June 22, 1988

HOW TO WEAN THE AMERICAN FARMER FROM WASHINGTON

INTRODUCTION

Despite the current drought in the Midwest, for the first time in years, things are looking better for the American farm economy. Since the depression in agriculture bottomed out in 1986, the fortunes of United States farmers have improved considerably. Last year, net cash farm income reached an all-time high of $57 billion, more than double that of 1983. Farm debt declined, while exports continued to increase. In fact, the farm trade surplus this year is expected to be twice that of only two years ago.

Yet not all news from the farm is good. While the 1985 farm bill lowered price supports, making it easier for farmers to export their goods, it also led to huge increases in direct taxpayer subsidies to farmers. Last fiscal year these subsidies totalled $25.5 billion; this year they are expected to reach $20.3 billion. Not only do such subsidies bloat the already deficit ridden federal budget, they make farmers dangerously dependent on Washington and distort production incentives.

Changing Incentives. Real reform of federal agriculture programs is still needed. Two major reform proposals have been debated. The first, mandatory production controls, would limit the amount that farmers could produce, thus raising prices. Increased farm income, however, would come at the expense of consumers. As food prices rise, nonfarming businesses dependent on agriculture, such as suppliers of farm machinery and fertilizer, would also be hurt as they would lose billions of dollars in sales. What is more, high farm prices would make export subsidies necessary to keep U.S. crops competitive. The total cost of these subsidies could worsen an already bad budget picture.

A second, more sensible plan would be to "decouple" federal farm payments from production requirements. Instead of requiring farmers to actually produce a crop in order to receive a subsidy, that subsidy would be granted regardless of production decisions. Farmers would continue to receive a certain amount of subsidy based on past production levels, but decisions about when, what, and how much to plant would be up to them. As such, these decisions then would be determined by the market, rather than by Washington. Farmers would no longer have an incentive to grow crops already in excess supply, just to qualify for a subsidy. Instead, they could use their land for crops in shorter supply. In the long run, even the decoupled subsidies should be phased out over a set period of ten to fifteen years. After this period, U.S. agriculture would have been eased back to a completely free market.

U.S. FARM PROGRAMS

Many of today's programs began in the years after World War I. During the war, U.S. agricultural exports boomed as hostilities took vast amounts of foreign farm land out of production. After the war, of course, world food output rose, and demand for U.S. agricultural production dropped dramatically, leaving the U.S. farm sector with huge excess capacity. Eventually, the Agricultural Adjustment Act of 1933 created the Commodity Credit Corporation (CCC) to support farm prices and farm incomes. Originally envisioned as a response to a temporary glut, the CCC and the commodity programs associated with it remain virtually intact, despite massive changes in the farm economy since then.

Price Support Programs

The CCC currently supports agricultural prices by two principal mechanisms: direct purchases of commodities and "nonrecourse" loans. The CCC uses direct commodity purchases to support agricultural prices by standing ready to buy any amount of the commodity offered to it at a legislatively mandated support price. Milk prices are supported by such direct purchases.

The nonrecourse loan program is an alternative to direct purchase. This program allows farmers to borrow from the CCC. Farmers are allowed to borrow a certain, congressionally set amount per unit (known as the "loan rate") of the commodity. The farmer puts up the crop as collateral. The loan is called "nonrecourse" because a farmer can choose to forfeit the collateral in lieu of repaying the loan and interest. The CCC has "no recourse" but to accept the forfeiture as full payment for the loan. The loan rate, therefore, serves as an effective price floor for the commodity since, if market prices fall below the loan rate, a farmer can forfeit the crop to the CCC rather than selling the commodity in the market and repaying the loan.

Guaranteed Prices. Commodities eligible for nonrecourse loans include coarse grains, soybeans, sugar, tobacco, and wheat. Yet, these commodities represent only about a third of total U.S. agricultural production. Two-thirds of American agriculture, including livestock, operates without such a loan program.

Besides providing a price floor, the nonrecourse loan program also subsidizes credit to farmers because the interest rate charged by CCC on nonrecourse loans is lower than market interest rates. Thus the program subsidizes farmers' costs, enhancing income. Loan rates and direct purchases also act as price insurance. By providing farmers with guaranteed prices at the time crops are planted, these programs remove much of the price risk inherent in agricultural production, thus encouraging greater production.

To a great extent, the loan programs duplicate already existing market mechanisms that deal with price risk, including futures and options contracts.[1] However, the nonrecourse loan in effect provides such protection at no charge and thus discourages the use of private mechanisms.

