Forging a Deal on Agricultural Trade Reform

"Scenario Paper"

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The Doha Round focus on agriculture is often misunderstood in OECD countries because this sector represents barely 2-4 percent of OECD GDP and employment, and because the history of the OECD countries underlines the importance of manufacturing and services as engines of long-term growth. But agriculture represents 40 percent of GDP, 35 percent of exports, and 50-70 percent of total employment in the poorest developing countries—12, 15 and 15-40 percent, respectively, in the other developing countries. Three-quarter of the world's poorest people live in rural areas, the proportion in the poorest countries being as high as 90 percent (on average less than 20 percent in OECD countries).

In sum, agriculture is an urgent and vital problem for developing countries, and even more so for the poorest countries. It is *not* solely a problem for major farm exporting countries such as Argentina, Brazil or Thailand. It also affects the poorest developing countries which are often dependent on a very small set of commodities, many of them highly subsidized and protected by OECD countries, such as sugar, cotton, or rice. Absent protection in the North, greater diversification in the South would be feasible.

1. The Uruguay Round heritage

The Uruguay Round brought agriculture into the WTO legal framework. But it did so at a substantial cost.

First, it did not go further than putting in place a legal framework for *future* liberalization. The Uruguay commitments did not noticeably lower the effective level of OECD farm protection since 1995. Total net transfers from consumers and taxpayers to farmers in OECD countries constituted 51 percent of the farm production in 1986-88. In 2002, they still amounted to 48 percent of farm production (US$318 billion, that is, 5.5 times the total OECD official development assistance to developing countries, or about 100 times the share of OECD official development assistance granted to agricultural production in developing countries). In sum, half of the value of OECD production at farm gate—roughly three-quarters of the value added—is still derived from transfers. As the number of active OECD farmers continued to decline sharply during the 1990s, support per

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farmer has risen in many OECD countries—by 30 percent in the U.S. and 60 percent in the EC, sending the wrong signal in terms of resource allocation.

Second, the Uruguay Agriculture Agreement granted a reverse "special and differentiated treatment" to OECD WTO members by allowing them to adopt many exceptions to the traditional WTO rules: export subsidies (the so-called "Peace Clause"); production subsidies having significant impact on trade flows; "specific" tariffs (denominated as a fixed sum of money per unit of product, in contrast with *ad valorem* tariffs expressed in percentage terms of the import price) which are devastatingly protectionist when world prices are low (precisely when protection is very much sought after by domestic farmers); tariff-rate quotas (restrictions combining a lower (in-quota) tariff rate for a specified volume of imports and a higher (over-quota) tariff rate for imports above this volume) often used as a way to maintain existing preferences; etc.

2. Forces for changes are at work

Fortunately, economic forces are slowly fragmenting the rigid situation inherited from the Uruguay Round, opening the possibility of new coalitions and of compromises.

First, the range of producer support across OECD countries remains wide. The tariff equivalent of the "producer support estimate" (PSE) estimated by the OECD is less than 5 per cent in Australasia, 23 per cent in North America, 57 per cent in the EU, more than 140 percent in Japan, Korea, and Norway, and culminating to 295 percent in Switzerland. The range of PSE estimates across emerging countries is widening, with noticeable increases in Mexico, Turkey, and the Central European (new EC Member states) countries.

Second, the ultimate beneficiaries in OECD countries are increasingly diverse. Farmers get only a small portion of all the money poured into agriculture—only 25-30 cents of every dollar or euro of support. The remaining 70-75 cents end up in the pockets of landowners and suppliers of other farm inputs, or it is completely wasted. Among farmers themselves, there are huge differences. The smallest 25 percent of European farms receive less than 4 percent of total European support (same in the U.S.), whereas the largest 25 percent of European farms receive 70 percent (80 percent in the U.S.) of the total. This provides a rationale for reform from the perspective of farmers themselves—with small OECD farmers feeling increasingly closer to developing countries' farmers than to OECD large farmers.

