

*Farm
Safety
Net*

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11/23/98

HOW TO FIX THE FARM INCOME SAFETY NET

I. Introduction

For more than a decade bipartisan farm policy has directed producers to seek income increasingly from markets rather than from Federal subsidies. The 1994 Crop Insurance Reform and 1996 Farm Bills attempted to create a farm income safety net of market-oriented crop insurance and commodity marketing loan programs, rather than ad hoc disaster, market intervention, and price support programs. Farm income reached a record \$61 billion in 1997 as export demand grew and world commodity stocks tightened from 1995.

In 1998 in the US, regional inadequacies of crop insurance (including low coverage and participation), weather and multi-year production problems, and nation-wide low prices for many commodities provoked sharp criticisms of the 1996 Farm Bill and crop insurance. Proposals appeared in July to revive price-setting Federal subsidy programs, mainly through raising USDA's "marketing loan rate" to boost crop payments to farmers (see Appendix B for discussion).

II. Administration Proposals

In response, an NEC-led interagency group this summer crafted a package of proposals to address the specific areas of need throughout the nation's farmland. This included targeted assistance for regions of need, primarily through a supplemental crop insurance benefit for multi-year losses.

Second, the President announced on July 18th the purchase and donation overseas of 2.5 million tons of wheat to boost US farm prices and to relieve hunger around the world, using existing USDA authorities and mandatory funding. In November, the President announced an additional food-aid package of 3.1 million tons of wheat and other commodities for Russia.

Finally, the Administration agreed to support Sens. Harkin's and Daschle's proposal to remove the 1996 Farm Bill limitation on marketing loan rate levels.

III. Status of Farmer Assistance

The Administration negotiated a \$6 billion disaster assistance package in the FY 1999 Omnibus Appropriations Bill to boost farm income. The President further charged Secretary Glickman with addressing the "gaps" in the farm safety net that were exposed during the 1998 crop year. The marketing loan provisions of the 1996 Farm Bill did work to the extent of providing \$2 billion to farmers under existing authority, spending that was not projected in the FY 1998 Mid-Session Review of the Budget. The \$6 billion in additional assistance should maintain farm

income in crop-year 1998 near the 1997 record level. The issue is how much enhancement does the safety net need? Should Federal programs prevent any farmer's income from falling below the five-year average level? Should income supplements be targeted to smaller, low-income farmers? Total additional USDA outlays for production agriculture approved since July, above those assumed in the FY 1999 Budget, amount to approximately \$10 billion, including the costs of the recent food-aid programs.

IV. Problems in Farm Country and Options for Dealing with Them

In its FY 2000 Budget request, USDA proposes to continue the path of the 1996 Farm Bill, and Administration policy, by helping farmers to manage risk. It recommends a series of program changes to: make crop insurance more attractive by covering more risk at reduced costs; enhancing emergency programs; and expanding risk-management education.

Gaps in the Safety Net

This section lists the five main problems with the current farm income safety net. Under each problem, options are analyzed, in addition to the USDA proposals.

Problem One: Crop loss due to natural disaster -- crop insurance can fail to indemnify enough of the loss because:

- a) Too little acreage is insured by the farmer; and
- b) Insured acreage is covered at too low a percent of expected revenue (e.g., 30%).

Options:

1. Fix Crop Insurance. Increase crop insurance subsidies on both Catastrophic (CAT) and higher levels of coverage ("buy-up") by increasing coverage on free CAT policies and increasing premium subsidies on higher levels of buy-up policies. (See Appendix A)

<u>Estimated costs:</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
(outlays in millions of dollars)	1,541	1,587	1,635	1,684	1,734

The proposed increases hold two strong attractions for farmers: a) the obvious attraction of increasing the value of their insurance policy at no extra cost, and b) increasing the likelihood that they will receive an indemnity payment. In other words, instead of simply decreasing the amount of the farmer insurance cost at current coverage levels (which would have no impact on the probability of receiving an indemnity payment), the USDA proposal would: a) avoid cost increases to the farmer; and b) raise the level of indemnity payments.

Because this option is a marketing strategy to increase program participation, its success ultimately hinges on its impact on buyer behavior. Insurance will not be required of producers,

and they will have to make their own risk management decisions -- to buy or not to buy. However, large media advertising campaigns (also proposed by USDA) combined with a program structure that would virtually eliminate the lower coverage range of buy-up insurance would help to ensure the expected response on the part of farmers, as long as they can be convinced that the government will not once again revert to ad hoc disaster payments as future "disasters" arise.

Pro:

- Consistent with the market-oriented farm policies of the 1996 Farm Bill.
- The President explicitly noted the need to fix crop insurance.
- Expected to significantly increase participation in the program toward the goal of 80 percent of insurable acres, if not undermined by ad hoc disaster spending.
- Crop insurance is more inclusive than other current and former USDA programs that covered only eight major "program crops" like wheat, corn, cotton and rice. Crop insurance covers nearly 70 crops.
- Crop insurance is more friendly to the beginning farmer because any producer wishing to farm on insurable acreage is eligible for crop insurance, whereas other programs (like AMTA payments) have more cumbersome eligibility hurdles.
- Avoids sending a "mixed message" on the economic structure of farm policy, and encourages producers to actively manage their risk, albeit on very concessional terms.

Con:

- Because the program does not guarantee benefits or require participation, its efficacy is ultimately dependent on buyer behavior.
- Increasing coverage at the CAT level could result in a "buy-down" effect; i.e., farmers who previously paid for buy-up insurance opt for free, and increased, CAT coverage.
- Budget "watchdog" groups may protest the new subsidies to U.S. agriculture as unnecessary and wasteful.

2. Cover More Non-insured Crops. Increase support for non-insured crops covered by the Non-insurance Crop Assistance Program (NAP). ✓

<u>Estimated costs:</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
(outlays in millions of dollars)	471	485	500	515	530

Despite the growth in the number of crops covered by the insurance program over the last decade, many crops remain for which no insurance is available, e.g., artichokes, lettuce, ginseng, mushrooms, and many more. This option proposes to increase NAP coverage on par with coverage increases of CAT insurance; i.e, guarantee about 40 percent of expected revenue, and includes livestock among “non-insured” commodities covered under NAP.

Pro:

- Addresses the vulnerability of producers who raise crops and livestock for which no insurance exists.
- Would be perceived as unfair if CAT coverage is raised while NAP is not.

Con:

- Costly to cover more minor crops, mostly vegetables, which was not a source of national farmer dissatisfaction in summer '98.

3. Risk Management Accounts. Provides a tax advantage for building financial reserves to be used for farm contingencies. In its “Bluebook” of policy guidance for the 1996 Farm Bill, the Administration proposed “income stabilization accounts”. Treasury representatives suggest that the permanent tax relief measures for farmers in the FY 1999 Omnibus Appropriations Bill are sufficient. These included: extending loss-carryback provisions in “good” years for farmers, and permanent extension of income averaging. These were scored by Treasury as reducing tax receipts by \$1 billion annually, but the actual effect of these changes in the tax code on farm income is not yet known.

Risk management or income stabilization accounts could be designed to provide benefits for only relatively small or low-income farmers. Such account are being tried in Canada and France. They normally permit pre-tax deposits into the account up to a certain amount. Incentives such as a government contribution component could be considered as well. In the event of a disaster, the farmer is permitted to withdraw the funds without penalty. The withdrawals would help support the farmer until the next crop year and will likely be taxed in a lower bracket than the farmer’s normal income.

The income amounts deposited, the withdrawal triggers (e.g., gross revenues, net income, price index below moving average, etc.), eligibility and consequent costs are widely adjustable. This concept could be announced as a pilot program for a specific commodity or region.

<u>Estimated costs:</u> (outlays in millions of dollars)	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
	200	200	200	200	200

Pro:

- Encourages prudent savings while reducing the impact of future disasters on both the farmer and the Federal budget.

- Builds on producers' current ability to manage their income streams by savings and timing of input and capital purchases for tax purposes.

Con:

- Treasury representatives believe this option will disproportionately aid large, wealthy farmers while providing little assistance to small farmers.

4. Standing Emergency Programs. The USDA proposal includes livestock assistance, and would also permit farmers to receive both CAT and NAP benefits, USDA disaster loans, and other USDA farm credit. Some were included in Summer '98 Administration package. ✓

<u>Estimated costs</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
(outlays in millions of dollars)					
a) Emergency livestock feed	24	25	25	26	27
b) Allowing both CAT and NAP benefits	10	10	11	11	11
c) Small agriculture-related business loans (discretionary)	50	52	54	56	58

Pro:

- Small farm- and small business-oriented.
- CAT and NAP can be re-structured to also limit benefits to larger, well-capitalized. operations

Con:

- Without proper limits in place, CAT and NAP are subject to abuse by larger businesses.

Problem Two: Multi-year crop loss due to natural disaster, where

- Poor production history hurts "good" farmers by raising premiums and lowering the insurable yield;
- Even buy-up coverage levels, after consecutive loss years, may indemnify too little to sustain the farm operation.

