

February 27, 1985

HELPING U.S. FARMERS SELL MORE OVERSEAS

INTRODUCTION

Given its overall 1984 trade deficit of \$123 billion, the U.S. pays little attention to what is probably its most profitable export: agricultural products. Last year alone, the U.S. exported \$38.0 billion in farm goods and imported only \$18.9 billion. Ironically, while multilateral negotiations have reduced tariffs on manufactured products in recent years, they have done little to liberalize agricultural trade. As the world's largest exporter of agricultural products, the U.S. would benefit greatly from freer trade--as would U.S. farmers. A major obstacle to less encumbered agricultural trade is the conflict between U.S. domestic and foreign agricultural policy. This year, the Reagan Administration and Congress will be writing a new farm bill. It should be done in a way to make it easier for the U.S. to negotiate with other nations for lower barriers to U.S. farm exports.

U.S. agriculture enjoys a comparative advantage over other countries for many products. The favorable American climate and an abundance of fertile land are the key reasons. So are modern technology and the large amounts of capital invested per worker.¹

¹ Robert E. Baldwin, "Determinants of the Commodity Structure of U.S. Trade," American Economic Review, May 1981, pp. 126-146.

This paper is the fourth in a Heritage series on agriculture. It was preceded by Bruce Gardner, "Agriculture's Revealing--and Painful--Lesson for Industrial Policy," Heritage Foundation Background No. 320, January 3, 1984; E.C. Pasour, Jr., "The High Cost of Farm Subsidies," Heritage Foundation Background No. 388, October 22, 1984; and E. C. Pasour, Jr., "The Free Market Answer to U.S. Farm Problems," Heritage Foundation Background No. 389, October 30, 1984.

U.S. farm policy should maximize these advantages by encouraging specialization based on U.S. strengths, with Americans, as they can so well, producing and exporting a wide variety of agricultural products, while importing products that other countries make more efficiently. Such freer trade would increase income for the U.S. and its trading partners and expand overseas markets for U.S. farmers.

Since the 1930s, the goal of domestic farm policy has been to increase farm income. The trouble is that too often this leads to price policies that interfere with international trade. Since the strategy often had pushed domestic product prices above world prices, it has required import barriers and export subsidies, thus sacrificing some of the benefits of international trade. It has become clear in recent years that this strategy has been costly to the American taxpayer without solving the problems of the American farmer.

The new farm bill, to be enacted this year, should be compatible with freer international trade and capitalize on the comparative advantage of American farmers.

U.S. AGRICULTURE IN THE WORLD ECONOMY

Importance of Agricultural Exports

The U.S. is the world's largest exporter of agricultural products. And although the U.S. share of agricultural products in total world trade has been declining for many years, the share of agriculture in U.S. exports has remained steady at 20 percent.

Since World War II, though much progress has been made in reducing tariff barriers for industrial products, agricultural trade has been excluded systematically from multilateral trade negotiations. Because the U.S. is a net agricultural exporter, Americans are particularly harmed by this failure to liberalize agricultural trade. A study by Frederick Brown and John Whalley, of the University of Western Ontario, for example, estimates that the failure to include agricultural trade in the Tokyo-Geneva round of multilateral trade negotiations, conducted between 1973 and 1979, cost Americans billions of dollars.² It thus would be in U.S. interests to encourage multilateral agreements for freer trade in agricultural exports.

A key step toward this would be for Congress to phase out domestic agricultural price support policies that raise U.S. prices above the world level and result in protectionism. This would give Washington much more credibility when it tries to persuade others, such as the European Economic Community and

² Fred Brown and John Whalley, "General Equilibrium Evaluations of Tariff-cutting Proposals in the Tokyo Round and Comparisons to More Extensive Liberalization of World Trade," Economic Journal, December 1980.

Japan, to alter their highly protectionist policies that adversely affect U.S. farm exports.

Composition of Agricultural Exports

During the past 30 years, grain (mainly wheat and corn) and oil seeds (mainly soybeans), have displaced cotton and tobacco as the primary U.S. agricultural exports.

