

THE REVENUE INSURANCE BOONDOGGLE: A TAXPAYER-PAID WINDFALL FOR INDUSTRY

by **Bruce Babcock**

Professor of Economics, Iowa State University

Preface by **Craig Cox**

Senior VP for Agriculture and Natural Resources, EWG

"Allies of big agribusiness are pushing to trade direct payments for a system that guarantees income – at taxpayers' expense – for the richest of corporate agriculture businesses, which are already doing far better than most of the U.S. economy."

-Environmental Working Group



**ENVIRONMENTAL
WORKING
GROUP**

Table of Contents

Preface3

Full Report.....7

Agriculture in the Cross Hairs7

Crop Insurance Cuts Curbed Windfall Profits8

Revenue Insurance or Yield Insurance: Which Should be Subsidized?.....11

How Revenue Insurance Works16

Revenue Insurance as Index Insurance18

Double Indemnity.....21

Reform Options22

References.....25

Preface

By **Craig Cox**

Senior Vice President for Agriculture and Natural Resources

and **Nils Bruzelius**

Executive Editor

Environmental Working Group

As a Congressional “Super Committee” presses to meet its Nov. 23 deadline to come up with a deficit reduction proposal, powerful farm state legislators and agricultural industry lobbyists have moved to hijack the process of rewriting the federal farm bill and enact a new, multi-billion dollar entitlement for the largest, most profitable farming operations. Their goal is to have the 12-member committee adopt their scheme, drafted entirely behind closed doors, while shutting out everyone else with a stake in the outcome – including taxpayers and advocates for healthy food, rural revitalization, children, conservation, public health and the environment.

The champions of big agriculture are trying to pass off their scheme as budget reform by letting it be known that they are ready, at long last, to part with the long discredited farm subsidy programs known as direct payments, which send out cash even during years of record-high farm income. You don’t even have to be a farmer to get a payment. It has become clear, however, that allies of big agribusiness are pushing to trade direct payments for a system that guarantees income – at taxpayer’s expense – for the richest of corporate agriculture businesses, which are already doing far better than most of the U.S. economy.

At the heart of this scheme is an expansion of the federal “revenue insurance” program, an already heavily subsidized program that insures business income won’t fall below a “revenue guarantee” – something that would be the envy of any other industry – even as it enriches the insurers. This paper by renowned agricultural economist Dr. Bruce Babcock, who developed one of the first revenue insurance products, clearly demonstrates that the justifications for preserving and expanding this taxpayer-subsidized program are hollow.

Big agriculture’s supporters argue that the revenue insurance program should be immune from budget cuts because it has already been trimmed and further cutbacks will leave farmers vulnerable and put America’s food supply at risk. The reality is far, far different. Babcock’s close analysis shows that the supposed cuts did

little more than make a trivial dent in the windfall profits that insurance companies and agents reap from the program, while the taxpayer-subsidized premiums entice growers to buy expensive and unnecessary policies that can pay out even if they suffer no crop loss at all.

The little noticed transformation of crop insurance into a business income guarantee has done all of this, and more:

- doubled the cost to taxpayers of the heavily subsidized system to \$8 billion a year.
- produced billions in windfall profits to insurance companies.
- delivered big payouts to agribusinesses that suffered only paper losses.

Environmental Working Group, which has long advocated for meaningful reform of the nation's misguided farm and food policies, commissioned Dr. Babcock to do this analysis of the revenue insurance program. It confirmed our worst fears.

We are releasing it now in order to shine the spotlight of truth on the shameful effort to exploit the federal deficit reduction effort in order to give Big Ag, and its insurers, a business income guarantee no other sector of the economy enjoys. The farm bill is far too important to be left to the subsidy lobby and its champions on the Agriculture Committees. The Super Committee and the leadership of the House and Senate must not let themselves be used as pawns in the subsidy lobby's chess game. Instead, the renewal of the farm bill should be done in an open and transparent process that recognizes these facts and embraces these basic principles and values:

- Taxpayers do not and should not guarantee business income for anyone.
- It is time to cut through the maze of farm subsidies programs to get back to what most people would consider a safety net – stepping in when working farm and ranch families suffer unpredictable and potentially crippling losses caused by bad weather.
- Crop insurance, which began as part of such a safety net, has undergone expensive mission creep. Over 80 percent of "crop" insurance policies now insure business income even if there is no yield loss caused by weather. This has doubled the cost to taxpayers and opened the door for large payments to producers who suffer only paper losses, and for windfall profits for insurance companies.
- Direct payments never had anything to do with a safety net and should have been eliminated years ago.

It is entirely possible to construct a true safety net that protects working farm and ranch families from crippling

crop failures AND save billions of dollars that can be used to reduce the deficit and reinvest in critical conservation and food programs – a safety net for families, children and our land and water. Here's how:

- Eliminate direct payments, counter-cyclical payments, loan deficiency payments, ACRE (Average Crop Revenue Election) and SURE (Supplemental Revenue Assistance Payments). (Savings: \$57 billion over ten years).
- Provide every farmer with a FREE crop insurance policy that covers yield losses of more than 30 percent; and eliminate federal premium and other subsidies for revenue-based or other crop insurance products. (Savings: \$26 billion just in premium subsidies over ten years).
- Have the federal government take bids from insurance companies to service the policies, eliminating windfall profits and encouraging the private sector to develop and offer innovative options for farmers to increase their insurance coverage – but not at taxpayers' expense.
- Require producers to meet a basic standard of conservation practices in order to be eligible for publicly financed crop insurance.
- Ensure full transparency by requiring USDA to make available information about who is getting the free policies, the taxpayer cost of providing those policies and how much farmers receive in insurance payouts.

This proposal would generate approximately \$80 billion in savings over 10 years – nearly four times more than the \$23 billion in cuts proposed by the Agriculture Committees and nearly three times more than the \$30 billion proposed by the Obama Administration and House Republicans.

An open farm bill process could develop our idea and others that would meet or exceed deficit reduction targets proposed by the Agriculture Committees and the Administration while still providing resources to invest in critical food and conservation programs – programs with far more public benefit than the duplicative and wasteful proposal to guarantee business income for producers of a handful of favored crops.

This reinvestment in families, good food and conservation must include these elements:

- Maintain funding for the Supplemental Nutrition Assistance (SNAP) and the Women, Infants and Children (WIC) programs in order meet the needs of families and children during these difficult economic times.
- Add incentives to SNAP to make it easier for participants to afford fresh food.
- Ensure that schools have the money they need to meet the new federal school lunch standards and make sure that school lunches provide children with fresh fruit and vegetables every day.

-
- Restore cuts to critical conservation programs that protect our soil, clean up our water and preserve habitat for fish and wildlife. This should include adding \$10 billion above the current baseline of \$64 billion to restore funding for the Wetlands Reserve Program, and increasing funding for technical assistance.
 - Increase funding for programs that provide new market opportunities for sustainable and organic farmers and ranchers, create new jobs and increase access to healthy food by strengthening the local food economy.

