April 14, 2008

Dear Chairman Parsons and Members of the Property and Casualty Insurance (C) Committee:

I write to you on the behalf of the Competitive Enterprise Institute, a Washington, D.C.-based think tank devoted to classical liberal economic policies. We advocate these policies because we believe in freedom for both individuals and business enterprises. Our only permanent interest is the Free Market itself.

We commend the C Committee's willingness to revisit a regulatory framework that many people believed had serious flaws. The current report represents significant hard work on the part of the committee and brings much important economic research to bear on vital questions confronting America's insurance industry and its consumers.

We do, however, wish to raise some serious concerns about the framework proposed and suggest that the Committee again revisit it and replace it with a model entirely free of state-imposed rates. We wish to make three major points

- ***The Committee's Discussion of "Competitive Economics and the Economics of Regulation" Ignores Literature on Both Government Failure and the Problems of Price Controls.***
- ***The Committee Still Envisions Continued Price Controls Despite Denying that it Does so.***
- ***The Committee Wrongly Believes that Insurance is Not Subject to the Same Rules of Supply and Demand as Other Goods.***

A discussion of our points follows:

The Committee's Discussion of "Competitive Economics and the Economics of Regulation" Ignores Literature on Both Government Failure and the Problems of Price Controls.

While paying lip-service to the idea of a free market for insurance and providing an adequate review of the economic literature concerning insurance pricing, the Committee focuses unnecessarily on the possibilities of "market failure" and neglects the potential for "government failure" while failing to perform an adequate survey of the literature concerning the failure of price controls.[1] Essentially, Committee C postulates that only government—as opposed to natural market mechanisms—can correct inevitable market failures.

As best as we can discern, however, the reasoning that supports this conclusion is circular. To back its case, the Committee's approvingly cites a scholar who finds that private market discipline cannot work to regulate because the existence of state regulation precludes the market's natural disciplinary function: the failure of inefficient firms.[2] This reasoning, frankly, is bizarre: essentially, the Committee is arguing that the existence of state regulation makes state regulation necessary. It does not even consider the possibility of eliminating government-imposed rate regulation. It should do so.

Just as importantly the Committee makes no effort to look at the extensive literature concerning the problems resulting from both direct and indirect price controls. For example, the Committee may wish to acquaint itself with the Department of the Treasury's recent *Blueprint For a Modernized Financial Regulatory Structure* which provides an ample argument as to why almost all rate regulation fails to serve the public interest; so does a wealth of other academic research.[3] Committee C would benefit from weighing down clearly on one side or another of the question of rate regulation. If it wishes to continue its defense of the current price control system, it should provide a reply to the research—and working examples in Illinois, Vermont and elsewhere—that shows the consumer and market benefits of systems with minimal or no rate regulation. In addition, any regulatory framework should weigh the possibilities of market failure against the possibilities of government failure: regulation cannot and should not justify itself.

The Committee Envisions Continued Price Controls Despite Denying that it Does.

The report, as written, spends 330 self-contradictory words attempting to distinguish between rate regulation and price control. In fact, no meaningful difference exists. The Committee also incorrectly reports that "one state [Massachusetts]. . .promulgates the rates that insurers must charge," and then only for auto insurance.[4] (Massachusetts, in fact, has allowed a limited form of open competition since April 1, 2008.) The absence of bureaucrats dictating particular rates to particular companies, however, does not mean that the "impression that most or all states tell insurers what they can charge" is wrong.[5] (Even though the committee implies that it is.) In fact, most states do play a major role in dictating the prices insurers charge and the system fits within the historical American experience of price controls. In short, price controls are the norm in American insurance markets.

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[1] See e.g. Clifford Winston. *Government Failure Versus Market Failure: Microeconomics Policy Research a nd Government Performance.* Washington: AEI-Brookings Joint Center for Regulatory Studies, 2006.
[2] Line 299.
[3] Department of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure*, 2008, 129.
[4] Line 588
[5] Line 586.

A history of "price controls" as economists understand them does *not* typically involve the directly government made prices that Massachusetts previously imposed in on automobile insurance rates. Price control in the United States, in fact, has rarely involved efforts to disable the price mechanism altogether. Instead, government has used various mechanisms—many of them quite similar to those involved in insurance regulation—to discipline prices. Economy-wide price control efforts during World War II for example, sought to avoid full-scale "repression of the market" and, in fact, often operated under what insurers would call a "file and use" framework. The name of the mechanism used implement this price regulation regime—"General Maximum Price Order"—itself implies something less than total control.[6] More limited price and wage controls during the Vietnam and Korean wars—mostly limited to war-related industries--likewise, allowed a certain degree of pricing freedom. In fact, one must go back to the Colonial period to find cases where prices set by government fiat alone (like those in Massachusetts) were the norm.[7] In short, price controls, as economists understand and historians have spoken about then, are the norm in American insurance markets. Not all states, of course, regulate to the extent that one could consider the system one of "price control" but many do.

