

The U.S. Commodity Loan Program

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Introduction

Commodity loan programs in the United States are one of the major domestic support programs, and have been in existence in various forms since the 1930s — primarily covering major field crops. Different versions of these programs, over time, have been designed to provide different benefits to producers, and have addressed different policy goals. The policy goals and program benefits have included price support, income support, price stability, and short-term liquidity. The future direction of commodity loan programs will depend, in part, on the combination of policy goals that are to be achieved by the programs.

Commodity Loan Programs — Price Supports and Marketing Loans

Commodity loan programs have operated in two major ways. Commodity loan programs supported market prices over most of their history, starting in 1933. In the past 15 years, however, marketing loan provisions have been added to commodity loan programs for major field crops. Marketing loans

provide income support to farmers, but do not support market prices.

Loan Program Operation

Commodity loan programs allow producers of designated crops to receive a loan from the government at a crop-specific loan rate per unit of production by pledging production as loan collateral. A farmer may obtain a loan for all or part of a new crop at any time following harvest through the following March or the following May, depending on the crop. However, most loan placements occur shortly after harvest, when prices tend to be seasonally low, providing short-term financing to farmers.

Before marketing loans were introduced (discussed later), to repay the loan, the farmer would return the loan principal plus accrued interest charges. Alternatively, the farmer could choose to settle the loan at the end of the loan period by keeping the loan proceeds and forfeiting ownership of the loan collateral (the crop) to the government. If market prices were below the loan rate, the farmer would benefit from settling the loan this way and keeping the higher loan rate.

Additionally, if market prices were above the loan rate but below the loan rate plus interest, keeping the

loan proceeds and forfeiting the crop would make economic sense because the alternative of repaying the loan plus interest would cost more than the market value of the crop. Price support to the sector was provided by the acquisition of crops by the government through loan program forfeitures combined with restrictions on CCC sales, essentially removed crops from the marketplace when prices were low.

The addition of marketing loan provisions changed the operation of commodity loan programs. Marketing loans were implemented for rice and upland cotton in 1986 under the provisions of the 1985 Farm Act. Starting in 1991, subsequent legislation made marketing loans available for soybeans and other oilseeds. Marketing loans for wheat and feed grains were implemented starting with 1993 crops, under the GATT trigger provisions of the Omnibus Budget Reconciliation Act of 1990. The 1996 Farm Act continued marketing loans for all of these crops.

With marketing loans, loan placements may occur as described earlier under nonrecourse loan provisions. However, as implemented, marketing loan provisions allow farmers to repay commodity loans at less than the original loan rate (plus interest) when market prices are lower. This feature decreases the loan program's potential effect on supporting prices by reducing governmental stock accumulation through forfeitures. Instead, farmers are provided economic incentives to retain ownership of crops and sell them (hence the term "marketing loan") rather than forfeit ownership of crops to the government to settle loans.

Producers can receive marketing loan benefits in two different ways: through the loan program and through direct loan deficiency payments. Under the loan program, farmers place their crop under loan, as described earlier, by pledging and storing some of their production as collateral for the loan, and receiving a per-unit loan rate for the crop. Rather than repaying the full loan, farmers are allowed to repay at a lower loan repayment rate when market prices are below the loan rate (plus interest).

Marketing loan repayment rates are based on local, posted county prices (PCPs) for wheat, feed grains, and soybeans, or the prevailing world market price for rice and upland cotton. When a farmer repays the loan at a lower posted county price or

prevailing world market price, the difference between the loan rate and the loan repayment rate (the marketing loan gain) represents a program benefit to producers. In addition, any accrued interest on the loan is waived.

Alternatively, farmers of crops covered by the loan programs (except extra-long staple cotton) may choose to receive marketing loan benefits through direct loan deficiency payments (LDPs) when market prices are lower than commodity loan rates. The LDP option allows the producer to receive the benefits of marketing loans without having to take out, and subsequently repay, a commodity loan. The LDP rate is the amount by which the loan rate exceeds the posted county price or prevailing world market price and, thus, is equivalent to the marketing loan gain that farmers could obtain for crops under loan. If an LDP is paid on a portion of the crop, that portion cannot subsequently go under loan.

Comparison of Marketing Loans vs. Price-Supporting Loan Programs

The switch in the way that commodity loan programs have been operated, moving from price-supporting programs to marketing loans, results in important differences in effects on commodity markets. While both alternatives provide support to farmers' revenues, this is accomplished through significantly different policy mechanisms.

Price-supporting Loans

With price-supporting loans, market prices are directly supported at the loan rates because the government accumulates stocks through loan forfeitures when market prices are below the loan rate, effectively removing supplies from the marketplace. Program costs reflect the full loan rate being paid to farmers on a portion of the crop. Costs associated with acquisition and storage of these stocks also add to the agricultural program budget.

Production is increased as farmers base planting decisions on program-supported prices (equal to the loan rate). Overall economic efficiency is reduced because of this misallocation of resources. Although there is an increase in production, prices are not free

to respond because excess production goes into stocks with the government's effective purchase of supplies at the loan rate. Thus, market demand faces prices that are held higher than they would otherwise be. This not only means that domestic market demands see higher prices, such as higher market prices for feed that increase production costs to livestock producers, but that U.S. exports to international markets are at higher prices, thereby reducing U.S. competitiveness in global trade and encouraging increases in foreign production.

