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This issue focuses upon agriculture subsidies and how they may impact the Nebraska economy. The issue begins with a piece by Nothdurft *et al*. examining the effects of subsidies on innovation. It is Norhdurft's conclusion that subsidies discourage innovation and the entrepreneurial spirit in agriculture.

Professors Frederick and Johnson present the case for subsidies. They argue for agriculture subsidies and what they do for the Nebraska economy.

Pursell argues that agriculture subsidies have insulated Nebraska agriculture and nonagriculture producers from market signals and also have reduced innovation and the entrepreneurial spirit in Nebraska's economy, both its agriculture sector and its nonagriculture sector.

The purpose of this issue of *Business in Nebraska* is not to answer the question of agriculture subsidies and their impact upon the Nebraska economy. The purpose is to encourage Nebraskans to explore the implications of agriculture subsidies and their impact on the Nebraska economy.

# AGRICULTURE, MARKETS, AND INNOVATION: THE REAL PROBLEMS

*"The lack of (federal price) supports increases efficiency by forcing us to rely solely on innovation and marketing."*

William Barker
Monterey County (CA) Farm Bureau Association

It is no coincidence that the farmers in deepest trouble in the current farm crisis are those whose products are covered by federal commodity programs, particularly those involved in the production of export grains. At the root of the farm problem is a commodity production and marketing system that, while it reduces uncertainty and encourages innovations in production, artificially protects markets and strongly discourages farmers from concerning themselves with the changing tastes of consumers and markets. Yet it is the judgment and tastes of consumers that ultimately determine the value of what farmers produce. As the pressure on states to formulate new farm policies increases, it is crucial to understand the flaws in this system.

## The Problem of the Protected Market

Agricultural development, like all economic development, proceeds through the process of innovation--the discovery of new products, new ways of producing old products, and new markets. The viability of each innovation is determined in the marketplace by consumers who are the ultimate judge of its value. But for a significant segment of American agriculture, this process is short-circuited by federal farm programs that make it more difficult for farmers to act as efficient businesspersons by overriding basic market signals. The purpose of price supports and acreage limitations was to reduce the risk farmers faced because of shifting commodity prices. The unintended consequence has been dramatic growth in the production of the crops protected by these programs, growth that has outstripped both domestic and international demand.

Open markets send signals to producers about how consumers value different products and about trends in consumer tastes or preferences. Federal support programs, in effect, screen producers from this information by substituting a mechanism that guarantees the farmers both a consumer (in the form of the federal government) and a price. One of the signals the government sends in the place of the market is that anyone can farm crops covered by these programs and be guaranteed a living. Caught in the embrace of these programs, farmers act as if they had no choice but to continue to produce the same crop they always produced and to sell it to the federal government whenever the market price falls too low. True market signals influence their behavior only to the extent of determining to whom they will sell, not what or whether to produce. (Many USDA marketing orders have the same effect; e.g., those for oranges.)

A protected system creates overproduction, uncontrollable government cost, marginal incomes for participants, and the perpetuation of inefficient producers at the expense of efficient producers and the taxpayers in general. Furthermore, this artificial market is not passive. Throughout the 1970s boom, it sent "plant" signals to the nation's grain producers, who expanded production knowing that even if exports slowed, the federal government would buy the surplus and their land would retain its value. Unfortunately, only half of the formula was correct; many of these same aggressive farmers face severe financial difficulty as their land values--and their equity--continue to drop.

## The Problem of the Protected Farmer

The ultimate test of any enterprise is whether customers are prepared to buy the final product at a price which allows the producer to meet expenses and earn a profit large enough to stay in business. But for farmers who raise crops covered by federal farm programs (whether they actually participate in them is irrelevant), this testing ground is largely absent. Certainly they struggle with the elements to wrest sufficient harvest to cover their operating loan and pay for other expenses as well. But producing goods within a budget despite the vicissitudes of sudden changes in input costs, labor disputes, technical difficulties, and other problems is a challenge that faces all businesses.

