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To you . . .

From: ***Terence J. Centner***
Assistant Professor
The University of Georgia
Re: ***Sextons' "Taxing Co-ops"***

Sexton and Sexton argue, in their articles "Taxing Co-ops" that the current taxation of cooperatives is fair using an analogy of vertical corporations. While theoretically their argument has considerable merit, the provisions of the Internal Revenue Code do not appear to embody this theory.

The tax code distinguishes individuals from corporations; taxes are imposed by different Parts of Subchapter A. The Code imposes a tax on individuals in section 1. On the other hand, corporations are taxed under section 11. Since corporations are defined to include associations (§ 7701), including all cooperatives qualifying under Subchapter T by reason of the language of sections 521(b) and 1381(a), cooperatives are governed by the tax provisions for corporations.

The privilege imparted by tax law to vertically integrated corporations to file consolidated returns is only to affiliated groups of corporations. This dispensation thereby impacts intracorporate tax consequences and only concerns the taxation of corporations under section 11. The consolidated returns provisions do not affect the important tax principle of double taxation for corporations whereby corporate earnings are taxed at the corporate level under section 11 and a second time at the individual level under section 1 when funds are transferred to individuals.

Labeling patrons and the cooperative as a vertically integrated business which should qualify for the consolidated returns privilege available to corporations is contrary to the principle of double taxation for corporations. A cooperative involves affiliated individuals who are taxed under section 1 and a corporation that is taxed under section 11, rather than solely affiliated corporations. Thereby, treatment of a cooperative and its patrons as an integrated business qualifying for consolidated returns would enable corporate earnings to completely escape taxation at the corporate level. The consolidated returns provisions were not intended to effect such exception. Rather, they provide that earnings are only taxed once at the corporate level and were not intended to impact the taxation of earnings paid to individuals.

I would also point out the insightful findings of Caves and Peterson in their article "Cooperatives' Tax 'Advantages': Growth, Retained Earnings, and Equity Rotation," which was in the May 1986 issue of the American Journal of Agricultural Economics. Caves and Peterson advance the argument that the existence of the capital gains tax deduction means that farmers in high income tax brackets may be better off dealing with corporations if some of the return can be transformed into capital gains. This may explain why the Sextons' figures on fruit processing organizations show the corporate mode of business paying less income taxes than Alternative A cooperatives.

■

From: ***Randall E. Torgerson***
Administrator
Agricultural Cooperative Service, USDA
Re: ***Sextons' Taxing Co-ops"***

In the second and third issues of CHOICES, Richard and Terri Sexton have attempted to revisit issues surrounding cooperative taxation. In the first article, they observed that treatment is fair but not for the reasons often given by cooperative leaders. In the second, the theme is that current tax treatment doesn't harm the economy.

The central theme of the first article is that vertically integrated business is the appropriate model to evaluate cooperatives' tax treatment, and that a member's relation to a cooperative is no different than that of vertical subsidiaries of a corporation under unified ownership. Tax treatment under both is similar.

The authors contend that comparing cooperative tax treatment with Subchapter S corporations and partnerships is inappropriate because of cooperative size. Their supporting set of figures doesn't provide a proper perspective. Cooperatives by most any measurement are far closer to Subchapter S corporations and partnerships in size than they are to the 12 percent of the nation's corporations that are double-taxed. The largest of these has annual sales greater than all 5,625 farmer cooperatives. And many of the larger corporations have more stockholders than there are farmers.

Nonetheless the authors' conclusion is but another in the arsenal of cogent arguments in defense of the present tax treatment of cooperatives. The authors do not explicitly state the fundamental differences in purposes and operation of the two organizational types. Simply put, cooperatives are user-owned businesses that render service to members on an at-cost, or not for profit basis. Earnings belong to the members, i.e., the cooperative is not entitled to entity ownership of results of the business. Capital replacement and growth needs of the cooperative—including servicing of net worth—are serviced as with any businesses, but the fundamental purpose of the organization is not changed. Herein lies the basic reasons for differences in taxation.

The Sextons fail to point out several other important aspects regarding the relationship between a cooperative and its members.

Any cooperative or noncooperative corporation can operate under the rules of Subchapter T and be sub-

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Torgerson *Continued from page 5*

ject to a single tax. The fact that non-cooperative corporations do not choose to operate in this fashion is testimony to the basic differences in organizational purposes. Secondly, all income generated by a cooperative is subject to taxation. However, the tax treatment of cooperatives provides for different exclusions from taxable income under Subchapter T. Thus, a corporation operating under Subchapter T must always distribute at least 20 percent of its allocated earnings in cash to member/patrons, and any unallocated income is taxed at the statutory corporate rates.

Cooperatives transfer income to member owners on a quite different basis than do other types of businesses. Distribution of income by the cooperative represents an adjustment in the value of transactions between the member and the cooperative. Therefore, the income transfer is based on the member's volume of business with the cooperative. Investor-corporations return income according to the amount of investment, which has no relation to business transactions.

