Coping With Excess Capacity

Speculations on the Coming Agricultural Policy Environment

by John A. Schnittker

U.S. agricultural policy has been dominated since 1981 by excess capacity to produce at existing incentive levels, declining export opportunities, chronic surpluses, overinvestment in land, record budget costs, and increased federal intervention wrapped in the rhetoric of getting the government out of agriculture. Any analysis of the prospects for U.S. agricultural policy changes in the next 5-10 years must consider both how those issues will develop and the prospects for dramatic changes in the political and economic systems as we move into the fourth year of recovery, and toward a decisive presidential election.

The Economic and Political Environment

Excess capacity to produce wheat, corn and other feed grains, soybeans, cotton, rice, and dairy products is greater than ever, and it is probably increasing in the policy and technological climate of the late 1980's. Excess capacity is once again being pushed into new commodities and new regions by federal farm programs; government costs of farm programs are higher than ever and rising.

Farm financial problems have largely been recognized and digested, with most of the threatened farmers identified and some $300 billion in cash and paper losses taken. With that trauma passing, we are approaching a new financial and emotional equilibrium in rural America. As some farmers and investors lose out, windfall gains are falling on well-financed farmers and other investors in the form of reduced land values, lower rental rates, declining interest and energy costs, and farm program payment bonanzas under the 1985 Act. The highly concentrated agriculture of the future is being shaped by these events.

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What appeared in 1984 to be strong political momentum for farm policy reform was largely aborted in 1985. The actual and prospective loss of many thousands of farmers over a five year period became a central political rallying point in opposition to any material reductions in federal subsidies to U.S. farmers, and later in support of higher subsidies. Congress again decided to spend more money than ever in the name of helping small and mid-sized family farmers, without actually directing any substantial part of the money to the objects of their concern, or to long term measures to treat the causes of farm distress.

Neither the five year 1985 farm bill nor the bill to restructure the Federal Farm Credit System provides any real hope of survival for the most financially insecure farmers. There is no sign of renewed 1970's style prosperity, to return declining farm balance sheets back to their peak of around 1980. That era is gone!

The new laws are familiar and transitional, serving to prevent general agricultural and institutional disaster over the next few years, permitting a number of farmers to survive who would have failed if the rapid "phase out" of farm payments had been adopted as proposed by the Reagan Administration, and bringing reasonable returns to low-debt farmers. Meanwhile the farm economy waits nervously for the other shoe to drop—if and when federal payments must be reduced.

The 1985 farm bill offers little prospect of major income improvement for many years for producers of supported crops. Any increase in prices generated by unusually strong demand for grains or cotton in response to lower prices and cheaper dollars would not go to most farmers until average farm prices exceed target price levels, which are 50 to 100 percent above effective market supports. Farm product price increases would largely result in reduced deficiency payments from the Treasury.

The economic characteristics of agriculture I have mentioned serve to define the critical agricultural issues for the

Wheat on the ground beside already-filled bins at the Rockford Grain Growers Inc. terminal, Rockford, Washington, in the 1970s.
PHOTO BY WASHINGTON WHEAT COMMISSION

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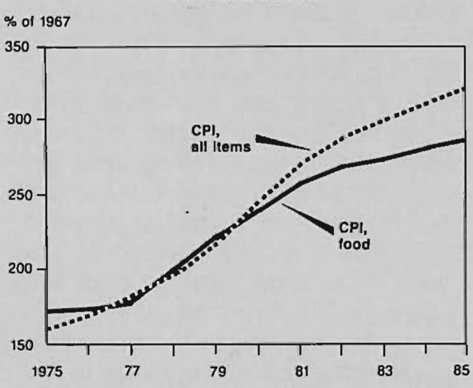
next few years. Linkages to the general economy via financial markets, energy costs, demand for food, and the trade balance are interesting and important but they are peripheral. Trade confrontations and negotiations will take up a lot of air, but are overrated except to the people caught up in their excitement. The general economic and political issue most important to agriculture is whether or not arbitrary spending cuts linked to deficit reduction will override basic law for an extended period, putting farm payments under continuous attack, and stretching the period of income reductions for supported crops and related land price deflation into the 1990's.

