

Staff Paper 202

BASIC COMMODITY PROGRAMS:  
UNDERSTANDING HOW THEY WORK AND  
ASSESSING 1990 FARM BILL PROPOSALS \*

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A. THE HISTORICAL PERSPECTIVE

How has agricultural policy changed over the years? Prior to the closing of the western frontier and for the first 150 years of this nation's history, government involvement in agriculture was primarily limited to: (1) land ownership and settlement policy, (2) scientific input, and (3) basic regulations. So, the U.S. essentially had a market oriented policy.

The western frontier closed and the depression hit. The farm economy was devastated. The consequence of free market is that it sometimes results in price extremes. One infamous South Dakota market quotation reported in Don Paarlberg's book "American Farm Policy" reported: #2 shelled corn at 4 cents/bu., #3 at 3 cents/bu., #4 at 2 cents and eared corn 3 cents less. Unemployment was 25 percent and many farmers lost their land.

The Great Depression caused a distinct change in government's role in agriculture. For the first time in the nation's history, government intervened in the market place to support prices on behalf of farmers.

The first attempt was the Federal Farm Board of the late 1920s. It established a grain reserve. The concept was for the government to buy low and sell high thus acting as a market stabilizer. However, the history books treat the program as a failure because it was too little, too late and was overwhelmed by the magnitude of the Great Depression.

In 1933, the U.S. instituted the Agricultural Adjustment Act (AAA), which is regarded as the forerunner of our current farm policy. Initially, parity price supports were implemented without production controls. This simply added to the surpluses until production controls were added as a precondition for receiving support payments.

Although many developments have occurred in agricultural policy since the 1930s the basic concepts have remained the same. The government has been periodically stabilizing and supporting prices, setting-aside acreage and acquiring grain reserves ever since. My point is that the pendulum does swing upon occasion and usually during a crisis.

#### B. AGRICULTURAL POLICY AS A SHOCK ABSORBER

In all years since the Great Depression, the U.S. has planted between 330 and 390 million acres to crops. Sometimes you see a lower set of numbers for program crops because some crops are excluded.

Prior to the Depression we operated our agricultural plant at full capacity. With the implementation of the AAA we reduced our acreage in production and accumulated an "ever normal granary." Then in response to World War II, we expanded agriculture to peak capacity once again. The U.S. operated above 370 million acres in the 1940s until 1955.

In the mid-fifties, we began to accumulate large grain reserves and instituted land-retirement programs such as the "Soil Bank" were implemented to reduce farm production. As a result, U.S. agriculture operated at below 340 million acres from

1961 to 1972. During the late 1960s, the U.S. began reducing grain reserves and completed this task with the infamous 1972 Russian Wheat Deal.

After 1972, unprecedented export demand more than offset the bringing of 30 million acres back in production. Record farm prices and incomes resulted in spite of expanded acreage. Exports were growing 8 to 10 percent per year. As a result, we were expanding production 4 to 5 percent per year. By 1978, U.S. agriculture was back up to peak crop acres and policymakers, economist, lenders and farmers all thought that the good times were going to continue into perpetuity. They simply didn't.

The early 1980s provides a classic case of the stages of agricultural overcapacity. First, export demand caused total demand to drop. Second, government grain reserves began to accumulate. Third, it became cheaper for government to pay farmers to set-aside land rather than store additional grain.

U.S. acreage in production remained at full tilt until the 1983. We kept hoping for the export demand to return. While the U.S. has since recovered market share, total world trade in grains has experienced almost no growth during the decade of the 1980s. In 1983, we instituted a Payment-In-Kind program. Although a drought had some impact, 1983 turned out to be the largest one-year acreage blip in history. We went from peak to trough to peak acreage again all in the process of three years.

Then, we debated the 1985 Farm Bill. A major conclusion of the debate was that the rules of the agricultural economy had changed. In the 1960s, with an inelastic domestic demand for food, the U.S. raised support prices and thus increased farm

income. However in the 1980s, the U.S. relied more heavily upon export markets. After support prices were increased in the 1981 Farm Bill, international competition undercut our prices and expanded their production forcing more of the adjustment upon U.S. farmers. This coupled with a rising exchange value of the dollar dramatically reduced agricultural exports and contributed to the farm depression of the 1980s. The U.S. could no longer design domestic commodity programs in isolation of international trade policy and the global politics of trade.

