



JOINT ECONOMIC COMMITTEE

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HURRICANE SPENDING AND THE FEDERAL BUDGET

Last year, three major hurricanes – Katrina, Rita, and Wilma – struck the U.S. Gulf Coast. In response to these disasters, Congress enacted two supplemental appropriations acts to provide a total of \$62.3 billion for rescue, relief, reconstruction, and recovery operations.¹ Federal policymakers are now changing their focus from short-term rescue and relief to long-term reconstruction and recovery. This report identifies some key considerations for evaluating such proposals.

Existing Federal Programs

When considering new programs or additional outlays, federal policymakers should be aware that hurricane relief is currently available from many existing federal programs. The federal government will indemnify the insured flood losses of National Flood Insurance Program (NFIP) policyholders. Other existing federal programs that provide benefits include:

- **Unemployment benefits.** Under the *Robert T. Stafford Disaster Relief and Emergency Assistance Act*,² workers who lost their jobs in a federally declared major disaster area, but are ineligible for regular unemployment compensation benefits are eligible for disaster unemployment assistance for 26 weeks.
- **Federal nutritional programs.** Victims may be eligible for nutritional benefits under the Food Stamp program, child nutrition programs, or the Special Supplemental Nutrition Program for Women, Infants, and Children (WIC).
- **Temporary Assistance for Needy Families (TANF).** P.L. 109-68 provides additional TANF funds for affected states.
- **Individual and household grants.** Under the *Stafford Act*, FEMA may provide temporary housing to disaster victims for up to 18 months.

¹ P.L. 109-61 and P.L. 109-62.

² P.L. 100-707.

- **Public assistance grants.** Under the *Stafford Act*, FEMA may make emergency grants to state and local government in a federally declared major disaster area to pay at least 75 percent of the cost of removing debris and hazardous waste, and repairing, restoring, or rebuilding damaged or destroyed state or local government structures.
- **Transportation grants.** The Federal Highway Administration may provide emergency grants to state and local governments to rebuild roads and highways damaged by a federally declared major disaster.
- **Small Business Administration (SBA) loans.** The SBA offers several different types of loans to the victims of a federally declared major disaster.

Economic Impact of Federal Spending

As total federal government spending rises, the economic costs from additional government outlays at some point will exceed their benefits. Consequently, excessive government spending will reduce the long-term rate of economic growth and could eventually cause economic stagnation. Thus, hurricane relief outlays should be offset by spending cuts elsewhere to the extent possible.

An empirical study by the Joint Economic Committee (JEC) found a statistically significant relationship between higher government spending as a percent of GDP and lower rates of real GDP growth in the United States and in other economies between 1960 and 1996. Among Organization for Economic Cooperation and Development (OECD) member-states, for example, a 1-percentage point increase in government outlays as a percent of GDP decreased the real GDP growth rate by 0.1 percentage point.³

³ James Gwartney, Robert Lawson, and Randall Holcombe, *The Size and Functions of Government and*

This reduction of the long-term economic growth rate is mainly due to three factors:

- Deadweight losses or excess burdens from taxation (economic losses from excessive tax rates)
- Disincentives from social welfare benefits for economically productive behavior
- Reductions in productivity growth

Another JEC study identifies the optimal level of government spending as a percent of GDP to maximize economic growth during the post-World War II years. For the United States, the optimal level of federal government spending was about 17.5 percent of GDP.

The Congressional Budget Office (CBO) estimates that federal outlays will be 20.3 percent of GDP in the current fiscal year. Because projected federal outlays exceed their growth optimizing level, additional federal outlays may dampen economic prospects. Thus, federal policymakers should consider offsetting any additional outlays for necessary relief, reconstruction, or recovery programs for hurricane relief with deferrals or reductions of the projected increases in other lower priority programs.

Moral Hazard

Moral hazard occurs when knowledge about a contract or law causes a person to change behavior to the detriment of other parties to the contract or society generally. The NFIP creates two moral hazard problems. After the NFIP, some people bought homes or located businesses in flood-prone riparian neighborhoods, knowing that the NFIP would indemnify a significant portion of their flood-related losses.

The NFIP also discourages some policyholders from undertaking measures to mitigate flood risks. For example, some NFIP policyholders that would have moved their homes or businesses to higher ground in the absence of the NFIP may instead choose not to move, knowing that the NFIP will indemnify a significant portion of their flood-related losses.

Economic Growth, prepared for the Joint Economic Committee, 105th Cong., 2nd sess., April 1998.

FEMA takes various steps to reduce moral hazard risk among the NFIP policyholders. For example, FEMA often demands that local building codes require a minimum elevation for the enclosed floors of new structures built in special flood hazard areas. Moreover, FEMA provides funds to states and localities to mitigate flood losses through three programs, usually on a 75 percent federal and 25 percent state or local cost-sharing basis.

