Since their inception as part of the 1986 farm program, generic commodity certificates have become a major influence on markets, especially the corn market. They also are having a significant impact on the federal budget, an impact which current budget practices do not always reflect.

To date the issues surrounding these certificates have been largely ignored by official Washington. With the exception of a recent GAO report on certificates, few detailed studies have been published. In addition, few top and middle-level policymakers outside of USDA have taken the time to understand this newest innovation in farm programs. Consequently, grain traders and farmers who trade the certificates have developed a better understanding of them than have most policy officials and others who have keen interests in the farm sector and a stake in how the federal government transfers income to farmers.

This gap in understanding is all the more serious because policymakers do not have a clear idea of what they can do or want to accomplish with certificates. Further, the federal budget effects of certificates are outside the generally accepted budgetary procedures for federal programs.

How It Started

The Administration did not have a clear understanding of the new certificate program when it first approved the use of certificates in lieu of cash in early 1986. Policy officials were exhausted by the long process required to complete the 1985 Farm Bill. Staff personnel worked frantically to design policy guidance and to prepare regulations for the 1986 farm programs. Since certificates were only a small, albeit significant, aspect of the commodity programs, certificates received only a small portion of attention. At the time, the issues surrounding certificates appeared a great deal simpler than they actually were.

The idea of generic certificates originated within the Department of Agriculture (USDA). Officials at
serious attention by higher officials in staff drew up guidelines covering their aspects of implementing the new program approved by OMB with only much later. Although Congress had included authority for Payment-in-Kind (PIK) in the Farm Bill, it played no part in originating or implementing the new program.

Not New, Yet Different

The idea of using government commodities for federal payments is not new. It was used for both the 1983 and 1984 programs. The payments were frequently referred to as PIK programs.

However, the new certificate program differs from previous PIK programs in a number of significant ways. First, the payment is with generic certificates rather than actual commodities. They are generic because the holder may redeem them for any crop he has under loan with USDA's Commodity Credit Corporation (CCC), or use them to purchase any commodity CCC has to offer.

As a result, certificates issued to a wheat farmer in Montana may, in some circumstances, be used to redeem wheat in Kansas, corn in Iowa, or rice in Louisiana. This makes it extremely difficult to forecast exactly how certificates will affect the market or the federal budget.

Second, certificates are quasi dollar bills. A specific dollar amount is inserted on each certificate when it is issued. Each certificate has an expiration date. In many ways they are currency redeemable, not in gold or silver, but in government controlled commodities. As will be demonstrated later, the way CCC "prices" commodities for exchanging the certificates has everything to do with the way the program influences commodity market prices.

Third, the new certificates are negotiable. They can be bought and sold like a form of currency. The market for certificates is fairly sophisticated. Buyers usually pay 5 to 10 percent above the designated value for the certificates. Negotiability dramatically increases the freedom of movement associated with certificates. The reason people pay these kinds of premiums is linked to the way that USDA operates the program.

What CCC Does

CCC issues most of its certificates to farmers who participate in government programs. In order to participate a farmer must agree to reduce his acreage by as much as 35 percent. Farmers who receive the certificates can exchange their certificates for commodities or they can sell the certificates to someone else who wants the commodities CCC has to offer.

Naturally someone has to specify what price will be used when a particular commodity is exchanged for certificates. For example, how many bushels of wheat does the certificate holder receive in exchange for a $50,000 certificate?

When deciding what price to "post" for wheat in Saline County, Kansas, USDA officials do not check the local market price. Instead they check the price at the "two nearest terminals" (among 11 different terminals throughout the country) for No. 2 Hard Red Winter Wheat. Then they subtract or add a differential to represent the difference between the terminal markets and the local elevators. The posted county price (PCP) is then the higher of the two adjusted terminal prices. The price for direct purchases is set somewhat differently. Local posted prices are thus a function of actual market prices at 11 terminals adjusted by periodically determined differentials between local warehouses and the two nearest terminals.

In choosing this method of setting prices, CCC has denied itself even greater flexibility in setting its sale prices or managing its large inventory of commodities. Whether the Department should exercise the type of micromanagement allowed by its decision making on posted prices has never been discussed at a high level within the Administration. Certainly it has not been publicly debated.

Besides using certificates to pay obligations to farmers for participation in commodity programs, the Department uses certificates to fund other programs authorized in the 1985 Farm Bill. The major programs funded to date in this way have been the export enhancement, targeted export assistance, and fuel ethanol programs. Using certificates allows the Department to implement these programs without specific appropriations passed by the Congress and signed by the President, since the cost of certificates falls into the general CCC budget.

CCC issues certificates only to farmers. In turn, farmers who receive the certificates have four options:

—They use their certificate to pay off a commodity loan they have with the CCC;
—They purchase commodities at the posted county price from CCC's inventory at any location in the country;
—They redeem the certificate for cash—the face value less any reduction under the Gramm-Rudman Act; or
—They sell the certificate to someone else.