As a result, policymakers and agricultural interests designed a 1985 Farm Bill that would make the U.S. competitive in world markets, protect farmer income and keep government costs low. In general, the 1985 Farm Bill was successful on two of three goals. It immediately lowered loan rates, froze and then slowly reduced target prices. It experimented with Marketing Loans and PIK certificates. It established a long-term land retirement program called the Conservation Reserve Program (CRP).

## C. WHAT ARE THE CURRENT TOOLS AND HOW DO THEY WORK?

### I. PRICE AND INCOME SUPPORTS.

#### - NONRECOURSE LOANS, LOAN RATES, PRICE SUPPORTS.

The Commodity Credit Corporation (CCC) makes nonrecourse loans at established rates to farmers for wheat, feedgrains, soybeans, cotton, sugar, wool, tobacco, and honey. If the market price is above the loan rate, the farmer can repay the loan, plus interest and storage, within 9 to 12 months and then sell the commodity on the cash market. If the loan rate is above the market price, the farmer may forfeit the grain to the CCC as full payment for the loan and thus receiving the loan rate as the market price. The nonrecourse commodity loans are frequently referred to as price supports because as the national market price falls below the loan rate, more farmers forfeit loans and the CCC acquires enough grain from the market to keep the market price from falling to far below the loan rate.

- TARGET PRICE, DEFICIENCY PAYMENT, PROGRAM YIELD, PAYMENT RATE.

Deficiency payments are sometimes referred to as income supports and are payments made to farmers in return for participating in acreage set-asides and complying with other farm program requirements. Target prices and deficiency payments are set for cotton, wheat, corn, grain sorghum, oats and barley. The deficiency payment equals the payment rate times the program yield times the farm program acreage. The payment rate is the difference between the politically established target price and the higher of the commodity loan rate or the national average market price. In general, the program yield for a farm is based on the county average program yields for the previous five years dropping out the highest and lowest year. The farm program acreage is the farmer's crop acreage base less set-aside and diverted acres. The crop acreage base generally represents the average acreage that would normally have been planted to the crop for harvest during the previous five years.

- MARKETING LOANS.

A marketing loan is a nonrecourse loan with a repayment rate that may be lower than the announced loan rate. In general, if the market price goes below the announced loan rate the CCC may lower the repayment rate to the world price. Thus instead of forfeiting the grain to the CCC, the farmer repays the loan at the lower repayment rate and sells the grain on the cash market. In general, the marketing loan repayment rate becomes the market price floor and the CCC effectively pays farmers the difference between the repayment rate and the announced loan rate. The marketing loan changes the nonrecourse loan concept from a price support program to a price and income support program.

- GENERIC PAYMENT-IN-KIND (PIK) CERTIFICATES.

A generic PIK certificate is a negotiable commodity certificate that can be redeemed by the holder for farmer-owned reserve commodities, any uncommitted CCC reserve commodities or cash. The certificates are issued to complying farm program participants in lieu of cash payments under a variety of provisions in the 1985 Farm Bill. The certificate is issued for a dollar amount, therefore the amount of a commodity that can be redeemed is determined by the daily redemption price as determined by the CCC. The negotiability of the certificates allows for the sale and resale of the certificates up to their specified expiration date. The certificates allow the government to reduce grain reserve stocks and storage costs without having market price reach the normal release price levels. Therefore, the government is not likely to use certificates if government stocks are low.

## - PAYMENT LIMITATIONS.

Payments received under the wheat, feed grain, cotton, and rice programs are limited to \$50,000 for all payments per person per year except for disaster payments which are limited to \$100,000 per person per year. This does not include nonrecourse loans, compensation for recreation, marketing loans, certain portions of deficiency payments resulting from reduced loan rates, inventory reduction payments, cost reduction measures by the Secretary.

