

A COMPREHENSIVE RISK MANAGEMENT SYSTEM

Bread for the World Institute

Congress is scheduled to rewrite the farm bill in 2012 in the midst of a bipartisan push to reduce the federal deficit. Above all, the emphasis will be on eliminating unnecessary programs.

The U.S. Department of Agriculture website lists 11 major risk management programs,⁹² including crop insurance, which includes multiple products of its own.

The current patchwork of programs could be replaced with a comprehensive system of revenue insurance. It could cover all crops and all farmers (eliminating the current bias against fruits and vegetables), provide more help to the farmers who most need help (instead of sending the biggest checks to the most affluent landowners), and do more to encourage environmental protection.

One well-designed program to help farmers manage risk would provide them with all the support they need from government. It could also save taxpayers billions of dollars.

Revenue Insurance for the Whole Farm

A farmer's revenue is determined by what he earns from all his farm activities. Every farmer has a break-even point, and everyone's is different.

A farmer mainly needs government assistance to protect against severe losses in revenue. An unexpected price shock or weather event can be devastating. Farming is a capital-intensive enterprise. Equipment requires large capital investments to purchase and maintain. Inputs like seeds and fertilizer, and fuel to run equipment, are other production costs incurred annually. Land prices must also be accounted for.

What farmers do not need is income support. This is a crucial point because most farm policies are designed



Risk management is a core competency of any farmer.

to help farmers manage risk by subsidizing income—for example, the Direct Payments program. Farmers are under no obligation to produce a crop to receive this support, which comes to nearly \$5 billion per year for all program participants.

With farm household income consistently exceeding average household income over the last several decades, there is no justification for income support. Decades ago, when farm household income was much lower than average household income, subsidizing farmer incomes made more sense. Agriculture was once the main driver of rural economies, but that is not the case any longer in many parts of the country.

Revenue-based protection is not a new concept. More than half of all government crop insurance programs are considered revenue-based (as opposed to yield-based). Several revenue-based proposals have been put forward during previous farm bill reauthorizations. Revenue-based support has won more attention than ever in 2011 because a substantial restructuring of farm policies appears inevitable as the 2012 farm bill draws near. In 2011, some of the largest commodity groups, such as the

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From 1995-2010, U.S. apple producers received \$262 million in government support. Compare this to what corn producers received. See photo caption on page 43.

corn, soybean and cotton growers, have put forward their own versions of a revenue insurance package.

In September 2011, a revenue support plan was proposed by Senators Brown (D-OH), Thune (R-SD), Durbin (D-IL), and Lugar (R-IN). The Aggregate Risk and Revenue Management Act of 2011 (ARRM) aims to replace several of the current risk management programs. The Congressional Budget Office scored ARRM as costing \$28.5 billion over 10 years, a savings of \$19.8 billion compared to preserving the status quo.⁹³ While ARRM is a laudable effort to consolidate existing programs into a more efficient risk management system, it could go further in key respects—as could the other revenue-based systems mentioned above. The fact that ARRM saves \$19.8 billion underscores how much could

be saved by restructuring the existing risk management system. It is possible to achieve even greater efficiency and still provide farmers with adequate protection.

Revenue insurance should cover the whole farm enterprise. A whole-farm approach covers all activities from which farmers generate revenue. Most government crop insurance programs that are revenue-based apply to single crops rather than the whole farm. Whole-farm insurance is currently available under the federal crop insurance program, but it has been only lightly used.

Not only are farmers able to insure crops separately, they can also insure all the different fields they farm separately. Farmers with lots of land tend to farm multiple fields. Fields may be located miles apart, sometimes counties apart. As their enterprises grew in size, they may have had little choice but to farm this way. Land becomes available where it is, not always where the farmer wants it to be. If farmers weren't forced to expand this way, most would likely choose such an approach anyway as part of a risk management strategy. Diversification is an axiom of risk management, but since most large farm operations are not diverse in terms of the variety of crops they produce, they diversify by managing noncontiguous fields. It makes sense when you consider that a hailstorm could wipe out a farmer's crop on one field and not touch another less than a mile away.

While it may make sense to farm this way, it makes very little sense to insure parts of the enterprise when a farmer's revenue (and his financial well-being) is ultimately determined by the sum of his activities. A whole-farm approach to revenue insurance is critical to achieve a higher level of efficiency.

Government Support that is Trade Compliant

World trade has been moving inexorably toward more openness, and U.S. agriculture has benefited greatly

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and stands to benefit still more if the trend continues. Open markets benefit consumers, too. In a period when agricultural markets have become more volatile, trade liberalization can help to smooth out some of the volatility. That's especially important in poor countries, where large portions of the population spend most of their income on food.

Decoupled support is favored by economists because it is the least trade-distorting. Decoupling means support is not linked to production of particular commodities.⁹⁴ Programs that are coupled with production provide farmers incentives to produce when prices are low. This production then drives prices still lower and thus distorts the market. U.S. farmers have every reason to embrace the principle of decoupled support. U.S. policymakers should too, because the opening of markets in other countries depends to some extent on the willingness of the United States to lead by example.

Trade compliance is an issue for all farm programs. The United States is a member of the World Trade Organization (WTO) and like all members must comply with WTO rules. In 2003, Brazil brought a case against U.S. cotton subsidies, arguing U.S. programs coupled with production were distorting trade and harming Brazilian cotton producers. Through every step of the process, the WTO ruled in favor of Brazil. With the appeal process exhausted in 2009, the United States was faced with a choice of either reforming the cotton program or accepting WTO's ruling, permitting Brazil to raise tariffs on a range of U.S. exports. Rather than reforming the cotton program, the U.S. government negotiated a settlement with Brazil that costs U.S. taxpayers \$147 million a year. The U.S. government is calling this a temporary fix until the next farm bill, but for the past two years the United States has been subsidizing the Brazilian cotton industry so that the Brazilian government will allow the U.S. government to continue subsidizing its own cotton producers.

