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Guns and Butter, Crop Insurance Reform, and the Farmer Safety Net

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Republicans control both houses of Congress as well as the presidency. Control means accountability, and large federal budget deficits do not harmonize with the Republican self-image of fiscal prudence. Thus, one of the top agenda items this spring and summer will be how to reduce the federal budget deficit.

President Bush and congressional leaders have ruled out tax increases. This leaves only two ways of reducing the deficit: either spending will have to be reduced or we can hope to experience an unexpected boom in economic growth. Basing fiscal policy on hope is not prudent, so most observers think that the president and Congress will try to reduce spending. Agricultural spending is again on the table for budget cuts. Senator Judd Gregg of New Hampshire, chairman of the Senate Budget Committee, says that he will scrutinize farm programs and that “Agricultural entitlements are crying out to be reformed.” Farm groups are working both to forestall cuts to farm programs and to figure out where cuts should be made if they are inevitable.

An optimistic way of looking at spending cuts is that they present an opportunity to improve program performance. After all, reducing farm spending will not inevitably harm farmers. For example, land owners will bear the brunt of cuts to commodity programs through a decline in land rents and land prices. Because most farmland is owned by absentee landlords, such cuts will have a smaller impact on farm operators than would seem likely. In addition, smart reforms of farm programs could result in both lower costs and better farm programs. Replacing the marketing loan program with an expanded countercyclical payment program would make U.S. farm programs more compliant with World Trade Organization negotiations and would reduce spending while leaving the U.S. farm safety net largely in place. Another program that is ripe for reform is the U.S. crop insurance program. One simple change would be to eliminate the option whereby farmers can insure against losses on a field-by-field basis. As will be demonstrated, elimination of this option would save taxpayers more than $300 million while having no impact on the ability of the crop insurance program to meet its primary purpose of providing assistance when farm income is low.

Before getting into the details of such a crop insurance reform, it is useful to take a brief detour into our federal government’s books to see why farm groups’ fears of spending cuts are well founded.

A “GUNS AND BUTTER” FEDERAL FISCAL POLICY

The best way to understand our federal fiscal policy is to measure tax receipts, government expenditures, and the resulting deficit or surplus as a percentage of gross domestic product (GDP). GDP is the most inclusive measure of the income of a country, so adjusting taxes and spending by GDP can help give a better perspective of their relative magnitude.

Figure 1 shows federal tax receipts, outlays, and deficits since 1980 expressed as a percentage of GDP. As shown, total outlays were fairly constant at about 22 percent of GDP until about 1992, at which time they began a long decline that was reversed in fiscal year 2002 (which runs from October 1, 2001 to September 30, 2002). This reversal can be explained by fairly large increases in both defense and non-defense spending.
spending, which came about because Congress did away with the “pay-as-you-go” rules that restrained spending throughout President Clinton’s two terms in office.

The pattern of tax receipts more closely follows the business cycle. The deep recession in the early 1980s and the milder recession in the early 1990s show up as declines in receipts. Congress passed tax increases in 1993, which, combined with the economic growth in the 1990s, grew federal tax receipts to above 20 percent of GDP. This growth in tax revenue, combined with spending restraint, led to budget surpluses from 1998 to 2001. A mild recession in 2001 and tax cuts passed by Congress have led to a dramatic downturn in federal tax receipts. This drop in receipts, combined with an increase in spending, has increased the budget deficit to about 3.5 percent of GDP.

Apologists note that the deficits are not as large as they were in the mid-1980s when they were regularly 5 percent of GDP. However, the reason they are not as large is that we are generating a large surplus in the so-called off-budget accounts, which consist primarily of the social security surplus. This surplus was created by policy reforms (tax increases and benefit cuts) in the mid-1980s. We are currently running a surplus of about 1.5 percent of GDP in this fund. When this surplus is accounted for, we are running budget deficits of about 5 percent of GDP.

Subtracting the off-budget surplus shows a clearer picture of federal finances. After all, social security surpluses are being generated today so that we have the financial resources to pay promised benefits tomorrow. It is this last picture of federal finances that has many economists worried that we are truly pursuing a “guns and butter” fiscal policy whereby we are borrowing about 5 percent of GDP from overseas lenders to pay for our guns (military spending) and butter (domestic programs).

