A proposed Increase in Farmer Paid Premiums for those over the AGI limit

The Senate Ag Committee recently passed a means testing amendment. Farmers with more than $750,000 Adjusted Gross Income (AGI) will have their premium subsidy reduced by 15 percentage points from current levels. However this could have some unintended consequences. Below is the amendment language:

Notwithstanding any other provision of this subtitle and beginning with the 2014 reinsurance year, in the case of any producer that is a person or legal entity that has an average adjusted gross income in excess of $750,000 based on the most recent data available from the Farm Service Agency as of the beginning of the reinsurance year, the total amount of premium subsidy provided with respect to additional coverage under subsection (c), section 508B, or section 508C issued on behalf of the producer for a reinsurance year shall be 15 percentage points less than the premium subsidy provided in accordance with this subsection that would otherwise be available for the applicable policy, plan of insurance, and coverage level selected by the producer.

The amendment states that if over the AGI limit, then the premium subsidy is reduced. The question is does this apply to the catastrophic (CAT) contracts? A

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CAT contract does not have a premium but it does have an “imputed premium”. From an economic viewpoint there is little difference but there may be a legal one.

Currently a CAT policy has a $300 processing fee, but no farmer paid premium costs. CAT provides a 50% yield guarantee and pays losses at 55% of the approved Risk Management Agency (RMA) price. CAT was originally a part of the reform legislation during the mid-1990’s to eliminate the need for ad hoc free disaster aid. Clearly this goal was not accomplished with the most recent example being the SUpplemental REvenue program (SURE).

Often it is assumed because CAT provides such low guarantees that their dollar amount of coverages are also low, but that is not true for high value crops or nurseries. The counties with CAT contracts that averaged over half of a million dollars of coverage per policy are posted on: http://www.agmanager.info/crops/insurance/risk_mgt/rm_pdf12/AB_40K_Family.pdf

For example, in San Mateo County, California there is only one policy therefore, that “farmer” has $3.8 million of CAT coverage and is receiving an imputed premium subsidy of $33,300. The farmer pays none of the imputed premium. This nursery has expected revenue of about $13.7 million but contributes nothing towards the premium cost for the protection. Some of the largest amounts of CAT coverage are on nursery crops with effectively a 100% premium subsidy.

If the CAT subsidy is treated as an imputed premium rather than a subsidy, then likely some of the large farms will drop their coverage back to CAT. If this same nursery were purchasing buyup coverage at 50% coverage but 100% of the price the premium cost would be about $60,545 with the farmers’ share of the premium at about $19,980. However, because this farmer is over the AGI limit, she will suffer a 15 point reduction in subsidy and her premium share will increase from 33% of the premium to 48% of the premium generating a farmer paid premium of about $29,062. Any production loss would be the same under both policies but the 50/100 policy will pay the lost production at 100% of the RMA price.

However, the CAT would pay the same production loss but at a reduced price that equals 55% of the RMA price. Effectively that is the same as a co-pay of 45% but the producer pays no premium versus $29,062 of farmer paid premium in this example.

Part of the issue is policy makers are trying to evaluate crop insurance as a traditional income transfer program and they don’t consider the risk transfer. While it may appear it is a transfer of cash from taxpayers to farmers, the decision is made at the farm level where it is clear that at least some farmers are purchasing risk protection. The best example is Iowa where over the past 17 years, farmer paid premiums have exceeded indemnity payments, so Iowa farmers in aggregate have collected no net transfers. However, they did receive risk protection as would be true for the purchase of any insurance contract.
RMA rates for Iowa would not be the same as a private insurance rate because the RMA rates do not include any expense load and the catastrophic load may not be sufficient for the private market. Also there is the issue of being able to buy private reinsurance that many not be available if Iowa were the only state in the pool.

RMA is in the process of cutting rates for Iowa, so the expectation is farmer paid premiums will not exceed indemnity payments in the future. Even so, some individual farmers will pay more in premiums than they collect indemnity payments. The rate applies to the pool not to the individual farm.

**CAT versus 50/100 Buyup.** Will farmers over the AGI limit be willing to pay an extra 15 points of premium? Currently CAT, 100% subsidy; 50% coverage, 67% subsidy; 55% coverage, 64% subsidy; 60% coverage, 64% subsidy; 65% coverage, 59% subsidy; 70% coverage, 59% subsidy; 75% coverage, 55% subsidy; 80% coverage, 48% subsidy; and 85% coverage, 38% subsidy. For farms over the AGI limit the subsidy would be reduced by 15 points. For those farms over the AGI limit the new subsidy would be 50% coverage, 52% subsidy; 55% coverage, 49% subsidy; 60% coverage, 49% subsidy; 65% coverage, 44% subsidy; 70% coverage, 44% subsidy; 75% coverage, 40% subsidy; 80% coverage, 33% subsidy; and 85% coverage, 23% subsidy.

**Compare CAT with 50/100 Buyup.** If the rate were set at an actuarial fair rate where the example San Mateo nursery’s farmer paid premium is equal to the indemnity payments then the nursery net indemnity payments would be higher with the free CAT than the 50/100 buyup that would require a farmer paid premium of $29,062. This just considers the net transfers of cash and gives no credit for the risk protection provided by a policy that has 45% more liability. The reader needs to remember there are farmers who have paid crop insurance premiums for years without any indemnity payments but they received risk protection that would cover them had there been a loss.

