

# Farm Savings Accounts as a Tool For Dairy Farm Risk Management

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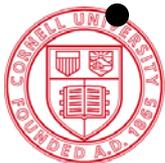
# Background on FSAs

- Originally proposed as an alternative to loan and other traditional crop programs prior to 2002 Farm Bill
  - Need to give this a fresh look when applying to dairy
- Idea is to encourage farmers to save when times are good
  - House Ag Cte and NMPF are focusing on net revenue programs
  - Assumes average net returns over a period of years is “good” (adequacy)
- Assist farmers in managing net revenue risk (stability)
- The amount and type of encouragement includes
  - Tax deferral
  - Government matching
  - Both
- Various implementation schemes
  - This can made harder than it needs to be
  - Keep it simple, keep it personal



# Basic Questions on FSAs

- What Problem(s) are FSAs intended to fix?
  - Do farmers lack sufficient risk management tools or are existing tools not as effective as FSAs
  - Is farm savings constrained? Do farmers systematically under-save?
  - Are FSAs “better” than DP, CCP, LDP, MILC, etc.
  - Less government cost?
  - Less user cost or easier to use?
  - More adaptable to individual needs
- Should/can we ask/insist that farmers to save the assistance that the government provides them in good times?
  - These programs provide such incentives
- What current strategies do farmers use to manage between good and bad times?



# Why FSAs? What are the basic questions?

- How do farmers manage risk now
  - Hedging output prices and/or input prices?
  - Insurance on production? Revenue insurance?
  - Maintain cash reserves?
- Are Net Revenue “adequate” on average, over a period of years?
- Are there some kind of constraints on savings now?
- What advantages might FSAs have for government/taxpayers compared to current programs?
- What advantages might FSAs have for farmers compared to current programs?



# Examples of Proposed FSAs

1. Farm and Ranch Risk Management (FARRM) Accounts
  - Tax deferral incentives
2. Counter-Cyclical Accounts
  - Direct government support program
3. Individual Risk Management Accounts (IRMA)
  - Blends aspects of CC and FARRM
- Canadian Net Income Stabilization Account
  - 1990 to 2009, replaced in 2003 by the Canadian Agricultural Income Stabilization Program, which seeks to combine ongoing net income protection with disaster assistance
- ☛ Farm Income Stabilization Account Act of 2007, proposed by Sen. Richard Lugar



# General Outline of an FSA

- Eligibility: requires some rule for who qualifies as a farm business and under what income/net revenue conditions deposits can be made into the FSA
- Deposits: define a rule for the maximum deposit by a farmer, general a percentage of net revenue
- Incentive: may include a federal income tax deferral on deposits and/or a matching payment by the US government. Match may be an amount or a percentage, it may be fixed or variable. Variable incentive could be a higher percentage that declines or caps out with higher farm contributions or it could increase as need increases (e.g., Canadian disaster assistance concept)
- Withdrawal rules:
  - At discretion of farmer



# What has held back adoption of FSAs?

Traditional programs in crops have been satisfactory to farms (the devil you know) and FSAs seem less lucrative.

Some previous proposals were too complicated

- Withdrawal triggers, in particular, seem prone to becoming complicated (doesn't have to be the case)

Most farms currently find ways to avoid high tax rates

- Are current approaches “better”?



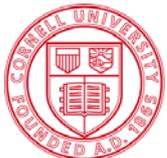
# We Know Relatively Little About

- The extent/magnitude of variation in annual farm income at the farm level
- The extent to which savings accounts might impact this situation
- Farmers' ability and willingness to fund the accounts



# So What Problem are We Addressing?

- Profitability (includes non-cash values, longer term)
  - The level of profits is occasionally low or
  - Chronically low
- Cash flow (strictly cash, shorter term)
  - Measures sources and uses of cash
  - Assigns money to and from operations, investments, financing and/or reserves
  - Shocks to operations may result in inability to pay the bills even on a farm that is profitable in the longer term



# Cash Flow Model

Sources of Cash

Uses of Cash



Cash Farm Receipts (Sales)

**Operating Activities**

Cash Expenses (ordinary)

Extraordinary Expenses

Personal withdrawals, family expenses, nonfarm debt payments

Sale of Assets

**Investing Activities**

Capital Purchases

Money borrowed (structured debt)

**Financing Activities**

Principal payments (structured debt)

Increase in Operating debt

Decrease in Operating debt

Cash from nonfarm capital

Nonfarm money borrowed

Beginning farm cash

**Cash (Liquid) Reserves**

Ending Farm Cash

# Do Farmers Need an Incentive to Save?

The government deposit match:

- Provides an income/wealth boost
- Encourages holding higher cash balances – something businesses don't necessarily like to do or lenders may not “allow”

Ability of FSA to address the “problem” depends on the magnitude of “under-saving” and farmer’s current alternatives

