

Background Paper

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Abstract

This paper investigates the link between development, economic growth, and the economic losses from natural disasters in a normative analytical framework, with an illustration on hurricane flood risks in New Orleans. It concludes that, under broad conditions, it is optimal for (i) the probability of disaster occurrence to decrease with income; (ii) the capital at risk — and thus the economic losses in case of disaster — to increase faster than economic growth; (iii) the average annual losses to grow faster than income at low levels of development and slower than income at high levels of development. In that case, increasing risk-taking reinforces economic growth, and improving protections transfers risks from frequent low-intensity events to rare high-impact events. These findings are robust to a broad range of modeling choices and parameter values, and to the inclusion of risk aversion. Risk-taking is both a driver and a consequence of economic development, and should not be indiscriminately suppressed. The observation of a trend in disaster losses should not be confused with the presence of excessive risk taking. In a descriptive framework, suboptimal decision-making (the introduction of prospect theory's decision weights, biases in risk perception and myopic expectations) may amplify these trends and lead to excessive or insufficient risk taking. In all instances, the world is very likely to experience fewer but more costly disasters in the future.

Keyword: Development; Economic growth; Risk; Natural disaster; Economic losses.

JEL: O10; O44; Q01; Q54.

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1 Introduction

The damages caused by Hurricane Sandy in Haiti and in the US show that poor as well as rich countries are vulnerable to natural hazards. Large damages in New York City and New Jersey — with a preliminary estimate of direct damages in excess of \$50 billion — raise questions on the level of coastal protection in these areas and on the rapid coastal developments that have driven so many households and so much capital and infrastructure into risky areas. In spite of large financial and technical resources, the economic vulnerability to hurricanes remains high in the richest country of the world, and statistical analyses suggest it has been growing in the last hundred years (Pielke et al., 2008).

This is not an isolated situation. Increasing investments in disaster risk reduction have lead to a significant reduction in human casualties (Kahn, 2005; Kellenberg and Mobarak, 2008), but economic losses from natural disasters have been growing as fast or even faster than economic growth in many countries; see for instance statistical analyses in Barredo (2009), Miller et al. (2008), Neumayer and Barthel (2010), Nordhaus (2010), Pielke et al. (2008), and Bouwer et al. (2007). Climate change is not responsible for this evolution (Schmidt et al., 2009; Neumayer and Barthel, 2010; Bouwer, 2011; IPCC, 2011). The trend in hurricane losses relative to wealth in the US is for instance fully explained by migrations toward hurricane-prone areas and increasing population wealth (Pielke et al., 2008). Globally, there is a trend toward more risk taking: between 1970 and 2010, global population grew by 87%, but the population living in flood plains increased by 114% and in cyclone prone coastlines by 192%. The GDP exposed to tropical cyclones increased from 3.6% of total GDP to 4.3% over the same period (UN-ISDR, 2011).

This global trend in economic disaster exposure and losses is a major concern in many countries. Disaster losses represent an increasing burden on economies and public finances (e.g., Benson and Clay, 2004; Loayza et al., 2009; Fomby et al. 2011; Strobl 2011), and their trend threatens the functioning of insurance and reinsurance markets (e.g., Michel-Kerjan, 2010). Cross-country studies have suggested that economic disaster losses are increasing less rapidly than income, making them easier to manage (Toya and Skidmore, 2007; Mendelsohn et al., 2011). But the trend in economic losses in the US and many other countries suggests that the relationship between economic growth and disaster vulnerability is more complex than these studies suggest, and that the economic vulnerability to disasters may not always decrease with income (Schumacher and Strobl, 2011).

This paper investigates the interlinkages between economic disaster losses and development, first in a normative and optimal framework, and then accounting for suboptimal behaviors. It considers the fact that higher income makes it possible to invest in better protections against disasters, but may also lead to higher investment in at risk areas. It also considers the role of investments in at risk areas in contributing to economic growth,

for instance because development of coastal areas is critical for export-led growth or because agglomeration externality and urbanization (often in flood plains) are major drivers of development (Ciccone et al., 1996; Ciccone, 2002; World Bank 2008). Compared with previous investigations of trends in disaster economic losses (e.g., Lewis and Nickerson, 1989; Schumacher and Strobl, 2011), this analysis proposes an explicit modeling of risk taking (how much is invested in risky areas?) and of protection investment (how much is invested in protection?), to characterize the two-way link between economic growth and disaster losses. It does so in a more general framework than previous studies, and it confirms the robustness of its results by investigating the role of risk aversion and different forms of behavioral bias.

In a normative and optimal framework — and assuming no change in climate conditions and hazard characteristics — risk-taking generally increases with development. Natural disasters are likely to become more destructive in the future, even relative to income, and even in the presence of risk aversion. Reciprocally, increased risk-taking reinforces economic growth, suggesting that risk taking should not be indiscriminately suppressed. Risk-taking is both a driver and a consequence of economic development. In this optimal context, average annual losses from disasters grow with income, and they grow faster than income at low levels of development and slower than income at high levels of development. In a descriptive framework that includes biases in risk perception and decision-making, these trends can be amplified, and risk taking can be excessive or insufficient, providing a rationale for public action.

The next section describes the most generic model and the conditions under which disaster losses increase with economic growth. Section 3 presents more detailed results for different specifications of protection costs, and Section 4 investigates special cases of production functions. Section 5 applies this model to New Orleans, demonstrating that reasonable parameter values lead to a situation where economic growth incentivizes risk taking and increases disaster losses. Section 6 shows that these results remain valid with imperfect decision-making. Section 7 concludes.

2 Development and natural risks

It is generally accepted that richer populations invest more to protect themselves from natural hazards. A richer population, however, may also invest more in at-risk areas, increasing exposure to natural hazards. These two trends have opposite impacts on risk, and the resulting trend in risk is thus ambiguous. This trend is investigated in this section using a simple model.

2.1 A general economic growth framework

We assume there are two categories of capital. Capital R represents the capital related to activities that need to be (or benefit from being) located in areas that are potentially at risk of flooding. There are two categories of such capital. First, some activities directly depend on being in risky areas, such as ports that are located in coastal areas or river flood plains. Second, positive concentration externalities make it profitable to invest in at-risk areas, even in sectors that do not depend directly on being at risk — such as finance in New York City or manufacturing in Shenzhen — to benefit from spill-overs from the industry that need to be located in flood-prone areas (such as ports): (i) lower long-distance transport cost; (ii) infrastructure for local transportation, water, energy, and communication; (iii) large labor market with access to skilled workers; and (iv) access to public services and amenities (art and culture, schools, university, etc.).

Capital S represents the rest of economy, which can be located in safe locations without loss of productivity. These two capitals are inputs in the production function:

$$Y = e^{\gamma t} F(R, S) \quad (1)$$

where t is time, F is a production function and γ is the exogenous growth in total factor productivity. Classically, we assume that $\partial_R F(R, S) > 0$; $\partial_S F(R, S) > 0$; $\partial_R^2 F(R, S) < 0$ and $\partial_S^2 F(R, S) < 0$ (decreasing returns).

The capital R can be affected by *hazards*, like floods and windstorms. If a hazard is strong enough, it causes damages to the capital installed in at-risk areas, and can be labeled as a *disaster*. We assume that in that case, a fraction X of capital R is destroyed. It is assumed that this is the only consequence of disasters.²

These disasters (i.e. hazards that lead to capital destruction) have a probability p_0 of occurring every year, unless protection investments reduce this probability. These protection investments take many forms, depending on which hazard is considered. Flood protections include dikes and seawalls, but also drainage systems for coping with heavy precipitations in urban areas. Windstorm protections consist mainly in building retrofits and stricter building norms, to ensure that old and new buildings can resist stronger winds.

It is assumed that better defenses reduce the probability of disasters, but do not reduce their consequences.³ This is consistent with many types of defenses. For instance, seawalls can protect an area up to a design standard of protection, but often fail totally if this

²Disaster fatalities and casualties are not considered in this simple model, assuming that early warning, evacuation and emergency services can avoid them, which is consistent with the observation that disaster deaths decrease with income, at least above a certain income level (Kahn, 2005; Kellenberg and Mobarak, 2008). Human losses could be taken into account if it is assumed that fatalities and casualties can be measured by an equivalent economic loss, which is highly controversial; see a discussion in Viscusi and Aldy (2003).

³This is equivalent to the self-protection of Ehrlich and Becker (1972).

standard is exceeded; building norms allow houses to resist up to a certain wind speed, but when this wind speed is exceeded, houses are completely damaged and require total rebuilding. This modeling choice is made without loss of generality, if there is no risk aversion.⁴ In that case, indeed, reducing the probability of a disaster or the consequences in case of disaster is equivalent.

Better defenses are also more expensive, and the annual cost of defenses C increases when the remaining disaster probability p decrease.⁵ The function $C(p, R)$ is assumed twice differentiable, $C(p_0, R) = 0$ (the probability of occurrence is p_0 in the absence of protections), $\partial_R C(p, R) \geq 0$ (it is equally or more expensive to protect more capital), $\partial_p C(p, R) \leq 0$ (the cost increases when the probability decreases), $\partial_p^2 C(p, R) \geq 0$ and $C(0, R) = +\infty$ (the marginal cost is increasing and it is impossible to reduce the probability to zero) and $\partial_{pR}^2 C(p, R) \leq 0$ (the cost of protecting more capital increases when the probability decreases).

