2018 Farm Bill Economic Principles and Policy Challenges

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The development of the 2018 Farm Bill presents numerous challenges to agricultural producers, stakeholders, and policymakers in terms of both program design and funding priorities. As policy alternatives and preferences are considered, it is also appropriate to consider some of the basic economic principles of farm and agricultural programs.

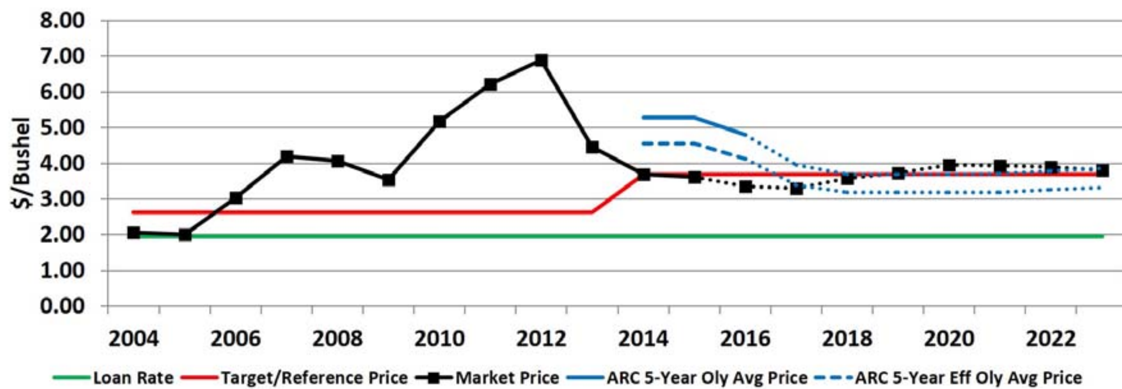
Historically, commodity programs have provided the foundation of farm income support to agricultural producers since the first farm bill, the Agricultural Act of 1933. Those programs have evolved over the decades in response to economic, budget, and political factors from supply control and price support programs to direct income support programs to the current mix of income support and risk management programs.

Commodity Programs

ARC and PLC. The commodity programs in the 2014 Farm Bill represent a mix of income support and risk management. The Price Loss Coverage (PLC) program mirrors previous price-based income support programs with a fixed reference price and PLC payments whenever and for however long market prices average below the reference price for the marketing year. The Agriculture Risk Coverage (ARC) program at the county level (ARC-CO) or the farm-level individual coverage (ARC-IC) establishes an annual revenue guarantee tied to moving average yields and prices, providing a cushion against substantial shocks to revenue, but one that moves over time to reflect production and market conditions.

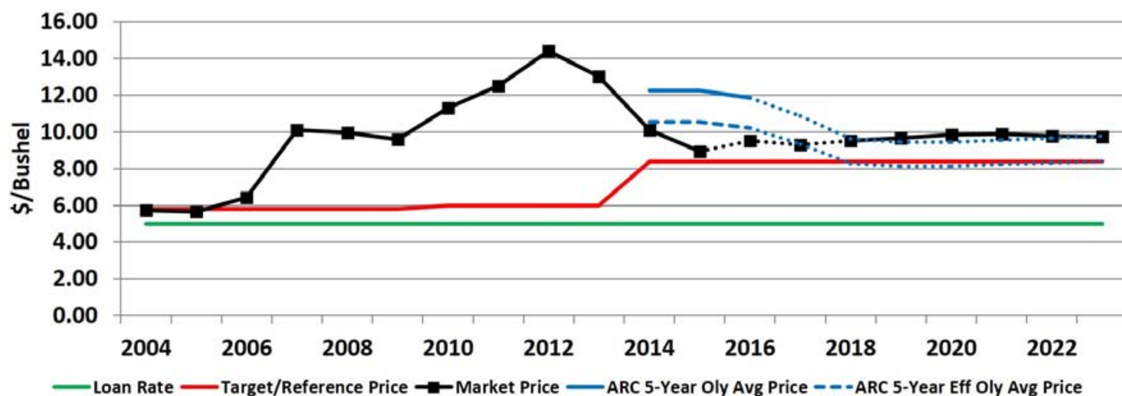
Comparing PLC and ARC under the 2014 Farm Bill provides a clear illustration of the differences. For many commodities, as illustrated by corn in Figure 1, the ARC program provided substantial support for the 2014-2016 crops as prices fell from market highs in the years running up to the 2014 Farm Bill. But, as lower prices have continued, the Olympic average price in the ARC formula has fallen and the effective price protection in ARC (calculated at 86% of average prices assuming average yields) has fallen below that of PLC. By comparison, PLC did not provide much projected support as the current farm bill was implemented, but falling prices have made it more relevant and supportive at current price levels. While ARC has performed as it was designed for the 2014-2018 period, the projections ahead for only modest recovery in prices suggest that under a continuation of current policies, any preferences for the revenue and moving average features of ARC may give way to the higher price protection offered by PLC. As such, the Congressional Budget Office has projected that given a choice in 2019, most producers of corn and other commodities will switch enrollment from ARC to PLC and that has been assumed into the budget baseline. Soybeans are one of the few commodities where price projections over the next several years remain above the reference price such that ARC protection may still be comparable to or favored over PLC (see Figure 2). A fundamental economic question is the appropriate role if any for the safety net to protect producers indefinitely from low prices such as with PLC or to help producers adjust to market conditions as with ARC.

