Insurance Price Controls, "Affordability," and Taxation by Regulation

Benjamin Zycher

Kangaroo courts. A presumption of guilt before innocence. Sentence, then verdict, then trial. Irrelevance of exculpatory evidence. Dishonesty by prosecution witnesses. Rewriting of rules to deny due process. Consistent violation of procedural safeguards.

No, I am not talking about Iraq. As insurance rate regulation increasingly is seen and treated as a struggle among interest groups for shares of a pie allocated by regulator-politicians, those manifestations of regulatory dishonesty inexorably will become the rules of the game known as insurance rate regulation in many U.S. states. More specifically, regulation of insurance rates, traditionally aimed at preserving insurer solvency and "fairness" in the rate structure—that is, efficiency, defined as rates reflecting expected losses for given consumers and consumer classes—increasingly has been transformed into a system designed to guarantee "affordability." What that means in practice—indeed, it cannot mean anything else—is regulators' imposing binding price controls on insurance services experiencing rapid increases in costs. That in industry parlance is the growing phenomenon known as "rate suppression" and is particularly acute in property-casualty and workers' compensation insurance.

Because regulation of insurance rates is becoming politicized, which is to say, subjected to fierce interest group competition, wealth redistribution will come to hold center stage among the various regulatory goals. Again, that means, as day follows night, that the imposition of binding price controls on insurance, with all of their attendant effects, both inevitable and perverse, is the wave of the future. That is the fundamental implication of the substitution of "affordability" for solvency and efficiency considerations in the regulatory approval of rates, combined with the increasingly short time horizons of regulators.

Benjamin Zycher is Vice President for Research at the Milken Institute for Job and Capital Formation.

Two central realities link the "affordability" end with the price control means. First, rate regulation by state officials can do nothing about the inexorable rise in underlying costs, as the cost increases afflict medical care and other sectors highly complementary with the provision of insurance services. As even the federal government almost never is capable of restraining input costs important for given goods and services sectors, only insurance rates themselves, from the viewpoint of state regulators, are subject to direct influence. Second, the "affordability" goal, when translated by political behavior into actual rules and policies, inexorably is transformed into a wealth redistribution mechanism. Since regulators have neither the power to tax (explicitly) nor the power of the purse, the redistribution goal evolves quickly into a system of implicit subsidies, under which some rates are maintained at levels that are artificially high so that others can be held down.

Market Incentives for Low Solvency Risk

Such a system of implicit subsidies is viable only in the short run because the highly competitive nature of insurance markets means that the higher rates on some services needed to support the subsidized rates on others will tend to be competed down by rivals. But if the regulated system of implicit subsidies is not viable, then the wealth redistribution itself cannot be maintained without a steady erosion of insurer solvency, an issue to which I return below. For now, it is useful to review the historical record on insurer insolvencies, as well as the market forces that provide incentives for a high degree of reliability.

Regulation of insurance rates, traditionally aimed at preserving insurer solvency and "fairness" in rate structure, increasingly has been transformed into a system designed to guarantee "affordability."

The growing clamor over the insolvency problem in the insurance industry has obscured the relatively small magnitude of the problem. By the mid-1980s there were about 3,600 property-casualty insurance companies in the United States; an annual average of six property-casualty insurance failures requiring guaranty fund assessments occurred in the 1970s, of which a third took place in 1975. The annual insolvency rate from 1984 to 1989 was considerably higher than the historical experience, but still was always lower than 1 percent of all insurers. Attendant upon that change was a sharp increase in net assessments by guaranty funds during the 1980s, but total assessments remained below .005 percent of total premiums every year. Among life and health insurers, an average of eleven failed in interstate operations from 1985 to 1989, but the average guaranty fund assessment during the 1980s was only .05 percent of total premiums. And almost half of the life and health insolvencies occurred in 1989, which suggests that the central causes were sharply rising health care costs and profitability problems afflicting life insurance contracts with payments sensitive to changes in interest rates.

Popular assertions about fraud, mismanagement, and weak regulation explain neither the low absolute number of insurance insolvencies over time nor the sharp relative growth of insolvencies in the 1980s. Insurers face investment risks associated with shifts in interest rates, as well as underwriting risks associated with the size of future claim costs. The unexpected growth in liability claim costs for policies sold during the early 1980s is an obvious source of the increase in insolvencies observed during the 1984 to 1989 period, the period of the liability insurance crisis. Such increases in liability coverage costs are obvious after the fact but present enormous problems for both insurers and regulators in the measurement of "adequate" loss reserves before the fact. In short, the popular "fraud, mismanagement, and weak regulation" rationalization for recent experience is overly simplified, particularly since mistakes are a good deal easier to identify after the fact than before.

