

ECONOMIC BRIEF NO. 33

Insurance: Sharing Life's Risks

This series of economic briefs explores fundamental concepts in economics and community and economic development.

It's a risky world out there. Market systems thrive on risks, because profits are the rewards for taking chances on new products, new ideas, new markets. But markets work even better if certain kinds of risks can be shared or transferred, because otherwise those risks might

hazards. But some hazards like flooding don't lend themselves to private insurance.

The average flood insurance premium for a large pool of customers would be too high for those on the mountain top and too low for those in the path of water. When it comes to floods, most people have a very low risk or a very high risk with hardly anyone in the middle. The message from the market is "don't build on the flood plain," but if the community or the nation doesn't agree

and pension plans are available, fewer firms are offering pensions, many workers do not take advantage of what is available, and more of what is offered is subject to the rewards and risks of the stock market.

Social Security plays a useful niche role in this market by offering a floor guarantee and a mandatory plan for those too poor, too short-sighted, too long-lived, or too unlucky in their investments to provide adequately for their old age. Social Security and Medicare are two rare instances where the government has become the direct provider.

The government can also use mandates, guarantees, and subsidies. The government requires auto insurance and bank deposit insurance. It subsidizes flood insurance and crop insurance. It offers guarantees of student loans and mortgage loans.

Insurance doesn't eliminate all financial risks. But whether offered by private firms or through government, it provides a valuable means of pooling risk, reducing an individual's risk, and encouraging people to undertake ventures they might otherwise find too risky.

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discourage people from undertaking desirable activities. An important way in which risk is shared or transferred is through insurance.

With a large number of houses, cars, lives, or other assets in an insurance pool, it is possible to estimate the statistical probability of loss fairly accurately and to charge a premium that is low relative to the value of the amount at risk. The system is a good deal for both parties.

The market has done a pretty good job of pooling common risks for many insurable

with that message, what happens when disaster comes?

The federal government steps in. Offering insurance against flood and natural disasters just ensures that the people who are in the path of disaster will make some contribution to the cost of that disaster relief when the inevitable happens. But, unlike a private company, the government can take the money from another pocket if premiums are set too low.

Outliving assets is another risk that has not been adequately resolved with private insurance. Although annuities

The oldest known instance of a primitive insurance scheme was among merchants travelling along the Yangtze River in China.

A group of six merchants would each divide their cargo among all six ships. If one ship sank, each lost only one-sixth of his merchandise instead of one merchant losing everything.