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ETHANOL

EXPORT ADMINISTRATION

FREEDOM OF INFORMATION ACT (FOIA)

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93 JUN 11 P3:34

MEMORANDUM

TO: Howard Paster
John Podesta
Mike Lux

FROM: Barbara Chow

RE: Agriculture Inventory

DATE: June 10, 1993

I have asked USDA, USTR, and the Treasury Department to put together a list of near-term discretionary administrative actions of interest to farm state legislators. Attached is a partial response to my request. As you will note, there are three principal actions that would be of direct benefit to rural Senators.

Members for whom these changes may be important include: Baucus, Boren, Bumpers, Conrad, Daschle, Dorgan, Exon, Harkin, Heflin, Kerrey, Nunn, Pryor, Shelby, and Wellstone.

1) **Expansion of the Export Enhancement Program (EEP).** The EEP program was created in 1985 to combat unfair trade practices through U.S. subsidies of foreign commodity sales (mostly wheat). USDA has proposed an increase to 36 million tons. This proposal is currently under interagency review. The main opposition is from State and OMB on foreign policy and budget grounds. The USDA proposal has a fair degree of congressional support.

2) **Loan rate increases.** Populist farm groups (e.g. National Farmers Union) have long urged this and previous Administrations to raise commodity loan rates. Proponents of this concept, including Senators Conrad and Dorgan, argue that it will improve farm income, and reduce dependence upon federal subsidies by allowing farmers to draw more from the marketplace than the government. Opponents of the proposal, including the Bush Administration have pointed to the significant budgetary cost and exposure of higher loan rates and the potential negative impacts on trade. A modest increase in loan rates (e.g. 5 cents) would probably have little impact (either from a budget or farm income perspective) but could be an important symbolic gesture differentiating this Administration from its predecessor. The additional costs would increase the deficit but need not be offset, since they are the result of administrative action.

3) **Rural Electrification Administration (REA) Prepayment.** Rural electric cooperatives borrowed a significant number of high interest long-term loans during the early 1980's. They

are now interested in repaying these loans without prepayment penalty in order to take advantage of the lower interest rates. They argue that the federal government is profiting from these loans, receiving more in interest than its cost of borrowing. Opponents of this provision argue that prepayment without penalty sets a poor precedent for other FFB loans and will cost the federal government about $1 billion in reduced interest payments. As in the loan rate proposal, these costs would increase the deficit (over several years) but would not be "scored" if it is legislatively achieved. The biggest winner from a change in prepayment policy is Georgia.

In addition to these issues, there may be a number of trade concerns which are likely to be of interest to farm state legislators.

Given the uncertainty of the Senate Finance Committee action, I need some guidance on how to proceed on these issues. I recognize that the package coming out of the Finance Committee may be sufficiently different from our program that we will not be actively lobbying it on the Senate floor.

On the other hand, it is clear that moving forward on these proposals, in combination with likely action taken by the Finance Committee to ease agriculture concerns would significantly assuage concerns by farm state legislators. Should we push for resolution of these issues? Should we press for support for NAFTA as part of this package?

EXPANSION OF THE EEP

The USDA has recently proposed within the Administration an expansion of the EEP to more countries. This proposal is supported by many in Congress, especially those representing grain producing areas. The main opposition has come within the Administration on foreign policy grounds (adverse effects on Canada, Australia, etc.) and on budget grounds (possible outlay increase, although budget neutrality has been maintained heretofore).

The EEP package for 1992/93 had an allocation of 33 million tons for targeted destinations. USDA expects that sales under EEP to those destinations will total 24 million tons. For 1993/94, USDA has proposed an expansion to 36 million tons. For existing targeted markets, the package calls for a slightly reduced allocation. A reduced allocation to China and the FSU-12 exceeds increased allocations to other existing targeted markets. The additional markets proposed for 1993/94 account for about 4 million tons in allocations. These countries include western hemisphere countries (Mexico, Chile, Ecuador, and others), Indonesia, and Finland.

<u>Reasons for expansion</u>:

- The U.S. has been losing market share in the countries proposed for expansion, particularly to Canada which provides its producers an extensive program of support and whose policies cannot be considered as nonsubsidizing.
- Canada's exports to the U.S. have risen dramatically over the past several years. While still accounting for a small percentage of total U.S. wheat use, these exports are concentrated in the North Central states and have become both a political and economic problem there. The recent binational panel's ruling that Canada does not export unfairly to the U.S. is viewed as unjust and flawed by many including those in the Administration who prepared the case. Expanding the EEP to encompass Canadian markets may reduce some of the economic and political distress caused by Canada's exports to the U.S. and to other Western Hemisphere countries.
- The U.S. is now facing a sharp decline in wheat prices. The U.S. farm price of wheat averaged $3.25 per bushel in 1992/93. USDA's current forecast is $2.75 per bushel for 1993/94. Part of the expected drop is due to a forecast reduction in wheat exports. Wheat exports were 1,340 million bushels in 1992/93 but are expected to total only 1,225 million in 1993/94 due to increased supplies in competitor countries and reduced imports in areas such as the FSU. A broadened EEP is about the only policy tool available to address the lower price and reduced exports expected for 1993/94.
- The budget cost of the expanded EEP is minimal if there is any cost at all. See attached paper on the outlay issue.
- The primary motive for the EEP remains trade policy reform. The Uruguay Round remains incomplete, but it is clear that the U.S. policy of meeting unfair competition head on has helped push the Round toward strong export disciplines.

In order to prevent backsliding from the Blair House agreement and to stimulate the remaining negotiations, the U.S. should continue to demonstrate that unfair competition (e.g., Canada) will not be ignored.

