

# **Insurance Regulation: Market or Government Failure?**

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# **Insurance Regulation: Market or Government Failure?**

Stephen B. Pociask , Joseph P. Fuhr and Larry F. Darby<sup>1</sup>

## Executive Summary

More than 100 years ago, there was a shift in public sentiment towards increased regulatory oversight of large and concentrated industries that resulted from concern from potential monopoly harms. This regulatory oversight was innocuously justified as being in the *public interest*, and imposed on several industries, including railroads, telecommunications, trucking, insurance and airlines. Over the next fifty years, these regulations grew to include setting prices, approving market entry, and determining the services and markets to be served. Since the late 1970s, however, a wave of reform has led to a significant reduction in regulatory oversight in these industries, with one notable exception – the insurance industry – which remains largely regulated for consumer services.

This report reviews the history of insurance regulation, the economic justification for regulation and the consequences on consumer welfare resulting from reduced regulation. The purpose of this paper is to assess whether regulatory reforms should be considered in the insurance industry, similar to reforms that have occurred in other industries. The following represents the key findings of this report:

- There are no studies that demonstrate that insurance regulation produces more benefits than costs for consumers.
- Insurance regulation came about with no clear economic justification. Early on, insurance regulation was imposed to prevent prices from being too high or too low.
- However, relying on regulators to determine the right price leaves consumers without competitive prices, creating inefficiencies and consumer welfare losses.
- In contrast, regulatory reforms in the transportation services industry has led to over \$50 billion of annual benefits to consumers from lower prices, higher industry productivity and innovation, and better service quality.

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- Regulatory reform in the insurance industry appears to yield consumer benefits. In Illinois, a state without insurance price regulation, there is increased competition and lower consumer prices.

State insurance regulation is onerous and costly, due in part to a lack of uniformity in services and rules among the 50-state regulatory commission system that is currently in place. For consumers, the system imposes needless costs that result in higher consumer prices, as well as impeding service and quality innovation. Evidence suggests that having a national regulator could maintain adequate consumer protections while lowering the duplicative costs among the 50 states. By giving insurance carriers an option of federal regulation – referred to as an *Optional Federal Charter* – carriers could save billions of dollars, which, in absence of regulatory entry barriers, would be passed along to consumers in the form of lower insurance prices. One study found that an Optional Federal Charter for life insurance regulation would result in billions of dollars of benefits. In other words, merely allowing federal regulation – not full deregulation – would save consumers billions of dollars without sacrificing consumer protection. It is very likely that similar benefits are possible for property and casualty insurance, if regulations could be standardized across the U.S.

Economic history teaches that there are appropriate roles for both government and markets in assuring optimal performance of different sectors of the economy. History also teaches that economic and social changes redefine these roles, while calling for a rebalancing of the mix between them. So it is in the insurance industry. Experience with government controls in other sectors has led to substantial costs to consumers without yielding identifiable benefits. Consumers in the end pay all costs of government involvement – as taxpayers, as buyers of services, as employees and as stakeholders in the companies involved. Evidence to date indicates that consumers are not being well served by a wide variety of insurance regulations. There are numerous beneficiaries of course, but they are not consumers. Developments in economic analysis and a host of empirical evidence accumulated in recent years leave no doubt that consumers' interest and the nation's overall economic welfare would be served by systematic and targeted reforms of out-of-date regulations. The rules of the marketplace sometimes fail and warrant government entry. However, rules of government also fail and warrant government reforms.

In summary, the consumer costs and benefits of insurance regulation is a legitimate area of economic inquiry. This study finds the extent of today's insurance regulation cannot be justified based on economic theory. Whatever the original economic justification for insurance regulation was, it is no longer valid today. Furthermore, in light of the huge consumer benefits that resulted from regulatory reform in other industries, and given

the absence of rigorous cost/benefit analysis of insurance regulation, it appears that consumers are losing as a result of an onerous and duplicative state system of regulation. Reforms and modernization of state regulations, including permitting an Optional Federal Charter, can maintain reasonable consumer safeguards, while encouraging market efficiency, service innovation, lower industry costs, and lower prices for consumers.

## I. Purpose

New York Senator Charles Schumer and New York Mayor Michael Bloomberg released a report detailing problems in the banking, securities and insurance industries.<sup>2</sup> One of their major findings is that regulations are threatening the global competitiveness of the U.S. financial services industry. If nothing changes, the report predicts that the U.S. will lose its position as the number one financial market in the world. Noting that the insurance industry faces imposing regulations at the hands of 50 (plus) state commissions, the Schumer/Bloomberg report recommends a national insurance charter, which would streamline regulations, encourage market-based principles, and end the current balkanized statewide process.<sup>3</sup>

In addressing whether the current regulatory regime benefits consumers or whether regulatory reforms are needed, it would be helpful to understand why the insurance industry is regulated. This study gives a brief history of insurance regulation, theoretical framework for industry regulation, analyzes what happens when industry regulations are modernized, and whether regulatory reforms are needed in the insurance industry. While far from comprehensive, the intent of this study is to determine whether insurance regulation should be considered for reforms, and whether further research should be undertaken to understand the consequences that these regulations have on consumer welfare.

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<sup>2</sup> Senator Charles Schumer and Mayor Michael Bloomberg, “Sustaining New York’s and the US’ Global Financial Services Leadership,” January 22, 2007.

<sup>3</sup> Ibid, p. 116. Specifically, recommendation #8 calls for a “federal charter for insurance based on market principles for serving customers.”

