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October 17, 2011

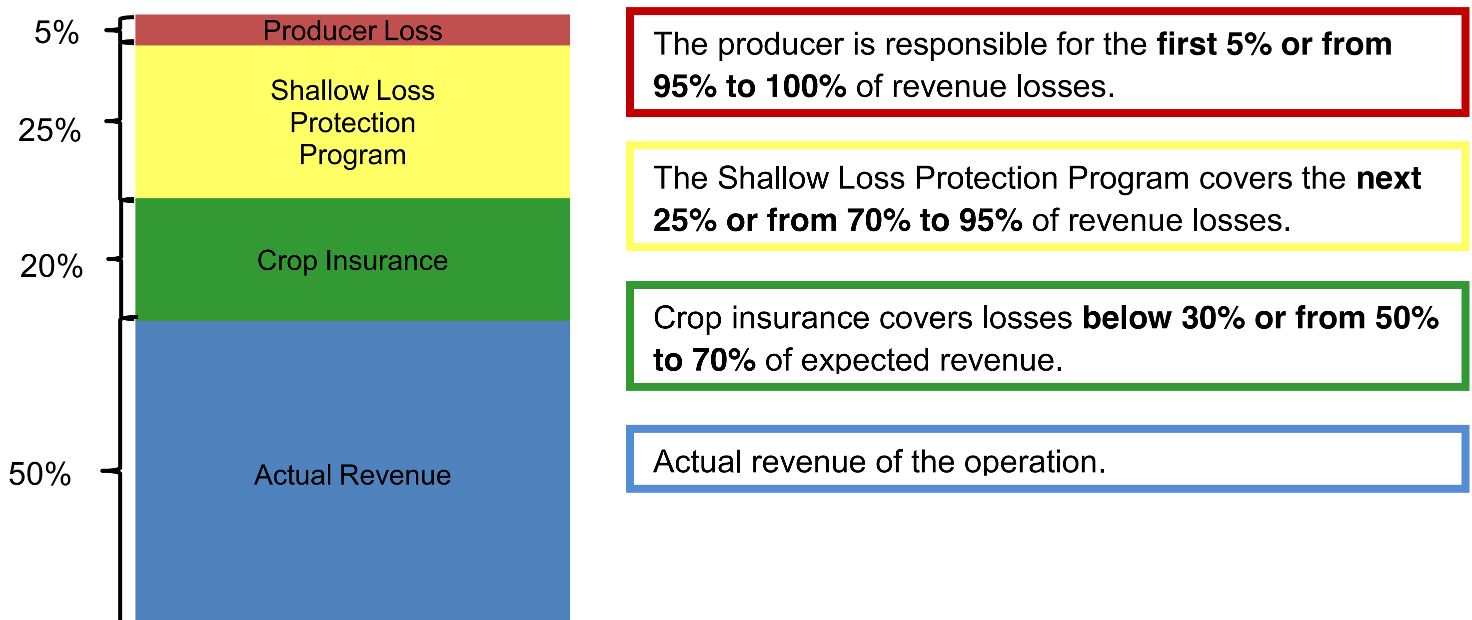
The Honorable
Committee on Agriculture, Nutrition and Forestry
United States Senate
Washington, DC 20510

The Honorable
Committee on Agriculture
United States House of Representatives
Washington, DC 20515

Dear Sen. / Rep. :

There is a great deal of discussion about replacing all or some combination of direct payments, target prices, the Supplemental Revenue Assistance Payments Program (SURE) and the Average Crop Revenue Election (ACRE) program with a "shallow loss" revenue program. Under such a program, the government would compensate producers for relatively small losses. Generally speaking, proposals range from a coverage level on the high side of either 90 or 95 percent. This means a producer would suffer the first small percentage of losses, but the federal government would begin to pay for losses when actual income falls by just 5 or 10 percent.

On the low end of the coverage level for a shallow loss program, proposals range from 70 to 80 percent, meaning some combination of all these ideas could provide farmers with revenue protection that looks similar to this chart.



A shallow loss program is a drastic departure from any previous farm policy design. Federal farm programs have traditionally existed to help farmers survive large, systemic losses. Shallow losses, however, can arise from a variety of systemic or individual sources and do not typically jeopardize the survival of a farm operation. If a shallow loss revenue protection program is not crafted very carefully, such a program runs the risk of introducing unintended distortions into agricultural markets.

Our biggest concern is that by reducing the risk of shallow losses, farmers may be encouraged to take on more risk than they would in response to market signals alone. This is basically analogous to the classic moral hazard problem of insurance. Insured individuals may engage in riskier behavior than they would if they weren't insured. If someone has a car insurance policy with only a $250 deductible, they may drive faster or in more extreme weather conditions than if they purchased a high-deductible policy.

