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Marketing Loans, Loan Deficiency Payments, and Commodity Certificates

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Summary

Marketing assistance loans are one of the three primary subsidies in U.S. farm commodity programs. Since the loan program is tied to current production, it is a source of controversy in international trade negotiations. The 2002 farm bill continues the marketing loan program and sets loan prices through 2007. Policy issues for the 109th Congress regarding loans include payment limitations (especially the unlimited use by farmers of commodity certificates to avoid the limits), and the U.S. response to international pressure over the trade-distorting nature of marketing loans.

One purpose of the loan program is to provide short-term financing to allow farmers to pay their bills soon after harvest and facilitate orderly marketing throughout the rest of the year. The loan program also provides significant income support when market prices are below statutory loan rates. Marketing loan benefits to farmers averaged $6 billion from FY1999-FY2002, but have since declined to under $500 million as market prices have increased. This report will be updated as events warrant.

Background

Commodity support provisions in the 2002 farm bill (P.L. 107-171) include three primary types of payments: (1) annual direct payments unrelated to production or prices, (2) counter-cyclical payments if prices are below statutorily-determined target prices, and (3) marketing assistance loans that offer interim financing and, if prices fall below statutorily-determined loan prices, additional income support.[1] This report explains the design of the marketing loan program and examines some recent data and policy issues.

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[1] See CRS Report RS21779, *Farm Commodity Programs: Direct Payments, Counter-Cyclical Payments, and Marketing Loans*. All three payments apply to the "covered commodities" (corn, sorghum, oats, barley, wheat, upland cotton, rice, soybeans, and the minor oilseeds) and peanuts. Other "loan commodities" receive marketing loans but not direct or counter-cyclical payments; these include extra long staple cotton, wool, mohair, honey, dry peas, lentils, and chickpeas.

The primary purpose of the loan program is to give farmers short-term funds to meet expenses until the commodities are marketed, hence the name marketing assistance loans. Without such credit, more farmers might be compelled to sell their crop at harvest, thus oversupplying the market and lowering prices. Marketing loans and loan deficiency payments (LDPs) permit marketing based on price signals rather than creditor pressure.

Commodity loans have long been part of farm policy, but the current approach to marketing loans and LDPs began with the 1985 farm bill. The intention was to prevent the program's former storage requirement from distorting supply. However, when market prices were low from 1998 to 2001, the loan program became a major source of "counter-cyclical" income support since the 1996 farm bill had no other price-triggered supports.

How Marketing Loans Work

When the producer needs cash but wants to wait to market the commodity, taking out a loan is feasible regardless of market prices. LDPs are available only if market prices are less than the loan price (also known as the loan rate, which is different from the interest rate charged on marketing loans). Loan prices generally are set below normal downside market price fluctuations, but market prices occasionally drop even lower.

Marketing loans are available for the crop actually produced, unlike direct or counter-cyclical payments that are tied to historical bases and decoupled from actual production. Furthermore, while the 2002 farm bill sets loan prices at the national level (**Table 1**), USDA adjusts these to local loan prices to reflect geographical differences.[2]

The marketing loan program has four mechanisms to provide benefits when market prices are below loan rates:

- loan deficiency payments (LDPs) — a direct payment instead of a loan,
- marketing loan gains (MLGs) — repaying a loan at a lower market price (the posted county price, or the average world price for cotton and rice),
- "commodity certificates" — purchased at the posted county price to repay the loan, with similar results to MLGs but without payment limits,
- forfeiting the collateral (commodity) and keeping the principal (cash).

Obtaining a Loan. Producers taking out a loan pledge their harvested commodities as collateral for interest-bearing nonrecourse loans from the USDA Commodity Credit Corporation (CCC).[3] The value of the loan is the loan price multiplied by the quantity pledged as collateral. Loans mature in nine months, but can be repaid earlier.

Repaying a Loan. Loans can be retired in three ways: (1) repaying in cash, (2) repaying using commodity certificates, or (3) forfeiting the commodity to the CCC. Forfeit effectively results in selling to the government for the loan price. If market prices exceed the loan price when the loan is repaid, the producer repays principal plus interest.

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[2] Local loan prices are on the USDA website, [http://www.fsa.usda.gov/dafp/psd/LoanRate.htm].

[3] The interest rate charged on commodity loans was 2.125% during August 2003 (1% above the CCC's cost of borrowing from the U.S. Treasury, as mandated by the 1996 farm bill).