Most other businesses, however, also face the continuous problem of finding customers for their products and of adapting their production systems and products as customer preferences change, as the products of their competitors improve, and as new technologies become available. Farmers selling a supported crop do not face this problem, but they should. No business can continue producing a commodity valued less by consumers than it costs to produce unless it receives a subsidy that protects it from true market conditions. Given the choice of competing for customers' dollars or producing for a guaranteed buyer, it is not surprising that many farmers choose to farm the subsidy.

The farmer thus protected faces less risk than otherwise may be the case and receives less reward. With too many farmers, both efficient and inefficient, producing too much of the commodities covered by federal supports, surpluses grow, prices decline, and incomes are held down. Farmers who are failures can not fail, and farmers who are winners can not win. Even in periods of moderate interest rates and inflation, the rewards of farming the subsidies are meager; in tougher times, they are nearly nonexistent.

Subsidized credit has the same general effect. Subsidized loans keep in business many farmers who in any other business would have failed. By making it possible for inefficient or unwise farmers to stay in business, such programs make it more difficult for the efficient farmers to reap the rewards of their efforts and reduce the incentives for innovation.

Government efforts to prevent failure have other consequences that seldom are considered fully. Trying and failing are crucial to any healthy industry. Those that fail are the enterprises that can not produce goods as cheaply as their competitors or who are less alert than their competitors to changing market conditions or new market opportunities. Unless ineffective producers are weeded and new producers are allowed into the market, innovation will occur only slowly and consumers will pay higher prices for goods. Failure and success are both integral parts of a process resulting in a more efficient allocation of resources. Federal crop and credit subsidies that try to ensure against failure also may reduce the chances of success by short-circuiting this process.

WILLIAM E. NOTHDURFT
ROGER J. VAUGHN
MARK POPOVICH*

*Excerpted from "Creating an Entrepreneurial Farm Economy" by William Nothdurft, Roger Vaughn, and Mark Popovich. Available from the Council of State Policy and Planning Agencies, 400 North Capitol, Suite 291, Washington, D.C. 20001 at a cost of $5.00. Phone 202/624-5386 for more information.

# THE CASE FOR FARM PRICE AND INCOME SUPPORTS

One cannot deny that compelling arguments can be made against the federal government's farm price and income support programs.

Severe financial stress in the farm sector in the 1980s, however, has made these programs more important to producers and their families than at any time since the 1930s. For example, in the 1982-1984 period, direct government payments amounted to about 60 percent of all net farm income generated in Nebraska. In 1986, government assistance is likely to make an even more important contribution to net farm income.

In what appears to be an irony--if not an outright contradiction--some observers blame agriculture's economic woes on these same support programs. Furthermore, it is argued that termination of these programs would reduce financial stress. In actuality, a wide array of factors have contributed to inadequate farm income, including a rapid buildup in farm debt during the euphoric, expansionary years of the 1970s--a period when support programs were used relatively little.

In our judgment, there are three major reasons why an adequate price and income support system should be kept in place.

## THE NEED FOR AMPLE PRODUCTION CAPACITY

Most Americans take for granted an adequate supply of wholesale food at reasonable prices. But few citizens appreciate the role that public price and income supports play in assuring that supply. In the absence of such support, our food system would behave much differently.

Although not all commodities are supported, commodities such as wheat and feed grains are supported and form the foundation for much of what we eat--bread, red meat, poultry, eggs, and milk. Consumers want these food products without fail. Price and income supports provide assurance that production of foodstuffs will continue regardless of conditions in the general economy. Excess capacity, which can arise from such programs, serves to buffer the nation's food supply against intervention.

Like other consumers around the world, U.S. citizens also prefer that most foods come from domestic producers, even if they can be imported at a lower cost. Self-sufficiency in the production of one of the essentials of life is very important. In the event of war or other international disturbance, no one wants to worry whether food supplies will be adequate.

For many years citizens have enjoyed the luxury of a stable food supply delivered at a cost that makes U.S. food expenditures lower relative to family income than in any other country of the world. Why change a system whose results are that satisfactory?