The analogy drawn between the vertically integrated corporation and the cooperative is well argued and useful. It is especially appealing because it argues what cooperative theorists like Emelianoff and Phillips have argued economically, that the cooperative is an extension of the business enterprise of the individual patron, i.e., a vertical subsidiary.

The authors' premise in the first article is that co-op tax treatment is fair because it is consistent with treatment given integrated corporate entities. But in the second article, their premise is that the treatment is an "advantage," but justified. These positions are either inconsistent or in conflict.

However, two areas require specific comment. One is that the single tax on cooperative earnings gives cooperatives an advantage. This point cannot be conceded and is simplistic especially as it pertains to capital gains.

Capital gains are a mechanism to transfer wealth, not income. This is a very critical point in understanding the difference in tax treatment of a cooperative or corporation. While the authors recognize the differential tax treatment afforded to capital gains, the more critical distinction is that cooperative members generally have no mechanism to receive capital gains that represent an increase in the capitalized value of their operations other than through liquidation.

Shareholders in a corporation pay tax on capital gains only when they sell their shares: (a) at a reduced tax rate, (b) in the future, (c) when they receive the gains in cash, and (d) timed by individual discretion. This represents a major advantage over how cooperative patrons are taxed on noncash patronage refunds retained by the cooperative: (a) at full ordinary income tax rates, (b) currently when allocated, (c) before redeemed in cash, and (d) at the cooperative's discretion.

The second area is the authors' reference to "instances of anticompetitive behavior attributed to co-op manipulation of marketing orders ..." We know of no judicial opinions finding cooperatives have engaged in anticompetitive conduct through manipulating marketing orders.

(Torgerson's letter was written and received previous to passage of the Tax Reform Act of 1986.)

■

From: *Richard and Terri Sexton*
University of California, Davis
Re: *The Authors Reply*

Mr. Centner has apparently misconstrued the whole point of our articles. His letter implies that we believe subchapter T (The portion of the tax code applying to cooperatives) is irrelevant—that co-ops could achieve the income pass through from co-op to patron afforded by subchapter T merely by invoking the consolidated returns provisions of the Code. No one, least of all ourselves, has attempted to make this argument to our knowledge. Rather, the co-op tax controversy has centered on two points: (1) is subchapter T an unfair and unjustified aberration from the general taxation principles embodied in the tax code (the main topic of our first article), and(2) has co-ops use of subchapter T been harmful to the economy (the topic of our second article)?

Opponents have attacked subchapter T on the fairness question by comparing the co-op/patron relationship to that of the corporation and shareholder. On this basis, subchapter T appears unfair because it affords single taxation of co-op earnings while ordinary corporations' income is twice taxed.

Our defense of subchapter T was to note that the appropriate model for the co-op/patron relationship is not the corporation/shareholder but the vertically integrated corporation, i.e., the co-op vertically integrates its members either forward into product marketing or backward into input supply. Thus, subchapter T is a logical extension of the consolidated returns provision to accommodate the group vertical integration aspect that is the economic essence of a cooperative.

A couple of other misconceptions in Centner's letter ought to also be clarified. Co-op patrons may be any type of business organization, such as corporations or partnerships, not just individuals as Centner implies. The patron's economic organization does not affect the tax status as is entirely appropriate since the vertical integration function embodied in the co-op/patron transaction is unaffected by the patron's organizational choice. Since the co-op/patron relation is fundamentally different from that of the corporation and shareholder, subchapter T does not provide an argument eliminating the double tax on dividends.

Finally, in respect to the importance of the co-op tax advantage, the Caves and Peterson conclusion that high tax bracket farmers may be better off dealing with ordinary corporations than with co-ops is old news to those well versed in co-op matters. For example, the same point was made over 10 years ago in Schrader and Goldberg's book *Farmers' Cooperatives and Federal Income Taxes*.

The key point not mentioned by Caves and Peterson is that a co-op can elect to be taxed as an ordinary corporation. Thus, co-ops should never on average (that is, across the entire membership) have a tax disadvantage. The fact that co-ops almost never elect this option is ample empirical evidence that an advantage to the Subchapter T treatment does, in fact, exist.

POPULATION GROWTH

From: *Donella Meadows*
Resource Planning Center, Dartmouth College
Re: *Johnson's "Population Consensus"*

D. Gale Johnson and his Working Group for the National Research Council report a "new consensus" on the important question of how (and whether) population growth affects economic growth.

As is nearly always the case with "consensus," this one is only a statement by a carefully selected group of like-biased people. The findings of the group were predictable just from the names and disciplines of its members. I am a member of a group with an opposite bias. I know what we all say to each other about the NRC report. If any one of us had been a member of the Working Group, either the final conclusions would have been different, or there would have been no consensus.