Any given year, the economic surplus π is given by:

$$\pi = e^{\gamma t} F(R, S) - C(p, R) - L - r(R + S) \quad (2)$$

where r is the interest rate, L is the loss from disasters, and is given by a random draw with probability p . If a disaster occurs, losses are equal to XR , i.e. a fraction X of the capital located in the risky area is destroyed. In any given year, the expected loss $\mathbb{E}[L]$ is equal to pXR and the expected output is equal to:

$$\mathbb{E}[\pi] = e^{\gamma t} F(R, S) - C(p, R) - (r + pX)R - rS \quad (3)$$

Note that in this equation, disaster losses appear as an additional cost of capital at risk, in addition to the interest rate r .

We also define the *risk-free situation* as a situation in which there is no risk, either because $p_0 = 0$ (no hazard), because $X = 0$ (no vulnerability), or because $C(p, R) = 0$ (costless protections). In the risk-free situation, there are still two capitals R and S , but none of them is at risk.

2.2 Optimal choice of p , R , and S

We assume that a social planner — or an equivalent decentralized decision-making process — decides which amounts of capital R and S are to be located in the risky and safe areas, and the level of protection (p and $C(p, R)$) that is to be built. Her optimization

⁴The role of risk aversion is investigated in Appendix A.

⁵The probability p here includes both the probability that an event exceeds protection capacities, and the defense failure probability, even for weaker events.

program is:⁶

$$\begin{aligned} \max_{p,R,S} \quad & \mathbb{E}[\pi] \\ \text{s.t.} \quad & 0 \leq p \leq p_0 \end{aligned} \quad (4)$$

We assume first that there is no risk aversion and we assume that the expected surplus is maximized. From the social planner's perspective, doing so is acceptable if disaster losses remain small compared to aggregated income, consistently with the Arrow-Lind theorem for public investment decisions (Arrow and Lind, 1970). As discussed in Mahul and Ghesquiere (2007), this theorem holds only if some conditions are met, including if disaster losses can be pooled among a large enough population (e.g., a large country), and with many other uncorrelated risks, i.e. in the presence of comprehensive insurance coverage or post-disaster government support, or if disaster losses can be smoothed over time thanks to savings and borrowing (i.e. self-insurance) or reinsurance. In other terms, the optimal pathways determined by this analysis are valid assuming that the social planner ensures that individual losses remain small thanks to temporal smoothing and redistribution or insurance across individuals. Appendix A investigates the case with risk aversion.

Assuming⁷ $p < p_0$, first order conditions lead to the optimal values of p , R , and S :

$$e^{\gamma t} \partial_R F(R, S) - \partial_R C - (pX + r) = 0 \quad (5)$$

$$e^{\gamma t} \partial_S F(R, S) - r = 0 \quad (6)$$

$$\partial_p C = -XR \quad (7)$$

While the marginal productivity of capital S is r , the marginal productivity of capital R is $r + pX + \partial_R C$, i.e. the cost of capital r plus the capital losses due to disasters pX plus the incremental cost of protection $\partial_R C$. The term $r + pX + \partial_R C$ is what we define as the *risk-adjusted cost of capital*, and it is larger than the risk-free cost of capital, to account for natural risks.⁸

Since $pX > 0$, $\partial_R C > 0$, and $\partial_R F$ is decreasing, the first equation shows that the presence of risk ($X > 0$ and $C > 0$) leads to a reduction in R .

⁶This model is more general than the model of Schumacher and Strobl (2011). In the latter, the only decision concerns protection investments that mitigate disaster consequences, and there is no benefit from taking risks and thus no trade-off between safety and income. This model also differs from Hallegatte (2011) in that it is more general on the shape of production and protection cost functions, and it introduces the interest rate to account for the consumption–investment trade-off.

⁷If $p = p_0$, then there is no protection in place — because protections are too expensive — and the situation is highly simplified: disaster risk reduces by a fixed fraction the productivity of the capital at risk. Classically, this reduces the amount of such capital without influencing its growth rate on the balanced growth pathway.

⁸Equivalently, one can define the risk-adjusted marginal productivity of capital as the marginal productivity of capital reduced by the cost of protection and disaster capital losses: $e^{\gamma t} \partial_R F(R, S) - \partial_R C - pX$.

Proposition 1 *The presence of risk and the possibility to protect against it lead to a reduction in the capital that is located in the risky area, compared with the risk-free situation.*

Taking the derivative of Eqs. (5–7) with respect to time t , one gets:

$$\gamma e^{\gamma t} \partial_R F + [e^{\gamma t} \partial_R^2 F - \partial_R^2 C] \partial_t R + e^{\gamma t} \partial_{RS}^2 F \partial_t S = (X + \partial_{pR}^2 C) \partial_t p \quad (8)$$

$$\gamma e^{\gamma t} \partial_S F + e^{\gamma t} \partial_S^2 F \partial_t S + e^{\gamma t} \partial_{RS}^2 F \partial_t R = 0 \quad (9)$$

$$\partial_t p \partial_p^2 C = -(X + \partial_{pR}^2 C) \partial_t R \quad (10)$$

Equation (10) shows that if $(X + \partial_{pR}^2 C) < 0$, then an increase in at-risk capital (everything else being unchanged) leads to a decrease in protection (i.e. an increase in the probability of occurrence), because the cost of protection then increases more rapidly with R and p than the avoided disaster losses. If $X + \partial_{pR}^2 C = 0$, then the probability of occurrence is independent of R , and thus constant over time even in the presence of economic growth.

If we have

$$(X + \partial_{pR}^2 C) > 0, \quad (11)$$

then having more capital at risk leads to an increase in protection, and the probability of occurrence p and the amount of capital at risk R evolve in opposite directions. In the following, we assume that this condition is met.

Replacing $\partial_t p$ in Eq. (8) and replacing $e^{\gamma t} \partial_R F$ by $(r + pX + \partial_R C)$ yields:

$$\partial_t R = \frac{\gamma(r(1 - \frac{\partial_{RS}^2 F}{\partial_S^2 F}) + pX + \partial_R C)}{-e^{\gamma t}(\partial_R^2 F - \frac{(\partial_{RS}^2 F)^2}{\partial_S^2 F}) + \partial_R^2 C - \frac{(X + \partial_{pR}^2 C)^2}{\partial_p^2 C}} \quad (12)$$

Since $\frac{\partial_{RS}^2 F}{\partial_S^2 F} < 1$, the capital at risk increases over time when:

$$-e^{\gamma t}(\partial_R^2 F - \frac{(\partial_{RS}^2 F)^2}{\partial_S^2 F}) > -\partial_R^2 C + \frac{(X + \partial_{pR}^2 C)^2}{\partial_p^2 C} \quad (13)$$

To interpret this inequality, we can disregard for now the interactions between R and S (i.e. assuming that $\partial_{RS}^2 F = 0$) and assume that protection costs are independent of R (i.e. $\partial_R^2 C = 0$ and $\partial_{pR}^2 C = 0$). In this case, the capital at risk increases over time when:

$$-e^{\gamma t} \partial_R^2 F > \frac{X^2}{\partial_p^2 C} \quad (14)$$

This inequality is verified if the marginal productivity of the capital at risk decreases more rapidly with R than the marginal cost of protection increases with p . In this same situation, the probability of disaster decreases with economic growth.

Proposition 2 *If $X + \partial_{pR}^2 C > 0$ and if the production function is sufficiently concave — or if the protection costs are sufficiently convex — then economic growth leads to an increase in capital at risk (i.e. an increase in losses when a disaster occurs), and a decrease in the probability of occurrence. If the production function is less concave, then economic growth leads to a decrease in capital at risk and an increase in disaster probability.*

It is interesting to note that — counter-intuitively — the capital at risk increases over time when the production function concavity is high (i.e. returns of capital at risk are rapidly decreasing), and decreases otherwise.

Note that if development leads to a reduction in capital at risk R and an increase in p , then at one point the economy reaches a situation where there is no protection and $p = p_0$. In such a situation, capital at risk R grows at the same rate as in the risk-free situation.

The capital R in the risk-free situation is referred to as R^s , and its evolution is:

$$\partial_t R^s = \frac{\gamma(r(1 - \frac{\partial_{RS}^2 F}{\partial_S^2 F}))}{-e^{\gamma t}(\partial_R^2 F - \frac{(\partial_{RS}^2 F)^2}{\partial_S^2 F})} \quad (15)$$

Assuming that the capital R increases with economic growth, i.e. that condition (13) is verified, then the comparison of Eqs. (12) and (15) explains how the protection influences the evolution of capital:

- The term $pX + \partial_R C$ in the numerator is the impact of risk and protection marginal costs on marginal productivity; it increases the numerator and accelerates the absolute growth in R .
- The term $\partial_R^2 C$ in the denominator is the decreasing or increasing return on protection; if the returns on protection are constant (e.g. $C(p, R) = RC(p)$ or $C(p, R) = C(p)$), then this term does not exist; if the returns are decreasing (i.e. costs are convex and $\partial_R^2 C > 0$), then this term increases the denominator and slows down the growth in R ; if the returns are increasing, then the growth in R is accelerated.
- The term $-\frac{(X + \partial_{pR}^2 C)^2}{\partial_p^2 C}$ in the denominator is the impact of the change in protection that is provided if more capital is installed in at risk areas (if the probability of occurrence is fixed, this term does not appear). Since $\partial_p^2 C > 0$, this term is negative and reduces the denominator and thus accelerates the growth in R .

2.3 Trend in average annual losses

Average economic losses due to disasters are equal to $\mathbb{E}[L] = pXR$.

$$\partial_t \mathbb{E}[L] = XR\partial_t p + pX\partial_t R \quad (16)$$

It can be rewritten:

$$\partial_t \mathbb{E}[L] = \partial_t p \left[\partial_p C - \frac{p \partial_p^2 C}{1 + \frac{\partial_{pR}^2 C}{X}} \right] \quad (17)$$

Since $\partial_p C < 0$ and $\partial_p^2 C > 0$, and under condition (11), then $\mathbb{E}[L]$ and p evolve in opposite directions.

