

## PolicyPennings by Daryll E. Ray &amp; Harwood D. Schaffer

## Economist's suggestion: Revamp revenue insurance to reduce taxpayer-paid windfalls

An examination of the farm bill proposals from commodity and farm groups like the National Corn Growers Association, the American Soybean Association, and the American Farm Bureau Federation, as well as proposals by Congressional leaders like Lugar and Stutzman makes it clear that they all base their proposals on the existence of some form of revenue insurance to serve as the foundation of a 2012 Farm Bill. There are implementation differences among the proposals and differences in the nature of the wrap-around programs that are used in conjunction with revenue insurance.

In previous columns we have criticized revenue insurance as providing an upside-down safety net that does a good job of protecting farm incomes when crop prices are extremely high—well north of the cost of production—and an extremely poor job of protecting crop producers when prices are well below the cost of production like they were in the 1998-2001 period.

On November 3, 2011, the Environmental Working Group (EWG) released a study by Bruce Babcock, Professor of Economics, Iowa State University, in which he offers a different critique titled, “The Revenue Insurance Boondoggle: A Taxpayer-Paid Windfall for Industry” ([http://static.ewg.org/pdf/Crop\\_Insurance.pdf](http://static.ewg.org/pdf/Crop_Insurance.pdf)). In the previous column, we examined the Preface written by the EWG which builds on Babcock’s analysis, but takes a distinctive tack on policy. In this column, we look at Babcock’s critique in more detail.

After discussing the 2010 agreement which reduced the overhead costs of the crop insurance program by 7.5 percent and the assertion that further cuts to crop insurance would destroy the program, Babcock writes, “The intense political support for the crop insurance program is a reflection of how hard and effectively the industry lobbies Congress. Crop insurance companies and independent agents are dependent on federal subsidies for their livelihood. Farmers, their suppliers and companies that buy farm products would hardly notice if commodity or conservation subsidies were eliminated, but a large portion of the insurance companies’ and agents’ business would disappear. This creates a powerful incentive for the industry to lobby hard while feeding highly self-serving information to Congress and the media.”

Babcock’s first critique of what he calls the crop insurance boondoggle is that “beginning in 2007... per-policy revenue [for the insurance companies] in-

creased dramatically, primarily because of rising crop prices. That might have been reasonable if the cost of servicing policies had increased with higher prices, but the vast majority of the companies’ costs do not vary with commodity prices. Rising prices have no effect on the insurers’ cost of visiting farmers or sending them emails, nor on the cost of salaries, claims adjustments, office space or computer equipment. The only industry cost that might vary with commodity prices is the cost of reinsurance, but the federal government provides extensively subsidized reinsurance as part of its contribution. Thus most of the increase in revenue per policy driven by rising crop prices represents windfall profit for the insurance industry.” He then argues that most of these windfall profits could be cut from the federal subsidy to crop insurance “without sacrificing the industry’s ability to service farmers’ policies.”

Following up with a question about yield insurance and revenue insurance, Babcock asks, “which should be subsidized?” He asserts that “Most people think that the USDA’s crop insurance program provides payments to farmers when they lose a crop. This is understandable, since its advocates justify the program on the grounds that farmers have little or no control over the hail, wind, floods and drought that can cause crop damage and reduce yield. It comes as a surprise to many people that a large share of the taxpayer-supported subsidies go to protect farmers against adverse price movements, not yield losses. In 2011, only 17 percent of farmed acres were covered by yield insurance, while 83 percent carried revenue insurance.”

According to Babcock, revenue insurance is nearly twice as expensive as yield insurance alone. “Before 1998, premium subsidies for revenue insurance were limited to the subsidy amounts that farmers could receive for yield insurance.” But when subsidies were increased to include a share of the price risk in addition to yield insurance, government costs began to skyrocket to the point where they are now “much more costly than direct payments.” Estimates of the 2011 difference between the governmental costs for yield insurance (\$4.7 billion) and the governmental costs for revenue insurance (\$8.6 billion) was nearly \$4 billion a year. In total, the federal government pays more out in insurance subsidies that what it spends in direct payments.

After showing that farmers could get payments even though they had not suffered a loss in income

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from what they expected when their financial and planting commitments were made—only a decline in prices between springtime, when the policies were bought, and harvest time when prices are often at their season low—Babcock offers some reform options: 1) return to pre-2007 subsidy levels, saving as much as \$2 billion a year; 2) fix the level of subsidies offered to farmers, reducing their incentive to purchase the most expensive insurance; 3) give farmers free yield insurance and let them buy additional coverage at their own cost; 4) don't duplicate insurance coverage with programs like ACRE, SURE and Lugar's ARRM.

Babcock concludes, "The only rationale for a new federal revenue guarantee program on top of existing revenue insurance programs is that it seems politically easier to defend than direct payments. If Congress judges that the existing yield and revenue insurance program is not providing adequate coverage, it should provide farmers with an ARRM-like program through the farm bill, end insurance subsidies and set the insurance industry free of direct government control. A few straightforward steps can be taken to create a cost-effective and easy-to-deliver safety net through the Farm Service Agency (FSA).

Insurance payments should either be based on a fixed number of acres or on yield shortfalls only. If revenue protection must be offered, each year's guarantee should be adjusted to reflect current market conditions.

"There are two pending county revenue protection proposals that come close to meeting these criteria. One was originally proposed for the 2008 farm bill by the National Corn Growers Association; the other was offered recently by the American Farm Bureau. Running either of these programs through FSA, rather than through the crop insurance program, would greatly reduce administrative costs. And either could serve as the foundation for a strong farm safety net. Privatizing the crop insurance industry would then allow farmers who need additional protection to buy it from insurers in a manner that would look more like the unsubsidized auto and life insurance than what crop insurance is today: an over-regulated, over-subsidized industry whose fortunes rise or fall with the effectiveness of its Congressional lobbying efforts."

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