Agricultural Credit Policy

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Background

Modern agricultural production systems are capital intensive, but relatively low-margin segments of the U.S. economy. As such, a large portion of capital used in farming is borrowed. For the majority of commercial-sized producers, credit is necessary to facilitate input purchases and can be a significant cost of production. Farm credit demand has been steady in recent years and creditworthy farmers generally experience competitive lending markets.

The federal government has a long record of supporting agricultural credit markets, dating back to 1916, when Congress chartered the Federal Land Banks, the first component of the Farm Credit System (FCS). Today, three institutions have primary responsibility to deliver federal farm credit policies. The USDA's Farm Service Agency (FSA) provides direct loans and loan guarantees to farmers unable to meet conventional credit standards. The cooperative FCS is a government-sponsored enterprise (GSE) with an implicit federal guarantee, which serves farmers that meet conventional lending standards. The privately owned Federal Agricultural Mortgage Corporation (Farmer Mac), also a GSE, provides liquidity for rural lenders by buying agricultural and rural home loans. Other federal lenders with less prominent roles serving agricultural producers include the Small Business Administration, the Commodity Credit Corporation, and the Rural Business and Cooperative Service. The Federal Home Loan Bank System (FHLBS) also serves as a source of funds for rural lenders. Roughly one-third of the $180 billion in farm debt at the end of 2000 was held by or guaranteed by the government, through FSA or GSEs. In some regions or for some classes of borrowers, the federal government supplies or supports half of all farm credit needs.

Federal credit subsidies may have different objectives, but they all work to lower production costs for farmers and increase access to credit. Today, direct and indirect federal farm credit subsidies are substantial — totaling hundreds of millions of dollars annually. In addition to specific farm credit policies, the regulation and supervision of financial institutions, as well as monetary, fiscal, tax, and antitrust policies have a significant effect on the operation of agricultural credit markets.

The credit titles in the last three farm bills have dealt mostly with FSA farm loan policies, and their content reflects the issues of those periods. The 1985 Farm Bill was drafted during a farm economy downturn and emphasized help to farm borrowers unable to repay their loans or assist after failure. The

1996 Farm Bill was drafted during a period of relative farm prosperity and focused on limiting FSA eligibility, encouraging graduation from FSA loans, and reducing loan program costs. Most significant changes to farm credit policies are not made in farm bills. Policies regarding the banking industry come under the authority of the banking committees and, thus, may not be a part of farm bill deliberations.

Credit Policy Issues and Options

Federal farm credit policies over the past 85 years have been motivated by perceptions that private lenders were not adequately, efficiently, or fairly supplying credit to farmers. Federal credit policies seek to address concerns about social equity and to enhance economic efficiency by raising lender competition, lowering transaction costs, or improving market information. Some specific policy objectives have included raising farm-family incomes, overcoming the difficulties of financing farm startups, stemming the out-migration from farming, reducing the financial impact of natural disasters, decreasing interregional variation in borrowing costs, improving liquidity to rural capital markets, and reducing credit rationing.

Today, Congress is faced with defining a proper role for federal farm credit subsidies as structural change in agricultural production and within the financial services industry continues at a rapid pace. Past federal farm credit programs and policies may be inappropriate or ill equipped to address issues relevant to a modern and increasingly industrialized agriculture. In this context, policy makers may address the role of federal credit policies in providing a farm financial safety net, affecting farm financial market performance, and in addressing concerns of social equity and structural change. These and any other policy objectives will likely have to be balanced against concerns over federal credit subsidy costs.

Credit facilitates the acquisition of production inputs. In the context of the World Trade Organization, any new proposals calling for additional government farm credit subsidies would likely be considered trade-distorting domestic support. As such, some policies and proposals would likely be in the "amber box" domestic support category.

