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Possible Economic Consequences of Reverting to Permanent Legislation or Eliminating Price and Income Supports

POSSIBLE ECONOMIC CONSEQUENCES OF REVERTING TO PERMANENT LEGISLATION OR
ELIMINATING PRICE AND INCOME SUPPORTS. Economic Research Service, U.S.
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ABSTRACT

If the agricultural legislation expiring in 1985 is not replaced, farm price and income supports will revert from the programs provided for in the Agriculture and Food Act of 1981 and subsequent legislation to the programs provided for in the permanent support statutes. Reverting to the permanent support programs, dating back in some cases to the 1930's, would raise price and income support levels significantly and greatly reduce the role of market forces in determining farm returns. Conversely, if all price and income supports were eliminated in 1985, Government intervention in the market would end and supply and demand forces would determine farm returns. Adopting either of these two outerbound policy alternatives would have significant and far-reaching impacts on farm operations, the agribusiness sector, the general economy, and ultimately the world market for farm products.

Keywords: agribusiness, agricultural trade, conservation, crops, economy, elasticity, farm inputs, farm policy, finance, food costs, land use, land value, livestock, parity, permanent farm legislation, price support

PREFACE

The Federal Government will consider new farm legislation in 1985 to replace the expiring Agriculture and Food Act of 1981. In preparation for these deliberations, the Department of Agriculture and many other groups throughout the Country are studying the operation of the 1981 law and earlier farm legislation. The Economic Research Service (ERS) prepared this report to evaluate two very different approaches to farm price and income support programs: reverting to the large-scale programs provided for in the permanent support statutes originally enacted in the 1930's and eliminating price and income supports entirely. While neither of these outerbound alternatives is likely to be adopted, analyzing their impacts provides valuable insights into the general operation of support programs for use in evaluating the options that are considered.

Other reports in USDA's series of background papers deal with the major program commodities, the farm industries that produce them, and the farm programs under which they are produced. These commodity papers are available from EMS Information, Room 1470-S, USDA, Washington, D.C. 20250, (202) 447-7255. They include Honey (AIB-465), Wool and Mohair (AIB-466), Wheat (AIB-467), Tobacco (AIB-468), Peanuts (AIB-469), Rice (AIB-470), Corn (AIB-471), Soybeans (AIB-472), Oats (AIB-473), Dairy (AIB-474), Sorghum (AIB-475), Cotton (AIB-476), Barley (AIB-477), and Sugar (AIB-478). Background papers are also available on Federal Credit Programs in Agriculture (AIB-483), the History of Agricultural Price Support and Adjustment Programs, 1933-84 (AIB-485), Foreign Exchange Constraints to Trade and Development (FAER-209), Financial Constraints to Trade Growth: The World Debt Crisis and its Aftermath (FAER-211), and the Impacts of Policy on U.S. Agricultural Trade (ERS Staff Report No. AGES840802).

This report was prepared by Patrick O'Brien and Thomas Fulton with contributions from Samuel Evans, Michael Price, Gary Lucier, Gerald Rector, and Michael Hanthorn, as well as Robert Barry, Kenneth Baum, Thomas Carlin, Ronald Gustafson, David Harrington, John Miranowski, Fred Nelson, Clay Ogg, Leroy Rude, John Schaub, Gerald Schluter, and James Zellner.

NOTE

Detailed projections for a number of farm and nonfarm indicators were developed in the course of this study. They are cited here not as official USDA forecasts but as indicators of the magnitude and general direction of the changes likely with a move toward more or less Government intervention in the market.

The data and assumptions used in preparing this report and the results reported on here are based on information available as of September 1, 1984.

