

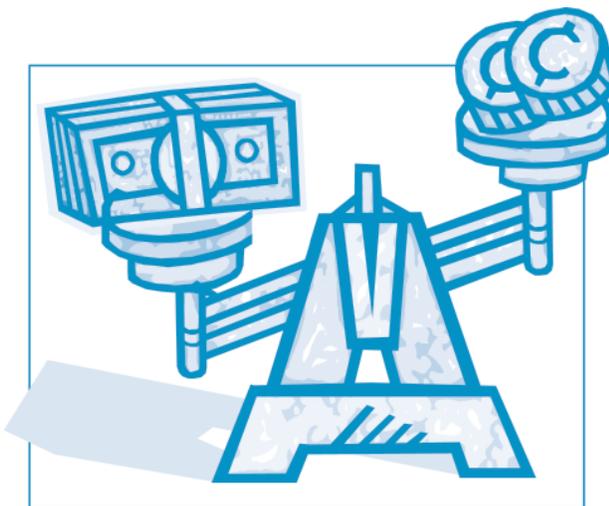
Corn Belt Contributions to the Crop Insurance Industry

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The crop insurance industry enjoyed another banner year in 2007, collecting \$6.5 billion in premiums yet paying out only \$3.2 billion in losses. I estimate that the industry will collect a record \$2.8 billion from taxpayers. In contrast, the net amount that farmers received from the program in 2007 was only \$750 million. Interestingly, since the beginning of this decade, the \$11.3 billion in net payments to farmers (indemnities received minus farmer-paid premiums) is about equal to the amount that taxpayers have paid the industry (\$11.1 billion). Overall, taxpayers have spent more than \$22 billion since 2000 delivering about \$11 billion in net payments to farmers, making crop insurance one of the least-efficient means by which taxpayers support the farm sector.

The scale of this inefficiency is well known to regular readers of this *Review*. What is difficult to understand is why the program persists in its present form when more efficient risk management programs could be adopted in the farm bill. One explanation is that campaign contributions from crop insurance companies and agents have persuaded key members of Congress to support continuation of the program. An alternative explanation is that farmers in certain regions excessively benefit from the program and that members from these regions are protecting the interests of their farmers. Support for this hypothesis comes from Senator Roberts from Kansas and Senator Conrad from North Dakota



who have argued that reform of the crop insurance program threatens the viability of the program in those regions that depend most heavily on insurance payments. Specifically, they worry that a drop in crop insurance participation by Corn Belt farmers might force farmers in higher risk areas to pay more for insurance.

Implicit in this worry is the assumption that industry profits generated by Corn Belt farmers allow farmers in other regions to pay lower insurance premiums than they would have to pay otherwise. If this is true, then if Corn Belt farmers dropped out of the program, other regions would suffer. An examination of recent crop insurance data offers support for this conjecture.

Experience with Crop Insurance Since 2000

Participation in the crop insurance program was given a large boost with passage of increased premium subsidies that were included in the 2000 Agricultural Risk Protec-

tion Act. Since that time, farmers have had to pay a bit less than half the amount that USDA's Risk Management Agency (RMA) has determined is needed to cover insured crop losses. This amount is called the actuarially fair premium. The large premium subsidy means that if all farmers pay actuarially fair premiums then the ratio of indemnities received (crop losses covered) to farmer-paid

premium should equal two. While the period since 2000 in looking at crop losses is too short a time to judge actuarial fairness of crop insurance premiums, it is instructive to see if there is a discernible geographic pattern to the ratios since 2000.

As shown in Figure 1 on page 2, Great Plains states all have ratios greater than 2.0 while farmers in the five Corn Belt states all have ratios less than 2.0. This shows that farmers in the Great Plains have benefited far more than have Corn Belt farmers from crop insurance. Note that Indiana, Illinois, and Iowa all have ratios less than 1.0. This means that farmers in these three states have paid more dollars in premiums than have been returned to them in indemnities. That is, far from receiving subsidized premiums, Corn Belt farmers have, in fact, been paying more into the program than they have gotten in return.

