

FREE RIDER PROBLEMS IN INSURANCE-BASED PRIVATE DEFENSE

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Let us construct a libertarian theory of war and peace.

— Murray Rothbard¹

LIBERTARIAN WRITERS INCLUDING HOPPE, HUMMEL, and Murphy have attempted to deal with the presence of free riders in theoretical private defense constructs. As with the provision of most public goods, free riders are also a problem in the production of security. This paper proposes a solution toward the free rider problem and analyzes further problems previously unconsidered in the literature.

THE NATURE OF PRIVATE WAR

To begin a discussion of insurance-based defense, we need to explore the differences between a hypothetical private war and current warfare between states. When products are brought from government control into private hands, the nature of the product often changes. War and security would certainly change with privatization. Market forces would necessarily requires new objectives and weapons in wars.

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¹ Rothbard, Murray. "War, Peace, and the State" In *Egalitarianism as a Revolt against Human Nature: and Other Essays*. Washington, D.C.: Libertarian Review Press, 1974. p. 66.

Much of the current privatization literature assumes that private wars would center on territorial acquisition. Certainly, the objective of any government lies in maintaining a monopoly of force within a certain territorial boundary. With territory being the primary incentive of governments, wars have unsurprisingly been fought for millennia over this age-old government incentive structure.

However, without a desire to form a coercive monopoly, a private defense firm faces a different set of incentives and picks fights with a sense of profit and loss. As Bob Murphy notes, “Combat is very expensive, and private companies take much better care of their assets than government officials take care of their subjects’ lives and property.”² While the government has lesser concern for “subjects’ lives and property,” private companies must take into account these factors affecting their balance sheets. Furthermore, if a private defense firm wished to annex territory in war, it would run into a series of obstacles. First, companies would likely have strict charters and mission statements guiding their actions. Many customers would be skeptical of hiring with a firm bent on domination.³ But more importantly, private companies lack effective claims to sovereignty. The capability of a private company to maintain a coercive monopoly would be at the very least politically volatile and at worst, it would incite rebellion amongst the local population.

Nonetheless, there exist two possible benefits to land acquisition by a private force. First, the freed citizens could become future customers. Second, property seizure could result in company profits—especially seizures of public lands. The second consideration could produce incentives akin to privateers in olden naval conflicts. The privateers fought with a goal of capturing enemy ships and reselling their cargo and hulls privately to the highest bidder at the home port. Similarly, private armies could capture government property such as courthouses, roads, and parks with the intent of resale on the private market. However, this “privateering” could run into problems regarding the sovereignty and title of the captured property. The local residents may not recognize the right of the company to confiscate these public properties. After all, privateers captured foreign ships and resold them in the domestic country—not foreign one. Imagine a revolutionary war American privateer capturing a British ship and then reselling it to British taxpayers in London. It’s certainly

² Murphy, Robert. *Chaos Theory: Two Essay on Market Anarchy*. New York. RJ Communications LLC, 2002. p. 19.

³ But then again, some may invest for this very reason!

possible, but many people would stay clear of such trade. To make matters worse, land is even more personal: the locals might be very angry to see their local city park being sold by a private army. However, other assets in the state's possession might be easier to capture and trade e.g. the gold in Fort Knox, airplanes, tanks, missiles, technologies, etc.

Another different incentive for a private defense firm is the point where combat ceases. The defense firm fights until marginal benefit equals marginal cost. This cost/benefit analysis does not need to be purely nominal. The firm may be defending its homeland and could be fueled by the pure nominal profit motive by elements such as patriotism and duty. Also, contracts may force private companies to fight at a loss. Some of these contracts may stipulate lengths of combat, casualties, and territorial control. Without these sorts of contracts, many customers would be unwilling to hire a firm that isn't obligated to keep fighting in the worst case scenario.⁴ Since private armies have different incentives, this will necessarily change the nature of a war between a private army and a state.