Even more serious, the loan programs, as well as direct purchase programs, can stabilize prices well above the market price. For instance, the loan rate for sugar is approximately three times the world market price. The inevitable result is a growing crop surplus.

Of course in theory, direct purchase programs and nonrecourse loan programs allow the government to acquire commodities when they are in surplus and resell them in times of relative scarcity, when the market price exceeds the price support level. In recent years, however, price supports have been established at levels so high that purchases rarely are balanced by resales The result is long-run surpluses.

Production Retirement Programs

Partly as a solution to this problem, lawmakers created production retirement programs. These programs take a number of forms. The most common are those that take land out of use and those limiting directly the amount of a commodity that can be marketed.

Restrictions on land use frequently are required as a condition for participation in other commodity programs. For example, corn farmers had to retire 20 percent of their corn acreage from production to qualify for the 1987 corn program. Under some other programs, farmers are paid directly for such acreage retirements.

Programs limiting production basically are attempts to achieve two goals: 1) to limit the government's budget exposure by reducing the amount of production eligible for government support, and 2) to raise market prices and farm income by artificially restricting the supply of the commodity. These programs have met with only limited success, because farmers understandably retire their least productive land first and then use resources that would have been used on the retired acreage to farm the remaining acreage more intensively. The result: a 20 percent reduction in crop acreage may translate into little or no reduction in production. In fact, record crops often are harvested in the face of stringent land retirement requirements. Programs with such acreage restrictions include wheat, the coarse grains, and tobacco. A peanut program controls the amount of peanuts that can be sold in domestic markets.

Payments Not to Farm. There are also programs paying farmers not to farm. For instance, under the Dairy Termination Program, selected farmers were paid to kill their entire herd of dairy cows or sell them for export and then retire from dairying for at least five years. This program has met with only limited success, as remaining dairy farmers have increased their production.

1 Kandice H. Kahl, "Agriculture Options: An Alternative to Federal Farm Programs," Heritage Foundation *Backgrounder* No. 414, March 7, 1985; "A Welcome Endorsement of Agriculture Options," Heritage Foundation *Backgrounder Update* No. 39, March 2, 1987.

Deficiency Payments

Some commodity programs exist solely to enhance farm income. Under the largest such program, farmers are provided "deficiency payments" to make up, in cash, the difference between the market price and a congressionally determined "target price." Congress legislates a target price (at a level higher than the loan rate). Farmers participating in commodity programs receive deficiency payments to make up the difference between the average market price for the commodity and Congress's target price. Deficiency payments let the CCC support farm incomes without acquiring surplus commodities while also allowing the selling price of commodities to be established by the market. Commodities for which farmers receive deficiency payments include coarse grains, rice, and wheat.

Deficiency payment programs usually operate in conjunction with nonrecourse loan programs and acreage retirement schemes. Because deficiency payments tie income support to production levels, they encourage producers to expand production. Yet these policies coexist with policies requiring farmers to retire land from production. In short, farmers are urged by the government to stop and go at the same time.

THE FOOD SECURITY ACT OF 1985

Every four or five years, Congress considers an omnibus farm bill. These bills amend the permanent farm legislation enacted under the Agricultural Adjustment Act of 1949. The most recent omnibus bill is the Food Security Act of 1985. While this act was being debated, U.S. agriculture was in the throes of one of its worst depressions since the 1930s. Farm prices, exports, and incomes were all depressed. Land values were dropping at alarming rates in real terms for the first time since the 1930s. From being a growth sector of the American economy, as it was in the 1970s, farming had become a problem child. Because of these problems, federal expenditures on farm programs mounted to all-time highs.

Staggering Payment Increases. Part of the underlying problem arose because the previous omnibus farm bill, the Agriculture and Food Act of 1981, had mandated support and target prices in nominal terms, overlooking the possibility of a significant decline in inflation. When high market prices failed to develop, the high target prices had two results: They encouraged extremely high production even though market conditions were deteriorating, which led to staggering increases in payments to farmers. And at the same time, the loan rate, because of low world prices, became the effective world floor price for many commodities. With, effectively, a price guarantee from the U.S., foreign farmers produced more than they would have otherwise, confident that CCC purchases would keep up the world price. Thus, the federal government actually was helping foreign producers, at the expense of U.S. taxpayers, to displace U.S. producers in commercial export markets.

