

## STAFF PAPER SERIES

U.S. Farm Policy:

Can FAIR be Fixed?

by

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DEPARTMENT OF APPLIED ECONOMICS

COLLEGE OF AGRICULTURAL, FOOD, AND ENVIRONMENTAL SCIENCES

UNIVERSITY OF MINNESOTA

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A paper prepared for the Minnesota Extension Service briefing materials on current issues in agricultural policy.

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### **ABSTRACT**

In the scheme of things, the 1996 Federal Agricultural Improvement and Reform Act (FAIR) contained important breaks with a tradition of crop-by-crop subsidies dating back to the Agricultural Adjustment Act of 1933. It freed many producers of "program commodities" (maize, grain sorghum, wheat, barley, oats, cotton and rice) from a system of crop-specific base acre accounting, merged these accounts into a single "whole farm base," and allowed production of any but a few crops on these lands. Overall, the freedom to produce in direct response to market forces, rather than on the basis of crop-by-crop subsidies, as well as the budget discipline of predetermined payments, were important steps in the direction of decoupled lump-sum compensation. Yet from the point of view of advocates of policy reform, FAIR represents an unfinished agenda. A variety of problems and issues remain. First, the coverage of "freedom to farm" is only partial, with numerous commodities left out of the decoupling program. Second, those critical of the distributive impacts of the commodity programs find little to cheer about in the new contracts, and consider the acronym FAIR ironic. Supply responses induced by price levels in the first two years of FAIR have led to substantially lower prices and marketing receipts in 1998. A call has now gone up to resuscitate some form of safety net, such as a return to deficiency payments or an extension and increase in contract payments under the 1996 Act. It is appropriate to move now to finish the unfinished agenda of the 1996 Act by implementing a long term safety net based on some form of revenue assurance (à la Cochrane and Runge, 1992).

## U.S. Farm Policy: Can FAIR be Fixed?

C. Ford Runge

### 1. FAIR and Farm Policy

In the scheme of things, the 1996 Federal Agricultural Improvement and Reform Act (FAIR) contained important breaks with a tradition of crop-by-crop subsidies dating back to the Agricultural Adjustment Act of 1933 (see Stuart and Runge, 1997). It freed many producers of "program commodities" (maize, grain sorghum, wheat, barley, oats, cotton and rice) from a system of crop-specific base acre accounting, merged these accounts into a single "whole farm base," and allowed production of any but a few crops on these lands. Through such "freedom to farm" provisions, payments to farmers were thus decoupled from these crops. Farmers with recorded base acres were given the opportunity (which nearly all accepted) to sign a seven-year "contract" with the U.S. Department of Agriculture (USDA), under which payments will be continued on the merged base acres on a declining schedule until the year 2002. By fixing these future obligations on a per-acre basis, the floating obligations implied by the previous system of deficiency payments were ended (for now), resulting in agricultural subsidies that are no longer open ended entitlements to future payments from the Federal Treasury. While signers of the contract with USDA were entitled for seven years to a per-acre payment (whether or not they produce a crop), the total amount of these obligations was fixed at \$35.6 billion and therefore predictable from a budgetary point of view. Overall, the freedom to produce in direct response to market forces, rather than on the basis of crop-by-crop subsidies, as well as the budget discipline of predetermined payments, were important steps in the direction of decoupled lump-sum compensation.

Yet from the point of view of advocates of policy reform, FAIR represents an unfinished agenda. A variety of problems and issues remain. First, the coverage of "freedom to farm" is only partial, with numerous commodities left out of the decoupling program. The mechanisms under which producers of these absent commodities (dairy products, sugar, peanuts and tobacco) receive compensation (and they differ) represent relatively low budget exposure, reinforcing their backburner status. Second, those critical of the distributive impacts of the commodity programs find little to cheer about in the new contracts, and consider the acronym FAIR ironic. A recent analysis of payments offered to corn growers under the 1996 legislation concluded that when these payments are compared with an equal degree of protection afforded by a portfolio of put options contracts, corn growers will be overpaid between \$2.9 billion and \$12.7 billion over the seven years of FAIR for switching to a decoupled system (Stinson, Coggins and Ramezani, 1998).

As in the past, those who have accumulated the largest eligibility through combined acreage bases will receive the largest payments, effectively limited only to \$80,000 per operation. Since these payments will be made *over and above* any marketing receipts, the largest producers will augment their already significant receipts with generous lump sum transfers from USDA. This will further reinforce the concentration of roughly 90 percent of receipts and payments in the hands of the 100,000-200,000 largest producers of field crops. While 1996 market prices were near all-time highs due to short grain stocks world-wide, making it difficult to justify such transfers on grounds other than pure political expediency, recent market price declines have made contract payments slightly less egregious from a distributive perspective. A related issue is whether the contract payments, once decoupled from specific crops, should necessarily be completely divorced from market receipts. An alternative would be to make them countercyclical, so that payments are made in times of low marketing receipts and recede in high times (see

Cochrane and Runge, 1992). Fourth, political realists tend to doubt that the end of the seven-year contract will actually terminate transfers to these producers, as advertised. Careful observers of the Congressional Budget Office "scoring" of spending have noted that \$4 billion remains in the 2002 budget for commodity programs, despite the alleged end of contract payments in that year.

