Automobile Insurance Regulation, Direct Democracy, and the Interests of Consumers

Benjamin Zycher

Bring the kids indoors. Hide the silverware. And, above all, hold on to your wallet. Why? Because the consumer groups—unelected, unappointed, and unaccountable—have taken it upon themselves to protect us from the purportedly dishonorable intentions of the insurance industry. This most recent of the consumerist crusades has manifested itself in that old trendsetter, California, where, amid the tolling of church bells and the joyous shouts of aspiring bureaucrats, the voters in November 1988 approved Proposition 103, a system of price and regulatory controls on property and casualty insurance.

This law was the response of the electorate to the unwillingness of the state legislature to deal effectively with a perceived "crisis" caused by escalating automobile insurance rates. It was also the response to the prospect of a blatant wealth redistribution scheme. Before turning to the provisions and implications of Proposition 103 itself, it is useful to review briefly the sources of the perceived crisis in the California market for auto insurance, as well as the straightforward politics of Proposition 103. I then explore the economic and regulatory implications of Proposition 103 and derive some conclusions, which ought to be of interest to those in other states faced with similar regulatory proposals and political pressures.

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The "Crisis" in the California Market for Auto Insurance

When consumer groups proclaim the presence of a crisis, what they usually mean is a pattern of rising (real) prices for some particular good, particularly as the price increases may affect the consumerists' political constituencies adversely. (Indeed, consumer groups often are able to find signs of impending crisis regardless of the pattern of price movements.) Since some prices in a market economy are certain to rise, absolutely or relative to others, no economy in which prices are

driven by market forces can be free from "crises" afflicting helpless consumers. By that criterion, "crisis" is too mild a term to describe the recent throes of the market for auto insurance in California. Between 1982 and 1986, average auto insurance premiums rose 10.2 percent annually for the nation as a whole, while in California they rose by 12.2 percent. During 1987 and 1988, premiums in California rose at an annual rate of over 14 percent, and by 1988 the average premium per insured vehicle in California ranked fourth in the nation—exceeded only by Massachusetts, New Jersey, and Nevada. In 1988 the average premium per insured auto in California was $673.18, while for the rest of the nation, the figure was $482.47, a difference of almost 40 percent.

Rapidly rising insurance premiums in California were the natural market response to large increases in important costs faced by insurance companies that were greatly exacerbated by misguided regulatory policy. The average size of insurance claims rose substantially during the 1980s. Cost increases in medical care, auto repair, and litigation have all contributed, but the cost surge has been greatest in liability coverage, that is, in compensation for bodily injury and property damage. From 1982 through 1988 the number of insured autos increased about 3.5 percent per year, but the number of paid claims rose by over 18 percent per year, and the average cost per paid claim rose by almost 15 percent annually.

The number of bodily injury claims per insured auto rose by about 2 percent per year between 1982 and 1985, but then increased sharply over the next three years. They rose by almost 7.5 percent in 1986 and by over 9 percent in 1987 and again in 1988. Moreover, the average size of such claims rose by about 10.5 percent annually between 1982 and 1988. Meanwhile the consumer price index for medical care rose just over 7 percent per year over the same period. As a result, the average bodily injury claim paid in California in 1987 was $6,505; for the other 26 states with a tort (fault) system of auto insurance, the average during 1987 was $4,519, a difference of 44 percent.

In addition, auto litigation costs increased annually in California by over 13 percent between 1982 and 1988. Increased litigation tends to increase total costs because of attorneys' fees, court fees, the costs of obtaining depositions, and other expenses. Moreover, the prospect of litigation provides incentives to inflate medical bills as awards for pain and suffering are often computed as a proportion of direct medical expenses. The number of property damage claims per insured vehicle fell by over 1 percent each year between 1982 and 1988, but the average size of these claims increased by about 9 percent per year. For collision and comprehensive insurance coverage, the number of total claims paid increased by almost 9.5 percent per year and rose by almost 6 percent annually per insured vehicle. This increase in insurance company outlays came about despite both an annual decline of roughly 2.4 percent in the number of collision claims per insured auto and a yearly reduction of over 4 percent in per-vehicle comprehensive claims. Sharply higher repair costs drove the average size of collision and comprehensive claims up by about 8 percent annually.

