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Implications of Budget Reconciliation for Commodity Programs

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There appears to be a renewed emphasis in Washington on reducing the federal budget deficit. Although the US economy is improving, it appears that the only way to make real progress in reducing the deficit is to reduce government expenditures. The desire to reduce the deficit, coupled with the President's agenda that includes several controversial and potentially costly items, has many in Washington discussing the possibility of budget reconciliation for fiscal year 2005/06 after a budget resolution is passed in 2005.

The details and intricacies of budget reconciliation are far beyond the scope of this paper. In general, however, if budget reconciliation happens, the budget committees will send instructions to authorizing committees indicating the amount of the required spending reductions relative to baseline spending. It will then be up to the authorizing committees (the agriculture committees in the case of most agricultural programs) to decide what programs are cut and by how much—as long as the required overall reduction is achieved. At this point, there is only speculation about what programs would be cut, but the agriculture committees would have a wide range of programs to choose from, including nutrition, export assistance, conservation, and commodity programs, to name a few.

Producers and their groups are having a hard time accepting the prospects of cuts in program benefits. They cite the fact that commodity program spending has been less than projected by the Congressional Budget Office (CBO) over the past few years due to higher actual prices than were projected. In their mind, this results in savings to the federal government, and they shouldn't be asked to take cuts. Unfortunately for producers, in the world of budget scoring, lower payments due to higher commodity prices do not represent budget savings.

The purpose of this paper is to discuss a few of the alternatives available to the agriculture committees for achieving budget reductions from commodity programs. The three primary mechanisms used to provide support to covered crops produced by US farmers are the countercyclical payment program (CCP), the marketing loan/loan deficiency payment program (ML/LDP), and direct payments (DP). The fact that these programs are interrelated has the potential to create additional issues that should be addressed prior to implementing changes to avoid unintended consequences (Table 1).

A hypothetical example is provided assuming that a 10% reduction in March 2004 CBO baseline spending levels is required over the 2005–2014 period. To project budget savings, a stochastic simulation model was developed to imitate the CBO budget scoring process and the results of achieving savings by implementing reductions in target prices, loan rates, direct payment rates, and the payment fraction. CCPs and ML/LDPs are received when the market price is less than the program's respective trigger level. As a result, a deterministic model, which uses mean prices, fails to score reductions in target prices and loan rates as a budget saving. A stochastic model, on the other hand, simulates the full distribution of prices, so any decreases in target prices and loan rates result in budget savings. It should be noted that changes could also be made to payment limits to achieve budget savings (although this paper does not consider payment limits).

The example will discuss the consequences of (a) reducing target prices that would reduce CCPs; (b) reduc-

Table 1. Impact of a decrease in current farm policy instruments on CCPs, DPs, and ML/LDPs.

Policy tool	CCP	DP	ML/LDP
Reducing target price	Decrease	No change	No change
Reducing loan rate	Increase	No change	Decrease
Reducing direct payment rate	Increase	Decrease	No change
Reducing payment fraction	Decrease	Decrease	No change

ing the direct payment rate that would reduce DPs; (c) reducing loan rates that would reduce ML/LDPs; and (d) reducing the 0.85 payment fraction used in the calculation of DPs and CCPs—essentially lowering both of these payments.

2004 CBO Baseline

The CBO develops baseline budget projections to give Congress a baseline to measure the effects of proposed changes in law against (CBO, 2002). For agriculture, CBO projects government expenditures, by program and crop, assuming a continuation of the current farm bill for 10 years. As a point of reference, the 2004 CBO baseline, projected CCP, DP, and ML/LDP payments for the nine major program crops is about $120.5 billion over the 2005–2014 period. Total DPs for nine crops (corn, wheat, cotton, grain sorghum, barley, oats, rice, soybeans, and peanuts) is estimated at $49.7 billion, whereas CCPs and ML/LDPs are $36.7 billion and $29.1 billon, respectively. It should be pointed out that current projections of market prices over the next few years are significantly lower than were projected in the example baseline (2004 CBO March baseline). This means that the 2005 CBO baseline that will be used for measuring savings will likely have significantly greater projected CCP and ML/LDP expenditures.

For this paper, the stochastic budget scoring model was optimized using optimal control theory to estimate the decreases in target prices, loan rates, direct payment rates, or payment fraction to achieve a 10% budget savings. The model was optimized once with an across-the-board percentage change in a policy variable (e.g., target price) to achieve the budget savings. Next, the model was optimized once for each commodity to find the percentage decrease in a policy variable (e.g., target price) to achieve a 10% budget savings for each crop.

Target Prices

Cutting target prices will reduce CCPs. Countercyclical payments are a safety-net payment triggered when season average price falls below the target price minus the direct payment rate. The CCP is paid on a historical yield (created in the 2002 Farm Bill) and base acreage, which is then reduced by the 0.85 payment fraction.