ECON/6-7-93

RAISING GRAIN LOAN RATES

A policy option proposed by some members of the House and Senate has been to raise grain loan rates. USDA considered an increase for the 1993 crops, however, none was announced. Program signup has closed, and some wheat has already been harvested and marketed, making any 1993-crop program changes impractical. The 1994-crop wheat program had to be announced by June 1, and a 0 percent acreage reduction program was announced. However, no announcement was made regarding the 1994-crop loan rate.

The policy decision for the 1994 loan rates will be difficult and controversial. Loan rates were sharply reduced for the 1986 crops by the 1985 Farm Bill because the high loan rates of the early 1980's were seen as hurting competitiveness and leading to lost sales and excessive carryover levels. Since 1990, grain loan rates have risen but have been set at about the minimum permitted rate:

Crop and year	Statutory minimum	Announced rate
Wheat		
1986	2.40	2.40
1987	2.28	2.28
1988	2.21	2.21
1989	2.06	2.06
1990	1.95	1.95
1991	2.04	2.04
1992	2.21	2.21
1993	2.45	2.45
Corn		
1986	1.92	1.92
1987	1.82	1.82
1988	1.77	1.77
1989	1.65	1.65
1990	1.57	1.57
1991	1.62	1.62
1992	1.72	1.72
1993	1.70	1.72

The process of setting loan rates for grains involves calculating a "basic loan rate" which is based on 85 percent of the average of past market prices. The basic loan rate cannot fall by more than 5 percent from the previous year. The announced loan rate may be set up to 10 percent lower than the basic rate depending on the expected stocks-to-use ratio. In addition, to ensure competitiveness, the Secretary may exercise discretion to reduce the loan rate by up to an additional 10 percent. This discretion has been exercised in every year, except for corn in 1993.

A major change in the grain loan program is in effect for the 1993 crops. Marketing loans have been implemented in response to the GATT trigger requirements of the 1990 Budget Act. This means producers may repay the loan at less than the loan rate plus interest and fully discharge their debt to the government.

Arguments for raising the loan rate above the statutory minimum:

--Producers would receive more in loan principal at harvest and thus be better able to meet operating expenses.

--Grain program loans are made at lower interest rates than most producers could obtain in the private sector, thus there is an interest rate benefit.

--Grain market prices are expected to be low at harvest time and 1994 does not look promising at this point, thus many producers may want to store rather than market grain at these low prices. The higher loan rate would provide a financial opportunity to store.

--If the loan rates are raised to the point that market prices are below loan rates for at least part of the crop year, producers would receive marketing loan gains--the difference between the posted county price and the loan rate. Participating producers would be eligible for marketing loan gains on all their production. Since total production exceeds the production on which deficiency payments are made, farm income would be higher when marketing loan gains are received. (Deficiency payments apply to "program yields" and "payment acres" which are reduced by the 15 percent normal flex or triple base, whereas marketing loan gains apply to actual yields and planted acres.)

Arguments for not raising the loan rate above the statutory minimum:

--If loan rates are raised, more loans will be made and loan outlays and storage costs will increase. Although this will increase outlays when they are added up over any finite number of fiscal years (such as 1994-98), these outlays are recoverable if the loans are ultimately repaid and no forfeitures occur. However, if loan rates are raised enough to cause marketing loan payments to be made, nonrecoverable farm program outlays would increase.

--Higher loan rates have a negligible effect on farm income unless they are raised sharply. If rates are raised so that marketing loan gains do not occur, then the only income gain to producers is the time value of the additional loan. For example, a 10 cent loan rate increase gives the producer 10 cents more at the start of the season, but the producer must repay the 10 cents at the end. The interest benefit on this is negligible. If marketing loan gains are incurred, then each $1 increase in income requires a $1 increase in program outlays. Thus, any substantial income increase requires a substantial outlay increase.

--There is a fear that if higher loans mean higher program costs there will be greater pressure to raise acreage reduction programs (ARPs) to offset the costs. Higher ARPs reduce farm income, exports, and farm related economic activity.

--Budget exposure of higher loan rates could be great. Even if the loan rate increase is limited so that no marketing loan gains are "expected," budget costs could still turn out to be large if weather or foreign markets lead to lower than expected market prices.

--Higher loan rates distort production incentives. Because production on normal flex acres is eligible for loans but not deficiency payments, higher loan rates could encourage producers to plant more program crops on flex acres, which could be contrary to what the market is signalling.

Conclusion: Any increase in loan rates will have supporters and opponents. The minimum permitted loan rates will decline for 1993 grains. At this point, the basic loan rate for 1994 wheat is $2.72 a bushel and the minimum permitted is $2.33, compared with the 1993 rate of $2.45. For 1994 corn, the basic loan rate is likely to be $1.90, with the minimum permitted $2.33, compared with the current $1.72. One option would be to hold rates at the 1993 levels, which would not be an increase over 1993 but would be an increase compared with the statutory minimum. Other options include moving rates toward the basic levels, but that would incur budget outlays as described above.

ECON/6-7-93

PREPAYMENT OF REA LOANS

The Rural Electrification Administration (REA) has a portfolio of about $12 billion in direct loans and $18 billion in guarantees of loans made by the Federal Financing Bank (FFB). The direct loans have interest rates of 2 and 5 percent. The Government will incur an annual loss on these loans until they are repaid. The guaranteed loans have interest rates based on the Treasury cost of borrowing at the time they were advanced. In most cases, guaranteed loan funds are disbursed to borrowers through a number of advances, over several years. The decline in interest rates since the time these loans were advanced has resulted in annual gains to the Government.

