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Some Trade Implications of the 2014 Agricultural Act

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The United States, Japan, and the European Union (EU) all subsidize their farmers heavily. Together these three regions account for over 80% of Organisation for Economic Co-operation and Development (OECD) farm subsidies, totaling about $300 billion per year. The Uruguay round of the General Agreement on Tariffs and Trade (GATT), which concluded with the establishment of the World Trade Organization (WTO), aimed to rein-in farm subsidies in these and other countries, and to modify farm subsidy programs to be less production- and trade-distorting. Since the completion of the Uruguay round in 1995, farm subsidies have declined in the EU and Japan. Unfortunately, after Congress passed the 1996 Farm Bill (the Federal Agriculture Improvement and Reform Act), U.S. farm subsidy programs expanded. The trend towards larger subsidies in the United States was reinforced through the provisions of the 2014 Farm Bill. The new legislation not only expands subsidies paid to U.S. farmers but also ties those subsidies more directly to recent and current production and market conditions and, therefore, makes them more production- and trade-distorting. On both counts (larger and more distortive subsidies), the 2014 Farm Bill fails the test of being consistent with WTO objectives.

The WTO's Doha round, initiated in 2001, has focused over the past 13 years on reducing agricultural trade distortions. The provisions of the 2014 Farm Bill, which chart a diametrically opposite path, may well have cost the United States any credibility in future agricultural trade negotiations in the Doha round. Perhaps even more importantly, the 2014 Farm Bill has undermined U.S. credibility in regional trade negotiations targeted at improving market access and protecting intellectual property in both agricultural and larger non-agricultural sectors of the U.S. economy.

Expanding global trade is an explicit economic goal of the Obama Administration. In his State of the Union Address in 2010, President Obama announced the National Export Initiative and set a goal to double American exports by the end of 2014, including agricultural exports. U.S. agricultural exports are forecast at a record $149.5 billion in fiscal 2014, up from $108.5 billion in 2010. This is almost a 40% increase and it reflects a significant expansion of exports to China, Canada, and Mexico, among others. During this five-year period, dairy exports doubled with exceptionally strong export sales to Asian economies. The 2014 Farm Bill may lead to even more domestic U.S. production and higher exports, but at the same time, it will draw international attention to the fact that, for a large number of commodities, U.S. agricultural exports are being influenced by domestic subsidies.

The United States is promoting freer trade through the Trans Pacific Partnership (TPP). The TPP was initiated in order to create a platform for economic integration across the Asia-Pacific region. The 12 TPP members (Australia, Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States, and Vietnam) account for close to 40% of the world's economy and one-third of world trade. The U.S. Administration has championed the TPP as being an upgrade to existing trade agreements. The U.S. government stated that it was particularly interested in greater market access for agricultural products in TPP countries. Passage of the new farm bill

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has made this outcome less likely. The TPP initiative is clearly at odds with agricultural protectionism in U.S. Congress. If the TPP fails because of the provisions of the highly protectionist 2014 Farm Bill, then the economic costs of the farm bill will go well beyond domestic welfare costs associated with deadweight losses due to inefficient income transfers and unproductive lobbying activities. In addition, there are likely to be significant foregone economic benefits associated with failure to attain greater economic integration in the Asia-Pacific in sectors outside of agriculture.

Many aspects of the 2014 Farm Bill conflict with U.S. commitments under current international trade agreements. One obvious conflict is the so-called commodity *crop insurance*—now even more transparently product-specific and more trade distorting (Smith and Glauber, 2012)—a policy that could be successfully challenged by WTO members. However, two other aspects of the 2014 Farm Bill are especially noteworthy in conflicting with the international trade commitments of the United States.

The first is that the U.S. Congress failed to modify mandatory Country-of-Origin Labeling (COOL) on meat products despite its clear violation of WTO rules. Efforts by important agricultural groups such as the National Cattlemen's Beef Association and some Congressional members failed to terminate the COOL program when rewriting the farm bill. In other words, the WTO did not seem to be important to the U.S. House and Senate agricultural committees, the chairs of both who recognized that COOL was probably a serious WTO violation but found it more politically convenient to ignore the issue.

