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TARGET PRICES, LOAN RATES AND DEFICIENCY PAYMENTS

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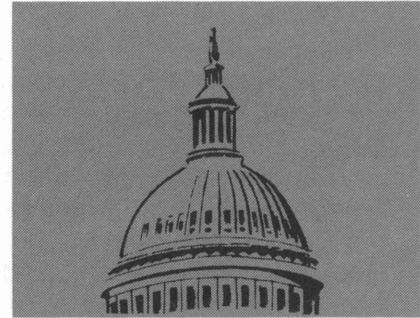

WHAT IS THE ISSUE?

A major instrument of U.S. agricultural price and income policy has been price support through the Commodity Credit Corporation (CCC) non-recourse loan program. The Agriculture and Consumer Protection Act of 1973 introduced an additional policy instrument for income support, the target price concept. Designed to vary support inversely with market price, it was initially extended to feed grains, wheat, and upland cotton. Rice was added in 1976 under separate legislation. Deficiency payments are made to producers only if the market price falls below target price levels.

The target price/loan rate instruments are expected to be an integral part of replacement legislation for the 1973 Act. In fact, primary issues in the 1977 debate are expected to center around these concepts. The central issue of the debate will be the support levels, on what basis these should be set, and how they are to be adjusted over time. A secondary issue could be whether to retain the target price concept, depending upon levels adopted for the loan rates.

WHY IS IT AN ISSUE?

The target price concept provides a system of support payments to producers which vary inversely with market prices. Deficiency payments are viewed as income supplements to producers, moderating the adverse effects of short-term price fluctuations. While farmers may produce any number of acres of the program crops (or designated substitute crops), deficiency payments apply only to production from allotted acreages. This feature is in contrast to price support loans for which all of a farmer's production is eligible (except rice, for which loans are limited to "normal" production).

While the target price concept was unique in the 1973 legislation, it has not been fully tried and its usefulness may be debated, depending upon the level of loan rates. If loan rates are raised to relatively high levels in new legislation, target prices could well be phased out. On the one hand is the view that they are not needed with high loan rates. On the other, if loan rates are low and target prices high, the potential for large deficiency payments is increased and the public might be unwilling to finance large treasury outlays with surplus production.

Provisions of the 1973 Act regarding target prices and loan rates were designed to promote a greater reliance upon the market. As this was achieved, certain concerns and greater producer and consumer uncertainty arose due to (1) increased lack of knowledge about future conditions resulting from the absence of government programs with known provisions (in the 1960's, for instance, producers knew that price would approximate the loan rate due to the presence of large stocks); (2) unbounded competition between domestic and foreign consumers (resulting in arbitrary export control and purchase agreements for selected countries); (3) considerably more farm product and food price instability than had existed in several decades, with largely unknown and subtle effects and (4) potentially unbounded increases in farm production costs due to such uncontrollable influences as the international energy situation and widespread inflation with no comparable changes in minimum prices for farm products.

THE CURRENT SITUATION

Under the 1973 Agriculture and Consumer Protection Act, target prices for 1974 and 1975 crops were set at 38 cents per pound for upland cotton, $2.05 per bushel for wheat and $1.38 per bushel for corn with reasonable rates to be set for other feed grains in relation to the rate for corn. Adjustments in target prices for 1976 and 1977 as provided in the 1973 legislation are based on changes in USDA's Index of Prices Paid for Production Items, Interest, Taxes and Wage Rates (PPI) and changes in the 3-year moving average of individual crop yields. Following this adjustment procedure 1976 target prices were 43.2 cents a pound for cotton, $2.29 for wheat and $1.57 for corn.

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While upward adjustments caused by increases in the PPI can be partially or totally offset by increases in average yields, the legislation is interpreted to prevent reductions in target prices due to increases in yields. However, target prices may fall below the previous year's level due to declines in the PPI.