Figure 1. Farm Income Safety Net for Corn



* Prices and price projections as of August 2017 from USDA-FSA, USDA-NASS, USDA-WAOB, and CBO. ARC 5-year effective Olympic average price based on 86% of ARC 5-Year Olympic average price for illustration only as ARC protection is tied to revenue.

Figure 2. Farm Income Safety Net for Soybeans



* Prices and price projections as of August 2017 from USDA-FSA, USDA-NASS, USDA-WAOB, and CBO. ARC 5-year effective Olympic average price based on 86% of ARC 5-Year Olympic average price for illustration only as ARC protection is tied to revenue.

Beyond the overall support levels and decisions between ARC and PLC, the mechanics of ARC and the variability in payments across county lines have been an issue for producers. Variable ARC-CO payment rates across county lines are by design as guarantees, revenue, and any payments are calculated with county-level yield data. But, the source of the data has been an issue as decreased participation in producer surveys and an expanded number of program crops means data can be lacking in some counties. The USDA Farm Service Agency (FSA) starts with survey data collected by the USDA National Agricultural Statistics Service (NASS), but then looks to crop insurance data from the USDA Risk Management Agency (FMA) if survey data is lacking before using other procedures to estimate missing data. Any discrepancies between NASS survey data and RMA crop insurance data can skew calculations and payments under the program. Regardless of the source, it would seem the program needs a consistent and complete data set to function accurately and transparently. Beyond the yield data set, the bigger issue with varying ARC-CO payment rates may be the relatively brief historical yield period in the guarantee. The 5-year Olympic average yield only averages 3 years after eliminating the high and low yields from the calculation. This average itself can be skewed relative to a longer-term average such as the 10-year actual production history (APH) that producers use for crop insurance protection or some historical trend projection of expected yield in the county. Examining both the yield data and the length of the yield history are important details for considering the ARC program going forward.

Dairy and Cotton. While distinct from the issues of other commodity programs, dairy and cotton programs are an integral part of the commodity program discussion due to the calls for reform and additional support that present potential budget challenges to the overall title and the overall bill. Dairy producers are still adjusting to the new Margin Protection Program for Dairy (MPP-Dairy) implemented in the 2014 Farm Bill. The MPP-Dairy program represented a watershed shift away from the existing price support and income support programs of past farm bills to a new margin-based program that protects the margin between milk prices and feed costs. With participating producers paying premiums into the program, the MPP-Dairy program takes on the appearance of an insurance program to help producers manage risk. However, dissatisfaction with the margin calculations, the premium costs, and the overall support dairy producers have received from the program have all led to calls for substantial program reforms or changes.

Cotton producers face even more distinct issues. The 2014 Farm Bill ushered in a supplemental crop insurance program for cotton as a replacement for commodity programs in response to the World Trade Organization (WTO) ruling against U.S. cotton programs. However, satisfaction and participation in the supplemental insurance program has been limited and the cotton industry has been calling for additional assistance, notably for cottonseed, either through legislative or administrative action. Cotton ginning cost-share assistance has been delivered by the Secretary of Agriculture, but a focus in the farm bill debate is the potential re-establishment of a cotton commodity program, whether for cotton or cottonseed.

The challenges for either program extend beyond mechanics and economics to budget. Efforts to include at least partial support for changes in the two programs as part of the appropriations process may lay the groundwork for future programs, but the spending issue is likely to remain a key issue in the commodity program title.