In subsequent years, the government sells or releases stocks when prices are higher, keeping prices from rising further, but also extending market impacts over a longer time period. Although this imposes further distortions to the marketplace, effects are in the opposite direction to those that occur in the lower-price years when the government accumulates stocks. As a result, government stock accumulation in low price years and stock release in higher price years may contribute to some reduction in multi-year price variability. Also, while effects of price supporting loan programs may extend over a longer period of years, multi-year cumulative impacts on total supply may be largely offsetting.

Marketing Loans

In contrast, program benefits under marketing loans are provided through an income transfer rather than through a price support. Per-unit revenues to producers are supported but market prices are not. Government budgetary costs are largely through direct payments to farmers and costs of net loan activity (including marketing loan gains), but there are not significant governmental stockholding costs. In contrast to price-supporting loans with costs reflecting the full loan rate paid on part of the crop, marketing loan costs reflect a portion of per-unit revenues (the gap between the loan rate and the market price) potentially paid on the full production of the crop.

As for price-supporting loans, production is increased as farmers base planting decisions on net returns that reflect program benefits. However, for marketing loans, net returns reflect part of the revenues coming from the marketplace and part from the government in the form of the marketing loan

benefit (either a marketing loan gain or a loan deficiency payment). Again, economic efficiency is lowered because of the resulting misallocation of land and other resources. With marketing loans, the government does not remove production from the marketplace through stock accumulation, so the increase in production results in prices in the marketplace being allowed to decline.

Impacts on equilibrium levels of quantities demanded largely reflect market adjustments to the higher production and lower prices. In domestic markets, lower market prices for feeds, for example, benefit livestock producers by reducing their production costs. Foreign demand is influenced by factors such as income, prices, and exchange rates. Thus, the reduction in prices due to marketing loans' impact on production pushes U.S. exports higher, reflecting increased competitiveness in global trade.

In contrast to price-supporting loans, effects of marketing loans occur mostly in years when marketing loan benefits exist. While there may be small dynamic carryover effects to subsequent years through marginally higher private-sector stockholding, there is no substantial release of government-held stocks as can occur with price-supporting loans. As a consequence, production impacts in low price years are not offset in later periods. Thus, while marketing loan distortions are more focussed in years of marketing loan benefits, multi-year impacts on supply are likely larger than for price-supporting loans. Market prices are more variable than with a price-supporting loan program, but per-unit revenues to producers are increased.

Looking Towards the Future: Operating Provisions Important

Other provisions are also important for the operation of commodity loan programs, whether implemented as price-supporting loans or as marketing loans. For example, there is a wide range of potential procedures for setting loan rates. Rates could be pre-determined in agricultural legislation or they could be allowed to vary across years, based on formulas that use historical market prices, for example. If set by formulas, they could be subject to caps, as in the 1996 Farm Act. Additionally, the

Secretary of Agriculture could be given varying amounts of discretionary authority for rate setting.

Commodity loans could apply to all or part of a crop. For several decades, loans generally have been available on all production from land enrolled in programs. If loan programs cover less than full production, any of several qualifying factors could be used to determine eligibility, such as program yields or other historical measures of production or acreage.

Other issues relative to commodity loans also could be addressed in the forthcoming farm bill discussion. Are current relative loan rates among commodities, such as corn and soybeans, appropriate? Equally important to some producers, can loan-rate differences between counties, especially adjacent counties in different states, be made more equitable? To what extent do WTO obligations impose limits on loan rates and commodity loan programs?

Policy Options and Consequences

A number of policy options are possible with respect to commodity loans. In general, the options are to: 1) retain marketing loans (within the structure of nonrecourse loans), 2) revert back to a system of strictly nonrecourse loans, or 3) eliminate all loan programs.

However, two other possibilities deserve brief mention. First, recourse loans (sometimes called advance recourse loans) could be authorized. Recourse loans require repayment of the full cash value of a loan plus interest. Such loans cannot be satisfied by forfeiting collateral (a stored commodity) to the government. In most situations, recourse loans would not be expected to have much of an impact on commodity prices or farm income, and government costs would be minimal. Farmers might have an interest in recourse loans if interest rates or other loan terms were more favorable than could be obtained in the private sector. This assumes, of course, that

neither marketing loans nor nonrecourse loans were available.

Another possibility is to reimplement a multi-year loan program, perhaps along the lines of the old Farmer Owned Reserve program. This option is discussed in depth in another paper in this series. At least some impacts of such a program, such as reducing price variability, would be expected to be similar to nonrecourse loans. An important difference, however, is that impacts under a multi-year loan program would be spread over a longer time period.

Consequences of the general loan program policy options are discussed for 1) farmers and ranchers, 2) agribusinesses, 3) consumers, 4) taxpayers, 5) the environment and 6) rural communities. The time frame for consideration of consequences is an "intermediate" period, perhaps one or two years into the future.