Loan rate adjustments are not covered by formula under the current legislation. Generally, upper and lower bounds are prescribed for specific crops and the Secretary of Agriculture is allowed discretion in setting loan rates within those bounds. Once loan rate levels are announced they cannot be reduced for that crop year. They may however, be increased if changed circumstances are judged to justify increases. Loan rates for the 1976 feed grains and wheat crops were increased from earlier announced levels in October 1976, when such a judgment was made, based on declines in market prices to near or below production costs.

Due to a combination of generally low target prices and relatively favorable market prices no deficiency payments were made in 1974 and 1975, and very little loan activity has occurred. This is reflected in the reduced Treasury expenditures for farm programs from $4 billion in 1972 to less than $0.5 billion in 1975. The total amount of deficiency and disaster payments any person may receive under the wheat, feed grain and cotton programs was limited to $20,000 (reduced from $55,000 in the 1970 act). This payment limitation, however, does not apply to price support loans, even though the loans may not be redeemed, or to set-aside payments.

ALTERNATIVES TO PRESENT PROVISIONS

Levels under the 1973 Act were generally viewed as satisfactory (both specified levels, adjustment procedures and bounds for loan rate determination) when the legislation was enacted, but economic conditions since have led to their being criticized as unrealistically low (except in the case of rice).

Most frequently mentioned alternatives deal with setting the initial levels of support (target price and loan rate) at higher levels than currently prevail, and how subsequent adjustments in these levels will be made.

Parity vs. Cost of Production

Farm price supports, prior to target prices/deficiency payments, have been related to parity prices. Loan rates, except for upland cotton, are still related to this concept. Various proposals have been advanced to move completely away from the parity concept to a cost of production index to set both target prices and loan rates.

The parity price for a commodity is determined by a formula which gives this commodity the same purchasing power, in terms of goods and services bought by farmers, that it had in the 1910-14 base period. The parity price is then adjusted, to relate farm prices to the rest of the economy, through a factor obtained by dividing the commodity's most recent 10 year average farm price by the general price level for the 1910-14 period.

The major objection to the parity price concept has been that it only reflects prices and price changes, and does not take account of changes in technology and productivity. The costs of producing a bushel of wheat, however, reflects changes in both input prices and in output per unit of input. Thus, cost of production is viewed by many as a more accurate measure of equitable price levels. Nevertheless, primarily because of its long history of use, the parity price of a commodity continues to be a standard by which many judge the adequacy of present prices.

Cost of production studies were required by the 1973 Act. The Economic Research Service, USDA, conducted a major survey and study of 1974 production costs of feed grains, wheat, cotton, and milk, and now updates those costs annually. These data were used to "establish a current national weighted average cost of production" for the selected commodities and could form the basis for indexing target price and loan rate levels to changes in production costs.

Of course, the 1973 legislation made a major step away from the parity relationship and toward costs of production. But, while the notion of using production costs to establish and adjust loan rates and target prices has the appeal of simplicity and fairness, some serious inherent problems exist with its use.

These problems arise both in measuring the cost of producing farm commodities and in linking target prices and loan rates to that cost. Major difficulties relating to measurement include (1) the lack of market-determined price information for the farmer's own labor and management, (2) the problems of computing a cost for the use of cropland and (3) the extreme variability in the cost of producing a farm commodity across the United States. Relative to the linkage problem, major difficulties involve (1) the possibility of building in a land price-cost spiral and (2) how high to set the level of target price and loan rate relative to the cost of production.

The farmer and his family provide a significant share of the labor and management but what they actually get for their labor, management, and "owned" inputs is the difference between total cash receipts and total cash expenses. It is difficult to determine the true economic cost of these inputs.

Land costs, based on current values and interest rates, make up from 25 to 50 percent of total production costs for most U.S. crops. But what determines this current value? Much farmland is purchased for reasons other than production even when farmers are the buyers. And most U.S. farmland was purchased at far less than current prices.

There are several methods to compute the land costs and these methods give varying results. For 1974 average corn production costs, the land charge could vary from $.44 to $1.15 per bushel depending upon the method by which land costs were computed.

