FAO TRADE POLICY BRIEFS
on issues related to the WTO negotiations on agriculture

No. 5 REDUCING THE TRADE-DISTORTING IMPACT OF AGRICULTURAL SUPPORT[1]

SUMMARY

- *To be effective, new disciplines on domestic support policies under the WTO Agreement on Agriculture need to take into account weaknesses in current ways of measuring and classifying trade-distorting support.*
- *An effective review of the Green Box criteria should take into account the details of policy implementation and the likely impacts.*
- *The characteristics of minimally trade-distorting policies include limited effects on reducing farm income risks, availability for only a limited period, and not allowing increases in entitlements.*

Since the mid 1990s, there has been a significant change in the type of support to developed country agricultural producers, with a shift towards categories of payment that are exempt (in WTO terms[2]) from reduction commitments. Between 1995 and 2001 the proportion of support in developed countries, defined as production or trade-distorting (Amber Box), fell from 43 to 36 percent of total expenditure, while the proportion that could be termed Green Box policies (those with little or no trade-distorting effects, not subject to reduction commitment) increased from 42 to 50 percent.

The August 2004 WTO Framework Agreement provided further impetus for continuing this shift in agricultural support mechanisms. The rationale is clear: the goal is to reduce the trade-distorting impact of many current systems of support for producers in some developed countries. However, creating more rules and disciplines along the lines of the Framework Agreement will not necessarily achieve this objective because of difficulties in identifying, measuring, and classifying trade-distorting domestic support.

1 Deficiencies in measuring domestic support

Total aggregate measure of support (AMS) is the basis for a legal commitment to reduce trade distorting domestic support in the WTO Agreement on Agriculture and a measure of the support classified as Amber Box. Unlike the OECD's producer support estimate (PSE), which indicates annual monetary transfers to farmers through policy measures, the AMS is not an indicator of total support to producers. The main components of the AMS, to be used in calculations by all countries, are: i) the level of market price support as measured by the gap between a historical world reference price fixed in a base period

[1] This Trade Policy Brief focuses largely on the use and disciplining of domestic support in developed countries, which currently accounts for almost 90 percent of total global expenditures on domestic agriculture support. For more details on the issues covered, please refer to FAO Trade Policy Technical Note No. 5 on Domestic Support at: http://www.fao.org/trade/policy_en.asp

[2] FAO Trade Policy Technical Note No. 5 provides an explanation of the WTO classification of domestic support policies and further detail on all of the technical issues discussed in this Brief, as well as a full reference list.

(1986-88)[3] and the domestic administered price[4] (which may not be the same as the current domestic market price); and ii) budgetary expenditures on domestic support policies considered trade-distorting. By contrast, the market price support in the PSE is measured at the farm gate level using actual producer and border prices for commodities in a given year. The PSE also covers all transfers to farmers through agricultural policies, whereas the AMS covers only domestic policies in the Amber Box and excludes production-limiting policies (Blue Box), policies that are minimally trade distorting (Green Box) and a *de minimis* level of trade distorting policies.

Because of this method of calculation of the AMS, the use of existing levels of (trade distorting) Amber Box support may not be affected even if a decision to commit countries to reduce support is expressed in terms of cuts to the total AMS ceilings. For example, the AMS can be reduced without actually cutting support to producers. Governments could, for instance, simply lower the administered price and instead support the domestic price received by producers, which plays no part in the calculation of the AMS, by a higher level of border protection,. Similarly, if the world price falls, they could increase actual support levels through some domestic price stabilization policies, which would again not affect the AMS because the administered price and the historical world reference price remain unchanged in the calculation.

2 Deficiencies in domestic support classification

The current system of classifying support into categories raises a number of issues. Countries can simply re-instrument (i.e. change the form of) their support policies to conform to certain commitments (so-called "box shifting"), without reducing the production and trade impact of their total support. Even if further discipline mechanisms would require them to reduce expenditure on policies classified in the Amber Box, a new Agreement may not constrain countries from expanding policies in the other two boxes even if the latter have certain production and trade distorting effects as well. There is concern that policies which countries themselves classify as eligible for inclusion in the Green Box may not be really neutral in terms of production incentives.

Recognising this, the 2004 WTO Framework Agreement calls for a review of the Green Box criteria to ensure that measures have no, or (at most) minimal, trade-distorting effects on production. Revised rules and criteria have great potential to ensure that support designated as falling into the Green Box distorts trade as little as possible.

3 Identifying trade distorting domestic support

The remainder of this Trade Policy Brief considers the features of policies that could distort production and trade, to facilitate an effective review of Green Box criteria.

Most domestic support policies influence, to a greater or lesser extent, farmers' production decisions and may therefore always potentially distort trade. However, the analysis is highly problematic. It is one thing to recognize direct trade distortion effects from domestic support; it is quite another to define and quantify the production impact of different policies. There is little empirical evidence on how current decoupled payments distort trade, because many have not been operating long enough. Where they have been an element of support, decoupled payments are not currently used to the extent foreseen, following, for example, the introduction of the Single Farm Payment in the EU's Common Agricultural Policy (CAP)[5]. Using the limited existing empirical evidence on the production-distorting effect of "decoupled" payments in this new context could result in misleading inferences on the potential impact of the programme of support.