The Congressional Budget Office projects that the budget deficit will be reduced to around 2 percent of GDP by 2010. But this is an unrealistic projection on which to base policy because it makes two questionable assumptions: that President Bush’s tax cuts will be rescinded and that the alternative minimum tax will not be reformed or eliminated. Thus, cutting spending really is the only tool deficit hawks can use to cut the deficit.

Figure 2 gives a breakdown of our federal spending. Nondiscretionary spending and interest on the debt are considered off limits to budget cutters. This eliminates fully 61 percent of the budget. Thus, spending cuts must come from discretionary spending.

In the short run, it is unlikely that Congress will cut military spending because of President Bush’s Iraq commitment. In fact, holding defense spending constant will require a significant reduction in planned expansion of weapon systems. Thus, we are left with cutting non-defense, non-discretionary savings, which accounts for 19 percent of the federal budget.

To illustrate the problem facing deficit hawks, if all non-defense, non-discretionary outlays were entirely eliminated, this would reduce total spending by 3.1 percent of GDP. As shown in Figure 1, a spending cut of this magnitude would not eliminate the budget deficit. We would still be in red ink but the National Weather Service, National Science Foundation, National Institutes of Health, National Parks System, FBI, EPA, Department of Education, U.S. farm programs, and many other federal programs funded out of discretionary spending would be gone.

This brief exploration of the problem facing budget cutters shows why they will be taking a hard look at all agencies and programs for areas where efficiencies can be increased or programs can be eliminated. And agricultural programs are a prime target.
SAVING MONEY FROM SMART REFORM

OF THE CROP INSURANCE PROGRAM

The crop insurance program provides an example of a smart reform that can both save money and improve the program. To understand how this might work, we must first review some program details.

Congress last reformed the crop insurance program in 2000 by significantly increasing the subsidies farmers receive when they buy more expensive, lower deductible policies. The new subsidies resulted in a significant increase in the amount of insurance that U.S. farmers purchase each year, which was the objective of the reform. Total (unsubsidized) crop insurance premiums, which are the best measure of the size of the program, have increased 68 percent since 2000.

This growth in the program is a direct result of the way that farmers receive their subsidies. Congress mandated that per acre subsidies must be proportionate to total premiums. Thus, the more farmers pay for insurance, the more they receive in subsidies. Farmers have many choices in the program. They choose which products to buy (Revenue Assurance, Crop Revenue Coverage, or standard yield insurance); the level of coverage to purchase; and whether to insure their fields in separate insurance units or to combine them into a single unit.

The particular subsidy proportions chosen by Congress create an incentive for most farmers to buy insurance at the 75 percent coverage level (a 25 percent deductible). At this coverage level, farmers pay only $45 for each $100 worth of insurance that they purchase. This creates a large incentive for farmers to purchase the most expensive insurance that is available to them. The most expensive insurance available is Revenue Assurance with the harvest price option (or Crop Revenue Coverage, which gives equivalent coverage) and insuring crops on a field-by-field basis, which is known as buying “optional units.” It is this incentive for buying optional units that could allow a large impact under smart reform.

OPTIONAL UNITS IN CROP INSURANCE

Farmers who grow a crop on more than one section of land can create a separate insurance unit—an “optional unit”—for the land in each section. Each optional unit stands alone when it comes time to calculate premiums and indemnities. If hail damages a crop on one unit, the farmer will receive an insurance indemnity to cover the hail losses. This payment arrives even if the farmer’s other field units receive beneficial rainfall instead of hail.

The alternative to optional units is to insure all of a farmer’s crop in a single insurance unit. The insurance guarantee on this single unit is exactly equal to the sum of the insurance guarantees on the optional units. However, the frequency of insurance payments will be lower on the single unit because production from all fields is pooled together when calculating whether there is a loss. Reflecting this lower frequency of payments, USDA charges a 10 percent insurance surcharge for optional unit coverage.

Why would farmers pay a premium surcharge for no increase in their insurance guarantee? The explanation, of course, is that because of the proportionate subsidies, farmers only pay a surcharge of 4.5 percent. What farmer would not pay 45¢ for coverage that returns $1.00? Approximately 90 percent of land enrolled in the crop insurance program is enrolled as optional units.

