

GAO DRAFT REPORT
CROP INSURANCE: OPPORTUNITIES EXIST TO REDUCE
GOVERNMENT COSTS FOR PRIVATE-SECTOR DELIVERY

Analysis and Commentary

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ABOUT THE AUTHORS

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Dr. Neels has assisted clients in a variety of industries, including commercial air carriers, travel agents, airline computerized reservation service providers, pharmaceutical and biotechnology companies, health care providers, petroleum producers and refiners and transportation equipment manufacturers.

Before joining PHB, Dr. Neels was vice president at Quintiles, Inc. Dr. Neels was also vice president at Charles River Associates and has served on the research staffs of the Rand Corporation and the Urban Institute. He received a B.A. and Ph.D., both from Cornell University.

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In consulting to private sector clients, Dr. Leone has focused on industries experiencing significant economic and political change. His public sector clients include government agencies at all levels; he has testified in federal and state regulatory proceedings and appeared before congressional committees to discuss government policies affecting business.

Dr. Leone has advised the Executive Office of the President and various cabinet departments on the implications of numerous public policy initiatives. He was also a senior economist with the Council of Economic Advisers, serving both President Carter and President Reagan. He is widely published, and *The New York Times* described his book, *Who Profits: Winners, Losers, and Government Regulation*, as "[s]ophisticated, illuminating and, above all, tirelessly evenhanded."

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Putnam, Hayes & Bartlett, Inc. (PHB) is an economic and management consulting firm that assists decision makers in business, regulatory and litigation matters. By combining an understanding of economic fundamentals with industry-specific insights and quantitative problem-solving skills, PHB has grown to become one of the most respected advisors to business leaders throughout the world.

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Government and business leaders also call on PHB to assess the likely economic consequences of changes in public policies and to create alternative strategies for achieving public policy goals. PHB assists regulators, enforcement agencies, ratemaking organizations and other public sector clients to formulate policies that achieve defined public policy goals. The company has also worked to determine the possible impacts of public policies on such variables as investment, employment and profit levels, suggesting, where appropriate, modifications to lessen an adverse impact without compromising the basic regulatory goal.

With in-depth experience in the areas of regulation and deregulation, PHB specializes in providing regulatory frameworks that have made possible the major restructuring and privatization of publicly owned companies and infrastructure worldwide. PHB staff have evaluated policies adopted by government enforcement agencies and the actions of rate-setting agencies. They also have substantial public policy experience in the areas of trade, the environment, antitrust, energy, technological innovation and health and safety.

INTRODUCTION

On March 5, 1997, the GAO issued a written version of its draft report, entitled *Crop Insurance: Opportunities Exist to Reduce Government Costs for Private-Sector Delivery*. In this report, the GAO concluded that private insurers participating in the federally sponsored Multiple Peril Crop Insurance Program were overcompensated under the administrative expense reimbursement program. The report also compared the costs to the government of private versus government delivery of catastrophic insurance. Although the actual private delivery costs were lower, the catastrophic insurance program experienced an underwriting gain in 1995, which, if retained by the government, was large enough to offset the private sector's delivery cost advantage. The GAO thus concluded that government delivery was the less expensive alternative. Finally, the report examined a number of alternative expense reimbursement arrangements which, it argued, offer the potential for cost savings.

This report provides an analysis and critique of the GAO's findings. To place the GAO's factual findings, arguments, and conclusions in context, we review the recent history of the crop insurance program. This review reveals that the program has been successful in meeting the objectives set for it by Congress. Examination of the program's history and analysis of the GAO's methodology and reasoning call into serious question many if not most of the GAO's recommendations.

This analysis contains six sections. The first examines the role that private sector involvement and private competition have played in the development of the Multiple Peril Crop Insurance Program, focusing particularly on the success of the private sector in building participation in the program to the point where it constitutes a viable alternative to ad hoc agricultural disaster assistance. The second analyzes the economic basis for GAO's criticisms and discusses that agency's misunderstandings regarding the fundamental economics of the public/private partnership that lies at the heart of the federal crop insurance program. The third section reviews concerns expressed by Congress at the time of the passage of the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994 regarding the importance of maintaining a viable public/private partnership and potentially serious consequences that unilateral cuts in payments to private companies could pose for that partnership. The fourth focuses on the GAO analysis of private company administrative costs, discussing the limitations of the GAO's analysis and identifying instances in which the GAO report presents a misleading picture of company expenses and/or behavior. A fifth section discusses the GAO's proposals for restructuring the administrative expense reimbursement system and cutting private company reimbursements. A final section discusses the conclusions we have drawn as a result of this review and considers the implications for the future of the program of implementing the cuts in the administrative expense reimbursement that the GAO has suggested.

Our analysis of the history of the crop insurance program and of the GAO's draft report leads us to four principal conclusions:

- Involvement of the private sector has been critical to the program's success. Without the active participation of private insurance companies the program could never have met the goals set for it by Congress.
- The crop insurance program has achieved a dramatic expansion in scale while maintaining tight control over administrative costs. On an inflation adjusted per-insured-acre basis, administrative costs have declined markedly since the mid 1980's.
- The GAO's allegations that the private insurance companies are earning excess profits are inconsistent with the program's recent history. If the crop insurance program did enable private companies to earn excess profits, we would not expect to have seen the dramatic decline in the number of companies participating in the program that has occurred in recent years.
- The GAO's methodology is seriously flawed, especially its excessive reliance on data drawn from a two year period characterized by below-average crop losses.

We also find that the GAO study shows little appreciation for the concerns voiced by members of Congress regarding the critical importance of private sector involvement in the program and the resulting need to provide companies with an adequate return and an economically viable role. In an apparent effort to provide justification for budget cuts, the GAO has adopted a narrow perspective incapable of informing the policy discussion and has presented a misleading and incomplete analysis of program costs. It has paid little attention to regulatory/administrative reforms called for by Congress and has failed to address many of the topics identified by Congress when it called for an evaluation of the crop insurance program. It has proposed changes to the existing administrative expense reimbursement that could create perverse incentives and necessitate a costly and intrusive regulatory role for federal authorities. Unilateral payment cuts motivated by the GAO's analysis jeopardize the viability of the public/private partnership responsible for the crop insurance program's recent successes.

THE VIABILITY OF THE MULTIPLE PERIL CROP INSURANCE PROGRAM DEPENDS CRITICALLY ON CONTINUING PARTICIPATION BY PRIVATE INSURERS

The multiple peril crop insurance program could not exist in anything resembling its present form without the active participation of private insurers. Their involvement has been a key element in Congress' efforts to establish an insurance program that would be widely available to all of the nation's farmers. They have supplied the resources and the manpower necessary to deliver insurance to all areas of the country. They have provided valuable expertise that has shaped the evolution of the program and have been a source of innovation in program design and product concepts. Throughout the modern crop insurance program's period of evolution and growth members of Congress have been particularly aware of the critical role played by private insurers and on many occasions

Congress sought to preserve an active and vital role for the insurers. The recommendations of the GAO pose a grave risk of nullifying these efforts.

The passage of the Federal Crop Insurance Act of 1980 marked the birth of the present federal crop insurance program and the start of the public/private partnership that has been the foundation for its success. With the passage of this Act, Congress for the first time embraced the goal of establishing a program that could provide protection for all farmers in all regions, with the intent that it replace ad hoc disaster payments. The Act contained numerous provisions designed to increase participation by farmers in the program. Previous limitations in Federal Crop Insurance Corporation's (FCIC) ability to offer reinsurance to private companies were eliminated. Congress expected that the private sector would play a major role in marketing the program to farmers and increasing the number of farmers who took advantage of the protection that it offered.

In fact, in the years following the passage of the 1980 Act the size and scope of the program expanded dramatically. The number of county crop programs (i.e., an insurance contract for particular crop in a particular county) grew from under 5,000 in 1980 to more than 15,000 in 1983 (see Exhibit 1). This rapid increase was primarily due to the entrance of existing crop programs into new counties. By 1990 the number of crops for which insurance was available had increased to 50, from 28 in 1980, and nearly all of the nation's counties were represented in the crop insurance program.

With the help of the private sector the participation rate, defined as net insured acres divided by total eligible acres, also increased throughout the 1980s (see Exhibit 2). From a low of 10 percent in 1980, participation grew to 32 percent by 1993. Although this growth represented a major expansion, Congress was concerned about the program's failure to achieve the goal of 50 percent participation that had been set in 1980. Widespread crop losses caused by the floods of 1993 and calls by uninsured farmers for federal disaster assistance prompted a reexamination of the program that eventually led to passage of the Federal Crop Insurance Reform Act of 1994.

