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Institutional Barriers to an Insurance-Based Farm Safety Net

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Institutional Barriers to an Insurance-Based Farm Safety Net

Since the advent of revenue-based insurance products in the mid-1990s, crop insurance and farm support programs have been on converging paths. In the ongoing debate and discussion over the re-authorization of the Farm Bill, crop insurance has figured as a component of the farm income safety net to a much greater degree than ever before. In fact, a number of proposals would essentially convert all farm support spending to insurance designs.

Current federal budget realities provide a compelling reason for a shift in spending priorities away from direct government support. Moreover, as a political matter, the income position of program crop farmers relative to the general population of taxpayers has made continued direct support to agriculture increasingly problematic. However, there are also substantial obstacles to be overcome in effecting a shift from direct support to insurance-based support. Over the 80-plus years that farm programs have been in place, powerful institutional arrangements have developed within the framework provided by the federal farm programs. (For a good discussion on this topic, see Rausser, 1982.) These arrangements and the entrenched interests they support are understandably resistant to a wholesale change in the way farm support is provided.

Increasingly, there is tension between those groups who are invested in traditional farm support programs and the growing number of groups who are invested in an expanded role for the federal crop insurance program. For several commodities, the historical share of government support as a portion of their overall income level remains high. Often these are the same commodities where the crop insurance programs are at least perceived to be not particularly effective. For other commodities, traditional farm program designs based on fixed nominal support prices are now so far out of the money that producers see little if any reason to continue devoting scarce resources to the vestiges of these policies and are ready to make the complete shift to insurance based systems.

The objective of this paper is to provide an assessment of the competing interests in the debate over farm policy design. More specifically, this paper examines the sources of resistance to insurance-based farm income support and discusses the circumstances under which institutional barriers to a shift to such support might be overcome. Particular focus will be given to how different interest groups view traditional farm program support versus crop insurance, exploring the reasons for their differences of opinion.

Historical Development of Farm Programs and Crop Insurance

Federal farm programs and federally-supported crop insurance both have a long and interesting history. Federal farm programs were initially established with the Agricultural Adjustment Act (AAA) of 1933. While private crop insurance covering named perils (e.g., hail or fire) had been offered for many years, federal involvement in multi-peril (or “all-risk”) crop insurance was first established with the Federal Crop Insurance Act of 1938. Despite their common roots in the New Deal, there was little if any correspondence between these programs

for most of their history. Crop insurance remained, effectively, a pilot program (Glauber, 2004) – receiving little attention from farmers and even less from policy makers. Farm programs, on the other hand, quickly evolved into the focal point of US agricultural policy.

The rapidity with which federal farm programs became an entrenched feature of the political landscape is today perhaps an underappreciated phenomenon. One could argue that farm programs were an entrenched phenomenon almost since the beginning of the Republic. The Homestead Act, The Morrill and Smith-Lever Acts, and Capper-Volstead were, of course, landmark pieces of legislation that clearly comprised something of a farm (and/or rural economic development) program. But federal policy prior to 1933 had never been concerned with direct interventions in the market for the purpose of supporting farm incomes.

It should be recognized that by the time the first AAA was passed in 1933 – under the dire circumstances of the Great Depression – farm interests had been agitating, with little success, for direct federal price and/or income support of some kind for well over a decade: since the commodity price collapse following World War I. In the 1920's, farm groups instigated five unsuccessful runs to pass the McNary-Haugen domestic price support plan – the last two of which ended with presidential vetoes by Coolidge.¹ In 1929, Congress passed the Agricultural Marketing Act establishing the Federal Farm Board, which would attempt to support commodity prices through means of judicious open-market purchases. Predictably, it failed to have much impact; and its failure (at a time of considerable financial distress in the agricultural sector) increased both the frustration of agricultural interests and their determination to achieve a more aggressive approach to farm income support.

Farm groups agitating for a more robust federal response to their problem of chronically low commodity prices and incomes finally found an eager ally in President Roosevelt. In May, 1933 the AAA was passed as part of his New Deal legislation. Like similar New Deal legislation (e.g., the National Industrial Recovery Act) the AAA was initially passed as an emergency measure, though unlike that similar legislation it did not have a two-year expiration – only an open-ended provision allowing its programs to be terminated at the president's discretion should the “emergency” be deemed over.