Proposition 3 *If $X + \partial_{pR}^2 C > 0$, then average annual disaster losses increase when the probability of occurrence decreases over time.*

This result highlights the need to consider the combination of exposure (R) and probability (p) to investigate risks. In particular, a reduction in the probability of occurrence does not mean that average losses decrease; on the opposite, this general analysis suggests that under mild conditions a decrease in the probability of occurrence leads to an increase in average losses, because of the increase in capital at risk.

Importantly, this analysis illustrates that protection reduces the hazard (the probability of occurrence of an event), but its impact on risk is more complex, because it also increases exposure (here, the capital at risk R). As a result, protection transfers part of the risk from one kind of risk (frequent and low-cost events) to another kind (exceptional and high-impact events), a process already stressed in Etkin (1999).

3 Special cases for protection costs

We already made assumptions on the shape of $C(p, R)$, but it is useful to explore two extreme cases for the dependence of $C(p, R)$ to R .

In a first case, we can consider a coast or a river, where additional capital investments are conducted at a fixed density and are thus using additional land, which in turn requires additional protection. In such a case, the protected area increases proportionally with the invested capital in the risky zone, and $C(p, R) = R\tilde{C}(p)$. For instance, this is the case in some parts of France, where population density is low and flood exposure increases mainly through the construction of individual houses, at low density. This situation can be labeled “horizontal” or “area-increasing” capital accumulation.

In a second case, we consider a given risky area, which is protected against coastal floods and where investment takes place. In such a case, the risky and protected area does not increase with investments, and the cost of protection is independent of the amount of protected capital: $C(p, R) = \tilde{C}(p)$. This is notably the case where additional investments take place through higher concentration and density, on a given area. Examples of such places are the Netherlands, New Orleans, or Manhattan in New York City. This situation can be labeled “vertical” or “density-increasing” capital accumulation.

Let us explore the consequence of these two assumptions on flood risks.

3.1 Horizontal accumulation

We assume first that the protection cost function has the form $C(p, R) = R\tilde{C}(p)$. The marginal cost and benefit of protection are equal (Eq. (7)), which means $R\partial_p\tilde{C}(p) = -XR$. Therefore, p is independent of R and constant over time.

Deriving the previous equation with respect to R gives $X + \partial_{pR}^2 C = 0$, and we can rewrite Eq. (5) as:

$$e^{\gamma t} \partial_R F(R, S) = \overbrace{\tilde{C}(p) + pX + r}^{r'} \quad (18)$$

Since $\tilde{C}(p)$ is constant and positive, the risk-adjusted marginal productivity r' is also a constant, larger than r . In this case, R evolves like risk-free capital, but with a larger interest rate (r' instead of r). Since marginal productivity needs to be larger, the amount of capital is lower in the presence of decreasing returns ($R < R^s$), i.e. risk leads to a reduction in capital R . With classical production functions (CES or Cobb-Douglas) and neutral technological change, the capital at risk R increases at the same rate as economic growth. Since p is constant, $\partial_t \mathbb{E}[L] = pX \partial_t R$, and average annual losses grow at the same rate as capital at risk and as risk-free economic growth.

Proposition 4 *In horizontal-accumulation locations — i.e. where flood exposure increases because the developed area at risk is expanded and where protection costs increase therefore proportionally with protected capital — rational decision-making leads to annual flood losses growing at the same rate as economic growth, with a constant flood probability, regardless of how protection costs vary with the residual probability of occurrence.*

3.2 Vertical accumulation

We then assume that $C(p, R) = \xi p^{-\nu} + C_0$. Assuming $p < p_0$, we can use Eq. (7) to find:

$$p = \left(\frac{RX}{\nu \xi} \right)^{-\frac{1}{1+\nu}} \quad (19)$$

We have $\partial_{pR}^2 C = 0$, and thus $X + \partial_{pR}^2 C > 0$ if there is risk, so that condition (11) is always verified. As a consequence, we know that p and R evolve in opposite directions: if capital increases (resp. decreases), the protection is strengthened (resp. weakened) and disaster probability decreases (resp. increases). We are in the situation where p decreases and R increases when condition (13) is verified, and it can be rewritten:

$$-e^{\gamma t}(\partial_R^2 F - \frac{(\partial_{RS}^2 F)^2}{\partial_S^2 F}) > \frac{X^2 p^{\nu+2}}{\nu(\nu+1)\xi} \quad (20)$$

Also, we know from the general analysis that $\partial_t \mathbb{E}[L]$ is positive and average disaster losses are increasing over time.

Proposition 5 *In locations where flood exposure rises as a result of increased density in a given protected area (e.g., New Orleans), rational decision-making results in a continuous increase in annual flood losses, when flood probability decreases over time.*

To know whether capital at risk and flood losses grow more or less rapidly than economic growth, assumptions are needed on the shape of the production function. This is what is investigated in the next section.

4 Special cases of production function

In this section, we keep the “vertical-accumulation” assumption, i.e. $C(p, R) = \xi p^{-\nu} + C_0$. All qualitative results are however valid if $C(p, R) = \xi R^c p^{-\nu} + C_0$, where $0 \leq c < 1$. We will assume that capital at risk R and safe capital S are separable inputs in the production function (the Cobb-Douglas case is explored in Appendix B).

If $F(R, S) = f(R) + g(S)$, then $\partial_{RS}^2 F = 0$, and all equations can be simplified.

The evolution of the capital at risk is:

$$\partial_t R = \frac{\gamma(r + pX + \partial_R C)}{-e^{\gamma t} \partial_R^2 f(R) + \partial_R^2 C - \frac{(X + \partial_{pR}^2 C)^2}{\partial_p^2 C}} \quad (21)$$

In the absence of risk and protection, the evolution would be:

$$\partial_t R^s = \frac{\gamma r}{-e^{\gamma t} \partial_R^2 f(R^s)} \quad (22)$$

We can also calculate $\partial_t S$ as:

$$\partial_t S = \frac{\gamma r}{-e^{\gamma t} \partial_S^2 g(S)} \quad (23)$$

If we now assume that $f(R) = \lambda R^\mu$ and $g(S) = \alpha \lambda S^\mu$, we can solve Eq. (6):

$$S = (\alpha \lambda \mu)^{\frac{1}{1-\mu}} e^{\frac{\gamma t}{1-\mu}} r^{\frac{-1}{1-\mu}} \quad (24)$$

and we obtain:

$$\frac{\partial_t S}{S} = \frac{\partial_t R^s}{R^s} = \frac{\gamma}{1-\mu} \quad (25)$$

With this shape of production function, a productivity growth at rate γ leads to a risk-free economic growth at rate $\frac{\gamma}{1-\mu}$ (i.e. R^s and S grow at rate $\frac{\gamma}{1-\mu}$).

With $p = \left(\frac{RX}{\nu\xi}\right)^{-\frac{1}{1+\nu}}$, we can rewrite Eq. (5):

$$e^{\gamma t} \lambda \mu R^{\mu-1} = r + pX = r + X \left(\frac{X}{\nu\xi}\right)^{-\frac{1}{1+\nu}} R^{-\frac{1}{1+\nu}} \quad (26)$$

This equation cannot be solved analytically, but two extreme cases — at low and high levels of development — can be analyzed.

4.1 Low development level

At a low development level, total factor productivity is low, the amount of capital is small (i.e., R is small) and the probability of occurrence of a disaster is large (p is large).⁹ In such an extreme situation, the capital interest rate r is small in the at-risk area compared with the flood-related capital losses pX , and Eq.(26) can be simplified by removing r , leading to the solution:

$$R(t) = R_0 e^{\frac{\gamma}{1+\nu-\mu} t} \quad (27)$$

If $\mu > \frac{\nu}{1+\nu}$, R decreases and p increases over time, until it reaches p_0 , i.e. the absence of protection. Then, capital at risk grows at the same rate as risk-free economic growth.

In the situation in which protection improves over time, $\mu < \frac{\nu}{1+\nu}$, the growth rate of capital at risk is $\frac{\gamma}{1+\nu-\mu}$, which is always larger than $\frac{\gamma}{1-\mu}$. In this case, therefore, the capital at risk grows more rapidly than the safe capital and risk-free income. The relative vulnerability of the economy can be measured by the amount of disaster losses when a disaster occurs divided by income or by the “fraction at risk”, i.e. the share of capital at risk R in total capital $R + S$. This vulnerability is increasing over time, as shown in Fig.1. Interestingly, the growth in capital at risk is more rapid when ν is smaller, i.e. when the convexity of protection costs is lower and protection costs increase slowly with the protection level.

Average losses pXR have a growth rate equal to:

$$\gamma_L = \frac{\gamma}{1 - \mu \frac{1+\nu}{\nu}} \quad (28)$$

⁹We assume here that p_0 is large, i.e. that the area-at-risk has a large flood probability in absence of protection, and that $p < p_0$. If productivity is so low that $p = p_0$, then pX can be replaced by p_0X , which is independent of R . Then, Eq. (26) can be simplified by replacing its right-hand-side by $r + p_0X = r'$. In this situation, the capital at risk is lower than in absence of risk ($R < R^s$), but it grows at the same rate. When development increases productivity, there is a time when protection is such that $p < p_0$, and the following calculation holds if p_0 is large enough.