## THE NEED FOR STABILITY

Prices of agricultural commodities are affected by an extraordinary array of factors, including weather, pests, conditions in the general economy, and political and diplomatic relationships with other countries. In the absence of price supports, prices would move erratically up and down.

Conventional economic wisdom is that higher commodity prices induce more resources (land, labor, and capital) to be committed to an economic enterprise. Lower commodity prices should cause resources to leave that enterprise. Resources committed to agricultural production often have few good alternative uses, however, especially within a period of five years or less. Tractors and specialized equipment, for example, cannot be used for much other than farming. Similarly, most land is not well suited to alternative uses. Even those who farm (operators and laborers) often are not as productive as they move from farm to nonfarm occupations.

Prices, if left to the dictates of an open market system, could signal to producers that they ought to plant fencerow to fencerow one year, but plant nothing the next year. Both producers and consumers would suffer as producers sought to catch up with the latest market signal. About the time resources were committed to meet perceived shortages, it would be necessary to reduce commitments in response to commodity price weakness.

Don Paarlberg, former chief economist in the United States Department of Agriculture, summarizes what happens in the absence of price supports: "Temporary extremes in farm prices and farm income give erroneous production signals. Windfall profits and undeserved losses are the attributes of wild price gyrations."

## SUSTAINING AGRICULTURE FROM GENERATION TO GENERATION

Food production will not go out of style. Another generation of food producers always will be needed. Citizens will benefit if those who produce foodstuffs do so as efficiently as possible.

In the absence of price and income supports, those producers who remain may not be the most efficient or innovative. Instead, the characteristic most likely to describe them is "debt free." These producers may be able to survive with $1.50 per bushel corn and $2.00 per bushel wheat. But they tend to be older producers and/or have smaller operations.

The question is whether society really wants to squeeze out younger, technically efficient producers who also tend to carry the most debt. That would seem to be the inevitable result if all price and income supports were abandoned. Just as significantly, will society benefit from having squeezed out many of today's innovative young farmers who otherwise would be producing the nation's food 25 years from now?

## OTHER FACTORS

In addition, other aspects also enter into the debate over price and income support programs. Should this nation's agricultural producers, who responded to economic and political signals for expansion in the 1970s, now be called upon to bear the full brunt of economic consequences emerging from a totally different economic ballgame in the 1980s? Just what is society's obligation to a sector in which real net worth has fallen to approximately one-third of 1980 levels in several states (including Nebraska)?

There is also the question of whether or not we have moved beyond a point in economic history where an essentially free market agriculture can operate effectively. Will the world market actually respond as the free market advocates believe? The sluggishness of U.S. agricultural exports in recent months is cause for concern.

Finally, there are questions relating to societal interest in maintaining a particular farming and rural culture. If society as a whole continues to have such a preference pattern, then public support to the agricultural sector may be justified, regardless of economic efficiency or equity issues.

## CONCLUSION

Although we present a case for farm price and income supports, this should not imply that current programs could not be improved. In an era of tight budgets and wide differences in the financial status of individual producers, an overriding question is whether the federal government is receiving good value for the dollars spent on support programs. New approaches to providing effective and equitable supply management and income support should be given careful consideration. Abandoning farm price and income supports seems infeasible. We advocate innovative programs that assure (1) a stable a high quality supply of food at reasonable prices, (2) a fair economic return to the producer, and (3) the long-term stewardship of natural resources and human resources in rural America. To do any less would cost all Americans in the long run.

ROY FREDERICK
BRUCE B. JOHNSON

Roy Frederick is Professor of Agricultural Economics, University of Nebraska-Lincoln. Bruce B. Johnson is Associate Professor of Agricultural Economics, University of Nebraska-Lincoln.