The AAA was struck down by the US Supreme Court less than three years after its passage in the case of the *United States v. Butler et al., Receivers of Hoosac Mills Corporation*. It is a testament to the popularity of the AAA programs and to the rising strength of the political coalition that supported them that within a mere 10 days of the Hoosac Mills ruling, a replacement plan for the AAA was released (Unsigned Editorial, 1936). Within 60 days, that plan was implemented as the Soil Conservation and Domestic Allotment Act of 1936. While farm programs have evolved dramatically over the years, they have been renewed, at irregular intervals, ever since – and always with the political support as well as the extensive

¹ For a more complete history of the McNary-Haugen bill and the movement that developed to support it, see Black (1928). For a more general discussion of various price-fixing proposals from the 1920 (along with skeptical comment) see Englund (1923).

programmatically input of agricultural organizations whose members are the primary recipients of program benefits.

In contrast to federal farm programs, crop insurance remained a small, underutilized program for much of its history. It was never, until very recently, the kind of priority for farm interest groups that the Farm Bill was. The gradual rise in the political and economic significance of crop insurance really began in 1980. Amendments to the Federal Crop Insurance Act in that year were intended to raise the profile of the program so that it could function as a less costly replacement for standing federal disaster assistance. Still, participation in the program remained fairly low. Subsequent reform acts in 1994 and 2000 finally sparked significant interest in the program among producers, primarily by dramatically increasing premium subsidy rates (Glauber and Collins, 2002).

The Federal Crop Insurance Reform Act in 1994 introduced the concept of revenue insurance within the federal crop insurance program. Prior to that point, crop insurance focused essentially exclusively on insuring against yield losses. Protection against declining prices remained a function of the commodity programs. These new revenue based programs represented a significant overlap between insurance and commodity support. To at least a certain extent, a producer was essentially able to 'double up' on revenue losses driven by price declines.

Revenue programs have grown to be a very popular product within the federal crop insurance program. In 2013, \$76.8 billion of the crop insurance program's liability was in the Revenue Protection (RP) product compared with just \$7.1 billion in liability in the Yield Protection (YP) product.

This overlap between crop insurance and commodity programs increased even more with the advent of the Average Crop Revenue Election (ACRE) and Supplemental Revenue Assurance (SURE) programs in the 2008 Farm Bill. As revenue based programs, they included some protection from yield losses as well as the traditional price protection.

The fact that crop insurance and farm programs are essentially covering the same risks naturally raises the question of why they are both still necessary. Simultaneously, the current drive toward fiscal austerity raises the question of whether or not both are still affordable. The fact remains, though, that both have strong political advocates; and it will more than likely be political considerations, rather than economic or other practical considerations, that determine how the balance between farm programs and crop insurance will ultimately be struck.

Farm Program and Crop Insurance Spending

For decades, farm program spending constituted the lion's share of federal support for agriculture. Other programs (conservation, research and extension, trade promotion, crop insurance, etc.) received a much smaller set of resources. This situation has changed quite dramatically in recent years. The change in the relative levels of federal support for farm programs and crop insurance reflect a combination of a two primary factors: a concerted effort to

expand crop insurance participation and the opposite effect that high commodity prices have on farm programs and crop insurance.

The growth in crop insurance participation since the reforms in 1994 has been fairly dramatic. For example, in 1994, only 30.5 million acres of corn were covered by crop insurance. Only 6.4 million acres were covered at the 75% coverage level or above². Liabilities under the insurance program on corn totaled just under \$4.6 billion. A decade later in 2004, just over 62 million acres of corn were covered by crop insurance. Over a third of those acres (24.3 million) were insured at the 75% coverage level or above. Program liabilities amounted to \$15.5 billion. Similar changes in participation could be shown for most other major crops over that time period as well.

As a budget outlay, the crop insurance program has not grown solely because of increased participation, though. Higher commodity prices since the mid-2000s have contributed to increased spending on crop insurance. As commodity prices (and yields, for that matter) rise, crop insurance guarantees rise as well. This increases crop insurance premiums and, therefore, premium subsidies. Premium subsidies more than doubled just between 2005 and 2008, rising from \$2.3 billion to \$5.7 billion. Administrative and overhead expenses for the program also increased dramatically over that time, rising from \$833 million to \$2.0 billion.