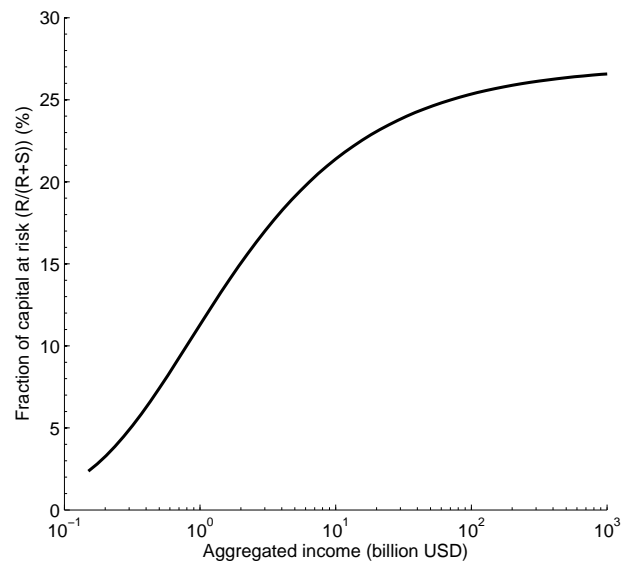


Figure 1: Evolution of the “fraction at risk”, i.e. the share of capital at risk R in total capital $R + S$, as a function of time. The fraction at risk increases with development, until it stabilizes at a high development level. Calculations use numerical values from New Orleans (see Section 5) and $\alpha = 2$.

In the situation in which protection improves over time, $\mu < \frac{\nu}{1+\nu}$, average losses increase over time, and they increase more rapidly than $\frac{\gamma}{1-\mu}$ and thus more rapidly than risk-free economic growth, i.e. the growth rate of R^s and S (in other terms, the income elasticity of average annual losses is larger than one).

In this case, annual disaster losses grow more rapidly than risk-free economic growth at low levels of development, when disaster losses dominate the interest rate in the assessment of the cost of capital, and when the returns on capital at risk are decreasing rapidly, more rapidly than a limit value defined by the shape of the production costs.

In that case, the economic surplus (generated by the at-risk capital) is

$$\mathbb{E}[\pi] = e^{\gamma t} F(R, S) - C(p, R) - (r + pX)R$$

and is growing at the same rate as losses, i.e. $\frac{\gamma}{1-\mu\frac{1+\nu}{\nu}}$. It means that the process of increasing risk-taking leads to a growth in economic surplus that is more rapid than risk-free economic growth. So, increasing risk-taking is also a driver of economic growth (even though the presence of risk leads to a lower output, see proposition 1).

Note that this case is equivalent to the case explored in Hallegatte (2011) where the total amount of capital ($R + S$) is fixed at an exogenous level K , and is independent of the risk level (which is equivalent to $r = 0$ provided that $R \leq K$). It is a situation in which there is no consumption–investment trade-off, and in which the capital at risk can keep increasing more rapidly than growth, until all the capital is located in the risky area. What follows shows that accounting for the consumption–investment trade-off changes significantly the results at a high level of development.

4.2 High development level

At a high development level, capital productivity is large, and the amount of capital at risk R is large.¹⁰ As a consequence, the probability of occurrence (p) is small. In such an extreme situation, the capital interest rate r is large compared with flood-related capital losses pX , and Eq.(26) can be simplified by removing pX , leading to the risk-free solution:

$$R(t) = R_0 e^{\frac{\gamma}{1-\mu} t} \quad (29)$$

At a high level of development, when disaster probability is very low, the capital at risk grows at the same rate as economic growth. This is why the fraction at risk stabilizes

¹⁰Using a *reductio ad absurdum* argument, it is easy to show from Eq. (26) that R tends toward infinity when productivity grows. Assume that R is bounded when $t \rightarrow +\infty$. In this case, the left-hand-side of Eq. (26) tends toward infinity when t increases, so the right-hand-side has to do the same. In that case, r becomes negligible over time, and the solution of Eq. (26) tends toward Eq. (27), which is not bounded when $t \rightarrow +\infty$. This is in contradiction with our initial hypothesis.

at high income levels, as shown in Fig.1. In this case, average losses pXR have a growth rate equal to:

$$\gamma_L \xrightarrow{t \rightarrow +\infty} \frac{\gamma}{1-\mu} \frac{\nu}{(1+\nu)} \quad (30)$$

Average annual losses are thus growing less rapidly than economic growth, but they never decrease in absolute terms. Furthermore, the growth rate in annual disaster losses is equal to economic growth multiplied by a “*protection factor*” ($\nu/(1+\nu)$), which depends only on the shape of the protection costs and is lower than one.

The protection factor is also the income elasticity of average disaster losses (in a given region, for a given hazard). It should not be confused with the income elasticity of disaster damages (when a disaster occurs), which is larger than one.

In that case, the different terms of the economic surplus from at-risk capital ($\mathbb{E}[\pi] = e^{\gamma t} F(R, S) - C(p, R) - (r + pX)R$) are growing at different rates. The production $e^{\gamma t} F(R, S)$ and capital cost rR are growing at a rate $\frac{\gamma}{1-\mu}$. The protection costs and average losses pXR are growing at a rate $\frac{\gamma}{1-\mu} \frac{\nu}{1+\nu}$, i.e. more slowly than production. When productivity tends to infinity, the economic surplus is growing at the rate $\frac{\gamma}{1-\mu}$, i.e. at the rate of risk-free economic growth.

4.2.1 Development and disaster trends

Appendix B shows that these results remain unchanged if R and S are two production factors in a Cobb-Douglas function. This analysis leads to three conclusions, concerning the trends in capital at risk, average annual losses, and economic surplus.

Proposition 6 *If (i) capital at risk and safe capital can be separated in the production function or are two factors in a Cobb-Douglas function, (ii) protection costs are convex with respect to the amount of capital to protect, and (iii) capital returns are decreasing more rapidly than a threshold that depends on the convexity of protection costs with respect to the disaster probability of occurrence (i.e. if $\mu < \nu/(1+\nu)$), then economic losses in case of disaster (R) grow more rapidly than risk-free economic growth. Their rate of growth converges toward the rate of risk-free economic growth as development proceeds. The relative vulnerability of the economy (the “fraction at risk”) is increasing over time.*

Proposition 7 *The average annual disaster losses follow a bell-shaped curve relative to income: disaster losses are growing more rapidly than risk-free economic growth at low stages of development and then keep growing in absolute terms, but more slowly than risk-free economic growth at higher productivity levels. At a high productivity level, the growth rate of annual losses is the risk-free economic growth rate reduced by a “protection factor” that depends only on the convexity of protection costs.*

Proposition 8 *The presence of risk reduces the economic surplus. However, because of increasing risk-taking, the growth rate of economic surplus is larger than the rate of risk-free economic growth at a low development level, and it tends to the rate of risk-free economic growth at a high development level.*

Capital does not need to be “more productive” in at-risk areas for the capital at risk to increase more rapidly than risk-free economic growth and the capital located in safe areas. This situation is observed if the production function exhibits decreasing returns and depends on two imperfectly-substitutable categories of capital (R and S), where R is related to activities located in risk-prone areas. In this case, there is an incentive to invest in at-risk areas to benefit from high marginal returns at low capital levels. Results are then independent of the relative productivity α of the two capitals. The productivity ratio (α) determines the ratio between the two capitals (S/R) at a high level of development.

5 Numerical application to New Orleans

We apply these formulations to the case of New Orleans, using the following illustrative assumptions:

- The capitals are separable. The capital R is located in the flood-prone area of New Orleans, and S is the capital located in safe areas in the rest of the region or the country. The interest rate is $r = 5\%$.
- The area is fixed, and the protection costs depend only on the probability of occurrence p , not on the amount of capital to protect: $C(p, R) = \xi p^{-\nu} + C_0$. In that case, condition (11) is always verified, and p and R evolve in opposite directions.
- In absence of protection, the city would be flooded every year ($p_0 = 1$).
- The cost of protecting New Orleans against category-3 storms is about \$3 billion in investments, and we assume a 10% annual maintenance cost; the probability of such a storm is one in 50 years. The annualized protection cost is $C(1/50) = \$450$ million per year, taking into account the cost of capital and maintenance costs.
- Protecting New Orleans against category-5 hurricane floods would cost about \$30 billion, with a 10% annual maintenance cost. The probability of such a storm is one in 200 years, so that $C(1/200) = \$4.5$ billion per year.¹¹

¹¹State officials estimated the cost of Category 5 protection between \$2.5 and \$32 billion (Carter, 2005; Revkin and Drew, 2005; Schwartz, 2005). More recent and detailed estimates by Louisiana Coastal Protection and Restoration (LACPR, led by the U.S. Army Corps of Engineers) reach even larger values.

These assumptions could be subject to discussion, but they provide an order of magnitude for the cost of protecting the city. Using these assumptions, we have:

$$C(p) = \xi (p^{-\nu} - p_0^{-\nu}) , \quad (31)$$

with $p_0 = 1$, $\nu = 1.66$, and $\xi = 6.8 \cdot 10^{-4}$.

For New Orleans, we assume that 50% of capital at-risk is lost in the case of flooding.¹²

The production function is $Y = e^{\gamma t} F(K) = \lambda e^{\gamma t} R^\mu$, with $\mu = 0.3$ and $\gamma = 0.015$ (total factor productivity grows by 1.5% per year). The risk-free growth rate, i.e. the growth in the capital S located in safe areas in the rest of the country, is $\frac{\gamma}{1-\mu} \approx 2.1\%$ per year.

The variable Y is the local GDP in the flood-prone areas of New Orleans. With an exposed population of 500,000 people, and a GDP per capita of \$24,000 (in 2009), the exposed GDP in the city is \$12 billion. To estimate λ , we numerically solve Eq. (26) to find R as a function of λ , and we chose λ so that the income in absence of disaster is $Y = \lambda R^\mu = \$12$ billion (in economic data, protection expenditures are included in income). The value is $\lambda = 3.53$.

