



Farm Policy and the General State of the Farm Economy

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On September 29, 2005 the Subcommittee on General Farm Commodities and Risk Management of the U.S. House of Representative's Agriculture Committee heard from a number of experts on the current state of the farm economy and the likely impacts of federal agricultural policy. This issue of the *NC State Economist* presents a slightly modified version of testimony made by the author during that hearing. A complete transcript of Dr. Piggott's testimony is available at <http://agriculture.house.gov/hearings/109/10917.pdf>.

General State of the Farm Economy

2005 was a prosperous year for U.S. agricultural producers. Estimated net farm income in the U.S. was \$71.8 billion – a 13% decline from the levels recorded in 2004, but still the second highest on record. Compared to 2004, the value of crop production in 2005 declined by 10%, the value of livestock production increased slightly by 0.6%, direct government payments increased by 61%. Direct government payments are estimated to have made up 30% of net farm income in 2005, compared with only 16% in 2004.

Since net farm income estimates in 2004 and 2005 are the two largest on record, a more informed perspective on the current state of the farm economy can be gleaned from comparing the 2005 levels with the previous four years. Net farm income, the value of production, and government payments were all substantially higher in 2005 than their respective averages for the previous four years. Net farm

income was 25% higher than the four-year average; the value of crop production was 5% higher; the value of livestock production was 16.7% higher; and direct government payments were 37% higher.

Examining the distribution of net farm income across sales classes reveals some key facets of the farm economy. Over the period 2001-2004, farms with annual sales in excess of \$250,000 accounted for only 8% of all farms, but accounted for 90.1% of net farm income. These large farms received 75% of the value of crop production, 76% of the value of livestock production, and 50% of direct government payments. Importantly, this latter figure suggests that large farms receive a disproportionate share of government payments.

There is substantial variability across farm types in the share of income received from on-farm and off-farm sources. *Commercial* farm operator household incomes averaged \$173,450 per year over the period 2003-2005, of which 72% came from on-farm sources and 28% came from off-farm sources. In contrast, *rural residential* farm operator household incomes averaged \$76,351 per year over the same period, of which –2% (a loss) came from on-farm sources and 102% came from off-farm sources. Thus, farms vary greatly across farm types, not only in terms of income, but in the share of income from on-farm and off-farm sources.

Farm household income across all family farms in 2005 is estimated to have been \$88,105. By

comparison, incomes for all U.S. households over the same period averaged \$60,528. In other words, average U.S. household incomes were only 69% of their farm operator household counterparts. It is noteworthy that this comparison does not take into consideration any cost of living differences between metropolitan and rural areas. Because most farm operator households reside in areas with a lower cost of living, the gap becomes wider in favor of the farm operator's disposable household income.

A final important indicator of well-being of the agricultural economy is to compare farm wealth, or net worth, with all U.S. households. Covey et al. (2004) provide estimates based on 2003 Agricultural Resource Management Survey (ARMS) data on the wealth of farms relative to median U.S. household wealth. These indicate that 94% of farms had net worth greater than median net worth of all U.S. households.

Farm Policy

The goals of farm policy should be to ensure adequate, safe, and high-quality agricultural production. In addition, consideration needs to be given to the potential environmental impacts of practices used, the burden on taxpayers, and consistency with WTO agreements. These goals are ambitious and present a significant challenge to policy-makers under the real-world constraints of limited budgets, political pressure, and the heterogeneity of the farm sector.

Safety Nets

A safety net in the context of agricultural policy can be broadly defined as financial support in *unexpectedly severe market and/or production conditions*. Ensuring an adequate supply of agricultural production requires that producers can earn a reasonable rate of return in a highly competitive industry, one which sometimes presents some challenging – and potentially catastrophic – threats to the financial solvency of the farm due to factors completely outside the producer's control.

Less than ideal production conditions due to adverse weather, flooding, droughts, disease, and pests are not uncommon in agriculture. These can adversely impact yields and, therefore, farm incomes. An economic safety net should be in place for agricultural producers during these periods. The challenge from an economic and policy-making standpoint is to establish this safety net without distorting market signals. Of course, this is complicated in practice but serves as a guiding principle for evaluating alternatives.