## II. PRODUCTION CONTROLS.

### - ACREAGE REDUCTION PROGRAM, SET-ASIDES, DIVERSION PROGRAM.

The Secretary annually has the authority to announce acreage limitations, set-asides, or paid land diversions if total supplies are expected to be excessive. If a set-aside program has been announced, farmers must set-aside a certain percent of their crop acreage base in order to be eligible to receive commodity loans, purchases, deficiency and other payments. Acreage diversion programs pay producers a given amount per acre to idle a percentage of their base acres. The crop acreage base generally represents the average acreage that would normally have been planted to the crop for harvest during the previous five years.

### - LONG-TERM LAND RETIREMENT, CONSERVATION RESERVE PROGRAM (CRP).

Long-term land retirement is a voluntary multiple year program in which the government pays farmers an annual rental rate per acre to remove cropland from the production of surplus commodities. The Conservation Reserve Program (CRP) is a long-term land retirement program that provides incentives for taking highly erodible cropland out of production. In periods when significant excess agricultural capacity exist, operating a long-term land retirement program in conjunction with annual acreage reduction programs can reduce the government per acre costs of taking land out of production. However, increasing the acreage under long-term land retirement programs reduces annual program flexibility in meeting wide annual variations in commodity demand and use.

### -ACREAGE ALLOTMENTS, MARKETING QUOTAS, MANDATORY CONTROLS.

Mandatory controls refer to acreage allotments and marketing quotas imposed by government on all producers in order to reduce the production of a commodity. In one recent proposal, such supply management tools would only be imposed after a favorable vote in a farmer referendum. In the case of acreage allotments the restrictions are placed on the acres that may be planted. In the case of marketing quotas, the restrictions are placed on the quantity that may be sold, the remainder must be stored or disposed of outside the restricted market. The number of acres allotted to each farm or the marketing quota is set at a given

percentage of the farm's production history. The percentage is based on the estimated national production needed to meet supply objectives. In some cases, certificates might be issued to those holding quotas or allotments that would allow each producer to buy or sell the rights to produce. In this case, the value of the allotments or quotas are capitalized into a market value of the certificates.

#### - PROGRAM CROSS-COMPLIANCE, OFF-SETTING COMPLIANCE:

Cross-Compliance provisions requires farms that produce more than one program crop to participate in the commodity programs for all of the commodities in order to be eligible to receive loans, purchases or payments for any one of the commodities. Sometimes commodity programs have adverse impacts on other commodities. Imposing cross-compliance increases the acreage reduction cost efficiency of farm legislation, however, such provisions are often strongly resisted by farmers. Off-setting compliance provisions require a producer of a commodity to be in compliance with the program requirements on all farms in order to be eligible to receive program benefits.

#### - CONSERVATION COMPLIANCE, SODBUSTER, SWAMPBUSTER.

Conservation compliance requires farmers of highly erodible land to have an SCS conservation plan for the farm approved by January 1, 1990 and implemented by January 1, 1995. The sodbuster provision prevents farmers from bringing additional highly erodible farmland into production if it had not be farmed during 1981-85. The swampbuster provision prevents farmers from draining, and converting wetlands into cropland for production. Farmers who violate the above provisions are not eligible for farm program benefits and are barred from certain additional programs.

### III. GRAIN RESERVES.

#### - COMMODITY CREDIT CORPORATION (CCC) STOCKS.

The Commodity Credit Corporation has no recourse but to acquire grain when the market price of a program commodity falls below the commodity nonrecourse loan rate, giving farmers an incentive to forfeit their grain. CCC may not sell any of its wheat, corn, grain sorghum, barley oat, or rye at less than 115 percent of the national average loan rate adjusted for market differentials and carrying charges. However, if the marketing loan provisions are in effect, the sale price cannot be less than 115 percent of the average loan repayment rate for the crop. In the case of the marketing loan, the loan repayment rate is at or below the announced loan rate for the commodity. However, various certificates may be used to release uncommitted CCC stocks, even though market prices have not risen to CCC sales price.