The NRC Group's first conclusion was "population growth has modest effects—either negative or positive—upon economic development. I would have said, 'population growth has strong effects over the longrun, both negative and positive, upon economic growth. As the population gets larger and/or its rate of growth becomes faster, the negative effects increase and the positive effects decrease.' "

Conclusion two was "many other factors—including the stability and effectiveness of governments, the quality of the infrastructure, and the degree of market orientation—are significantly more important than population growth in affecting the pace of economic development." I would change "significantly more important than population growth" to "also vitally important." Johnson does not know, nor do I, how to quantify or compare the relative importance of all these factors, in different cultural and historical circumstances, at different points in the process of development.

Johnson's conclusion three reads, "political, social, and economic institutions respond to population growth and ameliorate or mediate what might otherwise be negative consequences of more population." That conclusion must come from a very one-sided collection of anecdotal evidence (such as Esther Boserup's book, cited by Johnson). I could match every story of successful adaptation with an equally valid story of failure to adapt—and I would claim that higher populations and faster rates of change reduce the ability of institutions to adapt.

The Johnson Group's report is just one more tiresome swing of the pendulum of officious statements by biased groups, each trying to overwhelm the opposite bias of the previous statement. Previous swings have been perpetrated by the Club of Rome, Herman Kahn, and the *Global 2000* report. Having been part of this process, I am now thoroughly sick of it.

I wish someone would have the courage to probe to the very foundation of these two opposite biases—the Malthusian and the Cornucopian, the ecological and the economic, the "everything-is-basically-OK" and the "everything-must-be-fundamentally-redesigned." There is something vital to be learned by asking why D. Gale Johnson perceives the world so fixedly the way he does, and why I perceive it so differently. Why none of these learned studies ever comes close to convincing the other side. What deep beliefs and assumptions are motivating each side, and what each side sees that the other is steadfastly ignoring.

Getting to the bottom of the argument requires assembling a panel with truly diverse viewpoints and forcing them to an honest and perhaps painful self-examination. It wouldn't be easy. But it would be a lot more fruitful than one more exercise in phony "consensus."

From: *Wayne A. Schutjer and C. Shannon Stokes*
The Pennsylvania State University
Re: *Johnson's "Population Consensus"*

A major strength of the Commentary by D. Gale Johnson is the third area of consensus he identifies, namely: "... political, social and economic institutions respond to population growth and ameliorate or mediate what might otherwise be negative consequences of more population." His conclusions suggest that the human species does not intentionally accept Malthusian checks to population growth and seeks to adjust to carrying capacity through changes in technology and the institutions that control access to resources and their efficient allocation. Recognition of that fact, however, deserves greater policy attention than his prescription for population policy implies, i.e., that all people should be provided with access to contraceptive information and the means that are required for them to have the number of children desired and that coercive measures are not justified to assure the adoption of family planning practices.

As Johnson notes, institutional change resulting from population pressure on the resource base often requires a period of adjustment. His commentary, however, minimizes the human costs required to stimulate and effect the ameliorative response. To put the matter directly, need women and their families throughout the developing world live lives of poverty, illness, and general misery in order to develop an appreciation for the advantages of limiting family size and to spur needed institutional change? Are there not governmental strategies intermediate to the "free-market" approach, which provides only family planning services, and those adopted by more authoritarian governments in which family size is a "state decision?" In short, can more humane motivations for limiting family size and institutional change be substituted for the human misery that comes from extreme resource pressure?

The free-market approach followed by governments during the European transition from high to low fertility in the 19th century did "work." But it worked at an enormous cost in human suffering. For several generations, actual fertility exceeded desired fertility for millions of women, and the result was widespread child abandonment, malnutrition, neglect, and abuse. Reread Charles Dickens. The misery he describes was often as much due to ungoverned family size as to the inherent evils of industrialism. Do we really want to hold this up as a model to the developing world?

An alternative strategy recognizes that any government policy aimed at institutions will likely influence the motivation of families to limit childbearing and, hence, become components of a national population policy. For example, research on changes in the land tenure system in developing nations indicates that government policies designed to provide rural families greater access to farmland does little to reduce the motivation for large families unless they are accompanied by ownership of that land. Parents who own land appear to desire fewer children as a potential source of old age security. Hence, they are more likely to adopt family planning. Similarly, parents farming as tenants are more likely to view children as economic assets and appear less likely to consider limiting family size.

Our disagreement with Johnson's Commentary is not with the conclusion that human populations can and usually do adapt to changing circumstances. This is not in doubt. What seems lacking is the recognition that the manner in which institutional change is brought about through government policies can itself potentially influence the motivations that underlie observed fertility patterns. Governmental failure to consider this possibility constrains population policy recommendations to a free-market approach to family planning and ignores both how and under what conditions adaptive responses take place and those policies that might render it a more humane and less Darwinian process.

■

From: *D. Gale Johnson*
University of Chicago
Re: *The Author Replies*

It is difficult to know what response to make to Donella Meadows' commentary on my Viewpoint piece in CHOICES. She denies the first conclusion that I stated; she weakens but does not radically change the second. She assumes that she knows the basis for my third conclusion, namely that "political, social and economic institutions respond to population growth and ameliorate or mediate what might otherwise be negative consequences of more population." She concludes, without explanation, that this conclusion "must come from a very one-sided collection of anecdotal evidence (such as Esther Boserup's book, cited by Johnson). As will become clear when the research papers prepared for the Working Group are published, there is substantial evidence in support of the conclusion that institutions do react to population growth, in the vast majority of cases, and respond in such a way as to offset all or most of the potential negative consequences of that growth.