Issue: Providing a Farm Financial Safety Net

USDA subsidized farm loans have traditionally been used to aid financially stressed farmers, especially during economic downturns or in response to losses incurred from natural disasters. Weak commodity prices have significantly lowered farm revenues in recent years. To maintain aggregate farm income at a politically acceptable level, the federal government is making record amounts of payments to farmers. These payments have lessened the need for credit and enhanced farmer creditworthiness.

While most federal farm aid is transferred through other means, farm loan subsidies delivered through the Farm Service Agency remain a significant component of the federal farm financial safety net. Congress more than doubled FSA's farm lending authority from fiscal 1998 to fiscal 2000 to \$5.6 billion to assist the least creditworthy producers. Federal farm loan programs are discretionary expenditures and, as such, are subject to annual federal budget allocations. While recent U.S. budget surpluses have reduced the urgency to cut federal outlays, the desire to trim costs and streamline loan programs remains an important policy objective.

Credit Policy Options and Consequences

Farm Service Agency Farm Loan Programs. Congress could elect to expand the funding or eligibility of FSA loan programs to assist a broader range of farmers. This policy would raise subsidy costs and, in the absence of sufficient needs testing or targeting, would likely be more of an income transfer mechanism as opposed to a financial assistance mechanism. If income transfer is the objective, other mechanisms can be more effective. Alternatively, Congress could elect to cut farm loan program funding and/or their scope of eligibility. Limiting funding or eligibility would mean that fewer borrowers would qualify for federal credit and, hence, would face greater credit costs or an inability to obtain credit.

An alternative to reducing funding would be the transfer of more funding to the guaranteed loan programs. Guaranteed loans allow more lending decisions to be made by commercial lenders. Because guaranteed loans are less expensive to make, more borrowers can be covered for the same budget cost. However, transferring authority could mean some borrowers might receive less federal subsidy and that very high-risk borrowers who qualify for direct loans might not qualify for credit with a loan guarantee.

Reevaluating the level of FSA credit subsidies is another option that could lower costs, while maintaining or increasing program coverage. Current law provides a 4-percentage point reduction on the interest rate paid on guaranteed operating loans, and provides 5-percent interest rates on direct farm ownership and operating loans for eligible borrowers. Statute requires that FSA provides set levels of additional subsidies on direct loans, regardless of need. Restricting or better targeting of subsidies could reduce program costs while improving or not significantly harming borrower performance. Such a policy change would raise capital costs for some, make some ineligible, and provide even greater subsidies to others.

Administrative changes could also be made to expedite and improve FSA credit decisions, reduce the burden for applicants and staff, and enhance the success of the agency's mission by providing more uniform program delivery to borrowers. Some of these changes may require congressional approval or encouragement. For example, FSA could adopt credit-scoring techniques to make faster and more consistent lending decisions, especially on smaller credit requests, much like private sector lenders have embraced.

Although the mission of USDA farm loan programs is to serve as a temporary source of supervised credit for those unable to obtain private credit at reasonable rates or terms, many FSA borrowers rely on federal credit for many years. Legislative changes in the 1990s sought to reemphasize the agency's role as a temporary credit source by imposing limits on program eligibility. Further restrictions, administrative changes, and financial incentives to encourage graduation from FSA could be adopted. Some farm businesses would fail; others would become commercially viable more quickly.

Emergency Disaster Loan Program. Federally subsidized crop insurance has replaced much of the *ad hoc* natural disaster relief and emergency federal credit once supplied to farmers in the aftermath of natural disasters. With even greater subsidies provided by the Agricultural Risk Protection Act of 2000, crop production losses can now be insured at more affordable costs through private insurers. Congress could elect to maintain the existing emergency program at some level of funding or choose to cut this program area.

Credit, whether subsidized or not, is typically a poor substitute for lost production income. Emergency loans carry high administrative costs and have a high loss rate despite offering large subsidies. Outright grants or subsidized self-insuring mechanisms provide a policy alternative. Most physical losses can also be insured through private insurers. If such policies were adopted, producers failing to obtain or unable to secure proper levels of insurance would be forced to use higher cost credit alternatives to finance a recovery.