The invisible hand of agricultural markets and current U.S. farm policy can be compared with the performance of trapeze artists capably swinging, switching, and flipping from the highs and lows of a platform on a bar (the agricultural market), with a safety net (the farm policy) in place below to break their fall if they unexpectedly miss their mark. The safety net must be precisely positioned to catch the trapeze artists: high enough to prevent any permanent damage but low enough not to encumber their free flowing movements. Importantly, the safety net cannot be set so high as to make the trapeze artists complacent and perform at less than their best. Rather, the artists need to be free and unencumbered by the safety net, striving for excellence and precision to prevent falling, but knowing that death is not imminent if they falter unexpectedly through no fault of their own. The challenge is to determine the height of the net relative to the performing trapeze artists to extract the best performances.

Policy-makers are presented with similar challenges in establishing the safety net for farmers. Ideally, they must choose the appropriate instruments and position the safety net without distorting market signals. This is complicated in reality because political pressures arise to meet short-run needs rather than tackle longer-term goals of economic efficiency and reduction of the burden on taxpayers. In practice, policy-makers might be limited to identifying and implementing the *least* distorting policy instruments in an effort to achieve the *most* efficient outcome possible.

Current farm policy has displayed an inability to adapt to these prospering times, exhibiting the characteristic of downward stickiness. Downward stickiness of government payments occurs when payments resist

change when market forces indicate that they should decline. Such stickiness reflects a predominance of policy instruments that are not market-based and, therefore, are market-distorting.

The policy stickiness, along with the heterogeneity of the farm sector noted earlier, call for a restructuring of the safety net based on market-based, targeted policies rather than a one-size-fits-all approach. Because larger farms produce the majority of agricultural products, policies that provide financial assistance to larger farms when unexpected disaster strikes – preferably through unsubsidized crop insurance – make sense from the standpoint of ensuring an adequate supply of agricultural products. On the other hand, providing an economic safety net for small farms is most sensibly accomplished through targeted rural development policies that create opportunities to improve or maintain current levels of smaller farms' off-farm income. Such policies would allow these producers to continue to farm if they choose, and preserve their rural lifestyle. Targeted rural development policies that enhance economic activity also benefit larger producers, but without further distorting price signals in the markets from which they derive the majority of their income. Such policies also benefit non-farm households in rural areas, many of which are poor.

Production Technologies

A second critical element of farm policy is promoting state-of-the-art production technologies. The goal of producing safe and high quality agricultural output requires creating an environment for agricultural producers to be the best they can be and to strive for continued improvement. Agricultural policies should facilitate and reward the adoption of new technology that results in more efficient, safer, higher quality food and more environmentally friendly production practices. Patent laws that provide incentives for innovation are important. The U.S. university land-grant system has a vital role to play here as well. During times of wavering budgets at U.S. land-grant universities, federal sponsorship of continued investment in agricultural research, development and extension must remain steadfast.

Farm Payments

A third critical element of farm policy is the mitigation of the reliance of some agricultural producers on farm payments. Producers of some agricultural commodities have become reliant on government payments. This reliance is burdensome to taxpayers and troublesome in relation to international agreements such as the WTO. It also changes producers' behavior and expectations. There is no real evidence to suggest that the incomes of farmers who produce commodities that receive significant government payments are any higher than those who receive little or no government payments. There is also reasonable evidence to suggest that government payments become capitalized in land values, land rents, and specialized assets. When this occurs, government payments are not really doing what they were intended to do – namely, support farm incomes – since the higher land values and land rents offset the benefits of the government payments.

Less reliance on government payments and a movement toward market-based, non-distorting policies such as unsubsidized, actuarially fair crop insurance holds the promise of making the agricultural economy more efficient and prosperous. The challenge is to significantly reduce the current levels of premium subsidies in the crop insurance program but at the same time to maintain participation rates.

Concluding Remarks

The state of the agricultural economy is sound due to favorable commodity outlooks and significant increases in direct government payments. Current farm policy is exhibiting downward stickiness due to its apparent inability to adapt to these prosperous times. Farm policy could be improved with an economic safety net that better recognizes the heterogeneity of the farm sector. Targeted policies that provide financial assistance to larger farms' on-farm income, along with rural development policies creating opportunities to

improve or maintain current levels of smaller farms' off-farm income, make the most sense. A movement toward market-based, non-distorting policies such as unsubsidized, actuarially fair crop insurance holds the promise of promoting a more efficient and prosperous agricultural economy.

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