In contrast with the crop insurance program, spending on farm programs declined as commodity prices increased. Payments under the marketing loan program and the countercyclical payment program, which had been quite large in some years under the provisions of the 2002 Farm Bill, essentially declined to zero as prices on program commodities climbed well above support levels beginning in the mid-2000s. Commodity Credit Corporation (CCC) outlays for commodity programs declined from \$21.6 billion in 2005 to just \$6.7 billion in 2011.

The cause for this decline is due in large part to the fixed nominal support levels provided by the commodity programs. Taking corn as an indicator commodity, its target price was set at \$3.03 per bushel as part of the 1981 act and has effectively declined - or the acreage on which those supports has been provided has been cut back - nearly ever since. The target price for corn under the 2008 legislation was set at \$2.63 per bushel. Again, these are nominal prices so while market prices have moved up in response to supply and demand factors, the support levels have effectively and actually declined over the course of the last 30 years.

As price-based commodity program payments have declined, the proportion of those payments accounted for by Direct Payments (DP) has increased. DPs are fixed, decoupled payments that eligible producers receive on a farm's historic production base whether they are producing a crop or not and regardless of the relationship between market and support prices. DPs were first established in the 1996 Farm Bill as temporary transition payments but were renewed in the 2002 and 2008 farm bills. Direct payments have been very popular with producers over the years but have recently lost much of their public appeal for two primary reasons. First, DPs are fixed at levels established in the 2002 Farm Bill. Commodity prices and

² On individual insurance, 75% was the highest coverage level available in 1995. Area yield insurance (Group Risk Protection, or GRP) was available at up to 90% coverage.

costs of production have changed dramatically since that time. Thus, DPs are less significant to producers now, viewed either for their contribution to total income or as a safety net for covering costs of production in the event of an adverse market event. Second, DPs have become a substantial political liability in the last few years as the general public reacts negatively to the idea of relatively "well-off" farmers being paid for not producing anything (potentially if not actually).

There is another reason for movement to these risk based programs, driven as much by budgetary scorekeeping rules as anything else. Cost estimates for DP's are easily calculated. Number of eligible acres times yield per acre times a payment rate per bushel produces a known number. Consequently the budgetary impact can be determined almost down to the dollar. Risk based program costs are a function of weather, of domestic and foreign demand and any number of other factors. This means there is a distribution around an expected outlay level. Certainly that outlay level may be lower than the expected value, but without question, it could be substantially larger. In keeping with the theory of the one-sided bet (see Jagger and Hull, 1997) one can design these policies where the expected value will meet the budgetary limit, but the potential outlay level for a very low price level could be much higher.

The changes in the pattern of federal spending on agriculture along with the change in the political fortunes of direct payments go a long way toward explaining the strong interest in moving programs away from policies of the past and toward insurance based designs. In short, it has become increasingly difficult, in political terms, to maintain what is an increasingly less lucrative program.

Crop Insurance Participation

If the changes in spending levels discussed here had proceeded uniformly across all program crops, the move to crop insurance would likely already have taken place. In fact, though, they have not. Farm program support still represents a substantial share of farm income for some program commodities. At the same time, crop insurance remains an underutilized (some producers would also contend, ineffective) tool on some crops and in some regions.

In terms of farm programs payments, direct payments are substantially larger for rice, peanuts and cotton than for the other program crops. Figure 1 shows the average total Commodity Credit Corporation (CCC) payments (mostly direct payments) per acre from the Congressional Budget Office's (CBO's) ten-year baseline for 2014-2023. Payments per acre are provided on the basis of both planted acres and base acres. Two things are apparent from this figure. First, rice, cotton, and peanuts receive far higher payments per acre under the direct payment program than the other major program crops. Second, rice and cotton plantings are far smaller than rice and cotton base acres. Thus, farmers with base acreage of those crops receive relatively large payments on those bases even if they choose to plant a more lucrative crop or even leaving the land idle. Remember the whole economic purpose of moving to direct payments is to remove government support from the planting decision.

