Agricultural Free Trade and the Southwest

For several years, the United States has worked to open foreign agricultural markets and remove domestic subsidies that distort prices. A multilateral agreement with many countries is currently under negotiation through the General Agreement on Tariffs and Trade (GATT). (*See the box titled "Will GATT Talks Open Trade?"*) Totally free trade in agriculture will not be obtained quickly, but the GATT is taking steps toward this goal.

Free trade in agriculture would mean an increase in consumer prices for most agricultural products. Yet, free trade in agriculture would benefit the United States. Why? Aggregate world output and income would rise, on net, despite higher world commodity prices. The rise in agricultural prices would be smaller than the reduction in taxes currently used for agricultural subsidies. This gain would occur because free trade implies the reallocation of production toward its most efficient locations. Only the most efficient farms would survive because markets would not be protected from competition. But the low-cost producers would increase output.

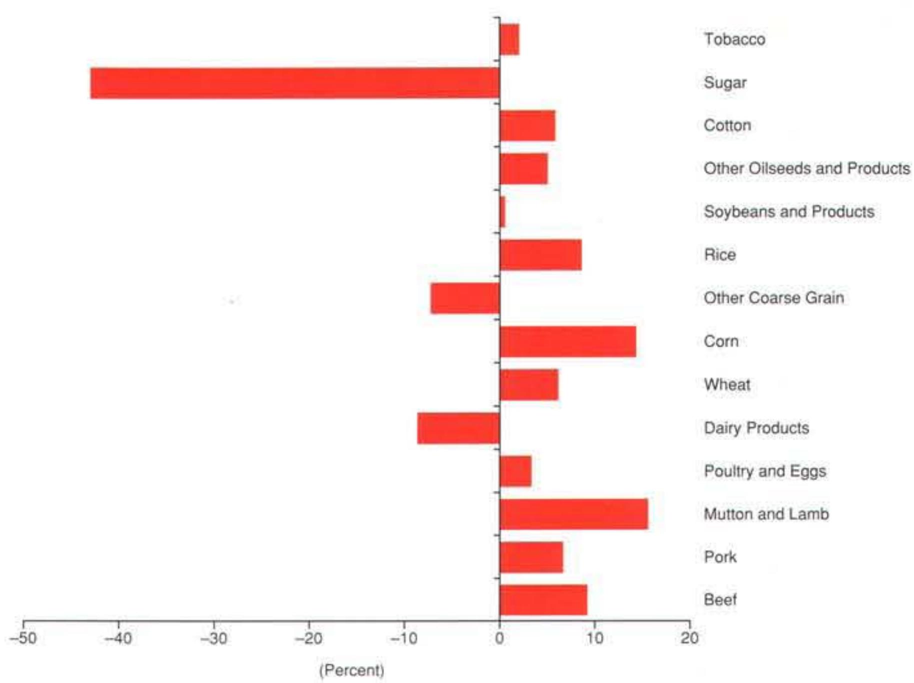
The resulting increases in production and income would not benefit everyone, however. Many farmers who are subsidized or protected from competition—including some Southwestern producers of rice, sugar, cotton and grains—would lose money if they continued to produce their crops in a free market.

The Cost of Protection

Many governments have created domestic programs and trade barriers to subsidize their agricultural sectors and protect them from foreign competition. These programs are an expensive way to transfer income from consumers and taxpayers to agricultural producers.

Farm subsidies lower domestic prices below world prices, encouraging domestic consumption rather than trade. This effect—along with

Chart 1
Estimated Change in U.S. Consumer Prices Resulting from Multilateral Trade Liberalization



Will GATT Talks Open Trade?

Agricultural trade liberalization is the focal point of the current round of the General Agreement on Tariffs and Trade (GATT). The GATT, which includes more than 100 countries, was created at the end of World War II to provide an international forum to advocate less government interference in all international trade. The GATT is working to increase world economic growth by reducing governmental protection and trade-distorting subsidies.

