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THE 1985 AGRICULTURAL BILL: STILL TIME TO TREAT THE FARM CRISIS

INTRODUCTION

The state of the American farm has attracted an almost unprecedented degree of public attention this year. The immediate result of this was congressional passage in February of a bill providing emergency federal aid to agriculture. Almost lost amid all this activity were proposals to address the underlying causes of the farm problem. Congress must now confront them as it contemplates drafting the quadrennial farm bill. The House and Senate Agriculture committees already tentatively have approved legislation covering most major farm programs, but have yet to report legislation formally to either House.

The proposals tentatively approved by the committees make several needed reforms. For the first time, for example, major farm price support rates would be linked to market prices. This should lead to lower overall price support levels, lower prices for consumers, and more U.S. farm exports. But the committees' proposals also would attempt to protect farmers from the effects of lower prices by increasing direct subsidy payments. The cost of farm programs would thus skyrocket, forcing taxpayers to pick up the tab. While details are not yet available, the Department of Agriculture estimates that the Senate committee programs would cost $50 to $60 billion over the next three years, exceeding the limits of this year's Budget Resolution by as much as $21 billion. The House committee plan is expected to be even more costly.

The "farm crisis" is nothing new. It is a longstanding problem, the result of years of ineffective, contradictory, and costly federal agricultural policies. These policies have long assumed that farm prices and production must be controlled by the federal government, rather than the normal forces of supply and demand. Yet such production and price controls have never worked in the U.S. or anywhere else. Congress thus should use the

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opportunity of this year's farm bill to shift gradually from an agricultural industry distorted by government fiat to one based on the free market.

In addition, private sector alternatives to many government farm programs should be explored by lawmakers. One possibility is to allow an "options" market to stabilize prices. Such innovations will be encouraged by a market-based system of agriculture just as they are in other industries free of government production and pricing controls. Unless the 1985 farm legislation breaks the current policy mold and moves toward such market-based solutions, the farm crisis simply will continue and deepen.

OVERVIEW OF FARM POLICY

The present jumble of agricultural programs constituting federal farm policy took root in the 1930s as part of the New Deal. Since that time, farm programs have been amended, expanded, and complicated in response to political pressures. For the past 20 years, the major agricultural programs have been reenacted every four years. The Agriculture and Food Act of 1981 expires this year.

Federal farm programs are extremely expensive by any measure. The federal government is expected to spend more than $18 billion on farm stabilization programs in 1985.[1] Over the last five years, farm programs have cost taxpayers almost $65 billion.[2]

Even more important than the dollar cost of these programs is their harm to the agricultural industry. As the chronic farm problem demonstrates, the programs have failed to assure a stable and adequate income for farmers. Instead, by distorting normal market incentives, the programs often bring contradictory and costly results. Examples:

o Federal payments to farmers and price supports intended to keep farm income high encourage more Americans to begin farming or expand their current operations, thereby increasing the amount of commodities produced and further depressing prices. The result: reduced income.

o Federal supports, by keeping U.S. prices above world food prices, hinder U.S. exports by giving foreign competitors an artificial price advantage.

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1 Office of Management and Budget, Budget of the United States Government: Historical Tables, Table 3.3. Due to an unusually large crop this year, actual expenditures will probably be even higher.

2 Ibid.

o Disaster loans to farmers hit by drought or other natural conditions encourage farmers to keep cropland in disaster-prone areas in production, at taxpayer's expense, causing further oversupply.

o Federal payments to large and small farmers alike, regardless of need, end up supporting large "agribusiness" corporations rather than low-income family farmers.

o Subsidized irrigation water causes otherwise uneconomic cropland to be farmed at great cost to the taxpayer, again increasing supply.

