Antitrust and Insurance: Should the McCarran Act Be Repealed?

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The McCarran-Ferguson Act (PL-15) passed in 1945 exempts the state-regulated property-casualty (P/C) insurance industry from important sections of the federal antitrust laws. There are a number of proposals currently in Congress, supported by a few industry representatives and many industry critics, that would repeal the McCarran-Ferguson Act (MFA). The focus of this study will be to examine whether the repeal of the P/C insurance industry's antitrust exemption would be intelligent public policy.

A Brief Regulatory History of P/C Insurance

Property/casualty (or liability) companies insure individuals, business organizations, and governments against the risks associated with personal injuries or the loss of property. In 1986 there were approximately 3,600 P/C insurance companies in the United States with net premium income of $176 billion and total industry assets of $374 billion (*Standard and Poor's*, January 1988; *Best's Review* January 1988).

The industry's antitrust exemption can be understood only in a broad historical context. The 19th-century fire insurance industry was a curious mix of business rivalry and interfirm cooperation. There was intense rivalry among insurers for the business of independent agents who actually sold or "placed" insurance. There was also vigorous competition among the independent agents themselves to sell insurance products. Since insurers could not control the agents directly,

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there was always the danger that severe price competition would threaten insurer solvency. Aside from the intense rivalry, however, there was also substantial interinsurer cooperation. There were industrywide agreements among insurers to pool loss experience data so that rational insurance prices might be determined. In addition, insurance companies often formed boards or compacts (cartels) in an attempt to control both the rivalry for agents and their unpredictable pricing behavior.

During the 19th century, state regulation of the insurance business was minimal (the setting of modest capital and surplus requirements), although some states did pass "anticompact" laws (1885–1907) in an attempt to restrict insurer rate collusion. There was an absence of federal regulation or antitrust intervention in the industry since the Supreme Court decision in *Paul v. Virginia*[1] had determined that selling insurance was not "commerce."

Intercompany agreements among insurers to stabilize prices were notoriously unsuccessful. Participating companies and agents would break the voluntary cartel agreement whenever it was in their individual interest to do so. Indeed, the alleged problems of inadequate rates and potential insurer insolvency were equally as important a public policy concern as price collusion, and led the Merritt Committee in New York (in 1911) to recommend that New York State regulate insurance company ratemaking (Day 1970). Other states followed New York's lead, and a system of state regulation of insurance rates came to exist in most states for many different types of P/C insurance by 1944.

In *U.S. v. South-Eastern Underwriters Association*,[2] the Supreme Court unexpectedly held that insurance activity that crossed state lines did constitute "commerce" and was fully subject, therefore, to the federal antitrust laws. The imminent application of the federal antitrust laws to insurance threatened the entire system of joint ratemaking and many other cooperative activities, and sent tremors throughout the industry. The major insurers, the agent organizations, and the state regulators mobilized quickly (led by the influential National Association of Insurance Commissioners), and Congress quickly passed the McCarran-Ferguson Act (MFA) in 1945, which partially exempted the insurance industry from federal antitrust regulation.[3]

[1]8 Wall. 168 (1869)

[2]322 U.S. 535 (1944). In this case, almost 200 fire insurance companies operating in six states were found guilty of "conspiring" to fix prices (through their trade association) in violation of the Sherman Antitrust Act.

[3]Boycotts, intimidation, and coercion on the part of insurance companies are still illegal under federal antitrust law.

The intent of the MFA was to preserve the existing system of state regulation in insurance, a system not totally unwelcomed by various industry and state special interest groups (*The Pricing and Marketing of Insurance* 1977, p. 22). Explicit *state* ratemaking was already exempt from antitrust prosecution under the precedent set in *Parker v. Brown*.[4] But much of the actual state regulation of insurance (in 1945) was not explicit state ratemaking. Rather, it was a system of state-supervised *industry* ratemaking under the so-called prior approval approach. Insurers were allowed to set rates under the auspices of industry-owned rating bureaus that filed the rates for approval with the state regulatory authority. To preserve this regulatory structure in the wake of the *South-Eastern Underwriters* decision, explicit Congressional exemption from federal antitrust law was required. The prompt passage of the MFA supplied that antitrust immunity (for joint ratemaking) and sanctioned the continued state regulation and state taxation of P/C insurance.

There have been some fairly significant regulatory changes in the P/C industry since 1945. The most important change, propelled by the continuing growth of the direct writers of insurance (such as Allstate), has been the trend away from rigid, prior-approval pricing to so-called open or competitive ratemaking systems (MacAvoy 1977, pp. 18–22). Competitive ratemaking is still state supervised (this assures the MFA antitrust exemption), and rating organizations still exist to collect and collate industrywide loss data for members. But generally it is no longer mandatory that an insurance company join a rating bureau or abide by any statewide joint rate agreement. In most states, competitive rating implies that prices for insurance need be filed only with the state regulators; the rates themselves are determined by the carriers. Some competitive ratemaking states do not even require the public filing of some insurance rates; some states forbid rating bureaus from determining "prospective rates" (projecting past loss and expense trends into the future). Competitive or open rating systems of various types are now operative in almost two-thirds of the states in the more traditional areas of P/C insurance (Meier 1988, pp. 33–87).