The current round of negotiations, called the Uruguay Round because it was started in Uruguay, is the most ambitious and complex ever undertaken by GATT. The Uruguay Round almost collapsed last year after four years of negotiation. Agricultural issues provoked such disagreement that negotiators, in effect, risked sacrificing agreements in other areas, such as services and foreign investment, to induce an agreement on agriculture. Without a GATT agreement, the current U.S. farm bill will allow increases in U.S. agricultural support and trade barriers.

The original U.S. proposal to GATT did not include the total trade liberalization discussed in the accompanying article. Instead, the United States and the Cairn's Group, a coalition of 13 nations exporting agricultural commodities, proposed a 90-percent cut in export subsidies and a 75-percent cut in internal supports over 10 years. This proposal was bold in comparison with the one from the European Community, which recommended a 30-percent cut in subsidies.

The United States is not likely to remove trade barriers without a commitment by other countries to open their markets. Removing only U.S. barriers would flood U.S. markets with foreign products without increasing the demand for domestically produced goods. U.S. agricultural prices would decrease more than if all countries removed trade distortions. And producers' income losses would be greater because increased output would not help compensate for price decreases.

Even if GATT fails, the United States may see freer trade. The United States has arranged a free trade agreement with Canada and is negotiating agreements with several other nations, including Mexico. With such agreements, U.S. producers would have to make adjustments similar to those mentioned in the accompanying article, although in much smaller magnitudes.

more blatant trade barriers, such as quotas and tariffs—provides incentive for many of the world's higher-cost producers to produce. Resources that could be used to meet consumer demands in other sectors are attracted instead to commodity production because of government support. This distortion lowers national efficiency.

The U.S. Department of Agriculture (USDA) estimates that in 1986 inefficiencies caused by agricultural subsidies reduced U.S. income by $9.2 billion in addition to the taxes spent on farm programs and consumers' extra expenditures required to pay artificially high farm product prices.

Taxpayers may choose to

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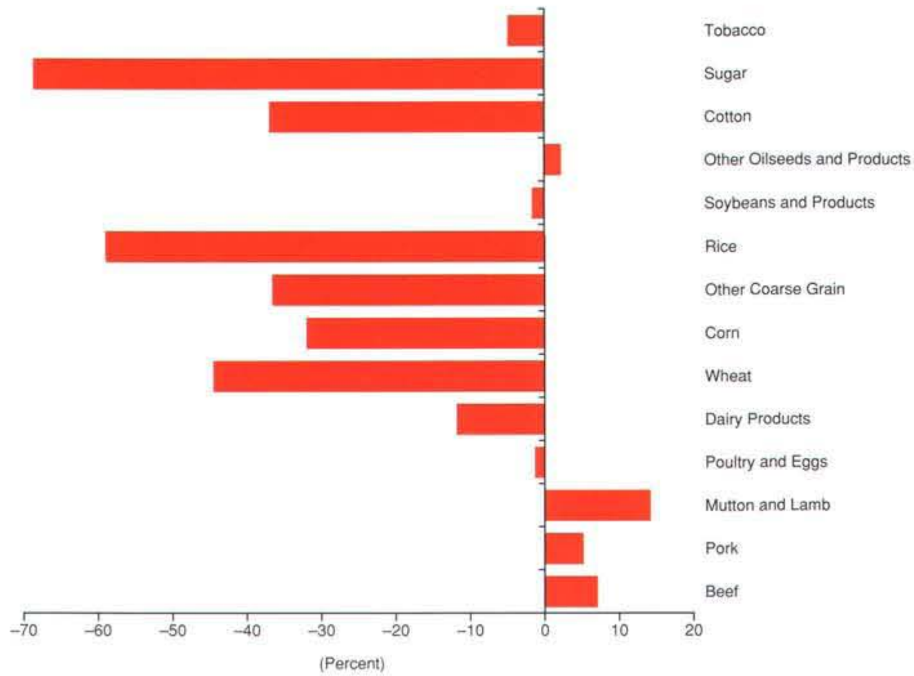
Chart 2
Estimated Change in U.S. Producer Prices Resulting from Multilateral Trade Liberalization



"With free trade, national policies would have no trade effects and agricultural product markets could function as if countries had no borders."

continue to transfer resources from the nonfarm sector to the farm sector, but a more efficient approach simply would be to write checks directly to agricultural producers. Such a plan could achieve the same farm income goal while increasing overall output and income. Most current trade liberalization proposals include lump-sum transfers to low-income producers.

