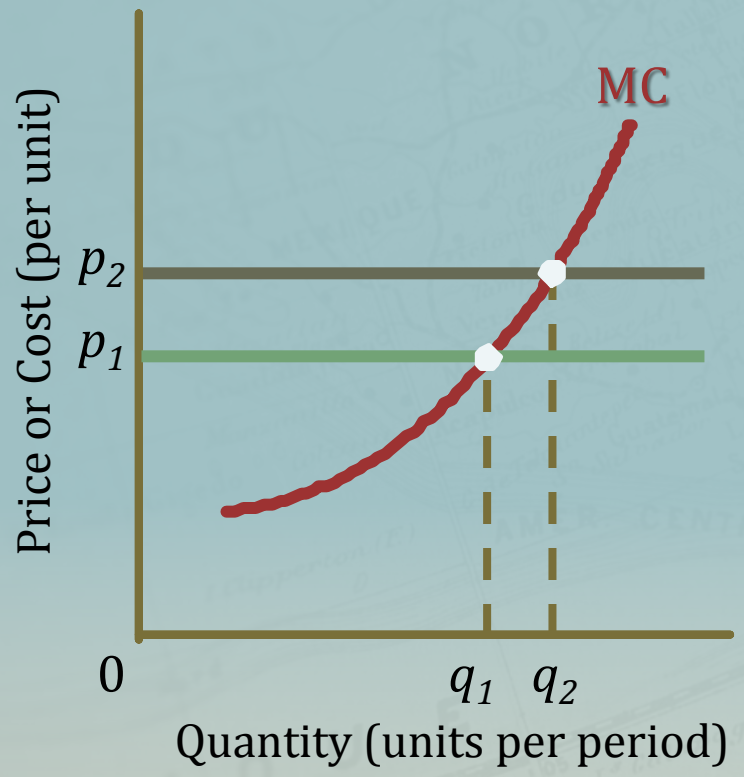
THE FARM PROBLEM PART II

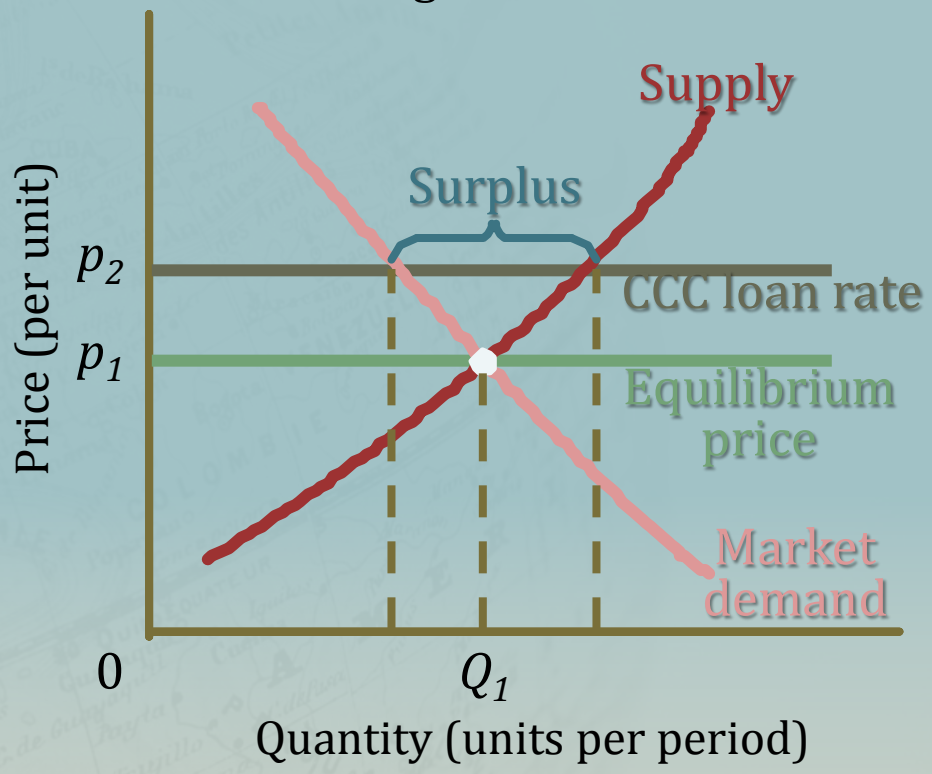
Farming is a profession of hope.
Brian Brett