The insurance industry's federal antitrust exemption can now be put in sharper perspective. The purpose of the antitrust laws, presumably, is to deter business practices (such as collusion) that might lower economic efficiency and harm consumer welfare. Since the states (which regulate insurance) have generally begun to move to competitive ratemaking, and since (as will be argued below) com-

[4]317 U.S. 341 (1943).

petitive pricing in insurance appears to promote consumer welfare, why continue to exempt the industry from federal antitrust?[5]

Rivalry and Cooperation in Insurance

The essence of the debate over the possible repeal of the MFA is the controversial cooperative activity that occurs in insurance. Much of this intercompany cooperation occurs within the industry-owned and staff-operated ratemaking organizations. Industry rating bureaus consolidate industrywide loss data, perform various statistical and actuarial manipulations with the data (including the projection of past cost and expense information into the future), print rates and rating manuals, and file rates and rating plans with the various state-regulatory authorities. In addition to the rating organizations, there is substantial intercompany cooperative activity with respect to underwriting, reinsurance, participation in assigned risk pools and state guarantee funds, and the formation of various insurance pools and syndicates to write large risks. All of these activities and more (such as agreements with agents) are controversial from an antitrust perspective, and they would clearly come under Department of Justice scrutiny should the MFA be repealed (*The Pricing and Marketing of Insurance* 1977, pp. 167–88).

To understand the controversy over the application of the antitrust laws to an industry such as insurance, it is necessary to review briefly some basic economic theory (Asch 1983). Conventional competition theory holds that consumer welfare is enhanced by vigorous interfirm rivalry. Competition can exist whenever markets are easily entered, when products are relatively homogeneous, when market information is reasonably accurate and available, and when no one firm or group of firms can control the market price. In such markets it can be established that price will tend to equal marginal cost and, in equilibrium, minimum average cost (cost includes a reasonable rate of return on capital investment). In short, economic efficiency and consumer welfare are said to be maximized by vigorous business competition.

Competition (and presumably efficiency) can be compromised by the existence of monopoly power. Firms are said to have monopoly power whenever they are able to affect market price by restricting

[5]The National Commission for the Review of Antitrust Laws and Procedures recommended "that the current broad antitrust immunity for insurance should be repealed." See *National Commission for the Review of Antitrust Laws and Procedures* (1979, p. 227). Critics of the industry have recently recommended that the industry's antitrust exemption be re-examined. See *Hartford Courant*, 25 March 1988.

market output. Presumably this economic power can be attained through internal growth, through merger with other firms, through interfirm collusive agreements to reduce output or fix prices, through product differentiation, or through various legal restrictions and barriers to entry. The effect of monopoly power, if exercised, would be to reduce consumer welfare (consumer surplus) and to misallocate scarce economic resources. The antitrust laws exist (purportedly) to maintain competitive markets and to deter the exercise of private monopoly power.

Rivalry in Insurance

The P/C insurance industry would appear to be "workably competitive," at least from a structuralist perspective (Joskow 1973), for the following reasons.

First, the product produced by the industry is relatively homogeneous, and has been standardized for easy buyer comparison by the industry trade associations and by state regulation. Product differentiation as a barrier to entry is not an important issue in insurance.

Second, there are thousands of P/C insurance companies, and state capital and surplus requirements do not appear to be overly restrictive of entry. In 1971 there were approximately 1,200 P/C companies in the United States (Joskow 1973, p. 379); in 1986, the number of companies had increased to approximately 3,600 (*Standard and Poor's* 1988). This strong increase in the number of new business organizations would indicate the absence of any substantial barriers to entry into P/C insurance.[6]

Third, concentration in the P/C industry is not high, especially when compared to levels of concentration in other U.S. industries. In 1986, for example, the four largest insurers received 22 percent of all premium income while the top 20 companies earned approximately 58 percent of all premium income. State Farm, the largest P/C company in the United States, had a market share of 8.8 percent in 1986; Aetna Life and Casualty, the fourth largest company, had a market share of 3.8 percent in 1986 (*Best's Review* 1987). By way of contrast, the top four cereal "breakfast food" companies in the United States generated 86 percent of that industry's output in the early 1980s. In primary aluminum, the largest four firms produced 64 percent of the industry's output. Even in the U.S. men's and boy's apparel industry—an industry noted for its intense competition—the

[6]Joskow (1973, p. 391) concluded that barriers to entry in insurance are "low," at least for agency companies. State capital and surplus requirements are generally not a significant barrier to entry. See *Monitoring Competition* (1974, p. 287).

four largest firms sold 26 percent of the industry's output, a level of concentration that was higher than in P/C insurance (Bureau of the Census 1986).

