# Briefly Noted

## The Flood Insurance Fix

BY IKE BRANNON AND ELIZABETH LOWELL
*American Action Forum*

The National Flood Insurance Program (NFIP) expired last September 30, but Congress passed a temporary measure reauthorizing the program until November. That gave the House and Senate more time to battle over their own versions of longer-term reauthorization bills.

Ideally, flood insurance would be provided by the private market, with actuarially sound rates that would discourage building in flood-prone areas. But it is unlikely that will happen in the United States, as generations of homeowners have purchased taxpayer-subsidized flood insurance, resulting in hundreds of thousands of homes and other buildings now located in flood zones. Besides, a private insurance market would invariably exclude the homes facing the gravest flood risk, with the result that government would feel obligated to provide financial assistance to any uninsured flood victims—a conundrum elegantly captured in the seminal 1977 paper by Finn Kydland and Ed Prescott that won them the Nobel Prize.

Having a national flood insurance program acknowledges this reality. If designed and administered effectively, the program would at least minimize the need for large future disaster aid outlays as well as force those who own buildings susceptible to flooding to bear the brunt of the costs via insurance prices that reflect the risk of flood damage. Unfortunately, that is not the sort of program the United States now has; instead, taxpayer subsidies have encouraged building in flood-prone areas.

Make no mistake—the NFIP has already caused a lot of damage and is in major need of reform. The below-market price premiums afforded by the NFIP have been a direct subsidy to developers who build in environmentally sensitive flood zones, as well as to owners of coastal vacation homes. The NFIP subsidizes premiums for the properties that are most likely to incur large flooding repair costs and bases its premiums on outdated flood risk maps.

Ideally, the legislation that comes out of Congress would do the following:

***Insist that we more precisely measure risk.*** The NFIP relies on inaccurate and outdated flood risk maps to price its premiums, setting flood insurance rates on a nationwide basis according to broad flood risk categories that may fail to account for local factors. By not accounting for the "residual risk" of constructing behind levees, the NFIP has given residents a false sense of security and has encouraged development.

At the same time, the NFIP faces strong political pressure not to reclassify flood zones as high risk, since it inevitably leads to increased premiums for people living in those zones. Past attempts to update its maps have not led to significant changes in the premiums it charges, since property owners with flood insurance can typically "grandfather in" underpriced premium rates if their properties are remapped into riskier flood zones. Accurately reflecting risk will depend to a large extent on resisting community pressure to preserve outdated flood risk designations.

High budget deficits may provide the opportune cover for legislators grappling with having to tell constituents who live in a flood plain that their insurance may soon double. In an environment with more modest deficits, such an achievement would be nearly impossible to attain.

***Price risk more accurately.*** The NFIP currently offers both "full-risk" and "subsidized" premiums for its flood insurance policies, both of which are underpriced by design. The NFIP's full-risk premiums cover losses relative to the historical average loss per year, providing insufficient funds to handle infrequent, very large catastrophic losses, such as the $17 billion of flood claims resulting from hurricanes Katrina, Rita, and Wilma in 2005. The NFIP also subsidizes premiums for the properties that are most likely to incur large flooding repair costs and frequent flood losses. For example, it subsidizes 90 percent of insurance policies for "repetitive-loss properties," which experience frequent flood losses. In other words, policyholders who

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ILLUSTRATIONS BY KEVIN TUMA

experience repeat or annual flood losses can receive subsidized insurance to pay for near-certain damages.

Premium rates clearly need to rise in order to reflect the true risk of living in a flood zone. The conundrum is that if the NFIP raises rates too high, people will simply refuse to buy insurance. Despite existing mandatory flood insurance purchase requirements, compliance remains low.

The NFIP must find other ways of retaining participation in the program, such as increasing outreach and better informing people of flood risks. Yet the reality is that the promise of future federal disaster relief is itself a deterrent to buying insurance. One way to mitigate that deterrent would be to require residents of high-risk flood zones to sign waivers forfeiting their right to federal disaster aid unless they purchase flood insurance—an empty threat, most likely, but one that would at least increase the incentive to buy insurance, even at full-price rates.

