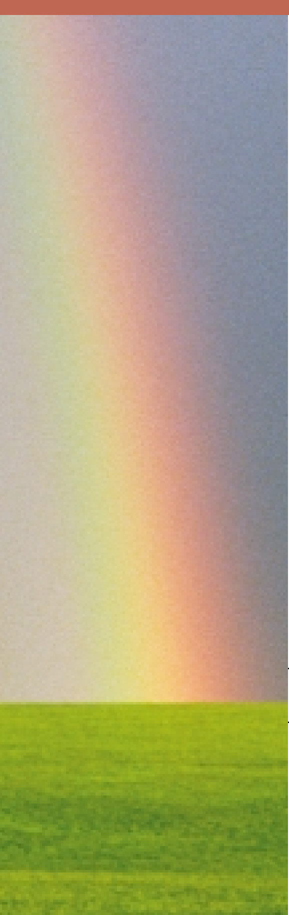
Putting Canada First

AN ARCHITECTURE FOR AGRICULTURAL POLICY IN THE 21ST CENTURY



GOVERNMENTS WORKING WITH INDUSTRY CAN CHANGE THE CURRENT RISK MANAGEMENT APPROACH TO SUPPORT THE OBJECTIVES OF GROWTH, DIVERSIFICATION AND INCREASED VALUE-ADDED ACTIVITY IN CANADIAN AGRICULTURE. IN PARTICULAR, PROGRAMS NEED A MORE BUSINESSLIKE APPROACH TO RISK MANAGEMENT—AN APPROACH THAT WOULD FOCUS ON ENHANCING INCOME FROM THE FARM THROUGH ACTIVE ENCOURAGEMENT OF RISK MITIGATION, ADAPTATION AND CONSIDERATION OF A FARM'S FUTURE POTENTIAL.

Business risk management

The Government of Canada and the provincial and territorial governments are working with the agriculture and agri-food industry and interested Canadians to develop an architecture for agricultural policy for the 21st century. The objective is for Canada to be the world leader in food safety, innovation and environmentally-responsible production.

To realize this vision, governments have agreed in principle on an action plan for an agricultural policy framework composed of five elements: food safety and food quality, environment, science and innovation, renewal, and business risk management. The framework, which is based on the setting of common goals for each element, entails important benefits for the sector and ultimately the general public.

Accordingly, governments have launched a national dialogue about the policy direction with stakeholders and interested Canadians to develop the proposed policy approach. This ***consultation*** *document is one of a series of publications dedicated to that end. To obtain additional information and contribute to this important dialogue, visit* www.agr.gc.ca/puttingcanadafirst *or call* 1 800 O-Canada (1 800 622-6232).

Canadian agriculture in the global context—Increased competition, lower commodity prices

Global agriculture has experienced a radical transformation in the latter half of the 20th century and the pace of change will quicken in the years to come. Technology and productivity improvements have led to a sustained, long-term decline in most commodity prices. In recent years, this price decline has been fuelled by liberalized trade, creating more intense competition, particularly from emerging low-cost producing countries. Lower demand for imports is also a factor, as traditional importing countries have used new developments in agriculture to move toward self-sufficiency. In addition, the United States and the European Union are heavily subsidizing the production of certain commodities—leading to further downward pressure on prices.

In this intensely competitive environment, the key to building a growing, successful agricultural sector for Canada lies in developing its capacity to produce innovative high-value food and non-food products that stand above the competition in the minds of consumers, whether for their unique attributes, their safety and quality, or the environmental responsibility with which they are produced. Risk management is a vital business tool to support this goal.

Canadian farmers have always faced a range of risks to their incomes, be they the forces of nature such as drought, hail and insects, or market-based forces such as price swings. And governments have long helped farmers deal with these risks through programs that have reduced the impact of farm income fluctuations. There is considerable debate, however, whether governments have designed their programs to effectively enhance growth in the current environment shaping the future of world agriculture.

The proposed Agricultural Policy Framework (APF) aims to put in place modern policies to help Canadian farmers face the issues of today and seize the opportunities they present. In this regard, in moving forward on new directions to secure the future success of the sector, Canadian Agriculture Ministers requested a review of current safety net programs.