INCENTIVES TO AVOID COMBAT

Private insurance-based defense runs into a web of problems most notably the free rider. The insurance company desires to militarily defend property while simultaneously wishing to avoid a costly conflict. Warfare causes damage to lives and property. As a result, even in the act of defense, the private army may endanger the property of paying customers. Murphy acknowledges this reluctance to war, ". . . incentives for peaceful resolution of disputes would be far greater in market anarchy than the present system."⁵ At first thought, the company would prefer to be annexed by a state with no altercation whatsoever. However, consider that the aggressor has the power of taxation and regulation which will adversely affect profits, the customer base, and daily business operations. In fact, it is highly unlikely that the private army will be allowed to operate in the annexed territory at all. The whole point of having a monopoly on

⁴ Nonetheless, the private defense firm still fights until marginal benefit equals marginal cost. The price of rescinding on prior contractual agreements enters into the calculation. Stipulated clear contracts would raise the costs of surrendering early reducing this outcome, but these contracts do not fundamentally change the decision-making process.

⁵ Murphy, Robert. *Chaos Theory: Two Essay on Market Anarchy*. New York. RJ Communications LLC, 2002. p. 19.

violence is to be the only force in the area. If the insurance and private defense companies refused to fight, they would likely cease to exist.

The firm must weigh the costs of defense versus the subjective probability of new taxes and regulations implemented by the conquerors. An important additional cost to ponder would be reputation. If customers expected the company to resist, they will never again choose the company. Even if the company avoids new regulations and taxes, its customer base will completely disappear. Though the decision to fight or not to fight seems like an easy cost benefit analysis, it is most certainly anything but simple. The firm must essentially decide between fighting or permanently losing its reputations—if not its whole capabilities to operate the business in a new regulatory regime.

VICTORY OBJECTIVES OF THE PRIVATE FIRM

With different incentives, victory objectives will change as well. As mentioned earlier, the private defense company has little capability or reasons to outright conquer an invading nation. With its limitations, the private firm would be far more effective causing public choice problems inside the aggressor's domain. The insurance company simply wants aggression to end—it does not seek to conquer the aggressor. The private company seeks to politically destabilize the aggressor and force him into a peace treaty or truce. As a result, the private defense would focus on hearts and minds rather than borders and territories. Hans Hermann Hoppe reiterates this idea by stating:

. . . insurers would be ready to counterattack and kill—wether with long-range precision weapons or assassination commandos—state agents from the top of the government hierarchy of king, president, or prime minister on downward while seeking to avoid or minimize collateral damage to property of innocent civilians (nonstate agents). They would thereby encourage internal resistance against the aggressor government, promote its delegitimization, and possibly incite the liberation and transformation of the state territory into a free country.⁶

The 1999 NATO Kosovo campaign is a perfect case study of this war methodology. There was no attempt to physically occupy Serbia by

⁶ Hoppe, Hans-Hermann. *The Myth of National Defense*. "Government and the Private Production of Defense." Auburn, AL. Ludwig von Mises Institute, 2003. p .368.

allied forces. NATO achieved its ends by destroying government infrastructure and the civilian economy with the fewest casualties possible. These actions in turn caused a change in Serbia's political climate. The Serbian president, Slobodan Milosevic, was politically cornered to the point where he had to order withdrawal from Kosovo—however NATO ground troops never physically marched into Belgrade or any part of Serbia. At the next election, Slobodan Milosevic narrowly lost. Later, he was surrendered to The Hague for war crimes by his own people. This Balkan conflict serves as a model for a private war response centering on public choice problems and hearts/minds.