Prepayment of both types of loans has been a controversial policy issue for the last several years. The following provides some additional background information on this issue.

DIRECT LOANS: Direct electric and telephone loans are made by REA to finance systems for the distribution of electric and telephone service. Most electric borrowers are cooperatives, while the majority of the telephone borrowers are private companies.

Prior to this year, legislation permitted direct loan borrowers to prepay their loans, as a general rule, at no less than the face value of the loans. Borrowers had little, if any, incentive to prepay on these terms because the cost of borrowing funds from other sources would be higher than remaining indebted to REA.

In theory, for both REA borrowers and the Government to be "indifferent" about the prepayment of direct loans, the face value of the loans needs to be discounted for the value (cost in the case of the Government) of their reduced interest rates. Prepayments, so discounted, should be neutral in financial terms for both parties. Neither should gain nor lose.

Legislation enacted in 1986 allowed prepayments taking place prior to October 1, 1987, to be made at a discounted value. This authority required borrowers to prepay all of their outstanding debt to REA and to forego any future assistance from the agency.

Legislation enacted in 1992 permits borrowers to prepay these loans at the lesser of the face or discounted value. Under this law, borrowers may prepay all or a portion of the indebtedness to REA. However, the law does require that borrowers who prepay not be allowed to receive new direct loans over the next 10 years.

Proposed regulations for implementing the new law are currently in Departmental clearance. Until the regulations are published final, and become effective, it is difficult to tell how many borrowers will prepay their direct loans. The prohibition on future loans may deter some from participating. However, there should be no argument over the financial terms of the offer. As noted above, these terms should be neutral for both borrowers and the Government. The issue of prepayment may be resolved for direct loans.

GUARANTEED LOANS: Loans made by the FFB and guaranteed by REA are used to finance the construction of generation plants and transmission facilities. As of December 31, 1992, REA's portfolio included about $10 billion of such loans with interest rates in excess of 8 percent. Based on the current cost of Treasury borrowing, the Government would receive about $1 billion more in interest payments than interest costs if these loans are held to maturity at their present interest rates.

It would be to the financial advantage of the borrowers to be able to prepay these loans. Many of the borrowers are able to obtain private credit at more reasonable interest rates.

Borrowers with loans made prior to 1983, which constitutes about three-fourths of the portfolio, may refinance with the FFB at current interest rates. They must pay a penalty of 1 year's interest at the old interest rate. The amount refinanced must have been outstanding for at least 12 years. Several borrowers have pursued this option in the last 2 years.

Refinanced loans are treated in the budget as new loans. Any significant increase in this activity would put these loans in competition with loans for new projects.

Loans made prior to 1983 may also be prepaid by the borrower at the higher of:
(1) face value, with the same penalty as applies to loans refinanced with the FFB, or
(2) present value. In most cases present value is higher.

For loans made since 1983, borrowers are not eligible for FFB refinancing and must pay a much higher penalty. The penalty is about 10 percent of the outstanding balance for each 1 percent decrease in the interest rate, which discourages prepayment. Legislation waiving the penalty was considered by Congress on numerous occasions, but never enacted except on a limited basis. The Reagan and Bush Administrations opposed this legislation arguing that it would provide an additional subsidy to borrowers and cost the Government up to $1 billion in interest payments.

Proponents of legislation to waive the penalty argue that the Government is making a profit on loans paying more interest than the current cost of Treasury borrowing. The prepayment penalty, in effect, captures this profit. Foregoing the penalty represents a cost to the Government only in the sense that it would give up an opportunity to make a profit at the borrowers' expenses. The only excuse for making such a profit is that borrowers agreed to it at the time they received their loans.

Legislation enacted in 1986 provided for the prepayment of up to $2.0 billion in guaranteed loans at face value without penalty. This law provided for the transfer of the guaranteed to private credit used to prepay the FFB, and required borrowers to certify that savings resulting from the prepayment were passed on to consumers or used to improve the financial strength of the borrower. Subsequent Appropriations Act language increased the amount to $2.5 billion. All but $350 million of the amount has been utilized. OMB has insisted that the remaining $350 million be reserved for troubled borrowers that may need to prepay to preclude delinquency or default on loans.

Other entities, including foreign governments have been permitted to prepay high interest rate FFB loans. Authorization to prepay high interest rate Foreign Military Sales Credit loans, guaranteed by the Department of Defense (DOD) was enacted in 1987 in P.L. 100-202. According to DOD, in May 1990, 10 countries had refinanced debt totaling $8.8 billion. In addition, in 1992 the Treasury Department agreed to refinance half of the Postal Service debt of $9.9 billion, reducing the interest rate from 8.76 to 6.56 percent.