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Misguided Regulatory Policy: The Assigned Risk Program. The effects on insurance premiums of the cost escalation just described have been greatly exacerbated by recent regulatory decisions with respect to pricing in the California Automobile Assigned Risk Plan (CAARP). All insurance companies writing auto insurance in the state are required to participate in the assigned risk plan in proportion to their share of the state auto insurance market. CAARP was established to provide insurance to high-risk drivers unable to purchase it in the voluntary market. CAARP rules require that a driver be rejected by two companies in the voluntary market before he is eligible for an assigned risk policy. This constraint on eligibility is widely ignored, however, in large part because CAARP rates must be approved by the insurance commissioner, and approved rate increases during the 1980s have lagged far below those necessary to cover the costs borne by the assigned risk program.

From the viewpoint of consumers, therefore, assigned risk policies have become a very good deal indeed. For example, a typical premium in

1988 for an adult male who lived in Watts and had no citations or at-fault accidents was $1,640. The premium for a similar policy available under the assigned risk program was $575. For a large number of drivers in California, CAARP has come to represent an insurer of first choice rather than last resort. Indeed, many insurance agents steer their clients into the assigned risk program as a means of acquiring "cheap" insurance. As Table 1 shows, new applications for auto insurance policies under CAARP have grown by an order of magnitude over the past several years.

Table 2 shows the relationship between revenues and costs in the assigned risk program. In the first six months of 1989, for example, CAARP's total costs exceeded premiums by almost two to one. In 1983 the CAARP deficit was $30 million. It grew to $40 million in 1984, $78 million in 1985, $152 million in 1986, $262 million in 1987, and $400 million in 1988, and the data for the first six months of 1989 indicate that the loss for all of 1989 probably exceeded $600 million. These deficits represent actual costs faced by the insurers, and so they must be paid by someone. Not surprisingly, the policyholders in the voluntary market must make up the difference by paying higher premiums.

This becomes apparent when we examine the experience of a single insurance company. As an example, assigned risk policies constitute only 6.4 percent of total California policies in force for the Farmers Insurance Group, but these policies account for over 46 percent of Farmers' auto insurance underwriting losses in California. These losses caused Farmers to announce a statewide rate increase averaging 5.9 percent in late 1989. Since 1984, the number of Farmers' voluntary market policies has grown by about 16 percent, while the number of its assigned risk policies has grown by almost 770 percent. During the same period, underwriting losses in the voluntary market grew by about 40 percent, while similar losses in the assigned risk market grew by well over 2,400 percent. The result is a daily loss on assigned risk policies for Farmers of over $250,000, and a loss for all of 1989 exceeding $100 million.

Table 1: New Applications for Assigned Risk Insurance Policies in California (thousands)

Year	Number	Percent Change
1983	94.4	
1984	136.7	44.8
1985	329.3	140.9
1986	323.8	(1.7)
1987	425.7	31.5
1988	781.2	83.5
1989	1233.4	57.9

Source: Western Association of Automobile Insurance Plans.

Table 2: Revenues and Costs of the California Automobile Assigned Risk Plan

Year	Premiums (millions of dollars)	Direct Losses (millions of dollars)	Loss Ratios (partial[a])	Loss Ratios (total[b])
1984	63.7	64.4	1.011	1.412
1985	111.5	111.1	0.997	1.393
1986	181.2	220.7	1.218	1.639
1987	220.0	322.8	1.467	1.939
1988	376.4	513.2	1.364	1.832
1989[c]	243.2[c]	367.0[c]	1.509[c]	1.998[c]

Source LeBoeuf, Lamb, Leiby, & MacRae.

Note: Data are for eleven companies writing about 77 percent of private automobile insurance in California.

[a] Direct losses/premiums.

[b] After inclusion of loss adjustment and administrative expenses, taxes, and various fees.

[c] Six months ending June 30, 1989.

From the viewpoint of consumers, assigned risk policies have come to be a very good deal. A typical premium for an adult male who lived in Watts and had no citations or at-fault accidents was $1,640 while the assigned risk premium for a similar policy was $575.