In a shallow loss revenue program for agriculture, this risky behavior may manifest in several ways. If a producer knows the government will cover all but 5 or 10 percent of losses, he or she may be inclined to buy more acreage than they can effectively manage and therefore bid up the price of land. Alternatively, some may pay higher cash rents than they otherwise would be willing to pay. They may borrow more money than they otherwise would be comfortable borrowing, and lenders may feel more secure in allowing farmers a higher degree of leverage.

These effects will not be limited to individual farmers. If anyone is willing to pay more in cash rent, everyone in the area may end up paying the same rate. The same applies to other agricultural inputs as well. Thus, farmers who are not inclined to bid the value of shallow loss coverage into their costs may be compelled to do so by market forces.

While some believe a shallow loss program will make it easier for a new farmer to enter into business because their risk would be limited, we unfortunately believe the opposite outcome is likely. The producers that are least able to compete in this environment will be those with the least equity in their operations – a group that will include most young and beginning farmers. In this manner, shallow loss coverage could become a further barrier to entry for young farmers and another factor driving further farm consolidation.

A true safety net program – one focused on mitigating the large, systemic risks that are endemic to agriculture to a much greater degree than in any other industry – avoids most of these problems. Farmers bear a reasonable degree of risk out of their own pocket, ensuring that their decisions will be driven primarily by market signals. Government programs offset part of the systemic risk, ensuring that agricultural production takes place at a level that provides additional benefits to the public at large.

If Congress indeed supports a shallow loss program, we encourage consideration of the following thoughts:

1. Coverage at the higher level should not exceed 85 percent. Anything higher than that level will encourage more risky decision-making. Land and rental values are likely to rise, new farmers will find it more difficult to begin farming, and a government program may further drive consolidation in the industry.

2. Coverage at the lower levels should not be provided below 76 percent. In 2011, more than $11.5 billion in gross crop insurance premiums were purchased. The following percentages of gross premium were purchased at these coverage levels:

Gross Premium (in billions)	Coverage Level	% Premium/Gross Premium
$618	50	5%
$81	55	1%
$510	60	4%
$1,124	65	10%
$2,702	70	23%
$3,146	75	27%
$1,922	80	17%
$1,008	85	9%
$463	90	4%
$11, 574		100%

In 2010, if shallow loss coverage was provided down to 76 percent, the new program would "overlap" current crop insurance purchases on 30 percent of the gross premiums. In essence, the government would be encouraging producers to quit buying crop insurance and instead take the free government shallow loss coverage.

In addition, this type of program also produces "winners and losers." For example, 74 percent of the gross premium in Illinois in 2011 was at the 80, 85 or 90 percent coverage level. Alternatively, less than 4 percent of the gross premium in Montana in 2011 was at the 80, 85 or 90 percent coverage level. If such a program were implemented, it appears Illinois producers currently paying for higher coverage levels would benefit far more in terms of "out of pocket" expenses than would producers in Montana.

3. Coverage should be crop-specific rather than based on "whole farm" revenue. In reality, the term "whole farm" is a misnomer as revenue from livestock is exempted. Still, the "whole farm" label is useful in distinguishing programs that aggregate revenue from multiple crops rather than those that base payments on the revenue performance of a single crop.

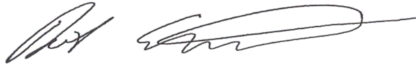
The whole farm idea may seem more "defensible" to the general public as payments would only be made when a producer suffered a loss on all of his or her eligible crops. However, the whole farm approach has the potential to create some perverse incentives. The primary problem is that it penalizes diversification. Diversification among multiple crops is one of the most basic risk management practices that a farmer can undertake. When returns to one crop are down, returns to an alternative crop may be up – or at least not down as much. A diversified farm will generally have a more stable income stream than a non-diversified farm. This means, with respect to whole farm support programs, a non-diversified farm is likely to receive higher program payments than a diversified farm.

Aside from the issue of diversification, whole farm programs will tend to pay out more in areas that are more risky for production. Thus, a whole farm program provides an incentive for more intensive production in more risky areas. This is not the incentive we seek to create in a farm safety net.

In addition, it is important to remember that farmers who are diversified are largely required to purchase and maintain various pieces of equipment to be able to grow and harvest specific crops. A typical Michigan producer very well might need different equipment for each of his crops – wheat, corn and sugar beets. If just one of those crops suffers a major loss, rolling that loss into a whole farm loss does nothing to help offset that equipment cost. On the other hand, some producers only produce one crop and therefore do not face the variable cost issues.

We look forward to continuing to work with you on proposals for the upcoming farm bill.

Sincerely,



Bob Stallman
President