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## Prospects for Reform: Lessons from US and European Experience

A successful Doha Round on agriculture depends on US and European policymakers having the political will to reform their domestic programs. Other members of the Organization for Economic Cooperation and Development (OECD) provide higher levels of support, but most of them are too small for their reforms to have much effect on global markets. Opening the Japanese and South Korean markets for rice would offer potentially large gains to Asian exporters, but if even a little flexibility is permitted for sensitive products, Japan and South Korea will exempt rice to the maximum extent permitted. These and the other Group of 10 (G-10) countries will fight to minimize their concessions on agriculture, but US and European negotiators, along with those from Brazil and other exporting states, will largely determine the parameters of the agreement. Thus, it is particularly important to understand the pressures for and constraints on reform in the United States and the European Union.

Given the high costs to consumers and taxpayers, as well as the highly inequitable distribution of subsidies among farmers, it is something of a mystery why reform should be so difficult. But political economy theories of rent seeking tell us that smaller groups with concentrated gains or losses have an advantage over larger groups with more diffuse interests when it comes to influencing policy. Smaller groups find it relatively easier to organize and engage in collective action in lobbying Congress, and the benefits from subsidies and trade protection give them both the means and the incentive to do so (Moyer and Josling 1990, chapter 1; Paarlberg 1999). Much larger groups with more diffuse costs or benefits arising from government policy—in this case, consumers and taxpayers—care less intensely and typically fail to organize to protect their interests. Moreover, food is a small and

declining share of the consumption basket in rich countries, and farm subsidies are a relatively small share of overall government budgets. But government support can be an important part of a farmer's income, and it contributes significantly to wealth by raising land values.

As long as key legislators receive large campaign contributions and other support from pro-subsidy agricultural interests and face little or no tangible opposition from other constituents or offsetting lobbying from other campaign contributors, this political equilibrium likely will remain stable. But one can imagine at least two scenarios that could upset the equilibrium. First, budget pressures often force legislators to choose among constituents and have contributed to reductions in the level of agricultural support in the past. Budget pressures have been a particularly important force for reform in Europe, and the legislators who rewrite the US farm bill in 2007 will confront such pressures as well. In addition, if inadequate movement on agriculture continues to impede progress on nonagricultural market access and services liberalization in the Doha Round, key political constituencies in those sectors will have an incentive to lobby in favor of agricultural reform in order to break the logjam.

This chapter reviews the recent history of European and US agricultural policies and the pressures for and against reform. It then explores the political economy of agricultural policy, particularly in the United States, and analyzes internal and external pressures for reform.

## **The Evolution of US and European Agricultural Policy**

Reviewing the evolution of European and US farm policy provides valuable information on the nature of current subsidies and protection, as well as insights into what has and has not worked in past reform battles. The European Economic Community (EEC; later the European Community and now the European Union) launched the Common Agricultural Policy (CAP) in 1962, when memories of food shortages during and after World War II were still fresh and the region was a large net importer of most agricultural products. Thanks to the CAP, European farmers who otherwise would have had to compete with imports were insulated from global markets. But high target prices eventually resulted in surpluses that had to be disposed of on world markets with the help of large export subsidies. US policymakers first provided support to US farmers during the Great Depression, when they were not much concerned about exports because of the collapse in international trade. US policies subsequently fluctuated more than those of Europe, depending in part on the degree of engagement with global markets and the effects of price supports and other policies on export competitiveness.

By the mid-1980s the costs of support had reached unsustainable levels, and the EC and US governments began to explore options for reform.

### **Box 3.1 Policy reform options**

In broad terms, agricultural policy reforms can be either fast or slow, and farmers may or may not be compensated. Orden, Paarlberg, and Roe (1999, 7–11) identify four combinations of these two choices that suggest four possible strategies for reducing agricultural support:

- The least radical is a “cash-out” that involves gradually replacing supply controls with direct payments that may be used to compensate farmers when market prices fall below targeted levels or when support prices are reduced by policy-makers. These payments may either continue to be coupled to prices or be based on historical payment levels and decoupled from current production decisions.
- The most radical and least likely option is a “cut-out” that quickly ends farm supports with no compensation.
- A “squeeze-out” works by raising the costs or reducing the benefits of farm program participation, thereby encouraging farmers to withdraw gradually.
- “Buyouts” promise a quick end to subsidies by compensating farmers for asset value losses linked to the loss of subsidies. Buyouts have been used in the United States in recent years to reduce price supports for peanuts and eliminate them for tobacco.

As a guide to assessing the relative merits and feasibility of various proposals, Orden, Paarlberg, and Roe (1999, 8–10) identify four alternative reform strategies, whose distinguishing characteristics are speed of implementation and whether farmers are compensated for reductions in support (see box 3.1). The revealed preference of policymakers in both the United States and Europe has been for a gradual and partial “cash-out,” which provides direct income support, often as compensation for lower levels of price support.

The Uruguay Round approach of encouraging a shift from trade-distorting amber box supports to minimally distorting “green box” measures (see chapter 2, especially figure 2.1) was also aimed at reducing the global spillovers from farm policies. But the Uruguay Round agreement, delayed three years over agriculture, was shaped more by US and EU reforms than the reverse. Even though the Uruguay Round helped to lock in those reforms and constrained backsliding to a degree, agricultural reform in the United States and the European Union in subsequent years continued to be driven primarily by domestic concerns. With the emergence of the Group of 20 (G-20), an informal association of developing countries with a strong interest in liberalizing agricultural exports, the hope is that the Doha Round will

create a more positive two-way interaction between domestic reforms and trade negotiations than its predecessor.

## **European Farm Policy: From Net Importer to Net Exporter to Incremental Reformer**

The 12 countries making up the European Community in the mid-1980s had only a quarter the arable land of the United States, but they had three times as many farms (Newman, Fulton, and Glaser 1987). When the CAP was created in the early 1960s, the EEC was a net importer of most commodities, and import restrictions were a necessary condition for supporting domestic prices above world levels. In addition, policymakers tilted in the direction of raising farm incomes indirectly, through price supports, rather than with direct payments, because the EEC lacked the tax power of a state. Because EC policymakers did have authority over trade policy, they chose as their principal tool a “variable levy” on imports that was adjusted as necessary to maintain internal prices.

Over time, because of high price targets, called intervention prices, and technological progress, production increased, consumption was dampened, and surpluses accumulated. As a result, EC expenditures for storage costs and export subsidies to dispose of surpluses increased sharply. Trade conflicts also multiplied as the European Community moved from being a large net importer to a net exporter of sugar, beef, butter, and wheat in the 1970s and 1980s (Newman, Fulton, and Glaser 1987). As figure 3.1 shows, imports fluctuated but exports grew steadily, and by the early 1990s the agricultural trade deficit had closed.<sup>1</sup> By that time, the European Community was under intense pressure, both from its budget and its trading partners, to find a way to reduce the costs of supporting its farmers.

