

Abstract

Decoupled payments are lump-sum income transfers to farm operators that do not depend on current production, factor use, or commodity prices. Such payments are not currently constrained by global trade rules, but many countries argue that they distort production and trade and that their use should be limited. This report examines the U.S. experience with decoupled payments in its Production Flexibility Contracts program under the Federal Agriculture Improvement and Reform (FAIR) Act of 1996. The payments have improved the well-being of recipient farm households, enabling them to comfortably increase spending, savings, investments, and leisure but with minimal distortion of U.S. agricultural production and trade. However, farm operators may retain as little as 40 percent of program benefits due to higher land rents. While commercial farms received the largest share of decoupled payments, they rent in over two-thirds of their program acres, which suggests that a sizable portion of their program benefits may be passed through to nonfarming landowners.

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Contents

	<i>Page</i>
Summary	iii
Introduction	1
Box: Rules From the Uruguay Round Agreement on Agriculture on the Exemption of Domestic Support From Expenditure Limits.....	2
Decoupled Payments As Income Transfers:	
Conceptual Framework of the Study	3
Decoupled Payments: Fundamentally Different From Coupled Payments	3
Income Transfers and Income and Wealth Effects	3
Box: Increased Market Orientation of World Agriculture.....	4
Market Distortions	5
Methodology	6
Box: Diversity in U.S. Agriculture (Participant and Nonparticipant Farms).....	7
Implementation of the U.S. Production Flexibility Contract Program	8
Program Goals	8
Decoupled Payments Continued in the 2002 FSRI Act	9
Market for Base Acres and Decoupled Payments	9
Land Rentals Reduce Benefits of Decoupled Payments for U.S. Farm Operators	10
Box: Payment Eligibility: Alternatives to Base Acres	10
Land Values and Expectations	11
Who Owns U.S. Farmland?	12
Effects of Decoupled Payments on Household Consumption, Savings, and Investment	13
Participating Farm Households Have Low Rates of Consumption Out of Income	13
Decoupled Payments Increase Household Consumption Expenditures	13
Farm Households Invest On- and Off-Farm.....	14
How Decoupled Payments Can Increase Onfarm Investment	15
No Evidence of Aggregate Investment Effects in U.S. Agriculture	15
Decoupled Payments, Credit Constraints, and Farm Structure	17
Risk Attitudes Influence Investment Decisions	18
Decoupled Payments and Farm Labor	19
Decoupled Payments and Recipients' Farm Labor Supply	19
The Life Cycle in Farm Labor and Ownership	20
Effects of Decoupled Farm Payments on Aggregate Agricultural Supply	22
Production Effects With Efficient Markets	22
Box: Production Effects of Coupled Farm Subsidies.....	22
Production Effects With Capital Market Constraints	23
Need for Additional Research	24
Conclusions	25
Recommended Readings	26
Appendix: Key Features of the Computable General Equilibrium Model	29

Summary

Decoupled payments are lump-sum income transfers to farm operators that do not depend on current production, factor use, or commodity prices and for which eligibility is based on fixed, historical criteria. Such payments are not presently constrained by global trade rules, but many countries argue that they distort production and trade and that their use should be limited. Further constraints on domestic support, which includes decoupled payments, are being discussed in the Doha Development Agenda, the new multilateral round of trade negotiations.

This report examines the U.S. experience with decoupled payments in its Production Flexibility Contracts (PFC) program under the Federal Agriculture Improvement and Reform (FAIR) Act of 1996. PFCs were fixed, annual payments to farm operators based on qualified acres historically enrolled in commodity programs. The payments totaled about \$36 billion from 1996 to 2002. Decoupled payments are being continued in the 2002 U.S. Farm Security and Rural Investment Act.

U.S. decoupled payments improved the well-being of participating households, enabling them to increase their consumption, savings, investment, and leisure, but with minimal distortion of U.S. agricultural production or trade. However, farm operators in aggregate may have retained as little as 40 percent of program benefits, with the remainder passed through to landowners. The low retention rate is due to rising rental costs on the large share of rented acres in the PFC program. While commercial farms received the largest share of decoupled payments, they rented in over two-thirds of their program acres and therefore had the highest potential rate of pass-through of program benefits to nonfarming landowners.

The potential for payments to lead to more investment in agriculture is a key concern of U.S. trade partners. This study finds that participating farm households exercise considerable choice in the allocation of their savings across their investment portfolios. Decoupled payments do not change the level or variability of market returns and therefore provide no incentives for additional farm investment. Although payments can alleviate credit constraints and reduce borrowing costs, allowing some farmers to increase farm investment, this report found no evidence at the aggregate level of increased onfarm investment stemming from decoupled payments.

The study includes a simulation of a permanent program of decoupled payments and finds that decoupled PFC payments would have a negligible impact on agricultural investment and production in the long run; however, household consumption and off-farm investment would increase. Payments increase land asset values by about 8 percent. If payments are assumed to be fully invested in agriculture, which could occur if all farmers are credit constrained or recipients' investment portfolios are limited to agriculture, the payments would increase aggregate onfarm investment by less than two-tenths of 1 percent and increase aggregate agricultural production by a maximum of one-tenth percent in the long run.

The analysis draws primarily on the most recent Agricultural Resource Management Survey (ARMS) data on households that received PFC payments to describe and analyze patterns of land ownership and rental, consumption, savings, investment, and onfarm and off-farm employment.