Another way of looking at the distribution of crop insurance payments is to simply add up premiums paid and indemni- ➡

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ties received. As shown in Figure 2, Texas, Kansas, North Dakota, and South Dakota have all received more than \$1 billion in net payments since 2000. In contrast, farmers in Indiana, Illinois, and Iowa

together paid \$750 million more in premiums than they have received from the program. Clearly, the recent experience in crop insurance suggests that Corn Belt farmers are paying too much in premiums, and Great Plains

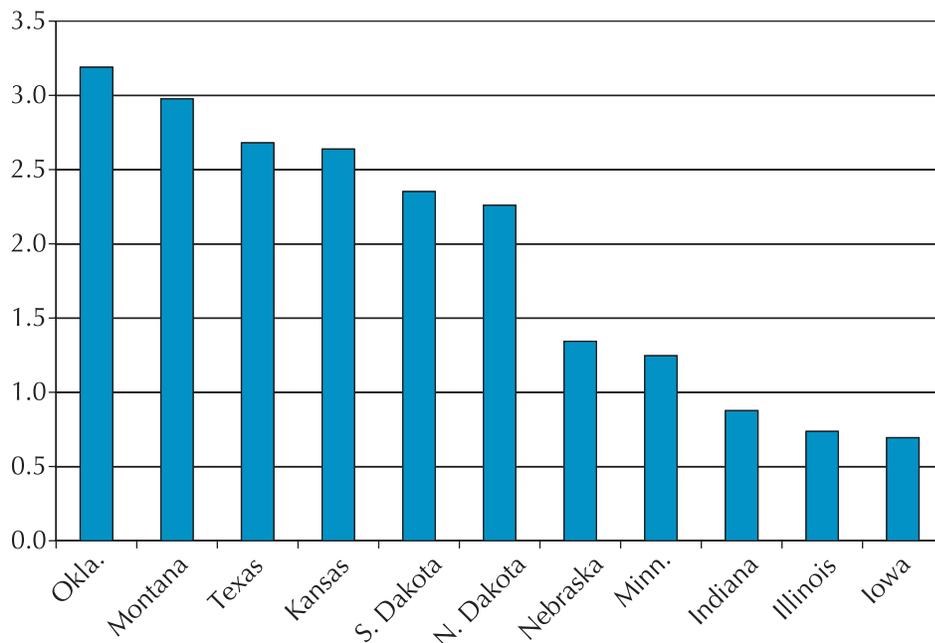


Figure 1. Ratio of total indemnities received to farmer-paid premiums from 2000 to 2007

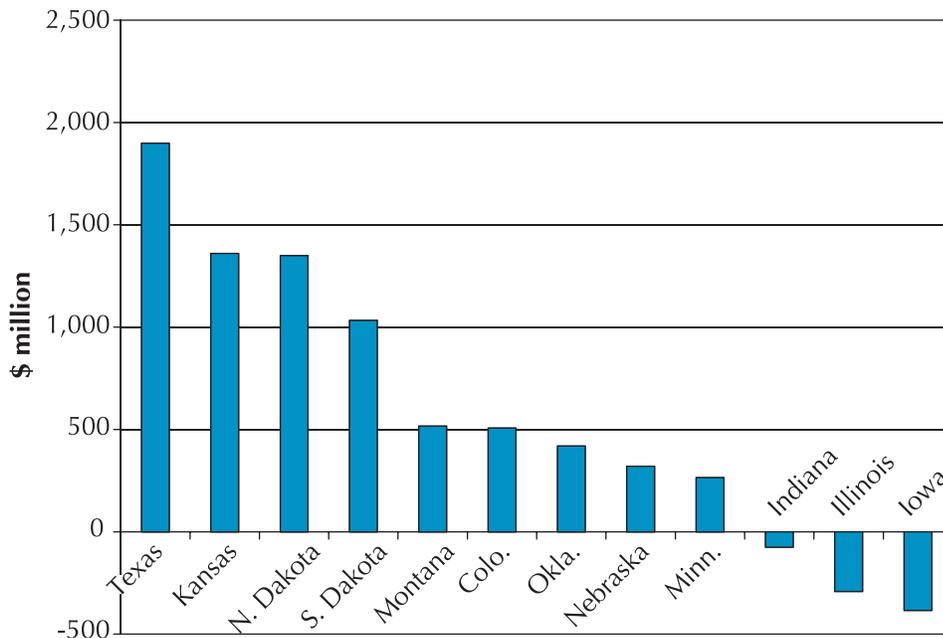


Figure 2. Total indemnities received minus farmer-paid premiums from 2000 to 2007