Supply responses induced by price levels in the first two years of FAIR have led to substantially lower prices and marketing receipts in 1998. In a recent analysis of Minnesota net farm income, Olson reports substantial declines off of the high levels of 1996-97, with corn prices received off 15 percent, soybeans off 18 percent, beef 5 percent, and hogs a whopping 29 percent lower. Only milk prices have increased (by 10 percent), reflecting a global shortage of butterfat (Olson, 1998). A call has now gone up to resuscitate some form of safety net, such as a return to deficiency payments or an extension and increase in contract payments under the 1996 Act. Farmers and their representatives have again emerged as special pleaders, willing to extend indefinitely a system of transfers from the public purse, despite signing a seven-year contract that was supposed to lead to a transition to the market. It is appropriate to move now to finish the unfinished agenda of the 1996 Act by implementing a long term safety net based on some form of revenue assurance (à la Cochrane and Runge, 1992).

Before discussing such an approach, I will summarize the main features of the 1996 legislation.

## **2. Summary of 1996 Farm Bill -- Major Provisions<sup>1</sup>**

President Clinton signed the Federal Agriculture Improvement and Reform Act of 1996 (FAIR) on April 4, 1996, following a protracted, politically charged legislative process. The 1996

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<sup>1</sup>The following material is drawn from Stuart and Runge (1997).

Farm Bill contains nine titles: the Agricultural Market Transition Act, containing the majority of its reforms; as well as titles on agricultural trade; conservation; nutrition assistance; agricultural promotion; credit; rural development; research, extension, and development; and a miscellaneous title.

## **2.1 Title I: Agricultural Market Transition Act (Freedom to Farm)**

Title I, the Agricultural Market Transition Act (AMTA), contains many elements of the vetoed 1995 Freedom to Farm Act (FFA). In shorthand, this title establishes the production contracts for wheat, feed grains, cotton and rice discussed above. In addition, it continues non-recourse loans, amends the dairy program, extends the peanut and sugar programs with minimal alterations, describes administration of the title, temporarily suspends permanent law regarding price support authority, establishes the Commission on 21st Century Production Agriculture, and includes other commodity provisions.

The AMTA contains most of the reform elements in the 1996 Farm Bill. Through the creation of transition payments contained in seven-year production flexibility contracts, the Act decouples subsidies from the crop grown. It also caps spending on agricultural subsidies at \$35.6 billion, over seven years, thus removing them in the aggregate from the entitlement category. In this sense, the AMTA fundamentally changes the way in which farm subsidies for the affected crops operate. The previous system, parts of which dated back to the Great Depression, provided program crop farmers with income support in the form of "deficiency payments," calculated on the basis of recorded crop acreage and government-set target prices. When the market prices fell below the target price, farmers received deficiency payments equal to the difference in price to augment their income. In return for this protection, the government sought to control the supply

of program crops through acreage reduction programs (ARP) (see Young and Shields, 1996; Cochrane and Runge, 1992). This combination of simultaneous support and control led to serious distortions in farming methods and the agricultural economy.<sup>2</sup>

In contrast, the AMTA establishes seven-year production flexibility contracts with fixed transition payments as the income support mechanism for farmers. Eligible farmers include those who participated in programs for wheat, feed grains, cotton and rice during the past five years. The Act eliminates income support deficiency payments, target prices, underplanting provisions, acreage reduction programs (ARP's), and the Farmer Owned Reserve Program (Hallberg, 1996). In doing so, it severs the connection between subsidies and current farm prices.

In addition, increased planting flexibility arises from the separation of eligible program acres from the crops planted on the acres. Under production flexibility contracts, 85 percent of 1996 base acreage computed under the 1990 Farm Bill (plus or minus Conservation Reserve Program [CRP] acres) determines payment acres. Under the production flexibility contract guidelines, farmers may plant any commodity they choose with limitations only on fruits and vegetables. For example, a farmer with 100 acres of program wheat receives 85 payment acres of wheat whether that farmer plants wheat, corn, hay, or soybeans (Salathe and Langley, 1996). The new system ends the Farmer Owned Reserve (FOR) and thus removes the government as a stockholder of commodities. Because the government no longer accumulates these commodities

