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Recent Developments in the Credit Union Industry

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By Douglas K. Pearce

Regulatory changes have exposed credit unions to more intense competition. Changes have also relaxed many of the restrictions on credit unions, improving their prospects for growth. They have adapted well to the new financial environment and are likely to continue competing effectively with other depository institutions.

Agricultural Policy: Objectives for a New Environment

By Marvin Duncan and Maria Borowski

In recent years, agriculture has become much more integrated into the general economy, with the result that old farm policies no longer suffice. A rethinking of policy objectives is needed so that programs can focus on the whole food and fiber industry as well as deal with farm problems.
Recent Developments in the Credit Union Industry

By Douglas K. Pearce

Less than a decade ago, U.S. depository institutions could be clearly distinguished from each other. Banks made commercial loans and offered checkable deposits. Savings and loan associations and mutual savings banks made residential mortgage loans and offered fixed-rate passbook savings accounts. Credit unions made consumer instalment loans and offered dividend-paying share accounts. In recent years, however, financial deregulation and high and volatile interest rates have led to a substantial blurring of these differences as each type of intermediary has broadened its range of activities in an effort to become a "financial supermarket."

Changes in the structure and behavior of the credit union industry have been particularly striking. Since 1977, regulatory changes have relaxed many of the traditional restrictions on credit unions. While these changes have improved the prospects for growth of the credit union industry, similar deregulation of other depository institutions has exposed credit unions to more intense competition. Moreover, because ceilings on deposit and loan rates were still in effect when short-term interest rates rose sharply in the late 1970s, growth of credit unions slowed substantially from 1979 to 1981. The credit union industry responded by making significant balance sheet adjustments and expanding the roles of their trade associations.

This article argues that credit unions adapted well to the new financial environment and that they are likely to continue to compete effectively in unregulated markets. The first section reviews the distinctive features of credit unions, the regulatory framework in 1976 before deregulation, and the performance of credit unions from 1961 to 1976. The second section describes the restructuring of the credit union industry with respect to the regulatory framework and functions of the trade associations. The third section examines the performance of credit unions from 1977 to
1983. The fourth section looks at the prospects for credit unions in the near term.

Structure and performance of credit unions before 1976

Distinctive features of credit unions

Credit unions are nonprofit, cooperative organizations composed of individuals with a "common bond" who borrow from and lend to each other.¹ As credit unions are mutual organizations, owned by their members, deposits are considered shares and interest payments on deposits are considered dividends.² Officers of credit unions are usually unpaid volunteers elected from the membership.³ The unique feature of credit unions is their common bond requirement for membership. The bond is usually the place of employment or the occupation of members but it can also be based on association ties, such as church or union membership, or, more rarely, on area of residence. Credit unions often receive subsidies, such as free office space, from their sponsoring organization. Unlike other mutual depository institutions, federally chartered and most state-chartered credit unions are not subject to federal or state income taxes.

These characteristics have given credit unions both advantages and disadvantages relative to other depository institutions in competing for household savings and consumer loans. On the plus side, volunteer help and sponsors' subsidies lower operating costs. The common bond feature of credit unions probably keeps down consumer loan rates by lowering administrative costs. In particular, occupation-based credit unions are well positioned to obtain low-cost-information on the income and job security of prospective borrowers. Moreover, loan repayments can be processed inexpensively through payroll deductions. The common bond may also make borrowers more reluctant to default on loans, and the lower default rates allow credit unions to charge lower loan rates. Payroll deduction plans for saving at credit unions are convenient for depositors, and the common bond may make them loyal to their credit union, reducing the interest sensitivity of depositors. The cooperative, nonprofit nature of credit unions combines with the common bond requirements to keep credit unions from viewing themselves as competitors. This has led to extensive pooling of resources through trade associations that allows individual credit unions to obtain some economies of scale that their small size would not otherwise permit.

The mutual organization and nontaxable status of credit unions also give them potential advantages. The capital of a credit union consists basically of reserves against loan losses, reserves built up by retaining part of the income generated in the past. This capital need not be paid a return, as is the case of such stock intermediaries as commercial

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² Some state-chartered credit unions accept deposits, but these are often treated as equity capital. Since credit union shares are equity, they represent a residual claim on credit union assets unlike the claim of bank depositors. Because credit unions are considered depository institutions, this article will use the terms shares and deposits interchangeably.

³ No officer except the treasurer can receive compensation. Most credit unions have paid clerical help, and larger credit unions employ professional managers. Officers of credit unions affiliated with large business firms may receive implicit payments from the firm for their services to the credit union.
banks. Therefore, if a credit union has enough capital, it can use all its income in excess of operating costs to pay depositors more or give borrowers refunds. A growing credit union generally needs to increase its capital. If credit union income were taxed in the same way as, say, mutual savings and loans, a credit union would have to generate more pre-tax income to make the desired addition to its capital. The tax-free status allows credit unions to charge less for loans or pay more on deposits given any desired addition to their capital. The taxation of credit unions is a controversial issue discussed in more detail later.

Some credit union characteristics also have negative aspects. Volunteer help may lack the incentive or the expertise to operate the credit union efficiently. A narrowly defined common bond—and this is the traditional bond—inherently limits the growth potential of a credit union. A common bond based on employment further restricts the asset growth of a credit union to the growth of its sponsoring firm. The common bond requirement also keeps credit unions from achieving much diversification across both depositors and borrowers. Thus, sudden plant closings or substantial layoffs can create severe liquidity problems for credit unions and sometimes force them into liquidation. A disadvantage to the mutual organization of credit unions is that the only source of funds is deposits. Credit unions cannot raise capital for expansion by selling equity.

The cooperative or mutual nature of credit unions presents problems in analyzing the industry. First, the objective of individual credit unions is not clear. While stock institutions, such as banks, may seek to maximize profits, the goals of credit unions are less well defined. Since members can be primarily savers or primarily borrowers, a conflict of interest arises when credit unions decide the rates to pay savers and charge borrowers. A decision to pay higher rates on deposits, all else equal, means a decision to charge higher loan rates. Refunds to borrowers or lower loan rates, on the other hand, imply lower dividends to saving members. This internal conflict exists as long as external competition does not force both loan rates and deposit rates to their market values. In other words, any "profit" a credit union makes is divided among borrowers and savers but the division can vary across credit unions.

A second problem is measuring industry performance. This article follows the custom of the credit union movement and takes asset growth as the measure of success. Since the traditional goal of credit unions has been to promote thrift among members and provide them with low-cost consumer credit, asset growth seems a reasonable proxy for this goal, particularly if most assets are consumer loans. As noted above, however, the officers of individual credit unions have no pecuniary interest in growth and may even prefer the ease of operating a small institution. On the other hand, the cadre of professionals in the credit union trade associations and managers of large credit unions have a clear interest in industry growth.

Regulatory framework in 1976

Credit unions can obtain either federal or state charters. Since regulations governing state-chartered credit unions vary across

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4 Flannery, "An Economic Evaluation of Credit Unions," analyzed a 1972 sample of federal credit unions and found that most credit unions appear to balance the goals of savers and borrowers or to be dominated by savers. He reported that credit unions with a residential bond are more likely to be saver dominated. This issue is also discussed in Donald J. Smith, Thomas F. Cargill, and Robert A. Meyer, "An Economic Theory of a Credit Union," Journal of Finance, May 1981, pp. 519-28.
states, this article concentrates on the regulations imposed on federal credit unions.\(^5\) The regulatory agency for federal credit unions is the National Credit Union Administration (NCUA), which is responsible for chartering and supervision. Since 1971, the NCUA has also administered share insurance for federal and many state credit unions through the National Credit Union Share Insurance Fund (NCUSIF).

In 1976, federal credit unions faced several restrictions on their lending activities and on the types of accounts they could offer. They could not charge more than 12 percent a year on loans, inclusive of all charges. The size of loans was limited, maximum maturities were five years on unsecured loans and ten years on secured loans, and loans had to be approved by a loan committee.\(^6\) These constraints effectively excluded credit unions from making loans through credit card programs and severely limited their ability to initiate residential mortgage loans. Consumer instalment loans for relatively small amounts made up most of the loan portfolio of credit unions. Funds not loaned to members could be invested in U.S. government and agency securities, deposits at insured savings and loans or mutual savings banks, or in loans to or shares at other credit unions.\(^7\)

Federal credit unions also faced restrictions on the accounts they could offer. Each share had a legislated par value of $5 so that a member with as little as a $5 deposit qualified for voting on credit union policy. The NCUA placed a 7 percent ceiling on share account dividend rates. Since this exceeded the Regulation Q ceiling deposit rates at banks and savings and loan associations, credit unions enjoyed a competitive advantage over other depositories when market rates were high enough to make their competitors' ceilings effective. Federal credit unions were not formally authorized to offer shares that resembled checkable deposits. The NCUA, however, had given temporary permission to some credit unions to offer share drafts. Because these accounts were essentially interest-earning demand deposits, their introduction subsequently led to legal challenges from banks.