Options:

5. Fix Crop Insurance. Introduce a new multi-year loss provision as an add-on to the standard Federal crop insurance policy; a version of which was included in Administration's summer '98 farm disaster aid package. This proposal would make the coverage permanent. *al Johnson*

<u>Estimated Costs</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
(outlays in millions of dollars)	171	176	181	187	192

The development of this provision is only in the discussion stages at USDA but the product could be rolled out by the 2000 crop year. OMB would take precautions to ensure that no duplicate benefits would be paid through these provisions to either new insureds or producers who received 1998 emergency assistance for multi-year losses.

The provisions would do either one, or both, of the following: a) retroactively increase the coverage level of the consecutive-loss years (if the farmer was insured in each year) and pay out a supplemental indemnity; and b) ignore the multi-year loss experience for purposes of calculating coverage in future years.

Pro

- Consistent with the market-oriented farm policies of the 1996 Farm Bill, while directly responding to one of the most vocal constituencies, (e.g., North Dakota) during the debate on 1998 emergency assistance.
- Crop insurance is more inclusive than other programs, covering nearly 70 crops.
- Crop insurance is more available to new farmers.
- Avoids sending a "mixed message" on farm policy, and encourages producers to take a proactive role in managing their risk, albeit on extremely concessional terms.

Con

- Because the program does not guarantee benefits or require participation, its efficacy is ultimately dependent on buyer behavior.

6. Land Retirement. Some producers farm land experiencing natural disabilities, like excessive wetness, that persist longer than one year, but are likely to return to production. USDA could enter medium-term contracts (3 - 5 years) to retire such land, including land in the Upper Plains diseased or under water, or land in the southwest quarantined due to karnal bunt. Payments would be made for "environmental benefits", including conservation practices aimed to restore the land to production. An area-wide problem could be required to trigger in a farm's land for eligibility. USDA's Conservation Reserve Program (CRP) retires land for 10-year periods, but not when they are made unproductive due to natural afflictions. A version was included in Administration's Summer '98 package and in the 11/13 USDA budget letter.

<u>Estimated costs:</u> (outlays in millions of dollars)	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
	50	75	100	100	100

Pro:

- Would fill a gap in the current program structure, since there is no program aimed at this problem.

Con:

- Unlikely need for medium-term retirement program; land problems better ameliorated through farming practices or purchased by USDA and permanently retired.

Problem Three: Low prices nationally, as much as 40 percent below the 5-year average, primarily due to large harvests and reduced export demand.

Options:

7. Enhance Revenue Insurance. Insure a minimum level of gross farm income by increasing premium subsidies on revenue insurance plans on par with standard crop insurance policies.

<u>Estimated Costs</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
(outlays in millions of dollars)	342	352	362	373	385

Standard crop insurance policies do not indemnify producers without crop losses due to natural causes. However, even a producer who harvests 100 percent of expected yield can be put on difficult financial footing through price declines. The Federal crop insurance program currently offers three policies that provide indemnities in the event of falling prices regardless of crop losses. These products are all less than three years old. Two are struggling to become established but one has been very successful. Crop Revenue Coverage (CRC), developed by one of the private crop insurance companies, now accounts for 16% of the crop insurance market (nearly \$300 million in annual premium). CRC has achieved this market share in just three years. This is a very high growth rate particularly in light of its price tag -- CRC premiums are 30 percent higher than standard policies on average.

Revenue insurance policies are subsidized by USDA at a lower percentage than standard yield coverage. It is worth noting that, in light of this lower subsidy on a high-priced policy, CRC's growth tends to contradict the notion that farmers are unwilling to pay significant premium costs for crop insurance. This, in turn, further supports options that retain market-oriented safety net programs, with an eye toward dialing down subsidies over the long term.

CRC's success in the market is attributable to one unique component of its coverage; CRC indemnifies if prices fall *and*, if prices rise; CRC will indemnify yield loss at the current market price if it has gone up during the insurance period. To summarize, revenue policies work much like standard policies but pay out indemnities in more circumstances:

- a) yield loss when prices remain unchanged (like standard policies);

- b) yield loss when prices fall (like standard policies);
- c) yield loss when prices rise (CRC pays out at the higher market price);
- d) no yield loss but prices fall (revenue policies only).

Further, farmers are notoriously reluctant to forward contract much of their crops out of fear that prices will increase after they have locked in their forward price. CRC coverage allows farmers to forward contract with the confidence that if prices go up after they have obligated themselves to deliver at a lower price, they will not miss out on higher revenues. The commodity exchanges find this aspect of revenue coverage attractive. However, they also have expressed some concern over the extent to which subsidized revenue coverage might compete with their futures and options contracts.

Pro

- Would significantly increase the number of producers protected against both weather risk and market risk.
- Private commodities exchanges benefit from increased trading volume due to the increased need for insurance companies to hedge their CRC underwriting risk, and due to greater volume of forward contracting by farmers.

Con

- Would not protect producers against a long-term leveling-off of low prices over multiple years. In other words, prices must drop during the insurance period for indemnities to be triggered.
- Private exchanges might protest at having to compete against government-subsidized price risk management tools.

8. Marketing Loans. Uncap '96 Farm Bill levels. (See Appendix B)

<u>Estimated costs</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
(outlays in millions of dollars)	4,000	4,000	4,000	3,000	3,000

Removing the 1996 Farm Bill's limitation on marketing loans rates (85 percent of a five-year moving average minus high and low years, but not more than the 1995 level) would enable the loan rates to rise to a level that practically guarantees regular annual payments in the years ahead. This would turn the marketing loan program into a type of "deficiency payment," a program abolished by the 1996 Farm Bill. As a general commodity program, it would apply to all major field crops for the 1.8 million participants in USDA crop subsidy programs. This was proposed by Sen. Harkin and Daschle in the summer, and by the Administration in some forms, but defeated in Congress on six occasions.

A targeted version was proposed by Sen. Daschle in the 1996 Farm Bill deliberations. This proposal would offer a higher loan rate for a minimum volume of production per farmer, e.g.,

10,000 bushels. Production above that level would receive a lower loan rate or none at all. This regime would provide relatively greater benefit to smaller producers.

Pro

- Popular with many populist supporters of the Administration.
- Would be perceived as supporting smaller, less efficient farmers.

Con

- Would return farm policy back to failed, costly past programs that hurt US exports and would lead to production supply controls, widely unpopular with farmers.
- Untargeted version would provide gratuitous financial windfall to many farmers.
- Targeted version would be opposed by many farmers, especially of cotton and rice.

9. Commodity Options. Increase USDA's current educational options pilot programs (OPP) and other risk management education and outreach efforts. 

<u>Estimated costs:</u> (outlays in millions pf dollars)	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
OPPs on two commodities	21	22	22	23	24
Education and outreach	29	30	31	32	33

Options on futures contracts are often cited as the equivalent of price insurance. Producers who purchase "put" options have effectively purchased a price floor. When prices go up, they can still enjoy the benefits of higher prices, but they are protected if prices fall below the floor, or "strike price", they purchased.

USDA has recently implemented a program to teach dairy farmers how to use these markets that provides a short term, hands-on trading experience with USDA sharing the cost of the options contracts. The program lasts only for six-months per producer and allows the producer to buy options on a limited quantity of milk. The producer learns the markets, the terminology, hedging strategy, and how to select and deal with a broker.

The program is not an on-going risk management subsidy like the crop insurance program. Its sole objective is to educate the producer in the hope that the producer will continue to manage price risk using options after "graduating" from the short term program. For OPPs to succeed, legislation would require a change to remove language requiring budget neutrality of OPPs. The 1996 Farm Bill stipulates that recipients of USDA program payments who participate in an OPP must forego in program payments the amount of the subsidies they will receive under the OPP in order for the OPP to be budget neutral. This provision does not apply in USDA's current dairy OPP because dairy farmers are not currently receiving program payments.

In addition, USDA would conduct aggressive outreach programs to organize county-level workshops, develop university curricula, and a multimedia advertising campaign.

Pro

- Consistent with the market-oriented reforms of the 1996 Farm Bill.
- Futures/options markets exist for most of the “program crops”.
- Complements the other options such as increased insurance coverage by alerting and introducing farmers to risk management tools.

Con

- Futures/options markets exist for only a limited number of crops.

10. Federal Assistance for Exports. Donations and support for faltering export markets.

<u>Estimated costs</u> (outlays in millions)	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
	2,500	2,500	2,500	2,500	2,500

The humanitarian food aid packages of July for wheat and November for Russia could be extended so long as the commodity to be donated remains in surplus in the US. While appropriated funding usually is not an obstacle for the mandatory programs and emergency authorities involved, this action is limited by GATT rules on subsidies, our trading partners' complaints, and the undermining of US commercial exports. The actual impact of Federal donations on US farm prices is in dispute, but the announcements of donations are seen as popular among many farmers, if not commodity markets. The Administration's active role in managing the Asian economic crisis--a major cause of reduced demand for US agricultural exports--is viewed as a general form of help to US farmers, but indirect and longer-term.