Third, OECD farm households earn much higher incomes than non farm households: Netherlands (250 percent) Denmark (175 percent) France (160 percent) Belgium (127 percent) Japan (120 percent) U.S. (110 percent) and Poland (105 percent). In wealth terms, the discrepancy is even wider: for instance, the U.S. farm household wealth is estimated six times the average U.S. household wealth. [Riedl 2004] In sum, resources are transferred from poorer OECD households to richer ones—a powerful equity argument for policy reform from the broader OECD countries' own perspective. The last irony is that current OECD farm policies have in practice largely failed to protect the

rural environment because of their intensive use of fertilizers and polluting production methods, hence hurting strongly rural (but non-farmers) households.

3. But no significant domestic reforms yet

Both the U.S. and the EC have adopted farm reforms since the 2001 Doha Ministerial., but these reforms are going in the wrong direction (the U.S.) or largely virtual (the EC).

The 2002 U.S. *Farm Security and Rural Investment Act* (FSRIA) will last until 2006. In a significant backward step compared to the previous Farm Bill, the 1996 Federal Agriculture Improvement and Reform Act (FAIR Act) which "decoupled" 60 percent of U.S. farm subsidies, the FSRIA reinforces the links between subsidies and production decisions by reintroducing support ("target") prices. Target price-based subsidies will largely insulate U.S. farmers from world prices—providing higher support when world prices decline and smaller support when world prices increase.

That the FSRIA economic impact is projected to be only marginally worse than the FAIR Act impact flows from the fact that the FSRIA locks in the actual level of support provided since 1998 because large *ad hoc* subsidies have been added, between 1998 and 2002, to those allowed under the FAIR Act. But the FSRIA will undoubtedly have a stronger systemic impact over the longer term because it has re-fueled hopes for ongoing farm protection in the U.S.—causing the chairman of the Indiana branch of the Farm Bureau (the largest U.S. farmers' association) to say that "*we are turning into Europeans*" [*Financial Times*, 15 January, 2004].

In June 2003, the European Council adopted the *Luxembourg Reform* of the Common Agricultural Policy (CAP). Enough information is available to suggest strongly that the 2003 reform, though still incomplete, is very modest—most prices will not change by more than 2 percent, compared to the situation which would have prevailed in the absence of the reform [FAPRI 2003]. That the EC reform will have no impact on the EC level of protection is best illustrated by the insignificant expected decline of the EC average tariff equivalent of the overall "producer support estimate" (PSE) from 57 to 56 percent as a result of the reform [OECD 2004].

More importantly, the 2003 mini-reform is generating several new problems: it tends to overcompensate farmers, to perpetuate the existing regressive European farm policy (helping more the rich than the poor farmers, hence unlikely to slowdown productions), to over-regulate for alleged environmental reasons, and to introduce new quantitative restrictions in EC production (fruits and vegetables) and imports (rice). In sum, the 2003 EC reform is almost exclusively an exercise in "box playing" (shifting subsidies from the Amber to the Green Box) with no noticeable impact on non-EC farmers.

However, both the U.S. and the EC reforms are due to be revisited in 2006-2007, as part of the normal legislative process in the U.S. and of the enlargement process in the EC, and under budgetary pressures. Increasing decoupling will have the political benefit of

being friendlier to small OECD farmers and promising in terms of building the coalitions necessary for taking on the extraordinary political forces which hold back agrifood liberalisation in OECD countries, particularly in Europe.

The political forces on farm reform are already undergoing a shift due to two major factors. First, public support for current OECD farm policies has been eroded by the critical campaigns of a few NGOs—from Consumers' Association to Oxfam—who have become key agents for farm reform. Second, sanitary crises in OECD countries (such as mad cow) have undermined public support for their own domestic farmers. While relatively few, these outbreaks have been traumatic for the populations involved, and they have contributed to increase public questioning of the existing farm policies.