Table 1

U.S. Agricultural Exports

| Product | Percentage of Agricultural Exports | |
|---------------------|------------------------------------|-------------|
| | <u>1950</u> | <u>1983</u> |
| Cotton plus tobacco | 44 | 9 |
| Grain | 29 | 40 |
| Oil seeds | 6 | 25 |

Source: U.S. Department of Agriculture, U.S. Foreign Agricultural Trade Statistical Report, 1983.

The market for U.S. grain has been eroded by the highly protectionist policies of the European Economic Community (EEC), which have transformed Europe from a net grain importer into a net grain exporter. The Community does not restrict soybean imports, but it has proposed a tax on oilseeds that would adversely affect the soybean trade. Moreover, the EEC complains that the U.S. has erected barriers against European exports, and U.S. soybeans have been discussed as a likely target of EEC retaliation.

The U.S. share of world flue-cured tobacco exports has declined from 60 percent in 1959 to 25 percent in 1982, partly because U.S. domestic price supports have driven up the export price, and partly because the federal allotment program restricts domestic production.³ Tobacco imports into the United States have become so large that the Department of Agriculture requested tighter restrictions on imports in 1981 and 1985. In both cases, the International Trade Commission rejected the request.

America's Comparative Advantage

Grain (mainly wheat and corn) and oil seeds (mainly soybeans) form the bulk of U.S. agricultural exports. Thirty years ago, almost half of U.S. agricultural exports consisted of cotton and tobacco.

³ Paul R. Johnson, The Economics of the Tobacco Industry (New York: Praeger, 1984) provides a comprehensive analysis of the tobacco program.

The comparative advantage of the U.S. in these products stems from its natural resources plus the application of modern technology and abundant quantities of capital. Pathbreaking research in agriculture and the resultant new technology require high capital intensity and large-scale operations. In 1979, the value of physical capital per worker was \$43,000 in agriculture as compared with \$21,500 for the economy as a whole. Large commercial farms play the major role in making the U.S. the world's agricultural leader. While only 29 percent of all American farms had cash receipts above \$40,000 in 1983, these farms earned 87 percent of total cash receipts.⁴ A prudent U.S. farm policy would take into account the underlying strength of these large commercial enterprises.

Products for Which America Lacks a Comparative Advantage

American growers do not enjoy a cost advantage in all agricultural products. Among the main imports that compete with domestic production are sugar and dairy products.

Sugar. Recent U.S. sugar policy has kept the U.S. producer price well above foreign prices. By the end of 1984, the domestic price was four times the world price. Because the domestic price level is kept up only by forcing up the price of imported sugar through quotas and duties, consumers have been paying much higher prices for sugar. Thanks to these artificially high prices, domestic producers in FY 1983 received \$1.5 billion more from the nation's consumers than they otherwise would have earned, amounting to \$98,000 per sugarcane farm and \$43,400 per sugarbeet farm.⁵ In 1982, President Reagan set country-by-country sugar import quotas. As world sugar prices fell, the quotas were tightened to protect domestic producers. This meant that the American consumer has not benefited from falling world sugar prices.

Penalized too have been those farmers who produce wheat, soybeans, and other crops that are competitive globally. The reason: Washington's protectionist sugar policy makes it difficult for the U.S. to persuade other countries to lower the barriers against U.S. farm exports. High cost U.S. sugar production, therefore, indirectly slows the lower cost production and export of U.S. corn, wheat, and soybeans.

Dairy Products. In the U.S. and most other industrial countries, dairy product prices are kept above world levels to increase the incomes of dairy farmers. These high prices produce a surplus that is sold on the world market. In 1984, U.S. dairy

⁴ Economic Report of the President, 1984, Chapter 4.

⁵ Sugar: Background for 1985 Farm Legislation, Economic Research Service, U.S. Department of Agriculture, Agricultural Information Bulletin No. 478, September 1984, p. 37.

product prices were two to three times the world price.⁶ Quotas, meanwhile, prevent imports from undermining the domestic price support program.