The second is the farm bill's new dairy margin insurance program. One implicit reason this program was introduced was to offset adverse effects on dairy net returns from the substantial increases in corn prices arising from U.S. biofuel policies, a clear example of unintended consequences of policy interaction that may well raise international objections and potentially lead to a trade dispute. Both COOL and the dairy margin insurance scheme are discussed in more detail below.

Mandatory Country-of-Origin Labeling

The 2014 Farm Bill failed to modify COOL as it applies to meats, a highly contentious and protectionist policy, especially affecting two close and important agricultural trading partners, Canada and Mexico. Supporters of COOL often point to surveys that show consumers have a stated preference for country-of-origin food labeling, but economic logic suggests that the benefits of COOL are unlikely to outweigh the costs of compliance. Surveys do indicate that American consumers say they would prefer to buy U.S. food products if all other factors were equal, and that consumers believe American food products are safer than imports. However, existing inspection rules ensure that foreign and domestic meats are processed using the same standards. Furthermore, surveys also suggest that labeling information about freshness, nutrition, storage, and preparation tips is more important to consumers than country-of-origin. More tellingly, the fact that the food industry has not found it profitable to voluntarily provide COOL is strong evidence that willingness to pay for this information does not outweigh the cost of providing it.

COOL was introduced in the 2002 Farm Bill (Carter, Krissoff, and Zwane, 2006) but not fully implemented until the 2008 Farm Bill. In 2009, Canada and Mexico filed WTO complaints against the United States' application of its COOL policies to meat—cattle, hogs, beef, and pork. Canada and Mexico alleged that COOL violated several WTO articles and is, therefore, an illegal barrier to trade under the Agreement on Technical Barriers to Trade (TBT Agreement). The WTO agreed with Canada and Mexico. According to the WTO, not only does COOL favor domestic meat products and affords less favorable treatment to meat products from Canada and Mexico, but the policy fails to adequately achieve its purpose of providing information to consumers about the country of origin. The U.S. Department of Agriculture (USDA) amended the challenged version of COOL, but the new version of COOL is perhaps even more onerous than the first. USDA's revision to COOL requires *born*, *raised*, and *slaughtered* production step labels. The American Meat Institute has pointed out that COOL causes companies to source their meat domestically in order to simplify compliance with labeling requirements. As a result, consumers do not have access to a variety of imported meats that may be either of higher quality or offered at a better price.

One of the main arguments in favor of COOL, the consumers *right to know*, has also been used to justify mandatory labeling of genetically modified (GM) food in Europe. Ironically, the U.S. government has strongly opposed mandatory GM labeling, and for good reason. The United States considers the EU's mandatory labeling of GM foods to be an unfair trade practice. In practice, GM labeling has not given EU consumers greater choice because food processors in Europe have recombined ingredients away from GM food to avoid labeling. This pattern is now developing with COOL and, therefore, U.S. consumers will see their choices reduced because labeled imported food will not be made readily available. The irony of the United States criticizing mandatory GM food labeling on the one hand and then mandating COOL on the other is not lost on U.S. trading partners.

Implicit Dairy Export Subsidies

Dairy subsidies received a potentially substantial boost in the 2014 Farm Bill. The legislation replaced the *Milk Income Loss Contract* and *Dairy Price Support* programs with a new *Margin Protection Program* (MPP). Dairy farmers can participate in either the new MPP or use the *Livestock Gross Margin Insurance* (LGM) for dairy, an insurance product introduced by the USDA Risk Management Agency in 2008. MPP creates a new *margin insurance* scheme that offers generous *insurance* payouts if there is a decline in average dairy income-over-feed-cost margins. Any dairy in the United States now has access to government-subsidized margin protection on up to 90% of their recent historical production. When dairy margins drop, government payments will be exponentially larger than under the previous legislation.

The MPP pays indemnities when the average difference between the national milk price and a feed ration index falls below a user selected coverage level. Margin protection is available from $4.00 to $8.00 per hundredweight and offers protection on up to 97% of the historical average margin. Payouts under the program are, therefore, likely to be frequent and may be very substantial. When dairy margins are low, as was the case in 2009 and again in 2012 (during the drought), indemnities to dairy farmers with an $8.00 level of margin coverage could result in annual taxpayer costs of about $5 billion dollars (Nicholson and Stephenson, 2014).

