GEORGE MORRIS CENTRE

The Political Economy of Risk Management Programming in Canada: Strategic Commentary on BRM and RMP Policy and Programs

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Introduction

In the first of this series of short papers on income support/risk management policies and programs, the George Morris Centre examined the historical income support payments across Canada from1981 to 2011. The second paper reviewed the most recent provincial risk management initiative in Ontario, the Risk Management Program (RMP) and its payouts for 2011. These papers identified the policy and program evolution over time; the shifting consensus over time of what governments and producers can afford and what risks to be covered; and the acceptance by governments and producers of varying initiatives to address these risk management issues. Moving forward, there are a number of issues in policy/program development, implementation, and determination of the eventual impacts at the individual and sectoral levels for future risk management policy and programming in Canada, and Ontario.

In this third paper of the series, the focus shifts to a more strategic or a political economy commentary on the likely options for 2013 and beyond risk management programming for Canada and Ontario. The lack of current and historical data on the actual financial or economic impacts on the participants and on their commodity industry from these programs is a serious gap in any analysis of Canadian risk management policy. This political economy commentary focuses on the economic and programming issues of any new income support/risk management programming within the context of the decisions-by governments and producers.

A Framework for Risk Management

It is clear that in the half century since the establishment of the Agriculture Stabilization Act (ASA in 1958) and the Crop Insurance Act (1959) by the Government of Canada- which provided limited federal government participation for these two program areas of risk management assistance- Canadian governments are fully committed to this policy direction. The current challenges facing governments and individual producer participants are: to achieve what desired levels of risk management at what costs to the public and to program participants; and, to better determine the effectiveness of such initiatives for both governments and individual participants as well as the broader agri-food sector.

The analysis of risk management policy in agriculture has tended to focus solely on government expenditures and program design, and not on the underlying business rationale for such initiatives. In their recent article on risk management in the Harvard Business Review (June 2012), authors, Robert Kaplan and Anette Mikes present a framework for analyzing and addressing the three basic risk categories facing any business. These three categories are: Category I-Preventable risks, primarily internal risks within any business organization, that are controllable; Category II- Strategy risks, those risks a business accepts in order to achieve superior results from a selected business strategy; and Category III- External risks, risks which are outside the business and far beyond its control (natural, political disasters are such examples).[1]

Since the late 1950's, Canadian governments and producers have grown into more formal and jointly funded programming to address primarily the Category II and III risks identified above. The Canadian farm community has argued-successfully- that the unique price, income, margin and weather risks they face as businesses in Canada require some level of joint funding with the public sector. In short, farmers are inundated by Category III risks that they simply cannot mitigate, and require public assistance. As such, risk management programs have attempted to deal with those risks beyond the capacity of an individual producer-adverse weather on a regional basis, severe commodity price volatility beyond an individual producer's control, and income/margin changes from severe market disruptions or cost increases far beyond an individual farm operation's capacity to handle. Many of Canada's primary agricultural prices and costs are set at national, North American or even a global level, and public-private sector involvement in such Category II risks may be appropriate.

Canadian agri-food sector policy includes a much wider set of legislative risk management initiatives designed to assure food safety (consumers), health of animals, plant protection, and environmental management. Canadian farmers have supported very strict measures to avoid wholesale market disruptions from major diseases (e.g. legislation on quarantine of animals is a good example); these circumscribe individual producers' independence so as to assure wider livestock or plant health security. These and other federal or provincial legislative initiatives provide a unique level of risk management for farmers, processors, retailers, foodservice, agribusinesses and consumers within Canada-and for Canada's international consumers.

Within Growing Forward, and now within the planned Growing Forward II policy framework, the various BRM programs reflect components of Category II and III risks. The increased sophistication of the various programs over time increases the capacity of these initiatives to properly address the price/income or weather risks faced by participating producers at reasonable costs. However, not all programs can thoroughly meet the very different scale, diversity, and complexity of all Canadian farm operations.

The above framework and its three categories of risk also recognizes that risks identified can move between categories as technology, management at the business level, innovation in business processes, and development of new markets evolve. Public policy discussions on risk management programming can include concerns in program design and administration so as not to inadvertently allow any specific program to cover risks of an individual producer's production/market decisions (i.e. weak production management skills, poor marketing skills,

[1] "Managing Risks: A New Framework", by Robert A Kaplan, and Anette Mikes, Harvard Business Review, June 2012.

inadequate animal health management). For example, farmers have greater access and understanding of commodity futures and options tools to hedge risks related to price; this effectively shifts risks from Category III to Category II, while reducing overall risk. BRM or RMP programs have been designed with increased flexibility over time to anticipate increased use of these instruments.

