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LETTERS

From You...



From: Tim Osborn

Economic Research Service, USDA

Re: Sinner's "Getting More Soil Conservation For Our Tax Dollars"

Using enrollment data from the Conservation Reserve Program (CRP), Jim Sinner contends that cropland retirement programs are more expensive, as measured by the government cost per ton of reduced erosion, when compared to incentive programs encouraging adoption of better conservation practices. Based on this comparison he recommends that emphasis be shifted away from land retirement under the CRP towards paying farmers to adopt less erosive cropping practices. He concludes that such a shift would "provide more program flexibility for farmers and administrators, and it would achieve the same conservation objectives at less cost to taxpayers and less economic impact on rural communities."

Of course, under current law, USDA is required to enroll at least 6 million additional acres into the CRP by the end of the 1990 crop year to meet the legislated 40 million acre minimum. Consequently, Sinner's recommendation that "no additional acres should be enrolled [in the CRP]" would be a violation of existing law if adopted. More importantly however, his cost comparison of the two approaches is incorrect and incomplete. It is incorrect because his comparison uses gross rather than net CRP government costs. It is incomplete because he makes no effort to account for CRP benefits that would not be provided, or would be only minimally provided, by a conservation practice incentives program (e.g., increased wildlife values). Failure to correctly deal with these oversights invalidates the primary thrust of his argument. A larger issue is the appropriateness of using government costs per ton of reduced erosion as a focus for U.S. conservation policy. Government costs, such as CRP rental payments, are often transfer payments and do not represent the foregone use of real resources. Clearly, a more appropriate criteria would have been to compare social benefits and social costs of the different approaches.

From SCS field manuals, Sinner indicates that "significant reductions in erosion can be achieved for less than \$1/ton in many situations" by adopting less erosive cropping practices. He compares this with a \$3/ton national average cost for CRP in FY88. However, the CRP government costs he uses are inappropriate because they represent gross program costs that do not account for offsetting savings in commodity program payments. USDA realizes direct cost savings as a result of retired program base acreage required for CRP participation, and indirect deficiency payment savings to the extent that commodity prices rise due to the supply control effects of the CRP. This along with its

environmental benefits is precisely what made the CRP so attractive and politically feasible. Assuming that price support and supply control programs will continue into the near future, it is the net government cost of land retirement that is relevant for comparison.

While estimates of the net Government cost of the CRP are extremely sensitive to baseline assumptions concerning the level of ARPs that would have existed in its absence, a recent analysis performed by Barbarika and Langley suggests that for each government dollar spent on the CRP, roughly 50 cents that would otherwise have been spent in commodity program payments is saved. Taking into account rental payments, cost sharing, technical assistance, and erosion reductions on all 33.9 million acres currently enrolled in the CRP, ERS estimates the gross annual government cost of the CRP to be \$2.78/ton of reduced erosion. If half of this is offset by commodity program payment savings, assuming Barbarika and Langley's result, then the net government cost of the CRP is \$1.39/ton of reduced erosion. When commodity program savings are accounted for, most of the apparent cost disadvantage of CRP relative to a conservation practice incentives program evaporates.

Sinner notes that the CRP has several objectives in addition to soil erosion control. These include protecting soil productivity, reducing sedimentation, improving water quality, improving fish and wildlife habitat, curbing production of surplus commodities, and providing income support for farmers. While he acknowledges that benefits from multiple objectives could be accommodated in accepting bids under his proposed conservation practice incentives program, his original conclusion that land retirement is unnecessarily expensive is based solely on the CRP's erosion control accomplishments.

In ERS's economic evaluation of the CRP, the greatest natural resource benefits were found to result from wildlife and water quality improvements. The CRP has not been devoted entirely to erosion control. In fact, program rules that allowed filter strips, cropped wetlands, and relaxed erosion criteria for tree planting to achieve other CRP goals diminished potential erosion reductions attributable to the program. Evaluating the CRP based only on its erosion reductions therefore omits many of its conservation accomplishments.

While Sinner's conservation practice incentive program might provide surface water quality benefits equivalent to the CRP it would not be expected to provide significant, if any, wildlife benefits when compared to cropland retirement. In addition, greater adoption of conservation practices such as reduced tillage could increase pesticide use and leaching in some locations causing a degradation of groundwater quality. However, chemical use on land placed into the CRP is practically eliminated with the exception of some continuing weed control. Therefore, despite Sinner's assertion to the contrary, a conservation practice incentive program oriented to erosion control would not achieve environmental benefits similar to the CRP. If we were to conceptually incorporate the CRP's additional environmental benefits into the net government cost per ton comparison, the remaining cost disadvantage of the CRP would be further diminished or eliminated compared to incentives for conservation practices.