Pro:

- Perceived in farm country as positive action.
- Can cause “additional” exports to those unable to purchase food.

Con

- Need for bulk commodities is limited. Truly hungry people not already being supplied by standing government programs tend to need consumer-ready foodstuffs.
- Limited by tendency to displace US commercial exports.
- Unpredictable impact on markets means unreliable domestic farm support program.

3. Risk Management Accounts. See above.

Problem Four: High producer expenses, where:

- a) certain regions have high production costs arising from natural factors; or
- b) there are exogenous shocks to input costs like fuel or livestock feed in a short crop.

Options:

8. Two-tier Marketing Loans. Higher loan rate for a minimal level of production (Sen. Daschle 1996 Farm Bill proposal). See above.

7. Enhance Revenue Insurance. See above.

Problem Five: Insufficient payments to neediest or smallest farmers while most payments continue to go to relatively wealthy and large-scale farmers.

Options:

13. Target by Income or Gross Revenues. Means-test existing AMTA payments or benefits in a new program. Targeting could be overlaid on most options.

14. Fix Crop Insurance. USDA proposal for special increase of crop-loss assistance on non-insured crops for small farms and increased incentives for private companies to seek out and “sell” free CAT coverage to limited resource farmers.

8. Two-tier Marketing Loans. See above.

V. Offsets

USDA has not proposed any offsets to date. OMB recommends PAYGO offsets from cuts in guaranteed Agriculture Market Transition Act (AMTA) payments. The shift in funding would effectively redistribute funds guaranteed to producers who have not experienced crop losses and rewards those who have actively managed their yield risk and paid a share of the associated costs. However, AMTA payments are only authorized through FY 2002. While baseline rules extend the authorization beyond 2002, under the explicit authority for AMTA, there would be no “real” offset in 2003 and beyond.

The expected distribution of AMTA payments by state compares favorably to the expected redistribution of those funds through the increased crop insurance subsidies (see Table 2). Some discrepancies arise among certain Midwestern states (Iowa, Illinois, Indiana, Nebraska) whose proportion of benefits would likely be eroded and shifted toward states with higher crop insurance losses. Many of the states experiencing increases in their proportional benefits are

those with particular problems over the most recent period (Texas, North Dakota, Minnesota, Georgia, North Carolina, South Carolina). In effect, the redistribution takes benefits from areas with a lower incidence of crop losses and moves them to areas that have been harder-hit in the past year and have had historically higher levels of uninsured or underinsured producers. Further, in a loss-year similar to the one experienced in 1998, the redistribution of benefits channels funds much more dramatically to areas in the most need (as shown in Table 2).

However, crop insurance payments are not guaranteed as under AMTA. Coverage begins at specified loss levels at the individual farm level. The same number of dollars is projected to be disbursed over the long run, but wide variations in year-to-year outlays will occur. The USDA's proposal channels funds to farmers who have taken proactive steps to manage their risk and suffered verified losses at the cost of guaranteed payments withdrawn from farmers holding AMTA contracts.

BACKGROUND

Appendix A: Crop Insurance

Crop insurance coverage is made up of two components, yield coverage and price coverage. The buyer can choose among various coverage combinations of both yield and price. The minimum coverage level insures 50 percent of average yield at 60 percent of a USDA-set price. This plan is known as Catastrophic Risk Protection (CAT), or "50/60" coverage. The highest coverage available nationally is the 75/100 level. The most popular coverage to date is the 65/100 level. At this level of coverage, if the insureds suffer a 50 percent yield loss, they are made whole on the lost production up to 65 percent (or 15 percent in this case) and the indemnity payment then comes the 15 percent of covered loss times 100 percent of the expected price.

USDA offers two general levels of insurance coverage; Catastrophic Risk Protection (CAT), and so-called "buy-up" coverage which is all coverage levels higher than CAT. CAT premium is 100 percent subsidized and the farmer only pays a nominal administrative fee for it. CAT covers only 30 percent of expected revenue. Buy-up coverage is available at levels between 60 and 75 percent of expected revenue and is subsidized on a scale that slides downward as coverage increases. In other words, 65 percent coverage involves a 40 percent premium subsidy, and 75 percent coverage involves a 24 percent subsidy.

USDA has performed marketing analysis to estimate how much an average producer is willing to pay for buy-up crop insurance. That amount is \$5.30 for each \$100 of liability insured. USDA proposes to apply that farmer-paid amount to a coverage level that is considered high enough to restore credibility to the crop insurance program in the wake of the harsh criticisms last summer. That level is 70 percent of expected revenue.

The following example illustrates how the insurance coverage works:

- a) a corn grower with 1,000 acres and an average yield of 100 bushels per acre has an expected yield of 100,000 bushels;
- b) the insured price set by USDA is \$2.30 per bushel;
- c) "70/100" coverage is purchased, so the farmer has insured \$161,000 of liability (70,000 bushels at \$2.30/bu.);
- d) if the farmer experiences a 40 percent yield loss (i.e., a harvest of 60,000 bushels) an indemnity of \$23,000 would be paid (i.e., the 10,000 bushels that would make the farmer whole up to 70 percent of average production multiplied by 100 percent of the \$2.30/bu. price);
- e) the total insurance premium for the coverage would likely be around \$8,000, of which 40 percent, \$3,200, is currently paid by USDA;
- f) USDA also reimburses the private insurers' administrative expenses at a rate of 24.5 percent of gross premium, or in this case \$1,960.

Appendix B: Boosting Farm Income Through Marketing Loans

A major goal of some farm interests is to increase USDA's "marketing loan rate" so it would guarantee farm income robust enough to cover the relatively higher costs of production of some U.S. farmers. Sens. Daschle and Harkin were chief proponents of increasing ("uncapping") marketing loan rates during the summer's debate on how to improve the farm income safety net.

How marketing loans work

USDA's marketing crop loans, a program to enable farmers to avoid selling during the lowest-price (harvest) period of the year, basically set a price floor for the crop, backed by the Treasury. Farmers take out a 9-month loan from USDA at harvest time based on a statutory "loan rate" or price per bushel. If market prices drop below the loan rate, farmers can repay the loan at the lower market price per bushel. USDA absorbs (loses) the difference between the market price and the (higher) loan rate price, and the farmer keeps the crop to sell on the market. Marketing loans are available for the major US field crops, like wheat and corn. Payments under the program are limited to \$75,000 per person per crop year.

Current issue

The 1996 farm bill capped the loan rate at 85 percent of the five-year moving average price for the commodity, but not more than 1995 levels. The 1990 farm bill gave the Secretary of Agriculture discretion to reduce the loan rate from the five-year average, depending on market conditions and budget costs. That bill also required that supply controls be imposed appropriate to those market conditions to determine the size of the crops produced and the cost to the government. Uncapping loan rates would raise them (by 22 percent for wheat, 15 percent for corn) to an average price level that would be unusually high at present, because it would include the historic record high price period of 1995 and 1996. Farm interests have not suggested reimposing supply controls, which is unpopular with farmers.

For example, a wheat farmer with 100,000 bushels in 1998 faced a capped loan rate of \$2.58/bushel, an average price of \$2.65, but a low price of \$2.35. He received \$23,000 (100,000 times the 23 cent gap between the low price and the loan rate) by asking USDA for a "loan deficiency payment" when the low price prevailed. (A loan deficiency payment is a common variation of a marketing loan. Foregoing entirely a USDA crop loan, the farmer gets a cash payment from USDA for the difference between the loan rate and the prevailing market price.)

The farmer then held onto the crop for 10 weeks and sold it at \$2.70 and received \$270,000. The marketing loan boosted the farmer's 1998 income by 9 percent under the current loan rate regime (\$23,000 divided by \$270,000). If the wheat loan rate had been uncapped, the USDA loan deficiency payment would have been \$81,000 (100,000 times the 81 cent gap between the low price and the uncapped loan rate of \$3.16 for 1998), a boost of 30 percent to the farmer's income.

Costs

USDA to-date has paid about \$1.6 billion in marketing loan gains on the 1998 crop for all major commodities. Probably the costs for this crop under current loan rates will total about \$2 billion this year. Uncapping loan rates for one year only on the 1998 crop, as Sens. Daschle and Harkin proposed, would have cost an additional \$5 billion in FY 1999. The cost for uncapping on the 1999 crop only, with outlays largely in FY 2000, probably would be about \$4 billion according to current price projections.

Policy significance

Federal attempts in the 1960s and 1980s to protect farmers from market cycles demonstrated that USDA price-support loan rates that are within about 25 percent of commodity market prices distort markets by:

- setting an effective floor on market prices for producers;
- stimulating US production;
- increasing taxpayer costs;
- leading to production controls, reduced exports and greater foreign production.