Using the 2004 CBO Agriculture baseline, it is estimated that a 4.5% cut in target prices would result in a 10% savings in government payments for the nine program crops over the 2005–2014 period. The problem with an across-the-board cut of target price is that it may not be an equitable way to achieve a budget reconciliation spending cut. The 2004 CBO baseline indicates that corn, wheat, and rice receive 30–33% of their payments from the CCP. In comparison, soybeans receive only 14% of total payments from CCPs, while peanuts and cotton receive more than half of their payments from CCPs. An across-the-board cut in target prices to achieve budget reconciliation instructions to cut spending would negatively impact soybeans, wheat, rice, and corn relatively more than cotton and peanuts. In other words, an across-the-board cut reduces the expenditures for some commodities more than others. Is this equitable?

Direct Payment Rate

Cuts to the direct payment rate would reduce DPs but increase CCPs. As the direct payment rate decreases, the CCP rate increases (in the absence of a change in the target price). Recall that the CCP rate equals target price less the direct payment rate minus the greater of the season average price and the loan rate. As a result, cutting the direct payment rate offers only limited benefits to meeting a budget reconciliation target, because rising CCPs offset DP cuts. Based on the 2004 CBO baseline for 2005–2014, it is estimated that a 50% cut in direct payment rate only saves 3% of spending to nine program crops, and cutting direct payment rates to zero only reduces federal spending for program crops by 5% because of increases in CCPs.

Additionally, the DP is a certain payment, whereas CCPs are risky. Therefore, cutting the direct payment rate to zero to achieve a 5% budget savings reduces producers' utility. Producers would lose $49.7 billion of certain DPs to gain access to uncertain CCPs. Another concern about cutting direct payment rates is that the DP is a decoupled payment, which was not included in the WTO cotton case brought against the United States by Brazil (see Mercier paper, in this issue).

Loan Rate

Reducing the loan rate will reduce ML/LDPs and increase CCPs (in the absence of other changes). To the extent that loan rates exceed producers' expected prices, loan rates encourage increases in supply. So, a reduction in loan rates can be expected to reduce the production over which ML/LDPs are paid. However, as the loan rate falls, the maximum CCP rate increases. Using the 2004 CBO baseline, it is estimated that a 17% cut in loan rates for the nine major program crops would reduce government payments to these crops 5%. (Note that this calcu-

lation ignores the supply response of lower loan rates.) With 17% lower loan rates, CCPs would rise about $10 billion—more than offsetting the $4.7 billion decline in ML/LDPs. This leads to the conclusion that cuts in loan rates are not a feasible option for reducing spending on the nine program crops.

Equity issues would also occur with cuts in the loan rate. In the 2004 CBO baseline, cotton receives only 2% of its government payments from ML/LDPs, whereas soybeans receive 53% of their payments from LDPs. Corn, wheat, and rice receive about 20% of their payments from ML/LDPs. Therefore, an across-the-board percentage cut in loan rates to meet budget reconciliation instructions to cut spending would mean soybeans would be footing most of the required budget savings for other crops (corn, wheat, rice, and cotton).

Payment Fractions

A payment fraction of 0.85 is used to reduce the DP and CCP by 15% in the 2002 Farm Bill. Cutting the payment rate fraction is a simple way to reduce government payments. Reducing the payment rate fraction from 0.85 to 0.74 would yield an estimated 10% reduction in government payments for the nine program crops over the 2005–2014 period. Producers would probably dislike this approach, because it reduces the certain DPs, and it makes some crops pay less than their share of the budget cuts. Cotton and peanuts receive about 97% and 89%, respectively, of their government payments in the form of DPs and CCPs, whereas soybeans receive only 47% of their payments from DPs and CCPs. Rice, corn, and wheat receive roughly 80% of their government payments from DPs and CCPs, so they would not prefer cuts in the payment fraction rate. Soybean producers, however, may prefer this method of achieving a budget reconciliation reduction, because they receive a relatively smaller portion of their government payments from CCPs and DPs.

Summary

Under the 2004 CBO baseline, the projected CCP, DP, and ML/LDP program payments for the nine major crops is $120.5 billion over the 2005–2014 period. It is anticipated that Congress will pass a budget reconciliation bill in 2005 requiring the House and Senate Agriculture Committees to comply with the budget reconciliation guidelines. The provisions of the 2002 Farm Bill make it difficult for the agriculture committees to cut payments by simply cutting target prices, loan rates, or direct payment rates.

A cut in the direct payment rate or cut in the loan rate increases CCPs. Cutting the payment fraction is the easiest tool to use, but it reduces both DPs and CCPs, making farmers worse off than simply cutting target prices and reducing an uncertain government payment.

Across-the-board cuts are easier to manage but raise significant equity issues. Cuts in loan rates put the burden of budget savings for the whole farm bill disproportionately on commodities that benefit more from LDPs. Similarly, cuts in target prices put a greater burden on a different group of commodities. To reduce the impacts of equity issues, the agriculture committees may need to consider reducing policy variables differently for each of the commodities.

A common ground that all program commodity producers share is a preference for DPs over CCPs and LDPs. Expected utility theory suggests that decision makers prefer a certain income over a similar but uncertain income. Any policy change that reduces DPs so farmers have to rely more on LDPs and CCPs will be met with disfavor.

For More Information

Congressional Budget Office. (2002) *The Congressional Budget Office: Who We Are and What We Do*. The Congress of the United States, Congressional Budget Office, Washington D.C.

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