# SUBSIDIES: HELP OR HINDRANCE TO FARMERS?

Agriculture subsidies have insulated Nebraska grain producers from the market for over 50 years. The cumulative effect appears to be a lessening in Nebraska's entrepreneurial spirit among both farmers and the business community. Nebraska agriculture and the agriculture of the Plains would find it traumatic to adjust to market-driven conditions. But subsidized agriculture--grain production, tobacco production, and dairy production--faces more difficulties than nonsubsidized vegetable and specialty foods production. Imagine the Nebraska grain farmer facing a market similar to that of the California cauliflower producer. On Monday, cauliflower was $10.00 per box; on Tuesday, it was $8.00 per box; and on Wednesday, it was $6.00 per box. Who knows

Nebraska's income and employment are above year ago levels, but lag national levels. Furthermore, real income and employment increases in the 1980s have been smaller than those in the 1970s. Nebraska's economy is growing, and its output is expanding--but it is not growing as rapidly as the nation, nor as fast as it was in the 1970s. Nebraska's relative position improved in the early 1970s, but has deteriorated relative to the nation in terms of both income and employment.

Chart 1 presents Nebraska and United States real personal income over the interval 1967 to 1985. Both increased with few interruptions. Nebraska's share of U.S. personal income is illustrated in Chart 2. This chart indicates that Nebraska persona' income has averaged about .66 of one percent of total U.S. personal income since 1980. In 1973, Nebraska's share of national personal income was .75 of one percent. In the 1980s, Nebraska's

(continued on page 5)

Chart 1
Total Real Personal Income
U.S. and Nebraska
Annual, 1965 to 1985 (in 1972 Dollars)

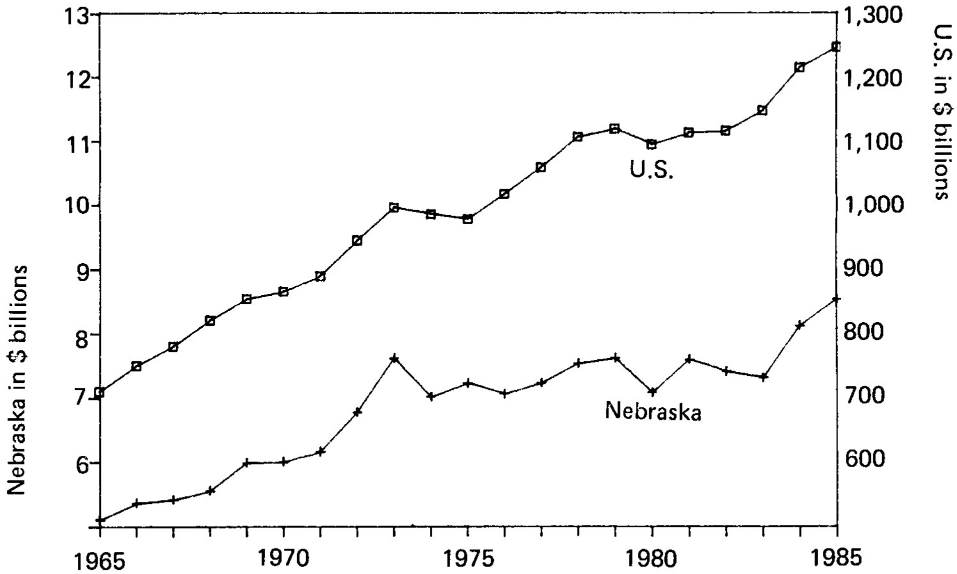
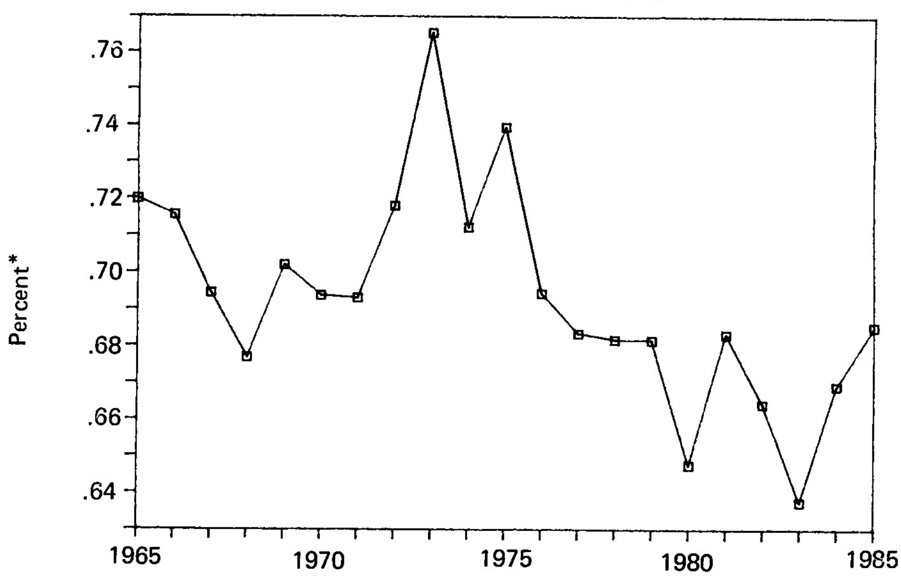



