

Business Risk Management Under Siege: Alternatives for Canada

Independent Agri-Food Policy Note
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The Issue

Business Risk Management (BRM) in Canada has been a source of controversy for some years. The primary focus has been the AgriStability, and to a lesser degree the AgriRecovery framework. With regard to AgriStability, industry concerns relate to the costs and complexity of enrolling in the program, and changes in the design of the program not present in its earlier conceptions nor in its predecessor the CAIS program—the reference margin limiting provision, and the changes in levels of the payment trigger and coverage of losses.

Consistent with this, the industry has engaged governments to press for changes to AgriStability. These have largely focused on changes in the parameters of AgriStability itself, and mostly with the federal government. In other cases, the industry has pressed provincial governments on BRM, resulting in maintenance or renewal of provincial BRM programs, notably ASRA in Quebec and RMP in Ontario.

The concerns regarding AgriStability have brought together the commodity segments of the industry—field crops, livestock, and horticulture—into a mostly common front to press governments for change.

Meanwhile, important changes to the context for BRM programming have occurred. The US has introduced repeated tranches of *ad hoc* support—initially under the Market Facilitation Program (MFP) in 2018 and 2019, the Coronavirus Food Assistance Program (CFAP), and most recently CFAP 2. These extend significant support beyond what is already provided in US Farm Bill programs, both in terms of breadth and depth.

The distortionary market effects of this additional US support will logically undermine the basis and effectiveness of AgriStability, quite apart from the current dialogue on payment triggers and coverage levels. The likelihood that these *ad hoc* US support programs will continue, at levels that likely exceed US limits on most distorting support, only deepens the concern. This stands to be exacerbated by the prospect of increased support payments by others (such as the EU). The ability of Canada and others to enforce disciplines on domestic support through the WTO has been dismantled.

This policy note documents this evolving situation, and proposes alternatives that Canada can pursue in a necessary redevelopment of its BRM policy.

US *ad hoc* Programming

Payments outside of programs established under the 2018 *Farm Bill* have occurred first under MFP in 2018 and 2019, and now CFAP and CFAP 2 in 2020. The trend has been to both broaden and deepen the extent of funding under these programs. Table 1 below provides an illustration and overview. Since the introduction of MFP in 2018, with the exception of 2019, overall payments and budgets have increased over time, ballooning to over \$US13 billion allocated for CFAP 2. The caps on payments have also increased, from an initial \$US125,000 per entity for each of crops and livestock, to \$US750,000 for entities that are partnerships or corporations with greater than 3 shareholders.¹ The first of the MFP programs covered the crop commodities also addressed in Farm Bill programs, plus milk, hogs and limited specialty crops;² MFP 2019 expanded the coverage of both non-

¹ More detail on CFAP and CFAP 2 is available at <https://www.farmers.gov/cfap>

² MFP 2018 made payments for cotton, corn, dairy, hogs, sorghum, soybeans, and wheat with fresh sweet cherries and shelled almonds as “specialty crops”

specialty and specialty crops. CFAP expanded the coverage of livestock to include cattle and small ruminants, and greatly expanded the coverage of horticultural crops under specialty crops. CFAP 2 has further expanded the coverage of livestock to include broilers and specialty livestock that includes turkeys and extends well beyond small ruminants, and further expands the coverage of horticulture under specialty crops.