I refuse to accept as legitimate any comparison between the report of the Working Group and the *Limits of Growth*, with which Meadows was associated. The *Limits of Growth* was subsequently repudiated by its sponsors as being a biased document designed not to present truth but to shock its readers.

Wayne Schutjer and C. Shannon Stokes accept the conclusion on the responses of institutions to population growth that Meadows found unsupported. They argue that the population policy enunciated, namely that all people be provided with access to contraceptive information and the means required to have the number of children desired is too limited. This they describe as the "free market" approach and say it isn't enough. I find unconvincing the argument that the free-market approach in Europe in the 19th century result in human suffering and misery as being an argument against a policy of providing information and access to means to limit family size. The argument rests upon two assumptions, both invalid. One is that during the 19th century there was reasonable access to information about contraception and the means to avoid pregnancy. The second is that there have been no significant changes in knowledge concerning fertility control, in the cost and availability of communications and in the means available for the prevention of pregnancy during the past century.

I agree that numerous institutional changes may influence fertility decisions and that it would be appropriate to give some weight to such effects. However, it seems to me to carry things rather too far to imply that decisions with respect to land policy should be influenced to a significant degree by presumed effects upon desired family size. Higher family incomes seem to be associated with smaller desired family size. Should this objective be sacrificed if there were a conflict between universal operator ownership of land and a mixed system with both tenant and owner operators but with higher average incomes for both groups?

Schutjer and Stokes raise a very important question, even if one has trouble accepting their answer to it. Their question is whether there is an acceptable approach that lies between the policy that I proposed and those followed by some governments that involve a significant degree of coercion. In deciding whether there is an intermediate position that is consistent with democratic values, one needs to consider that governments sometimes follow pronatalist policies while espousing the desirability of limiting population growth. For example, consider the pronatalist implications of U.S. income tax and welfare programs and the provision of free public education. And in recent years both the Administration and Congress have been unwilling to provide federal funding for abortions or a vigorous family planning program. Taking these and other factors into account, I find a population policy that minimizes the role of government in directly influencing fertility decisions has much to commend it.

■

From: ***E. Linwood Tipton,***
Executive Vice President
Milk Industry Federation and International Association of Ice Cream Mfrs.
Re: ***Babcock and Schmitz' "Look for Hidden Costs"***

As Bruce Babcock and Andrew Schmitz correctly point out, one doesn't have to look far for the costs that never appear on the federal budget bottom line—especially where our country's farm programs are concerned. Deception of U.S. citizens is practiced regularly by the politicians as they say, for instance, that our sugar program is operated at "no cost." The question is, "no cost to whom?" As even an untrained eye can see, the difference between domestic and world sugar prices (about a 16 cent a pound difference as Babcock and Schmitz have noted) is coming out of someone's pocket.

Consumers pay at the supermarket for all purchases of sugar or any items containing sugar or other sweeteners. Companies who make sweetened products pay higher ingredient costs, driving many manufacturing plants, and with them jobs, out of the United States. U.S. cane sugar refiners pay to operate facilities at less than capacity as the volume of imports decrease leaving many refineries no recourse but to close. Importers pay in loss of market in the U.S. creating social as well as economic problems in lesser developed countries such as the Philippines and Dominican Republic, and creating major hurdles to trade relationships with other developed countries such as Australia. Even U.S. sugar growers pay, as the high price of sugar continues to provide an economic incentive for less expensive alternative sweeteners and newly developed sweetener hybrids to capture more and more of the market.

It's time to bring these hidden costs out into the open and force our politicians to enact a more realistic, less costly sugar program. I applaud Babcock and Schmitz for their clear vision. It's equally clear that sugar prices must be lowered.

■

From: ***Cathy Jabara,***
Economist
U.S. Department of the Treasury
Re: ***Babcock and Schmitz "Look for Hidden Costs"***

I do not disagree with the overall point of the Babcock and Schmitz article that programs with import quotas that raise consumer costs, such as the sugar program, involve relatively large economic costs, as compared to programs with direct federal outlays, such as the corn program. Therefore, judging the cost of programs simply on the basis of federal expenditures may not reflect what consumers lose and producers gain.

Most economic theory textbooks show that a deficiency payment or producer subsidy is preferable to a price support or quota program for traded goods because consumer decisions are not distorted. However, I am concerned that Babcock and Schmitz underestimate the economic costs of the federal transfers involved in the corn program in two ways. First, the welfare or efficiency cost of transferring income from taxpayers to corn producers is not shown. Second, the welfare costs from distorted agricultural production are too low in the corn example.

