

Politics and the Public Interest in Farm Policy

Five Litmus Test Issues

Five programs, although not the most important features of farm policy, provide the most clear-cut examples of bad policy that I came across in my year of farm bill study and debate in Washington. In the context of farm policy, the actions that Congress takes on these programs provide a litmus test of whether federal policy today is driven by politics or the public interest.

Rice and cotton price support programs

Federal farm programs provide support to agricultural producers in two principal forms: deficiency payments that are linked to base acreages that each farmer has ascribed to each program commodity, and price support payments. Deficiency payments effectively compensate farmers for the difference between a fixed "target price" and the market price (or price support level, if it is higher). These payments are not tied to a farmer's actual per-acre production; instead, they compensate for a fixed per-acre yield that is invariant to a farmer's actual yields. To some extent, the payments do depend upon a farmer's decision about how many acres to plant to the program crop. However, if the Clinton administration's proposals to increase farmers' planting flexibility are enacted, deficiency payments will be further decoupled from acreage planting decisions. With such reforms, deficiency payments will not provide incentives for overproduction because, quite simply, farmers will not affect their payments when they adjust their production decisions.

For the wheat, feedgrains, cotton, and rice programs, price supports provide a floor on the price which farmers receive for their output; they pay farmers any positive difference between the support price (which is also called the loan rate) and a relevant market price (also called the repayment rate). This difference is paid on each and every unit of the program commodity that a farmer produces.

In the wheat and feedgrain programs, the support price is allowed to fall over time in response to market forces. As a result, price supports for these commodities serve to offer some rather minimal price insurance to producers. Because this insur-

ance comes at no cost to producers, the programs give producers a higher reward for their output, on average, and thereby provide some incentive for production beyond that which would be available in free markets; however, most analysts agree that this incentive is small. Over the past four years, for example, support prices for wheat and feedgrains have been substantially below market prices.

by Robert
Innes

Overall, the rice program costs taxpayers about \$1 billion per year for about 18,000 farmers.

The same cannot be said for price support programs for rice and cotton. Both of these programs differ from their counterparts for wheat and feedgrains in two respects. First, both programs specify minimum price support levels below which the support price cannot fall, regardless of market conditions; wheat and feedgrain programs, in contrast, do not have rigid minimum support prices. Second, both tie repayment rates to an international price index that is substantially below the domestic price; wheat and feedgrain programs, in contrast, tie loan repayment rates to the domestic price. Because higher price support levels and lower repayment rates translate into higher price support payments to producers—also called marketing loan payments—these two features of the cotton and rice programs have led to higher payments for the commodity producers. Moreover, because these payments are made on each and every unit of output produced, they provide incentives for increasing

Table 1. U.S. federal commodity programs

	Average Government Payment per Farmer in 1993	Approximate Price Subsidy 1991-94
Corn	\$8,600	20%
Wheat	\$5,000	26%
Cotton	\$22,000	76%
Rice	\$48,000	99%



both acreage plantings and per-acre yields of these commodities. Such incentives are above and beyond what the market would provide, leading to overproduction, which may sometimes be achieved with more intensive use of pesticides and fertilizers. As table 1 indicates, rice and cotton industries have also been among the greatest beneficiaries of federal commodity programs (including both deficiency payments and price support payments).

Program 1—rice

For rice, the support price has been set at its minimum level, \$6.50/cwt (hundredweight), throughout the past five years. Marketing loan payments have averaged about \$1.00/cwt—or 17 percent of the international price index—over this period. Over the coming five years, the Office of Management and Budget (OMB) projects that marketing loan payments for rice will be lower, but still noteworthy, averaging about 72¢/cwt—or 12 percent of the international price index—for a five-year taxpayer cost of about \$730 million. These benefits are over and above deficiency payments that will compensate for the difference between the rice target price, \$10.71/cwt, and projected market prices in the \$6.50 to \$7.50 range. Overall, the rice program costs taxpayers about \$1 billion per year for about 18,000 farmers.

