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CURRENT ECONOMIC ISSUES IN U.S. AGRICULTURE:
IMPLICATIONS FOR FARM POLICY CHOICES IN 1985

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This paper considers the economic basis for agricultural policy, with particular reference to legislation to replace the Agriculture and Food Act of 1981, which expires in 1985. The economic basis consists of problems for which farm programs are a plausible remedy. The most pressing of these problems involve instability of prices and incomes. Other closely related problems involve financial crises facing certain farmers, weak demand for U.S. farm exports, and a perceived threat to our soil and water resources. These problems will be discussed in turn, and their policy implications discussed.

Instability

Instability is a salient feature of U.S. agriculture, and has been cited as part of the rationale for farm programs from the 1920s to the present. Yet the causal connection between instability and policy choice is not well established. How much of existing or prospective policy makes sense as a response to society's desire¹ for more stable prices, as opposed, for example, to farmers' desire for higher prices? I will first consider how instability should affect policy, and then go on to a discussion of how the political and economic elements of instability are likely to bear on the agricultural policy choices made in 1985.

What is Instability?

Among the phenomena that have been identified as problems in U.S. agriculture, the following involve instability: sharp short-term commodity price fluctuations, long periods of low farm prices and farm income, random production due to biological and meteorological events, unpredicted macroeconomic policies, and "disorderly marketing" of farm products.

These phenomena are relevant to policy because they impose losses on people which may be moderated by governmental intervention.

But these phenomena do not encompass all change which causes losses. For example, the closing of an export market for U.S. soybeans can impose losses on soybean producers without there being an instability problem; or the meat packing industry may become monopolized and impose losses on cattlemen without there being an instability problem. This is perhaps too obvious even to mention. But it is not easy to state precisely what makes a problem an instability problem.

Instability necessarily involves changes, but change is not sufficient for instability. Trends in prices do not imply instability. This is important in the measurement of instability of, say, a price series. It means we should consider deviations around trend in calculating price instability. But what if a price series deviates from trend only gradually and predictably, as exponential or quadratic functions may do over a range of data? Should instability be defined as deviation from such a function? Going a step further, what if a price series followed a perfectly predictable cyclical pattern, with known period and amplitude? At least some such price series would be judged unstable by most observers. My suggested measurement would be based on deviations around the best-fitting monotonic (no turning points), continuously differentiable (no corners or gaps) function through the time series data, perhaps the mean squared logarithmic deviation.

Some have identified instability with unpredictability. But unpredictability is not necessary for instability, as the sine-wave cycle example shows. Still, unpredictability probably means instability is a greater problem for economic agents. They cannot plan as well for change of given magnitude unless they know when it is coming.

Let us now consider the nature of economic problems caused by instability of the kinds important in agriculture.

Price fluctuations. In the 1970s, agricultural commodity prices were unstable to a degree unprecedented in this century except during and after major wars (Robinson 1975; U.S., Office of the President, 1976). The sharp price fluctuations were attributed in part to policy failure (Schnittker 1973; Sanderson 1975), and whatever their cause were seen as requiring a policy response. There was a policy response, the main element of which was the Farmer-Owned Reserve (FOR) program for grain storage, established

in 1977. It was referred to by Secretary of Agriculture Bergland as the cornerstone of the Carter administration's farm program. The FOR program continues to the present.

The FOR appears to have stabilized grain prices, but not by as much as might have been expected (U.S. General Accounting Office 1981; Sharples 1981; Salathe, Price, and Banker, in press). What problems did it solve? Owners of grain-eating livestock did not see their feed costs fall quite as low as they would have without an FOR in 1978-79, and did not see their feed costs rise as high as they otherwise would have in 1980. But by the same token, grain producers did not see their receipts rise as much as they would have in 1980 without an FOR, while they received more than they otherwise would have in 1978-79.

