

Crop Insurance within the World Trade Organization

Chad Hart
Center for Agricultural and Rural Development and
Food and Agricultural Policy Research Institute
Iowa State University
568E Heady Hall
Ames, Iowa 50011-1070
515-294-9911
chart@iastate.edu
www.card.iastate.edu
www.fapri.iastate.edu

Testimony before the Subcommittee on General Farm Commodities and Risk Management, U.S. House Committee on Agriculture, April 26, 2006.

The views expressed in this testimony are those of the author, and do not necessarily represent the views of the Center for Agricultural and Rural Development, the Food and Agricultural Policy Research Institute, or Iowa State University.

Mr. Chairman, thank you for the opportunity to appear before the Subcommittee. My name is Chad Hart, and I am an agricultural economist employed at Iowa State University. I work in two research centers at the university, the Center for Agricultural and Rural Development (CARD) and the Food and Agricultural Policy Research Institute (FAPRI). Both CARD and FAPRI receive funding from annual USDA special research grants to conduct their research efforts. I serve as a U.S. agricultural policy and insurance analyst for both organizations. I have been employed in several private consulting projects within the crop insurance industry.

Based on consultation with Subcommittee staff, I have decided to direct my testimony at examining the implications of the World Trade Organization (WTO) agricultural agreement on the federal crop insurance program. The federal crop insurance program falls under the WTO guidelines for domestic support in agriculture. Since 1995, the United States has reported its domestic support to the WTO and has reported crop insurance support as non-product-specific aggregate measurement of support (AMS). Given this way of reporting crop insurance, it is considered as trade-distorting support and could possibly count against the U.S. domestic support limits. Since crop insurance is being reported as non-product-specific, it will not count against the U.S. support limit unless the sum of all non-product-specific support, including crop insurance, is above the *de minimis* level, 5 percent of the value of total agricultural production for the United States.

The U.S. computes crop insurance support as the net amount of indemnities or insurance payments farmers receive from the program. Net indemnities are calculated as the total amount of indemnities paid out by the crop insurance program less the total amount of premiums actually paid by farmers participating in the program. Over the period of time the U.S. has reported its domestic support, 1995-2001, crop insurance support has ranged from \$119 million in 1997 to \$1.77 billion in 2001. At these levels, crop insurance has been the largest or second-largest component of U.S. non-product-specific support. And while total non-product-specific support rose over this period, it never exceeded the *de minimis* level. Thus, crop insurance has never been counted against the U.S. domestic support limits.

Data published by the Risk Management Agency for the 2002-2005 insurance years indicate net indemnities peaked in 2002 at \$2.89 billion and have steadily fallen since then. Based on my estimates of total non-product-specific support, the U.S. will not have to count crop insurance against the support limits for the 2002-2005 period. The declining pattern in net indemnities has mainly been driven by extremely good crop production over the period, especially the record production year in 2004. However, this pattern is not likely to last. The crop insurance program has experienced substantial growth in premiums over the last few years as agricultural producers have utilized the premium subsidies provided by Congress to purchase higher levels of crop insurance protection and/or to switch to higher-priced revenue insurance policies. In 1995, total premiums for the crop insurance program were just over \$1.5 billion. By 2004, total premiums exceeded \$4 billion. This growth in premiums implies that expected net indemnities from the crop insurance program are increasing as well. Combine this growth in the crop insurance program with the potential for a national agricultural disaster, such as we experienced during the droughts of 1983 and 1988 and the floods of 1993, and the potential for crop insurance to count against domestic support limits increases dramatically. For example, if total indemnities in 2005 were twice the size of total premiums, a pattern we saw in 1993, then net indemnities would have

reached nearly \$6.3 billion, that is, approximately 3 percent of the value of total agricultural production in the United States. Adding in additional non-product-specific support could bring us to the point where crop insurance counts against the support limits.

The ongoing WTO agricultural negotiations and the conclusion of the cotton dispute between the U.S. and Brazil will likely affect the standing of crop insurance in the WTO. The U.S. has proposed reducing the *de minimis* exemption from 5 percent of the value of agricultural production to 2.5 percent.¹ If such a reduction were to occur, crop insurance support could exceed the *de minimis* level on its own and be counted against support limits. The ruling in the cotton dispute indicated that crop insurance support is “support to a specific commodity.”² This ruling raises questions about against our reporting crop insurance as non-product-specific and opens up the possibility that other countries could challenge our past reporting of crop insurance. If crop insurance were declared product-specific support, then some crop insurance net indemnities should have been counted against the U.S. support limits. For example, in 2001, crop insurance net indemnities for corn, upland cotton, canola, flaxseed, sunflower seed, peanuts, rice, and soybeans would have been counted against the limits, adding \$874 million to our reported AMS total. Thus, crop insurance faces several potential obstacles within the WTO.

