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The 2002 US Farm Bill and International Agri-Food Trade: Dusting Off the Prebisch Thesis

SPECIAL REPORT

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What one learns from a study of history, is that people fail to learn from studying history.
Arnold Toynbee

1.0 Introduction

Recent developments in American agricultural and trade policy suggest that the US is backing away from its position as a staunch supporter of freer trade. In the long run, this action will weaken the competitive position of US agriculture and the other protected sectors of the US economy, as was the case when the US did this in the 1920's. It will also clearly harm US trading partners, such as Canada. We'll discuss the direct impacts of the Farm Bill on Canada in another, forthcoming special report.

However, for our purposes in this report, the more immediate impact is to deter developing countries from pursuing freer trade as a means of increasing economic growth and improving standards of living. Support for freer trade from developing countries is essential if the current round of WTO is to achieve meaningful gains in trade liberalization. In turn, trade liberalization is absolutely required if low cost/resource rich countries such as the US and Canada are to have prosperous agri-food sectors. Current US policy initiatives give developing countries every incentive to retreat from liberalized trade to highly protectionist policies, just as outlined by Raoul Prebisch nearly 40 years ago.

The impact of current US agricultural policy initiatives is to weaken the Doha agenda by forcing developing countries to unilaterally liberalize trade without any significant concessions from the US. This places developing countries in a very difficult position, and dramatically reduces the prospects for future gains through freer trade.

In this special report, we outline the following issues that will impact the world agri-food trade context in the coming years:

- International trade in primary commodities from the developing country perspective
- The US Farm Bill and recent US trade policy initiatives
- The agenda for the Doha Round of WTO
- Impact of US policy initiatives on the success of WTO

2.0 Developing Countries and Trade in Primary Commodities

Most developing countries, almost by definition, rely primarily on the sales of natural resource-based products to generate income. Common examples are oil, minerals, jute, and farm products like cotton, wheat, coffee and cocoa. Because the citizens of developing countries have relatively low levels of disposable income and because foreign exchange is required for the purchase of finished goods, primary commodity sales are heavily weighted toward exports. Thus, developing countries have relied heavily on exports of primary commodities as a strategy of growth.

2.1 The Prebisch Thesis

Raul Prebisch was the Secretary General of the United Nations Conference on Trade and Development in the 1950's and 60's, and was outspoken about the impact of international trade on developing countries. Prebisch has been credited with formulating and advancing the primary commodity problem as an issue in international trade [1]. The primary commodity problem has three related components:

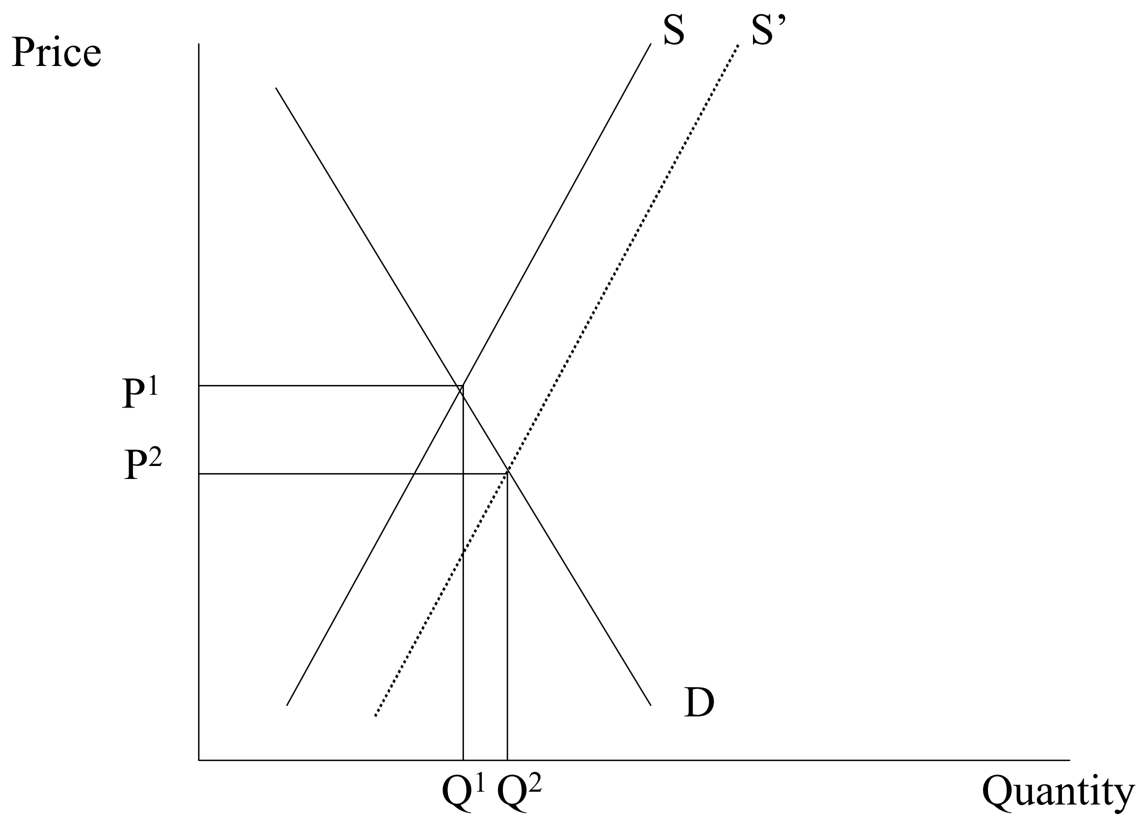
- The stability problem - Prebisch argued (in a less than lucid manner) that the international prices of farm products and other primary commodities are unnecessarily unstable, and that this instability distorts investment and the efficient allocation of resources
- The income problem - He also argued that because the real prices of primary commodities fall in the long run, the real incomes of developing countries also fall.
- The policy problem - Finally, he argued that the agricultural and trade policies of developed countries exacerbated the stability and income problems faced by developing countries.

The basis for Prebisch's ideas came from his observations about price inelastic supply and demand for primary commodities. The demand for primary commodities is price inelastic if the commodity is a small percentage of the cost of the final product, if there is a lack of substitutes, and/or if the demand for the commodity does not change with income. The supply of a commodity can be inelastic when there are high sunk costs, lags in production, or a lack of viable alternatives.

The consequence of a highly inelastic supply and demand is that prices are volatile relative to production – ie small changes in production create large changes in prices. This is illustrated in Figure 1 below. Because the demand curve, D, is so steep, a relatively small increase in product supply from Q^1 to Q^2 decreases price dramatically from P^1 to P^2. Similarly, if demand increased (shifted out to the right) or supply decreased (shifted to the left) the upward price adjustment would be dramatic.

[1] Prebisch, R. "Commercial Policy in the Underdeveloped Countries", *American Economic Review, Papers and Proceedings,* 44 (251-273). 1959.

Figure 1 Inelastic Supply and Demand for a Primary Commodity



Into this framework, the Prebisch thesis substitutes the following stylized facts:

- The supply of primary commodities grows more quickly than the demand. In primary commodities (especially farm commodities), technological improvements in production cause the supply to grow faster than the demand, causing the price to fall. The more inelastic the supply and demand, the more pronounced this effect. Thus, commodity prices decrease over time. Interestingly, this is opposite to the argument of Malthus. Malthus believed that population growth would cause demand to outstrip supply because resources are finite, leading to periods of misery and hoarding. Prebisch's thesis leads to an agriculture characterized by first mover benefits to those who adopt new technology. Technology in turn drives down costs, and eventually results in lower prices. Based on the evidence of the two hundred plus years since Malthus died, it would appear that he got it wrong and that perhaps Prebisch was right!

- Income in a developing country is influenced by fluctuations in commodity prices to a greater extent than changes in quantity. This results from an inelastic demand for primary commodities. Attempts at income growth through greater production are more than offset by the accompanying decrease in price. As a result, income actually decreases as a result of increased production. Alternatively, prices may fall in a country, not because of anything that country did, but because of actions in other countries. So the developing country has little control over the things that affect the incomes of its citizens.

- Protectionist policies and subsidies on behalf of developed countries aggravate the instability and income problem. Developed country tariffs, price supports, deficiency payments, etc. result in a supply response from producers in the sponsoring nation. As a result, the supply of product in the international market is increased, and the import demand from countries applying protectionist policies is reduced. The net effect is to reduce the world price, and to decrease the elasticities of supply and demand in the world market, so that the world price becomes more unstable.