With respect to crop insurance participation, also, there are substantial differences among regions and among crops. In informal conversations with farmers on the issue of crop insurance participation, a frequent refrain heard particularly from the southeast is that “crop insurance doesn’t work”. Of course, whether or not this is taken as an accurate assessment depends on the metrics one uses to examine the program’s performance. Based on the kind of actuarial metrics that appeal to economists, performance of the crop insurance program appears to be reasonably equitable.

Whatever the objective performance of the crop insurance may be, it is clear that as a subjective matter, crop insurance is not equally well-liked across all crops and regions. Consider, for instance, participation in crop insurance by corn producers across geographic regions. In the South, producers generally purchase lower levels of coverage and are much less inclined to purchase revenue-based products. Figure 2 illustrates this phenomenon using 2013 crop insurance summary of business data for corn from a number of select states. Clearly, Arkansas, Georgia, and Texas corn producers are taking lower levels of less extensive coverage than their counterparts in other states. There are undoubtedly many reasons for this, and the exploration of those reasons goes well beyond the scope of this paper. The greater diversification of farms in the South and the more extensive use of irrigation probably make insurance less of an imperative on many farms there. With respect to corn in recent years, many producers in the southern region are likely being required to use T-yields to establish guarantees, leaving them with relatively low coverage for their premium.

A similar phenomenon can be observed across crops. Figure 3 shows the percentage of acreage covered by buy-up levels of insurance, the percentage of acreage covered by revenue products, and the average coverage level across a select set of state/crop combinations. Buy-up participation and average coverage level on rice in Arkansas (a very low-risk production system due to 100% irrigated production) is well below the levels indicated for other crops. Note also that revenue insurance participation is quite small on Arkansas rice and non-existent on Georgia peanuts since a revenue product on that crop is not available.

Note in the foregoing illustrations that the crop and regional differences in crop insurance participation tend to be mutually reinforcing. That is the crops with relatively low participation (rice, peanuts, cotton) are specific to the Southern region, where participation also tends to be lower across all crops. Moreover, and almost certainly not coincidentally, rice, peanuts, and cotton are the three program crops receiving the highest level of support from farm programs on a per acre basis. Higher levels of program support render insurance less essential to farmers’ risk management strategies on these crops. So, the situation is this: rice, peanut, and (to a lesser extent) cotton farmers have more to lose in terms of farm program benefits from a shift of resources out of those programs and into crop insurance – insurance programs which they generally perceive as being less effective for them than for producers of other crops in other regions. In the case of peanuts, farmers would lack a revenue program to shift to as an alternative. In general, then, there remains a fairly strong southern preference for traditional

farm programs. This preference manifests itself as strong and effective political opposition to making insurance-based designs the sole means of farm support.

Lessons from Recent Proposals

Here it should be noted that the cotton industry, despite a history of vigorously defending direct farm support programs, has proposed shifting cotton programs to an insurance-based design known as the Stacked Income Protection Program (STAX). The STAX program would offer subsidized insurance designed to supplement existing individual insurance products and would be administered by the USDA Risk Management Agency (RMA) and delivered by crop insurance companies rather than by the Farm Service Administration (FSA). This change of strategy was largely driven by the need to remedy an adverse World Trade Organization (WTO) ruling against US cotton programs, so it represents something of a special case. Still, there are a couple of lessons to be gleaned from an evaluation of the cotton industry's strategy here.

First, this episode exemplifies the keen interest of commodity groups in maintaining "their share" of the federal budget baseline. The cotton proposal was designed to re-allocate funds (a large share of them anyway) currently itemized in the budget baseline as cotton programs to the new STAX program, which would only apply to cotton and thus would preserve a cotton line-item in the baseline. In effect, cotton commodity interests were saying, "Let us decide how we want to spend our money." This position was not unique to the cotton industry. Rice and peanut industry interests clearly echoed this sentiment with their insistence on a price-triggered support payment program for those commodities.