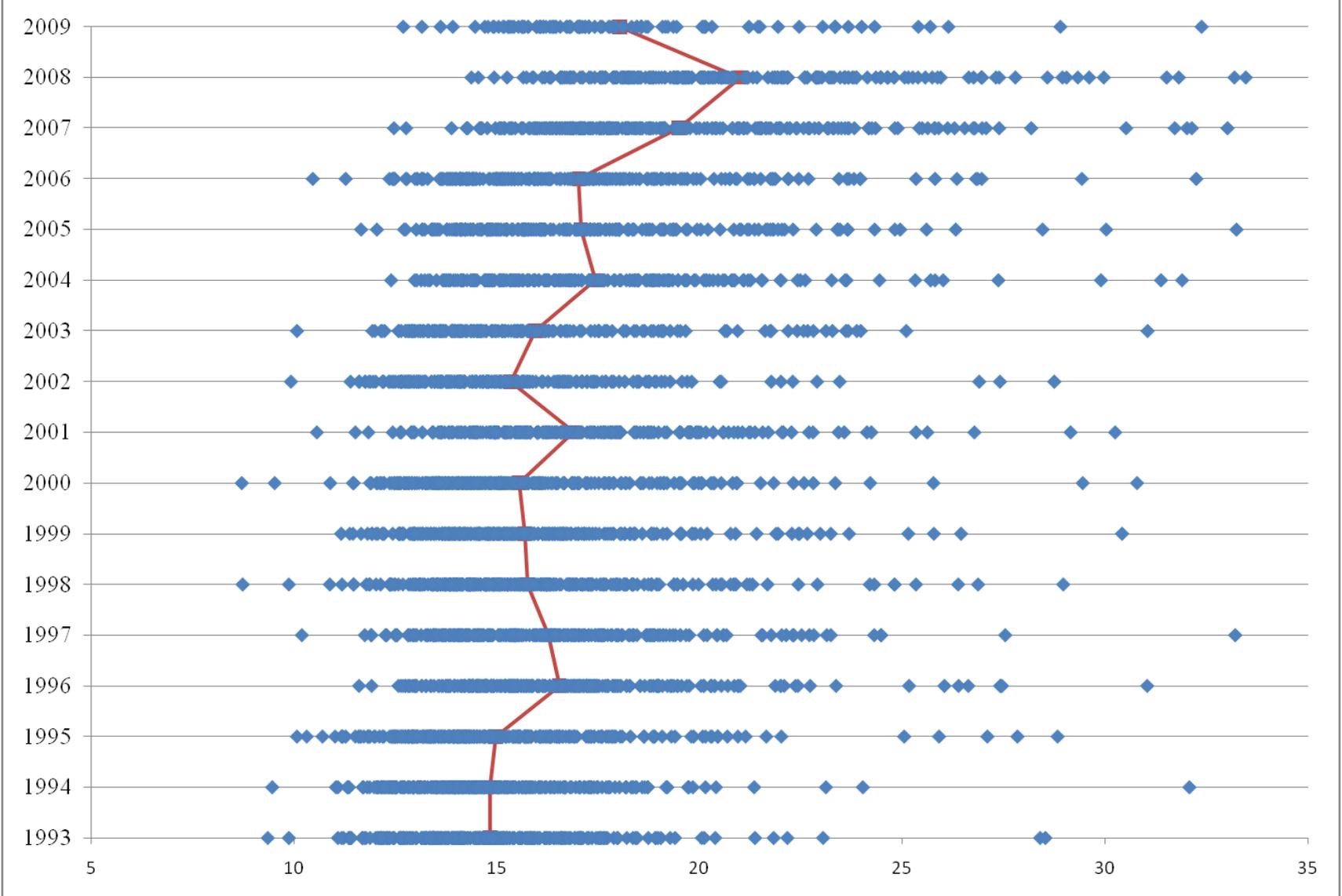


# Some Data

- Analyzed dairy farm business summary records 1993-2009
- Looked at costs, income, and cash flow
  - Across time
  - Across farms and time