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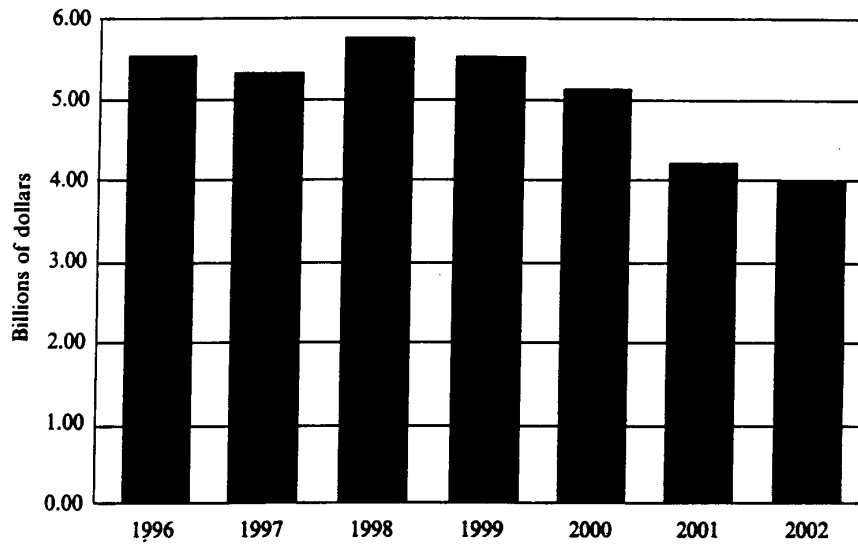
<sup>2</sup>Evert Van der Sluis and Willis Peterson (1994), at the University of Minnesota, recently completed a detailed evaluation of the impact of crop set-asides on rural employment and outmigration. Using 40 years of data from 100 randomly selected farming-dependent U.S. counties (1950-1990), the study found that the larger the number of diverted acres in a county, the smaller the demand for goods and services supplied by the rural nonfarm population. The negative impacts on rural communities appeared to outweigh any price-enhancing effects of acreage diversions.



through the FOR or loan programs, a much more limited reserve capacity exists in the event of sudden shortages.

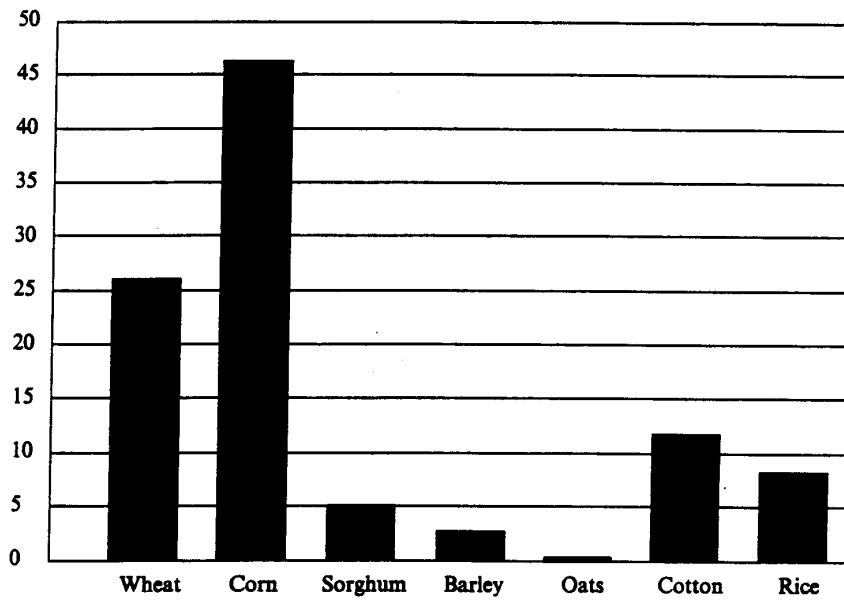
In addition to decoupling farm subsidies from cropping obligations, the AMTA caps total annual payments. The Act limits fiscal year total expenditures to \$5.6 billion in 1996, \$5.4 billion in 1997, \$5.8 billion in 1998, \$5.6 billion in 1999, \$5.1 billion in 2000, \$4.1 billion in 2001, and \$4 billion in 2002, thus ending the open-ended entitlement of previous legislation (Figure 1).

While payments decline after 1998 until 2002, they are generally constant until then. Spending on the basis of previous crop-specific base acreage is prorated, so that 26.26 percent of total funds will go to acres previously enrolled as wheat base, 46.22 percent as corn, 5.11 percent as sorghum, 2.16 percent as barley, 0.15 percent as oats, 11.63 percent as upland cotton, and 8.47 percent as rice (Figure 2). The annual payment rate for each crop depends on the total payment to be allocated, divided by the estimated eligible production. Within the crop allocation, farmers receive 85 percent of contract acreage multiplied by the farm program contract yield multiplied by the annual payment rate.