Because his comparison of CRP versus a conservation practice incentive program is incorrect and incomplete, Sinner's conclusion that conservation policy should shift away from land retire-

ment toward paying farmers to adopt less erosive cropping practices is not supported. When one considers the net government cost of the CRP and its non-erosion control benefits, it is not clear that the CRP is more expensive than the proposed alternative. Moreover, it remains to be seen if the technical costs Sinner cites for implementing conservation practices would be sufficient to encourage a significant number of farmers to participate in a conservation practice incentives program. In contrast the CRP costs represent the revealed preferences of some 333,000 farmers. The foregoing is not meant to imply that implementation of the CRP has been ideal. Clearly, enrollment could have been better targeted for environmental benefits, costs might have been reduced through the use of a more competitive bidding system, and rural economic impacts might have been lessened. Such improvements would have further improved the comparative position of the CRP.

From: Jim Sinner

Cornell University

Re: The Author Responds

Osborn raises some methodological questions which merit discussion, but draws the wrong conclusions because his own analysis is incomplete and uses outdated assumptions. Furthermore, beyond the methodological questions, he admits that CRP enrollment "could have been better targeted for environmental benefits." That is exactly the objective of my proposal: to better target the money spent by changing the program to obtain the desired environmental benefits at the least cost. I remain convinced that this would result in much less land retirement and much more reliance on improved farming practices.

Osborn says my analysis is incorrect because I use gross rather than net government costs, and that it is incomplete because I fail to account for non-soil benefits of the CRP. Clearly, one should use net rather than gross government costs, and Osborn is correct that commodity program savings lowered the net cost of the CRP in 1986 and 1987. After the droughts of 1988 and 1989, however, the baseline assumptions have changed, and the CRP generates few if any offsetting savings. Because of the large amount of land idled by the CRP, USDA has had to reduce set-aside requirements to provide an adequate supply of grain. In other words, the CRP, a paid diversion program is displacing an unpaid diversion program. Thus, net government costs for the CRP, for 1990 and future years, will be roughly equal to the gross costs I cited.

To the extent the CRP does increase the total amount of land idled, prices will rise and deficiency payments will fall, creating savings as Osborn claims. These short-term savings, however, impose a long-term cost on the U.S. agricultural sector. As the U.S. idles productive land to raise commodity prices, other countries increase production, undermining U.S. competitiveness in world markets. Nonetheless, I noted that if policymakers wish to reduce production to generate commodity program savings, despite these considerations, they can do so at less cost than the CRP by offering specific commodity bonuses under my proposed bid structure. Using this approach, USDA would enroll the commodity acreage desired rather than the CRP's smorgasbord of 34 million acres, a large part of which had been used to grow crops not in surplus.

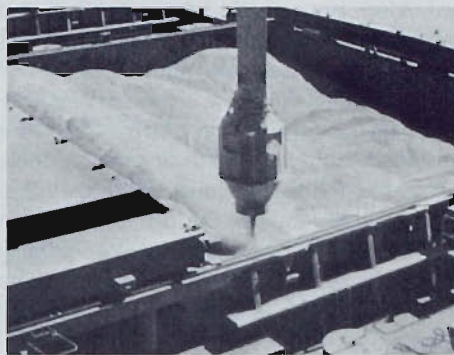
Secondly, there is the question of environmental benefits of the CRP versus my proposed program. While my analysis focuses on soil conservation, I point out that objectives such as improved groundwater quality and wildlife habitat can be incorporated into the proposed program, with better results than the CRP. In areas vulnerable to groundwater contamination, conservation practices requiring increased chemical use could be disallowed, and/or

bonuses could be offered for reductions in chemical use, thereby creating an incentive for low chemical input agriculture. Similarly, in areas where potential wildlife benefits are high, practices, including land retirement, which improve wildlife habitat would receive a bonus. Again, USDA would select the mix of environmental benefits, would know what it was getting, and would pay farmers on that basis.

It is important to stress that I do not advocate eliminating the use of land retirement, only that emphasis be shifted away from this approach. There will continue to be situations in which the benefits of retirement, by they supply control, erosion reduction, wildlife benefits, or some combination of these, will exceed the benefits of changing farming practices, and in these cases the land should obviously be removed from production. The key difference is that, in my proposal, farmers would be encouraged to submit applications which offer environmental benefits from improved farming practices, and these would compete with applications offering land retirement.

In other words, flexibility is the name of the game. The improved targeting of the program would enable policymakers to obtain the same, or a better, mix of environmental benefits as the CRP at less cost to taxpayers and with less economic impact on rural communities.

Osborn also notes that implementing my proposal would be a violation of existing law. I am suggesting that Congress change the law, not that USDA break it. Renewing existing CRP contracts when they expire, as some have suggested, would cost roughly \$2 billion per year to keep 35-40 million acres of inappropriately selected land out of production. In extreme cases, this means paying \$6 or \$7 per ton of erosion reduction on land where wildlife and water quality benefits are minimal, and where similar erosion control could be obtained for less than \$1 per ton. Much better would be to start a new round of bidding using selection criteria that identify and reward the full mix of environmental benefits offered by each farmer's application. This would keep appropriate land out of production while devoting the bulk of the resources to helping a much larger number of farmers adopt improved farming practices.



From: R. E. Anderson, Jr.

