CUTTING WASTE IN THE CROP INSURANCE PROGRAM

ENVIRONMENTAL WORKING GROUP

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PREFACE

BY CRAIG COX

EWG SENIOR VICE-PRESIDENT FOR AGRICULTURE AND NATURAL RESOURCES

MISSING A GOLDEN OPPORTUNITY

The heavily subsidized federal crop insurance program is finally getting some of the scrutiny it so richly deserves, thanks in part to the series of analyses Professor Bruce Babcock has conducted for EWG. In response, the crop insurance industry and its supporters – unused to such searching examination – are busy defending the status quo with arguments that, in Professor Babcock's words, range from the ridiculous to the patronizing.

They also totally miss the point. The argument is not over whether farmers should be able to insure their crops. The argument is over how big a role government – and taxpayers – should play in making that insurance available.

Professor Babcock's work, summarized in this paper, makes a compelling case that government's role has grown far too large and far too expensive. As a result, farmers are encouraged to take on too much risk at the expense of the environment, and insurance companies enjoy windfall profits.

The good news is that insurance payouts of $6.2 billion would have been plenty to put a solid floor under corn and soybean growers' revenue even in drought-plagued 2012 – just the kind of year when taxpayers' support for struggling farmers is needed.

The bad news is that the actual payouts were more than twice as much – a total of $14.0 billion. Farmers were overcompensated by $7.8 billion because popular, highly subsidized – and deeply flawed – Revenue Protection (RP) insurance policies fail to account for the added revenue that farmers harvest when they sell their crops at drought-inflated prices.

The worst news is that Congress is poised to enact a suite of even more extravagant subsidies that would have taxpayers picking up much of the deductibles on farmers' underlying crop insurance policies. One of the new subsidies, called the Supplemental Coverage Option (SCO), would have increased payouts by another $6.5 billion if it had been in place in 2012, Professor Babcock calculates. That would have brought the total over-compensation to a whopping $14.3 billion.

Because the House and Senate agriculture committees are bent on pumping up crop insurance, food assistance for hungry kids and conservation programs that keep our water clean and sustain our food production are being targeted for harsh cuts.

As lawmakers finalize a new farm bill, they should reverse course and use their budget knives to cut out premium subsidies for Revenue Protection insurance policies that wildly inflate crop insurance payouts. That alone would save $8 billion over 10 years, according to the Congressional Budget Office. Reducing the money paid to profitable insurance companies to administer the program from $1.3 billion to $917 million a year would save another $5.2 billion. The combined savings would be more than enough to erase the cuts to food assistance and conservation and would be a down payment on more far-reaching reforms.

Lawmakers working on the farm bill are about to miss a golden opportunity to cut wasteful spending, reduce the deficit and reinvest in the tools and infrastructure that would ensure farmers' future prosperity, clean up our water and help produce the healthy food we need.

What a waste.

EXECUTIVE SUMMARY

Congress could dramatically cut spending on the federal crop insurance program without sacrificing anything other than the political objective of propping up a crop insurance industry that only exists because of taxpayer support. Cutting this spending would not necessarily mean providing farmers with less money, because the freed-up funds could be spent on programs that benefit both farmers and the public.

The need for crop insurance reform is best illustrated by the excess payouts to corn and soybean farmers that followed the 2012 drought, the first widespread drought in the Corn Belt since 1988. Many farmers lost much of their crop, but these yield losses led to sharply higher corn prices that buffered the financial impact for farmers who still had some crop to sell. Almost all Corn Belt farmers buy a type of insurance called Revenue Protection. They like it because when market prices rise after they buy the insurance, any loss in yield is compensated at the new, higher price. Thanks to the large insurance payments corn farmers got under these Revenue Protection policies in 2012, most of those who suffered a yield loss actually ended up with more revenue than they anticipated when they planted. Overall, corn and soybean farmers collected about $7.8 billion more in insurance payouts in 2012 than they would have gotten if the loss calculations had factored in the higher prices.

Because Revenue Protection provides this "Cadillac" insurance coverage, it has a "Cadillac" price tag, and taxpayers end up picking up most of the tab. Industry subsidies, in the form of administrative reimbursements and subsidized re-insurance, rise when farmers buy the more expensive insurance. And in years when Revenue Protection coverage does not generate large, taxpayer-funded payouts, it results in large windfall gains for the companies.

Because taxpayers pay most of the higher premiums for Revenue Protection coverage, farmers have a strong incentive to buy these plans. If they had to pay the extra cost themselves, their "need" for Revenue Protection would lessen considerably.

A sensible reform would be to provide farmers with enough of a subsidy to ensure that they participate in the program, but to limit it so that they buy only the level and type of insurance they actually need. Farmers who value higher coverage levels would pay the higher price to get it. This was the way that premium subsidies were implemented prior to the crop insurance "reform" of 2000 that dramatically increased subsidies. The stated reason was to get more farmers to enroll in the program and lessen the need for Congress to provide *ad hoc* disaster assistance, but the subsidy largesse resulted in giving farmers wasteful incentives to buy the most expensive insurance.