The small number of insolvencies to be found historically and the rather shallow nature of the "fraud, mismanagement, and weak regulation" rationale raise an interesting issue. Why is the insurance industry so reliable? Executives and shareholders of insurance companies may be altruistic in the extreme, but it is unnecessary to adopt that view to see that market forces make such reliability profitable. Since consumers are willing to pay for a high degree of reliability—which is very different from perfection—the profit motive leads firms to provide the amount of reliability for which consumers are willing to pay and

to use market institutions as means of implicitly informing and assuring consumers about that reliability.

Foremost among the subtle market forces promoting reliability and thus reducing the probability of insolvency is the price of insurance itself. In such markets as that for insurance services, in which repeat business is important, market price is driven up to reflect the costs imposed upon producers by honest dealing and by a continuing effort to supply the reliability level consumers demand. Since fraudulent behavior might be profitable in the short term, one of those costs, ironically enough, is the gain forgone because of a refusal to deal fraudulently. Analytically, the increase in the price of insurance yielded by market forces is a stream of payments or rewards from consumers for reliable (or honest) behavior, the present value of which is bid up in competitive markets to exceed the prospective gains to be had through a failure to honor reliability commitments. Thus, is it literally true that the market price itself, quite apart from its role in terms of direct resource allocation, is a market guarantee of quality, because profit-maximizing firms recognize that the stream of reliability payments is more valuable than the one-time gain from cheating. From the viewpoint of consumers, the upward shift in price is a signal that the firm will earn greater total returns from honest dealing than from fraud. Thus do consumers typically become suspicious about prices that are "too good to be true." Indeed, they usually are. Therefore, market behavior is consistent with that insight, although consumers do not literally perform such a calculation.

Similarly, advertising provides profitability incentives to supply the efficient amount of reliability. Certainly, firms advertise to make the availability and the characteristics of their products more widely known. More subtly, firms advertise to signal to consumers that their services will be reliable and that their promises will be honored. Expenditures on advertising build up what can be termed "brand name (or advertising) capital," which earns returns for the firm as long as it honors its commitments. Brand name capital is thus analogous to a surety bond: if the firm begins to cheat its customers, they will go elsewhere and the firm will lose the returns on and thus the economic value of its investment in brand name capital. In short, the very fact that the firm invests in advertising—quite apart from the specific content of the advertisements themselves—signals to consumers that the firm will earn greater total returns by dealing honestly than by cheating. Thus, for goods the quality of which is difficult to measure before purchase, consumers trust brand names that they recognize and pay higher market prices for those products than for others. Indeed, consider an individual on a street corner who is trying to sell a can that he claims contains some tasty fruit. If he has no specialized investment that he would lose were his claim to prove fraudulent, the market will offer him a price of zero for the can. In plain language no one will trust him. The very fact, then, that a good is advertised signals that the good is worth advertising.

Agents and brokers have incentives to deal with "safe" insurers to avoid future losses of business caused by erosion of consumer confidence in the wake of an insurer's insolvency.

Other market institutions provide additional incentives for providing the efficient level of reliability. Agents and brokers have incentives to identify and deal with "safe" insurers to avoid future losses of business caused by erosion of consumer

confidence in the wake of an insurer's insolvency. Second-party demanders of insurance services such as banks have powerful incentives to monitor insurer solvency. And insurers with sizeable investments in such intangible capital assets as sales forces have important incentives to avoid bankruptcy.

Insolvency Risk under Insurance Price Controls

As an aside, the inherent efficiency of the insurance market is eroded by government guaranty funds, designed to honor policyholder claims in the event of an insurer's insolvency. The guaranty fund system reduces incentives for consumers to search for reliable (that is, safe) insurers and so imposes penalties upon insurers that make their promises to honor claims more credible by enlarging their capital structures to reduce solvency risk. Larger capital structures, after all, are not free. And agents and brokers in the absence of the guaranty fund system would have stronger incentives to identify and deal with safer insurers. In short, the guaranty funds offer the insurance system incentives to reduce the reliability of insurance services, even as they allow risky insurers to undercut the prices of their competitors.