The tensions between the forces at work and the absence of significant reforms raise the following question. Will the OECD farmers realize that, in this context, it is better for them to negotiate *now* in the WTO forum—when they still have some power for shaping the instruments and speed of liberalization—than in a decade or two when their political weight will be even smaller, maybe to the point to be too small to influence future WTO negotiations?

4. Lessons from simulations of farm liberalization

Simulating the impact of farm liberalization bring six important lessons when designing a possible farm deal, as shown by Table 1.

First, for developing and developed countries alike, farm reform is the main source of welfare gains from liberalizing trade in goods. Of all the economic gains that developing countries could get from global elimination of barriers to trade in goods, 43 percent would come from farm and food policy reforms alone.

Second, developing countries' welfare gains will mostly come from the developing countries' own farm liberalization, and most of the OECD gains will come from OECD countries' own farm liberalization. This reflects the basic point that protection hurts the consumers of the protecting country.

Third, however developing countries would still make significant gains from OECD farm liberalization (one-third of the welfare gains in Table 1). Similarly, OECD countries get noticeable welfare gains from developing countries' farm liberalization. In other words, developing countries still have a strong interest in liberalizing OECD farm policies, and vice-versa—hence the need of a Doha Round between developing and OECD countries.

Fourth, beyond these broad similarities, crucial differences between countries will define negotiating strategies. Among OECD countries, Western Europe (the EC) gains most from the OECD (its own) farm liberalization, whereas the U.S. gains almost as much from OECD and developing countries' liberalization. Among the developing countries, some key WTO members (Brazil, India) gain more from the liberalization of the trade between developing countries than from the opening of OECD markets. In the Doha

Round context, these observations suggest that (i) opening the EC markets is the main source of welfare gains from OECD liberalization, but also that (ii) Brazil and India (among others) should be more interested in opening developing countries' farm markets than OECD farm markets.

Fifth, most of the poorest developing countries stand to gain from farm liberalization, and they will even gain proportionally more than the other developing countries. The welfare gains for sub-Saharan Africa (excluding South Africa), South East Asia (except Indonesia) and South Asia (excluding India) represent 1.4, 2.6 and 4.6 percent, respectively, of their GDP, more than the gains for South Africa, Indonesia and India, respectively (and more than the rich OECD countries).

Last, these simulations show that, contrary to a widespread perception in many poorest countries, preferential (tariff-free) access to the EC or U.S. markets, through the Generalized System of Preferences (GSP), Everything But Arms (EBA) or African Growth and Opportunity Act (AGOA) is hardly helpful. This is because the absence of restrictions at the OECD borders does not prevent behind-the-border measures—price support and other domestic production subsidies. The presence of heavily subsidized OECD producers in the market makes it very hard for farmers from the poorest countries to compete in OECD markets, despite preferential tariffs. Moreover, poor countries (excluding China and India) are much more affected by farm protection than other countries: 29.3 percent of their farm exports comprise products that are subsidized by one or more WTO members, compared to 6.4 percent for middle income developing countries and 4 percent for the OECD countries, with China and India's exposure rate being around 5 percent. For countries such as Benin, Burkina Faso, Burundi, Chad, Malawi, Mali, Rwanda, Sudan, Tanzania, Uganda and Zimbabwe, 60 to 80 percent of their total exports comprise goods subsidized by OECD countries [Hoekman, Ng and Olarreaga 2001].

5. Guidelines for a Doha deal on agriculture: Proposals for a Leaders' G20

Table 2 summarizes the existing papers tabled by the major coalitions in presence (the G2 and the so-called "G20" led by Brazil, China and India in the trade arena) by the Chair of the General Council and by the Mexican Chair at the Cancun Ministerial. Colored items indicate the most economically sound suggestions—the closer from the suggested provisions the Doha Agriculture Agreement will be, the more likely it will deliver straightforward and effective farm liberalization. Ironically, they are very similar to the EC-U.S. proposals on trade liberalization ... in manufacturing.