Congress is currently poised to make things worse by passing a new program, called the Supplemental Coverage Option, on top of existing crop insurance. This coverage would mirror the policies that farmers currently buy and result in even more over-compensation. If this program had been in place in 2012, corn and soybean farmers would have received an additional $6.5 billion on top of the payouts that had already made 2012 a profitable year.

A sensible subsidy structure could maintain crop insurance enrollment while reducing program costs by at least $20 to $30 billion over 10 years. More ambitious reform would save billions more. Currently the government entices the private sector to take on some of the risk of crop insurance through overly generous reinsurance agreements, with the result that taxpayers cover most payouts in high-loss years and the companies make billions in low-loss years. Rather than subsidizing companies with federal dollars, it would be cheaper and more efficient to provide a county-level revenue insurance program through the farm bill. The private sector would be free to offer farmers additional add-on insurance on commercial terms to those farmers who want additional risk management help and are willing to pay for it themselves.

There is no valid economic argument for having taxpayers taking on so much of farmers' risk. Congress should instead make investments that would ensure agriculture can prosper and sustain itself in the future, focusing on issues such as renewable energy, transportation, clean water and food safety that address the interests of both agriculture and the public.

Cutting Waste in the Crop Insurance Program

BY BRUCE BABCOCK, PROFESSOR OF ECONOMICS, IOWA STATE UNIVERSITY

INTRODUCTION

IN WASHINGTON, REDUCING WASTE, FRAUD AND ABUSE IS THE CLASSIC WAY TO DEAL WITH BUDGET DEFICITS. THERE IS USUALLY LITTLE DISAGREEMENT ABOUT WHAT CONSTITUTES FRAUD AND ABUSE, BUT DECIDING WHAT SPENDING IS WASTEFUL IS OFTEN CONTENTIOUS. OVER THE LAST TWO YEARS I HAVE WRITTEN A SERIES OF PAPERS FOR THE ENVIRONMENTAL WORKING GROUP IN WHICH I HAVE ATTEMPTED TO EXPLAIN HOW THE COMPLICATED US CROP INSURANCE PROGRAM WORKS, AND I HAVE ARGUED THAT MOST, IF NOT ALL, GOVERNMENT SUPPORT FOR THE PROGRAM IS WASTEFUL, BECAUSE IT COULD BE CUT OUT WITH NO HARM TO THE PUBLIC INTEREST.

Of course, the recipients of this government support – insurance companies, insurance agents, most farmers and the legislators these recipients support politically – disagree. They have a very different opinion about what constitutes waste in the crop insurance program. This is to be expected: Those who benefit from government subsidies always argue that their subsidies are in the public interest. But when the arguments routinely rolled out in favor of continuing subsidies for crop insurance are subjected to close scrutiny, it's obvious that they range from the ridiculous – the nation's food security depends on them – to the patronizing – farmers cannot manage financial risks on their own.

The plausible, if not defensible, explanations for why federal crop insurance subsidies exist include:

- The Agriculture Committees of the House and Senate feel that the farmers who are their constituents are entitled to subsidies.
- In the absence of subsidized crop insurance, Congress would vote for even more wasteful spending in the form of *ad hoc* disaster assistance.
- The politically powerful crop insurance industry profits handsomely from federal premium subsidies.

Most economists agree that the best way to meet the first objective – providing subsidies to farmers simply because they are farmers – is through direct cash payments fixed at an amount that is not influenced by crop prices or any decisions a farmer makes. "Decoupling" payments from crop prices and planting decisions ensures that farmers respond to market prices, not the amount of subsidies they can claim. Such fixed payments do not distort planting decisions or influence market prices. There is budget discipline because payment levels are known ahead of time. And there is more transparency because everybody can see why the payments are being made. Congress adopted decoupled "direct payments" in 1996, and farmers continue to receive them today.

Soaring farm income since 2006 has called into question the wisdom and equity of continuing to provide cash payments to farmers when times are so good. Both the current Senate and House versions of the farm bill propose to end these payments.

Surprisingly, however, similar scrutiny has not focused on crop insurance subsidies. The cost to taxpayers of providing crop insurance subsidies has increased dramatically since 2006. In a rational world, public support for agriculture should increase when times are bad, not when times are good. But that is not what has happened. Agriculture's patrons in the House and Senate evidently noticed this lack of scrutiny to crop insurance subsidies and decided that they could continue to subsidize farmers even in the good times if they did so under the guise of providing farmers with a better "safety net" that makes payments only when a "loss" occurs. Thus was born the new programs that are now in the House and Senate versions of the farm bill.