Unlike banks, credit unions did not have to keep a specific ratio of cash assets to shares, although the needs of members necessitated that a small proportion of assets be held in cash. However, credit unions were required to maintain a reserve against possible loan losses. Gross income had to be allocated to maintain this ratio, analogous to a capital-asset ratio requirement, at 10 percent of their risky assets.\(^8\)

Credit union performance, 1961-76

Credit unions grew rapidly throughout the 1961-76 period. Assets at credit unions rose at an annual rate of 12.8 percent, compared with 11.2 percent at savings and loans and 8.6 percent at commercial banks. Credit union deposits also grew an average of 13.7 percent a year, compared with 11.1 percent at savings and loans and 11.6 percent for passbook and small time deposits at banks. As a result of this more rapid growth, credit unions' share of total household savings deposits rose from 3 percent in 1961 to 4.4 percent in 1976. Over

\(^5\) Differences between state regulations are given in issues of *Comparative Digest of Credit Union Acts*, Credit Union National Association, Inc.

\(^6\) The maximum unsecured loan was $2,500 while the maximum secured loan was 10 percent of the credit union's capital.

\(^7\) Many states allowed state-chartered credit unions more investment choices.

\(^8\) Risky assets are essentially loans that are not guaranteed by the government or secured by the borrower's shares.
this same period, credit unions increased their share of total consumer instalment credit from 9.3 percent to 16.1 percent. While the number of credit unions did not increase substantially over this period, membership almost tripled, reaching close to 34 million members by 1976.

Despite substantial growth, the credit union industry remained small compared with other depository institutions. Although total credit union assets exceeded $45 billion by 1976, this was only about 5 percent of commercial bank assets and 11 percent of savings and loan assets. Most of the 22,533 credit unions operating in 1976 were small. Four out of five credit unions had assets of less than $2 million. Together these institutions held only 18.5 percent of total credit union assets. The 60 largest credit unions held 14.5 percent of all credit union assets. Thus, the credit union industry was characterized by a large proportion of small institutions and few large ones.

Table 1 summarizes the balance sheets of credit unions at the end of 1976. Loans to members made up 76 percent of the assets. These loans were mainly for durable goods purchases (about 48 percent) and personal loans (32 percent). The restriction on maximum loan maturity kept residential mortgage loans to less than 5 percent of all loans.

<table>
<thead>
<tr>
<th>TABLE 1</th>
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<tbody>
<tr>
<td><strong>Balance sheet for all credit unions, 1976</strong></td>
</tr>
<tr>
<td>Total Assets, $45,225 million</td>
</tr>
<tr>
<td>Loans to members</td>
</tr>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Investments</td>
</tr>
<tr>
<td>Other</td>
</tr>
<tr>
<td>Distribution of Liabilities and Capital</td>
</tr>
<tr>
<td>Members’ savings</td>
</tr>
<tr>
<td>Reserves and undistributed earnings</td>
</tr>
<tr>
<td>Notes payable and other</td>
</tr>
<tr>
<td>Source: NCUA, 1976 Annual Report on State-Chartered Credit Unions</td>
</tr>
</tbody>
</table>

Investments were divided among U.S. government or agency securities (45 percent), common trust investments (21 percent), deposits at savings and loans (19 percent), and loans to or shares in other credit unions (15 percent). On the liability and capital side, members’ savings accounted for 86.6 percent. These were almost all in the form of regular share accounts since share drafts and other types of shares were uncommon.

**Credit union restructuring, 1977-83**

Three major developments affected the credit union industry over the 1977-83 period. First, the general movement toward financial deregulation eliminated many of the previous constraints on credit unions but also exposed credit unions to more competition. Second, changes in the regulatory structure provided the credit union industry with new sources of...
liquidity. Third, expansion of the services offered by credit union trade associations helped credit unions broaden their range of financial services and gave credit unions more convenient access to money markets.

Deregulation of credit unions

Of all the regulatory changes in the U.S. financial sector from 1977 to 1983, the most dramatic changes may have been in the credit union industry. Many of the restrictions on credit unions were removed either by legislation or administrative ruling, enabling credit unions to compete across a broad range of financial services. Some of these changes, however, have also eliminated or reduced competitive advantages of credit unions. Table 2 chronicles the major regulatory changes affecting federal credit unions since 1976.13

The lending powers of credit unions have been significantly enlarged. First, credit unions can now make residential mortgage loans of any size or maturity. They can also sell the mortgages they originate in the secondary mortgage market.14 Second, the NCUA can temporarily increase the interest ceiling on loans if warranted by economic conditions.15 Third, credit unions can now establish self-replenishing lines of credit for members. These latter two changes removed the barriers to credit union participation in credit card programs.

Regulatory changes have also increased the ability of credit unions to attract deposits. Credit unions can offer members a wide variety of share accounts, including accounts similar to money market deposit accounts, with no restrictions on the interest they can pay. Since the interest rates banks and savings and loan associations can offer on some accounts are still restricted, credit unions continue to have a competitive advantage. The Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 gave credit unions permanent authority to offer share drafts (checkable accounts). This provision was coupled at first with the stipulation that credit unions must meet the same reserve requirements as other depository institutions. The Garn-St Germain Depository Institutions Act of 1982, however, excluded from the reserve requirement credit unions and other depository institutions with less than $2 million in checkable deposits (about 95 percent of all credit unions).

Two other changes that may benefit credit unions are the less restrictive interpretation of the common bond requirement and the wider access of depository institutions to Federal Reserve services. The NCUA and state regulators have relaxed substantially the common bond aspect of credit union membership.16 This increases the potential membership for credit unions and allows more mergers between credit unions. The DIDMCA provided for the pricing of Federal Reserve services, such as wire transfers, and permitted the credit union industry to access such services directly rather than indirectly through correspondent relationships with member banks. This may reduce the costs of such services to some credit unions.

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13 See issues of Comparative Digest of Credit Union Acts for how these changes affected state-chartered credit unions.

14 Initially, credit unions were restricted to 30-year loans on homes that were less than 150 percent of the median house price in their area.

15 The NCUA can raise the ceiling (15 percent) for up to 18 months if it can demonstrate that growth, liquidity, capital, and earnings have been adversely affected and that interest rates have been rising in the last six months. The NCUA must inform Congress before raising the ceiling.

16 For a discussion of this change, see 1983 Annual Report, NCUA, pp. 9-11.
**TABLE 2**  
*Credit union regulatory changes, 1977-83*

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977</td>
<td>Amendments to Federal Credit Union Act</td>
<td>Increased loan maturities on nonresidential loans to 12 years. Allowed 30-year residential mortgage loans and 15-year mobile home and home-improvement loans. Permitted self-replenishing lines of credit. Permitted participation loans with other financial institutions. Permitted government-insured or guaranteed loans. Lowered reserve formula for larger credit unions. Allowed different types of share accounts, including share certificates.</td>
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<tr>
<td>1978</td>
<td>Financial Institutions Regulatory and Interest Rate Control Act</td>
<td>Restructured NCUA into three-member board. Established Central Liquidity Facility under NCUA. NCUA regulations Permitted sale of mortgages to FNMA, FHLMC, or GNMA. Set maximum rate on small share certificates at 8 percent. Permitted market rates on large share certificates ($100,000 or more). Permitted six-month, $10,000 certificates paying 1/4 percent above the six-month Treasury bill rate.</td>
</tr>
<tr>
<td>1979</td>
<td>Congress</td>
<td>Gave 90-day authorization (starting December 28) for credit unions to offer share drafts. NCUA regulations required credit unions with over $2 million in assets or offering share drafts to hold 5 percent of member accounts plus notes payable in liquid assets.</td>
</tr>
<tr>
<td>1980</td>
<td>Depository Institutions Deregulation and Monetary Control Act</td>
<td>Classified credit unions as depository institutions. Gave permanent authority for share drafts. Set required reserves on share drafts. Established timetable for phasing out interest ceilings. Raised loan rate ceiling to 15 percent and authorized NCUA to increase this ceiling. Required Federal Reserve System to price its services. NCUA regulations raised loan ceiling to 21 percent for nine-month period (starting December 3).</td>
</tr>
<tr>
<td>1981</td>
<td>NCUA regulations</td>
<td>Extended 21 percent ceiling on loan interest rate to June 1982. Allowed credit unions to make variable interest rate consumer and mortgage loans.</td>
</tr>
<tr>
<td>1982</td>
<td>Garn-St Germain Depository Institutions Act</td>
<td>Freed credit unions to set par value of shares and to determine internal organization. Eliminated limits on size and maturity of mortgage loans, allowed refinancing of first mortgages, and extended maturity limit on second mortgages. Excluded credit unions with less than $2 million in reservable accounts from reserve requirements. Permitted Central Liquidity Facility (CLF) to lend to the National Credit Union Share Insurance Fund (NCUSIF) and also made CLF an agent of the Federal Reserve System. NCUA regulations Allowed credit unions to determine the kinds of shares offered and the dividend rates paid. Repealed fixed liquidity requirement on federally insured credit unions. Permitted credit unions greater flexibility in the kinds of services they can offer and the joint sharing of activities with other credit unions.</td>
</tr>
<tr>
<td>1983</td>
<td>NCUA regulations</td>
<td>Expanded definition of “family member” in common bond requirement.</td>
</tr>
</tbody>
</table>
Financial deregulation also increased the range of activities of competing depository institutions. Savings and loan associations and mutual savings banks can now compete actively in the consumer loan market. While commercial banks, savings banks, and savings and loans are still legally constrained on the interest rates they can offer on some accounts, they can offer any rate on many of their deposit options and the remaining limits are being phased out. Thus, the traditional advantage of credit unions—the ability to offer higher deposit rates—is dissipating. Another earlier advantage for large credit unions has been eliminated by the requirement that they maintain noninterest earning reserves with the Federal Reserve based on the amount of their share drafts.\(^{17}\)

**Changes in the regulatory structure**

Several important changes in the credit union regulatory structure were made between 1977 and 1983. The NCUA was reorganized more along the lines of the Federal Home Loan Bank Board and the Board of Governors of the Federal Reserve. Up to 1978, the NCUA was run by an administrator counseled by an advisory board. The Financial Institutions Regulatory and Interest Rate Control Act of 1978 replaced this structure with a three-member board headed by a chairman. Members of the board are appointed by the President, confirmed by the Senate, and serve staggered six-year terms.\(^{18}\)

Perhaps a more significant change, also due to the 1978 legislation, was the establishment of the Central Liquidity Facility (CLF), under the administration of the NCUA. Until the creation of the CLF, credit unions had no access to a "lender of last resort," such as the Federal Reserve.\(^{19}\) The CLF fills this gap. Both federal and state-chartered credit unions can join the CLF by subscribing 0.5 percent of their unimpaired capital. The CLF generally makes short-term loans to member credit unions having unexpected liquidity problems. The CLF raises most of its funds by borrowing through the Federal Financing Bank and can, if the need arises, borrow directly from the U.S. Treasury. In addition to lending to individual credit unions, the CLF can lend to the NCUSIF.

