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Ideas for a More Prosperous Nation

ECONOMIC NOTE

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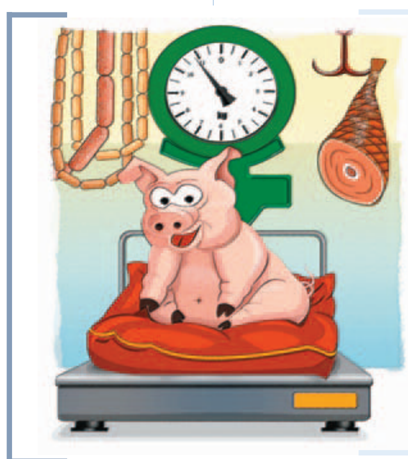
THE STABILIZATION INSURANCE PROGRAM AND THE CRISIS IN THE PORK INDUSTRY

In the last few months, serious setbacks afflicting Quebec's pork industry have been making headlines: the closing of slaughterhouses and processing plants, layoffs, and financial losses.[1] A number of causes have been used to explain this crisis, in particular the rise of the Canadian dollar, industry cycles, high sickness levels, a lack of competitiveness among slaughterhouses, added costs to meet environmental standards, rigidities in collective marketing, and so on. A moratorium decreed by the provincial government on increases in pork production from 2002 to 2005 also stalled the rapid growth that the industry had experienced for more than a decade and stymied numerous investment projects.

This Economic Note was prepared by Éric Grenon, economist, M.Sc., MBA, independent consultant and associate researcher at the Montreal Economic Institute. The author holds master's degrees in rural economics from Laval University and business administration from HEC Montréal.

Like other agriculture and agri-food sectors, the pork industry operates in a heavily regulated context, and it receives hefty government financial support. Since 1978 it has been insured against market risks. The Farm Income Stabilization Insurance program (*Programme d'assurance stabilisation des revenus agricoles*, also known by its French acronym ASRA) is considered a pillar of the Quebec model in agriculture and agri-food.



It must be recognized that some of the causes cited by industry players have contributed to the current problems. However, the recurrent nature of the pork industry "crisis" over the last 10 years provides reason to believe that structural factors rather than mere circumstances may account for more of the explanation. Has the stabilization insurance program, aimed at stabilizing income and development in the pork industry, really fulfilled its goals, or it is actually making this sector more fragile by preventing it from adapting to market realities?

The nature, cost and effects of stabilization insurance

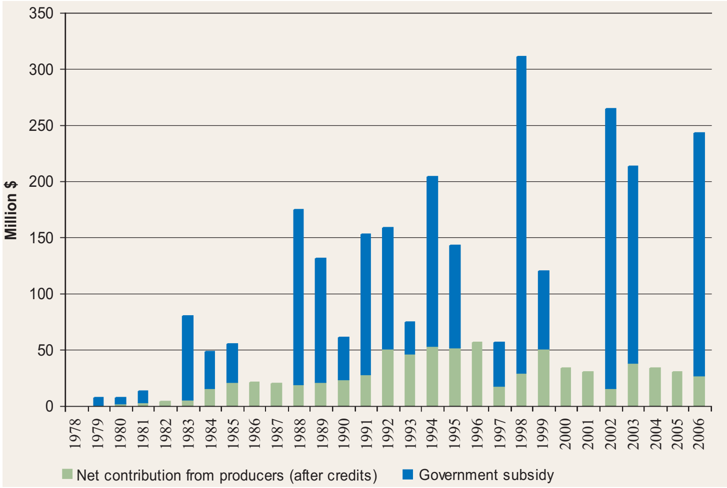
Quebec is among the provinces with the heaviest subsidies in agriculture and agri-food. Subsidies in Quebec are double the Ontario level, even though the two provinces have similar, diversified agriculture and agri-food sectors. Federal and provincial spending on the agri-food sector as a percentage of agri-food GDP is 15.3% of the total in Quebec but only 8.5% in Ontario[2].