My objective in writing this paper is to revisit and summarize my previous studies to demonstrate that Congress could dramatically reduce subsidies to crop insurance companies and farmers without sacrificing the policy objective of maintaining sufficient participation to limit demands for *ad hoc* disaster assistance. Moreover, a cut in subsidies does not necessarily mean less support for farmers, because the freed-up funds could be spent on programs that benefit both farmers and the public.

OVER-INSURING CROPS WASTE TAXPAYERS' MONEY

Crop insurance supporters typically argue that farmers need subsidized insurance to guard against losses in crop yields caused by the vagaries of nature. They argue that insurance against losses due to drought, flood, high winds or pestilence enable farmers to cover their production costs and ensure that they can plant another crop. In 2013, however only about 12 percent of the insured acreage of corn, soybeans, wheat and cotton carried insurance policies that cover lost yield, known as Yield Insurance.

Instead, farmers overwhelmingly choose policies that pay out anytime crop prices fall, yields drop or there is some combination of the two. In theory, insuring revenue rather than yield makes sense, because farmers pay their bills with money, not bushel baskets of their crop. If prices turn out to be better than expected, a farmer can still have a good year even if yields drop because of bad weather. Conversely, if production is good but prices are lower than expected, a farmer can have a bad year despite strong yields. Insuring revenue rather than yield takes into account these interactions between crop yield and price.

Under the crop insurance program, growers can choose between two types of subsidized policies that insure revenue.

I call the first type "pure revenue insurance" because it comes closer to meeting the policy objective of generating payouts only when producers actually experience a decline in revenue. The policies pay out when revenue at harvest falls short of a guaranteed level, which is set before the crop is planted. Because harvest revenue is determined by price *and* production, any combination of the two that leads to lower revenue triggers a payout. Low production caused by bad weather affecting large regions – the so-called "systemic losses" that crop insurance supporters claim crop insurance should cover – often results in a higher market price. The

TABLE 1

ALTERNATIVE CROP INSURANCE PAYMENTS IN 2012

	$ Billions		
Insured Crop	**Actual Payouts**	**Pure Revenue Insurance Payouts**	**Yield Insurance Payouts**
Corn	$11.83	$5.31	$8.48
Soybeans	$2.13	$0.89	$1.70
Total	$13.96	$6.20	$10.18

higher market price at which farmers sell the crop offsets some or all of the financial impact of their yield loss. Similarly, bumper crops often depress market price. Pure revenue insurance accounts for both of these scenarios. It triggers payouts only if the product of price and production drops below the insured level.

The 2012 drought in the corn belt was just the kind of event that generates systemic losses. If all corn and soybean farmers had chosen pure revenue insurance in 2012, the payouts would have totaled $6.2 billion (see Table 1). But actual payouts added up to $13.96 billion.

The reason actual payouts were so much larger is that corn and soybean farmers overwhelmingly chose the other type of subsidized crop insurance. I call this "Cadillac" insurance because it does not account for the financial benefits of high prices when calculating the effects of low yield, whereas it fully covers the financial impact of low prices at times of high production.

"Cadillac" crop insurance – its official name is Revenue Protection – works exactly the same as pure revenue insurance when the price at harvest time drops below the insured price that was determined before planting. When crop prices rise during the growing season, however, Revenue Protection policies actually increase the revenue guarantee. This feature turns a revenue insurance policy into a yield insurance policy, because the lost production is valued at the higher harvest price rather than the price at planting. Thus farmers covered by this "Cadillac" insurance can collect a payout even when higher crop prices give them the same revenue they expected when they planted.[1]

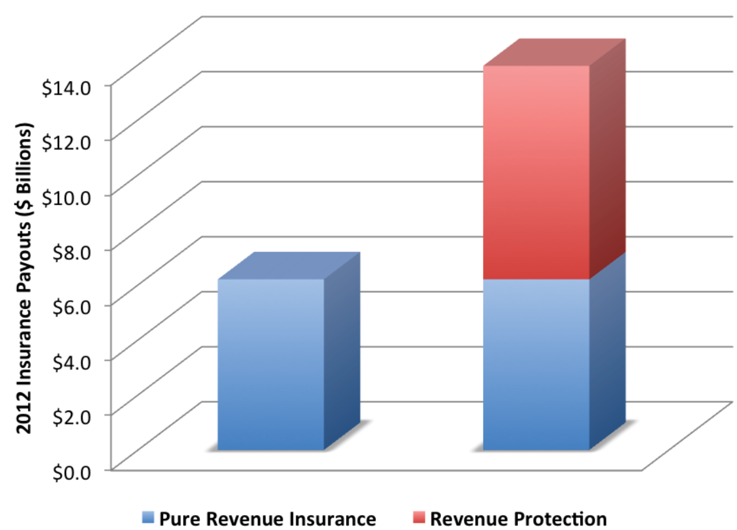
The 2012 Corn Belt drought led to widespread yield losses that drove up corn and soybean prices substantially between planting and harvest. The "Cadillac insurance" policies that most farmers chose likely over-compensated farmers for any actual drop in revenue, because the policies didn't reduce payouts to account for the greater revenue resulting from the higher drought-induced prices.

