

## WILL SAVINGS ACCOUNTS (EVER) BECOME PART OF U.S. FARM POLICY?

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### Abstract

Various forms of farmer savings accounts have been proposed to help U.S. farmers manage their income variability. Financial incentives include tax-deferral and government matching deposits. This paper estimates farmer eligibility, program size, and benefit distributions for two congressional proposals: FARRM accounts and a farm counter-cyclical savings account program.

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# **WILL SAVINGS ACCOUNTS (EVER) BECOME PART OF U.S. FARM POLICY?**

## **INTRODUCTION**

While farmer savings accounts are not part of U.S. farm policy to date, they have been proposed in Congress nearly every year since the mid-1990s as one component of a diversified farm income safety net. Most U.S. policy makers believe that a stronger farm safety is needed, even as they discuss the need to keep farming decisions market oriented. This view is apparent when comparing how the 2002 farm bill expanded the safety net over the 1996 farm bill. Even in the presence of this new farm bill, farmer savings accounts continue to be discussed as potential options to help farmers manage their year-to-year income variability with a form of self-insurance. Various ideas for these accounts remain popular with many members of Congress, the Bush administration, the Commission on 21<sup>st</sup> Century Production Agriculture, and most farm groups. Canada and Australia currently have different types of farmer savings account programs for risk management.

While the advent of the 2002 farm bill has increased the diversity of these proposals and the financial incentives offered, the underlying principle is the same -- farmers would make deposits when their income is high, and withdraw the reserves when income is low. Those who are able to build new savings balances could self-insure some of their income risk. Financial incentives to encourage farmer participation range from tax-deferral (with the possibility of tax bracket reduction when the deferred amount is withdrawn) to various types of matching deposits from the government (Edelman, Monke and Durst, 2001a,b). While savings accounts could give farmers another means to stabilize their incomes, taxpayers could benefit if the additional diversification and liquidity reduce the need for farm disaster relief or additional income support.

This paper compares the risk management potential of two proposals considered in Congress: the tax-deferred Farm and Ranch Risk Management (FARRM) accounts that have been proposed since 1996, and a proposal included in the 2002 Senate version of the farm bill that would provide government matching deposits to farmer-established savings accounts.<sup>1</sup>

## **FARM AND RANCH RISK MANAGEMENT (FARRM) ACCOUNTS**

Proposals in the U.S. for tax-deferred farm risk-management savings accounts originally surfaced after passage of the 1996 farm bill as a way to encourage farmers to save a portion of the transition payments during the relatively prosperous years of 1996-97. The specific form of Farm and Ranch Risk Management (FARRM) accounts was first introduced in Congress in 1998, proposed again in 1999 and 2000, and is currently before the 107<sup>th</sup> Congress (Library of Congress, H.R. 662). It receives broad bipartisan support and was part of broader tax legislation passed in 1999 by both the House and Senate that was vetoed for reasons unrelated to FARRM accounts. FARRM accounts have been part of the Bush administration's annual budget proposals in 2001 and 2002. Most farm groups and the Commission on 21st Century Production Agriculture also endorse FARRM accounts.

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<sup>1</sup> This provision was dropped during the conference committee.

## How FARRM Accounts Would Work

As proposed by Congress, farmers could take a Federal income tax deduction for a FARRM deposit of up to 20 percent of eligible farm income. Eligible farm income is defined as taxable net farm income from schedule F of IRS form 1040, plus net capital gains from the sale of farm assets including livestock but not land. Deposits would be made into interest-bearing accounts, and earnings would be distributed and taxable annually.<sup>2</sup> Withdrawals from principal would be at the farmer's discretion and taxable in the year withdrawn. Deposits could stay in the account for up to 5 years, with new amounts added on a first-in, first-out basis. Deposits not withdrawn after 5 years would incur a 10-percent penalty. FARRM funds would also have to be withdrawn if the participant stops farming. Deposits and withdrawals would not affect self-employment taxes.

FARRM account eligibility would be limited to individual taxpayers -- that is, sole proprietors, partners, and Subchapter S shareholders -- who report positive eligible farm income. To benefit from the tax deferral, the farmer must also owe Federal income tax in the year of the deposit.

Based on 1998 IRS data, the most recent available, over 800,000 farmers would likely be eligible to deposit as much as \$3.1 billion to FARRM accounts each year (table 1). This is fairly consistent with 1994 IRS data (Monke and Durst, 1999). Farm sole proprietors account for nearly two-thirds of eligible participants and over two-thirds of potential deposits. These estimates overstate what might realistically be deposited since they assume that farmers participate fully if eligible. Actual participation rates are unknown because the FARRM account program is not directly comparable to other tax deferral or saving incentive programs.