***Quit giving cut-rate prices to insure vacation homes.*** In addition to being irrational, the NFIP's subsidies are regressive, essentially transferring wealth from taxpayers to communities along the Gulf Coast, and especially to upper-income homeowners residing there. According to the Institute for Policy Integrity, the wealthiest counties have historically filed 3.5 times more claims and received over a billion dollars more from claim payments than the poorest counties. A large share of insurance benefits flows to upper-income houses, since beachfront property tends to be the most valuable and also faces the greatest risk of flooding. Charging full-risk premiums would at least require owners of second homes to assume the risk they take for living in flood zones.

Another way to discourage buying vacation homes in flood zones would be to disallow the home mortgage interest deduction for second homes. Providing an impetus for homeownership in the form of a tax deduction means that most of the benefits go to taxpayers in the highest tax brackets, most of whom can afford to buy a house (as well as a second house) without subsidies, while middle-class households that own or rent smaller homes receive little or no tax benefits. A vacation home owner in a flood zone can get federally subsidized flood insurance and a tax deduction, and should get neither.

***Abandon the idea that the government can provide flood insurance profitably.*** The NFIP currently has an $18 billion shortfall, and some in Congress have expressed a desire to try to reduce or eliminate that deficit via more aggressive pricing of insurance. While we share their indignation at government spending so much taxpayer money on such a program, it is impossible to charge premium rates *that people would actually pay* that would enable the NFIP to repay its $18 billion debt. Since the NFIP has limited means to compel people to buy flood insurance, the best it can do is charge premiums that are low enough to encourage participation in the program, but high enough to cover the cost of flood disasters to the greatest extent possible. High prices would leave us with few participants paying into the system, but a plethora of homeowners nevertheless expecting some form of government assistance in the event that their homes suffer major flood damage—and they would be likely to get it as well.

**Conclusion** | Both House and Senate reauthorization bills are a good start for reforming the NFIP. Both reestablish a Technical Mapping Advisory Council (which was disbanded in 2000) to review and update flood risk zones and rate maps. Both phase out subsidized premiums, introduce actuarial rates, increase annual limitation on premium increases, and set minimum deductibles. They provide for studies on longer-term reforms such as partial privatization, and the House bill also provides for a study on community-based flood insurance options. There are still details to work out, such as how much annual premium limits should be allowed to rise and what types of properties should have mandatory insurance purchase requirements. But, more than any other bill that is currently likely to gain passage, these hew close to the guiding principle that citizens, and not the government, should bear the risk they take for living in high-risk flood zones. R

# Third-Party Litigation Funding

BY DAVID S. ABRAMS | *University of Pennsylvania*

Imagine a world where, in addition to investing in shares of corporations or trading oil futures, markets existed that allowed for the exchange of litigation shares. In this world, an individual with a legal claim would benefit by obtaining funding for the claim and reduce the risk from an adverse verdict. Investors would be able to diversify through portfolios of litigation shares spread across a variety of locales and legal doctrines. They might particularly focus investment in areas where the law is most uncertain, which could otherwise deter risk-averse plaintiffs.

Would such a world result in the encouragement of frivolous suits, excess litigation, and unethical attorney behavior? Until now there has been virtually no empirical research to answer those basic questions. This should come as no great surprise, as pure litigation trading markets as described above still do not exist. But recent developments in legal systems allow us to begin addressing these questions for the first time.

In a new working paper that I've co-authored with Duke University law and economics professor Daniel L. Chen, we make an initial investigation into the way third-party funding has functioned in Australia. We use data from the largest Australian litigation funder, the Australian courts, and citation information to begin to understand how third-party funding can affect the legal environment.

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Interested readers can find the working paper upon which this article is based at: www.law.upenn.edu/faculty/dabrams.

**Developments** | Several recent legal changes in different countries have moved our world closer to the one described above. The 2006 *Fostif* decision by the Australian Supreme Court legalized third-party litigation funding in that country. Australia also became the first in the world to have a publicly traded law firm. Just last month a new law went into effect in England that will allow non-lawyers to be part-owners of law firms for the first time. In the United States there has been tremendous growth in the past several years in the fledgling alternative litigation finance (ALF) industry and discussions about prospective legal reforms that could promote it.