This framework sets out the basic parameters for a political economy commentary on broad options for next generation of BRM or RMP programming under Growing Forward II and for provincial programs (such as revised RMP in Ontario). The following assumptions also apply. It is assumed for the purposes of this analysis that based upon past decades of risk management programming across Canada, the options do not include a complete withdrawal of public sector funded risk management programs. Also, it is assumed that the directions by the respective governments to re-examine BRM programming so as to reduce expenditures or dependence upon these programs do not include returning to the status quo. Finally, included in this framework is the objective of accountability for funds by producers and governments to ensure program administration is fair and efficient, ensure program enforcement is undertaken to minimize (eliminate any abuse), and that both governments and participating producers want the programs to be effective in managing risks. A further goal of ensuring that these risk management initiatives do truly benefit the sector over time, leading to improved risk management, innovation, competitiveness, sustainability is a future direction to be considered by the analysis.

Risk Management- Political Economy Commentary– Examining the BRM and RMP Options[2]

Conceptually, the range of risk management program options can be very broad. However, with the Growing Forward II negotiations well along, and the RMP revisions in Ontario already in discussion, it is unlikely that realistic options for new risk management programming will involve totally new concepts. There is a current level of “acceptance” of the existing programs, design, and administration by both governments and participating producers which limits the extent of practical changes. The following commentary proceeds with an analysis of a number of changes which are significant and can be effective, but would not be seen as major program overhauls.

It is also recognized that the success of the various risk management programs, particularly within a full democracy as exists in Canada, depends upon several subtle, or even less than subtle, political and economic contexts. The options for any new risk management initiative must adequately address the underlying rationales for such programming-the income risk faced by

[2]The political economy commentary will focus on producer responses to key issues within policy and program options and not just price/cost issues.

participating producers must be sufficiently reduced or managed at a reasonable cost to participants, and to governments. Within this rationale is a balancing act between program complexity, oversight, administration costs and enforcement costs for both governments and producers, while achieving an acceptable level of risk management, for the program to be acceptable in the longer term. Equally important, for Canadian farm participants, there has to be a perceived, and a real (after the fact), sense of equitable treatment among producers of the same commodity, producers of different commodities within the program, and between regions- particularly at the national level.

Proposed program options can be placed within several broad areas, and examined within those areas for benefits/costs. These include:

- Program changes which maintain basic program design but alter target prices or margins, or alter the scale (%) of loss/margin to be covered by the new initiative;
- Altering the definitions of key components of the program design which have the effect of reducing payouts (e.g. determining costs of production with a productivity factor included);
- Introduce or expand the capping of individual or commodity payments under the existing program;
- Introduce program redesigns to replace part of the existing initiatives with a selection of other program options designed to address different policies to reduce/manage income risk (such as allowing producers to invest in/participate in new market development, innovation, sustainability initiatives to reduce/diversify income risks);
- Introduce in part or whole, a range of cross compliance requirements to achieve other agri-food policy goals and reduce, as appropriate, those producer payments when cross compliance is not achieved; and,
- Include other BRM or RMP related programs (possibly even unrelated programs) for cost reductions so as to ease adjustments in producer preferred risk management programs

This description of the possible risk management options is decidedly cryptic. There can be many more variations of the above options. However, the following commentary examines several broader issues affecting the above program options, and highlights the most challenging to industry observers or potential policy makers. This commentary will focus on the broader issues including: producer responses, cost containment, caps, trade neutrality; governance; administration/enforcement, farm structure impacts, cross compliance, and achieving the overall public policy objective.

Producer Responses

New program options which maintain the basic program design as favoured by producer participants will likely be the most likely to retain producer participation. Those requiring major administration changes, or re-evaluations of the risks to be covered, will be facing greater challenges in obtaining or retaining producer participation. At the same time, any new proposal which has the result of dramatically reducing producer participation (net payments drop considerably, remaining risks to be covered are too large, or the costs of participation are too high) must also be carefully examined. The underlying objective of any effective risk management program is to have sufficient numbers of the desired pool of producers participating so as to achieve the desired levels of risk reduction/management. If this objective is not met, then the rationale for such programming is undermined, increasing the likelihood of pressure for government ad hoc financial response in light of a major income risk in the marketplace. This result is one which governments (finance departments in particular) usually seek to avoid.

Cost Containment

Many alternative program designs can be structured so as to spend up to a fixed level of public funds. The assurance of effective constraints on spending can be better established with more significant reductions in the caps, or by more tightly limiting target prices/margins/costs used. However, each of these options has the capacity to then more dramatically limit producer participation. Cross compliance concepts can also be used to limit expenditures but these become very dependent upon both administration and enforcement efforts to assure participants that all are being treated equitably to ensure that such cost reductions (and cross-compliance objectives) are actually achieved over time.

