

Farm Subsidies Hurt Most Farmers

by Clifford Cobb, San Francisco, CA

The 1996 farm bill may have spelled the beginning of the end for agricultural subsidies, but the battle to end farm welfare is far from over. Congress has agreed to stop price support payments for all crops with the exception of sugar and peanuts. For most crops, the government will make lump sum payments that will be phased out over seven years. But one of the compromises necessary to gain passage of this farm bill was a provision that will cause the old subsidies to be reinstated automatically in seven years if another farm bill is not passed then. The defenders of the old subsidies presumably hope the political landscape will change again by then.

Whether or not the specter of price supports comes back to haunt American politics, those of us who seek to eliminate all unfair taxes and subsidies would do well to reflect on the history of this program for the lessons we might glean for future conflicts.

Background

Subsidies for farmers were first begun under the Agricultural Adjustment Act of 1933. It has been frequently modified since then, but the basic structure has remained intact. If this monument to the welfare state is ever to be disassembled, we must begin by understanding its architecture.

The 1933 Act, like many of Franklin Roosevelt's policies, was politically brilliant and economically bankrupt. The basic idea was that farmers should receive a "fair" price for what they produce. Specifically, the federal government guaranteed farmers a price for their program crops such as grains, sugar, tobacco, and other commodities. The price was based on "parity" — the ratio of in-

dustrial to agricultural prices that existed from 1910 to 1914. In fact, the parity formula has been modified in various farm bills over the past half century, but the concept that there is a "fair" price other than the market price remains conventional wisdom among farmers.

One subsidy method involves setting a "target price" (based on some parity formula) and providing "deficiency payments" to farmers based on the difference between market price and the target. The other method involves offering farmers a "loan," for which the farmer provides the federal Commodity Credit Corporation (CCC) with the program crop. If the market price falls below the "loan" price, the farmer simply pockets the loan and the government is stuck with the grain in its silo. In both subsidy programs, farmers are required to idle a certain amount of acreage. Yet, in both cases, the subsidy is paid per unit of output, so the farmer has an incentive to maximize output per acre on the remaining land.

Initially, many Americans probably saw the principle of "fair" prices for agricultural goods based on parity as being reasonable. In 1933, the families

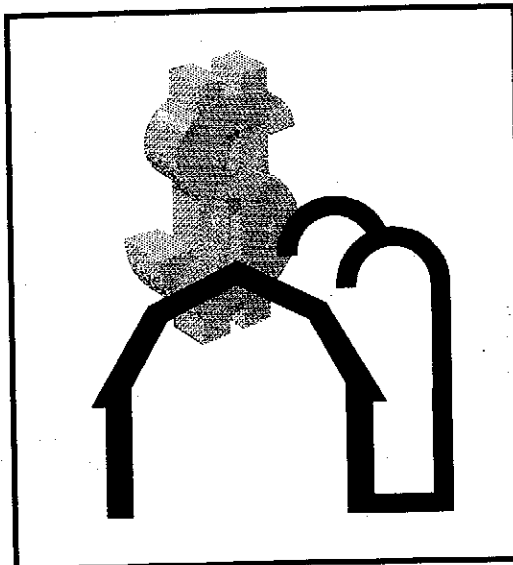
living on a farm (about one-fourth of the population) had an income of only one-third that of their urban cousins. From the beginning, however, the principle that urban taxpayers should subsidize rural farmers was based on the misconceived notion that rural poverty was caused by unfair commodity prices. Instead, the problem lay in a tax code that promoted concentration of land ownership and extremes of inequality by allowing private collection of rent.

Even if economic rents rather than income had been the basis of taxation, technical change would have driven millions of farmers off the land. The idea that farmers should receive parity assumes that all of the benefits of technical change in agriculture should be captured by farmers, none by society in the form of lower prices. (If computer manufacturers could have made that argument work for them, we would all be paying \$3,000 for 1985 technology computers and \$50,000 or more for those with Pentium chips.)

Agricultural productivity has increased far faster than industrial productivity in this century, which is why commodity prices have fallen despite increases in demand. A bushel of wheat might not buy as much as it once did, but an acre of wheat probably comes close. Only those farmers who were able to invest and expand were able to make a sufficient return to stay in business. As a result, fewer and fewer farmers have been required to produce the commodities required to meet the national and global demand for American agricultural goods.

The farmers who feared the inexorable forces of the market would drive them out of business have fought back. Arguing that preservation of family farming is essential to Ameri-

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can culture, they have claimed that the government should provide them with subsidies to stay in business. This clearly conflicts with the ideology of self-sufficiency, which is prevalent among farmers, but they resolve the conflict in their own minds by claiming the market is fundamentally unfair if it fails to provide them with parity.