Farm income stabilization insurance plays a central role among agricultural assistance programs. It began in 1976, applying initially to the production of fattening calves. Later, several other areas of animal or plant production[3] became eligible for the program. These included pork production, with piglets for fattening eligible since 1978 and hogs ready for slaughter added in 1981. Alongside corn for grain, pork production is among the main beneficiaries of the stabilization insurance program in absolute terms. Historical data

1. In late January 2007, Olymel announced the closing of Quebec's biggest slaughterhouse, at Vallée-Jonction in Beauce. On February 13, 2007, after a fourth general meeting, union members voted 62% in favour of accepting the management offer, containing a 30% cut in the wage bill. In the coming months, Olymel and its negotiator, Lucien Bouchard, wish to deal with other aspects of the company's financial, cyclical and structural problems, in particular the supply from pork producers and productivity increases that would boost production from 29,000 to 35,000 hogs per week.
2. Agriculture and Agri-food Canada, *Farm Income, Financial Conditions and Government Assistance – Data Book*, September 2005, p. 49, http://www.agr.gc.ca/pol/pub/cond-fin-sit/pdf/cond-fin-sit_2005_e.pdf (latest confirmed data 2003-04; more recent forecasts do not suggest change in the two provinces' relative situation).
3. Eighteen products are insurable under stabilization insurance: fattening calves, steers, grain-fed calves, milk-fed calves, piglets, pigs, milk-fed lambs, heavy lambs, oat, wheat for animal feed, wheat for human consumption, canola, corn for grain, barley, soy, non-stored potatoes, stored potatoes, apples.

FIGURE 1

Total compensation to the pork industry through stabilization insurance (net contribution from insured parties and government subsidy), 1978 to 2006



Source: Calculations by the author based on data from La Financière agricole du Québec, *Programme d'assurance stabilisation des revenus agricoles – Historique des produits assurables Porcelets et Porcs*, http://www.fadq.qc.ca/index.php?id=821.

on the program, compiled between 1976 and 2004, indicate that government assistance paid to producers (total compensation minus contributions from producers), not including federal programs, totalled $5.16 billion for all insurable products. Of this amount, $1.41 billion went to pork production.[4] Overall, 27.3% of total subsidies directed through the ASRA program went to pork production, representing about half the insured value among all products covered.

The program aims to guarantee positive net annual income to agricultural businesses in Quebec. According to rules instituted for all insurable products when the program was established, one-third of premiums are supposed to come from insured parties and two-thirds from La Financière agricole du Québec.[5] A farm operation may be counted several times as a subscriber if it is insured for more than one area of production.

Compensation results from the gap between average selling prices and stabilized income, based on the production costs of a model farm. Production costs are set based on surveys of specialized businesses. They are then indexed annually. The market price is determined according to an average compiled by La Financière agricole among buyers and farm operators. In practice, the market price is aligned with the U.S. price, which is the reference price in the North American pork market. The stabilization insurance mechanism guarantees that each pork producer will be compensated for the difference between production costs based on abstract calculations. Figures are obtained using a specialized farm as a model; they come from a survey[6] that does not reflect the real costs of each farm. In effect, each pork farm receives the same compensation level per piglet and hog when the market price is below a price based on the production cost model, regardless of its size or productivity. Farmers thus have less incentive to reduce their production costs and remain competitive in the domestic and export markets. In a market economy, businesses do not normally receive special compensation if their production costs exceed market prices; they must adapt to remain profitable.

Forecasts for 2006 from La Financière agricole[7] indicated that the Quebec pork sector would have nearly 7.3 million piglets (or 366,320 sows at a rate of 19.87 piglets per sow) and seven million hogs were counted and insured under the Stabilization Insurance plan. Compensation forecasts for that year stood at $15.48 per piglet and $18.60 per hog at slaughter. Compensation paid to producers in the pork sector through stabilization insurance would thus total $243 million in 2006. As an example, using the model of a typical farm,[8] each piglet producer would receive total compensation of $83,400 for that year and each hog producer would get $92,600. In

Each pork farm receives the same compensation level per piglet and hog regardless of its size or productivity.

