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Hurricane Insurance: Forcing All to Subsidize the Few

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Congress is considering disaster insurance legislation that represents a bigger danger to the American economy than a catastrophic hurricane season, ignoring the basic principles of how the incentives, disincentives, and assumption of the risk in markets really work. With the stark lesson from forty years of the National Flood Insurance Program that subsidizing risky behavior (building a home in a known floodplain) inevitably leads to more of that risky behavior (rebuilding in the floodplain), creating a similar program for hurricane zones is a very bad idea. Ultimately, such a program might create conditions for future disasters that make the aftermath of Katrina pale in comparison. Yet, last November, the House passed the Homeowners' Defense Act, a bill that would have the perverse affect of putting communities more—not less—at risk.

Encouraging Disaster. For almost two decades, an ever increasing number of citizens from the Midwest, Northeast, and Great Plains, seeking to escape cold winters and economic doldrums, have flocked to the sunny South. As those warmer states welcomed the new arrivals, more and more of the lower Atlantic Coast and Gulf Coast became densely populated. As densities rose, housing prices climbed, which significantly increased the economic costs of a hurricane hit.

Rather than demanding that people who freely chose to live in hurricane-prone locations assume responsibility for the risks of their decisions, some states keep rates artificially low by placing explicit or implicit rate caps on homeowners insurance or by creating entities that serve as insurers of last resort where high-risk homes are pooled. These subsidization schemes, in conjunction with the disproportionate share of federal disaster relief, distort the insurance market by undermining the assumption of the risk accepted by the risk-taker, thereby encouraging more risky behavior.

Quantifying Risk. Rather than push back on this trend and insist that those making risky decisions pay the true costs of their choices, Congress is considering a law that will perpetuate these practices. The Homeowners' Defense Act introduces guaranteed federally backed home insurance against disasters. In practice, however, the bill will force all Americans to underwrite the risks of those who chose to live in hurricane zones.

Over the last twenty-eight years, the United States has suffered from seventy-eight billion-dollar-plus disasters. Hurricanes and tropical storms constituted about a third of these catastrophes and resulted in a majority of the damage—about $334 billion. The states with the highest number of billion-dollar disasters form a crescent starting in Maryland, swinging down through the Carolinas to Florida and over to Texas.

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While there have been billion-dollar disasters in the Midwest, Northeast, and Great Plains, most of those disasters involved multiple states that only in the aggregate totaled more than $1 billion. For example, the Northeast flooding in June 2006 cost just over $1 billion but involved six states (Delaware, Maryland, New Jersey, New York, Pennsylvania, and Virginia). The majority of states in the Midwest, Northeast, and Great Plains suffered twelve or fewer billion-dollar disasters. Thus, the overwhelming lion's share of disaster claims will more than likely come from the hurricane belt. There is a fundamental unfairness in making some states—especially states trying to recover from the loss of manufacturing jobs over the last twenty years—subsidize the other states' risk for natural disasters.

Let Markets Work. Rather than continue to federalize an increasing number of disasters, Congress should allow the insurance market to set the proper rates in those higher risk places. In the rush to do more harm to the insurance market, Congress continues to forget one of the best lessons from Hurricane Katrina: despite the fact that Hurricane Katrina was the most expensive disaster in the history of the United States ($133.8 billion), the insurance market survived due to the reinsurance market. In fact, in some cases, within one year, the insurance companies were reporting sizable profits.

With the recent floods in the Midwest, another clear lesson is that a federal program, lacking the profit and loss incentive of the private sector, fails to ensure that risk is minimized. Specifically, in many places, the floodplain maps are outdated and wrong. As a result, homeowners were told they did not need flood insurance. Due to this government failure, many homeowners are left with no protection, which means the federal government will make them whole with tax dollars after the fact. Because the private sector depends on accurate information to protect profits and minimize losses, homeowners receive protection before the event, and the private sector is held accountable.

Finally, just like with flood insurance and Hurricane Katrina recovery programs, Congress will continue the program even if it goes bankrupt, forgiving loans whenever politically expediency calls for it to do so. Once created, as has happened with most federal programs, these programs will grow larger every year and cover more and more routine events.

Enough Is Enough. Most states in America are relatively safe from catastrophic natural disasters. The citizens living in those states should not be forced to subsidize those Americans who freely choose to live in a higher risk state. The Homeowners' Defense Act will distort the insurance market and encourage risky behavior. Congress must stop federalizing disasters across America and let the markets determine the appropriate rates for homeowners insurance. Rather than creating another massive federal program through the Homeowners' Defense Act, Congress should adopt a different strategy: letting the market due its job.

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