

**Revisiting the Lingering Myths
About
Proposition 103:
A Follow-Up Report**

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September 2004

Regulatory modernization of the property-casualty insurance marketplace has received renewed attention recently with the release of a proposal under review by the U.S. House Financial Services Committee. With policymakers now actively considering the “State Modernization and Regulatory Transparency Act” (SMART), considerable attention is being given to the key elements of reform, such as the role of market-based pricing and policy forms in achieving regulatory efficiency and protecting consumers. A key component of the proposal is the preemption of state rating laws, other than informational filing laws, for almost all property-casualty insurance lines. Other provisions cover regulatory structure and oversight issues.

There is widespread agreement among scholars of insurance regulation that moving away from government price controls and maximizing market competition enormously benefit consumers of insurance products. Despite this well-established consensus, however, a small minority continues to maintain that certain state price control regimes, such as California’s Proposition 103, are more beneficial to consumers than a market-based approach and provide a better regulatory model for policymakers to consider.

In 2001, Milliman, an actuarial research and consulting firm, published the results of a research study addressing these claims in the context of California’s Proposition 103 and the state’s automobile insurance market.¹ A principal finding of their extensive analysis was

that Proposition 103, which utilized government price controls, was not responsible for the positive developments in the California auto insurance market.

With heightened focus at the federal level on regulatory modernization of the insurance marketplace, claims that a state-administered rating system, such as California’s Proposition 103, should serve as the ideal regulatory model have resurfaced. Earlier this year, for example, California Insurance Commissioner John Garamendi authored a letter to the Honorable Michael G. Oxley, Chairman of the House Committee on Financial Services, arguing against market-based pricing of property-casualty insurance products in favor of a system of state-administered price regulation. In addition, he maintained that insurance is a product that is fundamentally and sufficiently different from other economic goods and services that it requires a substantively greater degree of regulatory oversight and government intervention in the marketplace.

Milliman’s original research addressed many of these fundamental issues, which are now receiving national attention as reform legislation is being considered. In order to shed light on many of the fundamental issues being discussed, we have asked Milliman to revisit their original analysis and update it with new data. The updated analysis, which turns out to reinforce their earlier findings, accompanied by an explication of the role of competition and the market process, can provide a useful empirical basis on which to evaluate many of the reform solutions being offered.

Background

There is a well-established consensus among scholars of insurance regulation that government regulation of the prices of insurance products reduces consumer welfare and stability in the insurance marketplace. Indeed, a variety of scholarly studies have been done demonstrating the adverse impact that price controls have on insurance consumers in several state-specific contexts (Massachusetts, New Jersey, and South Carolina). Nevertheless, price control regimes remain an intrinsic part of the regulatory systems of many states.

Since the evidence overwhelmingly supports market-based pricing as the best regulator of the prices of insurance products, proponents of government price controls have searched for a dramatic counterexample to support their position and pointed to one state-specific case that appears to support their case. A report written by the Consumer Federation of America (CFA) in 2001, entitled *Why Not The Best?* claimed, among other things, that California's Proposition 103 (which instituted a system of rigid price regulation in the state) saved California auto insurance consumers over \$23 billion between 1989 and 1998. In addition, it also cited statistics on the change in insurance premiums in California and elsewhere, purporting to demonstrate that under state-administered price regulation consumers were subject to rate decreases, while elsewhere in the US, rate increases occurred over the same time period.

In October 2001, Milliman issued a detailed

quantitative analysis of the claims in the CFA study.² Broadly speaking, the principal conclusions of our research were that the vast majority of the savings to California consumers were due to reductions in auto insurance loss costs, not regulation of prices, and that the loss cost reductions had little to do with Proposition 103.

This paper provides updated empirical analysis of a portion of our earlier study, in order to address the unsupported claims about Proposition 103 and the California auto insurance marketplace that are being repeated. In addition to quantifying the impact of loss costs on insurance rates, we also are commenting on several other economic arguments being made about insurance products and the competitive market process overall. We are providing extensive analysis of these claims because they have important implications for the reform solutions being discussed.