Babcock and Schmitz take into account the welfare cost of transferring income to sugar producers via consumers, but they assume that the government collects tax revenue from the private sector and returns it to corn producers with no net income change and no resource cost. Unless imposed in the form of a lump-sum tax, raising tax revenues interferes with economic decisions and distorts choices. In reality the opportunity cost to the economy of the $1.7 billion transferred to corn producers in the Babcock and Schmitz example is greater than the actual amount transferred. This is the efficiency or "dead weight loss" associated with tax collection. For example, the $1.7 billion could have been financed with a tax on automobiles, which distorts consumer decisions, or with an income tax, which distorts work-leisure choices and discriminates against saving in favor of consumption.

How important is the efficiency cost associated with raising tax revenue? Musgrave and Musgrave in their 1984 book published by McGraw Hill *Public Finance in Theory and Practice* state that the average "surcharge" per tax dollar is about 30 percent of revenue. Therefore, the net economic loss from the corn program should be increased from the $80 million shown in the Babcock and Schmitz article to $587 million just from the efficiency cost of revenue collection alone.

Babcock's and Schmitz's assumption that the supply response attributable to the corn program is fairly small because deficiency payments are based on historical production is also questionable. Farm deficiency payments are linked directly to current production that takes place within an eligible (moving average) acreage base. In the long run, corn producers will adjust acreage and yields until the marginal expected revenue (including deficiency payments) from increased production equals its marginal cost. The welfare costs associated with the corn program in any one year must take into account the higher average production induced by the program from year to year. In order for the corn program to work as a direct transfer with limited supply response, as suggested by Babcock and Schmitz, the deficiency payments must be given in a lump sum and be completely unrelated to whatever is currently produced (such as in the Boschwitz-Boren plan). A low supply elasticity tends to make a deficiency payment program look more attractive in terms of lower social costs.

While on a relative basis the social costs of the sugar program are more than the corn program, the absolute magnitude of the latter is by no means a trivial question. The social costs estimated for the corn program by Babcock and Schmitz appear to be grossly understated. The corn program also inflicts "hidden costs" on the economy. It is more likely that U.S. consumers and taxpayers can afford neither type of program.

■

From: *Clark Edwards and Clayton Ogg*
Economic Research Service, USDA
Re: *Babcock and Schmitz' "Look for Hidden Costs"*

Bruce Babcock and Andrew Schmitz warn us to "look for the hidden costs": one cannot judge commodity programs solely on the basis of federal government spending because there are hidden costs and benefits. They remind us of a guiding principle which is easily and frequently overlooked, but they stop too soon. They, too, leave important hidden costs and benefits out of sight. Let's look at their corn program example.

Babcock and Schmitz do not consider the effects of a feed grain program on livestock producers. Deficiency payments under the current program separate the market price from the target price. Cheaper feed is a gain for livestock producers. The increased livestock production decreases retail prices of livestock products, a gain for consumers. Demand increases for soybean meal as a livestock feed, but decreases for feed wheat. The program draws more resources into corn production and, at the same time, holds more cropland out of production. This makes resources relatively scarcer for other farm enterprises and bids up resource prices, particularly land values. Some of the gains go to land owners. Higher resource costs affect all farmers, so consumers may find themselves paying more, for example, for fruits, vegetables, nuts, and specialty crops.

Babcock and Schmitz then turn to acreage set-asides. What if enough acreage is idled to reduce corn production below what it would have been? With less corn and higher market prices, the side effects on other farm enterprises are different. Feed costs rise and livestock profits fall. The demand for soybean meal decreases, the demand for feed wheat increases, and resources are released for allocation to other farm enterprises. Consumer costs shift from taxes to higher retail prices for crop and livestock products. However, this version of the program, too, by increasing product demand and decreasing land supply, creates an artificial scarcity in agricultural production which can increase costs for products not directly related to corn such as fruits, vegetables, nuts, and specialty crops.

What about their sugar example?

The sugar quota program has little direct government expenditure but, since it keeps the domestic price generally around three or four times the world price, it has large indirect impacts. Quota induced technological change since 1979 favored corn fructose sweeteners. The use of all corn sweeteners doubled to about half the domestic market. Artificial sweeteners expanded to more than a tenth. And candy made from foreign sugars can be imported without affecting the sugar quotas. These changes displaced half of sugar imports.

Babcock and Schmitz say that much of the benefits of the sugar quotas go to foreign suppliers. But the trend was toward more corn products, more artificial sweeteners, and less imported sugar. Much of the current U.S. sweetener production could return to foreign sugar producers if corn fructose manufacturers were to face a severe price reduction. The world price received by sugar exporters would then move up as U.S. consumers substitute foreign sugar for higher cost corn fructose sweeteners. That is, curtailing the program could hurt foreign trading partners who now have quotas but could help those who don't. And it could hurt domestic corn farmers and processors.