## II. A Brief History of Insurance Regulation

*“The last people to decide whether a regulatory system should survive are the people who run it, and next-to-last are the people it regulates. Yet the question holds for both of them an enduring fascination, and their capacity to fret and chatter about it has no known limit.”<sup>4</sup>*

Consumers buy insurance to protect themselves against what is generally a small probability of a catastrophic loss, effectively transferring the risk of any loss to an insurance carrier. In turn, an insurance carrier spreads the risk it assumes over a large pool of policyholders, using capital reserves to shoulder any reimbursement costs to policyholders who may incur an unexpected loss.

Concepts of insurance date as far back as 3000 B.C. However, it was during 1500’s to 1700’s, when more modern types of policies began to develop for life, marine and fire insurance. The roots of Lloyds’s of London began at Lloyd’s Coffee in 1688, where shippers and traders would negotiate and obtain insurance on shipping fleets and their cargo.<sup>5</sup> As the U.S. colonies grew, the need for insurance grew as well, particularly for fire and marine insurance. Benjamin Franklin started what was probably the first insurance company in the colonies – the Pennsylvania Contributionship, which still operates today.<sup>6</sup> Over the decades, some insurers collectively agreed to set reserves, in order to maintain solvency and build public trust and confidence. Early regulation included reporting requirements, taxes on insurers, and granting charters.

Later, in the 1800s, many states established regulations to set standards and guard against problems of insolvency, after a number of catastrophic fires led to insurance bankruptcies. Regulations also were used to chase off wildcat insurance companies. During this period, regulators became concerned about insurance policy rates that were both too high and too low. For instance, if markets were too competitive, regulators believed that low rates could be predatory and would lead to a decrease number of insurance carriers.<sup>7</sup> That, in turn, would lead to inadequate funding for policyholders facing major losses. On the other hand, if rates were too

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<sup>4</sup> “The Future of Federalism in Insurance Regulation” American Life Convention, Washington, DC, October 1970, published in Richard E. Stewart, *Insurance and Insurance Regulation: Speeches and Paper 1968–1992*, downloaded on January 30, 2007 at <http://www.stewartconomics.com/Book020500.PDF>.

<sup>5</sup> For more information see <http://www.lloyds.com>.

<sup>6</sup> The Contributionship’s web site is <http://www.contributionship.com/>.

<sup>7</sup> The term “ruinous competition” was used.

high, according to the thinking at the time, insurance companies would be regarded as price-gouging by not offering affordable rates to the masses. During this time period, regulators also became concerned with preventing price discrimination.<sup>8</sup>

Starting with the passage of the Interstate Commerce Act in 1887, which regulated railroad rates, entry and exit, a mood of industry regulation swept the U.S., including the insurance industry. Since policymakers and regulators did not like high or low insurance rates, rate regulation of insurance was easy to justify in the public's interest.<sup>9</sup> By 1910, 47 state commissions were established,<sup>10</sup> and many states had developed processes for setting and approving insurance rates, including joint ratemaking.

When the Supreme Court ruled that insurance was a form of interstate commerce, the McCarran-Ferguson Act was passed in 1945 to restore regulatory powers to the states. In the years immediately following the passage of the McCarran-Ferguson Act, insurance regulations increased and peaked in most states, including regulations that controlled market entry, required that all insurance carriers be state-approved, limited price discrimination, and imposed various forms of price regulations, such as collective price setting.<sup>11</sup> Interestingly, the McCarran-Ferguson Act which spawned the last round of regulation was never intended to increase regulation in the states, according to both the courts and every Congressman that passed the Act:

*"It is not the intention of Congress in the enactment of this legislation to clothe the States with any power to regulate or tax the business of insurance beyond that which they had been held to possess prior to the decision of the United States Supreme Court in the Southeastern Underwriters Association case."<sup>12</sup>*

In recent decades, as will be discussed later in this study, while many of the effected industries have since undergone regulatory reforms, the system of state regulation of consumer insurance has largely

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<sup>8</sup> For instance see the regulatory history of insurance in Texas, downloaded on January 30, 2007 at <http://www.tdi.state.tx.us/general/history.html>.

<sup>9</sup> D. T. Armentano, "Antitrust and Insurance: Should the McCarran Act be Repealed," *Cato Journal*, Vol. 8:3 (Winter 1989), Washington, DC, at fn.7. Armentano points out that the Merritt committee (1910) recommended price regulation, mostly over concerns over inadequate prices.

<sup>10</sup> Economic History Services at <http://eh.net/encyclopedia/article/Baranoff.Fire.final>.

<sup>11</sup> Scott E. Harrington, "Insurance Rate Deregulation," Presented at the conference Rate Deregulation and Consumers, American Enterprise Institute, Washington, DC, September 21, 2006. All of the points in this paragraph are attributable to Harrington at page 2. Price discrimination became a way for state regulators to keep competitors from setting prices too low, while setting rates too high for risky buyers.

<sup>12</sup> Quote from H.R. Rep. No. 143, 79th Congress., 1st Session, 3 (1945), cited in *SEC v. National Securities, Inc.*, 393 U.S. at 459; *United States Department of Treasury v. Fabe* (91-1513), 508 U.S. at 491; et. al.

continued.<sup>13</sup> To understand why these regulations persist, it is helpful to understand the legitimate reasons to regulate. While there are other reasons to regulate, this study is only concerned with those cases where regulation leads to consumer benefits that exceed costs.

The next section discusses briefly the economic justification for regulation.

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<sup>13</sup> In about half of the states, price regulation on commercial insurance has been deregulated with no apparent repercussion on these consumers. However, various forms of price controls continue on consumer policies. For a discussion of this, see Harrington, 2006.

