

THE ROLE OF THE STATE AS AN INSURER OF LAST RESORT?

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Change has come to New Zealand in many ways over the years but never has it been more apparent and affected so many people than over the last decade. You can pay your bills by electronic transfer; obtain data by accessing a mini computer terminal small enough to fit in your pocket; the time to travel vast distances has accelerated and the style of business and the industries that provide economic value to our country have to a greater or lesser degree changed.

Along with these changes has come a new approach to financing business, and personal options and opportunities have broadened dramatically. Visibility and accountability is demanded of companies, government departments and even politicians, and is expected as of right.

We have clearly entered an era where no industries can expect to settle for the status quo, for the danger is that if they do, they will find that they are no longer relevant to the markets they are attempting to serve; or, horror of horrors, change is forced upon them by their competitors.

The insurance sector has been in business in one form or another for hundreds of years. Debate as to who should subscribe and the obligations of insurers to their customers is an oft repeated theme in the news media.

The role of the government and the obligations it should assume are also speculated upon, particularly after a major natural disaster has affected a group of citizens either in this country or overseas.

During the time of the Abbotsford land slip disaster some time ago real debate was heard about people's rights and obligations. New Zealanders with their traditional state provider expectations looked to the government of the day or to government agencies to assist and completely compensate those affected.

The ensuing nationwide media debate saw many words bandied about, but in fact little change to existing legislation occurred then. Now, after all this time, real debate seemed to be occurring and we appeared to be about to have an opportunity to look at the wider options and obligations for all emergency and disaster services.

The title of my paper is: "The Role of the State as an Insurer of Last Resort?" the choice of this was deliberate, because I believe that any discussion of an issue like this should involve a consideration of all the implications of the topic. These include and must begin with - an assessment of the role of all the players to see where the true obligations lie and to clarify who is currently really paying for what.

Over the last two years I have had the opportunity through my consultancy company Strategos to review a number of major government organisations including the New Zealand defence force, the New Zealand police, the Treasury, the Ministry of Agriculture and Fisheries and the Department of Justice. Currently, we are in the last stages of a major project for the New Zealand Fire Service Commission.

The environment in which state sector reform has proceeded to date can be summarised as follows:

- state expenditure in New Zealand as a proportion of GDP has been at historically high levels when there has been a discernible international shift in philosophy against the state provision of services.
- the level of the fiscal deficit is regarded as important by all key political agents in terms of its impact on macro-economic management.
- in general, there is a need to ensure that a focus is put, not simply on the cost of what the state does, but on what the state provides and how. This obliges analysts to ask questions such as:

- are the outputs of a given agency or organisation those which are optimal in terms of economic or

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social outcomes?, and,

- is the present method of delivering a service optimal, or could the same or an equivalent service be provided by the private sector at less cost?

From the analyses my consulting firm has conducted, it would seem that there are very few activities where a state agency exercising a monopoly or a quasi monopoly function is likely to be the optimal form of market organisation. There may well be some lessons to be learnt from this as far as the proposed Disaster Commission of New Zealand is concerned.

One of the problems which occurs in trying to evaluate or make change within an industry is the fact that very often the focus of the review, is too narrow. There are many examples of situations where it would be better if we could forget existing structures or ways of doing things that have been dictated by history, and reconsider the actual needs of the community as a whole in the light of current requirements.

In the case of actual and potential disasters affecting life and property, we have over the years developed a range of services in the nature of the Fire Service, the Ministry of Transport, the Police, the Ambulance Service, Civil Defence and the Earthquake and War Damage Commission, to name but a few. Those current structures invariably support stand-alone organisations, which raises the question do they all have to be separate, or indeed are they all necessary?

After all, there must surely be economies of scale in amalgamating - as a very minimum - property holdings, transport pools and other assets, particularly the sophisticated communications links that are needed to service many of those various functions. An assessment of this type will then assist in leading on to the next set of questions such as:

- are those services the most effective and efficient means of achieving a stated set of objectives? and
- who is funding them?

