MANAGING FARM SUPPLY

by Gordon C. Rausser

and William E. Foster

Kick the Habit; But Make Other Reforms, Too

It is time to turn our attention to the realities of contemporary agriculture, to put aside parochial, short-term interest and to formulate policies anticipating the 21th Century.

Of all the flaws in the present farm policy, by far the most counterproductive and even corrosive is the addiction to "managing" supply through commodity programs. Addiction is not too strong a word for the political routine in which our government finds itself. Like an addiction, a policy of production-based income supports feeds on itself—accumulation of surpluses are used to rationalize programs that lead to more surpluses.

Moving from current commodity programs will be an extremely noisy and painful affair. Congress especially will resound with many rationalizations why only more of the same will suffice.

More of the same will mean continued large budgets or high consumer losses, more large checks to large farmers, and prolonged agony by those with limited farm resources and limited nonfarm opportunities.

A coherent policy, compatible with our democratic system, would break the link between production and government benefits, provide for food security, restructure the Farm Credit System, strengthen incentives for conservation, and lead to cooperation with other nations needing similar policy reform.

Gordon C. Rausser is the Robert Gordon Sproul Chair Professor of Agricultural and Resource Economics, the University of California, Berkeley, and William E. Foster is a graduate student at the University of California, Berkeley. He is currently at the Board of Governors of the Federal Reserve System.

A Proposed Policy Design

First and foremost, all acreage reduction programs, voluntary diversions, and acreage set-asides should be eliminated. Programs that attempt to limit supply or enhance prices by renting land from farmers, or through government purchase of farm commodities, by design benefit the largest producers most. Under current policies, there is no way to avoid this outcome.

In the place of current policy, we suggest a broad package of interrelated components:

—Break the links between production and program benefits.

—Provide for food security with flexible storage.

—Restructure The Farm Credit System.

—Institute incentives for conservation and environmental protection.

—Cooperate with other countries on trade problems.

Decouple To Free Markets

Decoupling is now a buzz word in farm program discussions, but it is more than that—it would be, by far, the most important component in an improved policy.

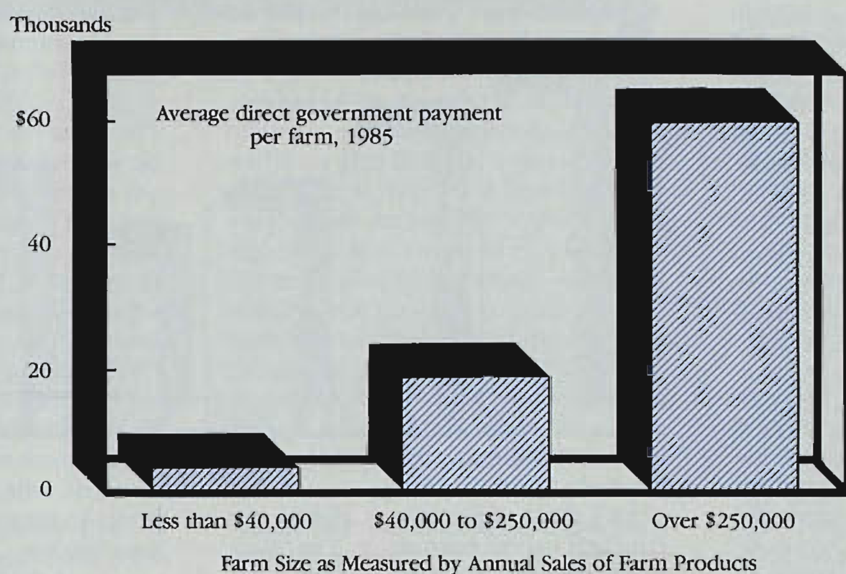
Decoupling means to remove income supports from production decisions, and to permit free market determination of commodity prices. Payments to farmers should not be linked to current production either through diversion requirements, subsidies, or artificially high prices. Rather, production decisions should be based on economic incentives derived from market supply and demand conditions and not artificial conditions created by government programs.

With decoupling, set-asides and acreage reduction programs should be phased out over a specified period of time. As a result distortions, such as intensive use of inputs, would diminish; budgetary outlays, for the most part, would be known in advance. Equally important, the government's heavy involvement in technical production decisions would be substantially reduced, thus leading to a more efficient use of resources.

Target to Need

While decoupling is important and is receiving much political support, it cannot be thought of as the only element of policy—it must be part and parcel of a larger set of programs. In particular, separating payments from production and prices should be combined with transfers ultimately based on need.

Direct Government Payments Are Largest for Largest Farms



A program of targeted income-deficiency payments would solve several major problems.