Crop Insurance

Crop insurance programs have permanent authorization and mandatory funding as a function of the Agricultural Risk Protection Act (ARPA) of 2000. But, substantial changes and expanded provisions for crop insurance included in the 2014 Farm Bill created a separate title for crop insurance and effectively tethered crop insurance funding to the overall budget baseline for the farm bill.

Producers have repeatedly called for continued support for crop insurance and generally note it as their #1 priority. At the same time, other interest groups have proposed repeated cuts to the crop insurance program, as has the current Administration and previous administrations. Proposed cuts to program benefits for individuals, either through an adjusted gross income (AGI) eligiblity cap or through a limit on premium subsidies (the federal share of premium costs) will affect not only the larger or more profitable operations that are limited out of the program, but also the remaining producers that form a smaller insurable pool. Any differences in actuarial performance of the remaining pool would affect the premium ratings and affect insurance costs for all participants.

Another proposed cut would remove the harvest price component of the Revenue Protection policy. This component adjusts the revenue guarantee for the insured crop based on the higher of the base price (established at the time of insurance purchase) or the harvest price. While the harvest price feature appears to provide extra benefits to producers in times of rising prices, it is a critical component of a producer's risk management strategy when coupled with marketing or hedging strategies to sell a portion of the crop before harvest. The harvest price component effectively provides replacement cost coverage when prices go up, replacing any lost bushels below the protection level (after deductible) at the higher harvest price such that those bushels can be purchased to fulfill any shortfalls in delivery on a marketing or hedging contract.

A remaining target of potential cuts in crop insurance programs is the overall premium subsidy level, or the portion of premium costs paid by the federal government. The federal share for the aggregate insurance portfolio has varied between 61 and 63% since 2014 (exact percentages vary by product and protection level). Increases in subsidy rates and other program changes under the 2000 legislation certainly

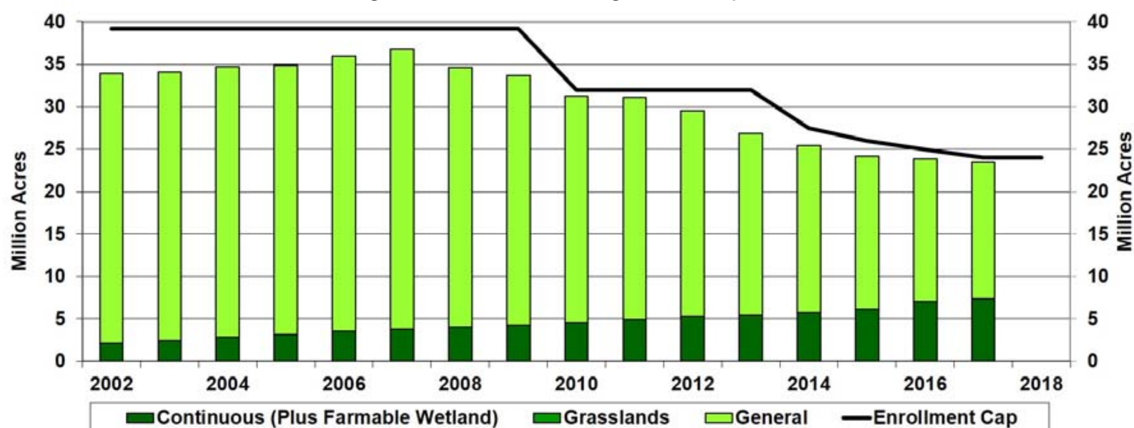
contributed to increased participation in crop insurance, but the question remains as to what level of premium subsidy if any is necessary to attract participation and maintain producer interest in the program. Furthermore, based on the debate over both support and design of the crop insurance program, is the fundamental goal to provide a program that directly protects producers from production or revenue (price and production) risk or is it to provide a tool that producers can use to make integrated risk management decisions, including farm programs, crop insurance, and marketing decisions?

Conservation

Conservation has been an integral part of farm bill legislation since the very beginning when the focus was on soil erosion and protecting the future productivity of the agricultural land base. Over the years, conservation programs have grown in breadth and in constituency, representing an important link to the broad coalition of stakeholders and policymakers that support farm legislation. The current mix of conservation programs provide incentives and assistance to producers and landowners for a range of practices and across a range of programs.