Given basic market circumstances and the policy environment, prospects are excellent for 2-3 years of stable food prices. As farm commodity prices fall, food companies will reap large gains from lower retail costs not accompanied by lower retail prices. U.S. food prices at retail will rise less rapidly than the general price level, and might even decline briefly before general inflation accelerates.

Food Prices



GRAPHS PROVIDED BY ERS DIVISION OF INFORMATION

Dealing With Excess Capacity

This overriding economic and physical characteristic of U.S. agriculture must be dealt with sooner or later by even more extreme price cuts, by effective production restraints, or some good luck. Surplus capacity is the result of a continuing surge in productivity here and abroad, the strong dollar, fixed loan levels and excessive payments in the 1981 farm law, mismanagement by USDA of the acreage reduction and loan rate authorities that were in the 1981 Act, and ineffective use of export subsidies for which virtually unlimited authority exists. The resulting loss of export sales has been accompanied by vigorous blame-laying and a dangerous surge of agricultural protectionism now embodied in some provisions of the 1986 House trade bill.

Production With Current Incentives

Excess capacity for the major farm commodities varies, but is substantial, as follows:

—*For wheat,* we have the capacity at full production and at the price and payment levels in the 1985 farm bill, to produce over 3 billion bushels per year. We can use and export about 2.3 billion bushels. Therefore the surplus capacity to be dealt with by acreage reduction, export expansion, stock increases, and/-or further future price drops is somewhere in the area of 700 million bushels per year.

Stocks on June 1, 1986, as the new harvest began, were nearly 1.9 billion bushels—almost one year's supply. Within the next few months or in 1987, idling 35-40 percent of our wheat land—or dropping prices dramatically via the marketing loan or aggressive export subsidies—may look like good alternatives to continued surplus accumulation.

—*For corn,* we now have the capacity at full production and current incentive levels to harvest close to 9 billion bushels per year. The domestic and export markets will take no more than 7.5 billion bushels per year in the near term—and that's optimistic.

Stocks on September 1, 1986 may exceed 4 billion bushels. There is real danger that they will exceed 4.5 billion bushels in 1987 despite massive and costly intervention to limit 1986 corn production. The case for decisive action against corn surpluses is even stronger than for wheat.

—*Excess soybean production* does not appear to be as great as for corn. Soybean growers, I am sure, would reject the idea that they now confront potentially chronic surpluses. But corn and soybeans are produced on the same farms, with the same equipment, and partly for the same markets. Soybeans share, therefore, in the huge excess capacity to produce corn. This may become increasingly visible if soybean price supports are not reduced in proportion to grain price supports plus payments under the 1985 Act, moving resources from corn to soybeans over time.

—*Cotton and rice* have excess capacity in the area of one-third of recent annual production. We are now dumping our highly subsidized rice in world markets at well under one-half the price level we guarantee to U.S. producers, and will do the same for cotton effective August 1, 1986. This will push market prices to levels that may be lower than long run equilibrium levels.

USDA OFFICE OF GOVERNMENTAL & PUBLIC AFFAIRS

An important link with international markets—barges on the Columbia River.

—*Dairy excess capacity* is in the neighborhood of 8-10 percent of milk production. Worst of all, it seems likely to increase over time because of declining feed costs and rising productivity. These conditions will persist except for temporary interventions such as the whole herd buyout now in progress and despite prospects for substantial reductions in price supports under the law.

The interaction of dairy and beef sectors in 1986 provides the most recent illustration of the effect of federal policies shifting farm problems from one sector to another.

