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**DECOUPLING FARM INCOME SUPPORT**

*This paper has been submitted by Australia (prepared by the Australian Bureau of Agricultural and Resource Economics) for Session IIa of the OECD Workshop on Emerging Issues in Trade to take place in Paris 26-27 October 1998. The views expressed in the paper are not necessarily those of the Australian Government.*

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## DECOUPLING FARM INCOME SUPPORT

1. Various countries wish to augment the incomes of their farmers by providing income support in the form of direct payments. In some cases this can be simply to increase the returns from the market in periods of low prices. In other cases arguments have been put forward by some countries that these payments are intended to reward farmers for their involvement in an increasing range of activities that extend beyond the production of food and fibre but for which no returns are available through normal agricultural markets.
2. In both case it has been argued by proponents of these payments that such support is purely the domestic concern of the country whose taxpayers are supporting the payments. Whether this assertion is true depends critically on the extent to which such payments have adverse flow-on effects on the interests of third countries or on agricultural markets.
3. As a principle it cannot be assumed that all direct payments to farmers, in whatever form and no matter their intended aim, are necessarily an acceptable form of agricultural domestic support because in practise they may well not result in minimal distortions to production and trade.
4. As a contribution to discussions in Session II on Emerging Issues at the Interface of Domestic and International Policy, Australia has submitted the attached issues paper prepared by the Australian Bureau of Agricultural and Resource Economics (ABARE) on 'Decoupled farm income support'. ABARE is the Australian Government's professionally independent economic research agency. Accordingly, views expressed in this paper are not necessarily those of the Australian Government. The findings in the paper provide an insight into an important emerging area for further research and analysis.

### **I. Farm income support**

#### *Implications for gains from trade of changes in methods of support overseas*

5. Agricultural income support policies in countries around the world have distorted world trade in agricultural products, imposing major costs both on countries that provide the support and on efficient agricultural exporters such as Australia.
6. In recent years, methods used to support agricultural incomes in developed countries, in particular the United States and the European Union, have been changing toward so-called 'decoupled' arrangements. By decoupling support from prices and production, these arrangements are intended to be less market distorting than previous arrangements.

#### *Decoupled support arrangements*

7. The move to decoupled support has been encouraged by WTO (World Trade Organisation) rules and has been occurring in parallel with the application of the WTO Agreement on Agriculture. Efforts to reduce distortions to world trade by implementing decoupled support arrangements can have many benefits in principle.
8. Wise use of decoupling can reduce distortions and therefore provide benefits. However, there remain practical concerns.

- Even with care to minimise them, distortions from decoupled support arrangements can be appreciable.
  - Most current efforts to decouple support in line with WTO arrangements fall well short of full decoupling.
  - There are potential dangers in countries claiming that their support arrangements are decoupled when in fact they are not fully decoupled and therefore remain substantially market distorting.
9. These concerns highlight the need to design strict rules, definitions and monitoring arrangements for decoupling.

#### **What does 'decoupling' mean?**

The notion of decoupling is the provision of income support in ways that are 'decoupled' from production and prices. An objective of decoupling is to reduce costly market distortions that arise through links between support and production, consumption, trade and prices.

#### ***Market distortions from support***

10. In competitive markets, resources are drawn to produce items for which returns are greatest and are drawn away from items for which returns are lower. Efficient operation of such markets maximises the returns from economic activity to society as a whole.
11. Only where there are marked differences between private and public values of economic activities might government intervention provide additional benefits. However, governments often intervene not to overcome these factors but to support special interest groups, including farmers.
12. These interventions produce costs to their economies.
13. Traditionally, most farm support policies have involved maintaining domestic prices above world levels by using tariffs, other import restrictions and production and export subsidies (OECD 1996, p. 13).
14. Such measures reduce aggregate incomes in the countries providing the support by maintaining or drawing resources into agriculture where returns would be low in the absence of support, and away from more profitable sectors. This leads to increased production, and in many cases lower domestic consumption, reduced imports and increased exports. In turn, this depresses world market prices, penalising efficient producers such as Australia and reducing global income.

#### ***Decoupling farm support***

15. 'Decoupling' support from production and prices emerged as a key issue in reforming agricultural policies in the Uruguay Round. It provided a way out of an impasse from differences in US and EU proposals (Franklin 1988), and was a key ingredient in reaching the WTO Agreement on Agriculture.