<u>Conservation Reserve Program (CRP)</u>. The CRP is the primary land retirement program, removing land from agricultural production for a period of time to produce environmental benefits. The CRP grew to nearly 37 million enrolled acres by the year 2007 before higher crop prices and profitability encouraged land out of the program at contract expiration and back into agricultural production. As enrolled acreage declined, the 2008 Farm Bill and the 2014 Farm Bill both lowered the authorized enrollment cap to capture budget savings from a smaller CRP. Now that commodity prices have come down, there is renewed interest in CRP enrollment, but virtually no room under the current 24 million acre cap. With about 23.5 million acres currently enrolled and a growing enrollment each year of high priority land and practices under the non-competitive continuous enrollment provisions, there is continued pressure to reduce general enrollment acres from the CRP (see Figure 3). General sign-up periods have been limited (the last was in early 2016) and at current acceptance rates and enrollment limits, more general enrollment land will have to expire and exit the CRP than can be renewed or bid into the CRP each time. If the CRP is to respond to increased interest, it will need to be expanded beyond the 24 million acre cap, which presents an additional budget challenge to policymakers and an economic impact on agriculture.

Figure 3. Conservation Reserve Program Enrolled Acreage and Caps



* Data from USDA-FSA and author calculations as of August 2017. Note that enrollment through the grasslands provision began in Fiscal Year 2017, but at less than 100,000 acres currently enrolled, is too small to be seen on the chart.

Another issue of note with the CRP is the concern from some groups about the average rental rates established for each county that drive the maximum CRP rents that can be paid. Congress previously called on FSA and NASS to expand survey efforts and gather data on rental rates by county to establish the relevant maximum rental rates for CRP contracts. While the data should be statistically sound, the

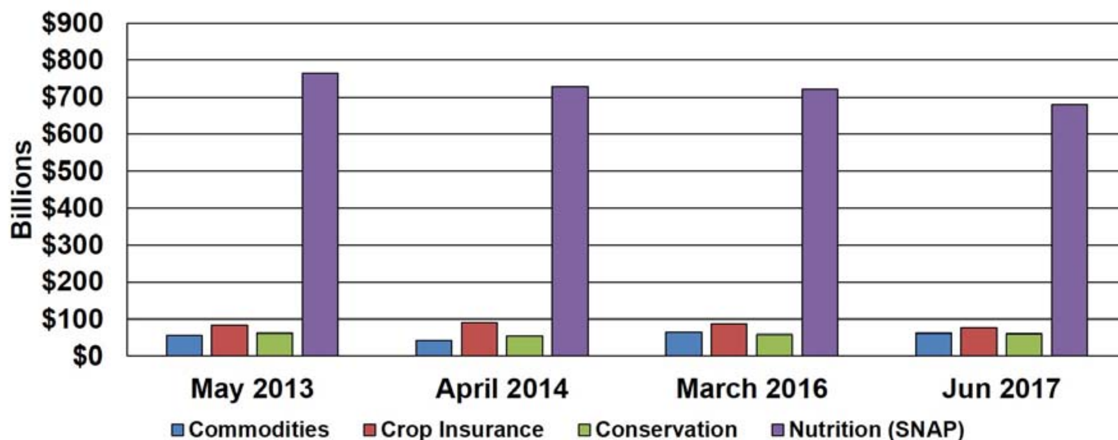
reality is that the survey at best lags current markets and conditions by a year. In a down-trending commodity market and a softening land market, rental rates from previous years provide an artificially high reference point for CRP rental rates, making CRP enrollment more attractive relative to continued agricultural production. While this may drive some of the additional interest and demand for CRP enrollment, it also places producers at a disadvantage to the CRP program in negotiating with landowners on leased land.

Other Conservation Programs. Beyond the land retirement element of the CRP, conservation programs administered by the USDA Natural Resources Conservation Service (NRCS) focus on working lands with incentives and cost-share assistance through both the Environmental Quality Incentives Program (EQIP) and the Conservation Stewardship Program (CSP) and on land preservation through the Agricultural Conservation Easement Program (ACEP). Additional assistance is provided through the Regional Conservation Partnership Program (RCPP) that pools program resources with local partner support as well as through the technical assistance delivered through NRCS offices. The working lands programs (EQIP and CSP) have grown in the share of total conservation spending and now represent more than half of the entire portfolio, although they face continual pressure for cuts to authorized spending in the annual appropriations process. Determining the appropriate role and balance of investments in land retirement vs. working lands, easements, and other assistance is a critical part of the conservation discussion.

