COMMENTS ON WEICHER

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John Weicher's interesting paper examines the importance of defects in new homes. Weicher is interested in predicting the demand for an insurance program for defects. Weicher is well aware that he is beset by data difficulties, and there is no need for me to repeat the serious data biases that Weicher recognizes and discusses in his paper.

My main comment on Weicher's paper is that, in order to investigate the demand for insurance, one must know not only the average cost of a defect but the variability of the cost of a defect. More specifically, one would be interested in insurance only if the distribution of a defect's costs was sufficiently risky. The incidence of home defects need not reveal much about whether insurance against defects will be demanded. The real issue is whether the distribution of damages from home defects is similar to probability distributions of events that we insure against. (I recognize that the data needed to estimate the entire distribution of damage costs may be unavailable.)

Even if it turns out that consumers would want to protect themselves against these home defects, there is a question as to whether an insurance market is the best mechanism. The usual problem of adverse selection in insurance markets means that the insurance program will attract the worst builders. This adverse selection will cause insurance premiums to be high and will diminish the attractiveness of using insurance.

It is also true that the uncertainty about home quality may be reduced by existing market mechanisms. For example, new homes often contain a one-year warranty during which the builder will repair any defect free. The reputation of the builder, in addition to a legally binding contract, provides the buyer with some insurance that the builder will honor the warranty. Second, when many new homes are purchased, the buyer often withholds an escrow fund to insure completion of any unfinished items. Although the escrow fund cannot usually be used at the buyer's discretion to repair defects, it obviously provides the buyer with some leverage in

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399
dealing with the seller. Finally, building codes provide some measure of quality assurance to buyers.

There are several indicators that lead one to question how much consumers want insurance against defects. First, the existing program has been subsidized so that current consumer participation cannot be used as an indicator of the demand for actuarially fair insurance. Second, there was no such insurance prior to the 1970s, and it is hard to believe that shifts in tastes for uncertainty are responsible for the recent appearance of the insurance. Third, if home defects are a serious problem, then reputations of sellers would be very important to buyers. Yet, the building industry is well known for the numerous small firms that enter and exit the industry, depending on business conditions. These facts suggest that consumers may not desire more protection from home defects than are provided by market mechanisms existing other than insurance.