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AFPC **POLICY WORKING PAPER**

# IMPACT OF FROZEN AND REDUCED TARGET PRICES ON REPRESENTATIVE TEXAS FARMS: THE CBO BASELINE


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# IMPACT OF FROZEN AND REDUCED TARGET PRICES ON REPRESENTATIVE TEXAS FARMS: THE CBO BASELINE

by

James W. Richardson, Ronald D. Knutson, Edward G. Smith,
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Federal budget pressures have led to several proposals which would directly or indirectly reduce the level of direct payments to farmers. While many of these proposals do not overtly cut target prices, their effects are equivalent. Previous AFPC working papers have evaluated the impacts of frozen target prices utilizing the Food and Agricultural Policy Research Institute baseline market price projections through an assumed four-year life of the 1990 Farm Bill. FAPRI did not evaluate the market price impacts of reduced target prices; therefore, the prior AFPC studies did not analyze this alternative. Recently, however, the Congressional Budget Office (CBO) reported its price projections for both frozen and reduced target price levels.

This article presents the farm level impacts utilizing the CBO price projections for the assumptions of:

- target prices frozen at the 1990 level for the period 1990-94, and
- target prices reduced over the period 1990-94 at the same annual rate as 1989-90.

Impacts are evaluated over the 1989-94 planning horizon for debt levels ranging from 20 percent of assets to 70 percent of assets.[1]

The analysis utilizes the farm level simulation model, FLIPSIM, developed by Richardson and Nixon, and analyzes the impacts on six representative Texas crop farms. The representative farms grow various combinations of wheat, cotton, corn, and grain sorghum, as is typical of the respective production regions given the current economic environment and the constraints imposed by the farm program (Figure 1). The farms and initial mix of crops produced are presented in Table 1. The assumed levels of target prices, loan rates, ARP, and market prices as

[1] The debt-to-asset ratio represents only debt against long- and intermediate-term assets.

determined by the CBO are indicated in Table 2. Sorghum farm program parameters and prices are determined based on the normal relationship to corn, i.e., 95 percent of corn price levels.

## Results

For purposes of this article, the impacts of frozen and declining target prices on representative crop farms in Texas are evaluated in terms of: net cash income, the probability of earning a 5 percent return on investment (success), and the probability of economic survival.

### Net Cash Farm Income

Tables 3 and 4, respectively, summarize the impacts of frozen and declining target prices on net cash farm income for representative Texas farms having a debt/asset ratio of 0.4.[2] In 1989, each of the farms had a positive net cash farm income. In 1990, the last year under the 1985 Farm Bill, target prices were lowered under **both** scenarios by 0.68 percent for cotton, 2.5 percent for wheat, 3.17 percent for corn, and 3.17 percent for sorghum. This annual rate of reduction over a 4 year 1990 Farm Bill caused the Northern High Plains wheat-sorghum farm to operate in the red. The medium Southern High Plains cotton farm, on average, earned a very small income of $3,230 in 1990 (Tables 3 and 4).

With frozen target prices, increases in farm input costs resulted in a negative net cash income for the Northern High Plains wheat-sorghum farm and the medium Southern High Plains cotton farm throughout the 1991-94 period (Table 3). By 1994, these two farms were experiencing large losses, while the Coastal Bend farm barely generated positive net cash income. By 1994, the Rolling Plains farm generated net cash income 18 percent lower than its 1989 level, while the Blacklands and large Southern High Plains farms experienced declines of 57 and 65 percent, respectively (Table 3).

With continuously declining target prices, negative net cash farm income was experienced by three of the six representative farms in 1993 (Table 4). By 1994, net cash farm income had dropped below $10,000 for all six Texas farms. This level of net cash income is not even

[2]Net cash farm income is calculated as total farm receipts less all cash expenses. Farmers must pay principal payments and family living expenses, and replace assets with net cash farm income.

adequate to cover family living expenses, replace equipment, and make principal payments. The result would be a severe financial squeeze.

