Sales Tax On Food Can Pay For Farm Programs

by Carlisle Ford Runge and Daniel Halbach

U.S. government costs to support farm income have risen dramatically as increased production and stagnant demand have created unprecedented domestic and international surpluses. These surpluses are putting strong downward pressure on farm prices and incomes.

In an attempt to maintain farm incomes, the 1985 Farm Bill froze target prices for two years, while loan rates were dropped to create a vent for export. With current surpluses, the large gap between target prices and market prices is covered with USDA deficiency payments to producers.

The consequence is a huge commodity program costing over $25 billion dollars in 1985-86. Food assistance programs, including food stamps, cost $20 billion. Thus, these two groups of programs now account for two thirds of USDA's budget.

Farm commodity programs are entitlement programs just like food stamps and social security. The exact mechanisms are complicated, but the principle of agricultural entitlement is simple: the federal government commits itself to make regular payments to those who meet specified conditions.

Unlike other entitlements, however, the more the farmer produces the larger the check that individual receives. The largest farmers gain most, raising serious questions of equity as well as efficiency.

An efficient way to finance federal farm program spending is to impose a national sales tax on food, offset by more generous food stamp benefits.

Federal farm program spending can be financed differently. An efficient way to do so would be to impose a national sales tax on food, offset by more generous food stamp benefits. This approach would help reform farm programs and reduce the federal budget deficit.

A sales tax on retail food sales should be combined with (1) a separate budget for farm programs, based on a minimum level of income support for the sector; (2) payment of direct income transfers to farmers financed through the food excise tax; (3) expansion of federal food stamp programs to compensate poor consumers for losses suffered from the tax.

These reforms address three policy targets: (1)budget exposure; (2) making the linkage from farm income support to consumer food prices more clear, and (3) direct attention to the problem of hunger and inadequate nutrition.

Limiting Budget Exposure

How much will the Food Security Act of 1985 cost? Nobody will know for sure until government deficiency payment checks to farmers are actually issued. Virtually all observers agree that $52 billion over 3 years, the Congress' original cost estimate, is low. Current estimates range as high as $90 billion over 3 years.

Freezing commodity target prices for 3 years, together with authority granted to the Agriculture Secretary to dramatically lower loan rates, are the primary features of the 1985 farm legislation. For example, while corn target prices remain frozen at $3.03 per bushel until 1987-88, loan rates were cut from $2.55 to $1.92 in 1986-87, and can be lowered again in 1987-88 to $1.81. At the same time, a huge glut of commodities has pushed market prices down. These lower prices mean larger deficiency payments to farmers from the federal government.

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There is a theoretical cap of $50,000 per farm on deficiency payments. However, the lowering of the loan rates by the Secretary of Agriculture allows this cap to be exceeded. In addition, many individual farmers are finding devices to become more than a single farm at a time, thereby collecting multiple deficiency payments.

Consequently, government deficiency payments are expected to make up a greater and greater share of farm income. Bailey, Byron, and Houck project that government payments will account for nearly half of U.S. net farm income in 1986, nearly two thirds in 1987, and over three fourths in 1988. U.S. farmers, in other words, will become largely wards of the state over the next 3 years.

Yet as critics of the programs have emphasized, a $50,000 payment is hardly welfare. Morever, as farm program costs grow, contributing to federal deficits, urban members of Congress are increasingly restive about paying for them.

Farm program costs are also notoriously difficult to forecast. As is clear from the figure, inaccurate predictions account for disparities of billions of dollars in a given year.

The difficulty of anticipating program expenditures has led some to propose the elimination of the entitlement feature of farm support programs. Farm programs would operate with a binding budget constraint. Once the budget was fixed, it would be up to the Secretary of Agriculture to distribute it.

The primary difficulty with this idea is that the revenue demands of the current system fluctuate too much to allow budgets to be accurately predicted. Unless an income support mechanism can be found that allows revenue requirements to be fixed in advance without reference to changing prices, the unpredictable impact of agricultural program spending on federal budget deficits will continue.

