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Report to the Honorable
Byron L. Dorgan, U.S. Senate

March 1993

WHEAT COMMODITY PROGRAM

Despite Reforms, Government's Involvement Remains Substantial

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Resources, Community, and
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March 18, 1993

The Honorable Byron L. Dorgan
United States Senate

Dear Senator Dorgan:

For over 40 years, the federal government, through the U.S. Department of Agriculture (USDA), has had a wheat commodity program aimed at reducing wheat price fluctuations while ensuring ample supplies for consumers. Before 1985, the wheat commodity program closely linked program benefits to each participant's recent level of wheat production. Under the wheat program, total returns for wheat were often above expected market returns for many producers. Consequently, producers grew wheat to receive these benefits in addition to returns from the commercial market.

In guaranteeing producers minimum prices for their wheat, the government allows producers to borrow money from the federal government, using wheat as collateral. If at the loan's maturity, the support price is above the market price for wheat, the producer may forfeit the collateral to the government and retain the loan proceeds. In this situation, the government is left with the costs of storing, transporting, and disposing of the wheat. In addition to this price support program, the government makes direct income support payments—deficiency payments—to producers.

In 1985 and again in 1990, the Congress enacted legislation that, over the subsequent 5 years, was to increase the influence of the commercial market on farmers' production decisions and to reduce the level of government support for wheat production. The reforms reduced this link between program benefits and current production by setting in motion a decline over time in the support prices the government guarantees farmers for their wheat and by basing deficiency payments on historic average yields, rather than current yields. Additionally, the 1990 legislation reduced by 15 percent the allowable acreage base on which wheat farmers' payments are determined. At the same time, the legislation permitted producers to grow other crops on the land constituting this 15 percent.[1] These changes, along with droughts in 1988 and 1989, which reduced supplies and increased prices, reduced loan forfeitures.

[1]In addition, producers have the option of increasing their flexibility by increasing their base acreage to another 10 percent.

You asked us to evaluate the effects of the 1985 and 1990 reforms on the U.S. wheat program. As agreed with your office, this report provides information on (1) the effects of the reforms on farmers' production level decisions, (2) the government's costs in managing wheat stocks, and (3) the government's continued involvement in wheat-related supports. Later reports will discuss issues related to U.S. wheat producers' income and the competitiveness of U.S. wheat exports.

Results in Brief

The 1985 and 1990 reforms have had a number of positive effects, including reorienting farmers' production decisions more toward market signals and greatly reducing the government's involvement and costs in managing surplus wheat. Lower support prices and efforts to dispose of existing wheat stocks reduced the government's costs for managing wheat stocks in 1991 to 9.3 percent of their 1987 peak.

Although the reforms have reduced the influence that the government has on wheat farmers' decisions to maintain or expand production as well as costs for the price support program, the government's role in the wheat market remains substantial. Specifically, the government continues to provide significant deficiency payments to producers—about $2.3 billion in fiscal years 1990 and 1991 each.

In addition, the 1985 legislation established two new programs that affect actual and potential wheat stocks. The Conservation Reserve Program (CRP) pays producers to remove cropland from production for at least 10 years. While CRP is applicable to crops besides wheat and has multiple objectives (including ecological and environmental benefits), the portion of CRP affecting wheat has resulted in costs to the government that have grown from $28 million in 1987 to over $500 million in 1991. Also, the Export Enhancement Program (EEP) has provided export subsidies for wheat that have varied significantly from year to year but have averaged over $400 million annually from 1986 through 1991. However, some of the CRP's and EEP's direct costs may have been offset by reduced deficiency payments resulting from lower domestic supplies and associated higher market prices.

Because a number of external factors such as weather and international wheat prices affect the government's costs from year to year, it is too early to accurately determine the impact of 1985 and 1990 reforms on wheat program costs. However, in the long run, we would expect costs to be lower than they would have been under the 1981 farm bill legislation.

