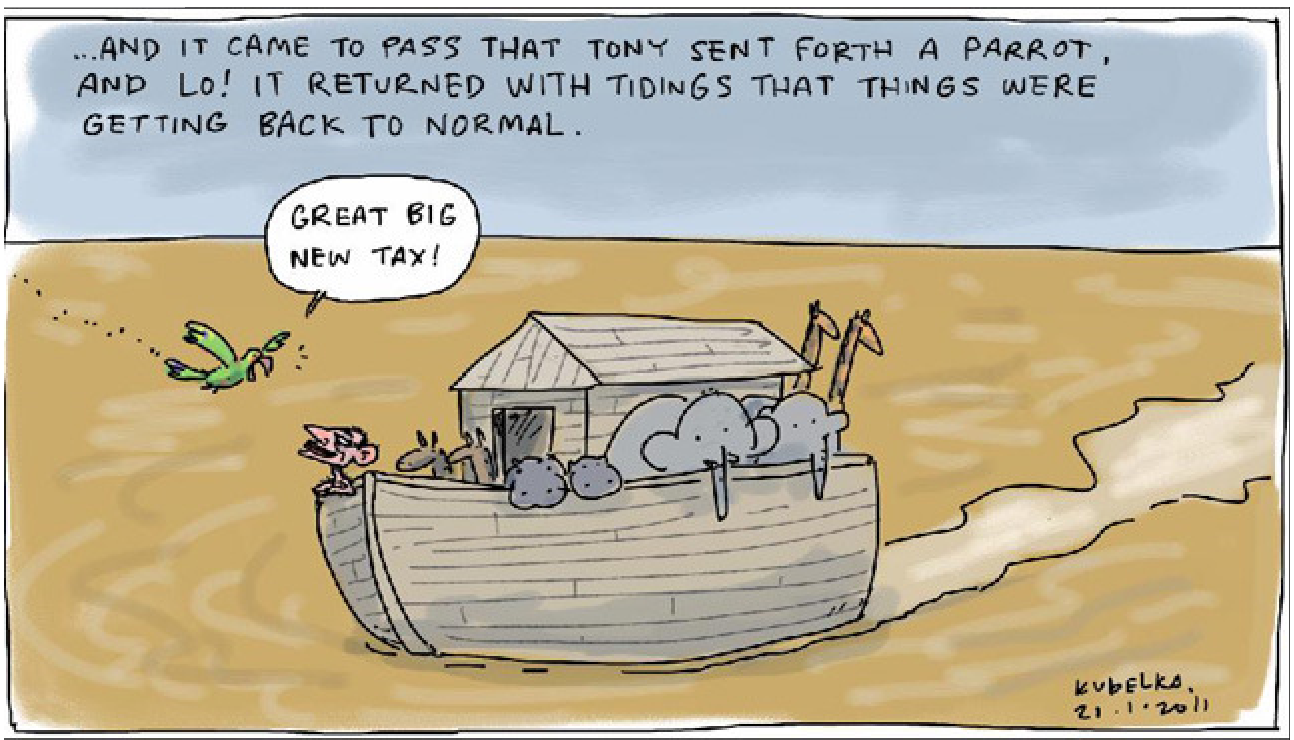
The Australian

We must reassess our sense of risk

- **Henry Ergas**
- From: **The Australian**
- January 21, 2011 12:00AM



n illustration by Jon Kudelka.
ource: The Australian

WITH the cost of the floods still rising, the question of how to pay for rebuilding has come to the fore.

There is an inescapable reality: with swaths of our capital stock damaged or destroyed, we are significantly poorer than we were only weeks ago. Belt-tightening is therefore required. But it is also crucial to rebuild on a basis that better manages future risks.

Just how much capital has been lost is yet to be determined. But though geographically concentrated, the losses are doubtless substantial. These translate into a fall in future income, much as if we had lost a valuable part of national territory. With income reduced, it makes no sense to retain spending plans unchanged.

It makes even less sense to merely add outlays for rebuilding to already high levels of public expenditure. In an economy suffering from capacity constraints, this would only shuffle activity around, while increasing prices on the way.