This "decoupling" of income support from prices and production is increasingly attractive to farm policymakers. Of course, even then, the distribution of the risks and rewards of farming will continue as a matter of political debate.

Linking Farm Income Support to Consumer Spending

The evolution of agricultural programs is closely related to a fundamental characteristic of farming: risk and uncertainty related to unstable farm prices and incomes. This instability has increased in recent years, as U.S. farmers have been more and more dependent on international markets.

In a recent analysis of the U.S. corn market, we found that the instability of corn prices relative to trend nearly tripled in nominal terms and nearly quadrupled in real terms from the 1960's to the early 1980's. Further, demand conditions such as export markets contributed increasingly to the instability. Domestic supply conditions such as weather had diminishing effects.

This instability provides a rationale for government intervention in farm prices and incomes. However, the instability in farm prices and incomes—and the government programs presumably designed to offset them—account for substantial year-to-year variations in program cost. Thus, the increased instability of farm prices associated with larger international trade has been transmitted to U.S. government spending.

In response to these conditions, some argue that the collective risk faced by agriculture creates a demand for assured net farm income to the sector as a whole but not necessarily to individual producers. McDowell and his colleagues and Schertz and Clayton, for example, propose programs that guarantee the net income of the sector.

Income transfers to individual farmers would be income tax credits to provide a floor income, with the remainder to be earned in the market. This minimum should be set sufficiently low to discourage entrants into farming.

If the guaranteed sector income were set sufficiently low, the approach would have a minimal impact on market clearing prices and would serve many of the current functions played by loan rates. In contrast to loan rates, however, such a policy would target sector farm income rather than farm prices as the relevant policy objective. In addition, by fixing the guaranteed income level and thus a maximum budget cost in advance, their plan would allow more accurate predictions of total budget exposure.

Such a program could force explicit choices linking how much the public is willing to pay to support farm incomes through transfer payments to farmers. If such a policy were implemented, a remaining problem would be to find a revenue source for the payments in the face of current budget constraints.

Increased Hunger and Inadequate Nutrition

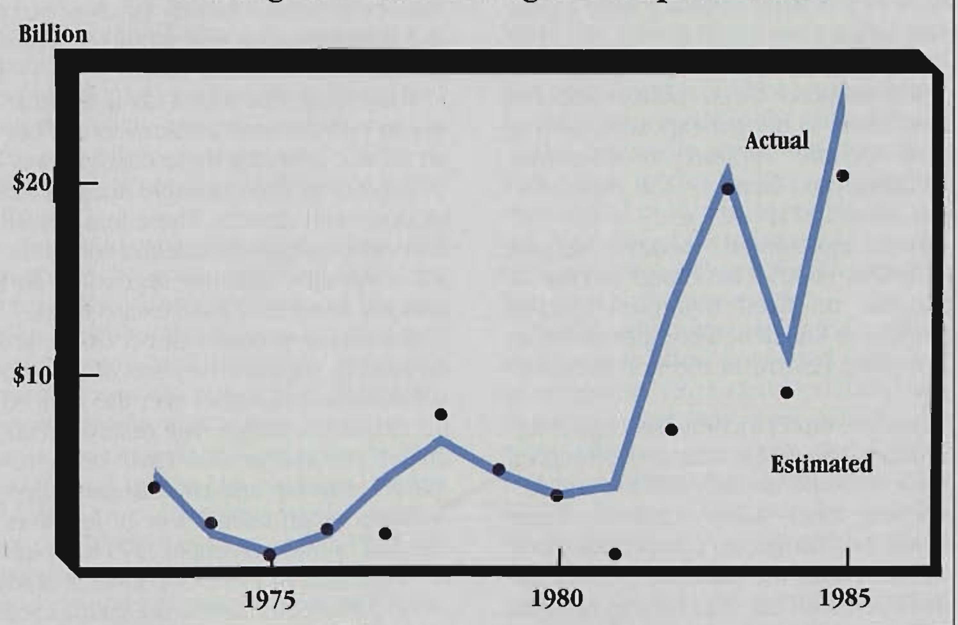
A final and equally serious target of agricultural policy should be hunger and inadequate nutrition in both rural and urban areas. These issues, as well as the suggested guaranteed income approach for agriculture, are related to the broader problem of reforming the welfare system as a whole.

