



## **Consumers Pay More for Insurance Price Regulation; Get Little in Return**

*Mounting evidence shows that onerous state-based price regulation has adverse consequences on insurance markets -- increasing industry costs, discouraging market entry and competition, and creating price distortions. This ConsumerGram provides additional evidence that state-based price regulation of automobile insurance tends to increase consumer prices, thereby reducing consumer welfare. These studies suggest that state-based price regulation of insurance services is not in the public's interest and that reforming regulation, such as the reduction and harmonization of state-based regulations or the adoption of an Optional Federal Charter, would significantly benefit consumers.*

### **The Price of Automobile Insurance**

To varying degrees, state insurance commissions regulate private passenger automobile insurance rates. Until recent market-oriented reforms, Massachusetts was the most price regulated state in the country, setting automobile insurance rates.<sup>1</sup> In 23 states, insurance companies must receive rate approval from state commissions before they can sell automobile insurance policies. In 14 states and the District of Columbia, insurance companies must file their rates before they can sell, a process that still provides state regulators an easy opportunity to intervene. Until recently, three states had similar restrictive rules for major rates increases and decreases, but allowed some rate flexibility within rate bands. On the other hand, 8 states have less price regulation, allowing insurance companies can set rates first and then file with the state commission. Among these states is Illinois, which requires only an informational filing. Wyoming has no filing requirement for personal automobile insurance.

The brands and styles of cars sold in one state are not unlike those brands and styles sold in neighboring states, so it is inexplicable that consumers would want vastly different insurance coverage or price regulation based on the state in which they live. The wide disparity in state-based price regulation, discussed above, suggests that insurance price regulation is arbitrary. If consumers benefit from less price regulation in some states, then how can they also benefit from more price regulation in other states? Some have suggested that lack of uniformity among the states has less to do with benefiting consumers and more to do with maintaining outdated price

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<sup>1</sup> To provide an illustration of regulatory differences among the states, the rate regulation classification described in the remainder of this paragraph was as of 2007.

regulations. If this is the case, then price regulations may be costing consumers more than helping them.

## **The High Price of Price Regulation**

For many insurance services, including commercial lines and life insurance, market forces are used to set customer rates, but regulation is common for personal auto insurance. Proponents of price regulations cite no empirical evidence that unregulated insurance markets would fail to produce efficient and competitive prices, despite the overwhelming evidence that the insurance market is not concentrated and has many competitors. There is no evidence that personal auto insurance markets works differently or is less efficient than commercial and other insurance lines. There has also been no cost/benefit analysis demonstrating that the insurance market suffers from market failures that would leave consumers better off with price regulation.

There are a number of reasons why extensive price regulation does more harm to consumers than good. In many cases, price regulation takes form of cross-subsidization, whereby state regulations force safe drivers to subsidize risky drivers. This encourages risky driving, accidents and deaths, but it also increases losses, claims and consumer premiums.

Price regulation, and regulation in general, increases surveillance costs, requiring more regulatory staff and higher budgets, but it also requires more expense and time for insurance company compliance with forms and prices. Increased regulation raises the cost of compliance and makes it difficult for carriers to challenge questionable claims, which increases consumer premiums.

Some evidence suggests that increased regulatory activity can increase industry costs and prices. Studies have found that consumers pay a high price for insurance price regulation and do not get much, if anything, in return for it. Studies by Litan, O'Connor, Cummings, Grace, Klein, Phillips and others found that price regulations do not decrease prices or profits and may, in fact, increase them.<sup>2</sup>

Another reason that regulation may affect prices is the common belief that regulations affect competitive entry and reduces the number of providers in the market. By reducing the number of competitors or the level of competitiveness in the market, price competition and service is impeded to the detriment of consumers. In some states, like South Carolina, market-oriented auto insurance reforms tripled the number of competitors in just one year, according to Grace, Klein and Phillips. In 2006, Joseph Treaster of the *New York Times* noted that some South Carolina drivers were saving 30-40% as a result.

Another reason why heavy insurance regulation could increase consumer premiums is that companies must deal with 50-state regulators, instead of one, compounding all of the costs cited above. The lack of uniformity can be expensive, according to many industry experts. For example, a CSC and ACLI study found that uniformity of life insurance regulation would save consumers \$11 billion over the next 10 years. Having uniform regulations between the states

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<sup>2</sup> These studies are cited in Robert E. Litan and Phil O'Connor, "The Consumer Benefits of an Optional Federal Charter: The Case of Auto Insurance, presented at the "The Future of Insurance Regulation," AEI, July 9, 2008.

would encourage interstate entry and competition, while eliminating wasteful duplication of regulatory costs between the states. Because states have failed to harmonize regulations, there have been increased calls for legislation that would permit an Optional Federal Charter.