The potential net gain to society from the evening out of price fluctuations has been analyzed in a series of papers sparked by Massell (1969). The basic idea is that if prices are permitted to fluctuate needlessly, resources are utilized wastefully--generating low consumer value relative to cost at the margin--during low-price periods, as seen from the point of view of the high-price periods. There is a net gain to a transfer of goods from low-price to high-price time periods, analogous to the gain from transporting goods from low to high price areas. But of course, just as gains from trade must take transportation costs into account, so gains from stabilization must take into account the costs of shifting goods from one period to another. This involves the temporal allocation of production and, for many agricultural commodities, storage.

Why is intertemporal allocation of goods a useful object of policy in a way that interregional allocation is not? Commodity storage is in some respects a more complicated and uncertain enterprise than is transportation. Based on the 1970s experience, however, this is not necessarily an argument for governmental as opposed to private market decision making in the area. A more telling normative argument is the possibility of externalities in commodity storage--the existence of social benefits of stabilization that are not captured by private traders. For example, commodity price fluctuations may trigger instabilities in other sectors of the economy. Without going into detail, however, it appears that the normative case for stabilization policy is not a strong one as applied to recent and current farm commodity markets (Smith 1979; Newbery and Stiglitz 1981).

In any case, it seems clear that in a positive sense the existence of the FOR and other stabilization policies (as well as stabilization arguments given for non-stabilizing policy such as acreage controls or dairy marketing orders)

is not to be explained by policymakers' thirst for stable markets per se. The only currently viable stabilization policies are those which stabilize "low" prices by bringing them up. Almost all parties in the political arena reject policies that would stabilize "high" prices by bringing them down via price ceilings or export controls. Instead, one of the main issues in governmental storage policies is how to release stocks so as to generate as little downward pressure on price as possible. My interpretation of events is that policymakers' stated interest in short-term price stability is more rhetorical than real. Nonetheless, I will later outline policies that could be defended on the grounds that they combat instability per se.

Agricultural depression. Sustained periods of abnormally low farm prices and incomes followed both the first and second World War booms, although moderated by farm commodity programs in the latter case. These periods had in the 1940s and 1950s been widely characterized as manifestations of a chronic "farm problem" caused by a persistent tendency to overproduce. This tendency was attributed to the conjunction of rapid technical progress with immobile farm resources and other unique features of agriculture (Brandow 1977). However, there is reason to believe that the problem of periodic low income is more properly characterized as cyclical, balanced by periods of exceptionally high farm prices and incomes. Therefore, the problem of sustained periods of low farm incomes is really a problem of instability, much as is the business cycle in the general economy (Melichar 1984).²

It is important, if true, to recognize the cyclical nature of low farm returns because it makes a difference for farm policy. Since 1977, the U.S. farm sector has again experienced a sustained period of price weakness, although even more than in the 1950s it has been masked by farm programs and the 1980 and 1983 adverse growing conditions in the Corn Belt. Under the cyclical interpretation of recent low farm prices and incomes, they are a consequence in part of the high prices and incomes of the mid-1970s, which induced over-optimistic investment in farm capital and skills.

What are the policy implications? The first is that output-expanding policies are a mistake. These include target prices above the market-clearing level, subsidies to agricultural inputs, and policies to expand demand. All have been part of the farm programs in recent years. The output-expanding policies receiving most attention currently seem to be the demand-boosting programs. For example, John Glenn's proposed farm program does not recommend any input subsidies and is silent on support prices, but on demand expansion he proposes a \$1 billion expansion of current efforts, which are

already quite extensive and are dubiously profitable to farmers and almost certainly unprofitable to the nation as a whole.

A second implication is that policy should not try to hold agricultural asset values up to their over-priced (as it now appears) mid-1970s level. If there is to be any policy besides waiting for the cyclical upturn, it should be in the area of helping farmers to adjust better to changing economic conditions. Attempts to change those conditions do not seem warranted when the market situation reflects supply-demand realities. But what if weak demand is due to governmental policy, or possibly policies of foreign governments? Current examples include export subsidies of the European Economic Community (EEC), Japan's import restrictions, and the U.S. government's interest rate (deficit) policies, which contribute to an overvalued dollar and weak exports. It makes sense to conduct U.S. policy to try to counter these conditions. But the relevant policy is not farm policy in the traditional sense.