First the question concerning effectiveness and efficiency in the achievement of objectives. If we continue to retain existing separate organisations for all those services we will, I believe - in this new cost conscious environment - face a number of conflicts of interest and the likelihood of achieving no satisfactory outcome for any individual organisation, let alone the public as a whole.

Risk management literature emphasises the importance of balanced solutions to problems, and especially the use of loss prevention and risk assumption techniques as a substitute, for example, for insurance. Due to the low frequency of occurrences such as earthquakes, decisions concerning the allocation of actual resources should be considered along with other emergency arrangements, to avoid having substantial

funds tied up in a particular project waiting for an event to occur while other more immediate areas of concern are unable to be funded.

Obviously the risk management process must devote detailed thinking and planning to the design and use of the economy's infrastructure and organisational structure. It must include loss prevention activities as well as preparedness and early warning responses. Comprehensive planning of rescue and recovery activities, pre-planning of priorities and allocation of emergency resources for quick recovery are also required. Along with all this is the need for comprehensive education about the whole range of potential disasters which face the population and the preventative measures people can institute for themselves.

It is, after all, only natural that, with separate agencies, each organisation will focus on the potential disaster areas they are in business to cover. The Earthquake and War Damage Commission in its deliberations, does not need to consider in-depth the impact a funding decision it makes will have on the providers of (say) the Fire Service.

By way of illustration, it seems that the proposed changes to current disaster insurance arrangements will, if implemented provide a situation where insurers will be placed in the unsatisfactory and potentially dangerous position of negotiating and recording three different sums insured for dwellings i.e. the indemnity sum insured - solely for the Fire Service levy, the 'modal' sum insured - representing the compulsory sum for the proposed disaster legislation, and finally the replacement sum insured - representing the insurers maximum liability. This is an obvious example of the impact of making a decision on earthquake cover which in fact directly affects the outcome for the Fire Service.

But, let's take a step back and consider what the real role of the government should be if a major disaster, such as an earthquake, hits New Zealand; and what we perceive to be the advantages and disadvantages of the present funding and administration situation, as these are central to most of the decisions which need to be faced.

Public perception of the effect that an earthquake can have, tends to be limited to the obvious destruction of buildings and loss of life. However, earthquake losses can be quite diversified. Long term secondary effects can be observed in many fields: population migration (especially due to repeated quakes); unavailability of construction materials and skilled labour; contamination and disappearance of water resources, toxic contamination, etc. in addition, other macro economic effects can be unemployment - which also creates consequential losses to the business community - changes to the exchange rate, balance of payments deficits, increased external borrowing, unfavourable developments in the capital markets and so on.

The reality for any government is that a major earthquake could affect the entire national economy and could cause regression for several years in the economic development and external debt situation of a poor country.

The second question concerns funding. Most of the money for the so called public amenities in New Zealand, such as electricity, telephone, water, roading and sewage etc., and the provision of the Police and the Fire Service, to name just a few, are paid for by visible taxation or taxes dressed up as levies or charges.

What is abundantly clear is that the existing means of funding disaster or emergency responses in New Zealand is inadequate. Please note I am talking about the inadequacy of funding responses as opposed to the simple funding of an orthodox public institution such as the Earthquake and War Damage Commission.

Therefore any definition of or comprehensive view of funding as consideration of what constitutes an appropriate response should be grounded in an understanding of two issues. First, those elements of the response which are in the nature of a public good and those which are essentially or substantially private in their impact. And secondly that the possible responses to most disasters or emergencies are several and varied. As a minimum they include:

- private market responses generated by statutory obligations;
- private market response generated through the use of insurance markets of all kinds both in a direct and indirect sense;
- voluntary individual action;
- voluntary collective action, such as neighbourhood responses on the type of basis which neighbourhood watch operates, with a greater or lesser degree of formal (but still voluntary) organisation;
- decisions to accept the risk adjusted cost without further action directed specifically at the disaster or emergency;
- public responses through regulation designed to prevent or ameliorate the costs imposed;
- institutional responses such as the establishment of a commission under legislative mandate funded through taxation of some form or another;
- indirect publicly provided responses such as education via state school curricula, television or other vehicles.