First, transfers targeted to troubled mid-sized farms—from $40,000 to $250,000 in sales—would mitigate risks currently associated with such enterprises. Farmers with mid-size operations are more apt to carry large outstanding debt and more likely to face barriers to acquiring capital. Furthermore, mid-size farms have fewer off-farm resources and fewer opportunities to diversify income sources. Indebted mid-size farms find it particularly difficult to handle adverse economic conditions. Targeting income deficiency to these farms improves their cash flow and, therefore, improves the equity positions of those in greatest need.

Second, targeting could ease the painful costs of shifting labor from agricultural production to non-farm activities. Most farmers with significant off-farm income have solved, in one way or another, the labor adjustment problem. Most farmers with high equity and low debt enterprises are far from the point of leaving farming. But there are many others still dependent on farm income and with limited equity in their farms. Income supports for these people providing immediate resources for retraining, job searching, etc., would facilitate the evolution of agriculture and improve the long-term flexibility of the sector.

Finally, targeting transfers without regard to levels of farm production of the recipients would enhance equity, preserve family farms, stimulate rural communities, and maintain the rural landscape. Current commodity policies, including programs that restrict production, have been of little help to rural communities. In fact, in some cases, commodity programs have facilitated the growth of large-scale operations. In turn, these programs have been inherently detrimental to rural communities and the family farm.

Transfers can be targeted to facilitate structural changes in farming while minimizing the human costs of labor migration. There are two ways. One approach would provide income support to targeted farmers unconditionally. Farmers would be free to use these transfers and other incomes in whatever fashion they considered most appropriate to their circumstances—from retraining to remaining dependent on farm production.

The other approach would make some targeted benefits conditional. For example, benefits could be payments for continued education and technical retraining. Similarly, loans could be made to farm households in order to reduce immediate financial stress once a decision to leave farming has been made.

Since decoupling will make it transparent that agricultural payments are for welfare, it will be desirable, from both an ethical and political point of view, that a standard be applied to targeted payments. A targeted farm income could be set, say for a farm family, that would be maintained if the recipient satisfied certain qualifications—that is, a prespecified test based solidly on the recipient's past. This is necessary to prevent farms being reconstituted to take unfair advantage of the reformed programs.

Moving from current commodity programs will be an extremely noisy and painful affair.

Establish Commodity Reserves

Government-owned commodity reserves should be accumulated and used to provide some minimal level of stability to market prices, to aid foreign development, and to provide food assistance abroad and food security at home. They should *not* be used to manipulate commodity prices upward.

Commodity storage programs are justified on the basis of moderating price and supply fluctuations through the accumulation of government stocks or by the subsidization of private storers. Traditionally, however, these programs have been operated in ways notoriously unresponsive to market signals, burdening farm policy with costly and sometimes embarrassing levels of stocks.

Moreover, governments throughout the world typically wait until a major crisis before demonstrating any visible concern about international food security. The present worldwide glut of food commodities makes this an ideal time to improve national and international mechanisms for food security.

Flexible storage programs must be developed that account for unpredictable economic changes and drastic shifts in market conditions—and therefore avoid sudden disruption of policy. Such a program would not attempt to manipulate or control world prices but to moderate large movements of U.S. farm product prices. For example, targeted levels of stocks would be based on Treasury costs and the need for safe reserves to meet goals of food security. On the basis of a specified price level, the Commodity Credit Corporation (CCC) would buy or sell a certain amount of commodity for every one percent decrease or increase in the market price around this specified level. The specified price would be linked to the level of stocks—the larger the supplies, the lower the targeted price. Tying these adjustments to stocks would reflect changes in the economic environment and avoid unmanageable divergence between world prices and unrealistic government-supported price levels.

For foreign development, food assistance abroad, or food security in general, the actual physical commodities would be held in governmental stocks. Simply in order to moderate unstable price movements, however, transactions need not be in terms of the physical commodity. Instead, the government can hold the right to buy or sell physical units of the commodity—that is, to take positions on the futures markets.

Restructure the Farm Credit System

The Farm Credit System is a creation of the federal government, and its hands have been tied from the start. Now the System is in serious trouble and the government has a responsibility to make it whole. This means, in the short run, shoring up the Farm Credit System's debt and, in the long run, integrating the System into the larger economy.

In the near term,. this might mean a shift of large amounts of money from current dubious commodity programs to the support of the Farm Credit System. However, there is a small bonus to be had in terms of targeting. Compared to transfers by current programs, a dollar to the Farm Credit System would be slightly more likely to go to those under the most financial stress—because strong borrowers with good credit have left, leaving weak borrowers with poorer credit in an ailing system.

At present, agricultural lenders are unable to diversify effectively the risk of their loan portfolio. There are two primary impediments to effective diversification: (1) It is extremely difficult for agricultural banks to diversify their portfolios by making agricultural loans to farmers in different regions, and (2) the Farm Credit System is limited to supplying only agricultural credit.