4. La Financière agricole du Québec, *Assurance stabilisation – Historique général depuis 1976*, http://www.fadq.qc.ca/index.php?id=822&L=1an.php%3Fl_id%3D399.
5. La Financière agricole du Québec, created in 2001 by the Quebec government in collaboration with the agricultural sector, is the province's main agricultural finance body. Its mandate is to stimulate investment while protecting incomes and promoting the success and duration of member businesses. Some 27,000 agricultural businesses benefit from its financing, insurance and income protection programs (including stabilization insurance). Its insured value under administration stands at $4.2 billion.
6. Production cost studies are conducted under the responsibility of the Centre d'études sur les coûts de production en agriculture (CEPCA), a non-profit organization. The latest survey on hogs and piglets dates back to 2002. The next survey on pork production costs is planned for 2008. Between surveys, the production cost is indexed annually to represent changes in cost levels.
7. La Financière agricole du Québec, *Programme d'assurance stabilisation des revenus agricoles – Historique du produit porcelets*, http://www.financiereagricole.qc.ca/fileadmin/cent_docu/stat/asra/hist_prod_assu/pcl.pdf and *Historique du produit porcs*, http://www.financiereagricole.qc.ca/fileadmin/cent_docu/stat/asra/hist_prod_assu/porc.pdf.
8. Based on the farm model valid for the 2006 insurance year, annual production of a typical farm stood at 5,385 piglets or 4,978 hogs sold.

practice, however, a few large producers may receive millions of dollars. At least two-thirds of these amounts are subsidies since the program's official rules require the insured parties (pork-producing businesses) to assume only one-third of the cost of insurance premiums. In practice, however, producers' contributions over the years have been below one-third of the premium and have shown a downward trend (their contributions amount to 29% of total compensation since stabilization insurance was instituted) due to federal government assistance programs that have enabled insured parties to obtain additional amounts per piglet or hog produced or, more recently, credits that reduce the amount of their contributions.

Figure 1 shows the history of total compensation paid to pork-producing businesses between 1978 and 2006. Total compensation consists of total stabilization insurance contributions from the insured parties (pork-producing businesses) plus government subsidies (including some related federal programs). Pork producers are fully compensated for all piglets and hogs produced when there is a gap between the average selling price (market price) and stabilized income. When stabilized income is higher than the average selling price, producers receive compensation that includes their share of the contribution plus a government disbursement to make up the difference. In Quebec, which is a net pork exporter, support to producers thus comes mainly through payments per piglet or per hog produced, thereby increasing the price received by producers without raising the price paid by consumers.[9]

Over the last 10 years, subsidies paid to the pork industry have been an average of $96 million a year.

During the entire period from 1978 to 2006, total compensation paid to the pork sector through stabilization insurance and certain federal government programs amounted to about $2.6 billion. Of this figure, government subsidies to pork production came to $1.84 billion. Over the last 10 years, these subsidies have been an average of $96 million a year. In the program's 29 years of existence, there have been only eight years without the pork industry being subsidized.

The operation of stabilization insurance raises another problem. Total compensation and the stabilization insurance mechanism rely on a theoretical model of a specialized farm, based on surveys. The auditor general of Quebec, in reports issued in the 1990s, challenged the efficiency, effectiveness and performance of programs based on production cost models.[10] It was shown that taxpayers could be shelling out millions of dollars too much to producers because of these models. In particular, the auditor general questioned the financial effects of using models that may be out of date and whether models of a typical specialized farm are representative, despite the existence of other forms of organization that are likely to have lower production costs but are excluded from this business concept. The models also failed to take account of the fact that most farm operators are involved in more than one area of production. Delaying revisions to the models also leads to major additional public spending.

The auditor general viewed stabilization insurance as originating from a theoretical concept. Production costs, yield and stabilized income are thus based on the model of a typical farm for each type of production insured. The number of insured units is the sole parameter that takes account of a producer's real situation. The other parameters follow from the model of the typical specialized farm. The entire system relies on two hypotheses in assuming optimal resource use: the specialized business is efficient in itself, and the techniques most often used are the most efficient. The department of agriculture has never verified these hypotheses. Moreover, in following up audits on resource optimization, the auditor general noted in later reports that some recommendations had not been followed, especially with regard to the efficiency of production cost models.

