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COVID-19 Policy Response Proposal: Macro-Prudential Economic Interruption Insurance

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The 2020 global COVID-19 pandemic has compelled countries around the world to implement widespread and long-term shelter-in-place programs in order to reduce disease transmission and save lives. The experience of implementing these policies in the United States has made three things clear:

1. The social distancing necessary to save lives causes enormous economic disruption, which has required extraordinary policy responses.
2. A lack of prior planning means that the policy responses are ad hoc and suboptimal, which will cause both greater economic losses and more inequitable outcomes than necessary.
3. The development of a planned economic program to sustain shelter-in-place programs when necessary would be a significant public good.

This policy proposal addresses the third point. In this paper, we offer a framework for developing what we refer to as *macro-prudential economic interruption insurance*. "Macro-prudential" refers to the fact that the temporary economic shutdown involved is both macroeconomic in scope and intentionally implemented by the government for the greater good. "Economic interruption insurance" describes the nature of the public good involved: it is insurance provided by the government to offset the imposed interruption of normal commerce. The insurance is designed not just to provide compensation for business losses (as normal business interruption insurance does) but also to minimize the total economic losses that are incurred. The insurance is structured to offer businesses the choice of whether to opt in for full coverage, as well as backstop the economy against the worst outcomes from business failures by those who opt out. And because the insurance coverages are prearranged, all economic actors will be able to plan with more certainty.

This special edition policy brief is intended to promote effective ideas among key decision-makers in response to the COVID-19 pandemic. It has been internally reviewed but not peer reviewed.

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Unfortunately, people can expect that this insurance will likely be needed again. Global pandemics are rare, but they do happen. The COVID-19 pandemic may ultimately be as lethal on a per capita basis as the previous two pandemics in 1957–1958 and 1968, even with the far more vigorous social distancing intervention being employed. Nor is the vigorous social distancing intervention being employed now unprecedented. During the devastating 1918–1919 influenza pandemic, virtually all major US metro areas employed some form of social distancing,[1] and the more vigorously they did so, the more lives were saved. Just as America has learned from experience how many lives can be saved through aggressive social distancing when necessary, so is it also learning that better policy planning could minimize the resulting economic damage.

While this proposal describes a policy that can work on day one, we would emphasize that America is nowhere near the end of the current crisis. Epidemiologists stress that any relaxation of existing social distancing mandates will be gradual and will continue to entail significant restrictions.[2] There will also likely be localized flare-ups of the disease that require the re-imposition of stringent restrictions on a regional scale. And the general public understands this: a recent poll suggests that over 60 percent of Americans would not feel comfortable returning to their regular routines even if the federal government were to lift social distancing guidelines after April 30.[3] Hence, the necessary work of developing an optimal policy response for the next crisis can have immediate applicability to the current crisis.

Finally, a comprehensive policy for macro-prudential economic interruption insurance can provide a unified approach and infrastructure for responding to multiple causes of disaster. There are reasons other than a pandemic that the government might need to employ some form of these policies. A catastrophic radiation event, major earthquake, or even some form of extreme weather conditions could possibly require people to shelter in place for an extended period of time. As with pandemics, insurers often decline to cover such eventualities, recognizing that the resulting nondiversifiable accumulation of risk exceeds the capacity of available private market risk capital. Indeed, the scale of the present experience has served to expose certain gaps in America's existing public-sector disaster relief programs that have historically operated in more localized contexts.

In this brief, we propose a set of policies that minimize the cost of implementing such a closure while prospectively clarifying how the costs and benefits will be apportioned, thus improving efficiency and promoting equity.

THE CURRENT POLICY CONTEXT

The need to employ social distancing to save lives necessarily reduces economic output. The challenge is to manage the process of reducing output as efficiently and fairly as possible. Some of the initial proposals that have been put forward are structured as idealized government "payer of last resort" plans, with certain European countries such as Denmark, France, and Germany offered as

examples.[4] While we are sympathetic to the motivation of these plans, we would note that the tax and social welfare systems of the United States are different in important regards from those of these countries. The United States needs a program that will work efficiently and quickly within its current system.

The current policy response has both fiscal and monetary components. From the fiscal perspective, in the absence of an adequate infrastructure for transfer payments, the Coronavirus Aid, Relief, and Economic Security (CARES) Act sought to employ preexisting structures on an ad hoc basis, restructuring unemployment insurance and repurposing a Small Business Administration program to provide contingent grants.[5] The challenges associated with these stopgap measures have been well chronicled. For example, the government is providing unemployment benefits in excess of employees' previous compensation largely because technological limitations of state unemployment systems cannot guarantee an even match. Likewise, the rollout of the small business paycheck protection program has been marked by widespread disarray and funding delays.