Background

The wheat commodity program was initiated in 1933 to reduce wheat price fluctuations and support the purchasing power of wheat producers.[2] Over the next several decades, the program was modified to respond to changing farm policy trends, such as the need for greater production during the 1940s, the need to control production and manage surpluses in the 1950s and 1960s, and the need to again allow production to expand in the early 1970s to meet world demand. As the program was evolving over the decades, so were agricultural practices. Improvements in technology and agronomy have greatly increased the yield that is possible from each acre.

By the early 1980s, increased domestic and worldwide production, high support prices that discouraged farm exports, unfavorable exchange rates, and a worldwide recession had contributed to the accumulation of large government inventories of surplus wheat. This situation created a need to control production and dispose of the accumulated excess government wheat stocks. In response, the Congress included provisions intended to address these issues in the Food Security Act of 1985; the Food, Agriculture, Conservation and Trade Act of 1990; and Title I of the Omnibus Budget Reconciliation Act of 1990. Among other things, these laws contained provisions that reduced incentives to overproduce relative to previous legislation, lowered the support price, removed acreage from production by establishing CRP, and established EEP to increase wheat exports.

Reforms Reduced Incentives to Overproduce Wheat

Before the reforms, the wheat program provided producers benefits that encouraged farmers to maintain or expand production, even during times of low consumption, low market prices, and high wheat stocks. The wheat program basically provided two types of benefits—price supports and income supports.

USDA, through its Commodity Credit Corporation (CCC),[3] supports wheat prices by removing stocks from the marketplace through a price support program. The program allows participating producers to get a 9-month government loan using their wheat crop as collateral. At any time during the 9-month period, farmers can repay the loan plus interest. Instead of

[2] After World War II, support provisions were recodified in the Agricultural Adjustment Act of 1949, which still serves as the main U.S. farm law. When a new farm act is passed (about every 5 years), it amends the 1949 act and supersedes the previous farm act.

[3] CCC is a wholly owned government corporation created in 1933 to stabilize, support, and protect farmers' incomes and prices; maintain balanced and adequate supplies of agricultural commodities; and assist in the orderly distribution of these commodities.

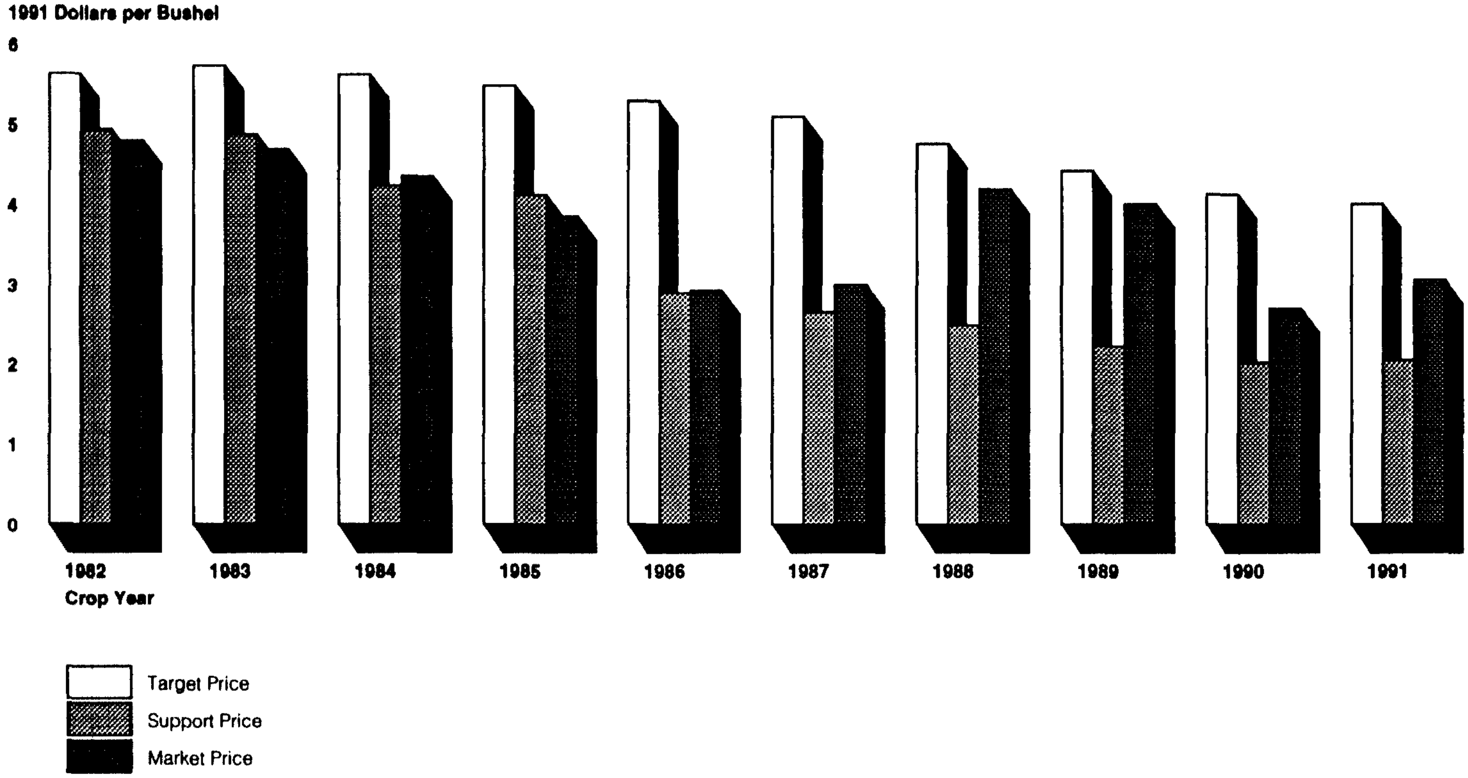
repaying the loan, farmers also have the option, at maturity, of forfeiting the crop to CCC without penalty—essentially selling the wheat to the government at the support price. Generally, the support price acts as a floor price for wheat program participants. However, because the support price was sometimes higher than the market price during the early 1980s, loan defaults were high and the government was forced to acquire large stocks of wheat and was left with the tasks of storing and disposing of them.