By law, CAARP must request rate adjustments each year that yield no profit in an accounting sense but that are adequate to pay claims and expenses. The authority to approve or deny these requests in whole or in part in straightforward regulatory fashion rests with the state insurance commissioner. Table 3 shows the requests and authorizations since 1983.

Obviously, disagreement can exist about the allocation of costs to the assigned risk program as well as about other accounting issues. The requested rate increases may be inflated in the expectation that the insurance commissioner will deny them in part. Nonetheless, there is little question that the assigned risk program fails by a substantial margin to cover its costs. Rate regulation in California has clearly created a large sub-

Table 3: Requests and Approvals for Assigned Risk Policy Rate Increases

Request Date	Percent Requested	Percent Authorized	Effective Date
April 1983	33.7	8.4	March 1984
July 1984	15.0 + 15.0[a]	13.9	January 1985
May 1985	62.0	10.7	February 1987
December 1986	25.0 + 25.0[a]	18.5	December 1987
February 1989	112.3	denied	litigation pending

Source: LeBoeuf, Lamb, Leiby, & MacRae.
[a] Single request for two increases over a six-month period.

sidy flowing from drivers participating in the voluntary market to those holding CAARP policies, a relationship that has prevailed since the early 1980s. Moreover, a 1987 law requiring California motorists to carry liability coverage has brought into the system a large number of drivers who have disproportionately acquired the necessary coverage through the assigned risk program. In short, along with the generally rising costs of settling claims, the expanding subsidy embodied in CAARP has exacerbated the perceived crisis in the California auto insurance market.

A common argument deems it appropriate to hold down rates in the assigned risk market to increase the availability of auto insurance to lower-income drivers. It is not at all clear, however, that the cross subsidies inherent in CAARP's pricing policies are an effective tool with which to subsidize lower-income individuals. Moreover, while some drivers in the assigned risk pool are newly registered in California and may therefore find it difficult to provide information about their past driving records, most drivers participating in the assigned risk system have poor driving records. Why should individuals representing an above-average risk receive a subsidy from better drivers? More to the point, there are often alternative modes of transportation by which an individual with a bad driving record can meet his transportation needs. Drivers who cannot afford to pay the costs they are likely to impose on others should be encouraged to take the bus, for example. Bus transportation is neither very fashionable nor enjoyable, and it is often inconvenient, but it is not life-threatening, and many people use it daily.

Geographic Variation in Costs and Rates

The large increases in average California auto insurance premiums obscure great variation in average premiums among different geographic areas within the state. For example, in 1988 an adult male with no citations or at-fault accidents who lived in Hollywood typically paid an annual insurance premium of $1,817. If the same driver lived in nearby Monrovia, his annual premium would have been $862, in San Diego $697, in San Jose $581, and in Redding $537. This variability exists because the insurance market is driven by competitive pressures to charge individual drivers premiums that compensate the insurance system for the cost of providing a particular policy, including administrative expenses and the losses that an individual driver is expected to impose. If insurance companies did not charge premiums that reflected the expected costs of insuring a given driver, low-cost consumers—such as good drivers—would necessarily subsidize high-cost ones, and competitors would seek to attract new customers by offering the low-cost drivers a better deal. In a market without significant price regulation, price structures that include cross subsidies are not viable for long.

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Thus, insurers determine premiums by considering an individual's driving record, age, sex, type of car, and other factors that are statistically significant predictors of an individual driver's future loss experience. As it turns out, place of residence is an important predictor of future losses. Drivers in rural areas tend to impose fewer costs upon the system than those in urban areas, as a result of lower vehicle densities, less theft, lower repair costs, and a host of other reasons. One way to compare the costs and premiums of rating territories in California is through data collected at the county level, presented in Table 4 for 20 counties.

Note that areas within counties can be far from homogeneous. Table 5 provides data similar to

those in Table 4 for six cities within Los Angeles County.

Tables 4 and 5 show the strong correlation between geographic variation in expected costs, as measured by the frequency and average cost of claims, and geographic variation in premiums.

The large increases in average California auto insurance premiums obscure the great variation in average premiums among different geographical areas in the state.

(The correlation is not perfect because of differences in driving records, average age of drivers, and other relevant factors that do not appear in these data.) As it turns out, the wide variation in premiums across the state played an important role in the passage of Proposition 103.