### III. Why Do We Regulate?

#### Introduction

Efficiently working markets are the best means for consumers to get what they want at the lowest price and highest quality. However, regulations are sometimes needed to protect consumers, correct for market imperfections and be a backstop for preventing assorted harms caused to consumers. Regulation can help consumers by providing recourse on common problems and complaints, helping industries establish common standards and guidelines, and, most importantly, increasing consumer welfare. If regulation does not improve consumer welfare, then it does more harm than good and needs to be reformed or eliminated. While markets can be a source of failure, so can government.<sup>14</sup>

In fact, it is sometimes the case that regulations, while protecting consumers in the name of the *public interest*, are often found to be wasteful, produce higher industry costs, delay innovation, reduce competition, slow the introduction of new products to the market and build operational inefficiencies into the businesses that are regulated. This regulatory waste, cost and inefficiency can lead to higher industry costs and higher consumer prices than otherwise, ultimately decreasing consumer welfare.

This study will investigate whether insurance regulation is needed and a benefit to consumers. In order to assess the general need for insurance regulation, it should always be the case that the cost of regulation be less than the benefits of regulation. However, a reliable quantification of both the costs and benefits are nowhere to be found. Due to the lack of empirical evidence regarding the costs and benefits of insurance regulation, a first step in understanding whether regulation is needed (or not) is to: 1) understand the economic reasons for why regulation exists; and 2) understand what happens to consumer welfare when regulations are removed.

#### Theories of Regulation

There are two notable economic theories that explain why some industries are heavily regulated and others are not. These theories are:

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<sup>14</sup>Historically, regulations were deemed to be in the public's interest, with no verifiable means to determine if this is, in fact, so. However, since the 1960s, cost/benefit analyses that measure consumer welfare measurement have been among the rigorous tools available to economist that can determine whether regulations have benefits that exceed costs. This point is discussed in Clifford Winston, "Government Failure Versus Market Failure: Microeconomics Policy Research and Government Performance, AEI-Brooking Joint Center for Regulatory Studies, Washington, DC, 2006, p. 7.

public interest theory, where public-minded regulators act to correct private market failures; and public choice theory, where regulators and special interest (often acting in their self-interest) work to redistribute wealth or utility among various individuals and groups.<sup>15</sup>

As the oldest economic theory of regulation, the public interest theory had been the accepted theory during the historical rise in industry regulations and it was the economic justification for government intervention in many industries. Public interest theory rests on one major premise – that regulators concern themselves only about the needs of the citizens. While the theory gives an explanation of why regulation exists, it is thin on empirical support and in a world of politics is wishful thinking.

For this reason, in recent decades, the theory of public interest regulation has been widely discredited in favor of the public choice theory, which has gained popular acceptance in the economic literature.<sup>16</sup> In contrast, the theory of public choice contends that regulators are not primarily concerned about the welfare of citizens at all. This newer (developed in the last 50 years) theory of economics raises question about the true motives of regulators (and others) and suggests that regulations do not always leave the public better off. This more advanced theory concludes -- just because regulation is said to be in the public's interest, does not make it so.

In fact, it is possible for regulations to impose enormous and unnecessary costs on business and consumers. In 2004, for instance, the amount of regulations (in pages) grew by 6.2% and off budget regulatory costs increased by \$13.5 billion dollars to nearly \$1 trillion dollars in total, making regulatory costs about twice the size of the U.S. federal deficit.<sup>17</sup> As a testament to government's below-average business acumen, when public produces private goods, it costs consumers twice as much, and usually at a lower level of service quality.<sup>18</sup> Given this, government regulation should be an option of last resort. Imperfect markets should

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<sup>15</sup> Another theory, called the *capture theory* is somewhat similar to the public choice theory, except for one main difference. The capture theory has only one group (the industry) competing for personal gain, whereas the public choice theory permits the competition of many groups. The capture theory does not adequately explain why cross-subsidization exists or why industries oppose some regulations. For the purpose of this paper, we will treat the capture theory as subset of the public choice theory.

<sup>16</sup> Professor James Buchanan's Nobel Prize in economics in 1986 is a testament to the widespread acceptance of the field of public choice economics.

<sup>17</sup> See Clyde Wayne Crews, *The 10,000 Commandments*, Competitive Enterprise Institute, Washington, DC, June 30, 2005, available at <http://www.cei.org/gencon/030.04645.cfm>.

<sup>18</sup> James T. Bennett and Manuel H. Johnson, *Better Government at Half the Price: Private Production of Public Services*, Carolina House Publishers, Inc., Ottawa, IL, 1981, pp. 37-73. The authors provide numerous examples of gross government inefficiencies and substantiate earlier work that government production of a good/service costs generally twice as much as private production.

always be tolerated, unless government solutions clearly produce better outcomes – namely, benefits exceed costs.

Regulation is sometimes needed to correct for market failures, and regulation can be beneficial to consumers when they provide more desirable outcomes than without regulation. There are three major types of market failures – externalities, imperfect information and natural monopolies (or more generally *market power*). Externalities are market failures that result when operations of some kind impose costs on others, such as a firm that pollutes the river and affects the operation of fisherman. These externalities are commonly controlled by taxes and fees, which force producers to privatize the cost that the polluter imposes on society.

