Government Intervention in Catastrophe Insurance Markets: A Solution in Need of a Solution

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Abstract

Private markets for catastrophe insurance regularly fail. It is then automatic to call on the government to provide the insurance in the absence of a private industry. Governments, however, have proven remarkably ineffective in providing insurance services because the political process (i) rapidly creates subsidized premiums and (ii) it fiercely resists risk-based premiums. The results are that the subsidized premiums actively encourage people to put themselves in harm’s way, and the lack of risk-based premiums discourages mitigation activities. Subsidized premiums also crowd out most attempts to reactivate the private markets. Finally, government insurance tends to be remarkably unresponsive to consumer demands for innovative contracts.

In this note, I would hope to accomplish two main tasks. First, I would evaluate the various federal and state programs in the US that provide each of the major catastrophe lines: earthquakes, hurricanes, floods, terrorism, mortgage default, and nuclear reactors. My goal here is to provide some simple, but accurate, documentation that the government programs systematically subsidize the level of the premiums and cross-subsidize the highest risks (eliminating risk-based pricing). My second goal would be to evaluate existing proposals for improving these programs and to offer some new ideas.

I would plan to write the note so that it could be responsive to each of your objectives: (i) highlight Howard's work; (ii) illustrate how Economics and Economists can contribute; (iii) push forward on a pressing problem.

This is a very safe topic for me to do, since I have written on aspects of it earlier (with Tom Russell). However, the quantitative demonstration of subsidies and cross-subsidies would be completely new, and I have some new thoughts on how to improve the delivery system. Also, I would like link to the recent government bailouts of Bear Stearns and the GSEs--after all, in effect the government is insuring these entities in a subsidized fashion with no risk-based pricing.