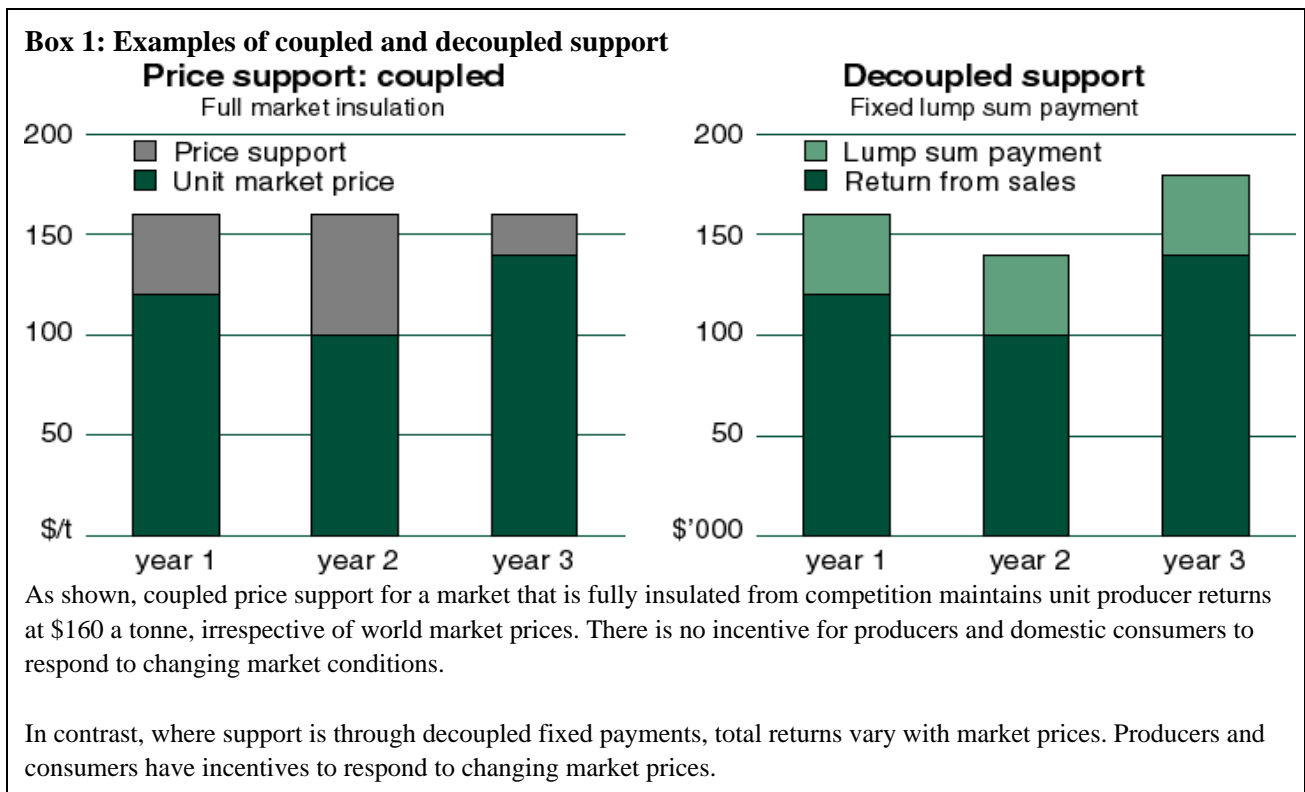
16. The main advantage of decoupling is that it promises to be less distorting than other forms of support. As some governments providing highly distorting support might be reluctant to withdraw the support quickly, they may prefer to reorient it to decoupled support that would distort markets and depress world prices much less.

17. With fully decoupled support, farmers receive payments that are not linked to their current or future production decisions, their input use or to world prices at all (Collins and Vertrees 1988). They receive it even if they do not produce anything. An example of such support is predetermined, fixed lump sum payments.

18. Farmers' decisions about what and how much to produce are determined by two things — the returns from additional units of production (marginal returns) and the costs of producing additional units (marginal costs). If income support is independent of these two variables, then production and selling decisions will be determined by world market prices for outputs and inputs. This is the conventional theoretical reasoning behind claims that decoupled support is nondistorting or minimally distorting.