Developing a Strategy

Perhaps the issue of farm subsidies is now moot. Perhaps not, if farm prices fall again in the next few years and the demands for farm aid are heard again. Given the longevity of these subsidies, we should assume that there are many battles still to be fought on this issue and that subsidies will persist in some form until the 1933 act is overturned.

Opposition to subsidies on the grounds that they are inefficient and costly to taxpayers were generally unsuccessful, at least until this year. The inefficiency ignores the emotional appeal of the family farm, which has served as political cover to support a program that primarily benefits the owners of mega-farms. (Farms with gross sales over \$250,000 received 32% of the price support payments in 1992, though they comprised only 6% of farms. This pattern follows from subsidies being based on total output of the program crops and from a farm operator having to leave some land idle to qualify for payments.)

Small operators are given enough crumbs to keep most of them from fighting the system. The strategy of pointing to the unfairness of the system has not worked. A more productive approach would be to take seriously the concerns of small- and medium-scale farmers who see themselves as stewards of the land and seek ways to accommodate them.

The key point to emphasize is that farm subsidies have NOT helped to preserve the "family farm;" instead they have accelerated its demise. If this central fact could be demonstrated conclusively to the millions of small- and medium-scale farmers who support policies that are contrary to their interests, it might be possible to break apart the political coalition that supports continued price supports.

The Effect of Subsidies on Agricultural Decisions

Disrupting the coalition that has maintained the price support system for over sixty years will require understanding the differential effects on farm operations of different sizes. Analyzing these effects could prove far more politically significant than repeating the obvious fact that subsidies to large operators are greater than payments to small operators. The key hidden benefit of price supports is the virtual elimination of

down-side risk, without any cost to the recipient. A farmer who plants a program crop can be assured of a minimum price for it, with the possibility that the market price will be much higher. In the absence of guaranteed prices for certain crops, a farmer would face the prospect of some good years and some bad years, depending largely on weather patterns in one region relative to others. A farmer does not benefit from a good production year if all producers of the same crop are highly productive that year. Overproduction may push the market price so low that the crop is not worth shipping to market. In order to avoid the risk of having a worthless crop, a farmer must diversify. Before the advent of price supports, a large proportion of farmers in the Midwest raised both livestock and rotated their grain crops. That way, if the price of the grain was low, they could feed the surplus to the livestock and reduce the financial loss. On the other hand, when the price of grain was high, their profits were not as high as they would have been with specialized farming because they had to feed part of their profits to the livestock.

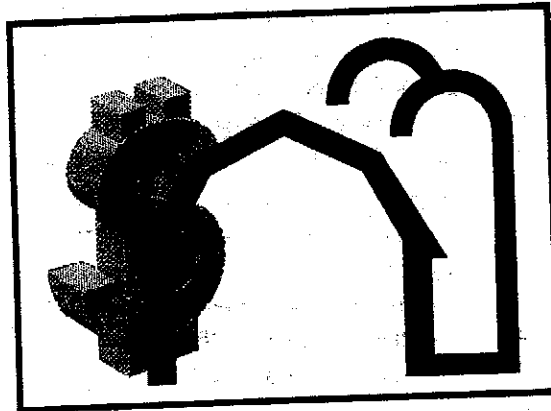
With price supports and no risk of bad financial years, farmers were able to specialize. Now entire counties, not just individual farms, grow almost nothing but wheat or a corn/soybean combination or raise nothing but pigs or dairy cows. By specializing, farm operators have been able to increase total output. But since overproduction was the original source of the financial problems faced by farmers, increased output is nothing to be proud of.

As a result of price guarantees and specialization, farmers have gone deeper and deeper into debt to buy capital and land. In a competitive market, a price decline for a couple of years might cause highly leveraged farmers to go bankrupt. Although farm size may grow as a result of technological innovation, the rate of growth is limited by the need to reduce risk of failure. By contrast, in a protected price environment, the same forces cease to function. Price supports reduce the price fluctuations experienced by farmers and thus make debt less risky.

Price Supports and Land Prices

In addition to reducing risk, price supports also raise the price of farmland. This occurs because the price supports raise the average annual returns per acre of farmland. This added rent is then capitalized in higher land prices. A theoretical 1985 study by the Economic Research Service of the U.S. Department of Agriculture found that removal of price supports would have cut the mean price of an acre of agricultural land from \$730 per acre in 1985 to \$510 in 1986. Thus, the price was inflated more than 40% above its value in a subsidy-free condition.

