PolicyPennings by Dr. Daryll E. Ray

The case for eliminating LDPs

U.S. farm payments are under pressure because of the need to reduce the budget deficit and because of the demand by less developed countries than rich countries, like the U.S., reduce their subsidies as a part of the World Trade Organization's Doha Round of trade negotiations. While at the G-8 summit in Scotland, attended by eight of the world's major economic powers, President Bush suggested that developed countries eliminate the $112 billion a year that they spend on subsidizing their farmers. Bush's goal is to achieve these reductions by 2010. At home, Bush has targeted the farm program for budget cuts - cuts that have been resisted by farm state senators and representatives.

While the possibility of getting both the U.S. and the E.U. to eliminate their farm subsidies as a part of the WTO negotiations may seem remote, we pose this question: setting aside for now whether the high-cost, government-payment components of the current farm programs would need to be replaced with other program types, what arguments could one use to justify the elimination of costly government payment programs - in addition to the too costly part? Last week, we looked at some of the arguments that might be used to justify the elimination of the direct payment program under such ground rules. This week, we will look at Loan Deficiency Payments/Marketing Loan Gains (LDP/MLG).

First, a little background. LDP/MLGs were initially used with the cotton and rice crops beginning with the 1985 crop year and effectively extended to the remaining program crops in later legislation. These payments were a part of the effort to make U.S. crops more price competitive in world markets. The proponents of LDP/MLGs argued that U.S. farm program provisions established crop prices at levels above those prevailing in the world marketplace.

The institution of LDP/MLGs allowed the domestic price of covered crops to fall below the crop's support price or non-recourse loan rate with the U.S. government picking up the tab for the difference. The introduction of LDP/MLGs, along with the elimination of annual set-asides in the 1996 Farm Bill, means government programs no longer provide a price floor for program crops. And, since the Farmer-Owned Grain Reserve was eliminated and the Commodity Credit Corporation no longer holds significant commodity stocks, prices are not constrained on the top side either.

Here are some of the effects. Farmers have every incentive to use all their land to produce as much as possible. With the elimination of supply control, they, of course, did just that. With the LDP/MLGs, prices declined and, for a given stock level, declined more sharply than under previous legislation. For example, corn price studies completed here at APAC show that beginning with the 1998 crop year, for the same stocks-to-use ratio, the price of corn was 35 cents a bushel lower than it was the prior 25 years. Similarly, at comparable stock levels, prices for other major crops decline more sharply under current farm policy than under previous policy regimes.

Demanders have no incentive to bid up prices because they know farmers will receive the difference between the price and the loan rate as a payment and, without the possibility of acreage set aside, they know that next year's supplies will likely be ample, so there is no need to buy ahead.

In fact, one of the significant beneficiaries of this program has been grain and soybean demanders. With the government supplying half - to more than all - of crop farmers net farm income in some years, clearly, integrated livestock producers, food processors, and export customers purchase feed and food ingredients at substantially below the full-cost.

Viewed this way, it becomes clear that by providing output at well below the full-cost of production, crop farmers are passing-through the government subsides to grain and soybean demanders.

The other major beneficiary of the all-out-production-then-compensate-for-resulting-low-prices approach is agribusiness. The fact that much to more than all of crop farmers' net income is from government payments means that too much is being produced to fetch prices that cover the cost of production.

Said another way, less needs to be produced which also means that less seed, fertilizer, insecticides, herbicides and other agribusiness supplied inputs are being applied to the nation's farms. Similarly, larger than economically-justifiable output means agribusinesses and others that provide volume-based services after commodities leave the farmgate are getting more business than otherwise would be the case. Such services would include marketing transactions, handling, transportation and other logistic services.

While those in countries that import our grains and seeds benefit from low-priced commodities, below-cost-of production prices can have a devastating affect on farmers in developing countries. Unlike many developed countries that replace lost market receipts with payments, countries in Africa and other developing parts of world can not and do not provide such protection.

U.S. farm policy has been criticized in the past as market distorting because of the "high" levels at which price supports were set in certain periods. Of course, from an economic theory perspective, market distortions resulting from policy-caused "low prices" are equally troublesome. The combination of using LDP/MLGs and the elimination of other program instruments may have caused program-crop markets to be more distorted in recent years than in previous times under other configurations of commodity programs.

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