The dairy program has cost the federal government more than \$1 billion per year since 1979. If Washington would allow domestic dairy prices to dip to world levels, U.S. consumers and taxpayers would benefit greatly. And as in the case of sugar, a U.S. move toward freer world trade in dairy products would make it easier for Washington to negotiate reductions in trade barriers for other U.S. products.

Recent U.S. Trade Performance

During the 1970s, increased trade opened the U.S. economy to international influences. The agricultural sector was particularly affected by this. The value of agricultural exports as a percent of total farm cash receipts rose from 15 percent in the 1960s to 30 percent in 1980.⁷ The export boom of 1973-1974, led by wheat, corn, and soybeans, yielded the largest net farm income since 1947. The U.S. share of world wheat exports increased from 33 percent in 1971 to 53 percent in 1973.

The U.S. export share for wheat fell to 38 percent in 1983. This was caused by the 1981 world recession, the appreciation of the dollar, the debt repayment problems of many importing countries, and expanded wheat production in the European Economic Community, Canada, Australia, and Argentina. Many of these factors were beyond U.S. control. What is not are the U.S. domestic price supports that have raised the prices of U.S. farm products--hurting exports while costing the Treasury \$3.3 billion for wheat in fiscal year 1984.⁸

FOREIGN INFLUENCES ON U.S. EXPORTS

Developments in other countries often have a damaging effect on the American farmer. And although these problems cannot be controlled directly by U.S. policy makers, international negotiations could resolve a number of them.

European Economic Community (EEC)

The European Economic Community pursues a highly protectionist agricultural policy, which has transformed it from a net importer

⁶ Dairy: Background for 1985 Farm Legislation, Economic Research Service, U.S. Department of Agriculture, Agricultural Information Bulletin No. 474, September 1984, p. 13.

⁷ Economic Report of the President, 1984, p. 121.

⁸ Wheat: Background for 1985 Farm Legislation, Economic Research Service, U.S. Department of Agriculture, Agricultural Information Bulletin No. 467, September 1984.

to a net exporter of wheat, sugar, and poultry products--to the detriment of the American farmer. The entry of Britain into the EEC, in 1972, increased agricultural protection, and the proposed addition of Spain and Portugal as members will increase the likelihood of further discrimination against U.S. products--particularly soybeans.

Japan

Japan is a major importer of U.S. products, last year importing \$6.9 billion worth of American farm products. Yet the U.S. could sell even more to the Japanese, were it not for Tokyo's protectionist agricultural policies. On the other hand, the United States has negotiated "voluntary" import quotas against a wide variety of Japanese manufactured products. Thus, liberalizing trade holds the potential for considerable benefit to both countries.

USSR and China

The Soviet Union and China have become major importers of U.S. agricultural products. After many years of no trade with the U.S., China became a major wheat importer in the 1970s. A formal grain trade agreement followed the improvement of economic relations, but in 1984 the Chinese resisted buying the minimum amount stipulated in the agreement. Beijing said that this was in retaliation for the Reagan Administration's import quotas on Chinese textiles. Chinese agricultural reforms, which have led to a substantial increase in wheat production, also probably reduced China's need for U.S. farm products.⁹ Thus future agricultural trade with China depends on a competitive U.S. price and Washington's willingness to allow more imports of price-competitive Chinese textiles and clothing.

U.S.-Soviet agricultural trade has been complicated by the use of export controls since 1975. The most recent grain embargo followed the Soviet invasion of Afghanistan in 1979. Proponents of sanctions expect them to influence Soviet international behavior. However, an empirical study of the use of sanctions since World War I concludes that sanctions designed to force powerful countries to make major changes in their foreign policy are rarely effective. Any benefits from sanctions must be weighed against the damage done to the agricultural sector. Two aspects of sanctions have particularly concerned agricultural exporters: (1) restricting agricultural trade in the absence of a general embargo, and (2) abrogation of outstanding export contracts.¹⁰ These issues are being discussed along with the review of the Export Administration Act, which expired in 1984.

⁹ Cargill Bulletin, December 1984, p. 8.

¹⁰ Gary C. Hufbauer and J.J. Schott, Economic Sanctions in Support of Foreign Policy Goals (Washington, D.C.: Institute for International Economics, 1983).