These contradictions are the inescapable harvest of policies that have supplanted the automatic pricing and supply signals of the market with politically determined government directives.[3]

CONGRESSIONAL PROPOSALS

Both House and Senate committees tentatively have adopted several major reforms proposed by the Reagan Administration and others. Although the specific reforms so far adopted by the committees vary, the general elements of the plans include:

1) Rates for Commodity Credit Corporation (CCC) non-recourse loans, the principal instruments of price supports, under both the House and Senate plans, would be set at 75 percent of the average market price for that commodity over the previous five years, after excluding the high and low years. These rates would not be allowed to drop more than 25 percent in any year. Currently loan rates for most commodities are set by Congress, without regard to market rates.

The Senate and House bills also provide, under certain circumstances, for CCC loan repayment at the actual world market price, rather than pre-set levels. The Senate would permit repayment of loans for most major commodities at the market price, as long as that price does not fall below specified levels. The House would give the Secretary of Agriculture discretion to establish a similar system.

2) Target prices used to calculate the level of direct subsidy, or "deficiency," payments to farmers would be set at 110

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[3] For an analysis of current agricultural programs and their unintended results, see George Dunlop, "The Department of Agriculture," in Stuart M. Butler, et al. (eds.), Mandate for Leadership II (Washington, D.C.: The Heritage Foundation, 1984); E. C. Pasour, "The High Cost of Farm Subsidies," Heritage Foundation Backgrounder No. 388; and Bruce Gardner, "Agriculture's Revealing--and Painful--Lesson for Industrial Policy," Heritage Foundation Backgrounder No. 320.

to 125 percent of the average market price, but would not be allowed to drop more than 5 percent in any year. This reform would not take place until 1987 under the Senate plan, and not until 1988 under the House plan. Target prices for most commodities are currently set as a proportion of loan rates, and thus not tied to the market.

3) The House proposal would require the Secretary of Agriculture to establish acreage reduction programs for wheat and feed grains; the Senate would allow, but not require, such programs. The President originally requested that all such authority be phased out.

4) The limit on the total amount of deficiency payments which may be received by one person would remain unchanged at $50,000. The White House proposed decreasing this cap significantly, and imposing a cap on the CCC loans available to each farmer.

5) Dairy support prices, under the House proposal, would be kept high through use of a complex "parity" formula. Since high support prices would encourage much more production, a "diversion" program would be established to pay dairy farmers not to produce milk. The Senate, however, proposes that support prices be gradually reduced, beginning in 1987.

6) The honey program would be unchanged under the House proposal, while the Senate would phase down support levels. The Administration proposed that the program be eliminated entirely.

7) Disaster relief programs remain untouched by either committee. The Administration, by contrast, proposed barring federal disaster relief loans to farmers in counties where crop insurance is available.

8) Under both proposals, "sodbusters," farmers who bring certain erosion-prone land into production, would become ineligible for federal farm payments for any commodity they produce. In addition, both plans would establish "conservation reserve" programs under which the Secretary of Agriculture would pay farmers to take erosion-prone land out of production for as long as 15 years. This reserve would total 25 to 30 million acres.

9) To encourage exports, both bills provide $325 million for "blended" credit programs, in which surplus commodities would be used to subsidize the price of exports. While the Senate plan would be limited to commodities affected by allegedly unfair trade practices of other countries, the House plan would not be so limited. The bills also provide $5 billion in export guarantees per year, and expand various other export programs.

Many changes are likely before the bills are finally sent by the committees to the full House and Senate for consideration. However, the present bills indicate the shape of the legislation to be approved by the committees.

ANALYSIS OF THE PROPOSALS

1) Loan rates

Commodity Credit Corporation (CCC) loans are currently the primary mechanism used by the federal government for supporting the prices of agricultural products. When participating farmers receive the loans, they pledge their crops for that season as collateral. Should the market price for the crops fall below the loan repayment amount, the farmers simply default and turn their crops over to the CCC, which must accept the crops as full payment of the loan. The farmer has no further obligation. In effect, the CCC becomes the buyer of last resort for the crops, ensuring the farmer that he can always sell his crop at a certain guaranteed price. By controlling the loan rates the government controls the minimum price of the crops.