While it is understandable that commodity groups would defend current support levels for their constituents, this practice creates a very strong status quo bias that greatly complicates any effort to change policy direction in a substantial fashion. This can create challenges. Budget allocations and support levels may need review in response to changes in market conditions, trade considerations, production innovations or any number of market-related factors. Baseline preservation strongly resists such adjustments, meaning that program support levels may actually reflect conditions that existed years (potentially decades) ago but that aren't, or shouldn't, be relevant to contemporary policy decisions.

Second, the cotton proposal's call for a major change in program delivery points to the fact that crop insurance companies and government agencies are also important stakeholders in the agricultural policy arena. A move to an insurance-based program potentially raises difficult questions about program delivery that will pit powerful groups against one another. Providing delivery of any new insurance-based program through the current public/private delivery model used by crop insurance would leave very little justification for maintaining the FSA at anything near its current level (if at all). Conversely, if an insurance-based farm program is delivered by FSA, this will raise the question of why all crop insurance is not delivered by FSA so that existing administrative and overhead (A&O) expenditures can be saved.³ Crop insurance industry and FSA representatives have and will continue to express strong feelings on this point.

³ This is essentially the approach proposed in Babcock (2012).

The emergence of the crop insurance industry as a distinct and influential interest group is itself an interesting development. Crop insurance companies represent the delivery mechanism for the federal crop insurance program. They could potentially also deliver any insurance-based farm program that might emerge as a supplement to (or replacement for) traditional farm programs. This concept of a program deliverer having a vested, profit-driven interest in the programs being delivered is new in the realm of agricultural policy; and it has important implications for policy development. The crop insurance industry will resist any program changes that are viewed as being incompatible with its current business model. This could very well limit the scope of program alternatives that are politically viable, regardless of their other merits. Perhaps counter-intuitively, this may make it harder to shift to insurance-based program designs. For example, the crop insurance industry would rationally resist the development of insurance-like program designs that would potentially substitute for existing higher-margin insurance products.

Summary

Over the past two years, much of the debate over how best to allocate increasingly scarce federal resources to farm income support has focused on direct support programs versus subsidized insurance. Within the community of program crop producers, opinions on this question are generally conditioned on past levels of program support and/or past experience with crop insurance. There has been considerable regional variability in these factors. Rice, peanuts, and cotton have received much higher per acre support from current farm programs than other program crops. Moreover, producers of these crops (and producers in the South in general) have been less active participants in crop insurance than producers of other crops and in other regions. Not surprisingly, then, as a general principle, southern producers have been strong supporters of maintaining direct support programs while producers in other regions have been more amenable to – even supportive of – a shift toward subsidized insurance.

Baseline budgeting practices serve to reinforce the differences of opinion among commodity groups, with each commodity group favoring program designs that will preserve their estimated share of the budget. Thus, groups with relatively large farm program baselines (e.g., rice) find it more difficult to shift away from those programs to true insurance-like programs. Cotton presents a counter-factual to this phenomenon in that they receive relatively large program payments but have advocated a move toward a subsidized insurance product. It is important to note, though, that their program options were somewhat limited by WTO considerations; and, perhaps more importantly in the present context, their proposal would have created a cotton-specific insurance product, thus preserving the cotton baseline.