Congress realized that farm programs had to be modified if the U.S. were to regain its leading position in world markets, yet lawmakers faced a painful dilemma. Regaining export markets required the U.S. to become price competitive. This meant cutting the loan rate. And cutting the loan rate meant cutting world prices, yet Congress was facing a farm depression at home. And cutting prices implied cutting farm incomes.

Congress resolved this dilemma by cutting price supports but maintaining target prices. This let U.S. farmers sell at internationally competitive prices. The problem, however, was that the total cost of the subsidies rose as deficiency payments increased to make up for lower market prices. In effect, the costs of farm programs were shifted to the taxpayer.

Export Enhancement Program. In addition, the Food Security Act significantly increased federal subsidies of farm exports. Advocates of such subsidies pointed out that the world agricultural market is highly competitive and trading is heavily subsidized by some countries. The European Community, for example, uses export subsidies ("export refunds") to dispose of surplus grain products. Thus many congressmen and farmers believed that the only way for the U.S. to regain lost export markets was to subsidize agricultural exports. In response to this, an Export Enhancement Program (EEP) was included in the 1985 farm bill.

The EEP uses CCC stocks to subsidize the sale of U.S. agricultural exports. Under this program, U.S. export companies making deals with importing nations can receive surplus crops from the CCC, free of charge, so that they can lower their prices to the importer. These companies then inform the CCC how much of a subsidy they need to complete the sale of U.S. agricultural products. The CCC decides whether to provide the subsidy.[2]

Sales under this program were first targeted at markets in which the United States actively competed with the European Community, which heavily subsidizes exports of farm goods. But, since the Food Security Act of 1985 required the CCC to spend at least $1.5 billion dollars on such export subsidies between 1986 and 1989, the EEP rapidly ran out of markets in which the U.S. competed with the European Community. Subsidized sales under this program thus have been expanded to other countries, including the People's Republic of China and the Soviet Union.

Not surprisingly, the EEP has raised tensions between the U.S. and its competitors in world markets. The Argentines, Australians, Canadians, and other exporters of wheat and grain products complain that they are being adversely and unfairly affected by this program.

PROPOSED REFORMS OF THE 1985 ACT

The Food Security Act of 1985 has been very expensive to maintain, while not substantially increasing agricultural incomes. At the same time, the U.S. has become an aggressive subsidizer of exports of surplus agricultural commodities.

Since 1985, two major proposals for the reform of farm programs have been debated: supply control and decoupling.

2 Such a subsidy would not be provided if it would be so large as to depress the market price significantly.

These approaches would take American agriculture in dramatically different directions. The first would increase government control over farmers. The second would free the farmer to produce according to his own needs and the needs of the consumer.

Supply Control

The major supply control plan is the "Save the Family Farm Act," introduced by Senator Tom Harkin, the Iowa Democrat, and Representative Richard Gephardt, the Missouri Democrat. It is a system of direct federal control over what farmers produce. Under its provisions, the Secretary of Agriculture would conduct referenda among farmers of each major commodity. If most producers of a particular commodity voted for supply controls, such controls would be implemented. The Secretary of Agriculture then would establish a national marketing quota for each commodity, intended to balance demand and supply. Acreage allotments based on the national marketing quota would be distributed to farmers, in which larger farmers would be required to retire a higher percentage of their established acreage. Marketing certificates would be issued to producers according to their acreage allotment and their established yield. Commodities could not legally be marketed domestically without a marketing certificate. In addition, certain minimum price support levels would be established. For instance, grain farmers would be guaranteed a support level of 70 percent of parity, which would increase by 1 percent a year up to a maximum of 80 percent of parity.[3]

The Harkin-Gephardt proposal also envisions the U.S. government taking an assertive role in international commodity markets. The President would negotiate a multilateral agreement to set up international cartels in each commodity market with the aim of increasing international prices for producers and preserving each exporter's market share. If such a cartel could not be negotiated, export subsidies would be used to maintain U.S. market share.

Unrealistic Scenario. Of course the ultimate goal of this plan, to increase prices for producers, consequently would increase the amount that consumers would be forced to pay for food. Even worse, the plan might not even succeed in raising farmer's incomes. For that to happen, farmers' total production costs would have to fall faster in percentage terms than revenues from reduced sales volume as the supply was withdrawn from the market. For this to happen, consumers seeking the scarcer commodity would have to bid up its price more in percentage terms than the supply was curtailed, causing revenue to rise even though sales volume had decreased.

