

Commerce and Consumer Protection Implications of Hurricane Katrina

by

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Major Points of My Testimony

- Do **not** impose price controls on food, gasoline, rents, etc.
- Make all federal assistance to displaced households temporary and independent of where they choose to live.
- Allow local property owners and the proximate state and local governments to make the key decisions about the restoration and post-Katrina composition of commerce on the Gulf Coast.

Good morning. My thanks for this opportunity to testify about the commerce and consumer protection implications of Hurricane Katrina.

We have all been concerned about the nature and magnitude of the human tragedy caused by Hurricane Katrina, but the recovery from this tragedy will depend importantly on both what the federal government does and what it does not do.

1. Maybe most important, do **not** impose any form of rationing or price controls on food, gasoline, rents. etc. Price increases following a supply shock serve two important functions: they allocate the available supply of goods to those who value it most, and they encourage those who own or produce the goods to increase the available supply. The historical record documents that price controls lead to other, less desirable, forms of rationing – by waiting lines, bribery, favoritism, and the substitution of lower quality goods and services.

In the absence of price controls, the price of oil has roughly doubled since 2002 with little general economic cost. In contrast, the economic effects of the oil shocks of the 1970s were more severe and lasted longer, primarily due to the extended price controls. The specific increase in the price of gasoline since Katrina was due to the temporary reduction of U.S. refining capacity by around 10 percent, not to some anti-social action by oil companies and distributors. At that time, I predicted that the price of gasoline would fall quickly as electric power, employees, and a supply of oil were restored to the refineries. And that is what has happened. The national average price of gasoline, for example, declined by 17 cents a gallon last week, and I expect that it will continue to decline to the pre-Katrina average price in August of \$2.50 per gallon, unless supplies are again disrupted by another hurricane.

Katrina also destroyed several hundred thousand housing units that will take longer to replace. In the meantime, the rents on available housing, especially on the Gulf Coast, will increase. Governments should **not** respond to this condition by imposing rent controls. Such controls, as with price controls on gasoline, misallocate the available supply and reduce the incentive to increase the supply. In addition, there is no reason to place the burden of providing housing for the displaced households on the owners of existing housing.

2. There is a good case, consistent with our natural generosity, to make ample assistance to those households displaced by Hurricane Katrina, *and there is ample funding within the \$62.5 billion already approved for such assistance*. Such assistance, however, should be temporary, say for a year, and should be independent of where the displaced households choose to live. Returning to the Gulf Coast, specifically, should **not** be a condition for receiving such assistance.

The federal budget cost of a rent voucher for displaced households, say of \$10,000, would be around \$6 billion, and the voucher should be usable anywhere in the country. The budget cost of a school voucher for all displaced school children would be about the same, and the voucher should be usable at either a public or private school anywhere in the country. President Bush's proposal for a training and labor voucher of \$5,000 per head of household would cost about half this amount. Such direct assistance to each displaced households allow them to make their own choices about where the combination of available housing, schools, and jobs best meets their interests. This combination of direct assistance would be far preferable to the FEMA plan to build massive mobile home villages on open land on the Gulf Coast -- villages with no trees,

stores, schools, churches, or community organizations that make a house a home. The total budget cost for this package of direct assistance, assuming there are no more than 600,000 displaced households that have no home to which to return, should be less than \$20 billion. One wonders what activities financed by the \$63.5 billion already approved should have a higher priority. The primary additional measure to protect both the Treasury and consumers would be to assure that the vouchers are allocated to and used only by the households displaced by Hurricane Katrina.

3. All too often, I hear otherwise thoughtful people question whether and how “we” should rebuild New Orleans. My response has been that these questions should **not** be resolved by the federal government; no one individual or group here in Washington has either the information or the incentive to make the decisions that best serve the interests of the Gulf Coast residents. Nationalizing these decisions would make them unusually vulnerable to pleas by special interests for the federal government to favor some post-Katrina composition of commerce that does not best serve the interests of the local residents. Most of the key decisions about how the Gulf Coast cities should be rebuilt and the post-Katrina composition of commerce on the Gulf Coast should be made by the local property owners and by the proximate state and local governments.

The primary remaining federal role, other than the assistance to the displaced households recommended above, should be to rebuild that part of the local infrastructure for which the federal government has had the historical responsibility. It is important to avoid any *increase* in the federal response to Katrina relative to its prior response to natural disasters. This would create a “moral hazard” problem by increasing the expectation of local residents and governments about the future federal response. This

would reduce their own incentives to make those decisions that would avoid or reduce the cost of future natural disasters. It is especially important for the federal government to avoid financing *any* rebuilding of private property that was not covered by flood insurance. Although flood insurance is heavily subsidized, many property owners do not buy this insurance, expecting the federal government to bail them out whether or not they are insured; this has already led to a decline in the share of flood-prone properties that have flood insurance. One potential federal measure that deserves serious consideration would be to require flood insurance on all properties on which there is a mortgage from a federally regulated and insured financial institution. But in the meantime, the federal government should not make this problem worse by financing the rebuilding of private property that was not covered by flood insurance.

On the three above issues, Congress faces a dilemma: the commendable incentive to be generous to the victims of a natural disaster may increase the costs of future disasters, both to the local residents and to the U.S. Treasury. As you address the federal responses to Hurricane Katrina, I encourage you to keep this in mind.