PolicyPennings by Dr. Daryll E. Ray

What is it that distorts markets?

We were interested in reading this year's *Economic Report of the President*, http://www.gpoaccess.gov/eop/, which contains a chapter on agriculture. One of the main themes of the report is that "support to agriculture can be provided in many forms that are potentially less market-distorting than existing commodity subsidies." In this column we look at the ways the chapter proposes that this less distorting support can be delivered.

After looking at a selected history of the evolution of agricultural programs and who currently receives the benefits, the report asserts that today's farmers "have many options for managing the risks they face" that were not available at the time commodity support programs were put in place in the 1930s. Among the market-based options that farmers can use "to protect themselves against short-term price declines" are futures and options markets, savings, and borrowing. We agree that these options are adequate to deal with short-term random price risks, but are less useful for a multi-year trough of low commodity prices like we saw in the 1998-2001 period.

Similarly, while diversification "among different types of crops and livestock" is a good idea, diversification alone will not protect farmers in a four-year trough of low prices. It is our observation that, within agronomic and marketing limits, farmers readily and swiftly shift acreage from one crop to another to find the combination that gives them the highest potential return. The problem is that there are few realistic options when all prices suffer from a 35-40 percent decline. Even contracts provide limited potential for mitigating income loss since market prices usually influence contract terms.

Crop insurance and total revenue insurance are also touted as market-based alternatives to subsidies. In the absence of government subsidies, the premiums commercial insurers would have to charge would be so high that few farmers could afford them or would be willing to purchase them. At present multi-peril crop insurance and total revenue insurance require federal subsidies to make them affordable to most farmers. Even with subsidies, revenue insurance has the underlying problem of protecting a constant percentage of declining incomes when prices go into a multi-year slide. Protection goes down with prices.

After looking at ways that farmers can manage risks, the report points out that, in 2005, total payments to farmers of $20 billion constitute "about 6 percent of the US Federal budget deficit for 2005 of $319 billion." Note the basis for the percentage is 6 percent of the 2005 deficit, not 6 percent of federal budget expenditures. As a percent of the Federal budget, the percentage is eight-tenths of one percent.

A second theme of the report is that "these subsidy payments can cause market distortions by stimulating more production than would occur without the subsidies." This argument echoes a central criticism of farm support payments by the World Trade Organization (WTO). WTO's litmus test of market distortion is: the impact of a farm program on agricultural production. The crucial question boils down to "does the program encourage increased production".

Yet, traditional farm programs may have an inconsequential impact on expanding agricultural production compared to other influences on production agriculture. Bruce Babcock, a director of an analysis unit that is commissioned by Congress to provide agricultural policy analysis, says "almost all analysts suggest that aggregate food production would change very little if we did away with the programs." Sugar, cotton and rice would undoubtedly experience some changes, but the production impact on aggregate crop agriculture would be minimal as acreages in those crops shifted to corn, soybeans, canola, wheat, and barley further depressing prices for those crops.

"From an economic perspective," the report argues, "the best way to provide agricultural support would be to focus on forms of support that interfere less with market forces while achieving the desired policy goals." In addition to lump sums that are not tied to market prices or quantities, the report suggests payments that can be made for "activities that benefit the entire farm sector. For example, investments in public goods like infrastructure for rural development (e.g., roads), agricultural research, market promotion, extension and teaching" are considered by WTO as non-market-distorting.

The report goes on to say "government support for activities that boost agricultural productivity in the US relative to that in other countries can help increase competitiveness of US agriculture in world markets. The exemption of these decoupled payments from WTO payment ceilings provides members of the WTO with the flexibility to transfer income to their agricultural producers, but in a manner PRESUMED (emphasis added) to have minimal potential to distort trade."

So why is WTO's "production affect" test not violated by government payments to "boost agricultural productivity in the US relative to that in other countries?" To us it seems inconsistent for the authors of the report to argue in favor of government sponsored investment in infrastructure and productivity increases while arguing against government programs that are designed to protect farmers against the inevitable, and occasionally sharp, price declines that result from publicly-financed-supply-growth that exceeds demand growth in a given period.

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