In the United States, as in countries with common-law legal systems, the doctrines of maintenance and champerty have long prohibited outside financing of litigation. Those doctrines, with medieval origin, prohibit entities without interest in a legal proceeding to be able to share in its proceeds. The rationale for the prohibition is sensible: one might worry that justice could be perverted by wealthy outsiders bribing lawyers and plaintiffs to bring false claims. But in an era where defendants may have substantial resources themselves or have backing from well-financed insurers, there is concern that the expense of litigation may deter the pursuit of worthy claims.

The type of ALF that I investigate is third-party litigation funding, where an entity unrelated to the parties or attorneys provides funding to the plaintiff in return for some share of the eventual settlement or jury award. Deals are usually structured so that the plaintiff maintains at least a third of the settlement (and usually over 50 percent) in order to ensure that the interests of the funder and plaintiff are aligned. This way, the plaintiff still has strong incentive to produce evidence, assist attorneys in the preparation of the case, and provide testimony.

One of the great promises of ALF is that it may provide a mechanism for financing legitimate claims that would not otherwise be possible. In this way, third-party funding could work in favor of the pursuit of justice. For example, poor or credit-constrained plaintiffs may have worthy claims, but lack the funding to pursue them. A third-party funder could provide the resources necessary to allow these cases to proceed. Even entities that do not lack funds may be unwilling to pursue potentially valuable claims if they are risk-averse. A risk-neutral funder could vastly reduce the uncertainty in the outcome by providing a floor for the settlement and thus making it worthwhile to pursue the claim. Other contexts where third-party funding could be of benefit include ones of uninformed potential plaintiffs and cases with large coordination costs.

**Empirical analysis** | Would all this new litigation made possible through third-party funding inundate the courts? This is one of the questions that Chen and I investigate empirically, but there are reasons to believe that this may not be the case in the long run. Initially, one may expect the amount of litigation to increase. But after a period of adjustment, litigants will adjust to the new level of funding and any changes in likelihood of victory, and thus elect to settle in order to avoid court costs. Indeed, the new level of litigation in the courts could actually be lower in the long run.

One of the major potential benefits of litigation funding is that it is likely to specifically target the most uncertain and least settled areas of the law. Because these are the types of cases with greatest uncertainty, they are the ones least likely to be pursued by risk-averse plaintiffs. A risk-neutral litigation funder could expect to make the greatest returns in these types of cases and thus would fund them at a higher rate. This could lead to earlier clarification of the law, which in the long run will have substantial benefits. Clarity of the law leads to greater certainty in long-term decisions, which benefits all (perhaps excluding litigation specialists). This is one of the reasons why litigation funding counter-intuitively could actually lower the burden on courts while funding cases of greatest legal significance. These are two of the predictions Chen and I examine empirically.

Australia has been the most active country in the world in experimenting with ALF. In 2006, with the *Fostif* decision, the Australian Supreme Court clarified the legality of third-party litigation funding, which had already been growing for several years. I obtained data from the litigation funding firm IMF Australia (no relation to the International Monetary Fund), which is the largest third-party funder in the country, with over 50 percent of the market. Combining those data with data on Australian court processing statistics and case citation information allowed me to investigate some of the empirical predictions relating to litigation funding.

IMF Australia has funded 113 cases from 2001 through 2010, with a total claim value of over $1.5 billion (Australian). They are selective in choosing cases, with only about one in seven receiving funding. The average duration of a case from funding to resolution is about 2.3 years.

If one could design the perfect experiment to investigate the impact of third-party funding, it would legalize third-party funding in one state while maintaining the prohibition on it in another, otherwise-identical state. A number of economic studies use actual law changes to approximate this idealized experiment. One could then look at settlement rates, amounts, court processing times, and other outcomes.

In the Australian litigation context, the analysis is trickier, as oftentimes there was little actual funding in states immediately after a law change. Additionally, settlement data are unavailable because settlements are not required to be reported. Short of the ideal experiment, we use the closest data that are available: we use IMF spending levels as a proxy for the openness of an Australian state to litigation funding and examine changes in court case processing in response.

Chen and I find a correlation between the spending level of IMF in an Australian state in a given year and net expenditures by the state court system. There is also a negative correlation between IMF expenditures and both the backlog of cases and the number of cases resolved in a year. Taken together, this is suggestive of an association between third-party funding and slower courts. Due to data limitations, this finding must be seen as tentative. It may potentially be explained by variables that were not controlled for or it may be a short-term impact.