Fourth, there is some evidence that the P/C industry has become slightly more concentrated recently. The largest 20 insurers did approximately 48 percent of the business in 1962, 54 percent in 1971, and 58 percent in 1986 (Joskow 1973, p. 381; *Best's Review* 1987). But this trend is not indicative of any decline in interfirm rivalry. Indeed, if anything, rivalry has increased in P/C insurance, and this has resulted in a slight overall increase in market concentration. The increased concentration is associated with the growth of the direct writers (such as Allstate) and the relative decline of companies that rely on the American Agency System.[7] It appears that industry resources are being reallocated from less efficient to more efficient business organizations, which is what one would expect from a competitive market process.

Finally, the great diversity of business opportunities in insurance, and the apparent absence of substantial economies of scale allow small, intermediate size, and large-scale firms to coexist and be rivalrous in the P/C insurance market.

By almost any structural measure, then, the P/C insurance industry would appear to be inherently rivalrous. There are no important structural factors that would appear to justify exemption from antitrust law or extensive state rate regulation.

If the P/C industry is inherently rivalrous, why is it regulated (at the state level) and why is it (partially) exempt from federal antitrust laws? State regulation of insurance and the antitrust immunity do not relate to the structure of the insurance market, but to controversies concerning the industry's historical *conduct* and *performance*. With respect to state regulation, the conventional wisdom is that the P/C industry was regulated (beginning in 1911 with the Merritt Committee Report in New York) because intense insurer/agent competition and even predatory practices threatened major insurer insolvency and put innocent policyholders at risk (*Monitoring Competition* 1974, pp. 9–13).

There is no reason to doubt that intense competition did exist in the 19th-century insurance industry. However, there is little empirical evidence to indicate that "predatory practices" made the industry generally unworkable.[8] Most of the insurer bankruptcies and insol-

[7]Direct writers underwrite and sell insurance products directly to buyers. Companies that use the agency system rely on independent agents to retail the insurance product.

[8]John Day (1970, p. 18) admits that there is "surprising little documentation to support the charges" (of predatory practices) in the famous *Report* of the Merritt Committee.

vencies that did occur were associated historically with the occurrence of unpredictable natural disasters (earthquakes) or with poor business management, and not necessarily with agent-made destructive price competition.[9]

Furthermore, antitrust scholars are extremely skeptical of the theory and practice of so-called predatory pricing (Easterbrook 1981). Predatory practices are economically irrational in industries that have no substantial scale economies or other barriers to entry, and where the probability of achieving monopoly (with such practices) is low. In addition, solid historical examples of true predatory behavior in the U.S. business system are few and far between (Koller 1971). There is no reason to doubt that business rivalry in insurance was vigorous, but this vigorous rivalry was also tempered naturally by reason and by intercompany cooperative agreements. The precise origin of and justification for state regulation in insurance, therefore, remains undetermined.

Cooperation in Insurance

The real controversy in insurance is not over the nature of the rivalrous market process, but over the costs and benefits of intercompany cooperation—especially through ratemaking organizations. As we have noted, there is a long historical experience with interfirm cooperation in this industry, and the major justification for insurance regulation and its antitrust exemption relate directly to the alleged social benefit of that cooperation. Indeed, the MFA was passed in order to exempt (state supervised) intercompany cooperation (especially in joint ratemaking) from federal antitrust regulation.

There has always been a strong skepticism in the general industrial organization literature toward interfirm cooperation, especially if that cooperation might "affect" market output and price. Interfirm agreements often have been seen as collusive, as trade restraining, and as attempts to lessen competition and reduce consumer welfare (Bork 1966). Indeed, the per se prohibition of horizontal interfirm price and output agreements is the one remaining area of antitrust where there is still near unanimity that vigorous enforcement is still appropriate (Bork 1978).

[9]Studies of modern-day insolvencies confirm that "inadequate rates" are not (usually) the explanation for such difficulties. See *The Open Rating Law and Property Liability Insurance* (1977, p. 79); see also *Monitoring Competition* (1974, p. 387). Comparisons of states with open competition pricing and prior-approval pricing show no statistically significant difference in insolvency rates. See *Report of the Advisory Committee on Competitive Rating to the National Association of Insurance Commissioners* (May 1980, p. 28).