Moral hazard also arises from other related government programs. Overly generous reconstruction grants to individuals and firms may discourage the purchase of flood insurance, defeating the congressional intent for establishing the NFIP, which is pre-funding flood-related losses through insurance.

Geology and Civil Engineering in Louisiana

Since 1930, Louisiana has lost about 1,900 square miles of coastal wetlands to open water. The loss of coastal wetlands aggravates the flood risk from storm surges.

South Louisiana has a dynamic geology, created by the deltaic process of the Mississippi River during the last 10,000 years. From 1727 to the present, riparian planters, entrepreneurs, localities, state governments, and federal agencies constructed levees for flood control; dredged rivers, built jetties, and dug canals for navigation; and drained coastal wetlands for agriculture and sites for homes, offices, and factories.

However, large-scale civil engineering projects on the Mississippi River, its tributaries, and its distributaries have disrupted the deltaic process. Silt (alluvium), which had previously been deposited on the delta, is now being trapped upstream or deposited into the deep Gulf. Without this alluvial recharge, South Louisiana subsides at a rate of about one-half inch per year. Thus, one of the unintended consequences of these large-scale civil engineering projects has been a gradual decline in the elevation of South Louisiana.

Breeches in the levees and floodwalls of the Lake Pontchartrain and Vicinity Hurricane Protection Project (LP&V) caused the New Orleans flood. The storm surge overtopped the levees and floodwalls along the Industrial Canal, suggesting that the storm surge simply exceeded the design of these structures. The levees and floodwalls along

the London Avenue and Seventeenth Street Canals were undermined, suggesting that flaws in the design, construction, or maintenance of these structures may have contributed to their failure.

The LP&V Project suffered from conceptual, financial, and managerial flaws including:

- **“Levees only.”** The LP&V Project relied on a single tier of levees and floods along the lakeshore and feeder canals rather than a comprehensive defense.
- **Competing priorities.** The LP&V Project competed with local navigation projects for United States Army Corps of Engineers (USACE) funding. One of these navigation projects, the Mississippi River Gulf Outlet, contributed to the New Orleans flood by funneling Katrina’s storm surge toward the Industrial Canal.
- **Localism.** Louisiana and its localities often chose to spend their funds on other priorities such as \$2.4 million for a Mardi Gras Fountain rather than paying their share for flood control projects.

Federal policymakers have begun to recognize the importance of environmental restoration to flood control.⁴ In 1990, Congress enacted the *Breaux Act*,⁵ creating a joint federal-state task force to identify and prioritize restoration projects.

In November 2004, the USACE completed a feasibility study, *Louisiana Coastal Area Ecosystem Restoration Study*, which recommended spending \$1.1 billion on five near-term restoration projects and other programs. Authorization for this program is in the *Water Resources Development Act of 2005* that has passed the House and is currently on the Senate calendar.

Federal policymakers should examine the adequacy of existing levees and floodwalls along the lakeshore and its feeder canals. In August 2002, the USACE completed an initial study recommending that the USACE conduct a

⁴ Key environmental restoration projects will mimic the deltaic process by pumping alluvial water from the Mississippi River over the levees onto nearby wetlands.

⁵ P.L. 101-646, Title II. The *Breaux Act* is formerly known as *The Coast Wetlands Planning, Protection, and Restoration Act*.

feasibility study about protecting New Orleans from the storm surge of a category 5 hurricane. The USACE estimates that a feasibility study would take five years and that construction would take another 20 years.

Conclusion

As the focus shifts from short-term rescue and relief operations to long-term reconstruction and recovery, federal policymakers should carefully weigh three issues before making additional authorizations or appropriations:

- Higher federal outlays may reduce long-term economic growth. One JEC study found the level of federal outlays that maximizes long-term real GDP growth is about 17.5 percent of GDP. Another JEC study found that a 1-percentage point of GDP increase in government outlays reduces the long-term real GDP growth rate by 0.1-percentage point. Since federal outlays will exceed the growth-optimizing level during the current fiscal year, additional federal outlays may dampen economic prospects. Thus, federal policymakers should consider offsetting any additional outlays for necessary relief, reconstruction, or recovery programs with deferrals or reductions of the projected increases in other lower priority programs.
- Indemnifying uninsured property losses discourages individuals and firms from buying property and business interruption insurance policies from private insurers and NFIP policies from FEMA or undertaking measures to mitigate flood risk in existing structures in flood-prone riparian neighborhoods. Simultaneously, indemnifying uninsured property losses encourages individuals and firms to rely on federal assistance after natural disasters, defeating the congressional intent for establishing the NFIP.
- Because South Louisiana is subsiding, it becomes more vulnerable to flooding each year. Any successful reconstruction plan must address subsidence through both large-scale civil engineering projects and environmental restoration.