**Figure 1** Schedule of contract payments

Source: Stuart and Runge (1997), p. 121.



**Figure 2** Distribution of contract payments by crop

Source: Stuart and Runge (1997), p. 122.

Each individual farmer faces a contract limit of \$40,000 or \$80,000 using the "three entity rule," which allows a relative to increase eligibility to the higher amount. To see how this would work for an individual farmer holding 100 contract wheat acres consider the following example:

**Example:** Suppose a farmer holds 100 contract acres, the following USDA example calculates the farmer's 1996 payment for wheat acres (Salathe and Langley, 1996):

Farm Contract Acres: 100

Contract Payment Acres:  $100 (.85) = 85$

Payment Production: 2,890

Program Yield:  $2,890/85 = 34$

Estimated payment rate for 1996: .94

Estimated Payment:  $(.94) (85) (34) = \$2,717.00$

It should be noted that 100 acres of wheat base is a relatively small amount. The average wheat farm in the United States in 1992 had an acreage of 202, but most commercial operations are larger than this average (USDA, 1995). Production flexibility contracts require compliance with conservation, wetland protection, and planting flexibility requirements. In brief, these stipulate that a conservation plan be maintained, that designated wetlands and erosion-prone soils not be disturbed, and that no fruits or vegetables be grown. In addition, compliance requires agricultural use of program acres, precluding development for nonagricultural uses such as vacation homes. The 1996 Farm Bill adds an early out option for some land in the Conservation Reserve Program (CRP) held by farmers who have signed the seven-year production flexibility contracts.

Contract holders remain eligible for non-recourse loans with marketing loan provisions as under the 1990 farm bill (see Vande Kamp and Runge, 1994). However, the Act caps the wheat and corn loan rates at relatively low 1995 levels and sets correspondingly low loan rates for sorghum, barley, oats, cotton, rice, oilseeds and soybeans. The programs for cotton and rice also retain government price guarantees by setting loan rate floor prices. The Act sets the minimum price for cotton at \$0.50 per pound and for rice at \$6.50 per cwt. Individual producers of these crops face maximum marketing loan gains of \$150,000 under the three entity rule. Loan deficiency payments continue on all loan commodities excluding ELS cotton. However, since loan rates are so low and current market prices so high, these payments will generally be small or zero.

The AMTA alters the dairy program through changes to price supports, milk marketing orders, and dairy export programs. Dairy price support alterations include the cessation of government assessments on dairy producers (which had been equal to 11.25 cents per hundredweight under the 1990 farm bill), phasing out price supports for butter, cheese, and powdered milk over four years, establishment of a recourse loan program and continuation of the Fluid Milk Promotion Program. The Act provides for the consolidation of the current 33 milk marketing regions into from 10-14 regions. It also consents to the Northeast Interstate Dairy Compact, a regional price-fixing scheme demanded in return for his support of the final bill by the leading minority member of the Senate Agriculture Committee from Vermont. Application of the scheme was subject to a finding of "compelling public interest" on the part of the Secretary of Agriculture, which he dutifully fulfilled in late 1996, opening the provision to court challenges from upper-Midwest producers in Minnesota and Wisconsin. The Act also continues the Dairy Export Incentive Program.

Despite innovations in wheat, feed grains, cotton and rice, the AMTA continues the price supports for tobacco without change and leaves the peanut and sugar programs largely intact. The minimal changes to the peanut and sugar programs illustrate the continuation of market distorting policies, although a small achievement was the elimination of the honey program, which had a small but well-subsidized constituency.

Modest revisions transform the peanut program into a “no net cost” to the government program, analogous to the sugar program. While the program operates as “no net cost” to the government, it costs American consumers several hundred million dollars a year in terms of higher product prices (Rauch, 1996). The sugar program itself continues as a “no net cost” program, although it was modestly adjusted by freezing the sugar loan rate, terminating marketing allotments, transforming the non-recourse loan program to a recourse loan program when import levels drop, and increasing the assessments on sugar processors by 25 percent. The principle device supporting domestic prices continues: tariff-rate quotas for sugar imports that keep domestic sugar prices high. Like the peanut program, “no net cost” in sugar policy refers to budget expenditures, however, American consumers pay approximately \$1 billion a year in higher prices (Rauch, 1996).

Other commodity provisions include: the authorization of the Options Pilot Program in which farmers are subsidized to participate in hedging production risks in futures and options markets. More broadly, provisions exist to support risk management education and the establishment of an Office of Risk Management. As part of this complex of risk management approaches, provisions direct the implementation of the Revenue Insurance Pilot Program, which some feel may be a prototype for future income support policies. However, a separate provision drops the requirement that farmers enroll in crop insurance programs, provided they waive their

rights to emergency crop loss assistance. In effect, this preserves the political opportunity of the Congress to use "emergency relief" as a form of transfer to constituents adversely affected by weather, wind and floods.