Perhaps the best measure of this over-compensation is the difference between the crop insurance payouts that insured farmers would have received if they had purchased pure revenue insurance and the actual payouts in 2012 (Table 1). That comparison indicates that actual payouts over-compensated producers by $7.8 billion, or 125 percent. Yield Insurance policies would have over-compensated producers by 60 percent ($4.0 billion), because those policies also do not account for the higher revenue from drought-inflated prices. My calculation does not imply that farmers received any payment in excess of what they were entitled to under their insurance contracts. It is simply the amount of payment that exceeded what they would have gotten if the higher prices had been accounted for in the insurance contract they signed.

Some measure of over-compensation was likely built in to pure revenue insurance as well in 2012, because it was based on prices that were historically high even before the drought hit. However, the additional over-compensation triggered by the generous premium subsidies that entice farmers to buy "Cadillac coverage" is stunning (Figure 1).

FIGURE 1

SUBSIDIZED "CADILLAC COVERAGE" RESULTED IN $7.8 BILLION IN WASTEFUL PAYOUTS IN 2012



Taxpayers pay most of farmers' crop insurance premiums, so it is not surprising that most farmers choose "Cadillac" coverage. Of course, just as "Cadillac" health insurance coverage costs more than more standard coverage, so too does "Cadillac" crop insurance. Most people who are covered by high-end health insurance choose these plans because their employers pay most of the extra cost. Employees would take much more care in assessing whether the benefits justify the extra expense if they had to pay the full cost.

The same is true of crop insurance. Over-subsidized premiums lead farmers to choose the most expensive type of crop insurance – Revenue Protection. This choice greatly inflates the government's cost because it over-compensates farmers for losses and over-compensates the insurance industry for running the program.

WINDFALL PROFITS FOR INDUSTRY COST TAXPAYERS BILLIONS

Subsidizing "Cadillac" Revenue Protection policies is the first layer of waste in the current crop insurance program. An additional layer of waste is the over-compensation that crop insurance companies receive. Although crop insurance contracts are sold and serviced by private companies, the expense of selling and managing those policies, adjusting losses and managing underwriting risks is largely paid by taxpayers, because premiums paid by farmers cover only about 30 percent of the program's cost.[2]

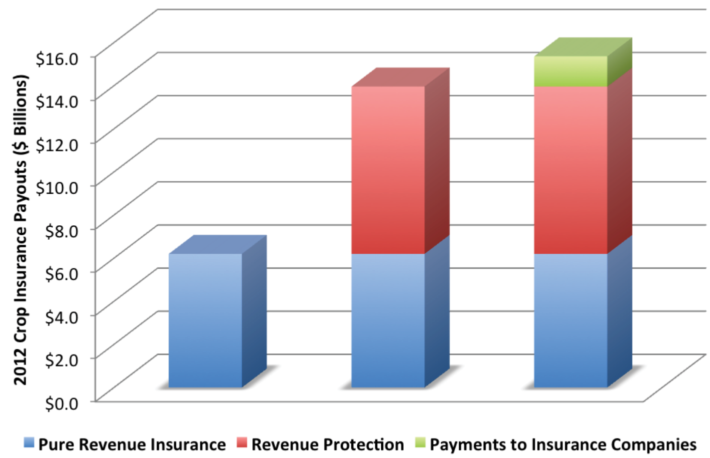
Using private insurance companies to provide crop insurance adds to the cost in two ways.

First, the federal government directly pays the companies for the administrative costs that would normally be built into the cost of a policy. These so-called Administrative and Operating (A&O) reimbursements totaled $1.4 billion in 2012, adding one more layer of spending.

The procedure used to share underwriting gains and losses between insurance companies and taxpayers adds yet another layer, because it is weighted in favor of the companies. The complicated

FIGURE 2

PAYMENTS TO COMPANIES ADD TO THE COST OF CROP INSURANCE



formula used by the program ensures that the government sends large sums to the companies when losses are small and makes most of the payouts when losses are large. As a result, between 2002 and 2012 companies enjoyed about $10 billion in underwriting gains while taxpayers suffered a net loss of $700 million. In fact, taxpayers paid more to insurance companies than to farmers in six of the last 12 years.

Even in high-loss years such as 2011, companies had large underwriting gains at the expense of taxpayers. Companies did experience an underwriting loss of $1.5 billion in 2012 – the worst drought year in the Corn Belt in a decade – but taxpayers had underwriting losses that were more than three times higher – about $5 billion. That demonstrates that companies make a lot of money in low-to-moderate loss years, and taxpayers bear most of the burden in high-loss years..