The lending institutions that lend across both regions and sectors are much better prepared to weather the storms of agriculture than are undiversified banks. Reductions in the barriers to regional risk spreading would be particularly beneficial to agriculture.

The Farm Credit System's form of organization has three notably undesirable consequences. First, the portfolio properties are unsatisfactory. When farmers have a difficult year due to poor crops or low prices, their equity investment in their Farm Credit System institution also does poorly. Second, when borrowers from the Farm Credit System with good credit believe their equity capital is at risk, they can go to another institution, borrowing enough to pay off their Farm Credit System loan and withdraw their equity from the Farm Credit System.

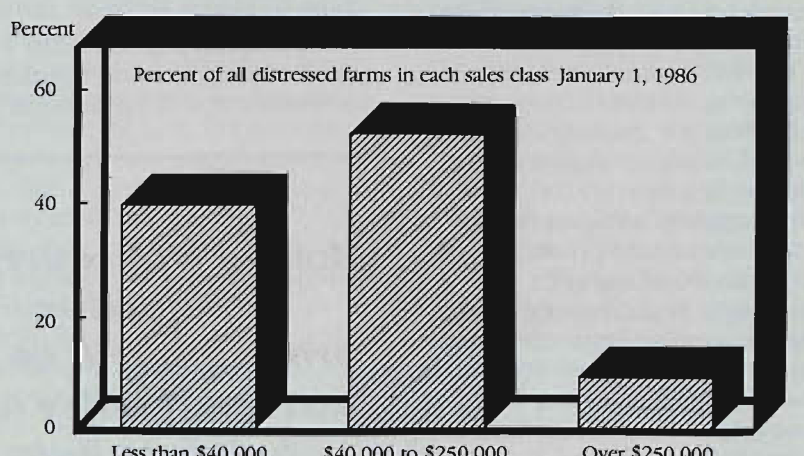
And third, the System's design encourages excess borrowing. The Farm Credit System is a government-sponsored agency—its debt is implicitly guaranteed. This means—all things being equal—that the System's value would be higher than that of a private credit institution. Especially in good times (like the 1970's) the System passes on this added value to its members in terms of lower interest rates. Members of the mutual credit association making up the System gain more of this extra value by increasing their debt.

The Farm Credit System should be reorganized. Its equity capital should be alienable—allowed to be bought and sold, and valued by an active market. Equity capital should not be tied to loans. This essentially means moving the Farm Credit System toward the organizational structure that prevails among commercial banks: rewards to decentralized unit managers for good loan management but losses borne by the organization as a whole. This approach will achieve the close relationship between farms and the farm credit system that is needed for FCS to be well informed about its borrowers, yet not force local institutions to bear risk that otherwise might be diversified. In addition, by allowing farmers to own or not own stock in the Farm Credit System as they wish, farmers could obtain better solutions to their own portfolio problems. Finally, allowing the Farm Credit System's capital to be explicitly evaluated by a watchful market place will introduce lending incentives, which will in turn, result in better levels and distribution of agricultural lending.

Conservation and Environmental Incentives

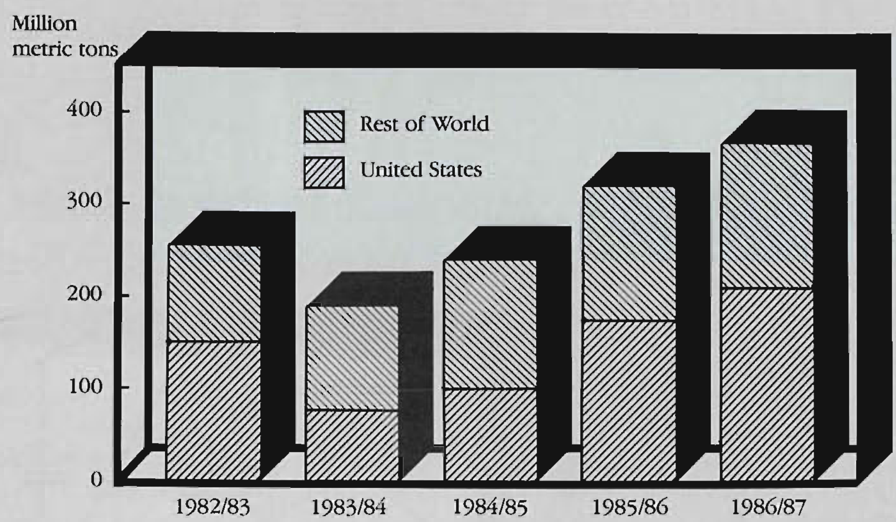
The provision of the 1985 Food Security Act that calls for placing highly erodible land in a conservation reserve is in the long-run interest of U.S. agriculture. Under the Conservation Reserve Program, landowners agree not to produce crops on highly erodible cropland for 10 years in exchange for an annual rental payment. This program has reserved 19 million acres to date, but unfortunately it has been weakened by competing supply management programs. The government is bidding against *itself* to idle farmland. Currently, many farmers are better off collecting deficiency payments or diversion payments for idling acreage