The Politics and Provisions of Proposition 103

Sharply rising auto insurance premiums during the 1980s, particularly in the heavily populated counties, led to political pressure for insurance reform. The state legislature found itself paralyzed by the conflicting demands and goals of competing interests. The insurers were anxious to end or reduce the subsidies inherent in the assigned risk program and to limit lawsuits and resulting litigation costs. The trial lawyers opposed no-fault insurance plans and other proposals to limit litigation. The consumer groups acted to enhance their own political power by constraining the ability of market forces to operate. The legislators were interested in any solution that would redirect the political heat toward the insurance commissioner or the governor.

Because of the political gridlock, the competing interest groups introduced several ballot initiatives purporting to solve the insurance crisis. Proposition 100, promoted by the trial attorneys, would have mandated rate reductions similar to those of Proposition 103 and would have stipu-

Table 4: Bodily Injury and Property Damage: Average Claims, Costs, and Premiums for 20 California Counties in 1988

	Bodily Injury			Property Damage		
County	Claims[a]	Cost[b]	Premium[c]	Claims[a]	Cost[b]	Premium[c]
Los Angeles	23.9	$10,197	$319.04	46.8	$1,484	$113.45
Orange	19.5	9,270	255.00	45.9	1,423	100.01
Ventura	16.7	9,665	225.51	41.7	1,425	90.62
San Francisco	16.3	8,705	208.95	49.4	1,355	94.64
Riverside	15.2	8,888	200.16	39.3	1,411	81.77
San Bernadino	15.6	8,631	196.22	40.6	1,372	80.95
San Diego	16.0	8,330	191.80	45.0	1,222	80.66
Alameda	14.4	8,654	191.46	45.3	1,307	87.81
Marin	13.0	8,516	190.78	45.3	1,301	87.20
San Mateo	14.1	7,738	189.01	44.4	1,342	88.97
Sacramento	15.3	7,881	181.42	45.7	1,217	83.09
Santa Clara	14.4	7,723	179.74	44.2	1,344	85.39
Contra Costa	13.2	8,702	177.92	43.2	1,330	80.99
Santa Barbara	10.7	9,077	176.65	38.0	1,209	77.90
Sonoma	10.6	9,873	171.38	38.9	1,265	75.89
Fresno	14.7	7,842	168.11	40.1	1,266	74.30
Kern	11.9	7,717	160.97	35.0	1,267	68.40
Humboldt	12.2	7,798	151.02	41.6	1,196	65.49
Butte	11.1	8,783	129.84	38.2	1,103	57.38
Shasta	9.7	9,803	126.34	34.5	1,114	56.97
State average	16.9	9,126	220.33	43.6	1,354	89.35

Source: Western Insurance Information Service.
[a] Per thousand insured vehicles.
[b] Average per claim.
[c] Average premium income per insured auto.

Table 5: Bodily Injury and Property Damage: Average Claims, Costs, and Premiums for Six Los Angeles County Cities in 1988

	Bodily Injury			Property Damage		
County	Claims[a]	Cost[b]	Premium[c]	Claims[a]	Cost[b]	Premium[c]
Beverly Hills	37.3	$13,608	$648.47	72.1	$1,733	$179.05
City of L.A.	35.8	10,690	454.23	56.2	1,513	140.17
Van Nuys	30.7	11,096	398.28	56.5	1,552	136.88
Compton	26.1	9,308	354.01	37.8	1,402	120.59
Pasadena	20.9	8,766	291.32	43.7	1,328	105.41
Long Beach	30.8	9,196	273.78	46.0	1,435	105.94
County Average	23.9	10,197	319.04	46.8	1,484	113 45
State Average[d]	16.9	9,126	220.33	43.6	1,354	89 35
State Average[e]	14.7	8,572	188.85	42.6	1,309	81 66

Source: Western Insurance Information Service.
[a] Per thousand insured vehicles.
[b] Average per claim.
[c] Average premium income per insured auto.
[d] Including Los Angeles County.
[e] Excluding Los Angeles County.

lated as a matter of statute law that there would be no changes in the right of plaintiffs to sue. Proposition 101, supported by some insurers, would have placed restrictions on litigation in auto tort cases and would have limited awards for pain and suffering. Proposition 104, promoted by most insurers, would have established a no-fault insurance system for auto accidents (as opposed to a tort or fault system) similar to that of New York.