CONTENTS

	Page
SUMMARY.....	viii
Alternative Market Settings.....	iv
Impacts of Reverting to Permanent Legislation.....	x
Impacts of Eliminating Price and Income Supports.....	xii
Longer Term Impacts.....	xiv
INTRODUCTION.....	1
Alternative Support Program Provisions.....	1
Report Scope and Organization.....	2
PROGRAM PROVISIONS UNDER THE PERMANENT LEGISLATION AND NO-SUPPORT SCENARIOS.....	3
Permanent Legislation Program Provisions.....	3
Program Provisions and Assumptions with Supports Eliminated.....	13
THE 1986-90 MARKET SETTING.....	13
The Economic Setting.....	14
Farm Sector Resource and Productivity Assumptions.....	16
World Market and U.S. Trade Assumptions.....	20
Supply and Demand Implications for U.S. Agriculture	21
FARM SECTOR IMPACTS.....	21
Crop Sector Impacts.....	22
Livestock Sector Impacts.....	29
Other Crop Impacts.....	34
FARM FINANCE IMPACTS.....	35
The Farm Sector's Income Position.....	35
The Farm Sector's Asset and Equity Position.....	40
Finance and Farm Structure.....	43
Typical Farms Analysis.....	45
NATURAL RESOURCE AND CONSERVATION IMPACTS.....	48
Land and Water Use.....	48
The Economics of Resource Conservation.....	49
AGRIBUSINESS AND RURAL DEVELOPMENT IMPACTS.....	50
Input Industry Impacts.....	51
Transportation, Processing, and Marketing Impacts.....	54
Rural Development Impacts.....	56
INTERNATIONAL TRADE IMPACTS.....	58
Export Price and Trade Policy Effects.....	59
U.S. Exports Under the Permanent Legislation and No-Support Scenarios.....	61
U.S. Import Restrictions and Permanent Legislation Trade Levels.....	65
GOVERNMENT EXPENDITURES, FOOD COSTS, AND ECONOMIC ACTIVITY.....	65
Government Expenditures.....	65
Food Prices and Food Consumption Expenditures.....	67
Economic Activity.....	69
CONCLUDING NOTE.....	70
Designing Effective Support Programs for a Changing Agriculture.....	70
The Rising Cost of Public Support.....	71
Market Responses to Price and Income Supports.....	72
Longer Term Impacts.....	72
The Probability of Reverting to Permanent Legislation or Eliminating Price and Income Supports.....	73
APPENDIX I. PERMANENT LEGISLATION AND NO-SUPPORT IMPACTS ASSUMING VARIABLE YIELDS AND EXPORTS.....	74
Permanent Legislation with Variable Yields and Exports.....	75
No Support Impacts with Variable Yields and Exports.....	77
Conclusions.....	78
APPENDIX II. EXPORT DEMAND ELASTICITIES.....	79
APPENDIX III. GLOSSARY OF AGRICULTURAL TERMS.....	81
INDEX.....	85

LIST OF TABLES

	Table	Page
Status of program authorities upon expiration of the Agriculture and Food Act of 1981 and subsequent legislation.....	1 ...	4
Projected U.S. macroeconomic indicators and historical comparisons.	2 ...	15
U.S. cropland base, 1969-83 and 1990 projected.....	3 ...	17
Agricultural productivity growth rates and characteristics.....	4 ...	18
Producer prices for selected program commodities under permanent legislation.....	5 ...	23
Producer prices for program commodities with no price and income supports.....	6 ...	24
Crop acreage under the permanent legislation and no-support scenarios.....	7 ...	26
Government stocks of selected program commodities under the permanent legislation and no-support scenarios.....	8 ...	28
Livestock and meat prices under the the permanent legislation and no-support scenarios.....	9 ...	31
Livestock and poultry production costs under permanent legislation and no-support scenarios.....	10 ...	31
Meat consumption per capita under the permanent legislation and no-support scenarios.....	11 ...	33
Dairy production and prices under the permanent legislation and no-support scenarios.....	12 ...	33
Cash receipts from marketings and CCC loan placements and gross farm income under the permanent legislation and no-support scenarios..	13 ...	36
Production expenses under the permanent legislation and no-support scenarios.....	14 ...	38
Machinery and equipment expenditures under the permanent legislation and no-support scenarios.....	15 ...	38
Average cash costs of production under the permanent legislation and no-support scenarios.....	16 ...	39
Selected input demand elasticities with respect to farm product prices under the permanent legislation and no-support scenarios..	17 ...	39
Alternative net income measures under the permanent legislation and no-support scenarios.....	18 ...	41
Projected land values under the permanent legislation and no-support scenarios.....	19 ...	42
Farm assets, debt, equity, and financial ratios under the permanent legislation and no-support scenarios.....	20 ...	44
Composite indices of economic well-being by type of farm, 1990.....	21 ...	47
Resource use under the permanent legislation and no-support scenarios in 1990.....	22 ...	49
Employment and gross national product in agriculture-related sectors of the economy under the permanent legislation and no-support scenarios.....	23 ...	51
Changes in use of selected inputs under permanent legislation and no-support scenarios, 1986-90.....	24 ...	52
Farm expenditures for fertilizer and fertilizer industry operating rates, actual 1977-84 and projected 1985-90.....	25 ...	53
Indices of production, utilization, export, and storage of farm products under the permanent legislation and no-support scenarios	26 ...	55
Structure of employment in metropolitan and nonmetropolitan areas, 1982.....	27 ...	57
Farming-dependent counties arrayed into thirds by selected variable depicting adjustment potential.....	28 ...	58