Loan rates are set in a variety of ways. But for most commodities, including wheat, feed grains, sugar and rice, they have been set by Congress. These prices thus have less to do with the supply of or demand for a particular commodity than they have with the clout wielded by particular interest groups lobbying Congress. The current proposals would replace this highly political method of determining support levels with a method based on average market prices. Beginning in 1987 under the Senate plan, and the following year under the House plan, loan rates would be set at the average market price for each commodity, excluding the high and low years.

A second reform, the "marketing loan" systems proposed by the committees, would further tie loan rates to the market price by allowing farmers to pay off their loans at the actual world price for that year. Thus, more farmers would be encouraged to pay their loans in cash, instead of defaulting and turning their crops over to the government. Under the House plan, loans would no longer be on a "non-recourse basis," meaning that farmers would no longer be able to satisfy their debt merely by turning over their crops. The marketing loan system would mean more crops would be sold on the market, and government-held surpluses would be decreased. However, primarily because they would encourage many more farmers to take government loans, marketing loans would significantly increase the costs of the CCC loan program.

By displacing the market-determined price of commodities with a price determined by Congress, the current loan program causes two major economic problems for farmers. First, the prices set are usually higher than market levels, so farmers are induced to increase production, flooding the markets with surplus goods. Thus, by insulating farmers from lower market prices, which otherwise signals producers that less production is necessary, the loan program actually aggravates farm problems.

Second, the current method of setting loan rates hinders exports of agricultural goods. While U.S. price support programs

increase the price of American products, they do not affect the price of foreign products competing with American farmers in the world market. The price support programs thus tend to keep the price of U.S. goods above world market prices, putting them at a disadvantage in world trade. America's share of agricultural trade has fallen in recent years. Example: U.S. share of world wheat exports fell from 53 percent in 1973 to 38 percent in 1983. Much of this could have been prevented had U.S. prices not been kept artificially high.[4] Given the growing U.S. trade deficit, as well as the dependence of U.S. agriculture on foreign markets, it is important that this barrier to trade be lifted. The congressional proposals take an important first step toward that goal.

2) Deficiency Payments

These payments are direct grants to farmers to compensate them in case prices they can get for their crops fall below a predetermined target price. These targets are usually set directly by Congress and are often a percentage of the CCC loan rate. The House and Senate committee proposals would set the target prices for most commodities at 110 to 125 percent of a five-year market average. This would take place in 1987 under the Senate plan and 1988 under the House plan. These targets could not be reduced more than 5 percent in one year.

In a sense, the deficiency payments do not harm agricultural markets as much as CCC loans. While deficiency payments encourage more production than is necessary, they do not artificially raise the commodity price to consumers and potential foreign buyers. Nevertheless, these payments represent direct costs to the government and a large part of the farm budget. Net outlays for direct payments are expected to total more than $7.3 billion in 1985 alone, compared to $3 billion in net outlays for CCC loans.[5]

While the committee proposals purport to tie target prices to the market, they will ensure high farm subsidies and government expenditures for years. For one thing, the target price plans will guarantee farmers income of up to 125 percent of market prices. For another, until the plan takes effect, arbitrary target prices will be set much as they now are. Lastly, since annual reductions would be limited to 5 percent per year, it may take many years before the 125 percent level is reached.

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[4] United States Department of Agriculture, 1986 Budget Summary, p. 17.

[5] Income and Balance Sheet Statistics 1983, Economic Research Service, U.S. Department of Agriculture, EC1F53-3, September 1984.

In sum, while the committees would reform the CCC loan program, lowering market prices, they would make up the difference by ensuring farmers increased direct cash subsidies from the taxpayers. While the specific cost of this change is not yet available, it is sure to be substantial.

