

1996 Farm Bill: A Price Response Experiment

Prepared Comments of Daryll E. Ray¹ Testimony before the Democratic Policy Committee

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The 1996 Farm Bill was intended to be transition legislation. The vision was that if we “give the market a chance” there would be no need for restrictive government programs that can distort prices and constrain farmers’ ability to freely decide which crops they plant. Acting on that vision, the 1996 legislation eliminated all farm program mechanisms that support or moderate farm prices or restrain, or in some way affect, planted acreages. The vehicle for transition in the legislation was a gradual reduction in direct payments to farmers over the seven-year life of the legislation. While not expressly written into the legislation, the stated intent of the legislation’s most ardent backers was that the transition was to be to total elimination of farm programs after the 2002 expiration of the legislation. But in reality, we do not appear to be headed to either transition. Government payments have increased to record levels, not declined. With the price and income experience of the last two years, elimination of all farm programs, including mechanisms to distribute emergency farm payments, seems highly unlikely.

The 1996 farm legislation has provided us with a real-time public policy experiment where the farm economy is the lab. If the hypothesis for acceptance or rejection in this experiment is: the Freedom to Farm legislation generates a prosperous agriculture, then all observers but a devoted few would likely reject the hypothesis. But, framing the hypothesis in that way sets the stage for a host of situational “only if” reasons or excuses why Freedom to Farm legislation didn’t work. For example, Freedom to Farm would have worked *only if* decoupled emergency payments had not been paid to financially strapped farmers allowing them to continue to produce. It’s true that the payments may have made it possible for some farmers to continue in agriculture. But the implication of the statement is that, if emergency payments were not made, crop production would decline sufficiently to rebalance inventories and all would be well. This notion disregards that, as a rule, other farmers take over the land of exiting farmers and production does not necessarily decline and may even increase. Or *only if* crop insurance didn’t encourage farmers to plant crops in high risk areas. Here again, there are no doubt instances in which the existence of crop insurance improperly influences planting decisions of individual farmers. Of course, insurance programs should be structured to minimize cost and opportunities for misuse, but the implication is that restructuring crop insurance will permanently solve agriculture’s price and income problems. These and other “only ifs,” like the long list of “only ifs” of the last couple of decades, generate inventory balancing and price moderating expectations but, when unfulfilled, confuse and frustrate farmers. {I am sure each of you can recite the litany of past “only ifs” just as I can: *only if* loan rates were lower, *only if* interest rates were in single digits, *only if* government payments were decoupled, etc. }

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Getting back to the public policy experiment idea, the Freedom to Farm legislation makes the market experiment possible while the hypothesis under test is the price responsiveness of the crop markets. For the last seven decades, we could only speculate about how price responsive farmers and users of farm products would be in free market environment. Even simulations based on econometrically estimated price response coefficients can't compare to observing markets in operation. We are engaged in an experiment—an experiment to reveal price responsiveness of grain/soybeans/cotton and rice markets under (near) free market conditions. Recall that it was the lack of price responsiveness that forced the enactment of farm programs in the first place. During the 1930s, output growth outpaced demand growth causing lower prices, but farmers did not respond by significantly reducing output nor did consumers respond to the lower prices by significantly increasing the quantity demanded. Inventories kept building and prices kept plummeting. Because the market did not work, farm programs were instituted. Thus, in the final analysis, it is abundantly clear to me, that whether or not returning crop agriculture to free markets is sustainable turns on the price responsiveness issue. This is very important. Price responsiveness IS the fundamental farm policy issue. It underlies the performance of all farm program approaches.

So what have we learned the last four years and what have been the consequences of designing farm policy specifically for expanding grain exports?

