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Taxation

PROCEEDINGS

U.S. FARM AND TAX POLICIES SYMPOSIUM

April 10, 1985

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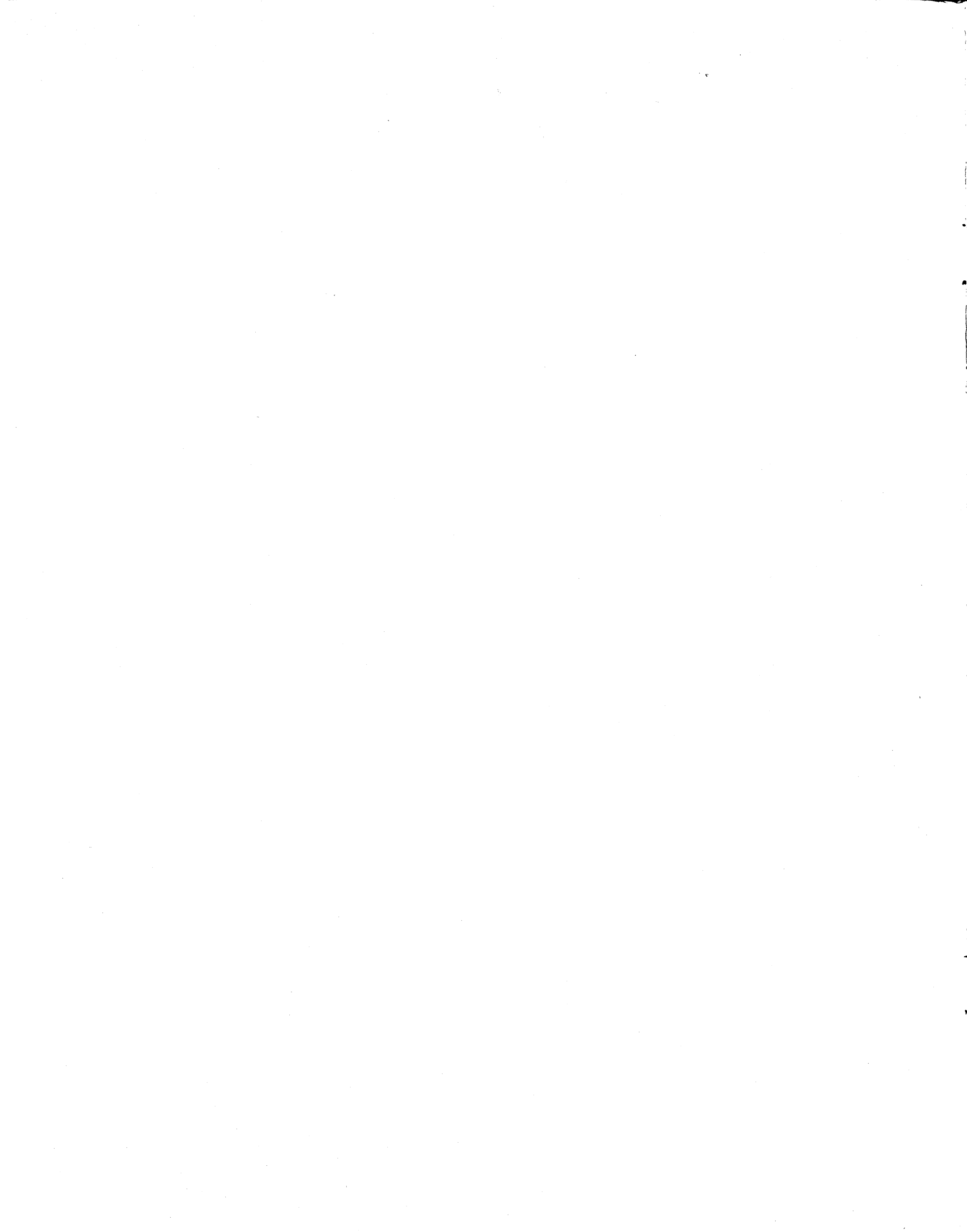

PREFACE

This proceedings of the symposium held on April 10, 1985 at Kottman Hall Auditorium at The Ohio State University contains the presentations made by Dr. Harold F. Breimyer and Dr. Neil E. Harl while they were Anderson Scholars in the Department of Agricultural Economics and Rural Sociology at The Ohio State University. Also included is an edited version of questions from the audience and Drs. Breimyer and Harl's responses to those questions. The symposium focused on some of the key issues pertaining to and impacts of U.S. tax and farm policies on the structure of U.S. agriculture and Third World hunger and demand.

Both Breimyer and Harl are distinguished professors and nationally recognized scholars of U.S. tax and farm policies. Dr. Breimyer is a native of Fort Recovery, Ohio, Professor Emeritus of the University of Missouri, a Fellow of the American Agricultural Economics Association, and Past-President of the American Agricultural Economics Association. Dr. Harl is a native of Iowa, Charles F. Curtiss Distinguished Professor of Economics at Iowa State University, Past-President of the American Agricultural Economics Association, and Past-President of the American Agricultural Law Association.

A grant from The Andersons of Maumee, Ohio made it possible to bring these two scholars to the Ohio State campus. The grant was provided by The Andersons to support scholarly activities which would enrich the scientific programs in the College of Agriculture at The Ohio State University.

- Joseph Havlicek, Jr.

U.S. TAX AND FARM POLICIES AND THEIR IMPACT ON THE STRUCTURE OF U.S. AGRICULTURE

by

Dr. Harold Breimyer

Introduction of Dr. Breimyer

Harold Breimyer is a native Buckeye. He was born in Fort Recovery, Ohio and raised in Mercer County. He attended OSU and received his Bachelor's and Master's there in 1934 and 1935 respectively. He studied at the University of California and received his Ph.D. degree from American University in Economics in 1960. He's had careers with the U.S. Department of Agriculture (1936-1966) as an Economist for the Agricultural Adjustment Administration, Outlook Economist for the Bureau of Agricultural Economics and Agricultural Marketing Service specializing in livestock outlook, and Staff Economist to the Administrator of the Agricultural Marketing Service. He was also Staff Economist for Agriculture on the Council of Economic Advisors and was Visiting Professor at the University of Illinois. In 1966, after logging those 30 years in the federal government, he became Professor of Agricultural Economics at the University of Missouri and on July 1, 1968, he became an Extension Economist as well. This last August he retired from the University of Missouri. He's had foreign experience including a tour of the Soviet Union as a member of the exchange delegation in 1958, he had brief periods working with the governments of Argentina (1961-62), Guatemala (1965), brief assignments with USAID in Peru (1967) and Colombia (1969), and an advisory role with the National Agricultural Research Institute of Spain (1974). He is the author of numerous bulletins, articles, speeches and of the following three books: Individual Freedom and the Economic Organization of Agriculture (1965), Economics of the Product Markets of Agriculture (1976) and Farm Policy: Thirteen Essays (1977). He has won three awards for best published journal article from the American Agricultural Economics Association (there's only one given per year). These awards are given for recognition of most outstanding contribution to the profession and to the topic of agricultural economics for that particular year. In 1968-69, he was President of the American Agricultural Economics Association and in 1973, the Association named him a Fellow. There are very few Fellows of the AAEA - at most, four per year, some years fewer; it's recognition of one's contributions throughout one's career. He's been a recipient of the University of Missouri's Thomas Jefferson Award and the Distinguished Faculty Award (both in 1983). Dr. Breimyer's areas of interest include marketing, price analysis and policy.

Dr. Havlicek, thank you for that almost complete introduction. You omitted one thing. That is the fact that I was given the Centennial Award of the College of Agriculture and Home Economics (here at OSU) in 1970. I'm proud of that. The plaque is on my wall.

My assigned topic is income tax and farm policy and the structure of agriculture, but I beg leave to reduce it to income tax policy. I do so for three reasons. One, the total topic is too long. Secondly, income tax has a great deal more meaning to structure of agriculture than the farm laws do. Thirdly, tax simplification or reform is now on the legislative agenda. It's a current topic. Therefore, I will confine myself to that.

Whenever a subject such as this comes up, we usually begin with two questions, classroom style. What do we mean by structure of agriculture? Does structure matter?

Structure of agriculture refers to the kind of business units of which agriculture is composed and the terms in which they operate. Here in the midwest we usually relate that to the idiom of the family farm. Then we ask, what's the family farm? Ordinarily the person who asks who is a family farmer is not one himself. The New York investment banker who spends $50,000 a year showing off his Charolais cattle to his guests -- he is not a family farmer. The California vegetable grower who employs 500 Hispanics, documented or undocumented, is not a family farmer. The family farm is defined primarily in terms of the multiple role of the farm operator who combines the roles of manager and worker and capitalist and owns at least some of the land. Furthermore, it's market oriented, and is an adequate unit. It is adequate for an acceptable living. I never use the term, small family farm. If it's small, it's part-time, less than family size.

What does it matter? I may as well reveal my stand in order to avoid anyone's guessing. I'm probably about as strong an advocate of the family farm as any person can be. I argue that there's really been no shortcoming in the performance record of our country's family farms. They have served the community and consumers very well. They present a nuisance in financing, though, as is exemplified in the current financial crisis. Also, family farmers aren't quite honest with themselves in admitting the public role in making it possible for the operator to be the owner.

In my judgment, the present financial crisis in much of agriculture is essentially a matter of terms of financing. We changed the terms between

the 1970's and the 1980's. In doing so, we have set in motion a stripping of $300 billion of asset values out of agriculture. The casualty rate is absolutely enormous, particularly farther west. By government decision, we have changed the terms of making finance capital available to agriculture, and the adjustment is extremely damaging.

Why do I and those of my age and background who share the same position look with favor on the family farm? I agree with my friend Philip Raup, University of Minnesota, that the family farm tends to be favored for the wrong reasons. I do not favor it on grounds that it's any more productive than some other kinds of agriculture. I do not contend that the family farmer is uniquely dedicated to conserving his soil. His record is not that good. I do not credit family farmers with exceptional Christian morality. I start from a different premise. Last weekend a distinguished Englishman, Sir Henry Plumb, opened a lecture by saying, "Agriculture doesn't begin with commodities; it begins with people." And with all respect to agricultural economists, the biggest mistake academicians make is to think that agriculture begins with commodities. It doesn't. It begins with human beings. All economic affairs begin with human beings. And so my defense of the family farm has to do with the status of the man on the land. It relates to whether the farm operator should enjoy the status that goes with owning at least a little of his land and being in charge of the operation.