Free Trade Increases Overall U.S. Output and Income

Free trade in agriculture would require the elimination of all trade-distorting agricultural policies, including subsidies. With free trade, national policies would have no trade effects and agricultural product markets could function as if countries had no borders.

Domestic producers would face world prices. This competition would encourage the world's low-cost agricultural producers to increase output, while high-cost agricultural producers would likely transfer their resources into other uses.

Without trade barriers, each country would specialize in producing the goods, whether farm or nonfarm, in which it is comparatively more efficient than other countries. Countries would then trade for commodities for which they are comparatively less efficient producers. Resources would be channeled from low-productivity uses to high-productivity uses, permitting higher levels of consumption and investment.

Under free trade, a U.S. producer of rice or sugar, for example, may find production unprofitable without subsidies. This producer would then transfer land, investment and management talent into a more profitable business. The producer's resources would be used more efficiently, and the U.S. Treasury would save the cost of the subsidy.

Taxpayers benefit from agricultural trade liberalization. The USDA estimates that in 1986 eliminating government agricultural programs would have saved the Treasury $30.9 billion. Producers' income would have declined $16.2 billion, while higher food prices would have reduced consumers' disposable income by $4.2 billion. The savings to the Treasury could more than compensate producers and still increase taxpayers' net income. Full compensation to producers would leave a $14.7 billion savings for the Treasury.

Free Trade Generally Reduces U.S. Agricultural Income

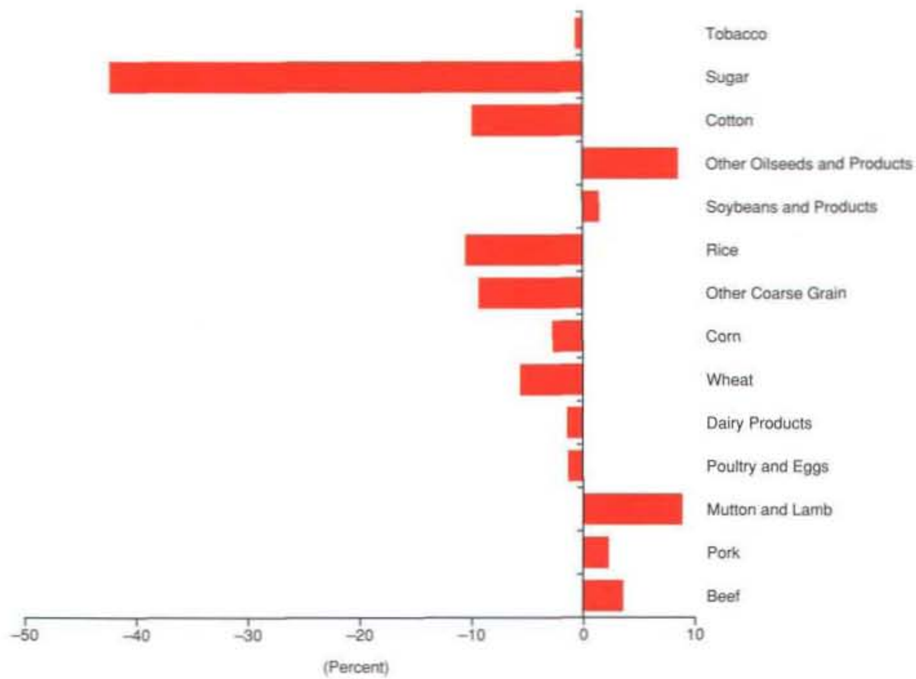
Worldwide trade liberalization would not significantly change world demand for agricultural products. However, what would change is where agricultural commodities are produced, and trade between countries would increase significantly. A USDA study suggests that trade liberalization would improve the U.S. balance of trade in agriculture and increase U.S. farm exports by nearly 25 percent.

The elimination of government support would increase prices for most domestically produced agricultural commodities (*Chart 1*). Consumer price increases would be greatest for lamb and corn. Sugar and dairy product prices would decline, however, because current government policy holds their prices artificially high to help pay the producer subsidies.