In the push for insurance reform, insurers wanted to end or to reduce subsidies and to limit lawsuits and their costs, lawyers opposed no-fault insurance plans and limits to litigation, and legislators sought to turn the political heat on the insurance commissioner or the governor.

The ballot returns, combined with polling data, indicated that the voters did not trust either the insurers or the attorneys, and all these initiatives were easily defeated. Finally, Proposition 106 would have indirectly affected auto insurance by limiting the size of contingency fees earned by plaintiffs' attorneys. This initiative was defeated much more narrowly.

Proposition 103 was sponsored by "Voter Revolt," an organization headed by self-proclaimed consumer advocate Harvey Rosenfield. Rosenfield's campaign for Proposition 103, aided by high-profile support from Ralph Nader, was characterized by a display of crass dishonesty shameless even by California standards. Rosenfield argued that insurers' profits were unknown because their books were closed. In fact, insurers' books are quite open because insurers are required to file financial statements with the Securities and Exchange Commission and the California Department of Insurance. Rosenfield also argued simultaneously that insurance companies are both obscenely profitable and grossly inefficient. He made those assertions despite a wealth of accounting data indicating substantial losses on auto insurance operations. In fact, the California Department of Insurance calculated an accounting return on equity after taxes of only 3.3 percent in 1988 for the auto insurance business. Rosenfield's assertion about inefficiency was based on an apples-and-oranges comparison of overhead expenses between insurers and public utilities. The absence, however, of either massive entry into the California market by new firms or substantial takeover activity argues against the Voter Revolt's assertions.

Much has been made of income earned by insurers on investments made with premium income. A common argument is that insurers happily lose money on auto insurance itself, because they can make it up with investment income. It is also argued that increases in premiums cover the

Dennis Renault, Sacramento Bee

"When are you going to recall this lemon you sold me, Ralph?"

losses arising from bad investments. These arguments are both inconsistent and incorrect. If income from insurance premiums is invested, then competitive pressures will force premiums down by the *expected*—not actual—income from the investments. Similarly, investment losses affect neither the demand (price) for nor the supply (marginal cost) of insurance. If a company tried to recoup investment losses by raising premiums, consumers would flee to competitors.

Rosenfield argued further that Proposition 103 would remove the insurers' "antitrust" exemption and thus implied that collusion had been a common practice sanctioned by law. In fact, collusion had been illegal for decades under the California insurance code. The main effect of the antitrust exemptions under the federal McCarran-Ferguson Act and under California state law was to protect the ability of the insurers to share actuarial loss data. This right was granted to allow small firms and new entrants to avoid the large fixed costs inherent in acquiring loss experience and thus enabled them to compete. Ironically, the removal of the antitrust exemption under state law will reduce the number of competitors. Moreover, it is difficult to see how an industry with 3,600 firms could collude successfully, especially as California insurance companies vary greatly in size, specialization, and other important factors.

The major provisions of Proposition 103, which apply not only to auto insurance but also to most property and casualty coverage, can be summarized as follows.

- Insurance premiums must be rolled back to levels 20 percent lower than those prevailing in November 1987, a year before the vote on the initiative. Thus, the actual rollback typically has been between 30 and 35 percent.
- The rollback provision applies to all insurers except those "substantially threatened with insolvency."
- The insurance commissioner must approve all rate increases.
- The insurance commissioner must be elected rather than appointed by the governor.
- "Good drivers" are entitled to an additional premium reduction of at least 20 percent. (As an aside, this provision in Proposition 103 was drafted so poorly that an individual with a conviction for drunk driving could have qualified as a "good driver." The legislature did summon sufficient courage to correct this particular problem.)
- The dominant rating criteria are to be the driving record of the insured, the number of miles driven annually, and the number of years of driving experience, in descending order of importance. Other rating criteria bearing a substantial relationship to the risk of loss can be adopted by Department of Insurance regulations, which must specify the weight given each rating factor.