Administrator

Foreign Agricultural Service, USDA

Re: Paarlberg's "Mysterious Popularity of EEP"

I read with special interest Robert Paarlberg's article "The Mysterious Popularity of EEP" which appeared in the Second Quarter 1990 Issue of *CHOICES*, since it is one of the programs for which my Agency is responsible. At this time of reexamination of U.S. agricultural policy, it is crucial that there be a well thought-out debate on issues such as the Export Enhancement Program (EEP).

Mr. Paarlberg's assessment of the EEP as a popular program in

the United States is misleading since it disregards the main purpose of creating an EEP—to retaliate against those countries who through their subsidizing practices have disrupted normal U.S. commercial sales. In effect, the program was not designed to be popular in the United States as much as it was intended to be *unpopular* to competing subsidizing exporters. The fact that the EEP, through recapturing market share for certain commodities in targeted countries, has gained recognition among exporters of U.S. agricultural products is a testament to its success. The fact that the program is acknowledged to be an important factor contributing to the attention given to the Uruguay Round of GATT negotiations demonstrates its success in achieving its trade policy goal. In support of his assertion that the “popularity” of the EEP is undeserved, Mr. Paarlberg touches on a number of points which are either inaccurate or need clarification. I will discuss briefly some of the major points needing clarification.

The chief target of the EEP has been subsidized exports of the EC. EC export subsidy costs doubled between 1980-84 and 1985-89. Kenneth Bailey, the author of several studies concerning the EEP, estimates that the EEP was responsible for 35-40 percent of the increase in EC wheat export restitutions between 1985 and 1988. A large part of the increase in EC subsidy costs was caused by the fact that it became much harder to dump the EC's subsidized overproduction onto the world market in the face of the EEP challenge. The EC, as provider of a lower-quality product, was forced to offer far greater price discounts in order to make sales. Moreover, during the period 1985-89, EC internal wheat prices started to be scaled downward for the first time, which should have contributed to a decrease in EC subsidy costs. However, as world wheat prices were only marginally lower in 1985-89 than in 1980-84, the EEP stands out as the main reason for the doubling of EC subsidy costs.

The nature of the problem the EEP was designed to address, in conjunction with budgetary considerations, led to the establishment of a program to *target* specific markets and commodities and adjust the bonuses paid to exporters to reflect the minimum necessary to meet competitors' subsidized prices. Studies have shown that the EEP has contributed to the expansion of exports of all commodities in the program. The program has been guided by criteria which have been successfully met. One of those criteria is that EEP sales must increase U.S. agricultural exports above what would otherwise have occurred in the absence of the EEP. For example, some empirical analyses have shown the EEP to have been responsible for significant increases in wheat, barley, and poultry exports. Furthermore, for example, the EEP is responsible for reopening the Chinese, Algerian, and Moroccan markets to U.S. wheat.

Mr. Paarlberg bases his criticism of the cost effectiveness of the program on inaccurate statistics. Between 1985 and 1987 government-owned commodities valued at \$1.21 billion (including wheat, corn, and soybeans) were provided to exporters to facilitate exports totaling over 26 million metric ton of grains, vegetable oil, and poultry; 58,000 head of cattle and 258 million eggs. Furthermore, we believe that the long-term costs to the U.S. budget and the U.S. economy of *not* challenging unfair trade practices far exceed the EEP cost.

There is no basis to Mr. Paarlberg's assertion that the EEP may have constrained U.S. agricultural exports. In point of fact, the exports in question would not have taken place in the absence of some such bonus procedure. No importer or exporter is constrained by the workings of the program since both are free to negotiate private sales as participation in the program is strictly voluntary. According to the program's design, there is no reason for importers to hesitate to negotiate sales for bonus considera-

tions since the importer's concern is the sale price, not the bonus level. It is interesting to note that Mr. Paarlberg, like many who have studied the EEP, has not taken the opportunity to gain a clearer picture of the sorts of procedures he criticizes by exploring the workings of the program with those of my staff who are responsible for its daily operations.

Two additional aspects of the EEP with which Mr. Paarlberg takes exception are its original cost effectiveness and budget neutrality criteria. Analysis done on the program with respect to wheat program outlays has concluded that over the period studied (the first three years of the program) both criteria were generally met. The analysis suggests that the EEP had a favorable effect on CCC outlays by accelerating the reduction of CCC stocks and the increases of farm prices compared to what would have happened without the program. Mr. Paarlberg does not account for the savings to the U.S. Government on storage costs, nor does he account for the value of increased exports or the multiplier effect generated throughout the economy (estimated to be at least another \$1.51 of business activity for every dollar received for U.S. exports). This should not be misread as U.S. Government support for export subsidies. The U.S. Government continues to believe that trade distorting practices are undesirable.

Finally, the abandonment of the EEP as a policy tool is an inevitable outcome of a successful agreement on liberalization of agricultural trade. Such an agreement would allow U.S. agricultural exports the opportunity to compete successfully in a free marketplace. Mr. Paarlberg inaccurately implies that the U.S. Government is interested in expanding EEP activity at the cost of a multilateral agreement on agricultural trade. The U.S. Government believes that by challenging unfair trade practices, and insisting upon remaining competitive, growth of total world imports will be enhanced and we will be moving in the direction of a time where programs like the EEP will not be needed.