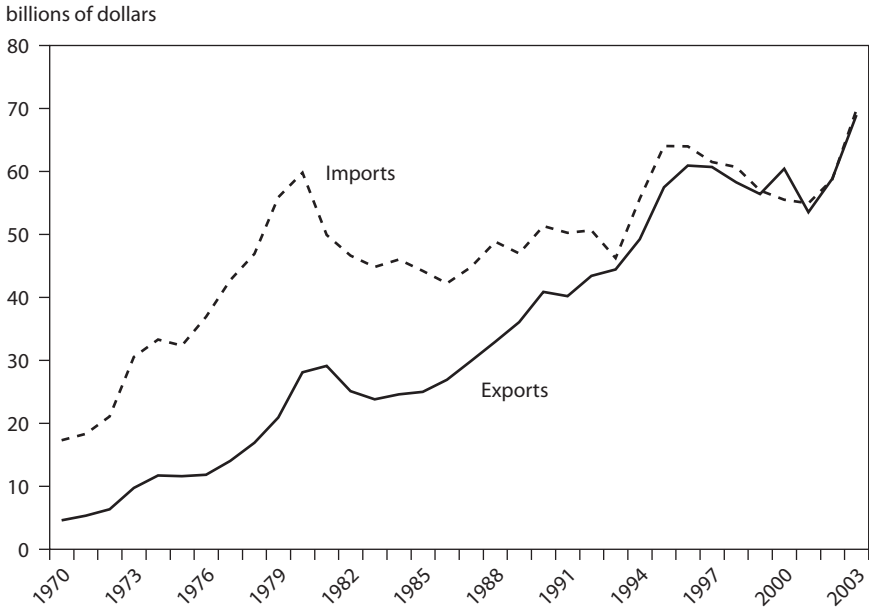
A key problem was that, for most products, the CAP initially controlled supplies primarily through trade measures: the variable levy on imports and export subsidies for surplus disposal. Not until chronic surpluses threatened to break the budget in the 1980s did policymakers resort to modest production controls, beginning with dairy products in 1984. At the same time, they modestly lowered intervention prices for cereals and, in 1988, began paying farmers to take land out of production. But these limited reforms did little to rein in surpluses, and budget outlays hit record levels (Moyer and Josling 1990, chapter 4). In addition, subsidized wheat exports and conflicts over oilseeds, beef, and other imports were roiling trade relations, particularly with the United States.<sup>2</sup> Finally, the United States and the proliberalization Cairns Group of agricultural exporters (including Australia, New Zealand,

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1. The data underlying the charts are in nominal dollars, which accounts for some of the fluctuation.

2. Bayard and Elliott (1994) document and analyze the numerous US-EC disputes over agricultural market access in the 1970s and 1980s.

**Figure 3.1 EC-10 agricultural trade (excluding intra-EC trade), 1970–2003**



Note: After 1985, the EC-12 includes Greece, Portugal, and Spain.

Source: UN Food and Agriculture Organization, FAOSTAT database.

Argentina, Brazil, and several other states) insisted that the new round of trade negotiations, launched in Punta del Este, Uruguay, in September 1986, address trade-distorting *domestic* subsidies to agriculture, as well as traditional trade barriers.

But member-state policymakers could not agree among themselves on further reforms, and the Uruguay Round negotiations were extended beyond the scheduled 1990 end date. After another three years of negotiation, European policymakers agreed on CAP reforms proposed by EC Agriculture Commissioner Ray MacSharry that modestly lowered levels of support, continued the move toward paying farmers to set aside some land, and introduced the idea of decoupling some payments from production, though this provision was weakened in the end (Swinbank and Tanner 1996, chapter 5). With this accomplished, EC negotiators concluded a deal with the United States to resolve an escalating bilateral conflict over oilseeds and, at the same time, to set the parameters for a multilateral agreement that would essentially ratify the reforms the European Community had undertaken unilaterally.

According to OECD figures, these reforms and the Uruguay Round agreement had relatively little effect on the overall level of EU producer

support, which has actually increased in value terms and declined only modestly in percentage terms since the 1986–88 period, from 41 percent of gross farm receipts to 34 percent for the 2002–04 period. But at the same time, the most trade-distorting elements of that support have declined from nearly 100 percent of the total to 65 percent (figure 2.3). Market price support also declined by more than a third, to 55 percent.

In preparation for the accession of 10 new members to the European Union and to determine the parameters of an agreement they could live with in the Doha Round, EU policymakers undertook additional reforms in 2000 and 2003. The 2000 reform, which lowered intervention prices for dairy products for the first time, also further lowered intervention prices for cereal and beef. Under this and earlier reforms, producers received compensatory payments for the price cuts that were linked to production limits and allocated to the blue box category of moderately distorting subsidies under WTO rules. The 2003 reform went further, introducing a “single farm payment” that is based on historical support levels and non-commodity specific (OECD 2004a, 7). Because the new payment is decoupled from current production, the European Union plans to allocate it to the WTO green box.<sup>3</sup>

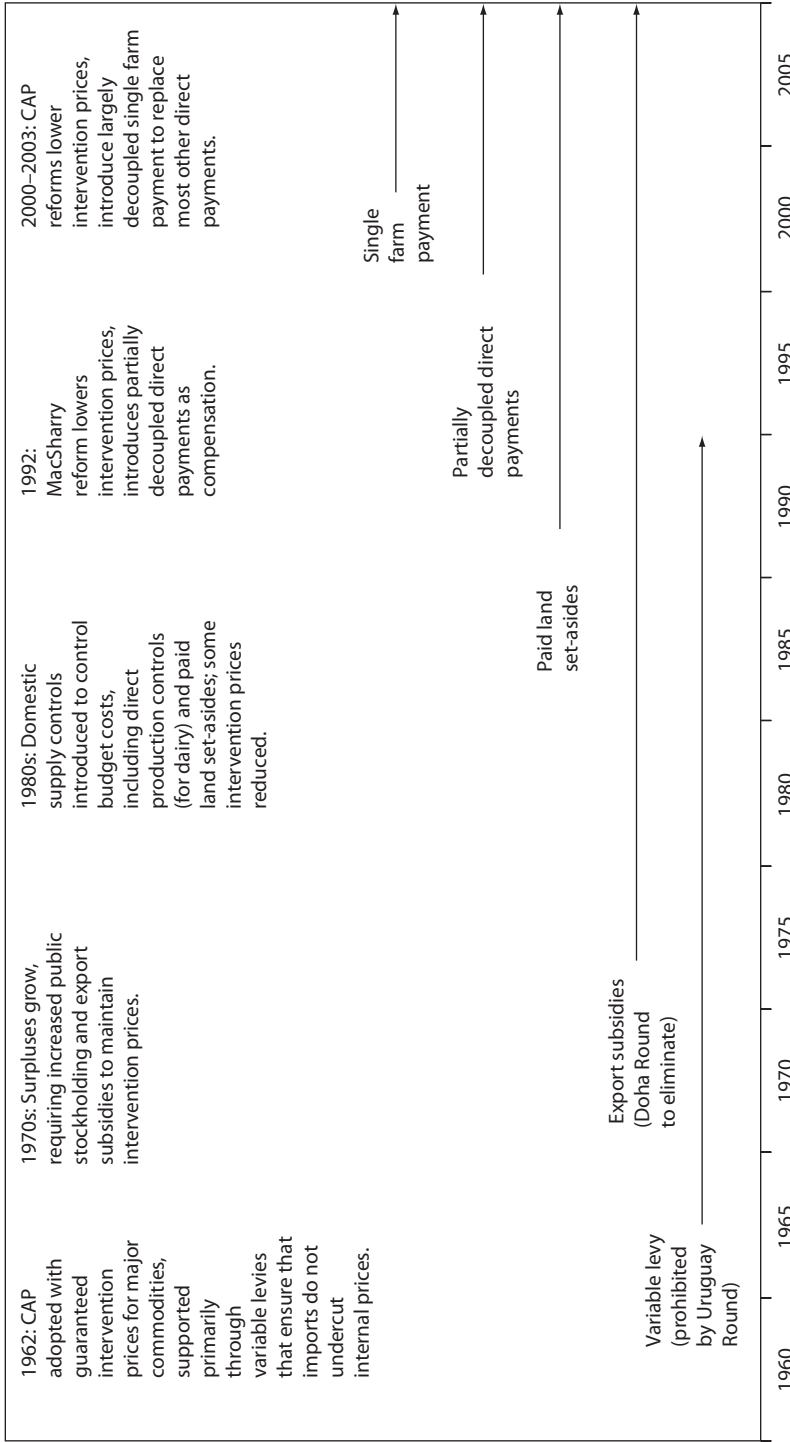
The initial EU plan proposed converting almost all commodity-linked payments to the decoupled single farm payment beginning in 2005. Under the final compromise, however, member countries were given flexibility to delay adoption of the single payment. Several decided to wait until 2006 and to permit designated shares of the payments for various commodities to remain “coupled.” According to the most recent OECD review of agricultural policies, the United Kingdom, Ireland, Germany, and several others will maximize use of the single farm payment while France will minimize it, meaning that many of its farm payments will remain trade distorting (OECD 2005a, 8). More important, the single farm payment does not affect market price support provided through trade measures, which still accounts for more than half of total EU support to farmers. In addition, while farmers do not have to produce particular products in order to collect the single farm payment, they are prohibited from shifting production to fruits, vegetables, or table potatoes, and they are required to keep their land in “good agricultural or environmental” condition.<sup>4</sup> Continued price support for most commodities and these constraints on land use are likely, at the margin, to encourage farmers to continue producing what they have traditionally produced. The evolution of the CAP is summarized in figure 3.2.