The other main prediction about litigation funding that one could test has to do with the significance of cases that are funded. One measure of the importance of cases is the number of citations they receive. The IMF data include information on all of the matters the firm considered, whether it ended up funding a case or not. In order to determine whether funding targets important cases, I compared the number of citations received by those published cases that received funding with those that did not. While the total number of cases with data is small, the results are striking. Funded cases receive over twice as many citations on average (11.0) than those that did not receive funding (4.6). This indicates that at least this particular third-party funder is funding cases that have greater legal significance than average.

So what can we make from these findings and how might they translate to the American context? One major difference is that contingency fees are legal in the United States and they provide some of the same benefits that third-party funding can. But contingency fees are not nearly as flexible. The source of funding is limited to the client's attorney, who himself may be risk averse or limited in how much work he is willing to perform without guaranteed pay. Contingency fees also tend to be for a relatively small fraction of the claim and may generally only be used for out-of-pocket expenses rather than a flat sum.

Third-party litigation funding would still likely have a meaningful effect on litigation in the United States. In addition, as other countries, particularly the United Kingdom, loosen their limitations on funding sources for law firms, American law firms may be hard-pressed to compete. For now, it appears that third-party litigation funding in Australia may be contributing somewhat to slower case processing, while focusing resources on more important cases. This may be a tradeoff worth experimenting with in the United States. R

# Why Greece Defaulted—and Others Will Follow

**BY PIERRE LEMIEUX** | *Université du Québec en Outaouais*

Late last October, European leaders accepted the inevitable and the Greek government defaulted on its public debt. Officially, the country and its lenders agreed to a modification in the terms of Greek bonds, but it's difficult to construe the large "haircut" imposed on the lenders as anything but a default.

The reason for the default is simple: over the past decades, the Greek state had built up an unsustainable public debt that other European taxpayers did not want to shoulder. The crucial fact is

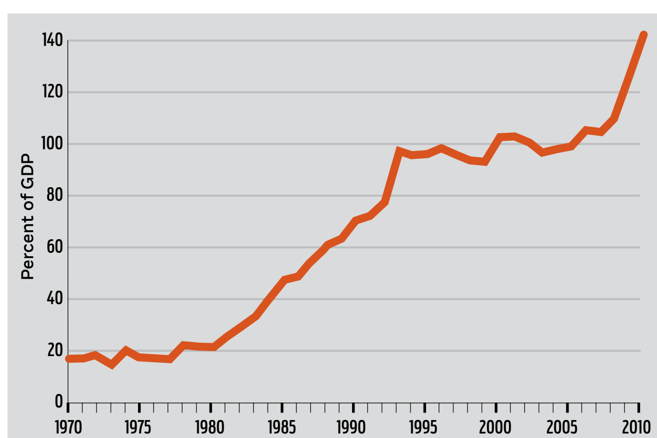

that the Greek debt problem is essentially structural and not a consequence of the recent recession, which merely precipitated the catastrophe. Data from the European Commission show that the ratio of Greek public debt to gross domestic product, which reached 143 percent in 2010, was already 105 percent in 2007. In the 1970s, the ratio was around 20 percent of GDP but, from 1980 to 1994, it exploded to 96 percent (see Figure 1). Most of the damage was done long before the Great Recession struck.

Part of Greece's problem is the stagnation of tax revenues. In 1995 (the first year that Organization for Economic Cooperation and Development data are available), government expenditures stood at 46 percent of Greek GDP, 7 points below the euro-area figure of 53 percent. However, government revenues in Greece were 37 percent of GDP, whereas the euro area's was 46 percent—a gap of 9 points. Greek taxpayers did not want to pay for high government expenditures and the state was not able, or not willing, to enforce higher taxes.

**Beyond Greece** | The already wide discrepancy between expenditures and revenues in the euro area (7.5 percent in 1995) points out that something has long been rotten in Europe at large. There too, the taxpayers were not paying for all the goodies they received

FIGURE 1

**Gross Greek Public Debt as a Proportion of GDP**




Source: European Commission

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from the state. In other words, Greece is not alone in having a structural deficit and public debt problem. With few exceptions (Ireland, Spain, and the Northern countries), European countries were, before the Great Recession, riding a trend of high public deficit and indebtedness that had started in the 1970s.