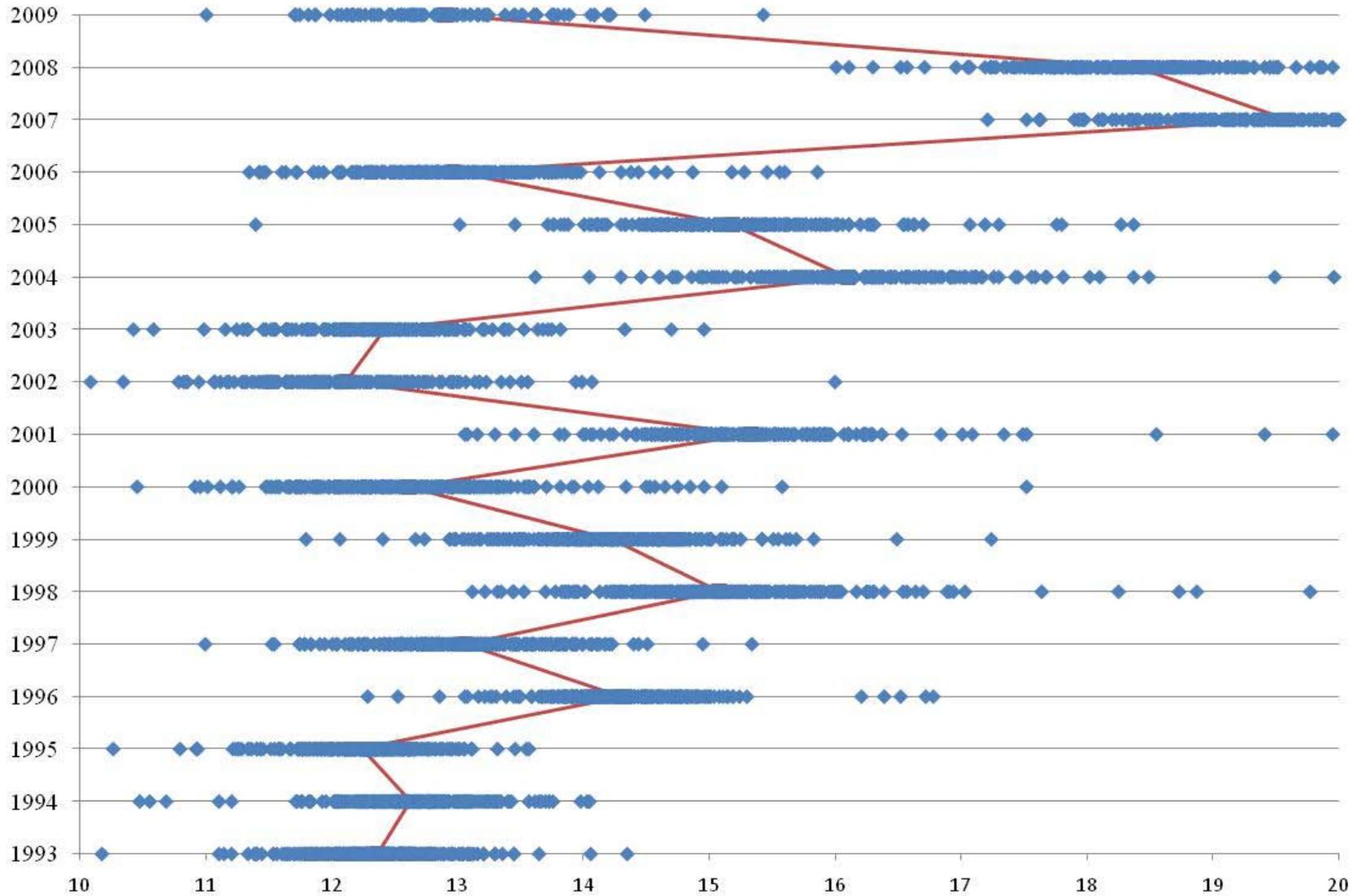


# Total Cost of Producing Milk, \$'s per CWT, NY Dairy Farms 1993-2009



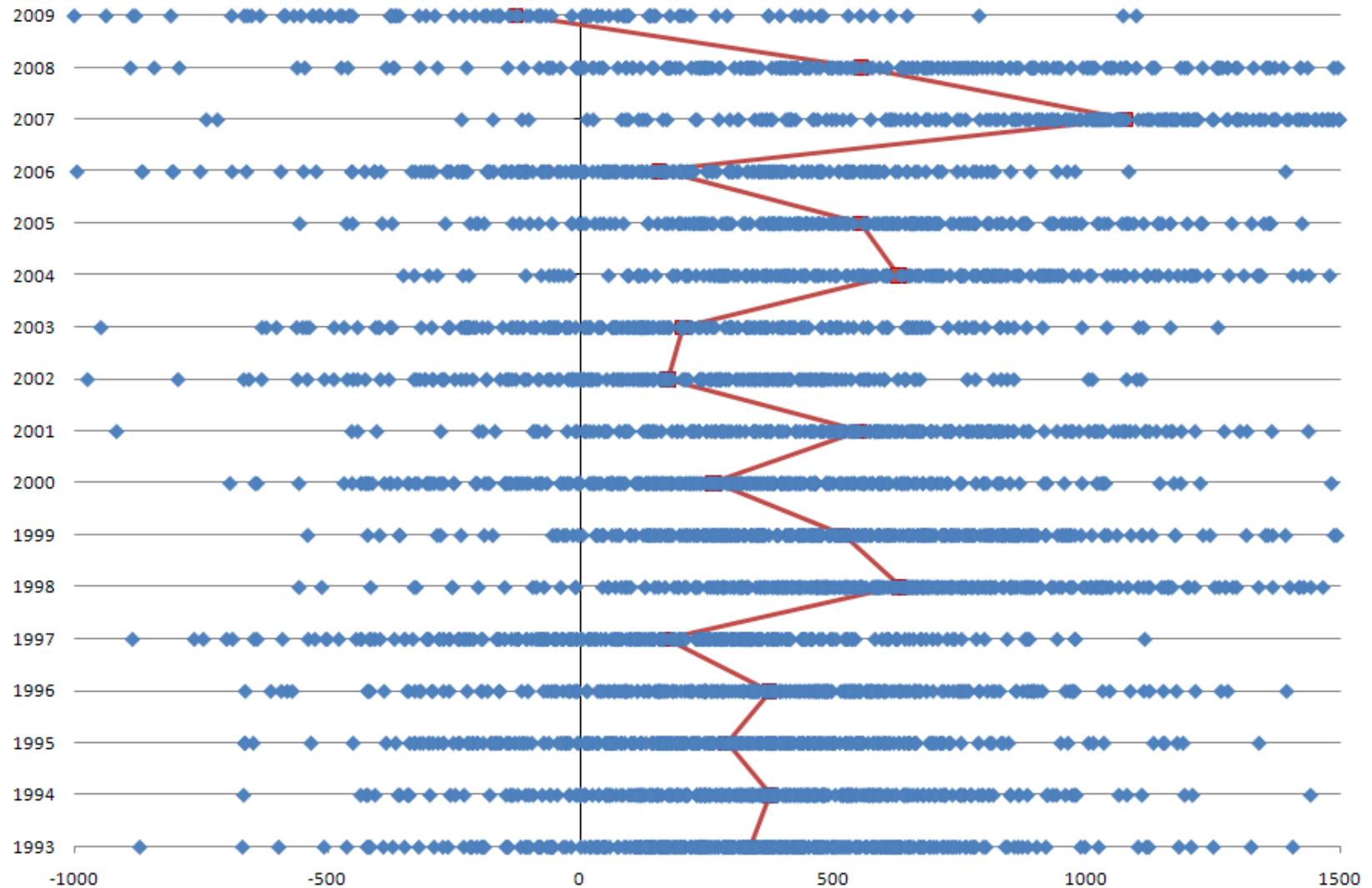
- There is a wide distribution in the cost of producing milk
- The average cost tends to be relatively stable from year to year

Milk Price Received, \$'s per CWT, NY Dairy Farms 1993-2009



- The distribution (across farms) of prices received is less variable than costs
- The average from year to year is highly variable