The government also supports the incomes of producers by ensuring a minimum return for their wheat by setting a "target price." When the average market price is less than the target price, USDA supports wheat farmers' income through deficiency payments. These direct government payments ensure farmers a minimum cash receipt for their crop. The deficiency payments are determined by the difference between (1) the target price and (2) the market or support price for wheat, whichever is higher. Deficiency payments are limited to 85 percent of the acreage base and to $50,000 per person per year.

From 1982 through 1985, expected returns to participants in the wheat program—deficiency payments and market receipts—exceeded expected returns from the commercial wheat market. Participating producers, whose decisions to maintain or increase production per acre were guided by program provisions, contributed to excess production and large surpluses.

The 1985 and 1990 reforms took a number of steps that addressed these issues. Specifically, the reforms lowered the support price established by earlier legislation. Under the 1990 act, the support price is established at 85 percent of average market prices over the preceding 5 years, excluding the highest and lowest years. The support price can be lowered below this level if (1) inventories of wheat are high relative to annual consumption and/or (2) the Secretary of Agriculture determines that such an adjustment is necessary to make U.S. wheat competitive in the world market. In part, as a result of the 1985 and 1990 changes, the support price has been consistently below the market price since 1986. The 1985 act also gradually lowered the target price from $4.38 per bushel in 1985 to $4.00 per bushel by 1990. Legislation sets target prices at a minimum of $4.00 per bushel through 1995. In constant dollars, the target price of $4.00 in 1990 is 24.8 percent lower than the 1985 price because of inflation. Figure 1 presents the target, support, and market prices for wheat in recent years.

Figure 1: Target Prices, Support Prices, and Market Prices for Wheat, Crop Years 1982-91[a]



[a]A crop year is from June 1 of one calendar year through May 31 of the following calendar year.

Source: USDA.