WTO members such as New Zealand, who have a comparative advantage in dairy exports, could challenge the U.S. meld of a subsidy and an insurance program. In 1999, based on a complaint from New Zealand and the United States, the WTO ruled that Canada was dumping subsidized dairy exports. Canadian dairy exports were found to benefit from implicit export subsidies arising from Canada's *supply management* program. It is plausible that the new U.S. dairy subsidies could be similarly viewed as constituting an export subsidy even though payments are tied to a dairy's recent historical production rather than current year production.

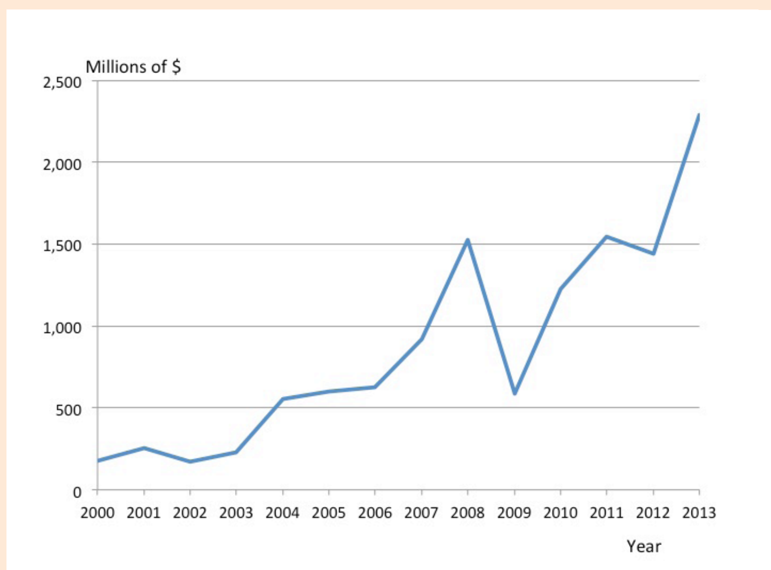
This program could be challenged through either the WTO (under the Agreement on Subsidies and Countervailing Measures—the SCM agreement) or through member antidumping and countervail duty laws. If corn prices spike and there is a big subsidy payout to U.S. dairy farmers then export prices would be lower than domestic U.S. milk prices inclusive of the subsidy. Viewed alternatively, export prices would be lower than U.S. production costs, a violation of trade law. Why is this an issue? Well, there is clearly a conflict between the 2014 Farm Bill and the growth in U.S. dairy exports. The U.S. dairy industry exports about 16% of its production (Figure 1) and is, therefore, vulnerable to a WTO ruling against U.S. dairy subsidies.

Analysts often treat government policies in isolation from one another, failing to recognize important interaction effects. Adverse interactions between the 2014 Farm Bill and the 2007 Energy Independence and Security Act (EISA) raise some important issues from the perspective of United States' trading partners. The EISA mandated use of over 14 billion gallons of corn ethanol in 2014, removing about one-third of U.S. corn from the market and driving up dairy feed costs. In turn, in response to higher feed costs, the 2014 Farm Bill MPP will now provide new subsidies to dairy farmers. You cannot blame the dairy lobby for seeking subsidies to offset losses due to the corn ethanol lobby, but the net effect is very costly to taxpayers and other industries that would benefit from freer international trade—especially in the Asia-Pacific region.

Concluding Comments

The U.S. dairy industry viewed the 1999 WTO ruling against Canadian dairy exports a significant trade victory. It is paradoxical that the 2014 Agricultural Act invites a similar international challenge to U.S. dairy exports. The U.S. biofuels policy has driven up the price of animal feed and

Figure 1: U.S. Milk Powder Exports



Source: USDA, FAS, GATS. HS code: 0402, Milk Concentrated.

now the farm bill has introduced a counteracting policy to subsidize dairy farmers when their price-cost margins are low. The net effect is that the corn ethanol lobby may have inadvertently subjected U.S. dairy exports to a potential international challenge.

Various aspects of the 2014 Farm Bill send a message to trading partners that U.S. agriculture is becoming more protectionist. Furthermore, the new farm bill indicates that international trade commitments have little or no influence over U.S. farm policy choices. This is unfortunate because foreign markets are extremely important to U.S. agriculture and so the industry has a huge stake in increased trade liberalization, not more protectionism. Lobby groups pushing for larger and more distortive subsidies are very shortsighted.

For More Information

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