Consequences for Farmers and Ranchers

Marketing loans support farm incomes, not commodity prices. As a result, marketing loans are associated with greater price variability than would be expected with nonrecourse loans. Moreover, to the extent that marketing loans encourage production even when prices are low, price variability under this option may be greater than if loan programs were eliminated.

Elimination of loan programs probably would result in a more efficient allocation of resources. Both nonrecourse loans and marketing loans encourage capital and other resources to be committed to production, even when supply-demand conditions are unfavorable. The higher the loan rate, the greater the tendency for inefficient allocation of resources to occur. Moreover, because some agricultural resources (land and equipment) have few alternative uses, resources tend to stay in agriculture for long periods of time, even if used inefficiently.

Resource distortions also occur because producers may be inclined to plant crops offering loans rather than other crops. Moreover, even among program crops, relative differences in loan rates can distort normal market forces. For example, in recent years, soybean loan rates appeared to have been high

enough relative to corn loan rates and market prices to encourage additional soybean production.

Compared to nonrecourse loans, marketing loans put a greater premium on producer marketing skills, especially when commodity prices are below loan rates. The fact that many producers opt to take loan deficiency payments (LDPs) rather than placing crops under loan and do so shortly after harvest adds to the marketing skills needed later in the season. (Early acceptance of an LDP ends government loan program involvement with that portion of a farmer's production and may be problematic if cash prices drop before commodities are marketed.) However, an advantage of both marketing loans and LDPs compared to nonrecourse loans is that producers are not required to keep a commodity in storage for 9-10 months during low-price periods to receive full benefits of the program. If loan programs were eliminated, producers might seek out additional opportunities in the private sector to reduce risk.

Both marketing loans and nonrecourse loans may impact the structure of the production sector. On one hand, the income or price safety net provided by loans could help keep smaller farms in business. Alternatively, loans could encourage larger farmers to expand. Marketing loans, in particular, have too short a history to draw any structural conclusions.

Consequences for Agribusinesses

Input suppliers should be relatively indifferent as to whether nonrecourse loans or marketing loans are used. Either way, producers of eligible crops receive cash-flow protection, an important factor for those who sell inputs. On the other hand, input suppliers might worry if no loan programs were offered — the extent of this concern would vary depending on the availability of other public and private income stabilization programs.

Other things equal, agribusinesses that store and process commodities want to purchase these commodities at the lowest possible price. At first, this might seem to favor marketing loans or the elimination of loan programs over nonrecourse loans. However, either of the first two options also leaves commodities more vulnerable to upward price spikes. In the end, many processors value steady commodity

supplies at moderate prices. Because they operate value-added businesses, a steady-as-you-go approach often works best. In short, nonrecourse loans may be favored over either of the other alternatives.

Consequences for Consumers

First buyers of crops supported by commodity loans may have different preferences with respect to the two types of loans. For example, foreign buyers may respond favorably to lower prices offered under marketing loans, especially if the price makes U.S. supplies more competitive with those offered elsewhere in the world. In the United States, livestock feeders typically want the lowest possible feed prices.

In contrast, a domestic flour miller (a first-buyer consumer and an agribusiness, as in the discussion above) may be mostly interested in obtaining a steady supply of a certain class of wheat. Purchases at the lowest possible price may be less important and, in fact, generally stable prices may be preferred.

Consumer preferences at the retail level with respect to marketing or nonrecourse loans could go either way. If commodities were expected to be plentiful much of the time, it would be logical for consumers to prefer marketing loans over nonrecourse loans. After all, marketing loans allow commodity prices to dip below loan rates in periods of ample supplies. In contrast, greater stability offered by nonrecourse loans may be preferable if commodity prices were otherwise expected to vary widely.

Consequences for Taxpayers

One of the advantages traditionally identified for marketing loans is that they eliminate much of the government's potential carrying costs (interest, storage, risk of the commodity going out of condition) associated with nonrecourse loans. However, when nonrecourse loans are replaced by marketing loans, some loan program costs shift from consumers to taxpayers because market prices are not supported.

Consequences for the Environment

Beginning with the 1985 Farm Act, marketing loans and nonrecourse loans generally have been available only to producers who engage in good conservation practices. Additionally, over a longer history ending in 1995, eligibility for loans often depended on taking a certain percentage of land out of production and devoting it to conserving uses. Typically, this would be the poorest land on a farm. Thus, both marketing loans and nonrecourse loans tend to be associated with enhanced conservation of natural resources. Elimination of loans could have a negative impact on the environment.

Consequences for Rural Communities

Many rural communities depend heavily on farmers and related agribusinesses for their economic sustenance. To the extent that marketing and nonrecourse loans enhance farm incomes, rural communities benefit as well. Farm leaders typically base a significant part of their requests for government support on the desirability of maintaining rural communities.

Concluding Comments

Nonrecourse and marketing loans have been perhaps the single most-used provision of agricultural commodity programs, dating back to farm legislation in the 1930s. Thus, the alternative of eliminating loan programs would be a significant departure from the commodity policy setting of the past century. The alternatives of nonrecourse loans alone or augmented with marketing loans have some similarities but also significant differences, with impacts over a wide spectrum of parties and for an extended period of time.