CHARTS: THE IMPACT OF PRICE SUPPORTS

Impact of price supports on the individual farmer



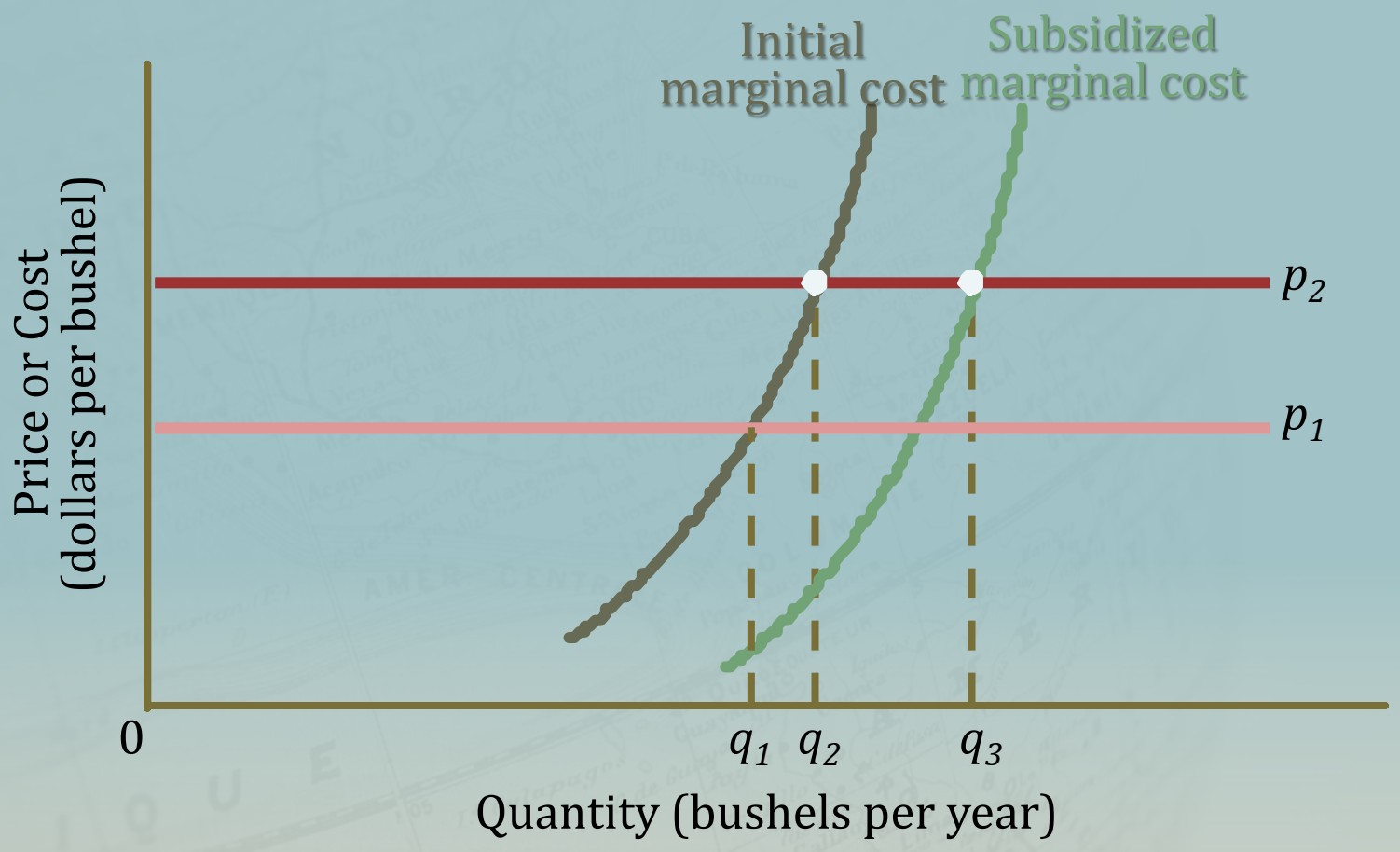
Impact of price supports on the agricultural market