**Table 1. Eligibility for FARRM accounts and Federal cost of deferred taxes, by organizational structure, 1998**

	Number of taxpayers			Maximum potential FARRM account deposits (annual)			Federal cost of deferred taxes
	Total number	Number eligible for FARRM	Pct. of group	Total deposit	Pct. of total	Mean deposit	
			%	\$ million	%	\$	\$ million
Total of farmers	2,632,947	818,116	31	3,130	100	3,734	867
Sole proprietors	2,118,178	522,859	25	2,204	70	4,215	551
Partners in partnerships	396,581	230,017	58	584	19	2,537	193
Subchapter S shareholders	118,188	65,240	55	342	11	5,237	123

Note: Due to data limitations, some individuals may be double counted across the sole proprietor, partner or shareholder categories; however, dollar amounts are representative. To qualify for tax benefits, individuals must have positive tax liability and net farm income. Actual participation and deposit amounts would be affected by individual behavior and can be expected to be less than eligibility and potential deposit amounts shown in the table. The government's cost is tax revenue forgone, based on the weighted average marginal tax rate for contributors. Source: Compiled by USDA-ERS from 1998 Internal Revenue Service data and simulations of FARRM Accounts.

<sup>2</sup> Unlike some other tax-deferred accounts such as 401(k)'s, only the principal in FARRM accounts is tax-deferred. The legislation states that earnings would be distributed at least annually and included in taxable income.

The loss in tax revenue to the Federal Government in the year of deposit could exceed \$850 million. While taxes would be due on amounts withdrawn during the 5-year period, this estimate is reasonable from the government's budget timing perspective and the possibility that account balances forced to be withdrawn after 5 years could effectively be rolled over based on future farm income. Furthermore, the possibility that some funds may be withdrawn during a lower bracket year would convert some of the tax deferral into tax exemption. The government's cost of a tax-deferred program would be greatest in the initial years when program balances could be expected to grow most rapidly and before withdrawals become required.

### **Benefits Vary by Type of Farm**

Even though sole proprietors dominate these FARRM account estimates, significant variation exists within their ranks. About 75 percent of all farm sole proprietors report a farm loss or have no Federal income tax liability. These proprietors could not participate or benefit from participating, respectively. Nearly half of the remaining 25 percent of sole proprietors who are eligible would be limited to contributing less than \$1,000 in any given year. Only about one of every six sole proprietors could deposit more than \$1,000 (Durst and Monke, 2001a). In a simulation of FARRM accounts in Texas, limitations on cash flow, especially for less profitable farms, hindered FARRM account participation (Herbst, Outlaw and Klose).

Similar variation is displayed when FARRM accounts are compared across the ERS farm typology using IRS data (for a description of the farm typology applied to tax data, see Durst and Monke, 2001b, p. 2; for the typology generally, see Hoppe and MacDonald). Large family farms with sales over \$250,000 are the most likely to be eligible, at 57 percent (table 2). Their average potential deposit is \$14,200, more than twice that of the next closest group. For these large farms, and even many primary occupation small farms, FARRM accounts could offer the ability to build a sizeable and useful self-insurance safety net over several years.

At the other extreme, however, limited resource farms - farms with sales less than \$100,000 and household income less than \$10,000 for tax purposes - are the least likely to be eligible. Because of low income, most of these farms do not owe income tax and would have no incentive to participate. For the 8 percent who are eligible, their average potential deposit is only \$540. With such small amounts, FARRM accounts would be of little value to limited resource farms.

FARRM accounts will also be of relatively little benefit to other groups of small farms such as retirement and lifestyle farms. Only about 20 percent of lifestyle farms would be eligible because most of these farms report taxable farm losses. However, most lifestyle farms may not need an additional risk management tool because their primary occupation and source of income is away from the farm.

