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Agricultural Marketing Assistance Loans and Loan Deficiency Payments

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Summary

Marketing assistance loans for the major crops were designed to facilitate orderly marketing by providing short-term financing so that farmers could pay their bills right after harvest and spread their sales over the entire marketing year. However, the persistence of very low commodity prices transformed the loan program into a major vehicle of farm income support. Marketing loan program benefits (primarily loan deficiency payments, LDPs) to farmers amounted to about $5.9 billion in 1999, and will exceed $6.5 billion in 2000. Such levels of use and high costs have revealed several administrative problems and given rise to several policy issues. Some policy makers have favored broadening the scope and enhancing the benefits of the program to achieve greater farm income support. Anticipated adverse market impacts have discouraged adoption of these proposals to date. A persistent policy issue is the payment limitation on marketing loan gains.

Support provisions in the 1996 farm bill (P.L. 104-127)[1] for wheat, feed grains, cotton, and rice includes two primary elements – (1) annual fixed production flexibility contract payments, and (2) the continuation of marketing assistance loans. Soybeans and minor oilseeds, while not eligible for production flexibility contracts, can utilize marketing assistance loans. It was anticipated that contract payments, averaging about $5 billion per year, would serve as farm income support, and marketing assistance loans would facilitate orderly marketing at little or no federal cost. Unanticipated and persistently low market prices altered the outcome. The contract payments have been supplemented with emergency "market loss payments" in 1998, 1999, and 2000. In addition, the marketing loan program has become a major source of "counter-cyclical" farm income support, amounting to $1.792 billion in 1998, an estimated $5.894 billion in 1999, and $7.651

[1] Title I (the Agricultural Market Transition Act) of the Federal Agricultural Improvement and Reform Act of 1996 specifically contains the commodity provisions for the seven crop years 1996 through 2002. See CRS Report RS20271, *Support Programs for Major Crops: Description and Experience*.

billion is forecast for 2000.[2] This report explains the design and operation of marketing assistance loans and examines some of the administrative and policy problems that have arisen.

Loans Facilitate Orderly Marketing

Nonrecourse marketing assistance loans are available only to the producers of wheat, rice, feed grains, oilseeds, and upland cotton.[3] Eligible producers can pledge their harvested commodities as collateral for interest-bearing loans[4] from the U.S. Department of Agriculture's (USDA) Commodity Credit Corporation (CCC). The loans mature in 9 months, but can be repaid earlier. The primary purpose of this loan program is to give farmers short-term funds from which to meet expenses until the commodities are marketed, hence the name marketing assistance loans. An important motivation for the government to provide such loan funds is to encourage orderly sales through the coming year. In the absence of credit, some farmers might be compelled to market their crop immediately after harvest, thereby oversupplying the market and receiving lower prices. Marketing loans make it possible for these farmers to sell in response to market price signals rather than creditor pressure.

The Federal Agriculture Improvement and Reform (FAIR) Act of 1996 (P.L. 104-127) capped the loan rates at their existing 1995 levels through the 2002 crop year. Other important commodity provisions in this farm bill included the replacement of target price deficiency payments with fixed "contract" payments of about $5 billion per year, the elimination of annual acreage diversion programs, and greater farmer control over production and marketing decisions with the expectation that they would assume more and the government less of the risk associated with the price instability.

Loans Support Farm Income

Nonrecourse commodity loans also serve the purpose of counter-cyclical income support when cash market prices drop below the loan rates. Since the loans are nonrecourse, farmers can fully satisfy the debt repayment obligation by forfeiting the commodities pledged as collateral. In effect, when farmers forfeit pledged commodities, they are selling them to the CCC for the loan price. Some observers of farm policy describe the loan program price guarantee as one element of the federal farm income safety net. Commodity forfeitures remove supplies from the market and, if the volume is sufficiently large, raise market prices for all farmers. Historically, this forfeiture mechanism served as a supply management/price support feature of USDA's commodity price and farm income support programs.