Based on the forgoing, Prebisch submitted that the pervasive tendency for developed countries like the US and the EU to embrace protectionist policies (particularly in agriculture) meant that developing countries were better off to adopt protectionist policies of their own as a means of growth than to pursue freer trade. According to Prebisch, developing countries were better off to subsidize production for export and prohibit imports as means to support incomes, given that developed countries were doing the same. This approach was endorsed by many third-world governments, and as a result, the problems of instability and low prices in international commodity markets were exacerbated, and relatively poor countries remained relatively poor.

3.0 The Doha Round of WTO

The reform in agricultural trade that was initiated with the Uruguay Round Agreement on Agriculture is continuing in the current round of WTO negotiations. There are three key areas or 'pillars' in the negotiations: market access, domestic support and export subsidies. The Doha Ministerial Declaration (DMD) issued in November, 2001 was a significant step forward for the negotiations, as agreement was reached on the overall objectives with respect to the three pillars. These objectives are: "substantial improvements in market access; reductions of, with a view to phasing out, all forms of export subsidies; and substantial reductions in trade-distorting domestic support".

With agreement on the objectives achieved, the negotiations are now concerned with narrowing the gap between the various proposals that have been submitted. Prior to the Doha meeting, 126 member governments submitted 45 proposals that outlined their initial negotiating positions. The goal now is to reach consensus on specific targets for each pillar and how these targets will be achieved. According to the work program set out by the WTO agriculture negotiations committee, the key negotiating principles are to be set out by March 1, 2003 so that member governments can complete their first offers or comprehensive draft commitments by the 5th Ministerial Conference later in 2003. The deadline for reaching a final agreement in the agriculture negotiations (and all other negotiations in the WTO) is January 1, 2005.

The initial negotiation proposals are a strong indication of the direction the negotiations are headed in, and where compromises will have to be made.

3.1 Market Access

In their initial negotiating proposals, Canada, the US and the EU all indicated they are seeking the reduction or elimination of tariffs. However, there is disagreement regarding Tariff Rate Quotas (TRQs). Although Canada would like to see minimum access commitments for TRQs from other countries, it also insists that the supply management system is not up for negotiation. The US is asking for substantial increases in TRQs (i.e. increased access to products under TRQs) and the EU wants to see rules and disciplines that increase the transparency and reliability of TRQs.

3.2 Export Subsidies

Canada and the US are both seeking the end of export subsidies sooner rather than later. The EU has indicated it is willing to reduce export subsidies, but will only do so if all forms of export subsidy, including export credit and food aid, are considered on an equal footing. Where State Trading Enterprises (STEs) are concerned, Canada and the US have opposite positions: the US wants to see the end of exclusive export rights for STEs while Canada wants to maintain these rights for the Canadian Wheat Board. For its part, the EU is seeking the end of unfair trade practices of STEs, such as cross-subsidization and price pooling.

3.3 Domestic Support

This is seen by negotiators as the key pillar – significant progress must be made in this area if the talks are to be successful. Canada would like to see the maximum possible reduction or even elimination of trade-distorting domestic support, and a cap on all types or 'boxes' of support. The US WTO proposal says it wants to 'reduce substantially trade-distorting domestic support'. The EU has indicated it will reduce domestic support on the condition that the concept of the blue and green 'boxes' remains.

3.4 Developing Countries

Developing countries are playing a more significant role in these negotiations than they have in the past, especially when it comes to making sure their concerns are heard and addressed in any new agreement. Essentially, what the developing countries want from the agricultural negotiations is what is embodied in the overall objectives – free and fair access to markets (especially those of developed countries), and meaningful reductions in trade-distorting subsidies of all kinds. In addition, a 'development box' has been proposed that includes the flexibility to ensure the special and differential needs of developing countries are addressed, such as reducing poverty and improving food security.

4.0 The 2002 US Farm Bill and Related Trade Policy[2]

The Farm Bill signed into law by President Bush in May, 2002 contains a variety of provisions that make it more protectionist than its immediate predecessor:

- An expanded and revised non-recourse commodity loan program

The new Farm Bill institutes Loan Deficiency Payments (LDP's) as part of the loan program for crops. This differs from the traditional approach in which the loan rate was held as a floor price based on government purchases. Under the new rules, farmers would know the loan rate in advance, and they would have to produce the product in order to receive LDP's. So clearly there will be a supply response as producers attempt to maximize support, which will drive down the market price of crops.