Issue: Coping with Structural Change and Helping Under-served Groups

Structural change in U.S. agriculture has hastened in recent years, especially for certain enterprises. Federal credit subsidies influence structural change by reducing the cost of capital and funneling subsidized capital to specific groups. The industrialization of agriculture is producing a dualistic structure where a relatively small number of large farms produce the majority of food and fiber, and a large number of small farms produce very little. Mid-sized farm numbers are falling and this raises concerns that farming is evolving in directions that may lead to the demise of the "family farm." Preserving the family farm remains at least rhetorically a policy objective. The average age of farmers rose one full year to 54 years from 1992 to 1997, while the number of young farmers continued to fall. These trends are raising concerns that an insufficient number of new farmers will be available to replace retiring farmers. The large amounts of capital required to operate a cost-competitive farm can be a significant barrier to entry for new farmers.

Federal credit policies attempt to overcome capital barriers by subsidizing start-up capital for new farmers seeking to reach a competitive size.

While the number of farms operated by racial and ethnic minorities rose somewhat from 1992 to 1997, these farmers still represent only about 3 percent of all farms, and their operations remain smaller than the typical non-minority owned farm. The number of African American-operated farms continued to fall, and now represents less than one percent of all farms. Legislation in the 1980s targeted FSA lending programs to socially disadvantaged farmers. Improving the access to credit and reducing capital costs for under-served groups is seen as one policy tool available to assist these producers in developing successful farm businesses.

Credit Policy Options and Consequences

Farm Service Agency Targeting. FSA farm loans currently target family-sized farmers, beginning farmers, and under-served borrowers to help them obtain an economically sufficient size. Targeting is largely accomplished through caps on the amount of FSA credit a borrower can obtain, or by allotting a share of annual lending authorities for targeted groups. Better targeting methods could be employed and more incentives provided to private lenders to increase guaranteed loan program targeting. However, while providing more credit subsidies reduces costs for qualified applicants, this by itself may be insufficient to have a significant effect on the policy objective being pursued, as many other factors may be more important. Evidence also suggests that non-targeted groups, frequently through higher bid prices for business assets, may capture a portion of the subsidy provided.

Farm Credit System and Farmer Mac Targeting. The FCS charter does not specifically require it to target its lending to small borrowers, beginning farmers, or socially disadvantaged groups. On average, the FCS lends to larger farms. Likewise, Farmer Mac is not required to direct its mortgage purchasing activity to under-served groups. The FCS is required to report to Congress on its lending to young, beginning, and small farmers and is supposed to operate special programs for these farmers. Congress could impose more specific mission requirements on the FCS and Farmer Mac to improve credit access and lower capital costs for these and other under-served groups.

A new mission could require detailed reporting on lending to targeted groups, and that a certain share of their lending or profits be devoted to serving these groups, similar to the mission goals imposed on the housing GSE's — Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System. Any new mission requirement could impose additional costs and, hence, make their federal charters less valuable. Redirecting credit subsidizes to targeted groups may not have a large effect on the policy objective being pursued, particularly in the absence of other policy adjustments. Also, evidence suggests that non-targeted groups, frequently through higher farm asset bid prices, may capture a portion of the subsidy.

Beginning Farmer Grants. The National Commission on Small Farms called for beginning farmer grants as an alternative to providing a subsidized loan. In lieu of an FSA loan, a beginning farmer might elect to receive the loan's subsidy value as a start-up grant, perhaps on a matching basis. While subject to the same economic arguments as a loan subsidy, a subsidy amount delivered via a grant could be less costly because the term of subsidy is more likely to be fixed, and because of potential administrative and servicing savings. In addition, beginning farmers would benefit by building equity, rather than debt. However, small grant amounts, given the economies of size and scale that exist in commercial operations, may not yield expected results and could end up supporting bigger "life style" operations.