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[2] Data are from the Economic Research Service, as of September 9, 2000.

[3] In general, to be eligible for nonrecourse marketing assistance loans and LDPs for wheat, feed grains, upland cotton, and rice, producer must have contract acreage for at least one of the commodities. For the 2000 crop only, the Agricultural Risk Protection Act of 2000 authorized LDPs to producers with no contract acreage (P.L. 106-224, Sec 206). No contract requirement has ever applied to soybeans and other oilseeds.

[4] The rate of interest on commodity loans (set at 7.125% for December 2000) is the CCC cost of borrowing from the U.S. Treasury plus 1%.

Commodities forfeited to CCC eventually come out of inventory, potentially displacing commercial sales and depressing market prices, which is a serious weakness in the use of nonrecourse loans to support market prices. In the past, to minimize this impact, large amounts were donated to developing countries, distributed through domestic food assistance programs, or diverted to nontraditional industrial uses.

CCC acquisition, storage, and disposal of forfeited commodities proved to be a costly, complex, and market distorting mechanism for supporting farm income. A transition out of commodity price support and toward direct farm income support began in the early 1970s. In place of supporting prices, the CCC shifted to making direct payments (called deficiency payments) to cover the difference between target prices, set by law, and lower market prices. Loan rates were gradually reduced in order to facilitate orderly marketing without interfering with market prices. By 1986, it had become an explicit policy that loan operations would not be used to isolate stocks from commercial markets in order to support prices. Under the alternative of making target price deficiency payments to support income, various production control mechanisms (such as acreage set-asides, acreage diversions, and cropland conservation reserves) were implemented to reduce supplies, raise market prices, and limit the amount of federal money spent for income support.

The FAIR Act of 1996 went even further to separate income support from intervention in commodity markets. Producers of wheat, feed grains, rice, and upland cotton were assured fixed, but gradually declining, annual contract payments for crop years 1996 through 2002, along with the freedom to plant (or not plant) nearly any crop and without any government limits on acreage. One motivation for this shift in policy was the tendency of other countries to increase planted acreage when U.S. farmers were required to take land out of production. The policy change was an explicit recognition that it was impossible to manage world supplies by limiting planted acreage only in the United States. The new policy retained nonrecourse marketing assistance loans, but capped loan rates at their 1995 levels.[5]

Marketing Loan Repayment Provisions

The marketing assistance loan rates were set below normal downside market price fluctuations, but occasionally prices do drop lower. Wheat, corn, and soybean prices during and after harvest in 1998, 1999, and 2000 are cases in point. When market prices drop below loan rates, borrowers have the option of repaying the loans at local market prices (called *posted county prices* for wheat, feed grains, oilseeds, and *adjusted world prices* for rice and upland cotton[6]) and retaining ownership of the commodities. Posted county prices for wheat, feed grains, and soybeans are previous-day nearby terminal market prices adjusted by CCC's County Average Location Differentials (largely transportation cost adjustments) to reflect the local cash market values.

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[5] The loan rate formula is 85% of the moving average of market prices received by farmers over the past five years, dropping the highest and lowest price years. The USDA has limited authority to reduce loan rates below the formula to encourage marketing, but may not raise them.

[6] Extra long staple (ELS) cotton is eligible for nonrecourse loans but is not eligible for alternative marketing loan repayment or for loan deficiency payment provisions.

This alternative repayment provision accomplishes several important objectives. It leaves the commodities in the hands of the farmers, and they (rather than the CCC) make the future marketing decisions. All of the costs and complications of government storage and disposal of inventories are avoided. Also, farmers have the opportunity to later sell the commodities at prices higher than their loan repayment rates. The difference between the loan rate and the lower repayment rate is called the *marketing loan gain* for the farmer. The gain is considered a government payment and is taxable farm income.

