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CONGRESSIONAL TESTIMONY

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"The Disaster Loan Fairness Act of 2011: Neither Fair nor Effective"

Introduction

My name is David Muhlhausen. I am Research Fellow in Empirical Policy Analysis in the Center for Data Analysis at The Heritage Foundation. I thank Chairman Joe Walsh, Ranking Member Kurt Schrader, and the rest of the committee for the opportunity to testify today on the Disaster Loan Fairness Act of 2011 (H.R. 3042). The views I express in this testimony are my own and should not be construed as representing any official position of The Heritage Foundation.

After the President declares a major disaster, the Disaster Loan Fairness Act of 2011 (H.R. 3042) would set the interest rates for the Small Business Administration's (SBA) Disaster Loan Program (DLP), including home disaster loans, business physical disaster loans, and economic injury disaster loans, at 1 percent for eligible applicants in declared disaster areas, regardless of whether applicants have access to credit. Under current law, for DLP applicants who are unable to obtain credit elsewhere, the interest rate shall not exceed 4 percent. For those applicants who have access to credit elsewhere, the interest rate shall not exceed 8 percent.

In fiscal year (FY) 2010, the SBA approved $574 million in disaster loans for 15,356 applicants.[1] The dollar amount of disaster loans increased to $739 million for 13,643 applicants in FY 2011.[2] As of January 31, 2007, according to the Government Accountability Office, the SBA approved over $5 billion in disaster loans for homeowners and renters affected by the hurricanes of 2005.[3] The interest rate subsidy of these 2005 hurricane SBA-backed loans cost almost $800 million to the federal government.[4] If enacted in law, the Disaster Loan Fairness Act will increase costs of interest rate subsidies incurred by the federal government.

Unfortunately, as my testimony will illustrate, the Disaster Loan Fairness Act does not provide the necessary reform to our nation's disaster prevention and recovery programs. My testimony focuses on the following deficiencies of the Disaster Loan Fairness Act:

- The Act fails to address the increasing nationalization of disaster responses;
- The Act continues the federal government's out-of-control spending; and
- The Act unnecessarily increases the moral hazard and other unintended consequences of providing disaster loans.

Instead of considering legislation like the Disaster Loan Fairness Act, Congress should focus on reforms that make America more resilient to catastrophes and reduce recovery costs imposed on the federal taxpayer.[5]

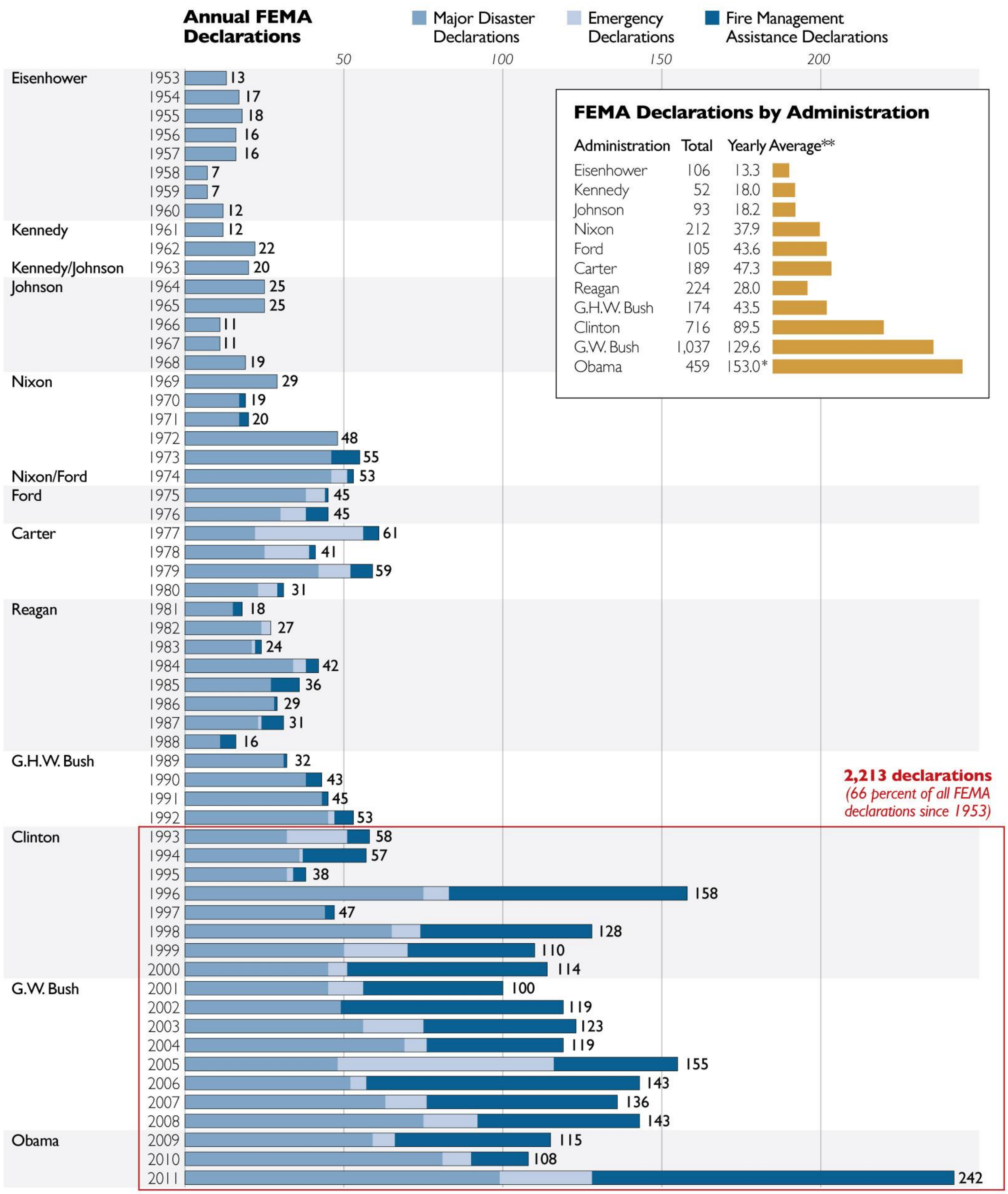
Increasing Nationalization of Disaster Responses