I tell my classes that as the nation grows and population presses more on land, a higher percent of the total returns from agriculture will go to the land owning portion. Do we want to move toward a system in which the major part of the income goes to a distant, nonfunctioning landholder, creating a class society in the rural community, or don't we? In my judgment a highly class-stratified society is damaging to democratic values. If it comes about here, we will move toward the kind of structure now found in Latin America. In my judgment, the heart of the trouble in Latin America lies in the region's land system.

The heart of the family farm issue is the people part; in addition, the record of production has been good. But, my objective here is not to advocate, but to teach. Each person can take whatever stand he likes. Irrespective of one's individual stand, income tax policy has a bearing.

My message begins with the tremendously significant role of income tax in our national economic policy - not just in agriculture, but in the

economy as a whole. The public at large does not appreciate how clandestine, insidiously pervasive and powerful is our income tax code. People just don't understand what a multiheaded monster we have in our tax code.

In my classroom teaching I say that one of the features of agriculture today is that it is influenced more by policies that are not agricultural in nature than by farm policies as such. My economist friends agree: general policies have more influence in agriculture just now than farm policies do. Then I follow with my rank order in which I put monetary policy first, income tax policy second, and fiscal policy and the government deficit a distant third. In this ranking, I violate the conventional wisdom of our time. It's not that I play down the fiscal aspect; it's rather that I play up the tax and the monetary aspect.

Let me present my summary, showing where I'm going to come out. The income tax code is the biggest single longer-run influence on the structure of agriculture. If the code is not changed, within a generation or so all assets in agriculture will be held under tax shelter. The less sheltered investor in agriculture simply cannot compete with the highly sheltered one.

To be sure, this is not the only matter that's bearing on agriculture just now. I said above that the terms of financing are primarily involved in the rising rate of divestiture, forcing full time farmers out of agriculture. But even so, the tax code contributes, because anyone who depends on borrowed capital is in trouble, but the man who brings in his capital under a 50% tax shelter can stay very well. In fact, the sheltered investor may pick up the pieces as the family farmer disappears.

What is meant by sheltering? Sheltering refers to those aspects of the tax code that allow some departure from normal established business practices when the tax is calculated. It's a deduction, therefore a subsidy to the costs that are deductible. The deductions are often called loopholes.

The person who has a shelter and can deduct some of his costs from his income subject to tax has an advantage over the man who can't do that.

At this point, I admit a constraint. As Dr. Havlicek said, in Missouri I've been doing teaching and extension for about 18 years and for the last 15 years I've been pushing and beckoning and subtly bringing along leading Missouri farmers. I have carefully nudged here and there, to the point that after 15 years the vast majority of them realize that tax shelters are very damaging to a family farm agriculture. My problem here at Ohio State is

that I have had 15 years available there but only 20 minutes on this program. Furthermore, life expectancy being what it is, I might not have a second chance to persuade Ohioans. Hence, I don't have time to be subtle.

I go back to the insidiousnous of the tax code and tax shelters, which bothers me a great deal. We hear a lot of talk about the role of government. For the past few years everybody's been told that the role of government is being reduced. President Carter said that, and of course President Reagan is saying it in spades. In a prepared text, I just call it a falsehood. It just isn't so. What we've done is to reduce to some extent the amount of direct regulation but we have definitely increased the role of monetary policy, tax policy, and fiscal policy. And those are the great powers.

Or to put it differently, and to explain why I call the income tax underhanded, under-the-table, people don't seem to realize that tax deductions are a cost to the Treasury and to society. One of Dr. Harl's Iowa senators said that he wanted to make certain soil conservation practice costs were tax deductible because in that way, he explained, "we can get conservation with no cost to the government. "When we have that kind of psychology and misunderstanding, we can see why we've gotten ourselves into the position we are in on the tax code.

A word more about government, the role of government. We frequently say that government is too big, but I suggest to you that the proper criterion for judging government is not size, but its role and efficiency. The criterion that counts is not quantitative, but qualitative. It's the <u>kind</u> of government. Even though there is a problem associated with big government and big expenditures and so on, the bigger threat in big government is not where the money goes, but where it comes from -- who pays it, and who does <u>not</u> pay it. This is the point that is missed so often. Our tax code is riddled with loopholes. The system began rather innocently. I believe it began in agriculture with a special tax code for cooperatives. In any case, the big thrust forward came in the Roosevelt administration when the interest paid on home loans was made deductible. For 50 years we have continually added more deductions. But the really big increment was the ERTA of 1981 which added more than 120 new kinds of deductions. The best estimates I can find are that deductions or loopholes or shelters (however named) reduce our income tax revenue about $370 billion. In addition, the

very complexity of the tax code helps to induce falsification and nonpayment -- avoidance -- which is estimated at $130 billion. So if all American citizens were paying the nominal rate of our taxes, which a few of us do, the government revenue would be up by $500 billion. That is two and one half times the deficit.

It is not necessary to elaborate. The meaning is clear. The situation is so damaging that a number of critics are saying it is going to collapse. Even some of my more liberal friends say that the only thing to do now is just give up the income tax entirely and go to a national sales tax or value added tax, which to me is the old line of throwing out the baby with the bath. I would argue that a good income tax is the most civilized way by which citizens can support their government. It would be a major mistake if we were to lose it.

As can be anticipated, I am very much in favor of the proposal of former Treasury Secretary Regan (now Chief of Staff) for tax "simplification" or reform. I hope it gets serious consideration. But it's going to have a rough road for enactment. I cannot be optimistic. If I may be permitted one bit of satire and even cynicism, all the professed believers in an open competitive market enterprise economy who have benefitted from tax avoidance are going to hurry to Washington where they will spend millions of dollars to make sure they keep the goodies coming to them.

As a matter of fact, political loyalties and identifications and ideologies are all mixed up these days. It's difficult to know who a liberal and a conservative is anymore. I do know that one of the biggest nests of rightists is the big California farmers who are getting free irrigation water. They would call it socialistic to ask them to pay for water, whereas most of us think it's socialistic when they don't pay. That's how mixed the situation is now.

Agriculture has a great many shelters. One is investment tax credit, but a deduction from the calculated tax is not the major concern. Much more significant are the many deductions from income subject to tax, because in this second category of deductions the benefit is proportional to tax bracket.

The principle is really that simple, but the particulars in the tax code are infinitely complex. They keep Dr. Harl's lawyer friends busy. It's a profitable undertaking, because what it amounts to is that one of the most

effective ways to run one's business is to read the fine print and find a line that promises a tax advantage over competitors. It makes reading the fine print a major factor in the competitive position of various businesses. I saw recently the finding of a poll indicating that a high percentage of Americans say they are fed up with the complexity and the subterfuge of the present income tax.

The most significant feature of the code is that an expenditure that can be deducted from income tax subject to tax is of advantage according to the tax bracket of the payer. In my extension teaching in Missouri I use interest payments as an example. Any investor in the 50% bracket who borrows money for his farming operation and is paying 14% to the bank is only paying 7% because the IRS pays the other 7%. On the other hand, we have many farmers in Missouri who've had some bad crop years and have no tax obligation. They pay 14%. The 14% interest payer cannot compete very long with the 7% one. It's no more complicated than that.

Agriculture has become a huge tax shelter. Data came out recently reporting that the income the Treasury loses by virtue of shelters in farming is almost twice the amount actually paid. The Treasury would be better off if there were neither taxes nor shelters in agriculture.

Agriculture is an attractive tax shelter, and aside from how it affects one farmer versus another depending upon his tax bracket, it has been a major source of new capital to agriculture in recent years. It therefore is accountable for a considerable part of the overproduction. So not only does sheltered capital crowd out the unsheltered man on the land, but it also adds to total output, reducing price and income and giving the established farmer a double whammy. The pattern, of course, varies by enterprise. For the more stable midwest crops such as wheat and corn it isn't so much a factor. It's more of a factor in some of the specialty crops, in cattle production and feeding, and a number of other enterprises. I conclude these remarks by quoting the scolding I've been directing at Missouri farmers. I've been explaining to them the irony that this particular government policy that is such a threat to the continuation of traditional agriculture was asked for by family farmers themselves. I've been giving this talk for a long time under the heading "Farming's Non-Instinct for Self-Preservation." The individual farmer, preoccupied with his own balance sheet, can't see how the economics of his business or any other business affects the

survivability of the industry of which he is a part. That is to say, what looks good to farmers individually will kill them collectively. The reason is that the average sized farmer gets a small break by his tax deductions, but his big competitor gets a big break from the tax code and the one who gets a small break cannot survive indefinitely against the one who gets a big break.

My students know that in the classroom I treat the principle under the heading, "fallacy of composition." What looks good to the individual in the short run may not be good for the group in the long run and may eventually feed back and be damaging to the individual himself in the longer term future. It is a very important aspect of policy for agriculture.

Probably the biggest mistake a farmer makes is to think of any policy in terms of how it affects him, and to fail to consider that what really counts is how it affects agriculture, the agriculture of which he is a part. Individual farmers, of course, even now, are affected variously. But I'm addressing policy for agriculture, for all farmers. I'm talking about the structure of agriculture, not how a given feature of policy affects each individual. I'm talking about how any policy bears on the kind of farming and farm community we will have in the longer run future. And tax policy is near the top among policies that have influence on our collective future.

As I said earlier, although I am pro-family-farm, the principle I am expressing is, I hope, accurate irrespective of one's own preferences. A person may not care. Each person has his own value system. All I'm saying with some emphasis is that there is a connection between income tax policy and the future make-up of U.S. agriculture. More than that, the overall policy is not confined to agriculture; and we all are citizens, too. I tell a Missouri farmer, "you're a citizen first, and a farmer second." He is an American first and a Missouri farmer second. A farmer in Ohio is an Ohio farmer second. The tax code is so selectively preferential, so loaded with goodies to the favored few, that I call it a contradiction to the very principles of democracy and a threat to keeping that system of government, even in the United States of America.

