POLICY PENNINGS

By Daryll E. Ray

Wiring the production throttle wide open

To hear some talk, you would think that the reason crop prices and market incomes are low is mysterious and difficult to figure out. Farmers know the reason: We are producing a greater quantity of the major crops than can be sold at profitable prices. This is not a new phenomenon. Except for rare and relatively short export-demand spurts, crop agriculture's capability to produce has exceeded demand growth for nearly a century.

The only difference between now and then is that for six of the last ten decades we had policy instruments to throttle back the use of agriculture's productive capacity as appropriate.

But, instead, since 1996 agriculture has kept the pedal to metal—on the curves as well as the straightaway—and farm prices and market incomes have crashed. Sure, it can be argued that it was raining on the road/track (promised export growth did not occur, exchange rates were 'high,' world economy slowed down, etc., etc., etc.) and the curves were not sufficiently banked (lower prices didn't generate much additional demand). Nonetheless, the crash could have been avoided if farmers had been less lead-footed.

So, why do farmers keep the production throttle wide-open when producers in other sectors would cut-back production sharply? Since each farmer produces too little to affect total supply, farmers have no incentive to reduce production as prices decline. From an individual farmer's standpoint, any reduction in her/his output means less revenue so there is no rational reason for him/her to leave land idle when crop prices tank. As any farmer can tell you: Cropland will be farmed, either by the existing farmers or by the ones that replace them.

Some contended that since farmers let land lie idle under the 0/92 program of the 1990 Farm Bill, they would let the same land lie idle under the new bill since they get 100 percent of the contract payment no matter what. But under previous legislation, the only way farmers could receive 92 percent of the payment was by idling the land. Since farmers don't have to idle land to get the payment under the new legislation, they, of course, don't.

Planting flexibility is great. But we should also understand what it accomplishes and what it does not accomplish. Planting flexibility affects crop mix but has little impact on total area planted. While farmers can plant any program crop they want and while total flexibility includes the possibility of planting nothing, in reality, farmers will plant something.

As long as a farmer can scrape together enough money to plant crops, he/she will continue until the family's equity is nearly depleted or the bank won't let him/her in the field. It matters not whether the money comes from market sales, coupled or decoupled government payments, outside employment, the spouse's job, or a loan from the bank. Farmers are committed to farming and will continue to farm as long as possible! Would this level of persistence be observed in any other industry? Of course not. No other sector would allow price to approach the cash cost of production, let alone, drop below it. Output would have been curtailed to better match demand long before the price dropped to the cash cost of producing the product.

If the farmer goes bankrupt, the land is purchased by another farmer and remains in production, perhaps at a high productivity level. Would this happen in another industry? Of course not. If the tire industry becomes undeniably overbuilt, high cost plants are permanently closed. The plant is not purchased by another tire company and put back into production; the assets are sold for use in another industry.

The bottom line is that total crop acreage (supply) is unresponsive to price declines in both the short and long run. That characteristic, alone, does not doom crop agriculture to depressed prices and incomes. It takes two additional conditions to do that, both of which we have discussed in recent columns.

One is the tendency for the total supply of major crops to grow faster than demand. That is, public and privately supported development of new technologies typically shifts the crops' supply curve faster than population and income growth expands demand.

Having excess productive capacity is not the problem. (Erring on side of too little agricultural productivity growth over time—now that would be a problem!) All industries strive to have more productive capacity than is normally needed. The difference is that other industries use only the productive capacity that is needed to meet current demand at profitable prices while crop agriculture tends to use all its collective crop production capacity all the time.

The other is that low prices do not cause the quantity demanded to increase sufficiently to reduce inventories and allow prices to recover—the need for food/feed is about the same whether food prices are high or low.

Under this combination of price unresponsive supply, price unresponsive demand and supply shifting faster than demand, prices and market incomes can be expected to be chronically depressed unless production is systematically throttled-back to better match demand. In the past, policy "governors" were available to override farmers' propensity to wire production throttles wide-open. Without such governors, more billions of taxpayer dollars are sure to be paid to farmers in lieu of their receiving market returns for more economically justifiable production levels.

This and the previous three columns were based on my testimony before the House Committee on Agriculture on February 14, 2001. The full testimony is available on our website: http://www.agpolicy.org.

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