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Congressional Misdiagnosis

Why Repealing McCarran-Ferguson Will Harm Competition in Health Insurance Markets

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As Congress moves forward with its health care reform efforts, a last-minute proposal to revoke the 64-year-old exemption from federal antitrust laws for health insurers has flown under the media radar. Proponents of the repeal proposal tout it as a broadly popular effort to slow the consolidation of the health insurance industry and promote more vigorous price competition. But the change would do nothing to prevent insurance firm mergers, which are already subject to federal oversight. However, federalizing antitrust enforcement over the insurance industry would unnecessarily duplicate existing state insurance regulations and jeopardize practices that help small insurers compete.

The McCarran-Ferguson Act, passed by Congress in 1945, reaffirmed the long-standing authority of state governments to act as the primary regulators over the insurance industry. The Act exempts insurers from most federal regulation, including federal antitrust laws, as long as the states have laws governing the same conduct. Proposals to revoke McCarran-Ferguson have been around for years, but they had little traction in Congress until the health insurance industry began to criticize the reform bills crafted by three committees in the House of Representatives and the Senate Finance Committee.

As early as fall 2008, the industry announced its support of broad congressional health reform efforts, and the industry's main trade association, America's Health Insurance Plans (AHIP), began to negotiate a mutually advantageous deal with the incoming Obama administration.[1] Health insurers would publicly support proposals that require insurers to issue a policy to any applicant and to charge premiums that are not based on health status. In turn, Democrats would require every individual in the country to have health insurance. If an employer does not provide

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a health insurance plan, the employee would be legally required to buy an individual plan or pay a monetary penalty.[2]

However, in October 2009, the industry began to criticize the House and Senate bills for containing what insurers considered to be weak enforcement provisions for the individual purchase mandate. AHIP released a study prepared by the accounting firm PricewaterhouseCoopers that concluded that the low financial penalties would permit too many health individuals to opt out of the purchase mandate, which would result in increased costs and higher premiums.[3] In retaliation, the House and Senate Judiciary Committees resurrected dormant proposals to revoke parts of the McCarran-Ferguson Act's federal antitrust exemption.

On October 21, the House Judiciary Committee voted in favor of a bill called the Health Insurance Industry Antitrust Enforcement Act, which would repeal the current federal antitrust exemption to the extent that it permits "health insurance issuers...or issuers of medical malpractice insurance to engage in any form of price fixing, bid rigging, or market allocations."[4] The Senate Judiciary Committee held hearings on alleged "price fixing" and other anticompetitive conduct in the health insurance industry, and a companion Senate bill was introduced by Sen. Patrick Leahy (D-Vt.).[5]

The House Democratic leadership also incorporated a McCarran-Ferguson repeal measure in the comprehensive health reform legislation it passed on November 7, applying all federal antitrust laws to the business of health insurance and medical malpractice insurance.[6] However, in order to secure the vote of moderate Democratic Sen. Ben Nelson (D-Colo.), who opposes the McCarran-Ferguson repeal, the Democratic leadership stripped the measure from the Senate's comprehensive health care legislation announced by Senate Majority leader Harry Reid (D-Nev.) on November 18.[7]

There is little doubt that Democrats' renewed interest in repealing the McCarran-Ferguson Act stems primarily from the insurance industry's criticism of the congressional health proposals. In his weekly radio address, delivered on October 17, President Obama criticized the industry for "filling the airwaves with deceptive and dishonest ads" and "funding studies designed to mislead the American people," and explicitly called for ending the federal antitrust exemption.[8] Sen. Charles Schumer (D-N.Y.) accused the health insurance industry of trying to "sucker-punch health care reform," and he insisted that Congress should "restor[e] the federal government's power to curtail price-fixing, collusion and other anti-competitive practices."[9]

But, where critics of McCarran-Ferguson Act see only dominant market power and higher premiums, a closer look reveals a system that permits state governments to encourage and supervise cooperative efforts by the industry that promote competition and keep costs in check. After all, insurers are only exempt from federal oversight to the extent that state governments have filled the void, and every state in the union has antitrust laws that forbid anticompetitive practices. Moreover, even under McCarran-Ferguson, insurers are already subject to a considerable amount of federal antitrust oversight for certain conduct, including the mergers that have resulted in recent industry consolidation.