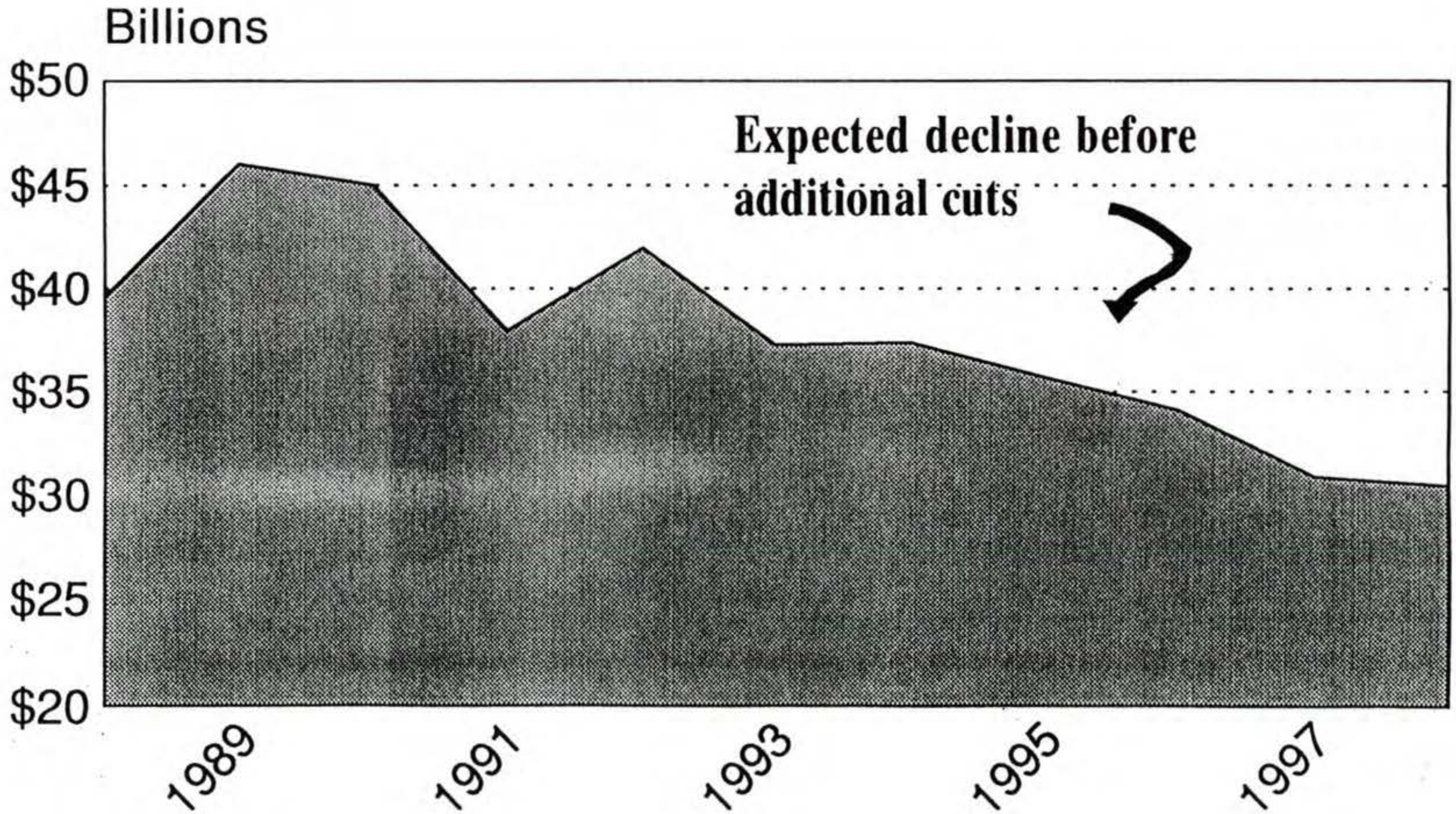
POLICY CONSIDERATIONS

The prepayment provisions of REA guaranteed loans are contractual terms between the borrower and the FFB. It is unclear whether the FFB has the authority to waive the penalty on prepayment. It could be done, however, with a legislative mandate.

If legislation is proposed to waive the penalty, the first step will be to resolve the matter of cost. As noted above, OMB has argued in the past that prepayment without penalty cost about $1 billion in reduced interest payments. Regularly scheduled interest and principal payments are reflected in the budget baseline for future years. These payments offset mandatory outlays for the entitlement programs. A reduction in payments increases the deficit. The Congressional Budget Office is likely to confirm OMB's position on "scoring" the cost against the baseline. One possibility that could be explored is to seek an adjustment of the baseline. Otherwise, the loss of the $1 billion in anticipated payments would have to be offset by a reduction elsewhere.

Net Farm Income Trend

Before Proposed Budget Cuts in Farm Program
Real $'s (1987=100)

