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Mr. Chairman, thank you very much for the invitation to discuss recent farm policy and the current state of the farm economy. First, I will comment on some of the key developments in farm policy that have led to the set of policies and programs now in place. Second, to provide a further context for the policy discussion that initiates with today's hearing, I will profile the current situation and the near term outlook for the farm economy.

Farm Policy to Date

Answers to three questions would help start the discussion about future farm policy: Why do we have farm policy? How has it been implemented? And how well has it worked? In reviewing how farm policy reached its current state, it is clear that farm policy is an attempt to address not one but several concerns. The driving force has been doubt about the ability of a free market to deliver safe food at reasonable prices to consumers, assure farmers fair returns, treat farmers fairly in international markets and provide proper management of the nation's resources. The relative importance of each of these concerns have waxed and waned over time, depending on the state of the farm and national economies and the social and structural dislocations taking place in U.S. agriculture. In response, a wide range of programs to address these doubts about the performance of free markets have been created and dissolved over time.

Farm policy prior to the great depression. If we go back far enough, such as the 1890s to the 1920s, concerns about the economic situation of farmers were addressed mainly through the goal of trying to make farmers more efficient, and the primary tools were agricultural research, education and extension. This goal and these programs remain an important part of farm policy today. During this period, farming was generally prosperous as domestic and foreign markets grew, and the number of farms increased from 4.5 to 6.5 million. However, beginning in the 1920s and continuing through the 1960s, a combination of strong growth in farm productivity and weak demand led to a series of farm programs with the goal of propping up farm prices and incomes. The debate during the 1920s on whether the Federal government should intervene in agricultural markets and start supporting farm prices pitted the Wallaces, who supported higher farm prices and supply controls, against Coolidge and Hoover, who wanted no special treatment for a single sector such as agriculture.

Government programs during 1930-1985. The great depression, combined with the deplorable financial condition of agriculture relative to the rest of society, ultimately led to the Agricultural Adjustment Act of 1933 and other 1930s legislation, which introduced price support nonrecourse loans, voluntary and mandatory production control programs, and even the first conservation program designed to reduce erosion, retire land and transfer income to producers. The essential problem facing U.S. agriculture at the start of the 1930s was the very low income of farm households. The household income of farmers averaged about one-third the level of nonfarmers, and 25 percent of the U.S. population lived on farms. The legislation of the 1930s attempted to raise farm prices and incomes at the same time that farm productivity was exploding, which led to chronic

surpluses and production controls. This experience provides a simple lesson for today: at the price Congress wanted farmers to receive, production usually exceeded domestic and export demand.

There are another couple of important lessons for today. First, transferring income to producers through production controls and higher prices reduced taxpayer costs because the consumer was paying the bill. Unfortunately, this meant the benefits of the productivity revolution in agriculture were not fully passed on to the public. Second, the patchwork of farm programs was not enough to offset the effects of increased productivity on the structure of agriculture. The number of farms fell from 6.5 million in the 1930s to less than 3 million at the end of the 1960s and now less than 2 percent of the U.S. population lives on farms.

In the 1950s, Public Law 83-480 (P.L. 480) was enacted providing as another avenue for dealing with persistent surpluses and direct payments were introduced in the 1960s as a way of supporting farm income, which paved the way for the establishment of target prices in the mid-1970s. Export programs and direct payments remain key features of today's farm programs. Farm policy was fairly benign during much of the 1970s as exports boomed but, again, high supported prices and rising yields led to the largest annual land retirement program in history in 1983, the Payment In-Kind (PIK) Program.

Farm policy from 1985 to present. By 1985, several principles emerged that started the farm policy push toward market orientation. First, there was a focus on farm program spending, as deficit reduction was a national priority and farm program costs had spiraled to \$26 billion in FY 1986. Second, there was a recognition that the high-price support/supply control policy was doing damage to consumers, to competitiveness and to the environment. And, third, agriculture was increasingly viewed as a sector where a small share of farms produced much of the output, and these large-scale producers had household incomes that, on average, exceeded those of nonfarm households. This raised fundamental questions on just how much and what kind of support the Federal government should provide to farmers and ranchers.

