
Agricultural Policy in OECD Countries Due for Reform

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Few economic sectors have generated so much political heat and distress at the international level as agriculture, far out of proportion to its modest—and diminishing—share of all economic activity. In many OECD countries, agriculture contributes no more than 2-3 per cent to overall GDP, and represents less than 5 per cent of the labour force. Why, then, is agriculture still so high on the international agenda when it comes to economic and trade policies?

There are several reasons, not the least that many countries' agricultural policies generate negative spillovers for other countries. There is widespread feeling that the performance of domestic agricultural policies leaves much to be desired. OECD analysis has clearly shown that there is a lot of scope for improvement.

Most of the complex agricultural policy regimes are aimed at, or have the effect of, raising farm receipts in one of two ways: by keeping domestic prices of farm produce above the levels that would result from market forces alone, or through direct government payments. OECD regularly measures this support to agricultural producers, which in 2003 amounted to a staggering US\$257 billion in the 30 OECD countries. This support made up for 32 percent of farm receipts. In other words, only 68 cents in each dollar of revenue for the average farmer in the OECD area come from the market—the rest is the result of policies. In the nearly 20 years since the OECD began to measure farm support, the overall level has declined only marginally, although there is significant variation in agricultural policies and their evolution over time across countries.

Three quarters of all producer support in OECD countries come in the form of high product prices and payments directly related to quantities produced and inputs used by farmers. Why are such policies not doing a satisfactory job? This is particularly obvious if we look at what they can and cannot do for farm incomes, one of the primary targets of agricultural policy. Price and output support are unnecessary, inefficient and inequitable when used as farm incomes policy. General income support for farmers is unnecessary because statistics show that the total incomes of farm households are in many countries not below the average for the non-farm sector. Farmers and their families adjust to changes in the economic situation by seeking alternative sources of income, which frequently constitutes a fairly large share of total household income. Furthermore, farm families derive financial benefit not only from their labour but from their land and capital assets; while actual labour income in agriculture may be depressed, family income overall can be adequate. Thus, broad-based measures such as price and output support are clearly unnecessary.

Why is price support an inefficient way to raise farm incomes? Because for each extra dollar spent on price support by consumers and taxpayers, no more than 25 cents actually end up in farmers' pockets, as remuneration for farm-owned labour and land. A sizable share of the rest goes to landowners outside the agricultural sector. Some 50 percent of agricultural land in the OECD area is rented, and the farmers who actually work the land pay rents that are inflated because of price support for sugar, milk and other farm products. Thus, the beneficiaries are non-

farm landlords and not the intended recipients of the policy. Moreover, as farmers respond to higher prices by expanding production, a substantial portion of price support also ends up in the industries supplying inputs to agriculture and is spent on extra resources. As a result, the income transfer efficiency of market price support for agriculture—as measured by the extra income to farmers per extra dollar spent on support—is a disappointing 0.25.

Why are price and output-related support policies inequitable? If governments keep domestic market prices high, or provide payments per ton of output, it follows that farms with large volumes of output will receive larger absolute sums. This might not be too significant if output volumes were reasonably equal across all farms. However, production volumes are, in fact, highly unequal. To cite only two examples: in the EU, the 25 percent largest farms represent slightly more than 70 percent of the gross receipts of the entire agricultural sector. Since most EU farm support is distributed according to output volumes, these farms receive 70 percent of all government support. In the US, the 25 percent largest farms have a 90 percent share of government support. In other words, price and output support favours the richest farmers over the poorest.

What can be done to improve the situation? A most important component of agricultural policy reform involves decoupling support from farm production, thus breaking the link between support and producer decisions in agriculture. Instead, direct payments can be made to farmers, based on the monetary value of the “old” transfer policies. The central justification of such decoupled payments is to allow farmers time to adjust to the new conditions under a reformed policy. While this process is underway, the general decoupled payments can be gradually reduced and finally eliminated. Over time, the focus can shift completely to payments targeted to specific objectives, such as maintenance and enhancement of the environment or the country-side. Such valuable services that farmers can provide to society cannot be sold through markets,

and hence government policies are needed to make sure there is not an under-supply of them. Again, broad-based price and output support cannot do a good job in making sure that these non-market services are provided, as paying farmers high prices for sugar and other products does not provide them with proper incentives for maintaining specific features of the environment and the landscape.

While reform along such lines greatly improves the domestic performance of agricultural policies, it also carries an important additional benefit at the international level. Price and output supports—dominant in most OECD countries—try to counteract the implications of the sluggish growth of demand for farm produce, by artificially simulating additional demand. However, such government policies cannot really expand demand at the global level, since they do not add to purchasing power world-wide. The only effect they have is to induce domestic farmers to produce more. The extra output generated by these farm policies depresses prices for farm products in international trade. This means, in effect, that the artificially created additional demand for domestic farm output in the high-support countries is, in reality, nothing less than market share taken away from farmers in other countries. In other words, well-intentioned assistance to domestic farmers, delivered through market distorting policy measures, effectively exports adjustment pressures, placing them squarely on farmers in other parts of the world.

However unintended these negative international spillovers of domestic price and output support policies in major OECD countries may be, they are nonetheless real. Reform of agricultural policy through decoupling support from production, and targeting it to specific objectives, is in the enlightened self-interest of the OECD countries because it improves the performance of their expensive farm policies. At the same time, and as a positive side-effect, such reform reduces market and trade distortions. It can therefore also contribute significantly to ending conflicts

in international trade resulting from current domestic farm support policies.



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