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Will reductions in domestic supports in OECD countries raise crop prices in developing countries? If not, what would?

By Daryll E. Ray

To most, the US and several other OECD countries are clearly to blame for the recent spate of low farm prices and incomes in developing countries. And no wonder, given the billions of dollars that are spent on domestic farm programs in those countries. The developed countries are also accused of coming up short on WTO's other two agricultural trade reform pillars market access and export subsidies. While acknowledging the other two pillars and a host of other constraining influences on farmer prosperity in developing countries, the focus of this paper is the criticism of domestic supports and domestic support levels.

The World Trade Organization (WTO) and a diverse list of others quite logically assume there is a one-to-one connection between high US domestic supports and US overproduction, which, in turn, puts downward pressure on farm prices worldwide. The WTO solution is also quite logical: Eliminate or significantly reduce domestic supports that are classified as trade distorting. While no substitution of supports is preferable, if domestic support must be considered, countries should choose lump-sum payment schemes in which the amount paid to farmers is invariant to what is or is not produced on their farms. Then the scourge of overproduction will be laid to rest, prices will recover, and farmers in developing countries will no longer suffer prices that are below the (full) cost of production in the US or other developed countries.

It sounds like a simple problem that can be solved simply. There are two premises in this logic, however, that should be examined. The first premise is that the reason the US overproduces is because of high domestic supports. The other premise is that once domestic supports are lowered, transformed into another type, or even eliminated, production will decline markedly. This paper questions the validity of both of these premises. The next logical question is then posed: if these premises are wrong, what other approaches would actually achieve the improvements in prices and incomes of farmers in developing countries desired by governments of developing countries, non-government organizations, and multilateral organizations?

US Production and Productive Capacity

The question is not whether US agriculture typically overproduces. It does and has for scores of years. The question is why. The answer is not encompassed by a simple statement that "US farmers receive subsidies to produce." It's a puzzle with many pieces. At the present, let's consider two of the component pieces. First, the US has long had a public policy to expand the productive capacity of agriculture at taxpayers' expense. Secondly, individual crop farmers have no rational choice but to use the full productive capacity of their land all the time.

US Policies that expand productive capacity

From its birth as a nation, the US pursued policies that promoted a phenomenal growth in the productive capacity of agriculture, supported by the taxpaying public. These

developmental policies increased agricultural productive capacity by making agricultural inputs more plentiful, more productive or less costly.

It began with frontier expansion through land distribution. As early as the late 1700s, the U.S government offered land for settlement at bargain-basement prices per acre and offered it to Revolutionary War veterans in recognition of their service.. In the mid-1800s, under the Homestead Act of 1862, land was virtually given to anyone who would settle and farm it.

Once the frontier closed, the U.S.'s most important developmental farm policy was public investment in experiment stations in each state (Hatch Act of 1877), land-grant universities (Morrill Act of 1862) and extension service (Smith-Lever Act of 1914). This set of institutions increased the supply, lowered the cost, and improved the quality of physical inputs like seed, chemicals, equipment, and of less tangible inputs like the managerial and decision-making abilities of farmers. Today private companies provide an increased measure of technologically advanced inputs but nearly all of those products are built on a foundation of basic and applied research completed through publicly financed research stations.

The mammoth growth in agricultural productive capacity in the U.S. was the result of a continual public investment in agricultural research and education. Economists compute the rate of return of the public's investment in research and extension to be between 20 and 60 percent. The combined annual expenditure by federal, state and local governments on these agricultural research and education activities continues to exceed \$10 billion. It is

estimated that private sector investment in agriculture research equals or exceeds this amount. Since 1950, the generation and diffusion of output-expanding technologies has doubled the total output of the eight major U.S. crops.

Clearly, the U.S. government has been intervening in agricultural markets in a gargantuan way for well over a century to expand productive capacity separate from any consideration of “farm program” subsidies.

