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How Budget Tightness Will Affect a New Farm Bill

The failure of the federal government during the 1980s to generate tax revenue equal to its spending for public services is usually viewed, and deplored, in fiscal terms. Critics strike analogies to profligate mismanagement of households.

The decade's revenue-and-spending imbalance has had a second effect, one remarked on less often but possibly more momentous. It is the gradual abandonment of a policy to use money to induce private action in the common interest.

Every society necessarily develops means for bringing individual behavior into an acceptable degree of social conformity. They are readily ticked off. The four principal ones are cultural rules (social pressure), education, compulsion, and monetary reward or penalty.

The fourth, monetary reward or penalty, has been the preferred choice among modern nations. A distinguishing mark of this century is the trend in many countries to use monetary incentives to bring about socially desirable private action. This technique is widely regarded as more acceptable than compulsion, and more effective than social pressure or education alone.

The United States has gone that route. It has clearly done so in agriculture. Farmers are paid to conserve soil, store products, build ponds, and plant trees. Free access to information and concessionary credit have fueled technological advances in farming and financed various amenities in farm and rural living.

There has been a gradual abandonment of a policy to use money to induce private action in the common interest.

In recent years, the most extensive and costly monetary inducement in agriculture has been in voluntary acreage reduction programs. During the last quarter century all commodity programs, except tobacco, have become voluntary. Participation is invited—induced—by promise of financial benefit.

The 1985 farm bill, called the Food Security Act of 1985, is the latest and most generous application of the principle. It even goes so far as to subsidize our farmers enough to undercut (by below-production-cost prices) competitive exporters in world commodity trade.

Significantly, the 1985 law also introduces the other side of the monetary coin—namely, monetary penalties. Conservation compliance calls for penalizing farmers who fail to take soil protection measures felt to be in the public interest. It denies them the benefits of other programs.

The Political Economy

In their wide use of monetary incentives and penalties, farm programs are a proxy for the monetary inducement principle as used widely in our economy, and applied not only to persons but also to states, cities, and commercial businesses. Monetary incentives are found in countless activities of government. For more than half a century, home ownership has been encouraged (subsidized) by deductibility of interest payments. Accelerated depreciation is a pervasive business subsidy. Subsidized loans encourage students to attend college. Aid to cities and rural water districts prompts public works projects. Highway trust funds not only help states build roads but forces them to impose highway speed limits. And so on.

Likewise, monetary penalties, although rare in farm programs, are used widely to discourage various kinds of anti-social behavior. We put a cost on misconduct and thereby hope to restrain it. Not only are theft and bodily injury discouraged in that way; so too are illegal business practices such as market-monopolizing, and hanky-panky in securities trading. Financial penalties are regarded as more civilized and humane than corporal punishment.

Furthermore, in our tradition, social purpose is taken into account in deciding how to raise government revenue. Taxes can influence how people and businesses behave. "Sin" taxes supposedly slow down consumption of alcohol and tobacco. The underground economy is sometimes brought to justice only by prosecuting its tax evasion.

But most significant of all, and most American, has been our reliance on the graduated income tax to generate revenue. A higher tax rate on higher-income taxpayers fits more than the ability-to-pay rule. It has also tapped huge windfall incomes and slowed, to some degree, the concentration of wealth.

All of this falls under the epistemological rubric of political economy. Two centuries ago economics was detached from political economy, primarily to avoid association with the term of ill repute, "politician." Call it what you will, farm policy decisionmaking is part of the political economy. And monetary incentive versus compulsion is integral to the political economy and to agricultural programs.

Demonetization of Social Incentive

The political stance during the Reagan years was to oppose the monetary-inducement system in principle and gradually replace it in practice. Many aid programs were cut back. Revenue sharing was squeezed to a trickle. Capstone to the decade's policies was a reduction not only in income tax rates, but their progressivity. Therefore, less revenue is available to induce sought-for private behavior. Because rates were cut most at the upper end, the income tax is now less able to capture the

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unearned (or noncompetitively earned) income called rent.

The 1985 farm law escaped the budgetary noose because it was enacted at a time when several Republican senators from farm states were fighting for their political lives. Also, the Executive and Congress played games of "let's pretend"—pretending that the new law would not cost too much.

Signs from the Bush Administration indicate that the money game is over, at least for now. The rhetoric regarding a new farm law calls for writing it along the lines of the 1985 law, but it is empty posturing. Budget frugality will be a major obstacle.

To consider aspects of political economy once more, if monetary inducement is less available, the only practical choices at hand are to reduce program objectives or turn to compulsion. In agriculture, compulsory acreage allotments are a feasible option for cash crops, but they face stiff opposition. Yet, underfunded voluntary programs have limited effect in sustaining prices and farm incomes (in the absence of drought). They set in motion a predictable calculus among farmers. To whatever degree a program is judged likely to lift market prices above no-program levels, farmers scurry to be free riders. Underfunded voluntary programs are self-limiting.