Loan rates that are low relative to market prices avoid these distortions, but can provide an income safety net in case of a price collapse. An NEC interagency process concluded in 1994 that raising loan rates slightly was dubious policy because of its market effects even when it would cost much less than under current price conditions.

Budgetary costs and policy problems could be reduced when raising marketing loan rates by targeting the payments to those producers in greatest need. For example, this could be done by excluding high-income farmers and limiting the higher loan rate to each producer's first few thousand bushels of grain.

Estimated Redistribution of Benefits if the Safety Net (SN) proposal's core options are implemented and offset by AMTA payments and a small amount of Environmental Quality Incentives Program (EQIP) funds **Table 2**

	How Benefits Distribute under AMTA & EQIP	Benefits After SN Avg. Year	States' Gain/Loss Avg. Year	Estimated Benefits after SN in a 1998-type loss year	States' Gain/Loss 1998-type
Alabama	38	49	9	98	60
Alaska	0	0	0	0	(0)
Arizona	46	34	(9)	26	(20)
Arkansas	237	211	(22)	195	(42)
California	238	301	50	240	2
Colorado	90	91	2	64	(26)
Connecticu	4	3	(0)	3	(1)
Delaware	1	2	2	1	(0)
Florida	16	87	59	45	29
Georgia	73	136	52	198	126
Hawaii	1	2	1	1	(0)
Idaho	76	54	(18)	56	(20)
Illinios	407	317	(77)	238	(168)
Indiana	204	147	(48)	116	(88)
Iowa	460	369	(78)	297	(162)
Kansas	344	298	(41)	206	(138)
Kentucky	55	55	0	41	(13)
Louisiana	127	133	5	128	1
Maine	4	7	3	3	(1)
Maryland	19	15	(3)	11	(8)
Massachus	3	4	2	2	(0)
Michigan	99	94	(4)	62	(38)
Minnesota	296	329	25	222	(74)
Mississippi	121	130	8	107	(13)
Missouri	154	159	4	103	(51)
Montana	113	104	(6)	92	(21)
Nebraska	344	287	(50)	218	(126)
Nevada	5	3	(1)	2	(3)
New Hamp	0	0	0	0	(0)
New Jersey	3	5	2	2	(1)
New Mexic	31	26	(3)	24	(7)
New York	56	37	(15)	29	(27)
North Carol	62	106	37	118	56
North Dako	220	283	50	240	20
Ohio	147	103	(37)	79	(68)
Oklahoma	136	113	(18)	84	(52)
Oregon	38	26	(8)	20	(17)
Pennsylvan	48	33	(11)	24	(23)
Rhode Isla	0	0	0	0	(0)
South Caro	29	46	14	71	42
South Dako	145	194	40	150	6
Tennessee	53	50	(2)	37	(16)
Texas	444	586	117	885	441

Utah	14	8	(3)	7	(7)
Vermont	9	5	(2)	4	(5)
Virginia	23	37	11	56	33
Washingto	95	80	(12)	64	(32)
West Virgin	3	3	1	2	(1)
Wisconsin	158	128	(25)	88	(70)
Wyoming	11	9	(0)	7	(3)
Pacific Basi	0	0	0	0	(0)
Puerto Rico	1	1	0	1	(1)
	=====	=====	=====	0	
	5,300	5,300	(0)	4,770	(530)

The table is a general illustration of how payments might be redistributed among states in an average loss year and in a loss year similar to 1998 after program participation levels have increased in response to subsidy increases.

Assumptions: Loss Ratio of .90; participation increases in key states

**How to Fix the Farm Income Safety Net
Summary of Costs and Offsets**

Table 1

	2000	2001	2002	2003	2004
Baselines					
AMTA Payments	5,100	4,100	4,000	[4,000]	[4,000] a/
Crop Insurance	1,592	1,675	1,736	1,808	1,891
Costs					
Section I. Crop Insurance (and NAP)					
CAT/Buy-up subsidy increases	1,541	1,587	1,635	1,684	1,734
Multi-year disaster coverage	171	176	181	187	192
Revenue insurance subsidy increases	342	352	363	374	385
Expand NAP and increase subsidies	471	485	500	515	530
Accelerate New Product Development	5	5	5	5	6
Section I. Subtotal:	2,530	2,606	2,684	2,765	2,848
Section II. Improve emergency responsiveness					
Standing livestock feed program	24	25	25	26	27
Allow multiple emergency benefits	10	10	11	11	11
Section II. Subtotal:	34	35	36	37	38
Section III. Risk Management Education:					
Workshops, curricula, advertising	29	30	31	32	33
Options Pilot Programs	21	22	22	23	24
Section III. Subtotal:	50	52	53	55	56
Total:	2,614	2,692	2,773	2,856	2,942
Alternative options:					
Uncapping Marketing Loan Rates	4,000	4,000	4,000	4,000	4,000
Donations and assistance for export markets	2,500	2,500	2,500	2,500	2,500

a/ Authority for AMTA expires after FY 2002

How to Fix the Farm Income Safety Net
Summary of Costs and Offsets (outlays in millions of dollars)

Table 2

Baselines	1999	2000	2001	2002	2003	2004	5-Year Totals	
AMTA Payments	5,500	5,100	4,100	4,000	[4,000]	[4,000]	21,200	a/
Crop Insurance	1,800	1,592	1,675	1,736	1,808	1,891	8,702	

Costs b/

Section I. Crop Insurance (and NAP)

CAT, Buy-up, Revenue Ins. subsidy increases	1,500	1,545	1,591	1,639	1,688	7,984	
Multi-year disaster coverage	100	100	400	200	200	1,000	
Expand NAP and increase subsidies	475	489	504	519	535	2,522	
Accelerate New Product Development	5	5	5	5	6	27	
Section I. Subtotal:	2,080	2,139	2,501	2,364	2,429	11,512	

Section II. Improve emergency responsiveness

Standing livestock feed program	24	25	25	26	27	127	
Allow multiple emergency benefits	10	10	11	11	11	53	
Land Retirement Program	50	75	100	100	100	425	
Small agriculture-related business loans (discret.)	50	52	54	56	58	270	
Section II. Subtotal:	134	162	190	193	196	876	

Section III. Risk Management Education:

Workshops, university curricula, advertising	29	30	31	32	33	154	
Options Pilot Programs	21	22	22	23	24	111	
Section III. Subtotal:	50	52	53	55	58	265	

Total:	2,264	2,353	2,744	2,611	2,681	12,653
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Alternative options:

Risk Management Accounts	200	200	200	200	200	1,000
Uncapping Marketing Loan Rates	4,000	4,000	4,000	3,000	3,000	18,000
Donations and assistance for export markets	2,000	2,000	2,000	2,000	2,000	10,000

a/ Excludes \$2.8 billion in FY 1999 emergency funding. Authority for AMTA expires after FY 2002

b/ Items in USDA's proposal not included in the above (FY 2000 costs in millions of dollars):

1) Multi-year coverage subsidy of 100% (add-on to above)	150
2) "Disappearing Deductible" alternative to multi-year	300
3) Emergency loans (discretionary)	50
4) Increase delivery expenses to private companies:	43
5) Expense reimbursement to companies under new subsidy:	165
6) Other adjustments	25
Total:	733

*Farm
Safety
net*

Billions

Crop Insurance

1.5 CROP INSURANCE - enhance participation

.1 MULTI-YEAR INSURANCE

.475 MULTI-CROP INSURANCE

.05 OPTIONS

.2 RISK MANAGEMENT

.034 Emergency

.05 Land Retirement

2.3 billion

Dan,
Is this right
for FY '2000?

→ how much ↑
→ legislation
→

① Crop insurance

Issue: program benefits tie to insurance (make ^{insurance} unworkable)

CEA - What about options

Franzer: R's won't let it stand

Gruber: Set low corn

Glenn: POTUS promise

→ no AMT change UP

- \$400 m. ll of \$2.75 b. → buy premiums

Spelling: What about call for conference

Larry: What would it mean for Freedom to Farm

Glenn - must be in SOTU

Sully K. →

more than a
couple of sentences

SOTU
b. parham
call to
fix crop insurance
→ every year -
with-year
-Voluntary

HOW TO FIX THE FARM INCOME SAFETY NET

I. Introduction

For more than a decade bipartisan farm policy has directed producers to seek income increasingly from markets rather than from Federal subsidies. The 1994 Crop Insurance Reform and 1996 Farm Bills attempted to create a farm income safety net of market-oriented crop insurance and commodity marketing loan programs, rather than ad hoc disaster, market intervention, and price support programs. Nonetheless, in his signing statement on the 1996 Farm Bill, President Clinton said he signed the bill "with reservation because I believe the bill fails to provide an adequate safety net for family farmers." and expressed his commitment to working with the Congress to strengthen the farm safety net.