Farmers produce at full productive capacity

In the agricultural sector, productivity-enhancing technologies are quickly adopted, typically increasing supplies faster than growth in demand, and putting downward pressure on prices. The lower prices, in turn, become further incentives to adopt more cost-reducing technologies, and prices continue their slide. In this way, production agriculture is under constant price pressure, with periods of brief reprieve generally the result of disasters or other random events.

Given that food is a necessity for life, it is urgent that the productive capacity of agriculture continue to stay well ahead of immediate needs. Most agree that this important part of agricultural and food policy should be continued. But the nature of crop agriculture means that all of its productive capacity tends to be used all of the time. This is true even as individual farmers go out of business because the land almost universally remains in production just under new management.

The result of this kind of thinking was the 1996 Farm Bill, which removed all vestiges of government price supports

and annual supply controls. It should be noted that the 1996 Farm Bill was debated and passed during a period of very high prices and high optimism for growth in the U.S. agricultural sector. The high prices were primarily a result of tight world markets, compounded by weather conditions in the U.S. that resulted in 1995 yields that were well below trend levels. At the time, USDA forecasters were projecting tremendous growth in U.S. crop exports for the foreseeable future.

Why Agricultural Markets Fail to Self-Correct

As suggested earlier, there are a number of components to the farm price and income problem. To this point we have only mentioned a couple elements: publicly-funded research continually expands productive capacity and major commodity crop farmers tend to use all of available productive capacity all the time. When the farm policy instruments that traditionally gauged production to demand and supported prices were eliminated in 1996, prices fell worldwide. But why should that be? If aggregate agriculture worked as described in economics textbooks, government production-throttling and other price-and-income bolstering programs should not be necessary.

It is important to understand why agriculture does not self-correct. Once that is understood, expectations concerning how agriculture will or will not react to changes in domestic and international policies can be formed more accurately.

The self-correction issue is so important because market disruptions occur so frequently in agriculture. One obvious disruption is weather-based, random fluctuations in yields. A longer

term, continuing force that affects agricultural markets is that productivity growth tends to outstrip the traditionally slower growth in food demand.

Domestic demand for agricultural products in a country like the US grows with population but, unlike the demand for cars, houses, clothes and most other product categories, doubling a consumer's income will have a minor impact on his demand for food. Likewise, the rate of growth in export demand over time has been disappointing, especially in the case of grains. If the growth in demand for agricultural products kept up with production, low farm prices and incomes would be much less of an issue.

But that is not the case, and as mentioned earlier, in order to reduce costs farmers eagerly adopt new technologies as they become available. As other farmers follow suit, output increases faster than demand and prices fall. The lower prices, in turn, become further incentives to adopt more cost-reducing technologies, and prices continue their slide.

The mere presence of low prices is not the problem. What matters is how consumers respond in terms of the amount they are willing to buy and how producers respond in terms of the amount they are willing to produce next season. If consumers bought more of the lower priced goods and producers cut their production, excess inventories would quickly vanish and prices would arrive at profitable levels once again.

If this adjustment could take place in the agricultural sector, there would be no fundamental price and income problem. This is exactly the way it

works in most product-producing industries: consumers buy more and producers provide less in response to a drop in prices, an increase in inventories, or a drop in sales. Prices rise and profitability re-appears. But neither the quantity of crops demanded nor the quantity supplied is significantly responsive to changes in price, so timely market self-correction does not take place. Total annual output remains relatively constant irrespective of prices, the level of subsidies, or other sources of revenue.

As mentioned earlier, even when individual farmers go bankrupt, total output changes very little. In contrast to other industries, where a plant closure means a reduction in industry size because the land and other assets are sold to a different industry, crop acreage typically remains in production. It is merely tilled by someone else. A farm sale does not typically reduce the size of the agricultural industry. In fact, output per acre may actually increase because the new owner may be a better manager or is better capitalized.