	Table	Page
Number of counties and average Federal outlay per capita:		
Nonmetro counties arrayed by average per capita outlay and specialization in agriculture, fiscal year 1980.....	29 ...	59
U.S. export unit values under the permanent legislation and no-support scenarios.....	30 ...	60
Price elasticities of foreign demand for U.S. farm exports.....	31 ...	62
Alternative U.S. agricultural export volume and value under the permanent legislation and no-support scenarios.....	32 ...	63
Selected Government expenditures under the permanent legislation and no-support scenarios.....	33 ...	66
Annual increases in retail food prices under the permanent legislation and no-support scenarios.....	34 ...	68
Food consumption expenditures under the permanent legislation and no-support scenarios.....	35 ...	68
Changes in Federal deficits and related indicators under the permanent legislation and no-support scenarios.....	36 ...	69
Interannual fluctuations in agricultural production, selected countries and regions	A-1 ..	74
Yield deviations assumed under the good weather and bad weather scenarios.....	A-2 ..	75
Export volume deviations assumed under the weak and strong export demand scenarios.....	A-3 ..	76

SUMMARY

Concern with the financial well-being of the farm sector, its growing dependence on costly Federal programs, and the changing agricultural trade environment have combined since 1981 to generate widespread interest in reevaluating price and income supports when the current program expires in 1985. Views on the direction that future support programs should take vary widely. They range from expanding the Government's role in determining farm prices and incomes--possibly by reverting to the interventionist programs provided for in the permanent support legislation originally enacted in the 1930's--to eliminating supports entirely. Implementing either of these outerbound alternatives when the Agriculture and Food Act of 1981 expires would have a significant impact on agriculture, the general economy, and ultimately the world market for farm products.

Reverting to the programs provided for in the permanent support statutes would increase the Government's role in setting commodity prices and farm incomes substantially. Such a reversion would take place automatically in 1985 if no new legislation were enacted and the 1981 Act were not extended. Congress has typically avoided reverting to the permanent support programs in the past by suspending them--rather than repealing or modifying them--with the passage of new but temporary farm legislation every 4 years.

While their specific provisions differ somewhat from commodity to commodity, the permanent support programs generally provide for minimum producer prices for the basic commodities, set without reference to supply or demand conditions in the market. 1/ Government-supported prices would be set high enough to guarantee producers some minimum level of income by ensuring parity between the prices farmers receive for their products and the prices they pay for production inputs and living expenses. 2/ The Secretary of Agriculture would be required in most cases to set commodity price supports high enough to guarantee producers 50 to 90 percent of parity using the 1910-14 ratio between the prices farmers paid and received as the benchmark.

