Outlook

Coming Monday:
Medicare celebrates a birthday.

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INSURANCE

To fix the mess at TWIA, focus on the fundamentals

By Seth J. Chandler

Texas has been spared a major tropical storm so far this hurricane season, but that doesn't diminish the fact that the state is woefully unprepared to deal with potential losses. If a significant fraction of possible Category 4 or Category 5 hurricanes were to strike, the Texas Windstorm Insurance Association (TWIA) would not be able to fully pay claims in Harris, Galveston, Brazoria and possibly other Texas counties. Since 2009, neither the state of Texas nor insurers in Texas are legally responsible to make up the shortfall. In 2013, let's hope the Legislature stops rearranging deck chairs on the Titanic and explores more fundamental reform.

It's not just a major hurricane problem or a Galveston problem. Right now, TWIA will not be able to pay with cash on hand or reinsurance funds many claims throughout Texas — not just the most densely populated counties — in the event of a serious storm. Instead, TWIA will be forced to borrow a limited sum, possibly at high rates, to pay the claims. The state will then have to impose significant surcharges on various forms of insurance over a number of years to pay the loans back. Running insurance in reverse and forcing policyholders to pay higher premiums just when they have been hit with losses is seldom a recipe for economic stability.

Unfortunately, as many coastal states are learning, there is no easy solution to this problem. Even those who like the free market must admit past difficulties in providing complete insurance along the coast for windstorm at rates that homeowners and businesses find tolerable. Special and explicit government subsidization of more complete windstorm insurance for the coast has its own financial costs, political problems and moral shortcomings. And the underinsurance engineered into the current law, coupled with some disguised subsidization, leaves Texas insureds at serious risk, particularly in the more densely developed areas of our coast.

The problem is tough because insurance works best where risks are known and uncorrelated. The fact that A has a fender bender with his car in Galveston County provides no information as to the likelihood that neighbor B will have an accident with her car at the same time. So auto insurance works well. Uncorrelated risk means that insurers do not have to stockpile a lot of liquid capital in order to pay expected claims. Something known in mathematics as the law of large numbers makes it unlikely that the amount of revenue an automobile insurer takes in won't be enough to pay claims.

David J. Phillip / Associated Press

Ben Higgins sits among debris outside his destroyed Galveston home in the aftermath of Hurricane Ike in September of 2008. If a large hurricane were to hit Texas this year, the Texas Windstorm Insurance Association may have difficulty paying a large number of claims for damage.

Windstorm risk along the Texas coast, by contrast, involves correlated risk with uncertain magnitudes. The fact that A's house in Galveston is blown down by a hurricane informs greatly the likelihood that neighbor B's house will be similarly destroyed. When insured risks are correlated, insurers and reinsurers have to stockpile lots of safe, liquid assets in order to pay claims in timely fashion. And keeping assets under the mattress hurts insurers and reinsurers in providing a decent return to their shareholders.

There are fundamental ways of addressing high magnitude, correlated risk that can be more successful. One solution is to reduce the magnitude of correlated risks. There is an awful lot of research showing that we can lessen the damage hurricanes cause through hardening: very tough building codes and other infrastructure improvements. A hardened site in Galveston, after all, is currently considered safe enough to house the smallpox virus. Burying power lines allows people to return to their homes sooner, which reduces the losses from a storm. Limiting publicly subsidized insurance plans to lower levels of coverage and requiring individuals to obtain private insurance for the excess also reduces the magnitude of correlated risk held by government plans. Lessening the economic consequences of hurricanes could attract private insurers back to the Texas coast, make state schemes less expensive, and make people feel more secure. The biggest bang for the buck will come from hardening the densely populated counties.

A second approach is to try to decorrelate the risks. Texas could pool its windstorm risk with California's earthquake risk, Washington state's volcano risk or windstorm risk from another region. Alternatively, Texas could pool its risk in, say, 2013 together with its risks in 2014 and 2015 by requiring coastal residents who purchase insurance from TWIA to commit to three-year contracts. There are many challenges with each of these plans, but given the absolute magnitude of the issue, even modest gains are worth exploring.