Another provision of the 1985 act froze the program yield used to calculate deficiency payments. These payments are now calculated using the average yield per acre from 1981 to 1985, excluding the highest and lowest yields, instead of farmers' recent yield per acre. As a result, producers cannot increase their deficiency payments by increasing production per acre. Another provision of the act links the level of land included in the Acreage Reduction Program to the level of wheat stocks. Under the Acreage Reduction Program, participating farmers must limit their planting of program crops to a percentage of their base and idle the remainder. While this program has existed since 1981, the amount of idled acreage was not explicitly tied to stock levels until the 1985 legislation. Finally, the Omnibus Budget Reconciliation Act of 1990 decreased by

15 percent the wheat acreage base eligible for deficiency payments and allowed farmers to plant a variety of other crops on that excluded acreage.

The government's current wheat program still provides for both the price and income supports characteristic of the pre-reform program. However, by diminishing the levels of the price supports, freezing payment yields, and reducing acreage eligible for payment, the 1985 and 1990 reforms encourage wheat producers to make production decisions more on market signals than on the government's program.

Government's Costs For Managing Wheat Stocks Have Declined

During the early to mid-1980s, the government incurred substantial costs for managing the wheat stocks it had acquired or paid farmers to store. These costs were for the storage, handling, and transportation of the wheat acquired from producers and for payments to producers for storing wheat under the Farmer Owned Reserve (FOR) program.[4] Prior to the reforms, a number of factors led to the government's acquisition of large wheat stocks. Among the factors were

- the wheat program's incentives that encouraged excess wheat production, including a high support price, often higher than the expected market price, which encouraged loan forfeitures to the government and discouraged exports;
- a worldwide recession that reduced the demand for U.S. wheat;
- unfavorable exchange rates; and
- aggressive European Community agricultural export programs.

Government-owned wheat stocks were about 200 million bushels in 1982, but climbed to over 600 million bushels in 1985, and peaked at 830 million bushels in 1986—a record high since the 1960s. At the same time, wheat stocks in the FOR program declined from over 1 billion bushels in 1982 to less than 500 million bushels in 1986. However, the overall costs to the government for managing the wheat stocks it acquired and those it paid farmers to store under the FOR program increased from $295 million in fiscal year 1982 to over $600 million in 1987.

The 1985 reforms included provisions that reversed this trend. The reforms reduced the support price to below the market price, significantly reducing the government's acquisition of additional wheat stocks.

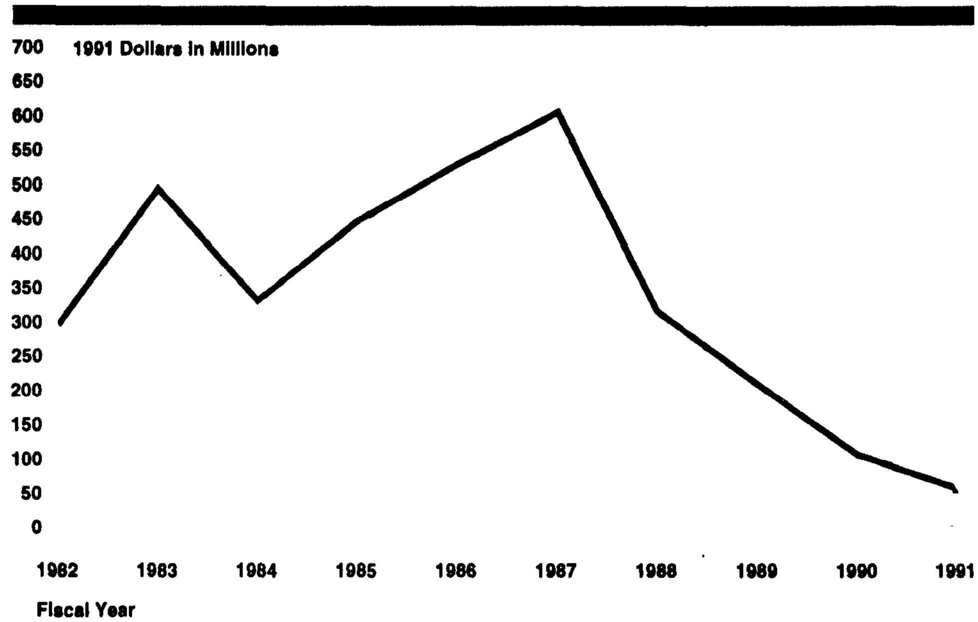
[4]Under FOR, prior to the 1990 legislation, farmers placed their grain in storage and received extended nonrecourse loans and storage payments for 3 years, with extensions as warranted by market conditions.