The rice program creates particularly severe overproduction incentives because of its peculiar marketing loan provisions. These provisions (minimum support price and world price repayment) should be revised to be consistent with those for wheat and feedgrains. Such a reform would reduce support to rice, but still maintain a high level of support to a commodity that has received particularly large government benefits.

Program 2—cotton and Step 2

For cotton, the situation is somewhat different. In the recent past, the support price has generally been

set above the minimum level of 50¢/lb. Nonetheless, the last three years have seen marketing loan payments averaging a little over 5¢/lb—or 11 percent of the international price index. Over the coming five years, OMB projects that international cotton prices will be above the support price, so that no marketing loan payments will be required. Such economic circumstances may offer Congress an opportunity to improve the structure of the cotton price support program, bringing its program provisions into line with those for wheat and feedgrains, without adversely affecting producers.

The picture in cotton, however, is not complete until one figures in the Step 2—or user marketing certificate—program that is unique to cotton. Like the price support program, the Step 2 program leads to farmer-received prices that are higher than free-market levels, thus favoring increased cotton production. Step 2 works by paying exporters of raw cotton—and domestic cotton mills that buy raw cotton—the difference between domestic and international prices for cotton. Without this program, buyers of raw cotton would only be willing to pay the international cotton price for the domestic cotton that they buy. However, with Step 2, buyers of domestic cotton pay the international price for their purchases, even if the domestic cotton price level happens to be substantially higher; this is because Step 2 payments effectively reduce the cotton price that these buyers have to pay. As a result, there is no economic force that drives domestic prices down to international levels, as would happen under free markets. Over the past three years, for example, U.S. cotton farmers were paid a market price that was an average of 9¢/lb above the adjusted world price.

Overall, the sugar program is widely recognized as anachronistic and counter to good economic policy.

Because of projected high international prices in cotton, the main distortionary cotton program is not the marketing loan, which is projected to provide zero support in the coming years, but rather the Step 2 program. Step 2 increases domestic cotton prices, and thereby provides support to cotton producers in the form of higher prices, rather than deficiency payments. Deficiency payments are less economically distorting because they are not tied to either actual cotton production or, assuming the planting flexibility reforms advocated by the Clinton administration are enacted, cotton acreage. That is,

deficiency payments need not provide incentives for overproduction, but the above-market cotton prices generated by Step 2 do. Eliminating Step 2 would enhance economic efficiency, and yet, would have only a small impact on cotton producers because deficiency payments would rise in tandem with declines in the domestic market price.

Sugar and peanuts

The federal government also runs price support programs for sugar, peanuts, and tobacco, but these programs operate in a very different way than do those for the other government-supported commodities. Rather than providing price insurance for producers, these programs sustain above-market prices both by restricting imports and by directly limiting U.S. sales by domestic producers. Consumers, rather than taxpayers, pay most of the cost for supporting high producer prices in these markets. And overall economic welfare suffers because production and sales are not allowed to expand when the public's value of extra production—the market price—is greater than the cost of new production.

Program 3—sugar

In the sugar market, quotas currently limit U.S. imports to about 15 percent of our consumption. As a result, the U.S. price of sugar has been nearly twice as high as the world price in recent years. Beyond import protection, the federal government sets minimum support prices for both cane and beet sugar. The support price for cane sugar has been set at its statutory minimum level of 18¢/lb since 1985. The support price for beet sugar is set by a formula that has caused it to rise in recent years, despite productivity improvements that have driven the cost of beet sugar production down. Before 1990, high domestic support prices were sustained in the face of entry by efficient new sugar producers by making the import limits increasingly tight. In 1990, however, having squeezed the import limits as far as foreign policy considerations would permit, Congress enacted a new mechanism to sustain the high support prices, namely, federal restrictions on the amount of sugar which domestic producers can sell. These marketing restrictions (called "allotments") are presently keeping an estimated 300,000 tons of sugar in warehouses—and off of the domestic market. The mechanism for allocating marketing allotments—which are entitlements to sell given quantities of sugar—tends to favor production of cane sugar over beet sugar, even though the two products are identical once refined, and even though beet sugar is cheaper to produce on average. Moreover, the prospect of marketing allotments inhibits growth in the domestic sugar industry. With allotments distributed partly in pro-