The bottom line is this: regardless of the cause of decline in revenue, total crop output declines very little in response. Self-correction works no better on the demand side than on the supply side. To establish an agricultural policy based on the assumption that free market adjustments will occur within a reasonable time is in direct conflict with what we know about how agriculture works. The following section provides examples of agricultures that continue to use nearly the same land resources after severe price or government subsidy reductions. The mix of commodities grown changes with changes in prices

among products but the land is not left idle.

This does not mean that current U.S. farm policy is blameless. Far from it. Excess production and fire-sale prices did not occur because farmers responded to payments and increased production. It occurred, as suggested earlier, because the U.S. no longer has the means to throttle its ever expanding productive capacity or to establish a floor on commodity prices. Acreage set asides and effective price supports are no longer part of the current U.S. farm program so all of agriculture's productive capacity is used all of the time. Predictably, when additional production from the acreage—that would have been set-aside under previous legislation—flooded the market, prices were driven below formerly-available price-floors. Once the land was brought back into production, it remained in production.

By far, it is the expanding size of agriculture's productive capacity that has the most depressing effect on prices. And yet, those public expenditures that expand productive capacity, including research and extension, general infrastructure and other capacity building activities, are classified as non-trade distorting and put into the green box. To me that classification and the conventional wisdom attached to it are totally inaccurate.

To me, all or most of the domestic support programs are assigned to boxes of the wrong color. If judged by the degree to which a domestic program depresses prices, an argument can be made that the blue-box supply control programs and the amber-box price support programs belong in the green box and the research, extension and many of the programs in the green box

belong in the amber box. Of course, the box designation partially depends on the how each program is administered. If supply control and price support programs were used to raise prices well above the cost of production, the amber box comes back into the picture. If research, extension and other currently designated "non-trade distorting" activities are only invested to the extent required to maintain productive capacity and not to expand it, then such policies should logically remain in the green box. None of these possibilities seem likely.

The most striking conclusion of all this is that, given the mammoth and likely accelerating growth in productive capacity and the nature of agricultural markets, a subset of the domestic programs that the WTO and others condemn may be the very programs that are needed to prevent dumping and to achieve politically acceptable price levels, especially in developing countries. If those or other programs were accepted, most of the issues concerning government payments would be mute. Government payments don't influence total crop production much no matter what but payments also would be de-emphasized if more price-oriented policies were implemented.

This is an abridged version of an article written by Daryll E. Ray from the Agricultural Policy Analysis Center, University of Tennessee, Knoxville, TN

G-33 Statement On Special Safeguard Mechanism (SSM)

1. Paragraph 42 of Agriculture Framework[1]states:

"A Special Safeguard Mechanism (SSM) will be

established for use by developing country Members"

2. According to the General Council's Decision, the SSM is an integral part of the Special and Differential Treatment (SDT) provisions under the market access pillar. As such, the SSM constitutes a fundamental element for addressing the existing imbalances in the agreement. In this context, the SSM should provide developing countries and Least Developed Countries (LDCs) with an effective and flexible instrument to address their distinct susceptibilities to import surge disturbances and the ruinous effects of down swings in prices.

3. The Agriculture framework does not provide specific guidelines with respect to the possible architecture of the SSM but such negotiations do not take place in a vacuum. Currently, there exist provisions on safeguards under Article XIX of the GATT and the Agreement on Safeguards as well as provisions on Special Safeguards (SSG) under Article 5 of the Agreement on Agriculture.

4. For several reasons these provisions have been insufficient and/or inadequate to address the concerns of developing country Members related to stabilising domestic markets and avoiding sudden increases of imports that threaten to disrupt domestic production and employment.

5. In that context a review of the experience of developing countries in the use of the existing safeguard provisions could contribute to identify basic parameters for the negotiations on SSM modalities.

6. That is, negotiations on modalities on the SSM shall be guided by the

purpose of devising a safeguard mechanism that as an SDT provision effectively responds to the needs and particular circumstances of developing country Members. As such it must represent an improvement from the existing safeguard instruments. The experience of developing countries in the use of safeguard measures

7. The general safeguard provisions under Article XIX of GATT and the Agreement on Safeguards are available to all WTO Members and for all type of products.