Table 1 Overview of US Ad Hoc Payment Programs

| | MFP 2018 ^a | MFP 2019 ^a | CFAP ^b | CFAP 2 ^c |
|--------------------------------------|--|--|--|--|
| Overall Budget/Spending \$US Billion | 8.60 | 14.40 | 10.10 | 13.21 |
| Maximum Payment Cap | \$125,000 crops; \$125,000 livestock | \$250,000 crops; \$250,000 livestock | Up to \$750,000 | Up to \$750,000 |
| Livestock Commodities | 2 | 2 | 5 | 6 + specialty livestock |
| Specialty Crops | 2 | 10 | > 100 | > 230 |
| Eligible Gross Income | No limit if >75% income comes from farming; otherwise <\$900,000 | No limit if >75% income comes from farming; otherwise <\$900,000 | No limit if >75% income comes from farming; otherwise <\$900,000 | No limit if >75% income comes from farming; otherwise <\$900,000 |

^a Source: US General Accounting Office

^b Source: USDA-FSA funds allocated as of Sep 20/20

^c Source: USDA-FSA Coronavirus Food Assistance Program 2 Cost-Benefit Analysis

The limits on eligibility based on gross income do not appear limiting to participation. However, another aspect of participation is the enrolment of commodities in which producers were shielded from price volatility addressed by programs, such as

through a forward contract. As Janzen *et al.* note,³ this has created gaps between the expected allocation of CFAP funds across commodities and actual allocation- they note the discrepancy between corn and soybeans; a similar discrepancy appears to exist between expected and actual payments for hogs.

What the above most strikingly illustrates is that the payments made under MFP and CFAP programs are material and broad-based across commodities, and outside the realm of the Farm Bill and its framework for farm subsidies.

Risk of US *ad hoc* Programming Continuing

The view could be taken that the MFP payments blunted the pain of the US-China trade war on American agriculture in 2018-19, that the CFAP payments address in part the strains of the Covid-19 pandemic, and are in part election year politics, and that when each of these events pass the US *ad hoc* payments will come to an end. While possible, this is a very narrow and risky interpretation. There are compelling reasons to think that these types of programs could be continued on into the future or even made permanent.

One motivating factor is the perceived inequity of payments from past programs across commodities and states, and the drive to correct for these inequities in improved design under new programming. For example, in a letter to US Secretary of Agriculture Sonny Perdue dated November 19, 2019, a number of Democratic senators complained that MFP payments were “picking winners and losers between regions and crops”, carrying the implied message that the programs needed to be fixed to restore perceived equity. These same concerns have recently been voiced by some Democratic senators in response to a US GAO report

³ Janzen, Joe, Jonathan Coppess, and Nick Paulson. 2020. “CFAP Payments to Date and Possible Future Ad Hoc Farm Payments.” *farmdoc daily* (10): 160, Department of

Agricultural and Consumer Economics, University of Illinois at Urbana-Champaign, September 3, 2020.

on MFP payments.⁴ It is thus reasonable to expect a demand for new programming and payments in the ongoing search for perceived “equity” across farm products and regions in the US.

Putting in place farm subsidies can be much easier than removing them. With US agriculture now three years and tens of billions of dollars into *ad hoc* payments, the industry will have adjusted to them and must now be loathe to see them disappear. This makes canceling these programs politically difficult—regardless of the victor in the November presidential election. If former Vice-President Biden is elected, he will have needed to carry some Midwest states that benefitted from these programs; conversely, if President Trump is re-elected, much of his base has been located in rural areas and in the Midwest. In either case, cutting off these payments would be politically costly.

Moreover, there is no burning platform to motivate a change in direction on these payments. With the WTO appeals process sidelined indefinitely, the US can operate with little fear of successful trade challenge from other countries, regardless of whether the US has exceeded its WTO caps on most distorting support.⁵ Moreover, with the agri-food trade situation with China still brewing— even with the US-China Agreement in place— there may be a desire on behalf of the US to retain access to elements of support in the event of deterioration in trade relations.

Effects of Ongoing US Support

The effects of ongoing farm support are well known, and should be of grave concern to Canada. In a free market, lower prices cure low prices as they signal adjustment to reduce supply. However, farm

program payments blunt this effect and derail the need for adjustment. Subsidy payments can also be used by farmers to finance expansion and increase production, exacerbating the low prices, and emboldening the demand for additional support in future.

