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U.S. Farm Subsidies and the Farm Economy:
Myths, Realities, Alternatives

by Karl Beitel †

USDA Photo by Sara Wilson

A wheat field outside of Pendleton, Oregon.

Over the last five years, groups spanning the ideological spectrum have come out in opposition to US and EU farm support payments, or subsidies. Critics of US and EU farm policy claim that subsidies are a major cause of overproduction. Overproduction depresses global prices, leading to a loss of economic viability and the destruction of small-scale agriculture, both in the US and globally. While US farm policy is highly discriminatory against smaller farmers, the excessive focus on subsidies has served to obscure the deeper forces underlying the long-term decline in global farm commodity prices. This Backgrounder will argue that declining agricultural commodity prices are rooted in the market's lack of self-correcting mechanisms. Even in the absence of subsidies, commodity markets do not tend to equilibrium or operate to ensure fair returns on farm labor. Recognizing this reality is essential to any sound reform of US commodity policy.

On the surface, the argument against subsidies is quite compelling. Reforms in US farm policy instituted after 1996 established subsidy programs in which payments to farmers are triggered once prices fall below a floor price (the *loan rate*), which is set by Congress. While these subsidies

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shelter US farms from risk, critics argue that the floor prices encourage overproduction, generating surpluses that are then dumped on the international market at prices well below the cost of production. In fact, critics claim, the main beneficiaries of subsidy payments are not farmers, but large agribusiness firms, whose access to a steady supply of cheap farm commodities reduces their costs and boosts their profits (as they don't pass through full cost savings to consumers). This line of reasoning leads to the assumption that reducing subsidies would curb overproduction and boost prices. Critics further note, correctly, that US agricultural tariffs are higher than those levied by developing countries, and call for their reduction.[1]

Without question, the current US subsidy system discriminates systematically against small farmers in the US and globally. But two linked misconceptions pervade the present subsidy debate: that subsidies are a principal—even the principal—cause of overproduction and falling prices; and, hence, that removing subsidies (and cutting tariffs) will significantly boost incomes for poor farmers in the developing world. Both these claims are inaccurate, and serve to obscure our understanding of the types of reforms that are required to restore real equity and long-term sustainability to the US and global farm economy.

Myth # 1: Subsidies Are a Primary Cause of Declining Prices

It is true that subsidies sustain production even as prices fall below the cost of production. But claims that subsidies are a primary cause of declining prices are confusing; the reality is more complex.

In part, the present confusion over the real effect of subsidies on price results from a failure to take a longer-term view of the US farm sector. When we examine the real, inflation-adjusted prices for several major US commodity crops over the last sixty years, two facts stand out: that these prices have declined steadily over sixty years; and that the price decline since 1996 has been far less severe than in previous periods, such as the years 1973 to 1986.[2] These two facts suggest that other factors underlie the longer-term decline, and that we must be careful in attributing recent trends in price chiefly to subsidies.

Furthermore, a 1998 upsurge in subsidy payments was triggered in response to falling prices, not the other way around. And prices fell not because of subsidies, but because the remaining vestiges of supply management programs were phased out in 1996, leading to increased competitive pressures on the supply side of the market.[3] Clearly, we cannot explain falling prices and stressed conditions in the global farm economy simply by pointing to the market-distorting effects of US commodity subsidies.

Myth # 2: Subsidies Are a Primary Cause of Overproduction

By keeping afloat farms that currently sell goods at below production costs, subsidies can indeed contribute to higher overall supply. But they are not the primary cause of overproduction; nor is excess supply the primary cause of falling prices and faltering farm incomes. Again, we need a more nuanced account of the actual causal effects.

Overproduction refers to a situation in which current supply exceeds current demand. Excess inventories accumulate, and prices fall. If overproduction caused the longer-term price decline, we would expect to see excess inventories rising as prices fall.[4] But inventories (in relation to usage) have remained constant or fallen for all major commodity crops (corn, rice, wheat, soy, and cotton) since the early 1980s.[5] Thus falling prices do not appear to be caused by overproduction, either before or after the 1996 subsidies were enacted. And (with the possible exception of cotton), this data offers no compelling evidence that subsidies as such are causing stocks to rise.[6]

Critics might argue that subsidy-fueled overproduction is being exported, or "dumped" overseas, and that's why we don't have climbing surpluses at home. The data don't appear to support this theory either: both the percentage of total domestic production that is exported and the US' overall share of total world exports are either constant or falling for almost all major US commodity groups since the early 1980s—including the period after 1996.

Myth # 3: Removing US Subsidies Would Boost Farmer Incomes Worldwide

To support the claim that eliminating US subsidies would boost both world commodity prices and farmer incomes in the developing world, critics cite studies that model the effects of phasing out US and EU farm supports on global output and prices.[7] But since these models rest on different assumptions, each yields different results—some estimating world price increases of 1.8 to 3.7 percent over ten to fifteen years,[8] others, that prices would decrease up to 3 percent.[9] Even the best case would lead to modest price increases and very limited benefits to select farmers.

So if subsidies are not driving declining commodity prices, what is? If eliminating subsidies won't really help poor farmers, what will?