## **Consumers Support an Optional Federal Charter**

Legislation introduced in U.S. House of Representatives and the U.S. Senate would allow insurance companies to choose the option of being state or federally chartered and regulated. This would have the practical effect of giving consumers the option to select among state and interstate insurance companies, much like consumers today can choose between state and federally chartered banks. The Optional Federal Charter proposal maintains many consumer safeguards, while encouraging market entry and interstate competition.

In general, consumers support such a concept. An ACI survey of American consumers released in 2008 found that 66% of consumers wanted more competition, 76% supported giving consumers a choice between federally-regulated and state-regulated insurance companies and 73% believe that increased competition would lead to lower insurance prices. The Optional Federal Charter would likely lead to less price regulation and provide more uniform regulation, which, if the studies cited above are correct, would provide consumers with billions of dollars of benefits.

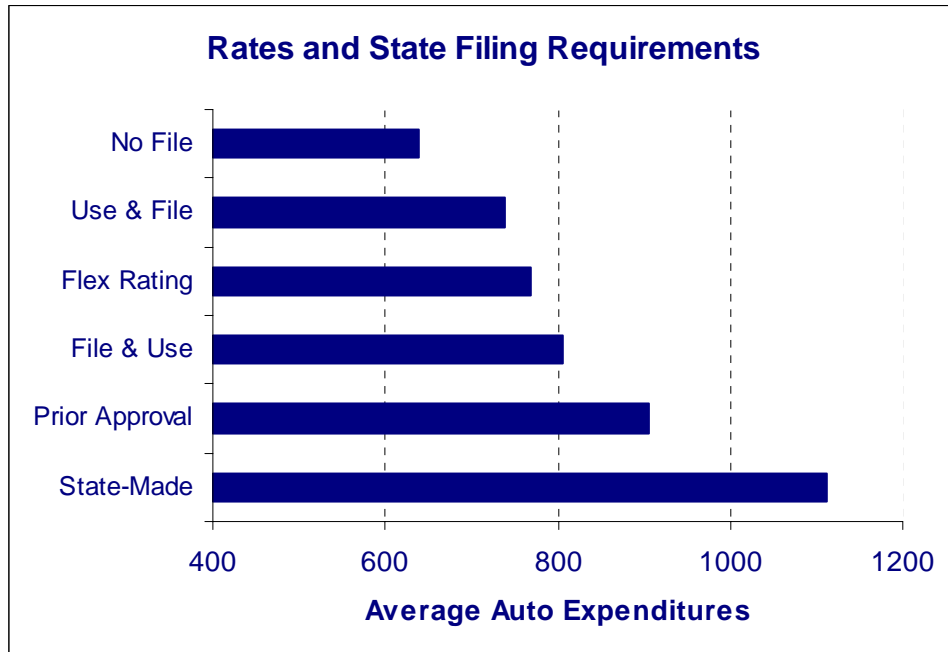
## **Would Less Price Regulation Benefit Consumers?**

March 27, 2008, a *ConsumerGram* analyzed the effects of regulation on auto and homeowners insurance and, while controlling for income, natural disasters and crime, found that higher levels of regulation lead to higher consumer premiums. The statistical analysis found that the average household pays about \$300 more for property and casualty insurance in heavily regulated states, compared to those in less regulated states. The overall effect of excessive regulations was estimated to raise consumer property and casualty insurance premiums by approximately \$13.7 billion per year.

While that *ConsumerGram* relied on an index of regulation constructed by the Competitive Enterprise Institute and Heartland, a simpler way to summarize the effects of regulation on consumers is to show average consumer expenditures for states grouped in terms of their regulatory regime. More specifically, to test whether auto insurance price regulation benefits consumers, we categorized the states based on their rate filing requirements, and calculated (weighted) average consumer expenditure (for the year 2006) for each category and sorted the results by the approximate severity of state-based price regulation. As discussed earlier, there are 6 general classes of state filing requirements, in increasing severity of regulation: 1) no filing requirement; 2) use and file; 3) flex rating; 4) file and use; and 5) prior approval and state made rates. If the prior studies are correct – that price regulation increases consumer premiums – we should see some graphical affirmation of these results.

The graph (below) shows a consistent and dramatic positive relationship between the level of price regulation and insurance expenditures. While many factors influence insurance

premiums and were accounted for in earlier studies, this graph shows clearly that more price regulation means higher consumer expenditures. The chart shows the differences to be substantial, consistent between the categories and in tune with earlier studies – that price regulation harms consumers. Therefore, evidence refutes the belief by some that increased price regulation provides some consumer benefits or that such regulation is in the public’s interest.



Alternatively, an Optional Federal Charter would provide uniformity and a reduction in onerous price regulations without negatively impacting rates as advocates for state regulation have suggested. In fact, the evidence cited here suggests that such reform would benefit consumers, increase competition, encourage service innovation and lower consumer costs.

### **Reform is Needed – Now**

It will be a long time before 50+ state commissions agree on uniform regulations that would decrease market distortions and increase competition for the benefit of consumers. A better prospect would be for policymakers to permit Optional Federal Charters, which would give consumers more competitive prices and an increased choice.

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