We find that the optimal capital at risk in New Orleans is $R = \$59$ billion, i.e. about 5 times the local income. Losses in case of flood would be about \$30 billion, which is consistent with data for the flood due to Katrina (removing losses due to wind) (RMS, 2005). The optimal protection level reduces the probability of occurrence of a flood to 2.2% per year, i.e. a return period of 45 years. This probability is close to the likelihood of a category-3 hurricane, i.e. the current protection level in the city. Model results are thus largely consistent with the current situation in New Orleans.¹³

Then, we numerically solve Eq. (26) for a series of t , to investigate the dependence of risk to income. We can calculate the trend in $R(t)$ and in average annual loss. We find that R is growing at a rate of 2.4%, as opposed to 2.1% for the risk-free growth. Average annual losses due to floods are growing at a 1.5% rate, i.e. slower than risk-free economic growth. Thanks to increased risk taking, the economic surplus π is growing at a rate 2.2%, i.e. more rapidly than risk-free economic growth.

In New Orleans, a rational decision-maker would thus make average disaster losses increase less rapidly than economic growth (1.5 vs. 2.1%), but would increase capital at risk more rapidly than risk-free growth (2.4 vs 2.1%). The consequence is that the

¹²This large fraction is due to the fact that large parts of the city are below normal sea level, causing them to stay flooded for weeks after Katrina hit the city. The long duration of the floods amplifies damages to houses and buildings. Furthermore, floods in New Orleans occur through dike failures, leading to high water velocity and large damages (RMS, 2005).

¹³It is useful to repeat here that the analysis assumes that early warning and evacuation prevents human losses in case of floods; the only impact consists in economic and asset losses.

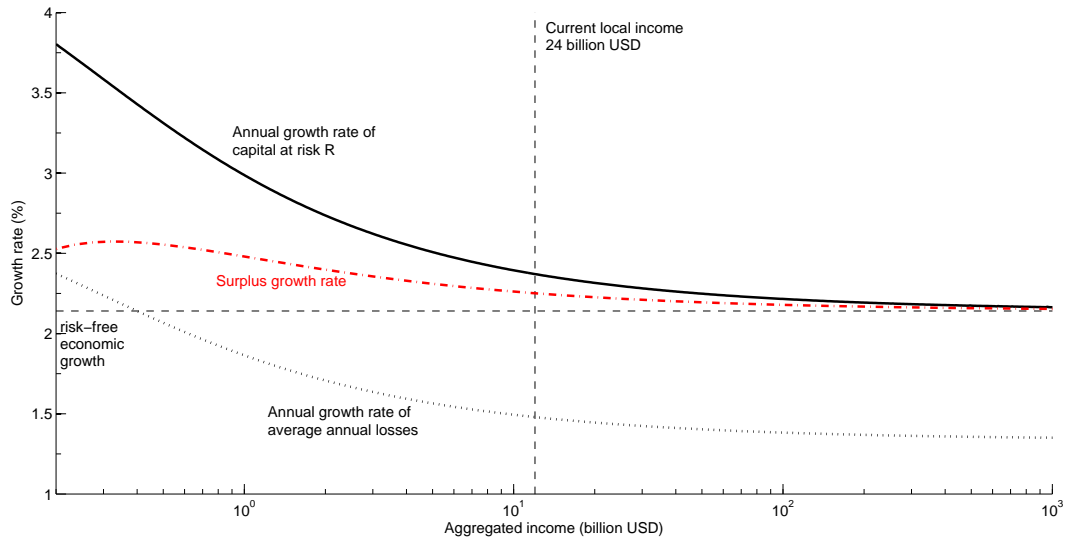


Figure 2: Annual growth rate of capital at risk R , average annual disaster losses, and economic surplus growth rate, as a function of local income. The horizontal line is the rate of risk-free economic growth. Growths in capital at risk and in economic surplus are more rapid than economic growth at early development stage, and these growth rates converge toward economic growth rate over time. Growth in average annual losses is faster than risk-free economic growth at low income levels and slower at high income levels. The vertical dashed line shows the current income in New Orleans.

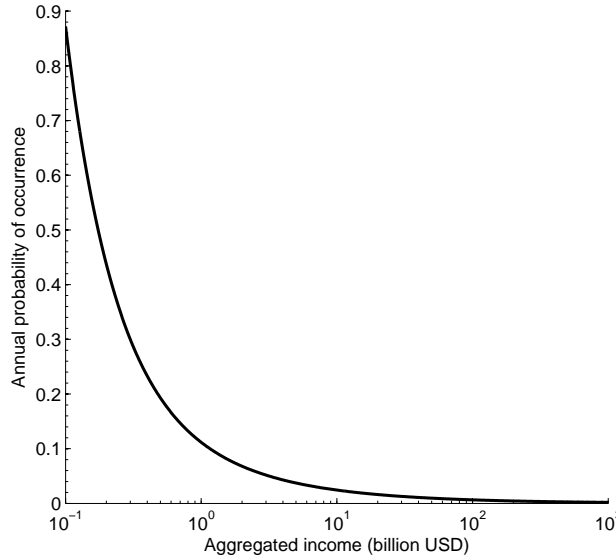


Figure 3: Optimal disaster probability of occurrence in New Orleans, as a function of local income. Improving protection levels make the probability of occurrence decrease with income.

average cost of disasters is decreasing relative to regional or national wealth, but the consequences when a flood occurs increase, even relatively to wealth. It means that the New Orleans region evolves toward fewer disasters with consequences that are growing relative to income, leading to an increased need for recovery and reconstruction support.

One can investigate how this result depends on the local income in New Orleans (and thus on total factor productivity), assuming that everything else remains unchanged (including protection costs $C(p)$ and the fraction of capital at risk lost in case of flood X). Results are reproduced in Fig. 2 and 3. Figure 2 shows the annual growth rates of capital at risk R , of average annual losses (pXR), and of the economic surplus, as a function of local income Y . The vertical line shows the current income in New Orleans, and the horizontal line the rate of risk-free economic growth. At very low productivity, the growth in capital at risk R would be 4.6% per year, i.e. more than twice the rate of risk-free economic growth. In this situation, the annual probability of flood would exceed 80% (see Fig. 3). This growth then converges toward the rate of risk-free economic growth (the horizontal dashed line) as development proceeds. The economic surplus growth rate is also larger than the risk-free economic growth rate at a low development level, but converges toward it as development proceeds.

Figure 1 shows how the fraction at risk — i.e. the fraction of capital located in at risk area — increases with income, assuming $\alpha = 2$ (i.e., that in the absence of risk, this

fraction would be 38%, according to Eq. (24)).

For average annual disaster losses, the growth rate is 2.8% per year at a low development level, i.e. 40% faster than economic growth. At an income of 40 million USD per year in the city, the growth rate of annual losses is equal to the rate of economic growth (2.1%), and this growth rate keeps decreasing until 1.3% per year, which is economic growth (2.1%) corrected by the “protection factor”, equal to 0.62 in the case of New Orleans.

In this case, therefore, the income elasticity of average disaster losses would be equal to 0.62 (i.e. a 1% growth in the US would lead to a 0.62% growth in average annual losses) and the income elasticity of disaster losses (when a disaster occurs) would be equal to 1.1 (i.e. a 1% growth in the US would lead a 1.1%-increase in the size of disasters when they occur).

Appendix A proposes an analytical framework to conduct the same analysis in the presence of risk aversion, and provide numerical results in the case of New Orleans. It shows that the qualitative conclusions of this paper are unchanged in the presence of risk aversion, at least within the range of realistic parameter values.

6 Taking into account biases in risk perception

This normative analysis suggests that capital-at-risk, losses in case of disasters, and average annual losses can increase with income, even in an optimal context with perfect information and a benevolent social planner (at least in the case where human losses can be avoided). Therefore, the observation that disaster losses increase over time does not automatically mean that risk taking is excessive and should be suppressed by public action.

Interpreting real-world disaster loss data series requires a descriptive approach, where realistic characteristics of decision-making and other sources of suboptimality are considered. There are many reasons for risk taking to be excessive (and potentially insufficient in some cases).

First, there are externalities and moral hazard issues in risk taking and risk management. Insurance and post-disaster support are often available in developed countries, and households and firms in risky areas do not pay the full cost of the risk, and may take more risk than what is socially optimal (e.g., Kaplow, 1991; Burby et al., 1991; Laffont, 1995). Also, Lall and Deichmann (2010), Hallegatte (2008) and Henriët et al (2012) show that risk mitigation has positive externalities and that private and social costs of disaster losses may differ, leading to inappropriate risk taking.

Here, we focus on the fact that risk perceptions are sometimes biased by information constraints and cognitive and behavioral failures. Since the information on natural hazards and risk is not always easily available, households and businesses may decide not to

spend the time, money and effort to collect them, and disregard this information in their decision-making process (Camerer and Kunreuther, 1989; and Hogarth and Kunreuther, 1995). And individuals do not always react rationally when confronted to small probability risks (as illustrated, e.g., by insurance decisions in Krantz and Kunreuther, 2007). They defer choosing between ambiguous choices (Tversky and Shafir 1992; Trope and Liberman, 2003). They do not always adequately take long and very long-term consequences into account (Kunreuther et al. 1978; Thaler, 1999). Kahneman and Tversky (1979) proposed the prospect theory to better explain individual behaviors, taking into account observed behaviors patterns and experimental results. In the specific case of insurance-related decisions, Krantz and Kunreuther (2007) represent decision-making as trying to satisfy a series of goals instead of maximizing an utility function.