Paying Off Commodity Loans

In order to understand the implications for farmers of these four options, it is important to understand how price support loans work. For example, in the fall of 1986 a corn farmer in Champaign County, Illinois, who cooperated with the corn program by withholding 20 percent of his acreage from production, could obtain a loan from CCC at $1.82 per bushel. The corn had to be stored at the farmer's expense.

In the past the farmer had to store

Federal budget effects are outside the generally accepted budgetary procedures for federal programs.
the crop until the loan matured nine months later. In the meantime, the farmer at any time could pay off the loan and sell the commodity on the market. Otherwise, at the end of the nine-month period the farmer could give the corn to the government as payment for the loan, regardless of the market price.

The loan rate thus operates as a floor on prices. Due to recent storage shortages, many farmers have to pay commercial rates in order to take advantage of the loan program. These circumstances lowered the effective price support by as much as 30 cents.

But with the PIK program, farmers may place their crops under loan and immediately redeem the commodity with certificates. This procedure allows farmers to obtain the full protection of the price support level without having to pay for nine months of storage—which explains why a farmer who did not receive enough certificates to redeem all his crops would be willing to pay a premium to purchase more certificates.

Consequently, fewer farmers now forfeit their crop to the government. Many farmers are motivated to put their crops under loan solely for the purpose of immediately redeeming them with certificates, which increases net lending by the CCC.

The loan redemption procedures are critical features to the effects of the PIK program on market prices. Ordinarily, if producers redeem a price support loan, they repay the face value of the loan plus interest with money. Thus, they simply do not pay off the loan unless the commodity’s market price is above the effective loan rate.

With the certificate program there is an incentive to always pay off the loan—but with certificates. For example, suppose a farmer had a price support loan of $240,000 (100,000 bushels times $2.40) and the posted county price was $2.00. The $240,000 loan obligation could be cancelled with commodity certificates valued at $200,000 (100,000 x $2).

Marketing and Arbitraging

The second major way farmers and grain merchants use certificates is for marketing and arbitraging among markets. In order to reduce the difference between the PCP and local market prices, CCC sets differentials for individual warehouses and continually adjusts the terminal prices used in determining the PCP’s. However, administratively set differentials never quite match market differences. Individual traders, especially large players such as Cargill and Archer Daniels Midland, thus devise marketing strategies that minimize storage and transportation costs and maximize their profits. These opportunities are at least one explanation why certificate premiums have not gone below 5 percent.

With What Effects?

The major effects of the PIK program are lower market prices, higher producer income, and larger free stocks. Most observers agree that making CCC stocks available at market prices has led to lower commodity prices. Admittedly, CCC attempts to follow rather than set the market price. However, its announced willingness to release its large inventories almost certainly has a depressing effect on prices.

Certificates enhance producer income through storage savings and the availability of premiums. Even livestock producers who do not receive certificates benefit from lower feed-grain prices.

PIK certificates also reduced what threatened to be a serious storage problem in the fall of 1986. By allowing farmers to obtain the full protection of the loan rate without storing their crops for nine months, the program increased farmers’ willingness to sell to market traders rather than to the government.

Just as important, it has also increased the willingness of the private sector to hold crops through the marketing year. This willingness has smoothed the marketing transition between crop years and strengthened the influence of private traders on commodity prices. By increasing the circulation of stocks, the certificate program has reduced Congressional pressure on the Administration to reimplement a costly loan program to encourage construction of farm storage.

Many people have had a tendency to credit all of the positive developments in the past year to the issuance of PIK certificates. That lower prices, higher domestic and foreign demand, and lower CCC inventories matched by higher free stocks have occurred is clear. The extent to which they would have occurred without certificates is not.

A Marketing Loan Program—Almost

There has been a long and vigorous debate on whether feedgrains and soybeans should have a marketing loan program that would permit farmers to receive a loan based on the support price, but pay off the loan based on lower world market prices. Such a program would allow all farmers to repay their commodity loans at current world prices without certificates.

USDA has opposed extending the marketing loan program to these crops. However, the Department has partially achieved the potential effects of a marketing loan program through PIK certificates. Both the PIK and marketing loan programs reduce commodity prices, increase free stocks, enhance producer income, and increase American competitiveness overseas.

The PIK program, however, produces weaker effects at a fraction of the cost. For this reason, many people have labeled the PIK program the poor man’s marketing loan.

There are still significant differences between the two programs, however. First, USDA only issues a limited supply of certificates. Consequently, the ability of farmers to “revolve” their entire crops through the loan program is limited. Commodities under loan cannot be repurchased from the government without certificates and the premiums attached to certificates impose a cost upon any farmer who uses them.

Under a marketing loan, farmers would need certificates to repay their loans at the market rate. As a result, both gross and net lending with the PIK program is probably lower than under a marketing loan program.

Second, the economics of generic certificates favor corn and, to a lesser degree, wheat. This is because it takes fewer certificates to redeem a bushel of corn than a bushel of wheat. Even more certificates are needed for a bushel of soybeans.

Most incentives to use certificates, such as storage savings or price discrepancies, are measured per bushel and do not vary much between crops. Consequently, certificates have had a great impact on the corn market and little impact on wheat or soybeans. Individual marketing loan programs would have significant effects on each commodity.