In summary, Title I changes the mechanism providing farm income support to some key program crops from deficiency payments to transition payments, caps farm spending, but leaves numerous commodities largely unaffected. In the face of more market orientation, a greater emphasis is also given to risk management tools. However, much of the past law remains in the dairy, sugar and peanut programs as well as the continuation of non-recourse loans and the retention of permanent law.

## **2.2 Title II: Agricultural Trade**

Title II amends the Agricultural Trade Development and Assistance Act of 1954 and Related Statutes, amends the Agricultural Trade Act of 1978, and contains additional agricultural trade provisions. Part of the impetus for adjustments in these parts of the Farm Bill was the 1993 Uruguay Round agreement in agriculture, which required a revision of spending and the volume of grain subsidized for export. The new legislation amends the 1978 Trade Act by continuing the Export Credit Guarantee Programs, capping annual spending on the Export Enhancement Program at \$3.2 billion over the seven years, limiting spending on the Market Access Program (the renamed Market Promotion Program) to \$90 million, providing embargo compensation under specific circumstances and authorizing first time statutory authority for the Foreign Market Development Program.

Under amendments to the 1954 Trade Act the FAIR act also extends authority for the Food for Peace (PL 480) program, a long-standing foreign assistance program and vent for U.S.

surpluses. It expands PL 480 program eligibility for low-interest food loans to private entities as well as foreign governments, and increases PL 480 program funding from \$13.5 million to \$28 million in order to cover administration costs. Other amendments affecting food aid policy include extension of authority for the Food for Progress Program, replacement of the Food Security Wheat Reserve with the Food Security Commodity Reserve, and increased funding for the Farmer to Farmer Program. Under the Food Security Commodity Reserve, the commodities that compose the four million metric ton reserve are expanded from wheat to include any combination of wheat, rice, corn or sorghum. In addition, the change increased the amount eligible, per fiscal year, for release to assist overseas relief efforts from 300,000 to 500,000 metric tons. Additional agricultural trade provisions include authorization for the Emerging Markets Program and direction for a new USDA trade strategy. The title also repeals several Agricultural Acts concerning trade.

### **2.3 Title III: Conservation**

Title III extends and alters existing programs, creates new initiatives and broadens the conservation agenda with \$2.2 billion in additional funding (Hallberg, 1996). The Act retains conservation compliance provisions in relation to transition payments and other eligibility for cost-sharing and insurance coverage from WPA (see Title I above). It also clarifies the definitions under the land conservation ("sodbuster") provisions, broadens wetland authority, extends the Conservation Reserve Program (CRP) for seven years, maintains "swampbuster" provisions, and continues the Wetlands Reserve Program (WRP) for seven years. Among the most significant changes are efforts to better target the Conservation Reserve Program (CRP), which since 1985 has held more than 36 million acres out of active crop production. In a period of low stocks and

high prices, there is pressure to bring much of this land back into production. Changes to the CRP include capping the maximum allowed CRP area at 36.4 million acres, strengthening the criteria regarding eligible land, and providing an early out option for land outside of environmentally sensitive areas. The new legislation caps the maximum WRP area at 975,000 acres. Beginning in 1997, it splits the area into three equal categories of permanent easements, 30-year easements, and restoration cost-share agreements.

New programs funded under Title III include the Environmental Quality Incentives Program (EQIP), Conservation Farm Option (CFO), Grazing Lands Conservation Initiative, Wildlife Habitat Incentive Program, Farmland Protection Program, an initiative for frequently flooded cropland, Everglades Ecosystem Restoration, and the National Natural Resources Conservation Foundation. EQIP combines the Agricultural Conservation Program, Water Quality Incentives Program, Great Plains Conservation Program, and the Colorado River Basin Salinity Control Program in order to coordinate the provision of technical assistance and funding for cost-sharing or financial incentives connected with conservation and environmental practices. The new law provides EQIP with \$1.3 billion in funding over the seven-year period.

In addition, the title establishes the Environmental Conservation Acreage Reserve Program (ECARP) to house the Conservation Reserve, Wetland Reserve and Environmental Quality Incentives Programs. Furthermore, by including the Wildlife Habitat Incentives Program, the title widens the conservation focus of the Farm Bill.