U.S. TAX AND FARM POLICIES AND THEIR IMPACT ON THIRD WORLD HUNGER AND DEMAND

by

Dr. Neil E. Harl

Introduction of Dr. Harl

Dr. Harl is a native of the state of Iowa. He received his Bachelor of Science degree from Iowa State, a Juris Doctorate (Law) degree from the University of Iowa in 1961 and then a Ph.D. in economics from Iowa State in 1965. In 1973, Neil Harl received the Outstanding Teacher Award at Iowa State University. He has also received the Outstanding Extension Program award and has been recognized for Excellence in Communication of Research Results from the American Agricultural Economics Association (this is for outstanding published research). He became a Charles F. Curtiss Distinguished Professor at Iowa State in 1976. Dr. Harl has also received the Outstanding Undergraduate Teacher Award from AAEA in 1976. He received the Distinguished Service to Agriculture Award from the American Society of Farm Managers and Rural Appraisers in 1977. He was elected to the Executive Board of the American Agricultural Economics Association in 1979 and in that year was also appointed to the Advisory Group of the Commissioner of Internal Revenue. In 1980 he received the Faculty Service Award from the National University Extension Association and was elected President of the American Agricultural Law Association. In 1982, Dr. Harl was named University Fellow at Drake University Law School. In 1983, he became President of the American Agricultural Economics Association. In 1984, he received the Distinguished Service Award from the American Agricultural Editors Association, the first Distinguished Service Award given by the American Agricultural Law Association, and also in 1984 he received the University Extension Distinguished Service Award from Iowa State. In 1985, he received the Distinguished Achievement Citation from Iowa State University. His main areas of interest include organization of the farm firm, taxation, estate planning and farm finance. Dr. Harl is author or co-author of more than 175 publications in legal and economics journals and bulletins and more than 375 in various farm and financial publications. He has spoken widely on estate planning and organization of the farm business. More than 160,000 copies (nine editions) of his Farm Estate and Business Planning are in use. He is the author of the 15-volume technical treatise, Agricultural Law. He is the co-author of Farmland and the author of Legal and Tax Guide for Agricultural Lenders.

Thank you, Dr. Havlicek. Ladies and gentlemen, I'm enormously pleased to be here and I'm particularly appreciative, Joe, that you left me a few moments for my presentation. I was beginning to wonder in that introduction if there would indeed be time. If I'd known it was going to be that good, I would have brought along at least one of my deans to hear it. They rarely hear commmentary like that. A mistake has obviously been made. That was the long form and the secretary was supposed to send you the short form introduction.

I shall refrain from commenting at this juncture upon Professor Breimyer's commentary about tax lawyers. I will reserve that until later. I do have a comment, but I think it would be inappropriate at this point, particularly in light of the fact that my time is so limited. We're going to get substantive tonight rather quickly because agriculture is in difficulty. It is widely perceived that agriculture is going through probably the most difficult, wrenching era in at least a half century. Agriculture today suffers from two major burdens: unfavorable terms of trade that relate to a strong dollar, vis-a-vis the major trading currencies and a huge and crushing debt burden. Any discussion of farm policy today requires that attention be given to these areas. Long term, the health of U.S. agriculture depends heavily upon resolution of these two problems. Long term agriculture needs and needs badly lower interest rates and better income. One of the best prospects for long term economic strength for agriculture is improved trade in agricultural products. For that reason, we will be taking a global perspective for U.S. agriculture because U.S. agriculture is fully integrated into the international economy. We might not have been able to say that with such conviction a decade and a half ago, but that certainly is the case today.

I.

If one were to attempt to formulate a rational food and fiber policy for the world, relatively little guidance could be expected from present policies. Food shortages persist with chronic recurrence in several countries of the Third World. Human beings are dying from malnutrition and from diseases exacerbated by food shortages - numbers that ought to be profoundly embarrassing to developed nations. Surely a strong and compelling argument can be made that every human being is entitled to reasonable access to a food supply sufficient for survival. At the same time, serious economic problems of production over-capacity plague many of the

food surplus nations at current price levels. Questions of full resource utilization are raised repeatedly in policy arenas with no very satisfactory answers as to how to achieve full resource utilization, how to maintain acceptable levels of income, how to sidestep problems of product surplus, and how to avoid program subsidies at levels unacceptable to taxpayers.

In recent months, the picture has been clouded. The high and rising debt loads as we indicated threaten to engulf fully a third of the nation's farm businesses and to threaten the existence of a substantial fraction of the agribusiness firms that serve agriculture and indirectly all firms in rural communities. Surely, the policy decisions for agriculture have never been more complex than they are at present.

Turning to the Third World side for a moment, problems of starvation have plagued this planet almost from the beginning of time. Crop failures which result in deaths and lack of food are not a stranger to our history. They're as old as recorded time. As some nations of the world have become more wealthy, starvation and malnutrition have become increasingly bizarre. The contrast between poverty and wealth, always sharp, has been magnified in a world that communicates the lifestyles of the wealthy to the far reaches of the world on an instantaneous basis. Expectations of individuals and their leaders cannot help but be shaped by the culture of abundance, if not of conspicuous consumption, that is part of the cultural message flowing from the United States and other developed countries. Severe and widespread problems of hunger in Ethiopia and elsewhere and the continuing battle to keep food supplies ahead of population growth in nearly a dozen countries have focused attention on the most serious global problems of the age. The disparity in income levels and thus in standards of living is in part attributable to natural resource imbalances. But the major factor explaining differences in economic well-being is the productivity level of people. That is why countries with seemingly comparable resource endowments have vastly different income levels per capita. And so the long term solutions to world hunger are likely to rest more with efforts to improve levels of personal productivity than with short term humanitarian efforts to provide food to the starving millions as important as those efforts are and as much as I support them myself in a short run context.

The ongoing problems of development in the Third World have been complicated and compounded by the economic crises that have gripped the

developing world in recent time. These problems are substantial and they pose a significant barrier to progress for the human family. Viewed from the perspective of the long range economic health of U.S. agriculture, domestic gains in demand for food can be expected to come principally through population growth. But with the prospect of a population growth of less than 1% a year, increases in the amount demanded are likely to be modest and to fall considerably short of increases in productivity in the farm sector. Dramatic increases are, therefore, more likely to be realized from increases in food demands in the Third World as diets are upgraded, in some instances as caloric intake is increased, and in greater utilization of agricultural products as substitutes for energy sources and for other industrial uses. Increasing the demand for food in the Third World is complicated by financial pressures on many Third World countries that are laboring under crushing debt burdens. They have a problem not unlike that of U.S. agriculture. The world is awash in debt, debt that probably cannot be paid in full in the normal course of events. Increasing the demand for food is difficult because of extremely low productivity of much of the labor in the Third World. Extremely low labor productivity means that the prospects for improving the demand for food in those countries are less than bright. Progress in improving agricultural exports is somewhat related therefore to improving the productivity of the human agent in the Third World. With improved human productivity, Third World countries could be more effective demanders of food. There is a poverty problem in the Third World. With increased human productivity, individuals could produce something the rest of the world wants and in turn could purchase food.

From a humanitarian perspective, the world cannot long tolerate conditions of abject poverty and hunger to the point of starvation. A universal human entitlement to sufficient food for survival is a not unreasonable expectation and should rank among the most basic of human rights. Food aid in areas of starvation is laudable and, as we said a moment ago, should be encouraged. But in the long run, food assistance programs have a damaging impact on local economies. The availability of food at zero or near zero cost depresses prices for locally produced products. So meaningful development in many of those countries can come only from increases in their income and in many cases that will be from

increased agricultural production. In other cases, increases in other kinds of production may be possible so they will be in a position to buy U.S. farm products.

In the devastation of post World War II Europe and Asia, enormous economic progress was made as economic and development expertise were made available under the largest rebuilding effort in the history of the human family. The plight of the Third World today is substantially different. The countries targeted for Marshall Plan assistance after World War II had populations with reasonably high levels of education and training relative to much of the Third World now. Moreover, improving productivity of individuals in the Third World will require a much longer commitment. Improvement will be gradual and painfully slow. Rather than measuring the task in terms of years, a Marshall Plan-type effort in improving productivity in the Third World will necessarily have to be measured in decades. Yet, without a strong commitment to improve productivity, generation will follow generation in traditions of the past with little change in the capabilities of individuals to participate in the production of goods for export or for use domestically. A vast commitment of capital and human resources is needed to raise the productivity of Third World countries to levels permitting meaningful participation in the economic benefits of development. The commitment made for decades in military aid has likewise been vast and growing. The hope for survival rests in some redirection of financing with a sharing of capital and human resources from the developed world.

In many instances, capital investments in Third World countries have produced disappointing results. Replicating capital intensive projects from the developed world run the risk of not meshing well with the needs and capabilities of Third World countries. The productivity of capital in development is not unrelated to the productivity of labor associated with that capital investment. The vaunted comparative advantage of U.S. agriculture will likely be pressed by several other countries, but the U.S. seems as likely to maintain a competitive edge in production of food and fiber products as with any other area of production activity.

II.

I'd like to turn now to a look at the U.S. agricultural economy. For well over a half century, U.S. agriculture has faced problems of production

over-capacity. From the time of the McNary Haugaen Bill and the efforts to achieve equality for agriculture in the 1920's, agriculture has suffered through almost continuous overproduction in the basic commodities: wheat, rice, cotton, corn and other feed grains. In the past, problems of over-production have ocurred as agriculture has modernized and become more efficient with more output from the same inputs. The consequence has been that resources, particularly human resources, have been squeezed out of agriculture, thus fueling development in the rest of the U.S. economy. Agriculture is a developing sector. The trend has been particularly marked since the 1930's. The trend in number of farms has been clearly downward. The increase in average size of farms has been, of course, just as consistent and just as marked. Why has that been the case? It's been the long march toward greater efficiency and it hasn't been just since the 30's. It's been almost from the beginning of the ages. Initially, 100% of the people were in agriculture. Everyone was engaged in food production. Then it dropped to 80% and then 60% and by the depression era it was down to about 25%. Now we're down to the vicinity of 2% or 3%. That has come about because of increases in efficiency. Developments in plant and animal breeding have been one set of forces; developments in machinery and chemicals, another set; and improvements in management ability have been the third. Agriculture has been squeezing out people.

Sometimes we're asked by the media, "Harl, is it for real this time?" "Is agriculture really having trouble as much as they say for we remember hearing farmers complain in 1969, 1972, 1979, 1980 and on and on..." And the answer is yes, agriculture is in trouble, and yes, you probably heard people complaining in all of those years and probably others. It's inherent that a sector that is a development sector that is always squeezing out people, will yield up the plaintive cries of those who either couldn't find a place in agriculture or couldn't maintain the competitive pace of the sector.

What we are seeing now in terms of debt has very little to do with the onrush of efficiency. What we're now seeing does not relate to the problems agriculture has faced by becoming more efficient. Yet, the two phenomena have one feature in common -- the number of farmers is likely to decline from both.

The out movement of people from agriculture in the U.S. is likely to be less dramatic in years to come in absolute terms over the next half century.