At the time the 1994 Act was passed, participation in the program was expected to increase to 80 percent.¹ These hopes could not have been realized without assistance from the private sector. Only the private companies could supply the sheer manpower needed to deliver the new catastrophic crop insurance product to the nation's farmers; the govern-

¹ Review of the Administration's Federal Crop Insurance Reform Proposal, Part 1 (Hearings), 1995-CIS-H161-1, March 25, 1994, p. 26. Typical of the statements made at this time: The change made in this bill will improve the delivery and coverage of Federal crop insurance programs by offering crop producers premium-free catastrophic insurance coverage for crops. One of the main reasons the current program is inadequate is because of lack of participation. This bill provides strong incentives to encourage crop producers to purchase additional coverage from private insurers. *Cong. Rec.* 140, August 5, 1994, p. H6993.

Exhibit 1

Geographic and Crop Coverage Offered Under the Mpci Program			
Year	Crops Covered	County Programs	County-Crop Programs
1980	28	1,676	4,651
1981	29	1,928	5,944
1982	30	2,999	14,588
1983	30	3,000	15,415
1984	34	3,010	17,879
1985	38	3,012	18,903
1986	40	3,013	19,064
1987	44	3,014	19,263
1988	44	3,015	19,675
1989	49	3,022	20,507
1990	50	3,026	23,533
1991	51	3,026	24,399
1992	51	3,026	24,414
1993	51	3,026	24,587

Source: Barry K. Goodwin and Vincent H. Smith, *The Economics of Crop Insurance and Disaster Aid*, Washington, D.C.: The AEI Press, 1995.

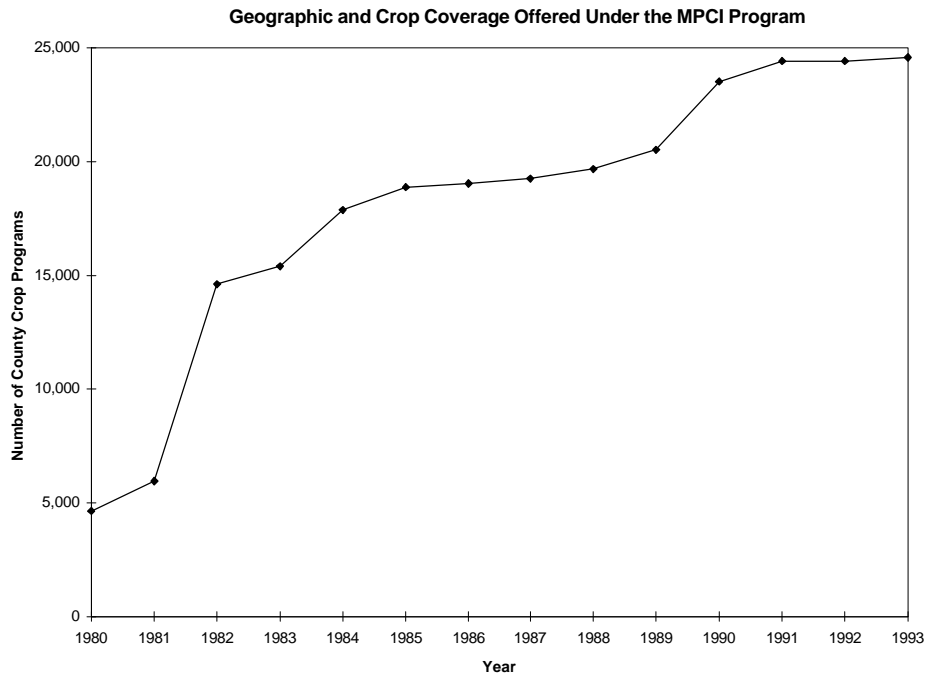
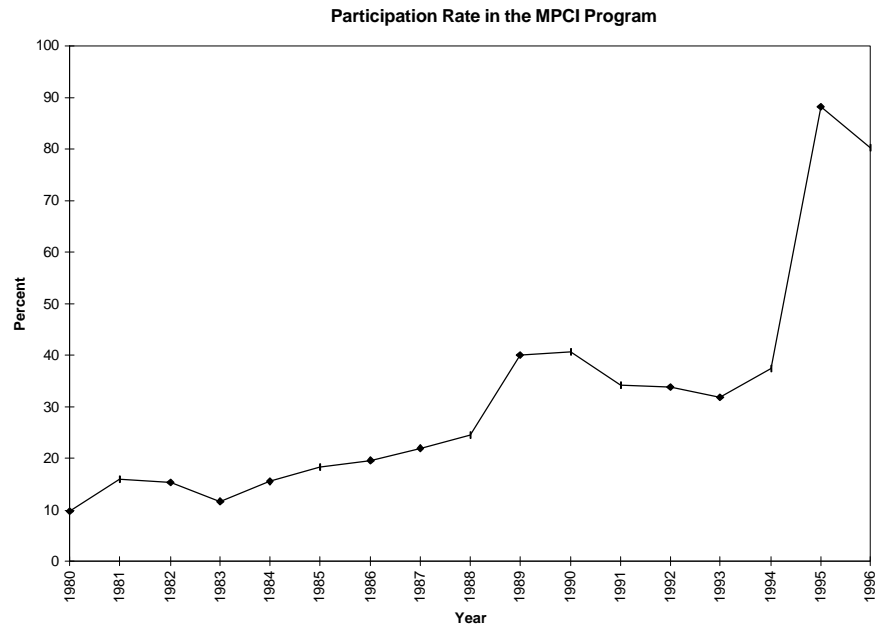


Exhibit 2

Participation in the MCPI Program		
Year	Participation Rate (%)	Insured Acres (000)
1980	9.6	26,272
1981	15.9	44,996
1982	15.3	42,721
1983	11.6	27,935
1984	15.5	42,668
1985	18.2	48,537
1986	19.6	48,632
1987	21.9	49,132
1988	24.5	55,541
1989	40.0	99,875
1990	40.7	101,63
1991	34.1	85,245
1992	33.8	84,416
1993	31.7	79,365
1994	37.4	93,452
1995	88.2	220,540
1996	80.1	200,357



ment simply did not have sufficient resources to do the job.² The critical importance of the role of private industry was acknowledged by Kenneth D. Ackerman, manager of the Federal Crop Insurance Corporation:

If I may, one of the major variables in this calculation is to what extent the private sector will step in and aggressively market this product. We hope that they will, and we hope that in most parts of the country, farmers given a choice and given a reasonable marketing effort by the private sector, that the bulk of this business will in fact go to private agents.³

Although the implementation of the 1994 Act represented a major challenge, private industry rose to the occasion. The new program offering catastrophic insurance coverage was implemented successfully. In the year following passage of the 1994 Act participation rates rose to 88 percent. Since that time private industry has assumed exclusive responsibility for the delivery of catastrophic insurance coverage in fourteen states and is expected to assume similar responsibility in other states soon. Although participation rates have fallen somewhat since the repeal of the 1994 Act provision that made crop insurance a prerequisite for receipt of agricultural program benefits, they have remained well above the 50 percent goal set by Congress in 1980.

In order to assure that crop insurance is available to all farmers the FCIC has required that the private companies participating in the program provide coverage and service to all applicants. Because of this requirement, private companies are precluded from taking many actions that other types of insurers use to contain costs and enhance economic viability. Private companies are required to offer coverage to growers with poor insurance experience, high loss rates, small acreage, or other characteristics that may make them impossible to serve profitably. This requirement adds to the cost of the program in ways that are entirely beyond the control of participating private insurers. However, it does support to social goal of making crop insurance available to all farmers.

The widespread availability and high participation rates that have recently been achieved with the help of the private sector have finally permitted Congress to attain its long-sought goal of turning the crop insurance program into a replacement for ad hoc agricultural disaster assistance. Before 1980, this assistance had been provided primarily through ad hoc appropriations, with the U.S. Department of Agriculture (USDA) dispensing approximately \$436 million directly to farmers annually between 1974 and

² Many current USDA employees – those people now administering the commodity programs have told me that they want no part of becoming insurance salespersons. And in checking with the department, I have found there is nothing budgeted to help train and cover the expenses for these local offices to adequately sell crop insurance. The simple fact is that the USDA will not be able to pull off crop insurance sales, and the department knows this. USDA will need – and I think fully expects – the private sector to help deliver crop insurance. *Cong. Rec.* 140, August 5, 1994, p. H6999. I think that ASC is having difficulty administering the programs it already has. It's being cut back on personnel and it has an increasing workload. I think there's a duplication of services that would take place since we already have a private system in place. Statement of Steve Lindholm, Hearings, 1995-CIS-H161-1, p. 112.

³ Hearings, 1995-CIS-H161-1, p. 30.

1980.⁴ This direct payment program was criticized as being too expensive and for encouraging production in areas prone to natural disasters.