It might be argued that commodity programs could be appropriate second-best policies given prior distortions caused, for example, by an overvalued dollar. This could possibly justify export promotion programs, but never production controls such as Payment-in-Kind (PIK). Production controls would not offset but intensify the distortion, which already was making U.S. farm output "too low." But even appropriate second-best policies are problematical, because the prior distortions might disappear or be significantly changed more easily than the policy response to the distortions.

Random production. As a cause of price instability, droughts and other causes of production shortfalls are relevant to policy as has already been discussed. Apart from these aggregate price effects, such events have important effects on the farmers who suffer them. While they are often localized phenomena, such as a flood in a particular river valley, they have implications for national farm policy. Congress has responded generously to the economic stress caused by natural disasters. In recent years, we have had Emergency Loans, Economic Emergency Loans, Emergency Livestock Feeding Programs, the Disaster Payment Program, and the newly expanded Federal Crop Insurance Program. All involve an element of subsidy, and except in 1983 have amounted to more in dollar terms than traditional programs during the last decade. To give an indication of scope, in 1977 two-thirds of U.S. counties were designated as disaster areas (USDA 1980).

The approach to random production taken in these programs

is not to attempt any influence on the random events themselves. Rather they compensate farmers for part of the economic loss from disaster. Thus they are basically insurance programs, with subsidized premiums. What is the justification for these programs? Unlike commodity storage programs, they do not directly stabilize consumption or product availability over time. Indeed, by reducing farmers' incentives to undertake risk-reducing activities, they may actually reduce the efficiency of resource allocation. There is evidence that the Disaster Payment Program has had this effect in the High Plains (Gardner and Kramer 1982).

Disorderly markets. This is the least well defined form of instability. It has been cited as the rationale for marketing orders. A key statement of purpose in the Agricultural Marketing Agreement Act of 1937, which governs marketing order to the present day, is the declaration of the original intent of Congress "to establish and maintain such orderly marketing conditions for agricultural commodities in interstate commerce as will establish, as the price to farmers, parity prices..." But what is the goal to be achieved through orderly marketing, apart from an improved economic environment for farmers? What does the crucial term "orderly" mean? By what criteria do we distinguish the "orderly" from the "disorderly"? On these matters the legislation is silent.

One of the most comprehensive studies of marketing orders (Federal Milk Order Study Committee 1962) devoted considerable attention to the concept of orderly marketing of milk and the role of marketing orders in achieving that goal. It concludes that the goal of orderly marketing in early (pre-1933) cooperatives was primarily local, seeking to avoid severe swings from surplus to shortage within the year and from peak to bottom of a production cycle. But under the marketing orders, "the ideal of orderly marketing has been given a more precise meaning and a broader frame of reference...a positive rationale of producer incomes and handler prices skillfully engineered through a blending of economic principle and market strategy" (FMOSC 1962 pp iii-11). The report never gives a really precise definition, but makes clear that what producers objected to in unregulated conditions was low receipts for their milk and that what they hoped to attain through marketing orders was higher receipts.

The 1937 act, however, states an intent "to protect the interests of consumers by...approaching the level of prices which it is declared to be the policy of Congress to establish..." and by authorizing no action to attain prices higher than this level. How prices are to be established for the benefit of consumers and producers simultaneously is not spelled out by Congress but is implicitly presumed to be a

consequence of orderly marketing. It is implicit in this view that unregulated markets would exhibit "market failure", in economists' jargon, corresponding to disorderly markets in some way.