In response to a private army, the state would adjust strategy its strategy as well. When battling a private firm, the state has no clear objectives common in state-to-state warfare such as capturing a capital, a leader, a Reichstag, etc. In this case, the government fights a baseless foe seeking profits. A reasonable goal would be to bankrupt the private company with a military campaign bent on maximizing financial losses. Hoppe referring to state warfare claims, "While the attacker still must be selective regarding the targets of his attack—if for no other reason than that even taxing agencies (states) are ultimately constrained by scarcity—the aggressor has little or no incentive to avoid or minimize collateral damage."⁷ The private company has an interest in minimizing collateral damage to customers. But when states attack a private defender, no such incentive exists. In conventional warfare, the state has "little or no incentive" to attack civilians or preserve lives.⁸ With a private army versus a state conflict, the incentives are suddenly drastically reversed. The state's primary incentive is to destroy the property of the insurance company patrons. The more customers killed and the more property destroyed the closer the private insurer comes to insolvency. If the two forces were battling over a block of insured property, the outcome would be horrendous. When government lacks a target, it always turns on the civilian population. A common example is most states' reactions to guerilla warfare. Without being able to target guerilla bases, the state begins to harass, arrest, or even murder suspected supporters in the

⁷ Hoppe, Hans-Hermann. *The Myth of National Defense*. "Government and the Private Production of Defense." Auburn, AL. Ludwig von Mises Institute, 2003. p. 358.

⁸ A state is not completely indifferent to lives and property. Certainly, there is some incentive to destroy the tax base or murder able bodied men of fighting age. In the worst case scenarios, some of these maniacal incentives take place in the form of genocide.

civilian population. Even the United States, a mostly just occupying force,⁹ randomly searches houses and destroys property of innocents in the process of battling insurgency in Iraq and Afghanistan. If the private defense lost in the defense of an insured block, the state would simply burn the entire block causing catastrophic damage in order to bankrupt the insurance company. With the destroyed property, the insurance company will be required to pay extravagant payments to policy holders.

The largest insured institutions with the biggest policies such as factories and skyscrapers would be the most valuable targets. Murphy suggests that large corporations would be the solution to the free rider problem. Instead, these corporations may be the Achilles heel instead. How many skyscrapers or factories does an attacking state need to bomb in order to bankrupt an insurance company engaged in an expensive war? Maybe only a dozen or so. Destroying insured buildings is an even easier task than relinquishing territory from another state. Murphy's argument states,

But make no mistake, military defense would be adequately funded, for the simple reason that shareholders of rich companies are anything but reckless when it comes to money. . . . The highest contributors might even advertise this fact, much as large corporations make ostentatious donations to charity in order to curry goodwill.¹⁰

Advertising would be catastrophic for the insured companies. This would be equivalent to openly showing the enemy your weak spot. The largest payers would become the biggest targets. In this sense, insurance policies would make large corporations less safe. Free riders could be safer than paying customers by not possessing insurance.

This could obviously create many free riders. The free rider gains from a lessened probability of war created by insurance payers, and he suffers less damage during the war. This counters Murphy's argument advanced in *Chaos Theory* which claims that big interests would carry the slack for free riders. In fact a neighborhood without any insurance customers in wartime would be the safest place to live. With no insured property to destroy and no troops defending the

⁹ This is not to mean the invasion of Iraq was just. However, despite Abu-Ghraib and U.S. torture techniques most reasonable individuals would prefer occupation by U.S. forces rather than many other world governments.

¹⁰ Murphy, Robert. *Chaos Theory: Two Essays on Market Anarchy*. New York: RJ Communications LLC, 2002. p. 43-44.

area, an invading army would have no reason to disturb the neighborhood. An insured home would actually produce negative externalities to surrounding neighbors as an invading army would seek to destroy it.

OVERCOMING THE FREE RIDER

With the targeting concerns mentioned in the last section, preventing free riders could become extremely difficult. Considering these problems mainly occur in actual combat, the private society would prefer to avoid conflict. However, to better understand a consumer’s decision-making process, the diagram below lists his choices and outcomes in various states conditions of war:

WAR OUTCOME	INSURED CITIZEN	UNINSURED CITIZEN
State Wins	<ol style="list-style-type: none"> 1. Loses freedom 2. Target of more damage 3. Possibly compensated for damage 	<ol style="list-style-type: none"> 1. Loses freedom 2. Target of less damage 3. Suffers all damage personally
Private Society Wins	<ol style="list-style-type: none"> 1. Target of more damage 2. Compensated for damage 	<ol style="list-style-type: none"> 1. Target of less damage 2. Suffers all damage personally

The uninsured free rider only benefits on the lowered probability of assault. In the event of an actual war, those without insurance will suffer the most. Though the insured will be more targeted, they will also be compensated for damages. The insured have far less to lose than the person without insurance. Any collateral damage to the uninsured will not be compensated. And wars always result in some collateral damage. The moment a war begins, the free rider is in big trouble. At this point, no one is protecting his or her property, and all damage will come out of his pockets.