Federal and state antitrust exemptions protected the insurers' ability to share actuarial loss data so that small firms and new entrants could compete.

As a practical political matter, the geographical location of the driver can be expected to be relegated to a minor or nonexistent role.

- The legal right of insurance companies under state law to share actuarial data is severely restricted.
- A publicly funded Consumer Advocacy Corporation is mandated to promote "the interests of consumers" in regulatory hearings. In addition, pri-

vate intervenors promoting consumers' interests in regulatory hearings must be compensated by the Department of Insurance out of assessments paid by the insurers.

The rating criteria mandated by Proposition 103 would yield an enormous implicit subsidy from low-loss geographic areas to high-loss ones.

- Various tax provisions in the proposition maintain the insurance companies' tax liabilities, despite the mandated declines in their net revenues.

- Heavy civil and criminal penalties are imposed for "noncompliance."

Wealth Redistribution under Proposition 103. Politics is the art of redistribution, and the voting patterns on Proposition 103 reflect that clearly. While the public debate—as well as most of the media coverage—focused on the promised 20 percent rollback in premiums, by far the most important provision politically was the effective elimination of territorial rating as a major factor in determining premiums. By eliminating territorial rating, the rating criteria mandated by Proposition 103 would yield an enormous implicit subsidy from low-loss geographic areas to high-loss ones. Under strict implementation of Proposition 103's rating scheme, average premiums would fall in San Francisco County by about 1 percent, in Orange County by about 8 percent, and in Los Angeles County by over 21 percent. These three counties contain about 3.97 million insured autos. Of the other 55 counties in California—containing about 7.35 million cars—54 would face increases in average rates ranging from about 1.4 percent in Ventura County to almost 58 percent in Modoc County. The one exception is San Joaquin County, which under Proposition 103 would experience no change in average premiums.

It is instructive to review the county voting patterns on Proposition 103 shown in Table 6. Note that Proposition 103 passed statewide by a margin of 51.1 percent to 48.9 percent.

All three counties whose drivers could expect to be subsidized under Proposition 103 voted in favor of the initiative. Of the other 55 counties in the state, 54 of which stood to subsidize the three winners, five voted in favor of the proposition. These counties—Alameda, Marin, Santa Clara, San Mateo, and Santa Cruz—ranked 51st, 49th, 45th, 52nd, and 44th, respectively, among the "losers" in terms of the size of the increase in average premiums drivers there could expect under Proposition 103. The other 50 counties voted against the initiative, and there is a strong correlation between the size of the prospective increase in premiums and the proportion of the negative vote. In short, "Voter Revolt" is a misnomer; Rosenfield's organization might more accurately be named "Voter Civil War."

Forthcoming Problems of Regulatory Implementation

The insurers, unsurprisingly, sued to block implementation of Proposition 103 on a number of grounds. The central features of the California Supreme Court decision (*Calfarm Insurance Company et al.* v. *George Deukmejian et al.*) can be summarized as follows.

- The "substantially threatened with insolvency" standard for relief from the rate rollbacks is unconstitutional under both the federal and state due process clauses.

Table 6: Percent Changes in Premium and Voting Percent for Proposition 103: Selected Counties

County	Change in Average Premium	Percent for Proposition 103
Los Angeles	−21.4	62.8
Orange	−8.2	51.7
San Francisco	−0.9	65.2
Alameda	+8.0	58.9
Marin	+9.1	53.5
Santa Clara	+11.8	51.0
San Mateo	+12.6	52.8
Santa Cruz	+13.0	54.2
Ventura	+1.4	44.8
San Diego	+10.7	44.1
Monterey	+15.3	41.6
Sacramento	+16.0	39.3
Tulare	+23.3	28.7
Sutter	+37.1	32.3
Lassen	+46.5	29.9
Siskiyou	+49.8	29.9
Modoc	+57.6	23.2

Sources: California Department of Insurance and Office of the California Secretary of State.

- Insurers are entitled to a "fair rate of return."
- Rate increases are subject to review by the insurance commissioner.
- The creation of the publicly funded Consumer Advocacy Corporation is unconstitutional.