In part because of the difficulties of designing and quickly implementing a large-scale fiscal response, the Federal Reserve (Fed) has implemented policies that range far beyond lowering the cost of funds and making loans more readily available to major banks. Most notably, the Fed is now providing facilities for loaning to small and mid-size businesses, effectively assuming credit risk for commercial entities. These steps take the Fed far beyond even its previous emergency authorities, but they have been authorized by Congress and appear necessary to limit the economic damage taking place.

A more systematic approach would better target assistance and avoid unnecessary damage to the economy. Our objective in this brief is to detail such a policy design so that society will be better prepared to address continuing shelter-in-place requirements imposed in response to the COVID-19 crisis and other large-scale crises that may follow.

MACRO-PRUDENTIAL ECONOMIC INTERRUPTION INSURANCE

We believe a comprehensive macro-prudential economic insurance framework should encompass three interconnected, mutually reinforcing objectives:

1. enable businesses to purchase comprehensive insurance coverage for systemic economic interruption events at an affordable price;
2. establish a baseline economy-wide payment protection safety net for businesses lacking shelter-in-place insurance that is sufficient to curtail systemic second-order shocks resulting from the closure of those businesses; and
3. provide assistance directly to individuals in situations where a business is unable to continue their employment through the duration of a crisis.

A crucial question for any form of insurance is whether it can be more efficiently supplied by the private market. Experience suggests that macro-prudential economic interruption insurance cannot be supplied privately. Catastrophic insurance that is offered by the private market must be diversifiable and idiosyncratic. Examples include property and casualty insurance tied to regularly occurring, localized events such as hurricanes, and insurance for normal business interruption that may occur for any number of reasons. Only the federal government is positioned to provide insurance to cover such nondiversifiable, concentrated risks. Private insurers, for example, proactively eliminated coverage for business losses caused by pandemics and viruses following the SARS outbreak in 2003. Other large-scale catastrophe coverage, including for terrorism, major floods, and earthquakes, has long been the province of government-backed efforts. We therefore believe that macro-prudential economic interruption insurance should be structured to leverage both the capabilities of the private sector and the experience of established public programs.

We would propose three specific policies to meet these objectives:

First, enhance the coverage of existing private business interruption insurance through an effective federal backstop.

Until the advent of SARS, many business interruption insurance policies covered risks associated with shelter-in-place mandates. The SARS episode made clear to insurers that such coverage was uneconomic to offer and infeasible to price. But SARS did not have a material impact on the US economy, so the exclusion of this coverage attracted little attention.

Nor are epidemics the first instance of insurers' refusing to cover certain risks when the potential for loss is high and historical incidence data are scarce. The industry confronted an analogous situation with respect to insuring terrorism risk following the 9/11 attacks, when it stopped covering those risks after recognizing that its exposures were too large and too concentrated to be underwritten economically.[6] The withdrawal of this coverage created challenges for firms particularly exposed to terrorism risks, such as airlines, to continue normal operations.

In response to this market gap, the federal government passed the Terrorism Risk Insurance Act (TRIA). Under TRIA, insurers are required to offer coverage for terrorism events; the government establishes a deductible, or "retention," that insurers must first cover independently, after which the government covers 80 percent of the costs up to a $100 billion cap. These costs are subsequently recovered through an after-event levy on plans. Such policies can include damages for both property loss and business interruption costs.

This model has proven effective in assuring availability of terrorism risk coverage for companies. Over time, the government has increased the retention for which insurers hold risk, encouraging innovation and underwriting discipline by private insurers. We believe a similar approach can be applied to shelter-in-place interruption events. In contrast with terrorism, it may be reasonable

to limit such a backstop to business interruption expenses, as property damage stemming from shelter-in-place policies will be more modest by comparison.

To be sure, introducing a government backstop to private insurance coverage presents certain limitations. Such policies often create opacity with respect to the true economic cost of coverage. Insurers can find ways to benefit by selling poorly written policies whose deficiencies may be exposed only rarely, leading bad actors to drive out good ones. TRIA's structure—including a large and increasing risk retention requirement together with meaningful cost sharing—helps to curtail such incentives. In addition, the insurance industry is regulated, albeit primarily at the state level. The creation of the Federal Insurance Office pursuant to the Dodd-Frank Act further provides federal oversight, including TRIA, and could readily encompass a new policy for macroprudential economic interruption insurance. A similar approach, called the Pandemic Risk Insurance Act (PRIA), is currently under review by the US House Committee on Financial Services.

