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Farm policy amid high prices: Which direction will we take?*

by Bruce A. Babcock, Center for Agriculture and Rural Development, babcock@iastate.edu, 515-294-6785

Increased demand for corn from ethanol plants, short wheat crops, and stagnant South American soybean yields have led to \$3.00 corn, \$5.00 wheat, and \$6.00 soybeans. These high prices suggest that producers of these commodities

should not expect any loan deficiency payments or counter-cyclical payments for either their 2006 or 2007 crops. If futures prices are any indication, then farmers might not see any payments from these programs for at least three or four years. High prices will not affect direct payments, of course. So \$2.1 billion in annual aid will flow to corn farmers, \$1.15 billion will go to wheat farmers, and soybean farmers will receive \$608 million for both crop years despite the high prices.

A lack of payments is good news for farmers, our budget deficit, and our trading partners. Farmers get to enjoy the benefits of high prices; the budget deficit will be relatively smaller; and

our commodity programs will have minimal impact on world prices. However, high prices pose a dilemma for farm groups and their supporters in Congress. The current set of programs was designed to generate payments to offset low prices. What should be done with our current programs if we are entering a period of high prices?

Although it is hazardous to forecast how Congress is likely to respond to high prices, past experience suggests a probability of near zero that Congress will declare the end of farm subsidies. Three more likely options for Congress are:

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Handbook updates

For those of you subscribing to the handbook, the following updates are included.

Grain Price Hedging Basics
– A2-60 (6 pages)

Using Hedging in a Marketing Program – A2-61
(5 pages)

Standard Measurements
– C6-84 (2 pages)

Please add these files to your handbook and remove the out-of-date material.

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1. Declare victory over low prices but keep current programs and associated target prices in place just in case this victory is short-lived.
2. Keep current programs but raise target prices for all crops or for those crops that would not otherwise receive payments.
3. Change farm programs so that they provide a better financial safety net, with payments arriving when they are needed.

Before turning to a more detailed look at each of these options, it might be instructive to see how Congress responded with changes in farm legislation in earlier periods of high prices.

Responses to High Prices in Previous Farm Bills

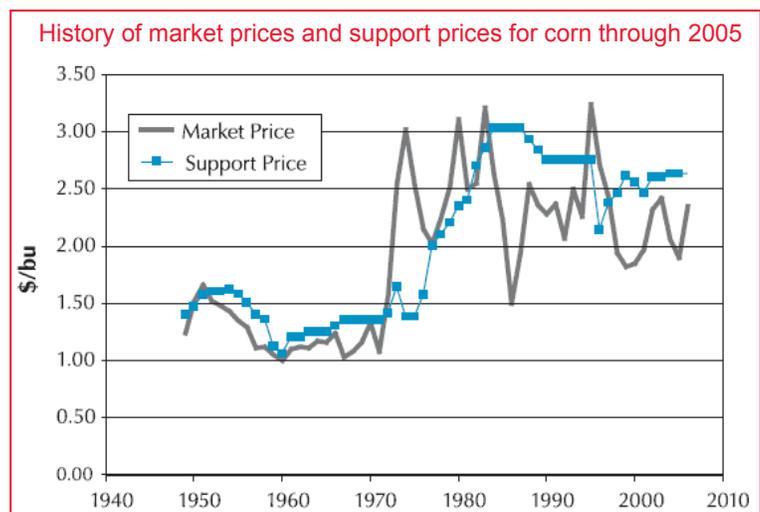
The commodity price boom in the mid-1970s resulted in support levels that were far below market prices. Congress responded with farm legislation in 1973, 1977, and 1981 that increased loan rates and target prices. Before the boom, corn loan rates were \$1.35/bu. At their peak, loan rates hit \$2.55/bu. Target prices for corn increased from \$1.38/bu to a peak of \$3.03/bu. The most common justification for this rapid increase in price supports was to combat rising production costs.