This use of the 1910-14 ratio, unadjusted for subsequent productivity growth, as the benchmark has worked over time to push up sharply the income support provided for in the permanent statutes. With increased productivity tripling farm output per unit of input since 1914, guaranteeing producers the same

1/ The program commodities include wheat, corn, barley, rye, oats, sorghum, rice, cotton, cottonseed, peanuts, soybeans, tobacco, sugar, milk, honey, wool, and mohair. Honey, cottonseed, peanuts, wool, and mohair are not dealt with in detail in this report.

2/ The concept of parity was originally defined in the Agricultural Adjustment Act of 1933. The Act specifies that Congress will "...establish and maintain such balance between the production and consumption of agricultural commodities, and such marketing conditions thereafter, as will reestablish prices to farmers at a level that will give agricultural commodities a purchasing power with respect to articles that farmers buy, equivalent to the purchasing power of agricultural commodities in the base period. The base period in the case of all agricultural commodities except tobacco shall be the prewar period, August 1909-July 1914. In the case of tobacco, the base period shall be the postwar period, August 1919-July 1929."

ratio between input and product prices as was in effect 70 years ago would generate roughly three times the real net income. Guaranteeing producers the same buying power as in effect 70 years ago would require a parity ratio of only 30 to 40 percent. Real commodity prices have tended to reflect this productivity growth over time and are currently 30 to 40 percent of the real 1914 level. Hence, even with supports set at the lower end of the 50- to 90-percent parity range called for in the permanent statutes, commodity prices would rise sharply above recent market-clearing levels and increase 4 to 6 percent per year thereafter regardless of market conditions.

The U.S. Department of Agriculture (USDA) would operate nonrecourse loan or direct purchase programs to support parity-linked prices in periods of surplus and would dispose of excess stocks if open-market prices moved above support levels. The direct link between the U.S. commodity market and the world market would effectively extend USDA support activities to underwriting international trade prices as well as domestic prices in periods of excess supply. With exports accounting for more than one-half of the demand for many program commodities, reverting to permanent legislation would put USDA in the position of manipulating U.S. stocks and exports in order to balance world import demand and export supply at parity-linked price levels.

Conversely, eliminating price and income support programs would take the U.S. Government out of the commodity markets. While several transition programs would be needed to ease the Government's exit, particularly in areas such as stockholding, farmers would ultimately depend entirely on market supply and demand forces to set prices and incomes.

Alternative Market Settings

The impact of adopting either of these two policy options would vary widely in alternative U.S. and world market settings.

If the no-growth market setting of the early 1980's were to continue, high price supports on the one hand or no supports on the other would move U.S. agriculture in fundamentally different directions. Reverting to the permanent support programs would generate a sizable increase in farm output that the market would be unable to absorb at parity-linked prices. Much of the expanded output generated by permanent legislation's higher prices would ultimately have to be acquired by USDA in order to clear the market. On the other hand, eliminating supports in this setting would lead to a significant contraction in the farm sector as production of the program commodities was scaled back, possibly one-third or more initially, to meet effective demand. The impacts under either alternative would be significant enough to spread quickly from the farm and agribusiness sectors to the general economy and the world market.

In a rapidly expanding market, however, differences between the permanent legislation and no-support scenarios for most of the agricultural and macroeconomic indicators analyzed in this report would narrow. In a sustained tight supply setting reminiscent of the mid-1970's, the open market could generate farm prices and incomes comparable to, or possibly above, returns for most of the program commodities under permanent legislation.

This study assumes that the U.S. and world agricultural economies recover from the slump of the early 1980's, but do not grow fast enough through 1990 to tighten supplies and put upward pressure on commodity prices and farm

incomes. ^{3/} In this setting reminiscent of the abundant supplies and weak prices of the 1960's, permanent legislation would move the farm sector toward increased dependence on Government programs to support incomes well above market-clearing levels. On the other hand, operating without supports in this setting would lead to serious financial problems for agriculture for several years, possibly into the 1990's, as sharply lower returns led to contraction in the sector and a large-scale revaluation of farm assets. In the long run, however, the agriculture that emerged would be in a stronger position than under permanent legislation to compete domestically with other sectors of the economy for resources and internationally with other exporting countries for markets.

