Policy Options for Import Competing Commodities
Consistent with Trade Liberalization

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Congress will write a multi-year farm bill in 2001 or 2002 to replace the 1996 Federal Agriculture Improvement and Reform (FAIR) Act, known also as the “freedom to farm bill.” Farm commodity policy will be at a crossroads as Congress takes up this new legislation. This paper addresses the need for a new policy direction for import competing crops, specifically sugar and peanuts. I will begin with a discussion of the current pressures on the sugar program, which proved costly in 2000, then turn briefly to discussion of peanut policy, which has traditionally imposed more restrictive production controls and faces similar pressures for reform.

Sugar Policy

Traditional sugar program management ran out of room to operate last year, and a new approach to domestic sugar policy is needed. This is a policy that allows greater market flexibility, while retaining the framework and terms of our existing border measures and international commitments.

To achieve this new policy, we must look beyond the two main options that have dominated the sugar policy debate. These options have been either to retain the current program instruments (as producer groups still seem to favor), or to eliminate outright domestic support and import restrictions (as modeled as an alternative in a recent GAO report). Neither option may prove viable. Instead, the reforms that are called for are steps that result in less market intervention, yet provide some direct support to producers. These steps have been taken progressively for other field crops since the 1960s. It is past time to apply these measures to sugar and peanuts.

Current Policies Are Out of Operating Room

Sugar policy has operated through a combination of loan rates at which stocks can be forfeited to the CCC, and border controls intended to keep market prices above the loan rates by restricting imports.\footnote{1} There is a pure arithmetic limit to this method of operating sugar policy: if imports are constrained to zero, then policy instruments other than border measures must be brought into play to sustain price-supporting loan rates against market pressure for lower domestic prices. The United States also has negotiated limits to this method of operating sugar policy. We are committed not to bring low-tariff sugar imports all the way to zero in the WTO, and to growing Mexican access under NAFTA.\footnote{2}

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Before 2000 it usually proved possible to maintain domestic market prices for sugar at levels commensurate with legislated loan rates without stock forfeitures, mainly by limiting imports that exceeded the minimum international access commitments. Last year was different. Domestic supply expanded compared to demand, putting downward pressure on prices. Even with only the minimum imports to which the United States is committed, the Department of Agriculture had to intervene, and did so by purchasing sugar, announcing a plow-down program for sugar beets, and accepting forfeitures of additional sugar. Thus, domestic sugar policy ran out of room to operate in its usual manner. Farmers faced uncertainty in the market, the traditional policy instruments came under stress, and the CCC ended up with accumulated sugar stocks of over 700,000 tons.

One path for sugar policy is an attempt to hold up the level of prices through current loan rates and constraints on domestic supply. Stocks can be accumulated by the CCC, and if that is not enough, crops can be plowed down in the field, or marketing allotments or acreage restrictions can be re-legislated, or paid land diversions can be adopted. But these are the types of government storage and supply-control measures that Congress has progressively abolished for most other crops.

The alternative to the current program offered by critics of sugar policy is likewise ill-advised: to unilaterally eliminate all domestic support and simultaneously increase imports until U.S. prices fall to world price levels. This is viewed as too draconian a short-term shift from past rules.

Instead, a new sugar policy is called for. This policy would avoid government entanglement in the sugar market in the short run, provide more market flexibility overall, and seek multilateral agricultural trade policy reform that will include sugar in the long run. These objectives can be accomplished by following a policy path of progressively converting sugar policy to direct payments.