By providing more generous benefits, the Disaster Loan Fairness Act does nothing to reduce the overreliance of state and local governments on the federal government for the provision of recovery assistance. Far too frequently, the federal government has been the primary source of recovery efforts for natural disasters that are inherently localized in small geographic areas and do not rise to the level that should require action by the federal government.

Increasingly, Americans are becoming overly dependent on federal assistance after natural disasters occur. In fact, there is evidence that with each new catastrophe, disaster victims have come to expect more federal relief than was previously offered.[6] Further, disaster assistance appears to have become a political tool because the number of disaster declarations is significantly higher in election years compared to non-election years.[7] For example, one study of Federal Emergency Management Agency (FEMA) disaster payments not only found that states having higher political importance to presidents receive higher payments, but states having greater congressional representation on subcommittees with FEMA oversight responsibilities receive more in disaster payments than states with less representation.[8]

Since the 1996, the year President Clinton sought reelection, the number of disaster declarations issued by FEMA dramatically increased.[9] Chart 1 demonstrates this trend. As my Heritage Foundation colleague Matt A. Mayer has previously showed, "the yearly average of FEMA declarations tripled from 43 under President George H. W. Bush, to 89 under President Clinton, to 130 under President George W. Bush."[10] The record of the most declarations in a year was set by President Clinton in 1996 with 158 declarations. However, President Obama smashed this record with 242 declarations in 2011. Given that 2012 is a presidential election year, this record may not last long.

FEMA Declarations, by Year and by Presidential Administration



* Based on data through January 19, 2012. ** Figures are prorated for Kennedy, Johnson, Nixon, and Ford Administrations.

Note: Annual totals may not add up to presidential totals during the same time period due to the January 20 inauguration date.

Source: FEMA Disaster Search database, at *http://www.fema.gov/femaNews/disasterSearch.do?action=Reset* (January 20, 2012).

Chart 1 • WM 3466 heritage.org

Since 1953, there have been 3,367 disaster declarations.[11] During the past 19 years, from Presidents Bush to Obama, presidential declarations number 2,213—66 percent of all declarations.[12] Essentially, this trend is the result of disaster responses that were once entirely local in nature and handled by state and local governments becoming "nationalized" and thus the responsibility of the federal government.

This nationalization has led to an ever growing share of the total cost of natural disasters being dumped on an already strained federal budget.[13] According to my co-panelist, Professor Howard Kunreuther of the Wharton School's Risk Management and Decision Processes Center, the amount for aid provided by the federal government as a percentage of total damage caused by a major disaster is steadily increasing.[14] For example, federal aid comprised 50 percent of the total damage caused by Hurricane Katrina (2005).[15] Just three years later, federal aid increased to 69 percent of total damage caused by Hurricane Ike (2008).[16]

The Robert T. Stafford Disaster Relief and Emergency Assistance Act of 1998 (Stafford Act) established that for a disaster to be eligible for federal assistance, the disaster must be "of such severity and magnitude that effective response is beyond the capabilities of the State and the affected local governments and that Federal assistance is necessary."[17] Regardless of this apparent requirement, FEMA "has approved disaster declarations for many natural disasters that historically and factually were not beyond the capabilities of states and localities."[18] Returning to the original understanding of what necessitates the federal government's involvement does not mean that local natural disasters are not "catastrophic" for a particular community. Rather, "It simply means that most natural disasters occur within confined geographic areas and that states and localities can handle them without federal involvement."[19]

The majority of states do not benefit from federal assistance, because only a minority of states receives the benefit of FEMA disaster declarations.[20] Thus, the majority of states send their disaster-response tax dollars to Washington, D.C., so FEMA can subsidize disaster response for the minority of states.