Without specifying other program rules to target eligibility and tax incentives, a large share of FARRM account benefits could go to relatively few large farmers or new tax benefits could flow to those who do not rely on farming for their livelihood. For example, the current FARRM account proposal does not specify a maximum deposit or accumulated balance. About 0.5 percent of sole proprietors would be eligible to deposit over \$20,000 annually, representing 25 percent of total sole proprietors' potential deposits. The average off-farm income for this group

**Table 2. Eligibility and size of FARRM accounts, by type of sole proprietor, 1998**

	Small family farms (farm sales under \$250,000)					Large family farms	All farm proprietors
	Limited resource	Retired	Lifestyle / other	Primary occupation, with farm sales...			
				Less than \$100,000	\$100,000 - \$250,000		
<b>Total number of farm sole proprietors</b>	183,477	294,755	1,140,727	269,595	147,028	82,594	2,118,178
Distribution of proprietors	9%	14%	54%	13%	7%	4%	100%
Percent of type with...							
...schedule F farm profit	53%	27%	19%	54%	72%	70%	33%
...taxable household income	11%	79%	89%	69%	54%	65%	75%
<b>FARRM accounts as proposed (20% of net Schedule F and gain on livestock)</b>							
Number eligible for account	13,887	68,895	187,215	131,465	74,770	46,627	522,859
Distribution of those eligible	3%	13%	36%	25%	14%	9%	100%
Eligibility within group	8%	23%	16%	49%	51%	57%	25%
Total potential deposits (\$ million)	7	225	235	601	475	661	2,204
Distribution of deposits	0.3%	10%	11%	27%	22%	30%	100%
Average potential FARRM deposit for those eligible (\$)	540	3,270	1,260	4,570	6,350	14,200	4,220

Note: To qualify for tax benefits, farmer must have positive tax liability and net farm income. The simulation assumes full participation if eligible. Actual participation and deposit amounts can be expected to be less than eligibility and potential deposit amounts shown in the table.

Source: Compiled by USDA-ERS from 1998 Internal Revenue Service data and simulations of FARRM Accounts.

exceeds \$250,000. One way to target benefits could be to limit annual deposits to a maximum of \$50,000. This would reduce potential deposits of sole proprietors by 17 percent from \$2.2 billion to \$1.8 billion and would affect only farms with more than \$250,000 of eligible farm income.

To meet goals of increasing risk management and achieving program efficiency, FARRM accounts must create new savings rather than replace existing risk management practices (Monke, 1997). New savings must come from reduced household consumption or from funds that would have been invested in the business. If deposits come from assets shifted from existing savings, saving that was intended for another account, or borrowing, FARRM accounts would serve more as tax-management than risk management. IRS data suggest that, at least initially, most farmers who are eligible would have ample resources to shift existing savings into FARRM accounts instead of creating new savings (Monke and Durst, 1999).

#### FARM COUNTER-CYCLICAL SAVINGS ACCOUNTS

In recent years, a variety of alternatives to FARRM accounts have been proposed. The initial version of the farm bill that passed the Senate contained a provision that would have established farmer savings accounts, but the provision was dropped during the conference committee (Library of Congress, H.R. 2646.EAS). Unlike the FARRM accounts which rely upon tax benefits to encourage participation, these farm counter-cyclical savings accounts would have

provided a matching government deposit to encourage farmer participation. This Farm Counter-Cyclical Savings Account proposal would have been established as a pilot program and thus would have been of limited scope and duration. The participation, costs and program impacts described below represent the effects of a full scale national program.

### **How Farm Counter-Cyclical Savings Accounts Would Work**

Under the proposed program, an eligible producer could establish a farm counter-cyclical savings account at a bank or other financial institution approved by the Secretary. The producer could deposit such amounts to the account as the producer considers appropriate. The government would provide a matching deposit. However, the matching deposit would be limited to 2 percent of the 5-year average adjusted gross revenue of the producer and could not exceed \$5,000 for any applicable year. Funds deposited to the account could earn interest at the commercial rates provided by the bank or financial institution in which the account was established.

While the proposal does not rely upon tax incentives to encourage farmer participation, it uses a tax-based measure of income for purposes of eligibility and determining the amount of the deposit from the government. This "adjusted gross revenue" measure is defined as the farmer's adjusted gross income from all agricultural enterprises including insurance and farm program payments, minus the cost of livestock or other items purchased for resale. It is derived from the Federal income tax schedule F or comparable tax form as determined by the Secretary of Agriculture.

Under the program, an eligible producer would include any individual or entity (as defined by the Secretary of Agriculture) that (1) shares in the risk or provides a material contribution in producing an agricultural commodity, (2) has a substantial beneficial interest in the enterprise, and (3) has earned at least \$50,000 in average adjusted gross revenue over the 5 preceding taxable years or is a limited resource farmer. For beginning farmers who do not have an adjusted gross revenue history, the estimated agricultural income for the current year will be used to determine eligibility.