The effort to reshape the nation's food and farm policies is at a critical point. If Big Agriculture and its lobbyists succeed in exploiting the Super Committee process for their own selfish interests, it will stymie the prospects for true reform for years to come. Americans who believe in healthy food, in protecting public health and the environment, in ensuring proper nutrition for children and the less fortunate, must speak up now. We must call on our representatives in Congress to stand firm against this cynical attempt to turn deficit reduction into a guarantee of prosperity for large-scale agricultural interests.

The Revenue Insurance Boondoggle: A Taxpayer-paid Windfall for Industry

by Bruce Babcock
Professor of Economics, Iowa State University

Agriculture in the Cross Hairs

Agricultural programs face significant budget cuts as Congress and the Obama Administration strain to meet deficit reduction goals. Conservation, nutrition, commodity and even once-sacrosanct direct payment programs are all vulnerable. One program that does not seem as vulnerable is crop insurance. The ranking member of the House Agriculture Committee, Collin Peterson (D-Minn.), was quoted as telling a Minnesota farm audience recently, "I am against making any cuts in crop insurance... any changes in crop insurance."

One reason Peterson and others give for resisting cuts to crop insurance is the 2010 agreement between the US Department of Agriculture and insurance companies that changed the program's operating rules beginning with this year's crop. These changes are expected to reduce the program's costs by about \$6 billion over 10 years,¹ a 7.5 percent cut in a program projected to total \$74 billion over the next decade, according to the Congressional Budget Office.

Senate and House Agriculture Committee members regularly argue that any additional cuts to the industry's subsidies will spell the demise of the entire program. In response to the Administration's proposal to limit subsidies, House Agriculture Committee Chairman Frank Lucas (R-Okla.) and Sen. Pat Roberts (R-Kan.), minority leader on the Senate Agriculture Committee, said in a joint statement: "The President's policy priorities reveal a lack of knowledge of production agriculture and fail to recognize how wholesale changes to farm policy would impact the people who feed us. For example, cutting \$8 billion from the crop insurance program puts the entire program at risk. We have heard again and again from producers that crop insurance is the best risk management tool available. In jeopardizing this program, the President turns a deaf ear to America's farmers."

Industry advocates go further. Jerry Hagstrom² reported in the trade weekly Agweek that, “A coalition of crop industry companies and agents also said, ‘On behalf of crop insurance companies, agents and producers who have stated that federal crop insurance is the cornerstone of U.S. farm policy, we strongly oppose the administration’s reckless cuts to crop insurance. The administration’s proposal does not ‘modernize’ crop insurance or implement it ‘more efficiently,’ as it purports to do. To be clear, the administration proposal would end federal crop insurance. Given the bad economy, high unemployment, recent deep cuts and widespread natural disasters, the administration proposal is divorced from reality and is an attack on rural America.’”

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.

Congress should take a close look at what exactly was cut in the 2010 agreement as well as why the program’s costs have grown so rapidly. That will clearly reveal that the 2010 “cut” to the crop insurance program simply reduced – but did not come close to eliminating – windfall profits that agents and companies had enjoyed since 2006. Neither the integrity of the program nor farmers’ benefits were affected. In addition, a close examination shows that for the major commodity crops, the way crop insurance premiums are subsidized has enticed farmers to buy the most expensive type of insurance, contributing heavily to the program’s rising costs. This insurance can pay out even if a farmer has not suffered any loss and duplicates the coverage farmers can obtain from traditional commodity programs. Far from showing that crop insurance should be protected from cuts, a clear-eyed analysis shows that it is possible to provide a strong, crop insurance-based farm safety net at much lower cost. The savings could be used to support programs that provide public benefits or as deficit reduction.

Crop Insurance Cuts Curbed Windfall Profits

It is easy to calculate the impact of the agreement reached in the summer of 2010 between crop insurance companies and the USDA by looking at what effect it would have had on the industry and program costs if it had been in place in previous years. Figure 1 shows how much crop insurance companies earned on each policy sold. This revenue consists entirely of government payments to cover both administrative and operating

costs and net underwriting gains, which are based on the amount of premiums collected and payouts on claims. The lower the payouts, the greater the underwriting gains. Shown are both the actual revenue collected (blue bars) as well as what the revenue would have been had the current operating agreement been in place from 2000 to 2010 (green bars).

