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# Issue Report

## Trade and Domestic Farm Policy

U.S. domestic agricultural policy continues to generate contentious issues in the international trade arena. As evidence, Brazil, Canada and other nations recently filed a complaint with the World Trade Organization (WTO) relating to U.S. violations of its domestic policy commitments and previous dispute settlement findings. Development of a new U.S. farm bill has rekindled the international debate that existed after the passage of the Farm Security and Rural Reinvestment Act of 2002.

The November 2007 conference, *Domestic and Trade Impacts of U.S. Farm Policy*, examined how provisions of domestic farm legislation now being debated may impact the United States' trade obligations, particularly in the World Trade Organization. (See Source, page 4). There are two major differences in the policy environment of today's farm bill discussions and that of the 2002 farm bill—the budget today is much tighter and crop prices are setting new records in many cases.

In the years leading up to the current farm bill debate, the federal government has consistently run large budget deficits, the result of wars in Afghanistan and Iraq and other spending programs. That contrasts with budget surpluses in the years prior to the 2002 farm bill. This has forced some discussion about tradeoffs between farm and general spending. As of yet, however, the tight budget has not resulted in any meaningful changes in the proposed structure of farm policy, despite urging from the Bush administration.

This lack of attention is, in part, related to higher crop prices. After the 1996 farm bill, crop prices dropped to historic lows and farm incomes declined. The result was a 2002 farm bill that increased subsidy payments to farmers, and added a new program—the counter cyclical payment program. By contrast, program crop prices are now at historically high levels and farm income has been at or above non-farm family incomes. With prices forecast to lead to lower government payment levels over the next seven years, there is little impetus for changing programs.

Today, both houses of Congress are controlled by the Democrats; Republicans controlled both houses in 2002. The extent to which this difference impacts policy outcomes remains to be seen. However, the version of the farm bill currently being debated does not make changes needed to bring U.S. policy into compliance with WTO rules. In addition, the farm bill now under consideration keeps most of the key elements of the 2002 farm bill intact, with no major shifts to conservation spending as some might expect with Democratic control of Congress.

### *Agricultural Production*

The confluence of energy legislation that includes an ethanol mandate and agricultural policy has created some interesting food versus fuel debates among agricultural interests, both in the United States and around the world. Feed costs represent 40% to 50% of the cost of production in many

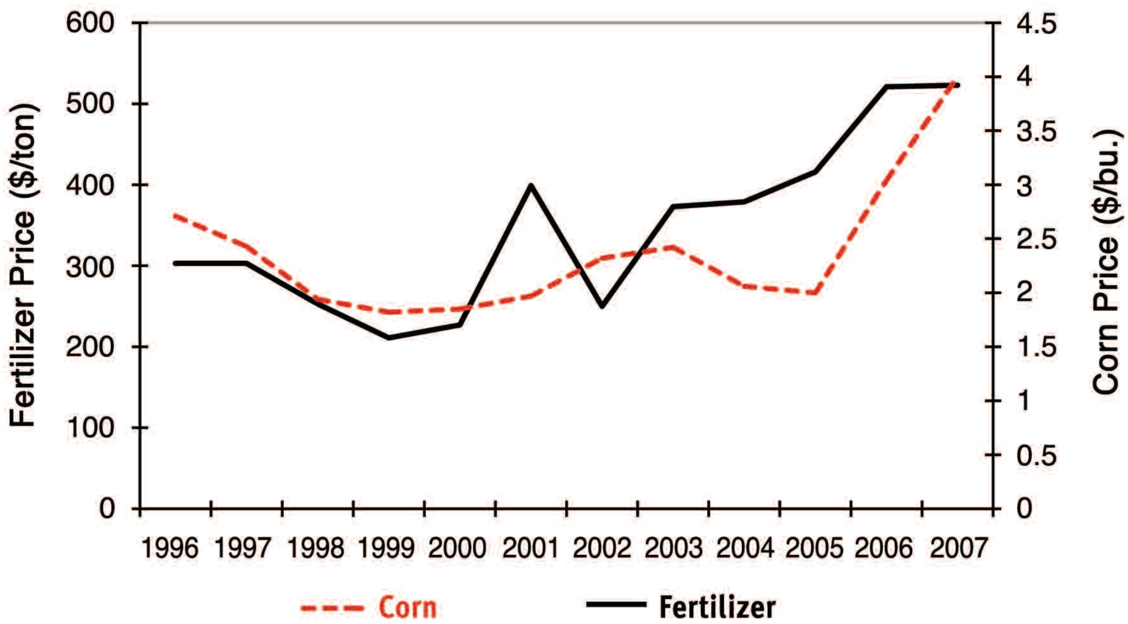


**Figure 1: Relationship between corn and fertilizer prices in the United States, 1997-2007.**

Source: USDA Economic Research Service

livestock enterprises, and corn represents 50% of feed costs. At the same time, the primary protein alternative, soybeans, remains at historically high prices. The ethanol mandate has many livestock producers concerned about their ability to competitively supply meat products to U.S. consumers. By contrast, seed technology and input suppliers see the ethanol mandate as a stimulus for agricultural production.