COST SUBSIDIES

- The market surplus induced by price supports is exacerbated by cost subsidies.
  - For example, irrigation water is delivered to many farmers at substantially below the cost of delivering it.
  - This difference amounts to a subsidy.

CHART: THE IMPACT OF COST SUBSIDIES

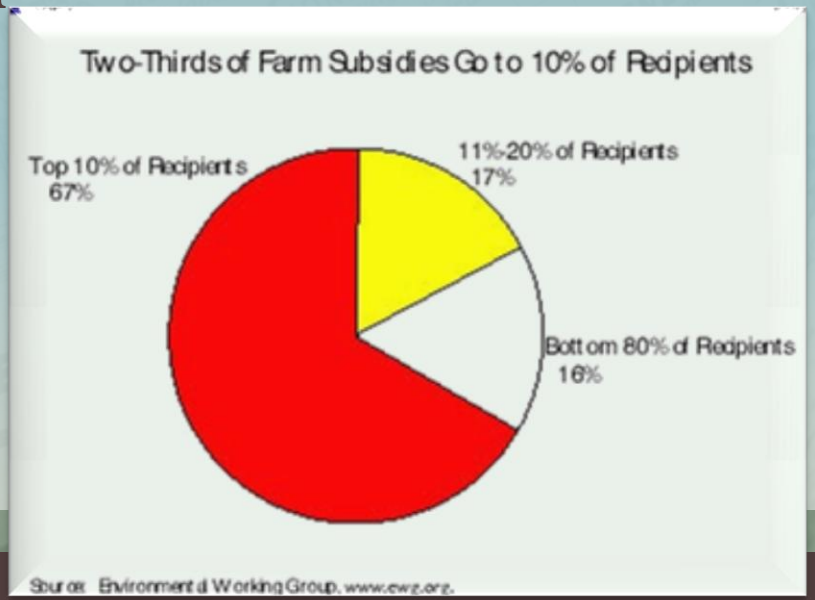


DIRECT INCOME SUPPORTS

The advantage of direct income supports is that they achieve the goal of income security without distortions of market prices and output.

DIRECT INCOME SUPPORT

- The principal form of direct income support are so-called deficiency payments.
  - A **deficiency payment** is an income transfer paid to farmers for the difference between target and support prices.