The cost-reimbursement formulas that determine how much money the private sector makes from the program are designed so that the more insurance farmers buy, the more money the companies make. The companies have every incentive to sell farmers high levels of insurance, inflating the cost every year – not just in bad drought years like 2012.

The two factors that most influence how much insurance farmers buy are cost and the likelihood of a payout. There is usually a tradeoff between the two, because more frequent payouts usually come at increased cost. But federal premium subsidies lessen that tradeoff, with the result that high levels of insurance that pay off more frequently are mostly paid for with taxpayer dollars, rather than a farmer's own money.

Consider a farmer who faces the choice of buying pure revenue insurance at an unsubsidized premium of $100,000, versus an equivalent amount of Revenue Protection at an unsubsidized premium of $150,000.[3] Given the difference in premium, Revenue Protection should cost the insurance company about $50,000 more in payouts on average. Without government subsidies, this farmer would weigh the extra benefits of Revenue Protection – including the $50,000 extra in average payouts – versus the $50,000 cost. Farmers who place a high value on the extra risk protection would buy Revenue Protection. Those who have more cost-effective ways of managing their risks would not.

Now suppose the government offers a 60 percent premium subsidy, so that $100,000 worth of pure revenue insurance costs only $40,000, and $150,000 worth of Revenue Protection costs $60,000. Farmers would only have to pay $20,000 more for Revenue Protection, rather than $50,000 more. A much larger proportion of farmers will make the Revenue Protection choice when the incremental cost of "Cadillac" insurance coverage is so much lower.

This premium subsidy explains why most farmers choose Revenue Protection, a choice that inflates both company profits and taxpayer costs. For example, for each farmer who chooses to buy $150,000 worth of Revenue Protection instead of $100,000 worth of pure revenue insurance, the crop insurance industry collects an additional $15,000 in extra reimbursement from the government.[4] This is in addition to the extra $30,000 that taxpayers pay in higher premium subsidies for each farmer who chooses the more expensive Revenue Protection.

Crop insurance companies clearly benefit from premium subsidies. Just as health insurers are among the biggest supporters of premium subsidies in the Affordable Care Act, crop insurance companies are the biggest backers of premium subsidies for crop insurance. What company would not want the price of its product to be subsidized by the government? Furthermore, for crop insurance companies, the more insurance farmers buy, the more money the company makes. This explains why industry is the biggest defender of premium subsidies that increase the cost to taxpayers even as they swell corporate bottom lines.

FARM BILL PROPOSALS WILL ADD TO THE WASTE

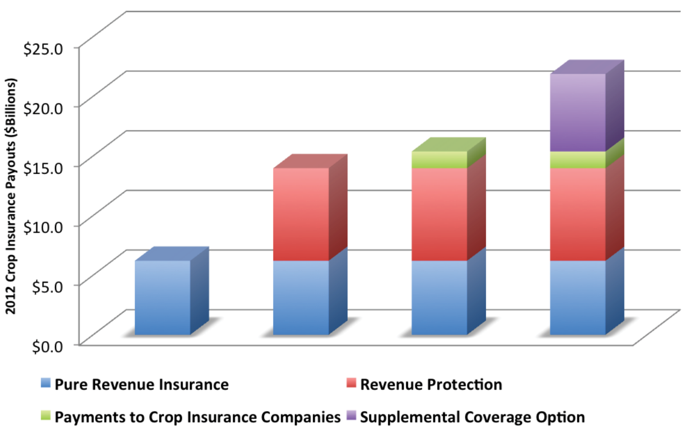
The crop insurance program has long been riddled with waste, and the agriculture committees in Congress are poised to make things much worse.

The committees are proposing to layer on a suite of new subsidies in exchange for ending direct cash payments to farmers. One of these is called the Supplemental Coverage Option (SCO). As its name suggests, SCO would add a new layer of coverage on top of a farmer's existing crop insurance policy. Both the Senate and House versions of the farm bill specify that this additional insurance will match the type of coverage in the farmer's underlying policy. This means that almost all of the new SCO policies would mimic the "Cadillac" coverage provided by Revenue Protection.

The reason Congress wants to create these new subsidy programs is, in my view, to continue making payments to farmers, but in a way that makes it appear that the payments are compensation for losses. Rather than using tax returns or financial statements to determine when a loss has occurred, Congress would make that decision by the way it has designed the new program. As a result, under SCO farmers would receive even higher payouts on top of the over-compensation they already receive from Revenue Protection coverage.

If SCO had been in place in the 2012 drought year, I calculated it would have paid out an additional $6.5 billion to corn and soybean farmers who had Revenue Protection policies.[5] This would have been on top of

FIGURE 3
SCO WOULD HAVE ADDED $6.5 BILLION IN WASTEFUL SPENDING



the $7.8 billion in over-compensation provided by the Revenue Protection policies alone.