19. Another advantage of decoupled payments is their transparency. Since decoupled payments involve budget outlays, information on them would be open to public scrutiny, thereby exposing governments to further pressures to limit farm support.

20. A comparison between fully market insulating price support and decoupled support — assumed here to be through fixed predetermined payments — is given in box 1.



21. The conventional theory of decoupling implies that it is possible to disengage farm production decisions from support.

22. In practice, however, it is virtually impossible to break the links between income support and marginal costs and returns — which, in turn, influence production and create market distortions (Roberts and Andrews 1991; Blandford and Dewbre 1994; Roberts 1997). This is because of the additional effects on production of farm policy induced changes to farm income, wealth and risks — often ignored by commentators. All of these effects are influenced by decoupled payments in ways that increase production.

23. Decoupled payments increase farm incomes and farmers' wealth over returns from the market alone. Given a farmer's specialised skills and knowledge in farming, and the absence of perfect capital and information markets, significant amounts of decoupled payments are likely to be invested in the farm (Roberts 1997). These payments would increase farm input use and allow access to improved technology, which would increase production and distort agricultural markets.

24. The payments increase income and wealth and, depending on how the payments are structured, can reduce risks from income variability. If, for example, the payments are large and stable relative to market earnings, aggregate incomes will be higher and less variable than from market earnings alone.

25. The reduction in income risk can reduce costs of borrowing by exposing lenders to lower risks of loan default, thereby increasing farm investment and production.

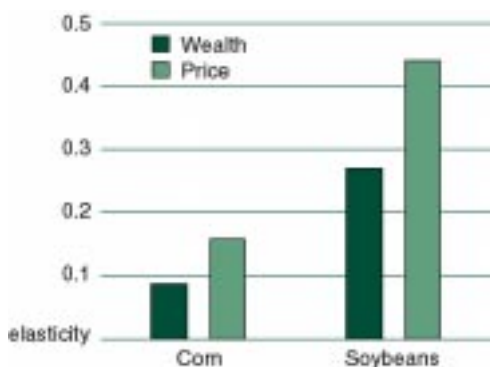
26. Also, decoupled payments are often provided in a way that increases land values and are linked to the status of landholders as farmers. This would maintain land in farming that might otherwise be used for other purposes.

27. Further, based on past experience, farmers may be justified in believing that establishing a basis of high production may provide the basis for higher payments under future support arrangements. This would give them an incentive to expand output. Expectations about the impact of current production decisions on future support could therefore reduce the extent of possible decoupling and lead to market distortions.

28. Another disadvantage with decoupled payments is that they involve costs of collection, administration and policing. More importantly, they add to costly distortions in resource use through the need to raise additional taxes to fund the payments.

29. A study of US acreage responses by Chavas and Holt (1990) incorporated wealth into their model and found that both wealth and risk perceptions were important determinants of acreage allocation decisions for corn and soybeans. Their estimated responses of plantings to changes in wealth were more than half those of the responses to direct price changes for each crop (box 2).

**Box 2: Change in US acreage in response to changes in farmers' wealth and market prices**



Elasticities show the percentage change in area that results from a 1 per cent change in farmer's wealth or in market prices. So, for soybeans, a 1 per cent increase in a farmer's wealth results in a 0.27 per cent increase in the area planted to soybeans.

30. These results imply that even if payments to farmers were decoupled from production and prices, the impacts of the payments on wealth would still influence production significantly.

31. In their study of white beans, corn, soybeans and winter wheat in Canada, von Massow and Weersink (1993) found that wealth and risk variables were important in explaining variability in plantings, but the effects of both were relatively small.

32. Hennessy (1998) concluded that the wealth and insurance effects of many support programs increased input levels 'even for supposedly decoupled programs'.

***WTO 'green box' and 'blue box' exemptions***

33. The WTO Agreement on Agriculture obligated members to reduce the total value of domestic support for agriculture overall by 20 per cent from its 1986–88 level.

34. However, some forms of support — termed either ‘green box’ or ‘blue box’ exemptions (box 3) — were excluded from the cuts on the basis of decoupling and related arguments. The amounts of support by major countries in these exempt classes are substantial and affect key commodities of interest to Australia, including cereals and meats.