#### -- FARMER-OWNED RESERVE (FOR).

The Farmer-Owned Reserve program provides original or extended price-support loans to encourage producers to store wheat and feedgrains for three years or longer. The FOR loan rates must be equal to or higher than current commodity nonrecourse loan rates. The farmer must continue to store the grain until the loan matures unless the market price rises above a specified release price which is 140 percent of the commodity loan rate, or target price, whichever is higher. The amount of grain allowed into the FOR is limited to a percent of domestic and export use. This is 30 percent for wheat and 15 percent for feedgrains. Here again, certificates may be used to release FOR stocks at any time.

#### D. THREE LEVELS OF DEBATE.

There have been three levels of debate over commodity policy in recent farm bills. There has been debate over (1) the level of price and income supports, (2) the program structure, and (3) who should decide the policy parameters.

In regards to the level of supports, pegging the supports to the parity index is often favored by those who want higher price supports. However, there are some technical problems associated with using an index that does not make an allowance for changes in agricultural productivity over the years. Pegging the supports to average cost of production was tried in the 1970s and early 1980s. However, in the early 1980s costs continued to rise while market prices dramatically dropped thus contributing to the declining share of world commodity markets for the U.S. A third approach is to set supports relative to an average of recent market prices. This provides both upward and downward price flexibility to be competitive on world markets, but also provides a cushion from dramatic price changes as well. A fourth approach is not to peg supports to any index and either allow the supports to set in the Farm Bill or allow the Secretary to set them annually based on an analysis of the competition.

The second level of debate revolves around the structure of the commodity programs. Since the 1930s, policymakers and interest groups have debated free market policy, voluntary supply management programs, and mandatory supply management.

The market approach would remove many of the current programs and allow "survival of the fittest" to take place. This approach would tend to increase exports and place increasing pressure on other exporters to either increase their subsidies or reduce their excess capacity. The least competitive U.S. farmers would exit from production to other endeavors.

The present commodity programs are voluntary. Farmers voluntarily choose whether or not to participate in commodity programs. The incentives to participate depend upon how the farmers perceive the benefits in return for costs of participation. The participating farmers agree to reduce production in return for government payments and other benefits.

Mandatory controls reduce excess capacity by enforcing penalties on those who do not comply with the mandatory restrictions. Under mandatory controls, acreage allotments or marketing quotas are used to restrict production. In a pure mandatory control system production is restricted to until prices increase to target levels, so there would be no government costs. However, recent proposals have included standby nonrecourse loans to be implemented if target price levels were not reached. Unless export subsidies and/or an international cartel is established, this structure would likely result in a declining share of world markets for U.S. agricultural commodities.

The final level of debate is over who should set the policy parameters. Congress may prescribe the parameters in the Farm Bill. The Secretary of Agriculture may be given the authority to set the parameters based on prescribed or unprescribed rules. A third independent policy board, has been suggested from time to time by various special interest groups.

An independent board could be given the authority to set the farm policy parameters much like the Federal Reserve Board establishes monetary policy. Perhaps the "revised golden rule" applies here. "Those with the gold, rule." Only in few exceptions, has sweeping authority been granted to independent board. A policy board made up solely of farm interests is highly unlikely unless farmers agree to self-finance the commodity programs. Recent commodity check-off programs are an example of this approach. Revenue insurance, mandatory multiple-peril crop insurance and/or commodity assessments might represent a move in this direction. However, until then, most of the policy-making power is likely to rest with the Congress and the Secretary.

#### E. HOW DO YOU EVALUATE THE POLICY ALTERNATIVES IN THE FUTURE?

The 1985 Farm Bill debate settled around three simple goals that were viewed as problems or inadequacies resulting from the previous farm bill: (1) competitiveness, (2) farm income protection, and (3) government costs. In the discussions with many farm organizations, agribusinesses and consumer and environmental groups, I am presently hearing a multitude of objectives. I have provided a list of 12 objectives (Table 1).

The debate may or may not eventually settle on a reduced list

of major concerns. The three objectives presently appearing at the top of current rhetoric for commodity programs are: (1) competitiveness, (2) flexibility and (3) government costs.

Some analysts are suggesting that the drought let the European Community off the GATT negotiations "hook" and that we need to keep up the competitive pressure if we are to maintain world market shares and make progress in the GATT negotiations during the next two years. Continuing lower loan rates, using marketing loans, reducing set-asides, and continuing export enhancement programs in the 1990 Farm Bill are tools to achieve this objective.