Chart 2
Nebraska Total Personal Income
as a Percent of U.S. Total Personal Income
Annual, 1965 to 1985 (in 1972 Dollars)




*Expressed as a percent of 1.0 percent of U.S. personal income

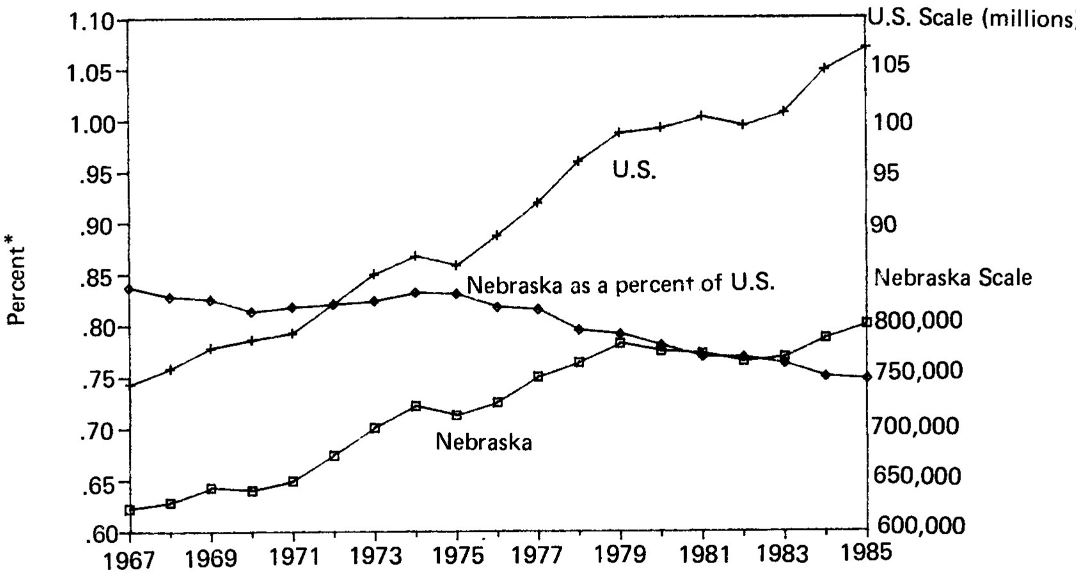
(continued from page 4)
share of personal income has ranged from a low of .64 of one percent in 1983 to highs of .68 of one percent in 1981 and 1985. The relative deterioration in Nebraska's income may have been halted temporarily.

Employment shows the same general trends. National employment growth has been somewhat higher than employment growth in Nebraska (Chart 3). Employment in July 1986 in Nebraska was estimated at 795,000, 6,500 above July 1985 levels.

Since 1981, Nebraska's share of nonagricultural employment has declined from .70 of one percent to .65 of one percent (Chart 4). Again, it is important to keep in perspective the fact that the state's employment base is expanding, but at a much slower pace than the nation.