"...Ministers agree to focus on making sure that all elements of safety net programming are working together, and that there is clarity about the purpose and performance of these programs in stabilizing farmers' incomes."

Federal–Provincial–Territorial Ministers of Agriculture Agreement in Principle on an Action Plan for an Agricultural Policy Framework, June 2001

Government programs must keep pace with market realities…

While the review showed that, in aggregate, safety net programs have been relatively successful in minimizing the impact of fluctuations in farm income, it is questionable today how adequately they promote the growth, innovation and adaptation necessary to succeed in an ultra-competitive global marketplace.

Canada's system of farm safety nets

- Crop Insurance—Participating producers will be protected for a yield per hectare based on the individual's production history. If production falls below that yield, the producer will be eligible for an indemnity. Generally, the maximum coverage available is 80 per cent based on the historic average yield in an area or the individual farmer's average yield, while up to 90-per-cent coverage is available for low risk crops or producers. Producers and governments share the cost of premiums, which are based on actuarial principles and vary by crop, region and individual loss experience.
- Net Income Stabilization Account (NISA)—To build up a reserve of liquid assets that can be drawn on in periods of financial difficulty, participating farmers can make after-tax deposits of up to three per cent of the first $250,000 in net sales (gross farm sales less purchases of agricultural

commodities). These deposits are then matched up to $7,500 on a one-for-one basis by governments. The producers' deposits also receive interest at a premium rate, paid by governments, on top of the market rate. Participants can withdraw funds to make up the difference whenever the gross margin from their farm business falls below the average of the past five years or if total family income from all sources falls below $35,000.

- Canadian Farm Income Program (CFIP)—Producers whose gross margin for a year falls below 70 per cent of the historical average receive payments to bring their margins up to that level. The historical average is the greater of the average of the previous three years or three of the previous five years where the highest and lowest margins have been dropped. The program is funded entirely by government; participants pay no part of program costs.
- Companion Programs—These programs are developed and implemented within each province and include a wide range of initiatives to meet specific provincial priorities. These are funded jointly by the individual provinces and the Government of Canada.

… lead to improved performance ...

As part of the safety net review, an analysis was conducted of approximately 2,500 similar-sized grain and oilseed farms located in the same region of the country. This analysis shows clear differences over a five-year period (1996-2000) between the high-performing and low-performing farms in the effects of safety net programs. A similar pattern is found in many parts of Canada and in many segments of the sector.

While all the farms had roughly the same sales—around $200,000 a year—the top 20 per cent consistently turned a profit without the assistance of safety nets, including in years where prices were depressed. The bottom 20 per cent consistently lost money—even in the years where prices were at their peak—and relied heavily on safety nets just to remain in business.

On average, safety net payments for the low performers were about three times higher than for the high performers—around $36,000 a year. Yet these payments had no appreciable impact on the performance of these enterprises over the five years. If these farms are to be viable over the longer term, they need access to tools that will support their adaptation and innovation, not just government payments.

The more profitable farms, in contrast, continued to build much larger NISA balances—at around $70,000 more than twice the average balance of the low performers.

... encourage active risk management and innovation ...

Governments designed the current safety net programs at different times over many years in response to varying pressures. This staggered development has led to a lack of cohesiveness and consistency between the programs and provides little incentive for producers to take decisions to more effectively manage their risks and enhance the income potential of their operations.

- Governments have created programming conditions that encourage selective use of programs in relation to what and how much is covered. For example, a farmer who believes that drought is a high risk one year can enroll in Crop Insurance that year and then withdraw the following year if the risk seems lower. Furthermore, most producers cover only a portion of their crops. While Crop Insurance can be an effective risk management tool, there are questions about industry perceptions of its usefulness.