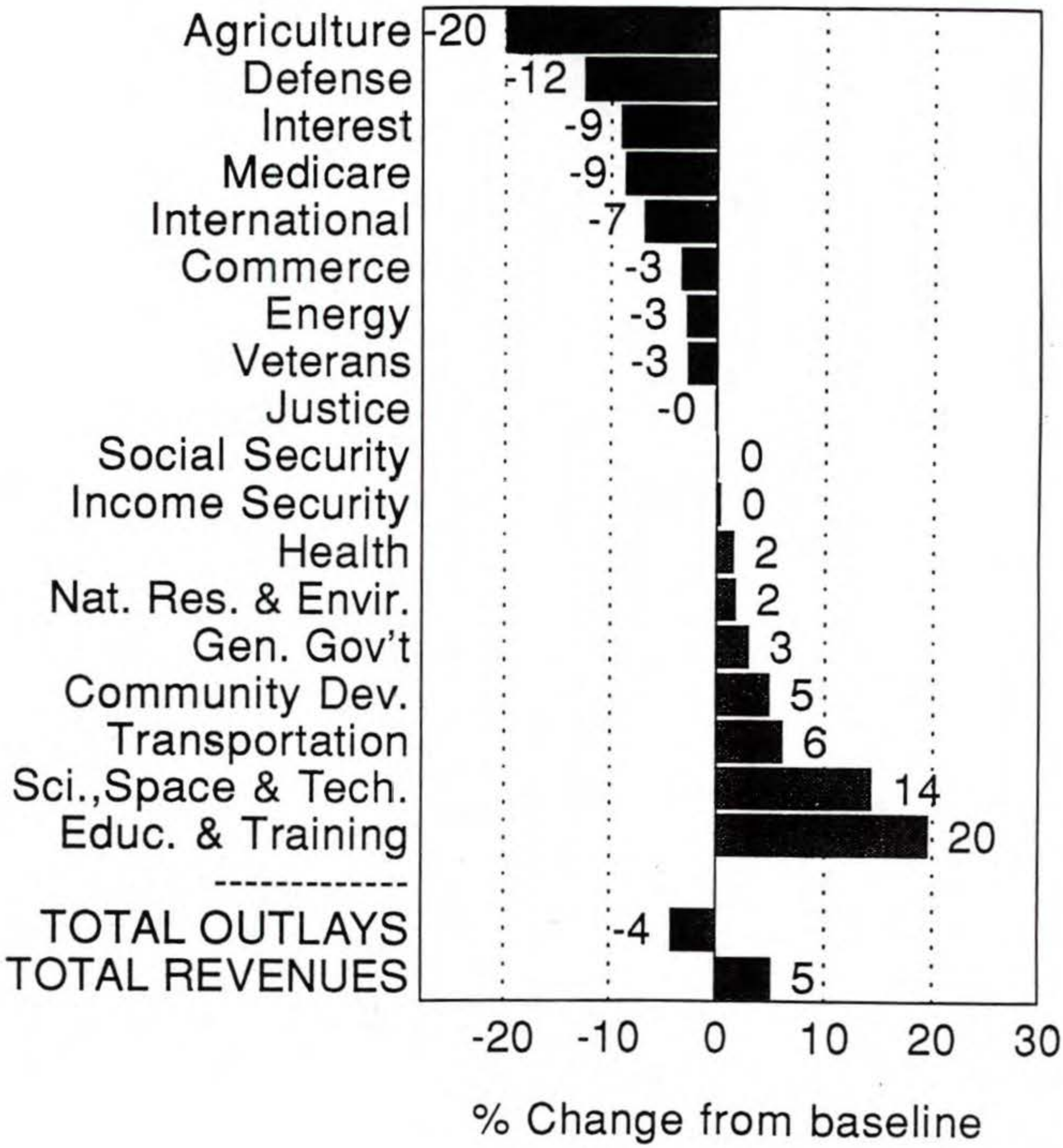


Source: USDA ERS, FAPRI projections.

file Agriculture

Effect of the Clinton Budget

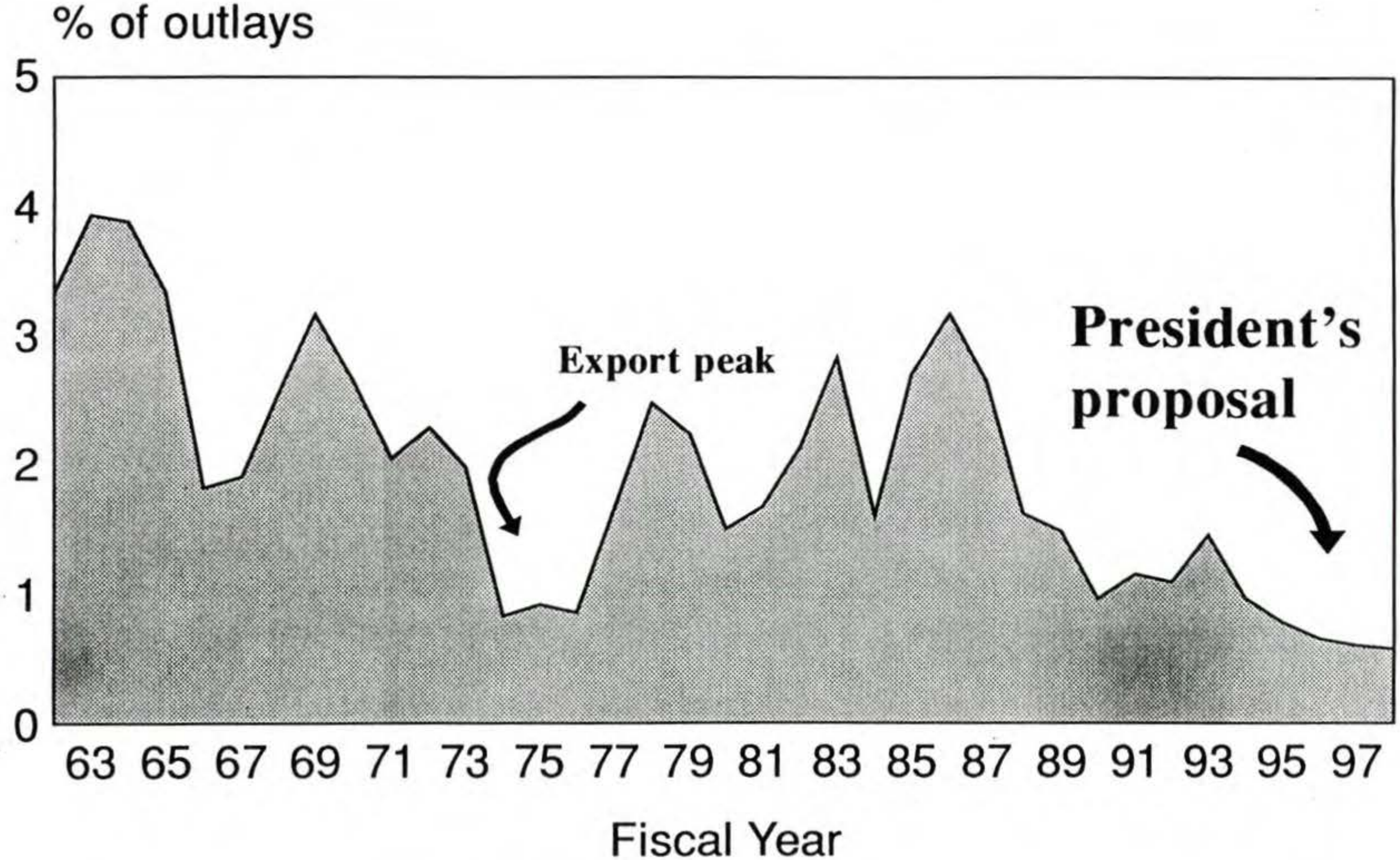
on Budget Functions and Revenues
FY 1998



Note: FY 98 plan contains $9.1 b. unallocated reductions (included in total outlays).