However, for the insured to receive compensation, the insurance company must choose a point of surrender where it still remains solvent. Without this sort of calculation, the insurance company would fight until bankruptcy—leaving no funds for the compensation of damages. If the insurance company has prudently made this calculation for surrender, the insured will be compensated regardless of the war’s outcome.

Much like Murphy, the Tannehills in *Market for Liberty* miss this connection between insurance and defense. According to them, the price of defense would be another overhead cost in production. Anyone buying a product would indirectly provide to the common defense provided by corporations. The Tannehills befuddle their message by saying,

A major portion of the cost of defense against foreign aggression in a laissez-faire society would be borne originally by business and industry, as owners of industrial plants obviously have a much greater investment to defend than do owners of little houses in suburbia.¹¹

Small homeowners will still greatly demand insurance and will provide a large portion of the defense funds. The Tannehills mistakenly separate insurance from defense. Although, the “little houses in suburbia” are assisted by a lessened probability of attack, they are not covered for damages caused by war. A corporation has far more to lose in absolute terms from wind damage than a suburban home, but this doesn’t mean that homeowners will not purchase insurance for wind damage. The tie between insurance and defense eliminates this proposed solution and perceived dilemma. Homeowners wish to insure their property for damages as much as anyone. Those living next to aggressive states would likely be as insured for war as those living in Florida are now insured for hurricanes. There isn’t much reason to believe the majority of residents would refuse participation.

Furthermore, war insurance does not necessarily have to keep the same form. New services could develop in the industry. For example, if the insurance company loses a conflict while still maintaining enough financial reserves to fulfill contractual agreements, the company could settle with customers monetarily to assist them with relocation. Today, refugees flee war torn countries only to be met by abysmal refugee camps. Imagine the alternative of private insurance. Refugees with insurance settlements could have the money to relocate almost anywhere. The free rider would appear far less care free. After a failed war, the uninsured would be starving in refugee camps while the insured received payment from the company. Even if the company can’t pay all of its claims, receiving some money in the case of a lost war is better than being left with nothing at all.

¹¹ Tannehill, Morris and Linda. *The Market for Liberty*. Lansing, Michigan. 1970. P. 131.

STRENGTHS AND WEAKNESS OF PRIVATE DEFENSE

A common libertarian argument for private troops is that the efficiency gains of privatization would themselves overcome government troops. Private societies would perform a superior job of controlling costs while maintaining greater wealth leading to greater military power. Jeff Hummel perfectly illustrates this perspective:

The same three categories of productive factors—labor (human resources), land (natural resources), and capital goods (wealth and technology)—serve as inputs into any military endeavor, with the labor applied having both a quantitative dimension and a qualitative, human-capital dimension. The combatant who can marshal a greater input of any one of these factors, *ceteris paribus*, has a military advantage, although there will be numerous situations under which governments decide that actually allocating these resources to war is not worth the potential gain in territory and revenue.¹²

Hummel stumbles over several problems here. In his own words, he reveals the problematic discrepancy by noting, “the combatant who can marshal a greater input of any one of these factors, *ceteris paribus*, has a military advantage . . .” The market and the state have different methods for allocating or “marshaling” resources. Governments amass and marshal military resources to build aggressive war engines beyond the necessities of defense. What else is aggressive territorial warfare than the surplus of military forces beyond a naturally demanded amount in the marketplace for defense? And the state has incentives to manufacture different weapons than the free market. For example, the creation of nuclear missiles would be hard to imagine arising from pure supply and demand.