This expense cannot be justified as the necessary cost of aid to poor farmers. The deficiency payment programs make little attempt to differentiate between farmers who need assistance and those who do not. In fact, the biggest share of payments goes to the largest farmers. It is estimated that 12 percent of U.S. farms obtain 45 percent of direct government agricultural payments.[6] Conversely, part-time farmers with very small farms also receive a large portion of the benefits. For example, in 1982, farms with less than $40,000 in revenue received 22 percent of direct government payments.[7] And, of the medium-sized "family" farms that do receive aid, many are not in financial need. Thus, of the billions spent on deficiency payments, only a very small part reaches small, full-time farmers in need of help.

3) Acreage Reduction

Acreage reduction programs long have attempted to control output. These programs over the years have included "soil banks," acreage reserves, outright payment to farmers for reduction in output, and reductions required as a condition for participation in other programs. The Senate proposal would continue stand-by authority for such programs, while the House would require reductions in wheat and feed grain acreage. A better plan would be to phase out all authority for acreage reduction entirely.

Acreage reduction programs have not worked as planned. For instance, in 1981, with no acreage reduction program in effect, 81 million acres of wheat were harvested by American farmers. Two years later, 28.2 million acres were idled under government programs. Yet, the total acreage harvested that year was only 20 million less than in 1981. Further, the total domestic production of wheat decreased only 15 percent, although over one-third of the wheat acreage was supposedly idled.[8]

This paradox was due to several factors: 1) many farmers not participating in government programs increased their cultivated acreage, in anticipation of higher wheat prices caused by the restrictive government programs; 2) those who did participate farmed their remaining acreage much more intensively, thus improving the yield per acre; and 3) foreign producers increased

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6 Economic Report of the President, 1985, p. 115.

7 Ibid.

their wheat production by 8 percent in 1983 to take advantage of the reductions in U.S. production.[9]

The acreage reduction program is ineffective, and should be eliminated gradually. Instead of relying on such adminstrative programs, production decisions for agriculture, as in other industries, should be determined by increases or decreases in the market price of the good.

4) Benefit Caps

The tentative committee bills would retain caps on deficiency payments at the current high level of $50,000 per farmer. No caps would be placed on CCC loans.

In the past, stringent caps on benefits were opposed by an argument that large producers would have no incentive to participate in federal acreage reduction programs if their benefits were limited. As these programs have been proved ineffective, however, it no longer makes sense to provide benefits to large farmers to encourage them to participate.

5) Dairy Program

The dairy price support program is one of the most expensive and least effective federal farm support programs. In theory, the program is simple--the federal government attempts to keep the prices of milk and other dairy products at certain congressionally mandated levels by purchasing unlimited quantities of the product at those levels. The costs, however, are staggering. In the 1983-1984 season, to keep prices at the preordained levels, the federal government purchased over 16.6 billion pounds of cheese and butter, at a cost to the taxpayers of over $2.6 billion. In 1984-1985, some 10.4 billion pounds were purchased, costing about $1.6 billion.[10] This cost, of course, does not include consumer outlays for higher-priced milk, butter, and other products caused by the support program.

The House dairy proposal would expand this wasteful program. Using a complex pricing formula, based on a "parity" of prices with an arbitrarily selected base year, dairy price supports by 1990 would be raised from the current $11.60 per hundred pounds (cwt.) to a level of perhaps more than $13.00. Such an increase would aggravate the current oversupply problem, since dairy

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8 "Acreage Reduction Programs," U.S. Department of Agriculture, p. 2.

9 Ibid., p. 5.

10 James F. Thompson and W. Frank Edwards, Dairy Policy and the Public Interest: The Economic Legacies, Cato Institute Policy Analysis No. 57, July 30, 1985, p. 3.

farmers merely would be encouraged to produce more. To avoid this, the committee proposal calls for a "diversion" program, similar to a temporary program used last year, in which farmers are paid simply not to produce milk.