Even following passage of the 1980 Act, however, the USDA continued to provide agricultural disaster assistance outside of the crop insurance program in the form of direct cash payments and subsidized loans. Over the 1981 to 1988 period the Agricultural Stabilization and Conservation Service (ASCS) dispensed \$6.9 billion in direct disaster payments,⁵ with \$5.6 billion related to crop losses and the remainder to livestock, feed and conservation programs. Payments peaked in 1981, 1988 and 1989 due to severe droughts. The 1988 drought was one of the worst on record, especially for central United States, and the Disaster Assistance Act of 1988 made more than \$4 billion available for disaster relief.⁶ In the following year, the Disaster Assistance Act of 1989 provided about \$897 million in ad hoc disaster relief⁷ and allocated \$1.48 billion to cover drought losses.⁸ Total disaster payments in fiscal year 1989 exceeded \$4 billion. Following widespread flooding and drought in 1993 and 1994, the Midwest Flood and Southeast Drought Aid Act provided another \$3.25 billion in disaster payments.⁹ In fiscal year 1994 the ASCS dispensed over \$3.1 billion in disaster relief.¹⁰

In the 1994 Act, Congress sought to eliminate ad hoc disaster assistance, and enlisting the private sector to increase the participation in the program was an integral part of its strategy. **However, if participation rates were to fall to the levels experienced during the 1980s, a significant natural disaster could result in nearly irresistible political pressures for a return to reliance on ad hoc disaster assistance appropriations.** Such an outcome would erase the results of Congress' twenty-year effort to rein in these programs.

The impressive expansion in the crop insurance program cited above has been achieved at a surprisingly modest cost. Total administrative costs for the program have, of course increased, growing from less than \$100 million in 1981 to \$319 million in 1994. Given the growth in the scope of the program, however, some increase in administrative costs was to be expected. During this time, total premiums paid increased very substantially, and the percentage of sales made by private companies grew from 36.4 percent in 1983 to 93.2 percent in 1993. As shown in Exhibit 3, however, on an inflation-adjusted per-insured-acre basis both reinsured company administrative costs and total program administrative costs have declined since the mid 1980s. Dramatically expanding the scale of the crop insurance

⁴ General Accounting Office, Disaster Assistance: Crop Insurance Can Provide Assistance More Effectively than Other Programs. GAO/RCED-89-211, September 20, 1989, p. 12.

⁵ GAO/RCED-89-211, September 20, 1989, p. 16.

⁶ GAO/RCED-89-211, September 20, 1989, p. 15.

⁷ GAO/RCED-89-211, September 20, 1989, p. 15.

⁸ Barry K. Goodwin and Vincent H. Smith, *The Economics of Crop Insurance and Disaster Aid*, Washington, D.C. The AEI Press, 1995, p. 61.

⁹ Goodwin and Smith, p. 61.

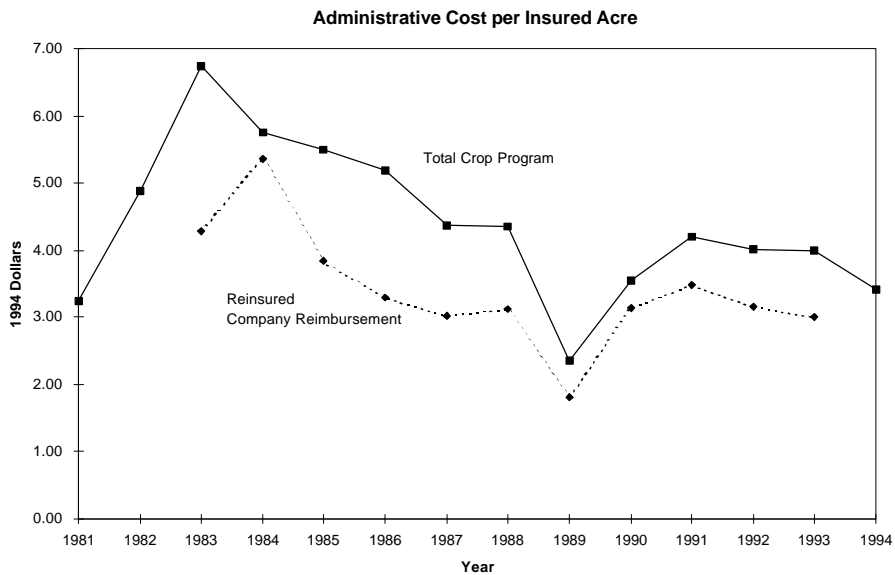
¹⁰ Goodwin and Smith, p. 62.

Exhibit 3

Nominal and Inflation-Adjusted Administrative Costs of MPCJ Program									
Year	Thousands Of Dollars (Current)			Thousands Of Dollars (1994 \$)			Dollars (1994 \$)		
	Reinsured Company Reimburs. Costs	Other FCIC Admin. Costs [1]	Total Crop Program Admin. Costs	Reinsured Company Reimburs. Costs	Other FCIC Admin. Costs [1]	Total Crop Program Admin. Costs	% of Sales By Reinsured Companies	Reinsured Company Admin. Cost Per Acre [2]	Total Admin. Cost Per Acre [3]
1981	3,663	88,288	91,951	5,819	140,246	146,064			3.25
1982	23,138	116,168	139,306	34,608	173,756	208,364			4.88
1983	30,436	100,870	131,306	43,658	144,691	188,349	36.4	4.29	6.74
1984	98,717	78,887	177,604	136,565	109,132	245,697	59.7	5.36	5.76
1985	103,237	96,371	199,608	137,912	128,740	266,652	73.9	3.84	5.49
1986	98,809	94,683	193,492	128,721	123,346	252,068	80.5	3.29	5.18
1987	98,717	71,177	169,894	124,733	89,935	214,668	84.0	3.02	4.37
1988	123,093	75,229	198,322	150,113	91,743	241,856	86.3	3.13	4.35
1989	139,783	61,309	201,092	163,626	71,766	235,392	90.4	1.81	2.36
1990	255,761	66,373	322,134	286,911	74,457	361,368	89.8	3.14	3.56
1991	248,266	83,343	331,609	267,913	89,938	357,851	90.3	3.48	4.20
1992	232,983	89,684	322,667	244,632	94,168	338,800	91.8	3.16	4.01
1993	217,511	92,230	309,741	222,599	94,387	316,986	93.2	3.01	3.99
1994	245,185	73,628	318,813	245,185	73,628	318,813			3.41

Sources: 1981-1982 data from Commission for the Improvement of the Federal Crop Insurance Program, Recommendations and Findings to Improve the Federal Crop Insurance Program.
 1983-1994 data from US OMB, Budget of the U.S. Government.
 Percentage of sales by reinsured companies taken from Goodwin and Smith.

Notes: [1] Other FCIC administrative costs include costs associated with direct agent sales and service contracts, as well as general FCIC administrative expenses.
 [2] Reinsured company administrative cost per acre = Reinsured company reimbursement cost/ (Total insured acres x Percentage of sales by reinsured companies).
 [3] Total administrative cost per acre = Total crop program administrative costs/ Total insured acres.
 Note that the acres used in [2] and [3] are different.



Note: Total crop program administrative cost per acre is calculated using total insured acres. Reinsured company reimbursement cost per acre is calculated using insured acres allocated to sales by reinsured companies.

program while maintaining this degree of tight cost control is an impressive achievement for which all parties to the public/private partnership deserve much credit.

Even this brief examination of the history of the program's expansion and evolution indicates clearly that both Congress and the nation's farmers have a strong and continuing interest in encouraging widespread participation by private companies in the Multiple Peril Crop Insurance Program. Congress has clearly recognized the critical role played by private insurance companies and has taken steps, in all key pieces of legislation it has passed since 1980, to ensure their continuing involvement. These facts provide the necessary background for evaluating the findings of the GAO study and for assessing the potential damage to the crop insurance program that their recommendations could cause if implemented.

THE NARROW FOCUS OF THE GAO STUDY IGNORES THE FUNDAMENTAL ECONOMIC REALITIES OF THE PUBLIC/PRIVATE PARTNERSHIP

The 1994 Act called for a broad evaluation of the Multiple Peril Crop Insurance Program addressing many important topics, including the average cost to deliver multiple peril crop insurance; the cost of complying with the requirements, regulations, procedures and processes of the Federal Crop Insurance Act; the cost differences for various provider firm sizes; the adequacy of the standard reimbursement for potential new providers; and new costs related to the provisions of the Act. The sections of the 1994 Act calling for an evaluation of the crop insurance program are reproduced on page 6.

