Is there a Role for Government Provision of Terrorism Reinsurance?

Kent Smetters
Deputy Assistant Secretary for Economic Policy, US Treasury (currently)[1]
The Wharton School, The University of Pennsylvania (on leave)
NBER

Abstract

The insurance industry has recently promoted legislation that, if enacted, would lead to a government backdrop for terrorism reinsurance. In essence, the federal government would reinsure the reinsurance companies for its terrorism losses. This paper considers four possible rationales for a government backdrop. Each rationale relies on the presence of an externality or a missing market, potentially leading to a failure of the First Fundamental Welfare Theorem. Each rationale is critically analyzed.

First, there might exist moral hazard in the form of ineffective loss control by the government. Specifically, the government is uniquely positioned to control losses due to its investigative powers (e.g., wiretapping) that it does not extend to the private sector due to obvious moral hazard reasons.

Second, there might exist moral hazard in the form of the "Samaritan's Dilemma" in which people willingly refuse terrorism coverage because they know that the government will provide coverage *ex post*. In other words, any *ex-ante* commitment by the government to not provide coverage is not time consistent since people believe that the government will still pick up the broken pieces after a large loss.

Third, it could be argued that there is the presence of “landmark externalities” where key landmarks (and surrounding structures) provide positive externalities to other structures in the form of being a more appealing target for terrorism. In this case, we would expect to see high premiums paid by landmarks with lower premiums paid by non-landmark buildings.

Fourth, a government backup could, in theory, be rationalized by spreading risk across generations. Efficient risk sharing across generations requires future, unborn generations to receive a positive transfer in some states of the world and negative transfers in other states of the world. The private market is unable to write these types of risk-sharing agreements due to the non-negativity constraint on private bequests. I.e., private citizens can only leave positive transfers; they cannot pre-commit the unborn to accept a negative transfer. (Presumably, the government does not give individual, private citizens the right to leave negative transfers due to obvious moral hazard reasons.) The government, however, can maybe provide efficient risk sharing through its taxation authority.

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