The change in average net cash farm income for 1994, due to shifting from frozen target prices to declining target prices, is summarized in Figure 2 for farms having a 40 percent debt-to-asset ratio. Decreasing target prices results in roughly a $19,000 decline in net cash farm income for the Coastal Bend and Blacklands farms, a $15,900 decrease for the medium Southern High Plains farm, and more than a $32,000 decline for the large Southern High Plains farm and the Northern High Plains farm. The Rolling Plains farm showed the smallest decline of only $9,200.

**Net Worth**

Reduced net cash incomes result in reductions in net worth for Texas crop farms. To quantify the impacts on net worth, the model results for ending net worth are summarized in Tables 5-9. Initial net worth values for the six farms are in Table 5 as a point of reference. The absolute change in the simulated values for ending net worth in 1994 (presented in 1989 dollars), assuming alternative initial debt situations, are presented in Tables 6 and 7 for the frozen and reduced target price assumptions, respectively. Percentage changes in net worth over the five-year period, 1989-94, are summarized in Tables 8 and 9 for frozen and reduced target prices, respectively. For debt levels greater than 40 percent, all farms but the larger Southern High Plains farm experienced a loss in net worth over the 1989-94 period with frozen target prices (Table 8). Declines in net worth are much greater for the declining target price scenario, exceeding 100 percent for three farms and falling more than 68 percent for two farms (Table 9).

**Return on Investment**

The return on investment criteria evaluate the probability that the representative Texas farms will earn a 5 percent or greater return on initial investment over the period 1989-94 (Tables 10 and 11). The medium Southern High Plains cotton farm and the Northern High Plains wheat-sorghum farm had only a 41 percent chance of earning a 5 percent return at even the lowest debt level, assuming frozen target prices through 1994 (Table 10). At the highest debt level, only the

large Southern High Plains cotton farm had greater than a 70 percent chance of earning a 5 percent return on investment if target prices remain at their 1990 levels (Table 10).

With declining target prices, the chance of earning a 5 percent return falls to less than one-third for the highest debt level evaluated with the exception of the large Southern High Plains farm (60 percent) (Table 11). If debt exceeded 40 percent of assets, the probability of earning a 5 percent return fell below 50 percent for four of the six Texas representative farms. These results suggest, as expected, that with declining target prices a relatively large number of farms in these regions would experience substantially greater financial stress than if target prices were frozen.