In the context of open and free trade with the US covering the vast majority of agri-food products, this prospect is ominous for Canada. Most farm products rely on arbitrage between the US and Canada in establishing prices. But when adjustment to price signals is overcome by subsidies in the US, it results in lower prices in both the US and Canada. Ongoing subsidy also underwrites existing capacity that should otherwise have retrenched based on market forces.

An illustration that is important for Canada is hogs and pork. US hog production has been increasing markedly in recent years. Figure 1 below provides some context. In 2014, the average US monthly commercial hog slaughter was 8.84 million head; the average monthly slaughter in 2019 was almost 10.8 million head, an increase of 21%.

Meanwhile, Canadian hog marketings have struggled to remain steady. Figure 2 below shows total annual Canadian hog marketings, 2015-19. The figure shows a marked difference versus the trend in the US. Canadian hog marketings increased from 2014 to 2015, but have since been essentially flat at around 27 million head/year, and have been below that level since 2017.

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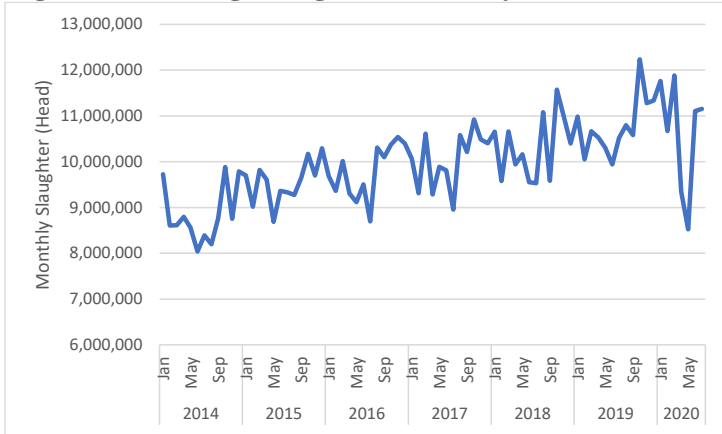
<https://www.agriculture.senate.gov/newsroom/dem/press/releases/independent-gao-report-confirms-trump-administration-payments-for-trade-damages-favored-certain-farmers>

⁵ Joe Glauber, Senior Research Fellow, International Food Policy Research Institute, observes that the US has likely exceeded its caps for most distorting support in 2019 and 2020 <https://www.csis.org/analysis/it-time-united-states-again-show-leadership-wto>

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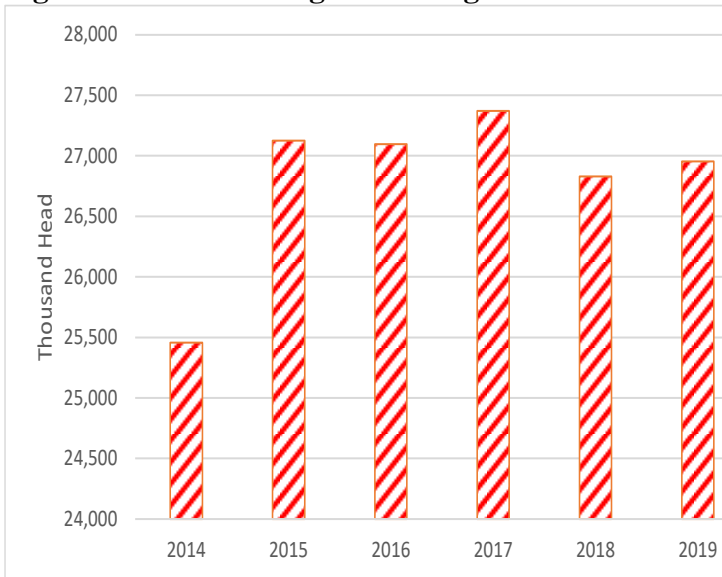
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Figure 1: US Hog Slaughter, Monthly