However, government military expenditure might force the production allocations of the private society. As the government increases military technology and spending, private armies must catch up leading to a private versus state “Cold War.” The private society would certainly possess the wealth to outperform the state, but would consumers’ elasticities of demand for defense keep up with the outrageous military expenditures of modern states. Consumers facing astronomical insurance rates to keep up with those expenditures would have some breaking point. While the consumer has a limit to his demand for insurance, states can continue to

¹² Hummel, Jeffrey. *The Myth of National Defense*. “The Will to be Free: The Role of Ideology in National Defense.” Auburn, AL. Ludwig von Mises Institute, 2003. p. 284.

inflate their currencies and tax the population to provide for the military budgets. Even countries experiencing hyperinflation maintain control of the populace.

The most devastating argument to the private market efficiency advantage is the ability of governments to also hire private armies! This already takes place in Iraq with Blackwater U.S.A.,¹³ a private army hired by the United States. Also, history has long track record of naval privateers battling alongside national naval forces. Though contractors don't have the exact same performance as purely private companies, this option would still give the state many of the market's advantages.

However, the market would likely focus on defensive strategies rather offensive innovations. As a result, private technology might have limited use for states. Over the long run, the private society would gain an upper hand in defensive technology. The current direction of military technology encourages destructive and offensive weaponry. Were market forces allowed to flourish in military technology, demand would develop defensive technologies and downplay offensives tools. Political rent seekers thrive on war, but the natural demand of most people rests with peace and security of their own property and persons. Despite this fact, almost every government military technology emphasizes offense rather than defense from long range bombers in the United States to the SCUD missiles of Saddam Hussein. Worldwide spending predominantly goes to offensive technologies crowding out less contractually-demand defensive technologies. In the absence of government intervention, the emergence of novel defense technologies would be styled to the new objectives. For example, instead of building the stealthiest airplanes in the world, the market would likely build the deadliest SAMs (Surface to Air Missiles) possible. This approach is the complete reverse of modern technology. Today, the world has spectacular bombing aircraft but no effective technologies to bring them down.

Despite some advantages of market incentives, private armies could be particularly disadvantaged in hiring private troops—after all, states have the power of drafting troops. While private hiring may be more efficient at the beginning of war, costs may later skyrocket on the private market. As the war goes on and becomes more violent, the private company will have to pay higher and higher wages to attract additional soldiers. Murphy tries to spin this as an

¹³ www.blackwaterusa.com

advantage by commenting, “For example, those areas on the front in urgent need of soldiers or ammunition would bid up their wages or prices, avoiding the arbitrariness of government troop deployment and supply.”¹⁴ At first, this seems to be a reasonable and efficient method. But consider the wages necessary to attract a soldier to World War I trench warfare. Preferences to avoid this butchery are nearly lexicographic; no price can entice the majority of agents. Private forces must address these costs while the state can coercively draft soldiers. Sechrest’s historical reference gives some relief to the private society argument, “It should be recognized that bot profit and patriotism usually motivated the actions of those who invested in, or served as part of the crew of, a privateer.”¹⁵ This could result in lower wages as service may be patriotically motivated. Despite the reputations of mercenaries, money need not be the only motivator for private armies. There will always be patriots who will fight for glory, God, and country with next to nonexistent wages in relation to the risk—just like voluntary U.S. troops today.

One critical objection to the concept of insurance-based defense revolves around Mises’s discussion of subjective and objective probabilities. The probability of war necessarily requires a subjective evaluation of probabilities. Though this seems to be a problem for the insurance industry, history of the industry can guide us by demonstrating successful utilization of subjective probabilities. Subjective probabilities were the foundation of the earliest emergence of the insurance industry. One specific example fitted to war is naval insurance. Clark in *Marine Insurance in Eighteenth-Century La Rochelle*¹⁶ provides historical rates for the insurance and observes adjustments taking place in response to war expectations. Although war is a unique event, the insurance rates in La Rochelle, France adequately adjusted to meet the subjective probabilities of war between France and England. Without actuarial tables, ancient underwriters and insurers systematically made a profit on these ventures.