Reflecting these principles, farm policy moved down a path toward reduced government intervention and support in agriculture between 1985 and 1998. In addition, other programs, such as crop insurance and conservation, were strengthened to help farmers deal with risk and environmental concerns. During the period from 1985-95, reduced government intervention included reductions in target prices and payment acres, fixed program yields, reduced price support loan rates, marketing loans, and the partial decoupling of payments from current production. Additional market-oriented reforms contained in the Federal Agriculture Improvement and Reform Act of 1996 (1996 Farm Bill) included the further separation of payments from production and prices, giving farmers almost total planting flexibility, the elimination of annual production controls for major field crops, and, with exception of oilseeds, capped loan rates at the 1995 level. These changes in farm policy eliminated much of the market distortions caused by previous farm programs.

The 1996 Farm Bill authorized about \$36 billion in production flexibility contract (PFC) payments to producers during FY 1996-2002 and specified each crop's proportionate share of PFC payments. PFC payments are distributed to eligible producers based on 1995 program crop yields and crop bases that would have been in place under the Food, Agriculture, Conservation, and Trade Act of 1990 (1990 Farm Bill) in 1996. For the most part, PFC payments are not affected by the amount of

acreage a farmer plants to a particular crop and not linked to the level of market prices. Because PFC payments largely do not depend on current production or prices, it can be argued that they have very little if any measurable influence on farmers' planting and production decisions. In response to the increase in planting flexibility in the 1996 Farm Bill, producers have greatly expanded soybean plantings and reduced wheat plantings--soybean planted area was up nearly 25 percent in 2000 and wheat planted area was down about 12 percent in 2000, compared with the 1990-95 average. Plantings of corn and cotton in 2000 were up about 5-10 percent, compared with the 1990-95 average, with the increase likely reflecting both increased planting flexibility as well as the elimination of annual acreage reduction programs.

Since PFC payments are not tied to the level of market prices, PFC payments exceed payments that would have been made under the 1990 Farm Bill target price/deficiency payment program when prices are high. The opposite occurs when farm prices are low. This reflects the counter-cyclical nature of payments under the previous target price/deficiency payment program. The PFC payments authorized under the 1996 Farm Bill exceeded payments that would have been made under the previous target price/deficiency payment program by about \$7 billion during FY 1996-97, as strong market prices would have resulted in much lower payments under the target price/deficiency payment program. Farm prices have been much lower the past three years and PFC payments in FY 1998-2000 were well below payments that would have been made under the previous target price/deficiency payment program, even though declining prices triggered a sharp increase in loan deficiency payments and marketing loan gains. Congress responded to the shortfall in direct payments by authorizing \$2.8 billion in supplemental PFC payments in 1998, and \$5.5 billion in supplemental PFC payments in 1999 and again in 2000.

The 1996 Farm Bill capped price support loan rates for wheat, corn, rice and upland cotton at the level announced for the 1995 crop. Meanwhile, loan rates for soybeans and other oilseeds were also capped at 7 percent above the 1995-crop level. In addition, the 1996 Farm Bill sets minimum loan rates for wheat and corn at 85 percent of the 5-year moving average of past market prices, excluding the highest and lowest price years. The same formulas apply to soybeans and upland cotton, except loan rates for those crops cannot fall below a designated level. Furthermore, the minimum loan rates for wheat and corn may be reduced by up to 10 percent depending on the projected stocks-to-use ratio. For the 1996-2001 crops, the Secretary chose to announce loan rates for wheat, corn, upland cotton, and soybeans at the maximum level permitted by Congress, contributing to the increase in oilseed plantings since 1995. The Secretary has no discretionary authority in setting the rice loan rate. With loan rates set at the maximum level allowed, loan deficiency payments and marketing loan gains increased sharply from less than \$200 million for the 1996 and 1997 crops, to \$3.8 billion for the 1998 crop, to nearly \$8 billion for the 1999 crop and projected to be \$6-\$7 billion for the 2000 crop, reflecting the abrupt decline in major crop prices over the period. Because these payments are made based on current production and prices, they affect farmers' planting and production decisions. It is estimated marketing loan benefits in the form of marketing loan gains and loan deficiency payments increased plantings to the eight major crops by 4-5 million acres in 2000.