Farm income was up in 1996 to \$56.4 billion and reached a record \$60.8 billion in 1997 as export demand grew and world commodity stocks tightened from 1995. In 1998 in the US, regional inadequacies of crop insurance (including low coverage and participation), weather and multi-year production problems, and nation-wide low prices for many commodities provoked sharp criticisms of the 1996 Farm Bill and crop insurance (see Appendix A for background on the current crop insurance program). Proposals appeared in July to revive price-setting Federal subsidy programs, mainly through raising USDA's "marketing loan rate" to boost crop payments to farmers (see Appendix B for background on the marketing loan program).

II. Administration Proposals

In response to the concerns about falling farm income, an NEC-led interagency group this summer crafted a package of proposals to address the specific areas of need throughout the nation's farmland. This included targeted assistance for regions in need, primarily through a supplemental crop insurance benefit for multi-year losses.

Second, the President announced on July 18th the purchase and donation overseas of 2.5 million tons of wheat to boost US farm prices and to relieve hunger around the world, using existing USDA authorities and mandatory funding. In November, the President announced an additional food-aid package of 3.1 million tons of wheat and other commodities for Russia.

Finally, the Administration agreed to support Sens. Harkin's and Daschle's proposal to remove the 1996 Farm Bill limitation on marketing loan rate levels, which did not pass the Congress.

III. Status of Farmer Assistance

The Administration negotiated a \$6 billion disaster assistance package in the FY 1999 Omnibus Appropriations Bill to boost farm income. All told, federal farm assistance for FY 1999 is likely

to be nearly \$18 billion (see Table 1) -- \$9 billion above the level assumed in the FY 1999 Budget, and farm income for 1998 is expected to be near the 1997 record level. The President charged Secretary Glickman with addressing the "gaps" in the farm safety net that were exposed during the 1998 crop year. Recently, the Congressional Agriculture Committees have announced their intention to address the problems through the crop insurance program.

NEC deputies have met to discuss how best to strengthen the safety net. In the process, they asked: How much enhancement does the safety net need? Should Federal programs prevent any farmer's income from falling below the five-year average level? Should income supplements be targeted to smaller, low-income farmers?

IV. Problems in Farm Country and Options for Dealing with Them

In its FY 2000 Budget request, USDA proposes to continue the path of the 1996 Farm Bill, and Administration policy, by helping farmers to manage risk. It recommends a series of program changes to: make crop insurance more attractive by covering more risk at reduced costs; enhancing emergency programs; and expanding risk-management education. A proposal could also re-establish the requirement that farmers purchase crop insurance, and send a message to farmers that these increased insurance subsidies would negate the likelihood of future emergency payments such as those provided through the FY 1999 Omnibus bill.

Gaps in the Safety Net

This section lists the four main problems with the current farm income safety net, then analyzes the options, in addition to the USDA proposals. The options can be dialed by benefits and costs. Also, to achieve targeting by income or gross revenues, means-testing could be overlaid on most options to address the recurring issue that insufficient payments go to the neediest or smallest farmers while most payments continue to go to relatively wealthy and large-scale farmers.

Problem One: Crop loss due to natural disaster -- crop insurance can fail to indemnify enough of the loss because:

- a) Too little acreage is insured, i.e., too few farmers participate due, in part, to complacency or underestimation of risks in low risk regions (e.g., Indiana, Illinois), and aversion to higher premiums and lower insured yields in high-risk regions (e.g., Oklahoma, Arkansas, Tennessee); and
- b) Insured acreage is covered at too low a percent of expected revenue (i.e., too little coverage is purchased by the average farmer).

Problem Two: Multi-year crop loss due to natural disaster, where:

- a) Poor production history hurts "good" farmers by raising premiums and lowering the insurable yield; and
- b) Even higher, "buy-up" coverage levels, after consecutive loss years, may indemnify too little to sustain the farm operation.

Problem Three: Low prices nationally, as much as 40 percent below the 5-year average, primarily due to large harvests and reduced export demand.

Problem Four: High producer expenses, where:

- a) certain regions have high production costs arising from natural factors; or
- b) exogenous shocks raise input costs like fuel, or livestock feed from a small crop.

Options: (see Table 2 for a summary of options costs)

1. Enhance Crop Insurance. Increase crop insurance subsidies on all Federal crop insurance products, both “yield insurance” and “revenue insurance” plans. This would be achieved by increasing coverage on free Catastrophic (CAT) policies (to effectively cover 42% of expected revenue vs. the current 30%) and increasing premium subsidies on higher levels of yield and revenue insurance. (See Appendix A for background on crop insurance.)

	(outlays in millions of dollars)				
<u>Estimated costs:</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
Yield insurance	1,200	1,236	1,273	1,311	1,350
Revenue insurance	<u>300</u>	<u>309</u>	<u>318</u>	<u>328</u>	<u>338</u>
	1,500	1,545	1,591	1,639	1,688

Estimated Benefit: A 25 percent increase in crop insurance participation, from 63 percent of insurable acreage to 80 percent. This benefit is virtually assured if crop insurance “linkage” is re-established (detailed below).

The proposed increases hold two strong attractions for farmers: a) the obvious attraction of increasing the value of their insurance policy at no extra cost, and b) increasing the likelihood that they will receive an indemnity payment. In other words, instead of simply decreasing the amount of farmer-paid insurance premium cost at current coverage levels (which would have no impact on the probability of receiving an indemnity payment), the USDA proposal would both avoid cost increases to the farmer and raise the level of indemnity payments.

Revenue insurance policies are currently subsidized by USDA at a lower percentage than comparable yield insurance policies. This option would increase the USDA premium subsidy for revenue insurance on par with yield coverage, increasing the incentive to purchase this expensive, but more comprehensive, coverage. It also has the added positive effect of increasing the farmers’ incentive to sell their crops on the forward market.

Farmers are notoriously reluctant to forward contract much of their crops out of fear that prices will increase after they have locked in their forward price. Crop Revenue Coverage (CRC) allows farmers to forward contract with the confidence that if prices go up after they have obligated themselves to deliver at a lower price, they will be indemnified against missing out on

higher prices. The commodity exchanges find this aspect of revenue coverage attractive because trading volume would increase. However, they also have expressed some concern over the extent to which subsidized revenue coverage might compete with their futures and options contracts.

Ensuring Participation

Because this option is in large part a marketing strategy to increase program participation, its success ultimately hinges on its impact on buyer behavior. Insurance is not currently required of producers, and they will have to make their own risk management decisions -- to buy or not to buy. However, large media advertising campaigns (also proposed by USDA) combined with a program structure that would virtually eliminate the lower coverage range of buy-up insurance would help to ensure the expected response on the part of farmers, as long as they can be convinced that the government will not once again revert to ad hoc disaster payments as future "disasters" arise.

To further reduce the uncertainty associated with buyer behavior, the Administration could reimpose the provision of the 1994 Crop Insurance Reform Act to require producers to purchase some level of crop insurance in order to receive any other USDA program benefits, especially the basic AMTA payments. This so-called "linkage" provision was in effect for one year, the 1995 crop year, and resulted in nearly doubling the amount of crop insurance sales. Linkage was not particularly controversial, and its abolition in the 1996 Farm Bill in response to some producers' objections was accomplished without serious policy review by the Administration or Congress.

Pro:

- Has best chance of enactment. In Congress, both the House and Senate, Democrats and Republicans, have indicated that reform of crop insurance this year is their top priority.
- The President explicitly noted the need to fix crop insurance.
- Consistent with the market-oriented farm policies of the 1996 Farm Bill.
- Would significantly increase crop insurance participation if not undermined by ad hoc disaster spending, and particularly if "linkage" is re-established (requirement that a producer buy crop insurance in order to participate in other USDA programs).
- Crop insurance is more inclusive than many other USDA programs, covering nearly 70 different crops.
- Crop insurance is more friendly to the beginning farmer. Other programs (e.g., AMTA payments) have more cumbersome eligibility hurdles.

- Avoids sending a “mixed message” on the economic structure of farm policy (the hope of future ad hoc disaster spending or direct price/income support), and encourages producers to actively manage their risk, albeit on very concessional terms.
- More revenue insurance purchases would increase the number of producers protected against both weather risk and market risk.
- Private commodities exchanges expect to benefit from increased trading volume.
- Could be used as a “transitional” fix: Subsidies could be dialed down as future conditions and policies warrant.

Con:

- Because the program does not guarantee benefits or require participation, its efficacy is ultimately dependent on buyer behavior (unless “linkage” is re-established).
- Increasing coverage at the CAT level could result in a “buy-down” effect; i.e., farmers who previously paid for buy-up insurance opt for free CAT coverage.
- Budget “watchdog” groups may protest the new subsidies to U.S. agriculture as unnecessary.
- Private commodity exchanges might object to perceived competition from government-subsidized price risk management tools, i.e., revenue insurance.

Recommendations:

USDA, CEA, OMB staff support; Treasury supports if subsidies scaled down in outyears and “linkage” required.