More Than One Half Financially Distressed Farms Are Mid-Sized



Note: Financially distressed farms are defined as those with debt/asset ratio over 40 percent and negative cash flow.
Source: USDA/ERS

World Stocks of Wheat and Coarse Grains Increase



under commodity programs than by placing land on a long-term basis under the conservation reserve program.

Over the period when supply management programs are being phased out, some friction might result from the concurrent operation of the conservation reserve program and the price-support programs. This can be effectively managed by the introduction of a land targeting scheme, as suggested in the work by Taff and Runge at the University of Minnesota. Specifically, acreage reduction programs should be restricted to highly productive lands not subject to significant erosion and the conservation reserve should focus on erosive lands.

Those lands declared eligible for the conservation reserve program should be declared ineligible for the acreage reduction program. The converse, however, would not be instituted. In other words, highly productive land not subjected to erosion could still be placed in the conservation reserve program. This approach would raise the amounts of poor land eligible for the conservation reserve and reduce bids and total program costs.

A redesigned conservation reserve program, in combination with income supports decoupled from production and targeted to farmers with particular characteristics would slow the growth of large capital-intensive farms, further facilitating land conservation. Similarly, a restructured Farm Credit System would help reduce the incentives for intensive land use by cash-needy farmers. Finally, and most significantly, eliminating commodity programs that couple income supports to production levels would ease the extensive and intensive use of land and other resources in production.

Negotiations and Trade Cooperation

Of course, the difficulties facing agriculture can also be traced to policies beyond our own borders. Commodity markets are internationally related—and so it is not surprising that disruptive agricultural policies are too. It just takes one country's acquiescence to the political power of its farmers to begin distorting world markets. This distortion turns into another country's justification to protect its own agricultural sector. Around it goes.

Now, many countries are trapped by the current state of agricultural trade. If any country tries to reduce its export subsidies or limit its farm support, it will lose market share to producers of other countries. Its own action will rarely be sufficient to induce a significant rise in world price. Thus, short-run or myopic rewards to individual countries from unilateral agricultural policy reform are often too little to encourage needed change. To break this deadlock, simultaneous action by many countries is needed.

At the same time, it is indeed difficult to coordinate the farm policies of diverse nations. These difficulties are no excuse for delaying the other components of the reform outlined above. Those steps are in the self-interest of the United States and should be done whether or not we can convince our trading partners to act in concert. After all, reacting to other nations' policies—notably those of the EEC—uses more than tax dollars. The continued lure to increase supply threatens our own farm sector's long run viability.

Moreover, reforming policies should provide incentive for other protectionist countries to make similar adjustments. At the same time the United States should actively pursue policy adjustments by other countries.

Multilateral agreements to move farm policies from their distortionary past are the best route to take. Coordinated reductions of subsidies in developed countries will lead to a general increase in world prices, which in turn will ease the pain of adjusting agricultural policies.

There is a growing worldwide recognition that something should be done soon. Cooperative solutions are now incubating in the Punta del Este Declaration from the Uruguay Round of the General Agreement on Trade and Tariffs (GATT). In order to go to the heart of the problem, GATT must reach beyond influencing external policies. In addition to developing codes that address border policies, a multiparty forum must also arrive at rules governing internal programs.

Establishing the design for regulating national policies is the final aim of cooperation. Initially, however, the most important function of international coordination would be to ease the transition away from production-oriented agricultural programs. Joint efforts could take many different forms. They could involve orchestrated or "lockstep" moves in decoupling supports from production and targeting income maintenance to producers with particular characteristics.

Certainly the possibility for cooperative ventures is much greater in today's environment because the U.S. has brought loan rates closer to world prices (and in some cases equal). This leads to one last point regarding the rest of the world. If multilateral talks fail, the U.S. should move unilaterally. To repeat: domestic reform is in our best interests regardless of what our international friends do. Unilateral moves on our part would create incentives for others to join us and respond with similar reforms.

And if we do go it alone, we should refuse responsibility for amassing or "quarantining" stockpiles of commodities, mainly grain. Surplus stocks in our hands have resulted from the policies of many. In fact, part of the reason many countries have been faring so long so cheaply with their production-based programs is because the U.S. has been prepared to be the residual supplier to world market and to accumulate supplies. ■