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WAR DAMAGE INSURANCE AFTER FIFTY YEARS: War Damage Insurance Revisited

NAME: Jack Hirshleifer

LEXISNEXIS SUMMARY:

... My special thanks to Professor Peter Siegelman for reviving and commenting on my ancient article, and to the editors for asking me to offer some additional thoughts. ... That is, upon retaliatory attack in place of defense. ... The U.S. General Accounting Office, for example, as quoted in an excellent article by Professor Kunreuther, stated that "insurers and reinsurers have determined that terrorism is not an insurable risk at this time." ... What *is* necessary is that insurer and insured both have confidence that valid claims can be met--not absolute 100% confidence, but enough confidence to warrant the one side in selling and the other side in buying policies. ... Terrorism insurance will certainly require a major government role, yet not quite so total a role as in war damage insurance. ... Public discussions typically fail to appreciate the distinction between simple compensation and contributory insurance. ... As emphasized by Professor Siegelman, my paper had argued--on the basis of observation and intuition, rather than analysis--that in the absence of a functioning pre-existing insurance program, demands for gratuitous ex-post compensation would be politically impossible to resist. ... As explained by Professor Siegelman, the fact that relief is more like charity than like lawful entitlement would reduce both the incentive to make claims and the willingness to accede to them. ...

TEXT:

[*41] My special thanks to Professor Peter Siegelman for reviving and commenting on my ancient article, and to the editors for asking me to offer some additional thoughts. Although Professor Siegelman has undoubtedly gone overboard somewhat as to the merits of that old paper, I cannot find it in my heart to condemn him for doing so.

I will provide a few descriptive remarks here as to the earlier background work on war damage insurance, and then comment briefly on possible implications for the topical issue of terrorism insurance.

My 1953 paper,ⁿ¹ and a 1955 article in the *Columbia Law Review* that followed up some of the ideas,ⁿ² were written in the age of nuclear scarcity. Not only were atomic bombs rare and costly, but potential enemies had only minimal capacities for delivering them across the oceans to our borders. These conditions passed away all too rapidly. Fission and then fusion bombs grew frighteningly in numbers and destructive capability, and the Soviets soon developed long-range bombers and then ballistic missiles for delivering them. In the face of such threats, it became conventional wisdom that passive forms of defense--protecting populations by shelters or dispersal, shielding vital factories and other economic assets, improving community police and fire responses, and so forth--could have no substantial mitigating effect. So such efforts were abandoned. In fact that belief and that abandonment were never entirely warranted. Under a number of quite reasonable scenarios, passive defenses might have saved millions of lives and untold amounts of wealth even in an age of nuclear plenty. But those possibilities were thrown overboard by our adopted national strategy of exclusive reliance upon MAD--"mutual assured deterrence." That is, upon retaliatory attack in place of defense.

Suddenly, we now find ourselves in a situation where defenses can certainly make a real difference. The terrorist threat is bounded; it is something that can be grappled with. What we have to contemplate are thousands of casualties--or at the very extreme, numbers in the low millions. Bad enough, but nuclear war might have killed or disabled numbers in the nine digits, indeed very conceivably a majority of our population. Even a [*42] very serious terrorist attack would not threaten national survival. Government, law, and the social order will continue to function. So although atomic war was so "unthinkable" as to seemingly paralyze our capacities for sensible defensive adaptations, that need not be the case here. We can step back and evaluate the pros and cons of possible mitigatory steps, one of which is terrorism insurance.

The second point I want to make concerns the magnitude of the pent-up demands for catastrophe insurance. In World War II the Federal War Damage Corporation issued over 8,000,000 policies with a maximum contingent liability of \$ 140 billion, an enormous sum for those days.ⁿ³ The program earned a nice profit for the government and private co-insurers, since only around \$ 1,000,000 in claims had to be paid out.ⁿ⁴ Or consider the ongoing National Flood Insurance Program (NFIP), for which only properties located in flood plains are eligible.ⁿ⁵ As of December, 2000 the total coverage was over \$ 567 billion.ⁿ⁶ Judging by data published on the web, it seems the NFIP has also been earning a profit. The premium rates have been high enough to cover claims by a good margin, except possibly in very bad flood

years.ⁿ⁷ These indicators suggest there will be intense demand for terrorism insurance, if and when the administrative obstacles can be cleared away.

I want now to take a swipe at an argument sometimes encountered--the supposed "impossibility" of war insurance or terrorism insurance. The U.S. General Accounting Office, for example, as quoted in an excellent article by Professor Kunreuther, stated that "insurers and reinsurers have determined that terrorism is not an insurable risk at this time."ⁿ⁸ It is possible to set up a list of perfectionist requirements for an insurance business: that risks ought to be objectively quantifiable, that they need to be independent of one another, that adverse selection and moral hazard should not exist, and that there ought to be lots of historical experience for working up actuarial tables. That's the kind of hidebound thinking responsible for past assertions that "airplanes will never [*43] get off the ground" or "blitzkrieg attacks will never work--the Maginot Line is impregnable." The insurance business never has and never can meet such ideal conditions--as only one important example, think of long-term care insurance. What *is* necessary is that insurer and insured both have confidence that valid claims can be met--not absolute 100% confidence, but enough confidence to warrant the one side in selling and the other side in buying policies. To support such confidence government always needs to be involved, whether to a relatively minor degree as in ordinary life insurance or in more major ways as in flood insurance. Terrorism insurance will certainly require a major government role, yet not quite so total a role as in war damage insurance.

