Decoupled Payments

Household Income Transfers in Contemporary U.S. Agriculture

Introduction

Domestic agricultural subsidies were brought under the discipline of global trade rules for the first time in the Uruguay Round of the General Agreement on Tariffs and Trade (GATT), which concluded in 1993. In order to reduce the spillover of domestic support onto world markets, GATT members agreed to limit expenditures on domestic agricultural subsidies, with some important exemptions (table 1). One is decoupled income support to producers. This support is defined in the Uruguay Round Agreement on Agriculture (URAA) as payments that are financed by the government (taxpayers) rather than by consumers, are not related to current production, factor use, or prices, and for which eligibility criteria are defined by a fixed, historical base period. (See box on URAA criteria for exemption of domestic support from expenditure limits.) The exemption of decoupled payments provides members of the World Trade Organization (WTO)—the successor organization to the GATT—with the flexibility to transfer income to their agricultural producers, but in a manner presumed to have minimal potential to distort production and trade.

Global agricultural trade negotiations resumed in March 2000 in Geneva. They have since been subsumed into the full round of trade negotiations launched in Qatar in November 2001 by the WTO. The new round, called the Doha Development Agenda, will continue the global agricultural policy reform process begun in the Uruguay Round. The negotiations are expected to address further constraints on domestic support and may include discussion of the criteria under which some policies should continue to be exempt from expenditure limits.

The United States adopted decoupled payments, called Production Flexibility Contracts (PFCs), in the Federal Agricultural Improvement and Reform (FAIR) Act of 1996. PFCs were considered to be a minimally distorting means to transfer income to U.S. agricultural producers. The United States will continue to use decoupled payments, now called “direct payments,” in the 2002 Farm Security and Rural Investment (FSRI) Act. Decoupled payments are also used by Mexico, which introduced fixed, annual payments to eligible producers in its PROCAMPO program, initiated in 1993. Recent policy reforms in Japan and the proposed reforms in the European Union increase the market orientation of their farm sectors, although subsidies in these countries continue to be linked to current production or prices and are therefore not decoupled.

For decades, economists have proposed decoupling support to agriculture as a way to facilitate agricultural reform (Beard and Swinbank). Decoupled support is advocated because it does not distort relative prices and therefore does not attract additional resources into the sector. In addition, payments that do not fluctuate with production or prices avoid the production distortions arising when programs act like insurance policies against low prices (Hennessy).

However, many countries have taken the position that, based on the experience with the URAA, the implementation of a minimally distorting payment has proven to be impossible. There are many conditions under which lump-sum payments can lead to production impacts. This outcome depends on certain assumptions about farmer tolerance for risk, farmer expectations about future payments, and the efficiency of factor—land, labor, and capital—markets (e.g., Tielu and Roberts; European Commission; OECD). Some countries argue that these market conditions exist and lump-sum payments therefore increase aggregate production. Consequently, they argue for lump-sum payments to face similar expenditure limits as traditional, distorting, commodity-based farm subsidies.

This report examines the U.S. experience with decoupled payments in its PFC program during 1996-2002 from the perspective of trade policy. It asks whether the decoupled payments have distorted U.S. agricultural production and therefore trade. Using data on farm households that participated in the PFC program, we analyze the effects of decoupled payments by looking at how the payments increased the income and wealth of participants and change farm household consumption, saving, investment, and work. These decisions can result in changes in the supply of resources to agriculture and in aggregate agricultural production.

Table 1—Treatment of domestic agricultural support in the Uruguay Round Agreement on Agriculture

Category	General criteria	General examples of policies	Examples of U.S. programs
Exempt domestic support (green box)	Measures must be financed by the government rather than consumers and must not provide price support to producers Specific criteria are defined for general government services, public stockholding, domestic food aid, decoupled income support, and other programs	Direct payments to farmers that do not depend on current production decisions or prices; disaster assistance; and government programs on research, extension, and pest and disease control	Production Flexibility Contracts
Exempt direct payments under production-limiting programs (blue box)	Production-limiting programs must be based on fixed area or yields, or cover 85 percent or less of the base level of production or head of livestock	Direct payments to producers, linked to production of specific crops, but which impose offsetting limits on output	U.S. deficiency payments program with set-asides under 1990 farm legislation
Nonexempt support (amber box)	Market price support, nonexempt direct payments and any other subsidies not specifically exempted are subject to reduction commitments	Market price supports, and output and input subsidies	Marketing loan benefits, Market Loss Assistance payments (1998-2002)

Note: Exempt domestic support, exempt direct payments, and nonexempt support are the categories of support in the WTO Agreement on Agriculture and correspond to the popular names of green, blue, and amber boxes, respectively.
Source: Uruguay Round Agreement on Agriculture, WTO.

Rules From the Uruguay Round Agreement on Agriculture on the Exemption of Domestic Support From Expenditure Limits

The Uruguay Round Agreement on Agriculture specifies criteria that green-box domestic support must meet in order to be exempted from expenditure limits. These criteria address program design and implementation. Many types of domestic support are exempted in addition to decoupled payments, including extension services, pest and disease control, stock holding for domestic food security, domestic food aid, disaster relief, and environmental programs. All exempted domestic support must meet the same *general criteria*:

- Support must be provided through a publicly funded government program.
- The support may not have the effect of providing price support to producers.

Different *specific criteria* exist for each type of program exempted from domestic support limits, reflecting their broadly differing objectives. For example, environmental payments must require specific production methods or use of inputs related to well-defined environmental goals and may only compensate for additional costs of compliance, in addition to meeting the general criteria for exemption. For decoupled income support to be exempt, the following specific criteria must be met:

- Eligibility must be defined by some clearly defined criteria in a fixed base period.
- The amount of the payment must not be related to the type or volume of production, prices, or factor employment in any year after the base period.
- No production shall be required in order to receive the payment.

Source: Uruguay Round Agreement on Agriculture, Annex 2, WTO.