2. Fix Multi-year Crop Insurance. Introduce a new multi-year loss insurance provision as an optional add-on to the crop insurance policy. A version of this was included in the Administration’s summer ‘98 farm disaster aid package and enacted in the Omnibus bill. This proposal would make the availability of multi-year coverage permanent.

<u>Estimated Costs</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
(outlays in millions of dollars)	100	100	400	200	200

The 1998 emergency multi-year loss benefits provided supplemental indemnity payments to qualified insured farmers (those with losses in two out of the last three, or three out of the last five consecutive crop years) equal to 25 percent of the indemnities received over the years of those losses. The new policy provisions would likely have a similar effect, i.e., retroactively increase indemnity levels to a guaranteed three (or five) year figure. This proposal could

similarly pay an additional 25 percent of indemnities received over a three or five year period, for those with multi-year losses. The coverage would begin to be sold for the 2000 crop, and that crop would be the first of the “multi-years” covered. Figures above reflect premium subsidy costs through FY 2001, and FY 2002 as the first year of expected indemnities. (No duplicate benefits would be paid through this proposal to producers who received 1998 emergency assistance for multi-year losses.)

Pro:

- Consistent with the market-oriented farm policies of the 1996 Farm Bill.
- Directly responds to one of the most vocal constituencies, (the Dakotas) during the debate on 1998 emergency assistance.
- Crop insurance covers more crops and is more available to new farmers than most other USDA commodity assistance programs.

Con:

- Because the program does not guarantee benefits or require participation, its efficacy is ultimately dependent on buyer behavior.
- Moral hazard, while true for subsidized crop insurance generally, could be greater.

Recommendations:

USDA, OMB staff support; Treasury supports if subsidies phased out after 3 years; CEA mildly opposed due to moral hazard concern.

3. Cover More Non-insured Crops. Increase support for non-insured crops covered by the Non-insurance Crop Assistance Program (NAP) and expand NAP to include livestock.

<u>Estimated costs:</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
(outlays in millions of dollars)					
Increase NAP on par with CAT	425	437	451	464	479
Expand NAP to include livestock	<u>50</u>	<u>52</u>	<u>53</u>	<u>55</u>	<u>56</u>
Total	475	489	504	519	535

Despite the growth in the number of crops covered by the insurance program over the last decade, over 1,600 crops remain for which no insurance is available, e.g., artichokes, lettuce, ginseng, mushrooms, which are covered by NAP. This option proposes to increase NAP coverage on par with coverage increases of CAT insurance (i.e, guarantee about 42 percent of expected revenue, vs. 30 percent currently). It addition, the option adds livestock to “non-

insured” commodities covered under NAP (see also Options 4 and 6 for enhancements to livestock assistance), since there is currently no “safety net” program for livestock producers.

Benefits can be targeted, such as through USDA’s proposal to increase crop-loss assistance on non-insured crops for small farms, and provide increased incentives (administrative cost reimbursements) for private companies to seek out and “sell” free CAT coverage to “limited-resource” (low income) farmers. (These options are not included in cost estimate above.)

NAP requires no application or sign-up. Producers who file acreage and production history reports with USDA are immediately eligible for NAP benefits. Producers provide these reports to USDA for other program purposes. Thus, the number of crop producers covered by NAP may not change but their benefits under NAP would increase by 40 percent (from 30 percent to 42 of expected production value). However, the change will increase the number eligible for benefits by over 300,000 by expanding NAP to include livestock producers.

Pro:

- Addresses the vulnerability of producers who raise crops and livestock for which no insurance exists.

- Could be perceived as unfair if CAT coverage is raised while NAP is not.

Con:

- Costly to cover more minor crops, mostly vegetables, which was not a source of national farmer dissatisfaction in summer ‘98.

Recommendations:

USDA, Treasury, CEA, OMB staff support.

4. Promote Commodity Options. Increase USDA’s current educational options pilot programs (OPP) and other risk management education and outreach efforts.

<u>Estimated costs:</u> (outlays in millions of dollars)	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
OPPs (e.g., soybeans and hogs)	21	22	22	23	24
Education and outreach	29	30	31	32	33

Options on futures contracts are often cited as the equivalent of price insurance. Producers who purchase “put” options have effectively purchased a price floor. When prices go up, they can still enjoy the benefits of higher prices, but they are protected if prices fall below the floor, or “strike price”, they purchased.

USDA has recently implemented a program to teach dairy farmers how to use these markets that provides a short term, hands-on trading experience, with USDA sharing the cost of the options contracts. The program lasts only for six-months per producer and allows the producer to buy options on a limited quantity of milk. The producer learns the markets, the terminology, hedging strategy, and how to select and deal with a broker.

The program vision is not for permanent subsidies. Its sole objective is to educate the producer in the hope that after “graduating” from the short term, subsidized program the producer will continue to manage price risk using options. For OPPs to succeed, legislation would require a change to remove language requiring budget neutrality. The 1996 Farm Bill stipulates that OPPs must be budget neutral “to the maximum extent practicable”. USDA interprets that to mean that recipients of USDA program payments who participate in an OPP must forego in program payments the amount of the subsidies they will receive under the OPP. This provision does not apply in USDA’s current dairy OPP because dairy farmers are not currently receiving program payments. Thus, the offset is not “practicable”.

In addition, USDA would conduct aggressive outreach programs to organize county-level workshops, develop university curricula, and a multimedia advertising campaign. The programs would reach an estimated 200,000 farmers, and 50,000 agricultural lenders with in-depth educational programs including over 50 hours of training in a classroom setting over two years. Commodity pilots other than soybeans and hogs could be substituted, or more added at an additional cost.

Pro:

- Consistent with the market-oriented reforms of the 1996 Farm Bill.
- Futures/options markets exist for most of the eight major “program crops” as well as livestock.
- Complements the other options such as increased insurance coverage by alerting and introducing farmers to risk management tools.

Con:

- Futures/options markets exist for only a limited number of crops.

Recommendations:

USDA, Treasury, CEA, OMB staff support.

5. Permit Risk Management Accounts. Provides a tax advantage for building financial reserves to be used for farm contingencies. In its “Bluebook” of policy guidance for the 1996 Farm Bill, the Administration proposed “income stabilization accounts”. However, the Administration has recently opposed forms of risk management accounts that primarily benefit

large, wealthy farmers - not the struggling farmers with inadequate safety nets. The "FARRM" IRA proposal, nearly adopted in the 1999 Omnibus bill, was in this category. It was dropped from the bill in part because it was "strongly opposed" by Treasury.

Income stabilization accounts could be designed as expenditure programs to provide benefits primarily for small or limited-resource farmers. Such accounts are being tried in Canada and France. They permit tax-free deposits up to a certain amount that are matched by tax-free government payments to encourage participation. In the event of a disaster, the farmer is permitted to withdraw the funds without penalty, providing a kind of insurance in bad crop years. Though the benefits of these accounts are larger for farmers that have tax liability, even struggling farmers with no tax liability receive substantial benefit because of the matching government payments -- in contrast to the tax-based FARRM proposal.

USDA and Treasury have not yet evaluated such an expenditure-based income stabilization account program, and so estimates of takeup rates and total program expenditures are highly speculative. A matching-contribution program could be piloted for a specific commodity or region.

The FY 1999 Omnibus Appropriations Bill included several new permanent tax reforms that were intended to target small, struggling farmers more effectively than tax-based income stabilization accounts. These included extending loss-carryback provisions in "good" years for farmers, and permanent extension of income averaging over three years. Most recently, Treasury estimated these enacted provisions will reduce tax receipts by \$200 million annually, but the actual effect of these changes in the tax code on farm income is not yet known.

<u>Estimated costs:</u> (outlays in millions of dollars)	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
	200	200	200	200	200

Pro:

- Encourages prudent savings while reducing the impact of future disasters on both the farmer and the Federal budget.
- Builds on producers' current ability to manage their income streams by savings, and timing of input and capital purchases for tax purposes.
- Makes more comprehensive an Administration safety net policy of "various solutions appropriate to segments and conditions in farm country".

Con:

- FARRM accounts are of no value to farmers suffering losses, because a tax deduction is worthless to them. Treasury estimates that more than 75 percent of farmers have no tax liability. Most of those who are taxable have substantial off-farm income.
- The proposal would respond to a perception of excessive volatility in farmers' incomes. However, other more effective and equitable tax provisions were enacted in the recent Omnibus bill to address volatility.
- Treasury strongly opposed adoption of the FARRM accounts during the FY 1999 Omnibus bill negotiations.
- Low farmer participation would be expected.

Recommendations:

USDA supports. Treasury, CEA, OMB staff oppose. Treasury would not oppose limited pilot of USDA matching contributions for small, limited-resource farmers.

6. Strengthen Standing Emergency Programs. USDA's proposal includes assistance for livestock, and would allow farmers to receive both CAT and NAP benefits, USDA disaster loans, and other USDA farm credit. Some were included in Summer '98 Administration package. "a)" and "b)" below could be targeted to small or limited-resource farmers.