In the following, we modify the model to account for some of these effects. We assume that capital investment decisions are made with imperfect knowledge, or with biases in risk perception or behavior. This assumption is consistent with the observation that most capital investment decisions are not made using all available disaster risk information. On the other hand, we model protection decisions as made with perfect knowledge of natural risks and assuming (wrongly) that capital investment decisions will then also be made optimally and with perfect knowledge. There is thus an inconsistency in the model between protection decisions and capital investment decisions. This hypothesis is justified by the fact that (public and private) decisions concerning disaster protections (e.g. the design of a dike system) are most of the time designed through sophisticated risk analyses taking into account all available information.

From the prospect theory (Kahneman and Tversky, 1979), we borrow the idea that people weigh different outcomes of a decision not using the probability of the outcome (here, the probability of occurrence p), but a “decision weight” π . In a classical decision-making framework — based on expected utility maximization — π can be interpreted as the perceived probability of disaster occurrence, and the difference between p and π is the bias in risk perception. In a prospect theory framework, the decision weights “should not be interpreted as measure of belief” but they can also be influenced by other factors such as ambiguity (Kahneman and Tversky, 1979). In this case, there are thus two distinct issues: the misestimation of probability of occurrence (due for instance to biased risk perception) and over- or under-weighting of some possible outcomes (which is a preference, not a mistake).

In the model, π is used by investors to decide the amount of capital to be installed in at-risk areas. In this section, we assume however that potential losses remain small enough for the utility function (in an expected utility maximization framework) or the value function (in a prospect theory context) to remain linear.¹⁴ Equation (5) therefore

¹⁴The reference point used by decision-makers to assess a situation is a situation with zero economic surplus. As shown by Kahneman and Tversky, different reference points can lead to different behaviors.

becomes:

$$e^{\gamma t} \partial_R F(R, S) - \partial_R C - (\pi X + r) = 0 \quad (32)$$

We investigate two ways of modeling the decision weight π . The first model assumes a static relationship between the actual probability of occurrence p and the decision weight π . The second model takes a dynamic view on risk perception and introduces myopic adaptive expectations.

6.1 Systematic perception bias or decision weighting

A first model can be proposed where the relationship between p , the real probability of occurrence, and π , the decision weight, can be represented as:

$$\pi = B(p) \quad (33)$$

Kahneman and Tversky (1979) propose that (i) when the probability of occurrence is low, the decision weight is higher than the actual probability of occurrence (for low values of p , we have $\pi > p$); (ii) “subcertainty” means that the perceived probability π is less sensitive to a change in actual probability than the actual probability (the slope of π is lower than one); (iii) π changes abruptly near the end-points, with $\pi(0) = 0$ and $\pi(1) = 1$. One function satisfying these conditions is:

$$\pi(p) = \begin{cases} 0 & \text{if } p < p_{min} \\ 1 & \text{if } p > p_{max} \\ p_b + p^\beta & \text{otherwise} \end{cases} \quad (34)$$

Events with a probability below p_{min} are considered impossible; low-probability events with probability higher than p_{min} are overweighted; and non-certain higher-probability events are underweighted.

Since protection is designed assuming the investments in at-risk areas will be optimal, the actual probability of occurrence remains equal to $p = \left(\frac{RX}{\nu \xi} \right)^{-\frac{1}{1+\nu}}$. Calculations from Section 4 can be carried out with decision weight, resulting in Eq. (26) to be replaced by:

$$e^{\gamma t} \lambda \mu R^{\mu-1} = r + \pi X \quad (35)$$

At very high development levels, protection is so high that $p < p_{min}$ and disasters are considered impossible. This may be the situation in the Netherlands for most decision-makers. In that case, as in previous cases, the capital at risk R grows as fast as risk-free economic growth, and is higher than what is optimal in a rational framework. It is therefore a situation of excessive risk taking.

At lower development levels, $p > p_{min}$ and we have:

$$e^{\gamma t} \lambda \mu R^{\mu-1} = r + X p_b + X \left(\frac{X}{\nu \xi} \right)^{-\frac{\beta}{1+\nu}} R^{-\frac{\beta}{1+\nu}} \quad (36)$$

In that case, a high productivity still leads to a situation where the fixed term $r + X p_b$ dominates the right hand side of Eq. (36), and the capital at risk R still grows as fast as risk-free economic growth.

At high development levels, risk perception bias or a prospect theory decision framework still thus leads to a growth rate in capital at risk that is as fast as risk-free economic growth, and thus to a growth rate in average annual losses that is lower than risk-free economic growth (namely, the risk-free rate reduced by the protection factor, like in previous cases). In this case, risk taking can be either excessive or insufficient compared with the optimal situation (depending on the parameters of the risk function $B(p)$). The shape of $B(p)$ also influences the boundaries between different situations: if p_b is large, the range of income levels for which changes in the probability of occurrence p are negligible is broader. As a result, the range of income levels for which capital at risk increases like risk-free growth is also larger.

Biases in risk perception change results at a lower development level. If the fixed term $r + X p_b$ is dominated by $X p$ in the right hand side of Eq. (36), then the growth rate of capital at risk R becomes:

$$\gamma_R = \frac{\gamma}{1 - \mu - \frac{\beta}{1+\nu}} \quad (37)$$

In locations where capital at risk R and the protection level would be increasing with economic growth (i.e., where the probability of occurrence p decreases), the presence of a large underestimation (or underweighting) of risk (a large β) can lead to the opposite outcome, that is a decrease of capital at risk and protection level over time.

If the growth rate of R is positive ($\mu < 1 - \frac{\beta}{1+\nu}$), then this growth rate increases with β . It means that capital at risk increases more rapidly if hazards are more under-weighted. Regardless of risk perception, however, the growth in capital at risk is larger than capital in a risk-free situation, and the economy evolves toward more risk taking.

Average losses $p X R$ have a growth rate equal to:

$$\gamma_L = \frac{\gamma}{1 - \mu \frac{1+\nu}{\nu} + \frac{1-\beta}{\nu}} \quad (38)$$

In the situation in which protection improves over time, $\mu < \frac{\nu}{1+\nu}$, and in presence of risk under-weighting, average losses increase over time, and they increase more rapidly than when $\beta = 1$, and thus more rapidly than risk-free economic growth. In short, the introduction of a systematic bias in risk perception (or of decision weights instead of probabilities) does not change the main conclusion of this paper, namely that development

leads to more risk taking (capital at risk increases more rapidly than risk-free economic growth). Biases in risk perception can however amplify this effect.

Even with biases in risk perception, situations where disaster losses increase more rapidly than risk-free economic growth are not always situations where risk taking is excessive: there are cases where risk taking is insufficient (compared with the social optimum) but increases more rapidly than income. Again, the observation of trends in economic losses should not be confused with conclusions on the presence of excessive risk taking.

6.2 Myopic expectations

This modeling disregards the dynamics of risk perception. In practice, it is likely that perceived risk is higher than actual risk during the years following an event, and lower after some times and when the memory of disaster losses has lost its acuteness. After Hurricane Katrina hit New Orleans in 2005, the number of U.S. households with flood risk insurance increased by 53 percent a year, only to drop back to pre-Katrina levels in three years, with a 33 percent cancellation rate. Meyer (2010) also shows that the primary motivator of decisions to invest in disaster protection is the size of losses already experienced in the past, not losses that were avoided or are predicted.

To account for these effects, a second model can be proposed where decisions on the amount of capital to install in the risky area are based on a disaster probability that is estimated empirically, based on previous disasters (see also, Hallegatte 2011). The empirically estimated disaster probability is π and is given by:

$$\pi(t) = \frac{1}{\tau} \int_{u=-\infty}^{u=t} e^{-\frac{t-u}{\tau}} F(u) du \quad (39)$$

Where $F(u)$ is a *Dirac* distribution if a disaster occurs at time u , and zero otherwise.

This modeling corresponds to backward-looking adaptive expectation, in which past events have an exponentially decreasing weight (with time scale τ). In other terms, agents assess future disaster risks from past events, with a memory characteristic time τ . The consequence is that the estimated disaster probability is higher than the real one just after a disaster, and lower than the real one when no disaster has occurred for a while. This behavior appears consistent with many observations (e.g., Kunreuther and Slovic, 1978; Tol et al., 1998).

The efficiency of this empirical process depends on the disaster probability. If there are many disasters over a period τ (i.e. if $1/p \ll \tau$), the estimated probability remains close to the real one. If the memory is too short, i.e. if τ is too low, then the estimated probability will often be different from the real one.

Here, we are interested in the dynamics between two disasters.¹⁵ Assuming that the last disaster occurs at time t_0 , we have $F(t) = 0$ for $t > t_0$, and:

$$\pi(t) = \frac{1}{\tau} \int_{u=-\infty}^{u=t_0} e^{-\frac{t-u}{\tau}} F(u) du + \frac{1}{\tau} \int_{u=t_0}^{u=t} e^{-\frac{t-u}{\tau}} F(u) du = \pi(t_0) e^{-\frac{t-t_0}{\tau}} \quad (40)$$

Replacing p by π in Eq. (26) gives:

$$e^{\gamma t} \lambda \mu R^{\mu-1} = r + \pi X = r + X \pi(t_0) e^{-\frac{t-t_0}{\tau}} \quad (41)$$

When no disaster occurs during a long period of time, economic actors think — correctly or not — that disaster probability is negligible (πX very small compared with r), and capital at risk increases as fast as economic growth.