**Objectives of a Direct Payments Policy**

Let me highlight five positive objectives of a direct payments policy. The policy should:

1. **Free up prices** to allow the domestic market to clear and set stocks valuation in response to supply and demand

2. **Avoid out-dated interventions** either through government involvement in purchases, forfeitures, stockholding, and stocks disposal, or through resort to government-managed domestic marketing allotments or production quotas

3. **Reduce incentives for oversupply** relative to demand either by domestic producers or by foreign suppliers with access to the U.S. market under existing international commitments

4. **Provide adjustment compensation** to farmers in the short run

5. **Create a sustainable long-run policy** with greater market orientation, more open trade, and a reasonable safety net for producers
Two New Sugar Policy Options

With these objectives in mind, I call your attention to two basic options for sugar policy. These are options for domestic policy reform. They can be carried out within the context of current international commitments and with no change in border measures. For this reason, they are not subject to the objection that domestic producers would be exposed to unfair competition from abroad at what is sometimes called the “dump market” world price.

Marketing loans (loan deficiency payments)

This policy would operate similar to other marketing loans. It is a minimal change that would free up sugar prices on the consumption side, while retaining the current loan rates to provide price guarantees to producers. With lower domestic market prices when supplies are large, sugar use would expand, helping bring supply and demand into balance. This change in policy would help restore market equilibrium in circumstances, like last year, when supply exceeds demand.

The cost of a marketing loan program for each penny of payment per pound of sugar is around $180 million, assuming full participation at recent levels of output. Because of the concentration in sugar production, the distribution of marketing loan payments would be skewed, unless some payment limitations are enforced. Nonetheless, for each penny of taxpayer cost, more than that penny is saved by sugar consumers. This shift of the support burden from consumers to taxpayers yields a net gain. There is a beneficial distributional effect as well, since low-income consumers spend a higher proportion of their income on food than high-income consumers, while those with high incomes pay a larger share of taxes.

Marketing loan payments would be an entitlement to farmers, and would vary with market conditions, so the total budget cost of a marketing loan program is not predetermined. If supply and demand dictated market returns below loan rates, then consumers would reap the benefits of low prices, while producers would receive some support. Conversely, if markets offer returns near or above the loan rate, then government payments would decline accordingly.

Introduction of marketing loans would provide a price guarantee for domestic producers, but would have a different—and from U.S. producers’ perspective, beneficial—effect on production incentives abroad. In particular, it would reduce export incentives in Mexico. Market prices, not the loan rates, would become the return to Mexican suppliers as they gain full access to the U.S. market by 2008. If market conditions dictate prices below loan rates, this would dampen Mexican investment in export production capacity.

Marketing loans would also ease adjustment to future multilateral trade liberalization. Domestic sugar producers would be ensured of compensation for any decline in prices if WTO negotiations or other trade agreements result in larger quantities of sugar imports by the United States as one part of a broad-based expansion of market access for agriculture.

Thus, marketing loans achieve some, but not all, of the positive objectives of a direct payments policy, while providing a guaranteed price to producers. Marketing loans should appeal to producers for this reason.
Fixed direct payments and lower loan rates

Guaranteeing prices to producers at current loan-rate levels under a marketing loan approach may turn out to be infeasible. If the principal market force putting downward pressure on prices is farmers’ increased ability to supply sugar when current loan rates set the price incentive for production, then a marketing loan program with current loan rates will prove to be expensive every year.

An alternative direct payments option is to implement fixed direct payments based on historical production and lower loan rates. Under this approach farmers would have a choice about whether to continue to produce sugar, but still receive payments. Price incentives determining production decisions would be market-based, with loan rates lowered to below expected market prices in most years. A safety net could be provided by accompanying the fixed direct payments with a marketing loan program based on the lower loan rates. These are not new policy instruments, but their application to sugar would be new.

A practical difficulty in implementing a fixed direct payments policy is determining the initial support expenditures. If existing loan rates are reduced, payments could be set as high as the differences between the old and new values. But market prices might not fall as much as the loan rates, or if they did, might not remain at those levels. In any case, the level of direct payments has to be determined in advance of market outcomes that are hard to forecast.

One option that could be considered is a “25/50” proposal: reduce loan rates by 25 percent and provide fixed compensation payments of 50 percent of the change in loan rate. Loan rates would be reduced from $0.18 to $0.135 for raw cane sugar, and from $0.229 to $0.172 for refined beet sugar. With payments based on average production during 1997-99, estimated cost would be around $450 million per year if there is full participation. The option would be retained to reduce or eliminate the payments in future farm bills.