The move to more marketed-oriented farm programs has been somewhat diverted by the sharp drop in crop prices from historic high levels in 1996 and 1997, which led Congress to enact four pieces

of legislation beginning in late 1998 and extending through last year that increased farm program spending by nearly \$25 billion. It is unknown whether Congress would have authorized this amount of increased spending on farm programs had the Federal budget been in deficit during FY 1999-2001.

State of the U.S. Farm Economy at the Start of Year 2001

What is next for farm policy depends on what extent the lessons of the past shape the next generation of programs, the current state of the farm economy, and the policy priorities of the Administration and Congress.

Farm prices historically weak. A simple measure of the overall strength of agricultural markets today compared with the past can be obtained by looking at the percentage change in each year's market value of total farm sales, compared with the previous 5-year average. That measure shows that the past two years have been pretty weak by historical standards, although the downturn in farm sales is being compared against a 5-year period of fairly strong market prices for some commodities in some years. The recent reduction in farm prices and returns from the market reflects large U.S. production, large production in key countries such as China, Argentina and Brazil, the global economic slowdown of 1998 and 1999 and its after effects, and the continuing high value of the U.S. dollar. For 2001, although there are hopeful signs, it is too early to predict more than limited improvement.

Agricultural exports low but recovering. In the mid-1990s, the value of U.S. agricultural exports rose sharply peaking at a record \$60 billion in FY 1996, up by more than one-third from just two years earlier. During the mid-1990s, a confluence of factors boosted exports: world gross domestic product (GDP) grew at an annual rate of over 3 percent, compared with less than 2 percent during the early 1990s and global grain and oilseed production fell about 4 percent.

The surge in exports led many to conclude that U.S. agriculture was entering a period of long term prosperity--continued and steady increases in world economic activity would be enough to keep farm prices strong even with normal weather. This new era of growth and prosperity for U.S. agriculture became a cornerstone for the 1996 Farm Bill. Obviously, that long-term forecast did not materialize. Good weather and strong prices led to an abrupt turnaround in world crop production, which increased sharply in 1996/97. Then, in 1998, world economic growth, excluding the United States, fell to a paltry 1.3 percent. The slowdown in growth combined with continued strong crop production caused crop prices to decline sharply.

The world economy has steadily improved over the past couple of years. The world economy grew 2.8 percent in 1999 and about 4 percent in 2000, but is expected to slow a little to 3.3 percent this year. Steady global economic growth and a weakening dollar are expected to cause the value of agricultural exports to rise to \$53 billion this fiscal year, up from the recent low of \$49 billion two years ago, but still well below the peak in 1996.

Over the next few years, the volume of U.S. agricultural exports is expected to register fairly strong growth, aided by large U.S. production and steady gains in world food demand, supported by income growth in most of Asia, Latin America, North Africa and the Middle East. Despite better demand, most major commodity prices are expected to recover only slowly because of large

production and stocks.

Farm financial conditions remain stable because of record government payments and greater off-farm income. Large U.S. production and sluggish exports boosted crop carryover stocks causing major crop prices for the 1999 and 2000 seasons to be the lowest in 15 to 25 years. Yet, a national farm financial crisis has not occurred in large part due to record government payments and greater off-farm income. Farm numbers have been fairly stable in recent years, the proportion of nonperforming farm loans has risen only slightly, the debt-to-asset ratio remains at about 16 percent, down from 23 percent during the farm financial crises of the mid-1980s, and farm real estate values and land rental rates generally continue to rise. In 1999, U.S. farm land values rose 3 percent nationally and were up in 42 states and cash rents paid for 2000 were up in 40 states. Bankers in the Chicago Federal Reserve District reported that land values in the district rose 7 percent over the 12-month period ending on October 1 of last year. While the national picture appears secure, regional and sector problems persist. The combination of low prices and structural change have caused the number of dairy and hog operations to decline and adverse weather in the Southeast, southern plains and elsewhere has contributed to regional pockets of farm financial stress.