The relationship between the credit union industry and the Federal Reserve System also changed considerably over this period. Not only can credit unions now buy Federal Reserve services directly, as large credit unions must hold reserves with the Federal Reserve, these credit unions also have legal access to the discount window. They do not really have the choice between borrowing from the CLF or the Federal Reserve, however, since the Federal Reserve requires that credit unions first approach the CLF. One difference between the CLF and the discount window is that the CLF always sets a penalty interest rate on its loans, that is, a rate slightly above market rates.\(^{20}\)

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\(^{17}\) The NCUA had required larger credit unions to keep a 5 percent ratio of liquid assets to deposits beginning in 1979, but this requirement was removed in 1982. The reserve requirements for credit unions are being phased in over time. By September 1987, credit unions will face the same reserve requirements as do member banks.

\(^{18}\) The NCUA divides the United States into six administrative regions, each with its own regional office.

\(^{19}\) For a discussion of previous recommendations for such a facility, see Flannery, "An Economic Evaluation of Credit Unions," pp. 162-64.

\(^{20}\) As discussed later, credit unions can also borrow from other credit unions through the Corporate Credit Union Network. The CLF sets its rate just above the average rate charged by corporate central credit unions.
Expanded role of trade associations

While regulatory changes have greatly increased the services that credit unions can offer, credit unions have had to turn to their trade associations for help in competing in these new areas. Credit unions have always relied heavily on services provided through trade associations. They rely even more now because of the competitive disadvantages they face in a deregulated environment where competition is vigorous and financial innovation rapid. The small size of most credit unions keeps them from realizing any economies of scale in such areas as data processing and investment. Moreover, the unpaid volunteers who make the investment decisions for most credit unions usually do not have the expertise in portfolio management that their counterparts in the banking or savings and loan industries have. These disadvantages have been largely offset, however, by the credit union trade associations having essentially integrated most credit unions into one financial network. The cooperative nature of credit unions and the common bond requirement encourage such integration since credit unions do not generally consider one another as competitors and their nonprofit status avoids antitrust problems.

By far the largest and most influential of the credit union trade associations is the Credit Union National Association (CUNA). CUNA, as the major spokesman and lobbyist for the credit union industry, is the umbrella organization for several companies providing services to credit unions. There are also trade associations at the state level. Known as credit union leagues, most of them are also affiliated with CUNA so that about 90 percent of all credit unions are connected with CUNA.

CUNA provides services to credit unions through the CUNA Service Group, Inc., and the Corporate Credit Union Network. The Service Group has several subsidiaries. ICU Services, Inc., sells to credit unions financial services such as investment trusts in U.S. government securities, automatic teller machine (ATM) and electronic funds transfer (EFT) systems, credit card programs, and IRA/Keough plans. CUNA Mortgage Corporation buys mortgages originated by credit unions and sells pools of these mortgages on the secondary mortgage market. CUNA Supply, Inc., wholesales operational and promotional supplies to credit unions. Credit Union Internet provides credit unions with computer services and allows credit unions to be linked to an online telecommunications network. These service companies, catering only to credit unions, make it possible for the industry to compete more effectively by gaining the benefits of economies of scale.

Since it was started in the mid-1970s, the Corporate Credit Union Network has grown rapidly, probably in response to the volatility of interest rates. The network provides liquidity and investment expertise for the credit union industry. It has a pyramid structure with about 17,500 individual credit unions at the bottom, 42 corporate central credit unions in the middle, and the U.S. Central Credit Union at the top. A corporate central credit union, owned by its member credit unions through capital subscriptions, acts as a credit union for credit unions. Corporate centrals provide an outlet for credit union investments by offering a variety of shares and deposits. They also make loans to member credit unions needing liquidity. U.S. Central, in turn, acts as a credit union for the corporate centrals. It offers investment instruments ranging in maturity from overnight to three years and makes

21 For background on the trade associations, see Melvin, Davis, and Fischer, Credit Unions and the Credit Union Industry, chap. 3.
loans to corporate centrals with liquidity needs. Essentially, the Corporate Credit Union Network allows credit unions to channel investment funds through the corporate centrals to one portfolio run by U.S. Central. In this way, individual credit unions do not need financial expertise to obtain competitive rates on their investments. Moreover, the Internet system permits the Corporate Network to be linked electronically so that instructions and information can be transmitted quickly and inexpensively.

In addition to providing liquidity and investment expertise, the Corporate Network also provides credit unions with services traditionally acquired through correspondent relationships with commercial banks. This is accomplished by U.S. Central, which, through the corporate centrals, serves as the credit unions' main link to the Federal Reserve System. U.S. Central can provide such correspondent services as wire transfers, share draft settlements, federal funds trading, coin and currency delivery, and corporate share drafts. Corporate share drafts are essentially NOW accounts for corporate centrals, a replacement for the correspondent balance accounts at banks. The corporate centrals can also hold the required reserves of credit unions on a pass-through basis. The ultimate goal of the Corporate Network is to supply all the services that credit unions have traditionally acquired through correspondent relationships with banks and savings and loans.

The dominant role of CUNA and its subsidiaries makes the credit union industry resemble in some respects one large financial entity. The individual credit unions collect deposits and originate loans. They buy their office supplies, computer services, and investment advice within the industry. Funds in excess of loans can be funneled into one pool to be managed by professionals or loaned to other credit unions. Thus, in analyzing the competitiveness of credit unions relative to other depository institutions, it may be more realistic to view the credit union industry as one financial network with thousands of branches rather than thousands of small intermediaries.

Credit union performance, 1977-83

The performance of the credit union industry between 1977 and 1983 reflected both economic conditions and regulatory changes. This section examines the growth of credit unions, the changes in their assets and liabilities, and the rise of the Corporate Credit Union Network over this period.

Growth

Total assets at credit unions more than doubled during the 1977-83 period, rising at an annual rate of 12 percent. While this growth rate was slightly less than in the 1961-76 period, it still exceeded asset growth rates at banks (9.9 percent) and savings and loan associations (11.4 percent). Deposits at credit unions grew slightly faster than assets at an annual rate of 12.7 percent. In contrast, deposits at banks grew an average of 9.2 percent a year and deposits at savings and loans grew an average of 9.5 percent. As a result of better deposit performance, the share of total

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22 U.S. Central belongs to the CLF and thus its member credit unions also have access to the CLF.

23 Large credit unions are much less dependent on trade associations.

24 All assets are at book value. Since savings and loans had assets with much longer maturities than banks or credit unions, the market value of their assets fell considerably when interest rates rose unexpectedly in 1979. The source of all data is Flow of Funds.
household deposits (including money market shares) held at credit unions rose to 4.9 percent in 1978. With the dramatic rise in money market funds beginning in 1979, however, this share fell to about 4.4 percent in 1983.

While credit union membership rose to over 48 million by the end of 1983, the number of credit unions declined by over 3,300, falling to 19,205 by December 1983. The size distribution of credit unions, however, did not change radically. Credit unions with less than $2 million in assets still made up more than 70 percent of all credit unions and held about 10 percent of all assets. The 60 largest credit unions still held about 14 percent of all assets.25

Growth in assets and deposits varied considerably from 1977 to 1983. Charts 1 and 2 show the annual growth rates in assets and deposits at credit unions, banks, and savings and loans. As these charts indicate, credit union growth was relatively rapid in 1977 and 1978, considerably slower from 1979 through 1981, and then rapid again in 1982 and 1983. The growth pattern was similar for savings and loans while bank growth fluctuated moderately.

The pattern of credit union growth reflects a combination of regulatory and economic conditions. Up until the end of 1980, there was a ceiling on the rates most credit unions could pay on small certificates of deposit and other accounts. When short-term interest rates began rising sharply in 1978, credit unions found it difficult to pay competitive rates. At first, the difference between the rates paid by credit unions and the ceiling rates paid by banks and savings and loans gave credit unions a competitive advantage. This advantage was largely offset, however, by the surge in money market funds, which had no interest rate ceilings. The competitive advantage of money market funds caused slower growth in deposits and assets at credit unions as well as other depository institutions throughout the 1979-81 period.