For over two decades the quota windfalls to more than thirty exporting countries have been justified as Alliance for Progress or Caribbean Basin development assistance. We cannot assume that the high price paid by U.S. consumers for sugar received under quotas directly benefits foreign sugar farmers. Brazil and some other countries have a sugar board capable of distributing the benefits from the valuable quota among producers. However, recent experience in the Philippines suggests that much of the higher price paid by U.S. consumers for foreign sugar may be captured by processors, special export companies, and political figures.

It may be discovered, as hidden costs and benefits are examined, that farmers specializing in nonprogram commodities share the burden with consumers of the corn program, or that U.S. corn growers and processors benefit more from the sugar program than foreign sugar suppliers.

We agree with Babcock and Schmitz's injunction to look for the hidden commodity program costs as corn, sugar, and other commodity programs are reviewed and debated during the coming year. Yet we feel it is more complicated than they imply.

■

From: *Bruce Babcock and Andrew Schmitz*
University of California, Berkeley
Re: *The Authors Reply*

The comments by Tipton, Jabara, and Edwards and Ogg reinforce our basic point that the effects of government agricultural policy on social welfare are far greater than is at first apparent.

Jabara correctly points out that one social cost not included in our analysis is the dead weight loss caused by revenue taken out of the private sector by our non-neutral tax system. The other point raised by Jabara concerning the elasticity of supply with respect to target prices needs further discussion.

Many economists have argued that high target prices are the source of our current excess supply of many agricultural commodities. This would be true if deficiency payments were tied directly to current production levels as Jabara argues. But the link between current production levels and current deficiency payments is much more tenuous.

Deficiency payments are based on program yields, which are determined by either county averages or a moving average of past yields, and base acreage. Base acreage can only be increased when a farmer is not enrolled in the program. A high per unit deficiency payment will encourage greater planted acreage from farmers who are not participating in the program but want to participate in the future with a higher base acreage. These expansion-minded farmers do not collect government payments in the current year but they collect higher future payments. Farmers who want to take advantage of the high target price in the current year must *decrease* planted acreage by setting aside a portion of their base. Farmers who continue in the program plant the same number of acres, assuming that the diversion requirement remains constant. The net effect of a high target price may be a decrease in planted acreage.

Program yields are unaffected by high target prices if county averages are used in their calculation. If they are based on a moving average of a farmer's past yields, then an expansion in current yield will slowly work its way into higher government payments as program yield adjusts.

The net supply effect of persistently high per unit deficiency payments is not as clear cut as Jabara believes. Program diversion requirements discourage production while the tying of program yields to past yields encourages increased yields. It is not clear that the elimination of, say, corn payments would result in a large corn supply contraction.

In our paper we assumed that the elimination of the corn target price would have resulted in a supply expansion from participating farmers, due to their planting previously set-aside acreage, and a supply contraction from nonparticipating farmers due to a lower market price and a loss of incentive to increase their acreage base. The resulting small change in total supply from the elimination of the corn program is the cause of the relatively small economic cost of the corn program.

Edwards and Ogg point out a number of the inter-industry general equilibrium effects of government policy. Although we agree that some of these effects are important and should be discussed when evaluating policy alternatives, the reliable estimation of a more general equilibrium model which can be used to simulate the effects of government policy on related markets is a difficult and time-consuming endeavor.

If the track record of existing large-scale econometric models is any indication of the likely success of such an investment, economists should think long about any future modeling efforts.

■

From: *Brady J. Deaton*
Virginia Polytechnic Institute and State University
Re: *Barkley and Rogers' "More New People in Old Towns"*

The Barkley-Rogers article raises serious questions about commonplace views toward small towns and rural communities. We should all think more about them because they affect our understanding of rural economic change. I have two principal concerns.

First, we generally think that people move from one community to another in response to money wage differences between regions. But this measurement is a narrow view and fails to capture important aspects of migration determinants. Barkley-Rogers don't, but most economists miss the importance of rural amenities and kinship ties. Yet, these factors appear to have been principal determinants of the 1970's population "turnaround," the urban-to-rural movement that occurred in most of the Western industrial democracies. Also, many of the new rural residents are former residents or kinfolk who left their home area at an earlier time. Therefore I emphasize those social determinants.

My research with Morgan, Anschel, and Weber reveals that people place a relatively high value on the amenities of their home communities as compared to wages. Most people want money wages but, they want a lot more as well. The importance of the "lot more" grew in recent decades as money wages rose safely above bare subsistence and as urban life has increasingly involved long commutes, crime, and other diseconomies.

Therefore, in order to evaluate how wages affect migration and allocation of other resources, wages must be considered in a place-specificity context. Equal money wages may be linked with very different packages of amenities and kinship values among communities. In addition, personal backgrounds, as well as tastes vary from one person to another, further stimulating very diffuse patterns of movement of people among rural communities and between rural and urban areas. In other words, people move to gain the entitlements associated with a particular community. These may be measured in wages, transfer payments, or aesthetic pleasures.