- Farmers have not responded to low crop prices by significantly reducing cropland acreage. Harvested acreage of the eight major crops declined from 239 million acres in 1997 to 230 million acres in 1999 or 3.7 percent. Using the index of crop prices for March 1997 and March 1999 as supply price response proxies for the 1997 and 1999 crops respectively, crop prices declined by 15.5 percent. This 3.7 percent reduction in acreage in response to a 15.5 percent reduction in the price translates into a two-year supply elasticity of 0.24.
- At the farm level, the experiment is resulting in a rapid deterioration of financial stability on our farms. More than 80 percent of FAPRI's 43 representative crop farms are projected to experience cash flow deficits over the next five years. Nearly half of all the crop farms are faced with a high probability of having to refinance their deficit before 2004.
- Domestic demand for crops has continued its long-term upward trend but exports have been flat since the mid-1980s. This pattern has continued after the crash in crop prices in 1998. Neither domestic demand nor export demand response to the lower prices has been close to a sufficient level to have a significant impact on rebalancing inventories.
- Recent experience with farm markets suggests that it is time to "Get Back to the Basics" of grain market economics. Clearly, the supply and the demand structure of grain agriculture is not a textbook case. Crop agriculture supply and demand do not react robustly to price declines like the markets for other sectors. It is not that agricultural economists were not aware of the way grain markets work, because they were. But beginning in the seventies, what used to be conventional wisdom about how grain markets work was drowned out by a very compelling argument that the nature of agricultural markets had changed to the point that the crop sector can now adjust rapidly to changes in economic conditions just as the textbook suggests. As great as that would

be, a more price responsive interpretation of grain markets has been proven wrong by the most definitive sources of all, the markets themselves.

- Grain markets are different from other markets. In the case of supply, even though prices decline, farmers use their land to grow something when other sectors would shut down their plants. Farmers tend to stay in agriculture as long as they can, but if financial bankruptcy forces some farmers to leave agriculture, other operators typically take over the land and continue agricultural production. Land tends to stay in agriculture operated either by the current farmer or the farmer who replaces him. In another industry faced with a continued oversupply of its product, land and other resources would be shifted to a totally different industry. Thus, in agriculture, since land tends to be used in agriculture no matter what, total crop supply declines very little even when prices plummet.
- In the case of domestic demand, by far, the characteristic that most defines the nature of food (and feed and other indirect food ingredient demand) is its absolute requirement for life. Because it is a necessity for life—like insulin for a diabetic—price is of little consequence. You will pay whatever is required to purchase the food that you need but you will purchase little more even if prices drop to near zero. Again, this minimal price response does not characterize the demand for most nonagricultural products.
- What about exports? We have been told that the export markets would do two things for grain agriculture. First, exports will be the source of demand growth for major crops. Secondly, exports would serve the price buffering function that government and Farmer-Owned-Reserve stock programs used to do. When prices fall, exports would expand sufficiently, we were told, that inventories would rebalance and prices would rebound. Neither has occurred.
- Not only have crop exports not been the driving force behind crop demand since 1985, but grain exports have not even increased. When viewed as averages over farm bill periods since 1985, major crop exports have decreased. It's domestic demand that has shown steady growth. Export trends for corn and soybeans are flat and exports trend downward for wheat. The "keep-prices-low" orientation of farm bills since 1985 has failed to expand exports of program crops. In fact, since 1985, crop export shares have lost ground both internationally and domestically. Exports of major U.S. crops represent smaller percentages of world exports and smaller proportions of total U.S. grain and soybean disappearance than before the U.S. lowered price supports and instituted other measures designed to increase exports, including recent use of marketing loans that allow market prices to fall below support prices.
- We have learned over the last 15 years that there are special circumstances that surround the export market that often overpower the influence of price. Governments of nearly all countries intervene in farm markets. For many countries, especially those that have experienced food shortages, wars, and other instabilities, any short-term economic distortions from government interventions in markets are dwarfed by longer-term considerations including preservation of the country itself, domestic tranquility, and economic and political independence. While the WTO and other trade organizations will have some successes freeing trade, it is naïve to think that these countries will experience a wholesale withdrawal of support for their farm sectors. When it comes to food and those that produce it, I am confident that countries will use traditional means and invent

imaginative new ways to protect the availability of one of the most basic requirements for life and those that produce it. As difficult as it may be to accept, economic efficiency considerations often lose out to non economic considerations in the case of food and food related products.

- In summary, its time to get back to basics. The 1996 act has confirmed that the price responsiveness of the total-crop supply and demand is low—low like agricultural economists knew it to be prior to the export-induced frenzy of the 1970s and 1980s. Once the low price responsiveness for aggregate (major) crop agriculture is acknowledged, a much broader set of policy alternatives becomes available for consideration.