Can Subsidies Hurt Iowa Agriculture?

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Many congressional leaders want to begin hearings this winter that could lead to a new farm bill. Nearly all interest groups want to see an increase in federal involvement in agriculture. But before Iowa’s farm groups push for a change in policy, they should understand that, for Iowa, some forms of government help are preferred to others, and some forms of government assistance can actually be harmful.

What could be wrong with subsidies? After all, increased government aid puts more money in the pockets of farmers. But most agricultural subsidies increase supply, which, in turn, decreases prices. The negative impact of lower prices might be greater than the positive impact of increased aid. We have outlined several agricultural subsidies below and examined their impacts.

AMTA Payments

Agricultural market transition assistance (AMTA) payments are program payments that are completely independent of a farmer’s production decisions and production levels. Hence, they do not induce an increase in supply. They simply increase cash flow to a qualifying farm operation.

LDPs

With the loan deficiency payment (LDP) program, all U.S. corn and soybean farmers are guaranteed a minimum price for all their production. In years when farmers expect market prices to fall below the loan rate, the resulting supply is greater than it would be without the program. That is, in some years the loan rate increases supply and reduces market price. However, this drop in the market price does no harm to farmers because per-bushel LDP payments increase to fully compensate for the price decrease.

Crop Insurance Subsidies

Crop insurance subsidies promote risky behavior by inducing more acreage into production in areas where crop yields are highly variable. Thus, the increase in crop insurance subsidies in 1999 and the likely increase in 2000 will induce an increase in supply and a lower market price for corn and soybeans. How likely is it that the negative effects of a lower price will be greater than the direct benefit that Iowa farmers receive from crop insurance subsidies?

First of all, we can say that in 1999 Iowa farmers were fully insulated from a drop in market price because, as discussed above, when the market price is below the loan rate, a further drop simply increases LDP payments. Iowa farmers, therefore, should not be concerned about the supply-enhancing effects of crop insurance subsidies as long as the market price is below the loan rate. But, with any luck, market prices for corn and soybeans will soon rise above the loan rate. When this occurs, will Iowa farmers receive a net benefit from crop insurance subsidies?

Iowa corn farmers received approximately $53 million in crop insurance premium subsidies in 1999. Soybean producers received $27 million. Using expected 1999 production levels for Iowa, this works out to 2.9 cents per bushel for corn and 4.9 cents per bushel for soybeans. Using conservative estimates of the impact of insurance subsidies on supply, we calculate that eliminating crop insurance subsidies would increase corn prices by at least 8 cents per bushel and soybean prices by at least 30 cents per bushel. This indicates that Iowa farmers are net losers from crop insurance subsidies when prices are above the loan rate.

Supply Controls

One of the bedrock principles of the current farm policy is the elimination of all government controls on supply. Proponents of the current policy thought that the free market was better at guiding production decisions than the government. But current policy is inconsistent in that government-mandated price guarantees and crop insurance subsidies are increasing supply at a time when the market is signaling that we have plentiful supplies.

A reduction in supply will induce an increase in price. If the price remains below the loan rate, then farmers will not benefit from the price increase because LDP payments would correspondingly decrease. If the price rises above the loan rate because of acreage set-asides, then the
benefits of the price increase are proportionate to yields. A farmer with 150-bushel yields will benefit by 50 percent more than will a farmer with 100-bushel yields. So, a Kansas corn farmer who produces 150 bushels per acre with irrigation receives the same benefit from the price increase as the Iowa dryland farmer who produces 150 bushels per acre.

The cost of acreage set-asides, however, depends on both yields and per-acre production costs. Cash rents for farmland are a good measure of the relative costs of set-asides. If cash rents in Iowa are $110 per acre compared to $65 per acre in Kansas, then the cost of acreage set-asides are nearly twice as high in Iowa as Kansas. In this example, the benefits from acreage set-asides are equal in Iowa and Kansas, but the costs are disproportionately high in Iowa.

What we have learned from this brief excursion into the impacts of subsidies is that a careful examination is needed before we can conclude that subsidies are beneficial. Clearly, fixed payments are beneficial to farmers, as are price guarantees. But, whereas the budget costs of fixed payments are known in advance, the cost of price guarantees can grow to unexpected levels. If the unexpected expense leads to supply controls, then it is questionable whether there is a positive net benefit to Iowa farmers. And, perhaps surprisingly, the net benefits from crop insurance subsidies are likely to be negative for Iowa’s low-cost producers. That is, Iowa producers would be better off if crop insurance subsidies were eliminated.

The European Union’s (EU) Common Agricultural Policy (CAP) is set to undergo comprehensive reforms, known as Agenda 2000, next year. The twofold objective of these reforms is to ensure the sustainability of European agriculture and to protect the livelihood of European farmers. In May 1999, the European Council officially adopted new financial and political guidelines—dubbed the Berlin Accord—that will increase government support to farmers through direct payments while reducing support prices for cereals, beef, and dairy products.

The Berlin Accord reforms are likely to stimulate increased production in the EU and thereby create substantial changes in European agricultural markets. The overall impact on markets for Iowa crops and livestock, however, is projected to be relatively small. Farm prices for corn, soybeans, and oats are modestly changed and, on average, decline by 1 percent between 2001 and 2008. The expanded cereals production in the EU will lead to slightly lower world wheat prices and lower U.S. exports. Iowa beef and hog prices increase slightly in the first two years of the reform implementations; then, for the remaining period, Iowa livestock prices decline relative to the baseline.

FAPRI (Food and Agricultural Policy Research Institute) at the Center for Rural and Agricultural Development (CARD) conducted an analysis that estimates the impacts of the Berlin Accord for EU agricultural markets. The analysis results were contrasted with a baseline scenario that maintains pre-Accord policies. The FAPRI modeling system incorporates forecasts of macroeconomic variables—such as gross domestic product, inflation rates, and exchange rates—that were obtained from Standard and Poors DRI, Project Link, and WEFA. Weather was assumed to be average during the projection period.

**Effects on EU Agriculture**

For crops, the CAP support prices for cereals is reduced by 15 percent in two steps, with the first reduction occurring during the 2000/01 marketing year. Cereals producers in the EU will be compensated for this reduction by an increase in direct payments from 54.34 to 63 euros per metric ton (1 euro =$.93). Payments to oilseed producers will be progressively reduced to the level for cereals by the 2002/03 marketing year. Producers of legumes and pulses (protein substitutes) will receive a direct payment of 9.5 euros per metric ton on top of the basic direct payment.

For beef, the support price is reduced by 20 percent over a three-year period. Then, in July 2002, the intervention price will be replaced by a beef basic price of 2224 euros per metric ton, and a private storage aid scheme will be introduced.