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Agriculture - Farm Safety Net

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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). In 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

**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	7,964	
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	56	265	
Total:		2,264	2,353	2,744	2,611	2,681	12,653	

Alternative options:

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