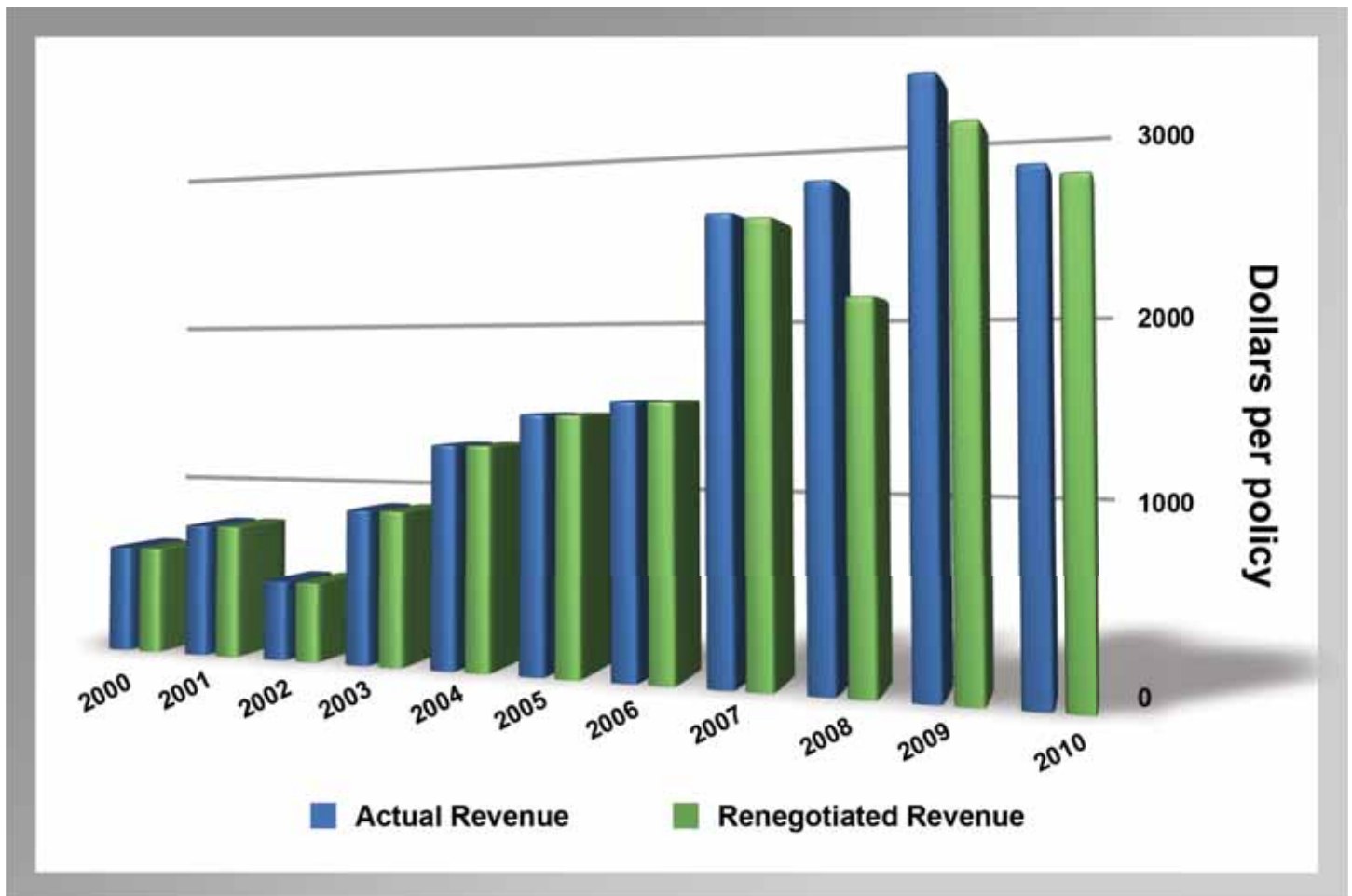


Figure 1. Company Revenue per Crop Insurance Policy Sold

Data Sources: 2000 to 2009: "RMA's Response to Comments on "Milliman Study;" 2010: RMA Summary of Business reports and author's calculations.

The average revenue from 2000 to 2006 was about \$1,000 per policy. During these years, farmers were well served by the program, agents made a good living and insurance companies made a decent return. This level of taxpayer subsidies was sufficient to support a healthy industry and a strong safety net for farmers. Beginning

in 2007, however, per-policy revenue increased 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.

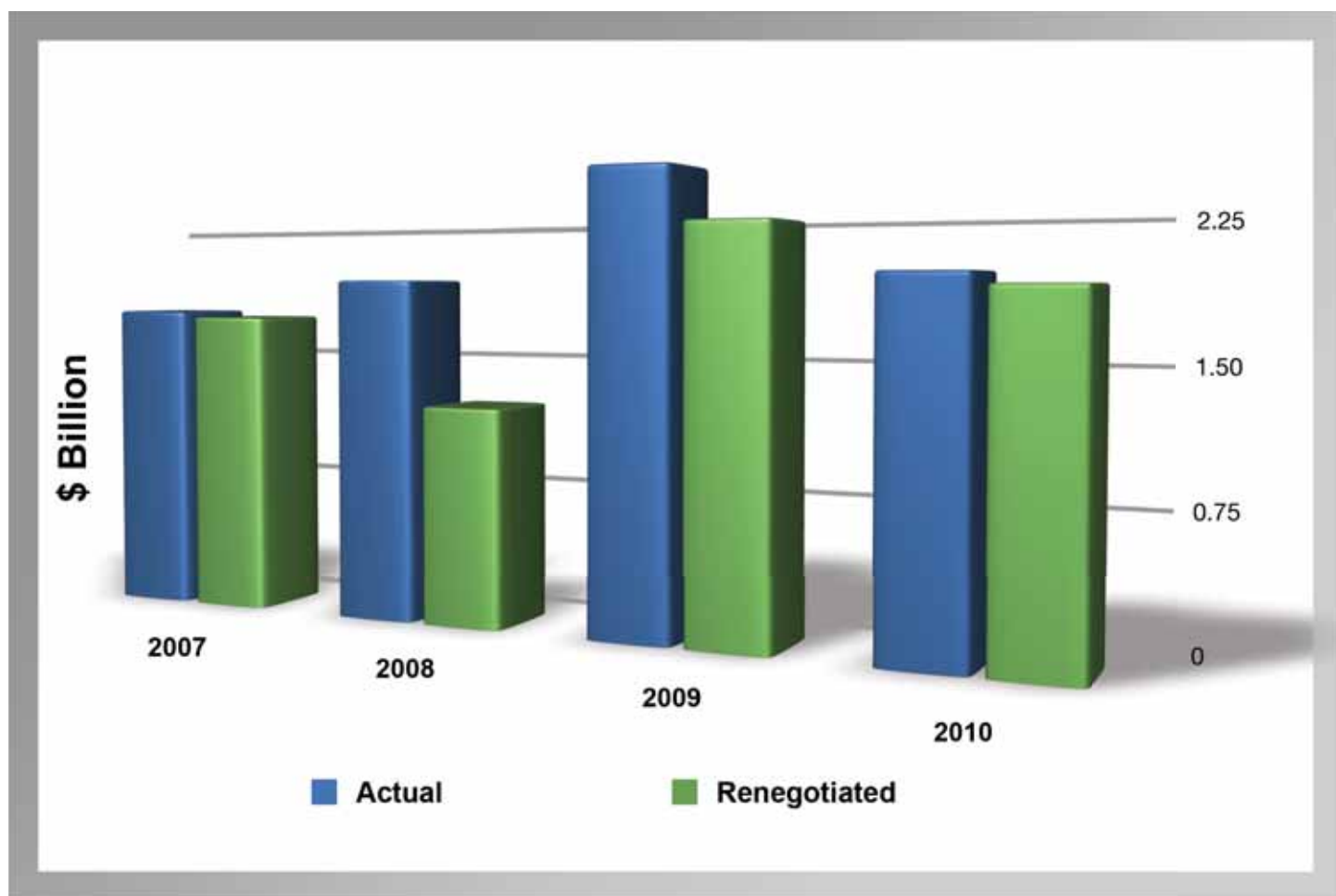


Figure 2. Crop Insurance Industry Windfall Profits from 2007 to 2010

The agreement did cap administrative and operating reimbursements (A&O) at \$1.3 billion a year. The effect of this cap can be easily calculated. Taking the average revenue per policy from 2000 to 2006 as a measure of the cost of providing the service, the higher subsidy in subsequent years amounts to windfall profit, shown by the blue bars in Figure 2. The green bars show what profits would have been had the current agreement to “cut” crop insurance been in place from 2007 to 2010. Actual windfall profits over these four years amounted to \$8.3 billion. Under the renegotiated agreement, these profits would have been reduced by only about 13 percent. The industry would still have enjoyed a windfall of \$7.2 billion.

These windfall profits demonstrate that much can be cut from the program without sacrificing the industry’s ability to service farmers’ policies. But there are additional reasons why taxpayer funding for crop insurance could be reduced without asking farmers to do without a strong safety net.

Revenue Insurance or Yield Insurance: Which Should be Subsidized?