Other costs of production also vary widely among farms. Geographic location may substantially affect

both prices and costs of production. Costs vary widely because of the wide range in management skills of individual producers. And size of farm affects cost per unit of output as operators of larger units are frequently able to achieve price advantages in input purchases and product sales.

Level of Target Prices and Loan Rates

The level of target price and loan rate depends much on the objectives of policy-makers. If market orientation is the major objective, relatively low levels will provide some protection against unusually low prices for the major crops. Some upward adjustment could still be made from 1976 levels.

On the other hand, target prices and loan rates can be viewed as devices to support U.S. farm income, a view generally prevailing in the 1960's. With this perspective, relatively high target price and loan rates are required to support farm prices which would normally be too low to cover costs of production. Market price would likely be continually lower than the target price and near the loan rate. Deficiency payments would be necessary in most years, government stocks would grow as farmers exercised their option not to pay off nonrecourse loans, and government expenditures on farm programs would climb from the relatively low levels of 1973-1976.

Other Considerations

Some concern has been expressed over the relative support levels established for the various covered crops. This concern arises primarily because initial levels and subsequent adjustments under both parity and cost of production concepts are not necessarily related to prevailing market conditions. These concerns might be addressed by (1) allowing some degree of discretion in setting levels to the Secretary of Agriculture, or (2) by linking adjustments to a moving average of market prices.

CONSEQUENCES

Low Target Prices and Loan Rates

A continuation of market-oriented policies, and attendant relatively low support levels, will mean relatively greater price instability for producers and consumers than under prior programs. Producers would receive protection from seriously low prices through the target price-loan rate mechanism but consumer protection from high prices would have to come through some other means – such as food reserves or ad hoc export embargos. Government program costs would continue at a low level and commercial agricultural exports would continue to be competitive in world markets.

High Target Prices and Loan Rates

Use of higher target prices and loan rates to support farm incomes, on the other hand, would substantially decrease price uncertainty on the part of both producers and consumers. The loan rate would essentially set the market price and government farm program costs could be expected to increase substantially. Producers could also expect set-aside provisions to be invoked as a requirement for price support loans as government stocks accumulated. These stocks could be used as a food reserve in times of widespread crop disaster, but might also have depressing effects on both food and farm prices.

If support levels were above world market prices, additional government subsidies would be required to maintain our competitive position in international trade channels. This would also affect our general trade negotiating position.

Specific Consumer Consequences

Consumers are affected by these alternatives primarily in two ways: (1) directly, through the influence of support levels on food prices and (2) indirectly through taxes levied to finance the cost of the government program. Under a low support level market-oriented program, such as has resulted under the 1973 Act, consumers have faced somewhat higher food prices and in the absence of crop surpluses – considerably more price instability. But costs of government farm programs have been substantially lower than in the past.

Under higher support levels, and particularly in combination with a reserves program, more stable prices and smaller price increases could be expected in the short run but higher government program costs would surely result. Should support rates be established at above equilibrium prices the longer term effects, higher feed prices leading to higher meat prices, could well lead to a boost in the overall rate of inflation. Meats make up 51 percent of the food component in the consumer price index.

Support Levels Tied to Costs of Production

Tying target price and loan levels to costs of production could, depending again upon the level of support, have substantial effects on the relative competitive positions of various regions, sizes of farm, and earlier versus recently purchased farms from the standpoint of land acquisition costs. It could also have substantial impact on farm structure, giving added incentives for larger, more capital intensive operations. This would make it even more difficult for young persons to enter farming and place added pressures on farmland prices.

The importance of selecting an "appropriate" land charge becomes even more obvious. If the charge is too high and support rates based on it are above equilibrium price levels, then over production will result and depress prices even more, cause surpluses to accumulate and government costs to increase. Export sales could also suffer. Too low a land charge, of course, leads to protection only from serious price declines and little else.

Yet, if the substantial procedural problems could be overcome, the use of cost of production as a guide for setting loan rates and target prices has inherent appeal and may have advantages over the parity concept.

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