Reduced agricultural support would also decrease the prices producers receive for most products (*Chart 2*). Producer prices for more heavily subsidized products, such as sugar and rice, would decline the most. The producer prices of cotton, corn, wheat and other coarse grains would also decline substantially. Livestock prices would increase because of expanded export demand. Livestock production currently receives very little government support, and the loss of its subsidy would have little effect.

Although overall U.S. agricultural output would remain virtually unchanged, the composition of production would change markedly with freer trade (*Chart 3*). Output would increase for products with rising producer prices and would fall for commodities with declining producer prices.

Chart 3
Estimated Change in U.S. Agricultural Output Resulting from Multilateral Trade Liberalization



Full trade liberalization, with total elimination of government support, would reduce gross U.S. agricultural income. Higher consumer prices would increase producer income from the sale of farm products. Producers would also benefit from a lower cost of production because of reduced administrative costs and greater efficiency. But for most producers, declining production costs and increased consumer prices would not compensate for the loss of government support (*Chart 4*). Income would decline for most crops. Producers of cotton, sugar, rice, wheat, corn and other coarse grains would have the largest income losses because these crops are heavily subsidized. Free trade, however, would raise the income of livestock producers. Increased foreign demand for beef, pork and lamb would boost livestock prices. These increases would more than

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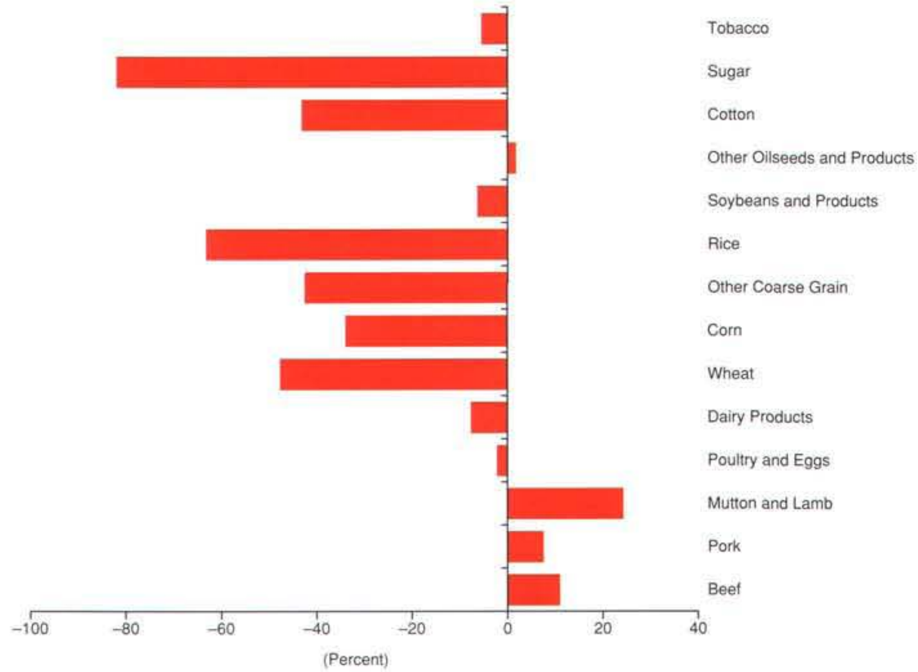
Chart 4
Estimated Change in U.S. Agricultural Gross Income Resulting from Multilateral Trade Liberalization



"For each region, the effects of free trade would depend on the level of current government agricultural support and the relative efficiency of commodity production."

compensate for rising feed grain prices.

Trade liberalization also would affect production of fresh fruits and vegetables. Freer trade could cause major shifts in trade patterns of fresh fruits and vegetables.

In the United States, fruit producers probably would fare better than vegetable producers because in winter months fruit producers face less foreign competition than vegetable producers. Relaxed trade barriers also would increase opportunities to export U.S. fruit. Prices and production of U.S. fruit might increase slightly, if they changed at all. However, fruit and vegetable growers receive little government support, so adjustments in these markets would not be as great as those in markets for other commodities.