Impacts of Reverting to Permanent Legislation

A decision to revert to permanent legislation in the slow-growth market setting assumed in this study would initially affect only the program commodity producers. Its impacts would quickly spread, however, through the rest of the farm and agribusiness sectors to the general economy.

Program commodity prices would increase sharply at the start of the 1986 marketing year, both in absolute terms and relative to the prices of other farm products, and would rise 4 to 6 percent per year thereafter. The nonrecourse loans and direct purchases used to support parity-linked prices would guarantee producers an outlet for their products, in most cases with little or no effective restriction on the volume they produced.

This combination of high support prices and a guaranteed outlet for their products would encourage program commodity producers to expand output without regard for effective market demand. Their existing capacity to produce would be used more intensively while new, often higher cost, capacity would be developed. Program commodity output could increase two-fifths or more from 1986 to 1990 despite substantially slower growth in effective demand for the commodities in question in the domestic and export markets. Farm operators producing commodities not eligible for support would face increased competition for land and other inputs from program commodity producers. Livestock operators other than dairy producers would be the most seriously affected. With meat prices unsupported, higher feed costs would reduce returns and result in lower meat and poultry output after operators adjusted to permanent legislation's higher cost structure.

Permanent legislation would also work among program commodity producers to shelter inefficient operators and force efficient operators to compete with them for production inputs. The resulting bidding up of input prices, combined with the added input demand associated with developing new capacity, could generate significant increases in production expenses offsetting as much as

^{3/} While it is difficult to assign probabilities, the scenario highlighted here was thought to be the most likely by the analysts involved. The probability of a weak enough or strong enough market setting to change the general conclusions of this study are very limited. Given the experience of the last two decades, the probability of a strong enough market to narrow differences between scenarios or a weak enough market to increase differences between scenarios significantly would be less than 3 in 20. However, this uncertainty about future market settings emphasizes the need to focus on the study's general conclusions rather than specific results.

two-thirds of the increase in farm receipts likely under permanent legislation. As a result, farm income gains would be appreciably smaller than increases in producer prices would suggest. Moreover, income improvements would come at least partially at the expense of operators producing commodities not eligible for program benefits but faced with higher input costs. Differences in growth in output and receipts between program commodity producers and other farm operators would widen over time, leading to an increasingly uneven distribution of income among farmers.

The asset appreciation and equity gains likely under permanent legislation would ultimately overshadow income gains. With higher price support levels capitalized into asset values, asset appreciation and growth in equity could return to the rapid pace of the 1970's. The asset losses experienced since 1981 could be reversed in 1 to 2 years and asset values could be as much as 50 percent higher by 1990. But gains in this area would also be unevenly distributed along tenure and equity lines. Many of the major beneficiaries of a reversion to permanent legislation would be landowners not directly involved in farming.

Much of the increased farm output likely under permanent legislation would accumulate as Commodity Credit Corporation (CCC) stocks as higher support prices encouraged growth in production and discouraged growth in demand. Domestic demand for farm products could drop as much as 10 percent from 1980-83 levels by 1990. Foreign demand for U.S. farm products could weaken even more sharply as higher export prices discouraged growth in world import demand and weakened the U.S. competitive position in the world market. Reverting to permanent legislation would signal a willingness to sacrifice export market share and accumulate whatever stocks were necessary to balance world import demand and export supplies at support price levels. Given this dual domestic and world market balancing act, CCC stocks of grains and cotton could grow to several years' use by 1990.

Accumulating stocks to support parity-linked prices, particularly in the absence of effective production controls, would make permanent legislation a costly program. In effect, roughly \$3 would be spent to acquire sufficient stocks on the open market to tighten supplies and boost commodity prices enough to raise net farm income less than \$1. By 1990, operating nonrecourse loan programs to support commodity prices could cost taxpayers \$50 billion annually. Most of this \$50 billion would, in theory, be recoverable. The commodities acquired by the CCC could be resold during periods of short supplies and high prices to recoup loans and any other costs incurred by USDA. But, with supports set well above likely market-clearing levels and CCC sales possible only if market prices moved above support levels, the probability of any large-scale resale would be remote.