Out-of-Control Spending

On December 31, 2011, the gross debt racked up by the federal government reached $15.2 trillion—the legal limit as authorized by Congress.[21] In response, on January 12, 2012, President Barack Obama formally notified Congress of his intent to raise the nation's debt ceiling by $1.2 trillion—from $15.2 to $16.4 trillion.[22]

The Congressional Budget Office (CBO) recently reported that the federal budget for fiscal year (FY) 2012 will be nearly $1.1 trillion.[23] "Measured as a share of gross domestic product (GDP)," the CBO reports, "that shortfall will be 7.0 percent, which is nearly 2 percentage points below the deficit recorded last year but still higher than any deficit between 1947 and 2008."[24]

For the end of FY 2012 on September 30, 2012, the federal government's gross debt is estimated to reach 104.8% of Gross Domestic Product or $16.4 trillion.[25] $16.4 trillion is a staggering sum that is difficult for Americans to behold. If we did we would be truly frightened at the prospect of paying it off. How did we accumulate this massive debt?

While the deficit and debt is driven largely by entitlement spending—Medicare, Medicaid, and Social Security—the Disaster Loan Fairness Act, and all the other new spending programs being advocated in Congress only move the nation closer to fiscal insolvency. While the cost of the Disaster Loan Fairness Act has not been formally estimated by the CBO, the annual cost of the legislation will greatly expand as the number of disaster declarations declared each year continues to rapidly grow. Further, the Disaster Loan Fairness Act does not provide any spending offsets. In addition, the Act does nothing to reduce the cost of future disaster recoveries. Given the increasing financial stress facing the federal government, reform should be focused on preventative measures that limit the costs of disaster recovery.

Moral Hazard and Other Unintended Consequences

Generous federal disaster relief creates a "moral hazard" by discouraging individuals and businesses from purchasing natural catastrophe insurance. Currently, SBA disaster loans are awarded regardless of whether the beneficiaries previously took steps to reduce their exposure to losses from natural disasters. Increasing the generosity of SBA disaster loans will only provide greater encouragement for homeowners, renters, and businesses to avoid purchasing adequate disaster insurance because natural disasters are low probability events. The Disaster Loan Fairness Act does nothing to reduce the exposure of Americans to property losses and the need for disaster assistance for future catastrophes.

While SBA disaster loans are intended to help applicants return their property to the same condition as before the disaster, the unintended consequence of this requirement is that applicants are forced to rebuild in disaster-prone locations. For example, instead of relocating out of a town sitting in a major flood zone, applicants are required to rebuild in the exact same location. Thus, applicants are still located in a high-risk area. In many cases, the loans fail to offer a long-term solution. While this dilemma exists with or without passage of the Disaster Loan fairness Act, the legislation only increases the incentive to rebuild in high-risk areas.

Conclusion

The Disaster Loan Fairness Act is neither fair to the federal taxpayer nor an effective reform of our nation's disaster prevention and recovery policies. The Act fails to address the increasing nationalization of disaster responses, while continuing the federal government's out-of-control spending. Last, the Act unnecessarily increases the moral hazard and other unintended consequences of providing disaster loans.

Instead of considering legislation like the Disaster Loan Fairness Act, Congress should focus on reforms that make America more resilient to catastrophes and reduce recovery costs imposed on the federal taxpayer.

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[1]U.S. Small Business Administration, *FY 2012 Congressional Budget Justification and FY 2010 Annual Performance Report*, p. 56, at *http://www.sba.gov/sites/default/files/FINAL%20FY%202012%20CBJ%20FY%202010%20APR_0.pdf* (February 13, 2012).

[2]U.S. Small Business Administration, *FY 2013 Congressional Budget Justification and FY 2011 Annual Performance Report*, p. 53, at http://www.sba.gov/sites/default/files/files/FY%202013%20CBJ%20FY%202011%20APR.pdf (February 13, 2012).

[3]U.S. Government Accountability Office, *Natural Disasters: Public Policy Options for Changing the Federal Role in Natural Catastrophe Insurance*, November 2007, p. 16, at *http://www.gao.gov/assets/270/269745.pdf* (February 13, 2012).

[4]*Ibid*.

[5]For an example of proposed reforms, see Matt Mayer, David John, and James Jay Carafano, "Principles for Reform of Catastrophic Natural Disaster Insurance," Heritage Foundation *Backgrounder* No. 2256, April 8, 2009, at *http://www.heritage.org/research/reports/2009/04/principles-for-reform-of-catastrophic-natural-disaster-insurance*.