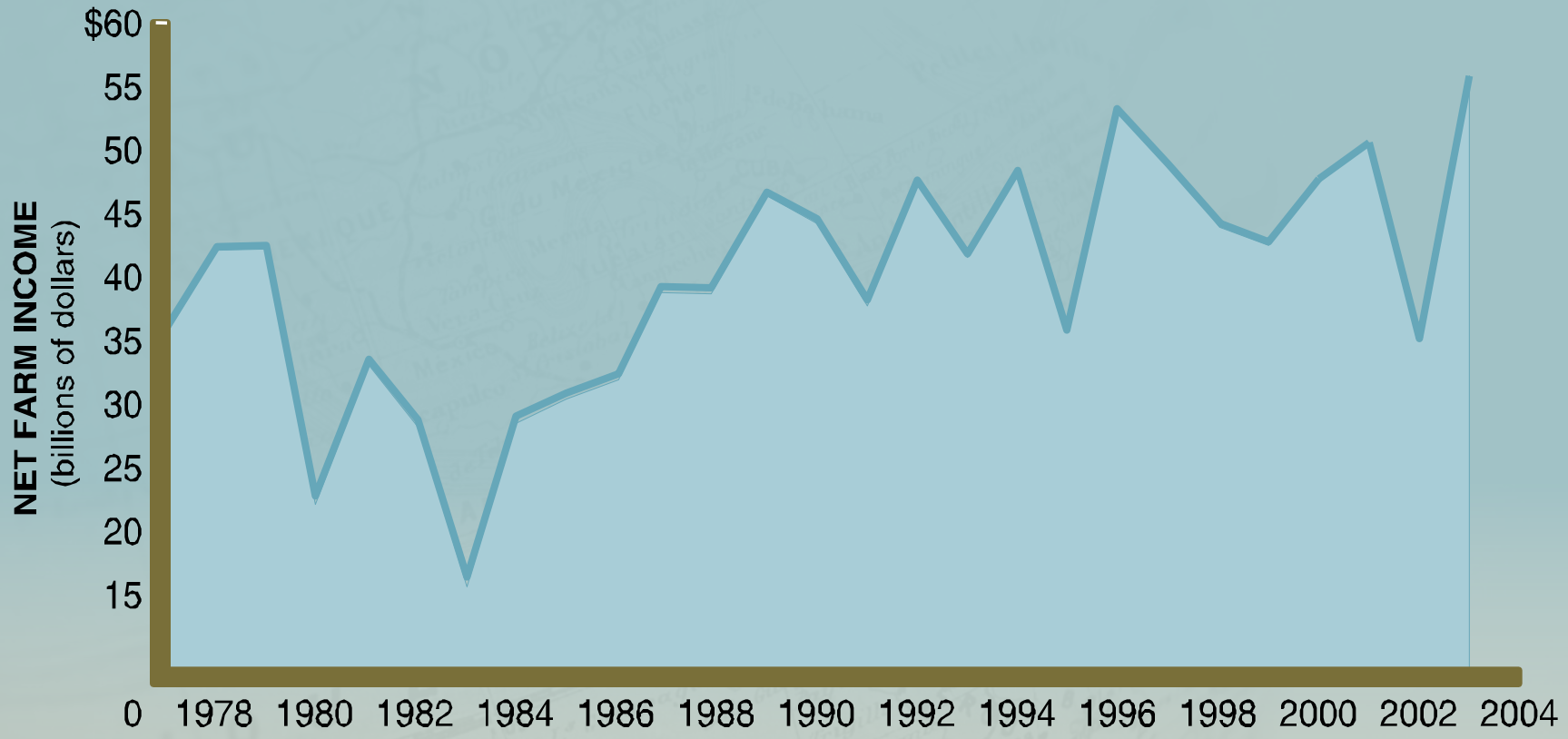
DIRECT INCOME SUPPORT

- In principle, direct income payments are a more efficient mechanism for subsidizing farm incomes.
- But many farmers would rather have price supports – *parity, not charity*.

THE SECOND FARM DEPRESSION, 1980-86

Despite price supports, supply restrictions, cost subsidies and income transfers, farm incomes have remained low and unstable, especially for small farms.

CHART: NET FARM INCOME, 1977-2003



THE COST SQUEEZE

- The cost squeeze was not due to abrupt price declines, but rather to steeply rising production costs.
- As a result, the profit of farmers fell abruptly.

FUEL COSTS

- The cost squeeze on farm incomes started with an abrupt increase in fuel prices.
- OPEC raised crude oil prices by 50% in 1979.

FERTILIZER COSTS

Fertilizers, being mostly manufactured from a petroleum base, went up in price along with fuel.