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3. Analyses of the 2003 reform may be found in Jotzo et al. (2003) and Kelch and Normile (2004).

4. Although not binding on any other country, a WTO dispute settlement panel decision that affirmed Brazil’s challenge to US subsidies on cotton raises questions about the green box eligibility of decoupled payments that include *any* restrictions on what can be planted. This issue is addressed in greater depth later in this chapter and in chapter 5.

**Figure 3.2 Evolution of the European Common Agricultural Policy (CAP), 1960–2005**



Note: This is a summary of broad changes in agricultural support policies that does not apply to all commodities at all times. Arrows cover period over which tools were used.

OECD projections of the effects of the 2003 CAP reform also suggest a continuation of recent trends, with little change in the overall level of support and a modest further reduction in the *most* trade-distorting elements to 64 percent by 2008 (OECD 2004a). The latter development is due to the fact that the single farm payment will mostly replace blue box payments, which are less distorting than amber box payments and are not included in the OECD's most trade-distorting category. In WTO terms, however, maximum decoupling could allow the European Union to move more than \$20 billion dollars in these partially decoupled blue box subsidies to the green box, thereby giving EU representatives more room to negotiate subsidy reductions in the Doha Round. The major problem for the European Union is that its relatively heavy reliance on off-budget trade measures means that further moves toward decoupled subsidies will require either additional budget resources or lower levels of support.<sup>5</sup>

## US Farm Policies: Earlier Reforms but Recent Setbacks

The United States, with its abundant endowment of land, emerged in the 19th century as a net exporter of bulk commodities, such as feed grains, oilseeds, and cotton. And as in many developing countries a century later, policymakers protected manufacturing at the expense of agriculture for decades. After World War I, global markets for US farm products shrank markedly, and pressures for subsidies or protection grew until they became irresistible during the Great Depression of the 1930s. With the collapse of global markets and the drought-created "Dust Bowl" threatening farmers' livelihood, and with few alternative jobs available elsewhere in the economy, the US government stepped in to encourage farmers to stay on the land.

Since trade had collapsed, and because the new policy was intended to be temporary, the government's response was developed with little regard to the international effects, including export competitiveness. The Agricultural Adjustment Act of 1933 sought to raise prices by paying farmers to reduce the acreage planted in most major commodities.<sup>6</sup> Section 22 of the act also authorized the use of tariffs and quotas if imports threatened to undermine these domestic supply control programs. Dairy products were protected from imports from the beginning, while beef (at relatively low levels), sugar, peanuts, and tobacco (at much higher levels) were added later.

As an interim measure to keep farmers in business until the supply controls took effect, the government introduced commodity loans. These

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5. The budgetary consequences of moving to decoupled subsidies will be even greater in countries such as South Korea and Japan that rely even more heavily on import restrictions to maintain prices and farm incomes.

6. This discussion of the history draws on Orden, Paarlberg, and Roe (1999, 18–24).

allowed farmers to take out loans using their crops as collateral, which they could either sell to repay the loans if prices rose or forfeit to the government as payment in full if prices dropped below the level specified as the “loan rate.” Like so much else in agricultural policy, commodity loans did not remain temporary. Instead, Congress took over the setting of loan rates, and they became another mechanism for providing a floor under prices.

Though there were fluctuations related to changes in control of Congress, with Republicans generally favoring lower loan rates and Democrats favoring higher ones, the policies forged in the 1930s remained more or less intact until the 1960s. During the recovery following World War II, US farm exports were mostly in the form of food aid. But as global commercial markets revived, high loan rates were increasingly seen as impeding US exports (Gardner 1990), as well as causing the government to hold large surplus stocks. At this point, US policy moved toward what Orden, Paarlberg, and Roe (1999, 61–67) call a “partial cash-out” of price supports (box 3.1). Congress lowered the loan rate to near world prices, allowing farmers to increase exports. Also, those willing to withdraw a portion of their acreage from cultivation, in order to reduce surpluses, could receive direct payments from the government to compensate for the lower loan rate on domestic sales. From this point on, US farmers were relatively more exposed to global market conditions than those in Europe, and US policy fluctuated more in response to changes in export markets and budget costs.

High prices during the 1970s commodities boom could have been used to ease farmers off public support through a “squeeze-out,” by keeping the loan rate constant in nominal terms and allowing inflation to erode the real value of supports. Instead, fears of food shortages and the low immediate budget impact lulled both US and EC policymakers into excessive generosity in raising nominal support prices to make up for inflation. Congress also introduced target prices and deficiency payments, which compensated farmers for any difference between the higher of the loan rate or the market price and the target price, albeit only on a base level, rather than all production.

These policies helped to set the stage for the US farm crisis and proliferating trade conflicts in the 1980s when inflation eased. High prices in the 1970s had stimulated production and exports, but the US trade balance soon turned sharply downward, driven by a confluence of events in the early 1980s (figure 3.3):

- overvaluation of the dollar;
- declining demand in developing countries because of the debt crisis; and
- increasing competition in export markets from the EC and emerging competitive exporters, such as Brazil and Argentina.

**Figure 3.3 US agricultural trade, 1970–2003**



Source: UN Food and Agriculture organization, FAOSTAT database.

US policymakers responded to the farm crisis of the mid-1980s, like their counterparts in Europe, with modest, incremental changes. The Food Security Act of 1985 resorted to extensive paid acreage set-asides to bolster prices. But it also lowered loan rates to encourage exports and, in response to European policies, added the Export Enhancement Program to provide export subsidies for commodities, especially wheat, that were competing with subsidized exports. Congress also linked environmental concerns to farm policy with a “conservation reserve” acreage set-aside program to take environmentally sensitive cropland out of production.<sup>7</sup> The Conservation Reserve Program (CRP) differed from traditional acreage reduction and diversion programs in requiring participants to retire land for 10 to 15 years at a time (with the possibility of renewal), rather than the much shorter periods explicitly geared to supply concerns. Still, the CRP did not

7. The 1985 farm bill also conditioned eligibility for programs on farmers’ protection of “highly erodible” land and their willingness not to convert wetlands to cropland. These two provisions were referred to as “Sodbuster” and “Swampbuster,” respectively.

retire land permanently and still had the effect of bolstering prices by reducing output, at least in the short run.

In order to reduce budget outlays for storage costs and to further promote exports, without regard for the beggar-thy-neighbor effects on other exporters, US policymakers shifted from traditional “nonrecourse” loans to “marketing loan” payments for cotton and rice. The secretary of agriculture was given the option to authorize marketing loans for other commodities as well. Nonrecourse loans led to government stockpiling when prices dropped below the loan rate because the government had to accept the commodities held by farmers as collateral. With forfeitures and storage costs escalating rapidly in the first half of the 1980s, Congress shifted to marketing loans to give farmers the option of exporting commodities held as collateral when market prices were below the loan rate. The government covered the difference with a “loan deficiency payment,” an important move in the trend away from market price support and supply controls and toward direct payments to support incomes. Target prices and deficiency payments were also retained in the 1985 farm bill.