The numbers are simply not there. Nonetheless, agriculture will likely continue to suffer from the economic consequences of development for the foreseeable future. The great beneficiaries of all of this have been the consumers because as people have been squeezed out of agriculture, the price of food has declined at the same time relative to income. Adjustment problems will continue to capture the attention of policymakers and to keep pressure on resource values in agriculture. In fact, as we look ahead to the next half century, we see accelerated adjustment problems for agriculture. Biotechnology as one major set of forces will lead to more adjustment problems than we have probably seen at any time in at least the last 30 years. Again, consumers are likely to be the beneficiaries. It is clear that rising standards of living have been made possible as the average percentage of income devoted to food purchases has plummeted in this century. Compared to the modest change in the preceding thirty or so centuries, the twentieth century has been like no other in terms of the transformation of agriculture. As congressional efforts have been made to ease the resource adjustment problems in agriculture, some have been concerned about the cost of easing the adjustment process. Others concerned about the cost of slowing the adjustment have lost sight of the highly significant contributions of agriculture to the development of the nonfarm economy by freeing resources. I think it is not an unreasonable expectation that when agriculture is having great and severe problems that assistance could be made available from the rest of the economy.

Let's turn now to a very quick examination of the debt situation in agriculture. This has certainly been an important phenomenon in the last few years. The media have focused upon it principally within the last six months, but the problem has been with us for some time and it is growing more severe. Why did we not read the road signs? Why did we not see the problems of domestic agriculture?

I think there are at least four separable roots to the problem. The first is any one of a half dozen factors that moved the farmer into the window of vulnerability.

* One, of course, is adverse weather conditions. The loss of a crop can be a severe blow. The loss of two crops can be devastating. The loss of three crops can put many people out of business. And so certainly that's one of the elements that moved farmers into the window of vulnerability.

* The second, losses in cattle feeding and even losses in hog production. Our numbers show that 29 of the last 58 months have been loss months for hog production. That's unprecedented in the history of hog production.
* Expansion to bring a child into the operation for many has taken down not only the child, but the parent also. They expanded at the wrong time and moved into the window of vulnerability. That has been so profound a message that it is likely to alter the interest and ability of parents to expand their operations into multigenerational units - the so-called superfirms that we've talked about in times past.
* Expansion in terms of machinery expenditure or purchase of land, all are factors that moved farmers into the window of vulnerability. Anything that increased the debt load significantly had that affect.

And so we have all of those plus the reduction in land value which has had a particularly significant effect for lenders. It is not just a farmer problem. It's a farmer problem, a lender problem, a supplier problem, a problem for the entire rural community.

We mentioned the window of vulnerability and left one for discussion separately, and that is high real interest rates. For once a farmer moved into the window of vulnerability, it took little more than high real interest rates to do them in. By real interest rates, of course, we mean the stated rate that is paid at the bank or the PCA less the rate of inflation. It has set records in many recent months. High interest rates have four effects on farmers.

(1) It obviously runs up the direct cost of production and that alone is a very significant factor; all borrowers know the effects of that impact.

(2) High real interest rates are associated with a strong dollar.

(3) Input suppliers, those supplying spare parts, new equipment, machinery, fertilizer and chemicals, also live in a world of high interest rates and those high interest rates get passed along in the form of added costs to purchasers. Farmers, because of the nature of the competitive structure of the input supply sectors, cannot generally pass those on in the short run.

(4) Finally, those who carry farm commodities in inventory, processors for example, find that their costs of carrying commodities in inventory up when interest rates are rising so they are likely to carry less. The result is about like an increase in supply which has a depressing effect on price. The last three are felt by everyone involved in production, even those who are not borrowers.

And so we have a number of impacts from high interest rates. The impact on trade has been particularly significant, more in our view than the embargos in the early 1970's or of 1980. High real interest rates have been a serious problem for agriculture in recent time and are narrowing the room that agriculture has to adjust to conditions of lower price supports as we'll note in a few moments.

Why do we have high interest rates? There may be some differences among economists as to what causes high interest rates and as one of my colleagues said not too long ago, "Yes, indeed there is." Some 15,696 economists say there is a linkage between the federal budget deficit and interest rates. There are five who disagree. But I think there is little doubt -- the budget deficit does contribute to high real interest rates. Only rarely, since 1950 has the federal budget shown a surplus. The theory is that in the business cycle you should run a budget surplus on the up side and a deficit on the down side. We seem to have forgotten 50% of our lesson and have been running deficits all the way around the cycle. In the mid 70's the budget deficit was significant. But the deficit almost closed toward the end of the 1970's. In fact, in 1979 it was down to about 26 billion. In the world of deficits, that's almost nothing. As you can see, it opened with the recession in 1980 and really opened up with the tax cuts of 1981.

I would like to digress at this point and talk about three federal policies that we think have contributed significantly to agriculture's problems today, a rare and unique coalescence of effects.

* The set of policies over at least five different federal administrations (to make it totally bipartisan). That came to treat inflation as not an aberrational case, but as a permanent part of life. We pay a huge price when, as a matter of policy, we come to view something as a part of permanent expectations that really ought to be treated as aberrational. We did that with inflation. We came

to accommodate inflation. It stayed with us so long that we came to adjust to it. We indexed almost everything we could. We indexed social security benefits, social security tax, federal civil service compensation levels, labor union contracts, and even the tax system, starting in 1985. Farmers couldn't really index the same way, so they chose to accommodate inflation in a somewhat different manner. In some cases they accelerated expenditures. If a combine was likely to be needed the next year and expected to be 15% higher, a farmer might accelerate the purchase by a year. If the eighty acres across the road came up for sale a year before they really would like to have bought it and land values were climbing, it was a fairly natural thing to do to expand. It so happens that when you change the policy, indexing is rather benign in its impact. Anticipating capital expenditures is not benign and can impact severely investors.

* The decision by the Federal Reserve Board on October 6, 1979 to take aggressive action by slamming on the monetary brakes. It was a rare Saturday morning meeting of the Fed taken because of problems existing at that time: inflation, a weak dollar, and associated problems. After the aggressive stance taken by tightening credit conditions and limiting money supply, interest rates shot up very sharply. Within a matter of several weeks we were looking at interest rates in the 19%, 20%, and 21% range. But remember, inflation was running close to 15%. What we saw then was a decreased level of economic activity. Inflation did come down. But, interest rates did not drop as far. They dropped about 14% or so and they stabilized. Why? That brings us to the third policy.
* The third policy, in my view, involved the Economic Recovery Tax Act of 1981 that cut the heart out of the federal revenue system. One of the objects of that legislation was to spur capital spending. Rather than spurring capital spending, capital spending dropped like a rock for more than two dozen months after enactment. We're paying an enormous price for the resulting mismatch in revenue and expenditures at the federal level. It is my belief that closure of the federal budget deficit has more to do with the fortunes of agriculture than what will happen in the Farm Bill in 1985. Fiscal and monetary policy

can easily swamp the effects of about any effort to bring stability into agriculture. What goes on in the House and Senate budget committees, the House and Senate tax writing committees, the Departments of Treasury, Commerce and State and the Federal Reserve Board will have more to do with the fortunes of agriculture than what happens in the House and Senate agriculture committees or in the U.S. Department of Agriculture, as ironic as that might seem. But agriculture is not well-equipped to deal with this new set of forces.

We do not, tonight, have time to look at the debt situation in any great detail. We will in other seminars on this campus, but not this evening. We will note only a couple of significant facts. First, the amount of debt is huge. It has grown since 1950 to a high level. Total farm debt is in the vicinity of $214 billion. The problem is not only the absolute magnitude, but the way it is distributed. Roughly two-thirds of the debt is held by the one-third of farmers who are the most severely stretched out financially. Approximately two-thirds of that debt is held by farmers with debt to asset ratios above the 40% mark. A year ago we thought most farmers above 40% could not stabilize themselves; they were on a conveyor belt headed toward solvency with only time being the necessary variable before they went over even though it would take a while. It is a scarry statistic to think that we have roughly two-thirds of the farm debt held by people who are unstable financially. That is the problem we face. As we said, it is not just a farmer problem. Farmers have options. They can pull the plug, go the bankruptcy route, and be back in business, if they care to. However, that may not be the best solution for the rural community because discharged debt goes ricocheting through the local community, taking down lenders, suppliers and others affected. I might add that I believe we have about one-third more debt than agriculture can sustain under any meaningful scenario. One way or another, probably a third of the debt will have to be either paid in the near term and soon, or it will be discharged. The debt problem is widespread enough in its magnitude that it threatens the very fabric of rural communities. Very few will be left unscathed because even if you are not in trouble financially, you will suffer the effects. You'll travel further for spare parts, encounter less competition for inputs supplied to you, have fewer places for outputs to be marketed, so we think it is a problem that is considerably beyond just being a farmer problem.

Very quickly, the data show that nationally we have about a third of the farmers over the 40% debt-to-asset mark. That group holds about 65% of the debt. Those data are borne out by several state level studies. Roughly a third of the farmers are not in trouble. They have a 0-10% debt-to-asset ratio. Data from Iowa indicate that group is about age 61 years of age; they are the smallest average sized operations. The group with an 11-40% debt to asset ration includes a great deal of commercial agriculture. The average age is 53. They are the next to the largest average size operation. The 41-70% debt-to-asset group has an average age of 48. They are the largest average size farming operations. Those with debt-to-asset ratios over 70% are the next to smallest with an average age of 46. It is a stairstep down in age, and yet it isn't only the young farmer who's in trouble. Disproportionately, however, it is the young farmer who is in jeopardy. We run the risk of losing a generation of young farmers. Most farmers are vulnerable, at least during the first decade of their operation. They are in the window of vulnerability simply because of when they were born and when they started. So it is a burden that falls disproportionately upon the younger individuals. The central region is the most severely stressed. About 42% of the farmers are in the over 40% debt-to-asset mark. We now believe that you cannot stabilize in all cases if you're below a 40% debt-to-asset ratio. In some cases, people are unstable as low as 30% depending upon the rate of return on farm assets and what interest rate they are paying for the money they are borrowing. The Far West is about where the central states were a year ago in terms of average debt-to-asset ratio. The South is in about the same position that the central states were in early 1984. Only the East seems to be largely escaping the worst ravages of the debt situation. Why that is the case we're not sure. Off-farm employment opportunities may have something to do with it. We thought for a while stability in dairy income might be a contributing factor. Then we saw some data in several states that showed that farms with major dairy enterprises were among the most severely indebted and most severely stressed. We began to rehypothesize. Farmers discount in the face of uncertainty of income and do not discount in the face of certainty of income. We suspect that with relatively certain dairy income farmers probably went a little closer to the edge than might have been the case otherwise.

What are the scenarios? None very good. We'll quickly outline four of them because this is, of course, what's really important.