Food Assistance

While the focus of agricultural stakeholders may be on key features of commodity, crop insurance, and conservation programs, the vast majority of total farm bill spending is clearly in the nutrition title for food assistance, particularly the Supplemental Nutrition Assistance Program (SNAP). As seen in Figure 4, food assistance is expected to account for more than 75% of total farm bill spending looking forward over the 2018-2027 federal fiscal years based on the June 2017 estimates from the Congressional Budget Office (CBO). While there are policy questions with food assistance programs ranging from eligiblity guidelines to assistance levels and block grant proposals, the fundamental lesson for agricultural stakeholders is that the food assistance title is a critical, but distinct part of the farm bill. While the farm and food, rural and urban coalition is largely credited with building and maintaining the support to pass modern farm bill legislation, it seems apparent that funding is not readily transferable between the food and farm sections of the bill. If there are cuts to food assistance, the expectation is that those cuts are about food programs and budget savings and not about finding resources to fund other program needs or enhancements.

Figure 4. Farm Bill Program Spending - 10-year Baseline Projections



* Data from CBO and author calculations as of August 2017. Each set of numbers is a different forward-looking 10-year period based on the time of the CBO baseline projections

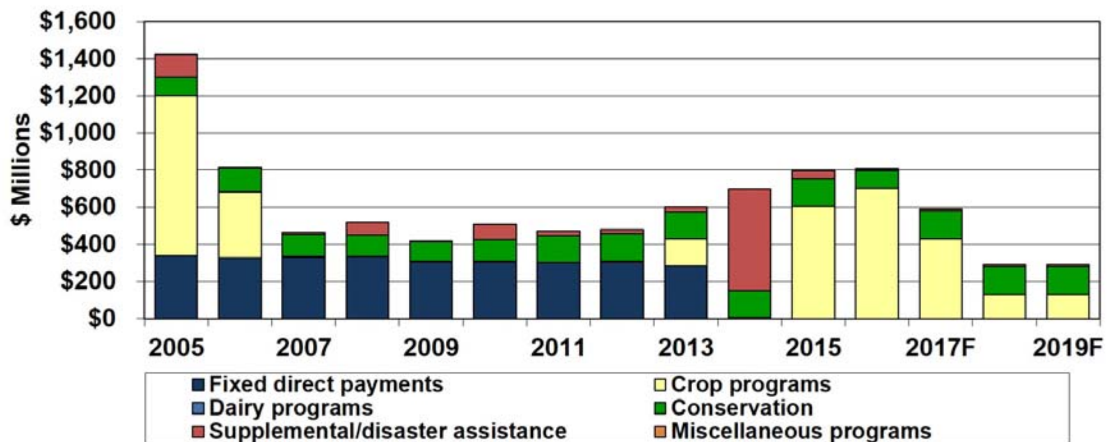
Additional Titles

Commodity programs, crop insurance, conservation programs, and food assistance account for 99% of the total spending on farm bill programs. While all of the remaining titles and program areas combined represent a relatively insignificant part of the budget, they are certainly not an insignificant part of the bill or of the constituency that supports farm bill legislation. Rural development programs including the much-discussed rural broadband infrastructure, trade programs for market promotion and development, ag credit programs, specialty crop programs, energy programs for biobased products, forestry programs, and even research and education programs all have been a significant part of multiple farm bills along with other titles and issues and merit the attention of agricultural stakeholders and policymakers alike. Other issues, including agricultural disaster preparedness, such as for livestock disease management have also received attention.

Budget Outlook

Understanding and addressing the full portfolio of titles and programs in the farm bill is important as different stakeholders establish and push for different policy preferences. Understanding the implications of federal budget challenges is important as well, noting that policy recommendations without sources of funding or program tradeoffs provide limited insight for the development of new farm bill legislation. In looking at the commodity, crop insurance, and conservation programs that provide the most direct support to Nebraska producers, the outlook is for diminishing payments as commodity program support and payments decrease (primarily ARC) through the 2018 program year (and are paid through 2019). Figure 5 provides some historical perspective on farm program payments in Nebraska and lays out the immediate path ahead for producers as they adjust to a smaller farm program portfolio from the federal government over the life of the current farm bill.

Figure 5. Farm Program Payments to Nebraska Producers



* Data from USDA-ERS and author calculations as of August 2017.

The longer-term outlook for farm program support and the broader agricultural economy will depend substantially on the decisions made regarding the 2018 Farm Bill as well as other policies that affect agricultural production, markets, and finance.