- Direct payments

Unlike previous legislation, farmers will be eligible for direct payments based on historic production from 1998 to 2001.

- Return to Countercylical Payments

The 2002 Farm Bill sees the return to Target Prices and historical production base as a means of support. Historic production base for grains will be retained, with provisions to update program yields and convert base acreage to soybeans.

- Country of Origin Labelling

Under this provision, all fresh produce, fish, peanuts, and meat products must carry a country of origin label at the retail level. Meat products must be from animals born, raised and slaughtered in the US in order to qualify for a US country of origin label. Ingredients in manufactured food products would be exempt. Initially a voluntary measure, country of origin labeling would become mandatory in two years.

4.1 Steel Tariffs

In late 2001, the US government established a tariff on a variety of steel products based on a finding of injury from imports. Tariffs range up to 30% in the first year, falling in years 2 and 3. In certain products, developing countries are not exempt from these measures[3].

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[2] Our forthcoming Special Report on the effects of the Farm Bill on Canadian producers will deal with considerably more detail on the Bill.

[3] Thelen Reid Report No. 60,March 14, 2002 ©2002 by Thelen Reid & Priest LLP http://www.thelenreid.com/articles/report/rep60_idx.htm

4.2 Canadian Softwood Lumber Duties

Following expiration of the 1996 Canada-US Softwood Lumber Agreement in the spring of 2001, the US government initiated countervailing and anti-dumping duty investigations against Canadian softwood lumber products. The result of these investigations was an 18.8% countervailing duty and a firm-specific anti-dumping duty ranging from 2.2% to 12.4%.

4.3 Measures Against the Import of Textiles

The US has an established record of protecting textiles; the average tariff rate on textiles is 17%[4]. In addition, as Gresser points out, US tariffs on textiles and clothing are disproportionately borne by developing countries, at least partly because the highest tariffs are highest on basic or lower grade materials, which tend to be produced by developing countries[5].

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[4] "Tangled up in textiles", *The Economist* Tuesday May 28th 2002.

[5] Edward Gresser "America's Hidden Tax on the Poor: The Case for Reforming U.S. Tariff Policy" Progressive Policy Institute, March 2002 Policy Report. Washington: The Progressive Policy Institute *http://www.ppionline.org.*

5.0 Impact on International Trade Prospects

Prebisch's ideas on trade and protectionism in primary commodities were always controversial, and have received abundant criticism[6]. To a large extent, the empirical implications of the Prebisch thesis have been proven wrong:

- The Prebisch thesis (the primary commodity problem) depends critically on inelastic supplies and demands in international trade. However, the supply and demand of primary products in the international market are typically *elastic*, particularly from the perspective of a small country.
- Intermediate goods and further processed products are of increasing significance in international trade; primary commodities are decreasing in significance.
- Many developing countries have successfully pursued development by unilaterally removing domestic protection and liberalizing trade (for example, Chile). This is precisely the opposite of the Prebisch thesis

However, the legacy of the Prebisch thesis is the attention that it draws to the impact of developed country interventionist agricultural policies on developing countries. Agricultural policies that induce a supply response or restrict trade in agricultural commodities have a perverse impact on developing countries, because they are more heavily dependant on trade in agricultural products. Developed country agricultural policies benefit a domestic vested interest at the expense of a poorer, broader populace in developing countries.

The intent of the agenda at the Doha Round would appear to dissolve the concerns advanced by the Prebisch thesis. The architects of Doha conceived of substantial improvements in market access, reductions (or phase out) of all export subsidies, and substantial reductions in trade-distorting domestic support. This can only be interpreted to mean that the export demand for primary commodities would be more robust than the past, and that the supply response to protectionist policies would be reduced. In addition, there would be a developing country box to address development through trade. The Doha vision suggests that the misery inflicted on developing countries by developed countries through trade would not happen.