A diversion program, however, will not alleviate the dairy surplus caused by high, artificially supported prices. In last year's diversion program, for example, only 20 percent of the farmers even participated, and production was decreased only about 3 percent.[11] What is worse, a permanent diversion program would create new problems. Among them:

o The program would be funded by a "production tax" on individual dairies, which could be as high as $1.05 per cwt. Thus, the income of many farmers would be decreased, not increased, by this program.

o The program could lead to localized milk shortages, despite the national oversupply. Under last year's program, many more dairy farmers in the southeast signed up for the diversion than in other regions, leading to shortages in that area.

o The program could hurt other farm sectors. Last year, for instance, many dairy farmers cut production by slaughtering thousands of cows, thus severely depressing the market for meat products. The House committee proposal attempts to avoid repetition of this by setting up yet another federal program: to have the government buy millions of pounds of red meat, costing taxpayers $200 million.

The Senate Agriculture committee takes a different approach. Under its plan, the dairy support price would be gradually lowered if the volume of government purchases remains high. On January 1, 1987, the Secretary of Agriculture would drop support prices 50¢ per cwt. if purchases of surplus exceeded 5 billion pounds. The next year the price could be dropped another 50¢ if purchases remained at 5 billion pounds, and a full $1.00 if they were at 10 billion pounds. The price, however, could be raised if purchases were 2 billion pounds or less.

This plan would be more promising if price decreases began next year rather than in 1987. The Senate plan, however, does attack the cause of the dairy problem--support prices. It seeks to remedy this rather than establish expensive, complex, and equally ineffective new programs.

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[11] See, General Accounting Office, Effects and Administration of the 1984 Milk Diversion Program, Report to the Congress (GAO/RCEO-85-126), July 29, 1985, p. 10.

6) Honey

This is the only commodity program that the Administration had slated for total elimination. Current law supports the price of honey at about 60 percent of "parity"--the price received during 1900-1914. This support is maintained through the use of CCC non-recourse loans, as well as direct government purchases of honey at a predetermined support price.

The honey price support program combines the flaws of most other support progams. It is expensive. The program cost $89 million in 1983.[12] It helps only a few people. Of the more than 200,000 U.S. beekeepers, 95 percent are hobbyists and 10,000 are part-time beekeepers, leaving only about 1,600 full-time commercial beekeepers.[13] They are just about the sole beneficiaries of the program. In addition, the program hurts potential exports and encourages imports. In fact, since the price of imported honey is much lower than price-supported domestic honey, many domestic honey producers and packers actually have imported honey for domestic use while selling their own supplies to the government at the higher price.[14] Surely, elimination of this program is long overdue.

7) Disaster Relief

The Administration proposed to limit the availability of Farmers' Home Administration (FmHA) emergency loans to those counties without alternative crop insurance. These disaster loans thus would be available on the same basis as federal disaster payments, which in 1981 were limited to counties without insurance. Neither congressional committee addresses this issue.

The current program is essentially a subsidized insurance system for farmers. It encourages farmers to cultivate land in areas subject to such natural disasters as drought and flood. The farmer is freed from worry about the consequences of farming such land since the taxpayers are assuming the risk. The result is high costs to the taxpayer when disaster hits or, when there is no disaster, extra land in production at a time when other government policies are attempting to reduce production. Limiting disaster loan availability would encourage farmers to make wiser use of their land as well as encourage private crop insurance.

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12 Honey: Background for 1985 Farm Legislation, Economic Research Service, U.S. Department of Agriculture, Agricultural Information Bulletin No. 465, September 1984, p. 24.

13 Ibid., pp. 2-3.

14 Ibid., p. 26.

8) Sodbusters

The Senate and House committees propose sanctions against "sodbusters." The Senate would bar a farmer who cultivates any highly erodible land from benefits from any federal farm program. The House provision only would apply to land which has not been cultivated since 1980.

In part because of federal incentives, much highly erodible farmland has been put into production recently. This threatens permanent damage to that and nearby land. While Washington should not prohibit cultivation of such land explicitly, it also should not provide rewards for its use. This proposal is an important step toward proper environmental protection.

The proposed "conservation reserve," however, is another matter. Here, the government would not simply be withholding benefits for farming on fragile lands, but would be paying farmers not to do so. As much as 30 million acres could be put in the reserve, costing the treasury over a billion dollars. It makes no sense to pay farmers to protect their own land.