Just how realistic is this scenario? Not very, conclude several experts. A study by University of Maryland economist Bruce Gardner concludes that supply controls without an international cartel always hurt farmers in the long run.[4] A study by the National Center for Food and Agricultural Policy reports that the Harkin-Gephardt proposal would raise

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3 Parity is the price that gives a farm commodity the same relative buying power it had in the 1910 to 1914 period. Parity prices as currently calculated are much higher than current market prices.

4 Bruce L. Gardner, "A 1987 Farm Bill? Pros and Cons and Policy Options," *Studies in Economic Policy* (Washington, D.C.: American Enterprise Institute, January 1987).

farm income in the event that an international cartel could be set up, but points out that it is generally conceded that such cartels are almost impossible to sustain.[5] Farm incomes could rise if the government could maintain exports through subsidies, but this would require the agricultural budget to triple from $20 billion today to roughly $60 billion to $70 billion by 1995.

Expanded Foreign Production. Creating a rigidly enforced cartel is thus the critical ingredient of the Harkin-Gephardt plan. But history teaches that, when the U.S. withdraws crops from production, foreign producers rapidly capture the market abandoned by the U.S. In 1983 and 1984, the CCC instituted a program paying farmers to retire acreage from production, using surplus commodities acquired by the CCC. Almost 70 million acres were idled as the U.S. effectively withdrew from world markets. Not surprisingly, producers in Brazil, the European Community, Argentina, Thailand, and elsewhere quickly expanded production as the price rose and captured the markets that the U.S. had abandoned.

Supply controls also would seriously harm industries closely related to agriculture, especially firms supplying fertilizer, machinery, pesticides, and other items used in farm production. In 1986, for instance, the Department of Agriculture found that an acreage reduction program idling 125 million acres of farmland would cost the U.S. economy two million jobs and about $64 billion in lost sales to agribusiness firms.

Decoupling Income from Production

Decoupling, the second proposal being considered, is much more sensible. The basic idea is simple and economically straightforward: making farm income support independent of production. In the case of the commodity programs this means making direct government payments to farmers independent of the amount they produce. Farmers no longer would have to grow or not grow particular crops in order to receive federal subsidies — they would be left totally free to make such decisions for themselves. Nothing would be required from farmers in exchange for subsidies.

Making the Real Function Explicit. In effect, decoupling would make farm subsidies more like a welfare program, in which policy makers explicitly declare that they will support a particular group of people. Farm programs are not usually labeled as welfare. They are more often described as economic regulations meant to stabilize prices and income. A more plausible justification for continued farm programs is to support farm income. This function should be made explicit and the wasteful regulatory effects of the programs eliminated.

Some farmers under a decoupling program undoubtedly would take the payment and do absolutely nothing. But others would begin to produce commodities for which there was a genuine market and money to be made, rather than those for which the only reward was a government payment. Existing commodity programs discourage such switches to commodities that are more in demand. By separating production from consumer demand, they fossilize crop production patterns. The result: less production of unsubsidized

5 National Center for Food and Agricultural Policy. "The 1985 Farm Bill Revisited: Midcourse Corrections or Stay the Course" (Washington, D.C.: Resources for the Future, February 1987).

commodities and consequent higher prices. Conversely, the market prices of program commodities tend to be lower than they would otherwise be, and production higher than consumer demand. Decoupling would eliminate these distortions by freeing farmers from the strictures of the farm programs and enabling them to produce the commodities that the consumer, rather then the government, is willing to buy. And because prices would no longer be artificially supported at high levels, the consumers, too, would be better off.

50/92 and 0/92

An integrated decoupling approach could be put into place in several ways. One idea that has received much attention originated with the so-called 50/92 provision of the Food Security Act of 1985. Under this provision, farmers had to plant only 50 percent of their program acreage for a particular crop in order to receive direct subsidies on 92 percent of their program acreage. This represented a partial decoupling, since it allowed 50 percent of the program acreage to be diverted to production of crops other than the program commodity. This provision was curtailed severely in the Food Security Improvements Act of 1986.