In 2012, the combination of Revenue Protection and SCO would have paid out so much that most corn growers would have ended up with income well above the record-high levels they anticipated when they planted their crop. For example, I calculated that with the combination of payouts from Revenue Protection, SCO and crop sales at drought-inflated prices, Illinois corn farmers in drought-plagued Champaign County would have had 15-to-30 percent more revenue in 2012 than the $1,136 per acre they anticipated in the spring.[6] Making somebody more than whole after a loss clearly fails any test of efficient use of taxpayer funds.

The farm bill being debated in a House-Senate conference committee would waste taxpayer dollars in other ways, too. In addition to the SCO proposal, the committee is considering a new target price program that would guarantee minimum prices for farmers and a new revenue guarantee that would cover part of farmer's crop insurance deductible. Layering these new subsidies on top of "Cadillac" crop insurance plans would take too much risk out of crop production, in addition to generating payouts that could push farm income above market levels at planting time.

FARMERS ACT DIFFERENTLY WHEN TAXPAYERS TAKE ON THE RISK

When financial risk is transferred from farmers to taxpayers, farmers respond by taking on more risk. They increase rent bids for land, expand more aggressively, manage crops less carefully and are more willing to grow crops on marginal land. Moreover, when government programs increase anticipated crop income above market levels, farmers' planting decisions reflect the programs' incentives, rather than the market's, particularly when farmers can affect the amount of subsidies they received through their planting decisions. Crop insurance subsidies and some of the new programs being considered by Congress are not decoupled from planting decisions, so we should expect to see farmers planting for the subsidies, rather than the market.

Congress is creating these new programs not to solve actual financial problems facing agriculture but to repackage direct cash payments into a more politically palatable form. An interesting hypothetical question is what proportion of actual farmers, the supposed beneficiaries of these new programs, would vote for the package of programs and crop insurance that is emerging in the new farm bill. When taxpayers take the risk out of agriculture, it disproportionately benefits those farmers who do not effectively manage risk. Furthermore, a look at 2012's political map shows overwhelming support for conservative candidates in areas where farmers live. It would be surprising if conservative-voting farmers would support such extensive government intrusion into their own and their neighbors' decision-making.

STEPS TOWARD A FISCALLY RESPONSIBLE SAFETY NET

The drought-plagued year of 2012 was a test of how the current and proposed add-ons to crop insurance perform in just the kind of scenario used to make the case for subsidized insurance. The result? Taxpayers could have put a solid floor under corn and soybean growers' revenue at a cost of $6.2 billion.

Instead, actual payouts to the farmers totaled $14 billion.

Thankfully, such large costs do not occur every year. I focused on 2012 because it is the only year on record that demonstrates how the crop insurance program works today. Most crop insurance business operates in the Corn Belt, and 2012 is the first year since 1988 when there were large yield losses there. The inflated payouts in 2012 came from the type of insurance nearly all farmers buy – Revenue Protection. Because this provides "Cadillac" coverage, it inflates the program's cost year after year through higher premium subsidies for farmers and larger operational subsidies for insurance companies.

Congress could and should take two important and immediate steps to move toward a fiscally responsible farm safety net:

1. Eliminate the proposed new crop insurance add-on programs, such as SCO, from the new farm bill.
2. Scale back premium subsidies in the existing crop insurance program.

But Congress should consider even more fundamental reform that would limit the taxpayer subsidies to county-based insurance programs that only pay out only in the event of large-scale disasters or sudden and steep price declines.

ELIMINATE CROP INSURANCE ADD-ONS

Congress seems poised to adopt new crop insurance add-ons that would take even more risk out of crop production in the name of providing farmers with a stronger safety net. There is no valid economic argument for having taxpayers take on as much of farmers' risk as existing crop insurance programs do, let alone even more. The reason Congress wants to pass these add-ons is that there seems to be less scrutiny of subsidy programs that purport to pay farmers only when a "loss" occurs, especially if the new programs purportedly save money. But these savings will be illusory if crop prices drop significantly from their current record levels, and the new programs would greatly insulate US agriculture from fundamental market forces that should dictate what farmers plant and how they farm. Congress should resist passing new safety net programs that serve no public interest.

SCALE BACK PREMIUM SUBSIDIES

One concrete policy objective of crop insurance subsidies is to enroll enough acreage at high enough coverage levels to minimize the need for *ad hoc* disaster assistance. Widespread participation in the crop insurance program certainly requires subsidies, because most farmers would not insure their crops if they had to pay for it on commercial terms. Some level of subsidy, is needed.

However, subsidizing farmers so heavily that they choose to buy low-deductible "Cadillac" insurance is not necessary to maintain enrollment. The cost of the program could be easily reduced by at least 30 percent if subsidies were capped, because farmers would find that they need "Cadillac" insurance much less if they have to spend their own money to buy it.