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However, according to a more empirical 1972 USDA study by Robert Reinsel and Ronald Krenz, "Capitalization of Farm Program Benefits into Land Values", subsidies are seldom fully capitalized. For crops such as cotton, wheat, and feed grains, the uncertainty of future government support prices cut the expected capitalized value in half compared to peanuts, rice, and other crops with more stable support programs. The authors calculated the total capitalized value of crop supports in 1970 to be around 8% of total farm real estate values.

(Another factor also reduces the capitalization of price supports in land values. Some of the added income from price supports is extracted as monopoly rents by suppliers of farm equipment, seed grain, chemicals, and fertilizer. Robert Leidenluft, in a 1981 analysis for the Federal Trade Commission, found that none of these industries were competitive, as measured both by the small number of companies dominating each market and by above-average rate of return on equity of those companies. That high degree of market concentration can be partly explained by the excessive specialization that a subsidy policy has promoted.)

Boom-bust Cycle in Farmland

Farmland prices follow a boom-bust cycle similar to, but not necessarily in conjunction with, rising and falling urban land prices. From 1972 to 1981, the sale of American agricultural commodities rose rapidly in world markets from \$8 billion to \$44 billion, in part due to the decline in the value of the dollar. Some commodity prices doubled. The price of farmland rose from \$184 billion in 1970 to \$737 billion in 1981. This was even faster than the growth of net farm income, because rising land values capitalized not only current income but expectations of even higher income in the future.

In 1977, commodity prices began to decline. The American Agriculture Movement arose in defense of high prices to avoid foreclosure on heavily indebted farms. (Farm debt rose from \$49 billion to

\$182 billion between 1970 and 1981.) The federal government propped up the farmers and their land values (and the banks that had lent to them) for a few years. But even though the CCC bought crops and increased its storage of them by a factor of five, it was unable to prevent the down side of the cycle from occurring.

How Price Supports Hurt Small Farmers

The system of price supports did not completely protect farmers from the fluctuations of market demand, but it did provide a cushion. It would seem at first blush that all farmers who were growing program crops benefited. However, large farms benefited from price supports relatively more than small farms. In the long run, that translated into an absolute advantage. Price supports accelerated the process of increasing farm size from an average of around 300 acres in 1960 to 450 today. Instead of helping small farms, subsidies have concentrated production and assets in the largest farms.

The key to the differential effect of subsidies lies in the higher leveraging and lower profit margins in large operations. During boom times, large farms, simply by virtue of their size, have better access to credit, despite the fact that smaller operators often generate higher net income per acre. That gives large units the chance to expand and take over smaller operations. Large farms thus tend to be more heavily indebted than smaller ones. In 1993, the debt-asset ratio of small farms (sales of \$20,000 to \$100,000) was around 12%, whereas for the largest farms (over \$500,000), the ratio was around 23%. During the mid-1980s, when farms were under severe financial stress, around twice as many large farms as medium-sized farms were very highly leveraged (debt-asset ratio over 70%.)

In addition, large farms spend more money than smaller farms on purchased inputs in proportion to their sales. In 1978, for example, farms with sales under \$100,000 spent around 71% of their sales income on production expenses, while farms with sales over \$100,000 spent an average of 85% on those purchases. (See

David Lins and Peter Barry in U.S. Senate, Committee on Agriculture, "Farm Structure: A Historical Perspective on Changes in the Number and Size of Farms.") Combined with the high level of indebtedness, this thin margin has made large farms more profitable in good times and more prone to bankruptcy in bad times.

In the absence of price supports and other subsidies, operators of large farms would incur much greater risk and failure rates than smaller ones. But because the large farms do not have to face ordinary market risks, they are able to survive and grow beyond their natural size. Thus, a system that protects all farmers from down side risk differentially helps the largest farmers. In short, subsidies are contributing to the demise of the very "family farms" they were intended to protect.

Foreign Consequences of Domestic Farm Policies

As if the damage to family farms in the United States were not enough, crop subsidies here also destroy the livelihoods of farmers in other countries as well. In order to guarantee prices, the federal government buys surplus agricultural commodities and places them in storage. Since the early 1950s, the U.S. government has effectively forced Third World countries to accept these surplus American commodities as part of "aid" packages under Public Law 480. The result was the dumping of grain on those countries at prices so low that local farmers could not compete. Not only did this contribute to rural poverty, it contributed to the swelling migration of people from the country to the shanty towns near cities. All of these were the effects — intended or unintended — of American "aid" policy. Had the U.S. government not held massive amounts of grain and other commodities in storage, this policy of making recipient countries dependent on American exports could not have succeeded. Thus, farm subsidies have not only made the U.S. economy less efficient and cost taxpayers billions of dollars, they have also been the instrument of a most vicious form of imperialism.