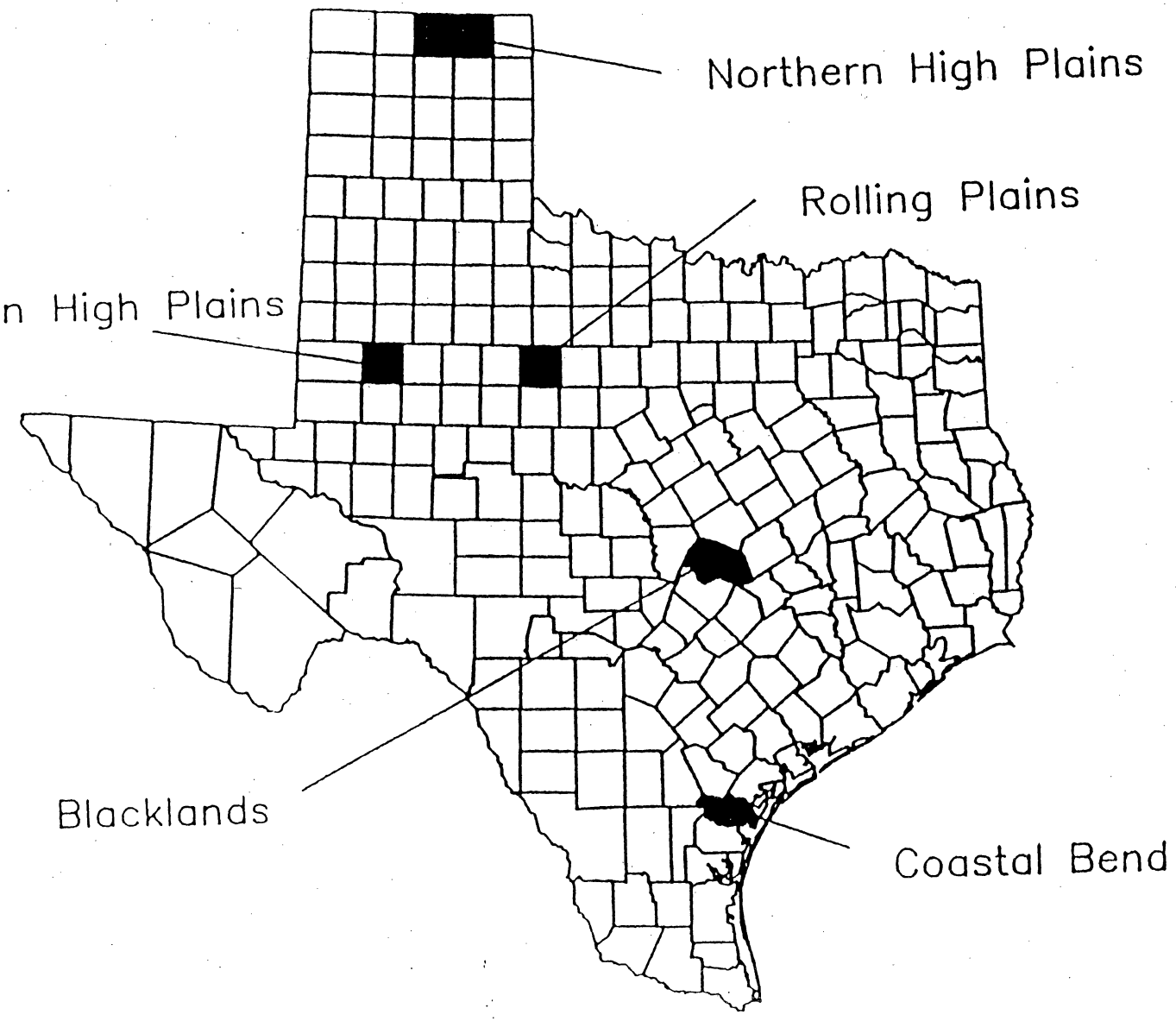
**Probability of Survival**

In the simulation model, farms whose debt-to-asset ratio increased above 95 percent were considered to have failed (declared economically insolvent). Assuming frozen target prices, the medium Southern High Plains cotton and Northern High Plains wheat-sorghum farms had less than a 40 percent chance of surviving if their initial debt-to-asset ratio was greater than 50 percent (Table 12). With declining target prices, these same farms had less than a 40 percent chance of survival if their initial debt-to-asset ratio was greater than 40 percent (Table 13). Declining target prices resulted in lower probabilities of survival for most all farm types and debt levels.

## Conclusions

The 1985 Farm Bill provided for successive annual downward adjustments in target prices for the major program crops from 1986-90. This study clearly indicates that, based on the CBO market price expectations, further proportional reductions in target prices throughout the life of the 1990 bill would place a substantial number of Texas crop farms in financial jeopardy. The farms most adversely affected would be moderate-size operations located on the Texas High Plains and Coastal Bend regions. As indicated in this and previous reports, even with frozen target prices, these farms are in a fragile financial condition when their initial debt-to-asset ratio rises above 40 percent.

Figure 1. Study Areas for Representative Crop Farms.