Loan Deficiency Payment Provisions

When market prices fall below the commodity loan rates, the opportunity to obtain marketing loan gains might encourage nearly all farmers to obtain loans, even those who would not otherwise do so. To avoid this, farmers may choose to receive *loan deficiency payments* (LDPs) in lieu of securing and repaying the marketing assistance loans. The loan deficiency payment is the calculated difference between the loan rate and the alternative repayment rate (the posted county price or adjusted world price). So, when market prices fall below loan rates, farmers who agree to forego loans have the same opportunity to benefit as do farmers with loans. For 1998 crops, spot market prices fell low enough that LDPs were made to producers of most eligible commodities. By early December 2000, the CCC had paid $2.7 billion for 1998 crop LDPs, $6.1 billion for 1999 crop LDPs, and $4.8 billion for 2000 crop LDPs.

Policy Issues

Low prices have transformed a program devised as short term marketing assistance into also a major income support program. This transformation has revealed several administrative design difficulties and provoked several controversial policy questions.

Payment Limitations. Together, the combination of all marketing loan gains and LDPs is called the *marketing loan benefit* and is subject to an annual per-person payment limit of $75,000. Low prices have put many large and even mid-sized farms up against the limit. When farmers reach the payment limit they can put all of the remaining crop under loan and forfeit the stored commodities to settle the loan. Receiving forfeited commodities is just as expensive for the CCC as making LDPs. Congress addressed the problem by doubling the payment limit to $150,000 for 1999 crops (P.L. 106-78). Also, in February 2000, the Secretary of Agriculture implemented a commodity certificate program (authorized by P.L. 106-78, Sec 812) to discourage forfeiture of loan collateral commodities. Farmers may purchase certificates at the posted county price up to the quantity of grain or cotton under loan, and then immediately trade the certificates to recover commodities under loan. While purported to discourage commodity forfeitures, certificates effectively serve to circumvent the payment limitation.

While certificates appear to eliminate the constraints created by payment limitations, there are problems. First, certificates require that commodities be put under loan. To put commodities under loan they must be held in storage. This necessitates storage facilities with adequate capacity. There is significantly more paperwork and time involved in processing a commodity loan than an LDP. The paperwork is a burden on the limited county Farm Service Agency staff, and (while commodities are in storage) storage expenses accrue to the farmer. In contrast, LDPs can be exercised as soon as the crop is harvested and with little paperwork, thereby facilitating immediate sale and shipment.

Another problem is that loan rates for high moisture corn, corn silage, and low quality grains are sharply discounted. These same commodities would suffer no discounts under LDP rules. The 2000 and 2001 crops of wheat, barley, and oats that are grazed and never harvested are eligible for an LDPs, but the "production" does not serve as loan collateral and can receive no benefit from a certificate program.[7]

The problems associated with certificates encouraged adoption again of the $150,000 payment limit for 2000 crops (P.L. 106-387, Sec 837). There are critics who believe that an increase in the payment limit would be inconsistent with targeting federal assistance to small family farms, and that aiding large farms encourages their growth at the expense of small farms. Others are critical of additional farm subsidies without any test of financial need being applied to the farmers.

County Loan Rates and Posted County Prices. It became apparent after the 1998 grain harvest that the spread between posted county prices and county loan rates was widely different in some nearby locations. Farmers complained of inequities. Then some elevators began reporting they were losing customers to nearby locations where higher LDPs were available. At least three conditions were contributing to the inequities. First, the USDA admitted that county loan rates did not reflect geographical differences in market prices because adjustments had not been made in a very long time for wheat and feed grains. The needed loan rate decreases in some locations were so large that the anticipated criticism prevented the USDA from taking action. Second, there was a single county loan rate for wheat, but a posted county price for each separate class of wheat. Third, the calculation of posted county prices necessitated setting boundaries around terminal markets and these boundaries gave rise to differences between adjoining regions. In early 1999, USDA considered, but did not implement, replacing daily posted county prices with a daily posted national price. Critics charged that this change might eliminate terminal market boundary problems, but would not solve the problem of outdated county loan rates, or wheat class differences. No action has been taken to correct geographic and grain class inequities.

