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## THE FREE MARKET ANSWER TO U.S. FARM PROBLEMS

### INTRODUCTION

Today's agricultural programs remain much as they were when originally instituted during the Roosevelt New Deal era.<sup>1</sup> What is different is that the contention that these programs are necessary and beneficial to the public is being challenged. It is now widely understood, for instance, that government-enforced restrictions on competition lead to higher domestic prices for milk, sugar, oranges, and other products. There is growing concern, moreover, about the soaring costs to the taxpayer of agricultural programs. Price support activities alone have increased from \$4 billion in Fiscal 1980 to about \$20 billion in 1983.<sup>2</sup>

Most farm program benefits are enjoyed by farmers with large operations whose incomes already exceed, on average, those in the nonfarm sector. These programs mainly assist owners of land and specialized farm resources, since the higher product prices received by farmers eventually are offset in large part by higher production costs made possible by the output price guarantees. Price supports and subsidized credit programs also encourage farmers to invest in land and capital facilities when there is already widespread concern about farm size and debt. Finally, marketing orders, import controls, price supports, and other

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<sup>1</sup> This paper is the third in a series describing these programs. It was preceded by Bruce Gardner, "Agriculture's Revealing--and Painful--Lesson for Industrial Policy," Heritage Foundation Backgrounder No. 320, January 3, 1984; and E.C. Pasour, Jr., "The High Cost of Farm Subsidies," Heritage Foundation Backgrounder No. 388, October 22, 1984.

<sup>2</sup> G. Edward Schuh, "Future Directions of Food and Agricultural Trade," American Journal of Agricultural Economics, May 1984, p. 242.

restrictions on competition not only distort the allocation of resources, but also restrict the freedom of individuals to engage in mutually beneficial exchange and are inconsistent with achieving a more open economy.

There is a great deal of evidence, therefore, that government agricultural policies do not serve the public interest. Farm programs instead are a form of income redistribution. In addition, other federal policies have done much to hurt farmers. Inflationary monetary and fiscal policies, for instance, along with subsidized credit and trade restrictions, have fostered instability in agriculture. There is no persuasive evidence, moreover, that agriculture is different from other economic sectors, in the sense that the competitive market process is incapable of coordinating its economic activity. And with the products of two of every five cultivated acres in the U.S. now sold abroad, farmers will suffer seriously from any government policies that encourage protectionism.<sup>3</sup>

Next year a new farm bill will be introduced in Congress to reauthorize existing farm programs. This bill is likely to be a watershed for U.S. agricultural policy if legislators use the opportunity to debate the fundamentals of farm policy. Only two basic choices exist for U.S. agriculture: (1) continuing and extending those protectionist policies that support U.S. farm prices above world market levels and assist and protect domestic producers through export subsidies and import controls; (2) opening the U.S. farm economy so that resource use and producer returns are determined through the market process.

In a more open economy, milk, wheat, sugar, and other product prices would fall, reflecting underlying demand and supply conditions. Prices of credit and other subsidized inputs would rise to reflect the cost of these resources in other uses. Government would encourage rather than impede the development of options markets and other market institutions through which farmers could reduce the risks in production and marketing. The U.S. government could spur trade by reducing its own trade barriers and working to reduce trade restrictions on other countries. Finally, the adoption of noninflationary federal monetary and fiscal policies would increase economic stability in agriculture, just as it would in other sectors of the economy.

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<sup>3</sup> Ibid. Following a large increase in the dependence of U.S. agriculture on international trade during the 1970s, exports of farm products have decreased substantially since 1981. For example, the acre equivalent of the decrease in exports of corn, cotton, wheat, and soybeans from 1980 to 1983 was 22.6 million acres. The combination of the decrease in exports and protectionist domestic farm policies has resulted in a ballooning of the cost of farm programs.

## THE ENTREPRENEURIAL MARKET PROCESS

The underlying problem in agriculture, as in any other sector of the economy, is how to secure the best use of resources, available to any of the members of society, for ends whose relative importance only these individuals can determine.<sup>4</sup> Given this foundation for economic action, there are two known ways of securing economic cooperation--the market system and central direction. The market system does what central planning cannot: it utilizes the detailed information contained in millions of minds that cannot be articulated and conveyed to a central authority in a statistical form.<sup>5</sup> In achieving spontaneous coordination, the price system provides the signals and the incentives for consumers and producers to alter their behavior in making consumption and production decisions compatible.

