Domestic Fiscal Policy Linkages to Agriculture

Fiscal policy is at least as important in its impact on the well-being of the farm sector as agricultural policy. Today, my initial focus will be on the microeconomic effects of fiscal policy on agriculture, i.e. the effects of the tax code on investment, supply, and net returns to farmers. Then I will focus on the aggregate linkages between fiscal policy and performance of the farm sector.

Microeconomic Effects

In recent years, commodity programs have transferred something on the order of $15 billion a year to American farmers. Less well-known is the fact that the total losses of American farmers for tax purposes exceeds total profits by more than $10 billion.

Agriculture has become a large net tax shelter. Certain parts of the farm sector, in particular custom feeding of cattle, dairy, orchards, and vineyards have been the recipients of significant amounts of nonfarm tax shelter investments. The farmers who own these farms may be doctors in New York City or economists in Illinois or airline pilots in California. These investments have resulted in larger agricultural production motivated by the desire to generate tax losses. The larger supply has depressed market prices for these commodities and, in turn, returns to family farmers in the business of farming to earn their living, not in the business of farming the tax code.

The current tax structure is characterized by high marginal tax rates and numerous credits, deductions, exemptions, and other special tax provisions. Special tax provisions attract greater amounts of capital to flow into agriculture than otherwise would be warranted. By the end of the 1970's, the U.S. farm sector employed twice as large an investment in machinery and

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Remarks by Robert L. Thompson, Assistant Secretary of Agriculture for Economics, at the symposium on "What Does Reducing the Federal Budget Deficit Mean for Agriculture," at the Annual Meeting of the American Agricultural Economics Association, Reno, Nevada, July 28, 1986.

equipment per person employed as the nonfarm sector of the economy. There is no inherent reason why modern agriculture should be so much more capital-intensive than the manufacturing sector. I cannot resist the conclusion that at least part of this capital intensity was generated by the existing tax code.

Not only does the tax code attract larger total investments in agriculture, it also distorts the pattern of investment in favor of the most benefited sectors. As tax depreciation and tax credit policies distort the mix of farm capital, they reduce the productive efficiency of that capital stock.

Preferential tax laws have encouraged a large number of family farms to incorporate and have probably stimulated a larger average size of commercial farm businesses, as high tax bracket farmers receive greater benefits than low bracket farmers. Various tax provisions encourage farmers to change their management practices and affect the patterns and timing of input purchases and crop and livestock sales to minimize the tax take. During times of inflation, various tax provisions appear to have encouraged farmers to increase their use of debt capital to expand, exposing them to higher risk. During the 1970's, total U.S. farm debt increased from $65 billion to more than $200 billion. Virtually all observers argue that this debt load which was induced in part by the tax code is substantially larger than is healthy for the farm sector.

The tax reform bills passed by the House and Senate both would change the tax treatment of agriculture significantly. Probably most important, reducing the maximum marginal tax rate to 27 percent substantially reduces the incentive for any tax shelter. In addition to the deletion of investment tax credit, changes in depreciation periods and changes in capital gains treatment of farm income all reduce the attractiveness of the farm sector as a tax

shelter. The Senate bill explicitly precludes passive nonfarm investors from claiming losses on farm investments to offset nonfarm earnings. These measures all should contribute to improving the supply-demand balance in much of agriculture by reducing the incentive to invest in excess productive capacity provided by the present tax code. Family farmers would benefit, of course, from large proposed reductions in the highest marginal tax rates, from increasing the personal exemption and standard deduction, and from such measures as permitting self-employed people to deduct half of their health insurance premiums.

The important point here is that fiscal policy can have a major effect on agriculture not only through its aggregate impact on interest rates, but also much more directly through its distortion of capital investment and, in turn, effects on supply of farm products and farmers' net cash income. This affects program and nonprogram commodities alike.

Macroeconomic Effects

As one of the most capital-intensive, debt-dependent and export-dependent sectors of the American economy, the interest rate and exchange rate are two of the most important prices affecting farmers' well-being. Therefore, fiscal and monetary policy acting through interest rates and exchange rates can have a larger impact on farmers than the effects of agricultural policy working through commodity prices.

In the 1980's, $200 billion a year Federal deficits in the face of tight monetary policy and low domestic savings have bid up U.S. interest rates and attracted large net capital inflows into the United States. Because we now live in a floating-exchange rate world, the exchange rate was bid up sufficiently to generate an equal and offsetting current account deficit. This squeezed agricultural exports, putting downward pressure on U.S.

commodity prices. The rigid minimum loan rates established in the 1981 Farm Bill prevented U.S. prices from falling as far as the exchange rate adjustment would have mandated. This substantially increased the budget cost of farm programs which insured that total net cash farm income was sustained through the 1980's at at least the 1981 level. But what happened was that a smaller fraction of this net income came from exports, and more and more was made up from government payments.

The large increase in total farm debt accumulated over the 1970's, together with the high real interest rates of the 1980's, meant that the interest rate really became the single most important price affecting the farmer's bottom line. In 1984, American farmers paid $21 billion in interest on borrowed money--six times the $3.4 billion spent in 1970. This was double the share of interest in total cash production expenses compared with 1970 and equal to 85 percent of average net farm income during the first half of the 1980's. Interest rates also have another less visible role. The interest rate is the opportunity cost of capital tied up in land, inventories, livestock, machinery and structures. Therefore with the increasing integration of capital markets and the increasing real interest rate charged to farmers in recent years, the interest rate has become an even more important determinant of the value of and the change in investment in these variables.

In previous decades, when the real interest rate never rose above 4 percent, farmers may have been able to pay less attention to the opportunity cost of their capital investments. However, when real interest rates in the early 1980's rose to unprecedented monthly high levels of 9-12 percent, interest rates suddenly became a much more important determinant of how large a herd of cattle a farmer should keep, of how large an inventory of grain he

could afford to carry, and--probably even more important--of what he could afford to pay for land.

This increase in real interest rates surely was one of the major factors causing the downward spiral in land prices in the 1980's. Increased variability in interest rates has added yet another source of riskiness to farm income and investment in agriculture. Banking deregulation has created stronger links between rural interest rates and interest rates at money-center banks. Removal of interest rate ceilings and relaxing of rules on interstate banking and portfolio regulation have broken the isolation of rural credit markets from the national market. Although this means rural areas feel monetary shocks more quickly, deregulation may also increase diversification and access to funds that should reduce the cost of capital in rural areas.

The role of the exchange rate will be treated in detail in another paper in this session. But in closing, let me emphasize that the exchange rate is a key medium of transmission of fiscal and monetary policy to the farm sector. Reduction in the large federal budget deficits by such means as Gramm-Rudman-Hollings will reduce the large net capital inflows into the United States, but until Federal borrowing on Wall Street actually declines, this benefit will not be realized. Until the conditions causing those large net capital inflows to occur change, the United States inevitably will run a large current account deficit and the dollar will remain at high levels that will be disadvantageous to the traded goods sectors--including agriculture.