Chart 3, which plots deposit growth at credit unions and the interest rate on three-month Treasury bills, supports the argument that high money market rates had a significantly, negative effect on credit union growth. The relatively high rate of unemployment over much of this period also was probably detrimental to growth. Since many credit union members make deposits through payroll deductions, high unemployment could have more adverse effects on credit unions than other depository institutions.

Deposit growth at credit unions began to increase after April 1982, when the NCUA lifted all restrictions on the rates and maturities of federal credit union deposits. Since this preceded by about eight months the authorization for banks and savings and loans to offer money market deposit accounts, credit unions had a head start in offering accounts with money market rates. The general decline in interest rates may have reduced the attractiveness of money market funds to the point where the convenience and insurance of credit union deposits outweighed the interest differential. The exceptionally rapid growth in 1983 probably reflected the lower short-term interest rates and the rapid recovery from the 1982 recession.

**Balance sheet composition**

The composition of both assets and liabilities of credit unions changed substantially over the 1977-83 period. Table 3 presents the bal-

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25 The asset distribution of commercial banks became somewhat more skewed over the same period. Banks with less than $50 million in assets comprised 66 percent of all insured banks and held about 9 percent of all bank assets. The largest 18 banks held 37.6 percent of all bank assets at the end of 1983.
Chart 3
Deposit growth and interest rates

Percent

Credit unions
3-month Treasury bill rate (annual average)

1977 '78 '79 '80 '81 '82 '83

0 5 10 15 20 25

ance sheet for credit unions in 1983. A comparison of Table 3 with Table 1 shows that the proportion of loans to total assets dropped abruptly from 76 percent at the end of 1976 to 57 percent at the end of 1983. Several factors account for this decline. First, interest rate differentials often favored investments over loans. Until late 1980, the maximum interest rate many credit unions could charge on loans was 12 percent. When interest rates on short-term investments, such as Treasury bills, rose above this ceiling, as they often did between late 1979 and late 1980, loans became unattractive assets. Second, the expansion of the Corporate Credit Union Network made money market investing easier for small credit unions. Third, the riskiness of consumer loans was increased by swings in interest rates and unemployment rates in the 1977-83 period. Fourth, as discussed below, credit union deposits became more sensitive to market interest rates. As a result, the share of consumer instalment loans held by credit unions peaked in 1978 at 16.7 percent. By the end of 1983 they had fallen to 13.8 percent.36

Not only did the distribution between loans and investments change between 1976 and 1983, the composition of investments held by credit unions also changed considerably. These changes represented a move toward

36 Commercial banks' share of the consumer instalment market also fell from 48.3 percent in 1976 to 45.7 percent in 1983. The share of savings and loans and mutual savings banks combined rose from 3.9 percent to 5.7 percent over this period and the share of nondepository institutions also increased.
short-term money market assets. The percentage of investments held in U.S. government or agency securities fell from 45 percent in 1976 to 22 percent in 1983, while the percentage in common trust investments fell from 21 percent to under 2 percent. Over the same period, investments in the form of deposits at corporate central credit unions rose from essentially 0 to 34 percent. Investments in the form of deposits at banks and savings and loans, mostly large certificates of deposit, rose from 19 to 37 percent. This last trend partly reflects credit union use of money brokers who direct the deposits to banks and savings and loans offering the highest yields.\(^{27}\)

The changing composition of credit union deposits also caused credit unions to hold more of their assets in money market investments so they could match the characteristics of their assets and liabilities more closely. At the beginning of 1977, almost all deposits were regular share accounts similar to passbook savings accounts at banks. By November 1983, however, share accounts comprised only 45.4 percent of all deposits. Share drafts, money market accounts, and fixed-rate certificates—all of which pay market-related rates—comprised 8.3, 9.0, and 37.3 percent of deposits, respectively.\(^{28}\) Deposit growth was also faster in large accounts. The rapid shift in deposit composition at credit unions suggests that depositors at credit unions are quite sensitive to the rates on alternative assets. Volatile interest rates thus required that credit unions, to offer competitive rates on deposits, hold assets with yields that moved with market rates.

**Corporate credit union growth and balance sheets**

The growth of the Corporate Credit Union Network over the 1977-83 period was extraordinary. Because of the large increase in deposits from member credit unions, total assets at corporate central credit unions rose from under $1 billion to about $7.9 billion. The composition of corporate central credit unions’ assets reflected the needs of their members. The percentage of deposits loaned to member credit unions requiring liquidity was high at first, peaking at 89 percent at the end of 1978. This percentage dropped quickly, however, to 5 percent by 1983. About 77 percent of corporate central credit unions’ assets are deposits at U.S. Central with the rest in U.S. government and agency securities, shares at the CLF, and other assets. About 90

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\(^{27}\) Institutions offering exceptionally high interest rates are likely to be more risky. While deposit insurance eliminates the risk for deposits up to $100,000, credit unions often made uninsured deposits. For example, when the Penn Square bank failed in July 1982, 139 credit unions held a total of $111.5 million in uninsured deposits in the bank (*Annual Report 1982*, NCUA, p. 6).

\(^{28}\) Other depository institutions experienced similar changes in the composition of their deposits. Passbook savings accounts at banks as a percentage of total bank deposits fell from 23.7 percent in 1976 to 8.9 percent in 1983, while such accounts at savings and loans declined from 40.4 percent of all deposits in 1976 to 19.9 percent in 1982.
percent of the corporate centrals' funds come from deposits by member credit unions.

Growth of the corporate centrals brought similar growth at U.S. Central, which had assets of $7.2 billion by the end of 1983. Most (85 percent) of U.S. Central's assets are funded by the deposits of corporate centrals, while the rest are funded largely through the issue of commercial paper (2.7 percent) and the sale of government securities under repurchase agreements (7.3 percent). The composition of U.S. Central's assets reflects the needs of the corporate centrals. Depending on market conditions and the maturities of their own liabilities, corporate centrals choose from a variety of deposit options, ranging from regular deposits available on demand to fixed-rate, fixed-maturity certificates of deposit. In 1983, corporate centrals held about 56 percent of their deposits in regular deposits and 44 percent in certificates. U.S. Central, in turn, makes investments that closely match the maturity composition of its deposits. In 1983, U.S. Central held about 46 percent of its investment portfolio in federal funds, 40 percent in repurchase agreements, and the rest in a variety of money market securities.²⁹

Prospects for credit unions

While the credit union industry seems to have adapted well to changing financial markets, the future growth and structure of the industry are uncertain. One trend likely to continue is the softening of the common bond requirement for membership. Traditionally, only a credit union member's immediate family was eligible for membership in the union. Eligibility requirements have now been diluted to where a credit union can allow anyone to join who is related by blood or marriage to a current member, substantially increasing potential membership. In addition, the NCUA has promoted mergers between healthy and weak credit unions, regardless of differences in their common bonds. These rulings will allow more diversification across borrowers and depositors as ties to specific employers are weakened.

There are, however, drawbacks for credit unions to a weaker common bond requirement. To the extent that the common bond kept default rates on loans relatively low, default rates should rise as the common bond requirement fades. Weaker common bonds also imply less of an advantage on information regarding borrowers. The disintegration of the common bond further reduces the distinction between credit unions and other depository institutions, making it more difficult for the credit union industry to argue for the continuation of their nontaxable status.

A second trend that is likely to continue is the expansion of financial services offered by credit unions. At present, there are considerable differences in the services offered by large credit unions (over $5 million in assets) and small credit unions. Many large credit unions have taken advantage of financial deregulation and now offer money market accounts, first and second home mortgages, credit cards, and share drafts. Most small credit unions, however, have yet to offer these services, maybe because of lack of expertise or incentives of their volunteer officers or inadequate capital to acquire the necessary equipment.³⁰ The Corporate Credit Union Network is trying to provide the support necessary for more small credit unions to expand their services, particularly in the areas of share drafts and credit cards.

²⁹ The composition of U.S. Central's portfolio is for February 29, 1984.

³⁰ For a breakdown of credit union services by asset size, see Credit Union Magazine, December 1983, p. 23.
Recently, CUNA started CUNA Brokerage, which gives credit union members access to discount stock brokerage through their credit union. This development is clearly a response to similar services now offered by banks and such "nonbank banks" as Sears. Some state-chartered credit unions have even begun making commercial loans.\(^3\)

It is not clear whether the trend toward smaller consumer loan-asset ratios will continue. Credit unions will have a greater incentive to increase loan-asset ratios, if money market interest rates do not return to the high and variable levels of 1979-81 and if the interest ceiling on loans does not become binding. Consumer lending should also rise if credit unions’ credit card programs become more widespread. On the other hand, the competition for consumer lending is increasing now that savings and loans are in the market and large banks are aggressively seeking to expand their share of the market by starting so-called "consumer banks." In addition, the volunteers running smaller credit unions may have become accustomed to the ease of investing funds instead of making loans, particularly given the convenience of investing through the Corporate Credit Union Network.

Complete deregulation of deposit rates could force credit unions to focus more on consumer lending if they want to continue their rapid growth. Consumer loans may generate higher returns than investments, given credit unions’ expertise, lower information costs, and comparatively low default rates. These higher returns will be required to maintain rapid deposit growth in the face of unrestricted competition for deposits from other depository institutions. Moreover, since the FDIC and FSLIC are requesting legislation to eliminate insurance on the deposits of institutions, credit unions may soon be unable to make insured deposits at risky institutions that offer high rates. Thus, credit unions may be forced to return to their previous practice of loaning out most of their deposits if they want to maintain growth. This strategy will be successful, however, only if interest rates are relatively stable.