8. Therefore, Members including developing countries can adopt special import measures under the Safeguard Agreement for agricultural products. Moreover, the safeguard agreement does not establish restrictions with respect to the scope of products to be protected by the measure, thus all agricultural products can have access to the special import measures under the Safeguard Agreement.

9. However, the GATT's general safeguard provisions require Members invoking the measures to prove injury or threat thereof to the domestic industry and establish through an investigation based on objective evidence that there is a causal link between increase in imports and the injury or threat thereof to the domestic industry.

10. In consequence, theoretically all developing countries have access to these provisions. In practice however, many lack the institutional capacity to implement in a rigorous manner the detailed procedural requirements necessary to apply the safeguard measures in accordance with the Safeguards Agreement.[2] Furthermore, the nature of agriculture in many developing countries

characterised by large number of subsistence and small farmers makes it difficult to meet the conditions established in the Safeguard Agreement to prove the causal link between increased imports and injury, necessary for invoking the measure.

11. An additional feature of the special import measures under the safeguard agreement is that it can be implemented only when a product is being imported in such increased quantities and under such conditions as to threaten injury to the domestic industry. Therefore, the measure would provide relief from import surge situations but does not address situations of price volatility per se.

12. The Agreement on Agriculture on the other hand, incorporated provisions on special import measures that waived the basic constraint of the safeguard agreement of proving injury or threat thereof to the domestic industry. The measure is thus automatic in the sense that the safeguard can be activated once the triggers are hit without the requirement to undertake an investigation process.

13. Besides, this instrument provided for special measures to be taken in response to both import surges (i.e. increased in the volume of imports) and downward swings in prices.

14. Indeed, agricultural markets are by their nature cyclical and subject to turbulence. On the other hand, poor farmers' livelihoods are often extremely vulnerable, meaning that temporary shocks can have significant and long lasting effects on the poor. Given that developing countries lack safety net mechanism to protect farmers' income and employment, downward pressures on prices can have deleterious effects on rural

development and agricultural production.

15. Thus the provisions on special import measures under the Agreement on Agriculture would seem more at reach of developing countries' institutional capabilities and special circumstances: there is no need to prove injury to the domestic industry for invoking the special import measure; and the safeguard instrument can be triggered both in response to import surges and down swings in prices (i.e. volume and price triggers).

16. However, not all WTO members have had access to this mechanism - something that the new SSM will address; nor has this instrument been available for all agricultural products. Furthermore, the specified technical conditions for making use of this instrument seem to act as constraining factors for their use by many developing countries.

17. An important deficiency is related to the fixed reference price built into the price-triggered safeguard. For developing countries having been exposed to inflationary pressures and instances of currency devaluation the fixed reference price in-built in this instrument has no relationship with current trends in prices hampering the possibility of the measure being invoked by the affected countries. As indicated by FAO: "To apply the safeguard, the current nominal price of imports in domestic currency should be lower than the corresponding average price effective during the 1986-1988 period, which was a period of very depressed international prices and strong overvaluation of many developing countries' currencies. This implies that the trigger price for these countries turns out to be very low in

comparison with any current prices." [3]

18. Additional elements in the architecture of this safeguard instrument act as deterrents in their use by developing countries.

19. For instance, only additional duties are contemplated in this instrument as relief measures while the general safeguard provisions under GATT allows for the use of additional duties and quantitative restrictions.

20. Furthermore, important constraints are in-built in this safeguard instrument with respect to the potential relief that the special import measure can provide by limiting the level of the additional duty to be imposed in respond to import surges. Such constraints as they currently stand, combined with the particular tariff profile of developing countries may not provide for adequate relief.

