

State of the Farm Economy and the Impact of Federal Policy on Agriculture

Patrick Westhoff
Food and Agricultural Policy Research Institute
University of Missouri
101 Park DeVille Drive, Suite E
Columbia, Missouri 65203
573-882-4647
westhoffp@missouri.edu
www.fapri.missouri.edu

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Mr. Chairman, thank you for the opportunity to appear before the Subcommittee. My name is Pat Westhoff, and I am an economist with the Food and Agricultural Policy Research Institute (FAPRI) at the University of Missouri.

FAPRI receives funding from annual USDA special research grants to provide information to members of Congress and their staff. Each year, we prepare baseline projections for the farm economy to provide a snapshot of what agricultural markets might look like under a continuation of current farm policies. Then we try to estimate how those projections might be affected if there were a change in U.S. policy, a change in world trading rules, or even a change in the weather.

This year, for example, we have published reports looking at possible impacts of the President's budget for agricultural programs¹ and of the energy bill recently signed into law.² The reports provide estimated impacts on everything from the farm price of wheat to net farm income and the taxpayer cost of farm programs.

We know it's never possible to accurately predict what will happen in agricultural markets—the only thing we can say with certainty about our projections is that they will prove to be incorrect. That is why we do not simply look at a single most likely future, but rather at a range of 500 possible futures. This approach allows us to look at how policies perform under a range of possible market conditions—when yields are high and when yields are low; when export demand is strong and when it is weak. This is helpful when looking at policies like the marketing loan and counter-cyclical payment programs that have major effects when prices are low but are less relevant when prices are high.

State of the Farm Economy

What one thinks about the current farm economy depends upon one's point of reference. If the point of comparison is 2004, one can say a lot of negative things about the farm economy in 2005:

- In contrast to the record yields of 2004, drought has sharply reduced crop yields in parts of the Midwest, including my home state of Missouri, and Hurricane Katrina has damaged crops and disrupted shipments of agricultural products.
- Higher energy prices have increased farm-level expenditures on fuel and fertilizer.
- Based on mid-September information, it appears that prices for corn, soybeans, and wheat are all likely to be lower for the crop harvested in 2005 than for the crop harvested in 2004.

¹ FAPRI, "The President's Budget: Implications of Selected Proposals for U.S. Agriculture," FAPRI-UMC Report #03-05, FAPRI: Columbia, Missouri, March 24, 2005.

² FAPRI, "Implications of Increased Ethanol Production for U.S. Agriculture," FAPRI- UMC Report #10-05, FAPRI: Columbia, Missouri, August 22, 2005.

- Average milk and hog prices are lower this year than in 2004, and cattle and poultry prices are about the same.
- USDA estimates, and we would agree, that farm income is likely to be several billion dollars lower in 2005 than in 2004.
- Government farm program costs in fiscal year 2005 may be double what they were in fiscal year 2004.

The outlook is much more positive if one does not use 2004 as the point of reference:

- National average yields for most major field crops in 2005 are generally near or even above the long-term trend, in spite of the serious regional yield problems.
- Consumer demand for meat and dairy products has remained strong in 2005, and annual average prices for cattle, poultry, and milk are all higher than expected earlier this year.
- At least in nominal terms, net farm income is still on track to be the second highest ever in 2005.

One could pick any number of other indicators to talk about the health of the farm economy. Whether higher land values are good or bad depends on one's perspective, but the average value of farm real estate increased 11 percent last year, and all reports indicate a further increase this year. Debt-asset ratios are low by historical standards, and institutions providing credit to farmers report low levels of problem loans.

Looking beyond 2005, one can again cite reasons for optimism, pessimism, and uncertainty:

- Provisions of the energy bill should contribute to increased production of ethanol and biodiesel and increased demand for corn, soybeans, and other crops.
- China is already a major market for U.S. soybeans and could become a major market for grain in the years ahead, but it continues to be hazardous to make predictions about Chinese agricultural markets.
- Brazil and Argentina have demonstrated their ability to expand crop production, but the pace of future expansion remains uncertain.
- USDA and FAPRI both expect lower 2006 prices for cattle, hogs, poultry, and milk, in part because of supply response to recent strong prices and returns.
- The agricultural economy will continue to be sensitive to movements in energy prices, and any increase in interest rates could affect debt repayment ability and land prices.

Impact of Federal Policy

All sectors of U.S. agriculture are affected by federal policy, but the largest and most direct effects are felt by the sectors receiving the bulk of government farm program payments (grains, oilseeds, and cotton) and the sectors benefiting from price support programs (dairy and sugar). While these commodities account for most of the harvested cropland in the country, they only account for about 40 percent of cash receipts.

To illustrate how markets and policies interact, consider the experience of the corn sector under the 2002 farm bill (Table 1). In 2004, corn yields reached record levels, and as a result corn prices fell sharply from the prices paid for the 2003 crop. Multiplying price times yield, the national average gross return per acre fell by about \$14 per acre between 2003 and 2004, as the effect of lower prices marginally outweighed the effect of higher yields.

Federal marketing loan and counter-cyclical payment programs are based on prices, not revenues. Thus the large drop in 2004 prices triggered a large increase in payments under those two programs. Total payments per base acre planted to corn increased by more than \$65 between 2003 and 2004, so corn producers had an unusually good income year in 2004, in spite of lower prices.

For the 2005 corn crop, both prices and yields are expected to be lower than they were in 2004. That translates into a large reduction in gross receipts from market sales, which is aggravated by a significant increase in production costs because of higher fuel and fertilizer prices. While government payments may increase slightly, overall net returns per base acre planted to corn are expected to be lower than they were in 2004 and even 2003.

Finally, however, note that 2005 net returns with payments are still expected to exceed those of 2002. Prices were substantially higher in 2002 than they are expected to be this year, and production costs were also much lower. The difference in overall net returns is entirely explained by differences in government payments. Prices were high enough in 2002 that there were no counter-cyclical payments and limited marketing loan benefits.

The lesson is that current corn program provisions are, by design, focused primarily on cushioning producers from the effects of lower prices. They are not designed to deal with net revenue losses caused by low yields or increased production costs. Certain crop insurance products do protect producers against significant reductions in yields or gross revenues, but they generally do not provide support when there is only a relatively modest reduction in yields. Federal programs do not protect producers from the risk of increased production costs.

As you consider farm policy options, Mr. Chairman, I would encourage you and your staff to continue to use FAPRI as a resource. Thank you for the opportunity to speak with you today.

Table 1. National average corn returns

Crop harvested in:	2002	2003	2004	2005
		(bushels per acre)		
National average yield	129.3	142.2	160.4	143.2
		(dollars per bushel)		
National average price	2.32	2.42	2.06	1.90
		(dollars per acre)		
Gross market revenue	300.06	344.16	330.33	272.08
Variable production expenses	143.77	159.67	168.57	182.70
Net market return	156.29	184.49	161.76	89.38
Marketing loan benefits	0.24	1.09	38.71	42.96
Net return including loan	156.52	185.58	200.46	132.34
		(dollars per base acre)		
Counter-cyclical payments	0.00	0.00	28.20	38.90
Direct payments	24.35	24.37	24.37	24.37
		(dollars per base acre planted to corn)		
Total government payments	24.58	25.46	91.28	106.23
Net return with all payments	180.87	209.95	253.03	195.60

Notes: Figures for 2002-2004 based on USDA reports. For 2005, average yields and prices are from USDA's September World Agricultural Supply and Demand Estimates. Other 2005 figures are from unpublished FAPRI estimates. Variable production expenses are defined as USDA's operating costs and hired labor, but exclude land and other fixed costs.