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When Are Farm Interest Rate Subsidy Programs Most Effective?

The U.S. Department of Agriculture provides subsidized credit to high-risk farm borrowers unable to obtain credit from commercial sources. To boost incomes and to relieve financial stress, Farm Service Agency programs can provide additional interest rate subsidies to borrowers. However, when market interest rates are low as in recent years, these additional subsidies are less effective in improving borrower income and financial performance. Directing these additional subsidies to beginning farmers and socially disadvantaged borrowers or reserving their use for more stressful economic periods may help control program costs while increasing benefits to borrowers and the public.

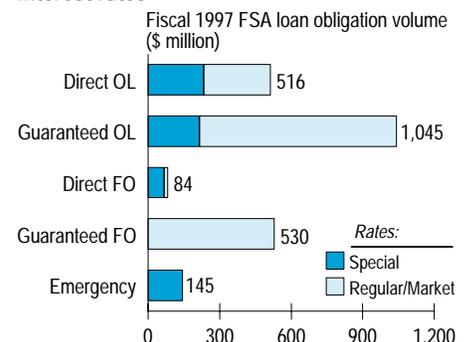
The Department of Agriculture's Farm Service Agency (FSA) provides direct and guaranteed loans to farmers unable to obtain loans from the Farm Credit System or other commercial lenders. All FSA loans provide some subsidy value or credit enhancement to the borrower. Interest rates on loans made directly by FSA are lower than those on loans from commercial lenders because FSA rates reflect lower government borrowing costs and do not fully account for administrative costs. However, some FSA loans are made to farmers at interest rates below the Government's cost of borrowing (or below market rates in the case of commercial loans that are guaranteed by FSA). These loans, made through special interest rate assistance programs, provide an additional subsidy to targeted borrowers (fig. 1).

Farm credit subsidies redistribute income to low-income farm households and have found strongest support during periods of high interest rates and financial stress. While less costly methods for the Government to transfer income to targeted populations often exist, subsidized credit has nevertheless been used to raise farm incomes and relieve farm financial stress. Various low-rate emergency loan programs have been used since 1918 to help farmers recover from natural and economic disasters. Low rates for direct FSA loans were introduced during the 1970's when market interest rates were high; low rates for FSA-guaranteed loans were introduced during the farm financial stress of the mid-1980's.

Originally authorized to stem acute cash-flow or profitability problems suffered by farmers, special low-interest-rate programs have become permanent features of Federal farm credit programs. Providing additional credit subsidies to borrowers may be appropriate when cash-flow problems are temporary and long-term financial prospects are good. However, providing subsidized credit merely to transfer income is costly and unlikely to be economically efficient. Delivering such subsidies to needy borrowers, while excluding such subsidies to borrowers with adequate access to financing, is very difficult. The second group of borrowers, if subsidized, would reap windfall gains, with no public benefit to offset program costs.

Figure 1

Nearly \$450 million of FSA's direct farm loan obligations were made at special low interest rates¹



¹Emergency + Direct OL + Direct FO loans.

OL = Operating loans. FO = Farm ownership.

Source: Economic Research Service compiled from Farm Service Agency (FSA) data.

Some FSA Programs Provide Additional Interest Rate Subsidies

To provide additional credit subsidies to low-income farm borrowers, FSA's emergency (EM), operating (OL), farm ownership (FO), and beginning farmer loan programs offer interest rates below the cost of government borrowing. For direct OL and FO loans there is a limited-resource-rate program; for guaranteed OL loans, there is an interest rate assistance program (see box).

Special low interest rates for direct lending programs have been used extensively. In fiscal 1997, 60 percent of the \$745 million in direct farm loan obligations (EM plus direct OL and FO loans) were made at rates below regular program rates. The percentage varies through time depending on interest rate levels, program design, funding, and the financial condition of applicants. By law, FSA is required to lend at least 25 percent of its direct loans each year at the limited-resource rate. The use of targeted rates peaked in fiscal 1981 when market interest rates and emergency loan authority were high, and again in the mid-1980's as the Government sought to relieve financial stress through credit programs.

About 14 percent of the \$1.6 billion in guaranteed lending in fiscal 1997 was made through the interest rate assistance program. Congress intended that the limited-resource rate and interest rate assistance programs provide temporary assistance to borrowers who cannot repay their debt at regular loan rates. Each program requires that the loan rate be increased to regular rates if the borrower's financial condition improves sufficiently.

In contrast to the limited-resource-rate and interest rate assistance programs, eligibility for emergency credit and beginning farm loan program rates does not depend on ability to pay regular program rates. In addition to being unable to obtain commercial credit, applicants for an EM loan must have incurred losses from a natural

FSA Loan Rates

Regular Direct Program Rate. Loan interest rates on direct loans (those made, funded, and serviced by FSA) are set for the life of the loan at the current average market yield on outstanding U.S. Treasury obligations having maturities of 5 years for operating loans and 25 years for farm ownership loans, plus 1 percentage point.