The issue of flexibility is being discussed from two perspectives. First, an increasing number of analysts suggest that the feedgrain program incentives, particularly for corn, (1) are responsible for a declining share of the world soybean market and (2) represent barriers for the adoption of more environmentally sound farm management practices. They suggest that farmers be given increased flexibility to make prudent farm management decisions decoupled from the distortions caused by farm policy regulations and incentives.

A second flexibility perspective has to do with the acreage reduction programs and long-term conservation reserve. The drought dramatically reduced the wheat and feedgrain carryover stocks. The current wheat and feedgrain carryover stocks are at levels that have been lower in recent decades, except for a brief period in the mid-1970s.

A recent FAPRI report pegs total idled acreage in the U.S. for 1988/89 to be 80 million acres. Because of the drought the

annual set-aside will be reduced from 20 percent to 10 percent for feedgrains and from 27.5 to 10 percent for wheat. The 10 percent paid land diversion for feedgrains is also eliminated. As a result, FAPRI expects about 24 million acres to come back into production this next year.

However, the U.S. would have less than 20 million acre cushion left in the annual acreage reduction programs. The remainder is in the long-term CRP. Presently there is 30 million acres in the CRP. However, the 1985 Farm Bill calls for a minimum of 40 million acres and a maximum of 45 million acres to be in the CRP by 1990. As a result, some analysts suggest that this raises a question of flexibility and whether we should continue to take an additional 10 to 15 million acres out of production long term.

The final objective is that of reducing the budget deficit. A point to remember here is that yes U.S. did spend a record \$26 billion on farm programs during the 1985 Farm Bill. But we are now spending about half. One analyst recently suggested that it may not be prudent for the U.S. to continue to reduce farm program spending if we are serious about making progress in GATT because supposedly the European Community has not dramatically reduced its \$30 billion in farm program costs.

However, on the other hand, the deficit problem is a major cause of the trade deficit and has contributed to higher interest rates. Both adversely affect agriculture. There are only so many ways to reduce the budget deficit. Agriculture will absorb its "fair share" of cuts and has as much to gain as other sectors from the positive effects of a deficit reduction policy.

## F. ANALYZING THE ALTERNATIVE PROPOSALS

Several different commodity program options are likely to be discussed in the 1990 Farm Bill debate. A few new concepts are presently being discussed by various special interests. But they will only be seriously considered if they achieve some of the objectives that are not being achieved under the 1985 Farm Bill.

For discussion purposes, I have selected five proposals for comparison (Table 1). In some cases it is difficult to assign a plus or minus in the absence of a detailed plan. With minor modifications a minus could be turned into a plus and vice versus. Therefore, if you disagree with my pluses and minuses, feel free to enter your own interpretations because you might be thinking about a slightly different version than I used in this analysis. I have only provided this model as food for thought.

### OPTION 1. CONTINUE CURRENT PROGRAMS.

Continuing the current program means that loan rates would remain low and target prices would continue to be reduced slowly from year to year to reduce budget exposure. The Secretary's authority would continue for Acreage Reduction Programs, Conservation Reserve Program, Farmer-Owned Reserve and Commodity Credit Corporation operations.

### OPTION 2. GRADUATED PAYMENTS.

Rather than reducing target prices to reduce program costs, deficiency payments and commodity loans could be graduated. One approach would be to lower the payment rates as size of farm, acreage in production or volume of production increases. Another approach is to apply the loans and deficiency payment rates only

to the portion of the crop needed for domestic use. The remaining provisions in current programs continue unchanged.

### OPTION 3. DECOUPLING PROGRAM PAYMENTS FROM MANAGEMENT DECISIONS.

Several types of decoupling are being discussed. Here we look at five approaches to decoupling farm program payments from production decisions.

The first form of decoupling is the voluntary form. The 1985 Farm Bill included a 50-92 program. Later a 0-92 program was added. These provisions allowed the farm program participants to receive deficiency payments based on 92 percent of their permitted acreage even though they elected to plant 50 to 92 percent or 0 to 92 percent of their permitted acreage. In other words the farmer would receive the same payment regardless of how much was planted. This program is a voluntary form of decoupling and is a part of a more comprehensive farm policy.

