POLICY ISSUES
Insights on food, farm, and resource issues
PI4 - September 2009
A publication of the Agricultural & Applied Economics Association
AAEA Agricultural & Applied Economics Association

Using Farm Sales as a Means Test for Receiving Direct Payments

Daryll E. Ray and Harwood D. Schaffer

JEL Classifications: Q18, Q17, Q15, Q51

In the State of the Union message before Congress, the President typically lists his legislative priorities for the coming year. Agriculture usually receives a brief mention, often using general language with few policy specifics. In his first State of the Union address on February 24, 2009, President Barack Obama's mention of agriculture was characteristically brief, but uncharacteristically specific. He said, "In [the 2010 fiscal-year] budget, we will…end direct payments to large agribusinesses that don't need them" (Obama, 2009). That short sentence and subsequent elaborations ignited a firestorm of questions and critical comments among agriculturalists of all stripes.

One question is definitional: What is meant by "large agribusinesses?" Another question centers on the "end direct payments" phrase. Does that statement imply a possible movement away from the policy approach of decoupled payments in general or only in this specific circumstance? And then there is the resolute-sounding judgment part: "[large agribusinesses] that don't need [direct payments]."

When agriculturalists in this country think of large agribusinesses, they think of Monsanto, Cargill, ADM, AGCO, and Pioneer Seed. But practically no direct payments or commodity payments of any kind go to these or most other agribusinesses of this sort.

Farmers who operate a "large" number of crop acres or who have large livestock, or fruit, or vegetable, or specialty-crop operations could be called agribusinesses, but that is not customary. Many such operations are incorporated to simplify tax and inheritance issues, but for the most part, they are family operations. Some may also sell seed corn or operate a field spraying service part-time but, even then, few would describe their overall operation as an agribusiness.

The substantive question really becomes: What constitutes "large"? In the days that followed the State of Union speech, administration officials said that direct payments would be reduced for farm operators with over $500,000 in sales. Previous administrations had pushed for lower payment limits based on adjusted gross income, but this was the first time a limitation threshold was based on gross sales.

Sales of $500,000 may seem large to someone earning $30,000 a year, but that would be mistaking sales for net income. Within the last decade, there have been years when grain farmers with $500,000 in sales would have had a negative net income had it not been for payments from commodity-payment programs—all payment programs not just direct payments.

More generally, by today's standards, $500,000 in sales does not translate into that large of a major-crop farm. Sales of $500,000 could be realized with fewer than 900 acres of corn or fewer than 1700 acres of wheat, farm sizes that local farmers would definitely not consider "large" and may consider unsustainable as a free-standing viable farm operation.

History of Payment Limitations

Restrictions associated with farm payment programs are not new. Restrictions of various sorts have been in place since the adoption of the Agricultural Act of 1970. Until recently, the limitations were only on payment levels, usually by the specific type of payment program. Payment limitations by program type continue to be included in the current (2008) farm bill.

Means testing for eligibility for receiving payments based on income or sales is new. It first appeared in the 2002 farm bill. Those with over $2.5 million dollars of net income were denied eligibility for payments unless 75% of the net income came from agriculture or forestry. The 2008 legislation set separate income eligibility limits for nonfarm income and farm income. The new nonfarm limit was reduced to $500,000 for all payment programs and the farm income limit was set at $750,000 for direct payments only. As was true with the 2002 legislation, the limits are now computed as the three-year average of adjusted gross income (basically, income after allowable deductions and expenses) as defined on the IRS-1040 form.

Direct Payment Program

The payments from the direct payment program are paid to eligible farmers based on historical production of one or more of the major (program) crops but without regard to current-year price or production levels. The program was created as 1) a 1996 farm program inducement to entice farmers to accept the elimination of price supports which set minimum prices that farmers could receive for feed grains, cotton, rice and wheat and 2) an attempt to help bring U.S. farm programs into compliance with World Trade Organization (WTO) policy goals built around payment mechanisms that are not directly linked to production decisions.

It was expected that decoupling payments from price and current production levels would, for any given commodity, result in production increases among the world's lowest-cost producers and decreases among the world's highest-cost producers, thus not distorting world trade.