Government intervention distorts this coordination. When government raises the price of milk above the market price, which balances supply and demand, producers are induced to produce "too much" and consumers to consume "too little." The result: costly surpluses. Market prices therefore provide correct signals to producers and consumers only when prices are free to change in response to changing economic conditions.

Profit and loss signals provide the fundamental driving force for change and progress in a private enterprise system. In the market, economic change and progress in agriculture (and in other sectors) is characterized by business experimentation.<sup>6</sup> Entrepreneurial decisions are guided by perceptions of profit opportunities, and where there are no government subsidies or "soft loans" to failing firms, only those enterprises that best anticipate market conditions remain in business. In this way, market forces shift resources away from less productive farms. Consequently, since the level of profits is determined by how well decision makers have anticipated market conditions, profit and loss signals are a measure of the responsiveness of producers to consumers.

The market, then, is a discovery process in which information is directed to those who can best use it.<sup>7</sup> This process can be fully effective only if price and profit signals reflect the underlying demand and supply conditions. Price supports, credit

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<sup>4</sup> F. A. Hayek, Individualism and Economic Order (Chicago: University of Chicago Press, 1948), p. 78.

<sup>5</sup> Leland B. Yeager and David G. Tuerck, "Realism and Free-Trade Policy," Cato Journal, Winter 1983/1984, pp. 645-666.

<sup>6</sup> John Burton, Picking Losers...? The Political Economy of Industrial Policy (London: Institute of Economic Affairs, 1983).

<sup>7</sup> F. A. Hayek, "Competition as a Discovery Procedure," Chapter 12 in New Studies in Philosophy, Politics, Economics and the History of Ideas (Chicago: University of Chicago Press, 1978).

subsidies, marketing orders, and other government programs only hamper and stifle the entrepreneurial discovery process, thereby distorting the allocation of resources and the pattern of production.

The only alternative to the market process is central direction. The political process accompanying such direction, however, is subject to formidable information and incentive problems. In principle, central planners could solve the economic coordination problem if full information were available to them and the incentive problems could be overcome. In reality, information problems are endemic in government programs because of the separation of power and knowledge. In the case of subsidized credit by the Farmers Home Administration (FmHA), for instance, FmHA officials cannot objectively determine the demand for so-called limited resource loans and decide which farmers "need a lower interest rate to have a reasonable chance of success."<sup>8</sup> Also inherent are incentive problems in which decision-making power is separated from responsibility. The fortunes of FmHA lending officials, for example, are affected relatively little by the success or failure of farmers receiving loans. When farm credit is available only from commercial firms whose loan officers are answerable to the stockholders, on the other hand, there is a strong tendency against overexpansion.

The market process is fueled by entrepreneurial profits and losses. Indeed, the occurrence of losses and business failure is a major factor in the process leading to a more efficient use of resources. But this loss-making function is likely to be impeded by credit subsidies, moratoriums on FmHA foreclosures, and other agricultural policies that substitute political judgment for the discipline of the market. Even if the information problem could be solved and the successes or difficulties of farms predicted in such cases, the decision to assist economically distressed farms would likely be dominated or heavily influenced by short-run political considerations.

In sum, nothing in the political process corresponds to the spontaneous coordination of decentralized decisions in the market process.<sup>9</sup> In the political arena, knowledge, authority, incentives, and responsibility are largely fragmented and uncoordinated. The manipulation of government policies for political purposes is a case in point.<sup>10</sup> The highly visible political advantages of

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<sup>8</sup> U.S. Department of Agriculture, A Brief History of Farmers Home Administration (Washington, D.C.: U.S. Government Printing Office, 1983), p. 15.

<sup>9</sup> Leland B. Yeager, "Is There a Bias Toward Overregulation?" Chapter 4 in Tibor R. Machan and M. Bruce Johnson (eds.), Rights and Regulation: Ethical, Political, and Economic Issues (San Francisco: Pacific Institute for Public Policy Research, 1983), p. 100.