The breadth of Congress' concerns as expressed in the language of the 1994 Act stands in strong contrast to the narrow focus of the GAO report. The GAO's agenda is stated clearly in the title of its report: *Opportunities Exist to Reduce Government Costs for Private-Sector Delivery*. In its executive summary, the report identified three topics to be addressed: the adequacy of the current reimbursement rate for expenses of participating private-sector companies; the comparative cost to the government in 1995 of private companies and USDA's delivery of catastrophic insurance; and the advantages and disadvantages of different expense reimbursement mechanisms. The GAO's stated objectives fail to explicitly address a number of significant issues whose examination was called for in the 1994 Act. Nowhere does the GAO consider changes made by the FCIC in response to increased program participation. Nowhere does the GAO consider cost differences for various provider firm sizes. Nor does the GAO consider either the adequacy of the standard reimbursement for potential new providers or the new costs associated with the passage of the 1994 Act. And although the report includes an appendix listing simplification and paperwork reduction actions taken by FCIC, the GAO makes no effort to quantify the administrative cost savings associated with these actions, or even to demonstrate that they have had the effect of reducing rather than increasing the costs to private companies of participating in the program.

The GAO's narrowly focused inquiry falls far short of the broad evaluation that one would expect considering it is to serve as the foundation for far-reaching recommendations with serious consequences for the program's operation and future viability. The study's narrow concentration on the relationship between private company administrative

**LANGUAGE OF THE 1994 ACT AUTHORIZING AN EVALUATION
OF THE CROP INSURANCE PROGRAM**

(P.L. 103-354 Sec. 118, Crop Insurance Provider Evaluation)

- (a) In General. The Comptroller General of the United States and the Federal Crop Insurance Corporation (referred to in this section as the "Corporation") shall jointly evaluate the financial arrangement between the Corporation and approved insurance providers to determine the quality, costs, and efficiencies of providing the benefits of multiple peril crop insurance to producers of agricultural commodities covered under the Federal Crop Insurance Act (7 U.S.C. 1501 et seq.).

* * *

- (d) Final Report. Not later than 2 years after the date of enactment of this Act, the Comptroller General and the Corporation shall submit a final report that provides the evaluation required under subsection (a) to the Committee on Agriculture of the House of Representatives and the Committee on Agriculture, Nutrition, and Forestry of the Senate. In making the evaluation, the Comptroller General and the Corporation shall
- (1) consider the changes made by the Corporation in response to increased program participation resulting from the enactment of this Act;
 - (2) include an evaluation and opinion of the accuracy and reasonableness of
 - (A) the average actual costs for approved insurance providers to deliver multiple peril crop insurance;
 - (B) the cost per policy of complying with the requirements, regulations, procedures, and processes of the Federal Crop Insurance Act;
 - (C) the cost differences for various provider firm sizes and any business delivered by the Federal Government;
 - (D) the adequacy of the standard reimbursement for potential new providers; and
 - (E) the identification of any new costs related to the enactment of this Act not previously identified in the information reported by the providers;
 - (3) compare delivery costs of multiple peril crop insurance to other insurance coverages that the provider may sell and determine the extent, if any, to which any funds provided to carry out the Federal Crop Insurance Act are being used to fund any other business enterprise operated by the provider;
 - (4)
 - (A) assess alternative methods for reimbursing providers for reasonable and necessary expenses associated with delivery of multiple peril crop insurance;
 - (B) recommend changes under this paragraph that reasonably demonstrate the need to achieve the greatest operating efficiencies on the part of the provider and the Corporation has been recognized; and
 - (C) identify areas for improved operating efficiencies, if any, in the requirements made by the Corporation for compliance and program integrity;
 - (5) assess the potential for alternative forms of reinsurance arrangements for providers of different firm sizes, taking into consideration
 - (A) the need to achieve a reasonable return on the capital of the provider compared to other lines of insurance;
 - (B) the relative risk borne by the provider for the different lines of insurance;
 - (C) the availability and price of commercial reinsurance; and
 - (D) any additional costs that may be incurred by the Federal Government in carrying out the Federal Crop Insurance Act; and
 - (6) include an analysis of the effect of the current or proposed reinsurance arrangements on providers having different business levels.

expenses and the magnitude of the administrative expense reimbursement apparently reflects a belief on the part of the GAO that this issue can be dealt with in isolation and that any changes made in this aspect of the program will have no further effects on its overall operation or viability. In this, they are wrong.

The attractiveness of the Multiple Peril Crop Insurance Program to private insurers depends not upon the relationship between administrative expenses and the administrative expense reimbursement, but rather upon those insurers' total earnings from the program. Those earnings depend both upon the revenues received through the administrative expense reimbursement, as well as the potential for realization of underwriting gains on insurance sold. Focusing exclusively on one source of earnings or the other provides an incomplete picture of the economics of private sector participation. Such a narrow focus can reveal little about the long-term viability of private companies' long-term participation in the program.

The only way to determine if private insurers are being overcompensated is through a broad evaluation that takes into account all facets of the relationship between private insurers and the Federal Crop Insurance Corporation. Such an evaluation would have to take into account not just the relationship between actual administration and delivery costs and the amount of the administrative expense reimbursement, but also the actuarial soundness of the Multiple Peril Crop Insurance Program, the magnitude of the insurance program's surpluses and losses over the entire loss cycle and the provisions of the standard reinsurance agreement that govern the division of underwriting gains and losses between private insurers and the FCIC. The GAO has conducted no such broad examination.

Even in the absence of a comprehensive evaluation of the returns to participation in the crop insurance program, however, the available evidence fails to support the GAO's assertion that the private participants in the program are being overpaid. If private insurers are overcompensated for their administrative expenses to the point where, considering their total gains from participation in the program, they are earning excess profits, we should see efforts by new firms to enter the market and share in those excess profits. Such an outcome would be the natural response of a free market with unrestricted entry.

The experience of the crop insurance program, however, does not support the view that private insurers are earning excess profits. The number of private firms participating in the program is not increasing, but declining. The number of Standard Reinsurance Agreement (SRA) holders has declined from approximately 50 in 1985 to 16 in 1996. **Thus, there is little evidence to suggest that the current terms under which private companies participate in the program are excessively generous.**

In this context, unilateral cuts in the administrative expense reimbursement that are made in the absence of any offsetting changes in other program features can only reduce the economic incentives for private insurers to participate in the program. Clearly this result would fly in the face of the stated goal of continued broad private participation in the program and continue or speed the decline in the number of private participants. It would place at risk the many benefits that the program and the nation's farmers have derived over the years from widespread private sector involvement.

IN 1994 CONGRESS RECOGNIZED THE RISK THAT UNILATERAL PAYMENT CUTS POSED FOR PRIVATE PARTICIPATION IN THE PROGRAM

The legislative history of the 1994 Act clearly demonstrates Congress' recognition that a successful crop insurance program requires public/private partnership. Without federal support, the program would not work; yet, without the private companies, the government could not make the program succeed. **Despite the relentless pressures created by the need to reduce the federal budget deficit, Congress clearly recognized that for the program to succeed in the long run it must foster industry growth by increasing both the number of companies in the business as well as the products and services they provided.**

Congress also recognized that without government support, crop insurance is not profitable for the private companies involved.¹¹ On their own, private companies would never provide it.¹² The infrequent and unpredictable yet widespread nature of large-scale disasters make the problem of risk-pooling more difficult than in other types of insurance. Experience both in the United States and abroad indicates that in order to have a widespread program of multiple peril crop insurance the government must step in and support the program through premium subsidies and expense reimbursements. The private sector has proven to be both willing and able to work with the government in the delivery of crop insurance to the nation's farmers. Nevertheless, this public/private partnership will only continue to work if the private sector is able to realize adequate financial return.¹³

In the debate leading up to the passage of the 1994 Act, the mandate to reduce the administrative expense reimbursement first appeared in an amendment to the bill H.R. 4217 drafted in the House committee. During an open business session on July 20, 1994,

¹¹ The only reason an insurance agent would do it is to pick up a guy's homeowner's insurance or the insurance on his tractor or his truck. They do not go out and make a living selling crop insurance. That is why there is not much market penetration right now. *Cong. Rec.* 140, August 5, 1994, p. H7000. Crop insurance is already a loss loser, most agents do not sell it now. The only reason why you do it is try to pick up the other lines: Automobile, house, so forth, and other farmers. *Cong. Rec.* 140, August 5, 1994, p. H7016.

¹² Well, there is a wind storm insurance pool, there is a national flood pool, there is a crime program for high-risk crime areas, assigned-risk automobile programs. All of these are taxpayer-subsidized for areas that the private insurance sector will not go into. *Cong. Rec.* 140, August 5, 1994, p. H7016. This is a situation that, hopefully, we are trying to correct. The government/private sector partnership is providing low-cost insurance to the producers. Why low-cost insurance? For a very simple reason: If it were a viable money-making endeavor, the private sector would be doing it on their own. They cannot. *Cong. Rec.* 140, August 5, 1994, p. H6994.