There has been some recent academic discussion that has questioned the conventional wisdom concerning the per se illegality of horizontal business agreements (Dewey 1979, Armentano 1986). This discussion can be summarized as follows: In an uncertain world, it is not obvious that horizontal agreements lower social welfare. Horizontal agreements may reduce information costs, price-adjustment costs, consumer search costs, inventory costs, and business risk generally. If the probability of increasing price above competitive levels is reasonably low, the existence of the increased efficiencies associated with cooperation can enhance social welfare.

In order to "reduce costs," P/C insurance companies cooperate in a variety of ways. The most fundamental and controversial area of cooperation involves the collection and preparation of statistical data on industry loss experience. To see why this sort of cooperation is necessary for efficiency, consider that accounting costs for noninsurance companies are incurred in the present and are known at the time of contracting and price-making. The insurance business is fundamentally different. The primary costs of writing a fire insurance policy—the actual loss experience associated with that policy—cannot be known with complete accuracy until the policy expires, and perhaps not even then. But although future loss experience cannot be known in the present, it can be reasonably anticipated. A pool of historical data that encompasses a large number of relatively homogeneous units of risk exposure can provide a high degree of predictive accuracy with respect to future cost. And since individual firms are unlikely to have a large enough loss-experience base for accurate anticipation of future costs, the pooling of loss experience is essential for efficient cost estimation and ratemaking.[10] The more extensive the pooling, the greater the accuracy (presumably) in predicting costs, and the more efficient the industry will be (presumably) in tending toward an equilibrium price and output.

Rating Organizations

Rating bureaus are private organizations that collect loss-experience information from various insurance companies and perform various data manipulations. These organizations are owned by the insurance companies, managed by an independent staff, and licensed in the states where they operate. In prior approval states, it is common for the rating bureau to use loss data to prepare what are termed

[10]Some large insurers may have enough experience in some lines of insurance to develop credible rates. Most of the hundreds of smaller companies, however, do not have such experience. See *Monitoring Competition* (1974, p. 579).

"advisory" rates for members, to file these bureau rates with the state regulatory authorities, to publish rating manuals, and to perform other various services for members. In "open competition" rating states, rating bureaus are generally not allowed to publish prospective rates or to require that member companies adhere to bureau-published prices.[11]

Supporters of rating organizations maintain that they provide essential services so that insurers can compete efficiently in the marketplace. Many hundreds of insurers are simply too small to have a loss (or expense) experience data base that would allow any accurate prediction of their future cost. Thus, the information provided through pooling is essential for efficient pricing. In addition, it is likely that there are substantial economies of scale in the collecting, filing, and publishing of information by rating organizations (*Monitoring Competition* 1974, p. 583). Some of these services could be provided by independent consultants on a contracting-out basis (MacAvoy 1977, p. 59), but the direct cost per unit of the service to the individual firms would likely be much higher. Most insurance companies (especially the medium size and small ones) choose to join and use the services of a rating organization even when such membership is no longer mandatory. This action is indirect evidence that the service cost to member companies (for discovering cost and price) is lower than it would be with some alternative arrangement.

In addition to explicit rating bureau coordination, insurance companies frequently form intercompany pools or syndicates in order to provide specific insurance coverage in high-risk areas. Syndicates are usually formed to spread the risk of providing extraordinarily broad coverage or insuring extraordinarily risky hazards, as in the nuclear fission and aviation industries. Insurance syndicates also exist to provide reinsurance and to allow small-company participation in writing risks that, on an individual firm basis, would simply be unavailable.

The formation of syndicates requires a high degree of intercompany coordination. Pools often require that members accept joint underwriting practices (classification, rates, rating plans), provide for the joint issuing of insurance policies, and provide for coordinated inspection and claim service. The provision of such coordinated activity allows the writing of insured risks that would otherwise not

[11]*Monitoring Competition* (1974, p. 576). On January 5, 1983, the Insurance Services Office (ISO) announced that it would develop "prospective loss costs" only in competitive rating states, and that this would tend to stimulate "independent pricing decisions" by insurers in those states (Caddy 1986, p. 175).

be written at all (pooling increases "availability") or not written at the lowest possible cost. This would appear to be a reasonable conclusion given the inherent nature of some risks (as in aviation) and given the decentralized structure of the domestic insurance industry.

Antitrust and Cooperation: A Legal Analysis

All of this intercompany cooperation, and more, would come under antitrust scrutiny if the MFA were repealed. This scrutiny is likely since there is a long history of Department of Justice (Antitrust Division) interest in similar arrangements in other industries. In addition, there is a long history of antitrust cases where interfirm cooperative activity has been prosecuted, in many cases successfully.

The clearest and most obvious area of antitrust difficulty involves the determination of prices by the industry rating organizations. The current process of determining such rates would likely be construed as a "contract or combination in restraint of trade," as prohibited by section 1 of the Sherman Antitrust Act.[12] Business conspiracies that have the purpose or the effect of "fixing, stabilizing, or tampering" with market price (or even with a component of market price) are illegal per se, that is, they are illegal without any examination as to their alleged social "reasonableness." The per se illegality of price fixing agreements among competitors is the oldest antitrust legal principle and is firmly established in the law.[13] Section 1 of the Sherman Act and coordinated ratemaking in insurance are incompatible.