And the third approach is, frankly, to develop a greater tolerance for the high rates that come with insuring correlated risk. Hardening the coast and looking for opportunities to pool our catastrophe risks with uncorrelated catastrophes will help. But Texans on our coast need to let it sink in that they are holding property that is unavoidably expensive to insure and budget for the higher premiums that result. And their legislators who deny this reality do their constituents no service by leaving them catastrophically underinsured.

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THE ECONOMY

President Obama misses the mark on tax reform

By John Diamond

President Barack Obama made news recently when he called for extending tax provisions that reduce taxes on those making less than $250,000, while allowing a roughly $800 billion increase in taxes on wealthier Americans.

The president is right to be concerned about these tax provisions expiring at the end of the year, which — coupled with planned spending cuts — would cause a poorly timed fiscal contraction. Unfortunately, though, his specific plan would harm the economy and moves in the opposite direction from the critical overhaul of the tax system necessary for the U.S. to maintain its competitive edge.

If the president's plan to extend just the tax cuts on individuals making less than $250,000 is adopted, marginal tax rates on various types of income would increase significantly, especially on dividend income, reducing the incentive to work and invest at exactly the time our economy needs it. At the same time, a significant amount of spending hidden in the tax code — in the form of tax credits and deductions — would be maintained.

The policy is consistent with the president's propensity to move the U.S. toward a narrow-base, high-rate tax system in the name of fairness. But what's fair about a tax code that permits 46 percent of households in the United States to use government services but pay no income taxes? According to the Congressional Budget Office (CBO), the bottom 20 percent of taxpayers face an average tax rate of 1 percent; the top 20 percent of taxpayers face a 23.2 percent rate and the top 1 percent face a 28.3 percent rate.

It is widely recognized that a tax system characterized by a narrow base and high marginal tax rates negatively affects growth and job creation. Just ask Western Europe.

Dean Rohrer

The president's plan maintains our increasingly unworkable status quo. U.S. economic growth has slowed in the last several months, as job creators nervously eye an impending raft of tax increases, new regulations and shrinking global demand.

Disturbingly, even if tax revenues as a share of GDP are allowed to increase to unprecedented levels (for example, if all of the tax cuts expired), CBO projects that our debt-to-GDP ratio will rise to a Greek-like 200 percent by 2037. Clearly, cutting and reforming government expenditures should be a fiscal priority, but it also is imperative to adopt a more efficient and simple tax system as revenues as a share of GDP will have to rise from current levels.

What would an efficient and simple tax system look like? It would start with a permanent reduction in tax rates, and a broader tax base that asked a greater number of Americans to contribute to the services they're consuming. That doesn't mean the wealthy get a break however, it's essential that reductions in tax rates are offset by decreases in spending elsewhere in the tax code (e.g., by reducing tax credits and tax deductions that benefit the rich and others.)

Economist Alan Viard and I analyzed the macroeconomic effects of a permanent reduction in tax rates on different types of income, as well as the effects of a permanent increase in tax credits and deductions. We found that rate reductions led to an increase in economic growth in the long run (providing that transfer payments were reduced), with dividend and corporate income tax reductions having the largest positive effects. On the other hand, the increase in personal tax credits and deductions decreased economic growth. This does not bode well for the effects of the president's plan.

It's tempting to push difficult and amorphous policy proposals like tax and expenditure reform off until after the election year. But with everyone focused on avoiding the fiscal cliff at the start of 2013, now is the time to begin laying the groundwork for serious fiscal reform, such as plans for reducing expenditures, reforming entitlements and moving to a broad-based, low-rate tax system. In doing so we must weigh the realistic benefits of short-term stimulus against the long-term costs of additional debt to economic growth and future generations.

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