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AGRICULTURAL AND FOOD POLICY

#### A Hiatus: The 1940s Through the Early 1950s

The massive complex of price supports and production controls put in place in the 1930s continued through the decade. Although economic conditions began to improve very late in the decade, the outbreak of World War II brought a sharp acceleration of economic growth. Agriculture, just as the rest of the economy, geared up to support the war effort. Commodity prices rose and the sector enjoyed prosperity through the war years. In fact, the commodity price supports were increased to near 100 percent of parity to encourage greater production to meet wartime needs.

At the end of World War II there was widespread fear of a repetition of the economic collapse that followed World War I. Congress moved in 1948 to prevent a return to the relatively low price supports set in the 1938 Act. This was followed in 1949 by major new permanent farm legislation—the Agricultural Act of 1949. In this legislation, the secretary of agriculture was given the authority to gradually lower the price support level to between 65 and 90 percent of parity. At the same time the parity concept was modernized to reflect the changing price relationship that had developed among commodities over the past 10 years. The 1949 Act also provided for acreage allotments and marketing quotas if approved by two-thirds of the producers. If producers did not approve marketing quotas, support prices would fall to as low as 50 percent of parity.

The 1949 Act has special significance because it was the last permanent farm legislation that has been enacted into law. All subsequent farm bills were amendments to the 1949 Act and specified an expiration date. If replacement legislation was not enacted into law before the expiration date, the provisions of the permanent 1949 Act would go into effect. That is, the secretary of agriculture would be required to adjust price supports, declare allotments, and hold a referendum for the imposition of marketing quotas. Such major changes in farm policy put substantial pressure on the Congress and the president to enact a new farm bill before the expiration date for the old bill.

The end of World War II did not bring the widely feared repetition of the economic collapse that followed World War I. Rapid economic growth was required to meet the pent-up demand for consumer goods.

Postwar food shortages in Europe and Asia, as well as the Korean War, kept demand strong and commodity prices at politically acceptable levels into the early 1950s. In fact, production controls for major crops remained suspended until 1954. However, output-increasing technological advances continued, and farm output once again began to grow faster than demand. Low commodity prices and low farm incomes in 1953 and 1954 again brought increased political unrest and the reimplosion of government controls on agriculture.

#### Postwar Surpluses: Attempts to Control Production

The excess capacity problem returned in full form in the mid-1950s and continued into the 1970s. Early in this period the Eisenhower administration used the flexible provisions of the 1949 Act to reduce the level of price supports and move agriculture in the direction of a freer market. From 1953 to 1960, price supports were reduced on wheat from \$2.24 to \$1.81 per bushel and on corn from \$1.62 to \$1.06 per bushel. Political resistance to these moves was tremendous. Trips to farming areas by Secretary Benson were frequently met with farmer protests.

Despite the efforts to discourage production by reducing price supports, surpluses continued to build. The traditional issue of the level of support remained but was tempered by large government expenditures. Increasing quantities of grain in the nonrecourse loan program were forfeited to the CCC. Prices remained at or near loan levels. At the peak, the cost of storing CCC-owned surplus commodities was \$3 million daily.

A growing consensus emerged that a practical solution to the surplus problem was the removal of large quantities of land from production. Even some of the more market-oriented policy advisers, such as J. C. Botum of Purdue University, became associated with specific production control proposals.

The center of debate turned on the appropriate type of production control program. Three specific methods were prominent in the debate:

- A **voluntary system of land retirement or acreage diversion** was instituted whereby the government paid farmers to take land out of production. Payments were based on the productivity of the land. Both partial farms and whole farms were removed from production. This "diverted" land had to be maintained in soil-conserving use. Incentives existed for landowners to participate in land retirement programs whenever the payment per acre minus the cost of maintaining the land in retirement exceeded the potential earnings from the specific land that was to be retired. The major objection to such land

retirement programs came from rural communities which were disrupted when many farmers placed whole farms in land retirement programs.<sup>14</sup> The effect was a lower level of economic activity resulting from reduced purchases of inputs and marketings of farm products with local businesses.