**Box 3: ‘Green box’ and ‘blue box’ exemptions**

**‘Green box’ exemptions**

Green box exemptions were generally considered to be minimally market distorting. They include general services such as research, pest and disease control, training and facilities, extension and advisory services, inspection services, marketing and promotion services, infrastructure services, public stockholding for food security purpose, domestic food aid, environmental payments and direct payments to producers if they meet specified criteria for being decoupled. The specified criteria include the status of recipients as farmers, the delinking of payments from production, prices and inputs, and the condition that no production shall be required in order for payments to be received.

**‘Blue box’ exemptions**

Blue box exemptions were not considered to be decoupled but were required to be production limiting, with payments based on fixed area and yields, or made on 85 per cent or less of the base level of production, or, for livestock, with payments made on a fixed number of head (WTO 1994).

*Blue box support*

35. The risk with this approach is that WTO members may see decoupled and blue box payments as sufficient to correct trade distortions, and use loosely defined decoupling and blue box criteria to avoid reducing support payments.

36. They could therefore be indiscriminating in defining acceptable decoupling, and so-called ‘decoupled’ or ‘production limiting’ payments could become a new form of institutionalised market distorting protection.

37. If that occurs, the political will to institute fundamental market based policy reforms, or even well designed genuinely minimally distorting arrangements, could be weakened.

38. Blue box programs based on limiting production may appear to be less market distorting than price supports. However, if the measures to limit production are not very effective, market distortions may not be reduced.

39. For example, where governments pay producers to ‘set aside’ a proportion of their crop land for production control reasons, farmers may be free to set aside their poorest land thus minimising the effect on production.

40. Also, the proportions of base areas to be set aside are determined by the government of the day. Under the WTO Agreement on Agriculture, no rules are indicated for setting them. If the set aside percentage is low, reduction in output distortions may be small.

## **II. Green box support**

41. Although the green box measures are supposed to be minimally production distorting there could be substantial scope for reorienting support toward these measures in ways that could markedly increase production.

42. Many green box payments have no direct links to product prices, but affect production indirectly. For instance, public purchases for food security, domestic food aid and marketing and promotion services increase product demand, so farmers benefit from higher prices and world markets may be distorted.

43. Also, payments for providing 'environment goods' along with food production could substantially distort markets if they are paid on a large enough scale.

44. In some countries maintenance of a 'lived in' rural environment is advanced as an argument for substantial agricultural support. Since 'environment goods' can be joint products of farm production, payments based on 'environment goods' would affect production directly. If many, or large, countries use 'environment goods' to justify substantial support, it could stifle market based reforms.

45. Therefore, although green box support seems less distorting than price support, it is often not free of distortions, and there is potential for some green box measures to be as market distorting as traditional forms of support.

46. However, some green box exemptions may be justified on welfare grounds, such as food aid to help poor people to purchase adequate food.

47. Others may be justified on grounds of public good benefits where activities might be unprofitable for individuals but would benefit society as a whole. For example, research into farming methods might not be undertaken by individuals or groups of farmers because relatively costless application of the results by others could prevent those undertaking the research from obtaining most of the benefits. In this case public research funding could be justified since society may benefit through cheaper, better food, by more than the cost of the research.

### ***Changing forms of support***

48. The United States and the European Union were key players in the Uruguay Round, and are expected to remain so in future WTO agricultural negotiations.

49. The European Union significantly reformed the Common Agricultural Policy (CAP) for cereals, oilseeds, protein crops and beef in 1992. The EU Commission has proposed further reforms in *Agenda 2000* (European Commission 1997), which were refined in a proposal in March 1998 (European Commission 1998).

50. The United States, in *The Federal Agricultural Improvement and Reform (FAIR) Act of 1996*, introduced changes toward decoupled support for some major crops.

*European Union*

51. The European Union's Agenda 2000 proposes strengthening the 1992 reforms (box 4) by extending them and by extending domestic support measures such as environmental and regional payments which might be construed as green box measures.

**Box 4: The European Union's 1992 reforms**

The 1992 reforms made policies somewhat less market distorting than the former highly market insulating arrangements.