Doubtless some businesses would benefit, especially those involved in reconstruction. As their prices would be higher, they might pick up extra profits, depending on what happened to input costs. But with the higher prices paid for by taxpayers, future tax burdens would rise, with the resulting distortions to the incentives to work and save, making us even poorer. And the pressure greater spending placed on interest rates would only magnify the pain.

The government's preference seems to be to fund increased outlays by a levy. Clearly, such a levy would reduce spending by taxpayers on other goods, freeing up resources for rebuilding. At the same time, it could allow the government to meet its goal of an early return to budget surplus.

But such levies are no free lunch. Rather, like all other taxes, they distort incentives, and particularly so when added to tax rates that are already high. This is plainly the case with the income tax, where higher marginal rates, even if temporary, would reduce labour supply. It seems difficult to believe that now is the time to make capacity constraints even tighter.

Rather, the best policy is to slash wasteful public expenditure. No more budgetary pea and thimble tricks: rather, what is needed is good, old-fashioned, scrutiny of whether programs really provide value for money, with the focus on cutting spending whose benefits fall short of its costs.

This requires the government to be serious about cost-benefit appraisal of major programs, including its broadband network. Such appraisal is desirable in any event; with future incomes reduced, it is vital.

The burden rebuilding imposes on taxpayers would obviously be smaller had a greater share of the assets been properly insured. Indeed, as much of that insurance would have been provided by foreign reinsurers, there would have been a partially offsetting transfer of income to Australia from overseas.

True, purchasing that cover would have somewhat reduced our consumption before the floods. But insurance would have played the role it should: it would have transferred income from the "no catastrophe" state of the world, where additional dollars were worth somewhat less, to the "post-catastrophe" state of the world, where each added dollar has high value. Overall, our welfare would be substantially higher.

But even more important, adequate insurance cover would have forced developers, homeowners and businesses to face the cost of risk: that is, to take account of the likely loss from extreme weather events. Because that didn't happen, there has been too much development, and too little investment in risk reduction, in disaster-prone areas. Moreover, without adequate insurance cover, taxpayer-funded bailouts, with all their distortions, are politically inevitable.

The only realistic option is to make insurance against extreme weather events mandatory: otherwise each business and homeowner will have incentives to free-ride, relying on future public bailouts to cover catastrophe-related damages. But mandatory insurance poses tricky problems.

The political difficulties are obvious: requiring proper cover would induce a potentially steep fall in property values and increase construction and maintenance costs in high-risk areas. But that is indispensable if we are to avoid perpetuating the errors of the past. And if those errors are to be avoided, it is also crucial that the costs of new risk-reduction measures be slated home to those areas, rather than being subsidised by activity in areas where risks are lower.

There are, however, also difficulties with ensuring insurance is available on an efficient basis. Specifically, given governments' failure to disclose detailed information about flood-proneness, insurance companies would need to set high premiums to protect themselves against potentially catastrophic losses. High likely costs for reinsurance, made all the greater by the global industry's recent disaster-related losses, could force premiums even higher.

Such high private sector premiums would fuel demands for a government insurer. But long experience shows government insurers rarely set rates that properly reflect risks, as powerful constituencies obtain insurance at subsidised prices. This merely recreates the incentives for excess settlement in disaster-prone areas while shifting the financing burden, when disaster strikes, on to taxpayers.

Rather, government must get its act together and make available the information required for sound risk assessments. That information is truly a public good; if there were ever a role for government, it is in ensuring its provision. At the same time, until the required information is fully available, government may need to facilitate the supply of reinsurance, lowering the risk each insurer faces in supplying cover.

The temptation for government is to play a peculiar version of Noah's Ark: recreating, after the flood, the world as it was before, but with added public spending to boot. In the biblical story, however, the flood was never to recur; our reality is that floods and other disasters are certain to. Business as usual would therefore be the worst outcome.

Rather, the government must acknowledge Australia's great vulnerability to extreme weather events, and expose activity in disaster-prone areas to the true price of risk. The alternative is to continue senselessly placing communities in harm's way, repeating the tragedy we have just experienced time and again.