<sup>10</sup> Edward R. Tufte, Political Control of the Economy (Princeton, New Jersey: Princeton University Press, 1978).

increased agricultural price supports or Social Security benefits, for example, are realized quickly, whereas the costs are diffuse and borne in the long run by taxpayers, who have no opportunity to vote on any one of these issues on its own merit.

#### WHY GOVERNMENT INTERVENES IN AGRICULTURE

There are two competing hypotheses to explain government intervention in agriculture: the public interest and income redistribution.

##### The Public Interest

The public interest justification holds that agricultural policy is designed largely to increase stability arising from variability in crop yields and prices. It is argued by advocates of government intervention that lower income for farm labor means that there is a resource allocation and income distribution problem. Similarly, the fact that prices vary from year to year because of changing market and weather conditions implies a stabilization problem. So government programs to deal with these "problems" often are defended on public interest grounds.

##### Income Redistribution

Income redistribution for some public purpose is another justification often used for government intervention in agriculture. There must be federal programs, it is said, to ensure that farmers receive an adequate income for their essential work by redistributing income from more affluent sectors.

The problem is that many farm programs seem designed less to achieve such public objectives than to engage in rent seeking (that is, economic benefits through political action) for individual purposes. Why, for example, are domestic producers of cheese, butter, or sugar given protection against cheaper imports? Is it because dairy or sugar producers have low incomes (and these markets are unstable) or because they have effective political lobbies? The latter explanation appears to be more consistent with the evidence. The role of Political Action Committee (PAC) contributions by big dairy co-ops in enactment of the 1983 dairy bill, from which some dairy producers will receive more than \$1 million--cited as the "biggest victory" ever for the dairy lobby--is hardly consistent with any supposedly lofty ideal of transferring income to poor farmers.

The results are similar in the case of the sugar program, tobacco program, peanut program, wheat program, and programs for many other commodities. In each case, the benefits are concentrated on a relatively small number of producers, and the costs are spread thinly across a much larger group of taxpayers and consumers. Although program costs to individuals are quite small, the potential producer payoff is large enough to induce sugar producers and other commodity groups to organize in political

attempts to achieve income transfers through the use of government power. Legislators, as part of a political process biased toward the short run, have incentives to respond. There is a great deal of casual evidence that price support programs, interest rate subsidies, and other programs to increase farm incomes are explained better by the attention to income redistribution rather than to the public interest.

#### THE ROLE OF GOVERNMENT IN MARKET-ORIENTED AGRICULTURE

Agricultural programs, especially price supports and subsidized credit, pose three types of costs:

- 1) These policies impede the market discovery process, since the most profitable pattern of production and resource use is distorted by price supports and subsidized inputs.
- 2) The programs delay economic adjustment. Consider the extension of credit on easy terms to farmers in financial difficulty. "Economic emergency" and other subsidized loans keep some farmers in business whose credit standing is too poor to qualify for loans from commercial banks. In too many cases, the result is merely to postpone failure until the next round of depressed prices.
- 3) These programs, as evidenced by expenditures of political action committees (PACs), farm organizations, and commodity groups, divert resources from the task of production to the scramble to obtain and retain government transfers.

There is no convincing evidence that agriculture is different from other economic sectors, in the sense that the competitive market process is fundamentally incapable of coordinating economic activity in agriculture. In fact, there is a significant sector of agriculture, including soybeans, many fruits and vegetables, poultry and livestock, in which there are no effective price support programs. This largely unregulated sector of agriculture accounts for about half to two-thirds of U.S. farm production. Government-promoted and sanctioned cartels in the production of milk, tobacco, peanuts, sugar, and other products are no more defensible (or consistent with government antitrust policies) than similar restrictions on competition in other areas of the economy.

It is increasingly being recognized that the U.S. cannot be a credible proponent of free trade as long as it indulges in protectionist domestic agricultural policies. Domestic agricultural programs require import restrictions on dairy products, tobacco, sugar, oranges, and other products. As the dependence of U.S. agriculture on exports increases, the liberalization of trade becomes increasingly important. The U.S. government can facilitate trade both by reducing its own trade barriers and by working to reduce trade barriers on the part of other countries,

including the European Common Market countries, in which price support programs have resulted in the accumulation of government-owned stocks.