5.1. Tariffs

The priority of the Doha negotiations should be a substantial reduction in high *tariffs.* Non-discriminatory (MFN) tariff cuts by OECD countries will have a much more powerful impact on the two other OECD instruments of protection—export and production subsidies—than preferential tariff reductions have had for two reasons. They will, almost automatically, generate equivalent cuts in export subsidies. And they will substantially erode the protectionist impact of the production subsidies mostly granted by

the G2 countries to their farmers—the lower the tariff rates, the larger the domestic subsidies need to be to provide a given level of protection (severe budgetary pressures in the G2 will help to cap the overall level of subsidies).

MFN tariff cuts focusing on high tariffs should be made by OECD *and* by developing countries. As tariffs are the main instrument of protection used by developing countries on imports from other developing countries, tariff cuts are the best tool for unleashing the gains to be expected from farm trade *between* developing countries (the expected main source of the welfare gains for developing countries, as seen above).

The best way to make high tariff cuts is via the *Swiss formula*. By reducing dispersion in tariff rates, it leads to an "uniform tariff" (same tariff rates on all the goods) which ensures both the minimization of domestic distortions between exportables and importables and, if moderate, the upholding of fiscal revenues. By reducing the gap between the levels of bound and applied tariffs, it reduces uncertainty. By requiring the transformation of specific tariffs into *ad valorem* tariffs, it removes an implicit bias against developing countries which often have lower unit value exports (reflecting lower quality, less processing, etc.). It offers immediate, costless information on the post-liberalization tariff rates—a huge benefit for the small negotiating teams of many developing countries. Lastly, it is friendlier to developing countries than to OECD countries because the farm tariffs currently applied by developing countries are generally lower than those imposed by OECD countries (see the discussion on S&D below).

Focusing on high tariffs should help to surrender the use of tariff-rate quotas. Expanding in-quotas have severe negative features: they generate quota rents that convert would-be free traders into supporters of the protective regime, they introduce scope for discriminating between countries, and they can reduce national welfare by much more than similarly protective import tariffs.

The Swiss formula approach is perfectly compatible with a "special and differential treatment" (S&D). A full discussion of S&D goes beyond the scope of this paper. One could argue that a S&D approach could be justified for the poorest developing countries under some conditions—the most important one being the adoption of an as uniform (and moderate) as possible tariff schedule by the poorest countries [Messerlin 2003]. Taking into account the dynamics of negotiations, the S&D dimension could be accommodated by a Swiss formula based on three maximum tariffs, a low one for the OECD countries, a higher one for the poorest countries, and an intermediate one for the other countries. Table 3 illustrates the fact that developing countries have a relatively low rate of farm protection (compared to OECD countries). The Doha negotiators could take into account this feature so that farm liberalization for the poorest countries would be concentrated on cutting high tariffs and on binding tariffs—the two main sources of large welfare improvements over the current situation.

5.2. Export subsidies

Export subsidies are almost exclusively an EC phenomenon (five-sixths of all export subsidies in the mid-1990s were granted by the EC) although other OECD and eight non-OECD countries can provide export subsidies under the Uruguay Agreement. Export credits, food aid (mostly used by the U.S.) are equivalent to export subsidies, but only proportionally to the subsidization component in interest rates or transaction terms.

Focusing on export subsidies reflects the economic interests of countries convinced to have comparative advantages in agricultural products—the U.S. during the Uruguay Round, Brazil and a few other developing countries today. It is thus understandable that such a concern drives WTO negotiations. But, limiting the Doha negotiations to export subsidies would be a mistake. Net-importing countries may lose their benefits from the prices depressed by the OECD farm policies, while they will not be able to benefit from the new market access opportunities provided by tariff reductions. Existing calculations suggest that removing only OECD export subsidies would harm all the sub-groups of developing countries, except Brazil and the rest of Latin America, whereas removing them *plus* tariffs would be beneficial for all the sub-groups of developing countries (except for the North Africa-Middle East region).

The objective of the Doha Round should thus be to ensure that the same export subsidy rules apply to agriculture as to manufactures. That requires an elimination of the export subsidies faster than tariff cuts—but it should not divert from the main goal of tariff cuts.