Federal Agriculture Spending

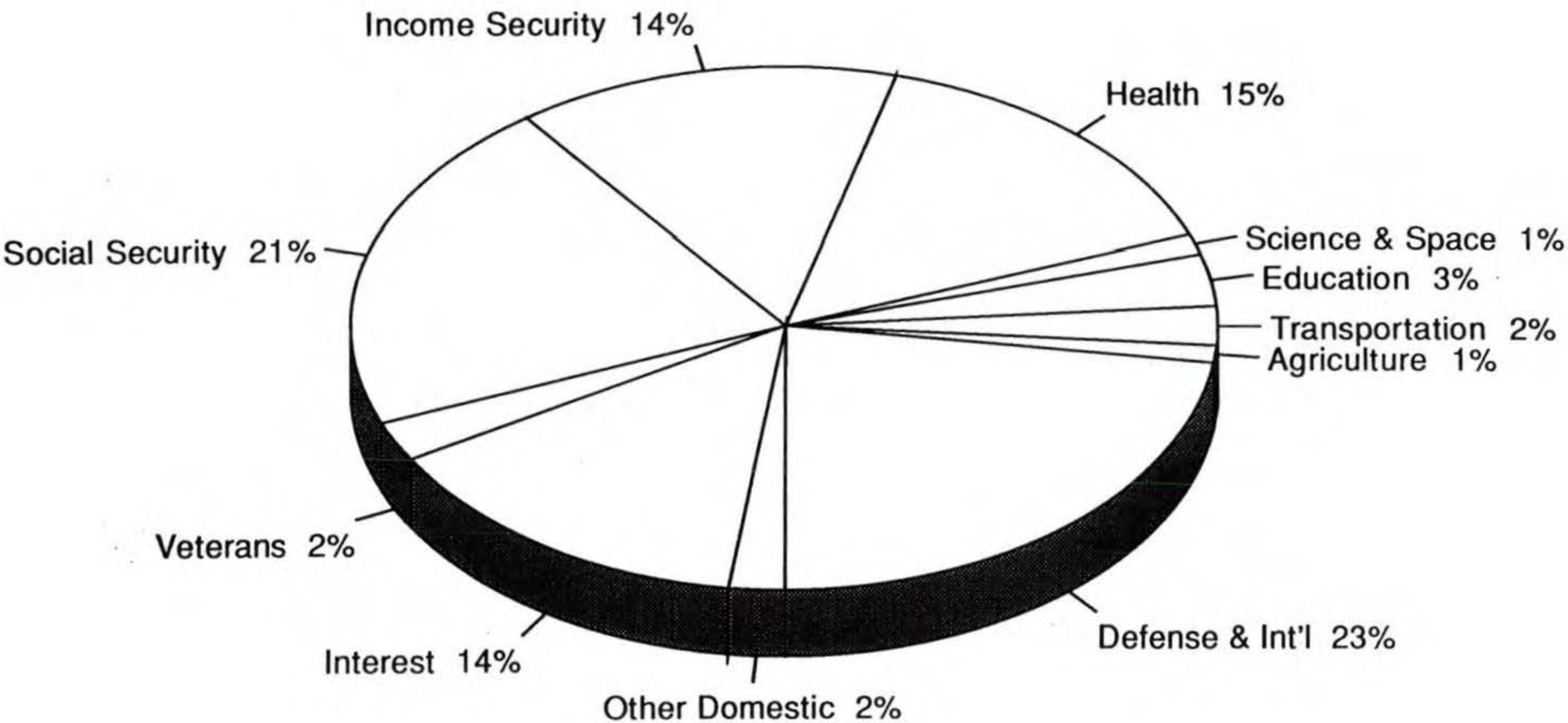
As % of Total Federal Budget



FY 93 - 98: CBO reestimates of President's budget

Federal Spending by Function

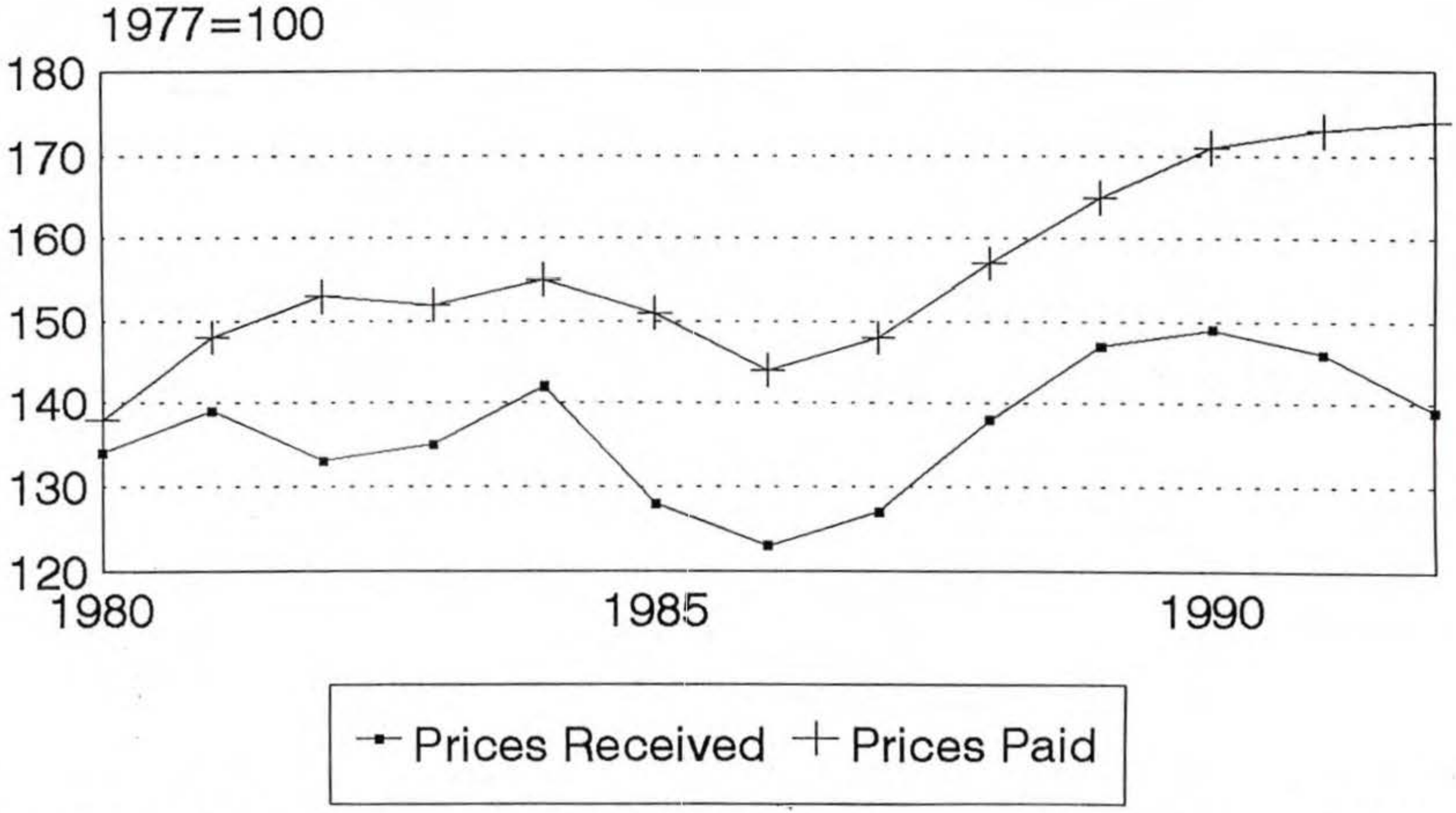