Time for Reform

Reform of sugar policy should be undertaken in the next farm bill. Existing policy operates through loan rates intended to set a price floor and import controls that have kept domestic market prices up. Under these policies, sugar imports spiraled downward when HFCS (high fructose corn sweeteners) displaced sugar consumption in the 1980s, and import levels have been managed to support domestic prices ever since. Adjustments to larger domestic supplies relative to domestic demand have been pushed onto foreign suppliers, but the room to do this has run out.

It is time to adopt polices for sugar that allow more domestic market flexibility in the short run, and can facilitate multilateral trade liberalization in the long run. If excess supplies relative to demand in 2000 were a passing phenomena, perhaps the traditional policy instruments of stock accumulation or marketing allotments could be dusted off and used effectively. USDA projections in February 2001 suggest some easing of the pressure on the domestic sugar program for a few years, but for many reasons it is likely that often there will be large supplies at current domestic price levels. Under this circumstance, the storage and production control approaches will eventually fail.
If sugar markets were more open worldwide, a case could be made for full elimination of domestic support and border constraints. Such open markets remain an elusive long-term goal of international negotiations, so an interim policy is needed.

Domestic policy can be reformed to provide market flexibility and producer support within the context of existing international commitments. Applications to sugar of direct payment policies can achieve these objectives.

**Peanut Policy**

I have focused on sugar policy because of the costly interventions required in 2000. For peanuts, forfeitures have long been avoided only by imposing production quotas, which as argued above, is an unattractive policy option. Prior to the NAFTA and WTO trade agreements, imports of peanuts and peanut products were minimal, yet domestic production quotas had to be imposed to keep prices of peanuts for food use above loan rates legislated well above world price levels. Peanut policy has gone past the arithmetic limit to operating price support policy for an import competing crop by limiting trade to which I refer above.

With the NAFTA and WTO agreements, peanut imports have increased to nearly seven percent of domestic consumption. This has led to a reduction in the domestic production quotas for peanuts for food use. The protected domestic peanut market faces pressures for additional trade access over time, just as does sugar. Thus, there are prospects for tighter domestic production restrictions for peanuts unless policy is reformulated. Even the current operation of the peanut program is indicative of what may lie ahead for sugar if policy continues to rely on supply restrictions: imposition of marketing quotas that become increasingly stringent may be required. These marketing quotas will hinder efficiency of the industry and the rent value they come to embody will end up going to quota holders, who are not necessarily farm producers, as has been well documented for the peanut program.

The alternative policies that should be considered for peanuts are similar to those outlined above for sugar. Introducing marketing loans based on current loan rates would introduce modest flexibility in the domestic market, and allow some expansion of demand. Lowering loan rates to a level consistent with world prices would do much more to allow domestic supply adjustment and alleviate import competition for the U.S. market. This policy reform could be accompanied by direct compensation payments to domestic producers.
Reference Notes

1 The economic effects of sugar production under high domestic prices maintained by import restrictions have been evaluated in numerous studies. Specific outcomes differ with 1) world market conditions (which have varied markedly, in part due to the interventions in the United States and elsewhere), 2) how responsive production and demand are to prices (supply and demand elasticity assumptions), and 3) other aspects of model specification. An overall message of these studies is that price support policies generate aggregate gains for producers (which can be large per farm because of concentrated production), aggregate losses to consumers (small on a per-capita basis), and net losses to society.

While it is beyond the scope of this testimony to reconcile the results of various empirical analyses, three careful studies conducted recently illustrate the types of results often derived. Borrell (1999) utilizes a detailed multilateral model delineating 24 countries/regions and seven classes of sweeteners to examine the long-run price, trade and welfare effects of full liberalization of world sugar markets. In his analysis, multilateral liberalization results in a 25-percent decline of the U.S. sugar price, while the world price rises by 38 percent. U.S. imports increase around five million metric tons with liberalization. Consumer gains are nearly $1.2 billion for the United States, while U.S. producer income falls by $0.7 billion, leaving a net estimated gain of $0.5 billion. Worldwide net gains are nearly $5.0 billion.

