



Worth Noting

Volume III, Issue XVII, 6 August 2003

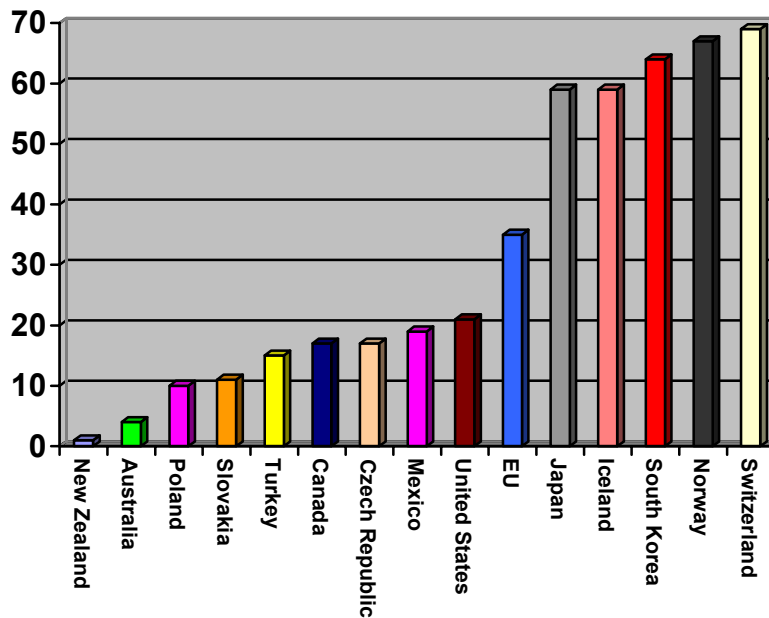
Worth Noting is the fortnightly management journal of research and conferences company L21. It is focused on management strategy issues of relevance to senior executives.

Agricultural Subsidies

Agricultural subsidies are one of the more resilient features of most developed economies. In an environment where protection is generally on the decline and the benefits of free trade are universally accepted, the market distorting influence of agricultural subsidies continues unabated. The OECD recently put the total value of agricultural subsidies in the developed world at \$475B in 2002. The European Union's Common Agricultural Policy (CAP) and the USA's pork-laden *Farm Security and Rural Investment Act 2002* are massive both in their financial size and structural impact. Simply put, the subsidy programs lead to developed economies producing products they should not produce. In many agricultural sectors, American and European farmers are unable to compete in the global market on their own two feet. Subsidies allow them to dump their products at prices they could never be produced for, hampering economic progress in this most critical of industries.

The OECD produces an excellent report each year comparing the various agricultural subsidy regimes in different countries. It is most useful to look at this data in the form of government provided producer support as a percentage of total agricultural revenue. Australia provides the second lowest level of support to agricultural producers in the OECD.

Percentage of Total Agriculture Producer Income Provided by Subsidies, 2001



Source: OECD, *Agricultural Policies in OECD Nations*, 2002

A number of points are made clear by this chart. Firstly, agriculture is characterised by an exceptionally high level of protection in developed nations – the OECD average is 31% of producer income. Secondly, those OECD nations which have the most internationally competitive rural sectors – New Zealand and Australia in particular – have the lowest levels of protection. Australia can be proud of the leadership role it has taken in attempting to reduce farm subsidies over the past two decades. Thirdly, the three giants of the world economy – the US, Japan and Europe – have high levels of agricultural protection. It is certainly clear that Australian farmers – and farmers from the developing world – have very legitimate grounds for criticism of the economic giants’ agricultural subsidy policies.

Fields of Dreams

Europe is the world’s most notorious protector of the agriculture industry. Led by France, the European Union has demonstrated an extraordinary willingness to protect inefficient food producers. The Common Agricultural Policy has grown from a small experiment in the 1950s to a bureaucratic monstrosity today. The CAP is, in our view, one of the worst pieces of economic policy in place in the developed world.

Traditionally, most of the CAP has been spent on subsidies with a direct link to production. These account for about 27B Euros of the 43B that the EU currently spends on the CAP. Production subsidies are one of the most perverse forms of protection, as the rational producer is given an incentive to produce massive quantities of protected product. Not only is the inefficient production practice protected, it is deliberately encouraged. Let's say the subsidy on sugar is 10c a kilo. For every kilo the farmer produces, they would be paid 10c under the CAP. So European farmers busily grow massive quantities of crops that they should not be producing at all. If a developing country can produce the crop to the same quality at a cheaper price, it should become the global producer of choice. But the CAP does not allow this: to indulge European food manufacturers and farmers, the EU hands them the weapons with which to bludgeon foreign competition.

The policy has led to perverse outcomes: the EU typically has huge surpluses of grain, dairy produce and other goods – the subsidy tap is not turned off, even if there is more food produced than Europe can possibly eat.

Bear in mind that the EU's entire budget is only a little over 100B Euros. Its member states elect to spend 40% of the organisation's budget on a policy that celebrates inefficiencies, stymies competition, and benefits mainly a few large food conglomerates.