### **“Freedom to Farm”**

After following the path of incremental reform for more than a decade, US policy took a sudden and dramatic turn in 1996 at a time of high commodity prices and with Republicans in control of the House of Representatives for the first time in more than 40 years. Orden, Paarlberg, and Roe (1999) argue that these two factors were both necessary and together sufficient to trigger a major shift in US farm policy. Still, the shift was less radical than it appeared, and important elements were reversed within two years when conditions changed and prices declined sharply. While some elements of the reform were retained, important reversals, including a move back toward linking payments to prices, were institutionalized when a new farm bill was written in 2002.

The chief innovation of the 1996 farm bill, initially called the Freedom to Farm Act, was to free farmers from having to produce particular crops in order to receive payments and, in times of low prices, refrain from producing as much as they otherwise might. Instead, farmers could, at their option, sign production flexibility contracts that would allow them to plant what they wanted in response to market signals (with a few exceptions) and would no longer link payments to current prices or production. Rather, the new decoupled payments would be based on historical acreage enrolled in subsidy programs, and would be reduced over time. The bill eliminated the long-standing acreage reduction program, though it continued the authority for compensated set-asides under the CRP.

Thus, the 1996 farm bill, which ultimately became law as the Federal Agriculture Improvement and Reform (FAIR) Act of 1996, marked a decisive

break with the past practice of trying to prop up prices by controlling supplies of the major commodities. Target prices and deficiency payments were also eliminated under the reform, but the concept of a price floor was retained through marketing loans and loan deficiency payments. It is important to note, however, that even this relatively radical reform, trumpeted in some news media stories as “ending farm subsidies,” applied *only* to the traditional program commodities that are exported (wheat, corn, other grains, cotton, rice, and oilseeds). Despite efforts to reduce market price supports for sugar, dairy, peanuts, and tobacco, the final compromise made minimal changes to programs for the more heavily protected, import-competing sectors.

The shift to Republican control of Congress made “Freedom to Farm” possible because the party was more ideologically opposed to market interventions in general and to mechanisms such as production controls in particular. Although there were regional differences, many Republicans also represented areas dominated by the larger-scale, more commercially oriented and competitive farming operations that chafed at supply controls and would suffer relatively less from reductions in price supports. Democratic Party concerns focused on smaller-scale farmers, whom they feared would not survive without supply controls to prop up prices (Orden, Paarlberg, and Roe 1999).

But the Republican takeover of Congress likely would not have been sufficient had there not also been a surge in agricultural commodity prices during 1994–96. Some skeptical farmers were sold on the radical shift to decoupled payments because sticking with the old system of deficiency payments would have meant that they received *less* from the government than under the system of historically based fixed payments under “Freedom to Farm” (Orden, Paarlberg, and Roe 1999). In other words, decoupled payments at a time of high market prices offered the opportunity for a windfall for farmers in affected sectors. Moreover, if traditional payments were authorized at low levels because of high prices and pressures to balance the budget, that would limit the baseline for farm spending for years to come.

Congressional Democrats argued against this reform on the basis that farmers would be trading away their permanent safety net for a short-term windfall. But, when prices collapsed following the Asian financial crisis of the late 1990s, and farmers in some regions were hit by severe flooding and others by drought, Congress quickly intervened with an ad hoc safety net by providing large emergency payments called “marketing loss assistance.”

While the next farm bill was being written, in 2002, Democrats regained control of the Senate by the slimmest of margins. Prices had recovered a bit but were still well below mid-1990s levels, and the appetite for radical farm policy reform had waned. Congress retained decoupled payments, but it renamed them “direct payments” and dropped the production flexibility contract concept. Legislators also undermined the reform element of these decoupled payments by allowing farmers to update the supposedly “fixed” acreage that would be eligible and by making new commodities eligible. Although the payments remain non-commodity specific, and therefore less distorting

than otherwise, the expectation of similar changes in future farm bills could encourage farmers to produce at higher levels than they otherwise would.

In addition to that retreat, Congress took a much larger step back from decoupling by introducing countercyclical payments. These are similar to the disbursements under the old target price/deficiency payment program and were intended to codify the ad hoc marketing loss assistance provided by Congress in previous years. The countercyclical payments are partially decoupled because they are paid based on 85 percent of base acreage and do not require that farmers currently produce the commodity in question. Still, the payments are based on the difference between the higher of the loan rate or market price and the target price, and that is likely to influence production decisions. The broad changes in US farm policy since 1960 are summarized in figure 3.4.

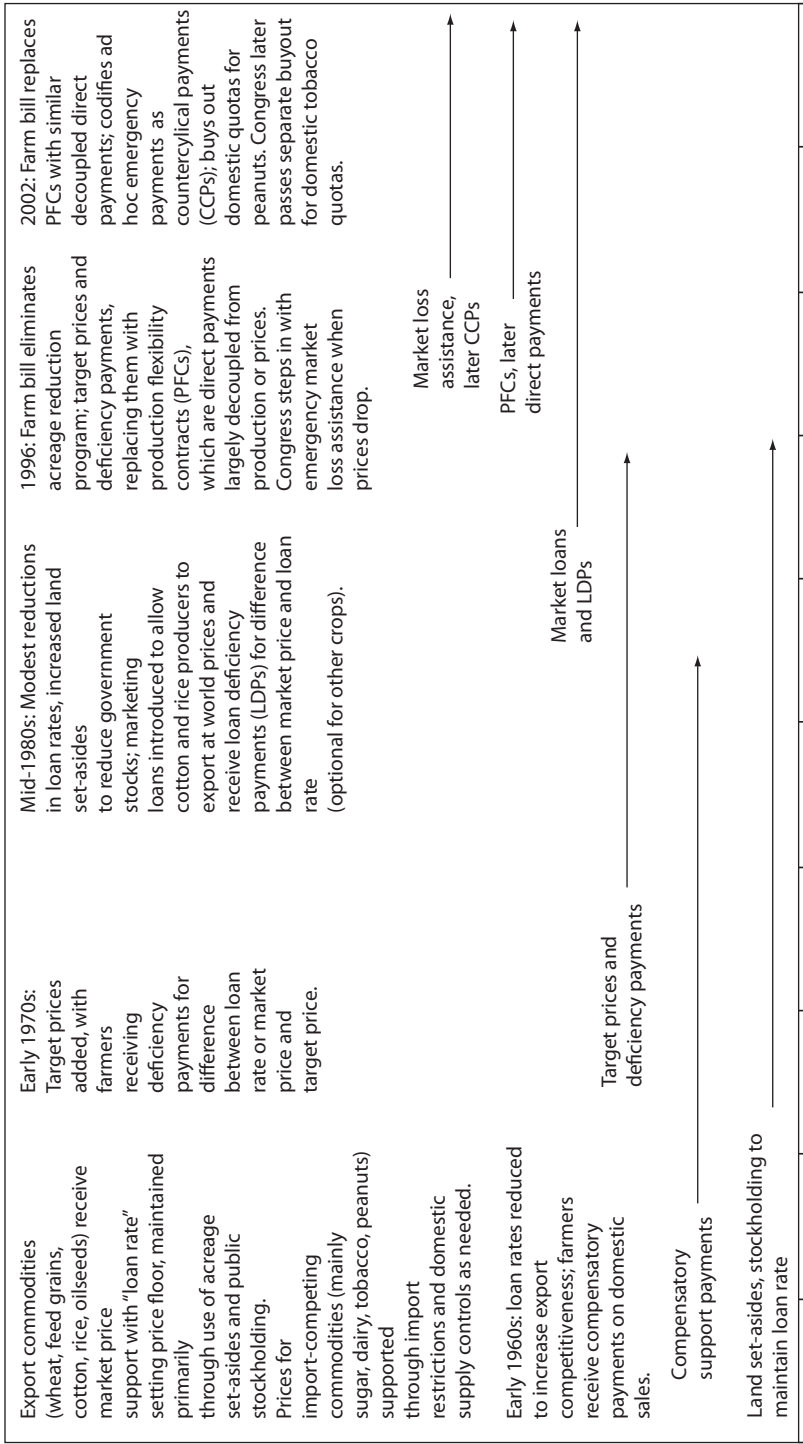
The net result of the farm policy changes since 1996 is that the overall level of US support for agriculture, as measured by the OECD's producer support estimate, was down about a fifth during 2002–04 from its peak during 1986–88 (17 percent of the value of farm production versus 22 percent earlier). But as figure 2.3 shows, the share of the most trade-distorting forms of support, after declining steadily under the 1996 farm bill, has gone back up, with the overall level of distorting payments (including those in the blue box) during 2005–06 approaching the 1999–2001 level. Moreover, while the United States' trade-distorting share started from a lower level than that of the European Union, the shares are now similar, though the overall level of European support remains higher (figures 2.2 and 2.3).

