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*CARD Briefing Paper 99-BP 25*

## Whither Farm Policy?

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September 1999

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## WHITHER FARM POLICY?

As the U.S. Congress prepares to pump at least \$8.7 billion in supplemental aid to farmers (on top of the \$10.5 billion that has already been earmarked), many people—both in and out of agriculture—are openly wondering if there isn't a better way to run farm programs. To many, it seems that we have no coherent farm policy in the sense that tax dollars are being committed with a clear objective in mind. After two straight years of supplemental appropriations, it is clear that the current farm program (the FAIR Act of 1996, commonly known as Freedom to Farm) is not a politically sustainable policy. And, the policy objective of the ad-hoc aid is clouded by the apparent inability of Congress to pass aid packages targeting assistance to the most at-risk farmers.

In fact, because federal price support payments depend on harvested production, the largest amount of aid will go to crop producers who harvest the biggest yields. Thus, Iowa corn farmers who expect bumper crops this fall will receive higher federal payments than will drought-stricken corn farmers in the eastern United States. (It should be noted that the farmers affected by the drought will receive crop insurance indemnities—if they had the foresight to purchase crop insurance—in addition to some emergency drought aid.) Furthermore, the group suffering more financial stress than any other—hog producers—will be receiving little federal assistance.

Many critics are calling for an end to Freedom to Farm. Some see solutions in

further reform of the crop insurance program, while others are calling for adoption of a new policy made up of remnants of the former farm bills. But, before any new reform proposal can be seriously evaluated, we need to ask—and answer—“What do we want farm policy to accomplish?”

### **Farm Program Proposals: A Crowded Menu**

It is naive to think that achieving agreement on farm policy objectives will be an easy task, especially when we consider the crowded menu of interest-group proposals.

- Environmental groups want farm payments to be used to entice farmers to adopt environmentally-friendly production practices.
- Many rural advocacy groups want farm program payments targeted to small producers, believing that many small farmers increase rural vitality more than fewer large ones.
- Input suppliers prefer payment schemes that do not require a reduction in planted acreage.
- Non-farming landlords prefer payment schemes that are predictable so that land values and cash rents will be enhanced.
- Farm operators who rent land should prefer payments that do not get automatically bid into land rental rates.

- Livestock producers—a group that has never been eligible for federal aid—simply hope that federal policy does not increase the price they must pay for their feed.
- Processors and exporters prefer a policy that encourages expanded production.
- True believers in the free market point out that the producer price floors in the FAIR Act (the loan rates) limit agriculture's flexibility. Land that should go out of production in response to low market prices stays in production because the government-guaranteed price is higher than the market price.
- Some point to the government's responsibility to maintain national food security and an affordable food supply as reasons to subsidize crop production.
- And Congress, it seems, just wants to be viewed as doing something for agriculture.

The wide reach and diversity of these collective policy preferences (the list is not exhaustive) indicate that we need to step back, gain a more unified perspective, and then discuss what the role of government in agriculture should be, and why.

### **Correcting Market Failures**

The first, and perhaps most frequently cited, reason for government intervention is to *correct market failures*. Economists deem a market to have failed when the price consumers pay for a product is significantly different from the cost of production. Agriculture faces two potential market failures: (1) agricultural pollution, and (2)

the exercise of excess market concentration in input supply and output processing.

Free-market prices generally do not account for the cost of pollution because pollution damages are not borne by producers of goods and services. Thus, agricultural prices will understate the full cost of production when agricultural production leads to substantial pollution. Steps can be taken to make sure that the cost of cleaning up pollution is fully reflected in the price of the good. Such intervention can actually increase the benefits of a free market economy by ensuring that all costs of production are reflected in market prices.

The use of market power by large firms to enhance their profits can result in a divergence of price from production costs also. The agribusiness sector has come under fire recently for allegedly manipulating input and output prices to the detriment of farmers. To date, however, convincing evidence of excess market power exists only in specific cases, such as the one brought by the U.S. government against the Archer Daniels Midland Company for fixing the price of lysine. Scant evidence exists for concluding that farmers have been the victims of price fixing by large agribusiness firms, although the potential grows as concentration grows.

### **Enhancing Farmers' Management Decisions**

A second argument for government intervention is that farmers need support because they face tremendous variability in output prices. Market prices for raw agricultural commodities are quite sensitive to quantities produced, so that in years of bumper crops, market prices can be quite low, and in years of short crops, market

prices are significantly higher. Government programs could stabilize prices by subsidizing commodity storage, or by placing a floor below which prices cannot fall. A more modern version of this reasoning is that farm incomes are highly variable from year to year because of a reliance on unpredictable export demand, and therefore government intervention is needed to stabilize income.

While it may be true that farmers face variability in yields, prices, and income, variability does not, by itself, constitute a market failure. Variability is simply a characteristic of agricultural markets. Farmers can take action to manage income variability, including diversifying crops (oats, alfalfa, vegetables, trees), incorporating livestock enterprises, and purchasing insurance.

It must be remembered that many U.S. farmers are able to manage variability and thrive with no federal subsidies. Producers of livestock, fresh produce, tree crops, and nursery crops do not receive government support. The markets they compete in are no less variable than markets for cotton, the major food and feed grains, or milk. The question of why producers of these latter crops need federal help in managing variability while other producers do not needs to be answered before variability can be used to justify intervention.