Another form of market failure results from imperfect information. For example, if consumers do not have as much information as sellers do, the result can lead consumers into making wrong decisions, which can affect the maximization of consumer welfare. Standards and rules are sometimes applied to help inform consumers. For instance, when purchasing a home, there is a truth-in-lending obligation that assures that consumers have been fully advised of their obligations, costs and risks. Regulations against false advertising, requirement for full disclosure and setting reasonable standards are other steps to overcome imperfect information. None of these steps requires onerous price regulation, or regulation of entry and exit of competitors. In terms of results, Winston found that the problems caused by imperfect information were small and government attempts to correct these imperfections produced little benefit.<sup>19</sup>

The third form of market failure is natural monopoly. Bailey states “entry and price regulation is deemed inappropriate in industries which do not have system-wide natural monopoly characteristics.”<sup>20</sup> Given the considerable market power associated with natural monopolies, it may make sense to regulate these firms. A natural monopoly has considerable control over price and cost advantages, which would make competitive entry very difficult. This is especially true for goods that are considered to be basic necessities for consumers. While there has been much debate concerning how to effectively regulate natural monopolies and there are examples of government failure in doing so, this has been the prominent economic justification for regulating industries. This justification for regulating the insurance industry will be examined in detail in **Section V** of this study.

Besides market failure, there are no other economic justifications to regulate price. For instance, maintaining industry solvency can be managed with federal capital reserve requirements and does not require price

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<sup>19</sup> Winston, 2006, p. 28.

<sup>20</sup> Elizabeth E. Bailey, “Price and Productivity Change Following Deregulation: The U.S. Experience,” *The Economic Journal*, March 1986, p. 1.

regulation, entry barriers or state-level regulatory oversight. While other reasons for state intervention are given, these reasons have not been justified as increasing net benefits to consumers. While redistributing income, cross-subsidizing services and socializing prices are common forms of government intervention, none of these are reasons for regulating an industry, and none of them necessarily improve total consumer welfare. While an unregulated industry can have inefficiencies, failures and fraud, imperfect markets only have to be as good as government regulation in order to be left unregulated. To do otherwise means that consumers will be made worse off.

While insurance regulations are said to be in the public interest, there is no sound economic rationale for establishing entry barriers, fixing prices, and cross-subsidizing consumers. In fact, all three of these actions are likely to have increased consumer prices and reduced the demand for insurance, thereby harming consumer welfare. For instance, entry barriers limit competition and restrict market supply, which will increase consumer prices. Price fixing is tantamount to cartel pricing, which may raise prices, reduce output and hide industry inefficiencies – all of which reduce consumer welfare. Cross-subsidies between consumer groups raise insurance prices, by increasing prices to low-risk consumers and lowering prices to high-risk consumers. These insurance cross-subsidies encourage more risky behavior, which leads to more losses. Increased losses, in turn, increase carrier costs and are ultimately reflected in higher insurance prices for consumers. On the other hand, economic price discrimination is common in competitive markets and can improve consumer welfare.<sup>21</sup>

In summary, the historical reasons to regulate were not based on sound economic reasoning, and public choice would suggest that other (less public-minded) reasons explain the regulation of insurance. Moreover, regulating when prices are too low harms consumers, while regulating entry barriers when prices are too high is counterproductive when regulations inhibit market entry.

The next section will examine a number of industries that had undergone regulatory reforms, assess the ensuing industry performance and address whether regulatory reforms resulted in increased or decreased consumer benefits.

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<sup>21</sup> The economic literature on this is clear that price discrimination maximizes consumer welfare, and it appears to be an important aspect of competition. For more information see William Baumol, “Regulation Misled by Misread Theory,” AEI-Brookings Joint Center, 2006; Hal Varian, “Price Discrimination,” *Handbook of Industrial Organization*, vol. 1, Schmalansee and Willig, eds., North Holland, 1989; and Michael Levin, “Price Discrimination Without Market Power,” *Yale Journal on Regulation*, vol. 19:1, Winter 2002.

## IV. Regulatory Reform: Empirical Evidence and Industry Analogies

### Industry Analogies

There are a number of industries that were regulated under the guise of public interest. The belief was that in the absence of competition, monopoly-like conduct would produce monopoly-like prices, thereby reducing consumer welfare. The rationale for regulation of these industries was to ensure reasonable prices, while preventing monopoly profits. Among these regulated industries were railroads, airlines, trucking, communications, stockbrokerage, banking, and insurance.

Over the course of the last three decades, several industries have undergone regulatory reforms. The consequences of these reforms are useful in understanding whether industry regulations, established to protect and increase the public's interest, are necessarily good for consumers. If regulations have, in fact, harmed consumers, then further inquiry into the need for industry regulation, including insurance regulation, is warranted. This section will provide a brief summary of industry reforms.

#### 1. Railroads

Eliminating price regulations on the railroads proved several things: 1) regulation is not the solution to solvency; 2) markets can achieve much better results than commissioners can; and 3) consumer welfare can increase significantly from regulatory reform.

During the 1970s, the U.S. railroad industry teetered on the brink of bankruptcy, in large part due to regulations that gave trucking a competitive advantage over railroads. The railroad industry was heavily regulated and included collective ratemaking and prohibitions on the abandonment of unprofitable routes. Eventually legislation was passed to deregulate railroads and encourage competition.

The balkanization and concentration of the industry made deregulation a risk for the public, who feared so called *captive shippers* would pass on higher transportation costs to consumers in the form of higher prices.

However, deregulation did the exact opposite. Railroads finally had the ability to price efficiently, target profitable markets and reduce costs. Roughly one-third of unprofitable track was abandoned, and, as of 1998, costs per ton-mile fell by 60% from the time when deregulation began.<sup>22</sup>

<sup>22</sup> Curtis Grimm and Clifford Winston, "Competition in the Deregulated Railroad Industry: Sources, Effects, and Policy Issues," in *Deregulation of Network Industries: What's Next*, Sam Peltzman and Clifford Winston, ed., AEI-Brookings Joint Center for Regulatory Studies, Washington, DC, 2000, p.43.