An issue with potentially important implications for the growth of credit unions is their tax-exempt status. There have been many challenges to this status, the latest being the report of the Grace Commission.\(^3\) The traditional argument for the nontaxable status of credit unions is that they are restricted in membership and exist only to promote thrift and provide low-cost credit to their members. As credit unions expand their services and phase out the common bond requirement, competitors will argue strongly for the taxation of credit unions.

The effects of taxation on credit unions would depend on the specific legislation. If credit unions were treated like mutual savings and loans or mutual savings banks, they could deduct the interest they pay on deposits, even though it is formally a payment of dividends. They could also deduct at least some of the income set aside for possible loan losses. If credit unions could add without limit to their loan loss reserves, they would never have to pay any tax. Presumably, therefore, some limit would be placed on the ratio of loan loss reserves to assets. It would seem that the only case in which credit unions would be significantly affected by such tax provisions is if

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\(^3\) Credit unions in 23 states were making commercial loans in 1983, although the volume was quite small. See *Credit Union Magazine*, January 1984, pp. 60-61.

they wanted to build up their capital beyond the tax-free maximum. If they are satisfied with the maximum ratio, they can adjust their loan rates and deposit rates and invest in tax-preferred investments, such as state and local securities, to keep their tax liability negligible. If, however, credit unions wanted to increase their capital more rapidly, maybe in the anticipation of higher costs arising from complete deregulation or in anticipation of additional expenditures required to expand services, taxation would retard their growth. This is because credit unions would have to raise loan rates or lower deposit rates to generate enough after-tax income to meet their capital needs. In this case, taxation would reduce the competitiveness of credit unions and slow their growth.

Conclusions

Volatile economic conditions and financial deregulation have caused considerable change in credit unions since 1977. While credit unions have maintained their position as the fastest growing depository institutions, their growth has been uneven. The high interest rates of 1979-81 combined with interest ceilings on loans and deposits and high unemployment rates to slow credit union growth substantially. With the subsequent removal of the ceiling restrictions, the fall in market interest rates, and the revival of the economy, credit unions resumed their rapid growth in 1982 and 1983.

The most dramatic change in credit union portfolios was the relative decline in consumer loans from about 80 percent of assets in 1976 to below 60 percent in 1983. This decline reflected both the more attractive returns on money market investments and the changing composition of credit union deposits from passbook accounts to more interest-sensitive accounts. Another important development was the expansion of services provided by credit union trade associations. The trade association connection allows credit unions economies of scale that are not available to most individual credit unions due to their small size. As a result, credit unions have greatly broadened the financial services they offer. In addition, credit union liquidity has been substantially increased by the creation of the Central Liquidity Facility and the growth of the Corporate Credit Union Network.

The prospects for future credit union growth are uncertain. Complete deregulation of interest rates by 1986 will eliminate the deposit rate advantage they have had. Credit unions should be able to compete successfully, however, if they retain their tax-free status and renew their emphasis on consumer lending.
Agricultural Policy:
Objectives for a New Environment

By Marvin Duncan and Marla Borowski

After a half century of experience with federal farm legislation, there is increasing evidence that agricultural policies and programs are no longer working well. They also have become unduly costly. Many observers believe U.S. agricultural policy is at a watershed—that the frame of reference in which farmers and agribusinesses operate has changed so dramatically that old prescriptions no longer suffice and new directions are needed.

In 1985, new agricultural legislation will be written and the debate over that legislation has recently begun. There is always considerable confusion and disagreement over what agricultural legislation should contain. Should it be narrowly defined—dealing only with farm problems or more broadly defined—dealing with the problems of the entire food and fiber industry? As yet, the policy objectives of such legislation have not been clearly outlined.

Despite the complexity of the issues involved, it has never been more important that policy decisions be forward looking and that they be sufficiently broad to encompass food and fiber policy interests, not just narrowly defined farm interests. This article asserts that the changed policymaking environment means traditional objectives must be reexamined and revised before appropriate agricultural programs can be formulated. Without a clear statement of objectives—an understanding of the end product desired—it is unlikely that agricultural legislation will be sufficiently forward looking or comprehensive to meet current and future challenges.

This article reviews the evolution of federal farm legislation and describes changes in agriculture and its linkages to the rest of the economy. It then outlines a number of policy objectives that are important for the environment in which agriculture will operate. Finally, program directions consistent with these policy objectives are suggested.¹

¹ Federal dairy and tobacco programs are not included in this discussion. Although these programs are important, a full discussion of them is outside the scope of this article.
History of farm policies

Agricultural policy objectives have evolved over the past 50 years as conditions in agriculture and the national and international economies have changed. The objectives of higher farm prices, higher farm income, soil conservation, and secure and adequate food supplies have driven U.S. agricultural policy.

The shape of farm policies and programs was determined in the aftermath of World War I and the Depression of the 1930s. After World War I, farmers were faced with falling farm prices, falling land values, a sharp decline in agricultural exports, and an inability to obtain suitable credit. By 1932, farm product prices were less than one-third of their 1919 level, largely the result of export sales that declined to 40 percent of wartime levels. Land values followed farm product prices downward, declining by half. Short-term credit adapted to farm production cycles and fully amortized long-term credit were generally unavailable, exacerbating the sector’s cash flow problems.

Although various farm programs were developed and passed by Congress in the 1920s, most were vetoed by Presidents Coolidge and Hoover. A consistent objective of these programs was to raise the prices of farm products above market clearing levels, through a variety of supply-reducing and price-supporting actions. Higher prices for farm products meant increased purchasing power for the farm sector, which accounted for 25 percent of the country’s population in 1930. The total rural population, which could also expect to benefit from more money in the hands of farmers, was 44 percent of U.S. population in 1930.

The Agricultural Adjustment Act of 1933 was the nation’s first comprehensive farm program and the first major New Deal legislation directed at agriculture. Its goal was to raise prices by limiting market supplies. Mandatory production controls for basic crops and federal surplus disposal programs were the tools. The Commodity Credit Corporation (CCC)—created that same year by Executive Order—made loans to farmers on their crops. Loan levels were generally set above market rates and loan maturities were set so farmers could hold their crops until prices improved. But the mandatory production controls, an essential part of the program, were declared unconstitutional by the U.S. Supreme Court and discontinued in early 1936.

New legislation passed later in 1936 sought to increase farm income, promote soil conservation and the profitable use of agricultural resources, and ensure adequate supplies for consumers. Payments for soil conservation activities were authorized. Acreage allotments for certain crops were later imposed, along with voluntary acreage set-aside programs to constrain production. These acreage reduction programs were generally not effective. By the end of the decade, the CCC was holding large stocks of major farm commodities.

With the onset of World War II, the thrust of farm programs shifted from restricting supplies to increasing production. CCC loan levels were set high enough to encourage full use of agricultural resources. Food aid to wartime allies markedly increased demand for farm products. When the war ended, legislation extended high CCC loan levels in an effort to avoid repeating the disastrous decline in farm prices and income that followed World War I.

1 The loan level is the value per unit of product that a farmer receives as a loan from the CCC. For example, if the wheat loan level is $1.50 a bushel, a farmer can receive a loan of $900 from the CCC by designating 600 bushels of wheat as loan collateral. At the loan’s maturity, a farmer can pay it off along with accrued interest, or under the nonrecourse option, surrender the collateral to the CCC in full settlement of the loan.
Flexibility in setting CCC loan levels was finally authorized following the Korean War, but only after stocks of major crops had grown extremely burdensome.\(^1\)

A series of major policy changes in the 1950s began with the Agricultural Trade and Assistance Act (Public Law 480), enacted to encourage the shipment of surplus commodities in exchange for foreign currency and strategic materials and for purposes of emergency relief. The PL 480 program became a major mechanism for disposing of surpluses and developing markets. It continues so today. To reduce agricultural production, a major multiyear acreage diversion program, the Soil Bank, was enacted. The program, in existence from 1956 to 1975, at its peak removed 58 million acres from production.

Domestic food distribution programs received increased emphasis in the early 1960s. A pilot food stamp program began, the school lunch program was expanded, and international programs were improved.\(^4\) Despite the best efforts of policymakers, agricultural products remained in abundance and farm prices under downward pressure.

A surge in export demand in the early 1970s—fueled by large sales to the USSR—combined with crop shortfalls in major producing countries to cause an abrupt turnaround in the crop supply-demand situation. Surplus stocks were quickly exhausted and crop prices soared. Livestock producers faced much higher feed costs, and consumers faced sharply higher food prices. But high world crop prices spurred increased production both here and abroad, and by the late 1970s, grain stocks were again becoming burdensome.

A series of measures were enacted in the late 1970s and early 1980s to support farm product prices and income at the higher levels farmers had become accustomed to during the export boom. A target price program was introduced that provided direct subsidies to producers if major crop prices fell below what was deemed a “fair” price. A reserve program insured large quantities of CCC grain from the market, to be released when market prices rose substantially. This program had perverse impacts—it provided price incentives for farmers to increase production and tended to price their crops out of the market, leaving huge crop surpluses. Government emergency lending programs to farmers added substantially to farm program costs during this period.

