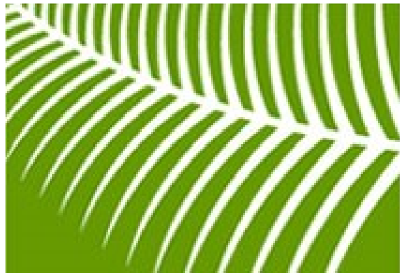

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The new farm bill, the 2002 Farm Security and Rural Investment Act, enacted May 13, 2002, seeks to provide a farm safety net at a relatively greater cost than under the previous farm legislation and continues the trend of high government payments. Over time, government subsidies have contributed significantly to farm income and to the continued strong performance of the nation's agricultural banks.[1]

The 2002 Farm Bill: What Farmers and Lenders Should Know

by:
Stephen L. Kiser

However, farmers and lenders must understand that the future may hold challenges to sustaining the current level of profitability.

Effects of Government Subsidies

Relatively high levels of government payments to farmers help explain why the nation's agricultural banks have continued to perform well, despite low commodity prices. During the past five years, at a time when commodity prices have been at historically low levels, the return on assets for this group of insured institutions has remained relatively stable, averaging 1.26 percent compared with 0.99 percent for all small nonagricultural banks.

High levels of government payments also have contributed to rising farmland values. In fact, a

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[1] An agricultural bank is defined as any insured institution that holds 25 percent or more of the loan portfolio in agricultural real estate or production loans.

USDA analysts suggest that government farm payments may slow the growth of rural communities in certain cases, by artificially inflating land prices and diverting capital away from businesses.

USDA/Economic Research Service report attributes $62 billion (20 percent) of U.S. farmland values to subsidy payments since enactment of the 1996 FAIR Act.[2] In addition, some United States Department of Agriculture (USDA) analysts suggest that government farm payments may slow the growth of rural communities in certain cases, by artificially inflating land prices and diverting capital away from businesses.[3] Alternative uses for agricultural lands — residential, commercial or industrial — also may have promoted local economic diversification and more rapid growth. However, such efforts were constrained, at least in part, by the fact that relatively high levels of government payments supported farmland values.

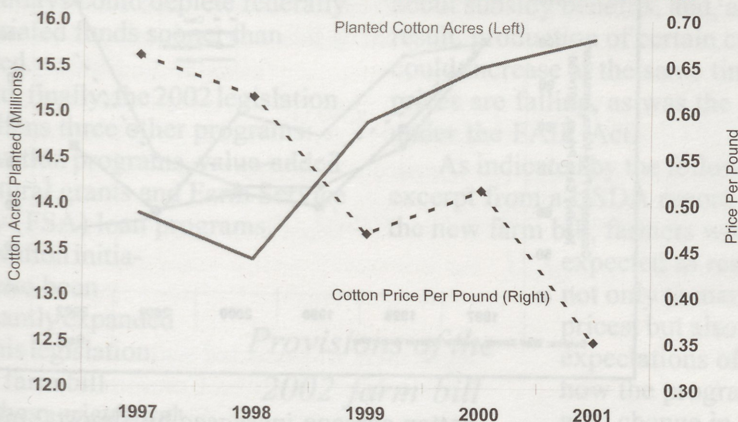
As farmland values have risen, insured financial institutions have increased lending secured by farm real estate. In fact, insured institutions nationwide reported a 90 percent increase in farmland loans for the 10-year period ending March 31, 2002, compared with 68 percent growth for all real estate loans. Increasing concentrations of farmland loans could be problematic for agricultural bank credit quality should the level of government payments fall at some point in the future, contributing to a decline in the cash flow from and value of farm real estate.

An Overview of the 2002 Farm Bill

The new farm legislation followed months of uncertainty for many farmers and their lenders about the nature and level of government payments. It allocates $190 billion over 10 years and differs markedly from the previous farm bill (the Federal Agriculture Improvement and Reform Act of 1996 [FAIR Act]), which was intended to promote a free-market ap-

[2] USDA/ERS, "Higher Cropland Value from Farm Program Payments: Who Gains?," *Agricultural Outlook,* November 2001.