The first voluntary land retirement program was enacted into law in the Agriculture Act of 1956. It was referred to as the Soil Bank program. Land in the program expanded rapidly to over 28 million acres in the early 1960s and subsequently mushroomed to over 63 million acres in the mid-1960s.<sup>15</sup> From 1961 through 1972 an average of 12 percent of the cropland was in retirement. Government costs of land retirement reached a peak of \$855 million in 1971.<sup>16</sup>

• **Mandatory production controls** represented an alternative to voluntary land retirement programs. Mandatory controls were advocated by President Kennedy's chief agricultural economic adviser, Willard W. Cochrane. As the author of the treadmill concept explained in Chapter 8, it was Cochrane's view that the only means of stabilizing farm prices and incomes in agriculture was to give the secretary of agriculture the power to control production. Without such controls, Cochrane argued, agriculture would be characterized by chronic excess capacity that would eventually destroy the family farm.<sup>17</sup>

In the Food and Agriculture Act of 1962, Congress gave President Kennedy the power to impose mandatory production controls. This power was, however, subject to approval by two-thirds of the producers of a commodity before the controls could be put into effect. In 1963 a proposal was put to a producer referendum for a system of penalties for planting wheat in excess of acreage allotments. In addition, the plan would have issued marketing certificates based on domestic market and export needs. The referendum was soundly defeated with over a million farmers voting. This defeat dealt a fatal blow to mandatory production control programs.

• The third production control alternative is **set-aside or acreage reduction**. Set-aside required that a certain percentage of a farmer's cropland be taken out of production in return for the right to receive farm program benefits. To induce farmers to set aside, program benefits must be sufficient to offset the income that a farmer forgoes from not producing on the set-aside acres.

<sup>14</sup>Wayne D. Rasmussen and Gladys L. Baker, "Programs for Agriculture, 1933-1965," in *Agricultural Policy in an Affluent Society*, V. W. Runtan, Arley Waldo, and James P. Houck, eds. (New York: W. W. Norton & Company, Inc., 1969), p. 84.

<sup>15</sup>Ibid.

<sup>16</sup>*Agricultural Statistics* (Washington, D.C.: SRS, USDA, 1972-1980); and *Commodity Credit Corporation, History of Budgetary Expenditures, FY 1961-79* (Washington, D.C.: CCC, USDA, December 28, 1979).

<sup>17</sup>Willard W. Cochrane, *The City Man's Guide to the Farm Problem* (Minneapolis: University of

Set-aside was made possible by the initiation of direct income payments to farmers. Direct payments were begun after the defeat of the wheat referendum. Farmers participating in the 1963 wheat program were eligible for support of \$2.00 per bushel, including the loan of \$1.82 and a \$0.18 per bushel income support payment.<sup>18</sup>

Set-aside was first introduced in 1970. In the 1981 farm bill the term "acreage reduction" was used in addition to set-aside, although the basic program concept did not change. Aside from its voluntary nature, set-aside had the main advantage of reducing government costs of controlling production. Not only were the payments involved in retiring land avoided by set-aside, but also income support payments were avoided to those farmers who chose not to participate in the program.<sup>19</sup>

However, one frequently gets what one pays for. Set-aside was not very effective at controlling production. Not all farmers participated; those who did participate set aside their poorest land; then they applied more inputs to the remaining land that they farmed. Experience with the set-aside program in the 1970s suggested that a 15 percent set-aside resulted in about a 3 percent reduction in production.<sup>20</sup>

The difference between the size of the set-aside and the actual reduction in production is referred to as **slippage**. Despite the magnitude of the slippage, authority for set-aside continued to be provided for in major farm legislation through the 1981 farm bill.

Production control programs have not been successful in keeping aggregate production within the bounds of domestic and commercial export needs. Efforts to control production of individual commodities simply resulted in overproduction of the uncontrolled commodities. Despite the large acreages retired from 1961 to 1972, wheat production increased 25 percent, corn production increased 55 percent, and cotton production decreased by only 4 percent.<sup>21</sup> Efforts to control production could not keep pace with continual increases in agriculture's productive capacity. Increased dissatisfaction with production control programs and high price support policies led to a search for alternative policies.