¹³ When you have a public/private partnership, the private partner must be treated fairly. The private partner must be compensated at a level essential to keep them in the business if they are going to rely on that private partner to make the program work. *Cong. Rec.* 140, August 5, 1994, p. H6997. Public-private partnerships only work where there is an opportunity for the private sector to realize some financial return competitive to what they might realize in other non-partnership ventures. Hearings, 1995-CIS-H161-1, p. 30.

Congressman Penny offered an amendment (hereafter the Penny Amendment) to the bill that would have cut an additional \$586 million, in part by reducing the administrative expense reimbursement rate to insurance agents to 30 percent on new policies and 28 percent on renewals.¹⁴ The Penny Amendment was voted down and replaced by several amendments contained in an en bloc proposal presented by Chairman de la Garza (hereafter the de la Garza Amendment). According to the House report, the de la Garza Amendment contained a directive that required the FCIC to study and solicit ideas from the crop insurers on how to reduce the average costs per policy and, to the extent practicable, set a target cost-reduction percentage and implement changes to meet that target. ¹⁵

Both the Penny Amendment and the de la Garza Amendment contained provisions for reducing the reimbursement rate to private insurers. The original bill, which did not contain any provision to cut reimbursements, kept the rate at 31 percent. The Penny Amendment reduced this rate to 30 percent on new policies and 28 percent on renewals. The de la Garza Amendment reduced the rate to 29 percent starting in 1997, to 28 percent in 1998 and to 27.5 percent in 1999. This amendment also required the FCIC to reduce regulatory requirements in ways that would lower private insurance providers administrative costs by an amount commensurate with the reduction in the administrative expense reimbursement.¹⁶ At the conclusion of the debate, a vote was taken, and the de la Garza Amendment was passed in place of the Penny Amendment.

The de la Garza Amendment reflected awareness on the part of Congress of the importance of balancing the need to reduce the program's demands on the federal treasury and the need to preserve the program's hard-won accomplishments. The language of the Amendment included an explicit prohibition of any action that would hinder program expansion or diminish service to customers. It is not clear that the GAO's recommendations are consistent with this mandate.

¹⁴ House Report 103-649 on H.R. 4217, "Federal Crop Insurance Reform Act of 1994," Aug. 1, 1994. (1994 *U.S. Code Congressional and Administrative News*, Vol. 5, p. 2541).

¹⁵ 1994 *U.S. Code Congressional and Administrative News*, Vol. 5, p. 2545.

¹⁶ Page 11, strike lines 8 through 11 and insert the following new paragraph: (2) in subsection (c), by striking , in which case the agent or broker in the first sentence and all that follows through the period at the end of the second sentence and inserting the following: , except that the rate established by the Board to reimburse approved insurance providers and agents for their administrative and operating costs shall not exceed, for the 1997 crop year, 29 percent of the premium used to define loss ratio under section 502, and for the 1998 and 1999 crops, such reimbursement rate shall not exceed 28 percent of the premium used to define loss ratio under section 502. Consistent with the provisions of section 506(p), the Board shall provide regulatory relief to such approved insurance providers and agents in an amount proportional to the reduction in the reimbursement rate established by the Board for the 1997, 1998, and 1999 crop years. No action shall be taken which would jeopardize program integrity, enhance opportunities for fraud or abuse, hinder program expansion or diminish quality of service to customers. *Cong. Rec.* 140, August 5, 1994, p. H7010. This language was restated in the final legislation in Sec. 106 (Crop Insurance), subsection (k) (Reinsurance), paragraphs 4, 5 and 7.

The provisions of the de la Garza Amendment also reflected the concern on the part of many members of Congress that cuts in payments to private insurers made in the absence of any other offsetting adjustments to the program could make participation in the program uneconomical and jeopardize the private sector involvement that is critical to its success.¹⁷ **It was for this reason that the 1994 Act linked reductions in the administrative expense reimbursement to administrative/regulatory simplification aimed at reducing the cost to the private sector of participating in the program.** In an effort to decrease the administrative burden on the private companies, the legislation provided for a reduction in paperwork. This decrease in paperwork, it was hoped, would translate into a reduction in administrative costs for the private insurers corresponding to the cutback in the reimbursement rate.¹⁸ Nevertheless, many were concerned that any reduction in the reimbursement rate would harm the program,¹⁹ by decreasing participation by private insurers and thereby reducing the availability of insurance services.²⁰

The GAO report fails to offer any credible analysis of the extent to which the FCIC's efforts to streamline the administration of the crop insurance program has lowered the costs of participation to private insurers. Its only treatment of this topic is contained in an Appendix in which the GAO presents a laundry list of specific actions taken by FCIC. This list is presented without analysis or comment or any attempt to determine whether these actions either together or in isolation have lowered private company costs.

¹⁷ I strongly urge my colleagues to vote against an amendment offered by Congressman Penny and Congressman Gunderson to cut over \$600 million from this program. If this magnitude of cut is made in the committee bill, the program will no longer be attractive to many of the farmers in my district. Moreover, drastic cuts in reimbursement for the private delivery system will make it uneconomical to deliver crop insurance to many of the small family farmers in my district. *Cong. Rec.* 140, August 5, 1994, p. H7002.

¹⁸ Specifically, my amendment, which is incorporated in the bill before us, directs the Federal Crop Insurance Corporation to reduce the paperwork burden to private insurance providers and agents, and lower the cost of each policy held by farmers. Further, the corporation after reporting to Congress, must adopt new procedures to reduce the cost of each crop insurance policy by a targeted percentage. Not only will these provisions allow the private sector to more efficiently deliver crop insurance, but the excessive administrative costs of the Federal Crop Insurance Corporation will be reduced. *Cong. Rec.* 140, August 5, 1994, p. H6999.

¹⁹ The amendment offered by my friend and colleague, the gentleman from Minnesota (Mr. Penny), in my opinion, breaks the public-private partnership required to make this program work. I believe it takes private-sector reimbursement levels to an area where we will not have the participation from the private sector required to make the program work. This is where the chairman's amendment has involved so much effort, so many discussions with all of the participants, to actually fashion a level of funding that will retain private-sector participation. *Cong. Rec.* 140, August 5, 1994, p. H6997.

²⁰ If increased risk is laid off on the private sector while return to the private sector is screwed down a little tighter, you will not have interest in private sector participation. Hearings, 1995-CIS-H161-1, p. 30. The basic reimbursement rate has already been reduced from about 34 percent to 31 percent of premium. However, to mandate that the reimbursement rate on renewals now be limited to 28 percent or a lower level, could impose serious burdens, particularly on smaller companies. Letter from Secretary Mike Espy, 1994 *U.S. Code Congressional and Administrative News*, Vol. 5, p. 2544.

THE GAO PRESENTS A BIASED PICTURE OF PRIVATE INSURER ADMINISTRATIVE AND DELIVERY COSTS

The findings presented in the GAO's draft report, even within the relatively narrow scope of the GAO investigation, do not appear to be the result of a balanced and objective assessment of the evidence. In numerous instances the GAO misrepresents the actual economic incentives facing private insurers, misinterprets or misclassifies expenditures or presents information in a biased or selective way.

The GAO's analysis of the administrative expenses of the private insurers suggests a lack of understanding of the private insurers' incentives to manage administrative expenses efficiently. The GAO appears to have approached its audit with the same mindset one should bring to an examination of someone's travel expense report. It appears to be looking for instances where the company has padded the expense report with questionable expenses in an effort to extract a larger-than-justified reimbursement. **The GAO fails to recognize that private companies have no economic incentive to misrepresent their costs.** By law, the administrative expense reimbursement is fixed as a percentage of premium revenue and, hence, is independent of any individual company's level of actual expenditures. For this reason, companies have nothing to gain by understating or overstating their actual costs.

This misunderstanding of companies' economic incentives appears to have infected the GAO's criticisms of how these companies have managed their costs. At one point in its draft report, for example, the GAO states that "Other Reported Expenses Represent Opportunities to Lower Reimbursement Rates."²¹ Under this heading the GAO identifies a number of elements of private company delivery costs that it characterizes as "excessive." However, the fact that a private company's administrative expense reimbursement is independent of its actual expenses means that any "excessive" expenditures made by that company represent a direct deduction from its bottom line. **Private companies have a clear and direct incentive to avoid such excessive expenditures. This economic fact should create a presumption that the expenses actually incurred by private companies represent their best and most considered judgment about how to most efficiently meet the needs of the program.** Instead the GAO has placed itself in the position of disagreeing with relatively complex business judgments made by companies that have every incentive to make them correctly. It has rejected the idea that competition between profit-maximizing private companies can result in the optimal management and containment of costs. Instead, the GAO has effectively argued that it can do the job better.

