Untying Profits and Risks

by George D. Irwin

With the phrase "privatization of profit and socialization of risk," Dr. Briemyer (Second Quarter 1988 issue of CHOICES) aptly characterizes recent public policy moves which provided financial assistance to the Farm Credit System. It is evident from the examples he provides in his commentary that programs which have this result are on the way to becoming a general strategy of the federal government. The approach is being applied well beyond financial assistance to the Farm Credit System.

In fact, the Agricultural Credit Act of 1987 makes a second use of the approach in structuring the secondary market for farm mortgages. The ACT provides a new institution, the Federal Agricultural Mortgage Corporation, with a unique mixture of public and private attributes. Farmer Mac enjoys not only "sponsored agency" status but a more specific and tangible component, a line of credit from the Treasury. It also brings lending by rural bankers, insurance companies, and other potential participants under the Agency status umbrella. To be sure, the Farmer Mac mechanism requires farm financial institutions to absorb the first 10 percent of losses directly and an additional percentage indirectly by the guarantee fees they pay to Farmer Mac's loss reserve fund. But farm financial institutions also keep all of the profit. The public receives whatever benefits accrue from the altered/augmented structure of the agricultural mortgage market and bears the catastrophic risk.

◆ Some recent Federal policies insulate private companies and individuals from past or prospective losses sustained in the marketplace. Profits, however, continue to be private. In the end the process used to stabilize agriculture against macroeconomic policy risk may be used so widely as to result in a loss of U.S. control of its macroeconomic environment.

Public intervention is usually justified by the "infant industries" argument—that public support is needed to overcome an entry barrier, but once overcome, the support can be withdrawn. Notwithstanding this ideal, precedent in both agriculture and housing demonstrates that this period of infancy is usually prolonged! The justification often evolves into a "public good" argument—that we need to preserve the family farm (or home ownership) and that permanent federal intervention is required to do so. Indeed, the administration's effort to privatize sponsored agency credits in the 1980s met with furious resistance.

The Broader Issue

Briemyer raises a broader issue in asking what motivates the policymakers to adopt such solutions and what are the implications for the kind of economic system we are creating.

He asks whether the chief motive may be "public concern for the quality of private management." I suggest it is rather "public concern over the possible impacts of the costs imposed on private management by unprecedented macroeconomic policy swings," compounded by the need to seek solutions which are off the federal budget. It is highly uncertain how these impacts might shake out. On the one hand, they could, over time, create pressures for firms to become larger and more integrated, or on the other to reduce financial leverage and employ other risk control strategies—strategies which disadvantage smaller firms but also inhibit growth of existing firms. Perhaps the public wants to avoid the risk of either outcome.

Macro policy risk has become an agricultural issue over the past 15 years due to internationalization of both agricultural commodity markets and financial markets. Government and university information sources and analyses have not served U.S. agriculture especially well—providing "feed the world" expectations, yet failing to make the connections between LDC debt growth as a component of petrodollar recycling and agricultural export demand. And the firm macroeconomic policy actions to address inflation, the dollar's foreign exchange value, and mounting fiscal deficits only made the situation worse. Policy did not, and perhaps could not, ease the impact on capital-intensive export sectors such as agriculture.

Instead of stabilizing the macroeconomic environment in which the private sectors operate, the implicit policy choice seems to have favored socializing policy risks. In the short run, this solution has meant compensating participants through generous farm program payments. It remains to be seen whether the policy is applied only to downside risk. Certainly Briemyer's "privatization of profit" infers that fruits of macro risks, like the grain export boom of the 1970s, are left to private parties. In all likelihood, the increased federal tax revenues arising from windfall export booms only partly offset the government costs in underwriting the losses on the downside.

The Irony of Policies

There is an element of irony in adopting policy that socializes private sector risks while widely promoting another policy that advocates the privatization of government functions. One might ask whether the functions were placed in government in the first place because private entities could not manage the risk. As Briemyer notes, however, it appears that only select governmental functions or parts of them are being privatized—those with the potential for profit once the risk is reduced. This tandem of socialization and privatization is likely producing a slightly different, mixed economic system, rather than just a transition step toward full privatization, including risks. That would not serve the vested interests of the primary participants nor, perhaps, the public interest.

In the longer view, it may be that these quasi-private solutions will themselves lose effectiveness. Federal budget problems may have grown to such levels as to virtually tie the hands of domestic policymakers in the future. We already see signs of this constraint in a proliferation of ingenious efforts to create off-budget, quasi-federal programs. The Farm Credit Assistance Corporation is just one example. Contingent liabilities for the federal government arise in each off-budget program which result in the socialization of risk. Each of these creates potential Federal budget liability in the future which, in turn, acts as another deterrent on policy flexibility.

Can it be that these policies enacted to restore stability by reducing agriculture's risk exposure to domestic macro policies will eventually increase U.S. vulnerability to macro policy risks arising in other countries? In reality, if such policy innovations are destined for a short half-life, may be be losing control of our macro economic environment to foreign interests and thereby exposing ourselves to greater volatility in the future?

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