[3] During the base period, world commodity prices were particularly low and hence domestic support, computed as the difference between domestic intervention and reference prices, was accordingly high, providing countries with a high bound AMS from which to cut.

[4] The domestic administered price is the base price guaranteed to domestic producers, for example an intervention price, and is financed by a transfer from consumers, in contrast to a direct payment which is taxpayer financed.

[5] See: http://europa.eu.int/comm/agriculture/capreform/index_en.htm for more details.

A useful starting point for understanding the relative impact of various supports is provided by the OECD which has developed a hierarchy of policies in terms of their impact on production relative to the effects of a purely market price support (MPS) policy amounting to the same level of total support. Their analysis suggests that subsidies on inputs are the most production-distorting, followed by payments on the basis of the main crop output. Policies estimated to be clearly less distorting than market price support include area payments and payments based on historical entitlements.[6]

A number of non-price factors can also influence the impact of a policy on production. These include the effect of a policy on the level of producers' risk, the effect of policy on incentives to, and constraints on, taking resources out of production, and the nature of policy design – particularly the ease of enforcement and the allowed frequency of policy change. Also often overlooked is the fact that the joint effects of two policy instruments may be more than the simple sum of the individual effects.

While non-price factors have been recognized as potentially influencing the distorting effect of support policies, their impact has not been completely documented and understood. Various analytical studies provide some guidance on policy measures likely to result in trade distortion. The following issues are notable.

- *Risk affects decisions on land and other production resources*. A policy that reduces risk is a form of insurance, affecting the distribution of possible prices for the producer, essentially limiting the possibility of low returns. With reduced risk, producers are prepared to invest more resources in otherwise risky crops. Support can also influence producers' perception of their own wealth and in turn can increase their willingness to accept risk. Most analyses conclude that wealth effects are modest, especially regarding intensity of resource use, but insurance effects can be significant.
- *Exit from agricultural production.* There is considerable uncertainty over what happens to agricultural production resources under de-coupled support programmes. For example, a new support mechanism may imply reallocation of support away from larger, more efficient to smaller, less efficient farms. This could slow structural change, with the smaller producers remaining in agriculture alongside more efficient farmers. Also, certain support policies may motivate producers to exit farming, but the land may just be transferred to other farmers and stay in production.
- *Policy design and enforcement.* The real impact of a policy depends not only on its type but more importantly on how it is designed, implemented and enforced. For example, some policies provide payments to farmers based on land under production during a historical base period, but at the same time do not allow planting of certain crops on the land eligible for subsidy payments. Such policies may create incentives for expanded production of other crops which are not subject to such restrictions, thus creating distortions in these crops.
- *Expectations of future assistance and updating base payment parameters.* Policies which generate expectations about future payments, or allow an update of base periods, are not decoupled from production. If producers know they will be able to update base period parameters (e.g. areas, yields and production), this will affect their current production decisions and they may maintain or increase current areas, yields and/or production hoping for higher future payments.
- *Combinations of measures*. Potential impact on production could be very different for a combination of policies, as compared to the impact of the sum of individual policies. However, there are few studies on the reactions of individual farmers to different types of payments when taking all effects into account. One example is an analysis of the United States support programme to maize.

[6] For a detailed discussion of the calculations, see FAO Trade Policy Technical Note No. 5.

Over the range of market prices from US$2.3 to US$5 per bushel, there is an expected positive relationship between output price and net return. However, when higher yields result in market prices lower than US$2.3 per bushel, net returns do not fall because other components of the support package (e.g. counter cyclical payments and the loan deficiency payments) come into play, which, perversely, push up net returns more the lower the market price. It is thus difficult to analyze the impact of direct payments on production decisions, without delving into the details of policy design and combinations of measures.

4 The way forward

The discussion in this Trade Policy Brief suggests that there are features of domestic farm support policies which, even if theoretically decoupled, may cause or contribute to incentives to increase production. The current system of categorizing domestic support presents the problems reviewed above.

This is an argument for systematically reviewing the criteria of all types of support policies, including those under the Green Box, which are exempt from reduction commitments.

Assuming the current system of classification of domestic support continues, and in light of the discussion above, policies likely to be Green Box compatible (that is, more decoupled than others) will be characterized by:

- limited effect on risks associated with prices or yields;
- payments that are transitory and for adjustment purposes only;
- no possibility of base updates;
- allowing all relevant land uses.

There is a case for reviewing the disciplining of entire systems of domestic support that involve combinations of policies, and for determining whether product specific caps on total support would prevent the re-activation of policies with production incentives through box shifts. Revisiting the way domestic support is measured could also help to ensure that further agreements on domestic support are effective in preventing trade-distorting effects.

Strengthening domestic support disciplines could, nevertheless, be associated with appropriate special and differential treatment for developing countries,[7] in the sense of giving them the flexibility and policy space needed to ensure that those developing countries with underdeveloped agriculture sectors are not constrained in the future from using domestic support policies to stimulate productivity improvements

[7] See FAO Trade Policy Technical Note No. 10 for a review of these issues.