In the absence of taking the traditional 'blue box" programs —supply management and storage programs—seriously, adopting the direct payments approach was seen as the WTO-approved basis for a producer safety net.

President Obama's Proposal and Reactions

In addition to the phase-out of direct payments for farmers with $500,000 in sales, President Obama's 2010 fiscal-year budget proposal also calls for a $250,000 limit on all farm program payments, reductions in premium subsidies and underwriting gains for crop insurance, the elimination of cotton storage payments, and cuts in funding of several USDA administered programs. The administration's subsequent discussion of these proposed budget reductions suggested that the savings would be used to increase the Food Stamp and other nutrition programs, giving some the impression of pitting farmers against hungry children.

While each proposal has its impact, it is the $500,000 sales rule that has received the strongest reaction from farmers, farm and commodity organizations, lawmakers, and analysts. Focusing on this specific payment limitation proposal—and putting aside the pros and cons of payment limitations and the merits of direct payments relative to other farm program approaches—typical comments included in the following paragraphs are often heard.

First, "to tinker with changes in direct payment eligibilities is to potentially reopen the 2008 Farm Bill." There are other programs that farmers would have attempted to negotiate if the $1.2 billion the Obama administration wants to save had been available for reallocation—expanded crop insurance programs, greater income protection in case of disasters, an increased percentage payment level under ACRE. The farm bill was put together by a bipartisan coalition and it may be as difficult to undo as the proverbial Gordian Knot.

It is important to note that Congressional farm leaders were quick to shoot down the President's proposal as a nonstarter, which is often the case when administration proposals are sent to the hill. It remains to be been seen whether or not, by proposing that farm payments limitations be based on gross sales, this administration is laying down a marker that it will pursue in future budget and farm bill discussions.

Second, "these 'very large family farms'—family-owned farms with over $500,000 in sales—produce 45.4% of the value of farm production in the United States." Nearly 20% of all agricultural production is produced on farms with sales in excess of $1 million. These are the farms that produce the bulk of agricultural products in the United States. The farms with sales in excess of $500,000 are the ones USDA describes as most likely to be able to employ a farmer or farm family member full-time without dependence upon off-farm income.

That is not to say that there are not farm operators with less that $500,000 of sales that make a viable living from farm sales, but these producers typically are not primarily growing "program crops," that is, the major crops covered by commodity programs. They are often diversified or specialized operations that produce high-value commodities, such as vegetables, fruits or nuts, or focus on specific markets, such as antibiotic-free meat, open-range production, or organics.

Third, "the current organizational structure of many family farms reflects, in part, the requirements of the existing set of policy regulations." When those policy regulations change, one could expect to see changes in the organizational structure of family farms.

The farm organizational structure of the largest recipients of direct payments (http://farm.ewg.org/farm/dp_analysis.php) is very revealing. Most of the recipients are family organizations that may include a farmer, his or her siblings, children, cousins and in-laws.

The structure of many of these operations reflect the triple entity rule of prior legislation in which a farmer was allowed 100% interest in one farm and half interest in two additional farms. These farm units of several related persons are then aggregated into the one entity, making them appear as "large agribusinesses." Often these farm units do, in fact, share equipment, management decisions, and labor.

If the new regulations were put in place, it is reasonable to expect the disaggregation of many of these units into smaller farms with sales levels under $500,000. If that were to happen, the estimated $1.2 billion in savings would fade.

Fourth, "a number of grain farmers who are eligible for direct payments also engage in livestock production." With a $500,000 sales limit in place, one would expect to see nongrain ventures like hog operations spun off as a separate enterprise under control of one family member with the grain operations broken into units with less than $500,000 in sales and divided among other family members.

Fifth, administration officials have suggested that "farmers could recoup lost payments by being paid for environmental services" such as carbon sequestration and/or earn income from energy production including solar, wind, and bioenergy. Such substitute payments have an appeal but may not be the godsend for farmers that some might expect.

For one thing, solar and wind energy production depend upon access to electrical grids that cannot be built by individual farmers. In addition, as long as priority access to electrical grids is given to "dependable" coal fired plants instead of intermittent wind and solar sources, the profitability of wind and solar is not certain. If farmers are going to be encouraged to bank on the "green" production of wind and solar energy, then they may need to be given priority on the electrical grid, with wind and solar generators in other areas and peaking plants being used to cover the down times.