The Legend of California's Proposition 103

The experience of California's auto insurance market in the aftermath of Proposition 103 is often cited by proponents of state-administered insurance pricing because it appears to offer a strong case for their regulatory approach. In the 1980s, California's auto insurance market was in crisis. Claim costs were soaring largely because a court decision (*Royal Globe*) in 1979 unleashed an onslaught of litigation in California courts; between 1980 and 1987, Superior Court auto liability claim

filings increased 82 percent and average claim severity quadrupled. This led, not surprisingly, to dramatic increases in auto liability insurance costs and was reflected in sky-high premiums for consumers. Consequently, Proposition 103, whose fundamental feature was price controls, was sold to voters as a way to keep insurance coverage affordable.

Price controls in state insurance markets have an unsuccessful empirical track record. This might have happened in California, too, if not for other factors that ended up driving down claims costs and reducing premiums. Proponents of government price controls, however, have continued to insist that Proposition 103 was responsible for bringing down auto insurance premiums in California. Let's examine their claims in some detail.

Claim: Proposition 103 saved California consumers \$23 billion over the decade from 1989 to 1998.

Analysis: It is critical to note that the CFA, which originated the \$23 billion figure, has never provided an independent analysis to support the assertion that Proposition 103 actually saved California consumers \$23 billion over the decade from 1989 to 1998. In fact, the CFA had itself merely cited earlier work by Jaffe and Russell as support for this claim. We have provided a lengthy critique of both the CFA study as well as the Jaffe and Russell paper in our earlier work,³ **and will not repeat them in detail here.**

Their conclusion regarding \$23 billion in

savings derives from an explicit assumption that absent Proposition 103, the annual rate of change in auto insurance premiums in California would have equaled the rate of change in the US excluding California. In light of the fact that auto premiums in the US (excluding California) increased approximately 33 percent between 1989 and 1998, while in California they were relatively stable (decreasing approximately 10 percent in the last year, 1998), the savings under this assumption have been substantial.

Finding: It is critical to reiterate the main conclusion of our prior analyses, which is, quite simply, that in the long run insurance rates are a function of insurance costs. The reason that rates came down in California over the last 13 years is that costs declined dramatically. In reality, the growth rate in average claim costs per insured vehicle in California slowed dramatically in the 1990s, compared to both the 1980s experience in California and the 1990s experience countrywide. Indeed, average liability claim costs and expenditures per insured vehicle in California actually declined for the decade ending 1998. This decline coincided with a multitude of specific legislative, judicial, and voter-approved initiatives which, in diverse ways, were overtly designed to address rapidly escalating claim costs. None of these initiatives were related to Proposition 103. Despite the broad claims of success that are made by the proponents of state-administered pricing regulation – the key feature of Proposition 103 – our

analysis came to a very different conclusion about the recovery of the California auto insurance market. Indeed, if Proposition 103 was responsible for reducing loss costs, as its proponents claim, then why did it take so long for it to really go to work for consumers by delivering premiums that were commensurate with the greatly improved picture on losses?

Factors That Actually Reduced Loss Costs in California

California experienced a steep rise in liability costs during the 1980s because of an extremely adverse tort environment prior to the passage of Proposition 103. This was followed by an equally dramatic drop in loss costs in the 1990s. The key factors that led to the improved environment were as follows:

1. The end of the bad faith doctrine with the *Moradi-Shalal* decision, which put the brakes on fraud, attorney involvement and excessive claiming/overpaying of claims to avoid bad faith.
2. Aggressive and coordinated fraud fighting by insurers and state-local law enforcement.
3. Proposition 213, where uninsured drivers were prohibited from suing for pain and suffering.
4. Comprehensive reform of the residual market to eliminate disincentives for cost control.
5. Vehicle and highway safety improvements which worked in concert with the above factors.
6. A strong seatbelt law that resulted in the

highest seatbelt usage of any state in the nation.

