PUBLIC GOODS AND PUBLIC CHOICE

Case Studies

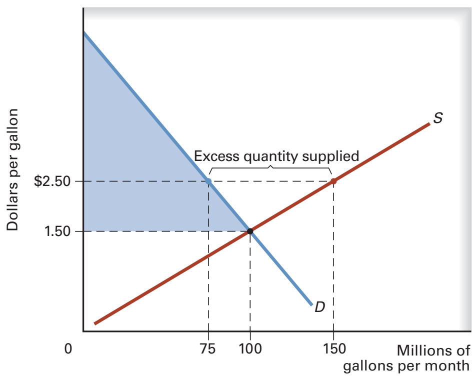
Case Study 16.1: Farm Subsidies

[**Note:** This is a more detailed look at farm subsidies than the similar material in Chapter 16 of the text]

The Agricultural Marketing Agreement Act became law in 1937 to prevent what was viewed as "ruinous competition" among farmers. At the time, one in four Americans lived on a farm. In the years since, the government introduced a variety of policies that set floor prices for a wide range of farm products. Now, only one in fifty Americans lives on a farm, but this program is still with us. Subsidies in the 2008 Farm Act cost U.S. taxpayers $15.4 billion in 2009. Worse still, the U.S. government often sells surplus crops overseas for lower prices. That sounds altruistic, but U.S. exports put some poor farmers around the world out of business. U.S. farm subsidies continue to be a sticking point in negotiating freer international trade agreements.

Let's see how price supports work in the dairy industry, using a simplified example. The exhibit below presents the market for milk. Without government intervention, suppose the market price of milk would average $1.50 per gallon for a market quantity of 100 million gallons per month. In long-run equilibrium, dairy farmers would earn a normal profit in this competitive industry. Consumer surplus is shown by the blue-shaded area. Recall that consumer surplus is the difference between the most that consumers would be willing to pay for that quantity and the amount they actually pay.

Effects of Milk Price Supports



Now suppose the dairy lobby persuades Congress that milk should not sell for less than $2.50 per gallon. The higher price encourages farmers to increase their quantity supplied to 150 million gallons per month. Consumers, however, reduce their quantity demanded to 75 million gallons. To make the floor price of $2.50 stick, the government every month must buy the 75 million gallons of surplus milk generated by the floor price or somehow get dairy farmers to cut output to only 75 million gallons. For example, to reduce supply, the government spent about $1 billion on milk products in 2009 under one federal program.

Consumers end up paying dearly to subsidize farmers. First, the price consumers pay increases, in this example by $1 per gallon. Second, as taxpayers, consumers must also pay for the surplus milk or otherwise pay farmers not to produce that milk. And third, if the government buys the surplus, taxpayers must then pay for storage. So consumers pay $2.50 for each gallon they buy on the market, pay another $2.50 in higher taxes for each surplus gallon the government must buy. Instead of paying a freemarket price of just $1.50 for each gallon consumed, the typical consumer-taxpayer in effect pays $5.00 for each gallon actually consumed.

How do farmers make out? Each receives an extra $1 per gallon in revenue compared to the free-market price. As farmers increase their quantity supplied in response to the higher price, however, their marginal cost of production increases. At the margin, the higher price just offsets the higher marginal cost of production. The government subsidy also bids up the price of specialized resources, such as cows and especially pasture land. Anyone who owned these resources when the subsidy was introduced would benefit. Farmers who purchased them after that (and, hence, after resource prices increased) earn only a normal rate of return on their investment. Because farm subsidies were originally introduced more than half a century ago, most farmers today earn just a normal return on their investment, despite the billions spent annually on subsidies.

If the extra $1 per gallon that farmers receive for milk were pure profit, farm profit would increase by $150 million per month under the government program. But total outlays by consumer-taxpayer jumped from $150 million per month for 100 million gallons to $375 million per month for 75 million gallons. Thus, cost to consumer-taxpayers increases by $225 million, though they drink 25 million fewer gallons. Like other special-interest legislation, farm subsidies have a negative impact on the economy, as the losses outweigh the gains. The real winners are those who owned specialized resources when the subsidy was first introduced. Young farmers must pay more to get into a position to reap the subsidies. Ironically, subsidies aimed at preserving the family farm raise the costs of farming.