### **Interest-Group Pressure**

A third reason for government intervention is simply that the government is responding to pressure from producer interest groups. There is nothing unique about interest groups lobbying for passage of legislation favorable to their constituents. In fact, that is the way that democracies function. One

policy option is accept this reality and design farm policy to transfer enough money to agriculture to satisfy political pressure, but do it in a way that minimizes the long-run damage to the agricultural sector.

### **Why the FAIR Act?**

Most observers believe that the FAIR Act was passed because of a unique combination of history and circumstances. In the mid-1990s, the national political climate and robust economic conditions turned the tide away from traditional farm policies that had government both supporting prices and limiting production.

- In 1995, the Republican Party took control of the House of Representatives and vowed to greatly decrease government's role in the economy to fulfill its "Contract with America." Some in the Party targeted farm programs from day one because they were seen as a prime example of government interference with free markets and the management of farm operations.
- Then, in the fall and winter of 1995, crop prices increased to levels such that traditional farm program payments would essentially disappear.
- Meanwhile, in Congress, Senator Lugar, Chair of the Agricultural, Nutrition, and Forestry Committee, and others saw the need to continue down the path of incremental reform of farm programs toward greater market orientation and lower government costs that had been initiated with the previous farm bills.

- Responding to the strength in commodity prices, mainstream producer groups rallied behind Freedom to Farm with its fixed program payments, and it passed.

Given this history, it is not surprising that many former advocates of FAIR are calling for a return to the old farm policy now that crop prices have fallen to levels where payments would be higher under the former supply-control programs.

But wouldn't an abandonment of Freedom to Farm reduce the flexibility and competitiveness of the agricultural sector? After all, many advocates of the current policy say that by getting government out of agriculture, Freedom to Farm has forced farmers to look to the marketplace for signals about what and how much to produce, rather than to government. But this is far from an accurate assessment.

Acreage was planted in 1999 solely because the government floor prices were in place. Thus, the large supply of crops in 1999 and the resulting low market prices were actually enhanced by the FAIR Act's floor prices. The supply expansion was especially significant for soybeans because the government floor price of soybeans was set high relative to the floor prices of corn and wheat in the FAIR Act.

In addition, the 1999 increase in crop insurance subsidies also increased production. There is an old adage that you always get more of what you subsidize. Thus crop insurance subsidies tend to increase risky behavior. The subsidies increase the viability of continuous wheat production in the arid Great Plains on land more suitable for wheat grown in a wheat-

fallow rotation. The subsidies also increase the production of corn and soybeans on land that is more suited for crops that can better withstand drought and high heat.

### **A Flexible and Competitive Agricultural Sector**

There are few people, if any, who believe that the current farm policy should be maintained; and at times the clamor for a new farm policy has been deafening. The loudest voices are saying that the U.S. government should dramatically *increase* its involvement in agriculture. Given that the role of government in agriculture in 1999 is already pervasive, these fervent appeals bring us back to our original question: What exactly do we want farm policy to do?

If we want policy to move midwestern agriculture to a market-oriented system, with farmers producing the commodities consumers want, in the quantities that can be profitably produced, then we should eliminate all government-guaranteed prices (the loan rates) and crop insurance subsidies. Under this policy alternative, land in low-yielding fringe production areas would come out of production in 2000, the supply of crops would drop, and the prices of corn, soybeans, and wheat would increase. The low-cost producers would be able to weather this disruption in supply and would come out of it in better shape than if the current policy is maintained. This policy objective, however, appears to be a "non-starter," because the vast majority of opinion leaders and farm organizations are opposed to a letting the market determine who should be producing crops in the Midwest.

If we want farm policy to supplement farmers' incomes in a way that maintains the long-run benefits of production flexibility

and a market-driven agricultural sector, then we should eliminate the loan rates and crop insurance subsidies, and simply write government checks to farmers. The size of the checks should have no relationship to the actual production decisions that farmers implement. If Congress needs to transfer more money to agriculture when widespread crop or revenue loss occurs, the size of the checks could depend inversely on the level of market prices or revenue levels in a region (state or county).

At the county level, such programs already exist. For example, the Group Risk Plan (GRP) and Group Risk Income Protection (GRIP) pay farmers indemnities if county average yield or county average revenue is below a certain level. Because the payments depend on county yield, a single farmer's actions cannot affect the level of payment. The government could give every farmer a GRP or GRIP policy. If farmers want to add individualized risk management protection, then they could pay the full cost of business-interruption insurance plan, much like other businesses do.

The key factor in a flexible and competitive agricultural sector is that farm-level production decisions need to be reflected in farm income. Only then will we see midwestern farmers producing the crops that consumers want, at prices that cover the cost of production.

Clearly, the debate about what to do about farm policy is very much alive. But what we need to focus on is the ultimate objective of farm policy and the costs of implementing policies to meet this objective. We should build on what we have learned from our experience with the old supply-control programs, the various environmental provisions, and with Freedom to Farm to design a policy that does not hinder agriculture's ability to respond to current and future economic realities.