## **Decoupled EU, US Subsidies: Implications for the Doha Round**

The goal of the Doha Round of negotiations on agricultural subsidies, like that of the Uruguay Round before it, is *not* to eliminate these subsidies, but to reduce them and encourage their conversion to less trade-distorting forms. To decouple subsidies, as the WTO seeks to do, requires governments to move from supporting farm incomes indirectly, by supporting the prices farmers receive, to providing support directly through payments pegged to historical production or payment levels or some other base that does not distort production and trade patterns. This approach is based on the US and European reforms described earlier in this chapter.

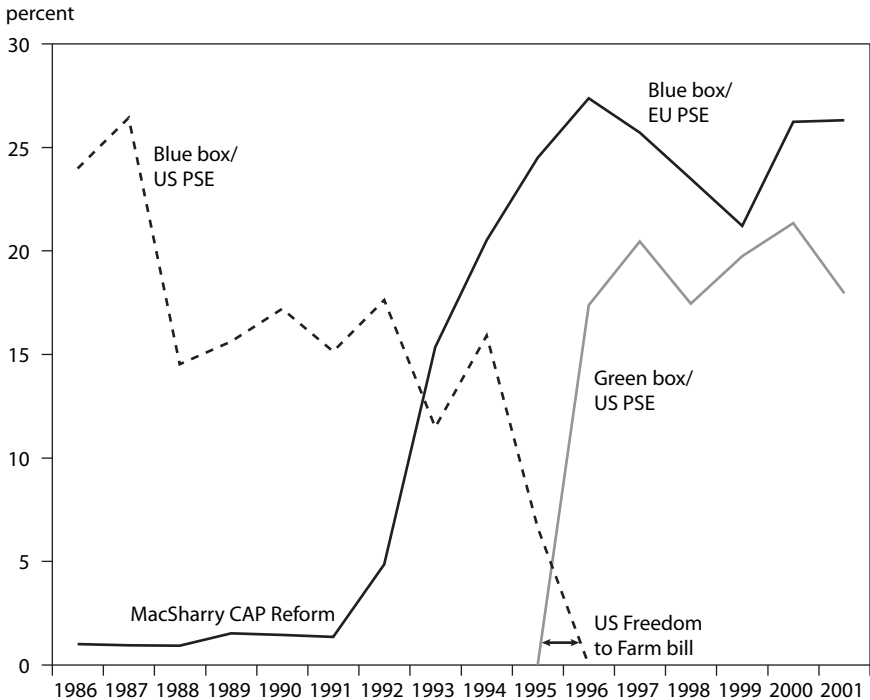
Although substantial differences in the details of reform and in other aspects of farm policy remain, European and US policymakers have moved to cut price targets and floors for most crops and to compensate farmers with direct payments based on fixed numbers of acres or animals, or production in a base period. Under the Uruguay Round framework, US deficiency payments and European compensatory payments could be allocated to the blue box for moderately distorting subsidies (see figure 2.1) because

**Figure 3.4 Evolution of US agricultural policies, 1960–2005**



Note: This is a summary of broad changes in agricultural support policies that does not apply to all commodities at all times. Arrows cover period over which tools were used.

**Figure 3.5 Partially or mostly decoupled subsidies as a share of producer support, 1986–2001**



CAP = Common Agricultural Policy

PSE = producer support estimate

Note: The US Freedom to Farm bill zeroed out the blue box/US PSE and added the green box/US PSE.

Sources: OECD (2005a) and US Department of Agriculture.

they were paid only on a fixed base and had production-limiting elements (for example, land set-asides).

But after the 1996 US farm bill abolished deficiency payments and created the mostly decoupled production flexibility contracts, the United States no longer had anything to allocate to the blue box and reported the new payments in the green box for minimally or nondistorting subsidies. As measured and categorized by the OECD, these blue box and, later, green box payments averaged 15 to 20 percent of total US producer support (figure 3.5). The 2002 farm bill retained decoupled direct payments, but the creation of countercyclical payments and the decision to allow farmers to update the base acreage on which the decoupled payments would be calculated are creating problems for US negotiators in the Doha Round.

Under current rules, the countercyclical payments will have to be in the amber box, either under the aggregate measurement of support ceiling or

**Table 3.1 US and EU agricultural subsidies** (millions of dollars)

	Amber box				Green box (decoupled payments only)
	AMS		De minimis	Blue box	
	MPS	Subsidies			
United States					
1998	5,776	4,774	4,762	0	5,659
1999	5,921	10,970	7,435	0	5,471
2000	5,840	11,025	7,341	0	5,068
European Union					
1998	38,382	13,949	142	23,012	144
1999	35,316	14,364	57	20,638	998
2000	27,945	11,512	678	20,239	449

AMS = aggregate measurement of support

MPS = market price support

Source: US Department of Agriculture, WTO Agricultural Trade Policy Commitments Database, available at [www.ers.usda.gov/db/wto](http://www.ers.usda.gov/db/wto) (accessed on April 14, 2000).

as non-product-specific de minimis. Keeping them there in the current round would make it difficult for US negotiators to agree to substantial cuts, so they are seeking to redefine the blue box to accommodate them. Other negotiators, however, are resisting and are also seeking additional clarification of the rules for allocating subsidies to the blue and green boxes to ensure that they are less or minimally distorting, in part by ensuring that “fixed” bases for payments remain fixed.

In the European Union, blue box payments went from negligible to somewhere between 20 and 25 percent of producer support in the latter half of the 1990s. With the 2003 CAP reform, the European Union is now essentially trying to replicate what US policymakers did in the 1996 farm bill and shift most of its blue box payments to the green box. The single farm payment is intended to replace most other subsidies, but only partially for some commodities and not at all for others. Moreover, this reform also does nothing to affect the still-high levels of EU market price support.

Table 3.1 shows US and EU notifications of amber box and blue box supports to the WTO, as well as the portion of the green box that is allocated to decoupled direct payments.<sup>8</sup> Although members are required to report these figures regularly, in practice there are long lags for most countries,

8. The bulk of US green box subsidies are for food stamps and general services; only about 10 percent are for decoupled payments to farmers. In the European Union, the bulk of green box subsidies are general services, environmental programs, regional assistance, and “structural adjustment through investment aids.”

not just the United States, and the latest data available in the US Department of Agriculture's WTO commitments database is for 2000. The US share of producer support that is attributable to decoupled payments during 1999–2000 is just under 20 percent. At this point, and until the 2003 reform is implemented, EU decoupled payments are negligible, but blue box payments were roughly a third of total producer support during 1999–2000. If maximum decoupling occurs under the CAP reform, most of these payments would become eligible for the green box. In both cases, the share of at least partially decoupled subsidies is higher than when the OECD data are used because the WTO measure of market price support in the denominator is smaller.

Keeping US direct payments and EU single farm payments in the green box, however, will require either further reforms of both programs, or renegotiation of the green box. A WTO dispute settlement panel ruled in 2004 in a complaint brought by Brazil that US direct payments were not fully decoupled and could not be allocated to the green box. The panel found that the payments were not decoupled because, while farmers were not required to plant any particular crop, or to plant anything at all, they had to refrain from planting fruits and vegetables in order to remain eligible for the payments.<sup>9</sup> The panel ruled that this would tend to encourage farmers to continue to plant what they traditionally had, or to plant another program crop that received subsidies.