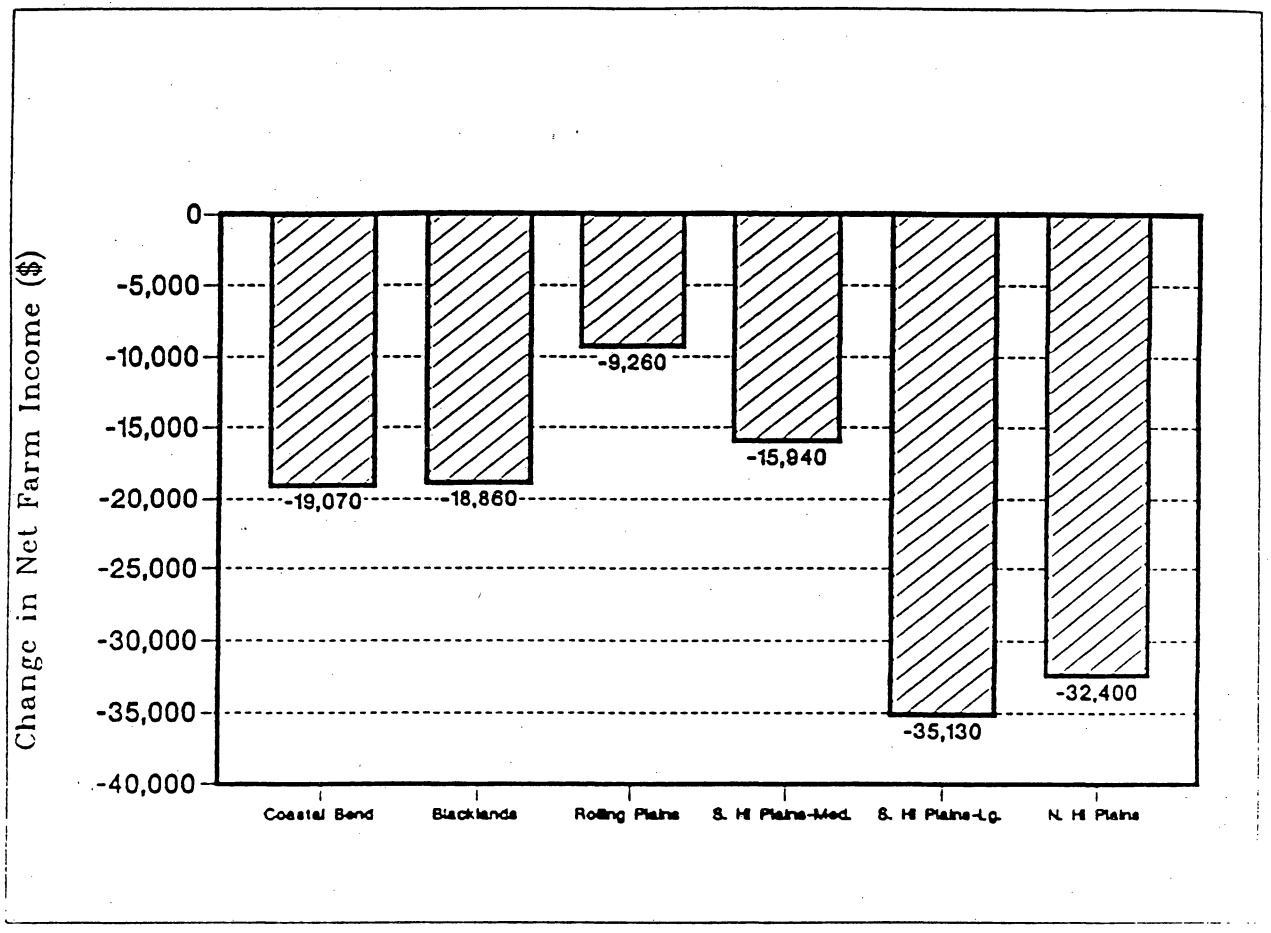



**Figure 2. Change in Average Net Cash Farm Income in 1994 Due to Shifting From Frozen Target Prices to Declining Target Prices for Six Representative Texas Farms, Assuming 40 Percent Debt.**