SOURCES: Barratt Kirwan, "The Incidence of U.S. Agricultural Subsidies on Farmland Rental Rates," *Journal of Political Economies*, 117 (February 2009): 138–164; Ani Katchova, "A Comparison of Economic Well-Being of Farm and Nonfarm Households," *American Journal of Agricultural Economics*, 90 (August 2008): 733–747; Bill Egbert, "Councilman Eric Gioia Having a Cow Over Milk Prices: $6 A Gallon Is Too High, He Says," *New York Daily News*, 5 July 2009; Calitza Jimenez, "USDA Pulls Plug on Some Farm Subsidy Data," Center for Public Integrity, 21 May 2010, at http://www.publicintegrity.org/data_mine/entry/2100/; and Joseph Glauber, "Statement Before the Senate Judiciary Committee," 19 September 2009, at http://www.usda.gov/oce/newsroom/archives/testimony/2009/VermontDairy.pdf.

QUESTIONS

1. "Subsidizing the price of milk or other agricultural products is not very expensive considering how many consumers there are in the United States. Therefore, there is little harmful effect from such subsidies." Evaluate this statement.
2. Subsidy programs are likely to have a number of secondary effects in addition to the direct effect on dairy prices. What impact do you suppose farm subsidies are likely to have on the following?

a. Housing prices
b. Technological change in the dairy industry
c. The price of dairy product substitutes

Case Study 16.2: Campaign Finance Reform

Critics have long argued that American politics is awash in special-interest money. Most Americans seem to agree. Two-thirds of those surveyed support public financing of campaigns if it eliminates funding from large private donations and organized interest groups. Since the 1970s, presidential campaigns, but not congressional races, have been in part publicly funded. Candidates who accept public funds must abide by campaign spending limits. But by rejecting public funds, candidates can ignore spending limits.

Senators John McCain and Russ Feingold proposed a ban on so-called soft-money contributions to national parties. *Soft money* allows political parties to raise unlimited amounts from individuals, corporations, and labor unions and to spend it freely on party-building activities, such as get-out-the-vote efforts, but not on direct support for candidates. *Hard money* is the cash parties raise under rules that limit individual contributions and require public disclosure of donors. The McCain-Feingold measure was approved as the Bipartisan Campaign Reform Act of 2002. The act bans the solicitation of soft money by federal candidates and prohibits political advertising by special interest groups in the weeks just before an election. The contribution limit is $2,300 for the primary and $2,300 for the general election, or a combined $4,600 for both.

Limits on special-interest contributions may reduce their influence in the political process, but such caps also increase the advantage of incumbents. Although there was anti-incumbent sentiment in the 2010 congressional election, historically about 95 percent of congressional incumbents usually get reelected. Incumbents benefit from a taxpayer-funded staff and free mailing privileges; these mailings often amount to campaign literature masquerading as official communications. Limits on campaign spending also magnify the advantages of incumbency by reducing a challenger's ability to appeal directly to voters. Some liberal and conservative thinkers agree that the supply of political money should be increased, not decreased. As Curtis Gans, director of the Committee for the Study of the American Electorate argued, "The overwhelming body of scholarly research . . . indicates that low spending limits will undermine political competition by enhancing the existing advantages of incumbency." *Money matters more to challengers* because the public knows less about them. Challengers must be able to spend enough to get their message out. One study found a positive relationship between spending by challengers and their election success but found no relationship between spending by incumbents and their reelection success. So campaign spending limits favor incumbents.

The U.S. Supreme Court in 2010 ruled that the federal government may not ban certain types of political spending by corporations and labor unions, ruling that: "When governments seek to use its full power, including the criminal law, to command where a person may get his or her information, . . . it uses censorship to control thought."

Barack Obama and John McCain together spent a little more than $1 billion in the 2008 presidential race (with most of that spent by Obama). More than a billion dollars sounds like a lot of money, but Coke spends at least twice that on advertising each year. The point is that even well-meaning legislation often has unintended consequences. Efforts to limit campaign spending may or may not reduce the influence of specialinterest groups, but by *reducing a challenger's ability to reach the voters, spending limits increase the advantage of incumbency, thus reducing political competition*.

SOURCES: Michael Ensley, "Individual Campaign Contributions and Candidate Ideology," *Public Choice*, 138 (January 2009): 229–238; Jess Bravin, "Supreme Court Reverses Limits on Campaign Spending," *Wall Street Journal*, 21 January 2010; Jonathan Salant, "Spending Doubled as Obama Led Billion-Dollar Campaign," *Bloomberg News*, 27 December 2008, at http://www.bloomberg.com/apps/news?pid=20601087&sid=apxzrZEHqU1o&refer=home#; the Federal Election Commission at http://www.fec.gov/; and Common Cause at http://www.commoncause.org.

QUESTION

1. The motivation behind campaign finance reform was to limit the influence of special interests. In what sense could that legislation have the opposite effect?