<sup>18</sup>These income support payments were referred to as "price support" payments. This terminology is, however, confusing since the term price support is generally used to refer to programs, such as the nonrecourse loans, that do indeed support market prices. Direct payments only support income.

<sup>19</sup>As budget considerations became a more decisive factor in influencing program decisions, the fact that it was not necessary to make direct payments to farmers who did not participate in the set-aside became a more important factor in set-aside decisions. In fact, the desire to reduce spending may have been the major factor resulting in imposing set-aside in the early 1980s.

<sup>20</sup>This relationship assumed no supplementary diversion incentive and no effective means of enforcing farmers to set aside land of at least average productivity.

<sup>21</sup>*Agricultural Statistics*, 1972.

### The Transition to a Market-Oriented Policy

Toward the end of this period, a new element—competitiveness in international markets—began seriously to enter the policy debates. The United States, despite its enormous capacity to produce food, was only a residual supplier in world markets. That is, only after the supplies of all other exporting countries had been absorbed in the markets did the importing countries turn to the United States. This residual status resulted from price supports that were above competitive world market prices, combined with an overvalued dollar resulting from fixed exchange rates. As a result, U.S. products were effectively priced out of the market. With support prices above world market prices, U.S. exports were generally conditional on either concessional foreign aid under P.L. 480 or an export subsidy of the difference between the domestic price and the world price. In 1962, for example, about 43 percent of United States export sales were foreign aid and subsidized commercial sales. Wheat export subsidies in 1962 averaged \$0.54 per bushel and export subsidies totaled \$656 million.<sup>22</sup>

*A market-oriented policy exists where the unimpeded forces of supply and demand are the principal determinants of farm prices.* Market orientation implies the absence of production controls, price supports above market-clearing levels, and export subsidies. Beyond that, there are different degrees of market orientation extending all the way to the free market, where government's role is limited to functions such as research and information.

Many of the program changes that occurred in the 1960s and early 1970s, including the advent of direct income payments and set-aside, can be argued to have been significant steps toward greater market orientation. However, these program changes appear to have been motivated as much by a desire to reduce government costs as by a desire to allow supply and demand to operate. That is, prior to 1972 even with direct payments, market prices had a tendency to rest on support levels, thus requiring sizable export subsidies most of the time.

The transition to a market-oriented policy was significantly furthered by favorable market developments beginning in 1972 by Secretary of Agriculture Earl L. Butz. These favorable developments included a perceptible tightening of the world food supply-demand balance and an increased willingness of countries to rely on imports as a source of supply. The opportunity to change policy direction was seized on by Secretary Butz, an advocate of the free enterprise philosophy.

From a market standpoint, the turning point was the decision by the USSR in mid-1972 to purchase large quantities of U.S. grain from the major grain companies. Since the U.S. wheat support price was above the world market price, the Nixon administration was faced with a decision of whether to pay an export subsidy averaging about \$0.60 per bushel for the Soviet sales.<sup>23</sup> Secretary Butz argued

forcefully that this sale represented an opportunity to dispose of a portion of the U.S. grain surpluses as well as make significant steps in the direction of reduced government involvement in agriculture.

Soviet purchases were larger than anticipated. Within a month, the Soviets purchased 17.5 million tons of grain. Export subsidies exceeded \$150 million on purchases of 400 million bushels of wheat.<sup>24</sup> Substantial public criticism resulted from the export subsidy and how it was handled.<sup>25</sup> However, the Soviet sale, combined with weather-related reduced production in other countries set the stage for implementation of the more market-oriented farm policy encompassed in the Agriculture and Consumer Protection Act of 1973.

#### Target prices

The major market-oriented innovation in the 1973 Act was the development of the target price concept of income support. *Target prices provide for direct payments to producers of the difference between the target price and the average market price whenever the average market price falls below the target price for a specified time period. The difference between the target price and the average market price is referred to as a deficiency payment.* The maximum level of the deficiency payment has been specified as the difference between the target price and the loan rate. Target prices have been established for all major food and feed grains as a means of supporting farm income.