Source: USDA NASS

Figure 2 Canadian Hog Marketings



Source: Canadian Pork Council

Canada has not pursued the same expansionary pork production growth trajectory as the US, but has experienced the price effects of US expansion. This is illustrated in Figure 3, based on CME futures. Essentially, the chart shows that lean hog futures

Figure 3: CME Lean Hog Futures Prices, Continuous



Source: futures.tradingcharts.com

have failed to muster a major rally since 2014, with a brief exception of early spring 2019. Rather, even with structural increases in US pork demand associated with African Swine Fever in China, US hog prices have failed to increase, under the weight of increased US production. Canada shares a hog and pork pricing model with the US under free trade and geographic arbitrage, and dampened hog and pork prices in the US have dampened prices in Canada.

The growth in the US hog slaughter clearly pre-dates support under MFP and CFAP; however it also mostly pre-dates the demand pulse represented by export demand from China following its African Swine Fever outbreak. Rather, with these supports now in place for hogs, there is less incentive for the US swine herd to retrench and bring supply more in balance with demand, and perhaps an incentive for renewed expansion- meaning that broadly weak hog prices can be expected to continue, for both the US and Canada. ⁶

⁶ In late September 2020 the CME hog futures market has experienced a rally, apparently related to the African Swine

Fever notification in Germany and anticipated strength in US pork exports to China.

AgriStability Under Ongoing *Ad Hoc* US Support

Apart from the obvious difficulties that ongoing US support poses in terms of lowering prices and increased price volatility, there are design characteristics of AgriStability that make it vulnerable in the current environment. In particular, the reference margin, based on the Olympic average of past AgriStability production margins, will erode in the face of multi-year downturns. Put differently, the three years that are counted in the calculation assume a general reversion back toward mean production margins. This general design of an index reference for farm income dates back to CAIS and the Canadian Farm Income Program, consistent with Annex II of the WTO Agreement on Agriculture. A structural decrease in farm prices and earnings will generate reduced earnings, and over time these will erode reference production margins and eligibility for stabilization under AgriStability. In the face of sustained reductions in production margins, the eligibility for payments under AgriStability will wither. The Appendix at the end of this note provides an illustration.

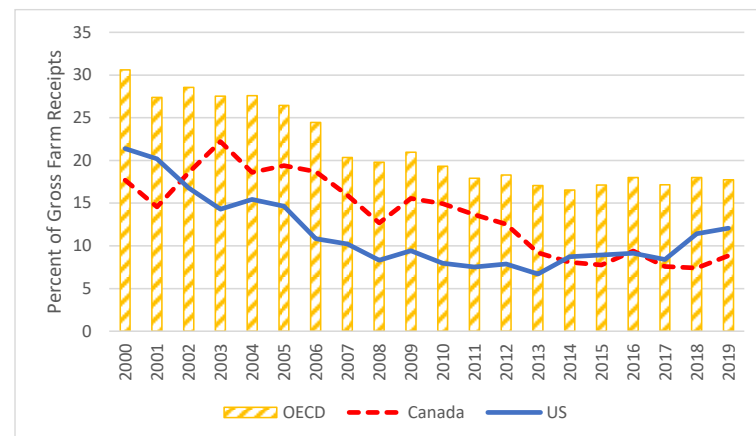
This design of AgriStability and its predecessors occurred in an environment without significant or repeated US *ad hoc* support, and with broadly declining agricultural support more generally- especially most distorting support- and very pronounced reduction in support for Canada and the US. This situation has now abruptly changed.

Figure 4 provides some context, using OECD Producer Support Estimates for the US, Canada, and OECD countries, updated to 2019. The figure shows a broadly decreasing trend of support, with the US and Canada at very similar levels for most of the last decade with producer support at around 8-9 percent of farm cash receipts. However, the data for 2018 and 2019 present a reversal for the US, with 2019 levels increasing to about 12 percent of farm cash receipts.

Canada’s PSE for 2019 is similar to recent years at just under 9 percent.

