Harvesting Crop Insurance Profits

A simple fix could save taxpayers $40 billion without damaging the U.S. food supply.

By BRUCE BABCOCK and VINCENT H. SMITH

Over the past three years, proposals from the Obama administration and the House Budget Committee to reform the $80 billion-a-year federal crop-insurance program have been defeated by opposition centered in the House and Senate agricultural committees. With the new Congress, Republicans and Democrats who stand for fiscal responsibility have an opportunity to finally implement reforms.

Farmers have a sweet deal with crop insurance: Taxpayers currently cover all the administrative costs associated with marketing and managing the program and fund more than 60% of the premiums to cover anticipated crop-insurance payouts, according to annual data from the Agriculture Department's Risk Management Agency. Farmers pay only about one-third of the real costs of their crop-insurance coverage. From 2003 to 2012, crop-insurance subsidies cost U.S. taxpayers $55.4 billion—66% of the cost of the program.

Proponents of federal crop insurance argue that roughly $6 billion a year in subsidized premiums is a small price to pay to guarantee the financial stability of the nation's food supply. That argument is specious, not least because 85%-90% of all crop-insurance subsidies are channeled to the largest 10%-15% of farm operations, few of which would face any risk of going out of business because of short-term fluctuations in their revenues.

What most Americans don't know is that a large portion of the program's cost is caused by the "harvest price option." By paying a higher premium—again, largely subsidized by taxpayers—farmers can indemnify their lost crop production at the higher of the market price just before planting or at the time of harvest. Almost all farmers choose the harvest price option because taxpayers pay such a large portion of the extra premium and it creates an opportunity for windfall profits.

The severe drought of 2012, for instance, caused average U.S. corn yields to drop by 20%. Market prices responded with an increase of 40% resulting, on average, in farmers receiving a 20% increase in revenues from corn sales. Under a standard subsidized-revenue insurance contract, those farmers would have been paid about $5 billion to cover the effects of the 2012 drought. But because nearly all corn farmers used the harvest price option to insure their crops, they received almost $12 billion in insurance indemnities—even though most had already benefitted from corn prices that were much higher than expected.

The harvest-price option resulted in the insured production losses being valued at the "drought-affected" higher prices, instead of the prices listed in the original insurance contract. Thus farmers enjoyed the benefits of higher prices on both what they harvested and on the production lost to drought. For most Corn Belt farmers the benefit of inflated insurance indemnities and high market prices made for a merry, and profitable, 2012 Christmas.

Federal crop insurance has provided yield coverage since 1980, but it wasn't until premium subsidies were dramatically increased in 2000 and extended to revenue insurance that costs began to escalate. According to the Congressional Budget Office, the estimated cost to taxpayers of the harvest price option subsidy is $4 billion a year, or about 45% of the total cost of the crop-insurance program over the next 10 years.

Elimination of harvest-price-option subsidies would not require drastic changes. Farmers wishing to pay the full cost for the harvest-price option would still be able to do so, but most farmers would not sign up because of the expense. Revenue declines caused by unexpected drops in prices and yields would be compensated, but farmers would not receive subsidized windfall gains when crop-market prices unexpectedly increase, as they now do under the harvest price option.

Bipartisan congressional support should go to programs that spend federal dollars to serve the public's interest and cannot be provided by the private sector. Subsidies that induce farmers to buy gold-plated harvest-price-option crop insurance fail on both counts. Eliminating these costly subsidies would save taxpayers $40 billion over 10 years while posing no threat to the nation's food supply. Come January, the new Congress should do just that.

Mr. Babcock is an economics professor at Iowa State University, where he directs the Biobased Industry Center. Mr. Smith, an American Enterprise Institute visiting scholar, is an economics professor at Montana State University.

This opinion piece was published in the December 24, 2014 edition of the Wall Street Journal