Industry multi-factor productivity not only increased in the years following deregulation,<sup>23</sup> but, according to recent data published by the Bureau of Labor Statistics, the upward trend in efficiency continues.<sup>24</sup>

As a result, deregulation led to a rebound for the industry. Compared to the ten years prior to deregulation, when the industry averaged 1-3% return on equity, in the ten years that followed deregulation the industry averaged nearly 11% return.<sup>25</sup> Through industry consolidation, balkanized carriers became end-to-end carriers.<sup>26</sup> In short, the industry turned itself around – reduced costs and increased profits.

As to the risks of modernizing regulations, proponents of regulation had warned that deregulation of a concentrated industry would lead to higher prices for shippers and consumers. However, intermodal competition – competition between trucking, airlines and ships – provided enough rivalry for efficiencies to lead to significantly lower prices. For instance, one study found that shippers received about \$12 billion of annual benefits from lower prices and improved services.<sup>27</sup> Another study estimated the consumer benefits from lower prices to be \$9.1 billion.<sup>28</sup> From the period 1982 to 1989, the average annual rates for shipping commodities by rail fell 4.6%, led by a 6.7% decline for farm products, a 6.9% decline for food products and a 6.2% decline for wood and lumber, as well as lower prices for many other commodity categories.<sup>29</sup> One can only wonder what would have happened to the railroads and railroad infrastructure, if railroads had failed under regulation; or what the consequences on consumers would have been, if the federal government needed to bail-out failing railroad operators.

In summary, regulation had left an industry near bankruptcy. Regulation did not result in solvency, did not encourage operational efficiency, and did not protect shippers and consumers. Though at the time there were doubters, clearly, railroad regulation was a cost with little

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<sup>23</sup> *Deregulation and Consolidation of the Information Transport Sector: A Quantification of Economic Benefits to Consumers*, Joel Popkin and Company, Sept. 29, 1999, p. 58. The chart compares industry productivity before and after deregulation, and shows the industry has experienced a marked increase in productivity since deregulation.

<sup>24</sup> Data for labor and multifactor productivity is available at [www.bls.gov](http://www.bls.gov).

<sup>25</sup> One estimate of profitability for the period 1962-1978 was 2.4%. See Robert G. Harris and Theodore E. Keeler, "Determinants of Railroad Profitability: An Econometric Study," *Economic Regulation: Essays in Honor of James R. Nelson*, 1981, p. 37.

<sup>26</sup> Richard C. Levin and Daniel H. Weinberg, "Alternatives for Restructuring the Railroads: End-to-End or Parallel Mergers?" *Economic Inquiry*, July 1979, p. 372.

<sup>27</sup> Clifford Winston, et. al., *The Economic Effects of Surface Freight Deregulation*, Brookings, 1990.

<sup>28</sup> Robert Crandall and Jerry Ellig, "Economic Deregulation and Customer Choice: Lessons for the Electric Industry," Mercatus Center, George Mason University, 1997, executive summary.

<sup>29</sup> Grimm and Winston, 2000, p. 45. They show that shipped commodity prices have continued to decline (averaging 4.1% per year from 1990 to 1996), highlighting the ongoing (and not onetime) benefits of deregulation.

benefit. Reforming regulations saved the railroad industry, led to lower prices and costs, and increased consumer benefits to the tune of billions of dollars each year.

## 2. Airlines

Regulations restricted market entry, segmented the industry into regional, national and international carriers, and routinely cross-subsidized services between short and long haul routes. Regulations determined what markets airlines could serve. Prices were not set rationally, but designed to help some travelers and markets at the expense of others.

Prices for interstate flights were set by the Civil Aeronautics Board, which led carriers to compete on service, not price. This regulation led to flights with many empty seats and higher service costs. Some unregulated airlines operated wholly within state markets, and could profitably set prices that were less than half of regulated carriers.<sup>30</sup>

Prior to the overhaul of regulations, most Americans had never flown, because they could not afford to fly. However, reforms made air travel affordable, and were the impetus of Senator Edward Kennedy's effort to deregulate the industry in the 1970s, according to then Senate staffer and current Supreme Court Justice Stephen Breyer:

*At one point, a woman from East Boston interrupted a hearing to ask the Chairman, Senator Kennedy, "Senator, why are you holding hearings on airlines? I've never been able to afford to fly." "That," said the Senator, "is why I am holding the hearings."<sup>31</sup>*

With deregulation in 1978, airlines quickly moved to hub and spoke operations that permitted significant cost savings, targeted cities with more passenger demand and allowed carriers to set prices. Many regional carriers became nationwide carriers, providing end-to-end services. Passenger complaints declined as well<sup>32</sup> and airline safety has increased.

As a result of regulatory reform, average airline fares declined significantly relative to regulated fares. By one estimate, as of 1994, fares were running about 27% below regulated fares.<sup>33</sup> After correcting for quality differences, the average annual consumer benefits exceeded \$20

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<sup>30</sup> See W. A. Jordan, *Airline Regulation in America*, Brookings Institute, Washington, DC, 1974; and M. Levine, "Is Regulation Necessary? California Air Transportation and National Regulatory Policies," *Yale Law Journal*, Vol. 74, July 1965, pp. 1416-47.

<sup>31</sup> Justice Stephen Breyer, University of Pennsylvania Law School Commencement Remarks, Philadelphia, PA, May 19, 2003.

<sup>32</sup> Morrison and Winston, 1999, P. 20.

<sup>33</sup> Steven Morrison and Clifford Winston, "Regulatory Reform of U.S. Intercity Transportation," in *Essays in Transportation Economics and Policy*, Jose Gomez-Ibanez, William Tye and Clifford Winston (ed.), Brookings, Washington, DC, 1999, p. 1.

billion.<sup>34</sup> Similarly, Crandall and Ellig report the annual savings at \$19.4 billion.<sup>35</sup>

In summary, airline regulations – particularly regulations on entry and pricing – were harming consumers. Regulatory reform had led to industry efficiencies that have driven down air fares and provided billions of dollars of benefits to consumers each year.