From: Rob Paarlberg

*Harvard Center for International Affairs
and Wellesley College*

Re: The Author Responds

Mr. Anderson, in his brief defense of EEP, manages to avoid all five of the important factual assertions contained in my own earlier critique of the program: (1) the fact that up to 90 percent of EEP wheat bonuses only succeed in cheapening sales that would have been made anyway; (2) the fact that the few genuinely “additional” wheat sales made under EEP usually cost taxpayers more per bushel than the wheat is worth; (3) the fact that European Community wheat exports have continued to rise despite EEP (USDA projects a record breaking 22 million tons this year—a 50 percent increase over the level of 1985-86, when EEP began); (4) the fact that EC farm budget pressures have diminished despite EEP (1990 agricultural outlays are running \$2.5 billion *below* target); and (5) the fact that EEP antagonizes Australia and Canada (our natural allies in GATT) far more than the EC.

One of my lesser assertions which Mr. Anderson does criticize (my assertion that EEP may have actually constrained some U.S. exports) is an assertion I am happy to repeat. Perhaps I should have cited the findings of a November 16, 1989, report by USDA's own Office of the Inspector General, which included (page 5) the observation that “Countries not targeted for EEP reduced their purchases from the U.S.”

Listening only to Mr. Anderson, the innocent reader might come away viewing EEP as a perfect solution to all our farm trade problems: a well-targeted, cost-effective, “budget-neutral” technique

for expanding U.S. exports and export shares, all at the expense only of our most wicked export competitors in the EC. Imagine the puzzlement of this innocent reader when Mr. Anderson, in the end, denies any enthusiasm for the program? The EEP is working so well, he seems to say, that we soon hope to get rid of it.

The confusion, of course, does not lie with Mr. Anderson, or with the Foreign Agricultural Service. When the EEP was initiated in 1985 (as the result of a bizarre budget resolution deal between OMB Director David Stockman and two United States Senators), USDA suspected that it would be a waste of money, and wanted no part of it. In the early months of the program, USDA administrators (to their credit) dragged their feet in launching bonus initiatives. It was the confused enthusiasm of some U.S. farm groups for EEP that eventually transformed the program into a political sacred cow. The main thrust of my argument was precisely against these confused U.S. farm groups. In times of farm budget austerity, they should not be using their scarce political resources to defend a program which mostly subsidizes their foreign customers.

The great hope of Secretary Yeutter (from his earliest days as U.S. Trade Representative) has always been to liquidate EEP by "trading it away for something" in the Uruguay Round of GATT negotiations. I hope he is successful. But my article provides several reasons why his strategy is likely to fail. Only time will tell. Until now, as I point out, the GATT negotiations have served more as an excuse for farm groups to *retain* EEP (the dubious "bargaining chip" argument) than as a means for the program's timely demise. If this tendency persists, and if EEP survives the Uruguay Round negotiations intact, those who have been defending this otherwise undesirable program as a "bargaining chip" should be held to account.



From: Dale L. Stansbury
Re: Barnaby and Skees' "Crop Insurance"

Barnaby and Skees' proposal for county loss crop insurance is an alternative disaster. It fails on several points including the individual risk management point. Any program that includes a county loss trigger precludes effective use of the program for individual risk management. In addition, the payment of "loss" benefits to all covered producers in an eligible county begs the question of equity because producers with major losses will receive the same payment as producers with no losses regardless of what it does to eliminate moral hazard. To the extent that the program is subsidized by the Federal Government, such payments to producers with no losses seems to be a blatant misuse of public money. It would not be cost efficient in catastrophic years since it would be possible for nearly all producers to collect payments regardless of actual losses. Adverse selection by individuals might be reduced but probably would not be eliminated. At the same time, adverse selection among regions would continue and would probably increase. In fact, the inclusion of a county

trigger may discourage use of the program by relatively low risk producers and regions. As a result, participation rates would probably not reach levels adequate to preclude the demand for *ad hoc* disaster programs.

Some administrative costs would be eliminated; however, administrative costs associated with annual premium collections, county based rates, marketing of the product, and indemnity payments will continue significant amounts of administrative costs of the current program. The authors do not touch on the question of delivery as to whether it would be through USDA offices, producer organizations, or private insurance companies and agents. If the latter method is used, few, if any, savings will be realized.

The authors recognize some of these problems in that they suggest that the plan be implemented as a pilot program. Alternatively, they suggest "stacking" this proposal on the current program. Double negatives work in grammar but not in public policy.

The area loss concept could be applicable to the problems of forages and pasture; however, it would have limited applicability to the "orphan" commodities because there is not good county level yield data or for major crops because of the points above.

Over the past nine months, I have reviewed over 20 "crop insurance" proposals. Nearly every one fails to meet minimum standards of effectiveness and efficiency. Most are preoccupied with program delivery (ensuring the welfare of the insurance industry). Some, such as the Administration's proposal, target low cost at the expense of all other objectives. Several substitute complexity for relevance. The crop insurance proposal outlined by Barnaby and Skees is certainly not as bad as many of the proposals; however, it appears to be another inadequate alternative.