Table 1. National Average Marketing Loan Prices

Commodity	2004-2007	Commodity	2004-2007
Wheat, $/bu.	2.75	ELS cotton, $/lb.	0.7977
Corn, $/bu.	1.95	Wool, graded, $/lb.	1.00
Sorghum, $/bu.	1.95	Wool, nongraded, $/lb.	0.40
Barley, $/bu.	1.85	Mohair $/lb.	4.20
Oats, $/bu.	1.33	Honey, $/lb.	0.60
Upland Cotton, $/lb.	0.52	Peas, dry, $/cwt.	6.22
Rice, $/cwt.	6.50	Lentils, $/cwt.	11.72
Soybeans, $/bu.	5.00	Chickpeas, $/cwt.	7.43
Minor Oilseeds, $/lb.	0.093	Peanuts, $/ton	355.00

Source: CRS, compiled from the 2002 farm bill (P.L. 107-171), Title I, Sections 1202 and 1307.

If market prices are lower than the loan price when the producer decides to repay the loan (that is, the value of the collateral is less than the principal of the loan), the producer repays the loan at the lower price (with cash or certificates), keeps the difference, and retains ownership of the commodity for selling in the open market. The repayment price is called the posted county price (or adjusted world price for rice and cotton).[4] The difference between the loan price and the lower repayment price is called a marketing loan gain (MLG) and is taxable with farm income as a government payment.

Commodity Certificates. Certificates are a relatively new loan repayment option. The outcome is the same as repaying with cash, but the benefit is not counted against the payment limitation on MLGs. USDA sells generic commodity certificates only to producers seeking to repay outstanding marketing loans for less than the loan price. The producer buys a certificate at the posted county price (or adjusted world price) for the quantity of commodity under loan, immediately exchanges it for the collateral, and thus pays off the loan.

Taking the LDP Option. When market prices fall below loan prices, producers can opt to forgo the loan can receive LDPs equal to the difference between the local loan price and the lower posted county price (or adjusted world price). LDPs offer similar income benefits to marketing loan gains and are also taxable. The availability of LDPs reduces the amount of grain placed under loan when prices are low.

These various repayment and LDP provisions accomplish several objectives. The government avoids the costs and complications of inventory storage and disposal. Farmers retain possession of the commodities and make marketing decisions, rather than the CCC taking possession and possibly accumulating market-distorting stocks. Farmers generally appreciate the marketing flexibility and sometimes have been able to sell their commodity for more than the loan repayment price. In such cases, however, the farmer is exposed to market price volatility and is speculating once the loan is repaid.

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[4] Posted county prices are previous-day nearby terminal market prices adjusted by CCC's County Average Location Differentials (largely transportation costs) to reflect the local market; they are available online at [http://www.fsa.usda.gov/dafp/psd/default.htm].

A History of Loans Supporting Farm Income

The marketing loan price guarantee is one element of the federal farm income safety net. In addition to facilitating orderly marketing, nonrecourse commodity loans provide counter-cyclical income support when cash market prices drop below the loan prices. LDPs provide the income support benefits of the loan program without actually taking out the loan. But the loan program was not always as market-oriented as it is today, and its role in supporting income used to be greater.

Before changes in 1985 to increase market orientation, the loan program was an important supply management and price support mechanism. Forfeiture was common because loan prices were higher and the current loan repayment options did not exist when market prices were below the loan price.[5]

The transition away from supply management and price support was gradual, beginning in the 1970s. Loan prices were slowly reduced so as not to interfere with market prices as often. Various production control mechanisms (such as acreage set-asides or diversions, and conservation reserves) helped reduce supplies and support prices. The 1985 farm bill completed the evolution to marketing loans with an explicit policy not to use loans to control market supplies.

The 1996 farm bill went further to separate income support from market intervention. Producers of wheat, feed grains, rice, and upland cotton received annual direct payments from 1996-2002, along with nearly complete planting flexibility. They could plant almost any crop (except fruits and vegetables) without government limits on acreage and still receive income support. This policy shift was motivated in part by the tendency of other countries to increase production when U.S. farmers were required to cut back, and the desire to decouple payments from production.

The 2002 farm bill continues the marketing loan program and LDPs, emphasizing that the loan program should minimize accumulation of commodity inventories. It reinstated loans for several commodities that had been cut from the program in 1996 (wool, mohair, and honey), and added dry peas, lentils, and small chickpeas to the list of eligible crops. Current loan prices are set by the 2002 farm bill (**Table 1**), rather than the formula approach used in previous farm bills.

Table 2 shows the volume of loan activity from FY1998 to FY2003, and estimates for FY2004-05. The volume of loans issued remains steady at nearly $10 billion, but the design of the program has been successful in minimizing the amount of commodities forfeited to about 1.5% in FY2002-03.

The use of commodity certificates has grown significantly since being introduced in 2000. In FY2000 only 9% of loan repayments were with certificates. By FY2003, 37% were repaid with certificates.

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[5] Forfeiting commodities removes supplies from the market and can raise market prices if the volume is large. But government stocks eventually come out of storage and can oversupply the market. To reduce this impact, commodities may be donated or diverted to nontraditional uses.