Evolution of the Regulatory Environment. Insurers in the United States have historically been regulated by the states, not the federal government, because insurance has largely been viewed as a purely intrastate activity. Ironically, it was insurers who first proposed federalizing insurance industry oversight in the mid-1800s because they wanted to escape special taxation and the patchwork of regulations that varied from state to state. But, in a landmark 1868 case, *Paul v. Virginia*, the U.S. Supreme Court held that insurance was not commerce, not subject to the interstate commerce clause, and therefore outside the federal regulatory domain.[10]

During the 18th and 19th centuries, state regulation was fairly modest, consisting mainly of simple chartering rules and minimal capital and surplus requirements. Following the *Paul* decision, most states began to create insurance-specific regulatory agencies with more robust industry oversight and more sophisticated methods of industry self-regulation.[11]

One of the industry's and regulators' biggest concerns was the possibility that intense, short-term price competition would leave insurers with insufficient capital reserves in the event that significant payouts were required. To address the problem, the industry privately attempted to create cooperative programs called rating boards or rating compacts to collectively set prices. A few states responded by passing laws forbidding industry rate-setting collusion. But such bans were largely superfluous because, as antitrust scholar Dominick Armentano points out, those early "agreements among insurers to stabilize prices were notoriously unsuccessful."[12]

By the early 20th century, in the wake of several high-profile insurer insolvencies, the industry began again to establish private rating bureaus, this time with the blessing and assistance of state regulators. The bureaus gathered risk and underwriting information from each insurer in the pool to compile larger data sets and produce more actuarially sound rating systems. Many bureaus also drafted standardized policy forms and recommended advisory rates. Rather than view this activity as harmful collusion or price-fixing, most state insurance commissions encouraged the practice because it helped keep rates stable and low and make insolvencies less frequent.[13]

The New Deal brought challenges to the state-based rating bureau system. In a 1943 decision, *U.S. v. South-Eastern Underwriters Association*, the Supreme Court reversed its previous rulings and held that an insurance company that conducted substantial business across state lines was engaged in interstate commerce and thus subject to regulation by the federal government.[14] The opinion made clear that states would continue to have authority to regulate insurers unless there were inconsistencies with federal law, but it left uncertainty regarding the legality of rating bureaus' information sharing and joint pricing activities.

To reduce the confusion, Congress passed the McCarran-Ferguson Act of 1945, which reaffirmed the primary role of states in regulating the insurance business.[15] The Act exempts the insurance industry from federal laws, regulations, fees, and taxes, unless they specifically relate to the "business of insurance." In order to protect the cooperative activities sanctioned under state law, the Act expressly provides insurers a partial exemption from federal antitrust laws in states that have enacted their own competition regulations, but it stipulates that the insurance industry would remain subject to federal antitrust enforcement "to the extent that such business is not regulated by State Law."

The McCarran-Ferguson Act did not lead to an absence of regulation, however, because every state in the union actively regulates insurers within its jurisdiction. Furthermore, the Act applies only to conduct that is an inherent part of the "business of insurance," and it explicitly subjects such conduct as boycotts, intimidation, and coercion to prosecution under federal antitrust law. Courts have also limited the scope of the antitrust exemption in other ways. For example, activities such as insurance firm mergers, bundling and tying arrangements, agreements to allocate geographic market shares, and other allegedly anticompetitive practices held to be unnecessary components of the insurance industry are subject to federal antitrust laws.[16]

Criticism of the McCarran-Ferguson Act. Critics of the McCarran-Ferguson Act believe the federal antitrust exemption makes it possible for insurance firms to evade meaningful antitrust enforcement and engage in a substantial amount of anticompetitive behavior because state antitrust regulation is ineffective. In testimony before the Senate Judiciary Committee, Assistant Attorney General for Antitrust Christine A. Varney argued that "case law can be read as suggesting that the Act precludes federal antitrust action whenever there is a state regulatory scheme, regardless of how perfunctory or ineffective it may be."[17] The Act's detractors often cite two main activities as evidence of insufficient state antitrust enforcement: allegedly collusive price-fixing practices and growing market concentration.

For example, Health Care for America Now, a coalition of over 1,000 labor unions and left-leaning advocacy organizations, argues that health insurer mergers and growing market shares of the largest health insurers over the past decade have contributed substantially to rising premiums.[18]And an Urban Institute Health Policy Center study in 2008 concluded that small insurers often charge premiums that "shadow" those of larger insurers.[19] But any threat to competition from increasing concentration in the health insurance market is a red herring because the McCarran-Ferguson Act does not exempt that conduct from federal antitrust laws.