Consider Figure 2, which compares gross public debt as a proportion of GDP in selected countries before and after the Great Recession. In 2007, the gross public debt in the typical euro-area country was 59 percent (unweighted average) of GDP, which amounts to nearly three-fourths of the level of 82 percent reached in 2010. In other words, nearly three-fourths of euro-area public debt was accumulated before the Great Recession and, in fact, before the mid-1990s.

With gross public debt at 113 percent of GDP in 2007 (OECD statistics differ slightly from the EU's), Greece and Italy came second and third in public indebtedness only to Japan (a special outlier). Note how Belgium (88 percent), Portugal (75 percent), France (72 percent), and even Germany (65 percent) were also pulling up the euro-area average. In all these countries, the level of public debt was already, in 2007, 73 percent or more of what it would reach after the Great Recession. A similar situation obtained in the whole OECD: by 2007, the typical member state had accumulated 75 percent of its 2010 debt.

In the United States, the ratio of gross public debt to GDP in 2007 was 66 percent of what it reached in 2010. Only the usual strength of the American economy prevents investors from being nervous about U.S. government securities—for now.

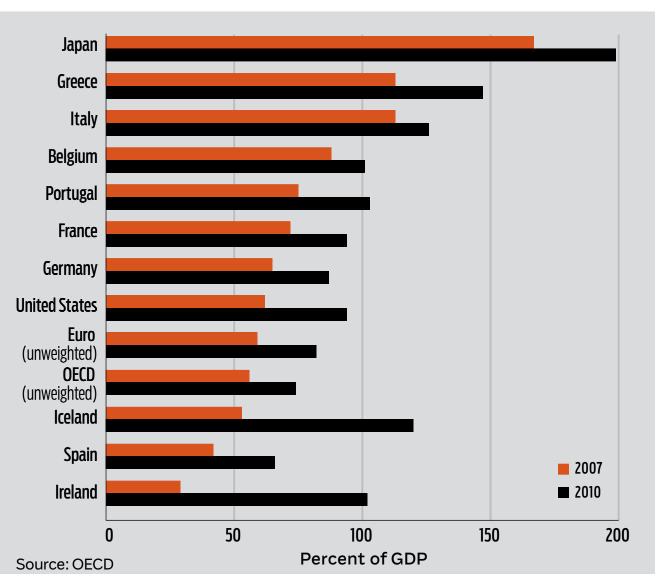
Note that these ratios of public debt to GDP underestimate the weight of pre-recession debt, as the reduced GDP boosts the post-recession ratio.

Two factors propelled this high level of public indebtedness. The first factor is the growth of government expenditures, especially the growth of the welfare state. Even in the United States, which has been spared the worst excesses, total government expenditures increased from about 8 percent of GDP before World War I to 37 percent in 2007 (and 42.5 percent in 2010). The second, related factor lies in the endemic deficits that have developed since the mid-1970s, and which Public Choice theorists James Buchanan and Richard Wagner had diagnosed in their prescient 1977 book, *Democracy in Deficit: The Political Legacy of Lord Keynes.*

Excluding record tax evasion and cooked statistics in Greece, the same structural factors that brought the Greek state to default are at work in other European countries and the United States. The aging of the population will only make matters worse. R

FIGURE 2

**Gross Public Debt as a Proportion of GDP**




# Shareholder Say-On-Pay, So Far

BY THOMAS A. HEMPHILL | *University of Michigan–Flint*

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 includes Section 951 requiring publicly traded companies to hold advisory "say-on-pay" proxy votes on executive compensation. Recently, the U.S. Securities and Exchange Commission officially adopted rules under Section 951 specifying that say-on-pay votes are required at least once every three years and that companies also are required to hold a so-called shareholder "frequency" vote at least once every six years to decide how often they would like say-on-pay votes.

Policymakers have repeatedly claimed that say-on-pay would give shareholders an invaluable voice on executive compensation. With the first wave of say-on-pay votes now behind us, what have shareholders said with this voice?