The idea of insurance is attractive; however, it appears that the only way to make crop insurance work, at a reasonable cost, is to make it mandatory, devote adequate resources to make the county programs relevant, deliver the policies through USDA county offices or producer organizations, and make FCIC a part of the mainstream of USDA (perhaps, part of ASCS).

None of these changes are included in the principal proposals. Farmers cannot be asked to assume responsibilities as well as privileges. Shucks, they can't even be expected to keep records. It is heresy to not support privatization even when it is a high cost, inefficient alternative. And, who would have the audacity to suggest hard work and cooperation by the government. Without such "unacceptable" features, Federal crop insurance is not likely to be a viable or adequate program.

One factor in the narrowness of the debate is the prominence of private crop insurance interests. In fact, since 1980, FCIC seems to have devoted more time and effort to the USDA/private insurance relationship than to program design, development of new commodity programs, or taxpayer interests.

The purpose of this comment is not to fault private insurance for their efforts. They have every right to work in their best interest. However, the public interest also deserves full consideration. It would seem that university "bureaucrats," whom society pays to think objectively, should be of help in this regard. The crux of my disappointment with the Barnaby and Skees article is that these gentlemen, prominent persons in the crop insurance area, have failed to provide either a definitive assessment of the problems or a viable alternative. At the same time, the lack of public interest information or of viable crop insurance alternatives is not the fault of Art and Jerry. The major responsibility here is with USDA. For whatever reason, the many lights in this area in ERS, ASCS, NASS, and even FCIC are kept beneath the bushel. The quality of public policy *choices* is dependent on the quality of the information. As in most cases, objective information is the short suit in the crop insurance policy debate.

**From: C. A. (Art) Barnaby, Jr., Kansas State University
and Jerry Skees, University of Kentucky**
Re: The Authors Respond

We appreciate the opportunity presented by Stansbury to clarify several points regarding the proposed alternative crop insurance program. *CHOICES* readers should beware of blanket statements that have no supporting evidence. Stansbury makes such statements in a number of places, and we suspect that we were equally guilty in our original article.

First, the contention that "a county loss trigger precludes effective use of the program for individual risk management" is simply wrong. It is important to recognize that all farmers do not receive the same payment. Farmers chose the liability they need and are paid a percent of that liability when the area has a loss. This and the fact that farm yields are typically correlated with area yields provides opportunities for individual risk management. It would also be possible for farmers to purchase named peril insurance to complement the county loss program.

We have been associated with two studies that have examined the farm-level risk protection provided with an area yield plan using a history of farm level yield data. Mario Miranda authored one of these articles that will soon be published in the *American Journal of Agricultural Economics*. The other study will be presented at the American Agricultural Association Meetings. In both studies, several counties were combined to reflect the area loss trigger—making the test on risk protection more problematic. Results were very similar—over 80 of 100 producers could receive individual risk protection under this plan. The key is how well the individual yield tracts with the area yield. One would suspect that these relationships would be stronger when the area was smaller. Also when there is widespread disaster, there would be more individual farmers with losses.

Stansbury also states that "adverse selection among regions would continue and probably increase." We suppose he means that there would continue to be variation in the level of participation among regions. This is likely to be true. However, there is no reason to believe that this alternative would result in more variation. The design and level of the deductible would be the key to this important issue.

Stansbury is concerned that administrative cost savings would be low. Keep in mind that under the current program, a large component of the costs are associated with individual assessments of the yield potential and risk (underwriting) and the individual loss adjustments. Both of these components would be eliminated. There would be increased costs associated with improved and more timely area yield estimates.

We have no problem with Stansbury's concern about "orphan" commodities. Reliable historical data are missing for most of these crops and we agree that this alternative is not the answer.

With regard to the subsidy question—we believe that Stansbury has a legitimate point that society would be rightly concerned when a farmer was paid even if they did not have a loss. However, we would remind *CHOICES* readers that the current commodity programs also have this flaw. Good marketers receive the same deficiency payment as poor marketers. In other words, when a farmer receives a price that is higher than the average price that generates a deficiency payment, he too is being paid when he does not have a loss. The principle with the county loss program is the same. However, we would add that our view is that the county loss program could be administered without a subsidy. In that case, farmers would have paid for the loss and, assuming that most would stay with the program, their long-run payments would equal the indemnities. This is not the case with the direct

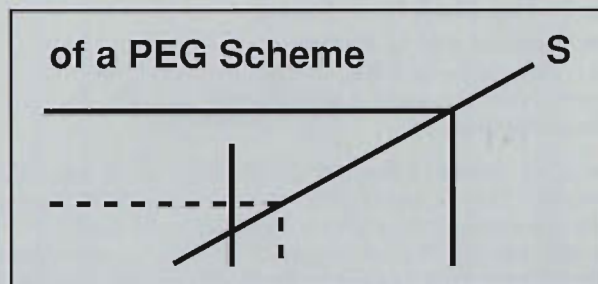
transfer of deficiency payments.