# Net Farm Income Per Cow, NY Dairy Farms 1993-2009

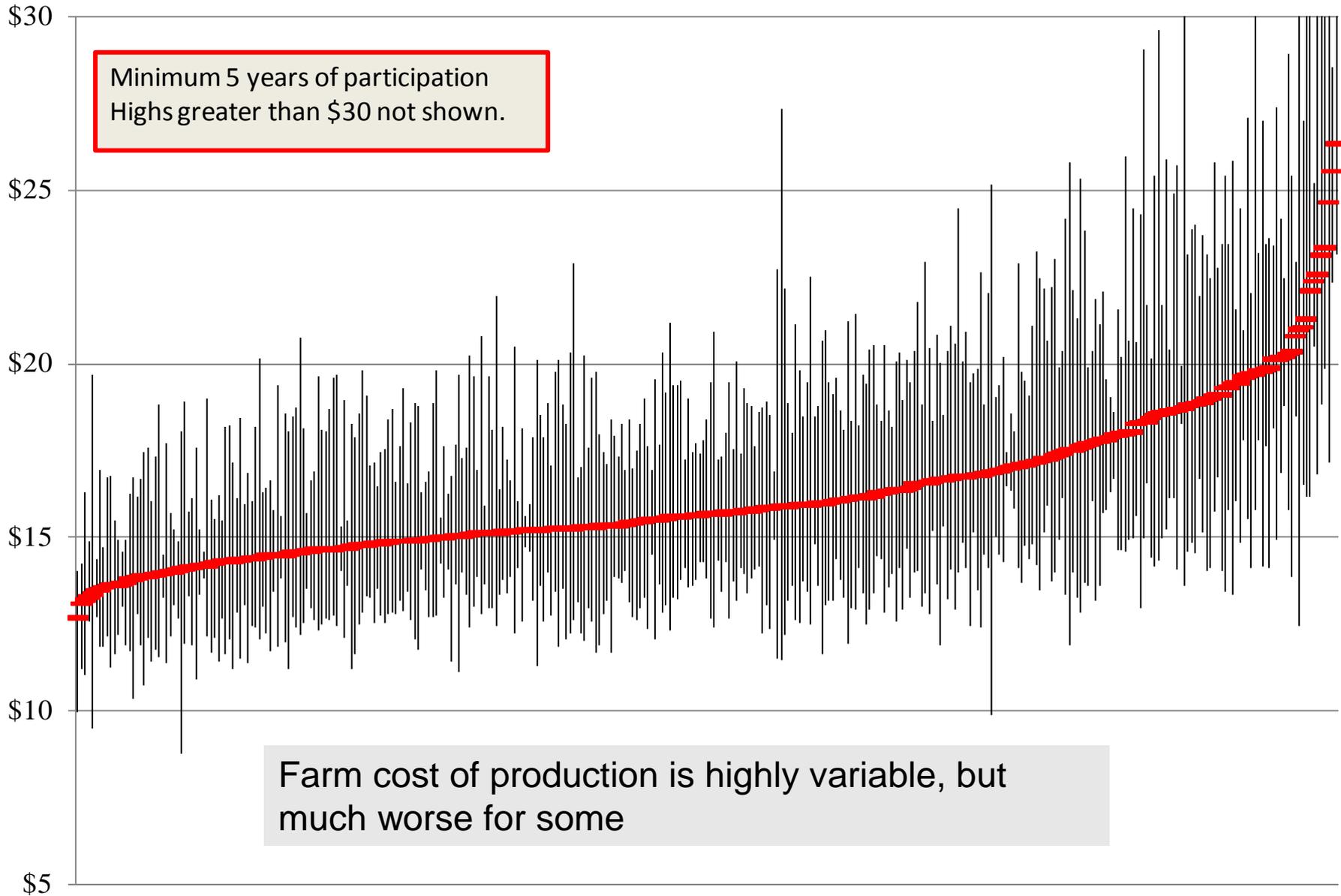


- Very wide differences in profitability, within and across years

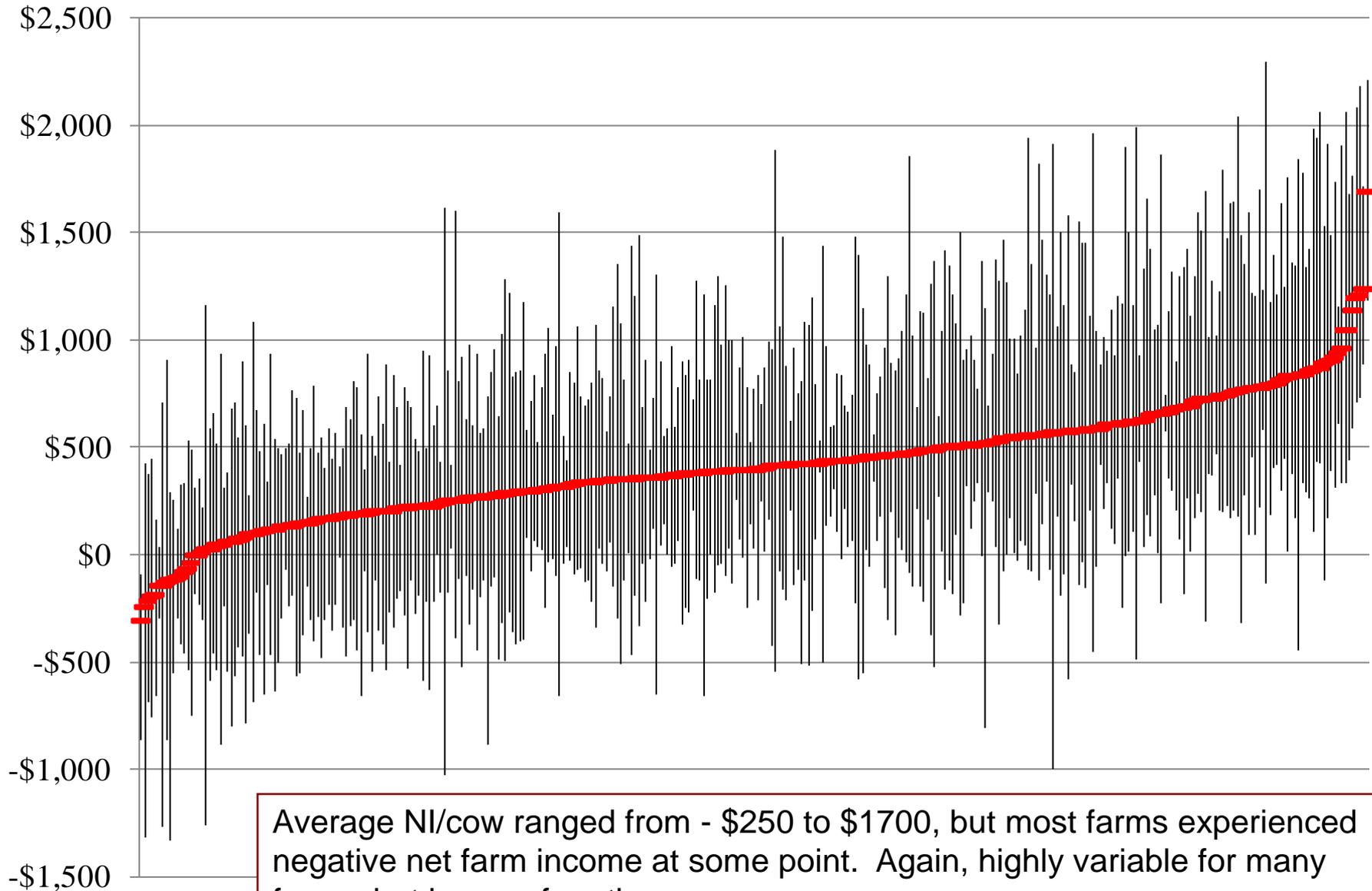
What does the variability look like for individual farms?