<u>Estimated costs</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
(outlays in millions of dollars)					
a) Emergency livestock assistance	24	25	25	26	27
b) Allowing CAT/NAP benefits and emergency loans	10	10	11	11	11
c) Small ag-related business loans (discretionary loans)	(50)	(52)	(54)	(56)	(58)

a) Emergency feed assistance would be provided during shortages or inaccessibility from natural disasters; plus compensation for dumped milk production and livestock deaths due to natural disasters. This is similar to a program USDA has operated over the last several years that has nearly exhausted its authorized funds. Funds unused in any year would carry over and be available in subsequent years.

b) Currently, under the 1996 Farm Bill, a farmer cannot receive CAT or NAP benefits in addition to benefits and remain eligible for USDA emergency loans for the same loss. The proposal would remove that language, thereby allowing producers to receive CAT or NAP and also be eligible for an emergency loan.

c) There is an eligibility “gap” between USDA and Small Business Administration (SBA) disaster loans that was highlighted in 1992's Hurricane Andrew and again by the President’s Recovery Task Force on the 1998 New England ice storm. USDA emergency loans are available only for family-sized farms that cannot secure private credit following a natural disaster; loans up to \$500,000 are made at 3.5 percent interest for 10 years. SBA is statutorily prohibited from providing its business disaster loans to “agricultural enterprises”; SBA loans up to \$1.5 million are generally made at Treasury rates for businesses that can secure private credit, while those that cannot can borrow from SBA at 4 percent interest. This proposal would fill the gap by authorizing USDA disaster loans at Treasury rates for agricultural-related businesses, large farms, and credit-worthy farm operations.

Pro:

- Small farm- and small business-oriented.
- Provides “seamless” federal emergency loan coverage.
- A standing emergency livestock assistance program would enable USDA to respond immediately to disasters with short-term aid, before CAT or NAP payments are made.

Con:

- Providing CAT or NAP and emergency loans on the same loss could be viewed as excessive subsidies for larger farm businesses..

Recommendations:

USDA, Treasury, CEA, OMB staff support a), b), and c).

7. Land Retirement. Some producers farm land that encounters natural disabilities (like excessive wetness or disease) that persist longer than one year, but that is likely to return to production. USDA could enter medium-term contracts (3 - 5 years non renewable) to retire such land, including land in the Upper Plains that is diseased or under water, or land in the southwest that is quarantined due to karnal bunt. Payments would be made for “environmental benefits”, including conservation practices aimed to restore the land to production. An area-wide problem could be required to trigger in a farm’s land for eligibility. USDA’s Conservation Reserve Program (CRP) retires land for 10-year periods, but not when they are made unproductive due to natural afflictions. A version of this proposal was included in Administration’s Summer ‘98 package (and in the 11/13 USDA budget submission addendum), but was not enacted.

<u>Estimated costs:</u> (outlays in millions of dollars)	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
	50	75	100	100	100

Pro:

- Would fill a gap in the current program structure, since there is no program aimed at this problem.

Con:

- Unlikely need for medium-term retirement program; land problems better ameliorated through farming practices or a program that would permanently retire land.

Recommendations:

USDA supports; Treasury, CEA, OMB staff oppose.

8. Marketing Loans. Uncap 1996 Farm Bill levels. (See Appendix B for background.)

<u>Estimated costs</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
(outlays in millions of dollars)	4,000	4,000	4,000	3,000	3,000

Removing the 1996 Farm Bill's limitation on marketing loan rates (85 percent of a five-year moving average minus high and low years, but not more than the 1995 level) would enable the loan rates to rise to a level that practically guarantees regular annual payments in the years ahead. This would turn the marketing loan program into a type of "deficiency payment," a program abolished by the 1996 Farm Bill. As a general commodity program, it would apply to all major field crops for the 1.8 million participants in USDA crop subsidy programs. This was proposed by Sens. Harkin and Daschle in the summer, and by the Administration in some forms, but defeated in Congress on six occasions.

A targeted version, a "two-tier marketing loan", was proposed by Sen. Daschle in the 1996 Farm Bill deliberations. This proposal would offer a higher loan rate for a minimum volume of production per farmer, e.g., the first 10,000 bushels. Production above that level would receive a lower loan rate or none at all. This regime would provide relatively greater benefit to smaller producers.

Pro:

- Popular with many populist supporters of the Administration.
- Would be perceived as supporting smaller, less efficient farmers.

Con:

- Would return farm policy back to failed, costly past programs that hurt US exports and would lead to production supply controls, widely unpopular with farmers.

- Untargeted version would provide gratuitous financial windfall to many farmers.
- Targeted version would be opposed by many larger farmers, especially of cotton and rice.
- Would compete/conflict with market-oriented programs (e.g., revenue insurance, OPPs).
- Fails to help individual farmers with diminished or failed crop.

Recommendations:

Treasury, CEA, OMB staff oppose. USDA does not support.

9. Federal Assistance for Exports. Donations and support for faltering export markets.

<u>Estimated costs</u> (outlays in millions)	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
	2,000	2,000	2,000	2,000	2,000

The humanitarian food aid packages of July for wheat and November for Russia (totaling about \$2 billion for 6 million tons of food, and used as the estimated cost for this option) could be extended so long as the commodity to be donated remains in surplus in the US, or whenever “emergencies” are found abroad. While sufficient funding usually is not an obstacle for the mandatory programs and emergency authorities involved, this action is limited by GATT rules on subsidies, our trading partners’ complaints, and the undermining of US commercial exports. The actual impact of Federal donations on US farm prices is in dispute, but the announcements of donations are seen as popular among many farmers, if not commodity markets. The Administration’s active role in managing the Asian economic crisis--a major cause of reduced demand for US agricultural exports--is viewed as a general form of help to US farmers, but indirect and longer-term.

Pro:

- Perceived in farm country as positive action.
- Can cause “additional” exports to those countries unable to purchase food.

Con:

- Need for bulk commodities is limited. Truly hungry people not already being supplied by standing government programs tend to need consumer-ready foodstuffs.
- Limited by tendency to displace US commercial exports.
- Unpredictable impact on markets means unreliable domestic farm support program.

Recommendations:

Treasury, CEA, OMB staff oppose. USDA does not support.

V. Offsets

USDA has not proposed any offsets to date. OMB recommends PAYGO offsets from cuts in guaranteed Agriculture Market Transition Act (AMTA) payments. The shift in funding would effectively redistribute funds guaranteed to producers who have not experienced crop losses and rewards those who have actively managed their yield risk and paid a share of the associated costs. AMTA payments are only authorized through FY 2002; however, baseline rules extend the authorization and baseline spending indefinitely.

Alternatively, offsets from non-USDA programs could be explored, or the proposal could not have an offset (in effect, spending the surplus).

The distribution of AMTA payments by state compares favorably to the expected redistribution of funds through increased crop insurance subsidies. Some discrepancies arise among certain Midwestern states (Iowa, Illinois, Indiana, Nebraska) that receive significant AMTA payments and whose proportion of benefits would likely be eroded and shifted toward states with higher crop insurance losses. Many of the states experiencing increases in their proportional benefits are those with particular problems over the most recent period (Texas, North Dakota, Minnesota, Georgia, North Carolina, South Carolina). In effect, the redistribution takes benefits from areas with a lower incidence of crop losses and moves them to areas that have been harder-hit in the past year and have had historically higher levels of uninsured or underinsured producers. Further, in a loss-year similar to the one experienced in 1998, the redistribution of benefits channels funds much more dramatically to areas in the most need.

However, crop insurance indemnities are not guaranteed as are AMTA payments. Coverage begins at specified loss levels verified at the individual farm level. The same number of dollars is projected to be disbursed over the long run, but wide variations in year-to-year outlays will occur. The proposal channels funds to farmers who have taken proactive steps to manage their risk and suffered verified losses, at the cost of guaranteed payments withdrawn from farmers holding AMTA contracts. Using AMTA payments as an offset achieves some targeting of AMTA benefits.

Recommendations:

USDA, OMB staff support AMTA offset. CEA opposes as unfair to farmers and taxpayers to “change the rules of the game at this point.”

BACKGROUND

Appendix A: Crop Insurance

Yield Insurance (USDA's standard multi-peril crop insurance products)

Crop insurance coverage is made up of two components, yield coverage and price coverage. The buyer can choose among various coverage combinations of both yield and price. The minimum coverage level insures 50 percent of average yield at 60 percent of a USDA-set price. This plan is known as Catastrophic Risk Protection (CAT), or "50/60" coverage. The highest coverage available nationally is the 75/100 level. The most popular coverage to date is the 65/100 level. At this level of coverage, if the insureds suffer a 50 percent yield loss, they are made whole on the lost production up to 65 percent (or 15 percent in this case) and the indemnity payment would amount to the 15 percent of covered loss times 100 percent of the USDA-set price.