These increases in US support- consistent with MFP and CFAP payments and validated in the OECD data- put in place precisely the situation that stands to erode AgriStability reference margins. AgriStability and its predecessors were not developed in an environment like this, and are ill-equipped to address it.

Figure 4 OECD Producer Support Estimates- US, Canada, and OECD Average



Source: OECD

<https://data.oecd.org/agrpolicy/agricultural-support.htm>

Alternatives for BRM in Canada

An important risk that Canada faces in the dialogue on BRM in agriculture, and on AgriStability in particular, is that proposed reforms undershoot the mark. The elements are lining up to present much greater risks to farm incomes than have existed in the past- the past that framed the design characteristics of current BRM programming. The risks are such that they should be viewed as both the risks to farmers of much lower or insufficient incomes in farming, and the risks that existing capacity cannot be maintained in agri-food going forward into the future. Thus there are

both short-term and longer-term perils that must be addressed.

In this situation, doing nothing is not a realistic option as Canadian agri-food risks being overwhelmed. It is also a complex and difficult situation. Canada lacks the treasury to match US subsidies. *Ad hoc* farm payments in Canada are eligible revenue for the AgriStability margin in the program year, but not included in the reference margin; they are also subject to offset against subsequent AgriStability payments, and clawed back if they exceed the eligible payment under AgriStability. Canada continues its effort to revitalize WTO and as such has an interest in remaining within its agreed upon limits on most distorting support.

The industry in Canada has requested the reinstatement of the 85 percent trigger on losses for AgriStability.⁷ It has also been suggested that the reference margin limiting provision be dropped. The former could help with immediate cash flow concerns and the latter would offer larger payments to some parts of the industry. Both of these measures have at best a two-year window to respond to the current trade and US subsidy effects.

In a more normal period, Canada, possibly joined by other countries, could mount a countervail action against some commodities in the US, e.g., hogs/pork. However, without a functional WTO Appellate Body, the US could simply appeal any decision and send the result of the initial determination into the ether. Furthermore, under the current US administration, any criticism of US policy and practice such as a countervail action could provoke retaliation by the US, under whatever rubric.

The reality is that any robust BRM program design depends on reasonably reliable policies and behaviour on behalf of Canada's trading partners and global competitors. That is not currently the case, and

by all appearances may not be for some period of time. In the interim, Canada must plan for adversity. This changes the BRM problem from one of elegant design to protect farm incomes and cash flow- within its interest in honouring commitments on domestic support disciplines- to the periodic need for cash injections to protect the economic viability of Canada's agri-food sector, and the investments made in its capacity.

This shift, driven by adversity, could lead toward greatly increased use of contingent lending by governments or their intermediaries to provide ready cash and cash flow for farms and commodity segments facing a much harsher operating environment, at low or no cost, and with highly enabling security and repayment terms. Advanced Payments, and the extensions made to the Advanced Payments Program to address trade injury previously, may provide something of a template or starting point for the strategic discussion that needs to take place.

Conclusion

This assessment of AgriStability and the broader BRM context suggests that Canada has about one year to work with provinces, farm and industry groups and many other parties across the country to strategically set out the future directions for BRM. It may not mean destroying the program structure that exists now, although modifications and additional program support are needed. Certainly, the outcome of the US elections in November may provide a clearer picture of US foreign and trade policy.

This effort needs to involve not just agriculture, but also Canada's foreign policy priorities, fiscal policy, trade negotiations particularly regarding the replacement or modification of the WTO Appellate Body to make it effective, and the future role of agriculture in addressing climate change. This means that the current table of federal-provincial-territorial

⁷ <https://www.producer.com/2020/06/groups-urge-agristability-reform/>

(FPT) Ministers of Agriculture will need to be expanded to incorporate these wider considerations. This represents a fundamental shift in policy development for agricultural programs, with greater complexity, and more participants. FPT Ministers of Agriculture will need to provide very strong leadership in setting the boundaries for the debate and a commitment to draw in other government Ministers and non-agricultural groups to make progress.

