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PolicyPennings by Dr. Daryll E. Ray

# Reform is in the eye of the beholder

Those expecting major reform in the shape of farm bill legislation are now turning their attention to the Senate. While the House legislation included an adjusted gross income cap, country-of-origin (COOL), extra money for fruit and vegetable growers, an alternate revenue-based program for counter-cyclical payments, and some expansion of conservation programs, it fell short of the dismantling of the direct payment and marketing loan program that some were angling for.

That leaves the Senate as the last hope of those who are looking for significant changes in commodity policy. The target continues to be the direct payment, marketing loan, and counter-cyclical payment programs which deliver the bulk of the government payment dollars to farm producers. One central question is: How and why did commodity policy drift into such a heavy reliance on payments?

Several elements contributed to this payment trend in the 1980s that affected all major crops such as the target-price based deficiency payment program. Other changes during this time affected a few crops early-on, but later were applied to all program crops.

The marketing loan program, including Loan Deficiency Payments and Marketing Loan Gains, (LDP/MLGs), also was initiated in the mid-1980s as a means of making US cotton and rice prices more competitive in the world market. The theory at the time was that US loan rates had been too high—above world prices—pricing US commodities out of the world market and forcing the US to become the residual supplier.

The LDP/MLG was established to allow the commodity to be sold at a price below the loan rate—the world price—with the US government making up the difference. Over the years this program was extended to other program crops and was made fully functional for all crops in the 1996 Farm Bill.

It was the establishment of this program and the elimination of the effectiveness of the non-recourse loan rate that allowed US farm production to be sold into the world market—as well as the US domestic market—at fire sale prices. These fire sale prices were well below the cost of production, opening up the US to charges of dumping.

Unrecognized with this policy change was the reality that the US is the oligopoly price leader in most major crops. Under these conditions competitors who want to move their product, price it just under that of the oligopoly price leader and float their product out of their ports. Price-followers can successfully engage in this marketing strategy to clear their markets. If the price of corn is $2.80, the price followers sell their corn for $2.60 a bushel. Likewise, if the price of corn is $1.85 a bushel, the price followers have no choice but to sell their corn for $1.65 a bushel if they want to clear their markets and make room for next year's production.

Three things became apparent. One was the explicit or implicit assumption of US policy makers that $1.65 corn would force others in the world to reduce production, allowing the price to increase. They didn't. Like farmers in the US, they planted in hopes that others would either make the acreage adjustment or experience a crop failure. When neither happened, crop prices remained in a sub-$2.00 trough for four years.

A second unrealized assumption was that low prices would dramatically increase export demand, bringing additional consumers into the market and sop up any excess production. With the excess production out of the market, prices would rise and farmers would be back in a profitable production situation. While exports and total demand may have increased some in response to the low prices, the adjustment was not nearly enough to return crop markets to profitability as US farmers came to depend on LDP/MLGs not only to provide some net farm income, but also to help them cover some of their production expenses.

The third was a reminder that a lowering-the-price strategy benefits price-followers but not the price-leader. The price-leader is unable to get under his own price. When the price leader reduces the price everyone goes down in tandem retaining the same relative price position. When you play limbo with yourself, you lose every time. And that is what happened to the US's use of LDP/MLGs.

The direct payments, in the form of decoupled AMTA payments, were established in the 1996 Farm Bill as means of weaning farmers off farm programs in a new economic environment that some said made farm programs unnecessary and counter-productive. The idea was to reduce the AMTA payments over a series of years until they reached zero. That never happened. The AMTA payments were decoupled from crop allocation decisions—farmers no longer had to worry about base acres—but they were not decoupled from farm profitability.

They provided an advance payment that allowed farmers to pay their rent without having to sell corn or take out an operating loan at the local bank. The AMTA/direct payments allowed some farmers to offer higher rental rates to landlords in hopes of increasing the size of their operation. At the aggregate level, the AMTA/direct payments also allow US producers to sell their crop into world markets at prices below the cost of production, because they include these payments as part of their gross income.

By 1998, even AMTA and LDP/MLG payments were not enough to keep the US crop sector afloat as prices plunged to sub-$2.00 price levels. And, compared to pre-1996 legislation, the list of available policy options to address the situation was indeed short. There was no Farmers-Owned-Reserve to take excess supplies off the market nor was there a set-aside program to reduce excess supplies in succeeding years. Congress responded by legislating emergency payments each of four successive years. This led to an early replacement of the 1996 legislation with the 2002 Farm Bill. The new bill included a counter-cyclical payment program much like the deficiency payment program that was cancelled in 1996—a program that, in effect, institutionalized the emergency payments.

Present payment programs do nothing to reduce production when prices fall so farmers continue to use all their acreage and other resources to produce one crop or another full-out, no matter what. That works fine when demand is exploding but can require a lot of taxpayer backfill when total crop production outstrips demand. Backfilling with money has been the choice of late to deal with agriculture's undeniable inability to self-correct on its own in a reasonable time frame. As mentioned, policy tools that could be used to adjust market supplies when demand falters are no longer legislatively authorized.

In general, farmers do not voluntarily idle productive cropland and food consumers do not increase total food consumption much with a general drop in food prices. Those are, of course, the two primary market-based ways to activate self-correction when prices plummet.

While backfilling with taxpayer money—rather then gauging output to meet demander needs at prices that cover production costs—is out-of-step with how other sectors operate, the nature of aggregate crop supply and demand suggests care should be taken as consideration is given to commodity policy possibilities.

It is the Senate's turn to suggest the direction for commodity and other agriculturally-related policies. Reform means different things to different people. It will be interesting to see what it collectively means to the 100 members of the Senate.

*Daryll E. Ray holds the Blasingame Chair of Excellence in Agricultural Policy, Institute of Agriculture, University of Tennessee, and is the Director of UT's Agricultural Policy Analysis Center (APAC). (865) 974-7407; Fax: (865) 974-7298; dray@utk.edu; http://www.agpolicy.org. Daryll Ray's column is written with the research and assistance of Harwood D. Schaffer, Research Associate with APAC.*

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