#### **2.4 Title IV: Nutrition Assistance**

Title IV reauthorizes the Food Stamp Program (FSP) and other smaller nutrition programs. The new law extends the Food Stamp Program for only two years due to the inclusion



of the program in current welfare reform efforts. Other programs continue for seven years including the Commodity Supplemental Food Program (CSFP), Soup Kitchen and Food Bank, Temporary Emergency Food Assistance Program (TEFAP), Commodity Distribution Program, Puerto Rico Nutrition Assistance Program, American Samoa Assistance Program and National Commodity Processing Program. Separate legislation in 1994 extended the school lunch and Women, Infant, and Children (WIC) Programs. These programs illustrate the substantial transfers to dependent groups in the form of food assistance, especially in American territories such as Puerto Rico and Samoa, but also to as many as one in nine Americans living in the 50 states.

## **2.5 Title V: Agricultural Promotion**

Title V authorizes the establishment of producer-funded programs for promotion, research, and education regarding agricultural commodities. The Act appropriates funds for the promotion of canola and rapeseed, kiwi fruit, and popcorn as well as extending the program for fluid milk. The law provides the Agriculture Department with the authority to establish new producer-funded promotion programs without prior congressional approval.

## **2.6 Title VI: Credit**

Title VI reauthorizes and revises farm loan programs, clarifies emergency loan assistance and provides for a study of rural credit availability. Among the issues addressed are the types of loan assistance to be made available, eligibility for credit assistance, and treatment of delinquent borrowers. The Act distances credit from direct loans, in favor of guaranteeing loans (Hosansky, 1996). New restrictions on the purpose and length of time for eligibility appear in the 1996 Farm Bill and repeal authority to make loans for most nonagricultural purposes. In addition, the Act

targets lending to beginning, rather than established, farmers and ranchers. It authorizes lines-of-credit for up to five years, providing additional loan opportunities for farmers. However, delinquent borrowers face tighter restructuring rules, collection practices and expedited sales of forfeited property. To qualify for emergency loan assistance, the law requires farmers to have held hazard insurance at the time of the loss. The Act limits emergency assistance loan amounts to \$500,000 per farmer.

Finally, Title VI provides for a study to examine the rural demand for credit and the current capacity and future ability of the current infrastructure to meet demands. As part of this examination, the study will investigate the Federal Credit System (FCS), commercial banks, and other federal agencies.

## **2.7 Title VII: Rural Development**

Title VII consolidates existing rural development programs and establishes new programs targeted at rural infrastructure development. The Act provides \$100 million annually for telemedicine and distance learning services, in which medical expertise and teaching are routed through new information systems to rural areas. A renamed and reorganized Alternative Agricultural Research and Commercialization Corporation, continues to make grants and loans directed towards non-traditional, non-food farm and forest products, expanding industrial uses of agricultural commodities.

A consolidated source of rural development funds was created in the Fund for Rural America, with approved financing of \$100 million annually for 1997-1999. This fund provides money in equal proportions for rural development projects, agricultural research, and discretionary spending for rural development or research. In addition, Title VII establishes the

Rural Community Advancement Program (RCAP). RCAP reorganizes and expands rural development infrastructure spending in three areas: rural community facilities, rural utilities, and rural business and cooperatives. The legislation also authorizes \$590 million for water and waste facility loans and grants, provides \$50 million in funding for the Rural Cooperative Development Grant Program, authorizes the National Sheep Industry Improvement Center, and establishes a Rural Venture Capital Demonstration Program.

## **2.8 Title VIII: Research, Extension and Education**

Title VIII provides broad reauthorization for existing programs, subject to appropriations limits, from 1998-2002 (Young and Shields, 1996). It appropriates funds for agricultural research, extension, and education programs at 1995 levels through 1997. The new legislation establishes the National Agricultural Research, Extension, Education and Economics Advisory Board. Furthermore, the law directs the Agriculture Secretary to develop a system to monitor research and extension projects. The title expands animal health and disease research, repeals authorization for a turkey research center, and authorizes research on human nutrition and citrus fruit pests. In addition, it provides for higher education research grants and amends the process for reviewing proposals for agricultural research facilities.

## **2.9 Title IX: Miscellaneous**

Title IX provides guidelines for the humane transportation of horses, amends the Plant Protection Variety Act, amends the Swine Health Protection Act, and provides for the collection and use of agricultural quarantine and inspection fees. It also establishes the Safe Meat and Poultry Inspection Panel and provides for overseas inspections of agricultural imports. Finally, it authorizes operation of the USDA Graduate School as a non-appropriated, non-federal entity and provides for the expenses of the USDA student internship program.