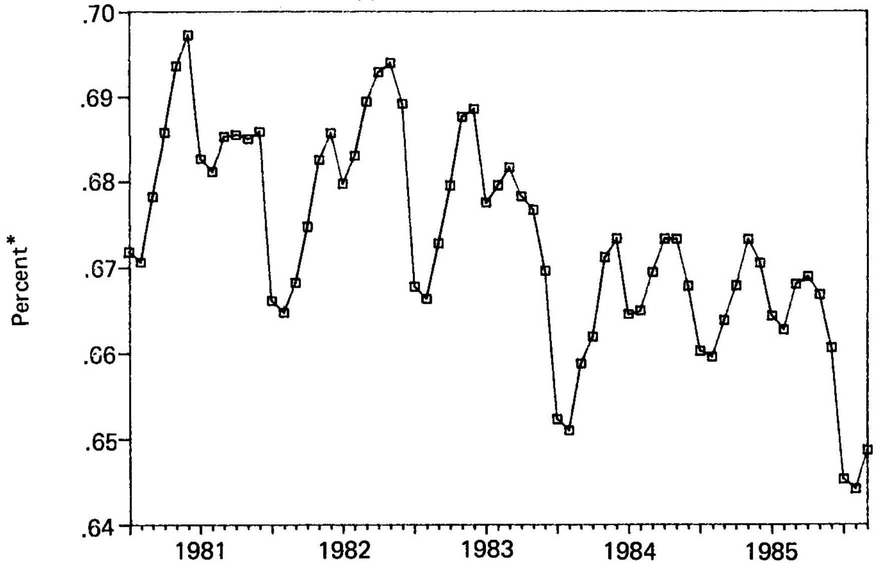
DONALD E. PURSELL

Chart 3
Nebraska and U.S. Annual Employment, 1967 to 1985




*Expressed as a percent of 1.0 percent of U.S. employment

Chart 4
Nebraska Nonagricultural Employment
as a Percent of U.S. Nonagricultural Employment
Monthly, 1981 to 1986




*Expressed as a percent of 1.0 percent of U.S. nonagricultural employment what the price will be Thursday? If the cauliflower is ready, it has to come out of the fields and go into cold storage.

Not all California vegetable producers are economically viable. The industry is more viable, however, than Nebraska agriculture because it is innovative and able to change quickly--California vegetable production is not hampered by subsidies and grain price supports.

The entrepreneur is the driving force in the American economy of the 1980s (Drucker). This person receives information, processes it, and is able to react quickly to rapidly changing consumer demands and prices. The entrepreneur does not wait for price support or target levels to be set, nor does he/she wait for farm policy to be determined before making decisions. Nebraska agriculture and Nebraska's business community are not reacting in the same entrepreneurial spirit visible in vegetable and fruit producers or in the same entrepreneurial spirit as the computer or chip manufacturers in Silicon Valley.

The implications for Nebraska are clear. Painful as it may be, Nebraska must face withdrawal of agriculture subsidies. Reliance upon Washington for farm subsidies is destroying Nebraska's entrepreneurial spirit; Nebraska ranked 46th in terms of percentage change in new corporations over the interval 1980-1985 (*Wall Street Journal*, May 19, 1986). Nebraska was far below the national average of new ventures and ranked well below suc' states as South Carolina, Georgia, Mississippi, and Alabama. Fiv years after the removal of agriculture subsidies, there would be many different agriculture producers than there are today. These producers would be better innovators and entrepreneurs, more willing to take risks and move quickly into the most profitable proposition.

A prosperous Nebraska agriculture will be an agriculture sector which can adjust and adapt quickly, relying upon signals from the market instead of signals from Washington.

This does not imply there is no innovation in Nebraska agriculture or its business sector. There seems to be more innovation currently than in the recent past. It is my opinion that removal of subsidies would encourage more innovation and experimentation.

DONALD E. PURSELL

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