Furthermore, the collaborative pricing schemes that exist in the health insurance market are not only supervised but actively encouraged by most state insurance regulators. Insurers actively share loss-experience data and related information through state-level rating bureaus, in order for each firm to have a large enough pool of data for accurately pricing risks and setting aside reserves. In some states, industry-run rating bureaus aggregate this underwriting data, and set uniform rates or calculate "target" or "advisory" rates for participating insurers under the supervision of state regulatory authorities.

In other contexts, this kind of activity would be viewed by antitrust enforcers as a red flag, suggesting prohibited price fixing conduct. But antitrust law has evolved substantially over the past few decades, with courts and federal regulators coming to view once-prohibited conduct as having benefits for consumers.[20] Although antitrust enforcers continue to believe that collusive pricing arrangements among competitors tend to reduce consumer welfare, many antitrust scholars and courts have softened their opposition in recent years.[21] Courts have come to recognize that there are many circumstances in which such horizontal pricing agreements can work to the advantage of consumers by, for example, increasing efficiency within an industry, enabling more effective comparison shopping by consumers, and forcing firms to compete on the basis of quality or other product attributes.

Similarly, the McCarran-Ferguson Act's sponsors explicitly included the antitrust exemption to protect insurance industry data sharing and joint rate setting activities because they have been found to have pro-competitive effects. Data sharing offers firms—and particularly smaller firms—greater protection against insolvency by providing them with more actuarially reliable data. Only the largest insurers are likely to have a large enough pool of underwriting data on which to set premium rates with any confidence in the accuracy of expected future costs. Joint rate setting and the identification by rating bureaus of "advisory" rates also create economies of scale that increase efficiency, reduce information costs for insurers, and lower search costs for consumers.

Repeal advocates seem to recognize that data sharing and joint rate setting are worthy of at least some protection. The Health Insurance Industry Antitrust Enforcement Act voted on by the House Judiciary committee and the McCarran-Ferguson Act repeal incorporated into the House health reform bill both stipulate that they do not preclude the collection, compilation, and dissemination of historical loss data or related actuarial services, so long as the conduct "does not involve a restraint of trade." The House Judiciary committee bill also exempts "information gathering and rate setting activities of any State commission of insurance, or any other State regulatory entity with authority to set insurance rates."

The House health care reform bill does not explicitly exempt this state rate setting conduct from federal antitrust enforcement, though the language would be superfluous since this type of state government conduct is already protected by constitutional federalism principles and the State Action Doctrine recognized by federal courts. For example, in the 1943 case, *Parker v. Brown*, the U.S. Supreme Court held that action in restraint of trade taken by a state government or one of its subdivisions (such as a local government or state agency), or such actions taken by private parties pursuant to the direction and supervision of the state government, are not subject to federal antitrust laws.[22] However, the Doctrine probably would not protect private insurance industry rating bureaus that are merely supervised, rather than created, by state regulators. Even if, following the repeal, state governments formally authorized private rating bureaus by statute or created state-run rating bureaus, the McCarran-Ferguson Act repeal would, at the very least, disrupt their useful activities during the transition.

McCarran-Ferguson's Narrow Scope. Although state governments could protect data aggregation and joint rate setting activities if they have the will to do so, repealing the federal antitrust exemption would not provide any pro-competition benefits. The critics' major concern of increasing concentration in the health insurance industry is not affected by the McCarran-Ferguson Act. Under the terms of the Act and subsequent court interpretation, insurance industry conduct that is not necessary to the operation of the insurance business remains subject to federal antitrust law. Federal courts have held that activities such as insurance firm mergers, bundling and tying arrangements, agreements to allocate geographic market shares, and other practices that are not unique to the insurance industry are not essential to the business of insurance and therefore may be policed by federal antitrust authorities.[23]

Furthermore, it is not at all clear that recent merger activity has resulted in monopolistic insurance firms. A handful of states do have highly concentrated markets. For example, in

