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The government's hidden housing subsidy for the rich

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In the long-running debate over housing subsidies, experts tend to focus on the mortgage interest deduction, a $70 billion tax break that functions as an expensive subsidy for wealthy Americans. But there are lesser-known government programs that also have the same problem—and are ripe for reform. We don't think of them this way but one of them is flood insurance.

Since 1968, the federal government has provided subsidized insurance for homeowners who live in flood-prone areas—a program known as the National Flood Insurance Program (NFIP). It was created after a Department of Housing and Urban Development study in 1968 recommended the federal government provide flood insurance, arguing that a government insurance program could better balance goals of mitigation and economic development in flood plains than the private market. As of 2016, the NFIP has over 5 million policies in force and saves policyholders around $3 billion annually. But the program is out of control: It is currently $24 billion in debt; future costs will be much higher.

The good news is that Congress has a perfect opportunity to reform the program, since the NFIP must be reauthorized by the end of September. It's time to implement real reforms that put the program on sound fiscal footing—and reduce this regressive housing subsidy.

The NFIP's main problem is that it doesn't really function like private insurance. For instance, it does not assess flood risk for each property; instead, premiums reflect average historical losses within a property's risk zone. Moreover, the floodplain maps determining a property's risk zone are often several decades out of date. As a result, premiums may bear only a tangential relationship to the true risk of flooding. The cost of an NFIP policy averages about half of what would be a market rate. Congress actually mandates this inaccurate pricing method. In 2014, it hastily revoked a few tentative steps at reform after constituents complained loudly when the NFIP tried to charge something approximating market rates for flood insurance.

Who benefits from flood insurance? People in flood-prone states like Louisiana and Florida, of course. But many beneficiaries also share another characteristic: they are upper income. Evidence suggests that recipients of flood insurance are on average wealthier than the typical homeowner. A Congressional Budget Office study found the median value of an NFIP insured home is about twice that of American homes in general. About 80 percent of NFIP households are in counties that rank in the top income quintile. As of 2012, 42 percent of NFIP propertiestook out the maximum $250,000 in coverage, reflecting the fact that properties near water tend to be more expensive than properties in general.

Wealthier households also tend to receive larger subsidies. A University of Massachusetts study examined the relationship between property values and premiums paid per $100,000 in coverage in that state, finding a negative relationship between property value and premium cost. For example, homeowners on Martha's Vineyard pay an average premium of $400 per $100,000, while residents of Fairhaven, a blue-collar town with a median household income of about $40,000, pay over $800. These numbers reflect the impact of the NFIP's explicit subsidies to homes built before the first Federal Emergency Management Agency flood map of a given area, which constitute 15-20 percent of the total policies in the program. Policyholders receive a 60-65 percent discount for these properties.

NFIP recipients are also heavily concentrated along the coasts of the states in the Southeast, and about 25 percent of explicitly subsidized coastal NFIP properties are vacation homes, according to the CBO. One of these homeowners receiving government money to live on the beach was John Stossel, the former ABC and Fox News pundit. He saved thousands annually on insurance for his waterfront property in New York.

The NFIP does not charge nearly enough to cover the expected costs of its liabilities. The assessments are not sufficient to build any buffer to cover an extraordinary year, such as what occurred with Hurricane Katrina in 2005 or Hurricane Sandy in 2012. Because homeowners don't incur the full cost of building in a flood zone we end up with more houses there than if homeowners incurred the full cost of the flood risk, which exacerbates the government's costs in the next disaster. Since 1970, the number of Americans living in FEMA-designated Special Flood Hazard Areas has increased from 10 million to over 16 million today.

The optimal solution would be for the government to get out of the flood insurance business entirely and leave it to the private market, which would endeavor to accurately measure risk and charge a price for its insurance that covers the expected costs.

While full privatization may not be politically feasible now, Congress could enact reforms that allow private insurers to compete with the NFIP on a level playing field and introduce a modicum of market discipline on the market. For example, mandating FEMA to release property-level flood data would greatly benefit private insurers. Reforms to improve actuarial fairness and the quality of mapping in the NFIP would also be welcome.

The Southeast Atlantic Coast Senators are sure to object to any changes that might make their constituents pay more, watering down good reforms that already passed the House. But these senators are missing the forest for the trees. Allowing private market competition in the flood insurance industry would save the government money in a markedly progressive fashion—something that should transcend ideological and geographical differences.

Smart reforms would also help Congress refrain from throwing money at disasters, bailing out homeowners who shouldn't have built in flood-prone areas to begin with. Sensible long-run incentives to mitigate damage would discourage such homebuilding by exposing homeowners and businesses to the real cost of building in floodplains.

The key is to act well in advance of the next disaster. Without new legislation, we will assuredly be bailing out wealthy homeowners once again before too long.

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