Some development-minded individuals and organizations even suggest that the ethanol mandate will increase crop prices globally, lifting the burden of developed-country overproduction from the developing world. The future interaction of energy and agricultural policy will have to be carefully monitored, as the past year has shown the dramatic impact even slight changes in long-term expectations can have on market prices.

Despite the impacts of energy policies on agriculture, the commodity and trade titles of the farm bill still have important implications. Given rising crop prices, due in part to energy policy, one might be tempted to believe that agricultural policy is no longer relevant. But observations suggest a couple key points relating to production agriculture and domestic and trade policy:

*Agricultural output prices have risen but so have input prices.* As shown in Figure 1, the run-up in corn prices has been matched step-for-step with increases in fertilizer prices. While agricultural prices are important, profitability, which considers changes in input prices, is a more appropriate measure for agricultural producers. Profitability is, however, considerably more difficult to quantify because of variations in efficiency across farms. Nevertheless, it is important to consider the changes in input prices as well as output prices when examining the health of the U.S. agricultural sector.

*Trade policy remains critical to the success of U.S. agriculture.* Market access remains a key cornerstone of U.S. agricultural desires for future trade negotiations. Other important issues include animal and plant disease protection to maintain a safe domestic food supply. These tasks fall under the purview of the U.S. Department of Homeland Security and the U.S. Department of Agriculture. However, funding for these tasks has not been deemed satisfactory by industry and consumer groups.

## Domestic policy and trade commitments

As with any new farm bill, there is considerable debate about the relationship between government payments and commitments made in international treaties.

*Compliance with past commitments.* The United States lost a landmark WTO dispute on cotton. A critical factor was the Step 2 program (an export and domestic use subsidy for cotton fiber), which was deemed a prohibited export subsidy by the WTO dispute resolution panel. Another vital finding related to the fruit and vegetable planting restriction on direct payments, which restricts farmers from planting fruit and vegetable crops on land on which they receive government payments. The WTO dispute resolution panel ruled that this restriction linked production decisions with government payments, therefore disqualifying U.S. direct program payments from the Green Box, the classification of payments with no limits on payment levels. By counting these payments in the Amber Box, the United States now violates its commitments for caps on trade distorting payments in some years.

While not immediately required to eliminate the fruit and vegetable planting restriction provision, the United States' lack of changes to that program led to a challenge by Canada, Brazil and others that the United States was in violation of its Amber Box limitations. The current versions of the U.S. farm bill circulating in Congress do not attempt to modify that restriction, which will reinforce the complaint in the WTO dispute resolution panel.

*Current proposals for subsidy reductions will be constraining.* During the Doha Round of WTO negotiations, the United States has repeatedly offered reductions in domestic support for agriculture in exchange for concessions from other trading partners. The most recent overtures suggest the United States would reduce its Amber Box cap to $15 billion from about $19 billion. Further cuts over time would reduce the cap to about $7.64 billion. Whether or not U.S. spending would stay within this limit depends on several factors. Dairy and sugar support account for 86% of the total calculated amount within the $7.64 billion limit if reported under current WTO rules.

One of the most important issues is the ability to use revised calculations of dairy price support based on butter and cheese, which reduces the reported payments from about $4.8 billion in 2007 to $2.2 billion for the same year based on current USDA baseline. The other major assumption is that program crop prices remain at relatively high levels so that cotton and rice payments do not put upward pressure on the Amber box ceiling. Together, these two factors save about $3.54 billion in Amber box expenditure annually. If prices decline or if the new dairy calculations are not accepted, the United States then becomes seriously exposed to exceeding the newly negotiated $7.64 billion Amber box support level.

An analysis of the potential distribution of government payments for the different proposals in the House and Senate versions of the farm bill shows that both the House Revenue Counter-Cyclical Payment (RCCP) and the Senate's producer option versions are more expensive than the current program. Figure 2 shows this simulation under the existing assumptions about calculations and Amber Box caps, done by Keith Coble and Barry Barnett, both of Mississippi State University. The critical feature of this simulation is that neither line in the figure includes milk or sugar support figures, which together are estimated to average $5.5 billion per year unless the new calculations for dairy are allowed.