Conservation reserve proponents argue that their scheme would reduce acreage, relieving overproduction. But this would suffer from most of the flaws plaguing the diversion programs. Farmers would cultivate their remaining land much more intensively, for example, while any reduced production which is achieved would benefit foreign producers. In today's world market, American farmers are not helped merely by reducing U.S. acreage.

9) Exports

The export subsidies endorsed by the House and Senate committees will do little to solve the farmers' export problems. To be sure, subsidies will increase exports, but will impose offsetting economic costs on the U.S., since the increase in exports will be paid for by the U.S. Treasury.

Increased subsidies, meanwhile, are likely to prompt foreign governments to increase their crop export subsidies and strengthen their barriers to U.S. crop imports. This is precisely what happened in the trade wars which preceded the Great Depression.

Instead of subsidies, the U.S. could encourage exports in two ways: 1) decrease price supports to make U.S. prices more competitive, as the committee proposals would begin to do; and 2) promote multilateral trade negotiations to extend GATT restrictions on tariffs to agricultural export subsidies. This would reduce barriers to U.S. food exports rather than raise new barriers to world trade.

PRIVATE SECTOR INITIATIVES

Congress should use the opportunity of the 1985 farm bill debate to explore private sector mechanisms to replace the government's role in stabilizing farm prices. This includes private crop insurance, private reserve systems, and long-term supply contracts. A very promising innovation would be an options market for agriculture.[15]

Such an options market would permit farmers to purchase "put options" on the commodity futures market, giving them the right to sell their crop to the provider of the option at a predetermined price. In this way, the farmers insure themselves against a substantial price drop. The provider, in turn, would receive a fee for assuming the risk. In effect, this system would operate much like the CCC non-recourse loan program, except that farmers would buy the protection at market rates, rather than at taxpayer-subsidized rates. While the market for such options is now small, several major financial institutions plan to introduce options programs in the near future. Options offer price protection without cost to the government or distortion of the market price system.

CONCLUSION

For the last half-century, the federal government has attempted to solve the problem of farmers by manipulating farm prices and production. It now is obvious that these policies not only are very costly but simply do not work. The solution is to "deregulate" agriculture and allow it to benefit from the same market forces that aid other industries.

The proposals adopted by the House and Senate agricultural committees achieve only a small part of this. They wisely tie the commodity loan rates to actual market prices; this will let the industry respond better to market forces and spur exports. Yet, the committees will keep direct subsidies high, encouraging further overproduction at higher costs to taxpayers. Important reforms such as caps on subsidies to individual farmers, elimination of acreage reduction programs, limitation of wasteful disaster loans, are ignored. What is worse, the House proposes a dairy program which ensures continued high costs and market distortions for taxpayers and dairy farmers.

If the Reagan Administration and Congress want to help American farmers this year, these tentative proposals must be

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[15] Kandice Kahl, "Agricultural Options: An Alternative to Federal Farm Programs," Heritage Foundation Backgrounder No. 414, March 7, 1985.

revised. They must move quickly. On September 30, current farm legislation expires, returning the U.S. to the "permanent" farm laws last in effect in the 1930s. This permanent legislation would force most farmers to cut production to levels set by a national "referendum" of farmers. The results would be disastrous in today's world agriculture market.

The threat of reversion to such anachronistic legislation offers an opportunity to those favoring genuine reform of farm programs. This threat makes expeditious passage of new farm legislation essential, increasing the leverage of those seeking more market-orientated policies. Thus, for instance, the threat of a presidential veto could be an important tool in making real changes in farm policy.[16] Given the reforms proposed in the current bills, and the opportunity for further improvements, there is still a good chance that long overdue farm reform can be achieved this year.

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[16] See James Gattuso and Stephen Moore, "Reagan's Trump Card: The Veto," Heritage Foundation Backgrounder No. 443, July 8, 1985.