portion to past marketings, investors in new sugar processing facilities must reckon with potentially severe limits on the amount of sugar that they will be able to sell; such prospects discourage investment. High domestic sugar prices also inhibit growth in domestic sugar-using industries.

Overall, the sugar program is widely recognized as anachronistic and counter to good economic policy. The marketing allotment provisions in the sugar program are particularly egregious from an economic point of view and should be eliminated.

Program 4—peanuts

A similar story can be told for the peanut industry. The U.S. peanut program sustains a high domestic peanut price by limiting imports to about 2.5 percent of domestic consumption, and by limiting the sale of domestically produced peanuts for edible



use. Imports of peanut butter and peanut butter paste are also limited to about 4 percent of domestic consumption. Domestic peanut sales are controlled by quotas that entitle their owners to sell a given volume of peanuts at the high support price. A farm's quota equals its last year's quota, adjusted for changes in total quota sales. Quotas can be leased or sold within counties, but not across county lines; hence, high-cost producers in one county cannot trade their quota rights to low-cost producers in another county.

Over the past four years, allowed quota sales have declined in tandem with increases in the support price; as a result, U.S. food use of peanuts has fallen 10 percent over this period and the current U.S. price for edible-use peanuts is twice the world level. With tight sales restrictions, many U.S. peanut growers are producing for the export market, according to a recent study. This conclusion implies that much of the current difference between domestic and international peanut prices is attrib-

unable to domestic sales restrictions as opposed to the tight import limits; if allowed to do so, domestic peanut growers could supply the U.S. market at about half the current price. In sum, invasive government restrictions on domestic peanut sales hurt consumers, impede efficiency, and obstruct growth in both domestic peanut production and peanut-processing industries.

Program 5—agricultural export subsidies

The U.S. Department of Agriculture gives export subsidies to a wide range of products under the Export Enhancement Program (EEP) (which subsidizes exports of wheat, flour, barley, barley malt, rice, poultry, pork, and table eggs), the Dairy Export Incentive Program (DEIP) (which subsidizes exports of milk powder and butter), and the sunflowerseed and cottonseed oil assistance programs (SOAP/COAP). EEP is by far the biggest program, costing taxpayers about \$1 billion per year,

...invasive government restrictions on domestic peanut sales hurt consumers, impede efficiency, and obstruct growth...

with wheat the dominant commodity; 77 percent of all EEP subsidies have gone to wheat exports and another 6 percent have gone to wheat flour. DEIP and SOAP/COAP have doled out about \$140 million and \$25 million per year over the past three years. The recent GATT agreement places important restraints on these subsidies for future years, whittling down maximum U.S. agricultural export subsidy expenditures to \$600 million per year by 2001. GATT also places restrictions on subsidized export volumes, but nonetheless allows about \$5.3 billion in U.S. subsidies over the next six years. Important features and trends in U.S. agricultural export subsidies include the following.

- *Export subsidies go mostly to huge corporations, many foreign owned.* For example, 70 percent of EEP subsidies have gone to ten large trading companies; five of these companies are foreign owned and have received 30 percent of the subsidies. Only four companies, two foreign owned, have received 50 percent of the EEP bonuses. For DEIP, a similar picture emerges. In 1994, seven companies received almost 90 percent of the DEIP subsidies, and 55 percent of the subsidies went to three European-owned companies.
- *Export subsidies support a large share of U.S. trade*

in the subsidized products and represent a large share of the export price received by U.S. traders. With wheat, for example, EEP bonuses have averaged between a quarter and a third of relevant market prices over the past four years, and subsidized wheat exports have represented almost 60 percent of total U.S. wheat exports. A similar story can be told for other products. In 1994, for example, table eggs received an average subsidy of 39 percent on 56 percent of total U.S. exports. And subsidies have been paid on almost all recent U.S. exports of milk powder and butter. In other words, it is not just the European Union going overboard on agricultural export subsidies, as EEP apologists would have you believe.