As for bioenergy crops, profitability is partly dependent upon uncertain oil and ethanol prices. In the case of cellulose-based ethanol, much of the technology and scale factors are yet to be learned and plants have to be built or reengineered. Farmers need considerably more information about production, storage and transportation of dedicated energy crops.

In the case of carbon sequestration, profitability depends on the price farmers receive when selling carbon allowances to electric utilities and other demanders, and the extent of increases in on-farm production costs. Legislation permitting, farmers could earn carbon allowances or credits by converting traditional tillage practices to minimum till or in other ways adopt practices that reduce emission of global-warming gases in the production of crops or livestock. But since many of the inputs used in agriculture are petroleum based, farmers can expect to pay more for those inputs as suppliers pass on the additional costs of complying with reduced emission standards or the purchase of carbon allowances. Whether farmers would consistently receive more from selling the allowances than the increase in the cost of inputs is an open question.

Summary and Conclusions

In his State of the Union Speech on February 24, 2009, President Barrack Obama said "In [the 2010 fiscal-year] budget, we will…end direct payments to large agribusinesses that don't need them" (Obama, 2009). Subsequently, administration officials provided more detail saying that direct payments would be reduced for farm operators with over $500,000 in sales.

This article discusses some of the issues surrounding the proposed $500,000 farm-sales threshold for phasing out direct payments to major-crop producers. By focusing on this specific payment limitation proposal, the pros and cons of having payment limitations in general and the merits of a direct payment program relative to other farm program approaches are not discussed.

By using a sales threshold rather than a measure of net income, farmers of even moderate-sized operations could exceed the $500,000 limit but have very little or no positive net income to report to the IRS. In this day and age, $500,000 in sales does not signify a large farm.

In fact, the lion's share of commercial, fulltime farms has farm output sales exceeding $500,000. Many of the operations that appear exceptionally large in payment data bases are really extended family operations that are incorporated to simplify tax and inheritance issues and for other reasons. If the $500,000 threshold were put into place, many of those farms would be separated into smaller farms with sales under the threshold. Often the same family members would be involved after the breakup as before. Under those circumstances, phasing-out direct payments after $500,000 in sales per reconfigured farm may generate relatively meager savings.

Administration officials have suggested replacing farmers' reductions in direct payments with payments for energy services and/or carbon sequestration. These payment substitutes are appealing and hold promise for the future but several wrinkles need to be worked out before such payments would become reasonably dependable. The challenges include issues of infrastructure, capital investment and the availability and dissemination of technical information.

Overall conclusion: Using farm sales rather than a measure of net farm income to determine payment eligibility limits adds an additional complication to an already challenging process.

For More Information

Environmental Working Group. (2009). 2007 Direct Payments. Available online: http://farm.ewg.org/farm/dp_analysis.php.

Hoppe, R. A., Korb, P., O'Donoghue, E.J., and Banker, D.E.. (2007). Structure and Finances of U.S. Farms: Family Farm Report, 2007 Edition, Economic Information Bulletin No. 24. Washington: United States Department of Agriculture, Economic Research Service. Available online: http://www.ers.usda.gov/publications/eib24/eib24.pdf.

Obama, B. 2009. Remarks of President Barack Obama – As Prepared for Delivery Address to Joint Session of Congress, Tuesday, February 24th, 2009. Informally designated "State of the Union Address 2009." Available online: http://www.whitehouse.gov/the_press_office/remarks-of-president-barack-obama-address-to-joint-session-of-congress/.

U.S. Department of Agriculture, Economic Research Service. (2008) 2008 Farm Bill Side-by-Side: Title I: Commodity Programs. Available online: http://www.ers.usda.gov/FarmBill/2008/2008FarmBillSideBySide041509.pdf.

Daryll E. Ray (dray@utk.edu) is Blasingame Chair of Excellence and Professor, Agricultural Policy Analysis Center, Department of Agricultural Economics, University of Tennessee. Harwood D. Schaffer is Research Associate, (hdschaffer@utk.edu), Agricultural Policy Analysis Center, Department of Agricultural Economics, University of Tennessee.