### 3. Whither Farm Policy Now (1998)?

The Congressional elections of 1998 reminded many farm state legislators of the need to tend to their flocks, especially as prices retreated in the face of surging production, declining export demand, and high land rental rates (reflecting a string of previously good price years). Together these elements, and additional problems of disease (mainly scab) in Northern wheat-growing regions, led to calls to re-open the 1996 FAIR legislation. Two main schools of thought, running essentially along party lines, predominated. Democrats, who were largely dealt out of the 1996 debate, argued that FAIR had failed, and that a return to high loan rates and other forms of traditional intervention in the farm economy were justified. Republicans, while acknowledging the increasing difficulty of some farmers, cautioned against opening the gates to changes, which could threaten the gains made in the direction of decoupling and flexibility. Senator Richard Lugar (R-IN) argued on the Senate floor that farmers are generally in good financial condition despite current low prices, following strong prices from 1995 to 1997 and high subsidies in 1996 and 1997. The amendments proposed by the Democratic leadership would pay increased subsidies principally to big farmers, he asserted, and little of the increased spending proposed would reach the scattered farmers facing new financial difficulty.<sup>3</sup>

Between these two poles of partisan debate, there is room for recognition that the 1996 FAIR payments, because they bear no relation to annual changes in farm prices and incomes, could be substantially better targeted than they are now. These improvements in targeting could take at least three forms:

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<sup>3</sup>John Schnittker. Personal communication. September 1, 1998.

- (1) **Countercyclicality**, in the sense that payments would increase in inverse proportion to declines in farm-level revenues.
- (2) **Progressivity**, in the sense that larger farmers would be more limited in the total level of subsidy received.
- (3) **Regionality**, in the sense that payments would be adjusted to reflect differences in geographic growing regions.

While it is hardly the only proposal for reform, Cochrane and Runge (1992) advocated a plan which contained all these elements, at the same time that it advocated decoupling and budget restraint, which FAIR incorporated. The proposal involved an income stabilization payment, based on the relationship of the Index of Prices Paid to the Index of Prices Received for a regional basket of commodities. This payment has several features that bear emphasis. First, the payment is intended to provide an income safety net in periods of deteriorating terms of trade for the farm sector. It does not exist to support farm income through good times and bad. It exists to stabilize farm income when prices paid out for feed, seed, fertilizer, interest on debt to plant a crop, and fuel costs are rising and/or prices received for the basket of regional commodities are falling. When the terms of trade are improving, the payments would disappear. A three-year moving average of Prices Received and Prices Paid would be calculated annually by the USDA for the six main regions of the country (Northeast, Northcentral, Southeast, Great Plains, Mountain and Pacific Coast). For each of these regions, the percentage change in each of the indices in a given year from the previous year would be calculated. (It is also possible to calculate these indices for smaller geographic areas if finer distinctions in the types of agriculture practiced are needed.) Whenever the percentage measure of change for the Index of Prices Paid exceeded

the percentage measure of change for the Index of Prices Received, a stabilization payment to eligible farmers would be triggered. It is reasonable to conclude that the stabilization payment arrived at for a given year could actually be paid to farmers in the first quarter of the following year. The trigger to either make, or not make, payments in a given year would be based on the pricing behavior of the previous three years, both with respect to prices paid and received. Thus, if the terms of trade deteriorated for two years, then improved for one, then deteriorated once again, payments would not stop abruptly in response to the transitory improvement, but only when the improvement was sustained for several years.

The above point, and the entire procedure for calculating changes in the terms of trade may be reviewed in Table 1. The index values of Prices Received and Prices Paid in Table 1 are hypothetical; but they are also representative in a general way of the behavior of those two classes of prices. The index values of Prices Received fluctuate importantly and irregularly. The index values of Prices Paid increase steadily over time. Given the index values of prices Received and Prices Paid in columns 1 and 4 of Table 1, the three-year moving averages of those indices are presented in columns 2 and 5. Given the three year moving average values for each year, the percentage changes in a given year from the previous year are presented in columns 3 and 6. In year 4, for example, the percentage change in the three-year moving average from year 3 to year 4 for the index of Prices Received is equal to .88; while the percentage change in the three-year moving average from year 3 to year 4 for the index of Prices Paid is equal to 1.047. ***Whenever the value of column 6 exceeds the value of column 3, a payment is triggered.*** In our example, the terms of trade turned against farmers in year 4, and they are entitled to a stabilization payment. In the hypothetical time series of Prices Received and Prices Paid presented in Table 1, farmers would have been entitled to stabilization payments in 7 out of the 11 years for which

computations were made (or in each of the years for which the percentage changes in column 3 are boldfaced).