The 1985 reforms also established mechanisms to reduce the large amounts of accumulated stocks. Specifically, the reforms authorized the government to release its wheat stocks by issuing generic commodity certificates, which have a fixed dollar value and an 8-month life. These certificates allowed USDA to remove wheat stocks from government storage, even though market prices had not reached levels set in legislation that would allow sales of government wheat stocks. USDA could use these certificates to make wheat program payments and to provide export subsidies to exporters. Between 1986 and 1988, certificates provided almost 62 percent of total wheat deficiency payments. Recipients of the certificates could exchange the certificates for cash from the government, use them to purchase government-owned commodities, sell them, or use them to redeem price support and FOR loans.

Furthermore, the 1985 farm bill established EEP to expand U.S. export markets by countering the export subsidies and other unfair trade practices of competitors, especially the European Community. Under this program, the government subsidizes wheat exports by providing cash bonuses or generic commodity certificates to U.S. exporters to allow them to sell wheat at lower prices. CCC provided EEP bonuses in the form of generic certificates until November of 1991, when CCC began paying bonuses under EEP in cash.

These changes, combined with the droughts that reduced production in 1988 and 1989, have allowed the government to dispose of most of the government-owned stocks and those under the FOR program. By 1991, the government's costs for managing stocks were about 9.4 percent of their peak in fiscal year 1987 (see fig. 2). Moreover, because the support price is now considerably below the anticipated market price, the government has greatly diminished the prospects that it will acquire large surpluses through loan defaults and incur the attendant costs in the future.

Figure 2: Government's Costs for Managing Wheat Stocks, Fiscal Years 1982-91

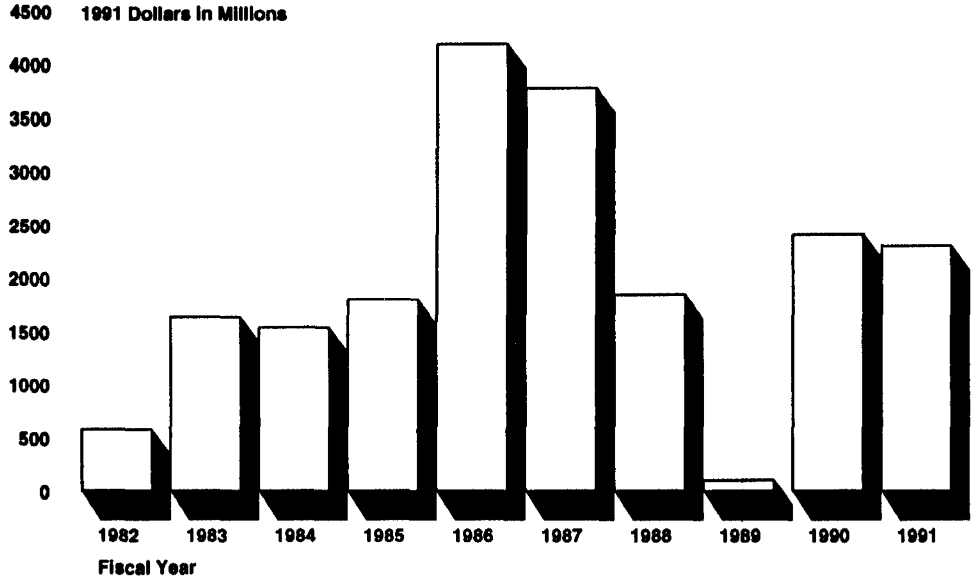


Source: GAO's analysis of USDA data.

