Government Lending: Some Insights from Agriculture

By Marvin Duncan

As the United States has undergone prolonged recession and vigorous competition in domestic markets from goods manufactured abroad, policymakers have begun discussing the need for an industrial policy. Discussions of industrial policy often include proposals for a government-owned redevelopment bank. The purpose of such a bank would be to provide credit for modernizing selected industries and developing markets important to the overall economy.

Although there is still no general agreement on either the scope or the dimensions of an appropriate industrial policy—if one is even called for—the issue is expected to be vigorously debated in coming months. Hence, it is appropriate that lawmakers become familiar with what has worked in the past and what has not.

Agriculture provides some interesting lessons for the rest of the economy on the use of industrial policy initiatives. The article discusses three agricultural lending programs initiated by the government, identifies the benefits of the programs to agriculture, and notes problems—actual and potential—associated with the program. Also, the article suggests criteria that could be used in judging the likely usefulness of credit programs that might be proposed.

The three credit programs are the Farm Credit System, the Commodity Credit Corporation, and the Farmers Home Administration. Although these are not the only government-initiated programs available to agriculture, they represent somewhat different government approaches to the problems of agriculture.

Farm Credit System

The Farm Credit System (FCS) was created by the federal government over the period from 1916 to 1933 to overcome financial market imperfections of that time. During the years when this system was being formed, farm credit needs were increasing as access to free government land ended, farms were being mechanized, and farm income stress was limiting farmers' access to traditional credit sources.

Long-term mortgage financing on terms suited to farm businesses was not commonly

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available then. For production financing, farmers had to rely on notes of 90 days or less with repayment provisions that were not typically adapted to farm marketing practices. Financing for farmers was usually available only from small banks that were isolated from the nation's financial markets. Consequently, as credit needs increased, shortages of dependable credit were commonplace.

Units of the system—Federal Land banks, Federal Intermediate Credit banks, Banks for Cooperatives, Federal Land Bank Associations, and Production Credit Associations—were organized as farmer-owned cooperatives. Unlike many programs the government has started, the Farm Credit System is now totally owned by its member borrowers. The last government funds used to capitalize the system were repaid in 1968.

The FCS has provided a means for intermediating loan funds from national financial markets to farmers and their cooperatives. It also has been a trendsetter in lending to agriculture. It has introduced several credit innovations, including long-term, fully amortized farm real estate loans, a well-trained cadre of professionals to service farm credit needs, loan packages designed to fit the needs of borrowers, and reasonably priced credit linked to the cost of funds in financial markets.

By performing its mission effectively, the FCS has grown remarkably. It holds about a third of all credit outstanding to farmers. In raising funds in national and international markets, it has built a solid reputation for sound credit management and financial strength.

The system has been criticized in recent years. Commercial banks have been critical of advantages they believe the system may have as a result of a regulatory framework different from that of banks. A few observers have suggested that its practices of average-cost pricing—as opposed to pricing at the marginal cost of loanable funds—may have contributed to excessive borrowing by farmers. Some have said that the FCS method of valuing farmland may have contributed to the escalation in farm real estate prices. On balance, however, the FCS has been remarkably successful in fulfilling the purposes for which it was created.

Commodity Credit Corporation

The Commodity Credit Corporation (CCC) was formed during the depths of the Great Depression as an independent agency of the government. Financed originally from funds of the Reconstruction Finance Corporation, it was later wrapped into the Department of Agriculture. Currently, the CCC funds its lending activities through a $25 billion line of credit from the Treasury.

The CCC was formed to help improve the prices farmers receive for their commodities. That is still the objective, which the CCC pursues by providing nonrecourse loans to farmers that use their commodities as collateral, by financing construction of farmer-owned storage, and by financing export sales.

The CCC program has benefitted agriculture a number of ways. The commodity loan program and its farm storage facility programs have been effective in giving farmers flexibility in product marketing. Export credit and credit guarantee programs also have been effective in expanding sales of U.S. agricultural exports.

While the marketing aspects of CCC programs have worked quite well, the setting of commodity loan rates—the value of commodities at which the government loans to farmers—has always been difficult. The commodity loan rates have been determined in the political process, have often been established well above market clearing levels. As a result, the government has sometimes acquired large, costly stocks of farm commodities when farmers defaulted on the loans or, as in the case of dairy products, when the CCC purchased diary products. The currently burdensome stocks of wheat, corn, and dairy products are cases in point.

Farmers Home Administration

The Farmers Home Administration (FmHA) was formed in 1946 as the successor to the Farm Security Administration of the late 1930s. Like its predecessor, the FmHA was formed to ease part of the distress of farmers by extending credit to producers that were no longer creditworthy by commercial lending standards. The agency currently is a part of the Department of Agriculture.

The FmHA still functions as lender of last resort to farmers unable to obtain credit from other sources. As such, it concentrates most of its lending on new entrants into agriculture, small farmers, and farmers that have lost creditworthiness because of natural disasters and unusual adversities. Lending to farmers facing economic emergencies increased rapidly in the 1970s.

The FmHA provides supervised credit to individuals, often at below-market rates, and participates in credit guarantee programs with commercial lenders. Farm ownership loans and farm operating loans outstanding at the beginning of 1983 totaled nearly $8.4 billion. Emergency loans—which began to increase rapidly about 1974—totaled about $10 billion, compared with only $82 million at the beginning of 1974.

The effect of FmHA lending has been mixed. Many farmers have entered agriculture through the use of FmHA loans, and many farmers have been able to revive failing businesses with the help of supervised credit from the FmHA. The FmHA is sometimes criticized, however, for extending credit in situations that offer little hope for repayment and, therefore, for delaying changes in occupation that might have been to the borrower's advantage. The emergency credit programs—with heavily subsidized interest rates and lax eligibility requirements—have been widely criticized for being available to farmers that already have access to credit from commercial lenders.

Government credit programs in perspective

Attention can now be turned to some criteria that might help in judging the potential usefulness of government credit programs. Such programs have often been proposed as a solution to a range of problems and will probably continue to be proposed as solutions in the future.

The results of credit programs in agriculture range from outstandingly successful to unsuccessful. On balance, the programs appear to have been most successful where they were devised to resolve imperfections in the market and to improve the economic efficiency of farmers and the farm sector. The Farm Credit System has been a successful program. It has improved the efficiency of farm credit markets and given farmers access to credit supplies from national financial markets. It has also developed credit lines adapted to the needs of farmers and built a lending staff that understands both the credit needs of agriculture and the business of agriculture. The Commodity Credit Corporation loan programs also have been successful. Farmers using commodity and farm storage loan programs have been able to market their crops more profitably. Export loans and loan guarantees have been useful in building farm export markets.

Programs that tend to circumvent the working of the marketplace, however, have not worked out as well. Emergency lending programs of the FmHA have not been effective in resolving borrowers' difficult financial situations. Efforts to use the CCC commodity loan program as an income subsidy mechanism instead of a marketing program have typically sent farmers incorrect price signals, often resulting in large inventories of government-owned commodities.

The argument has been made that a national industrial development bank is needed to provide capital investment for renewing American industry. However, the very large and efficient financial markets in this country can allocate capital to projects that are judged to be sound investments. Moreover, the private sector can make those decisions more quickly and with fewer mistakes than a government agency.

In summary, only when government credit programs have substantially improved economic efficiency or unambiguously improved equity in the sector without substantially distorting efficiency have these programs been of major long-run benefit to agriculture. There is little, if any, evidence from agriculture that government-administered generalized credit allocation has improved the sector's performance. This seems to be the lesson from agriculture that might be generalized to other sectors of the economy.