**First-year proxy results** | Equilar, a California-based executive compensation consulting company, analyzed the results of say-on-pay votes taken in the first six months of 2011 at the annual meetings of 2,252 firms, or 75 percent of those listed on the Russell 3000. As of June 30, 2011, only 1.7 percent (38) of those firms "failed" their say-on-pay vote, while 74.8 percent of the firms "passed" their say-on-pay vote with over 90 percent shareholder approval. Moreover, just 129 of the firms (5.7 percent) passed their say-on-pay vote with only a 50–70 percent approval rate, while 2,085 of the firms (92.6 percent) passed their say-on-pay vote with greater than a 70 percent approval.

Those are surprising numbers, since Institutional Shareholder Services (ISS), the largest advisement firm on proxy and shareholder issues in the United States, had recommended shareholder "nay" votes on say-on-pay for 293 firms (13 percent) through June 2011 — far higher than the 1.7 percent of firms whose shareholders voted down the compensation packages. This prompted Robert A. G. Monks, veteran corporate governance activist and

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founder of ISS, to say, "Say-on-Pay is at best a diversion and at worst a deception." Other commentators, citing the voting results, characterized say-on-pay as a "dud" or a "bust." However, it's an open question whether shareholders somehow "failed" in their voting, or whether the commentators simply have different opinions on executive pay than the shareholders.

**CEO compensation and turnover trends** | Why did shareholders approve so many compensation plans? Despite critics' claims that chief executive officers are paid ever higher compensation without regard to performance, recent research suggests that CEO pay in the United States has decreased over the last decade and is related to managerial performance. Steven Kaplan and Joshua Rauh, both of the University of Chicago Graduate School of Business and the National Bureau of Economic Research, found that in 2000, S&P 500 boards paid their CEOs an annual average of almost $17 million in compensation, including salary, bonus, restricted stock, and the expected value of options. In 2009, average CEO compensation was less than $8.5 million (in constant dollars), a decline of approximately 50 percent from 2000.

Dirk Jenter, of Stanford University and the NBER, and Katharina Lewellen, of Dartmouth University's Tuck School, in their recent study of CEO performance and turnover, found that 17 percent of chief executives with strong stock performance (in the top quintile) were removed from their position over a five-year period, while 59 percent of those with weak stock performance (in the bottom quintile) left office over that same five-year period — a stunning 42 percent differential in board decision-making accountability. The recent say-on-pay results, says Kaplan and Rauh, suggest that these shareholders agree with board assessments and employment decisions.

**Conclusion** | This first-year result of a 98.3 percent say-on-pay voting approval rate apparently reflects investors' overall satisfaction with the compensation packages that boards of directors recommended for their firms' CEOs. Of course, it would be premature to presume that the 2011 results are the final word on this issue. There is some indication that institutional investors will actively increase their involvement in say-on-pay voting during the 2012 proxy season. And the SEC is scheduled to adopt a rule under Section 953(a) of Dodd-Frank in the fall of 2011 to require U.S. public companies to disclose annually in their proxies the relationship between executive compensation paid and the company's financial performance. But for now, CEOs can breathe a sigh of relief, while executive pay critics have much to prove on behalf of their position. R


READINGS

- "Investor 'Say on Pay' Is a Bust," by John Helyar. *Bloomberg Businessweek*, June 16, 2011.
- "Performance-Induced CEO Turnover," by Dirk Jenter and Katharina Lewellen. Working paper, February 2010.
- "Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?" by Steven N. Kaplan and Joshua Rauh. *Review of Financial Studies,* Vol. 23, No. 3 (March 2010).


# Errata

In the Fall 2011 article "What Should We Do about Social Security Disability Appeals?" by Richard J. Pierce, Jr., the $2.1 billion in benefits granted by administrative law judge Charles Bridges was incorrectly characterized as being for a one-year period. That total was for a four-year period.

Also, the article incorrectly stated the portion of total federal spending attributable to Social Security disability benefits awarded by administrative law judges. For Fiscal Year 2011, these benefits equaled roughly 1 percent of total federal spending and 2.5 percent of the federal budget deficit.

In the Fall 2011 article "The Standard Environmental Narrative" by William L. Anderson and Patrick Moffitt, the text incorrectly indicates the authors' assessment of the Chesapeake Bay watershed nitrogen reduction efforts. The text should have read that "in bays like Barnegat and the Chesapeake, such programs have not been shown to have demonstrated value."