The Perversity of the Market

In most major industrial sectors, the market works basically like this: a few dominant firms exercise significant control over price. Firms observe one another, getting to know their competitors' behavior. They tend to avoid price competition, using non-price means to increase their market share. The farm sector is very different. Many individual farmers supply a given market. No single farmer controls enough of the total market to influence price by adjusting his or her own supply. Instead, farmers have to take the market price as given and adjust their output accordingly.

To break even, farmers must at least be able to cover their fixed costs. Therefore, they will not, as a rule, respond to falling prices by taking land out of production—that is, working to raise prices by limiting supply. Just the opposite: confronted with falling prices, farmers will attempt to increase output in hopes of offsetting falling per-unit revenues by a higher total volume of unit sales. Failure to do so will put them out of business—sooner rather than later.

So the normal operation of the market—which aggregates the decisions of many individuals—is for lower prices to trigger higher output, leading to even lower prices. The farmer's imperative to cover fixed costs, and the fact that farmers generally do not coordinate their individual actions prior to bringing their goods to market, gives rise to the seeming irrationality of farmers' responding to falling prices by trying to increase output.[10] And since the demand for most food goods is relatively unresponsive to price, a significant decline in price may be required to clear the market of excess supply. Thus the overall price level tends consistently downwards—and buyers' expectations of what they will have to pay adjust ever downward, too.

One additional feature of the commodities market is critical to understanding both the downward trend in commodity prices and a likely effect of eliminating US farm subsidies. On average, it's true that farmers in the US regularly sell goods at prices below their costs of production. But this doesn't mean all farms in a given sector are operating at a loss. Detailed studies by the USDA indicate that in most major US commodity sectors, larger farms continued to post positive net returns through 2001 (the last year for which relevant data is available). These producers—the large commercial growers—set the market standard for price: as their costs fall, market prices can fall below the average US farmer's cost.

Large growers' ability to "beat the market" means that removing subsidies could actually improve their competitive advantage. Furthermore, though subsidy payments favor large growers, many small- to medium-sized commodity farmers do depend on subsidies to survive. Cutting subsidies to these farmers would accelerate farm consolidation.

Alternatives

The commodities market by itself will never guarantee farmers a price that will cover their costs, because it cannot correct itself in the ways other market sectors can. Deregulating this market further—which is what eliminating subsidies would entail—will not and cannot defend the existence of small- to medium-sized family farms, either in the US or abroad.

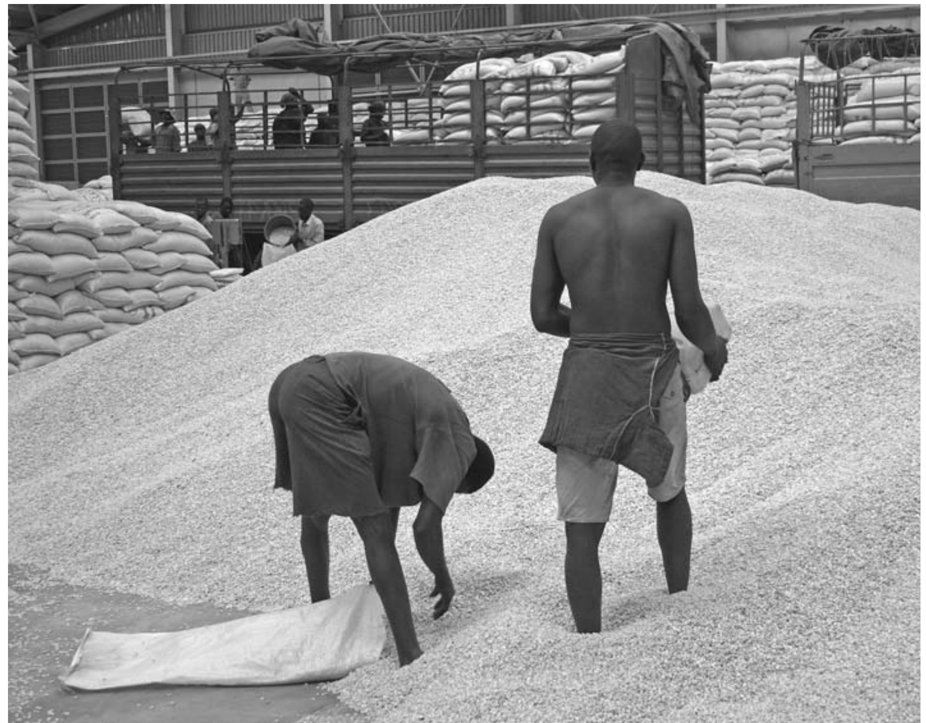
Photo courtesy USAID/Chemonics/M. Herrick

Workers in Uganda bag maize seed.

The only way to stabilize farmers' incomes and preserve a viable, diverse agricultural system is through some combination of price supports and supply management. Government price supports are the most effective means of stabilizing price and offsetting the negative consequences of rapidly falling prices: farmer bankruptcy, land loss, accelerated farm consolidation, and the competitive pressure to shift to more input-intensive farming methods. Supply management programs, which allow the government to mandate land set-asides when surpluses arise, can help compensate for farmers' lack of control over commodity prices; they can also be extended to embrace conservation initiatives and sustainable land management practices, benefiting the environment as well.