The FMOSC report begins its discussion of the concept of orderly marketing by stating:

The classical doctrine that unregulated competition would act as an automatic adjuster of both price and production had merit in its day of small-scale business operators. But as the investment required for an improved herd and for better physical facilities has grown, and as the managerial training of the modern dairy farmer has expanded, it has become less useful and indeed impractical (FMOSC 1962 pp i-14).

The idea seems to be that the problem requiring policy intervention is not price instability per se but the consequences of costly adjustment with large fixed investments in an imperfectly competitive setting.

Marketing orders have been much criticized as a remedy for disorderly markets, with industry spokesmen defending them but economists finding them generally to have created social costs exceeding their benefits. (For detailed discussion see Ippolito and Masson 1978, and the papers and discussion at a session on "Milk Prices and the Public Interest" sponsored by the American Agricultural Economic Association in 1979, American Journal of Agricultural Economics 1980.) Though the issues here are important, the acceptance of marketing orders by the Reagan administration as well as its potential successors suggests that this will not be a live issue in 1985.² Therefore, neither marketing orders nor the particular instability issues they address will be discussed further in this paper.

The financial crisis in agriculture. This is closely related to the agricultural price and income depression of 1977-82, but is more narrowly concentrated on those farmers who went heavily in debt in the mid-1970s. The subsequent decline in returns impaired their ability to service the debt and the decline in land prices reduced their net worth, quite sharply for the most highly leveraged. For farmers with \$500,000 or more in sales, the average equity loss in 1982 was \$229,000 per farm, and the average debt to asset was 37.4. For farmers with sales of less than \$40,000, the debt-asset ratio was 13.2 (USDA 1983). The incidence of farms with negative net worth was substantially higher for the largest farms. There have been many attempts to bail out these highly leveraged farms notably by forgiveness or postponement of repayment of principal on FmHA loans.

Other instability issues. The opinion is becoming almost commonplace that in the past few years policies outside the the farm program area, notably domestic macroeconomic and international exchange-rate policies, are perhaps more important than farm programs themselves in influencing the farm sector. The plausibility of this view depends in part on what influences are being considered. Certainly interest rates, other conditions of credit, and the nominal rate of inflation in input costs must be traced to these non-agricultural sources. But on the bottom-line issues of real farm prices (i.e., relative to nonfarm prices) and rates of return to farmer-owned resources, the point is not clearly true. In any case, whatever consequences macroeconomic policy does have for agriculture should be remedied by macroeconomic policy measures.

The Legitimate Role of Farm Policy

All of the factors discussed have caused economic problems for farmers. Farm policy has attempted to remedy most of these problems, with mixed success. Future policy will continue in this effort. Some suggestions have been made earlier as to policies that are especially poorly or well suited to dealing with these economic realities. It seems clear that a properly chosen farm program in the 1985 agricultural legislation could improve the economic situation for the U.S. farm sector. Yet the question may still be asked: Why should we do this?

This section considers a few possible answers to this question. They are that farmers are economically hard-pressed, and we should aid people in need; that farmers' economic problems were created through no fault of their own, and it is only fair that society as a whole share the burden created, e.g., by export demand weakened through U.S. foreign policy; and that the nation as a whole would be better off if these problems were solved, therefore appropriate farm programs are a profitable public investment.

Farmers are economically hard-pressed. This argument will not do as a rationale for farm policy because farmers, as a group, are economically well off. The accompanying table shows relevant data for commercial farms having \$40,000 or more in sales. Smaller farms are not plausible candidates for help through commodity programs because they receive most of their incomes from off-farm sources. Moreover, these commercial farms account for 83 percent of farm production, and so will receive the lion's share of commodity program benefits.

Farmers' losses are imposed upon them. It is a legitimate complaint that farmers are made to bear the brunt of

Table 1. Cash Receipts, Net Income, and Farms by Sales Class, 1982.