After rising during the 1990s, farm debt is expected to increase slightly this year, and as a percent of assets, is expected to remain unchanged from last year. A useful indicator of financial stress is debt held by farms as a percentage of the maximum feasible debt that farms can take on, which is referred to as debt repayment capacity utilization (DRCU). Maximum feasible debt is a calculation based on net farm income, the interest rate, an assumed 7-year average repayment period for debt, and bankers' guidelines on the maximum level of income that should be used for principal and interest. In 2000, U.S. farmers, on average, used a little over 60 percent of their maximum feasible debt and this figure is forecast to increase to 65 percent in 2001. Although the DRCU in 2001 would be the highest since 1986, and the level has been rising steadily in the 1990s, it is forecast to remain about half that of the 1984-85 farm credit crisis period.

DRCU may be taken a step further by looking at how this measure of debt stress is distributed among commercial farms. A commercial farm business is an operation that sells at least \$50,000 in farm products per year. Of the 2.2 million U.S. farms, about one-quarter, or 512,000 farms, sell at least \$50,000 in output per year. These farms account for 90 percent of total U.S. production.

Commercial farms that cannot service their debt and stop performing on their loans usually have debt equal to 240 percent or greater than their maximum feasible debt. In 1998, the number of farms in this category rose, but the number fell in 1999. The weak markets probably led producers to use government payments to pay down debt. In 1999, about 50,000 of the nation's 512,000 farm businesses had debt repayment capacity utilization of 240 percent or more.

The most obvious reason we haven't seen more of an increase in farm financial stress is record-high government assistance to farmers. For 1999, 2000, and the current forecast for 2001, net income excluding government payments are the lowest since 1984. However, net cash income in 2000, including the record \$22 billion in government payments, was up about \$2 billion from 1999 and about equal the previous 5-year average.

In addition to government payments, another reason a national farm financial crisis has not materialized is the strong nonfarm economy which has helped increase off-farm income opportunities

for farm households. Off-farm jobs in rural areas are a major factor in why the number of farms has stabilized at 2.2 million in the 1990s.

Farm income to decline in 2001. Assuming no supplemental assistance for the 2001 crops, net cash farm income is projected to decline from \$56.4 billion last year to under \$51 billion in 2001, as production expenses continue to rise and government payments decline. Lower loan deficiency payments, reflecting modest improvement in crop prices, and scheduled annual reductions in PFC payments are forecast to reduce government payments by \$2.5-\$3.0 billion in 2001. With no supplemental payment legislation in place for the 2001 crops, emergency assistance to farmers and ranchers is projected to fall from nearly \$9 billion last year to about \$3.5 billion in 2001. The farm income situation in 2001 is not unlike that in recent years, although this some of the drop in government payments this year is expected to occur through lower loan deficiency payments that will be made up in greater returns from the market.

The major field crops have been having particular market difficulty the past few years. Net cash farm income on a crop year basis for the major field crops--wheat, rice, corn, sorghum, oats, barley, cotton and soybeans--excluding government payments was low for the 1999-2000 crops and projected to remain low for the 2001 crops. Direct government payments accounted for three-fourths of net cash income for major field crops in 1999 and two-thirds in 2000. For 2001, net cash income for major field crops is projected to fall about \$6 billion, declining from almost \$26 billion for the 2000 crop to less than \$20 billion. The decline in net cash income between 2000 and 2001 is about equal to the amount of market loss assistance Congress authorized last year for major field crops. Absent new legislation, regions and crops that have been dependent on government payments are likely to see the greatest decline in farm income in 2001.

Major crop price and acreage prospects in 2001. Major crop prices for the 2000/01 season are expected to register only slight improvement from last year's depressed levels, reflecting another year of large U.S. and foreign production. Drought caused significant crop losses in some areas of the country in 2000, especially cotton in the southern and central Great Plains. Even so, cotton production was up in 2000. Soybean production was record-high in 2000 and corn production reached the second highest level on record, as growing conditions were generally very favorable for much of the Midwest. In contrast, wheat production was off 3 percent in 2000 as wheat plantings fell to a 27-year low. As indicated earlier, farmers have responded to the planting flexibility provisions of the 1996 Farm Bill by planting less wheat and more oilseeds.