Consumers would also face \$20 billion per year in added food costs by 1990 as a result of permanent legislation's higher commodity prices. In this regard, permanent legislation would resemble the support program in place in the European Community--minus the export subsidy provisions. Both involve large-scale public expenditures aimed at boosting domestic farm prices that, ultimately, raise food prices.

Permanent legislation would benefit some industries associated with agriculture but harm others. Stronger demand for purchased inputs would allow the fertilizer and machinery industries in particular to operate their currently underutilized plants more fully. In some cases, farm demand for inputs could

be strong enough to strengthen real input prices. Other agribusinesses such as the food transportation, processing, and marketing industries would fare less well. Higher commodity prices would slow growth and reduce the volume of products moving through the system to the domestic and export markets. This reduced activity beyond the farm gate would more than offset increased activity in farming and the input industries.

The impacts on the Federal budget of reverting to permanent legislation would also be significant enough, if the policy were pursued for any length of time, to affect the performance of the general economy. Financing \$50 billion annually of added Federal expenditures by 1990 would raise inflation if the Federal Reserve decided to expand the money supply to cover the added deficit. On the other hand, Government borrowing on the open market to finance the \$50 billion would raise interest rates.

Higher food prices, combined with the inflation generated by monetizing the cost of the permanent legislation program, could add 1 to 2 percentage points per year to the inflation rate. Borrowing to cover the permanent legislation deficit could add 1 to 2 percentage points to the interest rate. In either case, real economic activity and employment for the economy as a whole would grow more slowly, possibly as much as 1 percentage point less per year by 1990.

Impacts of Eliminating Price and Income Supports

The effects of eliminating price and income supports on the agricultural sector, the general economy, and the world market would be no less significant than the effects of reverting to permanent legislation.

Given the market setting assumed in this study, eliminating supports would force program commodity producers to gear output to market demand for their products. Production of program commodities would be as much as one-third lower than under permanent legislation. Operators producing commodities not eligible for support, however, would experience lower input prices and less competition for inputs from program commodity operators. As a result, livestock output in particular could increase slightly faster than under permanent legislation.

With no supports and market prices lower and more variable, program commodity producers would shift production patterns in an effort to reduce cash expenses while keeping output and receipts as high as possible. Farmers would tend to reduce use of purchased inputs such as fertilizers, fuels, and machinery. Adjustments would also be made in land use. As much as 30 million acres of the more marginal, higher cost land cultivated under permanent legislation would not be cultivated if supports were eliminated. While not all of this acreage would be highly erosive land, the smaller acreage planted would help ease agriculture's resource conservation problems significantly.

With market forces likely to push commodity prices lower under the no-support scenario, demand for farm products would be considerably stronger. Differences in demand between scenarios would be most pronounced in the export market. The decision to operate without price supports would signal U.S. unwillingness to continue to support world prices through CCC stock adjustments. It would also signal the United States' intent to become more price competitive in an effort to expand its share of the world market. Combined exports and domestic use of program commodities could be as much as one-fourth higher with the elimination of supports than under permanent legislation.

However, the higher marketings likely without price supports would fall short of combined marketings and loan placements under permanent legislation. As a result, farmers' gross receipts would grow more slowly than under the permanent legislation scenario. Differences in net farm incomes between the two scenarios would be narrower than differences in receipts imply, however, because of the lower production expenses likely with the elimination of price supports. Even with lower production expenses, however, net farm income could average roughly one-half the levels likely under permanent legislation.

The value of farm assets and farmer equity could decline more sharply than income with the abolition of supports, possibly to the extent of reversing the appreciation of the 1970's in 1 to 3 years' time. Land values would fall sharply initially to reflect their reduced income-earning capacity. Over the 5-year period analyzed here, land values could average one-half the level likely under permanent legislation. Farmers dependent on mortgaging last year's appreciation to finance this year's operations could find declining asset values an even more serious problem than lagging income.