The option of finding other BRM or RMP alternatives (or even very different programs) as substitutes for the original proposed cost reduction can be attractive-particularly for those advocating continuance of the preferred program(s). However, the selection of the alternative program can bring new policy challenges as the advocates for the substitute program argue against any “cuts” to their favoured approach. For some risk management programming, there are differences in views on the effectiveness and accessibility of the various risk management programming between commodities (RMP vs. SDRM in Ontario, possibly Agri-Stability vs Agri-Invest across Canada). These differences can be widened by varying risk management models- margin-based approach in contrast to a more focused matching contribution approach. The selection of which risk management programs can vary the effectiveness of the cost containment, but also raise new issues of cross commodity/producer comparisons which may hinder cost containment.

Past experience with ASRA in Quebec and the implementation of RMP in Ontario indicates that a cost-of-production trigger program can work. This is true for the price or margin trigger programs in the past or present. However, all such triggers require the program operations to be easily verifiable, transparent with data sources as possible, and not inadvertently alter participant behaviour through changes in program modelling. Importantly, for a cost-of-production trigger in a risk management program, there is an inherent challenge that the costs identified and the associated trigger will through design/re-design become unlinked to changes in farm operation productivity, technology, management, thereby raising program costs. There is also the tendency for costs to be "sticky" and not easily changed in any downward trend unless very effective program discipline ensures costs truly market focused. Most of all, it is important that the design of the program itself does not influence the input prices used in the production cost trigger, thereby amplifying the frequency and magnitude of payouts. This can be difficult to control.

Program Caps

Program caps can be used in any option, or as a key element in themselves to restrict net payments by to eligible participant. By limiting net payments to individual producer participants and/or limiting the total funds paid to a commodity groups, both cost containment and limiting payments to larger farm operations can be addressed. A recent National Farmers Union proposal argued for much tighter caps on such risk management programs[3].

If the caps are effective, cost containment can occur. However, if the impacts are excessive in the view of the producer participants, program participation could drop as the program caps run increasingly counter to the realities of farm structure. Moreover, if the caps do limit individual payments considerably, there is a real opportunity for those farm operations with multiple enterprises and multiple partners/owners to legally participate as several individual participants and gain a larger total payout from the new risk management initiative-effectively countering the policy intent. The administrative and enforcement costs to address these types of legal applications could undermine the program's perceived effectiveness and cost containment.

Trade Neutrality

As noted in the second paper of this series, the issue of raising a trade dispute due to risk management programming-particularly with a COP-based model such as RMP in Ontario-is under discussion. It must be recalled that a number of Canadian farmers are well aware of the significant adverse impacts of fighting, and possibly losing, a trade action on a primary agriculture commodity. Efforts to limit the net payments to producer participants may, in turn, reduce the interests of competing US producer groups to consider trade actions. But all of these decisions are within the US legal and political systems for initiating and then implementing a trade remedy process in the United States. It is not a Canadian decision. Program options can be tailored to reduce the likelihood of such US trade actions, but to be most effective, such options would also undermine the program's effectiveness to Canadian farmers in these risk management

[3] National Farmers Union "National Farmers Union recommendations regarding Business Risk Management Programs under Growing Forward 2", August 2012

programs. Trade neutrality can never be totally assured, simply managed carefully and governments and participating producers must better understand the trade dispute risks involved.

Program Governance

As program parameters are altered, there will be a need to more thoroughly include representatives of the producer groups to assure fairness, equity, effectiveness of administration and enforcement. However, with those options involving more significant changes- such as new cross compliance requirements, or using very different risk management tools-it can be anticipated changing the governance structures are required to include producer representatives into decision making processes, for improved transparency, oversight, and independent review processes to assure all participants of equitable payments and enforcement. These changed governance roles can increase administration costs, and increase program complexity.
Impacts on Farm Structure

A common criticism of any risk management program is that larger farm operations will gain larger shares of total payments unless specifically constrained by program caps, or program details limiting payments per production unit. This is a sensitive public policy discussion. One of the deeper public policy rationales for any farm program is at some point to provide sufficient risk management/income support to a desired group/segment of “family farms”, without significantly increasing total programs costs.

Unfortunately, such a discussion is often at odds with the current market realities, especially in the case of margin-based BRM programs (like AgriStability). Larger commercial farm operations are responsible for greater shares of overall farm production; policy options which operate contrary to this reality cannot be sustained. Either the program administration is overwhelmed, or the program effectiveness is in doubt, as larger shares of farm production are not properly covered by the program. Again, a balance has to be achieved in program design to address both public policy perception and farm structure reality. This will apply to all options.

