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Why Local Governments Don't Pay for Expensive Disaster Insurance.

Experts worry that some federal disaster aid is actually creating perverse incentives for cities and states — and deterring them from making better climate policies.

What makes a disaster? When we think of calamity, most of us think of flood waters that submerge towns, or hurricane winds that shred buildings. The U.S. federal government uses another kind of measure to decide whether an act of nature becomes an official disaster: its cost.

In deciding when to dole out federal assistance, the Federal Emergency Management Agency looks to see if per capita damage to uninsured assets exceeds a certain threshold; for 2021, that would be $1.55 per person in a state. The agency has a proposed rule to update that number to $2.33 per person and then index it to the consumer price index going forward.

Why should anyone care about that 80 cents? The answer is climate change.

A warming climate is contributing to more and bigger disasters. But human beings are stubborn. We continue to live and build in risky areas just like nothing is happening. Proverbial frogs in the boiling pot.

One of the best ways to make the costs of climate change more transparent is to price the rising risk into insurance policies. Private insurers and reinsurers are very sophisticated at guessing when things will go wrong and charging customers accordingly. Customers can refuse to pay the higher price, but if a disaster strikes they will bear the cost. Eventually the true cost of living by the ocean or in a wildfire zone becomes apparent.

It is an effective feedback loop, but brutal — which is where the federal government comes in. To greatly simplify the history here: As disasters have increased in certain areas, private insurers found flood insurance in particular too risky, and sent premiums sky-high. The federal government stepped in to provide subsidized flood insurance, racking up tens of billions of dollars in debt for covering claims.

But the government hasn't just covered the claims of individuals; it's also covered the claims of cities, states and some nonprofits through the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

Helping local governments recover from a public disaster might seem like an unalloyed good, but for a long time federal officials have argued that it creates perverse incentives for the localities to under-insure, knowing that in the end they'll never have to pick up the cost.

There are some areas, like debris clean-up and utility repair, where this argument doesn't really apply because localities would have a hard time getting insurance. But there is one category assistance in the Stafford Act that is particularly controversial because private insurers are downright eager to cover these areas: Category E applies to buildings, their contents, vehicles and equipment (BCVE). Think of school buses, court buildings and even churches.

A January analysis by the Homeland Security Operational Analysis Center looked specifically at whether states and localities were under-insuring for Category E. It found that while most of the states and localities did have some insurance, the proportion of overall building repair costs covered by insurance has only been 28% over the last decade or so. In other words, Uncle Sam has been on the hook for 72% of repairs. And according to an analysis by Hagerty, an emergency management consulting firm, Category E has historically accounted for the largest chunk of FEMA's assistance obligations.

Craig Fugate, who ran FEMA under the Obama administration, sees in these numbers not just under-insurance "but rather a wholesale risk transfer."

The concern is that this risk transfer will beget even bigger bills down the line. Without an incentive to purchase expensive insurance, states, cities, and tribes are largely shielded from the most immediate costs of a warming Earth. If towns had to pay for real risks, they would have a financial incentive to place new buildings and bridges out of harm's way. Instead, towns, eager to return to normal after a disaster, rebuild again in the same spots. (By law, FEMA can make them elevate the new properties, but not move them.)

There are endless examples of FEMA money that's been used to rebuild in an area that's very likely to flood in the future, from prisons and airports in Louisiana to public schools in New York City. This is important not just because of the expense of immediate replacement, but also because town planning and infrastructure often dictate where private residences and businesses are built. "If the state locals aren't internalizing the costs of these risks, you totally get the wrong incentives to encourage development in certain areas," said Lloyd Dixon, a co-author of the Homeland Security report and a senior economist at the RAND Corporation.

Within FEMA, there is relatively broad agreement that something needs to change about the current federal regime. The White House's fiscal year 2021 budget proposed ending Category E funding altogether.

Such a position was, understandably, very unpopular with states and the proposal didn't make it very far. That's where the current rule comes in. It won't eliminate Category E, but it does raise the threshold for state assistance. Not only does it raise the per capita minimum by 80 cents; it also raises the total minimum storm damage from $1 million to $1.5 million, a number that will also be indexed to inflation going forward.

In theory, over time as the thresholds increased, the number of storms covered would decrease and states and localities would be forced to have a more robust insurance practice. "They can either use their own budgets, or increase their use of insurances to cover risk," Fugate said.

But former FEMA administrator Brock Long is skeptical. He argues that raising the threshold for disaster assistance might just force states to look for even more uninsured assets. He says FEMA can't fix the problem with just rule-making.

"The Stafford Act was innovative when it was introduced in 1979 but it did not encompass climate change," he said. "It is time for Congress to consider legislative changes that reward communities for doing the right thing," he continued, "things like proper building codes and reinsurance capabilities need to be incentivized not penalized."

Colin Foard, who studies this issue for the Pew Charitable Trust, has a similar view. He says cities and states desperately need the money from the federal government to prepare for the future. If they want to reform the current problem, they shouldn't spend less, he says. They should just spend differently, perhaps mandating that Category E funds go toward buildings that are disaster resistant. "Every dollar spent on mitigation can save 6 in recovery," he said. "So if the federal government wants to do something about this, there is a more strategic way to lower everyone's costs."

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