Key to the welfare system are the federal food stamp and nutrition programs. They act as income support for the poor at the same time that they promote consumption of agricultural commodities.

Reforms in these programs are important both to agriculture and to consumers. A 1985 Harvard School of Public Health report argues that hunger and inadequate nutrition are increasingly serious public health problems, stemming largely from government's failure to provide an adequate minimum income standard.

Food stamp benefits are geared to in-

Farm Program Costs Rising and Unpredictable



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comes but not to what it actually costs to eat. Benefits are tied to household size and are the same from state to state, based on the USDA "thrifty food plan." In 1985, benefits averaged $44.00 per recipient per month, or 49 per meal. The 1985 report Harvard School of Public Health points out that based on USDA's National Food Consumption Survey over 80 percent of all households whose food expenditures equal the thrifty food plan level fail to obtain the recommended daily allowances for nutrients.

In many states, sales taxes on food are levied. Because the poor spend a higher percentage of their wage incomes on food than do the rich, food sales taxes fall regressively on the poor.

In 1985, seventeen states directly taxed food purchases at rates ranging from 3 percent to 6 percent. Some of the poorest states, such as Alabama, Arkansas, and Mississippi also imposed the highest food taxes.

While regressive, the fact that so many states have adopted food excise taxes also suggests that they are politically feasible. However, their regressivity remains a problem, which increased food stamp availability could help alleviate.

One of the particular ironies of the last several years is that the food stamp program, designed in part as a demand enhancing measure, has been cut at the same time that direct income transfers to farmers and farm surpluses have grown ever larger.

Three Policy Reforms

We propose three policy reforms. They relate to budget exposure, linking farm income support to consumer spending, and hunger—the policy targets identified above.

First, agricultural income support programs should be based insofar as possible, on fixed minimum income guarantees linked to a broader program of welfare reform in the non-farm sector.

Second, direct income transfers to agriculture should be financed through a national excise tax on retail food sales.

Third, food stamp eligibility rules should be changed to compensate poor consumers for the effect on them of the national excise tax. Food stamp benefits in states with existing sales taxes on food should be higher than in states without sales taxes on food.

Fix the Budget

The fact that the entitlements to farm program benefits go disproportionately to the largest farmers is in itself cause for concern on grounds of equity. However, it is the size and unpredictability of these payments that dominate current budget concerns.

This budget exposure would be both reduced and more predictable if transfer payments to farmers were based on a minimum income floor for the sector as a whole. The Secretary of Agriculture would be the authority to equitably distribute program benefits.

By determining the level of such an income floor for several years at a time, yearly marketing decisions by farmers could be taken with the knowledge that a minimum level of income security (and no more) was guaranteed. From the government's perspective, budget exposure would be more predictable. Of course, simply predicting a large expenditure in the face of current deficits is no solution unless additional revenues can be found, together with incentives to reduce these costs over time.

National Tax on Food Sales

Suppose that income transfers to farmers and food stamps were financed through a national sales tax on food. The logic behind such a tax is simple: consumers are direct beneficiaries of farm and food programs and should be made directly aware of their costs.

Many think that such a tax is unattractive in part because consumers are better off *not* knowing these costs. However, most of its objectionable features can be dealt with directly. These features fall into three categories: size and cost; political feasibility; and the regressive and unequal burden of food excise taxes.

If consumers paid a direct excise tax on food to support the costs of income stabilization to farmers over the 1973-86 period, an annual average retail food tax of 2.4 percent would have been required. Similar annual estimated percentages range from a low of less than one half of one percent in 1974 to a high of 5.8 percent in 1985. Of course, if costs were predictably based on guaranteed income payments, the percentage tax would be fixed at whatever level the Congress decided.