Those familiar with current farm programs are likely aware that the Direct Payments program is considered decoupled support. The Direct Payments program provides a lump sum to owners of farmland with a history of raising certain crops. The program was established 15 years ago with the publically stated intention of helping to wean farmers off government subsidies, but it has morphed into something altogether different. Much of the money is transferred to investors rather than farmers, largely through an increase in the value of the farmland they own. The program rewards landowners, not the farmers who work the land. In some cases these may be the same people, but every year billions of dollars are transferred to landowners who are not farmers. While it may help some farmers to manage risk by smoothing cash flow, it is a terribly inefficient way to do so, giving much of the program's resources to people with no direct involvement in agriculture.



Texas Agrilife Research/Kay Ledbetter

Corn subsidies, through a combination of income-support programs, totaled \$77.1 billion from 1995-2010.

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Blueberry crop damage in North Carolina from Hurricane Irene in August 2011.

The Direct Payments program should be eliminated. The fact that the Direct Payments program is decoupled from production—and therefore trade compliant—doesn't compensate for its other flaws. It doesn't provide benefits to all farmers, so it is essentially unfair. Whole-farm revenue insurance should be able to preserve the decoupling concept.

Shared Responsibility and Fairness

The principle of shared responsibility is paramount to how government and farmers work together to manage risk. For farmers, managing risk is about assuring their livelihoods. 2011 was a banner year for the U.S. farm sector, bringing some of the highest crop prices in a generation. In Kansas, Oklahoma, and Texas, however, 2011 also brought some of the worst drought conditions to that region since the Dust Bowl in the 1930s. Hurricane Irene pulverized farms up and down the East Coast, wiping out tens of thousands of acres of crops in late August. Every year, somewhere across the United States, farmers suffer losses because of adverse weather conditions they cannot avert.

Natural disasters such as droughts, hurricanes, floods, and tornadoes are referred to as systemic risks because they typically affect large geographic regions. For national

governments, it would be politically infeasible not to provide support. Disaster assistance has hardly ever faced widespread public opposition. The public understands that the food that ends up on its tables originated in some farmer's field. When government comes to the aid of ruined farmers, it is in a sense providing assurance to the public that its food security will not be undermined.

The government's responsibility is to provide support to farmers as protection in the event of a loss. Losses vary in nature. In the event of large losses due to systemic risks, such as natural disasters, the public should pay the greater share. (See the box below for more clarity about systemic risks). To cover more isolated risks, farmers ought to pay a commensurate share of the cost in insuring themselves. The federal government should define a level of coverage that it would pay for entirely, and then if the farmer wanted a higher level of coverage, she could pay for that additional increment of coverage unsubsidized. For a whole-farm revenue insurance program to qualify as nontrade distorting under WTO rules, the share of revenue insured by the government cannot exceed 70 percent.

The farmer would be able to supplement government support by purchasing a suitable complementary insurance product according to his own tolerance for risk

Systemic risks aren't solely weather-related. Crop prices may soar this year, but they could plummet in another year due to an economic recession or devaluation of currency in a key foreign market. No matter how well farmers manage their operation, they do not have influence over the rise and fall of crop prices in global markets. Variable input costs are another risk. Every farmer's revenue is affected by input costs, especially fuel costs. Crude oil prices could rise or fall suddenly depending on events in another part of the world that have nothing to do with how a farmer runs his or her business.

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exposure. This is consistent with the principle of shared responsibility and leaves individual farmers with plenty of flexibility. ARRM contains a similar provision: “While this new program would provide critical revenue protection when needed, participants would rely on current private revenue insurance to manage greater losses that occur on their individual farms.”⁹⁵ However, it should be noted that ARRM is not a whole-farm revenue program; it covers crop revenue on a crop-by-crop basis.

In exchange for public support, it is reasonable that farmers should comply with good environmental stewardship practices. No doubt most farmers are already good stewards of the environment. It is in their own best interest to be. Compliance should require little more, if anything, than what they are already doing of their own volition. The Direct Payments program (and nearly every other farm support and farm loan program) requires farmers to prevent soil from eroding from their land. This feature of the program should be preserved. There are currently no such requirements for crop insurance.

In addition, farmers must be able to demonstrate they are operating a viable enterprise. Viability can be measured in terms of average revenue over the course of a span of years. Naturally we realize that ups and downs occur in all industries. Indeed ebbs and flows in economic activity are the very definition of a business cycle. But if a farm is suffering revenue losses year after year, this does raise the question of whether it is a viable enterprise. It also raises legitimate questions as to whether the land being farmed should be used for agricultural production.

All farm enterprises should be eligible for public support—this ensures that one fundamental standard of fairness is met—but fairness is also a function of targeting and how people who need help the most are treated. Public support based on revenue treats low-income farmers (especially those for whom farm revenue makes up a significant share of household income) much fairer than income-support programs.

Conclusion

Policymakers have created an assortment of programs over many farm bill reauthorizations to help farmers. But it is not easy to tell why so many programs are needed. Invariably systems like this are inefficient, and the current risk management system lives up to that expectation.

Farming is a risky enterprise. Some kind of risk management system is necessary. The system outlined above would be more efficient than what exists now. Overall government spending on farm programs should fall by consolidating all existing risk management programs into a single revenue insurance program. Efficiency is a virtue under any circumstance. Given the pressures policymakers are under to reduce government spending, it cannot be overstated how much efficiency should be prized.



Under the risk management system proposed here, all farmers, regardless of income, would be eligible for support.