Government's Involvement With Wheat Remains Substantial

Although the reforms have helped focus producers' decisions on market forces and have reduced the government's costs for managing wheat stocks, the government is still heavily involved in the wheat market through the deficiency payment, EEP, and CRP programs. For example, deficiency payments were still about $2.3 billion in fiscal years 1990 and 1991, each. Figure 3 shows that deficiency payments in fiscal years 1990 and 1991, while lower than in the peak fiscal years of 1986 and 1987, were still above the pre-reform years of 1982 to 1985. As the government lowers the support price for wheat, market prices can fluctuate more than in the past, increasing the potential for higher deficiency payments.

Figure 3: Deficiency Payments, Fiscal Years 1982-91



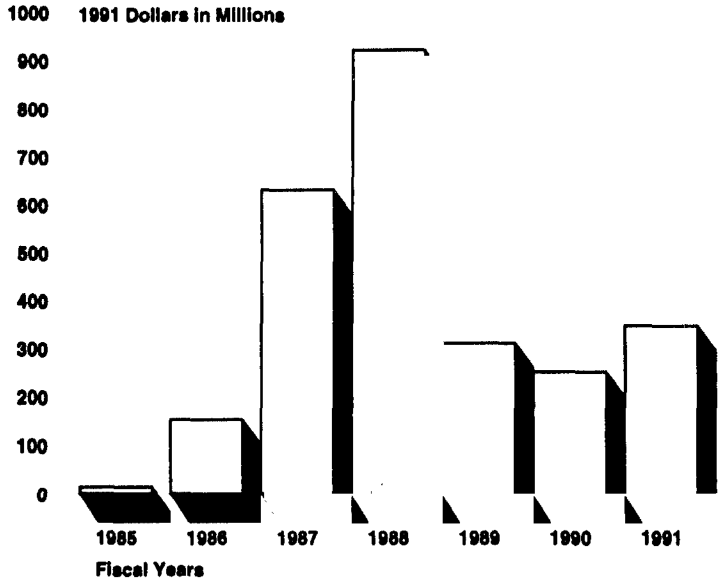
Source: USDA.

According to the wheat program economists in USDA's Economic Research Service, the 1985 and 1990 reforms have moved the sector toward greater market orientation, setting the stage for a long-run decline in government wheat program costs. They stated that, because wheat stocks are now at low levels relative to use compared with mid-1980s levels, and the program allows USDA to adjust acreage reduction requirements in response to market conditions, the risks of high program costs have been reduced. They added that part of the high deficiency payment costs in 1986 and 1987 should be considered costs of the transition from the pre-1985 policies to a more market-oriented program.

In addition, EEP and CRP, established concurrently with 1985 reforms, helped to achieve an overall balance between wheat production and use, but also incurred costs that partially offset other savings in the wheat commodity program from 1986 through 1991. Together, the portions of these programs devoted to wheat have cost the government an average of over $800 million annually.

Export levels and subsidies provided under EEP are significantly affected by world wheat production, world prices, and other nations' policies on subsidies. EEP's outlays for wheat exporters have varied considerably since 1985 (see fig. 4), averaging about $435 million annually from 1986 through 1991.[5]

Figure 4: EEP's Payments to Subsidize Wheat Exports, Fiscal Years 1985-91



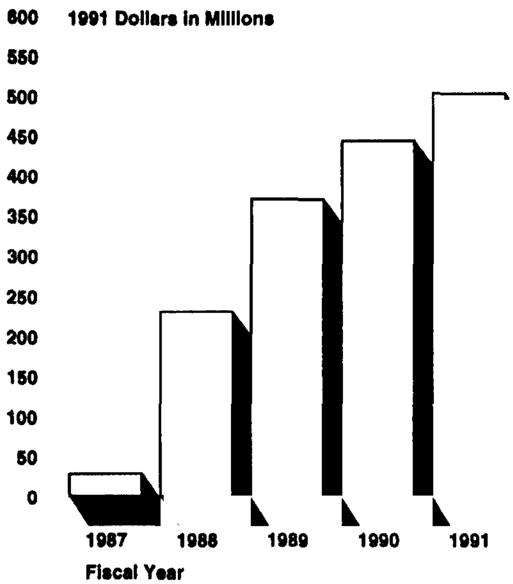
Source: USDA.