In 2001, wheat plantings and production could be down again as winter wheat area planted this past fall was off 5 percent from last year and the lowest since 1971. Corn plantings could also decline in 2001, while soybean area could exceed last year's record. Less fall planted wheat, higher fertilizer prices, and the benefits of the soybean marketing loan program provide an incentive for producers to further expand soybean plantings. Cotton plantings this spring are expected to remain about unchanged from last year. Assuming normal weather over the upcoming growing season, reduced plantings of wheat and corn would likely further reduce ending stocks, supporting improved market price prospects for these crops in 2001.

Major livestock and poultry product price prospects in 2001. Increasing milk production caused milk prices to collapse at the end of 1999, as dairy producers responded to two consecutive

years of high milk prices and low feed costs. The average all-milk price dropped to \$12.33 per cwt. in 2000, a 9-year low. In response to the collapse in milk prices, Congress authorized payments of \$0.65 per cwt. to dairy producers on production of up to 39,000 cwt. The sharp decline in milk prices this past year should begin to reduce the rate of expansion in milk production and lead to improved milk prices in 2001. The all-milk price is projected to increase by about 4 percent in 2001 but to continue to remain below the average of the 1990s.

Hog and cattle prices were much improved in 2000, with cattle prices up 6 percent and hog prices up 31 percent. Large production stressed hog prices in 1998 and 1999. In 2000, hog producers cut production in response to low prices the previous two years. Improved prices this past year could lead to a slight upturn in hog production and slightly lower hog prices this year, although large pork production during the second half of 2001 could reduce hog prices sharply in the fourth quarter.

Dry weather and lack of forage led beef producers to further reduce heifer retention in 2000, despite the increase in cattle prices. Beef production in 2000 was up 1 percent from the 1999 record. More favorable grazing conditions are expected to lead to reduced beef production and further improvement in cattle prices in 2001.

Declining poultry prices during the first half of last year reduced the expansion in poultry production in 2000. In 2000, broiler production rose 2 percent following a 7-percent increase in 1999. Broiler prices averaged 3 percent lower in 2000. In 2001, poultry prices are projected to remain steady. Returns to livestock and poultry producers in 2001 will continue to be supported by low corn and soybean meal prices.

Production expense prospects in 2001. Higher prices for farm production inputs are raising farmers' production costs. Increases in fuel prices and interest rates along with higher prices for other production inputs increased farmers' production expenses by 4 percent or \$7.6 billion in 2000, with higher fuel prices accounting for over one-third of the increase. In contrast, farm production expenses rose only 1 percent from 1997 to 1999. In 2001, farmers' total cash production expenses are forecast to increase \$1.5 billion to a record \$179.5 billion, as higher fuel costs lead to higher prices for fertilizer and other energy-related inputs.

Longer term outlook. Over the next several years, the agricultural sector is expected to continue to recover from the current weak market situation. Although there remain some lingering effects of the global economic crisis on the world economy, continued improvements in global economic growth, particularly in developing countries, are projected to increase steadily foreign demand for U.S. agricultural products. World real gross domestic product is projected to average about 3.5 percent per year over the next decade, compared with 2.6 percent in the previous decade. Almost all regions of the world are expected to realize above average economic growth in the decade ahead. Rising world demand for agricultural products along with continued progress toward freer trade through ongoing unilateral policy reforms in foreign countries and existing multilateral trade agreement are projected to lead to steady increases in U.S. agricultural exports. The total value of U.S. agricultural exports is projected to rise 43 percent over the next 10 years, reaching \$76 billion in 2010.

In the absence of any new supplemental assistance, farm income would likely fall below recent levels during the next few years, as gains in commodity prices and cash receipts are not expected to

offset the drop in supplemental government payments. Lower marketing loan payments could be offset by improvements in prices and receipts for major crops. Cash production expenses are expected to stabilize over the next couple of years as fuel prices moderate slightly but fertilizer and chemical expenses rise, reflecting the lagged effects of higher petroleum prices and modest increases in planted area. During this period of declining supplemental payments, farm financial stress for certain farmers may increase. Beyond the next few years, the outlook for the farm sector improves as expanding exports further strengthen farm commodity prices and increases in farm income and farm asset values help to moderate farm financial stress.

Mr. Chairman, that completes my testimony and I would be pleased to respond to questions.