The second form of decoupling simply would utilize a permanent historical commodity acreage base rather than one that is base on the previous five years. This would decouple program payments from current production and marketing decisions. New entrants might be penalized under this approach unless special allowances are incorporated into the policy.

Third, decoupling could be achieved by utilizing a whole farm acreage base. A diversion payment could be made to farmers based on a percentage of their whole farm base idled, then the farmer could plant any crop mix desired on the permitted acres.

A fourth type of decoupling would calculate payments to farmers on the basis of an income means test criteria rather than

a farm production volume criteria. Program payments would be based on income much like other nonfarm general assistance programs. If land ownership or volume of production is not used, then this form of decoupling would not only decouple program payments from production decisions, but would also decouple land values. Farmland market values would be capitalized based on world commodity prices alone rather than world prices plus program payments.

A fifth decoupling issue raises a debate on whether program payments should be completely phased-out or whether the U.S. should retain a farm income safety net. One proposal suggested freezing current deficiency payment levels and phasing them down over a specified period of years. During this period, farmers would either exit or be prepared to compete at world market prices without an income safety net. Eventually set-asides would also be phased out, but the conservation reserve would be maintained. This is the form of decoupling assumed for analysis purposes in Table 1.

#### OPTION 4.. A TARGETED MARKETING LOAN.

Here, current nonrecourse loans and possibly deficiency payments would be replaced by marketing loans. If the deficiency payments are eliminated, the announced marketing loan rate would be increased to current target price levels. If the deficiency payments are not replaced by the marketing loan, target prices would be frozen at current levels. To reduce program costs, the percentage of production multiplied by the payment rate would be reduced. For example, perhaps the marketing loan and/or the



deficiency payment would only be applied to the portion of the commodity needed for domestic use. One variation of this proposal eliminates set-asides but maintains the CRP. Alternatively, set-asides could also be used on a standby basis.

OPTION 5. MANDATORY PRODUCTION CONTROLS (SUPPLY MANAGEMENT).

This approach would impose acreage allotments or marketing quotas on all producers. Penalties would be imposed for not complying with the restrictions on production. A standby nonrecourse loan would be implemented if price targets were not met.

Table 1. Farm and Food Policy Options

Policy Objectives	Current Program	Graduat Payment	Decouple	Targeted Mkt Loan	Mandatory Controls
1. Adequate Supply of Food	+	+	++	++	+-
2. High Quality Safe Food	+	+	+	+	+
3. Competitive in World Markets	+	+-	++	++	-
4. Farm Price and Income Stability	++	+	-	+	++
5. Rewards Efficient Farmers	+	-	++	++	-
6. Provides Orderly Marketing Of Diverse Farm Products	+	+	-	+	+
7. Freedom and Flexibility in Operating Farms	?	?	+	+	-----
8. Fosters Rural Economic Growth and Efficient Food System	+-	+-	+-	+-	-----
9. Promotes Conservation and Protects Environment	++	++	+	+	++
10. Lower Government Costs	+	+	+	+	+
11. Lower Consumer Costs	+	+	++	++	-
12. Provides Family Farm Safety Net	+	+	+-	+	+-

## G. SUMMARY OF CONCLUSIONS

1. The U.S. government initially supported prices, set-aside acreage and acquired grain reserves because the previous free market policy resulted in price and income instability that was judged to be politically unacceptable.

2. Since the 1920s, commodity programs have caused acreage planted to crops to vary by 60 to 90 million acres between peaks and troughs. The peaks and troughs were associated with the Great Depression, World War II, Go-Go 1970s, and Farm Crisis of the 1980s.

3. There has been three levels of debate in recent Farm Bills. These include the level of price and income supports, the program structure, and deciding who should set the policy parameters.

4. We can no longer set commodity policy in isolation of international trade policy and global politics. The likely goals of the 1990 Farm Bill include maintaining international competitiveness, increasing flexibility, and government budget concerns.

5. Several options, including some new concepts, will likely be placed on the table. The ability to analyze and respond to them in an efficient manner may determine the length of the debate as well as the effectiveness of the policy eventually adopted.

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