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.³

There are good reasons why most farmers buy revenue insurance. Farmers pay their bills with dollars of revenue. A high price does little good for a farmer with a poor yield, and a good yield is of little value if prices are low. But the revenue insurance that farmers buy is much more expensive than yield insurance because it protects against both upside and downside price risk.⁴ For example, the average unsubsidized premium across all the 15 percent deductible Revenue Protection policies in Champaign County, Illinois was \$52 per acre in 2011. The average unsubsidized premium for a 15 percent Yield Protection policy in Champaign County was only \$28 per acre. The higher premiums for Revenue Protection translate directly into higher taxpayer costs because premiums are subsidized on a percentage basis, as are federal reimbursements to insurance companies. Premium subsidies for Revenue Protection policies total \$26 per acre, whereas premium subsidies total only \$11 per acre for Yield Protection policies. Across the 230,000 insured corn acres in just this one

county, this difference amounts to \$3.45 million in extra subsidies.

Figure 3 shows that for all crops except rice, per-acre premium subsidies for revenue insurance are much greater than the direct payments that have received so much attention from budget cutters. Rice is the exception only because direct payments for rice growers are so much larger than for other crops. Farm groups themselves are acknowledging that it is time for direct payments to end. Far more attention should be focused on the fact that the crop insurance program has become much more costly than direct payments.

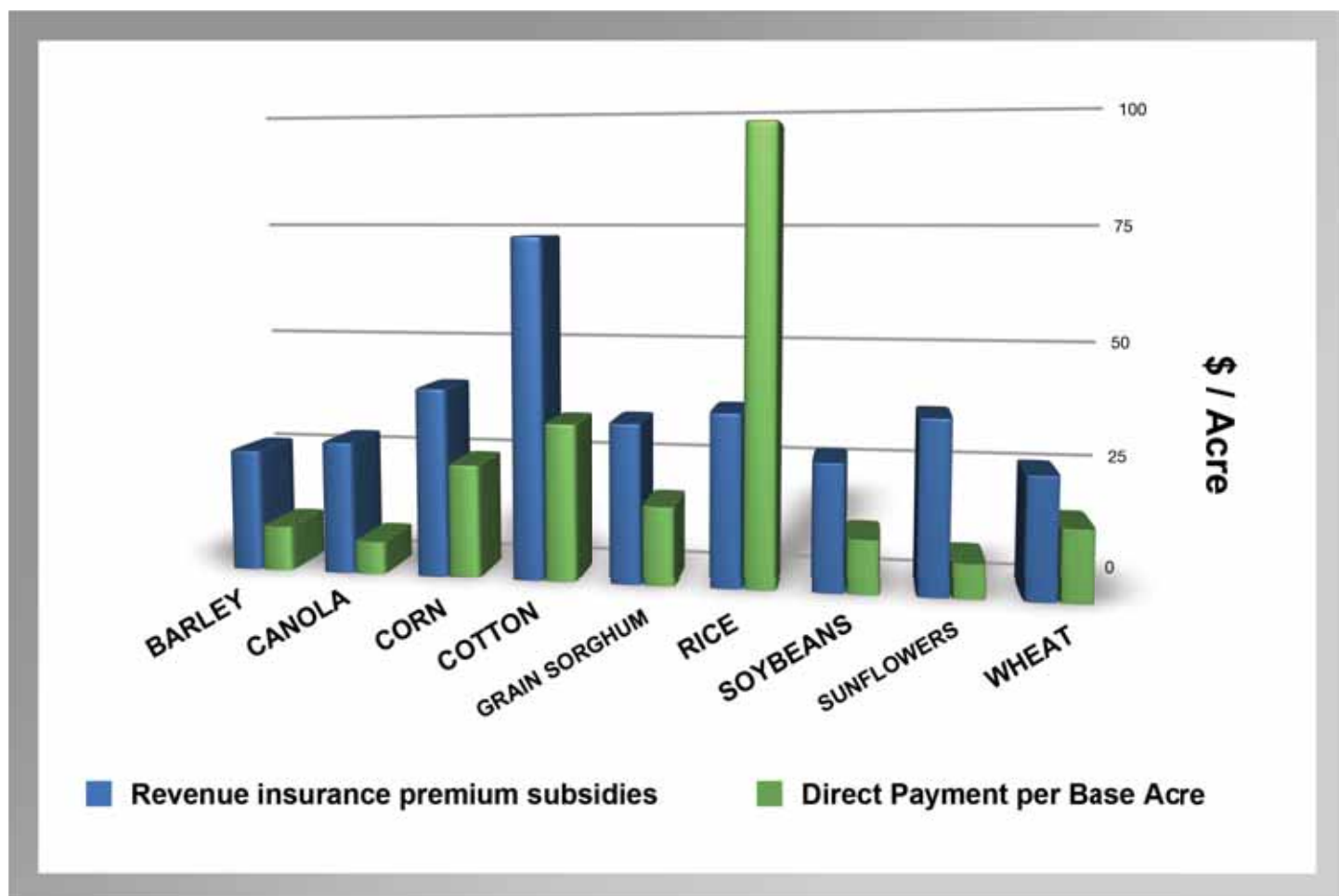


Figure 3. Comparison of 2011 Revenue Protection Subsidies to Direct Payments

It is useful to understand why there has been such large growth in the cost of the crop insurance program. One reason is the movement of farmers from yield insurance to revenue insurance, which began in earnest

in 1998 and 1999 when the farmers' share of revenue premiums dramatically decreased because of increased government subsidies. Because revenue insurance costs more, this movement increased both premium subsidies and subsidies to industry. Before 1998, premium subsidies for revenue insurance were limited to the subsidy amounts that farmers could receive for yield insurance.

One can estimate the cost of extending subsidies to revenue insurance rather than just yield insurance by comparing the per-acre taxpayer cost of providing each in 2011. This accounts for the increase in commodity prices, because the same price is used to calculate the cost of both types of insurance. Taxpayer costs include premium subsidies as well as the companies' expected underwriting gains and administrative and operating (A&O) reimbursements. The level of underwriting gains for 2011 has not yet been determined, so it is assumed to equal to 15 percent of unsubsidized premiums, just below the average percentage that crop insurance

Table 1. Estimated costs of crop insurance in 2011

Source: Summary of Business statistics from USDA's Risk Management Agency.

	Premium Subsidy	A&O	Underwriting Gains	Total
	\$ million			
Corn	2,552	516	615	3,683
Soybeans	1,372	277	331	1,980
Wheat	1,070	217	258	1,545
Cotton	703	132	158	993
Sorghum	124	25	29	178
Sunflowers	59	11	14	84
Rice	40	7	8	55
Canola	35	7	9	50
Barley	29	6	7	42
Total	5,984	1,199	1,429	8,612

companies have received from the government since 2001.