Insurance companies were formed long before all probabilities could be calculated. Even today, insurance companies prepare for

¹⁴ Murphy, Robert. *Chaos Theory: Two Essays on Market Anarchy*. New York: RJ Communications LLC, 2002. p. 49.

¹⁵ Sechrest, Larry. *The Myth of National Defense*. “The Will to be Free: The Role of Ideology in National Defense.” Auburn, AL: Ludwig von Mises Institute, 2003. p. 249.

¹⁶ Clark, G. John. “Marine Insurance in Eighteenth-Century La Rochelle.” *French Historical Studies*, Vol. 10, Issue 4. Fall 1978.

one-in-a-hundred year events and insure for unpredictable catastrophes such as earthquakes. These same subjective probabilities could be applied in modern war insurance.

Though private market efficiency has its benefits, the main strategic advantage of private armies is the absence of a central operation point. Once government buildings and infrastructure have been seized, usually a state collapses. On the other hand, the offices of a private army may not even be located in the war zone. In fact, office locations could be specifically diversified to lower risk. For example, Blackwater U.S.A. could fight a war in Sierra Leone, cede the entire territory to the enemy, and then continue resistance from headquarters located in North Carolina, U.S.A. The aggressor state would have to attack the United States to eliminate Blackwater—raising all sorts of problems in the process. The base of operations could be further diversified—imagine a Blackwater North Carolina, Blackwater Brussels, and Blackwater Beijing offices. With even three diversified locations, elimination of the command structure becomes virtually impossible. The state loses complete direction of assault.

This approach is much more preferable to often lauded abilities of guerilla warfare tactics. Hoppe and Stromberg as well as innumerable libertarians support idea of guerilla warfare based defense. Hoppe mentions Switzerland as the exemplar of the armed civilian populace. Though Switzerland seems rather successful with its defense by armed citizens, the country's success remains particularly hard to pinpoint on guerilla armament. The geography of Switzerland is as ominous as the armed and trained citizens. Furthermore, the support for guerilla warfare as a method of defense seems to go against some of the most basic tenets of the market—the division of labor. Why should the division of labor force the consumer to provide for his own defense? To support this view is to suggest division of labor is not applicable to defense and it instead requires collective action.

Most importantly guerilla warfare resistance is not defense. An armed individual can do nothing to halt a hundred tanks steam-rolling through a town. Hoppe along with others makes the mistake of assuming a collective defense mentality. An armed populace does not act as one in defense. Each person is armed and reacts individually. In the reality of combat, guerilla fighters do not fight together; they fight separately and distantly from the entire collective. This can be seen in the current Iraq and Afghanistan wars. The insurgents battle in different cells. They do not commit massive attacks simultaneously. The attacks consist of small individual clusters separate from

the entire resistance. Such forms of resistance can do little to protect borders.

If any resistance creates free riders, it is guerilla warfare. The Chechen war against Russia is often glamorized as a victory for guerilla forces. In reality, the Chechnyan guerilla forces are estimated to be between 1,600 and 1,800 troops by 1999,¹⁷ approximately 0.24% of the Chechen population.¹⁸ Though guerilla warfare was effective at destabilizing Russia politically, getting enough recruits to militarily remove Russian troops has proven impossible. Most people hate their occupiers; few actually join resistance groups. In general, most individuals have a preference to life over freedom. Guerilla warfare is an effective form of resistance for a prolonged war in which a private defense has already lost, but it is a pure plan for the first line of defense. Only a few examples of pure guerilla warfare can be properly labeled defense such as the Americans at Lexington during the Revolutionary War. At other times during the same war, Washington maneuvered a standing army with conscription. Furthermore, Jeff Hummel provides evidence of free rider problems in the American Revolutionary War by pointing out, “Colonial governments required those enrolled furnish their own arms (no small expense) and to muster for regularly scheduled training. Failure to do so resulted in fines.”¹⁹ In the case of the Revolutionary War, which had vast support in the population, forced conscription and fines were still necessary. Stromberg reveals the guerilla’s weakness by stating, “Guerilla strategists allow the enemy to advance into the interior, where his supply lines are longer, where he lacks popular support, and where partisans can harass his overextended armies. They force the enemy to exhaust his manpower and resources holding ground. . . .” The entire objective of defense is to prevent enemy forces from entering into the interior or holding any ground at all! Standing armies are not without logic.