An example of the GAO's intrusion into the realm of private business decision making is the objection it raises regarding leased aircraft expenses. By its nature, the crop insurance business involves travel to far-flung sites in rural areas. An astute businessman concerned about how best to transport staff to distant locations would consider both the relative costs of leased aircraft, regularly scheduled air transportation and ground transportation, as well as the travel time and resulting staff costs associated with each. There is no evidence that the GAO's criticisms of the use of leased aircraft are the result of any similar calculation.

²¹ Draft GAO Report, p. 35.

Instead, the GAO simply asserts that these costs are excessive without providing any evidence to support this assertion.

The GAO raises numerous objections to company expenditures for gifts and rewards to employees. The sums in question are often trivial from the perspective of a multi-billion dollar program \$8,391 to send company managers to a meeting at a resort location, for example, or \$8,242 to purchase cookbooks as gifts.²² The GAO fails to recognize or acknowledge that such gifts are often used in private industry to motivate and reward high-performing employees.

The standards used by the GAO to evaluate the appropriateness of private insurers administrative expenses are at times in conflict with basic economic principles. For example, among the items the GAO excluded from its calculation of private companies administrative costs are what the GAO characterizes as Expenses Resulting From Sharing Profits Through Bonuses.²³ The GAO states in justifying this exclusion that bonuses . . . did not appear a reasonable program expense, because they were paid out of profits after all necessary program expenses were paid.²⁴ Why such payments, which are made to labor, should be regarded as profits, which are generally defined as the residual claims accruing to shareholders or other owners of the enterprise, is not clear. The only reasons shareholders have for making payments to employed labor is to guarantee that their overall compensation is at competitive levels or to ensure continued above-standard performance. The fact that a portion of these payments varies with the performance of the firm provides no justification for classifying them as profit. In fact, the direct effect of paying such bonuses is to reduce profits. All that the existence of such bonus payments means is that these companies have adopted the widely recognized and widely praised practice of building performance incentives into the overall compensation system.

The GAO's ability to draw conclusions from its analysis is seriously hampered by the fact that its analysis is based entirely upon data drawn from a two-year period characterized by favorable loss experience. The historical record of the crop insurance program provides no basis for believing that relationships observed over such a short period will continue to hold over the entire loss cycle. The bulk of the losses in the program have occurred during infrequent and irregularly spaced years characterized by widespread natural disasters. The last such disaster was the flooding that occurred in 1993, immediately preceding the period of the GAO study. Large-scale natural disasters of this type have made premium setting difficult. They have also posed major challenges for program design and program administration, causing major changes in loss adjustment workloads and claims processing volumes.

Because of the highly cyclical nature of the crop insurance program, *any* analysis of the crop insurance program based upon a short period of time will present a biased picture, casting the program and its participants in either a favorable or an unfavorable light,

²² Draft GAO Report, pp. 37-38.

²³ Draft GAO Report, p. 31.

²⁴ Draft GAO Report, p. 32.

depending upon the period chosen.²⁵ **The program s performance, and that of the companies that make it up, can only be assessed in the context of the full loss cycle.** The GAO report does not present information that would allow a such full assessment.

The distortions introduced into the GAO analysis by its reliance on too short a baseline period are illustrated clearly by the report s speculations regarding the possible effects of recent increases in crop prices on future expense ratios.²⁶ Focusing on price changes and associated changes in premium rates between 1995 and 1996, the GAO calculates that the private companies have received an unanticipated bonus amounting to 3 percent of premium. These calculations are based upon a number of questionable assumptions. Specifically, they assume that the total volume of insurance written remains unchanged in the face of premium increases, and that there are no elements of the private companies administrative expenses that increase with premiums. The GAO thus ignores commissions, interest costs, bad debt allowances and other costs that do increase directly with premiums. They also implicitly assume that the price rise that occurred between 1994 and 1995 will persist indefinitely into the future.

In order to place the GAO s analysis in context and to demonstrate how limited the conclusions are that can be drawn from it, it is worth examining how crop prices have changed historically. Exhibits 4 through 7 present historical data on prices received by farmers for corn, wheat, cotton and soybeans, the four most important crops in terms of premium revenue generated. The ten-year history depicted in these exhibits makes it clear that crop prices are highly volatile. Prices change frequently and often by large amounts. They go up, but they also go down.

²⁵ GAO representatives admitted as much in their responses to questions posed during their presentation of the draft report. When asked why they had not included data for 1993 in their analysis, one of their arguments was that 1993 was itself not a typical year. In this they were correct. There may be no such thing as a typical year for the crop insurance program perhaps only typical decades.

²⁶ Draft GAO Report, pp. 39-41.