In 1987, the Reagan Administration proposed an extension of the 50/92 provision creating what it called the 0/92 provision. Under 0/92, farmers would not be required to plant anything at all on their program acreage to receive direct subsidies on 92 percent of their program acreage. However, price support rates would remain unchanged. To qualify for these payments, moreover, farmers would be prohibited from producing certain crops on the acres thus retired from production. Because of this, 0/92 in the short run could actually lead to more government intervention. If the price support rate were set above the average cost of production, farmers could make a better profit by growing a crop and selling it to the government, through the price control program, than by participating in 0/92. Further, if farmers did grow the crop, they could collect payments on 100 percent — rather than 92 percent — of their eligible program acreage, further increasing the incentive to grow crops just for resale to the government. The 0/92 program would do little to induce farmers to plant according to market conditions. In fact, it can be seen as just another supply control program, serving to weed out the most inefficient farmers from production while still making direct payments to them. The effective level of government intervention could therefore increase. Only inefficient farmers with higher costs of production would make more money by not growing the crop.

A 0/100 Decoupling Plan

A better program would not require any acreage to be planted, and it would lower price supports, yet provide direct subsidies on 100 percent of a farmer's land. At the commencement of the program, farmers would receive 100 percent of their deficiency payments (or effective production subsidies for commodities like milk and sugar where income is protected by support prices exceeding prevailing market prices). All producers, however, would be free to do anything they chose with their productive resources. They would be free to produce any commodity and to sell it to whomever they pleased. Similarly, they would be free to produce nothing at all and to use the proceeds from their income subsidies to support themselves while they sought other occupations.

Because there are legitimate economic reasons for the price stabilizing roles of the nonrecourse loan programs or price support programs, this program would be retained. Support, however, would be set at a level that would not interfere with the effective operation of the market. This could be accomplished by extending the loan rate cuts of the Food Security Act of 1985 and not giving the Secretary of Agriculture any authority to adjust loan rates. Giving the Secretary such authority makes this adjustment become a political decision. The loan rate for any crop year could be set, for example, at 60 percent of the average market price for the three preceding crop years. Perhaps the loan rate could also be tied to other factors, which are important determinants of agricultural prices, including the exchange rate.

Paying Going Market Rates. Eventually, the nonrecourse loan program should gradually make way for more efficient, market-based mechanisms for dealing with price risk. One such approach that should be considered is simply to convert the nonrecourse loan program over time to a market-based "put option," where farmers would bear the cost of writing the option contract. This would shift the burden of dealing with the price risk from the shoulders of the taxpayers to the shoulders of those who benefit most directly from the price insurance provided by the nonrecourse loan program.[6]

The credit subsidy component of the nonrecourse loan program should be eliminated immediately; farmers should pay going market rates for their commodity loans. Subsidizing the cost of farm credit results in more of the commodity being produced and sold than otherwise would be the case. Because farmers' incomes would be directly subsidized under the 0/100 plan, there would be no need for this additional program.

The mechanics of such an approach would be important. As a practical political matter and for the sake of economic efficiency, these direct income subsidies should be paid only to those farmers who are in business at the beginning of the program. If this were not done, there would be an incentive for Americans to enter farming simply to collect income subsidies. Of course, since current programs provide disproportionate benefit to large farms, a 0/100 approach would institutionalize this inequity for the duration of the transition program. This is by no means ideal, but politically, it seems essential. The point of such a program is not to correct all past injustices, but to relieve taxpayers, consumers, and farmers of the burden of inefficient government regulation of the farm economy.

Not Depending on Washington. The 0/100 program itself should be only temporary. In the long run, there is no reason for the government to provide such support payments to individuals without a demonstration of need, as in other welfare programs. The payments to farmers under this plan, therefore, should be phased out completely over a ten to fifteen year period. This should be long enough to give farmers time to adjust to a world in which they can not be dependent on Washington. After this time, U.S. agriculture could operate in a completely free market environment.

6 Kandice Kahl, *op. cit.*

CONCLUSION

The situation of the U.S. farm has improved substantially in the past two years. Farm income is up, exports have increased, and farm debt is shrinking. This good news does not mean, however, that all is well. The current farm bill, by reducing price supports, has made U.S. exports more competitive, but it also has led to a huge increase in direct subsidies. The result: U.S. farmers are more dependent than ever on Washington. Production incentives thus are increasingly distorted, as farmers plant according to Washington's directives, not the market's needs.

Genuine, lasting reform is needed. First, farm subsidies should be decoupled from production requirements. Rather than being forced to produce unneeded crops simply to qualify for subsidies, farmers should be allowed to plant whatever is needed by the market. In the long term, the subsidies themselves should be phased out. The result would be a completely independent agricultural sector, able to produce what is needed and only what is needed by consumers. The benefits would be shared by farmers, consumers, and taxpayers alike.

Prepared for The Heritage Foundation by
Robert G. Chambers
Professor, Department of
Agricultural and Resource Economics
University of Maryland