7. More vigorous enforcement of DUI laws, and a reduced blood alcohol standard.

First, in 1988 (the same year that Proposition 103 passed) the California Supreme Court abruptly switched liability rules, eliminating one of the most expensive classes of costly losses for insurers. Second, in the years following enactment of Proposition 103, California adopted the toughest seat belt, alcohol-impaired driving and road construction safety laws in the country.

In addition, California voters approved Proposition 213, the Personal Responsibility Act of 1996, which barred drunk drivers and uninsured motorists (as well as felons involved in auto crashes while committing crimes or fleeing from them) from compensation for any non-economic losses resulting from auto-crash injuries. Prop 213 raised the penalty for uninsured driving and encouraged uninsured drivers to purchase insurance since they not only would be in violation of the law, but also would not have access to compensation for non-economic losses if they were injured in crashes. (At the time of its enactment the RAND Institute for Civil Justice estimated that Prop 213 would reduce auto insurers' compensation costs for personal injuries by about 10 percent, translating into a reduction of about 5 percent in the average California driver's auto insurance premiums.) Along with the reversal of previous court decisions that encouraged costly lawsuits, Prop 213 led to a dramatic reduction in auto-related lawsuits,

which fell from 91,000 in 1988-89 to 42,000 in 1998-99. The number of driving under the influence-related claims dropped by about 60 percent.

The California legislature also cracked down on insurance fraud, such that by 1998, the empirical factors actuaries use to measure fraud and claiming behavior – which had been 2.3 times higher for California in 1992 – had dropped to rough parity with the rest of the nation. Finally, subsequent court cases challenging some of Prop 103’s price control provisions ended up moderating their adverse impact on the insurance marketplace. Taken together, these factors eventually brought loss costs under control and allowed the auto insurance market in California to recover.

Finding: These cost-saving steps were taken partly in response to the rising insurance rates that resulted from the increased costs during the 1980s. That is, the competitive market which existed before Proposition 103 was working to make people aware of the problem, and it was being addressed. Proposition 103 did nothing to solve the underlying problem, but rather took attention away from rising costs and offered a quick fix in the form of premium reductions. Fortunately, the passage of the proposition did not prevent the reforms from taking effect.

Loss Costs Ultimately Determine What Insurance Premiums Will Be

Claim: An argument (with accompanying data below) used by California Insurance

Commissioner John Garamendi in a letter to Chairman Oxley (cited earlier) is that since the passage of Proposition 103, auto insurance premiums have declined in California, while premiums have increased nationwide. The Illinois market, which has market-oriented pricing, has seen increases that outpace the national average. According to NAIC data for average auto insurance expenditures, reflecting liability and physical damage coverages, by state:

	California	Illinois	USA
1989	\$748	\$505	\$551
2001	\$689	\$682	\$718
% Change	-7.90%	35.00%	30.30%

Thus, the decline in (total) premiums (for all coverages) in California, in comparison to the increases in premiums in Illinois and nationally, is evidence of the benefits of rate regulation.

Analysis: Interestingly, this kind of simple comparison fails to provide any evidence of the underlying costs in these different jurisdictions that would allow for objectively understanding what caused the premium changes. We correct that failure here by showing that, in fact, auto insurance premiums are responsive to costs. Moreover, they are less responsive to cost changes in a regulated than in an unregulated environment.

Premiums and loss costs can each be expressed as an index with 1989 = 1.00.⁴ We use index numbers in these analyses for two specific reasons. First, the absolute levels of premiums and losses can vary across jurisdictions for many reasons that are

unrelated to regulation; the use of indexes allows the data to be displayed in a common format, regardless of the different levels of the variables. Second, and more importantly, the use of indexes focuses attention on the cumulative changes in premiums and losses over time, which is the issue of real importance in this analysis.

Loss costs in California began to decline as early as 1991, but premiums did not respond until at least 1997. This can be seen as one of the great failures of Proposition 103. (In the analysis below data are displayed through 2001 only, since that is the latest year for which we have cost information. In addition, we focus solely on liability premiums, while Garamendi and others have analyzed data on total premiums, including physical damage coverages. In our view, liability premiums are far more relevant, since nearly 90 percent of the estimated savings derived from liability coverages.)