	Farms	Gross Returns	Net Farm Income	Net family Income per Farm	Net Worth per farm
	Thousands	billion dollars		\$	\$
Farms with annual sales of:					
\$500,000 and above	25	45.6	14.3	597,900	2,651,000
\$200,000- 499,999	87	29.5	4.7	67,200	1,322,000
\$100,000-199,999	186	30.4	3.7	30,900	866,000
\$40,000-99,999	393	31.3	2.1	16,200	521,000
\$20,000-39,999	273	10.5	0.1	13,400	324,000
Under \$20,000	1,436	16.6	0.1	18,700	137,000
All farms	2,400	164.0	23.9	26,400	347,000
Percentage of total					
\$500,000 and above	1.0	27.8	59.9		
\$200,000-499,999	3.6	18.0	19.5		
\$100,000-199,999	7.7	18.5	15.4		
\$40,000-99,999	16.4	19.1	9.1		
\$20,000-39,999	11.4	6.4	0.6		
Under \$20,000	59.8	10.2	4.5		
All farms	100.0	100.0	100.0		

Source: USDA, Economic Indicators of the Farm Sector, 1982.

policy problems arising from international political affairs. It seems fair that the government should attempt to cushion the farm economy from shocks created by governmental actions. This indeed is what the Carter administration aimed to do following the halt in grain sales to the Soviet Union in January 1980.

On the other hand, there is not such a clear fairness argument for compensating farmers for losses suffered because land prices and cash flows unexpectedly moved unfavorably after a farmer had made highly leveraged purchases of land. Such losses, when due to unpredictable random events, are not the farmer's fault. But neither is it the taxpayer's duty to make good such losses. The situation is similar to other risky small business.

The most that fairness would seem to require is that policy make the appropriate insurance policies available to farmers where the market fails to do so. However, when the market fails to provide insurance for real economic reasons such as moral hazard that makes a cost-covering insurance program impossible (e.g., insurance against losses due to poor decisions when one is under the influence of excessive alcohol consumption), it is not clear that the provision of insurance is called for. Nonetheless, for price and output hazards facing farmers, governmental involvement in the provision of insurance has attractive features both economically and politically.

Policy as a profitable public investment. The area of intervention most likely to be socially profitable is governmental support of research and extension. Here we have evidence that past efforts have yielded returns (mostly in the form of lower costs to consumers) that outweigh the costs. But these policies, along with other investments in education and infrastructure--roads, utilities, transportation, communications--are not in the purview of farm commodity policy. Closer to the spirit of the market instability issue are regulatory programs in price discovery and information. These activities, however, are not prominent on the agenda for 1985 legislation. The real policy issues resolve to choices about intervention in farm commodity markets.

With respect to the commodity markets, the main potential for social gain is price stabilization as discussed earlier. Such policies are very difficult to establish and to manage appropriately once established. The information requirements are perhaps as likely to defeat governmental planners as private profit-seekers.

More importantly, my reading of past and current farm programs is that they are more properly viewed as income

redistribution measures than as solutions to cyclical or chronic farm problems that are genuine social problems. The benefit of price supports to farmers should be viewed as basically similar to the political gains made by other interest groups. Farmers are no less or no more to be criticized than those other groups. Nor is the political process that generates farm policy more to be blamed for agricultural than for other special-interest policies. Nonetheless, I believe that farm policy could serve the national interest better than it currently does, and I would like to suggest in closing what I take to be the policy lessons derived from the points made in this paper.

Commodity policy should be centered on the instability issues that have been discussed. Insofar as these concern farm income instability, they can be reduced to insurance issues. Farm programs for yield risk are already in the form of insurance, under the Federal Crop Insurance Corporation. Any politically inspired or economically required transfers from taxpayers to farmers is handled explicitly in the FCIC budget, which contains a subsidy to cover administrative costs (the normal costs of doing business for a private insurance company) plus a subsidy that reduces farmers' premium costs.