To be effective, price supports need to be complemented by better tariff controls on imported farm goods. Such a policy prescription, of course, runs completely counter to the entire neoliberal thrust of the last twenty-five years, and would effectively remove US farm policy from the regulatory jurisdiction of the WTO, signaling the end of the WTO's Agreement on Agriculture. This would, in our estimation, be a welcome development. If tied to complementary reforms of the international financial system that would allow developing countries to determine and direct their own internal development policies, this shift could open the path to real alternatives that would allow small and mid-size farms to cover thieir costs and continue to serve as stewards of the land.[11]

Pursuing such alternatives is an urgent necessity. Market liberalization does not, in itself, launch developing countries on a path of sustainable long-term growth capable of lifting their populations out of poverty. In fact the market, left to operate free from government intervention, will only exacerbate economic pressures in large segments of the rural farm sector, both in the US and globally. The farm sector has historically been subjected to extensive regulatory controls, which are needed to compensate for the market's inherent failures. An alternative to crippling free market policies exists: what is required is the political will to bring it about. Progressive agricultural and trade groups North and South must move beyond the subsidy debate and unite in support of alternatives that will sustain the world's farmers and ecosystems.

Notes

1. For various statements of this position, see Oxfam International (2002a) *Rigged Rules and Double Standards: Trade, Globalization, and the Fight Against Poverty;* Oxfam International (2002b) *Cultivating Poverty: The Impact of US Cotton Subsidies on Africa;* Oxfam International (2002c) *Stop the Dumping! How EU Agricultural Policies are Damaging Livelihoods in the Developing World;* B. Riedl (2002) *How Farm Subsidies Became America's Largest Corporate Welfare Program* Backgrounder No. 1520, Washington, DC: The Heritage Foundation; World Bank (2004) *Global Economic Prospects 2004: Realizing the Development Promise of the Doha Agenda;* and World Bank (2005) Global Agricultural Trade and Developing Countries.
2. Data on prices can be found at www.ers.usda.gov. The charts showing historical time series of real (inflation-adjusted) prices can be viewed at www.foodfirst.org/backgrounders/subsidies/real_prices
3. D. Ray, D. de la Torre Ugarte, and K. Tiller (2003) *Rethinking US Agricultural Policy: Changing Course to Secure Farmer Livelihoods Worldwide,* Agricultural Policy Analysis Center, University of Tennessee.
4. Excess inventory is measured by the "stock-to-usage ratio," which refers to the ratio, at year's end, of the amount of a commodity currently held in stock to the total amount of the good actually utilized—refined, processed, and/or sold to consumers —over the course of the year.
5. Some caution is warranted in interpreting this data, given significant cyclical variability in these ratios, and the fact that stock-to-usage ratios can decline yet still be at high enough levels to trigger falling prices. These caveats notwithstanding, the observed trend does not lend prima facie support to the claim that overproduction per se is driving a systemic decline in price. Data on stock-usage ratios is calculated from data available at USDA, Economic Research Service. To view full data table, go to www.foodfirst.org/backgrounders/subsidies/stock_usage
6. This argument is not stating that subsidies have no effect on output. Certainly, subsidies can sustain farm production as prices fall below costs. However, the longer-term trend does not support the claim that subsidies have triggered an explosive cycle of overproduction, leading to falling prices, given that stock-to-usage ratios are constant or falling somewhat in all cases except cotton.
7. See Oxfam, 2002a, ibid.
8. J. C. Beghin, and D. Roland-Holst (2002) *Global Agricultural Trade and the Doha Round: What are the Implications for North and South?* Center for Agricultural and Rural Development, Iowa State University; IFPRI (2003) *Impact of Alternative Trade Policies on Developing Countries,* Washington, DC: International Food Policy Research Institute; J. Monteagudo and M. Watanuki (2002) *Evaluating Agricultural Reform Under the FTAA* and *Mercosur-EU FTA for Latin America: A Quantitative CGE Assessment,* Washington, DC: Inter-American Development Bank.
9. Ray, et al., ibid. For a comprehensive assessment of simulation studies, see T. Wise (2004) *The Paradox of Agricultural Subsidies: Measurement Issues, Agricultural Dumping, and Policy Reform,* Global Development and Environment Institute, Tufts University.
10. Arguments along these lines can be found in Daryll Ray's columns, available at www.apac.org; see also F. Magdoff (2005) "A Precarious Existence: The Fate of Billions" *Monthly Review* 55:9 (1–14).
11. For some outlines of alternative policy regimes, see S. Amin (2003) "World Poverty, Pauperization, and Capital Accumulation" *Monthly Review.* October 2003, 55:5, pp 1-9; H. Chang and I. Grabel (2004) *Reclaiming Development: An Alternative Policy Manual* London: Zed Books; and O. Ugarteche (2000) *The False Dilemma: Globalization, Opportunity or Threat?* London: Zed Books.

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