

Restricting Reconstruction: Occupational Licensing and Natural Disasters

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Abstract

Shortages created by licensing are costly in normal times, but the costs are even more burdensome when a large portion of the community suddenly demands the regulated services. Qualitative analysis on the role of occupational licensing in Post-Hurricane Katrina Louisiana provides evidence on the effects of maintaining licensing on construction contractors. Licensing delays recovery by barring out-of-state contractors and requiring timely permitting and inspection processes, and many consumers still view contractors as corrupt. Florida's policy response in 2004 and 2005 was more conducive to recovery because the Governor reduced licensing requirements after major hurricanes to allow out-of-state and general contractors to offer roofing services.

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1. INTRODUCTION

Since the tremendous devastation caused by Hurricane Katrina in 2005, there has been a reexamination of the appropriate response to natural disasters and the determinants of recovery. Past scholarship examined how to best define recovery (Baisden and Quarantelli 1979) and how the social, political, psychological, and economic outcomes change because of the length and process of recovery (Quarantelli 1998). Economists have since investigated government's proper role given knowledge problems (Sobel and Leeson 2006) and the ability of the marketplace to assist or detract from the process (e.g. Congleton 2006, Shughart 2006, and Waugh and Smith 2006).

This paper investigates the role of occupational licensing requirements on the recovery process. Shortages created by licensing are costly in normal times, but the social costs are even more burdensome when a large portion of the community suddenly demands the regulated services. Recovery slows due to these rising costs. This paper examines Louisiana, which maintained restrictions on roofers, plumbers, and electricians after Hurricane Katrina. In contrast, Florida's policy response reduced licensing requirements for roofers after major storms in 2004 and 2005. Policy delayed recovery in the former and encouraged it in the latter.

This paper deploys qualitative analysis in order to understand people's perceptions about choosing between licensed and unlicensed professionals in the wake of natural disaster. Interview data provide information about how particular individuals interpreted their surroundings and what motivated their choice to use licensed contractors. Theoretically this is crucial, for as Israel Kirzner argues, "only in so far as we can find out what the knowledge and beliefs of the people concerned are in the

relevant respects shall we be in a position to predict in what manner a change in the price of the product will affect the prices of the factors” (Kirzner 1979: 138). Understanding peoples’ perceptions of the situation sheds light on the economic consequences of regulation.

2. WHY OCCUPATIONAL LICENSING?

Federal, state, and county governments license occupations for the explicit purpose of protecting consumers. Claims about the existence of asymmetric information and negative externalities often underlie these arguments. The literature on economic regulation, however, has identified costs from deadweight loss, rent seeking, and regulatory capture that occur because of licensing.

The dominant position in economics is that licensing restricts supply, increases prices, and transfers wealth from consumers to producers (Law and Kim 2005). Economists have long argued this, and even Adam Smith warned of these monopolistic tendencies when he wrote in *The Wealth of Nations* that “[t]he exclusive privilege of an incorporated trade necessarily restrains the competition” and its intention “is to restrain the competition to a much smaller number than might otherwise be disposed to enter into the trade” (Smith 1994: 136-137). Modern economists have echoed these criticisms and highlighted the many costs associated with licensing [see, e.g., Friedman and Kuznets (1945), Friedman (1962: 137-160), and Kleiner (2006)].

Government justifies licensing as a way to improve product quality, but there are several reasons why the quality of service received by a consumer may actually decline despite an increase in the average quality of licensed practitioners (Kleiner 2006: 48-52).

As the price of a good rises, people consume less of it, leading to a longer period of use of the old good. If licensing increases the cost of a new roof, for example, people may wait too long to replace it. A homeowner's roof would have been of higher quality *if* he bought one, but the higher prices precluded this. Similarly, as the price of a service rises, people search out less costly – and lower quality – substitutes. When contractors become more expensive, some consumers will substitute for day laborers or do the work themselves. Lower quality substitutes leave consumers worse off than if they hired unlicensed, professional contractors.

Some economists have defended licensing laws because of the existence of informational asymmetries. Akerlof's lemons model (1970) shows that markets may be thin or nonexistent when buyers and sellers cannot identify product quality. Leland (1979) applies Akerlof's model to occupational licensing laws and identifies welfare improvements from enforcement of a minimum quality standard. He notes two exceptions however. First, other forms of regulation, e.g. certification, may achieve these welfare improvements more effectively. Second, he argues that quality standards will likely be set too high if done by the regulated professional group, as is the case in nearly all occupational laws. Law and Kim (2005) argue that during the Progressive Era informational asymmetries, exacerbated due to increasing urbanization and advances in specialized knowledge, explains the enactment of many of these laws and justifies them on efficiency grounds.