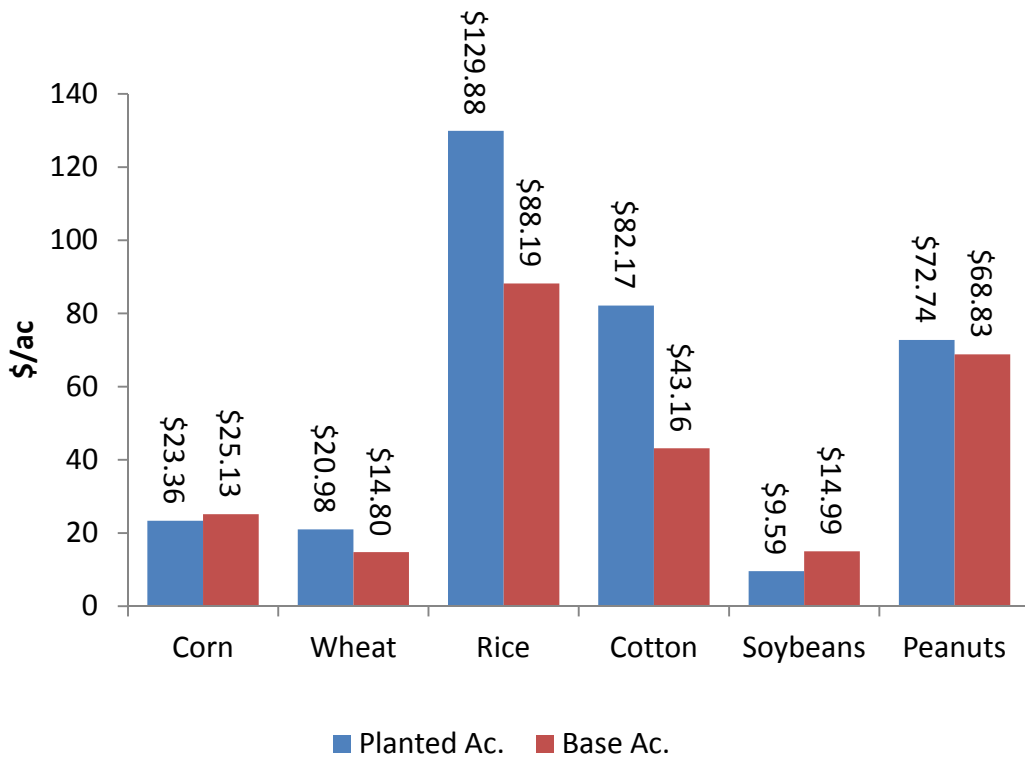
Moving to a full insurance-based safety net will require convincing producers with little experience of crop insurance (or bad past experience) that insurance designs can provide a level of support against relevant downside risks comparable to that provided by traditional farm programs. It will require balancing the interest of commodity groups who in a very real sense are competing with one another for a share of the federal budget. Finally, it will require a

definitive decision on the question of insurance-based program delivery. This last may ultimately be one of the most difficult issues of all. Delivery by crop insurance companies would largely render FSA obsolete; however, there is little precedent for winding down the operations of such an entrenched federal agency. It should also be noted that in the current political environment, once wound down, it would be very, very difficult to resurrect something like the FSA. On the other hand, FSA delivery of an insurance design would create significant unease in the crop insurance industry, which would rightly then see FSA as a potential rival for all crop insurance delivery.

In a more fundamental sense, moving toward a full insurance-based safety net will require a redefinition of the federal government's role in agriculture. For most of the past eighty years, the goal of farm programs (implicit in their design if not explicitly stated) has largely been to supplement the incomes of farmers. This approach has, not surprisingly, been quite popular, both with farmers and with farm-country representatives in Congress. Viewed from this perspective, a shift to insurance only – risk management and not income transfer – is a major shift, indeed. Once made, it would also most likely be, due to practical/political considerations, irreversible. This, along with the institutional considerations discussed above strongly suggests that the transition to insurance-based farm support will proceed slowly, with considerable hedging of bets along the way. That is highly consistent with the path we seem to be on as the current farm bill debate unfolds.