Under CRP, the government pays producers of wheat and other commodities to remove highly erodible cropland and certain other croplands from production for at least 10 years. In return for placing cropland in CRP, a participating farmer receives an annual per-acre rent and a portion of the costs—usually one-half—of implementing conservation practices and establishing a permanent ground cover. CRP's primary restriction on wheat production is retiring acres from the wheat base. CRP has multiple objectives in addition to curbing the production of surplus commodities and providing income support to farmers, including

[5]The Omnibus Budget Reconciliation Act of 1990 provides that if the President had not entered into a General Agreement on Tariffs and Trade agriculture trade agreement by June 30, 1992, the Secretary of Agriculture would have to increase export programs, including EEP, by a total of $1 billion for the period of October 1, 1993 though September 30, 1995.

reducing soil erosion, protecting long-term agricultural productivity, reducing sedimentation in streams and along roads, improving water quality, and improving fish and wildlife habitat. The costs of the portion of the program affecting the wheat base have increased steadily from about $28 million in fiscal year 1987 to over $500 million in fiscal year 1991 (see fig. 5). By 1991, CRP had reduced the wheat base acres available for production by over 10 million acres.

Figure 5: CRP's Payments for Cropland Devoted to Wheat, Fiscal Years 1987-91



Source: USDA.

Conclusions

The 1985 and 1990 reforms have had a number of positive effects, including reorienting farmers' production decisions more toward market signals and greatly reducing the government's involvement and costs in managing surplus wheat. Despite these reforms, the government's involvement remains substantial. Deficiency payments under the wheat program are above the 1982-85 levels, and CRP and EEP programs related to wheat production have added costs averaging over $800 million per year from 1986 to 1991.

Because the government's costs related to wheat production are affected by external factors such as droughts and international wheat production and prices, it could be misleading to compare trends in the government's overall costs from year to year. However, in the long run we would expect costs to be lower than they would have been under the previous 1981 farm bill.

Agency Comments

We discussed a draft of this report with the Director and an agricultural economist in the Grains Analysis Division of USDA's Agricultural Stabilization and Conservation Service and with the Head, Food Grains Analysis Section, and other agricultural economists in the Economic Research Service. These officials generally agreed with our findings and conclusions. However, they felt that possibly our presentation of the wheat program mechanisms should be discussed at a higher level of detail. We retained our level of detail, because the report is directed at a more general audience. At your office's request, we did not obtain written comments on a draft of this report.

Scope and Methodology

This report includes an assessment of (1) the effects of the reforms on farmers' production-level decisions, (2) the government's costs in managing wheat stocks, and (3) the government's continued involvement in wheat-related supports. Our later reports will discuss issues related to U.S. wheat producers' income and the competitiveness of the United States' wheat exports.

To assess the impact of the 1985 and 1990 reforms and the government's costs in managing wheat stocks, we collected and analyzed indicators of the program's performance, including data on production, yields, prices, outlays, and export levels. We found these data in USDA's publications and reports. Most of the data in this report came from USDA. We did not independently verify USDA's data, which came from a variety of sources. We also interviewed USDA officials with expertise on wheat.

To assess the government's current involvement in wheat-related price and income supports, we researched pertinent literature—including economic studies—about the government's wheat program and the wheat sector and interviewed academics and experts from interest groups. In addition, we reviewed wheat program outlays before and after the reforms. To ensure the overall quality of our wheat review, we engaged a prominent agricultural economics professor at Kansas State University, Dr. William I. Tierney, Jr. We conducted our work between March 1992 and February 1993 in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Chairman, House Committee on Agriculture; the Chairman, Senate Committee on Agriculture, Nutrition and Forestry; the Chairmen House and Senate Committees on Appropriations; the Secretary of Agriculture; and the Director, Office of Management and Budget. We will make copies available to other interested parties upon request.

Please contact me at (202) 275-5138 if you or your staff have any questions. Major contributors to this report are listed in appendix I.

Sincerely yours,

John W. Harman

John W. Harman
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Agriculture Issues

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