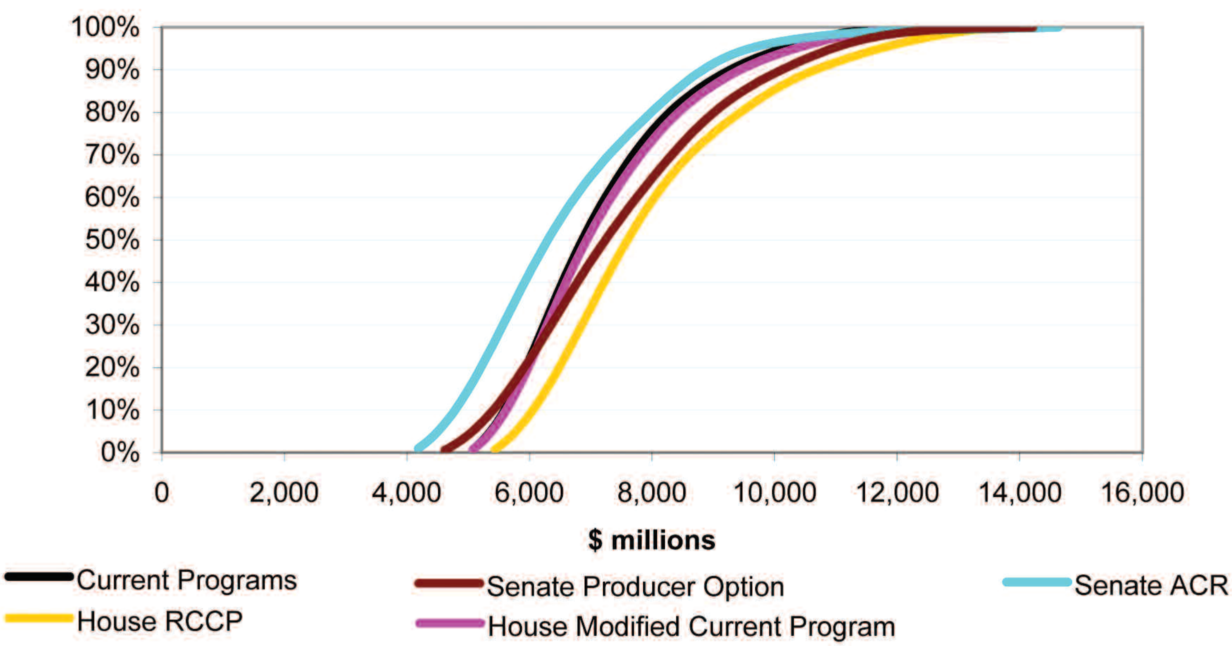


**Figure 2: Simulated distribution of government payments in 2010 under different scenarios**

Source: Keith Coble and Barry Barnett, Mississippi State University

If those supports continue into the future, U.S. subsidies could be expected to exceed the $15 billion cap 10% to 20% of the time. However, even adding in milk and sugar, U.S. subsidies are not expected to exceed the current cap of $19.1 billion with either the House or Senate versions, which may explain why lawmakers have not been concerned about WTO violations.

*It is not always about subsidies.* The clear frontrunner issue in the WTO is the linkage between domestic subsidies and market access. But that is not the only issue that relates to domestic policy. Sanitary and phytosanitary (SPS) restrictions to trade continue to be a hotly debated topic. The WTO provisions allow countries to utilize SPS restrictions to protect animal, plant and human populations from disease infestations from foreign sources. While most countries agree in principle to the SPS provisions, implementation is another matter. SPS restrictions are to be science-based, but the term is subject to interpretation. This ambiguity has resulted in claims and counter-claims of SPS restrictions being used as a non-tariff trade barrier.

## Summary

Trade policy is not necessarily restraining. Current subsidy commitment levels are not likely to be violated often, and other countries are self-reporting subsidy amounts that do not appear consistent with actual subsidization. With current proposals in place, the United States would have a difficult time meeting any commitments in future subsidy reduction without significantly altering the payment structure of farm programs. Even simple fixes, such as the fruit and vegetable planting restriction, could significantly reduce the probability of the United States exceeding its subsidy cap, but these have not been included in current farm bill proposals.

Proposed U.S. farm legislation alone is not likely to significantly alter production, prices or trade patterns globally in the near future. There is evidence that decoupled U.S. farm programs do have an influence on production—i.e., are likely trade distorting—but, the actual impact is very small. Without major changes in U.S. policy, major shifts in global prices and trade flows are not expected.

Legislative decisions relating to agricultural policy have, at several points, run counter to the United States' commitments within the WTO framework. These policy decisions make it more difficult to maintain global credibility as a free trader/subsidy cutter. It has made negotiations more difficult in the Doha Development Agenda, and may make it more difficult to negotiate favorable trade agreements in the future.

## The Source

The November 2007 conference, *Domestic and Trade Impacts of U.S. Farm Policy*, was sponsored by Farm Foundation; the Southern Region Research Committee; American Farm Bureau Federation; Center for North American Studies-Texas AgriLIFE Research and AgriLIFE Extension, Texas A&M University System; Louisiana State University Agricultural Center; National Center for Peanut Competitiveness at the University of Georgia; and the Center for Agricultural Policy and Trade Studies at North Dakota State University. Presentations from the conference are posted at *www.farmfoundation.org*. This *Issue Report* was authored by Parr Rosson, Texas AgriLIFE Extension, and Darren Hudson of Mississippi State University, who is also a Farm Foundation Fellow.



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