Cross Compliance

There is increased public interest and industry understanding of the different environmental, social and economic impacts from different types of farm activities, and from different farm program responses. There are calls for increased cross compliance for producer participants to link payments from one program area to efforts, initiatives or commitments to be proactive with, or refrain from, activities which may enhance, or be detrimental to another agri-food policy goal. These cross compliance concepts are in place to different extents in other jurisdictions, and designed to achieve a number of policy goals (e.g. providing environmental goods and services in the European Union and linking farm payment programs to such efforts).

It is plausible to use cross compliance measures to effectively limit/link risk management payments in achieving other policy goals. However, the experiences in successfully undertaking this are not numerous, and the costs of participation, oversight, and enforcement of the cross compliance measures (unless these are fairly simplistic-and therefore of limited public value) can be more substantial than the payments provided. (For example, if a cross compliance target is not fully met, does the risk management payment decline in proportion? If the costs of compliance are substantial, will the producers continue program participation?)

This may be an option for a pilot rather than a full blown program. The scale of applying an effective cross compliance commitment at the national level would be even more daunting than at a provincial level, but the conceptual issues are the same.

Broader Public Policy

The considerations posited above represent a range of possible options. A critical piece for any discussion on BRM or RMP programming must return to the basic rationale for the public sector, and the need to provide financial support for risk management options. All of the above options in some manner do attempt to manage farm income risk-but the costs/benefits and producer participation can all vary considerably. If the overriding goal of managing farm income risk is not achieved, or even perception is not achieved, then the option is in serious jeopardy.

Existing BRM programming may not be the best possible selection of risk management programming. These initiatives do have the advantage of being tested to some extent, and found somewhat acceptable by some of the intended clients and governments in addressing risk management. Even with new constraints on overall funding/operational changes, the existing programs can have an advantage of still being perceived as acceptable in addressing desired risks. Those options which may address income risks in different ways (innovation, market development, sustainability) or add more serious cross compliance criteria run the risk of not being perceived, or in practice not achieving, desired levels of risk management. If the partial failure of a producer to cross-comply with other programming/policy goals severely limits their perception of risk management payout, then the program option may not be deemed an appropriate vehicle for risk management, or can impose undesired administration/enforcement costs.

Conclusion

Canada's Growing Forward II negotiations are well advanced. In Ontario, the re-examination of its RMP initiative is also well underway. The apparent future of direction for the risk management programming at the national level, through the BRM initiatives, and the RMP in

Ontario, are likely to be moderate changes in the existing suite of risk management programming so as to achieve desired cost constraints, or obtain some preferred producer responses (improved competitiveness, greater reliance on own risk management efforts)

The options identified are examined through a commentary on the political economy impacts. It is clear that any option has a possibility of achieving a number of program cost and policy goals. There are no clear overall options that lack any downsides. All carry the substantial possibility of not succeeding in addressing the planned risk management goals; increasing administration/enforcement costs; or encouraging producer participation to vary considerably which would undermine program effectiveness. There are possible variations on the options identified to help address possible adverse impacts, but all will have administrative and enforcement costs, requiring additional public funds, or increased producer dissatisfaction.

As stated in earlier reports on income support/risk management programming, there is a need for improved (new) reporting of, and analysis of, the effectiveness of these initiatives on individual producers, and on the industry. In addition, increased transparency of the processes, the objectives and the results would also improve the longer term public acceptance of program evolutions and expenditures for this area of Canadian agri-food policy.

A key concern remains, how best to achieve the key rationale for public policy participation in this risk management policy direction (protection from/reduction in Category III risks) , without undermining the policy direction itself, and without unduly shifting the program's risk profile into Category I or II. Indeed, it is plausible that private sector options could be developed to address some of these risks, consistent with the changing farm structure across Canada, and the capacity of individual producers to manage such risks. This would benefit from a broader public dialogue regarding what risks we aspire to mitigate, to whom, without underwriting risky or reckless behaviour.

With considerably more time, consultation and analysis, a different, possibly far improved set of options could be developed, discussed, negotiated between governments and producer groups. The key parameters for improved BRM and RMP programming can be developed, which will lead to a more likely preferred option for producers and governments. It is also possible that given the very different risk management capacities of individual farm operators, and different farm financial structures, shifting away from a "one size fits all" risk management programming could be developed as plausible agri-food policy options. These issues will be the focus of the fourth and last in the income support/risk management series of papers.