Without this broad effort, agriculture may be relegated to *ad hoc* payment arrangements on a continuing basis with a high risk of WTO challenges or retaliation from other countries, breaking down the regional and commodity equity objective embedded in Canadian agricultural policy over the last 20 years.

Finally, there is no final or fixed “solution” that satisfies the potential environment over the next few years, but rather constant attention to evolving the actions by governments as the future unfolds. It is important to recognize that providing an early indication of actions by FPT governments is critical to prevent the negative adjustments to production capacity to current and forecast international market forces. The sector needs recognition that governments are working on it and are not waiting for answers until after damage is done.

Appendix: Understanding Collapsing AgriStability Reference Margins

The reference margin used in AgriStability employs an “Olympic average” of past annual production margins, with applicable adjustments, to establish the current year’s reference margin.⁸ An Olympic average takes the previous five years’ production margins, filters out the high and the low production margins from this period, and calculates a simple average of the remaining three years to establish the reference.

Because of this, the level and pattern in past annual production margins feeding into the Olympic average formula is quite important in establishing the level of the reference margin. In particular, a sequential downturn in annual production margins can project into the future and reduce reference margins and available coverage for an extended period.

Consider two scenarios- under scenario A, a farm’s production margin varies randomly each year between \$100,000 and \$125,000. In scenario B, a farm has three years of steady production margins at \$125,000, followed by a steady downturn decreasing at a rate of \$5000/year. With an initial 5 years of annual production margins, reference margins can be computed as Olympic averages out to Year 10 and compared from Year 5 onward.

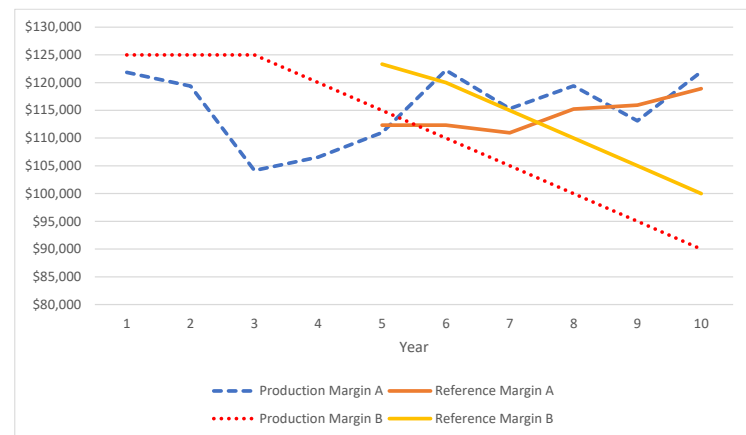
This is illustrated in Figure 1. Initially the reference margin for scenario B is higher as it contains two years with a production margin of \$125,000 (Year 5) and one year of \$125,000 production margin (Year 6). However, as progressively lower production margins come into the reference margin calculation, Reference Margin B declines, and by Year 8 falls below Reference Margin A. In contrast, Reference Margin A

which has no trend associated with it, oscillates between about \$112,000 and \$119,000.

These scenarios are simplified and stylized to illustrate the point that under consistent downward pressure on production margins, the reference margin will begin to collapse, compared with a scenario in which production margins vary randomly by year within a stable range.

The difficulty is that extended use of *ad hoc* subsidies by the US will drive Canada toward scenario B.

**Appendix Figure 1
Simplified AgriStability Reference Margins Under Alternative Scenarios**



⁸ There are many important nuances- such as the treatment of past program payments, inventory changes, and changes in a farm’s enterprise structure. This discussion deals only with the essence of AgriStability reference margins. The detail is

available in the AgriStability Handbook: <https://www.agr.gc.ca/eng/agricultural-programs-and-services/agristability/resources/growing-forward-1-program-handbook/?id=1294427843421>

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