Latin America

Debt repayment problems may have reduced the demand for U.S. exports, particularly by Latin America. So probably have agricultural improvements in Brazil and Argentina that have made their exports more competitive with U.S. wheat, soybeans, and tobacco. Argentine wheat has become so cheap recently that grain companies have considered importing it into the United States. Argentine and Brazilian tobacco exports also benefit from U.S. price supports and production controls on tobacco. Important, too, are U.S. import barriers to such Latin American exports as textiles and steel. This reduces the hard currency these countries would have for purchasing U.S. agricultural products.

Currency Exchange Rates

The appreciation of the U.S. dollar has inhibited American exports. Since 1980, the dollar has increased in value by more than the difference between U.S. and foreign inflation rates.¹¹ This increases the real price of U.S. exports abroad. Since a large share of U.S. agricultural output is exported, the agricultural sector is sensitive to changes in the real exchange rate.

The increase in the foreign currency equivalent of U.S. support prices also has contributed to the export decline since 1981 by widening the gap between domestic and world agricultural prices. A new farm bill that specifies rigid dollar support prices thus may inhibit farm exports further if the dollar remains strong--dollar support prices must reflect current world prices if U.S. exports are to compete in world markets.

International Commodity Agreements

The success, albeit short-lived, of the Organization of Petroleum Exporting Countries (OPEC) has renewed interest in international commodity agreements. By restricting production and exports of oil, OPEC members have transferred billions of dollars from importing countries to themselves. Some urge the U.S. to follow the OPEC example in markets for such agricultural products as wheat.¹² Under such a scheme, the U.S. would join other major exporting countries in restricting the production and export of wheat, and thereby raise the world wheat price above the level that would prevail under competition.

The fact is that Washington has tried to form a wheat cartel on many occasions, but without success.¹³ In addition to its not

¹¹ Jacob Frenkel and Michael Mussa, "The Efficiency of Foreign Exchange Markets and Measures of Turbulence," American Economic Review, May 1980.

¹² A. Schmitz, A. McCalla, D.O. Mitchell, and C.A. Carter, Grain Export Cartels (Cambridge, Massachusetts: Ballinger, 1981).

¹³ Thomas Grennes, Paul R. Johnson, and Marie Thursby, The Economics of World Grain Trade (New York: Praeger, 1978).

working, there are other reasons why the U.S. should have nothing to do with cartels for wheat, oil, sugar, or any other product. First, the use of monopoly power is damaging for the world economy as a whole. For each dollar of resources transferred to monopoly sellers, a cost of more than a dollar is imposed on the rest of the world.

Second, a wheat cartel is unlikely to enrich even its member countries. The evidence since the first International Wheat Agreement in 1933 indicates that member countries have been reluctant to accept cartel discipline. When crops and inventories were unusually large, members exceeded export quotas and violated minimum prices--just as OPEC members have done in recent years. If the U.S. restricted its wheat exports, the likely result would be simply a decrease in its world market share. During the U.S. grain embargo to the USSR following the Soviet invasion of Afghanistan, for instance, Argentina signed a five-year grain agreement with the Soviet Union. It is far more in U.S. interest to promote freer agricultural trade than to seek counterproductive international commodity agreements.

U.S. DOMESTIC AGRICULTURAL POLICY AND EXPORTS

Domestic agricultural policy has changed surprisingly little since the passage of the Agricultural Adjustment Act of 1933. Prices are still kept artificially high in an attempt to increase farm income. Prices are supported by making farmers eligible for federal non-recourse loans. The loan rate specifies a product price at which the farmer has an option to sell his crop to the government rather than repay the loan. The loan rate determines a minimum domestic price, since the government becomes the residual buyer at that price.

The farmer-owned grain reserve program, established in 1977, also has the effect of stimulating production while keeping grain off the market. In addition, the government pays producers the difference between a politically determined "target" price and the market price received by farmers. Like support prices, target prices stimulate production, but they also reduce market prices. Thus, target prices stimulate exports, by making U.S. products more competitive, while price supports depress exports, by making them less competitive.