- *The U.S. agricultural export subsidy business has been in a high-growth phase, with record subsidy levels in 1994, notwithstanding international trade negotiations.* While EEP outlays have totalled \$6.8 billion from 1985–94, \$4 billion has been spent in the last four years. All-time highs for EEP expenditures overall, and in subsidies for wheat and table eggs, were seen in 1994; second-highest subsidy levels were made for wheat flour, barley, barley malt, and frozen poultry; and for the first time in the program's history, the USDA handed out \$14 million in pork subsidies. Just this year, a pre-GATT DEIP program subsidized a record 156,000 metric tons of dairy exports in less than four months (compared with 196,000 tons for the whole of 1994 and a first-year GATT limit of 167,000 tons, again for a whole year).

Economic effects of agricultural export subsidies

The subsidy programs provide exporters with taxpayer-funded dollar "bonuses" on each unit of a commodity sold in a given country. If the subsidized volumes of the different products exported into different regional markets were less than would have occurred under free trade, then the subsidy programs would have no effect on trade. However, the programs in fact operate to concentrate subsidies in some markets, increasing exports—and lowering prices below international levels—in those markets. Between 1989 and 1993, for example, over 60 percent of the subsidies went to just four regions—the former Soviet Union, China, Algeria, and Egypt—and almost three-quarters of the subsidies went to those regions plus the Middle East. In these markets, subsidies compensate exporters for the difference between the international price and the lower price required to sell the subsidized product on the local market. However, because these price levels are difficult to observe, as are other costs of delivering the commodity abroad, the USDA may often offer "bonuses" that also give

exporters some extra profit.

The subsidy programs have a variety of economic effects, including

1. decreasing U.S. economic welfare by providing products to foreign consumers at prices that are lower than it costs to produce the goods domestically. That is, the program buys dear and sells cheap at the expense of U.S. taxpayers.
2. raising domestic prices, but only to the extent that subsidies increase exports and not imports. Export subsidies have been criticized both for subsidizing exports that would have occurred anyway, and for increasing U.S. imports. Imports respond to the tighter domestic supplies—and reduced export market potential—attributable to the U.S. subsidies. Most academic studies estimate that, because of these effects, programs have increased net exports by 10 percent or less of the volume subsidized. For example, some experts argue that high EEP subsidies on wheat contributed to a spike in 1993–94 wheat imports from Canada. A recent USDA study confirms this effect, estimating that the EEP program is responsible for between 40 and 48 percent of growth in U.S. imports of Canadian wheat.
3. displacing other U.S. exports. The U.S. Feed Grain Council has recently criticized U.S. wheat subsidies into the Phillipines for making wheat so cheap that Phillipine customers have substituted it for corn feed that they would otherwise have bought from U.S. farmers.
4. exporting jobs in food processing. By lowering the price of bulk products to foreign customers, the subsidies encourage competitors to buy the cheap raw products and process them into high value-added products that then compete with

U.S. value-added exports, the main source of export growth for U.S. agriculture.

As with any program that has a substantial bureaucracy to support it, a number of arguments have been put forward to justify the U.S. agricultural export programs. Upon reflection, however, none of these arguments stands the test of scrutiny.

Argument 1: U.S. export subsidies are bargaining chips to obtain reductions in European Union (EU) subsidies. Current evidence indicates that higher U.S. subsidies have actually led to an EU response of higher EU subsidies. With a GATT agreement in place that restrains EU (and U.S.) subsidies, it is time for the U.S. to abandon a subsidy war mentality that fails to appreciate that an export-subsidization strategy does not enhance our economic welfare, even in the face of subsidy competition.