My second concern is the policy significance of the research findings. The finding that new residents travel out of their new communities to make many purchases provides a proper caution to the common "Chamber of Commerce" approach to building a new tax base and expanding business opportunities. However, a rather substantial body of literature reveals that concerted local leadership and directed investments in industrial sites and improved local services can lead to substantial new job creation in small towns and rural areas. These effects may be cumulative over a sizeable population range before urban diseconomies set in as Kaldor has noted. If so, then the balance among the communities in the Palouse could be irreversibly altered. The resulting growth may be at the expense of some of the surrounding communities.

In earlier decades, much public attention was given to creating "balanced growth" patterns between rural and urban communities. This emphasis recognized that there must be both capital and labor in order to have communities with jobs for those who live in the communities. One of the important lessons is that we need to give a lot more attention to the needed mix of private investment, public investment and labor to make rural communities economically viable.

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From: *E. Linwood Tipton,*
Executive Vice President
Milk Industry Federation and International Association of Ice Cream Mfrs.
Re: *Novakovic in the 'Dairy Buyout*

Andy Novakovic's excellent article on the dairy buyout program is right on target, but the emphasis on the potential success of the buyout may be misplaced. There is no doubt that the buyout encouraged a significant number of dairy farmers to exit and with them, almost 12 billion pounds of milk. But it is still far too early to proclaim the program a success. The real measure of success must be whether or not milk production and demand are brought into balance over a sustainable period of time. The buyout alone, however, will not do this.

Many analysts question whether the buyout will offer even the temporary relief some are projecting for 1987. USDA's official forecasts for 1987 have milk production down by about 2 percent and CCC dairy purchases in the 5 to 6 billion pound range, primarily in response to the dairy termination program. I hope that these projections are right, but there are some signs indicating that we have not really turned the corner on surplus milk production, nor reduced the incentive to produce too much milk. In fact, one can easily argue that milk production will remain high and CCC purchases will still be in the 8 to 9 billion pound range in 1987.

The single biggest question we face, of course, is how are the nonparticipants in the herd buyout going to react. This makes the 1987 production outlook particularly uncertain. If nonparticipants go into a real expansion mode, we would expect to see cow numbers start increasing next spring and summer as most of the buyout participants have exited. The number of replacement heifers now in the herd could support this expansion. And a slowing down of the culling rate could keep 200 to 400 thousand cows in the dairy herd.

If this happens, we might see cow numbers averaging 10.6 to 10.7 million in 1987. If we further assume that output per cow increases by 2 to 3 percent, milk production would total 144 to 145 billion pounds, very close to that of 1986. And, if increases in commercial sales moderate next year, as many expect, government purchases could easily remain in the 8 to 9 billion pounds range.

How can a scenario like this be supported? Next year we are looking at large supplies of most feeds at very favorable prices. Corn supplies will be plentiful and forage readily available. The milk feed price ratio is now about 1.7 and is likely to remain very favorable through most of 1987, indicating continued high levels of concentrate feeding.

Another big factor in this analysis is the relative profitability of dairy farming, both in comparison to a year earlier and to other farm alternatives. In USDA's most recent milk production cost report, it showed that total cash expenses for milk production were down almost $1.00 in 1985 to $9.74 from $10.64 per hundredweight (cwt.) a year earlier. Even with the lowering of the milk price support by $1.00 per cwt. in 1985, returns to owned inputs were up by 10 cents per cwt. in 1985 compared to 1984. While data for 1986 are still not readily available, costs of most major items were down further in 1986 with crop prices, energy costs and interest expenses leading the way.

With moderate inflation projected for 1987, lower feed and fuel costs and a lack of viable farm alternatives, there will be a strong incentive to continue to produce too much milk. I have drawn this scenario not because this is the direction I wish it to go, but as a caution against undue optimism that the buyout has solved the surplus problem. The buyout is part of a transitional program put into place by the 1985 Farm Bill and was not intended to be the sole solution to the surplus problem. Its purpose was to buy out those dairy farmers who wanted to quit and to buy time for those remaining in business to adjust production to meet demand. The price adjustments, which were also written into the 1985 Farm Bill, are an insurance policy to guarantee that the right signal will be sent if the surplus problem persists. Combining the two aspects will work if given a chance.

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From: *Andrew M Novakovic,*
Visiting Associate Professor,
University of Wisconsin-Madison
Re: *The Author Replies*

My good friend Linwood Tipton is certainly correct to point out that it is too early to proclaim the Dairy Termination Program, or buyout, a success. It may take until after the five year commitments expire in 1992 to know for sure, if the program doesn't derail before then. The points Linwood makes about the importance of keeping production incentives down after the first flush of the buyout is over are resonant with what I said. He is more pessimistic on the short term outlook than I, but we agree on the direction of change.

The major difference between my paper and Linwood's comment might be stated as follows. I choose to see the glass as half full. Linwood says he sees it as half empty.