Support prices and target prices have recently been set at levels that impose large budgetary costs on the federal government. Wheat payments amounted to \$3.3 billion in fiscal year 1984. Washington has sought to cut these costs by controlling production or acreage. But because world agricultural markets are competitive, production and acreage controls in the U.S. allow foreign exporters to take markets away from American farmers.

A traditional justification for domestic price supports is that they increase the incomes of poor farmers.¹⁴ Yet the value of program benefits to a farm depends directly on the size of the farm. In 1982, for instance, 78 percent of government direct payments were received by the largest 29 percent of farms whose cash receipts exceeded \$40,000.¹⁵ Agricultural price supports not only damage U.S. agricultural export competitiveness, but also fail to concentrate benefits on small, struggling farmers.

Linking Domestic Programs and Foreign Trade Policy

Foreign trade policy for agricultural products in most countries has been mainly a by-product of domestic agricultural policy.¹⁶ The attempt by the U.S. and other developed countries to raise farm income through price support programs, for instance, has helped spawn protectionism in foreign trade.

U.S. Import Barriers

U.S. domestic farm policy has led to import barriers against several agricultural products, including sugar, dairy products, beef, peanuts, cotton, fruits, and vegetables. The budgetary cost of protectionism often has been high. The dairy program, for instance, has cost more than \$1 billion annually since 1979. In fiscal year 1983 costs were \$2.6 billion--or \$13,000 in subsidies for every commercial dairy farmer.¹⁷

Because of domestic price support programs, the U.S. has had to take a position on agricultural trade that is not in the national interest nor in tune with the Washington's call for reduced trade barriers. This contradiction seriously weakens the U.S. negotiating position in multilateral trade forums. In particular, it is a significant handicap to negotiators seeking to increase U.S. exports by reducing agricultural protectionism in the EEC and Japan.

GOVERNMENT ECONOMIC POLICY AND AGRICULTURAL EXPORTS

The agricultural sector is affected by macroeconomic policy through the inflation rate, interest rates, and currency exchange

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- ¹⁴ For a discussion of this rationale, see the papers by E.C. Pasour, Jr., "The High Cost of Farm Subsidies," Heritage Foundation Backgrounders No. 388, October 22, 1984, and "The Free Market Answer to U.S. Farm Problems," Heritage Foundation Backgrounders No. 389, October 30, 1984. Also see Bruce Gardner, "Agriculture's Revealing and Painful Lesson for Industrial Policy," Heritage Foundation Backgrounders No. 320, January 3, 1984.
- ¹⁵ Economic Report of the President, 1984, pp. 114-115.
- ¹⁶ An early statement of policy determination which remains valid 35 years later is D. Gale Johnson, Trade and Agriculture: A Study of Inconsistent Policies (New York: Wiley, 1950).
- ¹⁷ Dairy, op. cit., p. 28.

rates. There is evidence that high inflation rates are associated with variability of relative prices.¹⁸ And the high capital-labor ratio in U.S. agriculture makes farming particularly sensitive to the interest rate. Moreover, the importance of agricultural exports makes exchange rate changes critically important to the industry.

Dollar appreciation since 1980, together with fixed dollar support prices, has made U.S. exports less competitive. The key factor to determining the competitiveness of U.S. products is the support price expressed in the currencies of importing countries. Because dollar appreciation increases the foreign currency price of U.S. farm commodities, the long-run effect of the dollar support price on world trade cannot be known without predicting future exchange rates. Unfortunately exchange rate variations since 1971 generally have not been anticipated by forward currency markets, interest rate differentials, or econometric models.¹⁹ The unanticipated portion of exchange rate changes appears to be caused in large measure by the unpredictability of government monetary and fiscal policy. Congress thus could contribute to agricultural and other exports by making its expenditure and tax policy more predictable. And the Federal Reserve could assist agriculture by making money growth rates more stable and predictable.