Markets provide a variety of mechanisms for mitigating the problems associated with asymmetric information. Akerlof suggests that sellers offer warranties and establish brand names to provide information to buyers about product quality (1970). The allure of

repeat business creates an incentive for sellers to be honest when presenting information about the condition of goods. As Adam Smith argued in his *Lectures on Jurisprudence*:

When a person makes perhaps 20 contracts in a day, he cannot gain so much by endeavoring to impose on his neighbors, as the very appearance of a cheat would make him lose. Where people seldom deal with one another, we find that they are somewhat disposed to cheat, because they can gain more by a smart trick than they can lose by the injury which it does their character (1982: pp. 538-39).

Sellers lose future streams of income if they provide poor quality goods to consumers today. Certification from third parties (such as Underwriters' Laboratories or *Consumer Reports*), intermediaries, and specialized dealers, provide additional ways for buyers to obtain assurances about product quality (Klein 1997, Klein 2001).

Government rarely justifies licensing with explicit appeals to economic arguments about asymmetric information, yet underlying most of these laws is the presumption that consumers are not capable of identifying product quality. For example, the Florida Statute on construction contractors² states its purpose as follows: "The Legislature deems it necessary in the interest of the public health, safety, and welfare to regulate the construction industry" and achieve this by "establish[ing] his or her competency and qualifications to be certified..." Fundamental to this statement of purpose is the belief that consumers or third parties cannot identify the competency and qualifications of roofing contractors to an acceptable extent.

The costs associated with licensing are substantial. Estimates of the wage for licensed occupations indicate a 10 to 15 percent premium compared to the wage for the same occupation in states that do not require licensing, suggesting nation-wide costs from

² XXXII, Ch. 489.101 and 489.113

dead-weight loss of \$34.8 to \$41.7 billion a year (Kleiner 2006: 115).³ In the wake of a natural disaster, maintaining licensing restrictions leads to even greater costs. Moreover, these costs are concentrated on communities where a natural disaster was particularly damaging.

After a natural disaster, the demand for regulated services increases substantially. In an unregulated market, higher prices would call forth a greater supply of labor, but with licensing, the costly regulatory regime hinders this process. Most out-of-state practitioners cannot offer their services to needy consumers. State laws prohibit skilled, yet unlicensed practitioners from contracting. In extreme cases like Hurricane Francis or Hurricane Katrina, many of the licensed contractors fled the disaster area for their own safety, further reducing the supply of licensed contractors. Even when contractors feel it is safe enough to return, the disaster may have destroyed much of their capital (e.g. tools, residence, vehicles, etc.). Lacking these productive resources constrains their ability to contribute to the rebuilding process.⁴ Reducing licensing requirements will aid recovery by allowing increases in the supply of contractors in the days and weeks following a disaster.

When comparing unlicensed markets with licensed markets, one should ensure that licensed markets are represented realistically as opposed to relying on the ideal, theoretical implementation of licensing. There are several reasons to doubt the benefits

³ Licensed occupations comprise approximately 20% of the national total workforce, and licensing increases costs between 2 and 2.4 % relative to a market with no licensing. Incorporating estimates of the elasticity of labor demand yields the dead-weight loss from licensing (Kleiner 2006: 115).

⁴ Contractors may also be less likely to return if the community lacks certain auxiliary services. For example, if schools are not available for a contractor's children, he may not wish to return despite the demand for his services.

of licensing. This is especially true in times of crisis when the demand for contractors (licensed or unlicensed) increases dramatically. First, both licensed and unlicensed contractors can and do commit fraud and poor workmanship. Second, as evidenced by the number of people who opt for unlicensed workers or who do the work themselves after a disaster, licensed contractors fail to serve adequately the needs of some residents. Third, hiring licensed workers requires a time-consuming permitting and inspection process, which makes licensed workers relatively more expensive than unlicensed workers and delays rebuilding efforts after a disaster.