**Table 1. Characteristics of Representative Crop Farms in Five Regions of Texas.**

| Crop | Coastal Bend | Blacklands | Rolling Plains | Southern High Plains Medium | Southern High Plains Large | Northern High Plains |
|---|---|---|---|---|---|---|
| Cropland (Acres) | 1200 | 1000 | 1300 | 1360 | 3300 | 2240 |
| Owned (Acres) | 300 | 250 | 325 | 340 | 825 | 560 |
| Leased (Acres) | 900 | 750 | 975 | 1020 | 2475 | 1680 |
| Assets ($)[1] | 473,600 | 405,280 | 316,650 | 277,450 | 688,160 | 418,741 |
| Land ($) | 342,500 | 250,000 | 162,500 | 116,800 | 283,400 | 188,000 |
| Machinery ($) | 126,100 | 145,280 | 124,150 | 130,650 | 331,950 | 170,241 |
| Other ($) | 5,000 | 10,000 | 30,000 | 30,000 | 72,810 | 60,500 |
| Crop Mix (Base Acres) | | | | | | |
| Irr. Cotton | 0 | 0 | 0 | 448 | 1088 | 0 |
| Dry. Cotton | 456 | 330 | 909 | 911 | 2211 | 0 |
| Irr. Sorghum | 0 | 0 | 0 | 0 | 0 | 560 |
| Dry. Sorghum | 589 | 400 | 0 | 0 | 0 | 0 |
| Irr. Wheat | 0 | 0 | 0 | 0 | 0 | 560 |
| Dry. Wheat | 0 | 50 | 390 | 0 | 0 | 1120 |
| Dry. Corn | 95 | 220 | 0 | 0 | 0 | 0 |

[1]Land includes the 1989 market value of cropland. Machinery includes the market value of all farm machinery and irrigation equipment. Other assets consist of pastureland, livestock, off-farm investments, and cash or near-cash investments.

**Table 2. Target Prices, Loan Rates, and Market Prices for Cotton, Wheat, and Corn, Assuming Frozen and Declining Target Prices, 1989-94.**

| Crop | Frozen Target Price | | | Declining Target Price | | |
|---|---|---|---|---|---|---|
| | Target Price | Loan Rate | Price | Target Price | Loan Rate | Price |
| Cotton ($/lb) | | | | | | |
| 1989 | 0.734 | 0.50 | 0.50 | 0.734 | 0.50 | 0.50 |
| 1990 | 0.729 | 0.50 | 0.50 | 0.729 | 0.50 | 0.50 |
| 1991 | 0.729 | 0.50 | 0.50 | 0.713 | 0.50 | 0.50 |
| 1992 | 0.729 | 0.50 | 0.50 | 0.698 | 0.50 | 0.50 |
| 1993 | 0.729 | 0.50 | 0.50 | 0.683 | 0.50 | 0.50 |
| 1994 | 0.729 | 0.50 | 0.50 | 0.668 | 0.50 | 0.50 |
| Wheat ($/bu) | | | | | | |
| 1989 | 4.10 | 2.06 | 3.50 | 4.10 | 2.06 | 3.45 |
| 1990 | 4.00 | 1.97 | 3.26 | 4.00 | 1.96 | 3.35 |
| 1991 | 4.00 | 1.99 | 3.28 | 3.85 | 2.00 | 3.22 |
| 1992 | 4.00 | 2.14 | 3.41 | 3.70 | 2.14 | 3.18 |
| 1993 | 4.00 | 2.18 | 3.36 | 3.56 | 2.14 | 3.11 |
| 1994 | 4.00 | 2.15 | 3.44 | 3.42 | 2.08 | 3.13 |
| Corn ($/bu) | | | | | | |
| 1989 | 2.84 | 1.65 | 2.01 | 2.84 | 1.65 | 2.07 |
| 1990 | 2.75 | 1.56 | 1.99 | 2.75 | 1.66 | 2.04 |
| 1991 | 2.75 | 1.58 | 2.02 | 2.63 | 1.67 | 2.05 |
| 1992 | 2.75 | 1.59 | 2.10 | 2.51 | 1.76 | 2.07 |
| 1993 | 2.75 | 1.59 | 2.19 | 2.40 | 1.76 | 2.10 |
| 1994 | 2.75 | 1.64 | 2.25 | 2.29 | 1.76 | 2.10 |

Source: Congressional Budget Office, U.S. Congress, 1989.