* I anticipate continued high interest rates, in fact going higher with some decline in commodity prices. It's not a very good scenario.
* Decline in the value of the dollar would be most helpful. We're not sure that will occur in sharp and precipitous fashion, for if the dollar does start to decline, probably because the deficit has been tamed if not brought under control, it might cause part of the roughly $100 billion of foreign capital that's been attracted to this country to start home. If that's the case, we might have a capital shortage in this country, for if we didn't have that $100 billion, we would be experiencing even higher interest rates than we have. And so what we see is some instability in the value of the dollar, but any downside movement would be helpful.
* The Federal Reserve might take a look at the human family and decide that it might be better off with less restrictiveness with respect to monetary policy. The Fed might get that idea by looking at the Third World. They could get it by looking at agriculture, but we think it's more likely The Fed would be influenced by the Third World conditions. If the U.S. closes its trade deficit which is approaching $150 billion, that could be disadvantageous for some Third World countries that are now exporting more than they could if we were to close the deficit. It's a type of hidden foreign aid right now. We are importing $150 billion more than we're exporting. It is huge trade mismatch and one that we cannot long endure for it is weakening our manufacturing sectors as well as agriculture. If the dollar were to decline it probably would lead to higher rates of inflation. If so, what would that do to agriculture? Historically, agriculture has been a beneficiary of inflation. But in an era of deregulated financial conditions, we're not as confident that interest rates would lag inflation. It might very well be that interest rates would move up with inflation. We might trade 15% interest and 3% inflation for 25% interest and 13% inflation. If so, only those who had their debt pegged would, therefore, gain in the process.
* Finally, if the Third World countries that owe some $900 billion of debt were unable to keep their interest bills paid, defaults would be in prospect. We've lurched quarter to quarter in recent time helping

Third World countries pay their interest. If default were to occur, we would have genuine problems. The long tentacles would reach even into East Tipswitch, Ohio, for it would be massively destabilizing. That's a low probability event because much of the world is arrayed against that happening. It would be too destabilizing. This country is prepared to do what it takes to prevent that from occurring. As we reach the point of asking what all of this means in terms of domestic policy, we're going to be discussing in the next few weeks - The 1985 Farm Bill. It's in this general setting of high real interest rates, a record setting dollar against other currencies, and an enormous debt load, that the discussion and debate are going to take place. With agriculture fully integrated into the national and international economies, the sector does not enjoy the luxury of specifying the economic environment. It doesn't in any era, and it certainly doesn't now. Yet agriculture is caught in circumstances this year that provide little opportunity for maneuvering under alternative policies.

Quite clearly, U.S. agriculture in 1985 faces some clear-cut choices as to its future trajectory. With the cooperation of farmers, consumers and taxpayers, agriculture could move toward a program of supply management, reduced output and higher prices. That trajectory could involve downsizing agriculture by 30% to 40% and would bring modestly higher food prices. In the alternative, agriculture could move toward a more competitive position in terms of international trade and output, lower prices, full use of resources, and lower food costs for consumers. The latter policy alternative has a lot of appeal, especially to those who favor a market-oriented farm policy and I find a great deal of attractiveness there myself. Yet the strength of the dollar and the amount and distribution of farm debt assure that any movement toward internationally competitive commodity prices must be measured and related to progress in bringing down the value of the dollar and in stabilizing the farm debt situation. Agriculture simply has been sufficiently weakened to make rapid adjustments impossible without massive economic damage to the sector. On the other hand, if price and income support policies were to be sufficiently favorable to farmers to solve the economic problems of those with the greatest debt, we'd have serious problems of pricing U.S. commodities out of world markets. Problems of

production control would likely emerge, also. Therefore, it's unlikely that the debt problem can be solved by adjusting price support levels on farm commodities. Yet, the decisions made by the Congress relative to price and income supports in the 1985 Farm Bill promise to impact very substantially the resolution of the debt problem. Any reduction in farm income would increase the number of farmers in financial difficulty and speed up the rate at which they would reach insolvency. Under present conditions, the calculated shortfall in interest payments in 1985 on agricultural loans for the U.S. is about 2.2 billion. If we reduce the rate of return by a third on farm assets, from six percent to four percent, and increase the interest rate by two percentage points from an average of 11% to 13% on farm loans, the cost to solve the farm debt problem would quadruple. Under present commodity prices and assuming an eight percent return on land investment, farmland values are supportable, in the $1800 to $2000 an acre range for the best land. With a long term expectation of $2.25 per bushel for corn, farmland values could drop to the $675 to $700 range on the best land. That frames, I think, the issues.

I want to thank you so very much for your very kind attention.

HAROLD BREIMYER/NEIL HARL

Reactions to One Another's Presentation

Questions from Audience/Responses from Participants

Breimyer: I've quoted Dr. Harl so often, and favorably, that I'd have to press pretty hard to find anything to disagree with. I'm so pleased by the way he presents the debt situation, which I think he does essentially the same way I do. It is not a case of a bunch of poor, incompetent farmers who are getting their just desserts because of their production record. As a matter of fact, in the state of Missouri, we compared the records of those farmers who are experiencing operating losses and those who are getting operating profits. Those with the losses have better production records in terms of yield per acre and milk per cow than those showing profits. The difference is that they have debts and big interest payments to make.

Neil didn't quite say it, but in the last three or four years, the real interest rate has been two to three times its normal level. You see, what really counts is the difference between the nominal rate paid to banks and other lenders and the inflation rate; this difference is the real interest rate. The normal level is 3-4%. The actual rate has been running two to three times that, and is higher than can be carried. It simply cannot be carried indefinitely.

The financial situation is somewhat regional, being worst in the western Corn Belt and Plains. It will catch up to the East as well.

We have to be careful to point out that the high incidence is on the full time farmer - the one who doesn't have off-farm income to depend on. I think that unless we change our policies we're going to force some 300,000 full time farmers out of the farming. These are close to half the 700,000 full time commercial farmers in the United States. My judgment is that it's that bad.

Yes, in a sense hard pressed farmers can take Chapter 11 and so on. And food will be produced. What is at issues is a matter of one's values, and his sensitivity. I put human beings first and economics second. And as a personal confession, I may be more sensitive because my father and I (my family) went through a similar experience in the 1920's after World War I -

incurring the debts in the later nineteen teens and then trying to pay them off following a 50% cut in grain prices in the early 1920's. It was the same thing as we're having now. My mother almost lost her sanity. It was trauma. It was emotional distress of a kind that I still feel. In fact, I shudder when I even think about what our family went through. I suppose I don't want to see 300,000 families go through it when I know their production record is perfectly good.

What we have had is a 180 degree turn in national policy in terms of financing. It hurts. I'm getting some seniority, and I'm finding that more curiosity and less conviction goes with the stage. One becomes less sure of anything. Neil Harl talks first about the Third World and about the first world right here at home, and he suggests there may be some comparability between the debt load of the Third World and the several financial strains we're having here in the United States. Although I turn these things over in my mind, I can't make them fit together; but it seems to me that there may be a considerable similarity. The whole world has gone to a heavy debt structure and the whole world can't pay it. I could wager that these savings and loans failures in Ohio will have a sequential effect, one after another, because I remember that pattern very well from 1931. I'm apprehensive.

The Third World will not pay its debt. When it doesn't pay, what will happen to the creditors? What kind of a situation have most nations gotten into? It is unmanagable except by performing major surgery on the way governments go about their business. I can't resolve it; all I can do is endorse Neil's remark that there is some comparability to the situation here and worldwide, I think we've got some very real problems ahead.

Harl: I find little with which I disagree as to what Professor Breimyer has said. I would just like to make two or three brief comments. First, I have in my files, in fact I have a thick file, of recommendations (because I have somehow become the repository of plans on how to solve agriculture's woes) that suggest that agriculture be made more of a tax shelter than it is. I have a persistent group in one midwestern state that continues to bombard me with letters suggesting that land should be made depreciable. In their view, the way to solve the problem is to attract capital into agriculture. I think they are motivated by perhaps some right motives in the sense that they are concerned about the strength of the land market and certainly if we

cannot stabilize the land market, we have problems, serious problems. But I share Dr. Breimyer's concern. I guess I would just have one caveat and it's the same caveat I made in testimony before the Joint Economic Committee a year ago. In that testimony I was making the point that we needed to address, and soon, the problems of tax shelters in agriculture. There are many although some are more egregious than others. But I think there is an important question of timing. Last year about this time Senator Abdno from South Dakota introduced an amendment on the floor of the Senate that would have limited farm losses, in terms of being offset against non-farm income, to the average family income level of the U.S., approximately $23,600 a year. Immediately someone requested a fiscal note from the Treasury as to impact on revenue. Back came the reply. It would mean $2.6 billion in additional revenue over three years. That shocked many in the Congress. It was not generally believed that the amount of losses from farming was offset that much against non-farm income. If we move too aggressively, however, we might encourage too many people to jettison assets at a time when we are trying desperately to stabilize assets and to insulate machinery and land from the markets. And so we should consider carefully when we do it. Having watched the cycle of tax legislation, if we get up a head of steam now agriculture may well be in better shape by the time it gets passed so that may take care of it. I do think there's an important point of timing. The time to make such changes is while we're moving toward the upside so the removal of capital (if that's what occurs, as we presume) would not have an adverse impact.

Another point that is difficult for many to accept is that if we're going to get serious, really serious, about dealing with the tax shelters in agriculture, one of the key elements is going to have to be a re-examination of something that is dear to the heart of many farmers, bonafide farmers, and that is the cash method of accounting. Farm and ranch firms have been permitted to use cash accounting since 1919 by administrative decision by the Department of the Treasury. There were two arguments given in support of allowing it in agriculture and not allowing it elsewhere where inventories were a material income determining factor. One argument was that farmers could not master the double entry accounting needed to handle accrual accounting. The other argument was that farmers weren't making that much income anyway considering where the income tax rate was at that time.

It is the combination of cash accounting and the biological nature of agriculture that has brought about much of the sheltering that has taken place. Those factors plus the deduction of interest against off-farm income have been major elements indeed.