This pressure on asset values and equity would reflect the decapitalization of past program benefits and a shift toward pricing assets according to their capacity to generate income. As the transition progressed, many of the sector's less efficient and highly leveraged operators would be forced into liquidation. After several years of declining asset values and large-scale changes in ownership, asset values would tend to stabilize in real terms and increase gradually in nominal terms. The rate of return on new investment in lower priced assets could rise by the early 1990's to levels that compare favorably with returns in the rest of the economy.

The farm input industries would experience an initial drop and slower growth in sales of their products in this environment. Demand for farm machinery in particular would drop sharply and further weaken the outlook for an industry already operating well below capacity. However, eliminating price supports would work to expand economic activity and employment in other areas of the agribusiness sector. For example, the transportation, processing, and marketing industries would benefit from the increase in marketings likely with lower commodity prices. This mix of gains and losses would lead to higher economic activity and employment for the agribusiness sector as a whole with supports eliminated than under permanent legislation.

Eliminating supports would also reduce farm program costs well below the levels likely under permanent legislation. With no loans or purchases to finance, Government expenditures would be limited to financing disposal of the stocks held by the CCC or in the farmer-owned reserve at the start of the 1986 marketing year. The cost of operating the transition reserves assumed in this study would average less than \$500 million per year through 1991 and would pay for themselves thereafter with resale receipts until stocks were exhausted in the mid- to late-1990's. 4/

4/ The assumptions made here regarding USDA's disposal of CCC and farmer-owned reserve stocks minimize the possibility of swings in food supplies and prices early in the transition period while the private sector adjusts to carrying larger stocks. It was assumed that USDA would hold the CCC and farmer-owned reserve stocks on hand at the start of the 1986 marketing year off the market until commodity prices moved above 110 percent of the average for the previous 5 years. Without such a reserve in place, fluctuations in food supplies and prices could widen initially until the private sector took on the stockholding functions currently provided by USDA.

With commodity prices rising more slowly under the no-support scenario, food prices would increase at possibly two-thirds the pace likely under permanent legislation. This slower growth in retail food prices would translate into a \$20-billion lower food bill by 1990.

The consequences of operating without supports could prove strong enough over time to affect the operation of the general economy. The smaller Federal deficit likely with reduced agriculture-related spending would work to lower interest and/or inflation rates. This improved financial setting, combined with slower increases in food prices and expanded economic activity in the agribusiness sector, could accelerate growth in both gross national product and employment by as much as 1 percentage point per year by 1990.

Longer Term Impacts

The longer term, post-1990 effects of adopting either of these two support programs could prove more significant than their short- and medium-term impacts highlighted here.

After 5 years of permanent legislation and the changes in farm structure likely to accompany it, the agricultural sector would find it difficult to operate without continued large-scale public support. Program commodity producers would depend on price and income supports for as much as one-third of their gross incomes and over one-half of their net incomes. Their asset and equity positions would depend even more heavily on continued public support and the capitalization of program benefits into land values. On the other hand, withdrawal of support after 1990 would result in a sharp contraction in the sector and even greater financial adjustments than those described here under the no-support scenario.

Continuing the permanent support programs, however, would lead to even greater dependence on the Federal Government as the 1990's progressed. The sector's competitive position in the world market would deteriorate further, while domestic demand for high-priced farm products would grow slowly, if at all. As a result, farmers would look to CCC as the outlet for an increasing share of their expanding output while rapidly rising production expenses limited any improvement in their net incomes. Program costs would also rise at an increasing pace and possibly double from 1990 levels before mid-decade.

After 5 years without price and income supports, the farm sector would have contracted significantly. Many of its less efficient and highly leveraged operators would have been forced out of business and possibly 30 million acres of land would have been abandoned. However, return on new investment in lower priced assets would approach, and possibly exceed, returns under permanent legislation. The sector would also have shifted to a lower cost structure. This lower cost structure, combined with stronger growth in demand for lower priced farm products, would narrow differences in net farm incomes between scenarios significantly by the mid-1990's. In short, the farm sector would have made a difficult transition, but would have emerged in a stronger position to compete with other sectors in the economy for resources and with other exporters internationally for export markets.