PolicyPennings by Dr. Daryll E. Ray

Insurance being touted as core of 2007 Farm Bill

We have all seen those action movies where two characters are engaged in a life or death battle, and every time you think that one of them is dead that character rises up to attack the other in a vulnerable moment. Well, once again insurance-like programs are being touted as a key component of the 2007 Farm Bill.

One inherently attractive aspect of the insurance approach is that it provides a means to respond to widespread drought and/or storm damage for events like hurricanes Katrina and Rita. This reduces or eliminates the need for Congress to vote on and fund annual ad hoc disaster assistance legislation. But in policy circles, this disaster element of crop insurance is described, at least implicitly, as a component of revenue insurance.

A clear message is being sent that insurance-like programs are seriously being considered for the 2007 Farm Bill as the primary vehicle to address price problems in agriculture as well as yield disasters in crop agriculture.

Now don't get us wrong, we don't have any problem with insurance, such as traditional crop insurance, when the insured events are randomly scattered among the policy holders. Hail insurance for a crop like wheat makes a lot of sense. The overall frequency of a hail-out is fairly predictable so that the insurance company can reasonably assess its risk. In addition, the risk for any one field is random so that the chances of a payout can be spread over a large number of fields and policy holders.

Insurance becomes more problematic in situations where the policy holder has the ability to tip the odds in favor of collecting the indemnity. It is for that reason that insurance policies contain provisions to allow them to refuse payment in cases of arson and suicide. In these cases the policy holder would influence the risk factors - fire and death are no longer random.

Truly random events can be insured against in an actuarially sound manner by the private sector with the government only providing a regulatory role. You can almost bet your boots that if a subsidy is involved you are talking about a systemic, not a random set of events.

Some of the systemic problems are familiar. For example: farmers in drought-prone areas are more likely to plant their fields to crops than leave them as pasture if they can purchase subsidized disaster insurance that will provide them coverage in the case of a crop failure. Some have suggested that this is a problem with the current program, and as a result fields have been planted that otherwise would not have been planted. Farmers in this situation can take on additional risk knowing that their payout is going to be greater than their cost.

If you think that that is bad, consider a situation in which every policy holder is participating in an actuarially unsound insurance design. What is being bet with revenue insurance is that low prices are randomly distributed over successive years and farms just as with hail storms.

If low prices in crop agriculture were such a random event, then proposals for revenue insurance would make great sense. Insurance could be used to even out income between high income years and low income years. But as readers of this column know, low prices are not a random event in crop agriculture. Historically supply has grown faster than demand causing low prices that are systemic and chronic.

Under these circumstances, there are not enough high crop price years to compensate for the low price years. No wonder private insurers would refuse to offer coverage for the granddaddy of all systemic problems (low crop prices) unless the government is willing to provide them with large subsidies so that they can cover the expected and chronic losses that would face them. But even if the government made available the billions of dollars it currently spends on farm programs to subsidize, say an adjusted gross revenue (AGR) whole farm insurance program, farmers' incomes would ratchet downward during extended periods of low commodity prices.

It's a matter of arithmetic. Let's suppose that a general revenue insurance program protects 70 percent of farmers' revenue as measured over some period of time (probably based on your IRS 1040Fs). To fix ideas, let's suppose that last year' revenue is used to establish the "base point" for computing the 70 percent maximum coverage. Suppose prices tank and farmers receive 70 percent of their "base point levels" as a combination of market sales and insurance proceeds.

Fast forward one year. What if prices remain low or go even lower? The base revenue level for computing coverage this time around is not the same as before. Revenue protection for this new year becomes 70 percent of last year's revenue which is down 70 percent from the previous year. Granted, this is an extreme situation since the level of coverage could be based on a three or five year revenue average rather than just the previous year, but you get the idea. Negative compounding would occur, just at a slower rate.

When using revenue insurance as the fundamental component of farm policy, one of two things will happen during the inevitable extended periods of low and declining farm prices. Net farm incomes will plummet, land prices will collapse, and rural communities will depopulate faster or government costs will soar—not only because the program would be available to all agricultural comers—but also to fill the huge revenue gaps with supplemental payments.

Neither of these possibilities is very attractive. Converting the current program to an insurance-based program really solves nothing. Market distortions would continue. Farmers in developing countries would continue to accuse the US of dumping crops on the international market at below the cost of production, however defined. And commodity demanders/users and input suppliers would continue to be the real beneficiaries of farm programs.

Just as with the current program, an insurance-based program ignores the real issue in aggregate crop production – low price responsiveness of consumers and producers. Neither does anything to help farmers' better match production with what can be consumed at a reasonable price.

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