Finally, Skees has completed a study that examined the per acre costs of the current crop insurance program at the 75 percent coverage level for wheat, corn, and soybeans assuming that every acre in the country were insured in 1988. He also developed the per acre costs for a 90 percent of county yield program for the same crops. Here are the comparisons:

	Current Program	County Loss Program
Wheat	\$ 7.41	\$5.84
Corn	11.27	8.27
Soybeans	10.75	6.02

These comparisons highlight the fact that current rates have been inflated due to the adverse selection and moral hazard problems outlined in our original article. We still contend that a county loss program at 90 or 95 percent of county yields could offer equal or greater protection for many farmers at a lower cost. In fact, the numbers presented here have the subsidy for the current program and no subsidy for the county loss program.

At the time of this writing (July 20, 1990), the U.S. Congress has not included crop insurance in the Farm Bill; nor does it appear that any consensus regarding disaster assistance policy has emerged. Budget constraints have dominated the debate. We recognize that an area loss plan does not address all the problems with U.S. disaster policy. However, work completed since our original article was written continues to support the notion that it is one alternative that deserves some serious attention. The costs would be low if the only subsidy were an administrative subsidy. The program could be administered by either the government or the private sector. The major argument for use of the private sector is that it would provide an opportunity for them to sell a named peril product to complement the area plan. Finally, the area plan is preferred to free disaster assistance because farmers would pay for the risk protection and it would not create incentives for farmers in high risk areas to produce.



From: Bruno Larue and Jamie Oxley
The University of Guelph
Re: D. Blandford and Associates' "PEG"
First Quarter 1989 CHOICES

Blandford, de Gorter, Gardner, and Harvey (BDGH) have recently proposed a mechanism, known as the PEG, to minimize trade distortions associated with government intervention in agriculture. The debate about the PEG has so far focused on the domestic problems related to its implementation and has played down trade issues likely to be more important in the long run. We applaud the fact that the PEG makes the cost of domestic distortions more transparent. High transparent cost is probably the best possible deterrent against government intervention and the best weapon to fight protectionism.

However, the PEG is not without flaw. We are particularly con-

cerned with trade distortions that may result from the one-time setting of the PEG quantities. First, allocating PEG quantities based on a relatively high proportion of a country's production in a "normal" year would unduly favor countries using trade distorting policies. In fact, it is possible that some countries would end up with PEG quantities above the quantities they would produce under free trade. Trade distortions would be reduced but not eliminated. Secondly, even if the PEG quantities were not trade distorting under current market conditions, changes in technology may affect the comparative advantage of the countries and may make the PEG trade distorting. The same can be said about a fall in aggregate demand. While it is true that the PEG is not trade distorting at the margin, it could be trade distorting if the margin changes. (A graphical analysis of two cases under which PEGs may become trade distorting is presented in our working paper which is available upon request, University of Guelph wp90/08).

In order to deal with trade distortions resulting from an inefficient initial allocation of the PEG quantities or from changing market conditions, a monitoring and adjustment mechanism must be developed. BDGH suggest that national rental markets in PEGs could provide a monitoring method. We agree with this statement but recognize that rental markets need not exist if some flexibility in domestic allocation of PEGs is to be permitted. If trade distortions are to be eliminated then a mechanism must ensure that the level of production eligible for support is below production under free trade in all countries. If the PEG quantity for a given country is set too high, then that country will produce below or at the PEG quantity while a non-distorting country will produce above or at its PEG quantity. The adjustment we are suggesting consists of an automatic percentage reduction for countries producing at or below their PEG quantity. (Exceptions would be made to take the account abnormal weather conditions). Trade distorting countries would gradually produce and distort less and could easily maintain their level of domestic support by increasing the per unit support rate. Our monitoring method only requires the measurement of production in each country which is a simpler task than measuring national rental rates as suggested by BDGH.

Even if the PEG is not likely to receive serious consideration in the GATT in the near future, we believe that it is a good idea and that the professional should rally behind it. After all, it is the closest thing to lump sum transfers and ten years from now is may not be considered as such a radical departure from the status quo.

**From: D. Blandford, H. de Gorter,
Bruce Gardner, and D. Harvey**
*OECD, Cornell University, USDA, and the
University of Newcastle-upon-Tyne respectively*
Re: The Authors Respond

First of all, we thank Larue and Oxley for their strong support of the PEG proposal. They do, however, make several comments on the proposal and offer one suggestion to which we would like to respond.

The argument that PEG has focused on domestic implementation and has played down trade issues is incorrect. The explicit purpose of the PEG proposal is to allow governments the necessary domestic flexibility to support their domestic agriculture while minimizing international trade distortions. Our clear intention is that, ideally, PEGs should be bound and negotiated down within the GATT, and become the agricultural equivalent of the tariff.