As a result of huge crop accumulation and declining export sales, an unprecedented program to reduce the acreage of certain major crops was announced in 1983. The Payment-In-Kind (PIK) program gave CCC crop stocks to farmers as payment for diverting crop land to conserving uses. A total of 77 million acres was idled under PIK and voluntary acreage retirement programs, driving farm program costs to their highest level ever.

Throughout its history, government policy toward agriculture has been concerned primarily with problems resulting from overproduction. For most of the post-World War II period, government farm programs have idled crop acres to alleviate overproduction (Chart 1). Thus, policy and programs have been directed at limiting what was incorrectly thought to be only temporary excess farm capacity. They also have been directed at lim-

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\(^1\) When flexibility in CCC loan levels was adopted in 1954, U.S. wheat supplies amounted to two years of total domestic and export use. Corn supplies amounted to a year and a half of domestic and export use.

\(^4\) Food distribution programs actually began as part of Roosevelt-era farm legislation. A short-lived food stamp program, the school lunch program, and a milk distribution program were developed. For a fuller discussion, see Murray R. Benedict, *Farm Policies of the United States, 1790-1950*, The Twentieth Century Fund, New York, 1953, ch. 15.
CHART 1
Acreage idled under government programs

*No acres were idled under government programs in these years.* Source: Congressional Budget Office.

...iting farm income volatility, raising income to levels consistent with the rest of society, and protecting the future productive capacity of U.S. agriculture through soil conservation programs.

Historically, farm policy has been enacted as though the United States was a closed economy. Nevertheless, farmers and the general public were reasonably well served as long as the taxpayer costs of income transfer programs to farmers were not excessive and export markets were relatively unimportant. However, government efforts to insulate farmers from sagging world market demand and falling prices have become extremely expensive in the 1980s.

A changing environment

The number of groups with a special interest in agriculture has proliferated in recent years. New policy participants, such as taxpayer and consumer groups, commodity groups, and agribusinesses, are all becoming more active in the policy process. Moreover, the structure of agriculture has changed, as has its relationship to world markets. Broader economic conditions, as well as conditions within agriculture itself, affect the performance of the sector.

Policy participants

High farm program costs have caused taxpayer groups to question the budget priorities of the U.S. Department of Agriculture (USDA), as well as the efficiency and equity of its farm income support programs. Costs of such programs have soared in recent years, from an average of $3.5 billion a year in the
1970s to an all-time high of $20.6 billion in 1983.

Consumer groups have introduced a series of legislative initiatives in recent years, such as food stamps and child nutrition programs, that are concerned primarily with providing adequate food for the disadvantaged. Consumer groups became involved by trying to limit increases in food prices. As they became more knowledgeable, however, they also made their positions known on a broad range of food safety and efficiency issues. Despite farmer concerns about the appropriate role for such groups in developing agricultural policy, taxpayer and consumer groups remain part of the policy process.

Farm commodity groups have changed the way producers interact with policymakers and influence agricultural legislation. In the past, farmers exerted their influence through such general farm organizations as the Grange, the American Farm Bureau Federation, and the National Farmers Union. These organizations, each with a broad based farm constituency but with different approaches to policy, developed comprehensive farm policy and program proposals. There tended to be internal consistency in the proposals. However, the process no longer works that way.

Today, commodity groups as diverse as the American Soybean Association and the Wine Institute develop policy and program proposals of particular benefit to their members. Moreover, as these groups’ influence on public policy has increased, the influence of general farm organizations has waned. Agricultural policy and programs that emerge from this process frequently contain internal inconsistencies and contradictions that limit their overall effectiveness and tend to increase their cost. Thus, it is more difficult to produce forward looking legislation. And, in the balancing of conflicts and divergent views, the status quo tends to predominate.

In the past decade or so, agribusiness has emerged as an even more significant part of the agricultural sector. This is due to the increasing sophistication of technology used in agriculture and the growing specialization in agricultural production and processing. Purchased farm inputs now account for about 55 percent of total inputs into farm production, as compared with only about 44 percent in 1950. As farmers have become more dependent on purchased inputs for agricultural production, a complex input supply system has emerged. On the product side of the farm, processors, transporters, and marketers have grown in number and importance to serve a more geographically dispersed and sophisticated customer base.

Agricultural production accounts directly for 2.4 percent of the nation’s nominal GNP and employs 2.7 percent of its labor force. When broadly defined to include agribusiness, however, the agricultural sector is far more important, accounting for 20 percent of the nation’s nominal GNP and employing 23 percent of its labor force. Thus, the nation’s agribusiness sector is not only important for its ability to support production agriculture, but it also is of major importance in its own right. Agribusiness, dependent on growing farm product markets and a healthy farm economy for its own wellbeing, can be expected to exert an increasing influence in agricultural policy formation.

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5 Agribusinesses include both firms providing inputs to farmers and firms processing and marketing farm products.


Farm structure

The structure of farming has changed markedly in recent years. It is no longer appropriate to formulate policy and programs to meet the perceived needs of a typical family farm. Farming has become too diverse for that approach to be effective. The idealized family farm, a concept referred to by the press, praised by political leaders, and strongly supported by farmers, rarely exists today due to concentration and specialization in production. Indeed, three different groupings of farms have emerged—each with its own policy needs.

Of the nation's 2.4 million farms, 1.7 million have annual sales of less than $40,000. These operations are too small to provide an adequate family living. They are usually part-time farmers with income largely from non-farm sources. This group represented 71 percent of all farms in 1982, but produced only 16.6 percent of gross farm returns and overall had losses from farm operations (Table 1). Yet their annual net income per family was only slightly less than $18,000. Federal farm programs have little effect on these farmers' production decisions and income. Much more important are broader economic policies, infrastructure investment, rural development, and job training.

At the other end of the spectrum are commercial-size farms with annual sales of $100,000 or more. These 298,000 farms, representing only 12.3 percent of all farms in 1982, produced 64.3 percent of the sector's gross income and earned almost 95 percent of net farm income. Net family income per farm in this group ranged from well above U.S. median family income ($23,400 in 1982) to nearly $600,000 for the largest 1 percent of farms. Generally, this group of farms has more than achieved income equity with other Americans, but they have problems with income instability—a matter of growing concern for agricultural policymakers.

Somewhat fewer than 400,000 farms fell into the $40,000 to $99,999 sales class in 1982. These farms accounted for 16.4 percent of all farms and 19.1 percent of the gross income of the sector, but they earned only 9.1 percent of net farm income and had net family income per farm of $16,200, well below the median family income. In many respects, these farms are in transition. To provide an adequate income, the farms will either grow larger or be operated part time. Those who operate these farms appear to have more income problems than other farmers and share the income instability problem with larger farms.

A single policy prescription will not meet the legitimate needs of all farmers. Indeed, size is not the only differentiating characteristic. Different types of farmers have different policy needs. Livestock producers want ready supplies of feedstuffs at low and stable prices. Crop producers want the opportunity for upward escalation in crop prices. Producers for domestic markets want product prices that reflect U.S. price levels; producers for export markets are more concerned about world market competitiveness. Thus, it will not be easy to develop policy objectives and programs that reflect the differing needs within the farm sector, as well as the legitimate interests of non-farm groups.

World marketplace

Agricultural policy is further complicated by the world market in which U.S. farmers compete. Competition has increased sharply in recent years as a number of countries that previously imported food have become major food exporters. For example, Argentina, Brazil, and the European Economic Community
<table>
<thead>
<tr>
<th>Farms with annual sales of:</th>
<th>Thousands of farms</th>
<th>Gross farm income* (billions of dollars)</th>
<th>Net farm income* (billions of dollars)</th>
<th>Net family income per farm (dollars)</th>
<th>Net worth per farm† (dollars)</th>
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<td>$500,000 and above</td>
<td>25</td>
<td>45.6</td>
<td>14.3</td>
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<td>$100,000 and above</td>
<td>298</td>
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<td>22.7</td>
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<td>$40,000 - 99,999</td>
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<td>$20,000 - 39,999</td>
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<td>310,300</td>
</tr>
</tbody>
</table>

*Before inventory adjustment.
†As of January 1, 1983.
Source: U.S. Department of Agriculture, Economic Indicators of the Farm Sector, 1982.

all now compete head to head with U.S. farmers in world feed grain, oilseed, and wheat markets and will do so for the foreseeable future.

Export markets have become increasingly important to U.S. farmers as output has increased due to productivity gains and additional resources being brought into the sector. Total factor productivity in U.S. farming has grown at an annual rate of 1.75 percent over the post-World War II period. Agricultural economists foresee no slower rates of productivity growth over the rest of this century—and perhaps more rapid rates. Additionally, a great deal of new capital investment has occurred as farmers added equipment and farming practices embodying new technology. At the same time, the domestic market for farm products has become increasingly mature. Changing lifestyles, an aging population, and slowing population growth rates all point to slower growth in demand for food.

Exported crop production has increased from about 15 percent of harvested acres in 1950 to 32 percent in 1982. Export sales grew rapidly in the 1970s to meet the demands of a growing world market. For a number of major crops, the U.S. share of world trade also has grown. Unfortunately, tonnage of U.S. agricultural exports has been declining since fiscal 1980 (Chart 2), and the U.S. market share for major grain crops has declined from the

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heights reached in marketing year 1979. Exports, according to the USDA, now appear likely to grow at a rate of about 3 to 3.5 percent a year for the next four years, compared with 8 percent in the 1970s and 2.5 to 3 percent in the 1950s. U.S. market share, while lower than it was during the 1970s, seems likely to remain relatively favorable.