- Governments have not established effective linkages among the various programs. For example, producers receive a payment under CFIP, whether they participated in Crop Insurance or have made use of their existing NISA balance. Thus, governments may be encouraging farmers to forgo Crop Insurance and to not withdraw money from NISA in times of need.
- NISA was established to help producers take a more active role in managing their risk, but the design of the program often works against this objective. For example, the three-per-cent interest premium on NISA balances—paid by governments to encourage savings to cover downturns—may now inadvertently be encouraging producers to leave funds in the account even in times of need. As a result, NISA balances—currently $3.5 billion—remain high even when bad weather or other factors lead to declines in farm income.
- Safety nets could better encourage producers to be innovative and make use of private risk management tools, where these are available such as hedging and forward contracting. For example, a producer can "lock in" a price with a processor through a forward contract for their commodity, which protects against market price declines but forfeits the potential gains from a price increase. At the same time, a producer who does not use existing private sector tools to mitigate market risk receives some protection from price declines by the existing safety net programs and benefits if prices rise.

... and provide comprehensive protection against disaster

Safety net programs are intended to provide farmers with the stability they need to get through short-term income fluctuations and maintain viable farming operations. However, there are a range of situations not covered by existing programs that can severely hurt a farming operation's sustainability.

- CFIP was designed to provide protection for producers when they suffer sudden and drastic declines in income, yet the existing national program does not extend to cover the risk of operating losses (i.e. negative margins). Even the most successful farms face the risk of a severe income loss in the event of a disaster, but CFIP only provides limited assistance in such circumstances to cushion the blow. Only certain provinces have supplementary coverage in place for negative margins.
- Current programs also provide no coverage for the risk of income loss due to business interruption. Natural factors can sometimes cause serious asset losses for farmers. For example, a producer may lose a cow herd or their fruit orchard to disease. Government programs or private insurance instruments exist which cover most forms of asset loss, but it takes time to replace the assets and begin earning income from those assets again. This is a coverage gap that can suddenly hurt otherwise viable farming businesses due to circumstances beyond their control.

We need a Canadian risk management approach for 21st century success

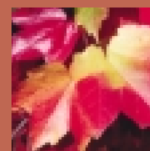
Governments working with industry can change the current approach to support the objectives of growth, diversification and increased value-added activity in Canadian agriculture. In particular, programs need a more businesslike approach to risk management—an approach that would focus on enhancing income from the farm through active encouragement of risk mitigation, adaptation and consideration of a farm's future potential.

Producers should be encouraged to take a more active role in managing the risks to their business. This includes not only assessing and mitigating all risks to income but also looking to capture new production and market opportunities. Producers who wish to diversify into new, potentially profitable crops would be able to do so with full confidence that they would have assistance in risk protection. When a producer chooses to use private risk management tools to help mitigate farm income risks, the new approach would recognize that initiative.

Governments, in concert with stakeholders, have much work to do to develop this new risk management approach. Key principles that could guide this development include:

- programming should encourage the adaptation and innovation that makes a stronger future for the farming operation;
- programming should encourage producers to proactively manage the risks facing their farming operations;
- programming should reflect the whole business, not just selected aspects of it, as all activities on the farm affect the overall level of risk;
- programming should provide comprehensive coverage to provide producers with tools to address their risks;
- predictable and stable programming would facilitate long-term planning by producers and governments;
- programming that is national in scope would reduce the threat of trade retaliation;
- programming should treat similar risks in a similar fashion across Canada; and
- programming should be financially sustainable.

The proposed APF aims to provide tools to the Canadian agriculture and agri-food sector to address the challenges of the future. This includes taking action in the areas of food safety and quality, environment, renewal, and science and innovation. A new risk management approach that encourages producers to adapt and act in these areas would be an important driver of the APF and contribute to the future success and prosperity of the Canadian agriculture and agri-food sector.



To learn more about this
federal–provincial–territorial initiative,
contact:
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Conclusion

Putting the Canadian agriculture and agri-food sector first requires a national vision and a national partnership. Governments and industry moving forward collectively to integrate all elements of the proposed APF would enable us to brand Canada as the world leader in:

- the production of safe food in an environmentally-responsible manner;
- meeting and exceeding diverse market specifications for quality; and
- innovation throughout the agri-food value chain so that investors and customers can be confident in Canada's ability to succeed today and into the future.

Branding Canada as the world leader in these areas will contribute to the continued growth and increased prosperity of the Canadian agriculture and agri-food sector by capturing new markets and customers.

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