However, the WTO agricultural agreement does exempt agricultural income insurance or income safety-net programs from domestic support limits under certain conditions. Paragraph 7 of Annex 2 of the WTO Agreement on Agriculture specifies these conditions. Eligibility for support can only be determined by agricultural income loss and the loss must be greater than 30 percent of average gross income or its equivalent in net income terms. Income guarantees must be based on a three-year average of past incomes. Insurance payments can compensate for up to 70 percent of the income loss. Payments are tied to income and not to individual components, such as yields, prices, or factors of production. The total payments from income insurance programs and natural disaster relief programs have to be less than 100 percent of the income loss.

Currently, federal crop insurance meets some of these conditions. Crop insurance is offered at coverage levels at or below 70 percent. In the vast majority of cases, indemnities are less than 70 percent of the loss. Revenue insurance programs, such as Income Protection, Adjusted Gross Revenue, and Revenue Assurance without the harvest price option, have payments that are triggered on revenues, not by prices or yields individually. Provisions in recent natural disaster relief programs have limited the combination of insurance indemnities and disaster payments to less than 100 percent of the loss.

But no existing crop insurance policy is based on a three-year average of past incomes. Adjusted Gross Revenue policies are settled on a five-year average. Most other crop insurance policies are based on four- to ten-year yield histories and annual prices. Thus, changes would likely have to be made to qualify any current crop insurance support as exempt under the income insurance provisions. While some policies may unintentionally meet the requirements, no current crop

¹ Office of the United States Trade Representative. “U.S. Proposal for Bold Reform in Global Agricultural Trade.” Doha Development Agenda Policy Brief, December 2005. Available at http://www.ustr.gov/assets/Document_Library/Fact_Sheets/2005/asset_upload_file281_8526.pdf.

² World Trade Organization. “United States – Subsidies on Upland Cotton, AB-2004-5, Report of the Appellate Body.” WT/DS267/AB/R, March 3, 2005.

insurance policies are designed to do so. For example, Adjusted Gross Revenue guarantees based on five years of income may fall below the specified 70 percent of the three-year average income. If so, those policies could qualify for exemption under the income insurance conditions. But the vast majority of current crop insurance policies do not fully meet the conditions.

Crop insurance policies could be evolved to better fit the WTO guidelines for income insurance. But while the WTO guidelines are quite specific in certain areas, other issues are left ill-defined. How might the insurance coverage be adjusted if producers substantially change their crop and/or livestock mix, adding and/or eliminating production on the farm? Can insurance coverage be offered on a single-commodity basis or must the coverage incorporate all enterprises on the farm (whole-farm coverage)? The answers to these and other questions hold the key to the ease with which the U.S. might shift its crop insurance program to fit under the income insurance guidelines. Recent work on which I have collaborated³ explores one possible evolution of crop insurance, designed to fit within the WTO guidelines for both exempt and non-exempt support programs. The work shows the potential for such changes but also the changes in infrastructure and support flows that might occur.

Crop insurance, like other federal agricultural support programs, falls under the domestic support requirements of the WTO agriculture agreement. As the negotiations for a new agriculture agreement continue, the status of crop insurance under the agreement could change, as could the conditions for exemption of income insurance from domestic support limits. Currently, the U.S. reports crop insurance as trade-distorting support that is exempt from support limits because of its relatively small size. However, as limits shrink and crop insurance grows, that exempt status may not last. There are potential challenges to the U.S. reporting of crop insurance, but there is also the possibility of transforming crop insurance into a program that would be exempt from support limits, regardless of size.

Thank you for providing me this opportunity to discuss these issues with you today.

³ Bruce A. Babcock and Chad E. Hart. "How Much 'Safety' Is Available under the U.S. Proposal to the WTO?" Briefing Paper 05-BP 48, November 2005. Center for Agricultural and Rural Development, Iowa State University. Available at <http://www.card.iastate.edu/publications/DBS/PDFfiles/05bp48.pdf>.