These developments all highlight the increasing importance of exports in policy deliberations. A return to growing U.S. export tonnage is important if the nation’s farm sector and its agribusiness sector are to prosper in the years ahead.

Broader economic policies

Agriculture’s strengthening linkages to the U.S. economy and to international markets mean broader economic policies are more important to the nation’s farmers and agribusinesses than ever before. Monetary and fiscal policies may be more important in determining the U.S. agricultural sector’s domestic performance and international competitiveness than narrowly defined farm policies.

Macroeconomic policies determine the frame of reference in which business activity occurs. These policies constrain or promote domestic economic growth, affecting demand at home for agricultural products. These policies also affect price stability and, as a result, the rate of change in agricultural production.
and marketing costs. Monetary and fiscal policies interact to determine the cost of carrying debt, to help determine the value of the dollar in foreign exchange markets, and to influence the terms of international trade. The large current federal budget deficits, and concern in financial markets over future financing of deficits, have served to hold up both interest rates and the trade weighted value of the dollar. That, in turn, has added to the cost of carrying the $215 billion of farm sector debt. The competitiveness of U.S. farm products in international markets has been impaired, as well.

Tax policies are particularly important to agriculture, which is both highly capital-intensive and an industry where investments are locked in place for long periods. Cash accounting, instead of accrual accounting, accelerated depreciation, tax credits, opportunities to convert ordinary income to capital gains for tax purposes, and inheritance tax laws are all immensely important in guiding agricultural investment and management decisions. Relatively favorable tax treatment for profits from agriculture has encouraged capital investment in the sector and added to excess capacity.

Because of the wide-ranging effects macroeconomic policies have on agriculture, it is highly important that these policies be appropriate. It is unlikely that specially targeted farm programs can overcome the adverse effects of unbalanced or unwise macroeconomic policy.

**Economic conditions in agriculture**

The economic health of the agricultural sector will undoubtedly complicate agricultural policymaking. Since passage of the 1981 agricultural legislation, the sector has been continuously buffeted by both cyclical and secular forces. Agriculture has suffered from the recent worldwide recession, which has adversely affected demand for farm products. Agriculture has recovered later and more slowly than the U.S. economy as a whole. It also has had to undergo the economic adjustments accompanying the downside of the 1970s export boom. As a result, farm export performance has been disappointing and farm asset values continue under downward pressure.

Secular changes are occurring as well. Continued productivity gains from technological innovation in agriculture mean growing capacity for the industry. Those innovations are fungible and quickly adopted by competitors overseas. U.S. agriculture also has a growing dependence on foreign markets, and is in the midst of adjustment to competition in worldwide food and fiber markets. That process has brought adjustments and uncertainties to the sector.

It now seems likely that new agricultural legislation will be written while the sector is plagued by excess capacity, weak crop prices, disappointing demand for farm exports, farm income pressures, and significant farm financial stress. Such an environment could bias Congress toward short-term, quick-fix farm policy decisions that prop up farm product prices and impede adjustment to market realities. A more forward looking approach to new agricultural legislation is needed—one responsive to changing conditions.\(^\text{10}\)

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\(^{10}\) Some voices, primarily from outside agriculture, assert the sector should stand on its own with no government assistance or intervention, succeeding or failing on its own merits. Those preferring this approach think agriculture is nearly alone in receiving government assistance and that agriculture, having become just like any other business, should be treated as such. However, there are myriad government programs providing assistance and protection to nonfarm sectors.
Policy objectives

As a first step in developing agricultural legislation, it is useful to identify a few policy objectives as guideposts. To do so is both more difficult and more important than it may seem at first. Setting objectives is difficult, because it requires decisions about the kind of agriculture the country should develop and an understanding of the forces shaping agriculture. Policy had specific objectives when the first federal farm legislation was developed, but some of these objectives have become less relevant in recent years. Thus, new objectives are needed, even as traditional ones continue to be important. Clearly defined objectives are important, because without them programs tend to lose direction and eventually work at cross purposes. Some of agriculture's current problems likely result from programs driving policy, rather than policy defining programs.

Objectives of continuing importance

Some objectives continue to be important to agricultural policymakers. These include an ensured food supply at reasonable cost, continued productive capacity of U.S. agriculture, income equity, and limiting federal budget exposure.

A safe and adequate supply of food. Ensuring a safe and adequate supply of reasonably priced food for U.S. consumers remains an important policy objective. While farmers may question whether reasonable prices are “fair prices,” they nonetheless understand this objective. For more than a century, Congress has funded research—and more recently regulatory programs—to ensure food safety and promote a series of technological breakthroughs that has enhanced agricultural productivity. Partly because of this public investment, U.S. consumers spend less of their income for food (16 percent) than people anywhere else in the world.¹¹

The federal government also provides food aid to economically disadvantaged Americans.¹² In fiscal 1985, an estimated 20 million people will receive food stamps. An estimated $11.6 billion will be spent on this program, along with another $5.5 billion for child nutrition and other food programs.

Program costs. Limiting farm program budget exposure, while not a new objective, has recently become much more important. Budget outlays for agriculture have escalated sharply since 1980 (Chart 3). But because of historically large federal budget deficits, agricultural program budgets now seem likely to be reduced. This is not necessarily bad. Budget constraints force a reevaluation of current and prospective programs. That reevaluation could result in reduced support for annual acreage retirement and income transfer aspects of farm programs and more emphasis on market development and economic adjustment.

Productive capacity of agriculture. Another objective of agricultural policy is to ensure continued productive capacity, an objective

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supported by both farmers and nonfarmers. It implies long-term programs for soil conservation and land reclamation. It also may imply public funding to remove some of the nation's more fragile crop land from production, returning it to a conservation use. While the general public will likely continue supporting conservation practices with cost-share funding, they may increasingly insist that the practices be more permanent, that farmers bear more of the cost, and that there be some recapture of public investment if the conservation practices are discontinued. Farmers and other users might also be asked to share in the cost of reclamation and irrigation projects—perhaps up front.

This objective also implies continued public support for agricultural research. Agriculture has become a major high technology industry that depends heavily on advances in biochemistry, genetics, plant and animal nutrition, mechanical engineering, processing technologies, and information transfer and processing. To maintain a competitive edge, even more rapid development and adoption of new technologies will be required. Consequently, increased public investment in basic agricultural research and technology transfer to producers and agribusiness is warranted.

Income equity. The objective of income equity is valid for the agricultural sector only under a markedly constrained definition. Commercial farmers and most part-time farmers have largely achieved income equity with other Americans. It remains a relevant public policy concern for the rural poor and middle-size farmers that are too big to be part-time operators and too small to be full-time com-
mercial farmers.

Perhaps the best way to address rural poverty and most other problems of part-time farmers is by improving the economic performance of the general economy, and through rural development, infrastructure, and job training programs. However, to further an income equity objective, full-time farms in the middle-size sales class may require continuing income support. Since their numbers are limited, that might be provided at a reasonable cost to government. Moreover, small and middle-size farms are probably the most appropriate recipients of Farmers Home Administration (FmHA) credit programs.

Farmers often object to an income equity criterion, preferring to compare current income with that of a previous year of favorable income. But taxpayers have become increasingly dissatisfied that the bulk of income transfers to agriculture go to only a small proportion of farmers—who typically have family incomes well above the U.S. median family income. Thus, where publicly financed income transfer programs are involved, income equity with other Americans may be a more reasonable—and more attainable—policy objective.

**Objectives of growing importance**

Other policy objectives are of increasing importance if public policy is to promote a strong and growing agricultural sector. These objectives relate to full use of resources, export market growth, sector adjustments, and income instability.

**Full use of resources.** Promoting reasonably full use of the nation's agricultural capacity is one such objective. The United States has been able to seize market opportunities—domestic and export—because of the growth and vigor of its farms and agribusinesses. Profitable production levels are necessary to retain those characteristics. Particularly in the case of agribusinesses, a lack of profits could cause capacity to wither, limiting the nation's response to new export market opportunities. Reasonably full use of agricultural resources benefits farmers and agribusinessmen and strengthens the whole U.S. economy.

**Growth in export markets.** The objective of export market growth is closely related to full use of resources. Because the domestic economy is relatively mature, growth in exports appears critical to achieving reasonably full use of the nation's agricultural resources. If agricultural output increases an average of 2 percent or more a year—as many suggest it could—increased export market growth will be needed to avoid growing excess capacity.

Fortunately, export market opportunities will arise as world population and income levels increase. As the economies of developing countries grow, they will likely import more of their total consumption of basic food staples. In the mid-1960s, developing countries imported about 1.5 percent of their consumption of total basic food staples. By the 1970s, the proportion had risen to 5 percent. Extrapolating that trend could mean as much as 8.5 percent of their consumption imported by the year 2000, representing net imports of about 80 million tons of basic food staples. Market opportunities could be particularly bright in the emerging middle-income countries of Southeast Asia and Central and South America.