**Table 3. Average Annual Net Cash Farm Income for Six Representative Texas Farms, Assuming 40 Percent Debt and Frozen Target Prices from 1991-94.**

| Farm | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 |
|---|---|---|---|---|---|---|
| | ($) | | | | | |
| Coastal Bend | 41,760 | 24,590 | 23,390 | 26,430 | 9,220 | 1,800 |
| Blacklands | 49,400 | 36,060 | 39,000 | 41,370 | 30,340 | 21,130 |
| Rolling Plains | 22,830 | 16,690 | 20,930 | 28,650 | 19,330 | 18,680 |
| S. High Plains - Med. | 25,520 | 3,230 | -5,110 | -1,360 | -13,520 | -26,310 |
| S. High Plains - Lg. | 103,350 | 84,540 | 69,250 | 83,840 | 58,440 | 36,170 |
| Northern High Plains | 24,130 | -1,250 | -11,930 | -15,160 | -32,590 | -50,100 |

**Table 4. Average Annual Net Cash Farm Income for Six Representative Texas Farms, Assuming 40 Percent Debt and Declining Target Prices Through 1994 at the Same Rate as 1989-90.**

| Farm | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 |
|---|---|---|---|---|---|---|
| | ($) | | | | | |
| Coastal Bend | 41,760 | 24,590 | 17,800 | 16,050 | -6,480 | -17,270 |
| Blacklands | 49,400 | 36,060 | 33,860 | 31,340 | 15,960 | 2,270 |
| Rolling Plains | 22,830 | 16,690 | 18,470 | 24,150 | 12,360 | 9,420 |
| S. High Plains - Med. | 25,520 | 3,230 | -9,290 | -8,680 | -24,730 | -42,250 |
| S. High Plains - Lg. | 103,350 | 84,540 | 59,090 | 65,430 | 30,700 | 1,040 |
| Northern High Plains | 24,130 | -1,250 | -20,020 | -31,650 | -57,090 | -82,500 |

**Table 5. Initial Net Worth for Representative Texas Farms, Assuming Alternative Debt Levels, 1989.**

| | Debt-to-Asset Ratio | | | | | |
|---|---|---|---|---|---|---|
| Farm | 0.2 | 0.3 | 0.4 | 0.5 | 0.6 | 0.7 |
| | ($) | | | | | |
| Coastal Bend | 373,380 | 326,520 | 279,660 | 232,800 | 185,940 | 139,080 |
| Blacklands | 386,232 | 341,703 | 297,174 | 252,645 | 208,116 | 163,587 |
| Rolling Plains | 267,320 | 237,655 | 207,990 | 178,325 | 148,660 | 118,995 |
| S. High Plains - Med. | 225,960 | 201,215 | 176,470 | 151,725 | 126,980 | 102,235 |
| S. High Plains - Lg. | 565,725 | 504,109 | 442,492 | 380,876 | 319,260 | 257,643 |
| Northern High Plains | 344,593 | 307,519 | 270,445 | 233,370 | 196,296 | 159,222 |