A third difference is the availability of CCC stocks to holders of certificates. The marketing loan has no provision for selling CCC-owned commodities. Therefore, the marketing loan approach adds a large source of additional stocks to the market and may depress prices even further.

Marketing loans allow traders and commodity brokers who do not have crops under loan to benefit from the program. The availability of this alter-
native source of supply may weaken the bargaining position of producers.

The most important effect of generic certificates may be to reduce Congressional pressure for much more expensive programs such as marketing loans or export subsidies. There is a perception that certificates have decreased storage problems and increased producer income. They have widespread support. Consequently, opponents of more costly innovations argue that the present system is slowly working. Nevertheless, since the idea to use commodity certificates originated in USDA, Congress remains skeptical.

**The Budget Effect of Certificates**

The intuitive appeal of PIK programs is that they substitute something the government has too much of (commodities) for something it has too little of (cash) as a way to pay farmers. The argument is that government costs are sunk and there is no direct budget effect since the government has already purchased the crops or lent money against them.

There are, however, significant indirect costs which may make the use of commodities at least as expensive as using cash for making payments. The two major indirect costs relate to revolving stocks and displacement of markets.

First, by allowing farmers to use certificates to repay their commodity loans at the PCP, CCC may be dramatically increasing the cost of its lending program. When a farmer repays a loan at the market price with certificates instead of cash, CCC loses money unless the loan would have been forfeited otherwise. The program also creates incentives for farmers to put crops under loan solely for the purpose of immediately repurchasing the crop at a lower price with certificates. In turn, loans increase.

This revolving stock phenomenon adds to costs even if the loans are later redeemed. This kind of phenomenon is the principal reason why marketing loans cost so much more than present programs.

The second major cost relates to displacement of private sales. CCC allows certificate holders to repay government loans or purchase CCC stocks at market prices. This practice drives prices down. To the extent that lower prices lead to demand for larger quantities or cause foreign competitors to reduce their production, these stocks are absorbed in commercial use. When this does not occur, newly released stocks merely displace private sales which would otherwise occur and the government accumulates equal amounts at some other location.

The accumulation occurs through its loan program since it is the residual purchaser. Consequently, the government ends up selling low (at the PCP) and buying high (at the loan market rate). This kind of phenomenon is the Administration's principal objection to the widespread use of export subsidies. Both the Office of Management and Budget and the Congressional Budget Office currently assume that most of the stocks released onto the market through the certificate program merely displace private sales.

This displacement could be mitigated if certificates created a climate in which futures markets offer incentives for the private sector to carry these stocks. Whenever certificates lead to a reduction in CCC stocks and loan forfeitures, even temporarily, the government realizes significant storage savings.

**Policymakers do not have a clear idea of what they can do or want to accomplish with certificates.**

Of course, alternative programs such as storage loans, marketing loans, export subsidies, or marketing quotas could be even more costly. Due to the variety of ways in which PIK certificates can influence different markets and the difficulty of measuring their impact, it is almost impossible to accurately model the effect of PIK certificates on commodity markets.

A recent study by the Government Accounting Office estimated the PIK program had added $107 million to $653 million to total CCC outlays. This cost is at least partially offset by an estimated storage savings of $169 million to $253 million. The study was careful to state several times that these estimates were highly dependent on present market conditions. Different conditions in the future could produce larger costs or positive savings.

An unpublished USDA paper estimates that the certificate program costs 5 to 10 percent more than using cash to pay farmers. OMB generally supports the 5 to 10 percent estimate. In its analysis, OMB has been much more cautious than the Department in its support of the certificate program, tending to concentrate on the budget impacts and urging restraint in issuing more certificates until their impact is better understood.

**Other Issues**

Given the widespread popularity of the program among farmers and grain traders, it will be difficult to stop issuing certificates altogether. There is still the question of how many certificates to issue each year and to whom. As stated above, OMB has tended to argue for a conservative approach until the true cost and effect of certificates are better understood. USDA and many members of the agricultural community argue that certificates are having a significantly positive impact on the market and are well worth whatever small cost they entail.

Exact estimates of cost may not be as important as achieving a better understanding of the effect certificates are having in the marketplace. Only when officials understand these effects can they determine whether issuing more certificates is desirable.

The PIK program is an outstanding example of when analyses following rather than preceding a major policy decision. For almost a year, analyses of the PIK certificate program were limited to brief, often unofficial, privately circulated description papers produced by staff members within different agencies and grain companies.

The Agricultural Stabilization and Conservation Service (ASCS), because it actually administers the program, has by far the greatest knowledge about certificates and studies them daily.

Other agencies such as OMB and CBO are not able to devote significant time and effort to a study of the certificate program. They tend to focus on the issue only when a decision is imminent or a problem arises, making it difficult for their leaders to develop a clear position on the proper use and objectives of certificates. These difficulties are related somewhat to the unavailability of information that shows how farmers and traders use certificates both on the county level and as part of national marketing strategies. Better communication between policymakers and the business and academic communities could help the farmer achieve a better understanding of the impact of policy decisions.