Exhibit 4

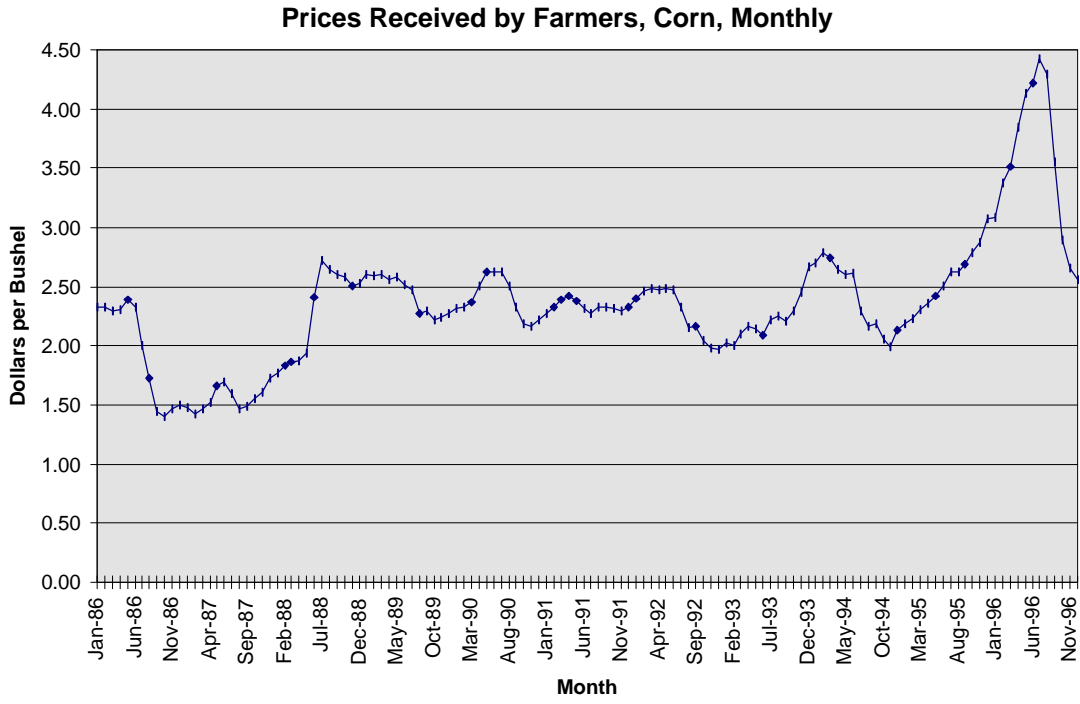


Exhibit 5

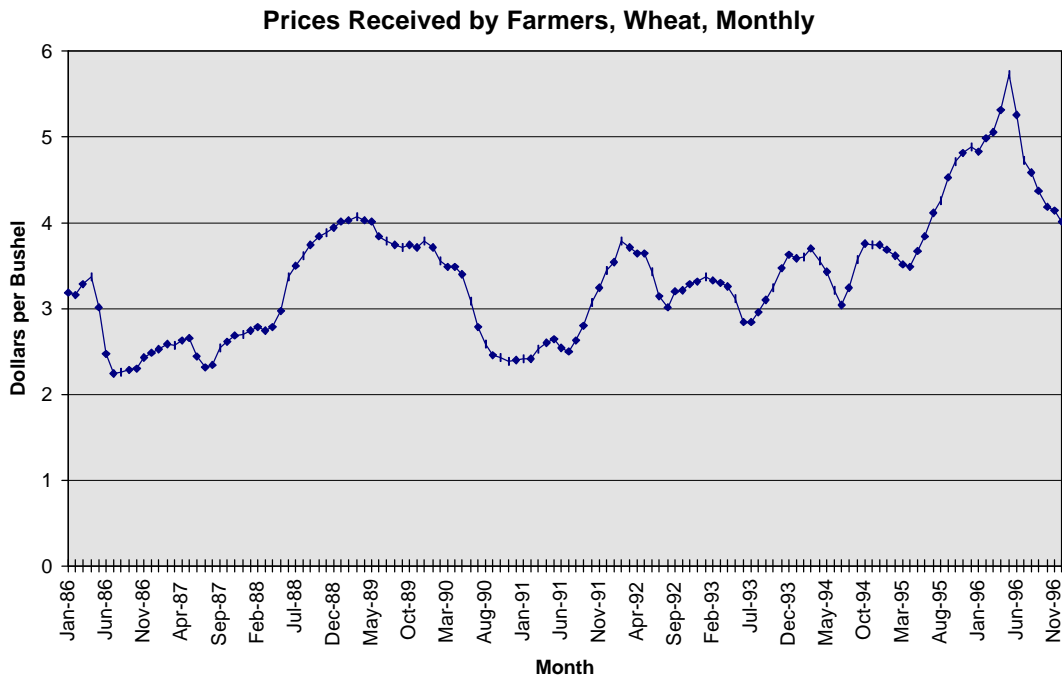


Exhibit 6

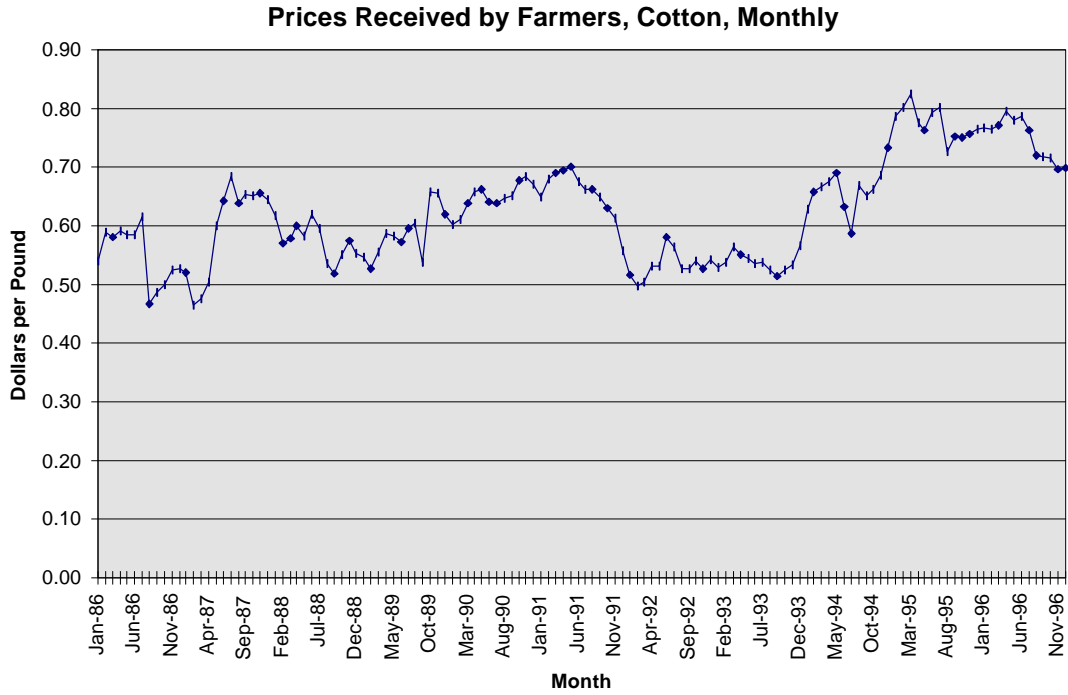
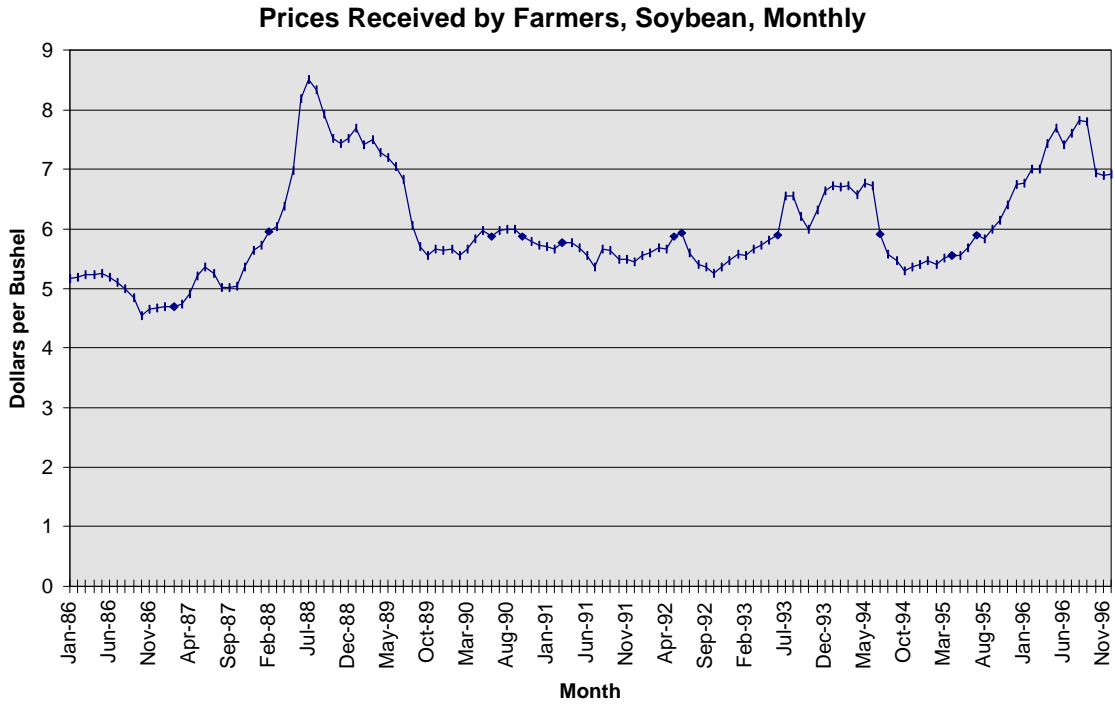


Exhibit 7



This examination of the historical record indicates that decreases in price are capable of causing changes in the expense ratio every bit as dramatic as those calculated by the GAO, but in the opposite direction. This fact is illustrated in Exhibits 8 through 11. Following the GAO's assumption that changes in premiums have no effect on any element of delivery cost, these exhibits calculate the effects on the ratio of administrative expenses of declines in crop prices and premiums.

Between the 1986 closing date for sale of insurance and the 1987 date, corn prices declined by 30.5 percent. Using the GAO's analysis framework with all of its flaws, Exhibit 8 shows how a price and premium decline of this magnitude would have affected the expense ratio in 1996. Following the GAO methodology, this 30.5 percent price increase translates into a 30.5 decrease in premium revenues. Also following the GAO methodology, expenses are assumed to remain unchanged. Dividing an unchanged administration cost by a reduced volume of premium revenue yields a dramatically increased expense ratio. Instead of declining, as the GAO projects, under these assumptions the expense ratio grows to 38.8 percent -- well above average historical levels, and well above the reimbursement rate provided for in the 1994 Act.

Exhibits 9 through 11 draw upon the price histories of the other three crops to show the effect on the expense ratio of other price decreases that have occurred over the history of the program. All of these crops have seen declines in price capable of causing major increase in the expense ratio.

The historical record on crop prices provides no basis whatsoever for believing that the decline in the expense ratio forecast by the GAO will persist indefinitely into the future. A dispassionate analysis of historical data must lead one to the conclusion that a favorable expense ratio in 1996 must be followed eventually by less favorable expense ratios. Over the long term the effects of increases and decreases can be expected to average out. Cutting the administrative expense reimbursement ratio to the point where, when prices are at historic highs, even the GAO's grudging estimate of administrative expenses is barely covered virtually guarantees that over the longer term payments to private companies will fall short of expenses, and probably by a substantial amount. **Once again, the only way to draw robust and balanced conclusions regarding the appropriate expense ratio of the program is to examine it over an extended period of time. The GAO conclusions in this regard are neither robust nor balanced.**

GAO'S ALTERNATIVE REIMBURSEMENT ARRANGEMENTS WOULD CREATE PERVERSE INCENTIVES

The GAO offers four alternatives to the present method of reimbursing private companies for their administrative expenses. These are:

- Placing a cap on the amount reimbursed per policy;
- Paying companies a flat fee per policy, plus a reduced percentage of premium;

Exhibit 8

Administrative Expense Reimbursement: Looking to the Past Illustrative Impact of Lower Prices		
	1995	Assuming Crop Price Decrease of 30.5%*
Premiums	\$1 billion	\$695 million
Reimbursements	\$310 million	\$215 million
Expenses	\$270 million	\$270 million
Expense Ratio	27%	38.8%
* Premiums decrease 30.5% assuming a price change from 1995 to 1996 identical to that which occurred for corn between 1986 and 1987.		

