Price extremes and market distortions

Free market and libertarian economists emphatically proclaim that supply management programs distort markets and thereby cause misallocation of economic resources. We agree.

But the relevant policy question is not whether distortion occurs. The question is "compared to what."

Economists routinely use the perfectly competitive model as the reference point. As surprising as it may seem, that standard is lacking in this case because key assumptions of the perfectly competitive model do not characterize agriculture.

In fact, the lack of congruence between the characteristics of agriculture and the assumptions of the perfectly completive model is the economic reason for the existence of farm programs (https://tinyurl.com/y2secxoo).

To us the most appropriate standard for considering the resource-use and general economic efficiency of a proposed farm program is to compare it with the dominant farm program currently in use.

The general philosophy of recent farm programs is to allow prices to go as high and as low as they want, with direct payments used to partially offset "low" prices. Given the characteristics of agriculture the price highs—which are almost always caused by external events—and subsequent price lows have been indeed extreme, very extreme.

Those extremes are major distortions away from what we might think of as a long-term cost of producing the product. This means that during periods of extremely high prices additional resources are brought into agriculture in the US and elsewhere as if those extremely high prices were going to continue for the foreseeable future.

Livestock operations and other consumers of the major crops have their markets distorted as well since they must pay excessively high prices for grains. Consumers face distorted markets characterized by reduced availability and high prices of meat and other food products.

When major-crop prices crash, as they invariably do, under current types of farm programs major-crop farmers continue to produce much as they did during the high price period. They really have no choice. They cannot affect price individually, so they continue to plant all their acreage, perhaps changing the mix of crops, but no acres are left behind.

As prices plummet below production costs, misallocation of the nation's resources continues. Major-crop production soaks up resources that could more efficiently be used in other sectors. Livestock producers and final consumers are again caught in, and suffer from, the series of misallocated resources.

A supply management program also suffers from these resource misallocation and related problems. The difference is that guardrails are put in place to keep prices from going unrealistically high or unreasonably low. Markets are free to move inside the band between the price guardrails.

Prices are kept within the bottom boundary of the band with scaled-back production/stock accumulation methods. Stock releases keep the price inside the upper boundary of the band (See https://tinyurl.com/y6b57luo for further explanation).

The net result is less misallocation of resources in the agricultural sector and in the general economy compared to recent farm programs. Meanwhile government outlays for farm programs become a fraction of the outlays of current programs.

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