# Total Cost per CWT of Milk, 341 NY Dairy Farms

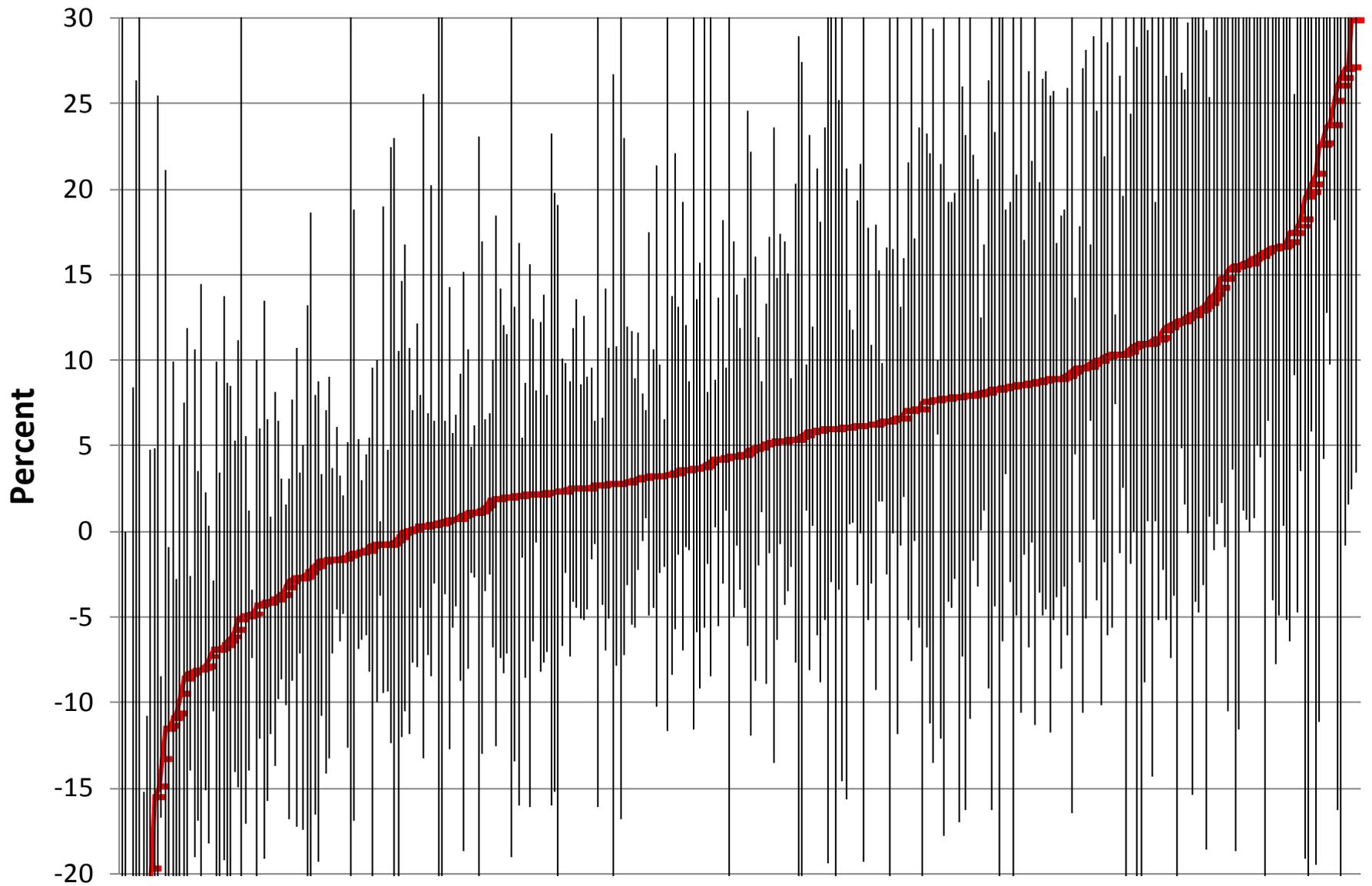


# Net Farm Income per Cow, 341 NY Dairy Farms



Average NI/cow ranged from - \$250 to \$1700, but most farms experienced negative net farm income at some point. Again, highly variable for many farms, but less so for others.