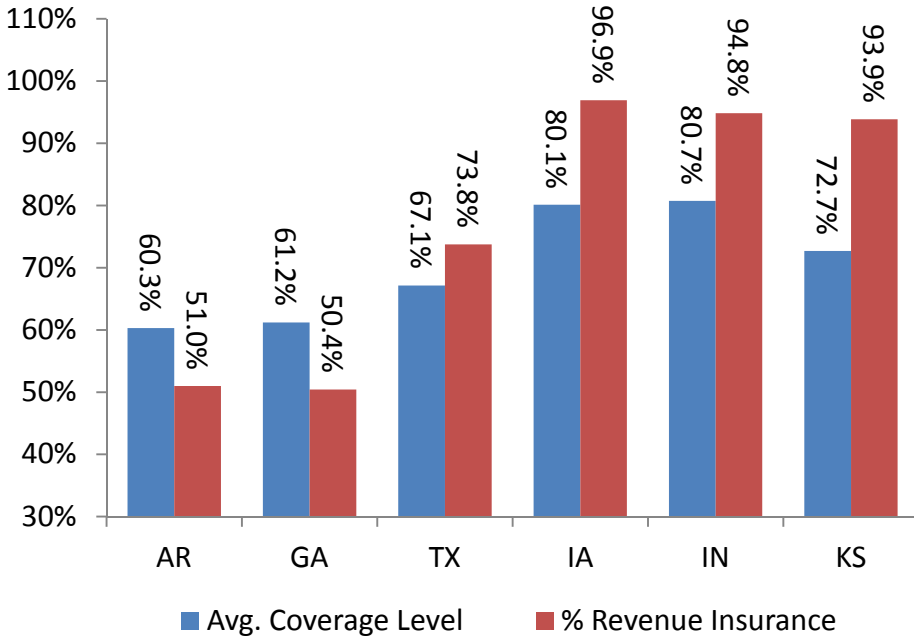
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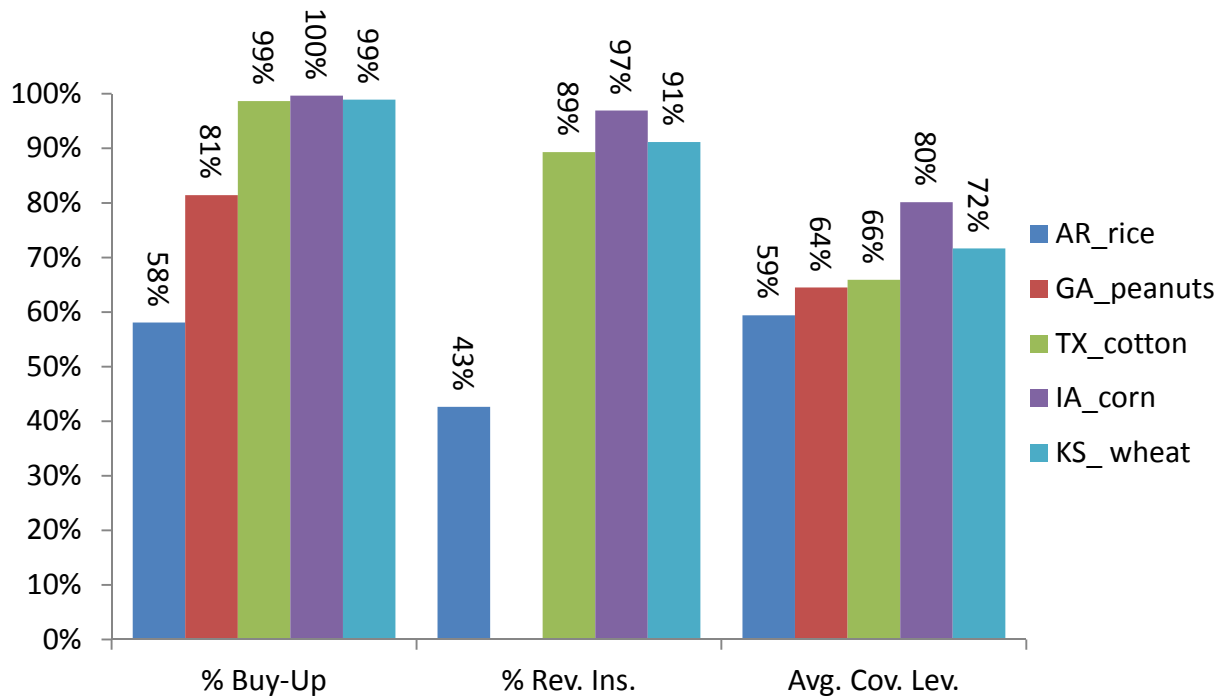
Data Source: Congressional Budget Office.

Figure 1. Average Commodity Credit Corporation Payments per Acre: 2013 to 2024 Baseline



Data Source: USDA Risk Management Agency, Summary of Business Online

Figure 2. Average Coverage Level and Percent of Acreage Covered by Revenue Insurance for Corn in Selected States in 2013



Data Source: USDA Risk Management Agency, Summary of Business Online

Figure 3. Percent of Acres Covered with Buy-Up Coverage, Percent of Acreage Covered by Revenue Insurance, and Average Coverage Level across All Insurance Types for Selected States/Crops in 2013