Only if aggregate transfer of cash is being considered, then the 50/100 buyup must be underrated before the net cash would exceed the aggregate CAT payments. Therefore, if a large number of farmers are able to determine if they are underrated, then they would buy 50/100 while the rest of the pool would buy CAT. The result would be underwriting losses because of the adverse selection between CAT and farmers paying 48% of the 50/100 policy’s premium. The production trigger is the same on both contracts, only the payment rate is different.

**What if the 15 Point Subsidy Reduction Applies to CAT.** The current CAT “100% subsidy” would be reduced to 85% and famers would pay 15% of the premium. Our example San Mateo County nursery would now pay $4,995 for the same CAT coverage that is currently being received free. The question then
becomes will these CAT buyers who currently pay no premium be willing to pay 15% of the premium? If a large number of the CAT policy holders drop their coverage will that loss of premium impact the cost of delivery or the actuarial soundness? While there are “few” large CAT contracts, they are important on special crops in California, Florida and other specialty crop producing states.

**Savings Likely Less Than Forecasted.** These mega farms will have a large financial incentive to create “paper farms”. Assuming a large number of mega farms form additional entities, then it will reduce the number of farmers over the AGI limit and subject to increased farmer paid premiums. For example continuous crop wheat insured at 75% Revenue Protection (RP) in Scott County, Kansas, unsubsidized premium is about $54 an acre; a 15 point increase in farmer paid share of the premium would be about $8 an acre. Therefore, a 10,000 acre farm over the AGI limit will pay an extra $80,000 a year in premiums. That will clearly create an incentive to create new entities to avoid the premium “surcharge”, and they can afford to hire lawyers and accountants to create more “paper farms”. This will clearly reduce the savings that advocates claim and will add to the administrative cost for the farmer, USDA, agent, and insurance company.

**Will this Means Test Apply in 2014?** The Durbin-Coburn amendment added a section that requires a Government Accountability Office (GAO) study before the means test is applied to crop insurance. Below is the language that requires a GAO study:

(i) Not later than 1 year after the date of enactment of this Act, the Secretary, in consultation with the Government Accountability Office, shall carry out a study to determine the effects of the limitation described in subparagraph (B) on--
(I) the overall operations of the Federal crop insurance program;
(II) the number of producers participating in the Federal crop insurance program;
(III) the level of coverage purchased by participating producers;
(IV) the amount of premiums paid by participating producers and the Federal Government;
(V) any potential liability for participating producers, approved insurance providers, and the Federal Government;
(VI) different crops or growing regions;
(VII) program rating structures;
(VIII) creation of schemes or devices to evade the impact of the limitation; and
(IX) administrative and operating expenses paid to approved insurance providers and underwriting gains and loss for the Federal government and approved insurance providers.

(ii) EFFECTIVENESS.--The limitation described in subparagraph (B) shall not take effect unless the Secretary determines, through the study described in clause (i), that the limitation would not--
(I) significantly increase the premium amount paid by producers with an average adjusted gross income of less than $750,000;  
(II) result in a decline in the crop insurance coverage available to producers; and 
(III) increase the total cost of the Federal crop insurance program.

This part of the amendment requires the Secretary to certify that the adoption of a means test will not impact the actuarial soundness, impact producers below the limit, or increase the total government costs. This will likely delay the implementation of the AGI means test for a year. However, if the Secretary finds the AGI limit will impact the insurance program then it is possible the AGI limit will not be applied. The required GAO study on the impact of an AGI limit on crop insurance will be a critical part of the Farm Bill, should this amendment be included in the Law.

**Current Thinking.** The best bet is CAT will not change and farmers over the AGI limit may enroll in CAT without penalty, and pay the $300 processing fee. Based on the required GAO study, will the Secretary certify no impact on crop insurance from an AGI limit? There is no agreement on the likely result. The big unknown is what will the GAO study conclude? There is also a possibility that this amendment will be deleted in the conference committee. Clearly adding the GAO study requirement slowed the rush to an AGI limit.

**Summary.** Assuming the Secretary certifies the $750,000 means test will have no impact on the crop insurance program based on the GAO study, then one would expect many of those farmers over the AGI limit, will lower their coverage in response to a 15 point increase in their farmer paid premiums. The example nursery would have paid about $19,980 in premium for a 50/100 buyup policy, if the firm were below the AGI limit. However, because this farmer is over the AGI limit, her share of the premium will increase from 33% to 48% of the premium generating a farmer paid premium of $29,062. This would generate about a $10,000 increase in farmer paid premium cost. If there is no change in CAT coverage then likely this grower would continue with her CAT contract that requires no farmer paid premium (does require a $300 processing fee).

The major question will be the response of farmers currently buying higher levels of coverage if they are over the AGI limit? Will they remain at the same coverage level and pay the higher premium cost or will they cut their coverage to a lower level of buyup coverage, or even CAT. If these large farmers, who are cutting their coverage, are also the ones generating the underwriting gains, then this would impact the rates paid by other farmers. However, this is the question that the GAO study is required to answer.