Expansion of agricultural export markets provides the United States with potential growth in both farm and nonfarm employ-

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13 Remarks by Dr. John Mellor, director of the International Food Policy Research Institute, Washington, before the spring meeting of the Food and Agriculture Committee of the National Planning Association, April 3, 1984.
ment. For example, USDA estimates that each billion dollars of export sales creates 33,000 U.S. jobs, 54 percent of them off the farm. That same amount of exports adds about $1.2 billion to total U.S. income. Moreover, export sales are an important source of foreign exchange. Farm exports are expected to total $38 billion this fiscal year (Chart 4). That will be 18 percent of all U.S. export earnings, a matter of no small consequence in an era of historically high trade deficits. Programs to achieve export growth need to focus on international economic development, market development, value-added exports, trade financing, and—importantly—price competitiveness for U.S. agricultural products.  

**Structural adjustment.** A necessary objective for farm policy is to facilitate the adjustment of agriculture to changing technology, economic conditions, and markets. The competitive structure of agriculture, coupled with a steady infusion of new cost-reducing and output-increasing technology, has meant that agriculture is among the U.S. economy's most dynamic sectors. Previous policies have too often impeded sector adjustments. Policies that stand in the way of orderly adjustment have been costly and ineffective for taxpayers—and ultimately for farmers.

Technological innovation and competition in the world market can be expected to change the agricultural sector greatly in the years ahead. Structural changes that led to increased farm size have already made the "family farm" ideal held by most Americans nearly obsolete. Increasing concentration also is occurring among firms supplying agricultural inputs and marketing farm products.

The day of easy entry and ready success in full-time commercial farming is probably past. Soon it may no longer be realistic to purchase and pay for a farm in a lifetime. Commercial farming has become big business—albeit still firmly in the hands of families, often more than one generation—and is rapidly becoming even bigger. Dealing with such a dynamic industry suggests the need for greater reliance on market forces to allocate resources and reward success in commercial agriculture.

**Instability.** Assistance in managing instability in agriculture is an objective of growing importance. The problem affects all U.S. business, especially firms dependent on export markets. As farmers depend more on purchased inputs and export markets, changes in market supply and demand have greater financial impact and can occur more often. Managing instability is a major problem for commercial farms—and, to less extent, for middle-size farms. Market instability also has a major effect on agribusiness, disrupting expected demand for farm inputs and causing abrupt changes in the volume of products processed, transported, and marketed.

Development of risk management opportunities—such as revenue or production insurance, or the use of commodity futures and options contracts—might offer some long-term solutions to instability. A strategic grain reserve of limited size could also improve stability. Recent history indicates, however, how difficult it is to resist using a grain reserve as an income support device. A well designed and administered multi-year land retirement program that removes land from production in years of excess supply and returns it in periods of supply shortfalls—an elastic crop land base—could also add stability.

Policy and programs to help manage insta-

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15 Value added exports of agricultural products are those to which processing has added value beyond that of the raw agricultural product. Examples are flour exports instead of wheat and meat products instead of livestock and feed grain.
bility must distinguish between cyclical instability and secular change. While it may be desirable to help the agricultural sector manage cyclical instability, it would be equally undesirable to prevent secular adjustment. To do so would be inordinately expensive for taxpayers, damage the competitive position of U.S. agriculture, and ultimately result in greater adjustment costs for farmers and agribusinesses. Assisting in an orderly adjustment may be the most that public policy should undertake.

The policy objectives presented here are not an exhaustive set. However, these objectives are important as policymakers deliberate new agricultural legislation. Moreover, these objectives point to a change in direction for legislation. The new legislation must recognize the impact of rapidly evolving technology, the changing structure of farming and agribusiness, increased farm linkages with agribusiness and the rest of the U.S. economy, and the importance of world markets.

Even then, not all policy objectives will be fully achieved. Instead, priorities and weights for the various policy objectives will be determined through the political process. Nonetheless, if legislation aims at achieving the objectives discussed, emphasis will shift from income transfer and price support programs to market development, limited adjustment assistance, and greater market orientation.

Program directions

Although it is beyond the scope of this
article to lay out a comprehensive and consistent set of farm programs, the policy objectives discussed imply some broad program directions. It is important that federal agricultural programs not work at cross purposes and that they move to achieve the policy objectives previously discussed. These criteria suggest the following program directions.

For objectives of continuing importance

Some type of income support for farmers, such as the target price program, appears likely to continue for a long time. However, if funding is to be available for more productive activities, such as market development, income support programs should be carefully targeted to farmers in need of assistance. Moreover, where income support is deemed necessary, direct payments to farmers may be the most cost-effective way to deliver that support. For both equity and efficiency reasons, an upper limit on the amount of government subsidies paid to any one farmer is needed. Currently, that limit is $55,000 a year.

A strategic reserve of major storable crops is likely to be part of any agricultural legislation. Both export customers and U.S. consumers want assurance of continued supply and some limited protection against food price shocks. A Farmer-Owned Reserve program of limited size and with realistic entry and removal prices would meet those needs.16

U.S. farmers increased harvested crop acreage from 290 million acres in the late 1960s to 365 million in 1982. That increase contributes to excess production. Moreover, some of it is erosion prone and not well suited to intensive crop production. Thus, it seems appropriate to retire as much as 30 million acres of such crop land to conserving uses for a multi-year period. Such a program also would provide an elastic crop land base that adjusts to market demand and would help avoid abrupt, large, and disruptive one-year acreage adjustment programs. Annual acreage adjustment programs of limited size appear likely to continue. Finally, it is unwise, in a time of excess production capacity, to provide subsidies—perhaps even CCC commodity loans—to producers converting range or forest land to crop land.

Competitive pressures in world agriculture highlight the need for continued technological innovation to lower production costs and increase output. Strong government support of basic agricultural research is needed to help ensure continued success for agriculture.

For objectives of growing importance

Several major agricultural products have not been competitively priced recently, perhaps as a result of arbitrarily determined CCC commodity loan levels. Yet price competitiveness is increasingly important in international markets. To regain a competitive edge, loan levels for major export crops should be set at or below world market clearing prices and adjusted annually on the basis of a multi-year moving average of such prices. Care must be taken to avoid creating artificial differences in relative crop prices.

Changes in CCC commodity loan programs that would redistribute program benefits have been suggested. One alternative is to make every producer of a CCC commodity eligible for CCC loans, regardless of whether a producer conforms to the current farm program. Such a change would require that CCC loan levels be low enough to avoid borrower

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16 Under the Farmer-Owned Reserve program, a farmer commits grain under CCC loan for a specific number of years. The grain can be released early if the farmer repays the loan plus a penalty payment or if market prices rise to a specified level, in which case no penalty payment is required.
defaults and stocks buildup. It might also require the use of recourse rather than nonrecourse loans. Another suggestion is to vary CCC loan levels to direct greater support to small and middle-size farms. These changes, however, would be controversial.

Given the importance of export markets, a much higher priority should be given to long-term market development programs. More creative financing and marketing arrangements should be developed to assist export customers in purchasing U.S. farm products. Such programs could include intermediate and long-term credit arrangements by the CCC or the Export-Import Bank, along with longer term food aid commitments, programs for infrastructure development in customer countries, and greater use of counter trade. In particular, international economic development programs could be important long-range market development mechanisms in the future, as they were in the past.

The success of agricultural export market development will be affected by a number of factors. The broader economic policies and international relationships of the United States must be conducive to trade growth. Also, the United States needs to be viewed as a reliable supplier. The current spread of trade protectionism needs to be reversed—a need that implies the United States may also have to lower its own import barriers for some products. Successful export market development will entail broad ranging, long-term commitments by both government and private firms.

Farmers likely will continue to call for federal programs to protect them against natural and market instability. Special attention should be given to improving the Federal Crop Insurance Program, implementing commodity options contracts, and developing revenue insurance programs that make use of futures and options markets. Emphasis on private sector development of such insurance or futures markets programs seems important to their political acceptability and their ultimate success. Public subsidies associated with these programs should be both limited and directed to farmers with the greatest need.

USDA farm credit programs remain popular among farmers. However, a tight rein on credit programs will be necessary. Some of those, such as the Economic Emergency Program, have poor track records. Administration of agricultural lending programs, other than CCC loans, should remain in the FmHA. It seems reasonable to target FmHA lending toward low-income farmers and new entrants into farming. Increased emphasis on loan guarantee arrangements with commercial lenders, rather than direct loans, would likely improve FmHA program performance.

To better achieve the objectives identified, the Secretary of Agriculture should be given more flexibility in administering programs. Although agriculture is a dynamic industry and becoming even more so, in recent years Congress has chosen to write much administrative detail into agricultural legislation, limiting the Secretary’s response to changing conditions.

Conclusion

Current federal farm programs were initiated a half century ago out of the problems associated with the aftermath of World War I and the Great Depression. While the programs have changed, they have largely remained rooted in the agriculture of the past. They do not deal effectively with the problems facing today’s agriculture and likely will do even less well for tomorrow’s agriculture.

Groups with a legitimate interest in agricultural policy are larger in number and have more diverse needs than before. No longer is
Congress dealing only with farm policy. More appropriately, it is food and fiber policy—agricultural policy in the broadest sense. But before Congress can design specific agricultural programs, it must identify the policy objectives these programs aim to achieve.

Policy objectives and programs must reflect agriculture's growing complexity and diversity. More attention should be given policies and programs that further export market growth, efficient and reasonably full use of agricultural resources, adjustment to change, and management of instability.

In the dynamic environment likely to characterize agriculture, increased reliance on market forces is appropriate. Moreover, greater discretionary authority in the administration of federal agricultural programs is preferable to more rigid prescriptions.