I would like to endorse and emphasize a point that Professor Breimyer made relative to the importance of looking at the macro impacts of tax policy. For many, many years it has been very difficult for people to see beyond the micro impacts. The micro impact is the impact you see when you put up a confinement livestock facility. You claim 10% investment tax credit and it's 10% off your calculated income tax. You can see that. You pay $75,000 for a confinement facility, with $7,500 off your income tax return and that cuts the price of that confinement facility by $7,500. That looks like a good deal. The problem, as Professor Breimyer so correctly pointed out, is that when you add up everyone's situation, dropping the cost of that facility by $7,500 induces some people to construct facilities who wouldn't have done so. It makes facilities feasible that were infeasible at the full 100% of cost. And once people build the confinement facilities, they're unlikely to leave them idle unless their lender simply says "thou shalt not feed anymore" because you are losing money. They're going to have sows in the facilities or pigs from sows. The result is increased production in total. Increased production, as we know from Economics 101, leads to a reduction in price. The macro impact so many times is an increase in supply and a drop in price. If consumers want to benefit, they should aggressively lobby for: 1) tax breaks in agriculture and 2) research in agriculture, because they're going to benefit in both cases.

I think that tax policy is likely to be an important legislative agenda item this year. I think it's essential that we have discussion and debate on tax policy. I'm observing a number of farmer groups that are struggling with this issue and are looking at the macro impacts even though we don't have as much quantitative evidence as we'd like on the macro side. Thank you very much.

Havlicek: We'll now open it up to questions from the audience and if you will, please direct them to either one or both of the speakers.

Question to Breimyer: If 300,000 fewer commercial farmers is a possibility, what will happen to the land? Will it be farmed? How will it affect output?

Breimyer: There won't be much impact on land. Some land will be idle; in fact, in my State of Missouri a little acreage was idle last year because the farmer couldn't get financing in time. But not many acres were involved. Most farmland will still be farmed or half-farmed by someone. It will be farmed by tenants or wage workers. The effect on total productivity will be small, and in view of our surplus, there's no major consequence there. The question is, who's going to farm and under what relationships and to what reward?

Question to Harl: Dr. Harl, I heard you speak Monday concerning the Agricultural Credit Corporation. I think it might be very relevant to the audience tonight if you and Dr. Breimyer could comment on the basic concepts behind that idea, if at all possible, please.

Harl: Could I just address one final comment to the question that was raised just a moment earlier? On January 11, we happened to be in Washington to visit with various people including a person by the name of David Stockman. Some of you may have heard that name. Toward the end of the discussion he turned to me and with some disdain said, "Harl, you know if you're right, we'll lose a third of the farmers. That will mean we won't need a commodity price support program anymore, will we? That will be a great saving." So we had a little discussion about supply response and my answer was very similar to the answer that Professor Breimyer gave; that you do not indeed cut production very much. If you take out 10% of the farmers, you are not going to cut 10% of the production. Somebody will farm the land, at least all but the most marginal land.

Now the question which was just raised about The Agricultural Credit Corporation. On November 27th of last year, 1984, I was on my way back from a Washington conference and I was profoundly troubled. We had been in conference all day talking about debt. I was so troubled that I felt that the programs in place and proposed were likely to be insufficient. And so on the way back on the plane I put together the first draft of what has come to be known as the Agricultural Credit Corporation (ACC). We believe that it's going to be important to insulate a portion of those resources from the market or we may see the market driven to unnaturally low levels, overshooting the equilibrium position. Considering the amount of land and other assets held by heavily indebted farmers, only time is needed to move them toward insolvency. If we're going to avoid massive hemorrhaging we're

going to have to somehow have in place a mechanism to help do that. As originally conceived, the ACC would be a Congressionally chartered corporation that would have the power with state and federal funding on a formula basis, 90% federal and 10% state, to take over land with debt attached. The ACC would not pay off lenders, just take over the land with the debt. The farmer would pay a reasonable annual amount for use of the land, we were assuming about 6% of its value, and would have the right to keep on farming it as a tenant. The lender would take a modest write-down of interest or principal as payment for the assurance that the interest would be paid for four years (we are viewing the program as having a four-year term). As we've said on other occasions, we are building a four-year bridge over profoundly troubled waters. We may get to the end of the four years and find there are still profoundly troubled waters beneath us and we may need to extend the bridge, but at least for planning purposes that's what we're thinking as to term. The farmer would eventually buy back the land if financially able and otherwise willing. In the meantime, the Agricultural Credit Corporation would keep the interest current on the loan. We're at the point where I don't think land lenders should expect necessarily to be paid principal by a heavily indebted landowner. But if we don't keep interest current, that being the lifeblood of the lender, we're going to do great damage to lenders. This program would keep the interest current on loans. As land values eventually come back up, if they do, and I think they probably will eventually, the public would be repaid because they would sell it back to the farmers at a higher price.

We circulated the concept in draft form, and it was discussed, particularly within the Farm Credit System. That system has pursued it rather aggressively and supportively. I was troubled by the original proposal because it triggered income tax liability when the transfer was made. Moreover, several states have limits on corporate ownership of land, plus there's just something that people don't like about corporations owning land, even if they're quasi public corporations.

On the Sunday morning before Christmas I awoke early, couldn't sleep. All at once it dawned on me there was a better way. So I bounced out of bed, much to the shock of my wife, went to my desk, started writing and developed option B. I think that option B is probably the better approach. The same kind of Congressionally-chartered corporation, keeping interest

payments current, with the farmer retaining title. A lien would be imposed on the land to secure repayment. Essentially what we would be doing would be mortgaging future increases in land value to keep interest payments current. The problem today is that farmers can't make payments, and lenders can't wait. Some agency, federal or federally related, must somehow bridge that time gap creatively. Eventually all amounts advanced will be paid back, we hope, unless things get worse. As to projections on cost, about 1/9th of an MX per year, actually about $1.9 to $2.5 billion a year for four years and we think that would eventually be repaid. It could be viewed now as an investment by the public in stability in their food producing system. We have been pleasantly surprised at the support of the nonfarm population for agriculture.

Question: Declining land prices contribute to the problem. Can anything be done about them?

Breimyer: When land values drop, the man who had had a 30% debt-to-asset ratio finds that suddenly it has become 45%. It automatically keeps climbing. I think Dr. Harl has done more imaginative and resourceful work on a debt transfer corporation than anyone I know. I have recently begun to endorse it publicly as being the only way out that I can see. With regard to land prices and how pulling out the tax shelters would bring them down more, I think land prices have to come down. There's no way to avoid it. The question is how we can soften the consequence. The only sound longer run future for land price is for it to be in line with earning power of land. We ought not try to keep it up by some kind of artificial means including tax shelters, in my judgment.

Former USDA Secretary Orville Freeman recently wrote a tract calling for among other objectives, action to keep land prices up. He sent me a copy. I replied saying no, the land price has got to come down. That's how we adjust.

Just two points about Dr. Harl's corporation idea. He doesn't quite say it, but in my judgment the hard part of his plan is how to deny making it available to those particular farmers who fail to qualify according to whatever terms are set up. In my judgment, the hard part is who -- a board, perhaps -- is going to decide what cases come within whatever terms are set as feasible? And how do we decide just what particular criteria will determine eligibility? A lot of farmers, the high flyers who went way

overboard, cannot be saved. In that regard, too, I think the corporation plan calls for a new organization. Farmers Home certainly is not staffed to do the job. Farmers Home is overloaded, it can't do it. In the final analysis, what a corporation would do is transfer farm debt to federal debt for if some interest payments are funded, they will be funded by borrowing, federal borrowing. What we do is transfer farm debt to federal debt.

Maybe there's a kind of ironic justice in doing that. If government policies that pushed the interest rates so high and made debt loads so hard to carry, perhaps it's fair for the government to carry some of agriculture's debt.

Question: Why is the interest rate such a sacred cow when land values don't mean anything? You see, we're talking about subsidizing the man who was lending the money, keeping the interest rates high, while we devalue our assets. That's meaningless to me. It would seem to me that a usury limit could be just as effective as devaluing the assets of our land.

Breimyer: A good deal of what we have said -- Dr. Harl may contradict if he likes --presents several options. One would be the kind of changes in policies that would reduce the interest rate. That would be highly beneficial. I'm sure Dr. Harl's mortgage corporation is based on the idea that we are not going to get a major change in interest rates in the near future.

That takes me back to a question about which I'm very curious. I'm absolutely convinced that it's devastating to a nation to have interest rates at twice their normal level for any period of time. Nor am I sure all the deregulation of the financial community is good in the long run. Maybe we have to go back to usury rules, but this issue opens up more questions than there is time to discuss. I'm full of ideas. Let me throw one out. Interest rates of any substantial size can be carried only in a growing economy -- so that a larger output in the future is available for repaying what was spent in the first place. In a relatively stable economy it is dangerous to have real interest rates above the normal three or four percent. Unless the U.S. economy grows steadily, something's going to break. We've either got to pull interest rates down, be prepared for massive government funding of everybody's debts including the savings and loans in the State of Ohio. I'm serious.

Let me throw out one more idea, as I'm speculating. One possibility for the future for which I think the odds are 55/45, is that within ten years

all major nations will be experiencing inflation as that is the only way they can get themselves out from under the debt situation they're in. And when that happens, farm land that was $1000 an acre and is now down to $600 will be priced at $2000.

Harl: I was sitting back there chuckling to myself, wondering why consenting adults who had deposited money in Home State Savings should be bailed out, but that's for another day. I didn't mean to provoke any outbursts. After all, I'm not even an Ohioian and I have no charter to even be commenting, but I just couldn't avoid that. To comment further on the question: interest is the price of money. If money is scarce, the price will affect that. If we artificially reduce that price, we have the same problem we have if we arbitrarily set the price of anything else. We have huge problems in the sense that you have problems of people wanting funds and some are willing to pay the higher price and if you depress it, you're not going to have people willing to supply funds at that rate under the present circumstance unless you just clamp over the entire economy a set of constraints. We have generally, I think, found that setting limits on price, even where we do so on a fairly systematic nationwide basis, causes us no end of difficulties, so I'm afraid that arbitrarily imposing a price on money, more than what would be the equilibrium price under the present supply/demand conditions, probably would cause a lot of mischief. I have no doubt but what interest rates are the number one problem and I think we need to pursue aggressively policies that will bring them down. I guess I just believe that we probably need to press in a somewhat different direction than a usury law.

Breimyer: Finally, I've got something on which I can disagree with Dr. Harl and 90% of all economists. Interest rates are not the price paid for money. Interest rates are the price paid for what you buy with money. Money doesn't have any value. And the reason I'm so alarmed at the present state of affairs is that all this would make sense if real goods were scarce. But they aren't.

What bothers me most about the government deficit is that we can run a deficit of $200 billion a year without incurring inflation. That's a scary thing about the economy. A good operating economy, a really sound economy, with that much deficit, will have inflation.