Second, curtail externalities arising from economic interruptions with a federally operated, limited safety net insurance program.

Absent a federal mandate, not all companies will carry private business interruption insurance that covers large disaster events. Of those that do, some will—even if not today—elect to exclude risk associated with pandemics, just as others presently choose to decline terrorism risk coverage decades after 9/11. While we believe that purchasing coverage should remain the decision of each business, we also recognize that businesses that fail owing to lack of coverage would impose costs on others. Business owners should be able to decide whether to bear the risk of being forced out of business, but such decisions should not in aggregate create large-scale risks for other individuals and businesses that those individuals and businesses cannot mitigate in advance. Consequently, we propose that the government establish a limited insurance program that will provide a safety net for the affected employees and vendors of these businesses.

This approach is similar in philosophy to the role of the Federal Deposit Insurance Corporation (FDIC), a highly successful model for correcting a specific market failure. If individual depositors believe that a bank is at risk of becoming unsound, they will be motivated to withdraw their funds, which will in turn destabilize the bank. Everyone is better off if nobody believes that a bank failure will put his or her savings at risk, so people keep their deposits in the bank. The same logic holds for large-scale economic interruptions: when everyone knows that there is a sufficiently sized, universal level of payment support in place, business managers and consumers will not be as motivated to withhold their spending to increase savings, so investment and consumption will remain at high levels, thereby benefiting the economy.

Comparable to the FDIC, this program would operate as a payer of last resort, temporarily covering senior debt payments,[7] employment costs, and vendor invoices up to an established level. (An important question is the degree to which more junior debt payments, such as rent or subordinated

debt, should be covered; we would emphasize only that the terms should be clear and transparent up front.) There are several proposals in active circulation that achieve this aim, although these vary in their implementation mechanisms.[8] As with the FDIC, the investments of equity holders would not be protected through this program, and in fact they could be sold via a standard receivership process to offset costs.

It may be appropriate for the government to apply a modest tax, or premium, to business incomes to help fund such a program, potentially targeted toward those businesses that decline commercial coverage. Eventually, the government may also seek to risk-rate these amounts, for example by charging a higher premium to larger companies or riskier sectors, similar to the FDIC's approach today.

Third, supplement unemployment insurance programs to provide direct assistance to affected employees.

In the present crisis, there has been an unprecedented increase in unemployment claims, totaling 10 million in the past two weeks. Many state programs carry exclusions for income and working arrangements that leave workers vulnerable to an economic interruption. For example, independent contractors (including so-called gig workers), recent state residents, or low-income workers may be excluded from eligibility. In addition, the payments provided by state programs typically fall well short of full income replacement levels.[9]

The Families First Coronavirus Response Act and, subsequently, the CARES Act have both provided additional temporary coverage to help mitigate the constraints commonly imposed by state programs. While unemployment insurance programs have long been seen as candidates for revamping, we do not suggest a structural reform in this paper. Rather, we would propose that benefits similar to those provided with respect to the current COVID-19 crisis be extended to cover subsequently declared economic interruptions, including the more localized incidence of the disease society may see going forward.

This crisis has also shown the limitations of the current technology systems employed by states, which eventually prompted the decision to pay some workers more in unemployment than they previously received in compensation, as not all states could readily reconfigure their systems to a full income replacement level. Establishing a consistent set of benefits applicable to economic interruptions would enable states to preconfigure and test their systems to more readily handle these circumstances, decreasing processing times and providing for more efficient benefit structures.

CONCLUSION

It is clear now that the COVID-19 pandemic has, in many ways, caught the nation unprepared. While they work to remedy the present situation through necessary improvisations, Americans should also invest time and resources in planning for eventualities that are plainly in sight.

The policies we propose would significantly enhance economic certainty for businesses and their employees that collectively now find themselves operating in an uncertain context. Importantly, these proposals would not necessarily add to the government's expenditures in a time of crisis and may ultimately yield savings. The federal government is likely always to bear the weight of the significant losses caused by social distancing policies and other major disasters. Today, these costs are embedded in a recovery program that presently exceeds $2 trillion, with even more to come. A failure to provide such support is politically untenable, as evidenced by the near-unanimous passage of stimulus legislation that in other times would attract extreme opposition from certain quarters.

