "overproduction" is lower prices that are harming farmers in other countries. In addition, many are authoritatively asserting that eliminating subsidies will result in lower production on the part of US producers and higher prices for all farmers. Based on this reasoning the argument calls either for putting out a contract (in the Godfather sense) on all subsidies or reassigning subsidies to a World Trade Organization (WTO) approved "good-works" environmental and other "multifunctional" projects.

Over the last three columns we have presented evidence challenging both the methodology and focus of a case that has the potential to be played out before a WTO disputes panel. The potential WTO case that has been laid out in several fora would involve a challenge by a soybean, corn, wheat, or exporting country asserting that US subsidies have encouraged overproduction resulting in lower prices.

Our first response was that in examining the impact of subsidies, one needs to take the lack of price responsiveness on the part of both producers and consumers into account. Because farmers are price-takers and not price-makers, most of them will tell you that they have every incentive to try to maximize production in order reduce the per-unit cost of production. That allows farmers to spread the high fixed costs out over a greater amount of production, as long as the price is above the variable cost of production.

We then argued that the effect of subsidies cannot be looked at one crop at a time because most US farmers grow more than one crop and a reduction in corn plantings does not mean that the land will be left idle. Instead, acres shifted out of corn will be planted to soybeans or another crop, leaving total acreage relatively unchanged – this is the low price responsiveness that we talked about. At most, the subsidies may be responsible for a three-tenths of one percent change in production. Looking at the crops one at a time runs afoul of the fallacy of composition.

Last week we argued that with low price responsiveness, it is not the subsidies per se that are responsible for the low prices, but rather the "market-oriented" Loan Deficiency Payment/Marketing Loan Gain (LDP/MLG) program. In fact the LDP/MLGs were designed to protect US producers while allowing the US price to drop to the world price. What the designers of this program failed to understand was that producers in other countries usually sell their crops for a discount off the US price. As a result, LDP/MLGs have allowed prices to fall below the loan rate with most of the benefits being picked up by integrated cattle feeders, importing countries, and the transporters and processors of grains and seeds.

Ignored in the discussion of trade distorting subsidies is the impact of government funded agricultural research and extension programs. In WTO parlance these payments are put in the green box and are considered non-trade distorting. We find it hard to understand how research programs which increase yield potential and decrease crop loss can be considered to have no impact on trade. By their very nature these programs result in increased production and, in the presence of weak price responsiveness, lower prices.

We are not arguing for the elimination of agricultural research and extension programs, but rather for recognition that the fruits of this research have had more impact on increasing the supply of food than farm subsidies. Since 1996, US corn and soybean yields have increased by 16 percent and much of this gain has its roots in basic research that can be tied to government funding.

If US subsidies are the cause of low prices, then we should see a different picture for those crops for which the US has no subsidies and no tariffs. Absent the presence of US programs these crops should have stable prices. Between 1980 and 2002, cocoa prices fell by 58 percent, coffee prices fell by 70 percent and pepper prices fell by 32 percent. Clearly US subsidies are not the cause of these low prices.

If both unsubsidized tropical crops and subsidized temperate zone crops have similar price/income problems, then maybe we should look at something other than "the obvious suspect:" subsidies. And that other suspect is the low price responsiveness for aggregate crop agriculture, both tropical and temperate.

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