Haley (1998) constructed a more detailed U.S. model with separate short-run (processing capacity fixed) or long-run (processing capacity adjustable) supply functions for nine domestic regions, and a complex three-stage demand structure for six types of industrial sweetener users and a two-stage structure for non-industrial sweetener consumption. Foreign excess supply is compressed into an aggregated elastic upward-sloping function. For a unilateral liberalization by the United States, Haley also finds a domestic price decline of around 25 percent. His equations yield a fairly price-responsive (but still inelastic) demand structure. When the U.S. price falls, domestic production declines by 2.5 million tons (28 percent) in the long run. Demand expands nearly proportionately to the price decline, so imports rise by almost 5 million tons, causing the world price to nearly double. Haley estimates smaller consumer gains ($0.67 billion) and total producer losses ($0.64 billion) than does Borrell for multilateral liberalization. Haley notes that his demand structure is the most obvious difference between his study and those indicating larger distributional and net effects from changes in sugar policy.

The most recent modeling study of the economic effects of the sugar program was conducted by the GAO (2000). The study utilizes the CARD global sugar model from Iowa State University, augmented to include domestic supply linkages to the corn, HFCS (high fructose corn sweeteners) and wheat markets, and to evaluate separate effects on domestic cane and beet producers, corn producers, sugar beet processors, HFCS producers, and cane refiners. The GAO estimates that the sugar program cost domestic sweetener users $1.5 billion in 1996 and $1.9 billion in 1998, while cane and beet producers received benefits of about $0.8 billion in 1996 and $1.0 billion in 1998. For unilateral U.S. liberalization, this study finds that domestic raw and refined sugar prices would fall around 40 and 25 percent, respectively, while world prices would rise 10 to 20 percent. With highly inelastic supply and demand assumptions, domestic harvested acreage falls by less than 5 percent, while imports rise by 1.1 to 1.6 million tons.

2 The Uruguay Round GATT Agreement on Agriculture guaranteed minimum agricultural market access under low-tariff TRQs, together with limited commitments to expand this access.
and to reduce high (often prohibitive) over-quota tariffs through 2000. Sugar imports by the United States exceed the general TRQ minimum market-access guarantees of three to five percent of domestic consumption. The U.S. made a commitment instead to a minimum sugar TRQ of 1.256 million short tons raw value. (A commitment to imports of 1.25 million tons had previously been included in the 1990 farm bill.) U.S. imports were expected to continue to exceed this level, so the Uruguay Round commitment by the U.S. was not viewed as a significant trade liberalization step. The Uruguay Round Agreement also prohibits introduction of new export subsidies. This precludes the United States from adopting a European Union (EU) type of regime, both importing sugar under high domestic prices to meet its Uruguay Round commitment and selling domestically-produced sugar at a lower world price with an export subsidy.

Under NAFTA, agricultural products are included in the long-run goal of eliminating barriers to trade with Mexico. Elimination of agricultural trade barriers is being accomplished over adjustment periods of five to fifteen years, with the most highly-protected commodities in each country subject to the longest phase out of that protection. For sugar, complex adjustment-period rules were first negotiated to postpone a common market between Mexico and the United States. These rules were revised in a “side letter” detailing adjustment-period commitments between the two countries. Thus, issues arise concerning the operative rules during the adjustment period to 2008, and with respect to the final agreement for elimination of sugar trade barriers.