Table 1 breaks down taxpayers' total 2011 cost of subsidizing crop insurance into its three components – subsidies to lower the premiums that farmers pay; subsidies paid directly to companies for “administrative and operating expenses;” and companies' underwriting gains. A&O reimbursements are limited to about \$1.2 billion for the nine crops listed under the agreement negotiated in the summer of 2010. The costs presented are for all types of insurance purchased in 2011, but farmers overwhelmingly choose revenue insurance. Policies to insure corn, soybeans, wheat and cotton alone account for 95 percent of taxpayer costs in 2011.

Table 2 shows how much taxpayers would have paid in 2011 if the program insured only yield. Limiting the program to yield insurance would reduce the cost of insuring corn by \$1.9 billion, soybeans by \$895 million,

Table 2. Estimated costs of crop insurance in 2011 if only yield insurance were purchased

Source: Summary of Business statistics from USDA's Risk Management Agency and author's calculations.

	Premium Subsidy	A&O	Underwriting Gains	Total
	\$ millions			
Corn	1,205	322	268	1,796
Soybeans	733	192	160	1,085
Wheat	616	166	138	920
Cotton	378	99	82	560
Sorghum	87	24	20	131
Sunflowers	42	12	10	64
Rice	24	6	5	35
Canola	23	7	6	36
Barley	22	7	6	35
Total	3,133	834	695	4,661

wheat by \$625 million and cotton by \$433 million. The cost of premium subsidies alone for these four crops would drop by a total of \$2.8 billion.

Figure 4 illustrates the magnitude of the cost increases that extending subsidies to revenue insurance imposes on taxpayers. Subsidizing revenue insurance about doubles taxpayer costs from \$4.7 to \$8.6 billion.

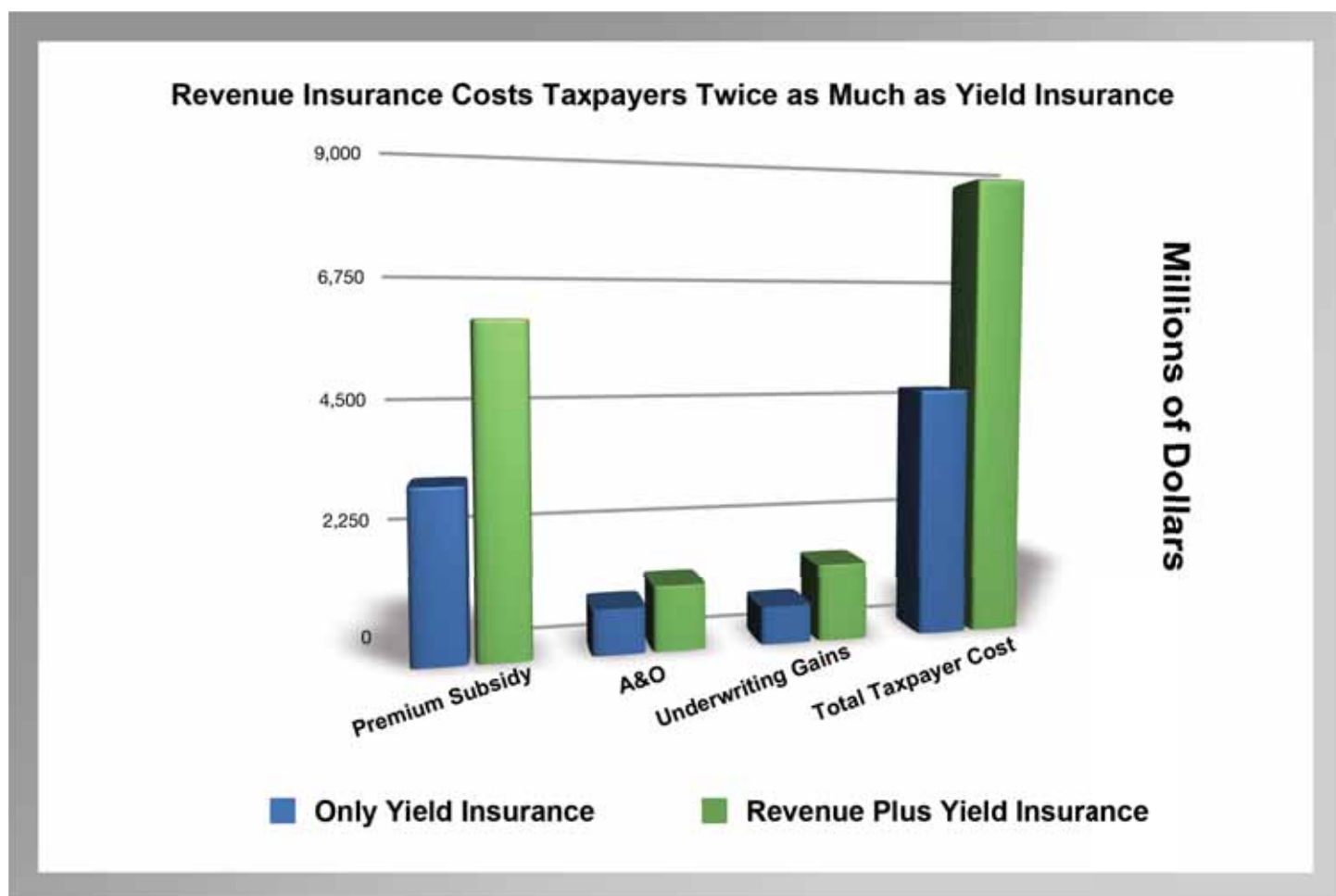




Figure 4. Subsidizing Revenue Insurance Doubles Taxpayer Cost

The question then becomes, what value are taxpayers getting for the extra \$4 billion a year they spend by subsidizing revenue insurance? Is that amount really necessary to build a strong safety net? Or could subsidizing yield insurance alone do the job, leaving farmers who want the extra benefit of revenue insurance to pay for it out of their own pockets? Examining the extent to which revenue insurance actually covers on-farm losses provides an insight into this question.


How **Revenue Insurance** *Works*





Revenue insurance is designed to protect farmer income from an unexpected drop. Because revenue equals price times yield, a drop in revenue can be caused by a drop in price, a drop in yield, or both. Revenue insurance policies need to establish both anticipated revenue and actual revenue. Anticipated (or projected) revenue equals a farmer's established crop insurance yield – which is based on a farmer's own records – multiplied by the projected price established just before the farmer signs up for insurance. A farmer then chooses a coverage level percentage, which typically varies from 65 percent to 85 percent of projected revenue, in 5 percent increments. The revenue guarantee equals this coverage level times anticipated revenue. The difference between anticipated revenue and the revenue guarantee is the policy deductible. This deductible creates a strong incentive for farmers to take good care of their crops.

Actual revenue equals actual yield times the harvest time price. If actual revenue falls below a farmer's revenue guarantee, the insurance makes up the difference. In major production regions such as the Corn Belt, lower than expected yields are often associated with higher than expected prices. This means that the cost of providing this type of revenue insurance can be lower than the cost of providing simple yield insurance. Sometimes yield insurance pays off but revenue insurance does not because higher prices offset the low yields.