I think the buyout pushed us in the right direction and had some people benefits beyond its market benefit; Linwood is saying it didn't solve the problem. I've said: isn't it a good thing that net removals are lower than they were and much lower than they would have been; Linwood says they won't be low enough. Linwood is saying the dairy surplus can't be solved without price cuts (barring changes in the economy or policy that neither he nor I expect); I have said that the buyout can work in tandem with price disciplines by speeding the adjustment process, reducing the price cuts required, and thereby softening the blow to farmers. Linwood knows the frustration of working with policy makers who want to avoid the reality of the marketplace; I choose to see them learning what the market realities are and that they can not be ignored.

Whether we wish to argue that the job is not done or rather that it has begun, at least we can say that we're not at a standstill or going backwards. Given the recent track record on agricultural policy, heading in the right direction is not a small accomplishment.

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From: *Timothy C. Mackey,*
Agricultural Counselor
Embassy of Australia
Re: *Derwent Renshaw's "European View" of "U.S./EC Struggle Over Agricultural Markets"*

Derwent Renshaw's "European View" of "U.S./EC Struggles Over Agricultural Markets" contained several relevant points which often do not get sufficient credence in the U.S., making it clear that all of the problems of world agricultural trade can not be laid at the door of the EC. I agree that more acknowledgment should be given the steps the EC *has* taken to limit grain overproduction, such as the reduction in intervention prices for some cereals for 1986/87.

However, it is essential to recognize the root cause of world grain overproduction; to which the EC has contributed along with other major economies such as the U.S. and Japan. This is the wide and increasing gap between the prices paid to farmers in these countries for their grain and the prices which that grain is sold for. For example, rice farmers in Japan are paid over 8 times the world price, EC wheat growers are paid over twice the world price and U.S. sugar growers are paid over three times the world price. Is it any wonder that framers in those countries produce more than the market wants, notwithstanding attempts at production controls? These price gaps have ensured that the stocks of most of these commodities are large and growing, thus depressing world prices further.

The results in the EC, the U.S. and Japan have been higher costs for their taxpayers and consumers. For countries like Australia, however, the result has been a very serious decline in our grain farmers' incomes. Neither grain prices nor growers incomes are subsidized in Australia and the full fall in world wheat prices of over 30 percent in the past year has been borne by our farmers.

It follows that the best solution to continuing overproduction is to lower domestic support prices and reduce the gap between them and market prices. It is understandable that individual countries are reluctant to do this unilaterally. This is why Australia has been such a strong supporter of the multilateral approach to halt and rollback agricultural subsidization. Only if all the important economies act together will this process be politically sustainable in each individual country.

Mr. Renshaw stated that over the past 15 years, Australian production of wheat had risen by 78 percent and acreage by 69 percent. This comparison is invalid, because 15 years ago wheat quotas operated in Australia. The level of plantings in Australia now responds entirely to market signals wheat plantings fell from 11.7 million hectares in 1985 to 11.4 million hectares in 1986 and are currently estimated to fall below 11.0 million in 1987. The yields from that acreage depend essentially on the weather, especially on rain, and can therefore vary widely in our uncertain climate. But the point is that when the price signals are allowed through, production restraints are unnecessary: growers just plant less.

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From: *Derwent Renshaw,*
Agricultural Counselor
Commission of European Communities, in Washington, D.C.
Re: *The Author Replies*

By no means everyone would entirely accept Tim Mackey's analysis that the root cause of world grain overproduction has been government price support policy.

Discussing increases in grain production in the European Community in his contribution to the Curry Foundation's 1985 study "Confrontation or Negotiation", Dr. Kenneth Robinson of Cornell University finds that "the evidence suggests that the adoption of new technology has played a much greater role in contributing to wheat surplus in Europe than support policies".

Nevertheless, price support has been a significant factor and it is by squeezing the prices received by our grain producers that the Community is attempting to bring production and budgetary outlays in this sector under control.

Farm price decisions taken last Spring in Brussels meant a freeze in official grain support prices for the third successive year which, plus the technical changes alluded to by my Australian colleague - such as tighter quality standards and a much reduced period for selling into intervention - have cut prices actually received by farmers by between 10 percent and 15 percent.

We are determined to persevere with and even intensify our efforts in this direction. Such moves might come as a surprise to those who believe, some perhaps as result of Tim Mackey's apparent implication, that the European farmer, unlike his Australian counterpart, is guaranteed a lifestyle of spacious ease by the Common Agricultural Policy.

European farm organizations would smartly claim that the opposite has been the case, citing in evidence the fall of 13 1/2 percent in average farm incomes in 1985 compared with 1984 and the 30 percent fall when comparing the last three years (1983/4/5) with the three year period a decade previously (1973/4/5). This contrasts very sharply with the increase for 19 percent in incomes over the European economy as a whole.

And, it is partly against this background that the painful and radical measures agreed in Brussels in mid-December for the milk and beef sectors have to be viewed. Briefly, European farm ministers decided to cut milk production by 9 1/2 percent by April 1989 and to reduce beef support prices by an average 13 percent.

With these difficult decisions finally behind it but with others to come in sectors such as grains and olive oil, the Community will be looking with keen interest and anticipation in the new round to its GATT trading partners for equivalent efforts. ■