Hawaii, Rhode Island, and Alaska, 95 percent or more of the health insurance market is served by just two insurers, with the least competition in the small group market.[24] But a recent U.S. Government Accountability Office (GAO) study showed that the average small group market is served by 27 insurers.[25] GAO further notes: "The median market share of the largest carrier in the small group market was about 47 percent, with a range from about 21 percent in Arizona to about 96 percent in Alabama."[26]

Critics argue that mergers between health insurers and increased market share produces dominant firms with the ability to charge higher premiums to plan enrollees (monopoly power) or to lower reimbursement payments to physicians, hospitals, and other suppliers (monopsony power).[27] But, the U.S. Department of Justice's Antitrust Division (DOJ) already has authority to review health plan mergers for their anticompetitive effects, and it explicitly considers the potential for merged firms to exercise monopoly or monopsony power when doing so.

Most mergers in any industry receive only cursory review. But, from 1993 to 2008, the DOJ conducted in-depth investigations of 34 health plan mergers[28] and concluded that most of them would not raise serious competitiveness problems, and that many would increase efficiencies that could lead to lower premiums. Indeed, as Boston University health economist Austin Frakt and attorney Ian Crosby have noted, larger insurers with greater market shares appear to be better able to offset the substantial market power held by health care providers. According to Frakt and Crosby, economic research "supports the notion that recent increased market power of insurers does not lead toward monopolistic pricing, but rather it provides a counter-balance to the power held by hospitals and provider groups."[29]

Rethinking the Antitrust Paradigm. Repeal advocates, such as Christine Varney, insist that the insurance industry need not fear a McCarran-Ferguson repeal because collaborative industry conduct "would be assessed by antitrust enforcers and the courts under a rule of reason analysis that would fully consider the potential pro-competitive effects of such conduct and condemn it only if, on balance, it was anticompetitive."[30] Still, it is worth repeating that, in addition to the fairly broad scope of federal antitrust enforcement under existing law, state competition authorities do still police price fixing, bid rigging, and market allocation conduct by insurers. Consequently, McCarran-Ferguson repeal would seem to provide no constructive benefit.

At best, the bills would merely subject insurers to duplicative and redundant federal policing in addition to that done by the states. This raises the risk that conduct condoned by state regulators for its pro-competitive effects could run afoul of federal antitrust enforcers who are less familiar with local insurance markets. Some antitrust experts suspect that, on the margin, many insurers would terminate certain cooperative activities to avoid the possibility of having to defend themselves in an antitrust investigation or subsequent court case.[31] Consequently, while repeal might like a modest proposition, it could have sweeping, long-term effects that inhibit rather than promote competition among health insurers.

Instead of needlessly amending the McCarran-Ferguson Act, Congress could make other changes to promote competition in the health care sector. One such pro-competitive change would be to allow individuals and business to purchase health insurance from any willing provider in any

U.S. state. Under current law, an insurance firm registered in one state may not cover individuals in another without registering in the second state and being subject to all of its taxes and laws.[32] This raises the cost of doing business across state lines and prevents many smaller and mid-sized companies from entering new markets. Permitting consumers to purchase insurance policies across state lines would enhance competition substantially.

Congress should also reconsider existing antitrust rules that restrict pro-competitive coordinated behavior among health care providers and other individuals and firms in the health care sector. For example, current Federal Trade Commission and Department of Justice regulations make it illegal for physicians in a practice that is not integrated financially to consult with one another on pricing policies, and for physicians in separate practices to negotiate jointly with insurers or medical products companies.[33] Similarly, while health insurers are permitted to establish provider networks for their enrollees, physicians generally may not bargain with one another to establish such networks on their own.[34] Other examples abound.

Even when federal antitrust enforcers have agreed not to challenge certain technically illegal conduct which they find to have competition enhancing effects, the uncertainty regarding potential enforcement can deter efficiency-enhancing, pro-competitive activity. Thus, explicitly permitting more flexible network and bargaining arrangements among providers can help them better meet the needs of patients, while delivering higher quality care more efficiently.

Conclusion. Ensuring fair and robust competition in the health insurance market is a key to increasing access and affordability for all Americans. Repealing the McCarran-Ferguson Act would help neither cause. Instead, it would subject insurers to an antiquated and unsuitable system of federal antitrust oversight that is more likely to reduce competition in the health insurance industry than enhance it. To increase competitiveness in the health insurance industry, Congress should instead focus on ways to reduce burdensome regulations that reduce innovation and other efficiency-enhancing, pro-competitive activity.

Notes

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