### Why Government Should Do Less

A primary policy goal should be to ensure that government policies do not create artificial instability in agricultural markets. In view of the inherent information and incentive problems, government may make its greatest contribution to agriculture (and to the overall economy) by doing less.<sup>11</sup> Consider some of the ways in which government actions destabilize the economy.

First, monetary disturbances affect relative prices. This is particularly true of interest rates, a key factor in investment decisions. Interest rates are very important in agriculture, which is characterized by a high rate of capital investment per unit of labor. Many of the widely publicized farm bankruptcies of recent years have involved heavily leveraged operations in which money was borrowed at the historically high interest rates of the late 1970s. And the anticipated inflation, primary cause of such high interest rates and the product of government's monetary and fiscal policies, has in effect caused major problems in the farm sector.

Second, administrations often manipulate short-run policies hoping to affect upcoming elections. For instance, Yale economist Edward Tufte, studying the period from 1947 to 1976, found a two-year political business cycle during which real income growth increased in eight of eleven election years as a result of increases in transfer payments, including Social Security and veterans' benefits.<sup>12</sup> Agricultural programs provide another avenue through which an Administration can manipulate short-run policies for political advantage. Prior to the 1976 election, for example, the Ford Administration raised the loan rate on wheat from \$1.50 to \$2.25 per bushel and tripled the tariff on imported sugar.<sup>13</sup> And President Carter increased dairy price supports significantly on the eve of the 1980 election.<sup>14</sup>

Third, subsidized credit programs operated by the Farmers Home Administration create an incentive to expand the size of farm operations through borrowing. When the cost of capital is decreased, farmers are induced to substitute capital for labor.

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<sup>11</sup> Paul Heyne, The Economic Way of Thinking (Chicago: Science Research Associates, 1983), 4th edition, p. 448.

<sup>12</sup> Edward Tufte, op. cit.

<sup>13</sup> Bruce L. Gardner, The Governing of Agriculture (Lawrence, Kansas: Regents Press of Kansas, 1981), p. 118.

<sup>14</sup> Dale Heien, "Future Directions for U.S. Food, Agricultural, and Trade Policy: Discussion," American Journal of Agricultural Economics, May 1984, p. 232.

It is likely that easy government credit has been a factor contributing to the recent increase in farm bankruptcies.<sup>15</sup>

Fourth, agriculture is heavily dependent on international trade and, consequently, is greatly affected by government policies affecting trade. The suspension of grain sales to the Soviet Union by President Jimmy Carter in 1980, for example, greatly increased uncertainty in domestic grain markets, since it meant that supply, demand, and price turned on foreign policy factors that could change daily. However, it is not only the measures directly affecting agricultural exports that are important. During the recent recession, for example, the Reagan Administration's ostensibly free trade policies succumbed to political pressures, as import restrictions were tightened for autos, steel, textile products, motorcycles, and other items. Foreign buyers, however, must have dollars from their exports to buy U.S. farm products. Consequently, voluntary or nonvoluntary import restrictions on autos, steel, and other products are especially damaging to agriculture.

Much of the instability of U.S. commodity markets during the past decade can be traced to government policies.<sup>16</sup> Therefore, government would make an important contribution to the stability of agricultural markets by reducing voluntary quotas and other trade restrictions, by eliminating credit subsidies, and perhaps most important, by following noninflationary monetary and fiscal policies.

#### Developing Market Institutions to Reduce Risk

Government also can create a climate to facilitate rather than impede the development of institutions dealing with weather and market risks. Consider the example of crop insurance. As a device to substitute a small, known cost for the possibility of a large loss, insurance is a key means of coping with risk in many areas of life. The current government-subsidized crop insurance program, however, in effect bars crop insurance by private firms.

It may be that farmers would not be willing to pay the full cost of crop insurance. The lack of participation at premium levels high enough to cover costs is sometimes taken as evidence

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<sup>15</sup> Michael T. Belongia, Agriculture: An Eighth District Perspective (St. Louis, Missouri: Federal Reserve Bank of St. Louis, Spring 1984). Although farm bankruptcies have been much in the news during recent years, the bankruptcy rate does not appear to be higher in agriculture than in the nonfarm sectors of the economy.