Regulatory barriers are likely to have an additional negative effect: they change the market composition of contractor types in the market. In an unregulated market, a shortage of contractors will call forth greater supply to fill the need. In the face of costly regulatory barriers, some of these firms will find it profitable to forego regulatory compliance. These same firms are also those most likely to defraud customers, have the least experience, and the least skill. Firms with well-established reputations and substantial assets face a greater cost from ignoring regulations and may be more visible to authorities, so they may choose not to enter the market because of these higher costs. “Fly by night” firms have no reputation, so they face lower costs from violating regulations and defrauding customers. This results in the market composition of contractor types becoming less trustworthy and less skilled.

3. NEW ORLEANS RESPONSE TO KATRINA

Louisiana's licensing laws create substantial barriers to responding to natural disasters. Obtaining a roofing, plumbing, or electrician's license requires a passing grade on a State administered examination and certification of at least \$10,000 in financial assets (Contractor Licensing Law §2156.1).⁵ This financial requirement may be especially burdensome for mobile, out-of-state entrepreneurs, who are likely to respond to a surge in demand. In addition, the licensing board does not administer the examination in Spanish, creating a high barrier to entry for an important segment of the construction workforce.

Louisiana's reciprocity agreement allows some licensed contractors in other states (General Contractors in Alabama, Arkansas, Tennessee, and Utah; Electricians in North Carolina) with 3 years experience to waive the "trade related" portion of the examination, and take only the "business and law" portion of the examination.⁶ Although the reciprocity agreement does allow some increase in supply from out-of-state contractors, substantial barriers remain. From the southeast corner of Utah, a contractor would have to drive 1,426 miles to get to New Orleans, LA.⁷ Such a cost will deter many contractors from entering a market characterized by regulatory uncertainty and damaged infrastructure.

Louisiana's reciprocity agreement even excludes contractors in border-states Texas and Mississippi. The Texas Department of Licensing and Regulation website's

⁵ Louisiana's Contractor Licensing Law §2156.1.C (accessed in 2008) does state that an "applicant without the net worth required herein may furnish the board a bond, letter of credit, or other security acceptable to the board in the amount of such net worth requirement plus the amount of the applicant's negative net worth if any, and the furnishing of such bond, letter of credit, or other security shall be deemed satisfaction of such net worth requirement for all purposes."

⁶ Louisiana Contractor's Licensing website accessed on May 3, 2008:
<http://www.lslbc.louisiana.gov/faq.htm#Does%20Louisiana%20have%20RECIPROCITY%20agreements%20with%20other%20states>

⁷ Source: Google Maps on May 9, 2008.

databases, however, shows listings for 136,294 licensed electricians⁸ and 64,365 licensed plumbers,⁹ none of whom are eligible to work as a contractor in Louisiana. Similarly, the Mississippi State Board of Contractors database¹⁰ shows 4,224 licensed Residential Builders and 1,590 Remodelers who are restricted from assisting in the recovery and rebuilding process. Even with a reciprocity agreement, Louisiana's licensing laws greatly reduce the ability for near-by, qualified contractors to enter the market and supply disaster-related demands.

Any work estimated at \$50,000 or more, must be completed by a licensed contractor. Regulations forbid unlicensed homeowners from making substantial repairs on their own homes, even when they are capable of doing so.¹¹ For example, if a person is a licensed contractor in another state, he still cannot legally repair his home. If the government intends licensing to protect consumers from contractors of unknown quality, why aren't homeowners, who know the quality of their work, allowed to fix their storm-damaged homes? The justification of licensing for consumers' protection fails when the person doing the work *is* the homeowner.

3.1. Licensed Contractors Disappoint Too

New Orleans' residents faced several problems when hiring a licensed contractor after Katrina. First, contractors were difficult to find. The surge in demand for contractors, the fact that many of them fled New Orleans, and the prior existence of licensing laws

⁸ <http://www.license.state.tx.us/LicenseSearch/> on May 9, 2008.

⁹ http://www.tsbpe.state.tx.us/license_registration.asp on May 9, 2008.

¹⁰ <http://www.msbec.us/Search2.CFM> on May 9, 2008.

¹¹ Louisiana Contractor's Licensing website accessed on May 3, 2008:

<http://www.lslbc.louisiana.gov/faq.htm#I%20OWN%20MY%20OWN%20PROPERTY%20and%20want%20to%20build%20my%20own%20office.%A0%20Can%20I%20do%20that>

created a shortage during the rebuilding process. Second, many interviewees conveyed what appears to be the common feeling about licensed contractors – they are corrupt.