Options for the Conservation Reserve Program

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Record crop prices are signaling the world's farmers to produce more. The recent prospective acreage report released by the USDA shows that the ability of U.S. farmers to grow more is limited by a lack of land. The USDA projects that acreage planted to crops in the United States will increase by about 1 percent in 2008 relative to 2007 acreage and about 2.5 percent relative to 2006 acreage. This lack of a supply response by U.S. farmers shows how insensitive aggregate U.S. planted acreage is to price changes, at least in the short run. It explains why introducing a major new demand for agricultural output in the form of biofuels should be expected to have such a large impact on commodity prices.

The only way that crop prices will return to lower levels is through an expansion in aggregate supply. This expansion can come from two sources: expansion in land planted to crops in other countries and conversion of land in the Conservation Reserve Program (CRP) in the United States. Brazil, Argentina, Africa, and Central and Eastern Europe all have land resources that are not currently planted or that could generate substantially more production. We should expect production in these areas over the next two to five years to increase sharply.

At current prices and current CRP rental rates, a large proportion of CRP land will be taken out of the program as contracts expire for the simple reason that

... the public interest in seeing lower crop prices needs to be weighed against the public interest in maintaining the substantial environmental benefits of land in CRP.

the returns from crop production are now higher than the returns that can be obtained from the program on most CRP land. In one sense, this is how the program is supposed to work. When the CRP began in 1986, crop prices were so low that Congress was desperate for any means to reduce supply. In addition, the farm crisis was in full swing in 1986. CRP rental rates acted as a stabilization program that created a floor on land prices. Today, with record high crop and land prices, there is no reason to use CRP to control supply. Thus, the decision to bring CRP land back into production would seem to serve the public's interest.

However, most CRP land today provides more than supply control. It also provides a wide array of environmental services, including critical wildlife habitat, reduction in nutrient and sediment loads in rivers and lakes, and carbon sequestration benefits. The transition of CRP from a supply control program to an environmental program began in the early 1990s and continues today. Consequently, the public interest in seeing lower crop prices needs to be weighed against the public interest in maintaining the substantial environmental benefits of land in CRP.

Current CRP Policy

If CRP policy remains unchanged, perhaps two million acres of CRP land per year will be brought back into crop production over the next 10 years as contracts expire. This would reduce the size of the program from today's 34 million acres to less than 15 million acres. The resulting expansion in planted acreage will have a noticeable impact on aggregate supply because 20 million acres represents an increase of about 6 percent of 2008 total planted acreage.

In addition to this steady increase in acreage as contracts expire, a substantial number of landowners will likely decide to pay the penalty to break their CRP contracts. The current penalty for breaking a CRP contract is to pay back all amounts that have been paid under the contract, including annual rental payments and cost share amounts, as well as a 25 percent penalty on one year's rental payment and interest costs on the monies paid. For most farmers, these stiff penalties mean that it makes no sense to break the contracts. However, for newly signed contracts, the penalties are nonexistent or small because large payments have not yet been made.

In 2006, the USDA moved to re-enroll or extend many of the contracts that would expire between 2007 and 2010. During that period, CRP contracts for nearly 28 million acres were scheduled to expire—over half of them in 2007. The re-enrollment and extension program (known as REX) was successful in re-signing over 23 million acres, in part because crop prices had not yet significantly increased. Figure 1 shows the change in possible CRP expirations from REX. Under REX, acreage was categorized with an environmental benefit index. Owners of the most environmentally sensi-