FY 1992 Actual



The Farm Cost-Price Squeeze

Prices Paid by Farmers Have Outpaced Prices Received

Index with 1977=100

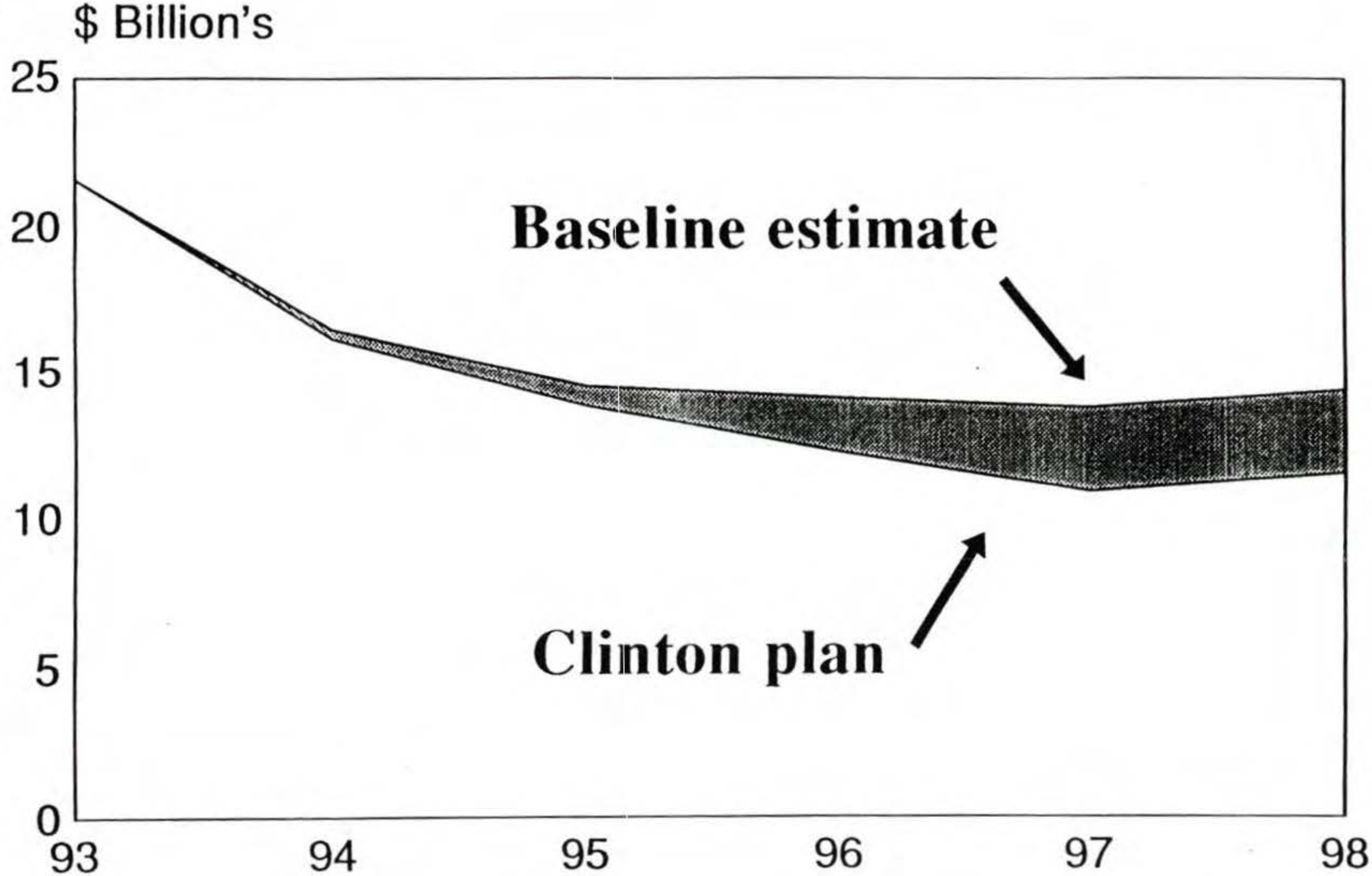


In 1992, the ratio of prices received to prices paid was