Even the collection of industrywide information (cost, sales, price) by a trade association and the use of that information by industry members is extremely controversial from an antitrust perspective. In *American Column and Lumber*,[14] for example, the Supreme Court condemned an industrywide trade association that had provided past price and sales information to members, and had made suggestions as to probable future prices and production levels for the industry as a whole. An even more restrictive ruling was made in *American Linseed Oil*[15] where just the collection of past information on costs

[12]"The existence and practices of rating organizations directly conflict with antitrust concepts. . . . When such activity results in advice or suggestions concerning price, it is likely to run afoul of the antitrust law" (*Monitoring Competition* 1974, p. 577).

[13]United States v. Trenton Potteries Co., 273 U.S. 392 (1927); United States v. Socony Vacuum Oil Company, 310 U.S. 150 (1940); United States v. Masonite Corp., 316 U.S. 265 (1942).

[14]257 U.S. 357 (1921).

[15]262 U.S. 371 (1923).

and prices was enough to condemn the arrangement. In *Maple Flooring*[16] and *Sugar Institute*[17] the Supreme Court attempted to make a clear distinction between a trade association that simply provided past information on prices—presumably legal—and an industrywide agreement to adhere to future price announcements—which was illegal per se. Yet that distinction has been blurred recently. In *Container Corporation*[18] the Court concluded that the reciprocal exchange of past price information between two different companies had the result of stabilizing future prices—admittedly in a downward direction, so that the exchange was declared illegal per se. (The container industry was highly concentrated.) This extreme approach was reaffirmed in *U.S. v. United States Gypsum Company et al.*,[19] where an intercompany exchange of price information—allegedly to better comply with the provisions of the Robinson-Patman Act—was declared illegal per se.

Some recent Supreme Court decisions concerning price agreements may have softened somewhat the per se prohibition. This change is most obvious in *Broadcast Music, Inc. v. CBS, Inc.*,[20] where the Court was persuaded that the overall efficiency of "blanket licensing" of copyrights outweighed the elimination of some price rivalry. The Court voted (8–1) to reverse a Second Circuit decision, which had found the licensing agreement illegal per se, and remanded the case for further consideration under a rule of reason. The complaint was ultimately dismissed.

In *Maricopa*,[21] however, maximum-fee schedule agreements among doctors were held to be unlawful per se even though the agreements clearly created information economies that would benefit consumers. And most recently in *NCAA v. Board of Regents*[22] the Court, while accepting a rule of reason approach to NCAA controls on the licensing of college football rights, decided that the specific controls involved here were unreasonable and illegal under the Sherman Act.

This brief review of the case history makes it clear that many of the most important activities of rating organizations in insurance would appear to be in direct conflict with antitrust law. Bureau organizations that collect historical loss and expense data, that project such

[16]268 U.S. 563 (1925).
[17]297 U.S. 533 (1936).
[18]393 U.S. 333 (1969).
[19]438 U.S. 422 (1978).
[20]441 U.S. 1 (1979).
[21]457 U.S. 332 (1982).
[22]468 U.S. 85 (1984).

data forward in time, and that formulate prospective or trended average rates for members would likely be engaged in an activity (without the MFA) that would violate the antitrust laws.[23] Even if a rule of reason were applied in such cases, this sort of activity would likely be judged an unreasonable and illegal restraint of trade.

Other Antitrust Problem Areas

There are several other intercompany activities that likely would be misunderstood, and might well be restricted, if the federal antitrust laws were applied to P/C insurance. One of these areas involves so-called restrictive underwriting where insurers—because of the existence of indeterminate or unacceptable risks—decide to restrict coverage or even eliminate coverage to selected individuals, firms, or governmental agencies. Recently there has been much discussion of a national "tort liability crisis," and of the restricted availability of insurance (or sharply higher rates) for risks associated with toxic wastes, product liability, day-care, and many other activities (Huber 1988). If this restricted availability of insurance (or higher rates) is accomplished through the auspices of an important industry rating bureau, such cooperative activities could well be seen as an illegal restraint of trade. Indeed, several states have recently brought a major antitrust suit against several large insurers and the most prominent industry rating bureau (ISO), claiming precisely such an illegal restraint (*Wall Street Journal*, 23 March 1988).

It is also quite common for insurers to cooperate and develop "assigned risk" plans where certain types of insurance (auto) are required by state law, and where industry underwriting standards may have restricted the availability of insurance. These assigned-risk plans and jointly determined rate schedules for insurance could be of concern to the Department of Justice if the MFA were repealed.