Aggie Bond Guarantees. Legislative proposals exist that would modify the tax code to increase Aggie Bond usage. One related proposal would be to allow USDA guarantees on Aggie Bonds used to finance FSA eligible beginning farmers. Aggie bonds are tax-exempt revenue bonds issued by states with funds used to provide low interest rate loans to farmers. Bondholders, typically commercial banks, are exempt from federal income tax on the interest income earned from these bonds, resulting in a loss of income to the federal government. Such a guarantee could increase credit access for eligible borrowers, but impose default costs upon the government. Some of the new subsidy would be captured by third parties, such as bondholders, perhaps making this subsidy delivery scheme more costly than alternatives. Because many states do not offer such programs, distribution of benefits would be uneven across the country.

Issue: Enhancing Agricultural Credit Market Performance

New technologies, regulatory reforms, and other factors are reshaping the financial services industry. These changes are reducing economic barriers, increasing market integration, enhancing liquidity, and, therefore, minimizing the need for government intervention in rural credit markets. Despite structural change within the financial services industry and within agriculture itself, concerns linger that some rural financial markets might still face a shortage of reasonably priced loan funds. For example, bank consolidations and mergers raise fears that the commitment of local institutions to agriculture will be lessened.

USDA's report, titled *Credit in Rural America,* concluded that rural financial markets work reasonably well in serving the financial needs of most sectors of the rural economy. The report went on to state "policies that provide untargeted subsidies to a broad range of rural lenders or borrowers, such as examined in this report, are unlikely to be cost effective." Nonetheless, legislative and regulatory policy changes continue to address concerns about credit market liquidity, competitiveness, and efficiency.

Credit Policy Options and Consequences

Reevaluate Farm Credit System and Farmer Mac Charters. A 1997 USDA credit study concluded that the farm sector is currently well served by the existing lending system and that there is little evidence to support the need for additional broad based federal credit subsidies. Bank legislation in 1999 gave small banks greater access to the funding of the Federal Home Loan Bank System by permitting them to use small business loans and farm loans as collateral when borrowing. Competitively priced farm credit for creditworthy borrowers can be obtained from a range of private sources, such as banks, input suppliers, and life insurance companies. Research has shown that rural GSEs largely serve the same clientele, as do private sector lenders. Also, because the FCS and Farmer Mac are single sector lenders, their ability to provide liquidity and stability to rural credit markets is hampered during periods of high farm financial stress.

Given the relatively unfettered charters the FCS and Farmer Mac enjoy and structural changes in agriculture and financial markets, policymakers may consider rethinking the basic role of these rural GSEs. One option might be privatization. Another option would be to give them a more specific mission. If a mission change reduced the value of their charters, it could result in downsizing and structural change for these two lenders. Other lenders may continue to meet most of the creditworthy loan demand if the federal charters of these competitors were more restrictive. Conversely, interest in helping farmers develop value-added enterprises remains high, and expanding the mission of either GSE to facilitate this and other policy objectives could enhance the value of their charters and provide greater subsidies to the rural economy.

Create a Rural Equity Fund for Agriculture and Rural Business Development. Some argue that rural areas are disadvantaged in attracting equity capital (as opposed to debt capital) for rural businesses, and that farmers would benefit financially if they were better able to capture value-added components of the food and fiber they produce. Ownership in value-added businesses might make farmers less dependent on financial support from government programs. One recent proposal (Senate Bill 3242) would create a public/private partnership to establish a rural equity fund to support projects that provide off-farm income opportunities, additional markets for agricultural products, and new businesses in rural communities. Under this proposal, USDA would match private investment dollars for a period of time and could provide guarantees for debt financing associated with projects being financed. While potentially benefiting particular business development, such a policy would impose costs upon the government and require it to make private sector investing decisions.

References and Suggested Readings

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