<sup>16</sup> "The instability of U.S. commodity markets during the 1970s and early 1980s has been largely a monetary phenomenon, not a weather phenomenon as is so commonly believed." G. Edward Schuh, op. cit., p. 244. Other countries as well as the United States contributed to the monetary instability.



that subsidized crop insurance is warranted. This conclusion follows if real world markets are measured against the norm of "perfect competition," where all risks would be insured. But in the real world, where risk reduction is achievable only at a cost, it is economic to shift risk only when the expected gains exceed the costs. Thus, the absence of insurance merely is evidence of an unwillingness to shift risk to others at premium levels that cover the full cost of providing the insurance.<sup>17</sup> Whether crop insurance is economic can be determined only through a market test.

The futures market is an important means of shifting risk in the production of crop and livestock products for which futures markets exist. Although trading in futures for agricultural products is now limited to about one year from the current period, it might be possible to develop selected futures contracts two or three years into the future.<sup>18</sup> A government agency would determine the projected price patterns on the basis of expected demand and supply conditions and then announce the price band within which it would buy or sell contracts maturing more than nine months in the future. Theoretically, such a mechanism would provide a relatively stable environment in which producers could hedge production and storage decisions over a longer period.

This proposal, however, faces the same incentive problems as all other actions by agencies in which power and responsibility are separated. Moreover, the enormous problems associated with obtaining sufficient information to make rational decisions are largely ignored. There is no reason to think a public agency can forecast accurately future demand and supply conditions for agricultural products. Economic prediction of general economic conditions even one year in advance has proved to be beyond the capability of economic forecasters. It may well be that government can make the greatest contribution in the case of futures markets by providing a stable legal framework.

Option markets provide a potentially attractive alternative for current government programs in insuring against risk in agricultural markets. Example: A corn farmer at planting might purchase a "put" option giving him the right to sell a corn futures contract at harvest at a specified price. If the market price of corn at harvest exceeds the specified price, the option need not be exercised, and the farmer could sell his corn on the open market and receive the higher price. If the corn price at harvest were below the option price, on the other hand, the farmer could exercise the option, thus ensuring himself the price he had been counting on. The purchaser of a "put" option, which

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<sup>17</sup> Harold Demsetz, "Information and Efficiency: Another Viewpoint," Journal of Law and Economics, April 1969, pp. 1-21.

<sup>18</sup> J. Bruce Bullock, "Future Directions for Agricultural Policy," American Journal of Agricultural Economics, May 1984, pp. 234-239.

entitles him to sell a commodity at a specified price, is insured against a decrease in price. Thus, the "put" option, like the conventional futures market hedge, provides security against price decreases. Unlike the conventional hedge, however, the "put" option allows farmers to reap the benefits of price increases.

There were no markets for "put" options in agricultural products from the New Deal era up until 1984. The absence of such option markets was not caused by market failure, but rather by a congressional ban on agricultural commodity options in 1936, following allegations of market manipulation. The 1982 Futures Trading Act lifted the 1936 ban and authorized a three-year pilot program with actual trading of agricultural commodity options scheduled to begin in late 1984.<sup>19</sup>

### GOVERNMENTAL INITIATIVES

Three steps could move the U.S. to a market-based agricultural production and marketing system:

1. Agricultural programs must be changed so that prices of farm products reflect the underlying supply and demand conditions. That is, price support levels should not be above the market clearing prices for wheat, cotton, milk, oranges, and other products. In expanding opportunities for exports of farm products, the U.S. government must reduce (not increase) trade restrictions and work to reduce trade barriers in other countries.

2. If interest rates are to allocate credit efficiently within agriculture and between agriculture and other sectors, the price of credit must reflect the actual cost of credit. This means that credit subsidies on loans by the Farmers Home Administration, the Rural Electrification Administration, and other agencies must be eliminated.

3. The government must eliminate or reduce those policies that create or increase market instability. The sad fact is that market instability in agriculture during the past decade has been largely attributable to government policies. The most important contribution the federal government could make toward reducing risk and instability in U.S. agriculture would be to pursue stable and noninflationary monetary and fiscal policies. Providing a stable legal framework for businesses engaged in agriculture is also important in the development and operation of futures markets, option markets, and other market institutions to reduce risk.