However, the 2002 US Farm Bill, along with protectionist measures in steel, softwood lumber, and textiles, stands in direct contrast to the Doha vision. This is true despite the fact that the US had a major hand in crafting the Doha vision. The combination of loan rates (really deficiency payments), direct payments, and countercyclical payments clearly increase trade-distorting domestic support. This is particularly clear with the loan rate program, since it explicitly couples production with support. The measures in steel, softwood lumber, and textiles, as well as the country of origin labelling provision of the Farm Bill obviously restrict market access. Thus, the US has adopted an intractable, xenophobic position best described as "free trade, no imports", coupled with heavy, distortionary domestic support.

[6] For example, Flanders, M.J. "Prebisch on Protectionism: An Evaluation", *Economic Journal* 74 (294) 305-326. 1964

5.1 Trade Liberalization and Less Developed Countries

There is a distinct irony to the current wave of US protectionism. For agri-food firms in developed countries, the domestic market for basic bulk food products is largely mature. Export is by far the easiest way to expand sales. In the case of developing countries, additional household income is typically first spent to upgrade the diet. Developed country agri-food businesses can immediately sell into these markets and satisfy the demand for upgraded diets without the same expenses of competing for market share they experience at home. Thus, developed countries need developing countries to realize the gains from freer trade.

However, the more that developed countries subsidize production and restrict trade, the less incentive developing countries have to liberalize trade themselves. It would require that they limit support and grant market access to developed countries, with little offsetting benefit in terms of increased market access or decreased support on behalf of developed countries. While there can be long-term benefits from unilaterally liberalizing trade, it is much easier for developing countries to sell liberalized trade politically when a tangible gain is associated with market access sacrifices. Why would developing countries grant domestic market access and reduce farm support when the policies of developed countries effectively prevent them from experiencing the offsetting gain from access to their markets?

5.2 What Direction for Smaller Developed Countries?

On top of the foregoing problems, US protectionism places smaller developed countries like Canada and the Cairns Group in an awkward position. On one hand, these countries stand to make significant gains from further trade liberalization through the WTO. This argues that these countries should continue to liberalize protection and grant access to imports, consistent with the Doha agenda.

At the same time, these countries have failed to match the domestic support granted by the US through emergency assistance over the last several years. Producers in these countries have experienced real pain as a result of low crop prices (at least partially caused by US farm assistance). The prospect of continued low incomes due to a supply response and lower prices from the 2002 Farm Bill argues for some form of offsetting assistance to protect domestic producers in smaller developed countries.

This is clearly a dilemma. The former alternative supports the vision of freer trade and all its benefit; the latter caters to the tangible damage to farm incomes that has occurred and presumably will continue. Current political inertia supports an increase in agricultural support in smaller developed countries

5.3 Conclusion

If the promise of the WTO Doha Round is to be realized, developing countries will have to be prepared to sacrifice domestic support and protection. However, given the protectionist position taken by the US, the gains that developing countries can realize by reducing their trade barriers will be limited. At the same time, the US wants significant reforms in export subsidies and domestic support in the Doha Round. What this means is that the US is virtually forcing developing countries to unilaterally adopt freer trade. The difficulty of this position placed on developing countries will make it hard for them to resist protectionist policies themselves, and will incent them to adopt the Prebisch thesis.

Given the sermonizing of the US on freer trade over the past few years, some countries may find it appropriate to help the US understand the implications of their sudden about face. We note that European Union has chosen to put its scheduled reduction of farm support on hold. Russia recently banned imports of US chicken, thereby backing up supplies in the US and affecting the prices of US livestock products. Many people believe this was retaliation for the steel tariffs. China's first dispute as a member of the WTO is a case against the US on the steel tariffs. And we are told that a developing country, whose economy relies heavily on agricultural production, has decided to re-tender a mammoth industrial project, and has declined to accept bids from US companies.

On one hand, these tactics by other countries are understandable, and may be the only way for smaller economies to get the attention of an economic giant. If enough countries adopt similar tactics, their individually small sizes can begin to stand up to the largest economy in the world. On the other hand, they illustrate the danger that can be the result of these aggressive economic actions by the US. Acts of retaliation and erecting fortresses around national boundaries smack all too much of economic warfare, and really do bring to mind memories of the 1920's.

Unfortunately, this makes the oft-used quote of the famous historian Arnold Toynbee disquietingly appropriate.