

The Australian

Neglecting to place a price on risk

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WITH memories of the Victorian bushfires still fresh, the Queensland floods are yet another grim reminder of how cruel the Australian environment can be.

The scale of the disaster, with its terrible loss of life, requires us to consider whether present policies properly manage the risks that environment creates.

The simple answer is that they do not. Rather, successive governments have allowed development in high-risk areas without requiring that development, and more generally those areas' populations, to face a price signal that properly reflects the costs those risks create. This has attracted additional activity to risk-prone areas, compounding the pain when catastrophes occur.

At the heart of the problem is the fact that each time disaster strikes, governments cover a large share of the losses borne by homeowners and businesses. This amounts to providing insurance at no charge, subsidising activity in high-risk areas at the expense of the areas where risks are lower.

Moreover, the willingness of governments to underwrite these risks at no charge has increased steadily since the Menzies government expanded drought relief in the 1960s, with ever fewer disciplines being imposed on public disaster assistance.

The unsurprising side-effect has been to reduce the take-up of private insurance, with the result that developers, homeowners and businesses are not exposed to the premiums that could force them to recognise the risk locating in disaster-prone areas involves.

That reduction in demand for private disaster insurance is then compounded by other distortions. High taxes on insurance are the most perverse of these, as they both discourage insurance take-up by low-income consumers and shift what demand there is to policies with high deductibles.

As well as suppressing demand, state and local governments reduce the supply of private insurance, particularly against floods. They do this by not providing adequately detailed maps of flood proneness.

Deprived of that information, insurers cannot align premiums with risks, forcing them to charge high prices so as to reduce the

losses to which they might otherwise be exposed.

This effect is substantial, with international studies suggesting that where reliable evidence on risk-proneness is

unavailable, premiums are 25 per cent higher than need be.

And in addition to responding by increasing premiums, insurers expand the range of exclusions, making insurance cover even less attractive.

The overall impact, cumulated over many years, is threefold. First, excused from the need to pay risk-reflective premiums, activity in disaster-prone areas expands beyond the point where its benefits exceed its costs, with the shortfall being foisted on to taxpayers who finance the "free" insurance governments provide. As property values rise, the quantum of the shortfall increases, compounding the distortion.

Second, absent an explicit price on risk, there are too few incentives for risk mitigation. Homeowners, for example, have less to gain from local government initiatives to reduce risk exposure, weakening the pressure for those initiatives to be undertaken. And for the same reason, there is less opposition to developments that increase risk than there should be.

Third, a vicious spiral is created, in which the increased scale of the population affected and the losses incurred, combined with low levels of insurance coverage, make it inevitable governments will step in with generous disaster relief.

This then merely confirms that taking out proper insurance coverage is individually irrational, reducing coverage ever further below adequate levels and accentuating pressures for future bail-outs.

A forthcoming paper by Anthony Bergin from the Australian Strategic Policy Institute canvasses options for breaking out of this morass. It is, in my view, impossible to do so without making disaster insurance coverage mandatory, offsetting the otherwise strong incentives for free-riding.

This is not to ignore the difficult issues mandatory coverage would raise. Nor is it to claim that insurance, with its risk-reflective price signal, would be a panacea. Rather, such a price signal will never be sufficiently granular, nor sufficiently responsive to individual mitigation efforts, to provide all the incentives for efficient investment in risk reduction.

There will therefore be a continuing role for building codes and other land use controls in managing the risks of catastrophic loss. But a price signal would reduce the load that has to be placed on those command and control regulations, with all the imperfections they inevitably entail.

But this does not exhaust the distortions that need to be addressed.

Rather, it is also apparent that governments have underinvested in collective goods that could reduce catastrophic risks. Simply put, in cost-benefit evaluations of projects such as extending dams and building new ones, and of burning-off in high bushfire risk areas, too low a value has been put on avoiding outcomes with a very small probability of occurring but that result in massive costs if they do eventuate.

Environmentalists rightly stress the importance of taking these low probability-high consequence risks into account in the context of climate change. But they ignore those risks when it comes to decisions they dislike. And state and federal governments have been far too willing to bend project evaluation processes to pander to the greenies' demands. The result is to increase the likelihood of devastating loss.

We will never be able to completely avoid those losses, nor would it be sensible to try. The Australian environment has always been, and will always be, harsh and unforgiving, and the costs it imposes are inevitably high.

But it is inexcusable for governments to make those costs greater than they need to be.

Now is a time to be generous. But as Queensland rebuilds, we owe the victims of this disaster a serious, considered reassessment of policies that have failed time after time, and that left as they are, will only fail again.

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