Let me turn to the central point of the 1953 paper. Public discussions typically fail to appreciate the distinction between simple compensation and contributory insurance. (Simple compensation is of course free insurance). As emphasized by Professor Siegelman, my paper had argued--on the basis of observation and intuition, rather than analysis--that in the absence of a functioning pre-existing insurance program, demands for gratuitous ex-post compensation would be politically impossible to resist.ⁿ⁹ So there is going to be either insurance or gratuitous compensation. Back in World War II every major belligerent (except Russia) had one or the other type of program: contributory insurance in the U.S. and the U.K., simple compensation in Germany and France.ⁿ¹⁰ And bringing matters up to date, Professor Siegelman has described the compensation arrangements undertaken after the 9/11 events.ⁿ¹¹

Why not simple compensation? The problem is that rational anticipation of gratuitous compensation subverts private incentives to self-protect. With regard to terrorist threats, self-protection could have many forms: personal immunization against disease, relocation of places of residence or business properties, and--perhaps the most important--community-level improvements in police and fire and medical services. As an alternative to anticipated gratuitous compensation, terrorism insurance would encourage a whole range of self-protective steps on the part of individuals, businesses, and communities. Of course, insurance availability by no means excludes national defense measures on the part of government. Nor do I want to necessarily [*44] endorse each and every possible mode of private loss prevention or loss mitigation as cost-effective. Nevertheless, in aggregate and over the years, such decentralized actions could significantly reduce national vulnerability.

I now want to offer, without extended argument, a few thoughts on the principles that should underlie a terrorism insurance program.

1. Should private insurance companies be permitted to offer insurance on their own, or should the government be a co-insurer, perhaps the major underwriter? I believe that private companies should be permitted to offer terrorism insurance on a competitive basis, subject to government regulation and standards. Especially in early years of the program before reserves have been accumulated, government backing--along the lines of Federal deposit insurance--will probably be required.

2. Should rates be proportioned to estimates of the risk, or should they be nationally uniform? Yes, proportioned to risk, as estimated by private insurers.

3. Granted that terrorism insurance is offered, should the government subsidize premiums? I do not see my way clearly on this, since arguments might be made either way. Private self-protection and collective military defense are substitutes, to a degree. Since the latter is difficult and expensive in many dimensions, private activity warrants encouragement. This argument militates against subsidy since financial protection through insurance is, on the individual level, a substitute for actions that would physically reduce vulnerability. On the other hand, private strengthening of any particular site against terrorist assault might merely divert attack to other sites. If so, the social benefit of private protection is less than at first appears--a consideration that favors a degree of insurance subsidy.ⁿ¹²

4. Even with an insurance program, after losses are suffered there would surely be demands for relief of the "improvidents" who chose to forego insurance. Should such benefits be paid? Yes, there will be such demands, and to some extent they will surely be responded to. And indeed should be, in my opinion. But relief is quite a different matter from restitution founded upon contractual insurance. As explained by Professor Siegelman, the fact that relief is more like charity than like lawful entitlement would reduce both [*45] the incentive to make claims and the willingness to accede to them.ⁿ¹³ So I do not believe that the prospect of post-disaster relief to uninsured parties would unduly subvert the incentive to insure.

I will call a halt here. Since I have not intensively searched the literature, it may be that all these ideas are already quite familiar to analysts and practitioners in the field. Still, for what they may be worth, I offer them in the hope that some of the suggested lines of reasoning may turn out to be useful.

Legal Topics:

For related research and practice materials, see the following legal topics:

FOOTNOTES:

n1 Jack Hirshleifer, *War Damage Insurance*, 35 REV. ECON. STAT. 144 (1953), 9 CONN. INS. L. J. 1 (2002).

n2 Jack Hirshleifer, *Compensation for War Damage: An Economic View*, 55 COLUM. L. REV. 180 (1955).

n3 *Id.* at 183.

n4 *Id.*

n5 Federal Emergency Management Agency, Insurance: Introduction to the NFIP, at <http://www.fema.gov/nfip/intnfip.htm> (last modified June 27, 2002).

n6 Federal Emergency Management Agency, Insurance: Total Coverage by Calendar Year, at <http://www.fema.gov/nfip/cy00cov.htm> (last modified June 27, 2002).

n7 Douglas Clement, *After the Flood*, FEDGAZETTE, Nov.1, 2001, available at 2001 WL 12750002.

n8 Howard Kunreuther, *The Role of Insurance in Managing Extreme Events: Implications for Terrorism Coverage*, BUS. ECON. Apr. 1, 2002, available at http://www.findarticles.com/cf_dls/m1094/2_37/86851405/print.jhtml.

n9 Hirshleifer, *supra* note 1, at 146-47, 9 Conn. Ins. L. J. at 6.

n10 See U.S. CHAMBER OF COMMERCE, 81st CONG., WAR DAMAGE INDEMNITY, (Comm. Print 1950).

n11 Peter Siegelman, *A New Old Look at Terrorism Insurance: Jack Hirshleifer's War Damage Insurance After Fifty Years*, 9 Conn. Ins. L. J. 19 (2002).

n12 The social benefit does not fall to zero, since the reduced availability of inviting targets raises raiders' costs and risks of attack and so may to some extent discourage attacks entirely. DARIUS LAKDAWALLA & GEORGE ZANJANI, INSURANCE, SELF-PROTECTION, AND THE ECONOMICS OF TERRORISM 2-6 (Nat'l Bureau of Econ. Research, Working Paper No. 9215, 2002), available at <http://www.nber.org/prox.lib.ncsu.edu/papers> (last visited Nov. 9, 2002). And even if the only effect is diversion, there is a gain whenever terrorists have to shift from their prime targets to secondary choices. *Id.*

n13 See Siegelman, *supra* note 12.