A similar approach could be taken for the various payments that support farm income. Farmers could purchase an insurance policy that paid indemnities triggered by low prices, as target prices currently do. By having farmers pay for at least part of the cost of this insurance, the overproduction incentives caused by target prices on grains, support prices on milk, and disaster payments would be reduced. They could be reduced to zero if the subsidy element were taken out, so that the programs did not transfer income from taxpayers to farmers in an average year. Yet protection against wide swings in income would be available.

A variant of this idea, utilized already in Canada and proposed in Senator Glenn's agricultural program, is farmer self-financed low-price payments, essentially an insurance policy in which premiums are paid only in high-price years. This makes sense for a roughly symmetrical two-tailed probability distribution of the income determining variable, which is the case for commodity prices but is less so for crop yields and not at all so for disasters like fires or hail where one observes a great many normal (but no disaster) years interspersed with rare disasters.

Income insurance schemes for farmers do not address problems created by market price instability for consumers or the nonagricultural economy. To address these issues requires market intervention of some kind. The best

might be a commodity storage policy that will increase the carryover of supplies from years of abundance to years of dearth. There is much debate about how best to accomplish this end. Proposals and past programs include subsidies paid to farmers to store products, acquisition and disbursements of commodities by the Consumer Credit Corporation (CCC), and the establishment of international institutions that conduct buffer-stock operations. My view is that, for the grains, there should be either an international buffer-stock approach or a simple subsidy to U.S. stockpilers of grain (farms or middlemen) without the price triggers and other regulatory apparatus of the FOR. The reason for opposition to a unilateral CCC stockpiling regime is that it must support the world trading price in low price years, and is likely to carry almost all the stocks for worldwide price stabilization at the expense of U.S. taxpayers. The reason for opposition to attempts by USDA to manage farmers' grain storage decisions is that they have not worked in the past, according to my reading of the evidence.⁴

Conclusion

The chief problems of U.S. agriculture today that can justify farm policy beyond laissez faire in commodity markets involve instability. However, instabilities of several types should be distinguished because their policy implications are different. Types of instability that might usefully be remedied include (a) instability created by agricultural policies of foreign governments which destabilize world commodity markets, the remedy being diplomatic efforts, possibly including retaliating trade interventions on our part; (b) instability created by macroeconomic policies generating inflation or unstable interest rates, the remedy for which should be sought in the macroeconomic policy arena; (c) instability in farm incomes, which could be remedied at least in part by insurance programs, perhaps with subsidized premiums; and (d) instability in market prices, which could be remedied in part by commodity stockpiling policy.

The qualifier "might", which introduces the preceding policies, expresses the expectation that even if the appropriate remedies could be spelled out in practical legislation, political pressures would result in the addition of subsidy elements so substantial that the net benefit to the public interest, as compared to laissez faire in agriculture, might be nullified. In view of the dominance of interest-group politics in the past, this outcome seems inevitable. Therefore, my recommendation is laissez faire. But practical politics rules out laissez faire. One should not even in principle reject practical politics unless one has an improved political system to propose, which I assuredly do not. Therefore, I remain with the recommendation of the programs of the

type outlined above--purely stabilizing buffer stocks and an income insurance program--as the most promising farm program framework in which to work out the economic rationale and political practicalities as they exist at present in the U.S.

NOTES

1. The phrase "society's desire" and related expressions which attribute preferences and values to collectives irritate some people on the ground that only individuals have preferences and values. However, based on the fact that collectives do make choices, namely political or policy choices, I use the term "society's desire" as convenient shorthand to refer to whatever it is that lies behind these choices.
2. However, major agricultural cycles have been quite low-frequency events, always triggered by wars or other major international events. Melichar identifies six such periods since 1800. My reasons for rejecting the "chronic" farm problem model are spelled out in "The Decline and Fall of the Farm Problem," paper presented at the Giannini Foundation Seminar, Berkeley, California, December 1983.
3. See "White House Hasn't Soured on Marketing Orders," Wall Street Journal, 14 January 1983.
4. "My reading of the evidence" is spelled out in U.S. General Accounting Office 1981 and Gardner (forthcoming).

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