Premiums in both the U.S. as a whole, and, in Illinois, have indeed increased over the past decade while in California they had been fairly level for around seven years, and then began a moderate decline in the most recent several years. In fact, over the entire 1989 to 2001 time period, average liability premiums increased 22 percent in the U.S. as a whole and 31 percent in Illinois while they declined by 22 percent in California.

This is often treated by proponents of Proposition 103 as *prima facie* evidence of the benefits of price regulation. When costs are considered, however, the premium changes become much more understandable. Figure 1 below shows indices of liability loss costs (as opposed to liability premium) per insured vehicle in California, Illinois and the U.S. as a whole.⁵

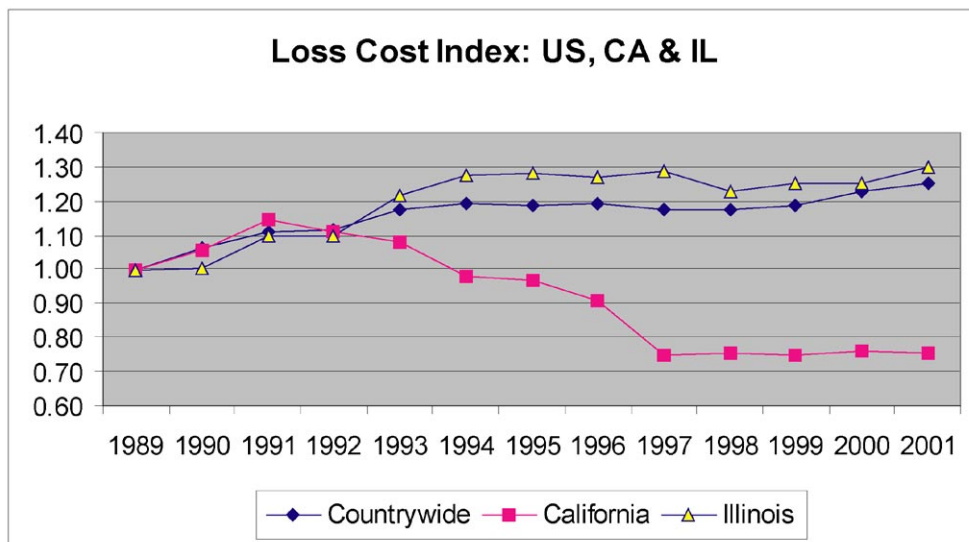


Figure 1

In fact, in the US as a whole, loss costs per insured vehicle increased 25 percent between 1989 and 2001, while in Illinois they increased 30 percent. In California, however, the situation is quite different; although costs increased in the first two years, they then entered into a significant decline – because of factors not related to Proposition 103 – and resulted in a cumulative 24 percent decrease in costs over the period. This decline was not matched, however, by commensurate premium decreases during the 1990s: on the contrary, California average expenditures on premiums remained relatively constant through much of the decade, and only began to decline in 1997.

The correlation between premiums and costs can be seen more clearly if we plot the two data series on the same chart, as is shown in the set of charts below.