U.S.-Mexican sweetener trade flows during the adjustment period have remained mired in conflict. Mexico protects its sugar sector and, under this regime Mexican output increased from a low level of 3.8 million metric tons raw value in 1994 to over five million tons by 1998. As Mexican sugar output has expanded, different views have emerged about the commitments in NAFTA and the side letter regarding duty-free Mexican access to the U.S. market under a TRQ. Meanwhile, the high U.S. tariffs on sugar imports outside of TRQs have been falling for Mexico under NAFTA: from 16 cents/pound in 1994 to 12.9 cents/pound in 2000 for raw sugar, with further declines scheduled in following years and the over-quota tariff to be eliminated completely in 2008.

While much of the recent U.S.-Mexico disputes and consultations over sugar has focused on short-term access questions, the common market that emerges in 2008 looms ever closer on the horizon. Once the tariff phase out is completed, NAFTA and the side letter contain no explicit trade restraints, other than imposition by Mexico and the United States of a common external tariff. In principle, if Mexican sugar production were to exceed domestic consumption at that time, the full excess could flow into the U.S. market.

3 The average payment per farm by state per penny of marketing loan would be, for sugarcane: Florida $279,600; Hawaii $584,615; Louisiana $45,815; Texas 19,417, For beets: California $20,045; Colorado $7,660; Idaho 15,940; Michigan $7,870; Minnesota $16,780; Montana $9,690; Nebraska $9,970; North Dakota $17,230; Ohio $1,820; Oregon $8,140; Washington $41,030; and Wyoming $9,100. These calculations are based on 1999 production levels and the 1997 Census of Agriculture estimates of the number of farms growing sugarcane or sugar beets, as reported by GAO, Table 3, June 2000.

4 The basic comparison is between the return from forfeiture versus the return from selling in the market. The return from forfeiture is the cane or beet sugar loan rates (which are subject to slight
regional adjustments). For raw cane sugar, the return from selling is the market price less interest paid on the loan, transportation costs incurred moving sugar to the refiner, and some location discounts charged by refiners. For beet sugar, the return from selling is the market price less interest paid on the loan and certain cash discounts. The difference between these returns varies by region. See GAO, Appendix II, July 1999.

5 While the outcome of the current WTO agricultural negotiations cannot be prejudged, it is reasonable to expect that a modest goal to expand TRQs multilaterally will be adopted. An increase of TRQs by 50 percent as a share of domestic agricultural markets would raise low-duty market access minimums from 5 to 7.5 percent of consumption. An equivalent expansion factor applied to the U.S. minimum import commitment for sugar would raise the obligation to 1.884 million tons. An increase of one-fourth would raise the minimum access commitment to 1.565 million tons. Such minimum import levels did not seem to threaten the U.S. sugar program when the Uruguay Round was completed, but are not being achieved in 1999 and 2000. Over-quota tariffs are also likely to be negotiated down, making circumstances more likely under which imports outside of the TRQ are possible.

6 With marketing loan payments tied to production, they count in the U.S. aggregate measure of support and do not qualify as a non-distorting WTO “green box” policy. To limit budget exposure and reduce production incentives, one option would be to limit loan deficiency payment eligibility to average production levels from the three-year period 1997-99. This would provide compensation related to market price levels for historical production, but would make the market price, not the loan rate, the incentive determining decisions about additional production. Such a “limited” loan deficiency payment program would require recourse loans for the output not eligible for payments (in order to avoid possible forfeitures). This program would, therefore, be different from current loan programs for other crops.

7 Domestic sugar production has shown an upward trend throughout the 1990s that is particularly steep since 1997. Over the full period, cane output has increased primarily due to high yields in Florida and rising acreage and yields in Louisiana. Beet output has increased due to increased acreage in the upper Midwest, and due to high yields in recent years. Domestic sugar consumption has also grown in the 1990s. Whether there is downward pressure on domestic prices in the future, given international import commitments, depends on this supply/demand balance. It is likely that supply will exceed demand in many years if the current sugar program is continued with loan rates at existing levels. Proposals to shift to direct payments to support sugar producers have been made before, but never in circumstances with such a prospect for persistent pressure of supply on demand and no room to cut imports.
References