One interviewee expressed the typical opinion in this way:

When the contractor works on my house I want to be there. I mean, I might not be there every day. If I can get there every other day, then I can watch the process. Because I know there's a lot of contractors – I mean, they're saying you need X amount of material, and they get the material for this location and for that one. So before you know it, they're going to get something off of every person that they come in contact with and spend more.

Clearly, there is a degree of mistrust. Licensing does not automatically remove the possibility for fraud.¹²

The intentional choice by residents not to hire a licensed contractor suggests that the current system is falling short. Many individuals opted for the “do-it-yourself” approach or hired unlicensed contractors and day laborers. One interviewee describes his hiring approach:

Interviewer: In terms of ...are they formal contractors or...

Interviewee: No, after – when the lake reopened so we can go back fishing, a lot of fisherman went back to fishing. They were trying to make money to – whenever they can to repair their homes. So after the lake reopened a lot of people that were repairing my house and repairing my offices, they went back to fishing. So I have to find other people. So now I have ...

Interviewer: And you find them yourself?

Interviewee: Yes, I find them.

Interviewer: Where did you find them?

Interviewee: Actually I just got – I went to one of the taco stands ... you know if anybody needs work.

There are costs associated with using illegal contractors. Market mechanisms that arise to protect consumers against opportunism are potentially less capable of functioning in

¹² The Federal Trade Commission (2007) reports that the New Orleans metropolitan area received 1,437 consumer fraud complaints in 2006. However, this includes more than just construction work, and the FTC does not distinguish between complaints made against licensed and unlicensed contractors.

exchanges with illegal, temporary workers. For instance, reputation is less of a constraint on corruption and poor quality because temporary workers will not be around to benefit from the future stream of income that good reputation generates. That licensed contractors were no panacea is evident from the fact that people still opted to use illegal workers.

3.2 The Regulatory Process Slows Recovery

State licensing laws intentionally reduce the supply of labor by preventing contractors of unknown or unacceptable quality from practicing. Skilled but unlicensed individuals cannot offer their services in times of crisis. In addition to hiring licensed contractors, legal rebuilding requires obtaining permits and having the work inspected. These processes are costly, and they are even less responsive to increases in demand than licensed contractors are. One individual expresses the point well:

And so a lot of people are doing that. People that I know that are working on their homes or have worked on their homes got no permits whatsoever because permits are just going to get in the way. You have to have inspectors for this and inspectors for that. At one time the city had I think a total of 4 building inspectors. This was last year. Four building inspectors in the city where 125,000 homes, not including businesses, were basically destroyed.

Government bureaucracy lacks the incentives and information necessary to respond quickly and effectively in times of crisis (Sobel and Leeson 2007). The additional delay from bureaucratic bottlenecks exacerbates the costs of licensing. In addition to the shortage of licensed contractors and the costs of complying with permit procedures, homeowners must wait for overwhelmed inspectors to approve the work before moving on. One homeowner tells his experience:

I've been waiting on a plumber – I've been waiting on a plumber for six weeks just to get a pressure test on my gas line at this location. Finally when I got a plumber out to test it, to do a real pressure test he still had to file the job. Once he filed the job, he still has to wait for the inspection that's inundated with work so I've been waiting now some two and a half weeks just to get an inspector to come out to inspect the job so I can get gas in here. So it's a frustrating situation...

Each stage in the regulatory requirements – from hiring a licensed contractor, getting a permit, having the work inspected – slows the recovery process. Removing these restrictions will allow people to rebuild more quickly.

Faced with these obstacles, some people hire illegal contractors and simply avoid the law as much as possible. This person bought a meter illegally and installed it:

Interviewee: He didn't do the electric work right. I had to get after – he got the meter now and all that. I don't know what connections he got now. But he got enough connections to get the meter –

Interviewer #1: Okay.

Interviewee: -- and get me some electric here.

Interviewer #1: Um hm

[...]

Interviewer 2: Did you need to call an inspector afterwards?

Interviewee: Huh?

Interviewer 2: Did you need an inspector?

Interviewee: No. I didn't need no inspector. [Laughter]

When the state's regulations become too costly, people will avoid it all together and engage in illegal activities.

In Jefferson Parish, adjacent to Orleans Parish, the federal government estimates that more than 20,000 owner-occupied houses sustained flood damage, 36,000 suffered wind damage, and floods wrecked 10,700 rental units (Moran 2006). Yet, political

leaders estimate “90 percent of households have returned [and] only 8,000 have collected permits to rebuild,” suggesting that many people are simply not applying for permits (Moran 2006).