### 3. *Trucking*

Before deregulation in 1980, the Interstate Commerce Commission not only controlled market entry, but it regulated what could be hauled, where it could be hauled to and the route over which it could be hauled. Rules were set up to make competition “fair” – often requiring trucks to return with empty loads or less-than-full truckloads. However, when regulatory reforms occurred, hub and spoke operations were commonplace for less-than-full truckloads. That, and other efficiencies, drove down prices between 28-56%, and consumer benefits reached about \$19.6 billion per year.<sup>36</sup> Similar to the airlines and railroad industry, reforms led to significant consumer benefits in the form of lower prices for shipped commodities.

### 4. *Telecommunications*

Some regulatory reforms have taken place in the telecommunications sector. Until recent decades, rules imposed barriers to entry that limited competition, required extensive subsidies between telephone services, and stifled innovation. When the AT&T consent decree was signed in 1982, breaking up Ma Bell, average long distance revenue was 61 cents per minute (in 2001 dollars). When barriers were removed, hundreds of long distance competitors entered the market and, as of 2001, revenues fell to 10 cents per minute.<sup>37</sup> Elsewhere, regulations delayed the introduction of wireless services to the market, a delay costing consumers \$25 billion per year (in 1983 dollars).<sup>38</sup> Similarly, regulatory delays in voice messaging services cost consumers \$1.3 billion per year (in 1994 dollars).<sup>39</sup> Numerous studies have shown that barriers to entry and the failure of regulators to allow for competition in the cable TV market had cost consumers between \$9 billion and \$23 billion per year.<sup>40</sup> Many states

<sup>34</sup> Morrison and Winston, 1999, p. 2.

<sup>35</sup> Crandall and Ellig, 1997, executive summary.

<sup>36</sup> Crandall and Ellig, 1997, executive summary.

<sup>37</sup> “Statistics on the Long Distance Telecommunications Industry,” Industry Analysis & Technology Division, Wireline Competition Bureau, FCC, May 2003.

<sup>38</sup> Jeffrey Rohlfs, Charles L. Jackson and Tracey E. Kelly, “Estimate of the Loss to the United States Caused by the FCC’s Delay in Licensing Cellular Telecommunications,” *NERA Discussion Paper*, Washington, DC, Nov. 1991.

<sup>39</sup> Jerry Hausman and Timothy Tardiff, “Valuation and Regulation of New Services in Telecommunications,” *MIT Discussion Paper*, June 1996.

<sup>40</sup> “Overwhelming Evidence – Cable Competition Benefits Consumers,” *ConsumerGram*, The American Consumer Institute, Reston, VA, 2006; and “Does Cable Competition Really Work?” The American Consumer Institute, March 2, 2006.

are now ending local regulation of cable TV services, thereby permitting open competition, which has resulted in lower consumer prices.

#### 4. *Examples of Reforms*

While deregulation of financial services is far from complete, some regulatory reforms have occurred with clear consumer benefits. Prior to deregulation, brokerage fees were fixed, effectively preventing price competition among brokerage houses. Deregulation of the brokerage industry has led to significant increases in productivity and falling brokerage fees for consumers.<sup>41</sup> In just a few years, deregulation of the industry resulted in an average decline in brokerage fees of 25%; and, for orders greater than 10,000 shares, a decline in brokerage fees of 50%.<sup>42</sup> With the advent of the Internet, online brokerage fees have declined even further.

In banking, regulation of time deposit interest rates and restrictions on asset investment were eliminated, and banks were permitted interstate operations, replacing some state regulations with federal regulations. As a result of these reforms, industry competition increased, as did productivity, which saw revenues per employee increase by 300% from 1984 to 1993.<sup>43</sup>

Price regulation of the natural gas extraction industry began in 1968, and for the next 17 years, regulation cost the economy \$9.5 billion per year.<sup>44</sup> Partial deregulation has resulted in a 30% decline in consumer prices, and a net increase in consumer benefits.<sup>45</sup>

#### 5. *Insurance*

The insurance industry is highly regulated, except for some states that have no price regulation on commercial policies, and states that have relaxed the rate approval process. Otherwise, consumer services remain heavily regulated, with one exception – insurance services in the state of Illinois.

Since 1971, the state of Illinois has not had rate regulatory laws in effect for most types of insurance. For the auto insurance service market, Professor D'Arcy compared Illinois to comparable states and found Illinois

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<sup>41</sup> Elizabeth E. Bailey, "Price and Productivity Change Following Deregulation: The U.S. Experience," *The Economic Journal*, March 1986, pp. 4-5.

<sup>42</sup> Gregg A. Jarrell, "Change at the Exchange: The Causes and Effects of Deregulation," *Journal of Law and Economics*, volume 27:2, October 1984, pp. 273-312. Also see, Kenneth W. Costello and Robert J. Granieri, "Deregulation-Restructuring: Evidence for Individual Industries," The National Regulatory Research Institute, Columbus, OH, May 1997.

<sup>43</sup> Costello and Granieri, 1997, citing Allen N. Berger, et. al. "The Transformation of the U.S. Banking Industry: What a Long, Strange Trip It's Been," *Brookings Papers on Economic Activity*, vol. 2, 1995, pp. 55-218.

<sup>44</sup> Paul W. MacAvoy, *The Natural Gas Market: Sixty Years of Regulation and Deregulation*, Yale University Press, New Haven 2000.