Adding the costs of food stamps and nutrition programs to farm program costs gives average cost of the programs equivalent to 6.4 percent over the period. It is important to emphasize that if these costs had been borne directly by consumers, rather than hidden in general revenues as entitlement expenditures, taxpayers may have been less willing to pay them.

In 1985, the average family of four spent approximately $3,830 on food. A 6.4 percent tax would mean a monthly food tax bill of $20.52. Now, these figures are only the averages of past expenditures. If transfers to agriculture were reduced due to consumer unwillingness to pay directly for them, excise taxes would fall accordingly.

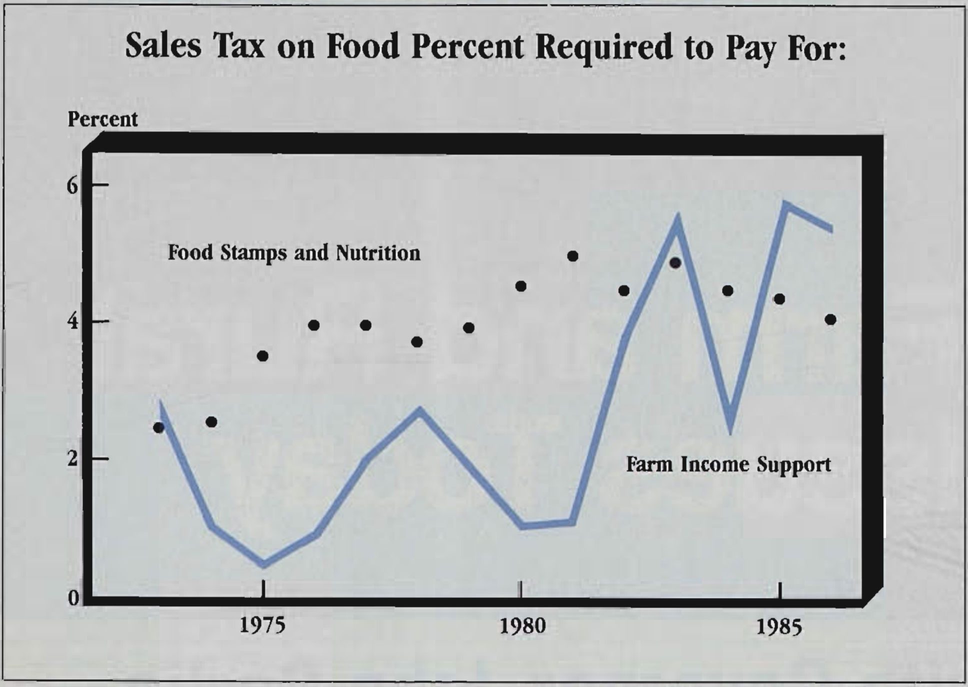
Is such a tax politically feasible? Conventional wisdom says no. However, budget pressures and public opinion may make it so. First, a large part of the general public appears willing to accept higher taxes, especially if they are for farm programs. Farm groups, of course, have traditionally emphasized the low cost of food to U.S. consumers in comparison with other Western countries.

Admittedly, it is often argued that consumers want still lower food prices, and consumer interest groups often lobby for them. However, there is evidence that the public may be willing to trade off marginally higher food prices for greater stability in the farm sector.

The February 1986 CBS News-New York Times poll of 1,174 adults found that 55 percent said they would be willing to pay more federal taxes in order to keep farmers in business. Fifty percent felt that the federal government should increase spending on farm income supports. Only 12 percent felt that such spending should be decreased. Thirty percent favored the same spending levels and 8 percent were indifferent.

Interestingly, the support for spending increases for farmers was greater in the general population than in a subsample of the agriculturally dependent Midwest. Of that group only 36 percent favored increased farm program spending, 14 percent favored decreases, 45 percent the same levels, and 5 percent held no opinion.

A separate national survey commissioned in December 1985 by Communicating for Agriculture, a farm issues education group, came to the same conclusion. Respondents were asked specifically whether they would be will-



ing to pay a one-percent tax on their groceries to fund a year of farm income support programs. Over two thirds, or 68 percent, said yes; 25 percent said no; and 7 percent were undecided.