Response to Overcapacity

The policy response to the extreme overcapacity in U.S. agriculture has been to drop price support loan levels slowly up to now, but very sharply beginning with 1986 crops. Roughly the 1984-85 level of total farm income protection has been continued via federal payments. Individual producers must agree not to grow crops on a specified percentage of their land to qualify for these payments, but payments are high enough to support acreage reductions approximately twice as high as required by law. In the year ahead:

—*Corn payments* will be roughly one third of total returns to corn production. They may total $7 billion or more.

About half these payments serve the function of reducing production a little below potential, while half serve to tell farmers to produce all they can on the allowable acreage. Such contradictory signals are not new in the history of U.S. farm programs, but the size of the contradiction sets new records each year as payments rise.

—*Wheat payments* will be well in excess of 40 percent of total returns and have roughly the same functional distribution as for corn—one half to reduce, and one half to increase production on the same farms.

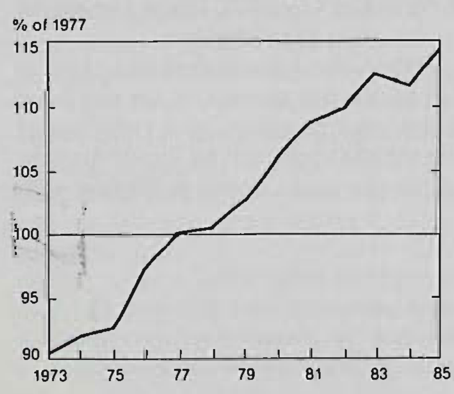
—*Cotton and rice* payments will be well in excess of 50 percent of total returns per bale or bag, since the "marketing loan" is in effect and cotton and rice prices in the marketplace will drop to market clearing levels, far below the official support level. The same contradiction applies in respect to payments, which are about 50 percent higher than would be required to achieve the acreage reductions called for in the law.

Coping With Technology

Technological developments in the next decade will remind us constantly of the futility of continuing to control crop production via limited acreage, and to restrain milk production by cow slaughter.

Large increases in animal productivity beyond that promised by present technology seem likely to be commercially feasible by 1990, and we should not be surprised if the date can be advanced to 1988.

Milk Production per Cow



The synthetic growth hormone somatotropin for dairy cattle appears to be the first major breakthrough, but others are pending. Big production gains would nurture the climate for agricultural policy reform, since they would increase federal costs under existing programs, leaving the uncomfortable choice between ending or restructuring spending under current programs or going back to a combination of more effective production controls, higher price supports, and export subsidies.

Will the 1985 Farm Bill Survive?

The 1985 farm bill may well be a major political embarrassment to Democrats and Republicans alike in less than a year. It is a Congressional bill, so the embarrassment would be most acute in Congress, but it was signed by the President with only the most limited suggestions for amendment. If the farm bill and related factors fail to improve farm income, to contain crop surpluses, and to expand exports quickly and substantially while costing $20-25 billion a year or more, then efforts to significantly amend the bill in 1987 will be encouraged.

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In fact, farm programs will be continuously under attack over the next 3-4 years, in view of the wide range of opinions as to what should be done. The easiest amendments will be those that postpone scheduled price support and payment reductions, such as those scheduled for milk on January 1, 1987. The most difficult amendments will be to accelerate the time when big farmers begin to be taken off federal payments, either via lower per farm limits, universal application of the present limits, Gramm-Rudman procedures, and/or phasing out deficiency payments earlier than now scheduled in the law.

A Political Scenario

The most compelling political scenario for revision of the farm support system in 1987 would develop:

—*if Democrats gain* four seats in the U.S. Senate (or even two key seats in states where the campaign will be fought largely on farm and rural issues);

—*if grain stocks* are forecast to increase in 1987, and again in 1988 from programs announced this year for 1987 crops;

—*if the whole herd dairy buyout* reduces milk production temporarily but by only 3-5 percent in 1986, and prospectively in 1987, after 12 percent of milk production was "bought out";

—*if realistic expectations* are for a new surge of dairy surpluses in 1988; and

—*if the cost of price support* programs is around $25 billion—instead of the officially endorsed $17-18 billion, plus $3-4 billion of in-kind payments in the 1986 and 1987 fiscal years.