Also of interest to the federal trust-busters would be insurance company participation in state "guaranty fund" associations. Guaranty funds, mandated in many states, allow some insurers to monitor the economic performance of other insurers in order to determine whether their financial condition is "hazardous" and merits state regulatory remedial action.[24] Such coordinated activities, where competitors can make recommendations concerning the economic solvency of rivals, and where they can make recommendations for gov-

[23]This was the Department of Justice's opinion in 1977. See *The Pricing and Marketing of Insurance* (1979, p. 169).

[24]Insurers contribute to guaranty funds and the proceeds can be used to pay the claims of insolvent insurers.

ernmental intervention, may well contain some inherent antitrust difficulties.

There may also be some potential antitrust difficulties in the business relationship between some insurance companies and the "independent" agents that sell insurance (*Monitoring Competition* 1974, pp. 544–45, 557–58). These contractual agreements frequently contain "volume requirements" for the allocation of business among insurers; these volume requirements might be seen as a kind of "division of market" agreement that violates the antitrust laws. In addition, it is not uncommon for insurers to require independent agents to write a "balanced book" of business, that is, to tie profitable insurance products to other more risky or less profitable insurance products. Such agreements might be challenged under section 3 of the Clayton Act, which outlaws tying agreements that may tend to lessen competition substantially. Finally, most commercial insurance is written at rates that are freely negotiated, and such rates might violate the Robinson-Patman Act's strict prohibition against price discrimination. These represent only some of the likely flash point areas where there may be antitrust liability for insurers, especially in private suits, if the MFA were repealed.

The Antitrust Laws and the Insurance Industry

Should the federal antitrust exemption for insurance be removed? An earlier study (Brainard and Dirlam 1966) replied negatively but a more recent analysis (*National Commission* 1979) answered clearly in the affirmative. The antitrust laws, especially the Sherman Act of 1890, purportedly exist to promote business competition and deter the existence of monopoly power. These laws are said to enhance free and fair competition, and to ensure that scarce economic resources are employed in a manner that tends to maximize consumer and social welfare. Since the state regulation of insurance is moving toward competitive pricing (this has slowed recently), why retain the industry's federal antitrust exemption?

There are at least four *general* reasons why the federal antitrust laws should not be extended to currently exempted industries such as insurance.

First, enforcement of the antitrust laws in other industries has frequently misconstrued the true nature of competition and monopoly power. Business competition is a dynamic discovery process under conditions of uncertainty that can include interfirm rivalry as well as interfirm cooperation; it is not an equilibrium condition, and the equilibrium economic models are misleading in that regard (Kirz-

ner 1973). Accordingly, a business organization's market share is not an indication of its market power but is, instead, an indication of its relative efficiency vis-á-vis other business organizations. Monopoly power, correctly understood, is to be associated with governmental restraints on rivalry or cooperation, and not with strictly free-market activity (Rothbard 1962).

Second, the history of antitrust enforcement reveals that the laws have been employed frequently to shelter and protect less-efficient business organizations from the rigors of the free-market competitive process. This protectionism is most obvious in the private cases where one firm sues another (95 percent of all antitrust litigation is private), but it is also evident in many classic government cases as well (Armentano 1982).

Third, antitrust regulation is a kind of government "industrial planning." It has been employed to raise or lower market prices, to break up companies, to end voluntary contractual agreements, and to prohibit mergers. Yet such decisions, to be rational, presume that the regulators or the courts can have access to economic information concerning social costs and social benefits that, it can be argued, are simply unavailable in the absence of a spontaneous market process. Antitrust is government regulation and is subject, therefore, to all of the general criticism of government regulation and planning in the literature (Poole 1983, Lavoie 1985).

Fourth, the antitrust laws are a civil liberties nightmare. The laws have been enforced arbitrarily, often violate conventional notions of due process of law, and always interfere with the legitimate natural rights of property owners. As Adam Smith observed more than 200 years ago, laws (such as antitrust) that interfere with voluntary and cooperative social activity cannot be made "consistent with liberty and justice" (Smith [1776] 1937, p. 128).

In addition, there are a number of *specific* reasons why the insurance industry's antitrust exemption should be retained. The most important reason is that ending the exemption would not increase efficient competition. It would tend to increase short-run firm rivalry—one aspect of competition—but it would lead to a substantial decrease in interfirm cooperation, the other essential element of efficient competition in this industry. As noted, there is substantial intercompany cooperation in insurance that promotes low costs and effective rivalry between companies of various sizes. If this essential cooperation were severely curtailed through antitrust regulation[25] (litigation or

[25]It has been recommended that certain specific collective actions be permitted by statute in lieu of the current blanket antitrust immunity. But there is no clear consensus

the threat of litigation), it is likely that the costs and prices of insurance services would increase, and there would be a strong incentive for industry consolidation through merger. Higher costs and increased market concentration would be the likely consequences of repealing the insurance industry's antitrust exemption.