High internal prices for cereals and, to a lesser extent, beef were reduced, with the reduction being replaced by direct compensation payments and payments per head of livestock held (headage payments).

Support for cereals, oilseeds and protein crops was brought under a common system for arable crops and area reduction programs were applied to these crops.

Compensation payments were based on past regional yields, regional area bases and animal numbers, but the yield based compensation payments for oilseeds differed from those for cereals.

Other support through border measures and export subsidies remains, although levels of export subsidies to bridge the gap between EU and world prices are lower than previously because of the lower domestic support prices.

52. The reforms reduced internal prices to closer to world levels for cereals and beef. They changed the form rather than the level of support. The reforms for arable crops partially decoupled support, as compensation payments are based on fixed regional yields, not on individual farmers' yields. Consequently, incentives to raise yields to increase benefits were reduced.

53. Payments on areas are limited to a fixed regional base area. However, each farmer receives direct payments on the actual area planted and the area set aside, and proportional reductions are applied if the regional base area is exceeded.

54. Member countries have the option to allocate total area quotas to each farmer. This could cap payments per farm but still allow farmers to increase areas planted in response to support, within that limit.

55. Under this reform policy, therefore, a link between areas planted and support payments persists.

56. Headage payments are similarly determined on a regional basis and subject to proportional reductions if there is an overrun in regional claims. They are subject to limits per individual farm on the number of animals for which farmers can receive payments and to limits on stocking rates.

57. So, while constrained, they are also not decoupled at the individual farm level. Further, receipt of compensation payments by arable crop and beef producers is contingent on them planting such crops or holding bovine animals, so production and support are still partly coupled.

58. The support for arable crops and livestock headage payments does not meet the green box decoupling criterion that 'no production shall be required in order to receive such payments' (WTO 1994,

Annex 2, para. 6e). Nevertheless, these payments have been exempted from reductions in domestic support under the blue box provisions for production limiting schemes.

59. While such payments *might* technically satisfy those provisions, it is open to interpretation. For example, one condition of the blue box exemption is that payments are on fixed areas. However, as indicated above, the payments are subject to regional fixed areas, but not necessarily to individual farm areas. In fact, the regional area bases have been exceeded in several instances and the penalties in the legislation have not been fully applied (Agra Europe 1998).

#### *Agenda 2000*

60. To deepen the 1992 reforms, *Agenda 2000* proposes further reductions in the support prices for cereals. It also proposes reductions in support prices for some dairy products and beef. The reductions would be compensated for by higher or new direct payments. It also proposes harmonising the oilseeds payment with those for cereals. But there was no proposal to cut prices for other major commodities, including sugar, or to reduce tariffs.

61. There are aspects of the restructuring of EU support arrangements for cereals and beef that are potentially significant for multilateral trade rules under the WTO Agreement on Agriculture. These relate primarily to reorientation of EU support toward currently exempt blue box domestic support and away from export subsidies, by replacing the latter with compensation and headage payments.

62. The recommended reductions in cereal support prices could take them below world prices in some, if not most, years, with EU producers being compensated by higher direct payments. When internal prices fall below world prices, EU exports would no longer technically be subsidised and would not need to heed WTO limits on subsidised exports (Gardner 1998).

63. But, with the proposed *Agenda 2000* increases in compensation payments, EU producers would be receiving even larger direct payments than under the 1992 reforms, instead of the export subsidies.

64. In effect, the pre-1992 export subsidy and domestic price support would be fully replaced by a production subsidy. Currently, because these subsidies are provided in conjunction with production constraints they are exempt from domestic support reductions under the blue box arrangements.

65. Also, under *Agenda 2000*, compulsory area reduction programs are recommended to be zero. Swinbank (1998) concluded that the European Union's proposed set-aside of zero per cent satisfies the blue box requirements if the 1992 compulsory set-aside is retained (European Commission 1997; Swinbank 1998).

66. This illustrates how weak the production limiting arrangements for blue box support are. Because an area reduction program exists, some might interpret the program to be production limiting, even if the percentage reduction is zero, as the area would be limited to that in the base period, 1989–91.