Potentially far more important than guaranty funds in terms of insolvency risk is the prospective effect of rate suppression or price controls on insurance.

Potentially far more important in terms of insolvency risk is the prospective effect of rate suppression or price controls on insurance. Consider an insurer beginning in its first year with a capital structure or "surplus" used to underwrite insurance commitments of $1 billion. Total earned premiums, including (expected) income from investment of premiums, are, say, $2 billion; but operating costs (or the "operating ratio") are $2.1 billion, or 105 percent of total premiums, themselves "suppressed" by price controls. Thus, there is an operating loss of $100 million; if income derived—or, more accurately, that is expected to be derived—from investment of the surplus is smaller than the operating loss, then the insurer's "surplus" or capital base must shrink. Table 1 presents a heuristic example.

Table 1: Progressive Erosion of Capital under Rate Suppression (billions of dollars)

Year	Starting Surplus	Earned Premium	Operating Costs	Operating Loss	Income from Surplus	Ending Surplus
1	1.0	2.0	2.1	.1	.07	.97
2	.97	2.2	2.31	.11	.068	.928
3	.928	2.42	2.541	.121	.065	.872
4	.872	2.66	2.80	.14	.061	.793

Even if income from investment of the capital base exceeds the operating loss, the net economic return to the capital base will be below normal on average; the capital market over time will shift the resources to uses not subject to the implicit tax regulators impose in the form of price controls yielding operating losses.

Table 2 shows for the U.S. property-casualty insurance sector total cost to premiums ratios, the real accounting rate of return to net worth, and total insolvencies for 1975 through 1991. What is striking about those data is the upward trend in the number of insolvencies in the 1980s, which are strongly correlated with the persistence of cost-premiums ratios well above one.

Table 2: Cost-Premiums Ratios, Returns to Net Worth, and Insolvencies

Year	Cost-Premiums	Rate of Return	Insolvencies
1975	1.08	-6.8	28
1976	1.02	3.2	8
1977	.97	12.7	9
1978	.98	10.4	7
1979	1.01	6.1	10
1980	1.03	1.2	5
1981	1.05	3.0	9
1982	1.10	3.1	8
1983	1.12	5.9	11
1984	1.17	-2.6	26
1985	1.16	-.8	49
1986	1.08	12.0	25
1987	1.04	9.6	19
1988	1.04	9.1	35
1989	1.08	4.3	39
1990	1.09	3.0	31
1991	1.08	n.a.	41

Table 3: Kramer Study Rate Suppression States

Private Automobile Insurance	Workers' Compensation Coverage	
Delaware	Alabama	New Hampshire
District of Columbia	Arkansas	New Mexico
Louisiana	Florida	North Carolina
Massachusetts	Georgia	Oregon
Nevada	Iowa	Pennsylvania
New Hampshire	Kansas	Rhode Island
New Jersey	Kentucky	South Carolina
Pennsylvania	Louisiana	South Dakota
Rhode Island	Maine	Tennessee
South Carolina	Massachusetts	Texas
Texas	Mississippi	Vermont
	Missouri	Virginia
	Nebraska	

Cost-premiums ratios are affected by a number of factors, only one of which is the stringency of price controls in states where given firms do business. Individual insurers do business in many or all states, and so the effects of price controls in one or some states tend to be obscured by overall business results for a given firm. In a study done for the Insurance Information Institute, Orin S. Kramer applies three criteria to state insurance markets and regulation and thus delineates "rate suppression" and "nonrate suppression" states for private automobile insurance and for workers' compensation coverage. Table 3 lists those states.

Kramer notes that while about 87 percent of the property-casualty industry writes some amount of business in states imposing effective price controls, less than 6 percent of the industry writes 35 percent or more of its business in states imposing effective price controls. That suggests that in the short run the price control problem will significantly affect the solvency positions of only a limited number of firms. On the margin, however, price controls are likely to increase the number of insurer insolvencies, and that effect is likely to grow over time. That inference is supported by data on percentages of all insurers, "nonweak" insurers, and insolvent insurers writing various proportions of their business in states Kramer classifies as "rate suppression" (or price control) states. Table 4 shows, for example, that insurers as a whole earned 15.6 percent of their premiums in rate suppression states, and 21.8 percent of all insurers earned more than 10 percent but not more than 15 percent of their premiums in rate suppression states. Among nonweak firms, 19.9 percent earned more than 10 percent, but not more than 15 percent, of their premiums in states imposing effective price controls, while 29.4 percent of insolvent insurers did the same.