Loan Rate Caps. In an effort to raise farm income in the face of low prices, some Members of Congress have proposed that the loan caps imposed by the FAIR Act be removed (H.R. 217, H.R. 1299, S. 30) and that loan rates be increased (H.R. 4949).[8] Higher loan rates would be a policy change of substantial consequence. During a period of low market prices, higher loan rates translate into larger marketing loan benefits. Members who oppose higher loan rates fear that the market-directed reforms of the FAIR Act would be undermined. It is argued farmers would base their production decisions on loan rates rather than market conditions. Land that might shift to more profitable crops based on market prices and relative production costs could be attracted to the most beneficial loan program. Some economists feel such a distortion already has been happening in the case of soybeans, where the loan rate covers a larger share of production

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[7] The Agriculture Risk Protection Act of 2000 (P.L. 106-224) authorized payments in lieu of LDPs to producers of 2001 crop wheat, barley, or oats who elect to graze the acreage.

[8] Removal of the loan caps and extending the term of loans were defeated by Senate vote during the second session of the 105^{th} Congress (S.Amdt. 3146). However, supporters continued to encourage these changes in the 106^{th} Congress.

costs than does the corn loan rate. Farmers moved land out of corn and into soybeans in 1999 and 2000, opposite to the signal being given by comparative market prices.

Loan Maturity. The maturity date on marketing assistance loans is about 9 months after the loans are made. In most cases, farmers who obtain commodity loans do so shortly after harvest. Therefore, a 9-month term means that the loans generally will be settled during the same marketing year in which the crop was harvested. This encourages farmers to market their crops rather than carry them forward into the next marketing year.

One proposal (H.R. 4979) would extend the maturity date on commodity loans to 20 months, another (S. 1635) would set the term at 36 months. The argument for a longer loan term is to make it easier for farmers to hold commodities off the market when prices are low in anticipation of higher prices in the next marketing year. Opponents contend that carrying inventories into the next marketing year would generate high storage costs, add to the total supply, create a burden on storage capacity, adversely impact on the end use quality of the crop, and serve to depress prices for at least another year. Additionally, the opponents assert, if farmers do want to speculate on a rise in prices, there are other vehicles available in the commodity futures markets.

The Future. The problems that beset the marketing assistance loan program in 1999 persisted as farmers harvested their 2000 crops. Market prices remain low and the marketing loan program continues to serve as a major safety net for farm income support. In 1998, 1999, and 2000, Congress responded to low prices by disbursing arguably non-distorting "market loss payments" in parallel with AMTA contract payments. The $5.672 billion in 1998 crop contract payments were matched by market loss payments of $2.811 billion (P.L. 105-277, Sec 1111). The $5.476 billion in 1999 crop contract payments were matched by market loss payments of $5.466 billion (P.L. 106-78, Sec 802). And $5.049 billion in 2000 crop contract payments were matched with $5.466 billion in market loss payments (P.L. 106-224, Sec 201(a)).

Policymakers are uncomfortable with the recurring need for *ad hoc* farm income assistance. In the 107th Congress, the focus will be on longer-term options that likely will provide market driven counter cyclical assistance. Alternatives include revenue insurance (already being pilot tested, see CRS Issue Brief IB10033), tax deferred income stabilization accounts (H.R. 957, S. 642), counter cyclical income support payments (H.R. 2792), and modifying the marketing assistance loan program. The likely vehicle for modifications of farm policy will be an omnibus farm bill in 2002 to replace the expiring 1996 farm bill.

This report will be updated and revised as legislative events transpire.

Related References: The USDA's Farm Service Agency (which administers farm income and commodity support programs) has program fact sheets available at [http://www.fsa.usda.gov/pas/aginfo.htm], and marketing assistance loan and LDP data at [http://www.fsa.usda.gov/dafp/psd/Reports.htm].