In 1995, Congress was again faced with a choice about what to do in a period when market prices were above price support levels. At that time, strong export demand, a weak dollar, and production problems resulted in high prices in 1995 and 1996. Prices also were expected to remain strong for several years. Congress responded quite differently with the 1996 farm bill. Rather than raise target prices, Congress eliminated the deficiency payment program and funded the direct payment program, assuring farmers of payments during what was expected to be a strong price period.

The graph shows the history of total support levels and market prices for corn through 2005. (The pictures for wheat and

cotton are similar.) The run-up in market prices during the 1970s was closely followed by a run-up in support levels. The run-up in prices in the mid-1990s actually resulted in a brief decline in support, until the market loss assistance payments were paid out in 1998. The maintenance of support levels in 2002 is clearly revealed.

It is interesting to consider what U.S. agriculture would look like today had Congress simply left support prices at their 1970 levels. The overall pattern of market prices for corn would look largely as it does in the graph, with some exceptions. High government support prices in the early 1980s undoubtedly expanded planted acreage, but annual set-asides somewhat counteracted these effects. The large buildup of stocks in the mid-1980s kept prices from rising higher than they otherwise would have in the drought year of 1988. And prices would not have risen as high as they did in the drought year of 1983 except for the large acreage reduction effort that year. But, especially since 1996, the overall pattern of prices and production have been largely unaffected by the billions of dollars in federal support given to corn farmers over this period. That is, if government had chosen to wean farmers from support in 1972, the U.S. Corn Belt would look mostly like it does today. The large run-up in commodity prices in the 1970s would have occurred. And we still would have had the farm crises in the mid-1980s, high prices in the mid-1990s, low prices in the late 1990s, and bum-



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per corn crops in 1994, 2004, and 2005. Ultimately, what we have to show for the billions of dollars that have been spent supporting corn farmers are perhaps a bit higher corn production, somewhat higher land prices and wealthier landowners, and some cases in which farmers' transition out of agriculture was made easier by payments. Whether these accomplishments are enough to justify the costs is an open question, but it is important to keep these long-run impacts in mind as we decide what to do with the next farm bill.

Three Alternative Paths

Extend the 2002 Farm Bill

For all the domestic and international criticism aimed at the 2002 farm bill, extension of its commodity provisions would represent a move to a free-market program regime for corn, soybeans, and wheat. The impact of the biofuels boom on the demand for corn should mean that market prices for all three commodities could remain above levels that trigger countercyclical and loan deficiency payments at current target prices and loan rates. Direct payments would still flow to producers, but these payments have little effect on planting decisions.

Maintenance of current target prices and loan rates would also give Congress and farmers assurance that a repeat of the late 1990s could not occur. Elimination of the deficiency payment program in 1996 left only the nonrecourse loan program and AMTA (Agricultural Market Transition Act) payments to cushion the blow of low prices. Congress felt that this was an inadequate cushion and passed emergency payments beginning in 1998 and made permanent this level of support with the countercyclical payment program in 2002. Maintenance of current programs at current target prices would mean that if prices were to return to the low levels of the late 1990s, then farmers would be assured of large payments.

Depending on the intricacies of budget scoring, holding the line on target prices could free up funds for use in other areas of the farm bill, such as conservation, research, energy, nutrition, and rural development, where a good case can be made

for spending scarce public funds on programs that serve broad public interests.

The most vocal advocate for extension of current provisions of the farm bill is the American Farm Bureau Federation. It will be interesting to see if Farm Bureau's position will change this winter given that its farmer members who grow corn, soybeans, and wheat will be receiving few payments over the next few years.

Raise Target Prices

An alternative to simply extending current provisions is to keep current programs but to "rebalance" target prices. Soybean and wheat growers have received almost no support from countercyclical payments since this program's inception, and corn farmers should not expect to see any support for the next few years. But rice and cotton producers likely will continue to receive both marketing loans and countercyclical payments.

