Should the World Emulate US Crop Insurance?

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ROME – With the increased frequency and severity of extreme weather events adversely affecting agricultural outputs and farmers' incomes, commercial crop insurance has been touted as the solution for vulnerable farmers all over the world. Financial and farm interests have been promoting US crop insurance as the solution. It is instructive to consider lessons from the 2012 drought.

Driven by the expectation of high maize prices, owing to the maize bio-ethanol mandate introduced almost a decade ago, US farmers planted a record 96.4 million acres in the spring of 2012 – even planting on previously fallow and marginal fields. Farmers also knew that crop insurance would guarantee a handsome return on their investment even in the event of crop failure.

Unexpectedly low crop yields caused by the drought in much of the US significantly drove up global cereal prices by mid-year. By July 2012, more than 55% of the US was in a state of moderate to extreme drought – the worst since 1956. US maize yield fell far short of the 166 bushels per acre that the US Department of Agriculture had projected in the spring. The USDA rated only 31% of the crops "good" or "excellent", while 38% were rated "poor" or "very poor".

When bad weather destroys part or all of their crop, those with a harvest-price clause in their insurance policies are compensated for most of their expected crop at the market price. When farmers can earn more from insurance at higher prices, they have an incentive to behave in ways that may raise prices even more, e.g. by delivering less.

Insurance payments for lost yields are based on current market prices, not some pre-agreed prices. Given the structure of these payoffs, it is not surprising that 85% of all planted US farmland was insured in 2012, up from 75% a decade ago, and only 25% in 1988. Hence, many US maize farmers had their highest incomes ever despite the harvest failure!

By reducing the harvest, the drought drove up prices, boosting farmers' incomes from insurance payments. If farmers with good insurance coverage make claims instead of harvesting, even less maize gets to market, raising prices – and insurance payments – further. When farmers planted in the spring, the maize price was less than $5 a bushel.

Indeed, with highly subsidized crop insurance, if prices rise high enough, American farmers can earn far more from a failed harvest, than from a successful harvest. As insurance paid 80% of current harvest prices, many farmers made more from insurance when prices rose above $6.25, than with a full harvest.

The supply shortfall pushed up maize prices to more than $8 per bushel. As more land had been planted than ever before, many had expected a bumper crop, aggravating the low yield's impact on prices. As the US is, by far, the world's largest maize producer, and maize is the most popular animal feed, the poor harvest raised other food prices as well.

Nevertheless, this is very big—and very good—business for the insurance companies. Every year between 2000 and 2010, US crop insurers collected more in premiums than they paid out. But insurance companies also have little incentive to deter excessive payouts as the US government covers roughly three-fifths of premiums and reimburses private crop-insurance companies for administrative and operating costs exceeding a fifth of total premiums. Thus, the larger the nominal losses to insurers, the greater the share of payouts the government covers.

In 1989-2009, crop insurance cost US taxpayers $68.7 billion, rising from $2 billion in 2002 to $9 billion in 2011, with more frequent and devastating extreme weather events. In 2011, when drought hit Texas and the US Southwest, total indemnified agricultural losses amounted to $10.8 billion. But, as the government subsidized both premiums and re-insurance, private insurers still made a profit of $1.7 billion. With the greater severity of the 2012 drought, the payout was much larger.

The federal government subsidy to crop insurance has since increased with the latest US farm bill. Yet, US policymakers have no reason to change things. Farm incomes account for a relatively small share of the US economy. In the run-up to national elections, powerful farm lobbies regularly call for even more federal protection. With candidates from both major parties vying for farm votes, neither side will discuss the perverse effects of US crop insurance or even its effect on the fiscal deficit – much less its impact on food prices and the world's poor.

Instead, crop insurance is still touted as the best means to reduce farmer vulnerability, or even to combat poverty in developing countries. In Europe, the crop insurance lobby is calling for a 'level playing field' by emulating US arrangements –by raising the level of support from the current 20 percent to the US's 70 percent!

As such generous underwriting is allowed under WTO rules, and most developing countries cannot afford to subsidize crop insurance to the same extent, their farmers will consequently be at a further disadvantage. In any case, most poor farmers in developing countries are unlikely to be able to afford even the subsidized premiums offered by commercial insurance.

The 'success' and popularity of US crop insurance is clearly due to high levels of government subsidy, beyond the means of most developing country governments. While the risk-sharing that crop insurance offers is undoubtedly attractive, commercial insurance companies would not participate if they were really sharing risk. Surely, there are better options for protecting farmers -- in the US and elsewhere.

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