Perspectives on the 2013 Farm Bill

Commodity Title:

Declines in farm support will increase market failures

By Stephen A. Ford

Economic agents in competitive markets rarely incorporate costs that are external to their businesses or consumption in their decision-making. The existence of these externalities and their costs to society are the sources of market failure that public policy seeks to address. As Congress considers cuts in agricultural spending in a new farm bill, it is important to recognize how declines in farm support will increase the market failures in agriculture that previous policies sought to address. Legislators must continue to recognize that all Americans benefit from farm policies, not just farmers.

The primary focus of farm spending reform in Congress seems to be a substitution of subsidized insurance-based programs for direct payments. The new programs present opportunities to mitigate shallow losses that traditional crop insurance policies do not cover. Unsubsidized crop insurance is very expensive, exceeding 13% of expected gross revenue for crops grown in North Alabama, for example. Further, these policies only cover up to 85% of expected production, leaving all profit margin at risk.

However, there are many who would cut the level of both crop and insurance subsidies to farmers. One basic concept taught in introductory economics courses is that the removal of subsidies on either input or output prices will result in declines in supply. The result in the case of agriculture is that commodity prices will increase somewhat as a result of lower levels of production if subsidies are reduced.

Not only will reduced subsidies result in lower supply, but individual farmers will either pay more for insurance or purchase less insurance. The results may prove significant. Increased insurance prices will increase cost structures, resulting in increased farm business risk. Lower insurance coverage by definition increases the uninsured business risk carried by farmers, as would the absence of shallow loss programs. This increased risk environment will lead to increased lending interest rates and in some cases capital rationing in the farm financial sector. Both of these financial effects can lead to distortions in competitive markets when planting decisions are based on capital availability rather than commodity market price signals.

Moreover, if farms have less risk protection and there is either a catastrophic weather or market impact on the agricultural sector, many farms may not survive. Only the largest and wealthiest

farm operations will remain in business, resulting in increased consolidation and concentration in the farm sector.

Reductions in farm support can also result in food price spikes as a result of acreage shifts and farm sector structural changes. Market impacts of the recent drought of 2012 and previous years' debates over the food vs. fuel use of commodities centered on price increases of only a few percentage points, yet resulted in significant public outcry. Policymakers should consider potential impacts of an unstable food sector that could result in even larger price swings.

Despite a declining relative importance of agriculture in local economies in general, agriculture is still the driving force in many communities. Even in rural counties where agriculture may only represent 10% of local economic activity, a 10% reduction in farm income would still generate a 1% decline in local economies. This may not sound significant, but it is as equally important to these communities as a 1% decline in GDP is to the nation.

Just as Congress debates farm program spending outside the context of the market failures farm programs address, so too does it ignore other market failures that equally affect agriculture. Reductions in public agricultural research are thought to be offset by the private sector, but private-sector product development often has patent protection that allows monopoly pricing to farmers. For example, Monsanto's earnings from its seeds and genomic segment increased to $2.57 billion in 2012 from $206 million in 2003. One reason is that seed prices paid by farmers are now 2.4 times their levels in 2003. In fact, Monsanto collects technology fees on herbicide tolerance or insect resistant genes on 96% of all cotton acres planted in the United States, primarily because there are no viable seed alternatives for most cotton producers. Stricter anti-trust legislation and increased public investment in agricultural research could provide partial farm income support and reduce farm business risk with little budgetary impact.

It is clear that declining farm income support will increase the likelihood of market distortions due to financial constraints, increase the risk faced by farm business and the likelihood of food price increases, potentially reduce local economic activity in many rural communities, and increase average farm sizes—all of which are undesirable outcomes to the American public. The reason the American public shares in the costs of mitigating farm risk is to avoid these market failures. They are paying for the non-market outcomes they desire.

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