We're controlling interest rates. We're controlling these through a monetary policy and other policies. We aren't doing so directly by usury laws, but I think the monetary system is a reflection of the intermix of monetary, fiscal and income tax policy. What we have is not just a case of a natural shortage of money. Money cannot be short if the things you bought with money are plentiful; and they are plentiful now.

Question: I wonder what's wrong with raising agriculture product prices as we raise interest. We talk about overproduction and we talk about the way we're treating our land. What causes overproduction - a low price or a high price?

Harl: Well let me make a stab at it in the following way. As price for corn goes up, it has certain impacts on producers. For example, if we were to see corn go from $2.50 to $3.50, we would see additional land brought into production, we'd see some cotton land, we'd probably see some cutover land, brought into corn production. Some land in dry areas that's marginal at $2.50 per bushel would come into production with irrigation at $3.50 per bushel. That's one way we would see production increase. We would also see production increase because people would take a look at their production situation and decide to buy more fertilizer and put it on. So we'd see more per production per acre. So it occurs, really, in two ways. As price goes up it induces more land to be devoted to that crop out of something else that's not returning as much and also more intensive use of the land that's in production. So in total, then, we would normally expect a well behaved supply curve to head upward to the right indicating that as price goes up, we'll see more production. Now to complicate matters, of course, here sits a farmer who sees price going down and as price goes down he's struggling or she's struggling to keep afloat and so they're not likely to take their land out of production until things get pretty bad. So long as they're covering their variable costs and part of their fixed costs, they'll stay right in place and produce. And so it takes quite a drop before an individual who isn't at the margin does more than cut back on fertilizer usage. We assume that if they're rational, they will reduce their fertilizer utilization. As price drops it will eventually force these marginal types out mostly in Missouri and the cutover areas of northern Wisconsin, and the sandhills area of Nebraska where center pivot irrigation and sodbusting have gone on.

Those are the areas that will eventually come out of production as price drops. Does that make a stab at it? You seem unconvinced.

Question: I'm not convinced. I would rather milk 60 cows on my farm with two boys and make an easy living than to milk 100 cows and put money in the bank.

Harl: You put a high priority on other uses of your time, perhaps. There may be two or three other people here in this room who say they would milk 100 cows just for the sheer joy of doing it. But not me. We milked five when I was growing up and that was five too many because we did it by hand. You have to look, of course, always at the behavioral response of the individual in terms of the weight they put on leisure versus the weight they put on economic return when you're looking at an enterprise like dairy.

Breimyer: Of course, I've got to respond to Dr. Harl's jibe about the poor land in Missouri. You see, we have some poor land in Missouri and where is it? Right up against Iowa! But now before I give this to him and he says it, I'll say what he would say. Iowa's poorest land is up against Missouri. I don't know what kind of soil it is, but it's where Missouri and Iowa come together and it's pretty poor land and it's the poorest of both states. One thing Dr. Harl didn't mention on the matter of trying to get prices up in line with interest rates, is that doing so would be a tremendous bonanza to those farmers who didn't have debt and didn't have interest to pay. I'm not sure we want that much difference between the various categories of farmers. I think the only solution is to get that debt down and get the interest rate down.

Just one more point. I hope that Dr. Harl and I have drilled in real hard on this. It's that the difficult situation in agriculture is essentially a financial situation and not primarily a commodity level adjustment situation. There are commodity problems, too. But the problems of 300,000 farmers who are in trouble are essentially problems of terms of financing.

One reason I'm hitting this so hard is that there are some advantages of being 70 years old and I'm a veteran of the depression of the 1930's. In the 1930's the bottom really dropped out of the market for all farm products, a collapse that caught all farmers. Today, commodity prices are not real good, but this is not the 1930's in terms of the market for farm products, even exports. Exports are down 10% or so, but they haven't

collapsed. This is not primarily a commodity distress. We do have commodity problems, but it's primarily a matter of the terms of the cost of money.

<u>**Question**</u>: Dr. Harl did a good job of characterizing the debates around the 1985 Farm Bill. I'd like to ask both gentlemen to kind of come off the fence and say what they would advocate for the 1985 Farm Bill and also to comment on Jim Hightower's Family Farm Reform Act, if they're familiar with that.

<u>**Harl**</u>: I have to add one footnote to all of that for historical accuracy, I grew up a mile and a quarter north of the Missouri line right in the middle of that area, so I'm very familiar with it. In my view, and I usually preface by saying I'm just a plain old ordinary garden variety professor on this point, we need to look carefully at any significant reductions in price supports at the moment. I guess what I'd like to see is a commitment that we would indeed, as agriculture could do so, move toward a more competitive stance with respect to the international market. Now let me drop a footnote there. One should not automatically assume that the international price of something is reflective, necessarily, of the free market because a market price is influenced by lots of difference forces. There are all kinds of subsidies in other countries and that's a complicating element. But I do believe that, in general, U.S. farmers probably want to be competitive and to produce on the basis of market signals and not to produce merely for a domestic market. But we're going to have to make that move slowly and deliberately. We're going to have to reduce price supports on a measured basis and I think it may take ten years, or at least seven, unless things change sharply for the better. Almost on a formula basis; as the dollar comes down, increasing the maneuvering room for agriculture, change in price supports can take place. I think that there can be some adjustment. But a reduction in price supports under present conditions will reduce farm income. That would be very damaging right now. So I would see some gentle movement in the direction of more competitive pricing, some gentle movement toward lower price supports, maintaining a target price concept for a time so that the cushion is there for the adjustment process to take place while we're stabilizing debt and while we're trying to bring the dollar down. I guess that's what I would like to see plus some additional effort at the federal level to try to help stabilize the debt situation.

Breimyer: Very quickly, because there isn't time to go into all the ifs, ands and buts, I come pretty close to where Dr. Harl does and I think most economists do. I too would be a little cautious on the price supports. I don't think we're pricing ourselves out of the world market or if we are, it's the exchange rate that's doing it, not the price supports. But nevertheless, there is some risk on getting prices too high and so most of us would be a little cautious on that. I would go one step further. I'd personally favor the idea of an export authority which would allow some latitude so we could adjust our prices as time goes on in line with what our traders are doing and not get locked in so closely to the CCC. I still think that would be a mature step forward. But then, like most economists, I would use the treasury funds more freely as an income supplement and I'm in favor of what Congressman Glickman and others are doing and that is targeting them more, gearing them more to the average sized farm. I'm pro family farm. I would not have a big direct payment to the very largest farms or the industrial type farms, but I would target that income supplement to the moderate sized farm. Insofar as we have production control -- and I think that there's still a place for it with markets being as unstable as they are -- it's got to have more teeth in it. Our control's been so loose the programs have essentially been ineffective. I would make them firmer. If farmers want to control production to boost the market, then they've got to reduce it. I would include the authority for mandatory acreage allotments and then I would go along with the route toward cross compliance. I think it's high time that we put a minimum soil conservation requirement into our commodity programs.

Question: We've heard a lot of comments made about the cost of our grain, our commodities, to foreign countries and the cost to buy shipping arrangements whereby half of it has to go in United States vessels. I read a rather interesting article in the Prairie Farmer just last week along with Dr. Harl's article. It said that the total result of this is putting $58,000 in every maritime worker's pocket. If that is true, this is one thing that needs to be worked on very badly because agriculture - farmers and producers - are being charged for this amount of money against a world market that comes back in a maritime worker's pocket. This is a direct subsidy to the maritime workers that is charged up to the farmers in this line. Another thing on it, Mr. Breimyer's statement, I agreed most heartily

with it up to a point. The United States has a very strict quota of tobacco production. The government holds three crops of tobacco in storage now in a tobacco pool. The farmers have not received any money out of that tobacco that's held in a tobacco pool, and yet we are importing tobacco from other places. Who makes the decision how much will be imported and why?

Breimyer: You had two questions. I think I know tobacco. Under Section 22 of the old AAA Act, if imports interfere with a program, they are restricted or put under quota. If imports cannot be shown to interfere directly with the program, then it's simply normal channels of trade, as affected by whatever tariff duty is there. I think that's a very simple answer to that.

The shipping. I'm almost certain that the half in U.S. bottoms is only for concessional sales, it is not the commercial exports. I hope I'm right on that. Where it came up recently is that some judge, a lady judge, said that the credit sales (blended credit) came under that rule. This is, of course, a very small part of the total exports. I'm not defending it, but one should not associate that particular rule with the great majority of our exports which are commercial. It is only the concessional including now the blended credit. Of course, the Assistant Secretary of Agriculture said that the reason the judge made that decision against the farmer is that she's a lady.

Harl: I'm not hurrying up here to defend Judge Green, who decided the case, but to say that there was a discussion in Congress last week. Since the justification for the U.S. bottoms policy is to protect our maritime fleet, which is believed to have defense implications, the cost of that should be billed to the Department of Defense, not to U.S. farmers. I find a certain amount of logical appeal to that.

Question to Breimyer: You made a comment early in your presentation about the tax sheltering system and how it's damaging the family farm. A further comment went on to say that the people who are shelterers tend to be crowding out the nonshelterers or the unshelterers. If Farmer A is smart enough to be a shelterer, odds are he might be smart enough to produce raw materials at a lesser cost. Now, is this really bad for agriculture or is it just bad for the family farm?

Breimyer: The tax does make a difference in structural implications. Why can't the farmer be sheltered? Well, if he doesn't have enough income to have a tax obligation, he can't have any shelter. The shelter only applies

when you have tax obligation. Many farmers who had troubles the last few years -- we've got a lot of them in Missouri --have virtually no tax obligation. If you have no income subject to tax, there is no shelter available to him.

Question to Harl: If we have 300,000 farmers who are leveraged somewhere in excess of 40%, suppose they do take the Chapter 11 route and let the courts help them solve all of their problems, where is this debt going to end up? Who gets the lump?