In that climate, the constant urge to rewrite the farm bill would become even stronger. If Gramm-Rudman levies must be applied to federal spending indefinitely, extraordinary efforts will be made on one hand to recapture some of the huge farm payments for other priorities, and on the other to exempt farm program payments from Gramm-Rudman effects, following the 1986 dairy example.

Unfortunately, any amendment process in 1987 would still be conducted in the context of a farm financial crisis—not as extreme as in 1983-85, but still serious. Whereas land prices declined by more than 50 percent from 1983 to 1985 in a number of important farm states, they may decline only 5-10 percent in 1986 and 1987, and could rise a little. But the atmosphere will be the same as before. In turn, it is difficult to conceive of Congress reforming farm programs in any meaningful sense by targeting benefits to need, or by progressively reducing federal payments before the 1988 elections, in such an economic and political climate.

More Spending?

It is not hard, however, to imagine Congress and the White House agreeing to spend more on farm programs across the board in 1987 and 1988, with the increased cash and in-kind payments not subject to any meaningful limitations per farmer. Congressional elections will be just ahead and the Presidential election campaign will formally begin the day after the 1986 Congressional elections close. In that climate, little fundamental reform would be sought.

I expect a new wave of adverse publicity by that time regarding multimillion dollar payments to many cotton and rice producers and to some wheat, corn, and milk producers in 1986 and 1987. This could lead to modest efforts to amend the $50,000 payment limitation, and to apply limits to certain in-kind payments which are now exempt.

Intervention Or Impasse?

Present farm policy includes a rhetoric of reduced government intervention but a reality of massive intervention. Legislative initiatives by farm-state Democrats and Republicans alike in the next few years are likely to lean toward more intervention and more spending. "Paid diversion" and export subsidies financed by in-kind payments will be the principal way to spend more federal funds, under the now established illusion that in-kind payments do not involve any new federal expenditures.

Idle U.S. Cropland

Crop year	Acres
1980	none
1982	11 million
1983	78 million
1984	27 million
1985	34 million
1986 onward	50 to 60 million

1980-85 DATA PROVIDED BY MICHAEL DICKS, ERS.

Present farm policy includes a rhetoric of reduced government intervention but a reality of massive intervention.

In fact, that is more or less true only when removals from CCC, reserve, and loan stocks are net reductions. When in-kind payments simply add to already excess free supplies, as in the case of corn in 1985 and 1986, they lead to increased new spending under the loan and deficiency payment provisions. This keeps the Commodity Credit Corporation perpetually strapped for cash and almost constantly in need of new borrowing authority.

One further possibility is that a serious political impasse will develop in 1987. This could happen if the Democratic Party controls Congress either by sheer numbers, or on farm issues by the weight of short term political forces. Such a Congress, with help from rural Republicans, could line up solidly against the Administration on agricultural policies. In that situation, it might be possible for both the House and the Senate to pass farm bill amendments by April 1987 which would intervene more directly in agricultural production. This might include the possibility of mandatory production control programs and higher price support levels for some crops, or other amendments which might cost even more federal money than existing programs.

Such amendments may well be vetoed by the President, leaving existing farm programs in operation with only minor amendments. With neither side able to achieve constructive amendments and neither side willing to compromise, a deadlock of this type would postpone farm policy reform until 1989. By then, a new President and a new Congress will be in office, the 1985 Act will have nearly expired, and spending cuts propelled by budget deficits may be the decisive farm policy issue.

Rounding Up the Mavericks

The political climate for agricultural policy amendments in the next few years will not be conducive to further reform of the sugar and peanut programs. Congress and the Department of Agriculture could not reduce the sugar price support in 1985 when support levels for almost every major agricultural commodity were being reduced drastically. Congress continued to control peanut marketing rigorously to maintain high prices for edible peanuts while cutting other price supports sharply.