Table 1. Hypothetical Illustration of Index Trigger System

Year	Prices Received			Prices Paid		
	Index Value	3-Year Moving Average	Trigger <sup>a,b</sup> Value	Index Value	3-Year Moving Average	Trigger <sup>a</sup> Value
	(1)	(2)	(3)	(4)	(5)	(6)
1	100			100		
2	90			105		
3	80	90		110	105	
4 <sup>c</sup>	70	80	<b>.88</b>	115	110	1.047
5	80	76.6	<b>.95</b>	120	115	1.045
6	70	73.3	<b>.95</b>	125	120	1.043
7	90	80.0	1.09	130	125	1.041
8	60	73.3	<b>.916</b>	135	130	1.04
9	50	66.6	<b>.908</b>	140	135	1.038
10	80	63.3	<b>.950</b>	145	140	1.037
11	90	73.3	1.157	150	145	1.035
12	100	90.0	1.227	155	150	1.034
13	110	100.0	1.111	160	155	1.033
14	120	110.0	1.1	165	160	1.032
15	110	113.3	<b>1.027</b>	170	165	1.031

<sup>a</sup>The value in year 4 of this column is the percentage change that the three-year moving average of year 4 is of the three-year moving average of year 3; and so on through the years.

<sup>b</sup>The boldface numbers indicate that stabilization payments would be made in those years.

<sup>c</sup>The trigger value for Prices Received in year 4 is less than the trigger value of Prices Paid, hence a stabilization payment would be made in year 4.

Source: Cochrane and Runge (1992), p. 123.



How would these stabilization payments be made to eligible farmers and how much would each farmer be eligible to receive? We proposed that payments be made on a per acre basis on the farmer's "whole farm base," the same base on which FAIR payments are now made. The level of payment per acre should be set so as to reflect, as near as budget and program limitations permit, the declining revenue stream resulting from the deteriorating terms of trade in that agricultural region. We recognized that this payment level would be a political number. However, it can and should be accompanied by a hard and fast program limitation of a total payment per farm per year of \$20,000; and by a *maximum* amount fixed in the federal budget each year available for distribution as farm income stabilization payments, as under FAIR. It bears emphasis that the main argument against payment limits has always been that large farmers would not then participate in the programs, and that acreage reduction programs (ARPs) would have little impact. Now that ARPs are history, one of the main arguments against payment limits is gone.

The combined effect of the Cochrane-Runge payment trigger system, payment limits set at \$20,000 per farm (contrasted with current limits of \$80,000) and regional determination of safety net payments is to:

- (a) introduce clear *countercyclicity* into FAIR;
- (b) convert FAIR payments from a regressive to a *progressive* system; and
- (c) target these FAIR payments *regionally*.

The potential effects of these stabilization payment levels can be visualized in the following examples. A 500 (payment) acre farm base, drawn up on the basis of FAIR acreage eligibility, would translate into a stabilization payment for that farm of \$5,000 if the per acre payment rate were set at \$10.00; and, if the per acre payment rate rose to \$40, the total payment to that farm

would rise to the limit of \$20,000. If there were 500,000 farms in the U.S. with a 500 acre "farm base" (which is a generous figure), the total federal expenditure for stabilization payments would amount to \$2.5 billion at a \$10 per acre payment rate; and, at a \$40 per acre payment rate the total federal expenditure would be \$10 billion. Stabilization payment rates would most likely vary between zero and 40 dollars per acre. Further, since it is unlikely that the terms of trade would turn against farmers to the same degree in all six regions at one time, it is possible, even probable, that the payment rate per acre might be zero in one region, \$10 in another region and \$30 or \$40 in another region. This scheme recognizes that there are important variations in economic conditions among farming regions.

In addition to its countercyclicality, progressivity, and regionality, two other important effects of this income stabilization scheme should be noted. First, although the program does not provide a permanent income subsidy to commercial farmers, it does protect farmers against dramatic declines in income on an ongoing basis, beyond the year 2002. Thus, it should be much easier for commercial farmers to obtain production credit than would be the case in the essentially laissez-faire setting envisioned, at least rhetorically, when FAIR terminates in 2002. The program eliminates part of the income risks from farming, but payment limits of \$20,000 still encourage the use of other risk-management tools, including crop insurance and futures and options contracts. Second, the program greatly reduces the unpredictable aspect of agricultural program expenditures in the federal budget by placing a cap, as does FAIR, on the income stabilization payment expenditures. Unlike FAIR, however, this program would not terminate in the year 2002.

#### **4. Conclusions**

The November elections of 1998, like any election cycle, concentrated political attention on the farm sector. Falling farm prices, together with regional experiences with disease and drought, have led to calls to reform FAIR. There are, in fact, substantial reasons to consider amendments to the 1996 farm legislation. These include the need for a more countercyclical stabilization payments, greater progressivity, and attention to the problems of specific regional interests. In addition, the commodity coverage of FAIR merits attention, as well as the specific calculation of eligibility for program payments. Although many defenders of FAIR argue that opening up the program to revision carries risks, so does maintaining it with the flaws outlined above. If these flaws persist, they may erode support for its most important innovations: decoupling and budget restraint. FAIR merits continuation, but these flaws should be fixed.

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