Operation of the target price program is illustrated considering three situations (Fig. 9.4):

1. The market price  $P_m$  is above the target price  $P_t$ . This is illustrated in the left panel of Fig. 9.4, which indicates that no deficiency payments would be made.
2. The market price  $P_m$  for the specified period is below the target price but substantially above the loan rate ( $P_l$  in the center panel). Deficiency payments would be based on the differences between the target price and the market price times the quantity of eligible production ( $P_t - P_m$ ) $Q$ .
3. The market price for the specified period is below both the target price and the loan rate (right panel). Deficiency payments of  $(P_t - P_l)Q$ , would be made—the maximum payment rate is the differential between the target price and the loan rate. Producers would probably elect to place commodities in the nonrecourse loan program. If unredeemed, the price received for the product would be the loan rate plus the additional deficiency payment,

<sup>22</sup>Precise data on export subsidies on wheat sold to the Soviet Union are not available. Export subsidies on wheat rose from \$80.9 million in FY 1972 to \$304.3 million in FY 1973. *Agricultural Statistics*, 1976. An excellent digest of developments associated with the Soviet purchases is contained in Dan Morgan, *Merchants of Grain* (New York: The Viking Press, 1979).

<sup>23</sup>William Robbins, *The American Food Scandal* (New York: William Morrow & Company, Inc., 1974).

<sup>24</sup>Commodity Credit Corporation *Financial Statements* (Washington, D.C.: USDA, 1962); and *FATUS* (Washington, D.C.: FAS, USDA, November–December 1980).

<sup>25</sup>*Agricultural Statistics*, 1974.

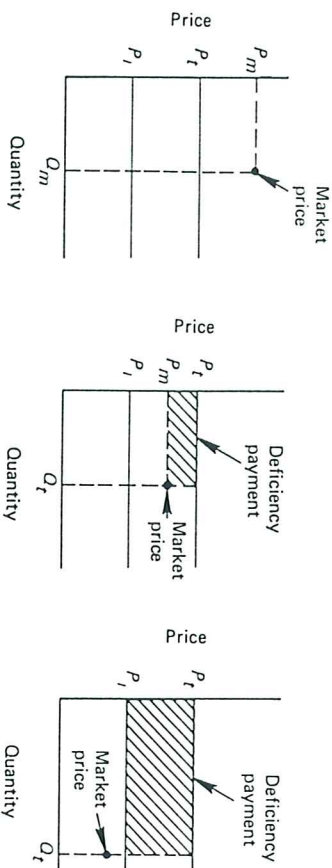


Figure 9.4. The target price/deficiency payment concept.

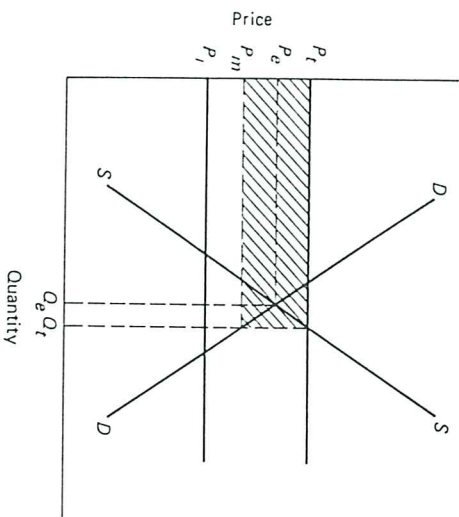


Figure 9.5. Target price impacts.

$P_1 + (P_t - P_1)$ . In actuality, the loan rate tends to be a price floor, and the market price is unlikely to fall below it.<sup>26</sup>

In a market context, the target price concept has some important economic effects (Fig. 9.5). Since the target price ( $P_t$ ) is a virtually guaranteed price to the farmer, it will encourage increased production  $Q_t$  if it is above the expected market price  $P_e$ . But at quantity  $Q_t$ , the market price will be  $P_m$ . The deficiency payment per unit will be the differential ( $P_t - P_m$ ), and total deficiency payments will be  $(P_t - P_m)Q_t$  (denoted by the shaded area). Note that the existence of a target price