Already, the National Association of Wheat Growers is advocating a 24 percent increase in the wheat target price. The two justifications they give for this proposed increase are that the current target price is too low given current market prices and that wheat farmers have simply not received their fair share of payments. The American Soybean Association in an October 12 press release asks "Congress to correct inequities under the current Farm Bill where target prices for oilseed crops are disproportionately low compared to other program crops."

A rebalancing of target prices requires some idea of what should be in balance. Should target prices be set so that per-acre payments are equalized? Should they be set to reflect past market prices? Should target prices reflect production costs somehow? Or should they be balanced to minimize their impact on planting decisions? When target prices are rebalanced, should cotton and rice prices be lowered or should we only consider increasing support levels?

A more fundamental question that should be addressed before target prices are raised is what ex-

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actly is supposed to be accomplished by commodity programs. Does a lack of payments to wheat and soybean farmers (and corn farmers in the future) somehow mean that farm programs are failing? Or does it mean that wheat and soybean farmers do not need public support because market prices are high enough?

Using payment flow to farmers regardless of market conditions as a metric of success of farm programs is consistent with what we know about the long-term impacts of farm programs discussed earlier--higher land prices, wealthier landowners, and easier transition of farmers out of agriculture. That is, if all farm programs are supposed to accomplish is to make land prices higher than what market returns would otherwise dictate, then an increase in target prices to assure continued payments would be justified.

Improve the Farm Safety Net

Rarely if ever do we hear anyone argue that increased land prices are the goal of commodity programs. Rather, we most commonly hear leaders talk about the need for a secure farm safety net to help farmers withstand unexpected financial stress. The biggest source of financial stress to wheat and soybean producers since passage of the 2002 farm bill has been low yields caused by multi-year drought, not low prices. And legislators from wheat country have been the strongest advocates of a new disaster assistance program.

The growing support for yet another disaster assistance program is evidence that Congress has failed to make subsidized crop insurance the centerpiece of a farm safety net. Despite billions of dollars in premium subsidies, billions of dollars subsidizing agent commissions, and billions of dollars subsidizing the risk-taking of crop insurance companies, Congress seems poised to spend billions more on some sort of disaster package.

The third alternative approach that Congress could take with the 2007 farm bill is to change farm programs to eliminate any holes in the farm safety net. There are three such holes that could be filled: uninsured acreage, the large crop insurance

deductible, and the impact of multi-year losses on crop insurance guarantees.

Uninsured acreage could be remedied by simply extending insurance protection to all who desire it by making it part of the farm bill. High deductibles are necessary in a crop insurance program because they discourage cheating. However, the most popular crop insurance program among Illinois corn producers in 2006, Group Risk Income Protection (GRIP), has low deductibles because it insures county revenue rather than farm revenue. Also, because GRIP bases its guarantee levels on long-term trend yields, two or three consecutive years of low yields in a county have no impact on a farmer's guarantees.

A farm policy that simply gave a GRIP-style policy to producers would thus provide the basis for a sound safety net that would eliminate any economic justification for disaster assistance programs. The cost of giving GRIP to producers would be relatively modest compared to running GRIP through the crop insurance program. On a per-acre basis, taxpayers currently support GRIP in the crop insurance program with subsidies to premiums, delivery costs, and reinsurance costs at such a level that farmers could be given a GRIP-based policy at the 94 percent coverage level in the farm bill at an equivalent cost. If this were done, then the one remaining safety net hole would be variations in farm yield not reflected in county yields, also called yield basis risk. This remaining risk could be largely covered by new crop insurance products offered by crop insurance companies.

A growing number of groups, including the American Farmland Trust and the Chicago Council on Global Affairs, advocate reform of farm policy around some sort of revenue insurance program. Somewhat surprisingly, the National Corn Growers Association is also considering supporting this kind of reform. The groups' proposals vary, but they all have in common the idea that commodity programs should be designed to deliver a sound financial safety net for farmers and that rural America would be better served by greater emphasis on the other titles in the next farm bill.