Ironically, the relatively small proportions of insurers earning large parts of their total premiums in price control states may tend over time to exacerbate the problem. To the extent that state regulators wish for whatever reasons to avoid driving insurers into insolvency, a standard free-rider problem is created when a given insurer does a small part of its total business in a state. From the viewpoint of the regulators in that state, their suppression of rates would not have much impact on a firm's overall solvency position, and they are likely to wait for regulators in other states to improve the financial condition of the firm by allowing rates to reflect costs more completely.

Price controls on insurance inexorably will erode service quality, as insurers reduce the speed of reimbursement and increase the scrutiny with which they examine claims.

Conclusions

Price controls on insurance inexorably will erode service quality, as insurers reduce the speed of reimbursement and increase the scrutiny with

Table 4: Percentages of Premiums Earned under Effective Price Controls

Percent of Insurers Earning X Percent of Total Premiums under Price Controls	All Insurers (1989)	Nonweak Insurers (1989)	Insolvent Insurers (1982–1987)
> 10 Percent	21.8	19.9	29.4
> 15 Percent	17.2	15.6	23.5
> 20 Percent	13.9	12.9	20.6
> 25 Percent	11.3	10.6	22.0
> 30 Percent	9.8	8.9	18.6
Percent of Total Premiums from Price-Control States	15.6	13.8	22.0

which they examine claims. Greater insolvency risk reduces the quality of insurance services, as the probability rises that insurance commitments will be vitiated by insolvencies. Moreover, insurers invest in a capital base to protect the value of such other investments as sales forces and brand name capital; the value of those kinds of intangible assets to both the firm and consumers would be eroded dramatically in the event of an insolvency.

The implicit subsidies engendered by price controls tend overwhelmingly to subsidize high-risk consumers of insurance at the expense of low-risk consumers. That reduces incentives to invest in safety mechanisms and thus increases accident costs over time. And price controls do nothing about underlying increases in the cost of providing insurance services.

To the extent that insurance rates are influenced by political pressures rather than by market forces, they will serve not as signals of consumer preferences and resource costs, but instead as tools with which to subsidize particular interest groups at the expense of others.

Politics is the art of wealth redistribution. To the extent that insurance rates are influenced by political pressures rather than by market forces, they will serve not as signals of consumer preferences and resource costs, but instead as tools with which to subsidize particular interest groups at the expense of others. Such wealth redistribution is part of a larger problem inherent in the behavior of democratic institutions: majority coalitions have incentives to transfer wealth to themselves at the expense of political minorities, as long as the adverse incentive effects of doing so—that is, the resulting impacts on work, saving, productivity, and resource waste in investments made to influence political outcomes—do not outweigh the direct benefits to members of the majority. It is no secret that insurance companies are a political minority par excellence, an unenviable position exacerbated in recent times by dramatic growth in the costs and thus rates for insurance services.

And the growing politicization of rates means that the politically ambitious increasingly will be drawn toward insurance rate regulation as a stepping stone upward. But ambition for higher office necessarily means a shortened time horizon with respect to the office held currently. Since the adverse solvency implications of artificially low rates are likely to follow rate decisions with a lag, current regulators do not bear all or even most of the political costs of rate decisions—and resulting solvency problems—inspired by political considerations.

Again, as insurance rates rise in real terms—driven largely by cost growth—political pressures for politicization of rates will grow as well. And as the flexibility of government budgets declines in the face of growing demands for both government spending and tax relief, regulation inevitably will be seen by state legislatures as a tool with which to subsidize favored groups outside the formal limits of government budgets. In my view the short-term outlook for rationality in insurance rate regulation is not salutary, but it is possible that a slow increase in the insolvency problem will constitute the two-by-four that gets the mule's attention.

Selected Readings

Kramer, S. *Rate Suppression and Its Consequences.* New York: Insurance Information Institute Press, 1991.

Litan, R.E. *Back to Basics: Solvency as the Primary Object of Insurance Industry Regulation.* State Farm Insurance Companies, January 1992.

Zycher, B. "Insurance Rates, Direct Democracy, and Solvency Regulation." *Journal of Insurance Regulation* (Winter 1991).