Argument 2: U.S. agricultural exports need subsidies to compete with subsidized EU counterparts. Although this statement may literally be true, it does not provide an economic motivation for export subsidies. If the EU wants to throw money down the export subsidy tube, the U.S. should not decrease its own economic welfare by following suit. Going beyond the economic arguments that will be dismissed in a moment, the only logical counterpoint is that our subsidies get foreign consumers “hooked” on U.S. products so that long-term gains more than offset the short-term costs of the subsidies. However, our agricultural export subsidies focus on bulk commodities for which loyalty lasts only as long as the price is better. As a result, long-term gains from “addiction” are nonexistent. Indeed, export subsidies can impede longer-term U.S.

(continued on page 24)



foreign market development by undercutting U.S. investments in local storage and distribution networks that lose out when USDA dumps subsidized product on the market at short notice.

Argument 3: Export subsidies can enhance “monopoly rents” of an agricultural industry in the international marketplace. If the U.S. wheat industry (for example) had an international monopoly, its profits could be increased by selling more product into a price-sensitive market and less into a price-insensitive market; in the insensitive market, a small quantity reduction would lead to a large price rise and a large gain in profit. Subsidizing exports into the price-sensitive market might achieve this end, in principle. In practice, however, when we subsidize commodity into one market, other countries can shift their sales into the price-insensitive market, eliminating the potential U.S. gain; that is, the U.S. does not, in fact, have a monopoly in world trade, even in wheat, where it has a 30 to 40 percent share.

Argument 4: Subsidizing exports may reduce economic costs associated with U.S. farm programs, both by reducing budget outlays (which have what economists call “deadweight costs” from necessarily distorting taxes) and by reducing economically harmful land setasides. To the extent that the export subsidies increase exports and not imports, they may increase domestic prices. Such price increases may reduce the budgetary costs of farm programs, but not by enough to offset the cost of the export subsidies themselves—even when the price increases are not moderated by reduced acreage setasides.

This brings us to the second argument. The essence of the argument is that, by raising the domestic price of a farm program commodity, export subsidies will reduce the use of land setasides that kick in when the commodity price is low. Since land setasides lead to an inefficient (and more costly) mix of land and other inputs in agricultural production, this effect of export subsidies is beneficial. This argument is particularly insidious in that it bases one bad policy, export subsidies, on another bad policy, land setasides. Clearly, land setasides are the problem here and these setasides should be phased out in tandem with phaseouts of price-in-

centive distortions in farm program payments. The latter objective is firmly stressed in the Clinton administration’s farm bill recommendations.

In summation, our export subsidy programs reduce U.S. economic welfare at a continuing high cost to taxpayers—and this at a time when budget resources for even the most valued government programs are in jeopardy.

*...our export subsidy programs
reduce U.S. economic welfare at a
continuing high cost to taxpayers—
and this at a time when
budget resources for even the most
valued government programs
are in jeopardy.*

Significant dividends possible

There are many issues in agricultural policy that are arguably more important than those raised in this paper, including the structure of farm program payments, strengthening of USDA’s conservation programs, preserving the integrity of the agricultural research system, and defining an appropriate government role in rural development. For example, I do not want to underplay the economic importance of increasing farmers’ planting flexibility in USDA’s deficiency payment programs, including farmers’ emancipation from the dictates of government acreage setasides. The Clinton administration’s landmark proposals to make such reforms clearly merit favorable action by Congress and promise to yield significant economic dividends. However, in an era when clearly inefficient programs that serve focused special interests are ostensibly on the table, the five areas discussed in this paper provide a clear test, in the farm policy context, of whether politics-as-usual still reigns in Washington, or whether good policy is now the order of the day. ■

Robert Innes is professor and resource economics at the University of Arizona. This past year he served as senior economist on the President’s Council of Economic Advisers.