But after disasters, where risk perception is relatively high (π is large), then Eq. (41) can be simplified, and the growth rate in capital at risk R is equal to:

$$\gamma_R = \frac{\gamma + \frac{1}{\tau}}{1 - \mu} = \gamma_S + \frac{1}{\tau(1 - \mu)} \quad (42)$$

In that case, therefore, capital at risk increases faster than the risk-free economic growth (γ_S). Here, the growth rate is independent of the shape of the protection cost function (ν), and only depends on the expectation timescale τ . We have:

$$\gamma_L = \frac{\gamma}{1 - \mu} \frac{\nu}{(1 + \nu)} + \frac{1}{\tau(1 - \mu)} \frac{\nu}{(1 + \nu)} \quad (43)$$

The last term of the equation is due to myopic expectations, and it leads to an increase in the growth rate of average annual losses. Since the risk-free growth is equal to $\frac{\gamma}{1-\mu}$, the growth rate of annual losses can be either slower or faster than risk-free economic growth, depending on the values of ν and τ .

Between disasters, annual average losses are growing more rapidly than risk-free growth if:

$$\nu > \gamma \tau (1 - \mu) \quad (44)$$

This is the case if protection costs increase rapidly with the desired safety standard (ν is large), if expectation are short-sighted (τ is small), but also if economic growth is slow (γ is small) or if the production function of capital at risk is close to constant return (μ is close to one). Using parameter values from our New Orleans case study, this condition is met if τ is lower than 158 years, a very long timescale. It seems therefore possible that after a disaster, a dynamic bias in risk perception makes mean annual losses increase more rapidly than risk-free economic growth, and potentially more rapidly than is socially optimal.

¹⁵ A more complete dynamic analysis is proposed in Hallegatte (2011), using a numerical model.

7 Conclusion and discussion

This paper proposes an analytical framework to analyze the trade-off between disaster losses and investment returns in areas at risk from natural hazards, and to explore the relationship between development and risk taking. This issue is first analyzed in a normative framework, and then in a descriptive one. The analysis uses various assumptions on decision-making, including the presence of risk aversion, biases in risk perception, and alternative decision theories such as prospect theory.

In an optimal framework, and under conditions that ensure that protection improves over time, the presence of risk and the possibility to protect against disasters lead to a lower amount of capital in risky area (compared with the risk-free situation), but it also increases the growth rate of capital at risk where protection costs increase less rapidly than the amount of protected capital (i.e. where investments are at least partly done by increasing capital density and concentration).

By improving protection, economic development drives the economy toward more risky behaviors (i.e. a growing share of capital is installed in at-risk areas). Protection reduces the probability of occurrence of an event, but its impact on risk is more complex because it also increases the consequences when an event takes place. In particular, it transfers part of the risk from one kind of risk (frequent and low-cost events) to another kind (exceptional and high-impact events).

Reciprocally, the increase in risk-taking is found to accelerate economic growth. Along an optimal growth pathway, increasing risk-taking is thus both a driver and a consequence of economic development. This interlinkage between development and risk taking suggests that risk should not be reduced at all cost, and that the observation of a trend in disaster losses should not be confused with the presence of excessive risk taking.

Most econometric studies have focused on average losses (that mix the probability of occurrence and the amount of losses in case of occurrence), not on the potential increase in damages *when a disaster occurs* (e.g., Toba and Skidmore, 2007; Rashky, 2008). However, current trends in disaster losses appear consistent with the prediction of this paper, namely a trend toward fewer but larger disasters (e.g., Etkin, 1999; Nordhaus, 2010; Bouwer et al., 2007; Pielke et al., 2008; Bouwer, 2011; Schumacher and Strobl, 2011). These results are also in line with UN-ISDR (2009), which observes that poor countries suffer from frequent and low-cost events, while rich countries suffer from rare but high-cost events.

The paper suggests that natural disasters will become less frequent but more costly with development and economic growth, and this result has some policy-relevant consequences. In particular, it means that development requires more resilience, i.e. an improved ability to deal with and recover from the rare events that exceed the protection capacity. The Tohoku Pacific earthquake could thus be an illustration of the type of

events the world will have to deal with in the future. Such a trend toward larger disasters translates into a strong and increasing need for crisis management and post-disaster support, through (1) forecasts and early warning to mitigate human losses (e.g., Subbiah et al., 2008; Hallegatte 2012); (2) rainy-day funds and insurance and reinsurance schemes to support reconstruction (e.g., Ghesquiere and Mahul, 2010; Jaffee et al., 2010; Michel-Kerjan, 2010); and (3) new international instruments for post-disaster support and solidarity (e.g., Linnerooth-Bayer et al. 2009). Finally, the growing role of exceptional disasters, on which knowledge and data is the scarcest, call for decision-making processes that are able to cope with large uncertainty (Lempert and Collins, 2007; Paté-Cornell, 2012; Hallegatte et al., 2012).

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A Taking into account risk aversion

The analysis presented in the main text does not include risk aversion, following Arrow and Lind (1970). It thus assumes that the social planner who determines the appropriate level of risk ensures that (i) aggregate losses remain limited compared with national income; (ii) there is risk sharing across individuals in the country to avoid large individual losses¹⁶; and (iii) there is temporal smoothing of disaster losses, through savings and borrowing (self-insurance) or reinsurance. In absence of these elements, risk aversion needs to be taken into account. This is the case, for instance, in small countries where the entire economy can be affected (as in Grenada after hurricane Ivan in 2004 where losses reached 200% of GDP) and where the risk-free level of capital R (R^s) is large compared with the rest of the economy ($R + S$).

To take into account risk aversion, we need to introduce an utility function, which we assume to depend on the economic surplus $u(\pi)$ and to have decreasing returns $u'(\pi) > 0$ and $u''(\pi) < 0$. The utility cost of disasters can be approximated by the insurance premium δ that the region would be ready to pay to avoid all losses, which is defined by:

$$u(\pi_0 - \delta) = pu(\pi_0 - L) + (1 - p)u(\pi_0) \quad (45)$$

where π_0 is the surplus in absence of disaster and is equal to $e^{\gamma t} F(R, S) - C(p, R) - r(R + S)$. This equation defines a function $\delta(p, R, S, t)$, which replaces pXR in Eq. (3) when risk aversion is accounted for.

$$\mathbb{E}[u] = \overbrace{e^{\gamma t} F(R, S) - C(p, R) - r(R + S) - \delta(p, R, S, t)}^{\tilde{\pi}} \quad (46)$$

And the maximization program becomes:

$$\begin{aligned} \max_{p, R, S} \quad & \tilde{\pi} \\ \text{s.t.} \quad & 0 \leq p \leq p_0 \end{aligned} \quad (47)$$

We use a constant relative risk aversion (CRRA) utility function with the form $u = \frac{\pi^{1-\rho}}{1-\rho}$:

$$\delta = \pi_0 - \left[p(\pi_0 - RX)^{1-\rho} + (1 - p)\pi_0^{1-\rho} \right]^{\left(\frac{1}{1-\rho}\right)} \quad (48)$$

Since $\delta > pRX$ in presence of positive risk aversion, the taking into account of risk aversion makes perceived risk larger and creates a non-linearity between R and risk. To go further, the optimization program can be solved numerically with the parameters and

¹⁶Since fatalities and casualties cannot be shared, it means that forecasts and early warning systems reduce human losses, as is observed in most developed countries where economic losses have increased while human losses have decreased.

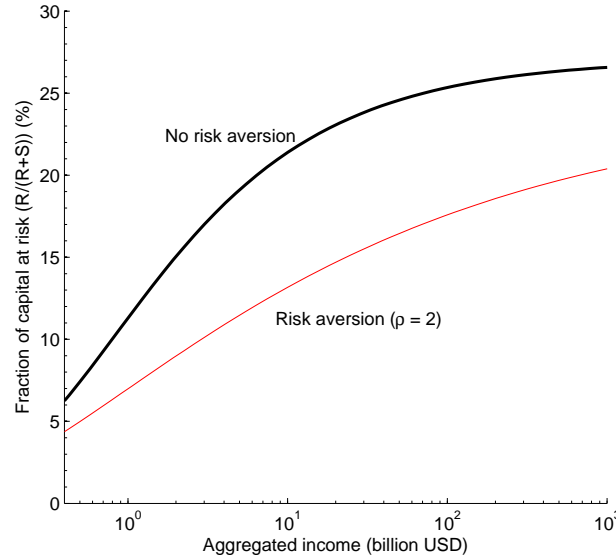


Figure 4: Evolution of the “fraction at risk”, i.e. the share of capital at risk R in total capital $R + S$, as a function of time, with and without risk aversion. Risk aversion reduces the fraction at risk at all development levels. Calculations using numerical values from New Orleans (see Section 5) and $\alpha = 2$.

functional forms from Section 5 on New Orleans, and using the same methodology to calibrate λ . Since risk aversion introduces total income in the equations of R and p , it creates a link between R and S even when the two capitals are separable in the production function. It means that the value of S (i.e. α) also needs to be calibrated. In practice, the value of S depend on how disaster risks in New Orleans are shared with risk-free capital (or capital that is subject to a risk independent of hurricane risk in New Orleans). As an illustration, equations are solved assuming that $\alpha = 2$.

Results for the fraction at risk are presented in Fig. 4, for a risk aversion $\rho = 2$. It shows that risk aversion leads to locating less capital in at risk areas, at all development levels.