at its lowest level ever, below 80%.

Source: USDA

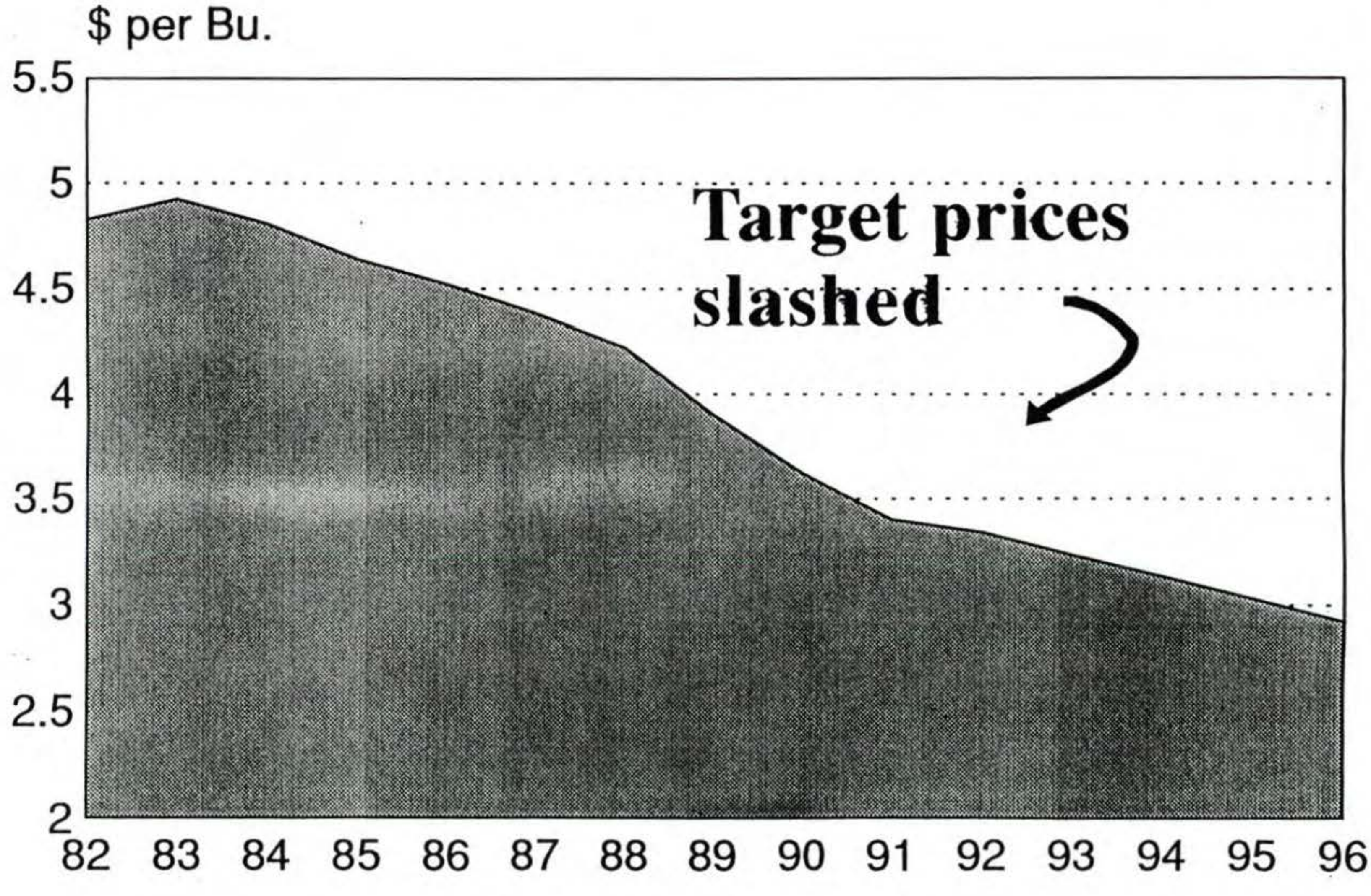
Agriculture Spending

In Clinton Plan



Target Prices for Wheat

Real $'s (1987=100)



U.S. Wheat Exports

Real $'s (1988=100)