

PolicyPennings by Daryll E. Ray & Harwood D. Schaffer

Crop insurance's need to guard against guaranteeing profits on marginal land

At the same time that the US Senate overcame a procedural hurdle in moving the 2012 Farm Bill from the Ag Committee to the Senate floor, the dependence of the commodity title on crop/revenue insurance continues to attract media attention.

One of the problems that insurers have to guard against is called moral hazard, because if they don't it could be costly to their bottom line. We have all read stories of a nighttime fire that destroys a business that is experiencing a financial crisis. As the fire investigator seeks to determine the cause of the conflagration, the possibility that the owner set the fire in order to collect the insurance has to be considered.

Fire insurance is designed to protect building owners against a random risk—fire caused by faulty wiring, lightning,...—events beyond the control of the owner. The possibility that the owner can commit arson introduces a moral hazard that must be guarded against. Thus the importance of the work of the fire investigator in determining the cause of the fire so that the random fire can be distinguished from one deliberately caused by someone with financial interest in receiving the insurance payout.

As we have been writing about our concerns with crop insurance, one of our readers sent us a story that does a good job of illustrating the problem of moral hazard. According to an article in the Asheville Citizen-Times (<http://www.citizen-times.com/article/20120605/NEWS/306050008/Farmer-faces-new-fraud-charges?odyssey=tab|topnews|text|Frontpage>), “[Robert Gardner] Warren, 64, was convicted in July 2004 of conspiracy to defraud the Federal Crop Insurance Corp. [FCIC] and conspiracy to commit money laundering. He was sentenced the following year to 76 months in federal prison. His wife, Viki Warren, pleaded guilty to conspiracy to defraud the FCIC and mail fraud and got 66 months....

“The Warrens owned R&V Warren Farms, which at one time was the largest vine-ripened tomato grower in the eastern United States and employed about 200 people....

“Warren Farms filed fake crop reports claiming losses that never happened. Prosecutors said employees threw ice cubes onto a tomato field, beat the plants with sticks and photographed the results to simulate hail damage to back up insurance claims.

““The employees also threw ice cubes into the air while other employees took pictures to support the claim of a hailstorm,” an indictment stated.

“The Warrens began the scheme in 1997 to defraud the FCIC and insurance companies reinsured by the agency of millions of dollars, obtaining crop insurance by creating false records purporting to show a history of high tomato production.”

To the extent that the fraud can be identified and the proceeds recovered, the potential for moral hazard in crop/revenue insurance is no different than many other types of insurances. But an article in the New York Times by Ron Nixon titled, “Crop Insurance Proposal Could Cost U.S. Billions) suggests the possibility of systemic moral hazard (<http://www.nytimes.com/2012/06/07/us/politics/bill-to-expand-crop-insurance-poses-risks.html?emc=eta1>).

Nixon writes, “Even some farmers argue that the subsidies are already generous to agribusinesses, especially with the government facing large deficits. Jim Faulstich, a farmer and rancher in Highmore, S.D., said he was in favor of farmers having crop insurance, but added that the insurance should not be used to make money at taxpayer expense.

““If we as farmers expect taxpayers to support premium subsidies, it's only fair that we grow on land that is capable of supporting it,” he said. ‘Could some of this land be profitable without the crop insurance subsidy? I think not.’”

What makes this use of crop/revenue insurance a moral hazard is that it takes a risk (crop failure) that is supposed to be random and makes crop/revenue insurance available, without a significantly unsubsidized premium and/or a very large deductible, to farmers trying to grow a crop on marginal ground where the chances of a crop failure are very high.

Nixon goes on to write, “‘Land that was once considered marginal is now being looked at more from a farm production and financial standpoint,’ said Bruce Brock, a real estate auctioneer in Le Mars, Iowa. ‘With commodity prices being what they are, people are looking everywhere for land they can plant corn or some other high-priced crop.’

“Mr. Brock said he recently sold about 1,300 acres of pastureland in South Dakota that fetched a price of about \$2,600 an acre. The same land would have gone for \$200 to \$300 if it had remained grassland, he said.

“By guaranteeing income, farmers say, crop insurance removes almost any financial risk for planting land where crop failure is almost certain.

““When you can remove nearly all the risk involved and guarantee yourself a profit, it's not a bad

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business decision,' said Darwyn Bach, a farmer in St. Leo, Minn., who said that he is guaranteed about \$1,000 an acre in revenue before he puts a single seed in the ground because of crop insurance. 'I can farm on low-quality land that I know is not going to produce and still turn a profit.'"

Under earlier farm programs, the implementation was under the supervision of county committees made up of farmers who were knowledgeable about growing conditions in their county. Based on their knowledge they could identify marginal land.

With the current program, there seem to be few-to-no controls on the introduction of crops like corn into fields and areas where the chances of crop failure are high and the chances of collecting indemnities that are larger than the farmer's premium cost plus the cost of putting the crop into the ground are also high.

We have had farmers tell us that they could rent a

marginal parcel of ground at some distance from their base operation and then be allowed to use the higher crop yield from their home place when insuring the additional marginal ground as a part of whole farm insurance coverage.

From a public policy perspective, taxpayers should not be subsidizing policies that guarantee profits by allowing farmers to plant crops on marginal land that should remain in pasture. In this case there are double societal losses—environmental and financial.

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