The challenges America presently confronts will undoubtedly evolve and are likely to persist for some time. While it is true that the time to fix a leaky roof is when the sun is shining, it is also true that when the roof needs patching, one should make sure to fix it right. Getting the policy response right will provide greater economic certainty for both the current crisis and the next one to come.

ABOUT THE AUTHORS

Patrick Wolff is an investor. He was managing director at Clarium Capital Management, where he worked from 2005 to 2010; he founded and ran Grandmaster Capital Management from 2011 to 2015; and he was managing director at Thiel Macro from 2015 to 2017. Since leaving Thiel Macro, Wolff invests privately and has worked in journalistic and nonprofit roles. Wolff is the founder of the Excellence in Investing for Children's Causes Foundation, which has raised $2 million primarily to support Bay Area–based nonprofits that work with underserved students. Wolff is also a chess grandmaster and was twice US Chess Champion in 1992 and 1995.

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NOTES

1. For a thorough review, see Howard Markel et al., "Nonpharmaceutical Interventions Implemented by US Cities during the 1918-1919 Influenza Pandemic," *Journal of the American Medical Association* 298, no. 6 (2007): 644–54.
2. "Coronavirus 'Is the Big One … I Hope Never to See Bigger': Harvard Epidemiologist," *USA Today*, April 8, 2020; University of California San Francisco, "Update on Covid-19, Focus on the Shape of the Pandemic, Digital Innovation, and the UCSF Response," lecture by George Rutherford, 8:00, April 9, 2020, https://www.youtube.com/watch?v=Odngvcd45ZY.
3. Survey conducted for CNN via telephone by SSRS, April 3–6, 2020, among a sample of 1,002 respondents.
4. Pierre-Olivier Gourinchas, "Flattening the Pandemic and Recession Curves" (Policy Brief No. 23, Economics for Inclusive Prosperity, March 2020); Arindrajit Dube, "Filling the Holes in Family and Business Budgets: Unemployment Benefits

and Work Sharing in the Time of Pandemics" (Policy Brief No. 24, Economics for Inclusive Prosperity, March 2020); Emmanuel Saez and Gabriel Zucman, "Keeping Business Alive: The Government Will Pay" (unpublished manuscript, revised March 16, 2020), PDF file.

5. H.R. 748, 116th Cong., 2nd Sess. (2020).

6. For example, here is what Warren Buffett wrote in his 2001 letter to Berkshire Hathaway shareholders:

    > Insurers have always found it costly to ignore new exposures. Doing that in the case of terrorism, however, could literally bankrupt the industry. No one knows the probability of a nuclear detonation in a major metropolis this year. . . . Nor can anyone, with assurance, assess the probability in this year, or another, of deadly biological chemical agents being introduced simultaneously . . . into multiple office buildings and manufacturing plants. An attack like that would produce astronomical workers' compensation claims. . . . The bottom-line today is that we will write some coverage for terrorist-related losses, including a few non-correlated policies with very large limits. But we will not knowingly expose Berkshire to losses beyond what we can comfortably handle.

    While no one else wrote it as eloquently, everyone else followed the same prescription, and so the industry started universally excluding losses owed to terrorism.

7. Debt is typically structured by order of payment. Senior debt is paid first; in return for this extra protection, the lender will receive a lower interest rate. Junior debt is paid after senior debt is fully repaid; in return for taking this extra risk, the lender will receive a higher interest rate. Debts are contractual relationships, and there are myriad ways that senior and junior debt can be structured, with many different kinds of protections and obligations. Leases and the associated rental payments are a kind of debt, and they are generally a more junior debt (i.e., their claim on the assets stands behind that of other lenders) because in the event of nonpayment the lessor has the ability to lock the doors and forbid further use of the property. Subordinated debt is a particular kind of junior debt.

8. These include a direct payment program as proposed by Emmanuel Saez and Gabriel Zucman, a loan forgiveness program as proposed by Glenn Hubbard and Michael Strain, and tax rebate approaches separately proposed by one of us as well as Senator Josh Hawley.

9. The concept of experience rating of unemployment insurance (UI) may also apply to economic interruptions. With experience rating, an employer pays a base tax rate, which is then adjusted based upon the amount of benefits charged to the employer's account; i.e., how often the employer lays off employees. Since employers pay higher UI taxes if they lay off workers more often, they have an incentive to retain employees. It may be possible to adjust the tax rate applicable to economic interruptions based upon the cash reserves or insurance held by businesses, thereby creating an incentive for businesses to be more resilient.