[3] USDA/ERS, "How Important Are Farm Payments to the Rural Economy," *Agricultural Outlook,* October 2000.



proach. The FAIR Act removed acreage restrictions, allowing farmers to react to market signals as they decided what crops to plant. The FAIR Act also established transition payments to help offset the cost of changing crops or to make it easier for farmers to leave the agricultural sector.

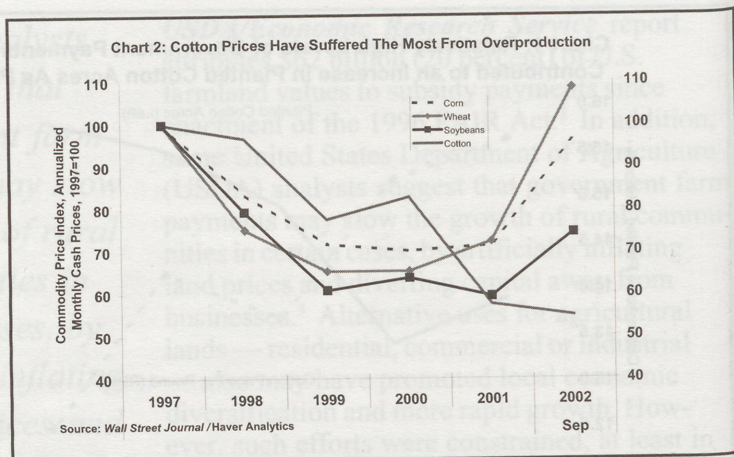
The new farm bill increases spending for commodity support programs by $31.2 billion during the next six years, of which $24.4 billion will be allocated to traditional program crops (corn, wheat, soybeans and cotton). The legislation provides income support to producers through direct payments, counter-cyclical income support payments, and loan deficiency payments.

Direct payments will serve the same purpose as the production flexibility contract (PFC) payments introduced in the FAIR Act. PFC payments were fixed payments based on a particular farm's historical acreage and yield and were intended to ease producers' transition to a free-market approach.

In addition to direct payments, the new farm bill introduces a ***counter-cyclical income support payment program*** intended to stabilize farm income when commodity prices are low. These payments are counter-cyclical because the payments will increase as commodity prices fall and are intended to alleviate the need for ad hoc federal emergency assistance, which contributed greatly to the overall cost of the FAIR Act.

Direct and counter-cyclical payments, as implemented by the new farm bill, will be influenced by incentives that were in place under the FAIR Act. These incentives prompted many producers to plant more acreage in crops that received higher subsidy payments, primarily cotton and soybeans, rather than follow market signals.

For example, as cotton prices fell 31 cents per pound (47 percent),



Source: *Wall Street Journal* /Haver Analytics

cotton acreage *increased* by almost 2 million acres (13.7 percent) following enactment of the FAIR Act (see Chart 1). During 2001, cotton prices averaged 35 cents per pound, 37 cents below the break-even price. Prices for all four commodities — corn, wheat, soybeans and cotton — have declined since the FAIR Act was implemented, contributing to a substantial increase in government payments from $7.3 billion in 1996 to $21 billion in 2001. Recently, prices for these bulk commodities have risen, in part, because of weather-related production declines (see Chart 2). However, these commodity prices are unlikely to remain at relatively high levels because the infrastructure and incentives for overproduction are still in place. A typical production year easily could reverse price increases, causing government payments to rise.

Under the 2002 farm legislation, farmers can reestablish their "base acres" (used to calculate direct and counter-cyclical payments) based on the past four years of production. As a result, subsidies are expected to rise under the provisions of the new legislation.

The 2002 farm bill also raises loan rates used to determine floor prices for ***loan deficiency payments*** for wheat, feed grains and upland cotton. The difference between these loan rates and current cash prices would result in large subsidy payments. Consequently, if

prices fall below current levels, subsidies will increase further, and these outlays could deplete federally appropriated funds sooner than projected.