Figure 5 shows that risk aversion has an ambiguous impact on the probability of occurrence: at a low development level, the capital at risk is so much smaller with risk aversion that it is optimal to increase the probability of occurrence; at higher development level, risk aversion leads to better protection and to a decrease in the probability of occurrence. Finally, Fig. 6 shows that capital at risk still grows more rapidly than income at all development levels, and the growth rate converges toward the risk-free growth rate. At high development level and in this simulation, the capital at risk is lower but increases

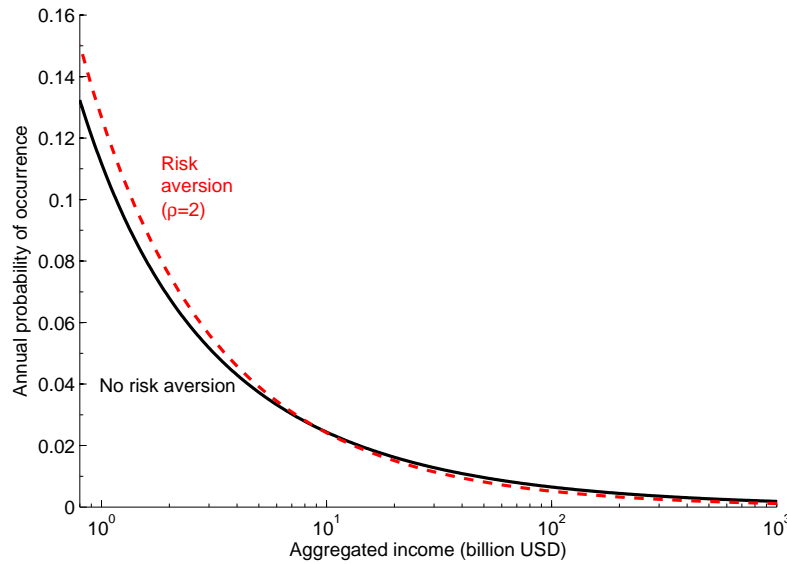


Figure 5: Evolution of the annual probability of occurrence, without risk aversion and with risk aversion ($\rho = 2$).

more rapidly with risk aversion than without risk aversion. At a high development level, average annual losses grow at a lower rate than risk-free economic growth, like in the case without risk aversion.

Numerical simulations suggest therefore that the qualitative results in the case without risk aversion remain valid with risk aversion. An exploration of various values of risk aversion (ρ) and of various risk sharing levels (modeled through α here) confirms that results are robust to the presence of risk aversion.

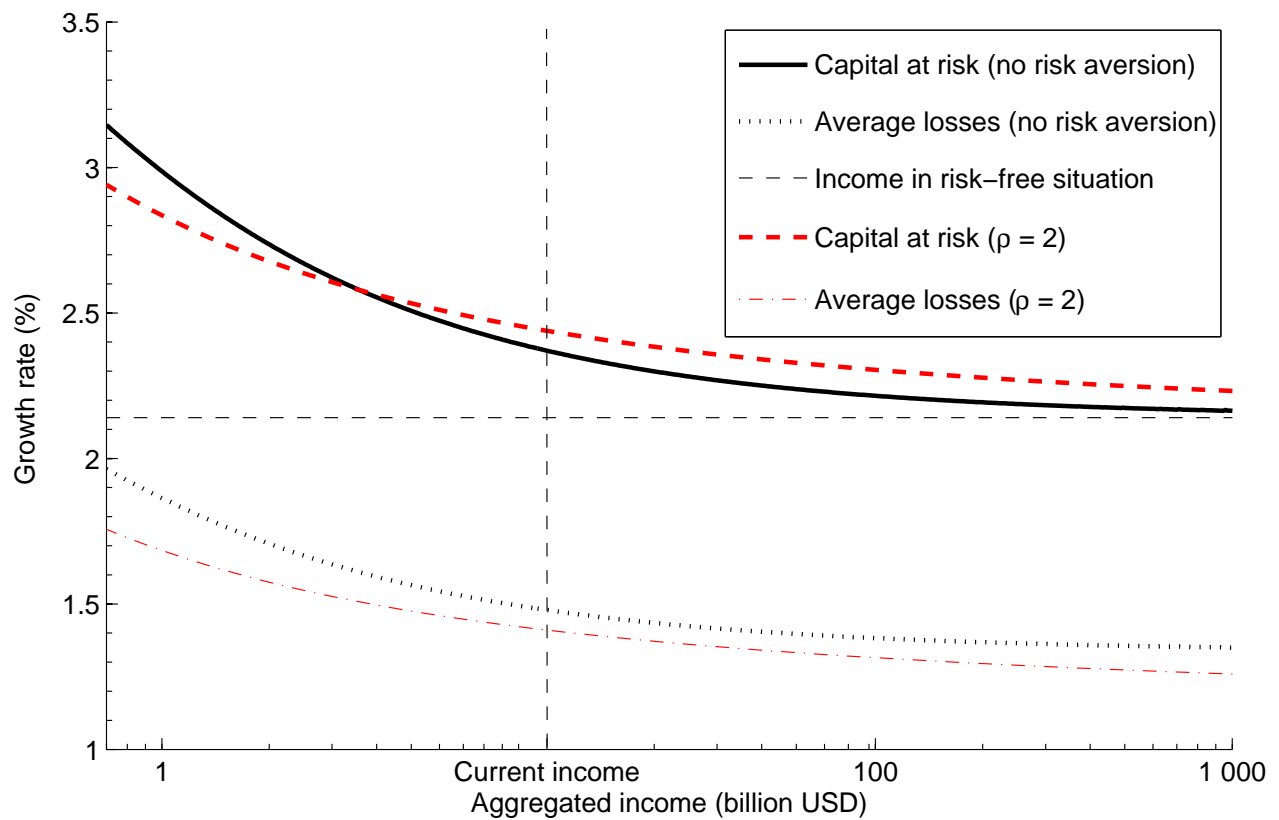


Figure 6: Evolution of capital at risk R and average annual disaster losses as a function of time, without risk aversion and with risk aversion ($\rho = 2$).

B Capital at risk and safe capital as substituable inputs in a Cobb-Douglas function

If R and S are imperfectly substituable, we can assume that $F(R, S) = \lambda R^{\mu_1} S^{\mu_2}$. This section demonstrates that this situation is similar to the situation where R and S are separable in the production function.

In this case, the marginal productivity of S gives us:

$$S = \left(\frac{e^{\gamma t} \lambda \mu_2}{r} \right)^{\frac{1}{1-\mu_2}} R^{\frac{\mu_1}{1-\mu_2}} \quad (49)$$

With $p = \left(\frac{RX}{\nu \xi} \right)^{-\frac{1}{1+\nu}}$, we have:

$$pX = X \left(\frac{X}{\nu \xi} \right)^{-\frac{1}{1+\nu}} R^{-\frac{1}{1+\nu}} \quad (50)$$

and the marginal productivity of R gives us:

$$\lambda \mu_1 \left(\frac{\lambda \mu_2}{r} \right)^{\frac{\mu_2}{1-\mu_2}} e^{\frac{\gamma t}{1-\mu_2}} R^{\frac{\mu_1+\mu_2-1}{1-\mu_2}} = r + X \left(\frac{X}{\nu \xi} \right)^{-\frac{1}{1+\nu}} R^{-\frac{1}{1+\nu}} \quad (51)$$

Here, we use the same approach as in the main text, and separate low and high development levels.

B.1 Low development level

At a low level of development, and using the same assumptions on p_0 , pX is larger than r , and the equation can be approximated by assuming that $r \ll pX$, which gives:

$$R(t) = R_0 e^{\frac{\gamma}{1-(\mu_1+\mu_2)-\frac{1-\mu_2}{1+\nu}} t} \quad (52)$$

So R is increasing if $1 - (\mu_1 + \mu_2) > \frac{1-\mu_2}{1+\nu}$, i.e. if $\nu > \frac{\mu_1+2\mu_2}{1-\mu_1-\mu_2}$. Using classical values for decreasing capital returns (i.e. $\mu_1 + \mu_2 \approx 0.3$), and assuming that the capital at risk and the safe capital have the same return convexity, it leads to $\nu > 0.64$, which is the case if protection costs are convex.

Since economic growth in absence of risk would be $\frac{\gamma}{1-(\mu_1+\mu_2)}$, the capital at risk increases more rapidly than risk-free economic growth. Average losses $\mathbb{E}[L] = pXR$ are growing at a rate:

$$\gamma_L = \frac{\gamma}{1 - (\mu_1 + \mu_2) - \frac{1-\mu_2}{1+\nu}} \frac{\nu}{\nu + 1} \quad (53)$$

Average losses increase more rapidly than risk-free economic growth if:

$$\frac{\gamma}{1 - (\mu_1 + \mu_2) - \frac{1-\mu_2}{1+\nu}} \frac{\nu}{\nu + 1} > \frac{\gamma}{1 - (\mu_1 + \mu_2)} \quad (54)$$

If R is increasing, then the denominator is positive, and this inequality is always verified. So, in this setting, at low levels of development and under mild conditions insuring that the probability of occurrence decreases with time, average disaster losses increase more rapidly than risk-free economic growth.

B.2 High development level

At a high level of development, pX is very small compared with r , and the equation can be solved by assuming at $pX = 0$:

$$R(t) = R_0 e^{\frac{\gamma}{1 - (\mu_1 + \mu_2)} t} \quad (55)$$

Which is also the rate of risk-free economic growth. Average losses $\mathbb{E}[L] = pXR$ are then growing at a rate:

$$\gamma_L = \frac{\gamma}{1 - (\mu_1 + \mu_2)} \frac{\nu}{\nu + 1} \quad (56)$$

In this case, the growth rate of disaster losses is lower than the rate of risk-free economic growth. Indeed, the growth rate in annual disaster losses is equal to economic growth multiplied by the same “*protection factor*” $\nu/(1 + \nu)$ as in the case of a separable production function.