21. Moreover, the trigger levels are less sensitive to low levels of imports with the implication that when the national food supply is based largely on domestic production, imports have to increase by more than 25 per cent in one year for invoking the measure. Yet, from a food security perspective in developing countries these are often the most sensitive situations and such a large threshold for triggering the measure severely restricts its responsiveness to the particular circumstances of developing countries.

22. In addition to the above, the current agriculture safeguard instrument requires certain level of sophistication in terms of administrative capabilities as well as customs' facilities and infrastructure. This sophistication is currently out of reach of many developing countries and thus a

simpler mechanism may be necessary in the context of designing a SDT safeguard provision for developing countries.

23. All these factors inhibit the use of the safeguard instruments under the GATT and the Safeguard Agreement, as well as the Agreement on Agriculture by developing countries and leave them exposed to the vagaries of international prices and sudden increase in imports with detrimental effects on farmers' livelihoods, rural development and food security. parameters for the negotiation of the SSM modalities

24. As the above brief review of the experience of developing countries in the use of existing safeguard provisions indicate, there are specific aspects to each of these instruments that constraint their use by developing country Members.

25. As an SDT measure the SSM must represent an improvement on the existing safeguard provisions in terms of establishing a mechanism that is responsive to the needs of the developing country Members and LDCs and the particular circumstances of their agricultural sectors. Building on the flexibilities embedded in the existing safeguard provisions rather than extracting from them would be the adequate approach to follow in devising the modalities for the new special safeguard mechanism.

26. In view of the above, the following general parameters should guide the negotiation of modalities on SSM [4]:

i) The safeguard measure shall be automatically triggered;

ii) The safeguard measure shall be available to all agricultural products;

iii) The safeguard measures should be available to address situations of import surges and swings in international prices. Therefore, price and volume-triggered safeguards shall be contemplated.

iv) Both additional duties and quantitative restrictions shall be envisaged as measures to provide relief from import surges and decline in prices;

v) The mechanism shall respond to the institutional capabilities and resources of developing countries; hence it should be simple, effective and easy to implement.

Editorial: Can WTO's Agreement on Agriculture(AoA) be really 'reformed'?

Chandrakant Patel

Four years into Doha Round, and against the backdrop of commitments in Paragraph 13 of the Doha Declaration to 'establish a fair and market-oriented trading system through a programme of fundamental reform', it is timely to ask the question: how realistic is it to expect a 'fundamental reform' of the AoA by the end of the negotiations, now generally expected to last at least until 2007.

A response to such a question must necessarily take into account at least three developments since the adoption of the Doha Declaration: first, the implications of the US Farm Bill of 2002; second, EU's efforts to reform its Common Agriculture Policy (CAP) initiated in 2003 and third, WTO's July

Package, adopted in 2004. In addition, account must also be taken of the conclusions of recent research suggesting a considerable degree of disconnect (i.e. inelasticity of supply) between provisions of subsidies to OECD farmers on the one hand and on levels of production, land use and exports on the other. Professor Darryl Ray discusses these latter issues in his article, "*Will Reductions in domestic support in OECD countries actually raise crop prices in developing countries? If not, what would?*"

The US Farm Bill of 2002 (adopted a few months after the Doha meeting) sent a clear message that for the US, protection of its agriculture and the farmers' well being took precedence over any multilateral commitments. The 2002 Bill, entirely unilateral in letter and spirit (like its predecessor the 1996 Farm Bill) raises permissible levels expenditures compared to 1996 legislation by 80 percent to a total of \$ 180 Billion for ten years. It extends support to new crops and undermines some of the decoupling of subsidy payments from production and market prices. Support provisions of the Farm Bill now extend to four areas: price and income support for grains and oil seeds, special programmes for sugar, dairy and peanuts and those affecting market access and export.

The latest round of CAP reform, initiated in 2003 (and whose implementation will begin this year) now freezes the level of subsidies provided to EU's farmers at the average levels of 2000-2002 until 2013. At the same time, decoupling subsidies from production to single farm payments means that the EU justifies shifting subsidies from the Blue Box to the Green Box, a process now sanctioned by the July Package.