In June of this year, the EU agreed to some limited reforms of the CAP. While the organisation lauded these reforms as "historic", to do so involves a very minimalist definition of history.

The headline from the agreement was that the EU had decided to "de-couple" production levels and the amount of subsidy paid. As described above, the system to date works on a simple, and blindingly stupid principle: the more goods a producer makes, no matter how inefficient the process, the more subsidy they are paid. "De-coupling" involves breaking the nexus between production levels and subsidies. The positive aspect of this change is that massive overproduction should cease: producers will have no incentive to make goods if there is no market to sell them to. Remarkably, this has not generally been the situation in Europe – producers have had an incentive to produce, not to sell.

The reforms to the CAP are still massively inadequate, however. Most importantly, the total amount of subsidies available remains unchanged. The CAP will still absorb more than 40% of the EU's budget – it is simply that the largesse will be distributed in a different way. Under the new system, farmers will be given a one-time annual payment, based on the size of their farms and the amount of subsidies they have received in recent years.¹

¹ Christian Science Monitor, *European Agricultural Reforms: A Pig in a Poke?*, June 30, 2003

The new system will be intriguing to watch. Producers will receive a (generous) one-off payment, and then be allowed to do with it what they please. Depending on the economics of the market in which the producer operates, a number of different reactions are possible. For producers who lack a strong competitive position even with the subsidy, the most rational thing to do would be nothing at all. That is, keep the subsidy and produce very little output. Why work to become competitive when you can simply bank a cheque? Clearly the EU will need to develop policies to stop this sort of abuse, but its very possibility (indeed likelihood) highlights the foolishness of the CAP.

Other producers will keep production at approximately the same levels, thereby enjoying the same effective production subsidy as at present. The incentive to produce absurd quantities of goods will be gone, and that is clearly a positive development. But to say that this is real policy reform is being very kind. The extremes of the irrationality of the CAP have been limited – but its core irrationality is alive and well.

America Too

If the US has the most vision in free market economics, then agricultural subsidies are its blind spot. Their existence is utterly inconsistent with the basic principles on which the United States has risen to greatness.

Last year, President Bush signed into law the *Farm Security and Rural Investment Act 2002* (“The Farm Act”). The Act increased by up to 80% in some cases the amount of subsidies paid to American farmers. The total value of the package is approximately \$325B over 10 years – about two-thirds the size of the CAP, with a comparable size economy. So the US policy is not quite as market distorting as Europe’s. But it is thoroughly bad policy which costs the United States substantial credibility when negotiating trade deals.

The US system does not involve a link between production levels and subsidies, which spares it the ludicrous overproduction which has plagued Europe. Its program centres on straight cash subsidies, so-called “counter-cyclical” payments, loan packages, and land management and conservation funding. Counter-cyclical payments provide increased subsidies when prices are low, and lower subsidies when prices are high. Their aim is to smooth out the bumps in the income of food producers, brought about by fluctuations in commodity prices. They provide an excellent example of the market distorting impact of agricultural subsidies: working out what subsidy to pay involves agreeing on a “target” price and adjusting subsidies accordingly. No other commodity producer is able to rely on a target price to smooth out their income – why should agriculture be any different?

The US claims, somewhat disingenuously, that the Farm Act is *good* protection as opposed to *bad* protection. It is true that the Act does not impose any new

quotas or tariffs, or encourage dumping. But as we noted above, trying to sugar coat protection as being somehow acceptable because it takes on a not-as-bad-as-it-could-have-been character is a very shallow debating tactic. All protection is bad, and the US has a lot of it in the agriculture sector.

Why it Matters

The proponents of agricultural protection argue that family farmers need a shield against the volatility of commodity markets and the low wages of the developing world. The image they attempt to convey is that protection helps decent, hard working farmers to stay on the land, and that in the absence of protection rural economies would be decimated.

It would be easy for us to argue that protection doesn't lead to benefits to those who are protected. In the long run, of course, it doesn't help the protected: it simply enshrines inefficient practices, causing producers to fall further behind and become more dependent on government largesse. But in the short term, protection can help producers to keep their heads above water.

Acknowledging that truth allows one to make an honest assessment of the pros and cons of protection. On the positive side, a relatively small number of people can be allowed to continue a particular way of life for the period in which the protection applies. That is the extent of the positive side of protection.

On the downside, there are an innumerable number of arguments. Protection locks in bad habits and stifles innovation. Its cost will always increase, as its very existence ensures that the core market disadvantage which it tries to patch up is in fact exacerbated. It involves a distribution of wealth from one group in society to another, without any reasonable justification. It represses living standards in the third world, as agriculture exports are one of the few viable paths to economic improvement available to developing nations. It increases the cost of food for people right across the globe, by refusing to allow the most efficient producer to supply the market.

Agricultural subsidies are wholly inappropriate. The short term benefits to food producers are massively outweighed by the costs to the global economy. Eliminating agricultural largesse should be at the top of the global economic agenda.