. The poll did not test the sensitivity of the response to the size of tax proposed or the length of time over which it would be applied. A three-percent tax over a longer period, reflecting the true average costs of farm income supports, might elicit less enthusiasm. And a seven-percent tax, designed to cover the costs of food stamps and nutrition programs, would probably elicit even less. However, such poll results belie the view that consumer support for higher taxes (and food prices) is nonexistent, especially if committed to farm programs and deficit reduction.

A second reason that excise taxes on food appear politically feasible is more straightforward: 17 states have passed them as part of a general sales tax system, including some of the poorest states in the nation. The principal difficulty with a food excise tax is the added burden that it would place on those states that already have such taxes and especially the poor in these states. The regressivity of such taxes is the third and most compelling objection to their political feasibility. Therefore, it merits a separate policy instrument.

Food Stamps and Welfare Reform

Excise taxes on food are regressive. As a percentage of income, food expenditures weigh more heavily on the poor. This argument applies not only to individuals but to states as well.

Since the tax proposed above is on retail food sales, it seems natural that compensation be paid to individuals and states in the form of expanded eligibility for food stamps. For individuals, expanded eligibility could result from raising the gross income eligibility ceilings, establishing net (rather than gross) income requirements, changing asset ownership limitations, increasing allowances under the "thrifty food plan," or some combination of these measures. For states with existing food sales taxes, additional food stamps could be made available to state welfare programs based on the state tax percentage.

There are at least four advantages to an approach that increases food stamp eligibility and compensates states with sales taxes on food. First, hunger and inadequate nutrition are increasing problems and deserve attention whether or not the broader program of reforms outlined above is adopted. Expanded food stamp eligibility, however, would not be costless. Food stamp and nutrition costs are explicitly included in the calculation of excise taxes above, although they need not be financed in this manner.

Second, expanded food stamp and nutrition program eligibility would increase the consumer demand for surplus agricultural surpluses. Expansion of food stamp and nutrition programs would lower storage costs of farm commodity stocks, and reduce pressures for a second domestic PIK program, and for additional export-PIK measures widely blamed for lowering world market prices. When the costs of the 1983 PIK program to the farm sector in lost feed and equipment sales are reviewed, demand-enhancing measures become relatively attractive compared to supply control alternatives.

Third, because food stamps are a form of currency, they are a relatively efficient basis for transferring income to consumers, who are then free to purchase the market basket of goods most consistent with their tastes and preferences. In contrast to actually "cashing out" these costs, food stamps also retain the tie in Congress from the farm states to urban consumers.

Fourth, expanded food stamp and nutrition availability would require no new welfare bureaucracy. The existing welfare apparatus would be largely sufficient, since only rules of eligibility would need to be altered (although an increased number of recipients might entail some additional personnel). Finally, such a program could be made part of a general reconsideration of family assistance as proposed in the early 1970's by the Moynihan Commission, in which income floors are set by the government in both the agricultural and non-agricultural sector, reducing both the complexity and disincentives of current welfare programs.

In summary, three policy reforms—a fixed budget for agricultural programs based on a minimum income floor for the agricultural (and possibly the non-agricultural) sector; a national excise tax on retail food sales; and increased food stamp eligibility and welfare reform would reduce the budget exposure from agricultural program spending; reduce income instability in the agricultural sector; and relieve hunger and inadequate nutrition.

By linking agricultural program spending directly to food prices, consumers would be made aware of the costs of these transfers. Whether they would be willing to pay them is an open question. However, poll data suggests that consumers would be willing to pay for income security in the farm sector.

The proposals are aimed directly at reductions in the budget exposure of agricultural programs as well as the unpredictability of these expenditures. On both grounds they are fiscally prudent and essentially conservative.

Finally, although expanded welfare assistance is often associated with "big government," expanded food stamp and nutrition programs may actually be more efficient, less costly, and involve less government than alternatives such as PIK or mandatory supply controls. When based on a guaranteed income floor, such transfers also are an appealing alternative to the current system of welfare. C