

PolicyPennings by Daryll E. Ray & Harwood D. Schaffer

Revenue insurance: The upside down safety net

In last week's column, we examined some proposed changes to the crop insurance program, particularly revenue insurance. The challenges to it are coming literally from the left and the right, with both wanting to make cuts in the program. In the current contentious atmosphere, let's step back and consider the rationale for a subsidized crop insurance program.

The crop insurance program, as with any insurance product is first and foremost a means of managing risk. In this way, the rationale for subsidizing crop insurance is no different than the rationale for the farm commodity programs we have had in the US since the 1930s. Each of these programs has been designed to protect farmers against risk.

In addition, the crop insurance program has garnered significant support because it is seen as less distortionary than traditional commodity programs. We leave the discussion of distortions in planted acreage and other distortions potentially caused by crop insurance programs to another column. In this column we want to focus on the issue of risk management.

From time to time we have been criticized for not getting on the crop revenue insurance bandwagon. The rationale for this challenge is that prices are on a new plateau and policy has moved beyond historic policy instruments and that we need to focus on what is realistic in Congress. Oddly enough, it is precisely the issue of risk management that most concerns us about crop revenue insurance.

Revenue insurance is heralded because it is market oriented—when prices are up farmers can protect their crops at a higher level of revenue per acre. And that is true; it is market-following. As a protection against a single-year decline in revenue, this type of crop insurance is superb, and adding the harvest-time price option only makes it more lucrative. As long as prices remain above or, better yet, well above the cost of production, crop producers are well protected.

So what is the problem with us? Well there is the obvious problem of defending to taxpayers a highly subsidized insurance product that can provide price-based benefits to crop farmers when the in-year reduced prices are still above production costs. Aside from that, we question the implicit, if not explicit, presumption that average prices will be just fine and there will be occasional random short-lived declines.

As we look at prices from a long-term perspective, we see that there are four periods in the last 100 years when there were multiple years of demand-driven increases in crop prices that during those times resulted in prices greater than the cost of production: World War I, World War II, the early to mid-1970s when US exports boomed, and the recent period when the demand for corn from the ethanol industry grew by 500 million bushels a year.

The other three quarters of the time, farmers have struggled to make it from year to year as we experienced long periods of low prices, punctuated here and there by a crop shortfall large enough to boost prices. And revenue insurance performs poorly as a risk management tool when farmers are already losing money because prices are below the cost of production and thus the market-following revenue insurance protection levels are also below the cost of production.

The feature that makes it attractive to some policy analysts is precisely the feature that we see as a fatal flaw. When prices are below the cost of production, farmers are expected to pay for an insurance product—even a subsidized insurance product—that, if it pays it does not allow farmers to cover the cost of producing the crop, though it might cover the premium cost.

And there will be times when revenue is up, but still below the cost of production. In that case, revenue insurance pays nothing and the farmer's share of the premium has only added to the cost of producing the crop, so they are further in the hole than if they had not purchased the insurance at all.

As David Orden and Carl Zulauf wrote in their paper, "The Political Economy of the 2014 Farm Bill," (<http://tinyurl.com/nomcm78>) "insurance products do not address multiple year price and revenue risks." The result is that revenue insurance becomes an upside down safety net. It pays handsomely when per acre crop revenue is high and makes a one year dip. But it pays poorly, if at all, when prices and revenue are in the gutter for years at a time. And that is when farmers need the safety net the most.

So from our point of view, a policy that pays best when it is least needed and pays poorly when it is most needed is not in the best interest of taxpayers or grain producers—it is not a risk management tool for all seasons. Most people do not see making a lot of money or even more money as being a risk—that is called an opportunity. The risk to be protected against is losing money—and from a public policy perspective the long-term potential loss of food production capacity—for multiple years at a time.

There are yield-based crop insurance and other insurance products that deserve public support, but we are not convinced that revenue insurance, as it is currently configured and subsidized, is one of them.

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