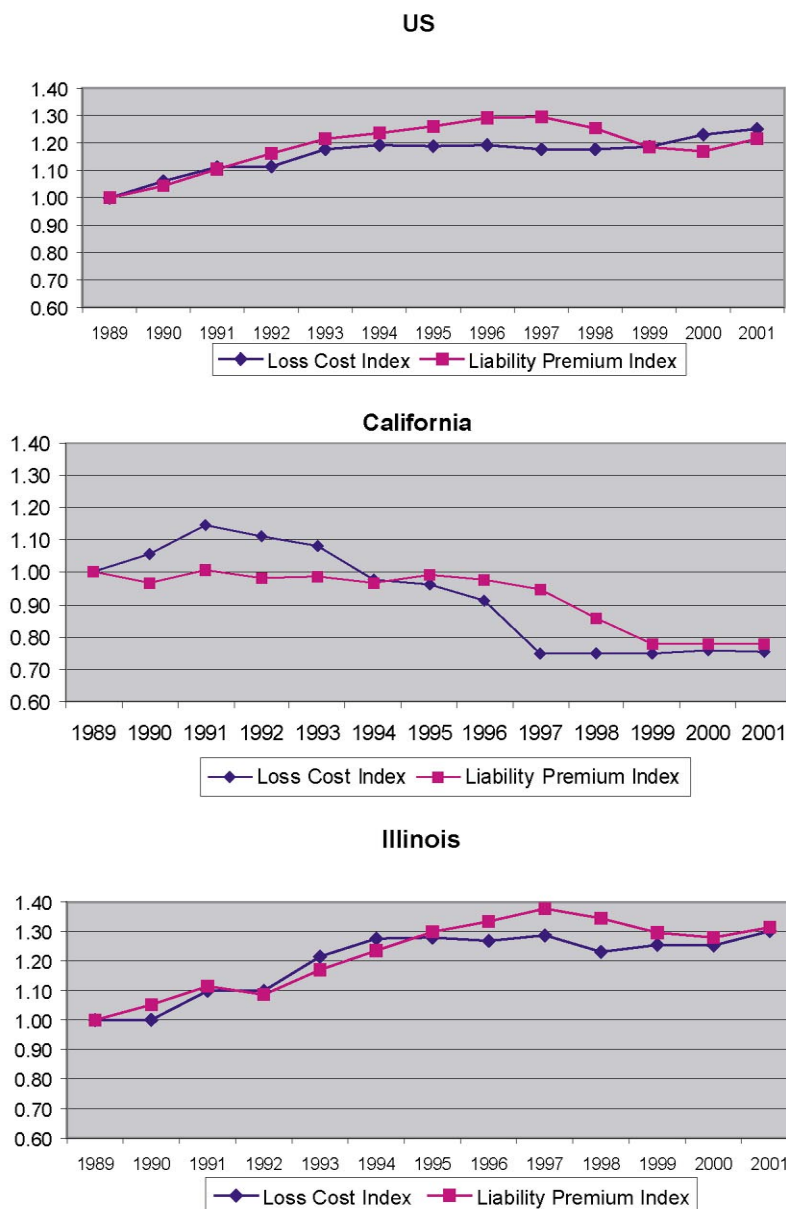


Figure 2

As is evident in these charts, the relationship between cost changes and premium changes is quite close in both the US and Illinois, while it is not as direct in California. For example, in California, costs per insured vehicle began to decline as early as 1991; premiums, however, did not fall meaningfully until 1997. Contrast this to the experience displayed in the other two charts, where there is a much closer correspondence between premiums and costs.

A more precise measure of the relationship between auto insurance premiums and costs can be obtained by calculating the correlation coefficient between the two variables. The correlation coefficient measures how closely two data series move together, with values closer to 1.0, meaning that the two series tend to move together more directly (and values close to -1.0 meaning the series move together inversely). For Illinois, the correlation over the past 13 years was .93, while in contrast, the correlation in California over the same time period was only .80. As noted, the lower correlation in California is due to the fact that while loss costs began to decrease as early as 1991-1992, premiums did not begin to decrease until around 1997. Although there are a number of factors which affect premiums, such as expense inflation and expectations of future losses, the correlation of .93 in Illinois shows that premiums track costs quite well in the absence of regulation. (In Milliman's previous report, we pointed out that the unfavorable regulatory environment occasioned by Proposition 103 probably dissuaded insurers from taking rate decreases more promptly, as they likely believed that subsequent rate increases would be hard to

achieve. We estimated that such regulatory lag might have cost California consumers billions of dollars.)

Finding: These charts amply demonstrate that the main factor driving insurance premiums and expenditures is the underlying cost of insured claims. In the US and in Illinois, claim costs increased throughout the 1990s, and premium increases followed; in California, claim costs decreased, and premium decreases followed, albeit with a significant time lag. Attributing the decrease in consumer expenditures for insurance to Proposition 103 illustrates a significant flaw – the failure to consider the relationship between premiums and loss costs. Indeed, the allegation that premium decreases were the result of Proposition 103, rather than the more obvious explanation that they were a limited response to declining loss costs, flies in the face of logic.