INTEREST RATES

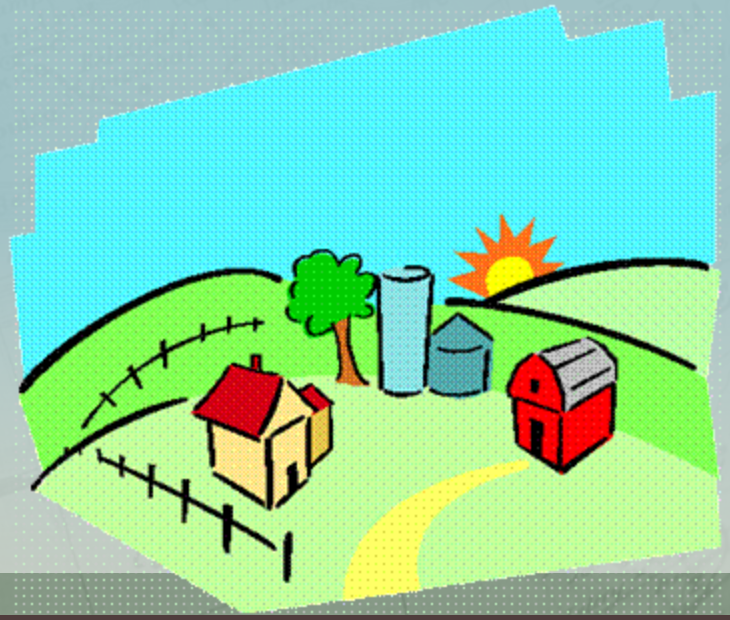
- Most of farmers' assets necessary for farming are often purchased on funds borrowed at variable rates.
- Therefore, when the interest rate skyrocketed, the debt burden of farmers mounted.

DECLINING LAND VALUES

High interest rates and declining incomes reduced the value of farmers' most important asset – their land.

DECLINING LAND VALUES

- The value of land reflects its present and future income potential.
- High costs reduced potential income and high interest rates made future income less valuable.



DECLINING EXPORTS

- In 1980, President Carter imposed an embargo on grain sales to the Soviet Union.
- Between 1980 and 1984, the international value of the dollar rose a staggering 50%.

STEPS TOWARD DEREGULATION

US government farm policy was changed during the 1980s and 1990s.

THE 1985 FARM ACT

- Congress passed the Farm Security Act of 1985 in order to limit government purchases of surpluses.
  - The support price of wheat was reduced.
  - Deficiency payments were capped.

THE 1990 FARM ACT

- By 1990, crop prices, farm incomes and farmland prices had all risen.
- Declining oil and fertilizer costs, and strong foreign demand for US Farm products increased profits.

THE 1990 FARM ACT

- The 1990 Farm Act continued the basic structure of farm subsidies.
- It increased the loan rates, effectively raising the price floor for farm products.
- Nevertheless it moved farming a small step closer to market realities.

1996: FREEDOM TO FARM

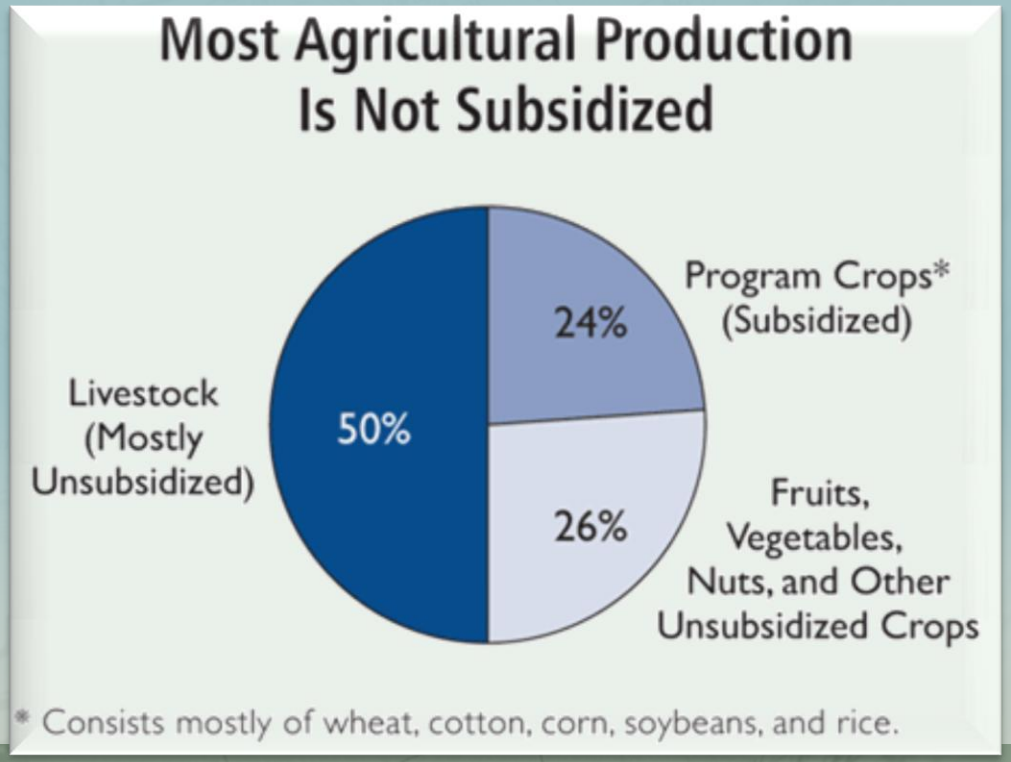
- In 1996, the Federal Agricultural Improvement and Reform Act made two radical changes in farm policy
  - Target prices and their associated deficiency payments were terminated.
  - Many restrictions on acreage set-asides were eliminated.

