Farm program considerations: Part 4

In our recent columns, we have talked about the importance of a price band as an essential part of establishing a supply management program for the major row crops. Equally as important as setting the loan rate at the proper level (http://tinyurl.com/hh5v3wz) is the setting of the release price.

Together, the loan rate and the release price establish a band within which the price of a crop like corn varies in response to market signals. The loan rate serves as a floor on prices because farmers can take out a government loan on their crop or a portion thereof at that rate and if the local price at the end of the loan period is below the loan rate plus interest, farmers can forfeit the crop as full repayment of the loan.

The stocks that are acquired through the crop loan program are held by in a reserve that is isolated from the market and can be accessed in response to a decline in production—usually as a result of weather or disease problems—in a given crop year or an unanticipated spike in demand that result in large price increase.

The release price determines the price at which reserve stocks begin to be sold into the commercial market. With an adequate reserve supply, the price remains within a band between the loan rate and the release price. The price band serves to protect producers from extended periods of low prices and consumers from a sudden and often temporary period of high prices.

The price band also benefits the market by preventing prices that are so high as to signal the need for farmers to bring extra acres into production when all that is needed is for the current extraordinary year to be followed by a year of normal yields and demand. It also benefits US export markets by having adequate stocks to meet their needs. In recent years, with no reserve, those customers have had to turn to other nations for their supplies.

One of the critical questions is where to set the release price in relationship to the loan rate. Set the release price too close to the loan rate and the price band becomes too narrow to provide meaningful market signals to both producers and consumers. If the release price is set too high, then customers are not protected from high prices and farmers are tempted into overreacting and increasing production "too much" in subsequent years.

If the US were to make a supply management program the cornerstone of future agricultural policy, we would suggest starting with the release price set at 175 percent of the loan rate. The ideal level could be somewhat higher or lower, but based on reading of history that is a price that would allow market forces to set production signals most of the time.

With the basics of the price band behind us, we want to turn to some of the criticism that have been leveled at supply management programs.

The one that we often heard from policy makers was that supply management programs guarantee farmers higher prices which, in turn, get capitalized into fixed resources like land. To some extent, we would agree. In particular, the most efficient farmers would benefit from a loan rate that is near their long-term cost of production. Any profit that they would make would be used to purchase extra land at prices that could not be matched by farmers whose long-term costs were higher. But that is always true and is not the unique result of a supply management program.

In our experience, it does not matter where the extra money comes from, it will be capitalized into land. It does not matter if the extra money comes from direct decoupled payments, counter-cyclical payment programs, or revenue insurance, a portion of it will be capitalized into land, resulting in higher land costs.

If a farmer and/or spouse works in town that extra income is likely to result in higher land prices, not because that farmer will use it to purchase more land, but rather because they are able to keep farming and thus keep their land from coming on the market, thereby putting downward pressure on land prices.

But compared to the way the revenue insurance program operated when prices were high, supply management programs have a very small impact on land prices. By guaranteeing revenue that is well above the full cost of production, as was the case in previous years, subsidized revenue insurance provided farmers with the wherewithal to drive up land prices and land rental rates, increasing production costs for nearly all producers.

If a supply management program had been in force in the late 1990s, farmers would not have had the incentive to lobby so hard for programs and policies to set blend requirements for mixing ethanol into the national gasoline supply.

In the absence of ethanol blend requirements and subsidized crop insurance, it is not hard to make the case that the increase in land prices would not have been anything like what we have seen over the last decade. Much of the crop insurance subsidy was capitalized into land at a level far above what would have happened with a supply management program.

Farmers often complained that the floor price, established by the loan rate, became a ceiling price as well. When the loan rate and the release price are set too close together, that is true. The solution is not to stop setting a reasonable loan rate, but rather to set a release price high enough to allow the market to work without bringing unnecessary land into production.

Critics also argued that farmers were farming the program instead of responding to market signals. That is true. Here the problem was setting base acres and setasides for each individual crop so that farmers established their cropping program to protect their base acres.

One of the few things that the 1996 Farm Bill got right was to allow for planting flexibility. With planting flexibility farmers can respond to market signals in planning their cropping patterns.

Overall, we believe that a supply management program would be less expensive than current programs while protecting farmers against long periods of low prices and consumers against a run-up in prices. Moreover, government costs would be lower than they have been over the last decade.

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