Once deposited to the account, funds could be withdrawn only if adjusted gross revenue for the current year dropped below 90 percent of the average adjusted gross revenue for the 5 previous years. The amount that could be withdrawn from the account is limited to the amount needed to raise current adjusted gross revenue up to 90 percent of the average gross revenue. This restriction on access to funds in the account would encourage farmers to deposit only enough to be eligible for the full government match. Upon retirement, the farmer could withdraw any remaining funds and close the account.

Based on IRS tax data for 1998, potential annual matching government deposits to this program would be about \$1.237 billion for farm sole proprietors. About 1 out of every 4 would be eligible to participate with an average potential government matching deposit of \$2,121 (table 3).

**Table 3. Eligibility and cost of farm counter-cyclical savings accounts, by organizational structure, 1998**

	Number of taxpayers			Maximum potential Federal matching deposits (annual)		
	Total number	Number eligible for matching	Pct. of group	Matching deposit	Pct. of total	Mean deposit
			%	\$ million	%	\$
Total	2,632,947	811,546	31	1,697	100	2,091
Sole proprietors	2,118,178	583,261	27	1,237	73	2,121
Partners	396,581	146,735	37	202	12	1,377
Subchapter S shareholders	118,188	81,550	69	258	15	3,169

Note: Deposit levels in the table are the government matching portion only. Total deposits, including the farmer's share, would be at least double the government deposit. Due to data limitations, some individuals may be double counted across the sole proprietor, partner or shareholder categories; however, dollar amounts are representative. Actual participation and deposit amounts would be affected by individual behavior and can be expected to be less than eligibility and potential deposit amounts shown in the table.

Source: Compiled by USDA-ERS from 1998 Internal Revenue Service data.

Participation and government deposits would be substantially higher without the targeting provisions. Excluding farms with gross receipts under \$50,000 (except limited resource farmers) lowered potential government deposits by about \$306 million and reduced the number of participants by up to 1.483 million farmers. Placing the \$5,000 cap on deposits reduced program benefits by an additional \$411 million but affected about only 82,600 farmers.

While farm sole proprietors would be the primary beneficiaries, partners in farm partnerships and shareholders in small business corporations (subchapter S) would also be eligible. Including these entities in the program would allow about 146,735 partners and 81,550 shareholders to participate. Participation and average matching deposits would be relatively high for Subchapter S shareholders since such entities are larger and thus a smaller share would be excluded from the program by the \$50,000 farm gross income requirement. Potential matching deposits would be \$202 million and \$258 million for farm partners and Subchapter S shareholders, respectively. This would bring the total annual cost for the 2 percent matching program for farm sole proprietors, partnerships and small business corporations to \$1.697 billion.

Given the inclusive definition of an eligible producer, share rent landlords, estates, trusts and other entities might also be eligible to participate in the program. However, both the number of additional participants and the potential government deposits would be relatively small.

### **Program Benefits Vary by Farm Type**

Examining the eligibility and potential deposit amounts by farm typology provides greater insight into the effects of the targeting provisions. While only about 1 out of every 4 sole proprietors would be eligible to participate in the program, potential participation rates range from no participation for retirement farms to 100 percent for limited resource farms, high-sales primary occupation farms and large farms. Restricting eligibility to those with gross receipts of over \$50,000 limits participation to only about 6 percent for lifestyle farms and to only 37

percent for primary occupation low-sales farms (table 4).

Average annual potential growth in account balances would also vary substantially. While the average government match would be \$2,121, the government match for limited resource farms would be only about \$366. Thus, the average account balance for a limited resource farmer would only increase by \$732, including both the farmer and government deposits. Government matching deposits would be \$1,440 and \$3,249 for the low- and high-sales primary occupation farms, respectively. Large farms would be eligible for the maximum \$5,000 government deposit. As a result, primary occupation high-sales and large farms would receive about 72 percent of all government deposits although they only represent about 11 percent of all farms.

### COMPARISON OF ALTERNATIVES

FARRM accounts and farm counter-cyclical savings accounts represent two different approaches to providing farmers with another option to help manage their income variability. Yet, the overall potential participation rates and program size for these approaches are very similar. Based on 1998 IRS tax data, both programs could potentially include about one-third of all farm sole proprietors, partnerships, and Subchapter S corporations. Total annual deposits could be between \$3 and \$3.5 billion.