The Director of Inspection and Code Enforcement for Jefferson Parish, Louis Savoye, also acknowledged that many people are bypassing the permitting process. He reports that the building department has cited 449 residents for not getting the appropriate permits (Moran 2006). He suspects that “people might have come in here [the building department] and seen lines out the front door, and thought, ‘I am not waiting. Catch me if you will’” (Moran 2006).

Obtaining permits for construction in normal times may be a relatively low cost, but after Hurricane Katrina, Jefferson Parish actually increased the permit requirements. Before Hurricane Katrina, Jefferson Parish required permits for all work on the house frame, foundation, and electrical or plumbing systems, but afterwards they required permits for roofing, siding, and carpeting work as well (Moran 2006). The parish waived the permit fees, but it increased the regulatory cost at a time when there were already supply shortages and many people were not complying with regulations.

Louisiana’s licensing laws slow rebuilding by reducing the number of legal contractors, delay recovery through a time-consuming permitting and inspection process, and fail to prevent fraud and poor workmanship. Reducing the regulatory barriers that hamper the provision of these services would allow the price mechanism to signal skilled workers (licensed and unlicensed) from other areas to bring their services to those in need.

3.3 Speeding Recovery: The Case of Florida's Roofers

In 2004, Hurricane Francis made landfall in Florida causing over \$9 billion in damages. Governor Jeb Bush responded to this massive disaster by issuing executive order 04-188, which temporarily reduced restrictions on roofing contractors. With that executive order, “certified, or registered, general, building, or residential, contractor [were] not required to subcontract roofing work...” Contractors could perform roofing services after obtaining a temporary license, which was conditional on certification of competency from their original jurisdiction. The Department of Business and Professional Regulation explicitly recognized that reducing the licensing requirements would increase the available supply: “This Order provides relief for Hurricane Frances victims by creating a larger pool of licensed individuals to choose from” (Department of Business and Professional Regulation 2004). The *Tampa Bay Business Journal* summarized the law and hinted at the potential supply increases it would allow: “City and county governments can now issue specialty-roofing licenses without the need for additional local enacting ordinances. The specialty licenses can be issued to both in-state and out-of-state contractors who fulfill the requirements...” The executive order would “speed up the rebuilding process” (Tampa Bay Business Journal 2004). The Department of Business and Professional Regulation asserted that the executive order “provides the quickest, most efficient way for these individuals to begin making repairs, while ensuring that consumers are still protected.” Following Hurricane Katrina in 2005, Governor Bush issued executive order 05-148, which similarly extended 60-day provisional licenses to roofers who the State previously prohibited from working.

Governor Bush, the Department of Business and Professional Regulation, and local journalists all recognized that reducing licensing requirements would increase the supply of available contractors. Licensed roofers from out-of-state and General Contractors in Florida who could not previously contract for roofing work, entered the counties worst hit and aided in the rebuilding process.

4. CONCLUSION

Hurricanes destroy peoples' homes, businesses, and communities; there is no reason to compound these losses with higher costs for rebuilding from occupational licensing. Louisiana's licensed contractors are not a "silver bullet" to end corruption. Many people preferred illegal workers in lieu of the costly, legal procedures required with licensed contractors. Government bureaus are slow to respond to increases in permitting and inspection services, which exacerbate the already lengthy delays caused by the shortage of contractors. Unlike Louisiana, which actually increased the licensing requirements, Florida reduced restrictions on roofing contractors, opening up the market for General Contractors to perform roofing services instead of subcontracting the work and allowing an influx of out-of-state suppliers to aid the rebuilding process.

In a market economy, voluntary exchange and changes in relative prices facilitate the coordination of people's desires and the use of scarce resources. It is unfortunate, then, that during a time when consumers have strongly felt needs and a natural disaster has destroyed substantial amounts of a community's resources that the government limits the ability for people to participate in voluntary exchanges. Occupational licensing represents one form of harmful intervention, but governments commonly impose other restrictions during times of crisis. For example, price gouging laws stifle the signal

communicated through changes in prices that generate information about consumer needs, incentivize good resource use, and encourage innovation (Skarbek and Skarbek 2008). When the government imposes rules like these, society is less capable of getting the most out of its scarce resources, and this is perhaps most important to do in times of crisis.

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