If the goal of reform is to cut wasteful government spending, premium subsidies should be capped at a dollar-per-acre amount that is enough to get farmers into the program. Whether this is $10 or $15 per acre is less important than ensuring that farmers use their own dollars to buy the extra insurance. This is exactly how premium subsidies were set prior to passage of the 2000 Agriculture Risk Protection Act (ARPA). Until that time, the dollar amount of premium subsidy available to a farmer could not exceed the dollar amount available if he or she had purchased a yield insurance policy with a 35 percent deductible (See Box: A Short History of Premium Subsidies).

This simple change would keep enrollment high, avoid the need to pass *ad hoc* disaster assistance programs and reduce costs by billions of dollars a year – billions that could be returned to agriculture in ways that serve the interests of both farmers *and* the public.

Consider what would happen with such a simple change in how premium subsidies are determined. Suppose that the subsidies were limited to the dollar

A SHORT HISTORY OF PREMIUM SUBSIDIES

Understanding why premium subsidies are structured the way they are today requires a bit of a history lesson.[7]

The Agricultural Risk Protection Act (ARPA) of 2000 doubled the share of policy premiums paid by taxpayers to about 62 percent on average. Previously, premium subsidies had been calculated quite simply: The dollar amount of subsidy available to each farmer could not exceed the amount available if he or she had purchased a yield insurance policy with a 35 percent deductible. This meant that farmers had to pay the full incremental cost of a lower-deductible policy or a more expensive revenue insurance policy.

Farmers in most regions of the country responded by buying 35 percent deductible policies. One reason was that this was the minimum amount they had to spend to acquire the fixed premium subsidy. Another reason was that USDA overestimated how much more farmers should pay for a lower-deductible policy. USDA overcharged farmers for lower-deductible policies everywhere but in the lowest-risk areas of the Corn Belt. Not surprisingly, only low-risk farmers chose to buy low-deductible policies. Farmers in higher-risk areas who were charged too much for lower deductible policies stayed with 35 percent deductibles.

To get farmers to buy more insurance and avoid *ad hoc* disaster programs, USDA could have revised its premium structure to more accurately reflect the extra amount that farmers outside the Corn Belt should be charged. Instead, Congress decided to lower the incremental cost of lower-deductible policies by increasing premium subsidies. The cost of buying lower-deductible policies was cut in half with the 2000 act. Not surprisingly, farmers responded by buying lower-deductible policies.

An additional change made by ARPA was that the same premium subsidy percentage available to farmers who purchased yield insurance was also made available to those choosing revenue insurance. This dramatically lowered the farmers' cost of switching to more expensive revenue insurance policies. Farmers responded by buying the most expensive type of revenue insurance.

In the end, USDA did improve the way it determined how much more to charge farmers for lower-deductible policies. The agency made this change when it was forced to reconcile differences in how much it charged for two revenue insurance products, Revenue Assurance and Crop Revenue Coverage. This resulted in a dramatic decrease in the incremental cost of lower-deductible policies beginning in the mid-2000s.

This meant that the share of premiums paid by taxpayers became far larger than was necessary to compensate for the previous over-charging for lower-deductible policies. Today these far-too-generous premium subsidies are being applied to expensive revenue insurance policies, giving farmers a powerful incentive to buy "Cadillac" coverage. Not surprisingly, farmers have responded by buying more insurance and the most expensive types of insurance.

The fact that we got to the current level of premium subsidies more by accident than design does not lessen the tyranny of the status quo. The current subsidies serve the interests of the crop insurance industry by heavily subsidizing the most profitable product they sell. Capping premium subsidies at a set dollar amount, as was done prior to ARPA, would result in billions of dollars in savings annually. These changes would have almost no impact on farmer participation and would not negatively affect farmers' ability to manage risk.

amount available with pure revenue insurance. In the example I have been using, this would mean that a farmer who bought $100,000 worth of pure revenue insurance and another who bought $150,000 worth of Revenue Protection would both get a $60,000 premium subsidy. The farmer-paid premium would be $40,000 for pure revenue insurance and $90,000 for Revenue Protection. It would then cost a farmer an extra $50,000 to buy Revenue Protection – instead of just $20,000 extra.

In this situation, far fewer farmers would opt to buy the extra protection because the full additional cost would be paid out of their own pockets, not the taxpayers'. Undoubtedly some farmers and crop insurance companies would argue that this change would be unfair and make Revenue Protection "unaffordable." But where is it written that taxpayers are obligated to make "Cadillac" insurance affordable? Giving farmers incentives to buy such generous insurance plans generates no benefits for taxpayers. The affordability argument is also disingenuous, because farmers would still be able to buy Revenue Protection for $40,000 less than it costs to provide, and they could still buy $100,000 worth pure revenue insurance for only $40,000.