The dispute settlement panel's finding, though not binding in any other case, suggests that the European Union's single farm payment could not pass the decoupling test either because it has a similar prohibition on planting fruits and vegetables (as well as a few other commodities). In addition, the meaning of the EU requirement that eligible farmers keep their land in "good agricultural and environmental condition" is not clear. The 2002 US farm bill explicitly states that land may be allowed to remain fallow and that farmers do not have to produce anything on it to remain eligible. With respect to the CAP reform language, a US Department of Agriculture analysis concludes that "in practice, this means that [European farmers] must continue producing something and most likely will continue producing what they have historically produced, given that their other options are limited" (USDA 2003, 2).

Finally, for most commodities these partially decoupled payments are not the only form of support, and other forms are still linked to production or prices. Under the CAP reform, intervention prices were lowered for some EU commodities but not others, and market price support remains significant for most. The OECD estimates that maximum implementation

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9. The fruit and vegetable sectors do not receive the subsidies that other crops do, and the authors of the 2002 farm bill wanted to keep producers in these sectors from having to compete with subsidized producers.

of the single farm payment would still leave more than 60 percent of EU producer support in the most trade-distorting categories. In the United States, the program crops that are eligible to receive direct payments are also eligible for marketing loans, which are not decoupled at all, and countercyclical payments, which are only partially decoupled.

In sum, going into the final stages of the Doha Round, roughly a fifth of US support to farmers is in decoupled green box payments. The EU situation is less certain because the single farm payment is just now being implemented and because countries are allowed flexibility in deciding how far to go in decoupling payments for some commodities. With full implementation of the CAP reform and the single farm payment, most EU *subsidies* might be eligible for the green box, but this would account for a third or less of total producer support. Moreover, the updating of base acreage in the 2002 US farm bill and the restrictions on planting certain crops in both the United States and the European Union suggest that these payments are not completely decoupled and could continue to influence planting decisions. Finally, sugar and dairy products, among the most protected commodities, remain largely unreformed.<sup>10</sup>

## Reform Obstacles and Opportunities in 2006

A variety of political economy theories explain the origin and, especially, the persistence of agricultural subsidies, most pointing to rent-seeking behavior and collective action problems to explain why support is so much more entrenched in agriculture than other sectors in most rich countries.<sup>11</sup> What seems obvious from a brief review of the past few decades is that when pressure for reform became irresistible, it was because policymakers were concerned about competitiveness (primarily in the United States) or the need to contain the budget costs of agricultural support. Minimizing the negative impact of agricultural supports on other countries was rarely if ever a driving force. This conclusion is supported by the limited gains produced by the Uruguay Round of multilateral trade negotiations, which mostly affirmed rather than led agricultural reform in OECD countries in the 1980s and 1990s.

Eventually, ongoing structural changes would be expected to make prospects brighter for agricultural policy reform. The number of farmers in the industrialized countries continues to decline while their average age

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10. In response to a Brazilian challenge in the WTO of the EU sugar program, the European Commission announced a plan to reduce internal prices by a third, but this will still leave EU prices at roughly twice the world level.

11. Moyer and Josling (1990) and Paarlberg (1999) review some of the more prominent and compelling theories.

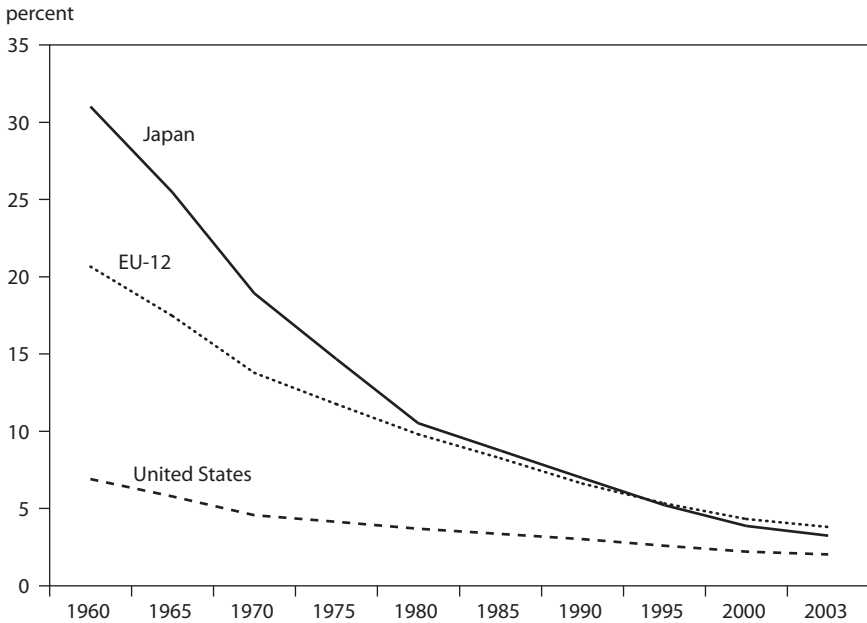
continues to increase, as does the concentration of payments to larger, richer farmers. Both the United States and the European Union are also facing renewed budget pressures that will again highlight the costs of farm subsidies. And perhaps most important, developing countries that are competitive agricultural exporters are demonstrating themselves to be better organized and more effective than they were during the Uruguay Round. In addition, with the end of the Multi-Fiber Arrangement of quotas restricting the textile and apparel trade, the rich countries have little left to offer in reciprocal negotiations outside agriculture. These factors, combined with the mobilization of nongovernmental organizations (NGOs) on behalf of poor developing countries, are contributing to a different dynamic in these trade talks, though the ultimate outcome remained highly uncertain in the spring of 2006.

### **Internal Pressures for Reform**

Of the various potential sources of reform pressure, structural economic change—the declining importance of agriculture in economies as they industrialize—has long seemed the most likely to eventually have an impact. But the question remains, when? Two decades ago, Honma and Hayami (1986) hypothesized that government support for agriculture would peak with the proportion of farmers in the total population between 5 and 10 percent, then begin to decline once it dropped below 5 percent. Perhaps it is just too early, but the trends in figure 3.6 do not appear to support this hypothesis. The share of the US population in farming dropped below the 5 percent threshold 30 years ago, but subsidies have fluctuated with world prices and the value of the dollar and have shown no consistent decline (figures 2.2 and 2.3). The share of the EU population in farming dropped below 5 percent much more recently, but budget pressures to reduce subsidy levels began before that. The Japanese farming population also recently dropped below the 5 percent threshold, but thus far Japan shows no sign of significantly reducing support for its farmers. Moreover, there has been little impact on policy from the facts that the farming populations of the United States and Europe are getting older—roughly half of US and EU farmers are at least 55 years of age—and that 50 percent of US farmers and more than 70 percent of EU farmers are, in effect, part-timers, earning significant shares of household income from nonfarm sources (USDA 2004).

Rather, the reverse appears to be true: The structural economic changes that remove common rationales for agricultural subsidies simultaneously make it harder to reform them. With industrialization and urbanization, the manufacturing and service sectors draw labor away from agriculture. Along with technological change and the substitution of capital for relatively more expensive labor, these structural changes contribute to consolidation of

**Figure 3.6 Share of population dependent on agriculture, 1960–2003**



Note: Agricultural population is defined as persons dependent on farming, fishing, hunting, or forestry for their livelihood, including nonworking dependents.

Source: UN Food and Agriculture Organization, FAOSTAT database.

agricultural operations. One consequence of declining numbers of farmers and the consolidation of farm operations is the accompanying concentration of subsidy payments. Because coupled subsidies tend to be based on levels of production and decoupled subsidies on historical levels of payments or acreage, most subsidies end up going to the largest operations. And with fewer farmers, it is easier and more profitable to organize and to lobby Congress for policies that raise prices and incomes, which, in turn, give those farmers both the means and the incentive to continue lobbying.