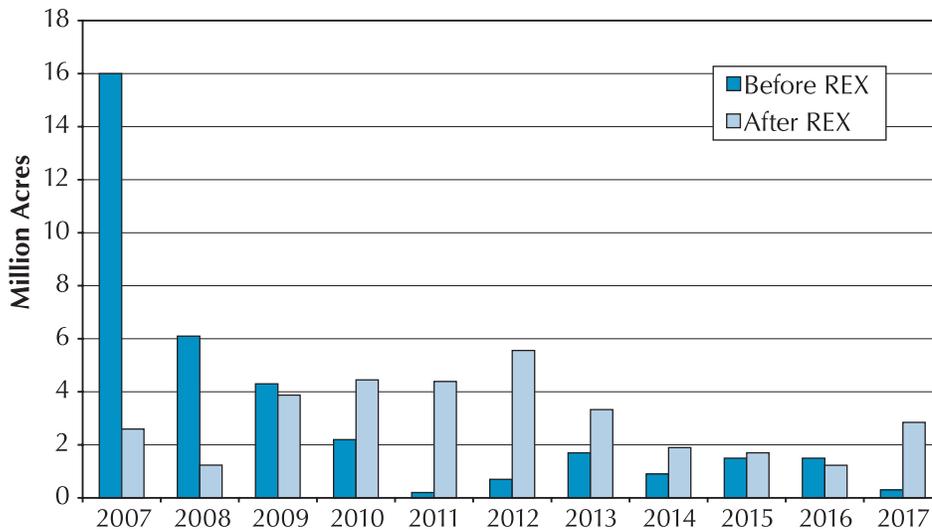


Figure 1. Projected Conservation Reserve Program acres, before and after the re-enrollment and extension program

tive 20 percent of eligible acreage were offered new 10- or 15-year CRP contracts; the next most sensitive 20 percent were offered 5-year extensions of their current contracts, then the next, 4-year extensions, and so on. This structure made sense at the time because it locked up the more environmentally sensitive land under new, longer-term contracts and allowed less environmentally sensitive lands to ease back into production over a five-year period. However, REX sign-up has created an unintended situation: the penalty for breaking CRP contracts is smaller for the more environmentally sensitive land than it is for less environmentally sensitive land because having a new contract greatly reduces the penalty. This suggests that the USDA might want to consider some possible new strategies for the CRP.

Options for the CRP

USDA has not yet indicated whether a change in CRP rules is being planned for this summer. Livestock groups favor reducing or eliminating early-out penalties for CRP to maximize the amount of land that is cropped. Environmental groups want current rules enforced. If nothing is done then, as Figure 1 shows, signifi-

cant expiration of CRP contracts will not occur until the fall of 2009. This means that much of this land cannot be planted until the 2010 crop year. If crop prices remain high, and the USDA does not significantly increase CRP rental rates, then a significant portion of this land will be brought back into production. But relief from high crop prices will not come until the 2010 crop is harvested. Because a significant portion of this land is likely going to come of CRP anyway, it might make sense for the USDA to eliminate penalties on contracts that expire in the next three years in order to get productive land back into production earlier. Bringing back some land into production would free up funds for the USDA to increase bids on the most environmentally sensitive land that offers the greatest environmental benefits. This proactive policy change could preserve the most environmentally sensitive land in CRP while allowing land that is perhaps needed to grow crops to come back into production.

One drawback of focusing only on contracts that expire in the next few years is that this would do nothing to keep farmers who just signed new contracts under the REX program from bringing their land back

into production. After all, it probably makes financial sense for a significant number of these farmers to pay the relatively small penalty on the new contracts and bring their land into production. One option that the USDA could take would be to rebid their entire portfolio of CRP contracts. This would allow the agency to concentrate its payments on keeping the most vulnerable land out of production—which would require significantly higher per-acre rental payments—while allowing land that is not especially vulnerable to be farmed in the 2009 season. This would meet the objectives of livestock feeders and others who want an expanded supply soon while simultaneously keeping the most vulnerable land out of production. A sensible approach to defining what land should remain in CRP would be for state offices to designate conservation priorities and then to seek land within their boundaries that most effectively meets their objectives. The length of the offered CRP contracts could be staggered so that not all contracts come due in the same year.

Changing CRP contract rules might create its own problems, however. The perception that the USDA “gave in” to political pressure from livestock and other crop user groups might weaken its future credibility when it enters into contracts. But there are sound reasons to believe that changing the rules is, in fact, justified. For the first time, agriculture is being asked to supply both food and fuel. Having to meet both demands with more than 30 million acres of land being held in reserve is difficult to rationalize. Most people recognize that the last two years have led to unprecedented changes in agriculture. Choosing to “re-optimize” CRP through a combination of penalty elimination and aggressive rebidding might be viewed as simply a reflection of this reality, rather than a sign of political weakness. ♦

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