To discern the implications of Proposition 103 as amended by the court, it is useful to begin with a few observations on the political climate within which the regulatory process will proceed. Since the insurance commissioner henceforth will be elected by popular vote, it is fair to assume that individuals espousing positions or handing down decisions construed as favoring the insurers—that is, allowing significant increases in premiums—will not enjoy long-lived political careers. The flavor of the campaign pledges now being made by the candidates for insurance commissioner reflect this. Conway Collis, Rosenfield's preferred candidate, believes that statements such as the following will yield electoral advantage: "If I'm elected Commissioner, I'm not going to be fair to the insurance industry. I'm not going to be reasonable. I'm not going to be even-handed. I'm going to break their backs. I'm going to be their worst nightmare come true" (*Los Angeles Times*, March 6, 1990). Another candidate, Ray Bourhis, boasts that he has "spent the last 17 years beating the insurance companies."

This political environment, combined with the court's requirement of a "fair rate of return," suggests that the developing system of insurance regulation in California is likely to display artificially low rates and concomitantly low-quality service, increased political tensions as a result of cross subsidies, higher costs, increased litigation, and an inefficient allocation of resources overall.

Artificially Low Rates and Lower Service Quality. The insurance commissioner is clearly expected to limit increases in premiums. As a result, the insurers will have increasingly strong incentives to degrade the quality of the insurance services they provide. Coverage limits will be frozen and will thus decline in real terms over time. Deductibles and other copayment features will increase. Insurers will take longer to pay claims. Certain kinds of policies will become unavailable, and certain classes of individuals will find it increasingly more difficult to find coverage. More generally, the heterogeneity of insurance services —that is, the range of options open to consumers —will decline, and consumers will be forced to invest more time and energy to search for policies with preferred characteristics. The true cost of insurance will rise inexorably.

Cross Subsidies and the Politicization of the Insurance Market. Rate decisions will also become ever more politicized as the cross subsidies inherent in Proposition 103 manifest themselves more clearly. Political pressures have already been brought to bear in a recent decision by Roxani Gillespie, the current insurance commissioner. Commissioner Gillespie determined that the rate increases required by Proposition 103 in rural areas are unacceptable, and she substituted a different pattern of cross subsidies that she finds more acceptable: "Our system gives Los Angeles County drivers the 20 percent rollback demanded by law. At the same time, it provides modest relief in Orange, Riverside, and San Francisco counties, while limiting rate increases in other areas to 4.5 percent. This is far better than the disastrous increases that would have occurred without it."

The developing system of insurance regulation in California is likely to lead to artifically low rates and low-quality service, increased political tensions as a result of cross subsidies, higher costs, increased litigation, and an inefficient allocation of resources overall.

Why should Los Angeles receive such blessings? Such rulings are certain to be challenged in court, both by insurers hurt by the rate rollbacks in Los Angeles and by drivers elsewhere demanding a different pattern of cross subsidies.

Higher Costs and a "Fair" Rate of Return. Once the game consists of determining a "fair" return, regulators cannot avoid arbitrary decisions about precisely what spending is eligible. Thus, the insurers and the commissioner will be thrust into debates about which costs are reasonable and which are not. For example, there is already political pressure to disallow political and charitable contributions, institutional advertising, and payments to affiliated firms from the costs on which insurers' "fair" returns are based.

While the debates continue about which costs are legitimate, the generally preferred approach

of the consumerists for determining an acceptable rate of return is to rank firms according to their average costs, and then arbitrarily to pick some percentile as a standard above which costs would be deemed "excessive." This will tend to drive out firms with higher costs attributable to higher quality service, since quality is difficult to measure, and thus will reinforce the trend toward deteriorating quality. The consumerists blithely assume that cost differences are explained solely by relative efficiency. They ignore the cost differences that stem from differences in the quality of service provided.

Furthermore, under proposals for implementing Proposition 103, firms whose costs are lower than the standard will receive no reward for their relative "efficiency" because their allowed prices will be determined by their reported costs. Nor will these firms suffer any penalty should they allow their overall costs to rise toward the standard; their rates would also be allowed to rise.