# Rate of Return on Equity, 341 NY Dairy Farms

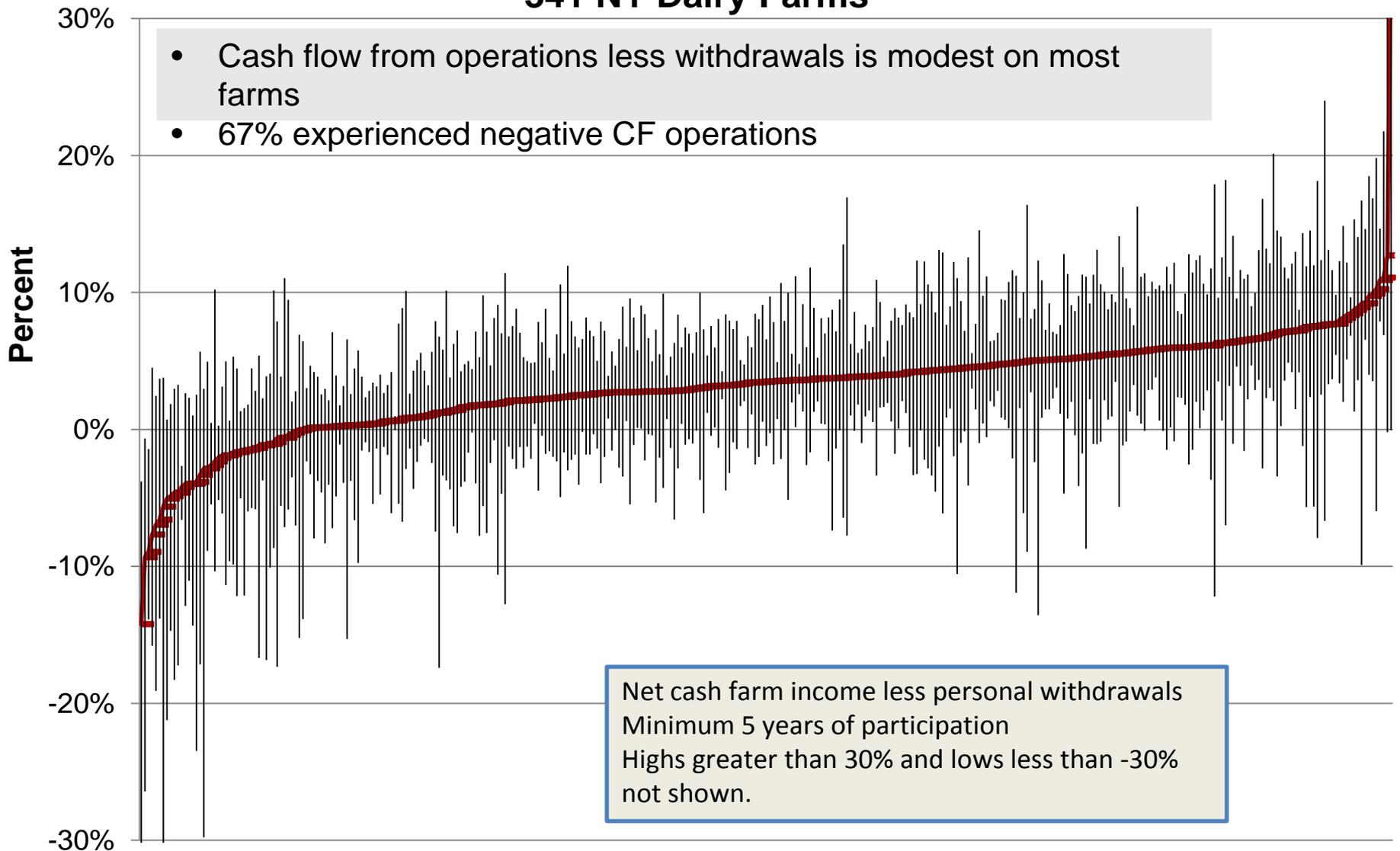


# What Does this Mean?

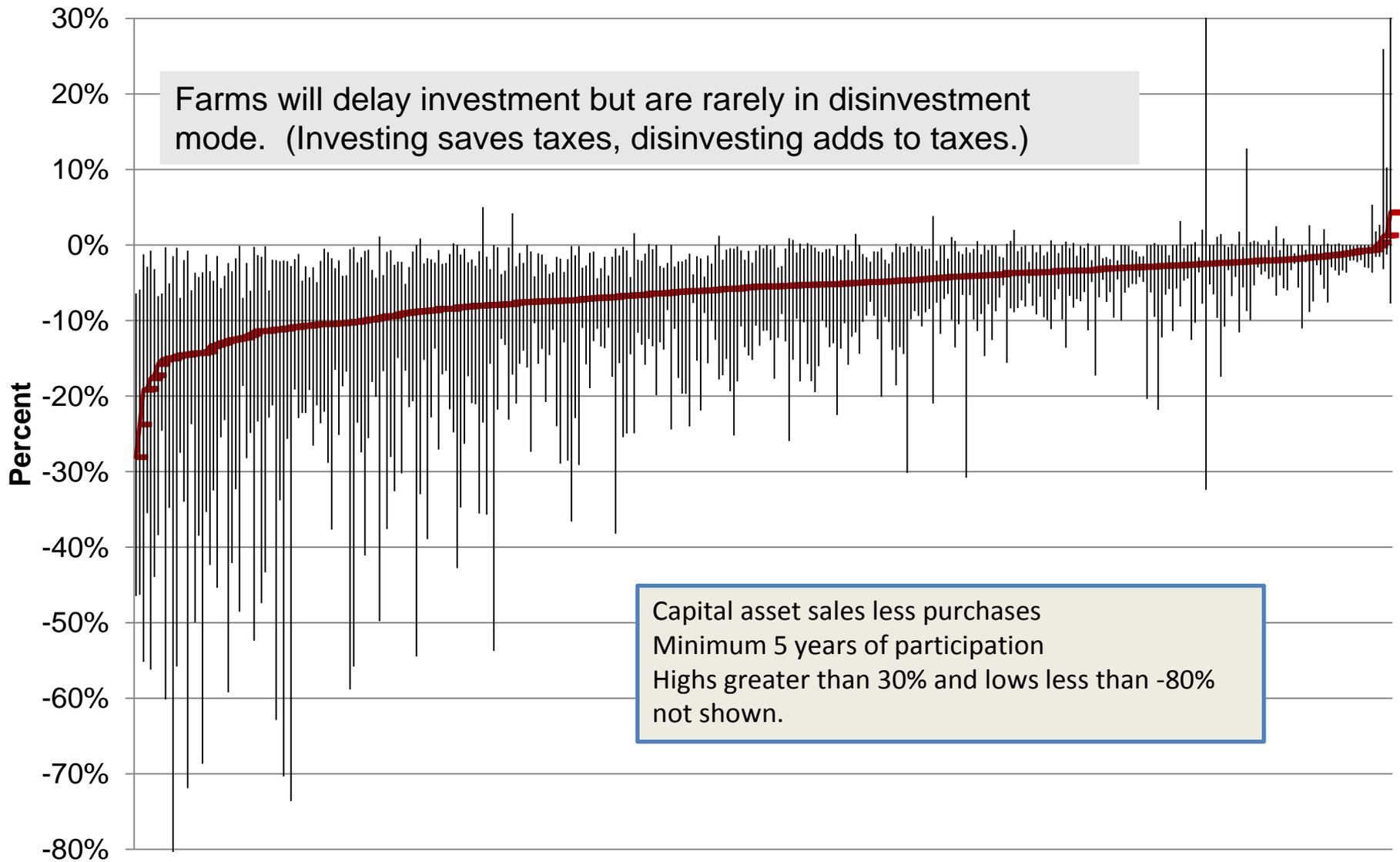
- There are wide differences across farms with respect to incomes and costs
- Differences in averages
