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The Morphing Of Crop Insurance

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The news that the USDA Risk Management Agency is in the process of renegotiating the terms of the basic agreement with crop insurance companies comes at a time when the Obama administration has questioned the generosity of the payments these companies receive over and above the USDA share of the risk involved.

This renegotiation offers an opportunity to look at the rationale for subsidized crop insurance as a component of the safety net offered to farmers. These insurance products insure farmers against yield loss, income loss and various combinations of the two.

We grew up at a time when the only kind of crop insurance available was hail insurance. In deciding on the purchase of this insurance farmers decided on the chance that they would be hailed out against the cost of the premium. Farmers also had, and still have of course, access to hail, wind, and fire insurance on their buildings and liability on their property.

All of these insurances were available without government subsidies. They were available through a wide variety of companies from township mutuals to nationally known firms. The companies made these offerings because the protected perils represented a random set of occurrences whose probability of independently happening to an individual policy holder could be calculated from past experience.

The premium charges included a portion to cover the actual risk, the sales and administrative costs of issuing the policy, a portion set aside in a reserve, a small premium paid to a reinsurance company to diversify their risk, and finally some profit that would be shared with the policy holders/owners if it was a mutual insurance company or the stockholders if it was a stock company.

These companies stayed away from insuring risks that were systemic, that is, risks that could affect all or a large share of their policy holders in a given year. Risks like these include crop prices, and yield. If there were a drought, it is likely that it would affect most of the farmers in the county or even in the state or broader sections of the country. As a result, for a private insurance company to insure yield, the premiums would typically have to be higher than most farmers would be willing to pay.

The same is even more true for price because experience shows that crop agriculture has experienced long troughs of low prices punctuated by price bubbles, and – in contrast to hail – all farmers experience the price declines. There is virtually no way that insurance companies could build up large enough reserves to pay costs that could run into the billions of dollars for four or more years at a time.

So how did insurance companies get in the business of subsidized crop insurance in the first place?

There were a number of factors, one of which was the necessity of Congress passing disaster aid bills to cover various widespread problems like floods and droughts. Given the variability of disaster occurrences and the logistical and political difficulties of targeting payments to those who were actually affected, the draw on the Federal budget varied widely from year to year, creating budgeting problems.

Some in Congress saw subsidized crop insurance as a way to even out the costs by paying an insurance company a subsidy to take on these risks. That way Congress would not have the bother of annual disaster packages, deciding who is in and who is out, and the variability in costs.

For others, crop insurance provided a way to "privatize' the problems of yield and crop price that they hoped would make the farm program World Trade Organization (WTO) compliant in that the government was not directly providing subsidies to farmers. While the expanded use of subsidized crop insurance may not pass WTO muster if challenged by other countries, some felt that it was a way to get the money off the books.

With subsidized crop insurance, several problems arose. First farmers were forced to purchase crop insurance if they wanted to be eligible for any additional disaster payments that could be provided by Congress. Thus the cost of the insurance premium had to be added to the cost of production of the crop.

Second, farmers in higher risk areas began to plant crops like corn. Without the insurance subsidy, the production of corn in a number of marginal areas was too risky, so farmers planted crops or pastures more appropriate for the area. With crop insurance they couldn't lose. If the crop survived, they had the more valuable corn to sell. If the crop failed they could collect crop insurance. As a result they had a guaranteed income that was higher than they would have with traditional crops for that area.

The inclusion of these areas increased the cost of crop insurance for everyone, but especially taxpayers.

Besides those in high-risk areas, who benefits from subsidized crop insurance as compared to the way it was before?

For one the insurance companies like subsidized crop insurance because they can't lose – the government subsidizes the risk above an agreed upon level. In addition the government payments cover a portion of the cost of their operation plus a reasonable profit on the policies put in force.

Local insurance agents love subsidized crop insurance because farmers are virtually required to have it. Bankers are reluctant to give loans to farmers who aren't adequately insured, providing additional pressure to purchase the insurance. For local agents it is like shooting fish in a barrel. Their only challenge is to beat out the other insurance agents in the area.

To help local agents do that, they are provided money from their insurance companies' home offices to pay a share of the cost of advertising the insurance. Ad salespeople from local newspapers and radio stations love the program because it brings in a stream of money from insurance agents competing with one another for a fixed pool of customers.

Given the reaction of local insurance agents to the program, it is clear that the commission they receive is high enough to make it well worth their while to compete to write this insurance. After the year's crop insurance deadline, they go back to selling life, casualty, disability, and health insurance.

Though the problems with the programs have begun to show and the Obama administration would like to pare the costs down, the program continues to have its advocates in Congress.

It seems that the insurance industry, like heavy industry and the defense industry before them, has come to enjoy the benefits of a pipeline to federal dollars. Defense industries are able to survive appropriation battles in Congress because they have strategically placed suppliers in a sufficient number of states and Representative districts to ensure a positive vote. There are few in Congress who can resist bringing home some "pork" for their district.

Similarly, besides their trade organizations' highly motivated lobbyists, crop insurance companies have company headquarters and local agents in enough Congressional districts to ensure consideration.

This demographic makes it difficult for Congress or the administration to make significant cutbacks in the program, even though it could be delivered less expensively through direct government programs via the existing county offices of the USDA's Farm Service Agency. ∆

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