Combinations of all of these are also possible. The important point is that there are many possible responses to a disaster. However there has been a tendency in New

Zealand to equate response purely with what the public expects the government to provide and what the public views as the provision of a free good.

This clearly raises the question of what is a public good. Public utilities are usually viewed in this way, but we must remember that more and more the Telecoms, Electricorps etc., are being told to be commercial and now have a strong commercial bias. This presumably means that they will be anxious to get back into business as quickly as possible after any disaster, and will therefore take appropriate risk management decisions - before the disaster occurs - to make sure that this is possible.

This therefore suggests that the genuine public utilities - like water, sewage, and possibly roading, should become the focus of any direct government intervention along with the provision of emergency medical supplies and facilities, shelter, food, etc.

I can see no justification whatsoever for the normal residential property to be regarded as anything other than a private good. This is, in fact, recognised in the White Paper on Disaster Insurance (policy) by the possible exemption for owners with independent assets from the proposed compulsory replacement insurance cover.

The proposed funding system is, in my view, just as iniquitous and unconscionable as the current system in which the insurance industry is used as a pseudo tax collector to raise funds on behalf of the government. Such an approach is inadequate, counter-productive in terms of response, and promotes inefficiency.

Unfortunately, the form and extent of government involvement has been determined by a "traditional" approach to the following dilemmas:

- whether to make earthquake insurance compulsory,
- the choice of the specific agencies (private or government insurer),
- the method of indemnification and allocation of compensation, and
- the attitude towards reinsurance,

when the approach in most other areas of the economy has been in favour of market mechanisms and individual initiatives.

The loss of lives and physical resources following an earthquake cannot simply be recovered by financial indemnity. The money that will come from foreign reinsurers will ease the situation in many cases but will often be insufficient to solve the severe problems associated with shortage of physical resources, manpower, etc. It may often lead to price increases similar to the effects of printing of money by the government. The earthquake insurance problems thus resemble the dilemmas of large national schemes such as Social Security which faces the need of guaranteeing social security and retirement income for the entire population and involves decisions

whether to finance the program by cross-subsidization (i.e. the pay as you go approach) or through a full funding system.

What I believe we in New Zealand must seek, is the best possible choice for the scarce resources which are available for all likely disasters. We need the simplest management structure possible to consider and to evaluate clearly the risks and their effects so that the right energy and funding can be appropriately directed.

To achieve this end, a single organisational structure would seem to offer the only acceptable way to achieve this objective.

If we had for example a Ministry of Emergency Services, New Zealand would be in the position to:

- a) develop a co-ordinated approach to a range of issues;
- b) give the appropriate weighting to all emergency services according to relevant risk factors;
- c) provide an organisational structure which divides policy from operations.

The advantages of this latter provision are threefold:

- it ensures available funds are not captured by the operational arm of an organisation to the detriment of, for example, so called discretionary areas of spending such as, PR, education, prevention etc.;
- it enables appropriate objectives and outcomes to be established and monitored by specialist staff who can assess the individual activities in the widest possible context; and
- it allows individual areas of activity to be weighed one against the other according to total budget availability.

Government has a responsibility to inform its people what limited areas of funding they can realistically expect it to meet and what the government will not meet. This will allow individuals to assess their own requirements and to understand fully what help can be expected in the event of a major disaster. We have no clear message at the present time.

My answer to the question: should the state play a role as an insurer of last resort, is, therefore, no if that role is as defined in the proposed legislation for the Disaster Insurance Commission of New Zealand. That legislation envisages the state as the prime funder with taxpayers merely disguised as house owners.