Exhibit 9

Administrative Expense Reimbursement: Looking to the Past Illustrative Impact of Lower Prices		
	1995	Assuming Crop Price Decrease of 22.1%*
Premiums	\$1 billion	\$779 million
Reimbursements	\$310 million	\$241 million
Expenses	\$270 million	\$270 million
Expense Ratio	27%	34.7%
* Premiums decrease 22.1% assuming a price change from 1995 to 1996 identical to that which occurred for wheat between 1990 and 1991		

Exhibit 10

Administrative Expense Reimbursement: Looking to the Past Illustrative Impact of Lower Prices		
	1995	Assuming Crop Price Decrease of 24.1%*
Premiums	\$1 billion	\$759 million
Reimbursements	\$310 million	\$235 million
Expenses	\$270 million	\$270 million
Expense Ratio	27%	35.6%
* Premiums decrease 24.1% assuming a price change from 1995 to 1996 identical to that which occurred for cotton between 1991 and 1992.		

Exhibit 11

Administrative Expense Reimbursement: Looking to the Past Illustrative Impact of Lower Prices		
	1995	Assuming Crop Price Decrease of 16.6%*
Premiums	\$1 billion	\$834 million
Reimbursements	\$310 million	\$259 million
Expenses	\$270 million	\$270 million
Expense Ratio	27%	32.4%
* Premiums decrease 16.6% assuming a price change from 1995 to 1996 identical to that which occurred for corn between 1989 and 1990.		

- Reimbursing companies according to a schedule of allowable expenses; and
- Reducing reimbursement rates as total premium volume increases.²⁷

These alternative reimbursement mechanisms are presented as ways of reducing payments to private companies. However, they have potentially far-reaching effects on the incentives facing private companies and agents.

The present system, whereby the private companies' reimbursements are set at a constant percent of premium revenues is easy to administer, and provides an efficient set of incentives for the various parties involved in crop insurance delivery. The companies are paid the same amount for every premium dollar. Reimbursement on a straight percentage basis makes it possible for the companies to follow standard industry practice and pay commissions to agents on the same basis. This simplifies the task of drawing into the crop insurance program agents who might otherwise focus on the sale of other lines of insurance. Payments are tied to revenue rather than cost and, hence, both the companies and the agents have an incentive to keep costs down. The government is freed of the task of monitoring company and agent expenditures or passing judgment on their appropriateness.

The GAO's first two alternatives both are aimed at reducing the reimbursement for large insurance policies. The report argues that the second alternative could provide higher reimbursements than the present system for some policies; however, since GAO indicates that this alternative system would reduce overall reimbursements, the number of policies experiencing such an increase is necessarily small. In general, these alternatives will cut reimbursements, and they will cut reimbursements for large policies relatively more.

²⁷ Draft GAO Report, p. 51.

Companies will face incentives to concentrate their marketing efforts on smaller policies. Although they could in principle adhere to standard industry practice and continue to compensate agents on a straight percentage basis, doing so could render the sale of some policies unprofitable. Companies would thus be under pressure either to bring the agent commission structure into conformity with the reimbursement mechanism, or to place tight control on agent activities in order to steer them toward more profitable policies. **Both companies and agents would face incentives to game the system by attempting to break large policies into smaller policies and, thereby, to increase the magnitude of the reimbursement received.** Attempts by the FCIC to prevent this from happening would undoubtedly involve close monitoring of the activities of companies and agents closely. Whether such efforts could in the end be entirely effective is not clear.

The GAO's third alternative marks a giant step backward in economic regulation. This cost-based reimbursement system would be subject to all of the well-known problems of such systems. Private companies would face powerful incentives to reduce unallowable expenses and to increase allowable expenses. Their ability to respond flexibly to changing circumstances could be greatly impaired. Incentives for cost reduction would be reduced or eliminated. In strong contrast to the present system, companies would face substantial incentives to increase their reimbursements by misclassifying their costs. To counter these incentives, FCIC would again have to greatly expand its monitoring staff and activities, increasing program costs and further inhibiting the ability of private companies to innovate or respond to market changes.

In many other settings, both in the United States and abroad, cost-based ratemaking has been abandoned because of perverse incentives that it creates and the cumbersome and costly regulatory structure that it requires. Regulatory reform efforts have sought to devise systems that align private company incentives with regulatory goals, and thereby reduce rather than increase the need for regulatory oversight. The GAO's suggestion that reimbursement be based upon a schedule of allowable expenses would require greatly increased enforcement efforts by FCIC, and is therefore suspect. It is surprising that the GAO would turn in this direction in seeking to reform a program, which, as we saw above, has been achieving its goals and working reasonably well.

The GAO's final recommendation involves cutting the reimbursement rate for larger companies. Despite its failure to analyze expense ratios for various provider firm sizes or to assess the adequacy of the standard reimbursement for potential new providers, the GAO speculates that this change might increase the number of participating firms. Entry into the business might increase in spite of a cut in reimbursement, GAO argues, to the extent that smaller or non-participating companies perceive that larger companies do not have an advantage based on size. ²⁸ **In the absence of evidence in support of this argument, it is probably more reasonable to expect that a cut in reimbursement even one targeted at larger companies would be more likely to decrease rather than to increase participation.**

²⁸ Draft GAO Report, p. 59.

CONCLUSION

If Congress were to follow the GAO's recommendations and ignore the phased reductions provided for in the 1994 Act in favor of deep and immediate cuts in the administrative expense reimbursement, the potential consequences for the crop insurance program could be serious. We could expect to see a reduction in the level of private sector involvement in the program, an erosion in program participation and capability and eventually higher costs to the federal government.

The immediate effects of a drastic reduction in the level of the administrative expense reimbursement are clear. Revenues to private insurance companies would fall, while in the short term their costs would remain unchanged. As their profits fell, private insurers could be expected to try to make up for the loss in earnings either by increasing their underwriting gains or reducing their expenses. However, since these companies already have incentives to increase underwriting gains and reduce expenses, there is no reason to expect them to find large and previously unexploited opportunities for increasing earnings. There is no evidence to suggest that the FCIC's efforts to streamline the program would offset the reduction in private company revenues. **For some companies, therefore, the business would cease to be profitable, and they would terminate their participation in the program.**

A reduction in the number of private companies participating in the program would lessen competition in the delivery of multiple peril crop insurance. Fewer companies would be available to compete for the business of farmers. Fewer companies would be available to suggest new ideas for innovative products or to develop ways of delivering those products more efficiently.

The actions taken by the surviving program participants would be likely to erode the capabilities of the crop insurance program. Some might attempt to increase their potential underwriting gains by increasing the amount of risk that they retain. Such a strategy would boost earnings during good years while increasing the risk that catastrophic losses would be experienced during years of widespread agricultural disaster. We would also be likely to see efforts by companies to withdraw from less profitable lines of business. In geographic areas that have experienced chronic losses, farmers may find fewer agents and companies interested in providing crop insurance. These changes would jeopardize the program's goal of universal availability. **The net result is likely to be reduced participation in the program by farmers and an erosion of the overall system's capacity for dealing with the next widespread agricultural disaster.**

It would be extremely short-sighted for the GAO, Congress or the Administration to consider short-term actions to reduce program costs without carefully considering how they are likely to affect the ability of the crop insurance program to respond effectively to the next major agricultural disaster. A major goal of the reforms that were implemented by the 1994 Act was to create a system of multiple peril crop insurance that would compensate farmers for their losses on a reliable and equitable basis and eliminate the need and demand for ad hoc disaster assistance. The ability of the program to achieve that goal is not demonstrated by its performance during a few good years, but rather only by how it performs during a major disaster causing widespread crop losses. It would be foolish to take the absence of a fire as an excuse for selling off all of the town's fire engines. **It would**

be similarly foolish to take the experience of a few good years as an excuse for scaling back our capability for dealing effectively with the major agricultural disaster that we know must recur.

The effects of weakening the program and impairing its ability to respond effectively to widespread crop losses are easy to anticipate: widespread crop losses accompanied by the existence of large numbers of uninsured farmers. **Together these would be likely to lead to renewed calls for ad hoc disaster assistance.** Costs incurred by the government in response to these calls could easily offset the savings generated over the short term through unilateral cuts in payments to the private companies that participate in the program.

The cost associated with ad hoc disaster assistance payments is not simply a problem for federal budgets in the far future or for members of Congress who have not yet been elected. The past decade has seen two major agricultural disasters—the drought of 1988 and the floods of 1993. Although the exact timing of the next such disaster is impossible to predict, it is reasonable to anticipate that it will occur within the next several years.

In the end, the only way to achieve true and lasting reductions in the cost to the federal government of the crop insurance program is to return to the goals set forth in the 1994 Act and to seek ways of simplifying and streamlining the program's operations. Administrative reforms that reduce the costs to private companies of participating in the program can make it possible to reduce the administrative expense reimbursement while strengthening rather than weakening the program's ability to achieve its most important goals. Had it paid more attention to these reforms, the GAO study would have been able to make a more valuable and constructive contribution to the twin goals of strengthening the crop insurance program and reducing the budget deficit.