The concentration of payments in the United States and the European Union is striking. According to a database of payments compiled by the Environmental Working Group (n.d.), the top 10 percent of recipients of US agricultural subsidies from 1995 to 2003 got 72 percent of total payments, an average of more than \$300,000 per recipient over that period, while the bottom 80 percent got only 13 percent of the total and an average payment of under \$7,000 (table 3.2). According to the US Department of Agriculture (USDA 2000), 64 percent of farms receive no subsidies at all, and only 40 percent of those that do have sales under \$50,000 annually. Similar comprehensive data are not available for the European Union, but a recent

**Table 3.2 Concentration of US farm subsidy payments, 1995–2003**

<b>Category of all recipients</b>	<b>Percent of payments</b>	<b>Number of recipients</b>	<b>Total payments, 1995–2003 (billions of dollars)</b>	<b>Payment per recipient (dollars)</b>
Top 1 percent	23	30,502	30.5	1,001,416
Top 10 percent	72	305,023	94.5	309,823
Bottom 80 percent	13	2,440,184	16.9	6,918
Subsidies received by top 10 percent of recipients, by commodity				
Corn	68	144,272	25.5	176,415
Wheat	74	122,420	13.8	113,004
Cotton	80	22,095	11.3	512,005
Soybeans	60	88,780	7.2	81,295
Rice <sup>a</sup>	65	5,848	6.1	1,044,507
Sorghum	75	54,017	2.5	47,034
Livestock	55	74,561	1.4	19,209
Barley	75	31,569	1.1	35,389

a. Rice subsidies are often paid to cooperatives representing a number of farm operations, and information on individual recipients is not available.

Source: Environmental Working Group (n.d.).

study estimated that 80 percent of CAP subsidies go to only 20 percent of farm operations, with large agribusinesses receiving the most.<sup>12</sup>

Although one might think that outrage over the inequitable distribution of subsidies would lead to calls for reform, most consumers and taxpayers simply do not care enough about this issue to become actively engaged. Moreover, the farm lobby and its congressional supporters have cleverly expanded the coalition backing farm bills by bringing in other issues that would attract supporters who would not otherwise vote for agricultural subsidies (Orden, Paarlberg, and Roe 1999, chapter 2). Food stamps and other nutrition programs were wrapped into farm bills in the 1970s to attract the support of urban legislators; in 1985, environmentalists were attracted by the CRP, which pays farmers not to produce in wetlands or areas prone to soil erosion. Whatever their views of agricultural subsidies, these groups may be

12. "CAP Reforms Fail to Diminish Gap Between Rich, Poor Farmers: Study," *Bridges Weekly Trade News Digest* 9, no. 29 (September 7, 2005). A few countries release data similar to the Environmental Working Group's on the distribution of farm subsidies, and a British NGO recently won a court case to force the disclosure of similar information in the United Kingdom. In late 2005, a group of European NGOs, journalists, and others banded together to create a Web site, [www.farmsubsidy.org](http://www.farmsubsidy.org), that brings together the available data. They acted in the hope that these efforts would create pressure for greater transparency on recalcitrant countries.

inclined to lobby against overall cuts in the agricultural budget because they know that the agricultural committees on Capitol Hill will be more inclined to take the cuts out of these programs than out of traditional subsidies. There are signs, however, that this dynamic may be changing, with a number of environmental and antihunger NGOs arguing for fundamental reforms in the 2007 farm bill (e.g., American Farmland Trust 2006).

Americans tell pollsters that they do not favor subsidies to large operations and do not favor subsidies at all except in “bad years,” but very few of them vote on this issue or bother to lobby their representatives. In contrast, US farm interests lobby vociferously and contribute lavishly; in the 2004 federal election cycle, they gave roughly \$36 million to political campaigns (Center for Responsive Politics 2006). Advocacy groups for poor countries have also stepped up lobbying for reductions in OECD farm support on grounds of *international* equity, but thus far Americans appear unconvinced by these arguments. A 2004 poll on globalization by the Program on International Policy Attitudes ([www.pipa.org](http://www.pipa.org)) showed that a slim majority of Americans (53 to 56 percent, depending on the question) thought that US subsidies to farmers were justified by the need to compete with farmers in poor countries with lower returns, and that it was “not our responsibility to take care of farmers in other countries” (Kull 2004, 24).

Sugar is one of the most striking examples of both the inequities of agricultural policy and the power of farm lobbies. It is a product that some developing countries can produce far more cheaply than US or European farmers, yet it is one of the most heavily protected, with domestic prices in both markets supported at two to three times world prices, and one of the least reformed. Those guaranteed prices create a mighty incentive to lobby for continued support as well as, in the United States, the means to get access to the key congressional players (see box 3.2 and Elliott 2005b).

Budget pressures have the potential to be more effective in stimulating agricultural policy reform because they force policymakers to make choices among competing priorities and constituents. Over the past two decades at least, reductions in farm subsidies are correlated with budget debates, especially in periods when markets turned down and the costs of support prices set in good times soared. In the 1980s, escalating farm subsidy costs coincided with large budget deficits in the United States and a budget crunch in the European Community that increased interest in reforms. Conversely, a likely reason that Japan and South Korea have reformed so little is that almost all support is provided through trade barriers that require few budget outlays. (Unlike the United States, both countries export very few farm products and have no competitive concerns about using supply controls to prop up prices.) But with coupled subsidies, outlays tend to be high in times of low prices, and it is politically difficult to cut subsidies when farmers are suffering losses.

The result of the tension between containing costs and helping farmers in bad times, when public support also tends to be highest, is that most

### **Box 3.2 The political economy of US sugar policy**

Support for sugar producers today has no connection to the original motivation, born of the Great Depression, to keep farmers on the land by supporting their incomes. Rather, the policy transfers hundreds of millions of dollars to a handful of farmers and processors at the expense of American consumers, workers, and firms of the US food processing industry and more efficient developing-country exporters. Despite changing rationales, however, the principal mechanism for supporting US sugar prices remains much the same, a system of country-by-country quotas that sharply restrict imports (see also chapter 4, box 4.1). Since the restoration of import quotas in 1982, US sugar prices have typically been two to three times higher than world prices, and imports' share of US consumption has decreased from nearly half to less than a fifth.

The distortions created by US sugar policy are many. As a result of artificially high prices, the United States produces more sugar than it otherwise would, and more efficient producers such as Brazil and Thailand, export—and earn—less. The costs to American consumers depend on the size of the gap between world and US prices at any given time, but several studies over the past decade calculate them at roughly \$1.5 billion annually, and the US Government Accountability Office (formerly the General Accounting Office) estimates that producers collect \$1 billion of the total (GAO 1993, 2000; see also Hufbauer and Elliott 1994, Tokarick 2003). As shown in table 2.4, estimates of the relative level of support for sugar are higher than for any other major product. Other costs of US sugar policy include degradation of the Florida Everglades, a national park that was designated a United Nations World Heritage Site in 1979.

Sugar is somehow able to maintain its protection despite being a relatively minor crop in the United States. In 2000, acreage planted in sugarcane and sugar beets represented 0.8 percent of total harvested cropland, compared with 23 percent each for corn and soybeans, 17 percent for wheat, and 4 percent for cotton. Sugar's share of gross farm receipts in 2000 was 1.1 percent, versus 3 percent for wheat, 8 percent for corn, and 6.5 percent for soybeans.