Finally, as long as premiums are below competitive levels, insurers will have only weak incentives to scrutinize claims, because claims paid are a legitimate cost by any criterion, and so will have to be allowed in rate bases reviewed by the insurance commissioner. If firms receive no benefit from scrutinizing claims and suffer no penalty for paying them, the incentives both to file and to pay claims will increase. In short, the regulatory process established by Proposition 103 is likely to whipsaw consumers between declining quality and rising costs.

Increased Litigation. Litigation will be endemic. The insurance commissioner will have strong incentives to leave to the courts the onus of rate increases that, however justified by market conditions, will be politically unpopular. This was clearly the experience with requests for rate increases in the assigned risk program. Even at this early stage in the implementation of Proposition 103, the legal challenges to existing and anticipated rulings are destroying whole forests of paper. Moreover, to make the regulatory task merely Herculean in scope, many rulings will have to apply to all or most insurers despite the heterogeneity of the industry. This approach is certain to yield additional litigation, particularly as the court's decision in *Calfarm* mandates that insurers be given "an adequate method for obtaining individualized relief." As time marches on, it will become increasingly obvious that Proposition 103 ought to be called FEAFA—the Full Employment Act for Attorneys.

Inefficient Resource Allocation. The process of regulated insurance pricing put in motion by Proposition 103 will increasingly distort resource allocation. Regulatory ratemaking inevitably considers only costs and not demand conditions. Further, the cost data used for ratemaking will consist of accounting entries that reflect historical costs rather than economic (or opportunity) costs. As a result, average cost pricing will supplant marginal cost considerations. This process has in other similarly regulated industries consistently yielded rates that are excessively low. This will give new firms just entering the market, and unburdened by historical costs, a relative advantage. But such firms, by their nature, represent less security to consumers than do long-established insurers. Some of the new entrants will be fly-by-night firms, others will be insufficiently capitalized, and many may have weaker incentives than do established firms to preserve their reputations.

Firms whose costs are lower than the standard will receive no reward for their relative "efficiency" because their allowed prices will be determined by their reported costs.

Conclusions

During a hearing, California State Assemblywoman Cathie Wright asked Rosenfield about the origin of the 20 percent figure for the mandated rollbacks in Proposition 103. His answer? "It sounded good." Along with the agony now engulfing the insurance sector in California, that response should give pause to other states considering similar types of so-called consumerist regulation of insurance markets. The interests of consumers are served by maximizing the total value of the available basket of goods and services. Only competitive markets can yield that outcome; artificially low prices for a given good, whether or not combined with perverse regulation, are inconsistent with that goal.

The interest of the "consumer" groups is far different: they enjoy few of the benefits yielded consumers by the operation of market forces, and they suffer few of the perverse consequences of the policy solutions that they espouse. Instead, the political power of the consumer groups—and the implicit payoffs yielded by such mechanisms as mandated payment for intervention in regulatory hearings—grow directly with the perversities created by expanding government power and inversely with the degree to which markets are allowed to operate to the benefit of consumers.

The California experience suggests that other states considering a similar path would do well to look skeptically at the assertions, promises, and, in particular, the hidden agendas of the purported consumer advocates. Moreover, if a competitive market is in some sense not working "well," it may be fruitful to examine other government policies as the likely source of the trouble. More generally, the travails of the California insurance market are illustrative of those awaiting the use of regulation as taxation, that is, as a means of resource allocation by government fiat. The urge to promote such regulatory mandates seems to have grown as the demands upon government budgets have expanded in both number and size. Federal and state decisionmakers ought to consider carefully the adverse effects lurking in the shadows should they succumb to such temptations.

The day after the California Supreme Court upheld most of Proposition 103, Paul Conrad, the clever but poorly informed editorial cartoonist for the *Los Angeles Times*, drew a California license plate reading, "WE WIN!" Sorry, Paul. We lost.

If the competitive market is not working well, it may be fruitful to examine other government policies as the likely source of trouble.

Selected Readings

Clarke, R.N. *et al.* "Sources of the Crisis in Liability Insurance: An Economic Analysis." *Yale Journal on Regulation*, Vol. 6, No. 2 (1988).

Armentano, D.T. "Antitrust and Insurance: Should the McCarran Act Be Repealed?" *Cato Journal*, Vol. 8, No. 3 (1989).