USDA offers two general levels of insurance coverage; Catastrophic Risk Protection (CAT), and so-called "buy-up" coverage which is all coverage levels higher than CAT. CAT premium is 100 percent subsidized and the farmer only pays a nominal administrative fee for it. CAT covers only 30 percent of expected revenue. Buy-up coverage is available at levels between 60 and 75 percent of expected revenue and is subsidized on a scale that slides downward as coverage increases. In other words, 65 percent coverage involves a 40 percent premium subsidy, and 75 percent coverage involves a 24 percent subsidy.

USDA has performed marketing analysis to estimate how much an average producer is willing to pay for buy-up crop insurance. That amount is \$5.30 for each \$100 of liability insured. USDA proposes to apply that farmer-paid amount to a coverage level that is considered high enough to restore credibility to the crop insurance program in the wake of the harsh criticisms last summer. That level is 70 percent of expected revenue.

The following example illustrates how the insurance coverage works:

- a) a corn grower with 1,000 acres and an average yield of 100 bushels per acre has an expected yield of 100,000 bushels;
- b) the insured price set by USDA is \$2.30 per bushel;
- c) "70/100" coverage is purchased, so the farmer has insured \$161,000 of liability (70,000 bushels at \$2.30/bu.);
- d) if the farmer experiences a 40 percent yield loss (i.e., a harvest of 60,000 bushels) an indemnity of \$23,000 would be paid (i.e., the 10,000 bushels that would make the farmer whole up to 70 percent of average production multiplied by 100 percent of the \$2.30/bu. price);
- e) the total insurance premium for the coverage would likely be around \$13,000, of which 32 percent, \$4,160, is currently paid by USDA;

- f) USDA also reimburses the private insurers' administrative expenses at a rate of 24.5 percent of gross premium, or in this case \$3,185.

Revenue Insurance

Standard crop insurance policies do not indemnify producers who have not experienced crop losses due to natural causes. However, even a producer who harvests 100 percent of expected yield can be put on difficult financial footing through price declines. The Federal crop insurance program currently offers three policies that provide indemnities in the event of falling prices regardless of crop losses ("revenue insurance"). These products are all less than three years old. Two are struggling to become established but one has been very successful. Crop Revenue Coverage (CRC), developed by one of the private crop insurance companies, now accounts for 16% of the crop insurance market (nearly \$300 million in annual premium). This is a very high growth rate over just three years, particularly in light of its price tag -- CRC premiums are 30 percent higher than comparable yield insurance on average.

Revenue insurance policies are subsidized by USDA at a lower percentage than yield coverage. It is worth noting that, in light of this lower subsidy on a high-priced policy, CRC's growth tends to contradict the notion that farmers are unwilling to pay significant premium costs for crop insurance. This, in turn, further supports options that retain market-oriented safety net programs, with an eye toward dialing down subsidies over the long term.

CRC's success in the market is attributable to one unique component of its coverage; CRC indemnifies if prices fall *and* if prices rise; CRC will indemnify yield loss at the current market price if it has gone up during the insurance period. To summarize, revenue policies work much like standard policies but pay out indemnities in more circumstances:

- a) yield loss when prices remain unchanged (like standard policies);
- b) yield loss when prices fall (like standard policies);
- c) yield loss when prices rise (CRC pays out at the higher market price);
- d) no yield loss but prices fall (revenue policies only).

The following is an example of revenue insurance, scenario "d" above:

- a) a corn grower with 1,000 acres and an average yield of 100 bushels per acre has an expected yield of 100,000 bushels;
- b) the insured price, established by the average price of December corn futures during the month of February, is \$2.45 per bushel;
- c) "70/100" coverage is purchased, so the farmer has insured \$171,500 of liability (70,000 bushels at \$2.45/bu.);
- d) by December, the farmer has no yield loss (i.e., a harvest of 100,000 bushels)
- e) but, the average price of that same December corn futures contract at harvest time (November) has dropped to \$2.00/bushel (i.e., down 45 cents/bushel). An indemnity of

- \$31,500 would be paid (i.e., the 70,000 bushels insured multiplied by 100 percent of the \$0.45/bu. price decline);
- f) the total insurance premium for the coverage would likely be around \$17,000, of which 24 percent, or \$4,160, is currently paid by USDA;
 - g) USDA also reimburses the private insurers' administrative expenses at a rate of 23.5 percent of gross premium, or in this case \$3,995.

Appendix B: Boosting Farm Income Through Marketing Loans

A major goal of some farm interests is to increase USDA's "marketing loan rate" so it would guarantee farm income robust enough to cover the relatively higher costs of production of some U.S. farmers. Sens. Daschle and Harkin were chief proponents of increasing ("uncapping") marketing loan rates during the summer's debate on how to improve the farm income safety net.

How marketing loans work

USDA's marketing crop loans, a program to enable farmers to avoid selling during the lowest-price (harvest) period of the year, basically set a price floor for the crop, backed by the Treasury. Farmers take out a 9-month loan from USDA at harvest time based on a statutory "loan rate" or price per bushel. If market prices drop below the loan rate, farmers can repay the loan at the lower market price per bushel. USDA absorbs (loses) the difference between the market price and the (higher) loan rate price, and the farmer keeps the crop to sell on the market. Marketing loans are available for the major US field crops, like wheat and corn. Payments under the program are limited to \$75,000 per person per crop year.

Current issue

The 1996 farm bill capped the loan rate at 85 percent of the five-year moving average price for the commodity, but not more than 1995 levels. The 1990 farm bill gave the Secretary of Agriculture discretion to reduce the loan rate from the five-year average, depending on market conditions and budget costs. That bill also required that supply controls be imposed appropriate to those market conditions to determine the size of the crops produced and the cost to the government. Uncapping loan rates would raise them (by 22 percent for wheat, 15 percent for corn) to an average price level that would be unusually high at present, because it would include the historic record high price period of 1995 and 1996. Farm interests have not suggested reimposing supply controls, which is unpopular with farmers.

For example, a wheat farmer with 100,000 bushels in 1998 faced a capped loan rate of \$2.58/bushel, an average price of \$2.65, but a low price of \$2.35. He received \$23,000 (100,000 times the 23 cent gap between the low price and the loan rate) by asking USDA for a "loan deficiency payment" when the low price prevailed. (A loan deficiency payment is a common variation of a marketing loan. Foregoing entirely a USDA crop loan, the farmer gets a cash payment from USDA for the difference between the loan rate and the prevailing market price.)

The farmer then held onto the crop for 10 weeks and sold it at \$2.70 and received \$270,000. The marketing loan boosted the farmer's 1998 income by 9 percent under the current loan rate regime (\$23,000 divided by \$270,000). If the wheat loan rate had been uncapped, the USDA loan deficiency payment would have been \$81,000 (100,000 times the 81 cent gap between the low price and the uncapped loan rate of \$3.16 for 1998), a boost of 30 percent to the farmer's income.

Costs

USDA to-date has paid about \$1.6 billion in marketing loan gains on the 1998 crop for all major commodities. Probably the costs for this crop under current loan rates will total about \$2 billion this year. Uncapping loan rates for one year only on the 1998 crop, as Sens. Daschle and Harkin proposed, would have cost an additional \$5 billion in FY 1999. The cost for uncapping on the 1999 crop only, with outlays largely in FY 2000, probably would be about \$4 billion according to current price projections.

Policy significance

Federal attempts in the 1960s and 1980s to protect farmers from market cycles demonstrated that USDA price-support loan rates that are within about 25 percent of commodity market prices distort markets by:

- setting an effective floor on market prices for producers;
- stimulating US production;
- increasing taxpayer costs;
- leading to production controls, reduced exports and greater foreign production.

Loan rates that are low relative to market prices avoid these distortions, but can provide an income safety net in case of a price collapse. An NEC interagency process concluded in 1994 that raising loan rates slightly was dubious policy because of its market effects even when it would cost much less than under current price conditions.

Budgetary costs and policy problems could be reduced when raising marketing loan rates by targeting the payments to those producers in greatest need. For example, this could be done by excluding high-income farmers and limiting the higher loan rate to each producer's first few thousand bushels of grain.

TABLE 1

Federal Outlays Supporting Production Agriculture
(outlays in billions of dollars)

	<u>FY 1996</u>	<u>FY 1997</u>	<u>FY 1998</u>	<u>FY 1999</u>
AMTA (1996 Farm Bill levels)	4.6	6.3	5.7	5.5
Conservation Reserve Program	1.7	1.7	1.8	1.6
Crop Insurance	2.2	1.5	1.6	1.8
Marketing Loan Payments	0	0	1.0	1.5
Commodity Donation Initiatives	0	0	0.6	1.4
Omnibus Ag Disaster	0	0	0	5.9
	=====	=====	=====	=====
TOTAL	8.5	9.5	10.7	17.7

Farm Income

(in billions of dollars by calendar year)

	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>
Net cash income (USDA estimates)	56.4	60.8	59.1	TB