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<sup>19</sup> David E. Kenyon, Farmer's Guide to Trading Agricultural Commodity Options, U.S.D.A. Agriculture Information Bulletin Number 463 (Washington, D.C.: U.S. Government Printing Office, 1984).

## CONCLUSION

U.S. agricultural policies have been designed to raise product prices above the market price ever since the New Deal era. Today's agricultural surpluses can be attributed directly to government price support programs in which farm product prices have been supported at artificially high levels. As such, the most effective means of eliminating surpluses of grains, milk, or other products is to eliminate price supports. Attempts to solve overproduction problems through payments to producers, land retirement, and other means misallocate resources and require restrictions on imports to prevent domestic consumers from purchasing cheaper imported goods. It is inconsistent for agricultural producers to support protectionist domestic policies for their own products while simultaneously advocating freer international trade.

The competitive entrepreneurial market process is just as applicable to agriculture as to other economic sectors. The free enterprise system is unique in its ability to harmonize resource use and to accommodate consumer demand effectively. The market process can only be fully effective if market signals, including prices, profits, and interest rates, reflect constantly changing economic conditions. Economic regulation and taxation of entrepreneurial returns thus will affect resource use adversely.

Government programs always have consequences that were not, and cannot be, foreseen. This creates pressures for new programs to deal with these unanticipated problems. The Agriculture Department's Payment in Kind (PIK) program in 1983, for example, was devised to deal with the problem of surpluses created by the government's price support programs. The PIK program, however, reduced sales of farm equipment, fertilizer, and other agricultural inputs, thereby hurting firms selling these inputs. To remedy this, Congress made agribusiness firms eligible for subsidized FmHA loans in 1984. In this example, as is often the case, the abruptness of changing economic conditions can be traced to government policies. That is, government policy is frequently a source of uncertainty rather than a source of stability.

The market is often justified on the basis of its productive achievements, and there is abundant evidence that, judged by its ability to produce goods and services, the market system is a phenomenon unique in world history.<sup>20</sup> Moral issues pertain as well, since a persuasive case can be made that prohibitions on mutually beneficial market exchanges are not fundamentally different from restrictions on First Amendment rights.<sup>21</sup> It is

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<sup>20</sup> Paul Johnson, "Has Capitalism a Future?" The Freeman, January 1979, pp. 47-50.

<sup>21</sup> Ronald Coase, "The Market for Goods and the Market for Ideas," American Economic Review, May 1974, pp. 384-391.

ironic that human rights issues are so heavily discounted or ignored in discussions of restrictions on economic freedom. It is argued, for example, that agricultural programs that restrict competition are not authoritarian, because no production control program in agriculture "has been engaged in without a favorable vote by farmers."<sup>22</sup> The fact that an infringement of civil rights occurs under majority rule, however, does not eliminate the human rights issue involved. Similarly, if economic rights are similar to First Amendment rights, the fact that a plebiscite precedes compulsion in the case of marketing orders and other government-sanctioned restrictions on competition does not dispose of the ethical issue. The voting in such cases excludes the much larger number of taxpayers and domestic and foreign consumers who bear the cost of the programs.

The notion of individual rights, including the rights of people to make voluntary economic transactions with each other, is central to questions concerning the appropriate role of government in agriculture and other sectors of the economy. In what George Mason University economist James Buchanan has labeled the "morally relevant" science of political economy, the focus is on the institutional framework that provides the greatest opportunity for individuals to pursue their own diverse ends through decentralized coordination of their activities.<sup>23</sup> The policy implication of this market-based approach is that the maximum scope for individual choice should be provided. Only in this way can the nation's agricultural resources be used most economically, serving the interests of farmers, consumers, and taxpayers alike.

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<sup>22</sup> Harold F. Breimyer, "Conceptualization and Climate for New Deal Farm Laws of the 1930s," American Journal of Agricultural Economics (December 1983), p. 1156.

<sup>23</sup> James M. Buchanan, "The Related But Distinct 'Sciences' of Economics and of Political Economy," British Journal of Social Psychology (1982), pp. 175-183.

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