Policy makers also should not set rigid support prices, while ignoring the possible adverse effects of dollar appreciation. The surest way to avoid this problem would be to abandon domestic support prices altogether. But if support prices are retained in the new farm bill, the Secretary of Agriculture should be granted discretionary authority to adjust prices to offset currency exchange rate fluctuations. It has been suggested that Congress write an exchange rate adjustment formula into the law, but no exchange rate adjustment formula could conceivably include all the relevant future information.

Nonagricultural Trade Policy

Foreigners will buy American farm exports only if they can earn dollars by exporting their own products to the U.S. U.S. import quotas--"voluntary" or otherwise--make it more difficult for other countries to buy American exports. They also cause the dollar's overvaluation, which reduces U.S. exports to all countries, not just those directly affected by the quotas.

¹⁸ Daniel R. Vining and Thomas C. Elwertowski, "The Relationship Between Relative Prices and the General Price Level," American Economic Review 66, 1976, pp. 699-708.

¹⁹ Richard Meese and Kenneth Rogoff, "Empirical Exchange Rate Models: Do They Fit Out of Sample," Journal of International Economics, February 1983.

RECOMMENDATIONS

Since American farmers have a comparative advantage in a wide variety of products, there is no basic conflict between increasing national income and increasing farm income. The U.S. has everything to gain from encouraging farm exports. To do so, several components of domestic agricultural policy that are incompatible with freer trade must be changed. These reforms should form the core of a pro-export 1985 Farm Bill and a general strategy to stimulate U.S. exports. Among the main changes are:

1) Deemphasize or abandon traditional policies that keep domestic prices above world prices.

If price supports are retained, flexibility must be introduced to keep U.S. products competitive in changing world markets. Government support for low-income farmers should be restricted to policies that are not related to agricultural prices.

2) Substitute tariffs for quotas for all agricultural imports, as part of a general policy to be applied to all U.S. imports.

Greater conformity to the principles of the General Agreement on Tariffs and Trade (GATT) by the U.S. will encourage other members to adjust their policies as well. And while both tariffs and quotas have the effect of driving up import prices, voluntary quotas have the added disadvantage of providing the exporting country, not the U.S. Treasury, with the benefits of those higher prices.

3) Actively promote multilateral trade negotiation to reduce the average level of agricultural protection in all countries.

The U.S. must be willing to accept less protection for sugar and dairy products in order to enlarge the export market for wheat, corn, soybeans, and other products.

4) Call for a revision of GATT rules so that agricultural export subsidies would be treated the same as tariffs, and primary products the same as manufactured products.

Current rules make an artificial distinction between primary and manufactured products. This provides an excuse for agricultural export subsidies. The GATT rules permit export subsidies that do not result in "more than an equitable share of world export trade in that product."²⁰ A unified treatment of tariffs and subsidies would clarify trading rules for market participants and simplify trade negotiations.

²⁰ Kenneth Dam, The GATT: Law and International Economic Organization (Chicago: University of Chicago Press, 1970).

5) Identify lowering export subsidies as a major item on the agenda for multilateral trade negotiations.

Agricultural subsidies, leasing, government assistance to steel, and many others practices are not covered sufficiently in existing agreements. It is time for the U.S. to take the lead in calling for a major new round of trade talks, as recommended by Ronald Reagan in his 1985 State of the Union address.

6) Resist using agricultural embargoes to promote foreign policy goals.

Though economic sanctions are a highly visible form of U.S. disapproval, they seem to have little lasting impact. Moreover, there is danger that they mainly penalize U.S. agricultural exports.

7) Abandon domestic controls on acreage, production, and marketing of agricultural products.

Surpluses will not occur if domestic prices adjust to changing world conditions. Controls designed to foster monopolies and cartelization are likely to prove counterproductive in the long run as foreign competitors undercut U.S. farmers.

8) Encourage research in agriculture.

American exports of agricultural and manufactured products alike are dependent upon technological innovation and the research and development expenditures that underlie it. It is appropriate for the federal government to continue its support for basic research and to foster an environment that encourages applied research by private institutions.

9) Make fiscal and monetary policy more stable.

The Federal Reserve and Congress should pursue more predictable and stable monetary and fiscal policies. This would result in more stable currency exchange rates, thereby improving the climate for trade.

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