**Table 6. Real Change in Ending Net Worth for Representative Texas Farms, Assuming Frozen Target Prices and Alternative Initial Debt Levels, 1989-94.**

| | Debt-to-Asset Ratio | | | | | |
|---|---|---|---|---|---|---|
| Farm | 0.2 | 0.3 | 0.4 | 0.5 | 0.6 | 0.7 |
| | ($) | | | | | |
| Coastal Bend | -23,250 | -32,350 | -46,870 | -62,860 | -86,950 | -112,870 |
| Blacklands | 14,338 | 5,347 | -4,014 | -16,445 | -33,126 | -57,467 |
| Rolling Plains | -21,890 | -29,205 | -36,480 | -46,635 | -54,710 | -70,965 |
| S. High Plains - Med. | -91,460 | -105,475 | -123,910 | -132,645 | -135,990 | -132,825 |
| S. High Plains - Lg. | 166,875 | 148,181 | 127,298 | 104,454 | 70,540 | 36,667 |
| Northern High Plains | -120,163 | -138,619 | -168,855 | -208,060 | -227,646 | -212,912 |

**Table 7. Real Change in Ending Net Worth for Representative Texas Farms, Assuming Declining Target Prices and Alternative Initial Debt Levels, 1989-94.**

| | Debt-to-Asset Ratio | | | | | |
|---|---|---|---|---|---|---|
| Farm | 0.2 | 0.3 | 0.4 | 0.5 | 0.6 | 0.7 |
| | ($) | | | | | |
| Coastal Bend | -54,820 | -66,510 | -81,860 | -100,740 | -136,690 | -164,030 |
| Blacklands | -15,122 | -25,403 | -36,584 | -50,865 | -70,806 | -111,457 |
| Rolling Plains | -35,790 | -45,065 | -52,940 | -60,715 | -70,330 | -87,045 |
| S. High Plains - Med. | -127,830 | -144,435 | -159,420 | -160,815 | -160,830 | -151,215 |
| S. High Plains - Lg. | 105,895 | 85,281 | 63,128 | 32,794 | -8,860 | -43,133 |
| Northern High Plains | -184,223 | -224,099 | -261,755 | -286,010 | -278,556 | -237,282 |

**Table 8. Present Value of Ending Net Worth, as a Percentage of Beginning Net Worth, for Representative Texas Farms, Assuming Frozen Target Prices and Alternative Debt Levels, 1989-94.**

| | Debt-to-Asset Ratio | | | | | |
|---|---|---|---|---|---|---|
| Farm | 0.2 | 0.3 | 0.4 | 0.5 | 0.6 | 0.7 |
| | (%) | | | | | |
| Coastal Bend | 93.77 | 90.09 | 83.24 | 73.00 | 53.43 | 18.85 |
| Blacklands | 103.71 | 101.56 | 98.65 | 93.49 | 84.08 | 64.87 |
| Rolling Plains | 91.81 | 87.71 | 82.46 | 73.85 | 63.20 | 40.36 |
| S. High Plains - Med. | 59.52 | 47.58 | 29.78 | 12.58 | -7.10 | -29.92 |
| S. High Plains - Lg. | 129.50 | 129.39 | 128.77 | 127.42 | 122.09 | 114.23 |
| Northern High Plains | 65.13 | 54.92 | 37.56 | 10.85 | -15.97 | -33.72 |

**Table 9. Present Value of Ending Net Worth, as a Percentage of Beginning Net Worth, for Representative Texas Farms, Assuming Declining Target Prices and Alternative Debt Levels, 1994**

| | Debt-to-Asset Ratio | | | | | |
|---|---|---|---|---|---|---|
| Farm | 0.2 | 0.3 | 0.4 | 0.5 | 0.6 | 0.7 |
| | (%) | | | | | |
| Coastal Bend | 85.32 | 79.63 | 70.73 | 56.73 | 26.49 | -17.94 |
| Blacklands | 96.08 | 92.57 | 87.69 | 79.87 | 65.98 | 31.87 |
| Rolling Plains | 86.61 | 81.04 | 74.55 | 65.95 | 52.69 | 26.85 |
| S. High Plains - Med. | 43.43 | 28.22 | 9.66 | -5.99 | -26.66 | -47.91 |
| S. High Plains - Lg. | 118.72 | 116.92 | 114.27 | 108.61 | 97.22 | 83.26 |
| Northern High Plains | 46.54 | 27.13 | 3.21 | -22.56 | -41.91 | -49.03 |