This simple change in how premium subsidies are calculated would have little, if any, effect on the number of acres insured by the program, but it would dramatically decrease its costs. In this example, the taxpayer cost would decrease by $45,000 for each farmer who opted for pure revenue insurance: $30,000 from smaller premium subsidies and $15,000 in lower reimbursements to companies. Given how much farmers have responded to premium subsidies, most would react to this change by switching to pure revenue insurance. The resulting 30 percent cut in costs, applied to the projected program cost from 2014 to 2023, would save $23 billion and reduce crop insurance industry revenue by 30 percent.

That such a modest reform proposal would save so much money illustrates that the current direction of federal farm policy in "strengthening the farmer safety net" is deeply misguided. Farmers do not buy "Cadillac" crop insurance because they need it; they buy it because it is subsidized. If it takes a subsidy to entice somebody to buy a product, it's a sign that he or she can do without it. The idea that farmers "need" more assistance to manage risk fails the market test.

Members of the agriculture committees of the House and Senate want to help their constituents, but it would be more sensible to bolster agriculture not with handouts but with new tools and investments to ensure its future prosperity. Instead of repackaging direct payments into crop insurance add-ons that farmers don't need, why not take the savings and invest them to enhance the transportation infrastructure important to agriculture? How about investing in the infrastructure needed to replace gasoline with future production of cellulosic biofuels? How about creating infrastructure to strengthen agriculture's ability to adapt to climate change, rather than bailing out farmers who do not adapt? Why don't we reduce subsidies and use the savings to invest in lessening agriculture's damage to water quality and wildlife habitat, or in lowering its greenhouse gas emissions?

Placing a realistic cap on premium subsidies is a simple but powerful way to move the crop insurance program in a more fiscally and environmentally responsible direction. But Congress should consider even more fundamental reform of the safety net taxpayers are asked to support.

FUNDAMENTAL REFORM

Capping crop insurance premium subsidies at a set dollar amount, as was the case prior to enactment of the Agricultural Risk Protection Act in 2000, would be an important step forward. But a more ambitious reform that would still meet the objective of high enrollment would be to limit government involvement in risk management to a program modeled on the existing Group Risk Income Protection (GRIP) plan. GRIP coverage is based on average county yields, rather than individual farm yields. The benefits of a county yield-based program is that it is easy to administer, does not distort how farmers farm and insures against widespread weather calamities that advocates of crop insurance claim that they want to cover.

The downside of county coverage is that when the program pays out, the money goes to all participating farmers in the county, even if some suffered no loss. Additionally, some farmers who suffer an individual loss will not get a payout unless enough of his or her neighbors lose enough yield to lower the countywide average.

Under this system, taxpayer-funded crop insurance subsidies would be limited to county-based pure revenue insurance. Those farmers who want “Cadillac” Revenue Protection-type insurance would have to pay for it. Limiting the government’s role in growers’ risk management options in this way would encourage the private sector insurance industry to develop innovative and affordable options to help farmers deal with unique, individual production risks. Farmers who need additional coverage based on farm-specific yields could turn to the invigorated private sector, which would design add-on policies that complement the county-based program.

This program would save billions of dollars that could be used reduce overall government spending and to invest in agriculture’s future prosperity. If the program were subsidized at $10 or $15 per acre, enough farmers would participate to keep Congress from having to pass *ad hoc* disaster assistance programs. And the program would intrude much less on farmers’ financial decisions than the programs currently in play in the deliberations over a new farm bill.

Because such an ambitious crop insurance reform must overcome opposition from the crop insurance industry, the lessons of previous reform efforts may be useful. Peanut and tobacco farmers’ opposition to reform of their programs was overcome by buying them out. Why not buy out the crop insurance industry? One year’s savings from reform of the program should total at least $3-to-$5 billion. Some portion of these savings could finance a transition of the industry from a system beholden to taxpayer subsidies to one that offers farmers innovative and affordable products that meet their individual needs. Crop insurance would become a truly competitive marketplace, with all the advantages such markets produce. Farmers would be offered a wide array of risk management options, taxpayers’ costs would be capped and farmers would have a solid safety net to protect them from potentially crippling losses caused by factors beyond their control.

ENDNOTES

3. For additional details about how revenue insurance creates wasteful spending, see Babcock, B. "The Revenue Insurance Boondoggle: A Taxpayer-paid Windfall for Industry" published by the Environmental Working Group.

4. For more details see Babcock, B. "Giving it Away for Free: Free Crop Insurance Can Save Money and Strengthen the Farm Safety Net" published by the Environmental Working Group.

5. Equivalent insurance means equal revenue guarantees at planting time for the two insurance products.

6. Crop insurance companies receive average net underwriting gains and A&O reimbursements equaling approximately 30 percent of unsubsidized premium.

7. See "Babcock, B. "Pumped Up: How Supplemental Insurance Could Bulk Up Farm Subsidies" published by the Environmental Working Group.

8. Ibid.

9. See Babcock, B. "Impact of Scaling Back Crop Insurance Premium Subsidies" published by the Environmental Working Group for more details.