Supporters of antitrust regulation in insurance have argued that the antitrust laws would not be used to attack efficient practices (such as information sharing and coordination) that lower industry costs (MacAvoy 1977, pp. 52–55). But the history of antitrust enforcement suggests that we maintain an extremely skeptical position with respect to such assurances. The fact remains that both government and private litigants have employed antitrust regulation against efficient business conduct and performance. Such conduct on the part of defendants in antitrust cases has often been termed (by the courts) "exclusionary" of less-efficient business organizations, and has frequently resulted in antitrust liability for defendant companies. Indeed, some of the most important and classic legal actions in antitrust history have been brought against business organizations that have lowered prices and increased market outputs (Armentano 1982). Firms that are truly inefficient tend to lose market share, and are rarely the focus of any antitrust attack.

Insurance and the Critics

Supporters of antitrust regulation in insurance have argued that intercompany cooperation—especially through rating bureaus—can lead to less availability and sharply higher prices for insurance services. They have identified some recent examples in auto insurance and in liability insurance generally where insurer rates have risen dramatically, or where traditional liability coverage has become almost impossible to obtain. They suggest that the application of antitrust to these situations would end insurer collusion, increase availability, and lower insurance rates (*Hartford Courant,* 23 March 1988).

There are at least two responses to such charges. The first is that the hefty increases in insurance prices recently (or sharply restricted availability) is the likely competitive consequence of a radically changed expense or loss-experience data base. While the industry in the 1980s has remained generally profitable due to its investment income, it has shown a vast underwriting loss on its property-liability

on which specific collective actions promote the "public interest." See *National Commission for the Review of Antitrust Laws and Procedures* (1979, pp. 236–45) 2nd *Report of the Advisory Committee on Competitive Rating* (1980). For a recent discussion, see Kouatly (1988).

insurance business.[26] Prices for P/C insurance have not generally been sufficient to cover the sharply higher costs of claims, especially in auto and workmen's compensation. Tort liability has been expanded by judicial reinterpretation (Huber 1988) and the insurance carriers have experienced or expect far higher costs than they anticipated when these policies were first written. Even with an industry fully subject to antitrust regulation, court-broadened tort liability would eventually have produced restricted underwriting practices and caused a substantial increase in rates (Priest 1987). It is not necessary to assume illegal insurer collusion to explain recent policy and pricing practices in this industry.[27]

The critics mistake the inherently cyclical price and profit performance of the insurance industry for monopoly power. When the market demand for insurance is strong and when interest rates are low, prices for insurance can be maintained or even increased. But stable insurance prices in one period always encourage an increase in capacity in the next period, and intense price competition becomes inevitable. This down-cycle was especially evident in the late 1970s and early 1980s when insurance firms scrambled for each and every premium dollar in order to invest at high interest rates. When interest rates declined, and when judges and juries dramatically increased the cost of future insurance claims, insurance availability was again restricted and prices increased. Prices in the late 1980s are again moderating somewhat as significant new capacity reaches the market. But all of this is supportive of the notion that the industry is workably competitive, and that there is no monopoly power in insurance.

The second response to the charge that the industry has functioned monopolistically is that the structure, conduct, and performance of the industry appear workably competitive (Joskow 1973). The P/C industry is extremely decentralized and there are few nonlegal barriers to entry. Profitable prices for insurance in one period lead to increases in capacity and to a moderation in prices in the next period. Higher claim costs (realized or reasonably expected) and lower interest rates lead to reduced availability and to higher prices. These are

[26]*Best's Review* (January 1988, p. 26) reports an underwriting P/C loss of $13.3 billion in 1983, $21.5 billion in 1984, $24.8 billion in 1985, $15.8 billion in 1986, and an estimated $9.8 billion in 1987 for a total five-year statutory underwriting P/C loss of $85.2 billion.

[27]The recent state antitrust suits allege that several major insurers illegally pressured the Insurance Services Office (ISO) and its members to adopt more restrictive ("claims made") liability policies. See *Wall Street Journal* (23 March 1988). (The companies involved have denied the allegations.)

competitive responses and not necessarily evidence of any monopoly power or inefficiency.