We should not expect reform amendments to these programs in the extremely political environment of 1987-88. Recent amendments to tobacco law have cut tobacco prices and may help exports, although our competitors will object. Gramm-Rudman provisions may effectively reduce the price support for sugar and peanuts fractionally in the coming season and perhaps somewhat more in subsequent seasons. However, prospects for fitting sugar, peanuts, and tobacco into the policy framework that is in use for other commodities are poor indeed in the next five years.

A New but Unstable Farm Financial Equilibrium

When the present financial restructuring has run its course, we will have lost or reorganized roughly one-third of the 700,000 commercial family farmers of 2-3 years ago. Some producers with

USDA-SCB PHOTO: GARY A. BATTE

Grain elevators—another essential link between U.S. farmers and international markets. These are at Black, Texas.

USDA SOIL CONSERVATION SERVICE

1969 photo taken in Santa Rosa County Florida of a field placed in the Soil Bank in the 1950s.

severe financial problems will reduce the size of their operations, but most of them will leave farming.

Nearly all the fixed assets, however, will continue in production. Debt will be reduced by perhaps 25 percent and capitalization by 40-50 percent.– By about 1988, the value of all farm assets, which peaked at $1 trillion in 1981 and is now roughly $700 billion, will have completed its decline to somewhere between $500 billion and $600 billion.

With reduced capitalization and debt, lower interest rates, and perhaps lower energy costs for a number of years, we can again have a profitable agriculture. There will be fewer and larger farms earning a competitive return on investment and a comparable return for labor and management while selling corn below $2.00 a bushel, wheat below $2.50 per bu., cotton below $.40 per pound, and milk at perhaps $9.50 per one hundred pounds after a few years, and collecting the payments that go with such production under present law. This, in my judgment, is the likely outcome some 2-3 years from now and longer, if Congress and the President are willing to spend $20-25 billion per year on farm programs indefinitely.

But if political and budgetary considerations after 1988 require that federal farm payments be ended abruptly or reduced progressively and phased out over time, then U.S. agriculture will face another round of withdrawal pains. Farm asset values could be in for another deflation, since the approaching equilibrium of 1987 or 1988 is clearly dependent on massive farm payments. If the economic climate surrounding farm payment reduction were to include either full use of our crop area, or continued ineffective production restraints, the financial pain for farmers and their communities will be increased accordingly, since market prices would be lower without some acreage restraint than with it.

Trade Recovery Decisive

During 1984 when there was a lot of talk about the need for farm policy reform, the key slogans were "become more competitive" and "get our export markets back". In response, Congress quickly decided that loan rates should be dropped sharply, and insured that this would be done by requiring such action in the law. But the ink on these documents was scarcely dry before people in the Administration and the farm and trade associations began to have second thoughts about the prospects for export expansion.

Today, it is realistic to expect some recovery of grain and soybean export markets in the 1986-87 marketing year. After all, 1985-86 was a very poor year, as foreign buyers awaited lower prices and used up pipeline supplies. Any real recovery of export tonnage is now expected to take 3-4 years, however, and it may take 10-15 years to get back to peak levels of 1980-81.

Exporting countries like Canada and Australia are not going to cut back production because of U.S. farm policy. Instead, they have begun to take steps to supplement farm income from their Treasuries, so they can compete as aggressively as ever for exports. The EC, which has expanded farm output in response to high price supports, will not cut back production materially as a matter of policy. The high cost of their export subsidy programs will force a reevaluation of EC agricultural policies, but at the usual "snail's pace", and including co-responsibility and tiered supports. Europe might even have a fling with acreage controls just as the U.S. experience has definitively shown that they are neither effective in limiting production nor cost effective.