1996: FREEDOM TO FARM

- In the place of deficiency payments, farmers were offered market transition payments.
  - Market transition payments were targeted at stabilizing farm incomes rather than farm prices.

1996: FREEDOM TO FARM

Farmers no longer have to keep set-aside acreage completely idle or grow only specific commodities.

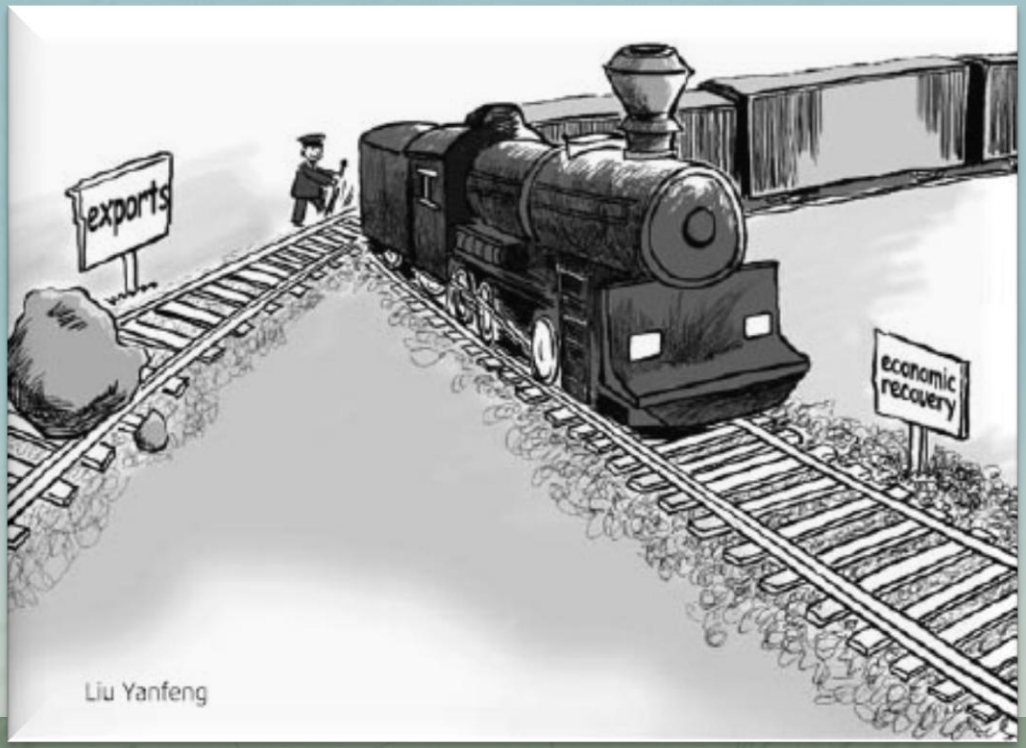


THE ASIAN CRISIS

- The Asian crisis that began in July 1997 was the principal cause of the farm economy turning sour again.
- US farm exports fell sharply when the currencies of Thailand, Korea, Indonesia and Malaysia, and other Asian nations tumbled.