67. As EU systems of support for grain are only partly decoupled, setting the variable set-aside percentage at zero would increase EU production and depress world prices further. Under such conditions, it becomes critical if substantial depression of world prices from EU protection is to be avoided that EU support is, in fact, minimally market distorting. It becomes even more important with potential EU expansion to incorporate the land rich eastern European countries.

68. In a WTO context, *Agenda 2000* appears to be based on the premise that blue box exemption for cereals and beef will be extended. The support is only partly decoupled and, additionally, its risk reducing, income and wealth effects will continue to encourage production, part of which will be exported. It would remain market distorting and other WTO members could be sceptical about accepting continuation of the blue box exemption for EU direct payments.

69. *Agenda 2000* would increasingly reorient traditional supports to green box measures by linking support payments to production of 'environment goods' and other social benefits from farming. Such payments include support for farming in less favored areas, agri-environment activities, marketing facilities and forestry.

70. Shifting support toward production of environment goods and other social benefits is likely to sustain many market distortions since agricultural production and these other benefits (they may be negative as well as positive) are joint products of farming (OECD 1998, p. 45).

71. The stated criterion for green box exemptions is that they have 'no, or at most minimal, trade distorting effects or effects on production' (WTO 1994). If subjective 'environmental' benefits are widely used to justify green box support, there is a danger of institutionalising highly market distorting policies.

72. *Agenda 2000* claims that 'the European model of agriculture is not the same as that pursued by our major competitors elsewhere, and that care will accordingly need to be taken to provide proper compensation for natural constraints and disadvantages' (European Commission 1998).

73. This subjective statement suggests that Europeans value agriculture and the agricultural environment more than others. Swinbank (1998) dismisses it as 'protectionist poppycock' and adds that 'the benefits of trade stem from the ability to take advantage of differing cost structures around the world'.

#### *United States*

74. The US FAIR Act of 1996 contained changes in the form of support for some crops. It replaced traditional crop-by-crop deficiency payment subsidies with seven-year contract payments based on a merged acreage base for selected program crops.

75. Specifically, producers of program crops (barley, cotton, maize, oats, rice, sorghum and wheat) have merged commodity specific base acreages into a single 'whole farm base' (US Department of Agriculture 1996).

76. Farmers receive payments for 85 per cent of their 1996 base acreage computed under the 1990 farm bill determined payment acres, regardless of what crops they plant or whether they plant at all (except that conditions apply for vegetables and fruits). In addition, the budgetary commitment is capped at US\$35.6 billion for seven years. Importantly, FAIR removes the acreage reduction policy that was used to control supply.

77. The changes in the FAIR Act have characteristics of decoupled support and represent important breaks with tradition (Stuart and Runge 1997).

78. They eliminate the direct link between income support payments and current prices and allow farmers of program crops to respond more to market signals. As such, these policies are exempt from support reduction requirements under green box arrangements.

79. Nevertheless, other market distorting measures, including cotton competitiveness subsidies and export subsidies, still apply for some of these crops and the contract payments will indirectly affect production through supporting land prices. So, although the contract payments should result in lesser market distortions than deficiency payments for some commodities, significant systemic distortions remain.

80. To the extent that wealth and risk reducing effects from the contract payments stimulate production, these distortions would be exacerbated.

81. Also, other important commodities (dairy products, sugar, peanuts and tobacco) were largely excluded from the decoupled program (Stuart and Runge 1997).

82. An important consideration concerning the degree of decoupling under the FAIR Act is that the arrangement expires in 2002. If US producers of the affected crops anticipate that the arrangements could change or be changed to coupled support, they could expand plantings to increase future support base levels. This would weaken the degree of decoupling with current arrangements.

### **III. Conclusion**

83. The goal of future WTO negotiations is to advance the benefits of trade through reducing market distortions imposed by farm income support policies. Decoupling may be a means toward this end but it is not an end in itself.

84. Decoupled arrangements provide opportunities to make national agricultural support policies less market distorting. They also increase flexibility for reaching agreement in multilateral trade negotiations.

85. However, they have definite limitations. First, they still distort markets to some extent. Second, efforts to decouple existing support arrangements have proven to be far less than complete. Indeed there are many instances where substantial decoupling is claimed but, in fact, little or no decoupling has occurred. This highlights that decoupling arrangements must be rigorously defined and applied or they may form the basis for institutionalising highly market distorting support systems.

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