The clear danger with the PEG proposal is that PEGs may be set too high, that is in excess of the free trade production quantities. There is no doubt about the appropriate definition of the PEG. PEGs should be not more than the free trade production quantity *so long as the PEG licenses to receive support are freely tradeable* and should be less than this quantity if there are restrictions on the tradeability of PEGs. In the practical world, there are two major difficulties: (a) free trade quantities are not currently observed, so that negotiations about the appropriate starting levels of PEGs are subject to disagreement about what these levels would be, and (b) as correctly highlighted by Larue and Oxley, the free trade quantities may change over time, especially because of technological change and developments in consumption habits and tastes, though we would argue that these changes are more likely to result in any existing PEGs becoming less rather than more distorting, aside from major shifts due to world climate change.

These difficulties raise the twin problems of: (a) identifying the appropriate mechanism for the initial negotiation/allocation of PEGs between countries; (b) identifying the appropriate monitoring mechanisms through which PEGs should be subject to renegotiation. Larue and Oxley's suggestion that observed production in excess of PEG is a clearer and more easily monitored signal that PEG levels are non-distorting than comparisons of PEG rental rates with PEG subsidy rates (as the difference between the PEG support price and the free trade market price) is questionable.

First, the equivalence of the quantity measure of distortion of PEGs with the price measure only holds in the event that PEGs are freely tradeable. If they are not, then the quantity measure is biased, since it cannot account for the *extent* to which existing PEGs are distorting. While the price measure may be unobservable in these circumstances, there will always be at least a black market if not a gray market price which can be discovered and used as evidence in negotiations about levels of distortions.

Second, in the event that current world market prices are *not* free trade prices, neither method is unambiguous. Even if we start from a position in which observed market prices are free-trade prices, following successful implementation of the PEG proposal for instance, shifts in supply and demand curves in the future could alter the free trade price so that it is no longer the observed market price. Stated like this, the problem collapses to the single problem of what to do in the event that existing market prices are not free trade prices—the current position.

The solution proposed by Larue and Oxley is that any country producing at or below its PEG quantity should be subject to an automatic reduction in its PEG quantity. As argued above, this is an appropriate solution only in the event that PEGs are freely tradeable, in which case our initial suggestion that PEG rents can be monitored and used as arguments for the reduction in PEGs is both equally valid and equally workable. Our suggestion has the added advantage in that it would be possible, at least in principle, for plaintiff countries to purchase PEGs in offending countries, thus reducing the PEG and the associated distortion while providing appropriate compensation to the losers. In the strict arithmetic of conventional welfare analysis, this option is perfectly consistent with global welfare optimization, although we have to admit that it is contrary to the "polluter pays" principle, and thus not necessarily an acceptable political option.

In the event of less than freely tradeable PEGs, then neither solution is perfect. In this more realistic case, we are forced back to the solution of regular monitoring and negotiations about the levels of PEGs, supported by evidence from world trade models about free trade quantities, and observations of black or gray market prices (rents) for PEGs. However, so long as all other forms of protection and support, including the ubiquitous nontariff barriers, are eliminated (or frozen), then this deals with agricultural trade distortion more effectively than the tariff approach adopted for nonagricultural trade.

Thus, our suggested "fall-back" and more realistic suggestion is simply to negotiate PEG quantities, given initial agreement to convert all present forms of support and protection to their PEG equivalents, and then to bind these settings under GATT. In this case, production in excess of PEG would be *prima facie* evidence that a country is not *presently* distorting, though *not* evidence that this country is nondistorting with respect to free trade. Thus, an initial outcome under which all countries set PEGs at some fraction of present production levels and progressively reduce them is a clear and long step in the right direction. No doubt there will be strong arguments that some countries presently distort trade more than others, and thus should be obliged to set their PEGs lower than others. The relationship between the levels of PEG payments and the reduction in PEG quantities, which establishes the total support level, should provide sufficient flexibility for negotiating countries to agree such differential PEG settings relative to current production levels.

Finally, we agree that PEG is strictly a "second best" solution, and in that sense is in Larue and Oxley's words "not without flaw." However, recognition that no country will freely negotiate their agricultural support policies away in an international arena forces us into a second best world. For the GATT to have meaningful impacts on agriculture, we believe that the fundamental objective of the GATT should be to remove distortion, not to eliminate support. Furthermore, the abstraction of free trade arguments from real and pressing needs to adjust distributions of not only incomes but also activity, and the omission of public good and externality considerations from the classical free-trade prescription, call into question the very notion of the so-called "first best" solution in any event. We

are pleased that Larue and Oxley think that in ten years time the PEG may not be considered as such a radical departure from the status quo. However, we argue that even now it is not a radical departure. It does, however, provide a realistic and potentially acceptable vehicle for radical departure from historical methods of support and towards quasi lump-sum transfers, should these become more politically acceptable in the future. We do not, however, go so far as to argue the primacy of lump sum transfers over all other methods of support as practical or realistic alternatives either now or at any time in the foreseeable future.

FCS AND S&Ls

From: George D. Beitzel

President, Western Farm Credit Bank

Re: Duncan and Prentice's "FCS and S&L Debate"

Having been on the inside of Farm Credit for 25 years, I disagree with Messrs. Duncan and Prentice's view that all financial institutions faced the same external economic environment in the early 1980s, but only those with inflexible lending policies, restrictive markets, or access to the Federal trough failed, thus concluding an internal not an economic crisis was the primary cause of the FCS financial disaster.