Two specific provisions of the Uruguay Round deserve attention. Exempting developing countries from export subsidy rules (Article 9.4) regarding marketing costs, internal transport and freight charges should be maintained under an appropriate form. The "Peace Clause" (Article 13) which exempted farm export subsidies from the WTO dispute settlement procedure (and lapsed in January 2004) is much more debatable, and could be re-introduced under a mild form only in case of very substantial progress in disciplining export subsidies.

5.3. Domestic support

Domestic support (price support, direct production subsidies, etc.) is a domain where OECD countries have got *de facto* a "reverse special and differential treatment" under the Uruguay Agreement. Domestic support measures that are deemed trade-distorting are listed in the "Amber" Box, and their aggregate monetary value (called the "Aggregate Measure of Support" or AMS) has been subjected to reduction commitments by the Uruguay Round. Moreover, the Amber Box has three main exceptions: the "Blue" Box (payments under production-limiting programs), the threshold of *de minimis* levels of domestic support (subsidies considered too small to be trade-distorting), and certain measures (Article 6.2) to encourage farm and rural development in developing countries. After the Uruguay Round, the OECD countries have allocated a large portion of their huge farm subsidies to the Blue Box, and benefited of the definition of the AMS on the basis of the whole farm sector, rather than on a product-specific basis. In sharp contrast, developing countries have only very marginally utilized Amber Box exceptions.

Amber Box disciplines raise two critical issues. First, farmers of certain developing countries have indirectly (but greatly) benefited from OECD domestic support via preferential access to protected OECD markets, as best illustrated by the EC sugar and banana regimes, with countries such as Mauritius (sugar) and the Caribbean states (bananas) enjoying quotas allowing them to sell their products on the EC markets at the much higher European prices. This has generated an "unholy alliance" between OECD farmers and farmers of these developing countries to the detriment of the rest of the world. A fair and economically sound alternative to maintaining preference margins would be to include in the Green Box the adjustment measures (i.e., decoupled subsidies) that OECD countries should take in order to compensate the farmers of the developing countries who benefit from the current situation.

Second, should developing countries seek to expand the coverage of permitted support instruments to allow them more freedom to subsidize? Indeed, many—including some of the poorest countries in the discussions on S&D—have argued that developing countries should counter-balance the current reverse special and differential treatment enjoyed by the OECD countries by demanding their own additional rights to subsidize.

This approach has three main flaws. First, the Uruguay Agriculture Agreement already gives developing countries a wide degree of freedom for subsidizing the development of their farm sector provided that these measures are "an integral part of development programs" (investment subsidies) or that "they are targeted at low-income or resource-poor producers" (input subsidies). There is thus no need for much wider freedom, but rather for clarification of certain existing provisions. For instance, how can one define low-income or resource-poor producers, poor remote areas, poor people, support for diversification, transportation subsidies for farm products, consumption subsidies for domestic food aid, public assistance for establishing farm co-operatives or institutions promoting marketing and quality control of food products, etc.? Second, most of the poorest countries do not have the funds to finance additional subsidies. Fighting for unusable rights has heavy costs in WTO negotiations. It wastes negotiating capital, hence diminishes ability to fight for more urgent goals, such as tariff cuts. Last but not least, the extra rights that the poorest countries could get to subsidize would probably come at the expense of ceding greater rights (e.g., subsidies for animal welfare could easily become subsidies to livestock producers) to OECD countries who are invoking "non-trade concerns" and which are rich enough to use such rights—thus perpetuating or even amplifying the asymmetries which currently plague the system.

As a result, domestic support should be seriously curbed by the Doha Round. That could be done by using a Swiss formula on the current AMS (expressed in percentage of the value added) by farm product, the main task of the negotiators being to fix the maximum AMS rate. Again, some differentiation between countries in the name of the S&D principle could be envisaged (it would not raise a problem in the Swiss formula context).

