Arguments against supply management: An evaluation

When we explain the concept of major-crop supply management that includes a loan rate that is marginally below the full cost of production, we are often met with one or more of the following concerns the person believes might undercut our argument.

One concern is that US production is now a smaller percentage of world production than it once was, possibly limiting its ability to influence the world price.

Another is that US exports are a smaller percentage of world exports and that limits the influence that a US supply management program might have.

A third issue: if the US increases the loan rate to 95 percent of the full cost of production, that could make the US vulnerable to a flood of cheaper, corn, soybeans, wheat, or whatever.

People say to us, “we like your ideas, but we just don’t see how it is going to work.”

In many ways these are not new arguments.

While US grain exports were an important contribution to the war effort in WWI, feeding civilians and soldiers alike as our European allies lost access to traditional sources of grain in Eastern Europe. Following the war, exports to Europe declined and US corn prices fell well below the cost of production. Even prices one-third their wartime high were not enough to stimulate export markets for US farmers.

After US crop exports began to decline following historic highs from 1979 through 1981, we began to hear arguments that the Commodity Credit Corporation loan rates were too high and the US needed to reduce them so with lower prices US farmers could recapture “their share” of world exports of commodities like corn, wheat, and cotton.

In response to these arguments, policies in the 1985 Farm Bill lowered the loan rates for crops, but the resulting lower market prices did not have the desired effect of increasing US exports.

The 1996 Farm Bill eliminated government stock holding policies and the accompanying link between loan rates and programs that isolated production in excess of demand in the belief that unhindered free markets would lead to a new era of prosperity for US farmers. Despite policies that allowed the price of corn and other farm commodities to fall well below the cost of production, exports seldom regained their previous highs, resulting in a further decline in the US share of world grain exports.

Low prices did not cause commodity exports to trend upward. In fact, with short-run shifts in availability or utilization, the directional link between prices and exports often runs the other way around.

The sudden high export demand of the early 1970s drove crop prices higher. But once productivity in the US and other countries grew sufficiently to meet this new demand, prices fell and only loan rates above $2.00 kept prices from falling to the levels of the 1950s and 1960s.

The first two comments we mentioned above question the ability of the US to influence world prices for US crops in a period where our share of world production is smaller than it once was.

To address them, we need to look at where the world price is set.

We believe that for the most part world crop prices are set on US commodity exchanges with the interaction of major commodity exchanges around the world.

Why do we believe that?

It is our observation that when importers in country A need to purchase corn, they solicit bids. The US bid is based on the relevant US futures price for the delivery month adjusted for transportation and other costs needed to get the grain to country A. If another country, Country B, wants to capture the sale, it will base its bid on the US delivered cost per bushel taking into account differential transportation and other costs and considerations. Country B has no interest in leaving money on the table. It wants to come as close to the US delivered price as possible without losing the bid. This price-setting approach continues until all of Country B's exportable production is sold.

Overall, the US is the world's residual supplier and the oligopoly price leader. So, what makes the US the oligopoly price leader?

First there is an oligopoly—a limited number of suppliers—for most agricultural commodities.

Second, the US is the price leader because it can make delivery from a stable supply of a range of agricultural commodities and has a stable currency that serves as the world's reference currency.

In this system, if the US were to set the corn nonrecourse loan rate at $4.00, that would put a floor on the futures price of corn on US exchanges and thus on the bids of the country Bs out there.

Having addressed the pricing issue, we turn to the question of whether or not setting the loan rate just below the full cost of production would make the US vulnerable to a flood of imports.

For the most part any exports from country B to the US would come at the expense of their exports to the country As they are now supplying. If imports become a problem, the US can set import tariffs on the affected commodities to make the import price equal to the US price.

The US could argue at the WTO that by setting the loan rate at a point where the US is no longer dumping commodities on the world at a price below the full cost of production, the US should be able to protect its markets with tariffs.

The US could also invite other countries (Canada) or country-like entities (EU), with a stable agricultural land base to join them in establishing mutually compatible supply management programs.

That would leave countries with increasing agricultural land bases to continue doing what they are already doing. Only when it has hit its maximum profitable land base will Brazil's agricultural expansion come to a close.

A US supply management program would also be a boon to peasant producers around the world by raising the price they can earn from their production. After the US eliminated the effectiveness of its supply management program in 1996 and prices fell, it was accused of ruining peasant farmers in Franc-Zone Africa by selling low priced cotton on the world market while giving subsidies to US farmers.

The reality is that it was not the subsidies that hurt these farmers, rather it was the elimination of the price floor, set by the US loan rate, that drove cotton prices downward, hurting farmers in both the US and Franc-Zone Africa. Establishing US farm commodity loan rates at just below the cost of production for US farmers could be one of the most effective and cost efficient development programs we could design.

Very few believe that farm programs can or will be eliminated in the US or in other countries due to the nature of how commodities are supplied and the nature of their demands.

An important question in this country is what type of program will society/US taxpayers be willing pay for in the years ahead?

The policy of “let it rip,” that is, all out total grain production disconnected from market realities with income shortfalls underwritten by US taxpayers does not seem sustainable in the future.

Advantages and disadvantages of an alternative farm policy cannot be considered in a vacuum but rather relative to other policy directions, or in this time and place, the current policy.

Policy Pennings Column 1044

Originally published in MidAmerica Farmer Grower, Vol. 37, No. 290, September 11, 2020

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