However, few farmers buy this type of pure revenue insurance. Most buy revenue insurance that increases the revenue guarantee if the fall harvest price is higher than the anticipated price. When this happens, the new guarantee equals the old guarantee multiplied by the ratio of the harvest price to the projected price. Farmers buy this more expensive form of revenue insurance for two reasons. One is that this provision protects them against the additional risk they take on if they enter into a forward contract. A forward contract is a promise by a farmer to deliver a certain amount of grain in the future at an agreed-upon price. If the farmer does not produce enough grain, he or she must buy additional grain on the open market to deliver. If the cost of this purchased grain is greater than the price in the forward contract, the farmer suffers a loss that is compensated by this revenue insurance.

The second reason that farmers buy this provision is that taxpayers pay a large portion of its cost. Most of us would buy more insurance if its price were cut in half. Farmers are no different. Current premium subsidies encourage even those farmers who do not forward contract to buy this expensive type of revenue insurance.

Revenue Insurance as Index Insurance

Revenue insurance was developed because of a recognition that revenue more accurately reflects a farm's financial health than simply crop yield.⁵ Farmers determine what crops to plant based on the revenue they expect to generate from their various crops at harvest and their production costs. Revenue insurance guarantees are based on market conditions (price levels) before planting – just before the insurance contracts are signed. The system assumes that the average level of harvest-time futures prices at that moment captures the value farmers expect from their harvest. This average futures price, referred to as the anticipated or projected price, is used as an indicator because the mechanism by which farmers form their expectations about market prices cannot be measured exactly. This projected price is then used to set the revenue guarantee that triggers an insurance payout if harvest revenue (price times yield) falls below the guarantee.

It is straightforward to calculate harvested yield because farmers report what they harvest. It is much more difficult to determine the price they receive for their crops, because farmers don't provide actual sales receipts. In addition, many farmers "forward contract" at least a portion of their production. This means they receive the going price at the time they entered into the contract, not the price being offered for the crop at harvest. Other farmers store their production and sell throughout the marketing year (before and after harvest). And some sell all their production at harvest.

To keep revenue insurance policies simple, companies use the average of harvest-time futures prices to set the value of harvested production regardless of when, and for how much, a farmer actually sells the crop. This average is only an indicator of the actual market prices farmers receive. Because few, if any, farmers actually sell all their harvested production at this average futures price, revenue insurance is a type of index insurance. The index determines whether a farmer suffered a loss because of a drop in crop prices. There is no direct connection to the price the farmer actually got.

The problem with index insurance is it can result in a mismatch between payments and loss. Farmers who have not suffered an actual loss can still receive a payout, and farmers who do suffer a loss can end up with no compensation. An example from 2008 illustrates how this can happen. The springtime futures prices used to set projected price and determine the revenue guarantee for 2008 was \$5.40/bushel for corn and \$13.36/bushel for soybeans, reflecting a short-term spike in commodity prices early that year. The projected prices for both crops were well above the prices that farmers had expected to get for their crops when they made

their production plans as early as the fall and winter of 2007. During the fall and winter of 2008, however, crop prices fell from these lofty levels. The harvest-time futures price that one revenue insurance product (Revenue Assurance) used to value crops fell to \$3.74/bushel for corn and \$9.22/bushel for soybeans.

The average price farmers actually received in 2008 turned out to be \$4.06/bushel for corn and \$9.97/bushel for soybeans (Figure 5). These prices were \$0.32/bushel (9 percent) higher for corn and \$0.75/bushel (8 percent) higher for soybeans than the prices used to determine whether a farmer deserved a payment from his or her revenue insurance policy.

Because the harvest-time futures price was about 30 percent lower than the springtime futures price, many farmers who bought revenue insurance were judged by the program to have suffered a loss. But the reality,