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Developing countries such as China, India, Pakistan, and others, which have increased agricultural production for their own reasons other than the cost of imports, will not be responsive to lower world prices for grains, oilseeds, and cotton. While we may expect that the rate of increase of agricultural production abroad will be slowed over the next five years by low world prices, we probably must wait for the overall world market to expand substantially before the U.S. can expect to reclaim significantly larger tonnages and a larger share of that market.

Even when U.S. export volume has increased, low unit prices will keep the value of agricultural exports low and possibly declining for several years. With the value of U.S. agricultural exports already reduced from a peak of over $40 billion to a probable $26-27 billion in 1986, we should not be surprised if that figure falls to $23-24 billion before any increase is realized.

This decline will help to worsen the trade balance or slow its improvement, and it will increase the anxiety in farm circles, generating continuous charges of unfair trade practices, tilted playing fields, and demands for retaliation against wrong-doers. The inconsistency between such charges and the huge U.S. farm subsidies will be generally overlooked here at home, but not abroad.

It is possible that cotton and rice exports will rise sharply in 1986 and 1987 with price supports effectively removed by use of the marketing loan, while wheat, corn, and soybean exports rise only 5-10 percent or less. If this happens, pressure to drop grain and soybean price supports further by the end of 1986 will be virtually unbearable. Only the specter of disastrous international repercussions could intervene to prevent such an action.

A Pattern for Reform

Ninety percent of farm production will be concentrated on some 400,000 farms in only a few years. The resulting huge payments— and the continuing growth of excess production capacity under the sponsorship of federal subsidies—may lead to a new political climate for farm program reform within 5 years. This may emerge during the 1988 campaign for the Presidency, or later, depending on personalities and circumstances, but the opportunity is there.

The pattern of reform could follow the "big bang" route championed by Dr. Willard Cochrane (CHOICES, Premiere Edition) and pioneered this year by the Senate Finance Committee's tax bill, or it could take the form of a slow deregulation of agriculture via periodic amendments of the 1985 farm bill, and budget paring along the lines of Gramm-Rudman procedures.

An abrupt reduction or termination of farm subsidies before 1989 is not likely. But if it comes, it is more likely to be engineered by the Democratic Party than the Republican, despite conventional notions of the positions of the two parties on farm issues.

The Senate tax bill provides one pattern for such a development. Democratic senators led by Sen. Bradley quietly provided the intellectual and political impetus for this bill over the past 3-4 years. They saw that the hodge-podge of tax loopholes that had been established over the years and preserved in the original Senate Committee bill (for which Sen. Packwood took the heat) no longer served traditional Democratic constituents.

Democrats in Congress (and possibly in the White House) some time in the next five years may recognize that nearly all the remaining small farmers earn their bread in the nonfarm work force. If Democrats realize that the beneficiaries of federal farm programs are mostly big and well-financed Republican farmers, they might produce a farm bill in (say) 1989 or 1990 comparable to the 1986 tax bill of the Senate Finance Committee—breaking sharply with a long tradition of federal assistance.

Gradual reduction in farm subsidies over the years seems the more likely route to reform, however, and the 1985 law provides a potential pathway, as follows:

—*Deficiency payments* will be reduced beginning in 1988, unless Congress defers the reductions until 1989, which seems likely in the current political climate.

—*Price supports* can be reduced to levels that are surely below long run equilibrium prices for supported commodities at full production.

—*Dairy product* supports will be reduced to only 72 percent of the 1981-82 peak level by 1989, and a pattern will have been established for further reductions, if Congress does not postpone the cuts.

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—*Acreage reduction* can be phased out or eliminated, if ways can be found to move the output of a full production agriculture at the low prices that will be required.

Holding on to the opportunities now in the law for a changed federal role in the farm economy will require a major effort. The decisive test will be whether experience under the 1985 Food Security Act, in combination with budget policy and political developments, sets the stage for more of the same or for major reform of farm policy in the next round. C