- Differences in variability, some low, some very high
- Most farms experience periods of negative net returns
- *How are they managing this?*



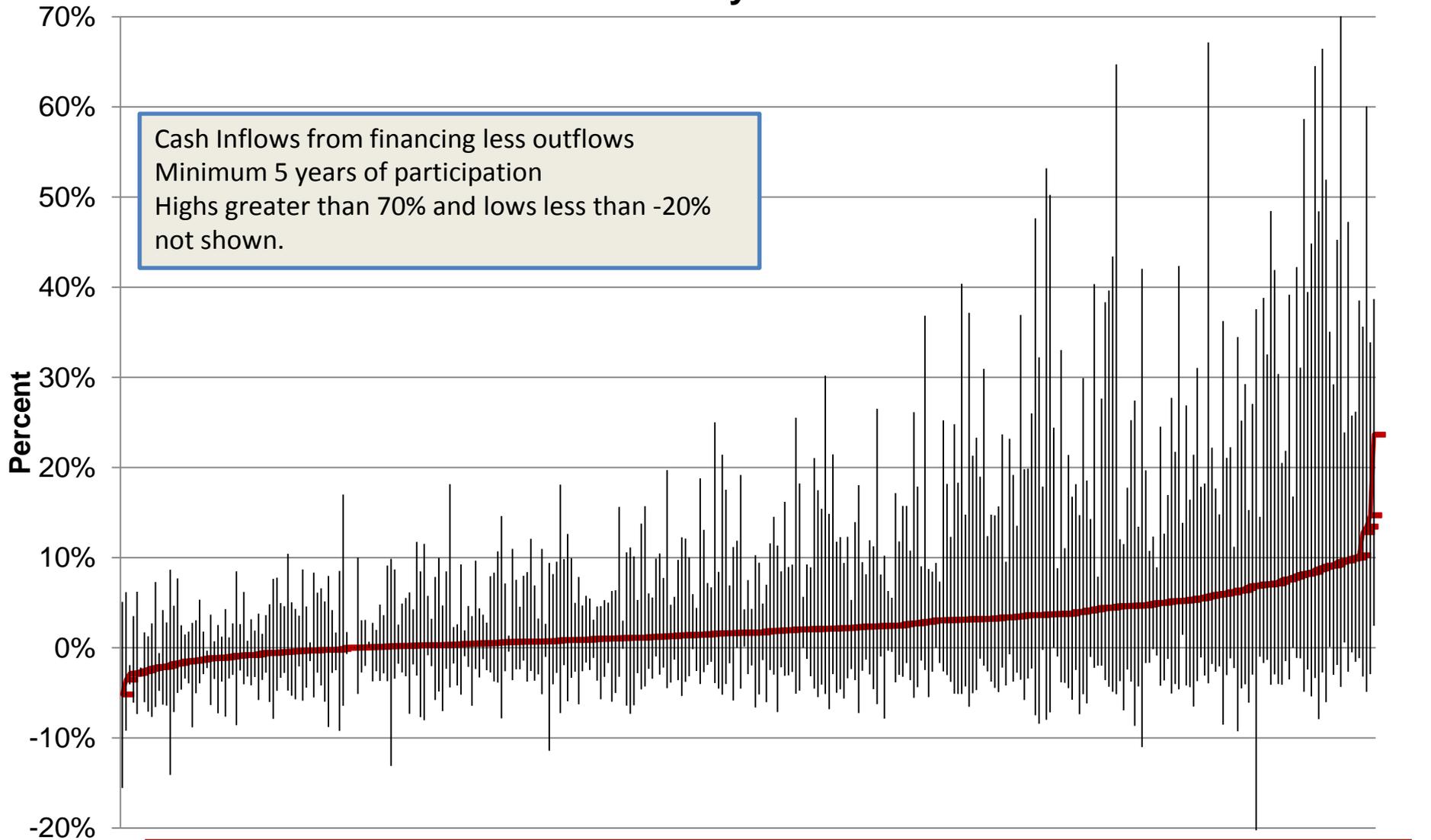
# Net Cash Flow From Operations as a Percent of Farm Assets, 341 NY Dairy Farms