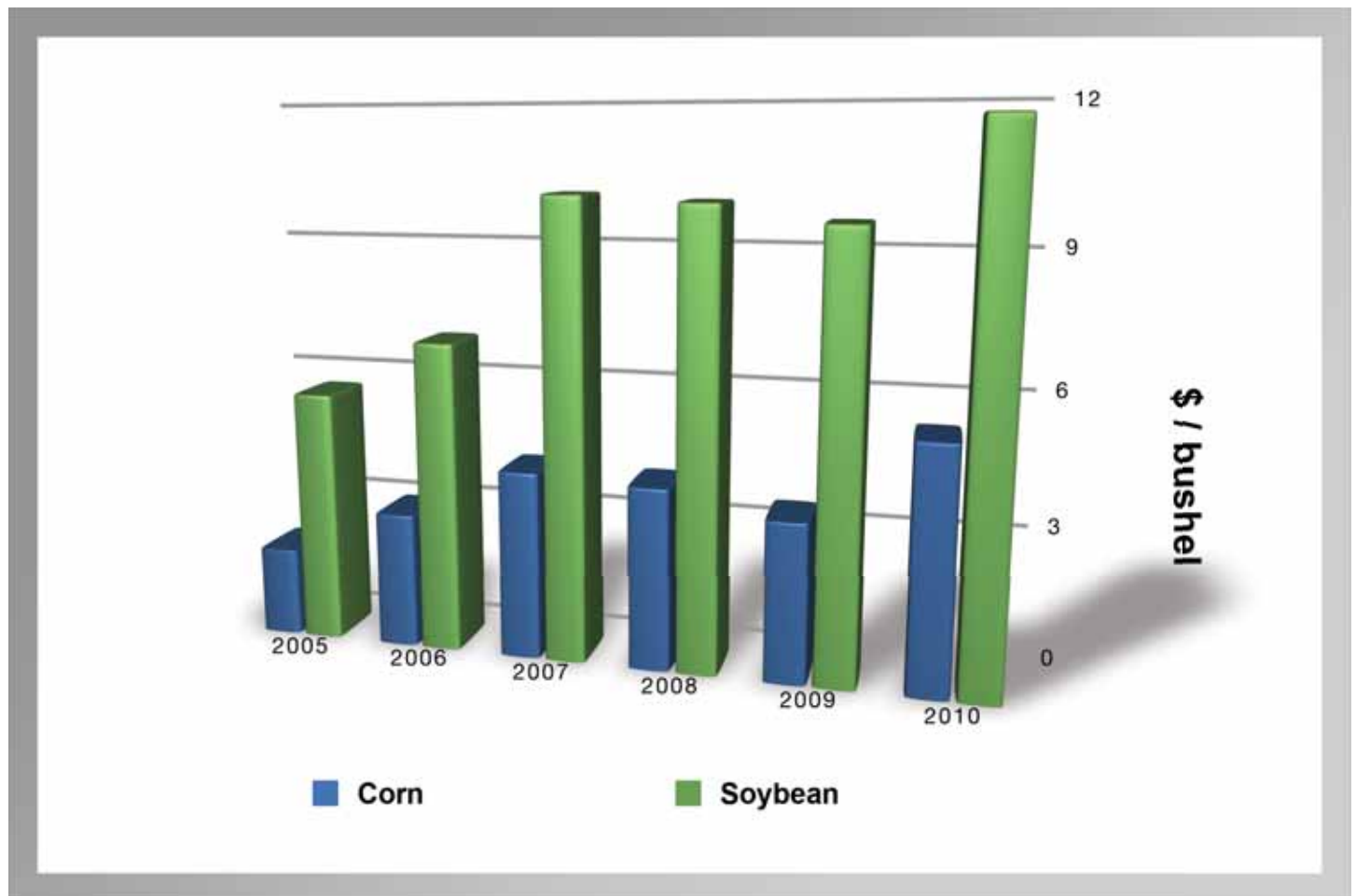


Figure 5. Average Price US Farmers Actually Received for Corn and Soybeans

Source: National Agricultural Statistics Service, USDA.

as shown in Figure 5, was that the prices farmers actually received for their corn and soybeans in 2008 was essentially the same as they received in 2007, and dramatically higher than in 2005 and 2006.⁶ Supporters of revenue insurance correctly point out that if farmers had made financial plans that year based on \$5.40/bushel corn and \$13.36/bushel soybeans and were then forced to sell at 30 percent lower prices, they indeed might have suffered a loss. But, most of their financial plans are made in the late summer and fall of the year before a crop is planted. For example, most cash rental agreements for Iowa cropland in Iowa for the 2008 were determined by Sept. 1, 2007. And most farmers decided on what type of seed to buy that fall.

The best signal about future market conditions was the price levels on the December 2008 corn futures contract and the November 2008 soybean futures contract. The monthly average price levels for these two contracts for August 2007 through February 2008 are shown in Figure 6. When corn and soybean farmers were

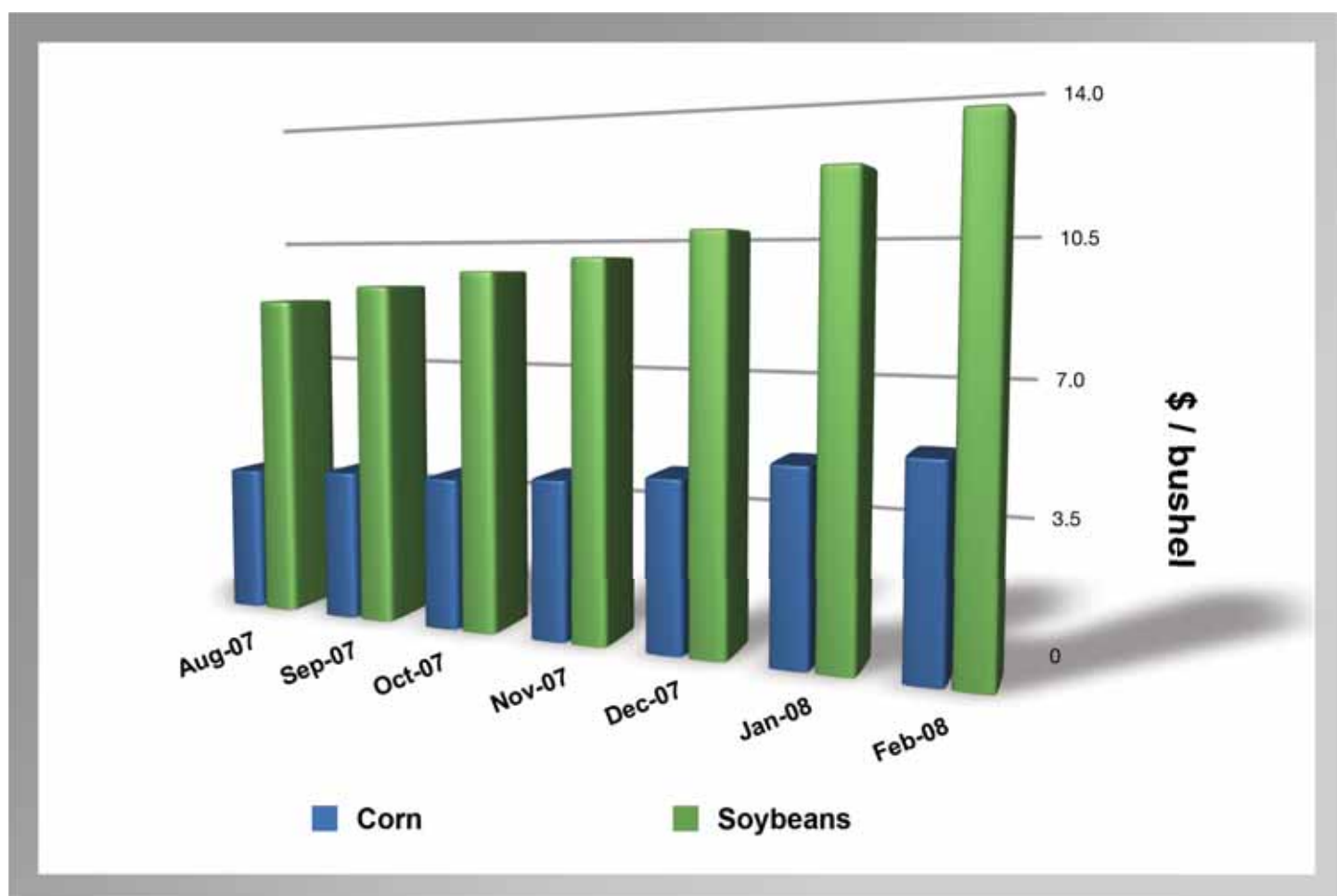


Figure 6. 2008 Average Harvest-Time Futures Prices

making most of their production plans for 2008, corn was valued at about \$4/bushel and soybeans were valued at \$9-to-\$10/bushel. It wasn't until the beginning of 2008 that price levels rose significantly. This implies that most farmers' financial plans were based on \$4 corn and \$10 soybeans, not the \$5.40 corn and \$13.36 soybeans used to set the revenue insurance guarantee. If the actual price farmers received for corn was \$3.74/bushel, as assumed by the policies, the price dropped by only 6.5 percent from the levels used to make their financial plans, rather than the 30 percent drop the policies projected. In fact, soybean prices dropped by only about 3 percent.

This example shows the inherent weakness of using an index of revenue gain or loss as the basis for determining whether a farmer should get a payout. In 2008, substantial indemnity payments were made to farmers whose revenue insurance policies assumed a loss when in reality they suffered no drop in price at all. Farmers had made their cropping plans based on prices that were nearly the same those for which they actually sold their crops. Farmers using more aggressive marketing strategies could have enjoyed revenues far higher than average and still have gotten an insurance payment.