For example, the State of Florida sells home owners' insurance through an agency of state government that operates as the Citizens Property Insurance Corporation. Florida's legislature and governor, furthermore, have banned Citizens from raising its rates until 2009, set those rates below market levels in coastal areas, and allowed consumers to purchase insurance from Citizens if they receive one quote more than 15 percent above Citizens' price. Coupled with actuarial adequacy standards (which create a price floor), this allows "competition" only within a narrow band between these standards and Citizens-rates plus-an-additional-fifteen-percent. For all intents and purposes, therefore, Florida's system amounts to a price control regime.

Any political system of rate regulation—however developed—will raise the possibility of price controls. NAIC model legislation seems to create enormous room for the imposition of price controls for nakedly political reasons. For example, section 4 of the model legislation, allows an insurance commissioner to declare any market "uncompetitive" if a "reasonable degree of competition" does not exist. The proposed tests for determining the lack of competition include "unreasonably high" profit levels "for companies generally in the market segment." This standard suggests a strong bias towards rate regulation. While insurance contracts must, of course, adhere to standards of conscionability, large short-term profits will likely to bring in new firms and make a market more competitive. Rather than recognizing this fact, however, the Committee has proposed a law that suggests political rate regulation in cases where a market is, in fact, just on the verge of becoming more competitive. We have similar concerns about language relating to "unfairly discriminatory rates" (Section 5(A)(4)(a)); the definition of

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[6] Hugh Rockoff. *Drastic Measures: A History of Wage and Price Controls in the United States*, London: Cambridge University Press, 1984, 86-87.

[7] Ibid 18-19.

excessive rates (5)(A)(1), the enumeration of "basic factors in setting rates" (5)(A)(4)(a). Coupled with the "file and use/use and file" system outlined in section 6, this amounts to a system that allows a high degree of price setting through political—rather than market—processes.

We urge the Committee to throw out its current law and adopt a model bill that eliminates the notion of a rate regulatory mechanism altogether. A no-file system or an informational-filing-only system will do the most to let market forces work as they should.

The Committee Wrongly Believes that Insurance is Not Subject to the Same Rules of Supply and Demand as Other Goods.

The Committee seems to believe, wrongly in our eyes, that insurance is somehow an exceptional product to which the laws of supply and demand simply should not apply. It writes, for example that the "absence of the conditions of voluntary change [sic] has in part necessitated regulatory intervention on the behalf of consumers."[8] The Committee believes that because it has a "kinked" demand curve, because some consumers sometimes face legal or lender-imposed mandates to buy insurance, and because insurance forwards social goals that it should be exempt from the laws of supply and demand. All three of these assumptions are wrong.

First, all demand curves for all near-necessity goods are "kinked" but this does not mandate price controls. According to the committee's definition, a kinked demand curve is one where demand is reasonably inelastic so long as the price of the product is reasonable to most consumers.[9] This is so for all "near necessity" goods like education, telephone services, Internet service, automobiles, and personal lines property and casualty insurance. These goods are *not* usually necessary for survival the way that food housing and medical care are. But most rightly individuals feel they need them to take part in modern society. This may well suggest that purely profit driven mechanisms will not prove optimal in supplying these goods. But it *does not* show that price-setting through state mechanisms—which the Committee and the proposed model law favor—will help supply the good more efficiently than direct social welfare efforts or private charity. In fact, the opposite appears to be true: programs ranging from Pell Grants to Lifeline Telephone Service mandates help more individuals afford these goods without actually controlling their prices. Such programs of subsidies and vouchers are the norm in nearly all insurance market.

Second, the Committee's closely related point that insurance purchase is often mandatory also misses the point. Many products are mandatory in some sense: people must buy food to stay alive so its purchase is also mandatory. No state, however, has found it necessary to regulate the pricing of food with anything near the precision that it regulates the pricing of insurance products.

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[8] Line 478
[9] Lines 687-690

Finally, the fact that insurance sometimes serves social goals—such as protecting drivers in the case of an auto accident and "a community as a whole in the event of a widespread catastrophic event," does not make insurance that unusual.[10] Nearly every business serves a social goal and some—banking, for example—arguably do more than insurance to advance the Common Good. In fact, a strong argument exists that charity and insurance operate from principles that are often the exact opposite of one another. Proper insurance rates, everyone agrees in principle, come from methodical, mathematical, dispassionate actuarial assessments of risk. When discussing social welfare efforts, a similar agreement exists: charity and welfare ought to serve people on the basis of compassion and need. Risk has no place in the calculations.

Attempting to conflate the two threaten to undermine both insurance and compassion. Officials in states such as Florida and North Carolina have appealed to social welfare aims in justifying enormous residual markets and price controls homeowners' and automobile insurance. As a result both states maintain residual markets that serve as wealth redistribution mechanisms from people who do not take risks to those who do. It's difficult to discern a philosophy of charity that suggests risk behavior rather than need should determine the targets of state-mandated welfare efforts.

In short, the committee is wrong to believe that insurance is unique. It is not. In the main, the same market forces that govern the pricing of almost every other good ought to govern the pricing of insurance as well.

Concluding Thoughts

The proposed personal lines regulatory framework represents a good deal of careful thought and contains much good work. Nonetheless, its insistence on continued price regulation represents a fatal flaw. The Committee should engage in a wholesale rethinking of the price regulatory regime and propose a model law that envisions a system governed by market forces rather than regulatory whims. We thank the Committee for this opportunity to submit comments.

Respectfully Submitted,

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[10] Line 550.