# Net Cash Flow From Investment as a Percent of Farm Assets, 341 NY Dairy Farms

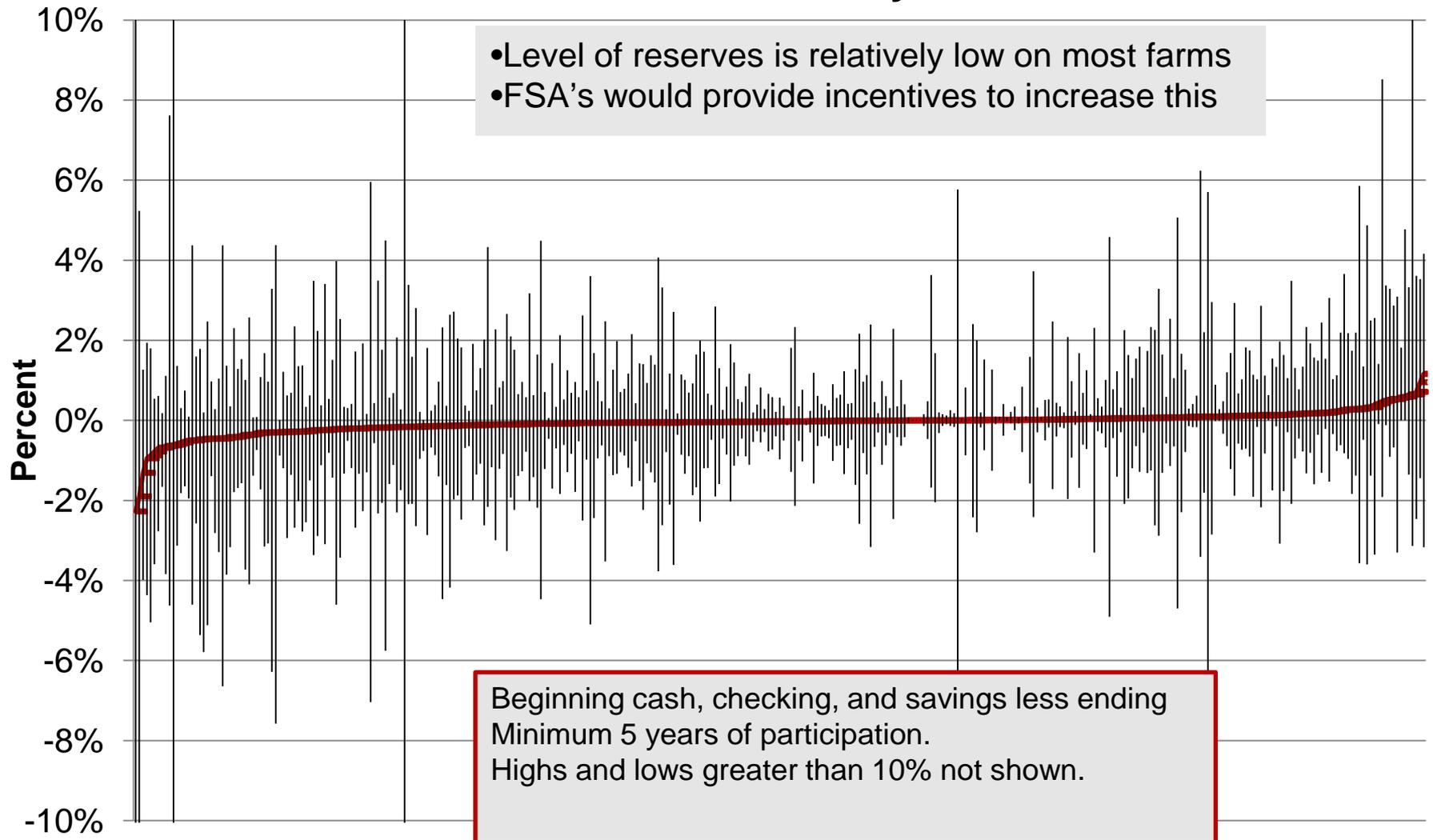


# Net Cash Flow From Financing as a Percent of Farm Assets, 341 NY Dairy Farms



Farmers are borrowers! Borrowing saves taxes. Paying off debt saves interest

# Net Cash Flow From Cash Reserves as a Percent of Farm Assets, 341 NY Dairy Farms



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# Farm Savings Accounts

- Farmers manage cash flow by
  - Investing in years when net returns are high
    - May incur debt as well
    - May over invest to avoid taxes
  - Borrowing in years when net returns are low
  - Allows personal choice, in conjunction with lender
  - Requires that Capital markets work efficiently
- Farms don't carry large cash reserves
  - Incentives to do so will need to be large – tax deferral **and** contribution matches
  - Savings and withdrawal rules must permit farms to manage their own risks and rewards
  - Can earn interest instead of paying interest



# Key Differences Between Farm Savings Accounts and Government Subsidies

- Farmers have personal responsibility and manage savings and withdrawals to suit their needs with an FSA
- Government programs have national, state or county triggers to determine payouts
- FSAs primarily manage your own money
- Government subsidies primarily transfer other people's money