Lower expected agricultural profits would decrease agricultural land values. The price of farmland reflects its potential income, which currently includes profits that are artificially high because of farm support programs. Moreover, farm programs have removed agricultural land from production, boosting land prices by reducing the supply of farmland.

The elimination of programs that restrict output would return unused agricultural land to production. As a result, the total supply of agricultural land would increase, and farmland prices would decrease.

The effects of liberalized agricultural trade will reach beyond farm production. Some nonagricultural sectors of the economy will suffer, but most will benefit. (*See the box titled "Effects of Free Trade on Nonagricultural Sectors of the Economy."*)

Trade Liberalization and Southwest Farmers and Ranchers

For each region, the effects of free trade would depend on the level of current government agricultural support and the relative efficiency of commodity production. States receiving larger amounts of agricultural subsidies would be hurt more than states receiving lower subsidies. States

Effects of Free Trade on Nonagricultural Sectors of the Economy

Free trade in agriculture would also affect nonagricultural sectors of the economy. For most sectors, free trade would increase income because resources that had been attracted to agriculture through subsidies and protection would be diverted elsewhere. But the nonagricultural sectors that benefit from agricultural subsidies would be hurt by the elimination of protection and subsidies.

More than 35 percent of the effects of farm subsidies accrue to nonagricultural sectors of the economy through the lower cost of subsidized commodities. For example, agricultural subsidies hold down input costs for the food processing and apparel industries. The transportation, warehousing, insurance and retailing sectors also benefit from subsidized commodity prices and the artificially high production they encourage. Free trade would increase input costs for some industries and reduce demand for other industries. Income would decline for either type of industry.

For example, a manufacturing firm whose inputs include agricultural commodities would face higher input prices for some commodities under free trade. These increased costs would lead to slight declines in output and income for many food processing, canning, apparel and textile firms. Reduced agricultural output would lower demand for services and wholesale and retail trade, as well as for banking and insurance firms that focus on agricultural markets.

Freer trade would have a more positive effect on producers using livestock byproducts as an input. The increased supply of livestock byproducts and the fall in their prices would boost output and income for these producers. Transportation of livestock would increase, although transportation of crops would decline.

Despite losses in specific sectors, freer trade would have a positive effect on the U.S. economy because the gross national product would increase as resources are diverted to more productive activities.

producing crops that can be grown more efficiently elsewhere in the world would be hurt. Regions that efficiently produce commodities in demand around the world would benefit from free trade.

In general, freer agricultural trade would increase the income from livestock and reduce the income from most crops. More than 60 percent of agricultural income in New Mexico, Oklahoma and Texas currently comes from the production of livestock. Free trade would likely increase income from livestock production in all three states.

In New Mexico, the increase in livestock income is likely to compensate for the reduction in crop income. New Mexico does not produce many crops that receive government subsidy.

In Texas and Oklahoma, the increase in livestock income would not entirely compensate for the loss of subsidized crop income, but agricultural income would drop only slightly.

"The economy, both in the United States and the Southwest, would benefit because resources would be reallocated to their most efficient uses."

Free trade would reduce agricultural income sharply in Arizona and Louisiana. Livestock production contributes only 30 percent of agricultural income in each state. Increases in livestock production would not be sufficient to offset reduced production of subsidized commodities.

Arizona agricultural income could drop 8 percent. For Louisiana, free trade could generate a 30-percent loss in farm income—one of the highest losses among the 50 states. More than 40 percent of Louisiana agricultural cash receipts now come from the production of cotton, rice and sugar, all of which receive large subsidies. Production of these commodities would fall about 42 percent with free trade.

Conclusion

Free trade in agriculture would remove government farm subsidies and protection, reducing income for most U.S. crop producers and increasing income for U.S. livestock producers. Agricultural income could increase in New Mexico and decline slightly in Oklahoma and Texas. Farm income would decline more severely in Arizona and Louisiana.

Despite increases in many commodity prices, overall U.S. output and income would increase. The economy, both in the United States and the Southwest, would benefit because resources would be reallocated to their most efficient uses.

—Fiona Sigalla

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