<sup>45</sup> *Ibid.*

to have less variable loss ratios and rate levels, lower consumer prices, the highest number of insurance carriers in the nation, and a low number of uninsured drivers.<sup>46</sup> Based on this, regulatory reforms have produced clear benefits for Illinois consumers, similar to those noted in other industries where regulations were modernized, reformed and, in some cases, eliminated.

There are examples where insurance regulation has harmed consumers, and reform of these regulations resulted in consumer benefits. After regulations in the District of Columbia (DC) and South Carolina resulted in subsidized rates for uninsurable high risk drivers, the size of this residual market grew substantially.<sup>47</sup> This put upward pressure on rates, and given rate controls, led to the exit of insurance carriers. In 1996, when DC regulations were reformed, carriers returned to the market, the residual market declined by 80% and average premiums declined.<sup>48</sup> In South Carolina, regulatory reforms had similar results.<sup>49</sup> From this experience, it is clear that inefficient pricing and onerous regulations can harm consumers. The successes in Illinois, and the reversal of missteps in South Carolina and DC, provide evidence that regulatory reforms can work.

State regulatory oversight results in needless costs, redundancies and lack of consistent standards which provide consumers no added protection. For instance, a study by Computer Sciences Corporation (CSC) and the American Council of Life Insurance (ACLI) estimated regulatory costs for life insurance to total \$11 billion over 10 years.<sup>50</sup> They recommend adopting an Optional Federal Charter that would reduce costly and redundant state regulations, which would lead to lower rates and greater consumer demand. As for property and casualty insurance services, an Optional Federal Charter would presumably reduce similar waste without sacrificing important consumer protections. In other words, regulatory reform, not necessarily full deregulation, has the potential for increasing consumer welfare.

Historically, market concentration was used to justify regulation. However, economists have since concluded that market structure does not necessarily determine conduct and performance. The empirical evidence shows that the insurance industry is not concentrated, particularly when compared to the noted deregulated industries. For example, the top ten insurance writers had a combined market share of 57.6% for automobile insurance premiums, 46.8% for property insurance premiums (including

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<sup>46</sup> Stephen P. D'Arcy, "Insurance Price Deregulation: The Illinois Experience," Brookings Institution, Washington, DC, presented at the Insurance Rate Regulation Conference, January 18, 2001.

<sup>47</sup> Harrington, 2006, p.13. In South Carolina, the residual market reached 40% of insured.

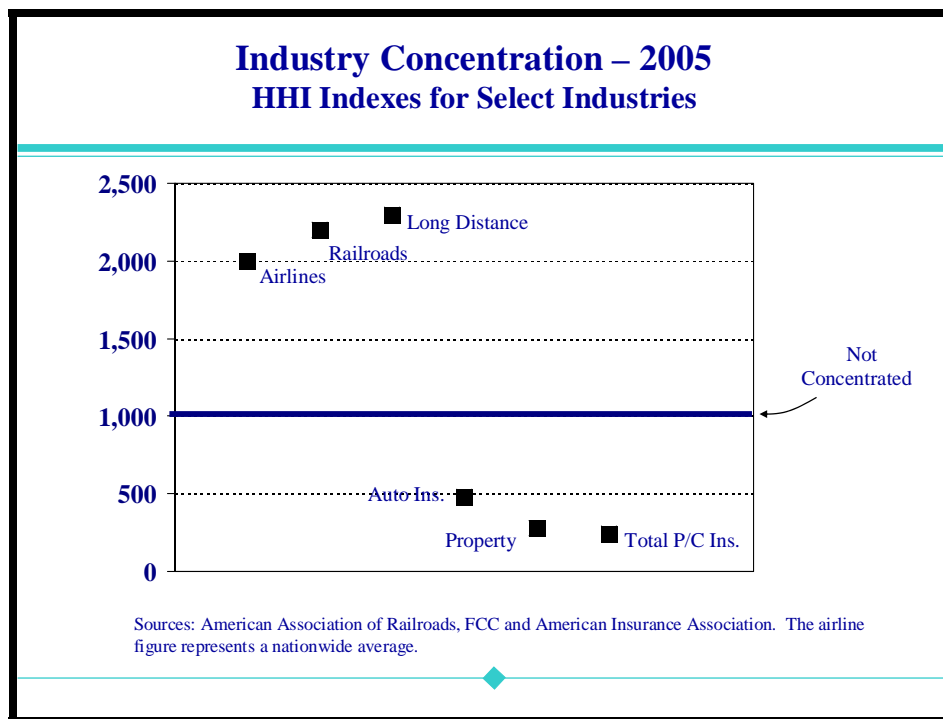
<sup>48</sup> Ibid.

<sup>49</sup> Ibid, p. 14.

<sup>50</sup> "Economic Impact of an Optional Federal Charter on the Life Insurance Industry: A survey of Leading U.S. Insurance Companies," CSC and ACLI, August 2, 2005.

homeowners), and 44.5% for property and casualty premiums.<sup>51</sup> Using the Federal government’s standard concentration measurement called *Herfindahl-Hirschman Indexes*,<sup>52</sup> where an index value of 10,000 denotes a pure monopoly and where an unconcentrated industry has an index value below 1,000, industry concentration indexes are estimated to be 483, 282 and 246 for the auto, property and total property and casualty markets, respectively. By these measures, it can be concluded these segments of the insurance industry are highly competitive. An analysis of state data would show similar results.

The chart below compares the concentration indexes for insurance services (auto, property and total property and casualty insurance) with key deregulated industries. The long distance market concentration index was over 3,400 in 1996, though it has continued to fall, despite mergers. Airlines concentration is no lower than 2,000, with individual major city pairs (not shown) as high as 7,000. Clearly, if concentration is not a concern for these deregulated industries, they must certainly not be for insurance. Therefore, by traditional standards, the insurance industry is not at all structurally concentrated and, as for market power, poses no risks to consumers.