Harl: Well, first of all, let me say a word about bankruptcy, the two basic routes. Chapter 11 and Chapter 13 are the reorganization chapters. They may involve some modest discharge of debt because there'll be some scaling back and there's also a rather unique provision called the cram down provision. It let's them cram down the throat of some creditors a further reduction, but aside from that the big reductions from debt do not come from Chapter 11. They come from Chapter 7. Chapter 7 is the liquidation chapter for bankruptcy. Now as a farmer goes through Chapter 7, what happens? It means that the assets are turned over to the trustee in bankruptcy and the exempt property eventually comes back to the debtor so the debtor gets back what is allowed as exempt assets. The rest of the assets are liquidated and the funds are used first to pay off the secured creditors, then to pay the costs of bankruptcy, including IRS, and anything remaining goes to the unsecured creditors. If there's anything left over, it comes back to the debtor. Usually there isn't anything left over and often there isn't anything left over for the unsecured creditors. Based on analysis of Iowa bankruptcy data, we can see who takes the hit here based on six categories of creditors. First are the government creditors. Those are Farmers Home Administration and Small Business Administration. In general, the government creditors are well secured. The next category are the corporate creditors. Those are insurance companies and the Farm Credit System (Production Credit Associations and the Federal Land Bank). They're quite well secured, also. The next category are commercial banks and they're quite well secured. The next category is the agribusiness firms. They're not very well secured. These are the suppliers. They supply feed, seed, chemicals, fertilizer and other inputs. The seed dealers do a little better, at least from what I've observed this year because at least my own supplier says, "We want cash this year, or we're not going to sell you seed corn." Nonetheless, suppliers in

general are not very well secured and they take a very large hit. The private creditors are mostly land contract sellers and for them the land stands as security. Typically, if there's a default, forfeiture returns that land very quickly to the seller. Finally, the group that takes the largest hit of all includes the personal creditors - the physician, the credit card company, the poor penniless lawyer, and others who have no security whatsoever. Typically, the unsecured creditors take very little, if anything, in bankruptcy. There is an uneveness with which the discharged debt goes ricochetting through the community.

As for the impact of discharged debt on lenders, let's assume a $50,000,000 rural area bank. And I caution you, in Ohio this may be bizarre because you don't have very many banks that have only rural farm loans. You have more diversity in loan portfolios than is true in many states and that's one of the delights of being in a state like Ohio. In Nebraska or Iowa, many banks loan either just to farmers or they loan to farmers and also to the elevator, the feed store, and the farm equipment dealer and that's not diversity because the same risk factors operate there. Assuming a $50,000,000 bank with 8% capital, we can see that banks and other financial institutions are more heavily leveraged than farmers are. It's just that financial institutions have lived in a rather stable financial world and have felt they could live with a relatively high percentage of leverage. We're assuming the bank is 75% loaned up. We're also assuming it has all agricultural loans or at least the same risk factors that agricultural loans would have. We're assuming this bank has a random sample of the 25% of debt that is most severely stretched out. We're also assuming a 60% recovery on collateral taking into account the costs to the lender of liquidation which are not insubstantial. We're looking at interruption of income from the assets as a cost of liquidation as well as all the direct costs involved. What are the consequences? We'd have $37,500,000 of loans, $9,375,000 in liquidation, recovery of $5,625,000, and losses of $3,750,000. Capital would have shrunk to $250,000 and long before that somebody asks, "Where's the capital?" And they would want to see a merger or an infusion of capital. Lenders have only a finite capacity to be forebearing. Forebearance is next to godliness, but there's a limit to forebearance, for they soon run out of capital. They have two ways to respond. They can either take loan losses out of capital, which they may be able to do for a while

before the examiners come around or they can raise their interest rates to cover their losses. We're seeing the latter happen. In fact, what we're experiencing, I think, is a rise in the price surface of money in agriculture - the interest rate - and those who are not in trouble will end up paying part of the price for the overall problem. We're seeing that occur both in commercial banks and in the Farm Credit System, especially the latter. The loan-loss ratios are going up at a very sharp pace. And lender income is dropping. So long as a lender can make money, the lender can pass along more than half of the costs of loan losses to the state and federal government in the form of tax deductions for what it sets aside. But if the lender is not making money, it comes out of the lender's hide. It's a little like the farmer who's not making money who doesn't get a benefit from an ACRS depreciation deduction on a piece of equipment.

The debt problem is, therefore, much broader than just farmers. In fact, in the second wave, it hits not only the lender and the supplier, it hits other firms as well that are tied into these institutions. And, of course, when a lending institution goes down, the people who are hit the most are the borrowers. The depositors are pretty well taken care of, except for some savings and loans in Ohio! In most places, either FDIC or FSLIC will take care of the problem, but the borrowers are cut loose and to find a lending home is not easy today unless you're a sterling credit risk. So one of the serious problems is to find a loan home. We're learning one thing, I think, in all of this problem set and that is you pay a price for non-diversity in loan portfolios. The energy people learned this in the early 1980's and we're learning this in agriculture now. When the dust settles, we're somehow going to have to come to grips with the question of how you deal with a lender that loans only to one sector, when that sector gets in difficulty. Of course, that's not just a problem for commercial banks. The Farm Credit System, by definition, loans only to farmers, except for the Bank for Cooperatives, of course. We have a great deal of work to do in terms of how to handle that problem.

Question: How are you going to bring the farm program to be effective if you're outlawing the big producers? Is what you're saying is that supply management is not part of that now?

Breimyer: You don't take them out of the Farm Bill. I know Luther Tweeten at Oklahoma State has been talking about this. I was very brief on my ideas

for a 1985 Farm Bill. I did say, though, that insofar as you're going to have production control, it's got to be effective. The present system of inviting farmers in when the only reward is eligibility for loans and for deficiency payments is bound to be very loosely effective in production control. It you're going to be effective, you've got to go to paid diversion. Whether the payment is in a commodity or in dollars doesn't matter. In a program of paid diversion, you bring in farmers of all sizes. You don't make any distinction.

The place for making a distinction among farms by size is in a direct payment income supplement.

Question: Is there a general problem of credit availability? I think it has been argued that with the reduction in the value of land and with the reduction in the value of other assets, agriculture can very well adjust to the situation if they have money available to do that. But what has happened, seemingly, is individuals cannot get capital at any cost.

Harl: There really isn't a problem of capital availability in the sense of dollars being available. The problem is the repayment capacity of the farmer and the way that frightens lenders who take a look at whether they're going to be left at the end of the season holding the proverbial bag. There is a capital availability problem to those who have a less than sterling financial condition. But for those who have no financial trouble, there's no difficulty in getting money. There's plenty of money to lend, in most areas. In fact the banks in our state all have funds to lend. The problem is in loaning to those who have clear repayment capacity.

Question: Has the situation for the suppliers changed recently? It seems to me that it has.

Harl: Oh yes it has changed, it has changed very sharply. Up until about the last year most of the farmers had enough collateral value so that it didn't frighten the unsecured creditor to provide inputs on a credit basis. Now that the assets have declined in value and the short term debt has rolled over a few times for that individual, the equity has been diminished to the point that there is nothing left if the unsecured supplier or creditor has to look for collateral for satisfaction at the end of the crop year. What has happened is so many farmers have lost collateral value that there isn't much available above the secured debt.

Question: Would you say that rural banks have been weakened in the past year?

Harl: I would say that is an understatement. Creditors are rational beings - very rational - and they simply cannot see it as a rational act to extend credit to someone who has a weakened financial condition. Last Sunday, the Des Moines Register, our statewide newspaper, ran a detailed rundown on the financial condition of 632 banks in Iowa. That's every bank in the state. And it showed where they were a year ago and it shows where they are today relative to their capital ratio, income or loss and classified loans, all as a percentage of their capital. I left shortly after I got it so I haven't had a chance to do any analysis. But it's a fascinating study on how financial institutions can weaken in the course of a year.

Question to Harl: I'd like to hear your opinion on what you think will happen with the proposed tax reform and what you would like to see happen.

Harl: What will happen? What we'd like to see happen? I was asked that question downtown this afternoon at a seminar for tax lawyers and I was a little bit more cynical, maybe, than I should be here. I guess I'll start out giving you the same answer, basically. The day that Don Regan announced the Administration's plan which was the 27th of November, I was there for a conference, as I said earlier. Before I left Washington, I had a good sense of what the problem is in trying to achieve tax reform. The lobbyists had their knives out and were noisily sharpening them, all over town. Everyone who represents a special interest was out telling people already how they would be adversely affected. People were told it will hurt charitable giving, capital gains changes will be damaging, it will stymie economic growth. There are so many people who are represented by so many well-placed individuals in Washington that it will be a noisy process. One of the key questions is: can the people in Congress withstand that kind of pressure from those who stand to lose and look to the constituency of those who stand to gain? I frankly am not at all sure that it's feasible politically to pull off the kind of reform that is proposed simply because there are going to be both gainers and losers and I am not at all sure that there aren't as many losers as gainers numerically. At least the Treasury believes that there are a few more gainers than losers, but I'm less sure.

Now what do I think should happen? I think certainly some changes ought to be made. I think ACRS (accelerated cost recovery system) was a huge mistake. I think permitting the depreciation of the Sears Tower over 15 years on an accelerated basis was a travesty. I think that moving the cost

recovery period on depreciable real property to 18 years did not go far enough. We must reduce the hemorrhaging of revenue in the Federal budget. I think there is no great and compelling reason for having a deduction for land clearing expense at a time when we've had 50 years or more of surpluses. I have great difficulty with that one. I do think tax simplification is a worthy goal of a great people, but I also wonder if it's the destiny of the human family because every time you see someone argue for tax reform, you're dealing with someone else's socially justified provision. The tax code got where it is not just as a random matter of enacting bills. It got there because somebody made a compelling argument that the proposal was good for something or somebody, and we're going to have to demolish a lot of those arguments that will be revisited. Tax reform is going to take a while and I doubt that it will happen in the next year.

The most pressing problem to me is that we must increase revenue and I think that is the number one priority. Second, we need to avoid distorting the economic system by what we do.

Breimyer: I'd go a lot farther. I'd knock out all the deductions except giving to charity. The combination of Bradley-Gephardt and Regan's plans together all, to me, are beautifully designed. Regarding the matter of whether the first issue is of getting more revenue, if Congress and the administration start increasing taxes without reforming the code first, that means that I'll be paying it and all the shelter people won't. The inequity of simply having a scaled increase in income tax without reforming at the same time would be so great that I think it would be obscene. Also, just nibbling at the edge here and there isn't enough. I think the Regan and the Bradley-Gephardt plans -- this becomes technical -- are very well thought through and should be the model.

But Dr. Harl is absolutely right. Give anybody a payoff for a few years and it becomes property. The silly people who think it's terrible to make some loans available for students to go to college think it's nothing to write off billions in tax deductions.

Havlicek: I'll tell you what, on that let me take the prerogative of the moderator and let me officially adjourn this symposium. Let me remind you of a couple of things. First, the tapes can be ordered - both the audio and the video. The other thing is that the refreshment bar, the grape juice and

that, is still set up and available. Neil, Harold, both of you will be available here for informal discussions.

Harl: I do have breakfast at 7:30 in the morning, so we should be out of here by 7:00 a.m.

Havlicek: By 7:30 a.m. we've got to get out - he and I have breakfast plans. I trust that none of you have been disappointed about coming this evening and that you have found this a very rewarding evening. Let's show our appreciation.