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Hurricane Harvey's Nationalized Insurance Nightmare

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Flood Damage: Whenever a disaster of the size of Hurricane Harvey occurs, causing billions of dollars in damage, it's natural to have sympathy and to want to help in any way possible. But it's also natural to ask whether we're insured for all this. And, for the most part, the answer is no.

Sound like a great idea? Well, maybe not so much. After massive losses with Hurricane Katrina, Hurricane Sandy and now Hurricane Harvey, the NFIP is all but bankrupt.

It owes close to $25 billion to the U.S. Treasury, which means it owes you, the taxpayer. How could that be?

The fact is, as with so many government programs, the very name of the agency is false. It is not providing "insurance" in any true sense, but rather a taxpayer guarantee. Big difference.

Real insurance works thusly: A company estimates the actuarial likelihood of an event and its damage. It then issues coverage, with premiums set at a rate that would cover the losses and still leave a profit for the insurer.

That's why the NFIP has a $23 billion debt, which is about to get a lot larger. It doesn't charge premiums large enough to cover its costs. The government bets that Americans, who are mostly kind, decent and generous, will simply bite the bullet and pay up.

It's a dishonest way to run government.

Private insurance, by the way, has been used since the very beginning of free-market capitalism to insure people against major losses. When run properly and not regulated to death, it works.

Unfortunately, the federal government has already admitted what everyone already knows: That the NFIP is unlikely ever to pay the $25 billion-plus that it owes the taxpayers. And, oh, by the way, that bill comes due next month as the debt ceiling approaches.

A recent Cato Institute study, written just weeks before Harvey hit Houston, outlines just how bad our federal flood insurance program is.

"The NFIP has serious design flaws," writes Cato fellow Ike Brannon. "Premiums are not priced to be actuarially sound, meaning they do not reflect covered risk. About 15%-20% of policyholders receive an explicit subsidy, saving them 60%-65% on the cost of their premium."

The problem, Brannon continues, is that "such subsidies are not based on need. The remaining 'full-risk' policies are not actuarially priced either, as they do not include a 'loading charge' — something private insurers use to build up reserves for especially costly years. Largely as a result of these deficiencies, the NFIP owes more than $25 billion to the U.S. Treasury."

It's quite an indictment of how we insure against flood in the U.S. And of course, the unseen effect of heavily taxpayer-subsidized flood insurance is that much development that takes place in those areas wouldn't take place at all if they there wasn't an implicit subsidy to do so.

So in effect, by subsidizing building in potential disaster zones, we're making enormous taxpayer losses inevitable.

With the subsidy, people build beachfront homes and businesses along frequently flooded coastlines, knowing that FEMA and its offspring NFIP will ultimately write checks when disaster strikes.

This isn't just about flood zones, either. In California and other earthquake-prone areas, people build in dangerous quake zones because they have heavily subsidized government "insurance" and the promise of FEMA aid.

No, we're not saying that the federal government shouldn't play any role in disaster relief. But as the brave, energetic and moving response by Houston citizens to help those most threatened by the disaster shows, the primary and appropriate response to tragedy is always local.

The 50-year-old NFIP today has more than 5 million flood insurance policies, about 5% of all U.S. households, with a total potential liability of more than $1.3 trillion. That's a huge liability.

Yet, it collects just $3.5 billion in premiums a year, not close enough to pay off its potential liabilities. This is no way to run a federal program — or any program, for that matter.

At the end of September, the NFIP is set to expire. It will only continue if Congress reauthorizes it, along with its growing losses.

It's time to sunset the NFIP. If not, let's at least begin looking for ways to encourage private insurers to either compete with NFIP or replace it entirely. Today, private insurers can do neither.

As with health care, we need a real insurance market — not a dysfunctional government-run one.