Limited-Resource Rate. Direct loan rates set at half the rate on 5-year U.S. Treasury notes, but not below 5 percent. Eligibility is to be reviewed annually. Limited-resource rates have been at their statutory minimum of 5 percent since 1986 for farm ownership and since 1990 for operating loans. FSA is required to lend a minimum of 25 percent of its direct loans at the limited-resource rates.

Guaranteed Program Rates. Loan interest rates on guaranteed loans (those made, funded, and serviced by commercial lenders, but guaranteed against default up to 95 percent) are negotiated between the borrower and the lender, but FSA regulations require that the lender charge guarantee borrowers not more than the average rate charged for similar unguaranteed loans.

Interest Rate Assistance. FSA reduces the rate on guaranteed operating loans by 4 percentage points from the loan rate negotiated between the borrower and the lender. There is no minimum rate, and eligibility is reviewed annually.

Emergency Disaster Rate. Rate fixed at 3.75 percent for the life of the loan.

Beginning Farmer Downpayment Rate. Qualified beginning farmers are eligible for 4-percent, 10-year, fixed-rate loans to finance the downpayment on a farm real estate purchase. Others may be able to obtain 4-percent loans under joint financing arrangements with commercial lenders.

disaster. Borrowers meeting the definition of a beginning farmer can obtain special low rates even though they may be able to pay higher rates. Interest rates charged on these loans are the same for all applicants and are fixed for the term of the loan.

FSA Borrower Profile Varies With Economic Conditions...

Data from USDA's Farm Costs and Returns Survey indicate that, compared with similar farms with no FSA indebtedness, FSA borrowers have lower incomes and less wealth. In 1995, about half of direct FSA borrowers reported debt-to-asset ratios over 0.40, compared with about one-fourth for similar farms with no FSA debt.

It is less clear whether limited-resource rates and interest rate assistance rates available for OL and FO loans are directed to the most needy FSA borrowers. Among direct-loan borrowers at the end of 1995, those paying limited-resource rates had lower net worths on average than those paying regular rates, but the difference was not statis-

tically significant. Farm income, off-farm income, assets owned, debt owed, operator age, and the distribution of farms by debt-to-asset ratio for direct OL and FO borrowers paying limited resource rates were all similar to those paying regular rates. Yet, analysis of FSA borrowers during the early 1990's showed limited-resource rates to be serving borrowers who appeared to have less ability to pay the higher regular program rates.

FSA's difficulty in directing limited-resource rate loans to the most needy borrowers during the mid-1990's may reflect prudent borrower choices. The early 1990's was characterized by generally higher interest rates with the differential between limited-resource and regular program rates being much higher than in the mid-1990's (fig. 2). The difference between regular program rates and limited-resource rates in the direct OL program fell from 3-4 percentage points in fiscal 1991 to as little as 0.25 percentage points in fiscal 1994. Since regular program rates are fixed for the life of the loan and limited-resource-rate eligibility is subject to

annual review, many borrowers may have opted to lock in favorable long-term fixed regular rates rather than risk a variable rate for marginal interest cost savings. With more limited-resource borrowers choosing regular rates, the two groups would appear more alike.

Another possible explanation for the similarity in FSA regular program and limited-resource borrowers in 1995 is that an improving farm economy and a reduction in the amount of funding for direct loans have begun to homogenize the two groups of borrowers. An improving economy and reduced direct loan funding mean that the most creditworthy FSA borrowers (who are more likely to have been paying regular rates) graduate to other credit sources. Also, the financial condition of the borrower may have been poorer when the limited-resource rate was approved than when the survey data were collected.

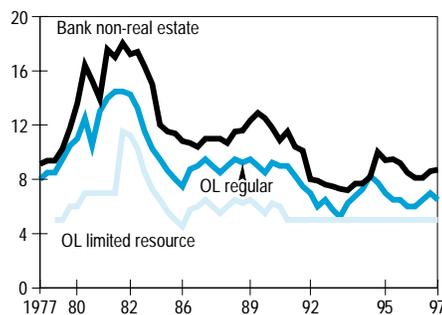
...As Does Their Impact on Borrower Finances

The additional subsidies provided through limited-resource rates or interest rate assistance can affect farm financial health by lowering expenses and by lowering the risk profile of the operator. These subsidies may enable these farmers to acquire resources, such

Figure 2

Although all FSA rates are lower than commercial rates, the added subsidy value of FSA's limited resource rates diminishes as the general level of interest rates falls

Interest rates, fiscal 1977-97 (Percent)



OL = Operating loans.

Source: Economic Research Service compiled from Farm Service Agency (FSA) data.

as land or equipment, that enhance their competitiveness, but they benefit borrowers less as market rates approach FSA rates. For example, raising the interest rate on all outstanding FSA direct limited-resource loans in 1995 (when interest rates were low) to the regular program rate would have resulted in an average additional interest cost of \$900 per farm. In the early 1990's (when interest rates were higher), such a move would have resulted in additional interest costs of \$2,700 per farm.

