Setting the non-recourse loan rate and release price

The US instituted a non-recourse marketing loan program to enable farmers to avoid having to sell their crop at harvest time, a time when prices are usually at their annual low. Instead of selling their crop, farmers can take out a 9-month, low-interest loan with the government. Farmers often use the loan to pay off production expenses, but there are no conditions on how they can use the loan.

The farmer can then wait for higher prices before paying off the marketing loan plus the accrued interest. This marketing loan has allowed farmers to engage in the orderly marketing of their crop at prices that are higher than those available at harvest. In the case where the market value of the crop at the end of 9 months does not exceed the value of the loan plus accrued interest, the farmer can forfeit the crop to the government as full payment of the loan. The farmer does not have to make up any shortfall in the value of the crop at the time of forfeiture; the government does not have recourse to any of the farmer's other assets to pay off the difference.

This marketing loan program is at the center of the APAC/TFU (Agricultural Policy Analysis Center/Texas Farmers Union) supply management program. The key to its role in the proposed program is the level at which the loan rate is set. The goal is to set the loan rate at a level where there is no need for additional programs.

In the past, when the loan rate was set too low, Congress had to establish a second Counter-Cyclical Payment program (CCP) to provide the level of net farm income necessary to maintain a robust crop agricultural sector.

It makes little sense to us to develop a secondary program to make up for the deficiencies of the primary commodity program, whether the primary program is the historic supply management program, the unencumbered free market program that resulted from the adoption of the 1996 Farm Bill, or the current revenue insurance program.

The task before the Congress as it writes the 2018 Farm Bill is to develop a program that gets the policies right in the first place so there is no need for counter-cyclical payments, emergency payments, loan deficiency payments, or payments under either the current Agricultural Risk Coverage or the Price Loss Coverage programs.

In the APAC/TFU proposal, the loan rate for corn is set at 95 percent of the olympic average of the national full cost of production for the prior five years. History indicates that once the marginal over-supply is taken off the market the minimum season average price paid to farmers for their corn is generally at least 10 percent above the loan rate.

Because corn is the dominant crop in the US, the loan rates for other crops are set at their historic ratio to corn. Over the last decade the corn-to-soybeans ratio of the season average prices paid to farmers was 2.5 to 1 (2.5:1); for wheat, the ratio was 1.44:1. The loan rate for all covered crops was set to their historic ratio. The one crop for which the APAC modeling does not use the historic ratio is grain sorghum. The corn to grain sorghum ratio was set at 1:1 to encourage the raising of dryland grain sorghum instead of irrigated corn over the Oglala Aquifer, slowing the depletion of that important aquifer.

By using the historic ratios, the loan rates do not skew the planting decisions of farmers. For instance, when the soybean-to-corn ratio increases to 2.8:1, some farmers will reduce their acreage of other crops to produce more soybeans. Similarly, if the soybean-to-corn ratio drops to 2.2:1, farmers will move acreage out of soybeans and into another crop, increasing total corn acres. By using the historic ratios, the APAC/TFU supply management program allows for planting flexibility rather than crop by crop interventions.

The commodities that are forfeited to the government under the marketing loan program are held by the government until they are needed by the market because of a production shortfall or an unanticipated increase in demand. The price at which agricultural commodities are sold into the open market is called the release price. In the model, the release price was set at 1.75 times the loan rate.

Establishing a wide price band allows the market to work relatively efficiently in guiding farmer planting decisions and allocating the available supply among competing uses. At the one end, the loan rate protects farmers from long periods of low prices and at the other the release price sets an upper bound, protecting consumers.

As we have seen in the 2007-2012 period, neither is an extended period of prices well above the full cost of production in the best interests of farmers because those prices bring sufficient resources into production to result in an extended period of low prices, as we have seen over the past 4 years.

Next week this column will focus on reviewing the complaints that have been made against setting high loan rates like the ones we used in the APAC/TFU supply management study.

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Dr. Harwood D. Schaffer: Adjunct Research Assistant Professor, Sociology Department, University of Tennessee and Director, Agricultural Policy Analysis Center. Dr. Daryll E. Ray: Emeritus Professor, Institute of Agriculture, University of Tennessee and Retired Director, Agricultural Policy Analysis Center.
Email: hdschaffer@utk.edu and dray@utk.edu; http://www.agpolicy.org.