<sup>26</sup>A circumstance where the market price could fall below the loan rate exists where receiving farm program benefits is contingent on farmers setting aside a portion of their cropland. If a large number of farmers fail to comply with the set-aside requirements and become ineligible for the loan, the loan rate is no longer a viable price floor.

above a free market equilibrium price  $P_e$  increases the level of output (from  $Q_e$  to  $Q_t$ ) and reduces market price (from  $P_e$  to  $P_m$ ). Since it is virtually impossible politically to reduce target prices, target prices above the free market equilibrium tend to foster ever greater deficiency payments by virtue of fostering increased production and lower market prices.

The impact of target prices on deficiency payments, output, and in turn government expenditures makes the criteria for setting the level of target prices particularly important. The Congress, in its continuing search for a workable criterion for determining farmers' economic welfare, in 1973 adopted a national average cost of production concept as the basis for annual adjustment of the grain and cotton target prices.<sup>27</sup> As a result, USDA was mandated to conduct cost of production studies for the major agricultural commodities. This also marked the formal end of the use of parity prices in setting support rates for grains and upland cotton. Parity prices, however, continued to be used as the price support standard for other commodities, such as milk and tobacco.

The use of cost of production as the criterion for setting target prices became highly controversial in the mid-1970s, when market prices fell from their 1973 peak. The issue centered on return to land in computing the average cost of production. USDA established the appropriate cost attributable to land as a proportionate weighting of the average acquisition price of land and the rental value of land. Certain producer interests argued that the cost of land should be based on its current market value. USDA correctly concluded that a higher return to land in computing the target price would be continuously capitalized into the value of land, touching off a price-cost spiral resulting in continuous target price increases.

The 1977 farm bill gave further support to the cost of production concept by using USDA estimates of cost of production to establish target prices and by annually adjusting target prices on the basis of the percentage change in cost of production throughout the life of the bill. Reliance on cost of production for establishing target prices, however, soon fell into disfavor as farm prices dropped below target prices in the late 1970s and early 1980s. Congress then made interim political adjustments in target prices for the 1980 crop year.

The controversy surrounding the use of cost of production as a basis for establishing target prices continued into debate on the 1981 farm bill. But in this case target prices themselves were called into question by the Reagan administration whose primary goal was to cut government spending. The Congress sensed two major consequences of the Reagan proposals to abandon target prices:

- Without target prices pressure would exist to once again raise support prices above market-clearing levels. Favorable production combined with a reduced rate of growth in export demand had already resulted in market prices for grain and cotton that were approaching loan-rate levels.

<sup>27</sup>Interestingly, the cost of production concept was first proposed and considered by the Congress in the 1930s but was rejected in favor of the parity concept.

- Farm incomes had fallen over 30 percent from \$31 billion in 1979 to \$21 billion in 1980 and remained at a low level in 1981. Political realities required a continuation of the target price concept.

Setting target prices on the basis of cost of production was, however, largely abandoned in the 1981 farm bill. In an effort to keep the projected cost of farm programs within the spending limits imposed by the Reagan administration, target prices were set by a process of political negotiation with an agreement that they would be increased by about 6 percent annually throughout the life of the bill. Of particular significance is the fact that in dairy, price supports were also set by political negotiation with parity achieving a considerably less important role in milk price support levels.

Another factor bearing on the appropriate level of the target price is that deficiency payments are, in a sense, export subsidies. That is, with the loan rate set below the world market price, the U.S. market price is the world price adjusted for transportation costs. The establishment of a target price above the world price encourages production (Fig. 9.5) and suppresses the world price. U.S. production is thus subsidized to the detriment of producers in other countries and to the benefit of U.S. producers and exports. Target prices are thus a barrier to free trade from a world perspective. Since virtually all countries protect their agriculture to a certain extent, target prices have been tolerated by other exporting countries because they have generally been set relatively low, reasonably close to the market equilibrium price  $P_e$  in Fig. 9.5. The existence of target prices, however, means that U.S. negotiators have to contend with charges that the United States subsidizes exports just as some other exporting countries—although the target price subsidy has generally been quite small.