A smart reform of the crop insurance program would be to either eliminate the ability of farmers to buy optional unit coverage or to eliminate the additional subsidy that farmers receive for buying optional unit coverage. The first reform option has the added benefit of a reduction in fraud and abuse of the program by making it more difficult for dishonest farmers to “move” production among fields either to make false insurance claims or to build up a higher yield history on a particular field in order to increase its eligibility for higher future levels of insurance.

COST SAVINGS FROM SMART REFORM

Significant cost savings would accrue from elimination of optional unit coverage. Table 1 (page 5) summarizes the estimated changes in taxpayer costs from this reform for fiscal year 2006, assuming that 90 percent of acreage is insured under optional units. Reducing premiums by 10 percent on 90 percent of the business reduces expected insurance payouts, cost reimbursements to crop insurance companies, and underwriting gains by 8.18 percent. Taxpayer costs of this program could be reduced by approximately $330 million. And because the total

Continued on page 5
Green Box programs are minimally trade or production distorting.

Both the United States and the European Union have significantly altered their agricultural programs over the last few years. They have moved a great deal of their subsidies to direct payments to agricultural entities. The U.S. direct and countercyclical payments and the E.U. Single Farm Payments all fit the description of direct payments. Given the current structure of the Green Box and the new definition of the Blue Box, U.S. direct payments and E.U. Single Farm Payments would be filed as Green Box. U.S. countercyclical payments would go in the Blue Box. These moves give the United States and the European Union a great deal of flexibility in dealing with the proposed reductions.

However, the WTO panel ruling on the Brazil-U.S. cotton dispute has concluded that U.S. direct payments “do not fully conform” to the guidelines for Green Box direct payments because of their exclusion of fruit and vegetable production on the payment-base acreage. By the same measure, E.U. Single Farm Payments, too, would not conform to the Green Box requirements. However, it should be relatively easy to fix both issues, so this is probably of minor concern to U.S. and E.U. negotiators.

The framework explicitly states that the reductions in total AMS permitted levels “will result in reductions of some product-specific support.” But true reductions may not materialize because there are loopholes in market price support (MPS) programs, and member states still have flexibility to provide support through other mechanisms. The change in Japanese rice policy in the late 1990s provides one example of an MPS loophole. Another example would be if the United States made superficial changes to the dairy and sugar programs to fulfill a target in product-specific support reductions without truly affecting actual support. The United States could also lower loan rates in the marketing loan program (reducing product-specific AMS) and augment the countercyclical program to make up the support difference (by changing the target price). Aggregate support would remain the same but would shift from the Amber Box to the Blue Box. The ability of reductions in total AMS permitted levels to force reductions in product-specific support will also hinge on the product-specific AMS limits. These limits have yet to be determined, although the framework does state that the limits will be based on “respective average levels.” To guarantee product-specific support reductions, the final level of total permitted AMS must be less than the sum of the product-specific AMS limits.

Recommendations for Moving Forward

The issues embedded in the current WTO agriculture negotiations are numerous because of the multitude of agricultural programs used by member states throughout the world. Putting all of the programs into categories has allowed negotiators and their advisers to condense this support into manageable points so that further clarifications can be

IS SMART REFORM DOABLE?

The word around Washington is that departments and agencies are being asked to identify perhaps 8 percent of their budgets that can be cut. If these cuts were to be made on a program-by-program basis, then the USDA’s Risk Management Agency would be forced to cut projected spending by 8 percent. Elimination of optional unit coverage would accomplish this 8 percent cut in the crop insurance program with no impact on the total amount of insurance provided to U.S. farmers.

Of course, the beneficiaries of optional units can be expected to fight their elimination. The primary beneficiaries are crop insurance agents, who will find that their commissions will be cut by about 8 percent; crop insurance companies, which will have reduced underwriting gains; and farmers, who will have reduced payments. But if cuts are going to be made, one would hope that they are made with an objective of doing the least harm to the mission of the agency or program being cut. Elimination of optional units is the type of reform that makes sense in an era of scarce federal resources.◆

Table 1. Estimated changes in taxpayer costs from crop insurance reform (FY 2006)

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<thead>
<tr>
<th>Current Program</th>
<th>No Optional Units</th>
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<tr>
<td>Total premiums</td>
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<tr>
<td>Total indemnities</td>
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<td>Total premium subsidies</td>
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<tr>
<td>Administrative and operating cost</td>
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<td>Underwriting gains</td>
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<td>Taxpayer cost of crop insurance</td>
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<th>(billion $)</th>
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