By sanctioning box shifting from the Amber Box (of total Aggregate Measure of Support and *de minimis*) to the Blue Box and then to the Green Box, the July Package provides an ex post rationale for the post-Doha agriculture support policies of the US and EU. In the process, it has effectively frozen, if not permanently derailed, any prospect of meaningful reform of the AoA for the foreseeable future. For example, to ensure that the EU does not have to make meaningful reduction commitments in Blue Box subsidies, the July Framework states “...*In cases where a Member has placed an exceptionally large percentage of its trade-distorting support in Blue Box, some flexibility will be provided on a basis to be agreed to ensure that such a Member is not called upon to make a wholly disproportionate cut.*” This escape clause crafted in favour of the US/EU is further buttressed by establishing near-water tight criteria for making direct payments to farmers to keep the subsidies intact: to illustrate, Annex A of the July Framework states that “Any new criteria to be agreed will not have the perverse effect of undoing reforms.”

A further consideration in assessing the prospects of a genuine reform of agriculture policies in the OECD countries (and of the AoA) derives from the conclusions of recent research and analysis that question the very premise of developing countries expectations of reform and strategies in the WTO negotiations. The core argument in support of a reform of the AoA is the view that domestic and exports subsidies for OECD countries agriculture leads to overproduction and lower prices worldwide (via dumping on world markets— defined as selling at prices below cost of production and/or selling abroad at

prices lower than domestic prices). The solution, then, is to eliminate or significantly reduce domestic support that is classified as ‘trade distorting.

As noted by Professor Darryl Ray in his article, the two premises upon which this line of reasoning is based— namely that subsidies are the cause of overproduction and that their elimination would lead to declines in levels of production (and improved levels of prices) are both questionable. In the first place, the US (and the other developed countries) have historically extended very strong support to their domestic agriculture and will continue to do so as a matter of strategy of self-sufficiency, national security and wider considerations stemming from agriculture’s ‘multifunctional’ role. Secondly, according to the analysis by Ray, farmers have no choice but to continue the full productive capacity of their land all the time. Consequently, size of acreage tends to remain invariant with respect to public expenditures. Thirdly, productivity of the agricultural sector in OECD countries will continue to rise: high returns from investments in research in agricultural, use of newer technologies, and progressively lower costs of agricultural inputs will lead to continuing increases in production and pressures on prices. Ray cites the experiences of a number of other countries (Canada, Australia and Mexico) to suggest that removal of and or reduction in subsidies have not lead to a significant drop in production: indeed, he shows that in several cases, production levels *increased in response to a reduction of subsidies.*

If the conclusions of the analysis by Ray are correct, then it is clear that the strategy of persuading developed countries to reduce subsidies will yield little or no improvement in the scale of

production, of dumping of export and improvements in levels of price remuneration for developing country farmers. Even assuming that the current negotiation lead to a significant reduction/capping of subsidy levels—an assumption unlikely to materialize for reasons noted--- the effect on production is likely to be marginal at best.

This being the case, what should be the approach of developing countries? The point of departure for them must be that developed countries—for their own reasons—will continue to subsidize and actively support their agriculture; consequently, developing countries will also need to look inwards and establish national criteria and yardsticks for protecting and promoting their own self-interest. The position outlined in the recent G-33 submission to the WTO on Special Products should be pursued as a first

step, as should the case for special safeguards measures (SSM). But these measures should be considered as part of the wider policies that developing countries need to promote, if necessary, outside the iniquitous AoA. However, WTO Agreements provide Members with several options, ranging from the imposition of quantitative restrictions for balance of payments reasons under Article 18-B to anti-dumping and countervailing measures. It is for developing countries to assert their rights to protect food security and farmers livelihood. In the current Round, as a minimum, they should not yield to pressures to undertake any further liberalisation in this sector.

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