<sup>51</sup> “Market Share Report 2005,” American Insurance Association, Washington DC, Jan. 2006.

<sup>52</sup> Calculated as the sum of the squared percent shares. For more information, see “Horizontal Merger Guidelines,” U.S. Department of Justice and the Federal Trade Commission, April 18, 1997, <http://www.usdoj.gov/atr/public/guidelines/hmg.htm>.

In summary, there appears to be little reason why insurance is regulated, except for the fact that it always has been. This suggests that huge consumer welfare benefits could be achieved, if the industry was carefully reformed, while leaving consumer safeguards in place to protect against fraud and abuse, as well as maintaining industry solvency. Therefore, it would appear that the insurance industry would be a good candidate for reforming and modernizing existing its forms and programs for government intervention.

**Summary of Industry Analogies**

The last several decades provide numerous examples of alternative forms and programs of government intervention that resulted in ending entry barriers, eliminating price and service controls, and eliminating service cross-subsidies. By and large, modernizing and reforming regulations has led to increased industry competition and productivity. As for consumers, industry prices have fallen, consumer welfare has increased and quality of service has improved. The chart below, from Ellig and Crandall (1997), summarizes the consumer welfare gains from regulatory reform, and shows that these reforms have led to annual consumer benefits in excess of \$50 billion.<sup>53</sup>

**Consumer Savings From Deregulation**

| <u>Industry</u>      | <u>Price Decline in 2 Years</u> | <u>Price Decline in 5 Years</u> | <u>Price Decline in 10 Years</u> | <u>Benefits in 1995 Dollars</u> |
|----------------------|---------------------------------|---------------------------------|----------------------------------|---------------------------------|
| <b>Natural Gas</b>   | 10-38%                          | 23-45%                          | 25-57%                           | \$2B-\$4B                       |
| <b>Long Distance</b> | 5-16%                           | 23-41%                          | 40-47%                           | \$5B                            |
| <b>Airlines</b>      | 13%                             | 12%                             | 29%                              | \$19.4B                         |
| <b>Trucking</b>      | N.A.                            | 3-17%                           | 28-56%                           | \$19.6B                         |
| <b>Railroads</b>     | 4%                              | 20%                             | 44%                              | \$9.1B                          |

Sources: Crandall and Ellig (1997), citing Morrison, Winston, et. al.

<sup>53</sup> Crandall and Ellig (1997), executive summary.

From these industry analogies, it appears that industry regulation has harmed consumers and reforming these regulations provided significant economic benefits to consumers.

## V. Potential Benefits of Reforming Insurance Regulation

The cost of regulation is sometimes thought of as a small price to pay for protecting consumers. However, even if the direct costs of regulating the insurance industry are small, say 1%-2% of industry revenues, the indirect costs imposed on consumers could be enormous. For example, the direct cost of the Interstate Commerce Commission in 1979 was less than two-tenths of 1% of industry revenues at the time. Yet, the benefits from deregulating interstate trucking and railroad is estimated to be \$29 billion per year – about half the size of the railroad industry’s total freight revenue.<sup>54</sup> Clearly, the direct costs of regulation seem inconsequential, but the total welfare losses imposed on citizens can be enormous.

While more research is needed to address specific policy proposals, the history and justification for insurance regulation, as well as the anecdotal evidence from Illinois and other states, suggest that reforming insurance regulations could lead to welfare benefits for consumers. It is very likely that today’s insurance premiums are artificially high in order to offset inefficient rates, compensate for added regulatory staff in the commission and industry, pay for the inefficiencies caused by a lack of national standards, recover processing and compliance costs, recoup industry fees and taxes, and so on. Regulations also reduce innovation.

The state-level system of regulatory oversight may encourage inefficiencies compared to interstate oversight. For instance, insurance carriers can substantially reduce risk, and therefore cost, by increasing the pool of policyholders. Facing 50 state regulatory commissions encourages small carriers when large carriers may be more efficient. State balkanization reduces the potential size of the insurance pool and increases industry costs. These cost increases are reflected in higher consumer premiums. The National Association of Insurance Commissioners has tried since 1970s to increase the uniformity of standard between states. However, if standards are ever set, there are no requirements that states must adopt them. An Optional Federal Charter will overcome this problem and reduce some of the cost of insurance regulation, without eliminating consumer safeguards.

More work is needed to analyze and quantify the potential consumer benefits of regulatory reform, but clearly, if consumer welfare is the goal, some modernization or elimination of regulations is needed.

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<sup>54</sup> These figures can be found in the Budget of the U.S. Budget appendix, 1981; and Statistical Abstract of the U.S. for 1981.

## VI. Summary

This report shows that the consumer costs and benefits of insurance regulation is a legitimate area of economic inquiry. Based on this study's observations regarding the growth of insurance regulation, the lack of economic justification for regulation and the many examples of consumer benefits from regulatory reform, we find that further study and quantification of the consequences of insurance regulation is needed. This study finds that there are ample questions that need to be addressed about the consumer welfare effects caused by insurance regulation. It is time for a clear understanding of why we have insurance regulation, what regulations are harmful and to what extent reforms are needed to increase consumer welfare. Market solutions only have to be as good as regulatory solutions. In the absence of market failure, regulation represents government failure.

In summary, regulation of insurance needs to be justified and its costs to society quantified. Simply terming regulation as *in the public interest* – without economic justification – is a disservice to all consumers, who deserve much better from their public servants and policymakers.