But that is only the half of it. In recent years environmental awareness has entered farm programs. Measures for environmental protection have been linked to voluntary acreage reduction—have ridden tandem with it, in the rural vernacular. Conservation Compliance and the Conservation Reserve Program do more than keep topsoil out of river water. They help reduce groundwater contamination and provide cover for wildlife. (In our population, there may be more defenders of wildlife than of farmers.) Manifestly, this linkage critically depends on funding basic acreage reduction. If farmers are not offered enough to retire their land, water will not be kept so clear nor wildlife protected as well.

If the alternate option of compulsion were to be chosen, we could have a different scenario. Conceivably, environmental concerns may be intense enough to compel farmers to protect highly erodible soils, keep chemicals out of groundwater, and plant trees on the steepest land, rather than let it gully and erode.

It is also possible that society will eventually reconsider. It may decide it does not want to choose between, on the one hand, abandoning goals of protecting farmers' income, soil, and water and, on the other, adopting compulsory rules to do so. It is at that time, that the merits of the monetary incentive will be recognized once more. The policy trend of recent years is not likely to be reversed at once. But an agonizing reappraisal could follow.

In summary, the large budget deficit and the national trend away from monetary incentives to achieve socially desirable individual action will hang as dark clouds over the drafting of a new farm law. They will limit what can be done to underpin farmers' prices and incomes. They will likewise frustrate the environmental goals attached to acreage reduction.

But neither alternative option—abandoning social objectives or accepting compulsion—will be found attractive. Society may soon find itself having second thoughts, and consider turning once again to monetary inducements in agriculture and other parts of the economy. We may decide that it is not so bad, after all, to tax ourselves in order to pay ourselves to do what we jointly regard as in our common interest. We may look with new favor on combining monetary inducements with monetary penalties for anti-social behavior. After all, political economy judgments are comparative. C

We May Not Need Them Anymore

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touch off another run up in land prices that will not be supported by future returns.

Prentice also makes a great deal out of the S&Ls' continued losses when the national housing market is firm. But much of the rapid S&L loan growth went into the Southwest's oil patch, where real estate markets have collapsed. If oil prices were to rebound, many S&L's would also turn around.

Careful About the Word "Bailout"

The word "bailout" usually refers to protecting equity-holders (i.e., stockholders, the owners) from loss as bankruptcy nears. The Chrysler bailout comes to mind as a correct use of the word. Similarly, FCS owners were protected from losses by the federal assistance. Because the FCS is a borrower-owned cooperative, borrowers were required to buy stock as a precondition of their loans. These farmer borrower-owners were fully protected under the Farm Credit Assistance Act of 1987.

S&L's have not been bailed out. When the FHLBB moves against an insolvent S&L, it is legally required to repay secured creditors in full and to repay depositors up to $100,000. Stockholders are last in line to get proceeds from the receivership. Because the vast majority of S&L's seized by the FSLIC are deeply insolvent, stockholders are completely wiped out.

It is the S&L's insurance fund (FSLIC) that is being rescued, and taxpayer dollars are going to honor the federal deposit guarantee. Nonetheless, the FHLBB is bestowing windfall gains to those that agree to take over insolvent S&L's, but they are not the owners who pushed the institutions into insolvency. The FHLBB must go this route because it does not have the cash to shut down the insolvencies, absorb the losses, and pay off the depositors.

Prentice mentions that the responsibility for FCS losses were not easily passed on, because the System's banks are held "jointly and severally" liable for all FCS bonds. But this one-for-all and all-for-one setup did not work. When the FCA instituted capital sharing, where banks with surplus capital were supposed to give funds to banks that needed capital, the surplus banks bollixed up the funds-transfer with lawsuits. Indeed, I believe there was enough capital in the System as a whole to cover all losses without federal assistance. But the capital was concentrated in a few healthy banks, while others approached insolvency.

Double-Edged Swords

I also disagree with Prentice's judgement that the new federally guaranteed secondary market for farm mortgages, Farmer Mac, is the "price" the FCS must pay for their bailout. This is much like Br'er Rabbit crying "Don't throw me into the briar patch." S&L's have earned substantial profits and protection through the various secondary home mortgage markets, as Prentice implies. A secondary market enables a financial institution to increase its leverage: an institution with a given amount of equity can make more loans. This increases profits and spreads risks away from the lending institution onto other investors and the federal government. So the FCS stands to reap big profits from Farmer Mac.

But secondary markets are also a threat to single-sector lenders. For example, commercial banks that wish to make farm or housing loans without specializing can make the loans, earn the origination fees, and sell the loans through the secondary market. This increases competition for the single-sector lenders. But it also makes the single-sector lenders somewhat redundant and perhaps unnecessary. C