[6]Erwann Michel-Kerjan and Jacqueline Volkman-Wise, "The Risk of Ever-growing Disaster Relief Expectations," Risk Management and Decision Processes Center, The Wharton School, University of Pennsylvania, Working Paper 32011-09, July 2011, at *http://opim.wharton.upenn.edu/risk/library/WP2011-09_ReliefExpectations.pdf* (February 13, 2011); Michele L. Landis, "Fate, Responsibility, and 'Natural' Disaster Relief: Narrating the American Welfare State," *Law & Society Review*, Vol. 33, No. 2 (1999), pp. 257–318; and Michele L. Landis, "Let Me Next Time Be Tried By Fire: Disaster Relief and the Origins of the American Welfare State 1789-1874," *Northwestern University Law Review*, Vol. 92, No. 3 (1998), pp. 967–1034.

[7]Thomas R. Garrett and Russell S. Sobel, "The Political Economy of FEMA Disaster Payments," *Economic Inquiry*, Vol. 41, No. 3 (2003), pp. 496–509, and Erwann Michel-Kerjan, "Catastrophe Economics: The U.S. National Flood Insurance Program," *Journal of Economic Perspectives*, Vol. 24, No. 4 (2010), pp. 165–186.

[8]Garret and Sobel, "The Political Economy of FEMA Disaster Payments."

[9]The data presented in Chart 1 are based on Matt A. Mayer, "Congress Should Limit the Presidential Abuse of FEMA," Heritage Foundation *WebMemo* No. 3466, January 24, 2012, at *http://www.heritage.org/research/reports/2012/01/congress-should-limit-the-presidential-abuse-of-fema*.

[10]Matt Mayer, "States: Stop Subsidizing FEMA Waste and Manage Your Own Local Disaster," Heritage Foundation *Backgrounder* No. 2323, September 29, 2009, p. 1, at *http://www.heritage.org/research/reports/2009/09/states-stop-subsidizing-fema-waste-and-manage-your-own-local-disasters*.

[11]Mayer, "Congress Should Limit the Presidential Abuse of FEMA," p. 3.

[12]*Ibid*.

[13]Some may argue that the reason for the growth of the federal government's role in disaster recovery is a result of the states not being able to afford financing their own disaster recoveries. The federal government is facing a severe financial crisis and can no longer bailout the states that avoid their responsibilities. Public safety is a priority of state and local governments. If state and local governments are not willing to adopt policies to mitigate the effects of natural disasters and recover from these incidents afterward, then they are not fulfilling their obligations to their citizens.

[14]Howard Kunreuther and Erwann Michel-Kerjan, "People Get Ready: Disaster Preparedness," *Issues in Science and Technology*, Vol. 28, No. 1 (2011), pp. 1–7, at *http://opim.wharton.upenn.edu/risk/library/J2011IST_PeopleGetReady.pdf* (February 13, 2011).

[15]*Ibid*., p. 3

[16]*Ibid*.

[17]42 U.S. Code § 5191(a).

[18]Matt A. Mayer, David C. John, and James Jay Carafano, "Principles for Reform of Catastrophic Natural Disaster Insurance," Heritage Foundation *Backgrounder* No. 2256, April 8, 2009, p. 3, at *http://www.heritage.org/research/reports/2009/04/principles-for-reform-of-catastrophic-natural-disaster-insurance*.

[19]*Ibid*.

[20]Mayer, "States: Stop Subsidizing FEMA Waste and Manage Your Own Local Disaster," p. 3.

[21]U.S. Department of the Treasury, Bureau of the Public Debt, "Monthly Statement of the Public Debt of the United States, December 31, 2011," Table 1—Summary of Treasury Securities Outstanding, December 31, 2011, at *http://www.treasurydirect.gov/govt/reports/pd/mspd/2011/opds122011.pdf* (February 13, 2012).

[22]David Nakamura, "Obama Asks Congress for Debt Limit Hike,",*The Washington Post*, *44* (blog), January 12, 2012, at *http://www.washingtonpost.com/blogs/44/post/after-delay-obama-asks-congress-for-debt-limit-hike/2012/01/12/gIQAA3ADuP_blog.html* (February 13, 2012).

[23]Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2012 to 2022*, January 2012, p. x, at *http://www.cbo.gov/ftpdocs/126xx/doc12699/01-31-2012_Outlook.pdf* (February 13, 2012).

[24]*Ibid*.

[25]Office of Management and Budget, *Historical Tables, Budget of the United States, Fiscal Year 2012* (Washington, D.C.: U.S. Government Printing Office, 2010), Table 7.1—Federal Debt at the End of Year: 1940–2017, pp. 139–140, at *http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/hist.pdf* (February 13, 2012).