THE ASIAN CRISIS

Abundant harvests in the United States, China, Europe and elsewhere also depressed farm prices.



RENEWED SUBSIDIES

- When farm prices and incomes plunged during 1997 and 1998, farmers again demanded federal aid.
- Because it was an election year, they got a fast response.

THE 2001 FARM SECURITY ACT

- The intent of the 1996 Farm Act was to wean farmers off the dole, making them more reliant on market forces.
- That isn't how it worked out, however.

THE 2001 FARM SECURITY ACT

- It was clear that farmers were prepared to rely only on good markets, not bad ones.
- Farmers got more permanent aid with the Farm Security Act of 2001.

MORAL HAZARD

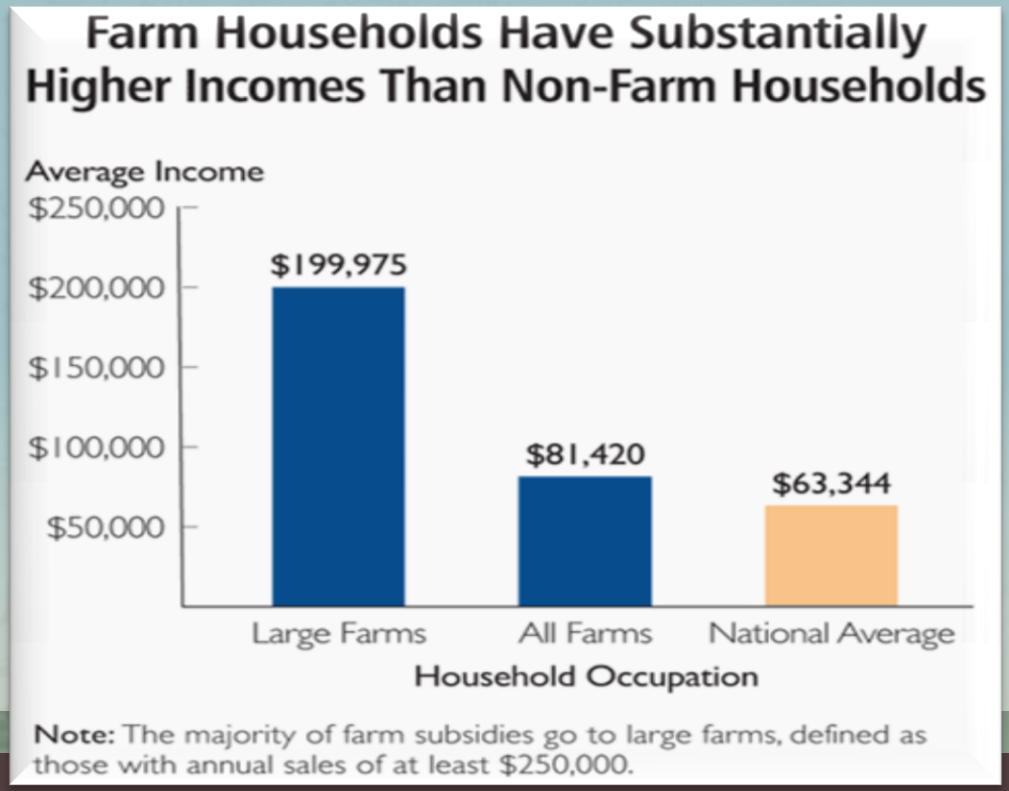
- Farmers do not manage their risk as they would in an unregulated market because they have come to rely on government intervention.
  - **moral hazard** – an incentive to engage in undesirable behavior

MORAL HAZARD

With government subsidies, farmers are not as likely to purchase crop insurance, or hedge the value of their crops by selling forward contracts on their crops.

MORAL HAZARD

The challenge for farm policy in the economy tomorrow is to maximize production incentives and minimize moral hazards.

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