Table 2 also shows the total income support benefits from the loan program. Loan benefits peaked in FY2000 at $8.1 billion, and have declined since as market prices have risen. In FY2005, USDA expects to provide under $200 million in loan benefits.

Table 2. Marketing Loans: Issued, Retired, and Benefits Paid

	Fiscal Year, Millions of Dollars							
	1998	1999	2000	2001	2002	2003	2004*	2005*
Loans made	7,189	8,358	9,692	8,267	10,131	10,718	9,069	9,614
Loans retired:								
Repaid cash	6,061	6,902	6,323	5,078	5,675	6,412	8,085	7,725
Repaid certs.	0	0	635	2,250	3,749	3,868	331	1,972
Write-off **	157	988	1,688	721	642	190	76	15
Forfeited	66	203	334	1,085	164	150	9	11
Total retired	6,284	8,093	8,980	9,134	10,230	10,620	8,501	9,723
Benefits to farmers: ***								
LDP	478	3,360	6,419	5,293	5,345	693	272	160
Write-off **	157	988	1,688	721	642	190	76	15
Total benefits	635	4,348	8,107	6,014	5,987	883	348	175

Source: USDA Commodity Credit Corporation, *Commodity Estimates Book*, July 2004.
* Estimate. ** Write-offs include marketing loan gains & certificate gains (repaying a loan when market prices are below the loan rate). *** Excludes implied gain over market price if loan is forfeited.

Distribution of Commodity Certificates

In October 1999, Congress amended the 1996 farm bill to allow commodity certificates to be issued to repay loans (P.L. 106-78, sec. 812).[6] It also exempted the use of certificates from payment limitations on marketing loan gains. In February 2000, the Secretary of Agriculture implemented the certificate program. The use of certificates to repay marketing loans continues under the 2002 farm bill.

The overall use of certificates grew dramatically from $635 million in FY2000 to $3.9 billion in FY2003. Some of the increase is due to greater loan volume because of low prices, but certificate use primarily has grown relative to cash repayments.

Cotton and, to a lesser degree, rice dominate the activity in certificates, and accounted for 71% of certificates issued in FY2000, growing to more than 99% in FY2003-04 (**Table 3**). Only in FY2000, the first year for such certificates, did feed grains, soybeans, or wheat have a noticeable share of the certificate volume.

Cooperative marketing associations (CMAs) account for much of the marketing activity for cotton and rice producers. Producers deliver commodity to the CMA and authorize it to participate in the marketing loan program on the their behalf. CMAs are more common for cotton and rice than for feed grains, wheat, and oilseeds.

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[6] Although bearing some similarities to the payment-in-kind (PIK) certificates used in the 1980s, the current certificates are not issued to producers as a tool to reduce CCC inventories.

Table 3. Use of Commodity Certificates, by Crop

	Fiscal Year, Millions of Dollars					
	2000	2001	2002	2003	2004*	2005*
Cotton	253	1,786	3,207	3,206	60	1,972
Rice	195	336	428	647	271	0
Soybeans, oilseeds	36	186	68	0	0	0
Feed grains	93	121	43	8	0	0
Wheat	58	16	3	1	0	0
Peanuts	0	0	0	6	0	0
Honey	0	4	0	0	0	0
Total	635	2,449	3,749	3,868	331	1,972

Source: USDA Commodity Credit Corporation, *Commodity Estimates Book*, July 2004.
* Estimate.

Policy Issues

The only major legislative issue regarding the loan programs since the 2002 farm bill has been the limit on payments that producers can receive.

Payment Limitations and Use of Certificates. Together, the combination of all marketing loan gains (from cash repayment) and LDPs is called the marketing loan benefit and is subject to an annual per-person payment limit of $75,000. In certain cases, this limit can be doubled for spouses or multiple farming entities. The use of commodity certificates, however, is not subject to any limit (see previous section).

On March 19, 2003, Senator Grassley introduced S. 667 in the 108th Congress to reduce payment limits on direct, counter-cyclical, and marketing loan payments, and count commodity certificates and loan forfeiture toward the limits. While the stated limit on marketing loans would rise slightly from $75,000 to $87,500, the effective limit is reduced by counting certificates and forfeiture toward the limit. This is a key feature because, as a practical matter, the limit on MLGs and LDPs is the point at which producers shift to commodity certificates without limit.

Certain critics of farm subsidies believe that high payment limits and unlimited commodity certificates are inconsistent with targeting federal assistance to family farms, and that such assistance for very large farms encourages their growth at the expense of smaller farms. They are critical of farm subsidies without any test of financial need.

Proponents of certificates argue against any change in the use of certificates and oppose any effort to tighten payment limitations. They assert that commodity payments are tied to production and that every acre should be eligible for payments regardless of the size of operation. To do otherwise, they contend, would be to punish efficiency and productivity.

For more information, see CRS Report RS21493, *Payment Limits for Farm Commodity Programs: Issues and Proposals*.