But the sugar industry has more political clout than its relative size would suggest. According to the database compiled by the Center for Responsive Politics (2006), 3 of the top 10 agribusiness contributors in the 2004 election cycle were sugar producers. In the narrower crop production and basic processing sector, sugar's share of total 2004 contributions was 23 percent, and sugar producers were in 7 of the top 10 slots. To put this in perspective, the sugar and dairy sectors contributed roughly \$3 million each to federal candidates in the 2004 cycle, while farm receipts were just over \$2 billion for sugar and \$23 billion for dairy products.

reforms have been modest and incremental. Indeed, the most far-reaching attempt to reform US farm policy came during 1995–96, when commodity prices were high, subsidy payments low, and pressures in Washington to cut the federal budget deficit intense. As explained above (and in detail in Orden, Paarlberg, and Roe 1999), the 1996 farm bill departed sharply from past practice, introducing payments to farmers that were largely decoupled from production and prices. In this environment, however, the desire to preserve a high budget baseline for future subsidies was at least as important in gaining congressional approval as the desire in some quarters to reform US agricultural policy.

In the European Union, long-standing budgetary pressures have been exacerbated by the accession of 10 Eastern European countries in 2004. Absorbing all of the farmers in these countries (and they are proportionately more numerous than in the 15 countries that previously constituted the European Union), confronts member states with a stark choice of either large increases in the CAP budget or lower levels of support. The European Union is dealing with this in the short run by phasing in the proportion of direct payments for which farmers in the accession countries are eligible: From a starting point of 25 percent it will rise to 100 percent only in 2013. But farmers in the new member states are immediately eligible for export subsidies and other “intervention mechanisms.” As all these costs rise, pressures to lower the level of support farmers receive will also increase.

In addition, discussions in mid-2005 on the EU budget revived long-simmering tensions between the United Kingdom, which provides relatively low levels of support to its farmers, and France, which is the largest recipient of CAP payments. A resolution of this tension in the 1980s had provided for a partial rebate of British contributions to the EC budget because of its low CAP expenditures. With the 2004 expansion, France wanted a reduction in the British rebate to provide additional resources for the accession countries. But British Prime Minister Tony Blair linked any rebate reduction to reform of the CAP, which France rejected.<sup>13</sup>

In the United States, a sharply deteriorating fiscal picture resulting from tax cuts and increased spending, particularly on the military, has revived the debate over budget deficits and is contributing to pressures to reduce agricultural spending in the next farm bill. In the 2006 and 2007 budgets submitted to Congress, President George W. Bush proposed modestly cutting the agriculture budget, in part by capping payments to individuals at \$250,000 (down from \$360,000). In addition, the president’s budgets proposed reducing the total value of all payments to supported crop and dairy oper-

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13. The dispute was resolved at the end of 2005 with the United Kingdom agreeing to give up roughly 20 percent of its rebate in return for France agreeing to a budget review during 2008–09 that could result in further subsidy cuts, five years earlier than previously agreed (BBC News, “EU Leaders Agree on New Budget Plan,” December 17, 2005, at [www.bbc.com](http://www.bbc.com), accessed on January 4, 2006).

ations by 5 percent. No details were provided, but the 2006 budget also proposed partially decoupling market loan payments and basing them on historical production levels.

But Congress rejected these proposals. With the House of Representatives intent on protecting commodity programs and cutting food stamps, and the Senate strongly supporting protection for food stamps, the two bodies compromised, first by cutting the 2006 agriculture budget by less than half of the president's request (\$2.7 billion versus the proposed \$6 billion), then by making no more than minimal reductions in subsidy programs and food stamps and making most of the cuts in conservation and research and development. In policy terms, all of this was directly contrary to the objectives of reform-minded WTO negotiators (*Inside U.S. Trade*, January 6, 2006, 1). In general, budget pressures have frequently triggered concern about agricultural subsidies in the United States, but to less effect than in Europe, perhaps because the European Commission lacks the power to independently raise revenues.

## External Pressures for Reform

The increased role played by developing countries in pushing for agricultural reforms was underscored by the contrast between the outcome of the Doha Round's mid-term ministerial meeting in Cancún in September 2003 and the endgame of the Uruguay Round. During 1992–93, US and EC negotiators concluded an agreement that resolved a bilateral dispute over oilseeds and set the parameters of the Uruguay Round agreement on agriculture. They then presented it as a *fait accompli* to the other negotiators, many of whom found it grossly deficient in the level of liberalization achieved. In hopes of avoiding the delays and disruptions associated with sharply divergent US and EU positions on agriculture through most of the Uruguay Round, other WTO members asked US and EU negotiators to work out a compromise prior to the Cancún meeting. But when the US and European negotiators came out with a proposal that appeared designed to protect their own policies, including retention and expansion of the blue box, the response was quite different from that of a decade earlier: The major agricultural developing countries organized themselves into the G-20 and rejected the proposal.

As of early 2006, Brazil, India, and other key developing countries continue to be reluctant to put forward their own offers on nonagricultural market access and services until they determine whether US, EU and other rich-country negotiators are serious about reducing agricultural support. Without that, a meaningful liberalization package simply will not be possible. But the battle is not just North-South. While the West African cotton-exporting states, Brazil, Argentina, and the other competitive agricultural exporters want significant reductions in US subsidies, US farmers will not

acquiesce to large subsidy cuts unless they get increased market access for their exports, including the large European and Asian markets.

In addition, Brazil's success in challenging US cotton subsidies and European sugar subsidies under the WTO's dispute settlement system creates another incentive to negotiate reforms. Recent studies suggest that the alternative in many sectors could be making reforms under the threat of WTO-authorized retaliation, without getting something in return in the form of increased access for manufacturing and services (Oxfam International 2005, Sumner 2005).

In addition to responding to WTO pressure on agricultural policies, the United States, the European Union, and Japan are also all engaged in bilateral and regional trade negotiations that are increasing the pressure for reform. For example, US negotiators overturned the principle of no exclusions in free trade agreements when it rejected increased access for sugar in the agreement with Australia. The Central American countries and the Dominican Republic will be permitted to increase sugar exports modestly, but US import barriers will not be eliminated, even though trade barriers will be coming down for all other sensitive products (albeit after long phaseouts). Several proposed partners in free trade agreements are even larger sugar exporters, and US negotiators will find it increasingly difficult to reconcile the existing provisions of the sugar program and the US trade agenda.

But there is a tension between the internal and external pressures for reform. In the European Union, and even more in Japan and South Korea, where trade measures are a major component of farm support, the budget impact of moving to decoupled subsidies would be high in the short run. Similarly, buying out the sugar and dairy quotas in the United States, as has been done recently for peanuts and tobacco, would require increased budget outlays (Orden 2005). Unless policymakers are willing to reduce support levels, this could make reforms involving decoupling more difficult in the short run. In the longer run, however, decoupling limits outlays by basing them on past production or acreage rather than on current prices. And whether announced as a buyout or not, moving from border measures to decoupled subsidies makes farm support more transparent and improves the chances that it will be reduced over time.

Unfortunately, events in spring 2006 suggested that policymakers in key countries had not yet summoned the political will to take on agricultural interests. In France, the government revoked labor market reform legislation in the face of street protests and dropped other legislation to reduce smoking in public places, suggesting that *any* economic reform is unlikely until after the presidential election in April 2007. In the United States, President Bush nominated the popular and effective US trade representative, Robert Portman, to become his director of the Office of Management and Budget just prior to a key April 30 deadline in the Doha Round agricultural negotiations. Many observers at home and abroad

interpreted the move as indicating that the president expected little from the round and had decided to devote his limited political capital to other priorities. Not surprisingly, the April deadline for agreeing on key elements of the agricultural negotiating framework was missed.

Political weakness and policy drift in France and the United States make it increasingly unlikely that the Doha Round can be completed in late 2006 or early 2007. That, in turn, means that the US Congress will likely have to vote on whether to renew so-called trade promotion authority, which authorizes the president to negotiate trade agreements that the Congress commits to vote up or down, without amendment. The current authority expires in mid-2007 and was passed in the House of Representatives by a slim 3-vote margin in 2002. There is no guarantee that Congress will approve an extension of trade promotion authority, especially if there is little progress in the negotiations before they have to vote. The risks of dithering are high.