Double Indemnity

Some farm groups are currently advocating enhanced revenue insurance options as part of the next farm bill, particularly in the ACRE (Average Crop Revenue Election) program that insures farm revenue at the state level. This would sharply increase the likelihood that farmers in a state that experienced a widespread climate disaster or price shock would be compensated twice for the same loss.

Because ACRE is not integrated with the crop insurance program, farmers can already get paid twice for the same decline in revenue. For example, when a major drought hits a state, farm yields drop – triggering crop insurance payments – and the state average yield also drops – thereby triggering ACRE payments. Unexpected price declines can also trigger both ACRE payments and revenue insurance payouts. In either situation, farmers get compensated twice for the same event. Moving to a crop reporting district basis for as proposed by the National Corn Growers Association, or to a county basis as proposed by the National Cotton Council, would increase the odds of double payouts because individual farm yields are more correlated with district and county yields than with state yields.

Even if ACRE programs were fully integrated with crop insurance, adding another revenue insurance program

on top of existing crop insurance programs effectively reduces farmers' deductibles. Lower deductibles increase the incentive for farmers to "farm the program" in an effort to lower production costs and increase insurance payouts, rather than making decisions based on market signals.

Reform Options

This analysis demonstrates that there are ample opportunities for budget savings in the crop insurance program. Rather than being immune from budget cuts, crop insurance should be one of the first places that Congress looks to for savings. Below are a few recommendations for reducing spending on crop insurance while providing farmers with a strong safety net.

Reduce Industry Windfall Profits Further: The renegotiated operating agreement between the government and the crop insurance industry reduced windfall profits by capping cost reimbursements. However, the new cap still provides much higher subsidies than industry needs to provide farmers with a high level of service. Furthermore, the renegotiation did little to reduce underwriting gains – profits generated when premiums exceed payouts. A return to pre-2007 subsidy levels would save as much as \$2 billion a year.

Reduce Subsidies: Current insurance subsidies create incentives for farmers to buy the most expensive kind of revenue insurance because the subsidies increase as the cost of the insurance increases. If the federal contribution to crop insurance premiums were fixed, farmers would think twice because they would be paying the additional premium with their own money, not taxpayers'. This could be accomplished by giving farmers a per-acre voucher that provides a fixed level of assistance that they could use to buy either yield or revenue insurance – whichever best suits their risk management needs. Only those who highly value the extra coverage provided by expensive revenue insurance would choose to buy it. Other farmers would find that less expensive yield insurance sufficed. This simple change would reduce program costs by at least \$2 billion a year without limiting the type of insurance that farmers can buy.

The Obama Administration proposal to make a small cut in the percentage premium subsidy would not lead to substantial savings because farmers would still pay much of the additional cost of expensive revenue insurance with taxpayer dollars.

Another simple option is simply to give farmers a free yield insurance policy. This would be the taxpayers'

contribution to the farm safety net. If farmers wanted to buy more coverage, they could pay the additional cost themselves. The data in Table 2 provides an indication of the potential cost savings of this approach. Based on the yield insurance coverage levels that farmers actually purchased in 2011, the total cost of the premiums to the government for these major crops would have been \$4.8 billion if all acres were insured with “free” yield insurance. At a cost of \$500 million to administer this free program, the savings would be almost \$3.3 billion in 2011 alone.

Don’t Duplicate Coverage: There is no reason farmers need two safety nets, one in the crop insurance program and another in the commodity title of the farm bill. Congress should decide once and for all where the safety net for farmers should reside. If the decision is that it’s up to the private sector to provide it, the logical course is to reform the current crop insurance program by eliminating the insurance industry’s windfall profits as well as insurance-type commodity programs, including ACRE and SURE. If Congress concludes that it would be more efficient to provide a safety net through USDA’s Farm Service Agency (FSA), it should design an easy-to-deliver program in the commodity title that protects farmers against major production risks and frees private insurers from federal oversight. A privatized crop insurance program could then offer policies to farmers who wish to fill in any gaps in coverage.

Recent proposals to lower insurance deductibles under the guise of covering “shallow losses” would be especially counter-productive. Meaningful deductibles serve a public purpose by reducing the likelihood that farmers will alter their production practices to maximize their opportunities for an insurance payout. Lowering deductibles would create incentives for growers to “farm the program” – instead of their fields. The last thing Congress should do is to adopt one of the growing number of proposals that would modify ACRE and SURE to create a new safety net on top of the existing revenue insurance program. Unfortunately, momentum seems to be building to do exactly that.

One proposal currently attracting attention, called Aggregate Risk and Revenue Management (ARRM), was proposed by Sens. Brown, Thune, Durbin and Lugar. This program pays farmers when two things happen simultaneously: (1) crop revenue falls below an established crop revenue guarantee calculated for the farm’s crop reporting district (a collection of adjacent counties) and (2) crop revenue for the insured farm falls below a guaranteed amount established for that insured farm. The details of the plan are complicated, but in essence ARRM is designed to reduce a farmer’s deductible to only 10 percent when combined with a revenue insurance policy that covers revenue shortfalls below 75 percent. Taxpayers would cover the total cost of reducing the

deductible, and the farmer would pay no additional premium for the extra protection.

A federal program to cover “shallow losses” would exacerbate all the problems that current revenue insurance programs create because it would:

- multiply “moral hazard” – the tendency to create incentives for risky behavior – by socializing most of the risk of producing the covered crops.
- create significant incentives to increase production of the handful of covered crops – encouraging plowing up environmentally sensitive land and discouraging diversification of cropping systems.
- distort markets and recouple farm subsidies to the kind and amount of favored crops produced.
- increase the potential for large payouts to farm businesses that suffer only paper losses.

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.

References

1. According to Shields (2010), some portion of the \$2 billion in savings that was not used for deficit reduction will be spent to support premium discounts for producers and the Pasture, Rangeland, and Forage crop insurance program. Thus the cut to crop insurance will be less than \$6 billion.
2. Hagstrom, J. Agweek, "Congress Pushes for Farm Program Fixes." <http://www.agweek.com/event/article/id/19171/> accessed on September 29, 2011.
3. As of Sept. 29, 2011, RMA Summary of Business reports indicate that 36.77 million acres were insured with Yield Protection while 175.7 million acres were insured with Revenue Protection. The crops for which these products are available are corn, soybeans, wheat, cotton, rice, sorghum, canola, barley and sunflowers.
4. Unexpected price increases may result in a loss to farmers who forward contract their crop and do not produce enough to fulfill their forward contract.
5. An even more accurate indicator of farm family financial health would be farm revenue minus production costs plus off-farm family income. This would require basing insurance payments on tax returns, much as people who qualify for the earned-income credit do. Farm groups would bitterly oppose such a proposal.
6. The National Agricultural Statistics Service (NASS) surveys buyers for information about how much they pay for crops on a monthly basis. The season average prices in Figure 1 are the average price paid over the marketing year.