6. Concluding remarks

Two main concerns are often voiced about farm liberalisation. First, it could affect food security—that is, the capacity of a country to ensure that its whole population will have enough food on a stable basis, whether domestically produced or imported. It is seen by many as a situation where rich, well-equipped and trained OECD farmers will wipe out poor farmers in developing countries, and where the price volatility of food products will increase. Far from this, existing calculations show that OECD farm liberalization would increase the food production of most developing countries or groups of countries. And, contrary to popular belief, trade is a powerful insurance policy against climate shocks and other sudden differences between countries, as best illustrated by the increased intra-EC trade needed to cope with the heat wave of summer 2003 in Europe).

Second, it is often believed that farm liberalization will generate food price increases, hence having a negative impact on poverty (whether individuals can buy enough food to live decently). But, the current estimates of world price increases of commodities after liberalization do not exceed 5 to 10 percent. Given that any liberalization would be implemented over 5 to 10 years (as for the commitments adopted during the previous GATT Rounds), the effects of such a change are quite manageable, even for the subset of poor countries that would be net food-importing economies after farm reform.

These concerns are strong enough to make popular the suggestion of a special safeguard for agriculture. The proposal for a special safeguard for agriculture is a bad idea for three reasons.

First, safeguards have proven to be difficult to control. The last thirty years of trade policy in developed and developing countries alike abundantly demonstrate that safeguards are seldom used for protecting the people for whom they were intended. More often, they fall into the hands of unrelated but powerful vested interests—farmers instead of consumers, traders instead of farmers, large farmers instead of small farmers, etc. The above concerns would be better addressed by introducing some flexibility during the Doha negotiations, for instance, by granting to the poorest countries a one-off opportunity to raise bound tariffs on a limited number of key specific products. Such an approach has many crucial benefits for the multilateral trading system that a special safeguard will not provide: it ensures that the measures taken will consist of tariffs, not quotas; it sets *ex ante* the maximum possible tariff increases (the difference between the applied rate and the maximum bound tariff); it sets such increases on a tariff line basis (safeguards tend to cover many tariff lines); it helps the poorest countries to start the crucial process of binding tariffs; it avoids the redundancy of making a special safeguard available to countries with very high bound tariffs; and last but not least, it will provide a key argument for developing countries to ask for the elimination of the special safeguard currently enjoyed by the OECD countries.

Second, in the context of WTO negotiations, granting a special safeguard to developing countries is likely to be "paid for" by keeping or "improving" the special safeguard currently enjoyed by the OECD countries. In this context, large countries have huge

tactical advantages. They will not hesitate to impose safeguards, hence generating the price turbulences that developing countries fear. By contrast, small economies will often hesitate to displease their powerful trading partners by taking safeguards against them. They will generally end up by imposing safeguards on the imports from their fellow developing countries, spreading turbulence and magnifying the initial problems.

Lastly, a special safeguard for food security reasons is a less efficient instrument than an alternative instrument: emergency food stocks. From an economic perspective, such stocks are completely different from stocks used for stabilizing domestic prices—in particular, they should be bought and sold at market prices. To develop this instrument would not require a lot of efforts (it can be based on the Uruguay Agriculture Agreement, Annex 2). One could go further by creating a designated financial fund at the world level (with a capital estimated at US$400 million). Such a fund would spread the costs over many countries, it would offer a transparent alternative to food aid as disguised export subsidies, and it would be available at the right time, that is, when food is necessary not when it is available in excess in developed countries (the most crucial and frequent problem of food aid).

If safeguards are not the correct answer, what are the appropriate answers to the above concerns about farm liberalization? They consist in combining farm trade liberalization with appropriate *domestic* policies and actions—such as infrastructure investments, for instance in transportation and telecommunications, well-functioning credit and other input (seeds, fertilizers) markets, competitive markets in distribution, etc.—not in closing domestic markets to foreign exports. These domestic complementary policies could be supported and, where necessary, financed by the international community (as in the case of emergency food stocks). They alone can ensure that the benefits of liberalization are reaped and its costs, particularly for the most vulnerable groups, minimized.

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