But behind the similarities in potential size and participation, actual participation and program levels as well as the distribution of program benefits would likely be very different. Actual participation should be much higher for the farm counter-cyclical savings accounts since the

**Table 4. Eligibility and size of matching deposits to farm counter-cyclical savings accounts, by type of sole proprietor, 1998**

	Small family farms (farm sales under \$250,000)					Large family farms	All farm proprietors
	Limited resource	Retired	Lifestyle / other	Primary occupation, with farm sales...			
				Less than \$100,000	\$100,000 - \$250,000		
<b>Total number of Farm sole proprietors</b>	183,477	294,755	1,140,727	269,595	147,028	82,594	2,118,178
Distribution of proprietors	9%	14%	54%	13%	7%	4%	100%
<b>Farm counter-cyclical savings accounts (2% of adj. gross farm rev., up to \$5,000, for farms with \$50,000 sales)</b>							
Number eligible for account	183,477	0	69,252	100,910	147,028	82,595	583,261
Distribution of those eligible	32%	0%	12%	17%	25%	14%	100%
Eligibility within group	100%	0%	6%	37%	100%	100%	27%
Federal matching deposit (\$ million)	67	0	134	145	478	413	1,237
Distribution of deposits	5%	0%	11%	12%	39%	33%	100%
Average matching deposit (\$)	370	0	1,940	1,440	3,250	5,000	2,120

Note: Deposit levels in the table are the government matching portion only. Total deposits, including the farmer's share, would be at least double the government deposit.

Source: Estimated by USDA-ERS from 1998 IRS tax data.



government shares equally in the cost of funding these accounts, while FARRM accounts are fully funded by the farmer with the primary benefit in most instances limited to the deferral of the Federal income tax on the deposit amount. With regard to the distribution of benefits, both programs effectively limit the availability of benefits away from lifestyle farmers. However, FARRM accounts also would prevent most limited resource farmers from participating due to the lack of a targeting provision. Farm counter-cyclical savings accounts, on the other hand, would allow more limited resources farmers to participate but would direct program benefits from retirement and low-sales primary occupation farmers to high-sales primary occupation farmers.

Both programs contain features that could limit their effectiveness. For FARRM accounts, the lack of a cap could result in a concentration of benefits among large farms and those with high nonfarm income. Also, the unrestricted access to funds could increase the chances that FARRM accounts are funded with existing liquid assets instead of new savings. The potential for FARRM accounts also may be limited because the program base is taxable net farm income, which is low or negative for many farmers. Conversely, the farm counter-cyclical savings account program bases deposits on taxable gross farm income, increasing potential participation rates, and targets funds by requiring a minimum amount of gross farm sales (\$50,000) to become eligible for the account. This greatly reduces the availability of the program for primary occupation farms with sales under \$100,000, clearly a group the program is intended to benefit. Strict limits on when and how much can be withdrawn from the accounts also greatly restricts farmer access to account deposits. This limited availability would reduce farmer deposit amounts and program participation.

## **SUMMARY AND CONCLUSION**

Farmer savings accounts continue to be discussed as a potential option to help U.S. farmers manage their year-to-year income variability. FARRM accounts and the proposal for counter-cyclical farmer savings accounts included in an early version of the 2002 farm bill are leading examples of such accounts. While the financial incentives to encourage farmer participation vary from tax deferral to matching government deposits, the underlying principle is the same -- farmers would make deposits when their income is high, and withdraw the funds when their income is low.

The precise role these accounts might play in the farm safety net had been uncertain. Earlier papers on FARRM accounts (Monke, 1997; Monke and Durst, 1999) raised questions regarding the kind of financial shortfalls to be covered by this type of precautionary saving. The amount of savings needed for adequate protection varies greatly whether the goal is to insure farm operating expenses, net farm income, or household income and whether other insurance or government support is available. Based on recent policy decisions in the 2002 farm bill, any type of farmer savings account enacted in the current policy environment would almost certainly be viewed as a supplemental form of income stability insurance beyond the protection offered by crop insurance, loan rates, or direct and counter-cyclical farm program payments. Therefore, account balances could be much smaller and yet meet program objectives.

Given the failure of even the pilot program for the counter-cyclical savings accounts to be included in the recently enacted farm bill, the most likely vehicle for enacting farmer savings accounts is the Federal tax code. Tax-based FARRM accounts are widely supported by the Administration, Congress and many farm groups, are less costly than proposals involving government matching deposits, and are not counted against agricultural spending levels. If enacted, FARRM accounts could provide a supplemental resource to draw upon for those who choose to participate but would not replace any portion of existing farm support programs.

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