Guerillas have similar objectives to private armies by seeking to disrupt political support inside the foreign aggressor’s homeland. A clear example is Iraq where insurgents are successfully changing America’s political climate toward the Iraq war. While making no military strategic gains and failing to actually overthrow any U.S.

¹⁷ Kramer, Mark. *Europe-Asia Studies*. “Guerilla Warfare, Counterinsurgency and Terrorism in the North Caucasus: The Military Dimension of the Russian-Chechen Conflict.” Vol. 57, No. 2, March 2005. p. 216.

¹⁸ *Ibid.* p. 210.

¹⁹ Hummel, R. Jeffrey. *Journal of Libertarian Studies*. “The American Militia and the Origin of Conscription: a Reassessment. Vol. 15, No. 4, Fall 2001.

bases, the insurgents have affected America's political climate enough to aid the election of the anti-Iraq war candidate, Barack Obama. Admittedly, guerillas can change the political climate rather quickly. But many times governments are stubborn and refuse to relinquish power. Low intensity combat can last decades and in the example of Ireland, centuries. Guerilla defense is not an option for insurance companies wishing to satisfy customers.

Another obstacle for private armies are property rights and accountability. Respecting property rights may seem to be a hindrance, but all armies need the support of the domestic population. With political delegitimization of the state as a primary goal, the support of domestic and foreign sentiments is crucial. A strong respect for private property becomes advantageous. Guido Hülsmann notes, "Rather, it is the most powerful means to convey support of the population. It is therefore no military disadvantage when our libertarian warriors pledge to respect the property of friends and foes. Quite to the contrary, it would be disastrous for the government not to quickly adopt the same strategy."²⁰ Hülsmann points out that guerilla groups who employ terrorism against citizens and governments have low chances of long-run success.

CAPITAL FOR PRIVATE DEFENSE

To understand the possibility of insurance-based private defense, we must analyze the current insurance industry's capabilities to cover disastrous events. In 2005, the U.S. General Accountability Office (GAO) set the insurance industry's equity capital levels also known as surplus levels to \$347 billion dollars.²¹ An estimated 20% of funds or \$69.4 billion dollars would lead to significant solvency issues in some companies. A portion of companies would experience critical solvency problems. The rest could meet contractual agreements above the 20% line. The Wharton School at the University of Pennsylvania made a study suggesting that the insurance industry could provide coverage for 92.8% of claims in a

²⁰ Hülsmann Guido, Jörg. *The Myth of National Defense*. "Secession and the Production of Defense." Auburn, AL. Ludwig von Mises Institute, 2003. p. 400.

²¹ GAO (General Accountability Office).. "CATASTROPHE RISK U.S. and European Approaches to Insure Natural Catastrophe and Terrorism." Report to the Chairman, Committee on Financial Services, House of Representatives. February 2005. p. 11.

\$100 billion damage storm.²² This level of funding would be certainly enough to combat most threats. Furthermore, a sum of \$347 billion is enough funds to even stand up to super-powers such as the United States in a conflict. It's an overwhelming amount of resources when compared to smaller belligerents such as Iraq or Afghanistan. Few countries could truly threaten the private society.

Other insurance markets such as health and life insurance could provide additional interested parties in providing defense.²³ Furthermore, these scenarios take into account only property insurance un-backed by reinsurance. In 1999, the Reinsurance Association of America presented congressional testimony stating, "The capital markets potential to provide capacity for natural disasters reaches into the trillions of dollars."²⁴

The current system is already overcapitalized with only the threat of natural disasters. With the new risk of war, capitalization will grow to meet the additional risk. Reinsurance on multiple layers would play a key role in providing necessary risk protection. U.S. capital markets can reach trillions of dollars, but the world market holds even greater resources. Today, almost half of U.S. reinsurance is covered by foreign markets.²⁵ This insurance structure gives private societies powerful advantages. The state draws resources from taxation while the private society utilizes international capital markets. Insurance companies are contractual webs of interests connecting various parts of the globe. The actual fighting may be occurring in Germany but the funding could be coming from Canada and Cambodia. Distancing finance from the battlefield adds additional protection for a private society. Even if the state directly attacks the headquarters of an insurance company, a separate reinsurance company could be providing funds from another location. The international financial community is not defined by borders.

