The Government, the Market, and the Problem of Catastrophic Loss

GEORGE L. PRIEST
John M. Olin Professor of Law and Economics, Yale Law School, New Haven, CT 06520-8215

Abstract

This article addresses the comparative advantage of the government to the private property/casualty insurance industry for the provision of insurance coverage for catastrophic losses. That the government can play an important role as an insurer of societal losses has been a central public policy principle since at least the New Deal. In addition, our government typically automatically provides forms of specific relief following unusually severe or unexpected disasters, which itself can be viewed as a form of ex post insurance. This article argues that, for systemic reasons, the government is much less effective than the private property/casualty insurance market in providing coverage of losses generally, but especially of losses in contexts of catastrophes.

Key words: government insurance; catastrophe; disaster

Virtually all approaches to the problem of catastrophic loss conclude that the magnitude and character of such losses compels some form of governmental solution, whether in the form of ex post disaster assistance or ex ante regulation to reduce exposure to the loss. With respect to disaster assistance, for example, in the U.S., a permanent source of government-provided aid has been in place since the creation of the Federal Emergency Relief Administration during the New Deal, and is frequently supplemented by the Congress in response to unusually severe or unexpected disasters, such as Hurricane Andrew in 1992 or the Mississippi River floods in 1993. Indeed, assistance of this form for losses from catastrophes follows a fortiori, given the wider program of government-sponsored insurance providing coverage of non-catastrophic losses such as crop and bank failures, unemployment, and more specific losses related to economic downturns, for example, through government guarantees of farm and home mortgages.

Similarly, though the empirical examples are less dramatic, there appears to be equal agreement concerning the role of the government in creating incentives to minimize exposure to potentially catastrophic losses through direct regulation. Many commentators, for example, advocate land-use controls and enhanced building codes to reduce the impact of natural disasters such as earthquakes, hurricanes, and floods. Others promote direct governmental regulation of workplace health and safety and of environmental hazards to reduce the incidence and magnitude of societal exposure to these sources of loss.

This approach appears to be largely accepted by the authors of the four articles on hurricanes and asbestos prepared for this conference. These writers seem to concur, despite the disparate character of the natural or social disasters which they address, that
governmental action in some form provides the most promising feasible solution. Thus, with respect to hurricanes, Mr. Jobe urges greater land-use controls and zoning to limit or prohibit growth in high-risk areas (Jobe, 1996), just as Professor Kunreuther calls for more stringent building codes as well as government-sponsored “all natural hazards insurance” and government reinsurance (Kunreuther, 1996). Similarly, with respect to asbestos, Professor Viscusi describes governmental regulation as “potentially a very effective mechanism for ensuring that the level of risk exposures is not too great...” (Viscusi, 1996). And, most vigorously of all, Mr. Sinfield argues that “[g]overnment intervention is necessary to control the whole compensation environment,” concluding that “[i]n essence I believe that it is time for central control and leadership in society” (Sinfield, 1966).

These endorsements of enhanced government insurance and regulation in the context of catastrophes are commended, if no more, by the eminence of these commentators within their respective fields. The fact that they are unanimous in the approach surely strengthens the point. Moreover, it should not be ignored that these respective calls for greater government involvement in the context of catastrophic losses derive from individuals who, either as private-sector insurers or as economists, might otherwise be expected to be suspicious of a greater governmental role. This article, however, attempts a different view. It addresses more generally the role of government, versus the market, in providing insurance for losses caused by catastrophic events, whether, after the fact, through the provision of government insurance, or, in anticipation of the loss, through regulation. It begins from the substantial theoretical and empirical literature describing the operation of the private market for insurance. Over the years, the scholarly community has developed a strong and clear understanding of how private insurance operates; the learning of this literature is widely accepted and is shared, I would believe, by virtually all participants at this conference. This article does little more than bring this learning to bear on the question of the most effective means of dealing with catastrophic loss through insurance or regulation and the comparative advantage, if any, of the government in doing so. I believe that it is an implication of our understanding of insurance that there are serious questions as to whether the government can serve as the most effective insurance mechanism or is, in contrast, structurally prevented from effectively serving an insurance role, both in the context of catastrophes and in contexts of less calamitous forms of loss. The empirical demonstration of this point is difficult, of course, because our experience has been so affected by the governmental insurance programs in effect since the New Deal. I believe that it is the implication of the approach, however, that once weaned from government assistance, it will become clear that the market for private insurance, rather than the government, provides substantially greater hope for dealing with catastrophes as well as other societal losses. This conclusion suggests that the most common solutions proposed for addressing catastrophic losses must be more closely examined.

Section 1 presents a simple and, I believe, uncontroversial discussion of how insurance in a competitive market operates to reduce the risk level. Section 2 compares the ability of the government to provide similar insurance services. It includes a discussion of two recent reports of government-provided disaster assistance that suggest systemic problems with government-provided insurance services. Section 3, then addresses the comparative effectiveness of the government to the market as a risk regulator. In principle, there are