One of the main documented effects[11] of the stabilization insurance program on the industry and on markets is a stabilizing effect to deal with exchange rate shifts between the Canadian and U.S. currencies. Producers ignore market signals and continue to produce since they expect to be

9. For more detailed conceptual explanations, see: Organisation for Economic Cooperation and Development, *Agricultural Support: How is it Measured and What Does it Mean?*, June 2004, http://www.oecd.org/dataoecd/63/8/32035391.pdf.
10. See Vérificateur général du Québec, *Rapport annuel 1994-1995. Chapter 7: Les assurances agricoles*, http://www.vgq.gouv.qc.ca/publications/rapp95/pdf/ch07.pdf; *Rapport annuel 1995-1996. Volume I. Chapter 2: Aide financière offerte aux producteurs agricoles*, http://www.vgq.gouv.qc.ca/publications/rapp96/pdf/ch02.pdf.
11. See Aïcha Coulibaly, Bruno Larue and Olivier Bonroy, *Les effets d'une variation du taux de change sur le secteur québécois porcin : le rôle du programme ASRA*, 2004, http://www.crea.ulaval.ca/Publications/Etude/Rapport%20des%20taux%20de%20change%20et%20ASRA.pdf; Bruno Larue, *Structures de marché, politiques internes, et impact du taux de change*, PowerPoint presentation, 2004, http://www.crea.ulaval.ca/Seminaires%20et%20colloques/CIE/2004/Larue.pdf.

compensated, based on the "production cost" set under stabilization insurance. The program deters moves to improve productivity and efficiency, since production costs remain high compared to competitors' costs. The production cost model holds back industry consolidation, in particular by keeping non-viable farms in operation; a business's viability and performance are not among the eligibility requirements for the main programs. All pork producers have an interest in being insured because stabilization insurance guarantees them positive income on the basis of a production cost model that includes remuneration for the farm operator plus a profit, regardless of market conditions or of the farm's real productivity. It slows industry consolidation at the production, slaughter and processing levels by failing to encourage a quest for efficiency and economies of scale compared to domestic and international competitors.

The ASRA program deters moves to improve productivity and efficiency, since production costs remain high compared to competitors' costs.

The challenge of international competitiveness and the sustainability of the pork industry

The competitiveness of the Quebec pork industry is fragile and is threatened by growing competition at the world level, whether from traditional competitors such as the United States or from emerging countries such as Brazil. The stabilization insurance program, based on a theoretical production cost model, presents a number of major shortcomings that stand in the way of laying new foundations for a pork industry that can sell on foreign markets in a profitable, stable and truly competitive manner over the the long run. In addition, slaughter operations and pork product processing are under threat because the U.S. industry has used the last 20 years to consolidate and restructure, both at the production stage and at the slaughter and processing stages.

A commission on the future of Quebec agriculture and agri-food, set for 2007, will look into the level and effectiveness of current government involvement in supporting and protecting farm income, in particular through the farm income stabilization insurance program. It should also pose serious questions about the program's validity in a context of worldwide competition and of the integration process in the pork industry's North American markets.

Taking account of high recurrent costs to taxpayers, the perverse effects on industry players and the failure of the theoretic production cost model to promote wealth-enhancing growth for all of Quebec society, the stabilization insurance program as it relates to pork production must be reformed to give the industry incentives to match market needs and truly to raise its productivity rather than protecting pork producers against market fluctuations and guaranteeing them consistently positive income regardless of economic conditions. A thorough reorganization of the Quebec pork industry is required, not only in terms of slaughter capacity but also in the areas of policy, assistance programs and regulation, including environmental matters. The long-term competitiveness and endurance of the Quebec pork industry depend on principles other than direct production subsidies and the existence of exchange rates that favour exporters.

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Montreal Economic Institute
6708 Saint-Hubert Street
Montreal, Quebec
Canada H2S 2M6
Telephone (514) 273-0969
Fax (514) 273-2581
Web site www.iedm.org

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