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PolicyPennings by Dr. Daryll E. Ray

Announce the elimination of LDPs and corn prices would jump immediately

In our last column we began looking at the possibility that the US corn, wheat, rice, and soybean programs could be subject to WTO challenges using similar arguments to those used in the cotton case in which Brazil challenged US farm payments to cotton producers.

This is a distinct possibility because in the cotton case the WTO panel ruled that direct payments (fixed decoupled payments) cannot be considered to be in the green box (non-trade-distorting) because of the fruit and vegetable planting restriction. In addition the marketing loan payments – Loan Deficiency Payments (LDPs) and Marketing Loan Gains (MLGs) – and the counter-cyclical payments (CCPs) were ruled as suppressing the price of cotton.

All three of these payment types apply to corn, wheat, rice, and soybeans, leaving these four crops vulnerable to WTO challenges as well. We will leave to another time guesses as to whether the WTO would be able to make a large collection of such rulings stick or even whether it can survive as the deity of agricultural trade in the long-run.

In part the cotton ruling was based on expert testimony from agricultural economists who testified on behalf of the Brazilian cotton producer. Last week, in order to identify the shortcomings of applying the cotton-analysis approach to other crops, we asked ourselves what we would say if we were asked to provide expert testimony on behalf of US corn, wheat, rice, and soybean farmers.

With the Brazilian cotton case looming large over WTO agricultural negotiations and thus over US farm bill discussions, we have been using this column to outline the arguments that could be used if one were called upon to provide expert testimony before a WTO disputes panel hearing a case against the US corn, soybean, wheat and rice programs.

In the first column in this series, we identified the underlying characteristics of crop agriculture. We then argued that looking at subsidies isolated from these characteristics is like straining at gnats while swallowing camels because numerous studies have shown that eliminating subsidies are not likely to reduce US aggregate crop production nor raise prices.

If the elimination of mailbox subsidies would not lead to significantly decreased production and the expected increase in the price of program crops, then why have prices been so low? To a large extent it is because of the use of Loan Deficiency Payments/Marketing Loan Gains (LDP/MLG).

In the mid-1990s, the non-recourse feature of the loan program was rendered ineffective by the extension of LDP/MLGs to corn, wheat and soybeans among other crops. Instead of forfeiting ownership of a crop whose price fell below the loan rate to the government in exchange for the government writing off the decrease in collateral value, the LDP/MLG allowed the farmer to retain ownership of the crop with the government paying the farmer the amount it would have written off.

This shift in policy was seen as positive change. It saved the government the cost of storage of forfeited grain, and it allowed the farmer to capture any gain in value if the price of the crop increased. In addition it was argued, the use of LDP/MLGs would allowed the US price to match the world price enabling US producers to recapture lost market share in these crops. The logic behind this was based on the belief that the US loan rate artificially held the US price above the world price, resulting in lost marketing opportunities.

The belief was that the world price was set by international supply and demand conditions apart from the US price. And if the US rendered the loan rate ineffective in setting a floor on prices, the US price would be the same as the world price. This would allow the US share of the export market to increase significantly because it was no longer locked out by artificially high prices.

The problem with this line of reasoning is that it failed to understand the role of US markets in setting the "world price." There is ample evidence to suggest that the US is the oligopoly price leader for most temperate agricultural crops.

Because of its control over a large portion of the supply, the oligopoly price leader sets a virtual ceiling on prices and all other competitors price off the leader. In most cases, unless they offer a premium product, the price for competitors is below that of the price leader.

As US prices fell from their 1996 highs, the prices of our export competitors fell as well, staying below the US price for the bulk of their sales. As the prices plunged below the loan rate during the 1998 crop year, it was expected that two things would happen: (1) our export competitors would reduce their acreage or at least slow down their rate of acreage expansion, and (2) the lower prices would enable to capture additional sales and our competitors would end up holding additional year-ending stocks. Neither thing happened even though prices stayed below the loan rate for the most of four years.

In the absence of a supply crisis, once the price fell below the loan rate, grain purchasers had little incentive to bid the price up. From their perspective, as long as the price stayed below the loan rate, the US government was in effect subsidizing their purchases.

Farmers, too, had little incentive to see prices rise above the loan rate because the lower the posted county price, the greater the LDP/MLG they could capture. To make more than the loan the farmer needed to wait to sell until the price was greater than the posted county price when they took the LDP. For farmers who had forward contracted their crop at a higher price, it was like shooting fish in a barrel.

While LDP/MLGs provided little incentive for US farmers to increase their aggregate plantings, they did protect them from the ravages of sub-loan rate prices. Farmers in the rest of the world were not so fortunate as they had to take the lower prices; Thus, the charges of US dumping of crops at prices below the cost of production.

We are not arguing that the US commodities were not sold at prices below the cost of production. They were. What we are arguing is that the problem is not farm program benefits themselves, but rather the mechanism by which they are distributed. If the US were to announce that it was going to scrap the LDP/MLG programs at the end of the current crop year and allow the non-recourse loan program to function, the impact would be immediate. Corn prices would jump from their current local prices in the $1.65-1.75 range to over $2.00.

Adhering to a faulty WTO-focused analysis and eliminating all subsidies is like throwing the baby out with the bath water. No one will be better off and many will be worse off. A better solution would be to eliminate the offending LDP/MLG program allowing the non-recourse loan rate program to set price floors for US farmers and farmers around the world.

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