This is not to assert that the P/C insurance industry in the United States is beyond criticism. Since the industry is inherently rivalrous, and since intercompany cooperation is essential to efficient operation, there is little economic justification for the traditional crazy-quilt pattern of state regulation. The bulk of these state regulations likely create an artificial product uniformity, temper the price rivalry emanating from the aggressive direct-insurers, and generally reduce consumer welfare (Ippolito 1979, Frech and Samprone 1980). Since the long-term trend in this industry is toward open rating, the bulk of the state regulatory structure that inhibits insurer price and product rivalry or cooperation—essentially a holdover from prior-approval ratemaking—should be abandoned.[28] The insurance industry at the state level should be deregulated in much the same manner as the transportation industry has been deregulated, and for precisely the same economic reasons. Deregulation in insurance, and the retention of the industry's antitrust immunity, would allow the suppliers of insurance to generate a market-determined mix of rivalry and cooperation that is essential to efficient service in this industry. That competitive mix, unknowable ex ante to any economist, regulator, or court, should be determined through an open-market competitive process and not by state or federal regulation.

The New Antitrust Skepticism

Deregulation in insurance and the retention of the industry's antitrust exemption fit in with recent public policy experience in other industries. The consumer gains associated with deregulation in railroads, trucking, and airlines (Morrison and Winston 1986) have been impressive. Moreover, during the 1980s, an important new skepticism concerning "traditional" antitrust enforcement has developed. Some antitrust scholars and administrators have argued that less, not more, antitrust enforcement will improve industrial efficiency, productivity, and competitiveness (England 1985). Critical enforcement areas have been criticized severely, and the new skepticism (the "new learning") has resulted in some modest changes in the enforcement of antitrust law in the 1980s. Merger guidelines have been liberalized and a vigorous market for corporate control has developed. Certain tying agreements and so-called restrictive practices (such as resale price maintenance) are no longer regarded by some

[28]Instead of state deregulation, some analysts have argued for a broadened state regulation that would include the insurance industry's investment income (see Caddy 1986).

reputable antitrust scholars as per se harmful.[29] Price discrimination cases have been curtailed dramatically since it is difficult to understand how prosecuting firms that charge lower prices promotes the public interest. Efficient business organizations that grow internally to achieve higher market share are no longer inevitable antitrust targets. Finally, there is even some serious academic skepticism concerning the current per se prohibition of horizontal agreements. If the risks to consumers are minimal, and if the agreements promise substantial cost savings, horizontal agreements can advance the "public interest" and can be permitted (Smith 1983, Armentano 1986). This line of reasoning is directly applicable to P/C insurance.

The antitrust policy skepticism of the 1980s is the result of a number of different factors. There has been an increasing realization recently among economists and others that specific business practices, once regarded as elements of monopoly power, may actually enhance efficiency and the competitive market process. There was a time in antitrust economics when almost any deviation from the purely competitive model was seen as "resource misallocating" and as a justification for stricter antitrust enforcement (Wilcox 1966). But deficiencies in the purely competitive model (as a welfare paradigm) have now been widely acknowledged, especially with respect to how actual business organizations efficiently adjust to economic uncertainty and change. Market output is no longer thought to be restrained inefficiently by product differentiation, or economies of scale, or by "restrictive" practices such as tying agreements.

Attitudes toward merger and increasing market share have also changed somewhat over the last 10 years (Brozen 1982). Economists now recognize that business organizations which are relatively more efficient than their rivals (or potential rivals) will tend to grow faster than their rivals, and will earn an increasing market share. Increasing market concentration that is the result of innovation and increased resource efficiency can be beneficial to consumers. In the absence of legal barriers to entry, it is not apparent why government antitrust regulation ought to interfere with such a benign market process.

Another important reason for the new antitrust skepticism is antitrust case revisionism. Prior to 1975 there was a widespread impression within the antitrust establishment that an impressive body of evidence existed that supported traditional enforcement policies. The laws had been enforced, presumably, to deter firms from reducing output and raising market prices. Yet this "public interest" theory of antitrust enforcement has come under increasing criticism

[29]Continental T.V. Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977); see also Posner (1981).

(DiLorenzo 1985). Most of the important case evidence demonstrates, contrary to the conventional wisdom, that many of the indicted business organizations had expanded market output and lowered market prices, and that trade had generally not been restrained (Armentano 1982). Antitrust, especially in the private cases, may have been employed as a club in an attempt to restrain the rivalry of more-efficient defendant business organizations and to allow less-efficient business plaintiffs to earn economic rents (Baumol and Ordover 1985). If this is the manner in which antitrust has actually worked in practice, it is hardly the sort of public policy that one would want extended willy-nilly to an industry such as P/C insurance.

Conclusion

Continuing to exempt the P/C insurance industry from antitrust regulation is consistent with the new skepticism concerning the social value of strict antitrust enforcement. It would appear especially inappropriate to extend the reach of the antitrust laws to an entirely new area (insurance) at the very time when the theory and practice of such laws are being seriously questioned in traditional areas of enforcement. The most intelligent public policy in insurance would be to continue to deregulate the P/C industry at the state level by removing all legal restrictions that deter competitive rivalry or cooperation, and to maintain the current McCarran-Ferguson Act exemption from federal antitrust law.

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