My experience indicates that almost all institutions engaged in agricultural lending on the West Coast, be they commercial banks, S&Ls, credit unions, insurance companies, dealer credit, or Farm Credit institutions, were damaged by the general economic collapse of agriculture which resulted in the demise of many farmers and their lenders.

The many valid weaknesses in FCS procedures pointed out by Duncan are unarguable but were the tip of the iceberg. The economic downturn or external force was the larger portion of the iceberg that, while not as easily seen, was the major factor in severely damaging the FCS ship of credit.

From: Paul Prentice

Farm Sector Economics Associates

Re: The Author Responds

Mr. Beitzel's experience is that "...almost all institutions engaged in agricultural lending...were damaged by the general economic collapse of agriculture..." I agree with this statement. It is a matter of economic theory as well as observed fact that the external economic environment faced by a lender has an effect on that lender's income and balance sheet. So, there is no disagreement on this point.

Rather, as was the case in the original debate between Greg Gajewski and I, the disagreement is over the degree of impact. I began the debate thinking, like Mr. Beitzel, that the external environment was the "major" cause of the FCS problems. No doubt that the collapse of farmland values was indeed a major shock, one that created problems for all lenders.

But not all lenders suffered equally. Some adjusted faster than others, some went under, and some simply hung on through the deep pockets of parent companies. They all faced the same external environment. But it was institutional factors that differentiated the survivors from the nonsurvivors.

Mr. Beitzel believes that internal weaknesses were only the "tip of the iceberg" that sank the FCS ship of state. He concludes that the external collapse was the larger, unseen, portion of the iceberg. If so, all ships hitting the iceberg would have sunk. But some were more watertight than others. It was the internal condition, not the external environment, that sank FCS. But thanks to Mr. Beitzel and others like him, that is being remedied.

A few facts, gathered from the February 1990 issue of *Agricultural Finance Outlook* tend to support this conclusion. Although the data is marred by differences in definitions, reporting times, sample size, and geographic dispersion, it does illustrate that institutional factors likely played a large role in the widely disparate rates of loan default and charge-offs among the various classes of farm lenders.

In 1985, both FCS and commercial banks had about the same rate of

delinquent loans: 8.7 percent and 7.3 percent respectively. By 1989 the external lending environment was much stronger, and delinquency rates for both lenders improved. But the rate of delinquencies for FCS was nearly twice as high as that for commercial banks: 5.7 percent and 3.3 percent respectively.

The data show that not all private market lenders out-performed FCS. In particular, life insurance companies (LICs) had relatively high default rates: a peak of 17 percent in 1986 compared with a 1986 peak of 14.4 percent for FCS and a 1985 peak of 7.3 percent for commercial banks. While LICs did not enjoy the same access to the federal trough as did FCS, they did have access to deep pockets elsewhere.

As with all economic and financial crises, lessons have been learned, no matter how painful. The surviving players are now stronger and more able to face the future of farm lending with a more realistic and flexible approach. The next step is to recognize that internal institutional factors are also behind the observed shift in market share.

FCS had a 31.8 percent market share of total farm debt in 1980, but by 1989 that had fallen to 25.9 percent. Commercial banks had a 22.6 percent market share in 1980, but by 1989 this had risen to 32.3 percent. The market shares have essentially been reversed inside one decade of rapid change. Yet both commercial banks and FCS face the same external lending environment. Recognizing the important role of institutional factors in determining farm lender solvency will serve the industry better than looking for external scapegoats.

From: Marvin Duncan

Farm Credit Administration

Re: The Author Responds

My good friend George Beitzel and I appear to agree on what he refers to as "the many valid weaknesses in FCS procedures" of the 1970s and early 1980s. I, however, believe the data indicate that weak or inappropriate operating practices and procedures were more damaging to the Farm Credit institutions, overall, than was the agricultural downturn, though I certainly recognize its impact. The Farm Credit institutions, as single purpose lenders, have a special responsibility to their investors, stockholders, borrowers, and to the U.S. taxpayers to assure a level of financial stability and resiliency to adverse economic conditions that will occur from time to time in U.S. agriculture.



From: Turner L. Oylo

Executive Director

Walnut Marketing Board

Re: Levins' "Farmers Who Solve Equations"

(Fourth Quarter 1989 CHOICES)

One cannot help but be amused at the Letters to the Editor concerning Levins' "Farmers Who Solve Equations." Reminds me of Martin Luther and his argument with the Papal authorities in Rome. To question the sanctity of the mathematical economist by none other than one of their own is undoubtedly a heresy requiring retribution. Interestingly, the arguments opposing Mr. Levins' thesis were written in English, a most satisfying development, and recognition that communication and thoughts can be expressed in this old fashioned manner. Methinks that we involved in public and private programs tend to agree with the concerns expressed by Levins. Perhaps this will encourage economists to work for the masses rather than for each other.