²² Nutter W. Franklin, Reinsurance Association of America. Congressional Testimony Hearing on S. 1361 the Natural Disaster Protection and Insurance Act of 1999 before the Senate Committee on Commerce, Science, and Transportation. April 13, 2000. p. 1.

²³ Car insurance companies would even have a stake as history has shown plenty of overzealous tank drivers entering cities with little respect for parked motorists.

²⁴ *Ibid.* p. 6.

²⁵ GAO. "CATASTROPHE INSURANCE RISKS The Role of Risk-Linked Securities and Factors Affecting Their Use," Report to the Chairman, Committee on Financial Services, House of Representatives. September 2002. p. 13.

Also, insurance companies never place their eggs in one basket. Any insured area would have the majority of customers located elsewhere. Geographical diversification and a focus on systematic disaster risk avoidance are insurance company standards. In fact most companies will refuse to accept policies beyond a certain level in a single geographic area. For this reason, an invading state would be assaulting multiple companies at once. This would be a fight of one state versus a single insurance company, but rather a single state versus dozens of allied insurance companies. Some of these firms may utilize political or military influence from their own national government against the invader—complicating matters even further. Each company would likely contract different private defense agencies or they could combine their efforts into a collective resistance. The state would have to go beyond bankrupting one insurance company and a single defense company. The state would have to bankrupt dozens of companies as well as drain the world's reinsurance and capital markets. In light of these facts, a government's attack seems futile.

Incentives for State Invasion

A private society without government regulation will possess enticing wealth as well as an unwelcome counter example to state power. The private society would also be involved in global unrestricted trade. Their lack of any strategic foreign policy would likely achieve complete neutrality with most nations. An attack on a civilized, peaceful, prosperous, and neutral private society could be viewed unfavorably in the eyes of international organizations such as the UN or NATO. These organizations or other states with trade interest in the private society may come to the rescue. Those within the private society are not the only ones profiting from a regulation-free zone. There is a strong likelihood of nearby states possessing financial interest inside the private society. These companies would produce political problems to any proposed invasions. Imagine the corporate political outcry were the U.S. to occupy Mexico. Countless corporations located near the border taking advantage of loose regulations and wage requirements would be devastated. These companies would suddenly be under the jurisdiction of U.S. rules and regulations. Similarly, were another state to invade Mexico, stakeholders all over the world might lend a hand to stop this encroachment on their investments. The First Gulf War perfectly exemplifies this scenario. The United States and most of the world had large financial interests in Kuwait through the importance of oil. When Saddam Hussein invaded Kuwait, American and coalition forces came to the rescue desiring to protect corporate interests. Similarly, plenty of

states would take interests in keeping the successful private societies without a state.

CONCLUSION

Ludwig von Mises once compared war to earthquakes.²⁶ Both may be insured, but only one can be prevented. The state has many advantages in long term warfare against private armies. However, private armies do not fight for territory but profit. Whether, the war is won or lost, insurance holders will fare better than the uninsured. The free rider only rides on a lowered probability of warfare, but as soon as a war breaks out, he's in huge trouble.

Guerilla warfare creates free riders and is not an adequate form of defense. With insurance tied to war working no differently than hurricane coverage, insurance companies will be able to effectively persuade the population into purchasing policies. With mass contractual reinsurance on a global basis, the private society can raise enough funds to compete with the military capacity of states. Through profit, contracts, and voluntary agreements, private armies can defend themselves.

²⁶ Mises, von Ludwig. *Nation, State, and Economy*. p. 154.