**Table 10. Probability of the Representative Texas Farms Earning a 5% Return on Investment, Assuming Frozen Target Prices From 1991-94 and Alternative Debt Levels, 1989-94.**

| | Debt-to-Asset Ratio | | | | | |
|---|---|---|---|---|---|---|
| Farm | 0.2 | 0.3 | 0.4 | 0.5 | 0.6 | 0.7 |
| | (%) | | | | | |
| Coastal Bend | 91 | 81 | 67 | 51 | 33 | 23 |
| Blacklands | 100 | 99 | 97 | 93 | 75 | 41 |
| Rolling Plains | 83 | 77 | 69 | 55 | 45 | 38 |
| S. High Plains - Med. | 41 | 34 | 31 | 25 | 17 | 13 |
| S. High Plains - Lg. | 96 | 95 | 92 | 84 | 79 | 71 |
| Northern High Plains | 41 | 28 | 19 | 12 | 6 | 6 |

**Table 11. Probability of the Representative Texas Farms Earning a 5% Return on Investment, Assuming Declining Target Prices and Alternative Debt Levels, 1989-94.**

| | Debt-to-Asset Ratio | | | | | |
|---|---|---|---|---|---|---|
| Farm | 0.2 | 0.3 | 0.4 | 0.5 | 0.6 | 0.7 |
| | (%) | | | | | |
| Coastal Bend | 76 | 63 | 43 | 31 | 24 | 12 |
| Blacklands | 99 | 96 | 91 | 71 | 39 | 21 |
| Rolling Plains | 78 | 68 | 54 | 45 | 41 | 30 |
| S. High Plains - Med. | 32 | 27 | 17 | 15 | 11 | 8 |
| S. High Plains - Lg. | 92 | 89 | 82 | 74 | 67 | 60 |
| Northern High Plains | 16 | 9 | 6 | 5 | 4 | 2 |

**Table 12. Probability of Survival Through 1994 for Representative Texas Farms, Assuming Frozen Target Prices From 1991-94 and Alternative Debt Levels.**

| | Debt-to-Asset Ratio | | | | | |
|---|---|---|---|---|---|---|
| Farm | 0.2 | 0.3 | 0.4 | 0.5 | 0.6 | 0.7 |
| | (%) | | | | | |
| Coastal Bend | 100 | 100 | 100 | 99 | 88 | 62 |
| Blacklands | 100 | 100 | 100 | 100 | 100 | 97 |
| Rolling Plains | 100 | 99 | 96 | 87 | 82 | 62 |
| S. Hi Plains - Med. | 91 | 80 | 64 | 52 | 37 | 23 |
| S. Hi Plains - Lg. | 100 | 100 | 99 | 99 | 93 | 83 |
| Northern High Plains | 98 | 93 | 77 | 54 | 31 | 10 |

**Table 13. Probability of Survival Through 1994 for Representative Texas Farms, Assuming Declining Target Prices and Alternative Debt Levels.**

| | Debt-to-Asset Ratio | | | | | |
|---|---|---|---|---|---|---|
| Farm | 0.2 | 0.3 | 0.4 | 0.5 | 0.6 | 0.7 |
| | (%) | | | | | |
| Coastal Bend | 100 | 100 | 100 | 95 | 71 | 36 |
| Blacklands | 100 | 100 | 100 | 100 | 99 | 85 |
| Rolling Plains | 100 | 97 | 93 | 87 | 79 | 52 |
| S. Hi Plains - Med. | 82 | 66 | 54 | 39 | 25 | 14 |
| S. Hi Plains - Lg. | 100 | 99 | 99 | 95 | 86 | 72 |
| Northern High Plains | 94 | 72 | 51 | 30 | 10 | 6 |

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