The more modest impact on interest costs of charging higher rates is not only a consequence of slim interest rate differentials, but also of less FSA indebtedness per farm in the mid-1990's. With reduced lending activity in the 1990's, FSA has become a less important source of credit for many direct borrowers. At the end of 1995, just over half of the typical FSA borrower's debt was directly supplied by the agency, with FSA direct indebtedness averaging just \$85,000, compared

with \$114,000 in 1991-93. With reduced indebtedness and low interest rates, borrowed capital costs are less important in determining financial viability than during past periods of higher rates and debt. Total interest expenses for all debts represented just 12 percent of total farm cash expense for the typical FSA borrower in 1995, compared with 15 percent in 1991-93.

Because the interest rate subsidy is greater and indebtedness higher, *guaranteed* FSA borrowers receiving interest rate assistance are likely to enjoy greater interest savings and thus be affected more by any rollback in program benefits. Yet, total interest expenses associated with FSA guaranteed indebtedness still account for less than 7 percent of total farm cash expenses for the typical guaranteed program borrower. Therefore, as for the direct programs, removal of additional interest rate subsidies has only a modest impact on the financial viability of these borrowers.

Budget Cost of Interest Rate Subsidies Limits Program Activity

Congress provides a certain amount of money, or budget authority, for FSA lending programs each year. The budget authority, in turn, supports an amount of lending, or obligation authority. The amount of lending that a given level of budget authority will support is determined by the budgetary subsidy rate, or the Government's cost of lending \$1 under the program. For example, a budget authority of \$1 will support \$10 of lending at a 10-percent total subsidy rate, but \$20 of lending at a 5-percent subsidy rate.

While regular FSA loan rates are below what a borrower could obtain without a Federal enhancement, these regular interest rates are not considered subsidized in terms of Federal expenditures. Providing loans to farmers at interest rates below the government cost of borrowing is a primary component of the budgetary subsidy rate. Anticipated loan default costs, repayment rates, and certain transaction costs are other, but more minor, factors that influence the subsidy rate.

The EM program is the most costly program with a budget subsidy rate of 30.4 percent for 1997. With a low 3.75-percent fixed rate, the gap between this rate and anticipated Federal borrowing costs requires a high amount of budget expenditures. Even though the limited-resource rate is currently 5 percent for both OL and FO loans, the subsidy rate for a limited-resource FO loan is usually higher than that for an OL loan because the cost of long-term borrowing is typically greater than the cost of short-term borrowing. In fiscal 1997, the subsidy rate for the farm ownership program was 21 percent as opposed to 12.6 percent for the operating loan program.

The budget subsidy rate for guaranteed operating loans was just 1.1 percent for fiscal 1997. Each dollar of guaranteed operating loan budget authority supported \$91 in lending authority during the year. However, when the 4-percentage-point interest rate assistance is provided, the budget subsidy rate for a guaranteed operating loan rises to 9.1 percent and allows just \$11 in lending authority for each dollar of budget authority.

For FSA borrowers with low household incomes, the annual savings through additional interest rate subsidies can be much more consequential. However, if the policy objective of an interest rate subsidy program is to redistribute income, other methods (grants, for example) may be more cost effective and have greater impact on borrower income levels. Forty-five percent of all limited-resource borrowers were near or below the poverty level and 33 percent of all guaranteed borrowers were near or below the poverty level in 1995. In the low-interest-rate environment prevailing in 1995, removing the additional interest subsidy for limited-resource borrowers would not have a substantial impact on the percentage of borrowers below the poverty rate. In fact, eliminating all FSA interest expenses for guaranteed borrowers would still leave 30 percent of these borrowers near or below the poverty rate.

If FSA loan demand is high, maintaining additional interest rate subsidies means that some FSA-eligible borrowers cannot be served. This occurs because Congress grants a fixed amount of money (budget authority) each year to make FSA loans, and loans made under interest rate subsidy programs require more budget authority per dollar loaned (see box, p. 3). Therefore, for each dollar in authorized spending, there is a tradeoff between the number of borrowers served and the level of assistance individuals receive.

Conclusions

Limited-resource interest rate subsidy programs are more effective in assisting the lowest income FSA borrowers when prevailing interest rates are high. Financial profiles of direct program borrowers paying regular FSA rates and those receiving additional interest rate subsidies were very similar in 1995. However, in the higher interest rate environment of the early 1990's, financial profiles of the two groups were more dissimilar. This result is consistent with the longer term interests of borrowers because their interest rate risk is greater in programs that offer temporary additional interest rate subsidies. When market interest rates are low, subsidies to reduce interest rates further have less impact on borrower income and financial performance than when market interest rates are high.

To improve effectiveness of program delivery, FSA interest rate subsidy programs could be more narrowly targeted to the most financially stressed farms, including beginning or socially disadvantaged farmers. Alternatively, the limited-resource-rate program and all other low interest rates could be reserved for use only during more stressful economic periods, and eligibility for these interest rate subsidies could be removed on a more timely basis. Also, requirements that a set percentage of FSA loans be made at limited-resource rates could be removed; under low interest rate conditions, borrowers are often better served by paying regular program rates that are not subject to an annual review.

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Further Readings

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