And, finally, the 2002 legislation strengthens three other programs: conservation programs, value-added agricultural grants and Farm Service Agency (FSA) loan programs. Conservation initiatives have been significantly expanded under this legislation, and the farm bill establishes agricultural cooperatives to help stabilize farm income. The bill also increases benefits under the FSA loan guarantee programs — for example, waiving eligibility time limits on direct and guaranteed farm operating loans; increasing the number of producers who qualify for FSA emergency financing; and increasing and making permanent interest rate assistance for guaranteed loans. In addition, the bill streamlines application documentation procedures.

Provisions of the 2002 farm bill may contribute to excess production of certain commodities and, as a result, continue to depress prices.

The 2002 Farm Bill Will Boost Farm Income, But May Have Other Consequences

Provisions of the 2002 farm bill may contribute to excess production of certain commodities and, as a result, continue to depress prices. As farmers attempt to maximize the farm bill's benefits, supply and demand forces could become artificially constrained. Production costs and commodity price levels could become secondary to concerns about subsidy benefits, and, as a result, production of certain crops could increase at the same time prices are falling, as was the case under the FAIR Act.

As indicated by the following excerpt from a USDA report, under the new farm bill, farmers would be expected to respond not only to market prices, but also to expectations of how the programs may change in the future. Because producers have the option of updating base payment acres in 2002 from 1996 levels and the addition of soybeans to this payment scheme, farmers may have an incentive to continue producing crops and/or to expand production in order to maintain a production history in anticipation of future government payments.[4]

In addition, farmers' expectations about specific provisions that eventually would be contained in the new farm bill affected farmers' 2002 planting decisions. For example, an amendment to cap government payments was adopted by the Senate but failed in conference committee.

[4] USDA/ERS, *Farm Bill 2002: Analysis of Selected Provisions: Counter-Cyclical Payments*, May 2002. www.ers.usda.gov/Features/farmbill/analysis/countercyclicalpayments2002act.htm.

This amendment, which could have resulted in lost payments to an estimated 50 percent of cotton producers,[5] was debated when farmers were making this year's planting decisions.

Lenders' collateral and cash flow coverage, as well as farmers' equity and borrowing capacity, could be adversely affected.

Subsequently, the number of acres planted in cotton is projected to decline by 12 percent during the 2002 crop year. Even though the farm legislation was enacted without the caps, the Senate Appropriations Committee continues to debate payment caps. Should these caps be implemented through the appropriations process, payments on certain commodities could decline substantially.

Moreover, the recent enactment of Trade Promotion Authority legislation (Trade Act of 2002) could contribute to a reduction in federal agricultural payments as the Bush Administration has indicated its desire to lower agricultural subsidies worldwide as part of the World Trade Organization negotiations.[6] The emergency drought relief package in Congress represents another example of the Administration's resolve to curb agricultural subsidies. The Administration continues to insist that any drought aid be offset by reductions in subsidies as legislated in the 2002 farm bill.

Conclusion

The 2002 farm legislation continues the trend of high government payments to farmers. However, as this article emphasizes, circumstances exist under which these payments could decline in the future. Importantly, should the level of

[5] Agricultural and Food Policy Center, "Farm Level Comparison of H.R. 2646 and S. 1731," Working Paper 02-4, March 2002, p. 5.

[6] *Washington Post*, "WTO Negotiations May Hold Key to Bush's Legacy on Free Trade," July 28, 2002, Section A, p.A06.

government payments be scaled back at some point, and if commodity prices remain weak, rural land values likely would be subject to downward pressure. As a result, lenders' collateral and cash flow coverage, as well as farmers' equity and borrowing capacity, could be adversely affected.

Now is the time for farmers and lenders to understand the significance of government payments to the current level of farm income, farm land values and the continued profitability of agricultural banks. Business strategies should be developed to address the possibility that payment levels could decline at some point in the future. **jal**

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