

# Farm program considerations: Part 3, setting the loan rate

One of the thorny issues in designing a defensible crop supply management program is setting the loan rate.

Set the loan rate so that it guarantees nearly all farmers a breakeven price and some will convert pastureland and land, that is too ecologically fragile to be cultivated, into cropland. The resulting overproduction then guarantees continued low prices and high farm program costs.

Set the loan rate too low and we end up with a farm bankruptcy crisis like the late 1980s. A series of low price years like we have seen in the past often results in widespread bankruptcies and financial crashes that take years to recoup causing non-productive churning of land ownership and untold hardship to thousands of farm families.

To us it is not in society's best interest to bankrupt cost-efficient crop producers. It makes little sense to bankrupt farmers who can produce crops near or below the sector's long-run total costs of production when the cause of the problem (long periods of low prices interrupted by an occasional year of two of high prices: see our earlier column at <http://tinyurl.com/j97sofl>) has existed for millennia and is well known in economic literature—a problem that no single producer can overcome.

To identify that spot between too low and too high is a more a matter of art than science. In the study we conducted for the National Farmers Union in preparation for what ended up being the 2014 Farm Bill, we suggested setting the loan rate for corn at the midpoint between the variable cost of production and the full cost of production. But it could be set a little lower or a little higher.

What is important is that there is a floor price that farmers can use when they sit down with their banker to take out an operating loan for the coming year. Over the previous 8 years that was not a problem because crop agriculture was profitable and revenue insurance provided a revenue guarantee that the banker could rely on. With an extended period of low prices, revenue insurance only guarantees revenue that is well below the full cost of production, not something that will make the banker comfortable enough to make that operating loan.

Once the corn loan rate is set then the loan rate for other crops can be set according to the historic price ratio between corn and the other crop. Because corn is grown on more acres in the US than any other crop, other crops have to compete with corn for acreage, subject to non-price constraints like season length, temperature patterns, and a host of other considerations. The goal is to get the relative loan rates of various crops right so that market-signals trigger changes in cropping patterns based on consumer demand.

For the loan rate to serve its essential functions of stabilizing the market and allowing the market to work in allocating acreage among the crops, it must change over time as costs increase. We did that in the early 1980s and then when the 1985 Farm Bill was being designed, the increase in the loan rates was blamed for shutting off our exports; loan rates were slashed.

The exports did not come back when the loan rate was lowered. For corn we have only seen exports rise above their 1979 and 1981 highs once since then as the easy money developing countries used to purchase grain for their people dried up and increased yields and acreage were seen in both consuming and export-competing nations. A low corn loan rate did not stop the advance of agricultural technology around the world.

As with setting the loan rate, figuring out the formula to use to compute an increase in the loan rate over time is more art than science. If it is simply pegged to a given point between the variable and full costs of production, then input suppliers can increase their prices to farmers in the knowledge that such increased generate an increase in the loan rate, triggering an undesirable situation. We think a rational discussion of this issue would be helpful.

What we do know is if we don't increase the loan rate then it soon loses its function and then people begin a discussion about a target price and some sort of deficiency payment. That just leads to further complications. If we get the loan rate right and we make the proper increases over time, then we enable the market to allocate acreage efficiently.

In addition, if we stay with a well-designed loan rate program, the price in the market would be such that the US could not be accused of dumping grain on the world market at a price that is below the cost of production. Over time other major exporting nations may have to join the US in this endeavor to provide price stability within a range that protects farmers on the low end and consumers on the high end.

At this point, we know that for many of our readers we are deep in the weeds of agricultural policy, but this discussion is essential to the development of a rational set of workable policies.

Next week, we will discuss the release price and the nature of the price band as well as additional criticisms that have been made of a loan rate program.

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