This empirical finding has profound implications in the context of regulatory modernization of the insurance marketplace. What proponents of Proposition 103 and price regulation fail to mention is that consumers were denied the benefits of lower premiums in response to decreasing loss costs, which their insurers would pass on to them in a competitive market. In a market-based approach, the premiums consumers are charged closely follow the actual loss costs that insurers are incurring; this ensures that positive developments in loss costs find their way into consumers' pockets. In addition, insurers are more likely to provide

insurance products if they are certain that they will be allowed to cover their costs. State-administered pricing systems, as our analysis shows, are much less responsive to real-world factors, such as declining loss costs, and can end up, for a variety of reasons, reducing consumer welfare.

Does Insurance Require Greater Regulatory Oversight?

Claim: Insurance products are sufficiently dissimilar to all other financial products and other non-monopoly services that they should be subject to higher scrutiny and require different regulatory oversight. Indeed, the most appropriate level of regulation should be local.

Analysis: These arguments are patently specious, on both the level of economic analysis and experience. There is no inherent reason why insurance is more complex or difficult to understand than many other products and services in our economy: nor is insurance more “required” than many other products and services.

To clarify this, consider some examples of other products that are mandatory and complex, but which have not called for additional oversight above and beyond that which is afforded to all market transactions. For instance, consider the purchase of an automobile. Clearly such a purchase is necessary to participate in commerce in many locales. Of course, since ownership of an auto is required before the purchase of auto insurance becomes mandatory, the purchase of an auto is as at least as necessary

as the insurance. Moreover, consumers are faced with a multitude of difficult issues in making such a purchase. An automobile is an extremely complex piece of machinery, with numerous variables to consider prior to purchase (such as size, style, weight, horsepower, safety devices and the like). It is very difficult to compare the quality of such a product with that of other manufacturers. In order to do so, it would be necessary to know a great deal about the manufacturing process and about the quality of materials that are supplied to manufacturers, in addition to the experience of all past purchasers of the product. Yet authorities have not found it necessary to regulate the prices of the product because of the complexity and mandatory nature of the automobile purchase. In addition, there are variations in the practices of local sales outlets that could require monitoring, but no special bodies have been created at the local level beyond the ordinary protections afforded the buying public.

In addition, the mode of financing the payment of such a purchase can be complex and quite difficult to understand. Consumers have the ability to pay cash, take out loans, or take the option to lease an auto. It can be quite difficult to know which option is best. In particular, it is not easy to know what the ultimate cost will be of taking out a lease, yet consumers generally have to make these decisions on their own. This purchase process is certainly “dissimilar” from that of other products and services, but the states have not seen it to be necessary to establish a local regulatory authority above and beyond the protections that are afforded by general laws in existence, such as consumer protection laws

and fair trade statutes.

The same sort of argument can be made regarding the purchase of a home, which is also necessary if one is to be in a position to purchase homeowners insurance. An investment in a home is very complex and costly. Problems may appear years in the future which will cost one dearly, especially if it is necessary to sell one's home at that time. The quality of materials and techniques that are used in construction are critically important, but most consumers are unable to monitor these sufficiently to be assured that the price of the home reflects the true value. In addition, most consumers must finance the purchase by way of a mortgage agreement which will typically be quite complex, but there is no local authority dedicated to regulating the interest rates paid on such loans. Similarly, rising home values have made real estate commissions more costly than the sum total of homeowners insurance premiums over the average length that a homeowner stays in a home, but there is no additional oversight of this area either.

Of course, there are many other products in today's marketplace that are quite complex, such as computers and other electronic equipment, where consumers are left to fend for themselves. There is a bewildering array of options when shopping for a computer, such as the type of processor, hard drive, display, operating system, memory, graphics cards, floppy drive and additional storage devices, software packages, video and sound cards, speakers, keyboards, internet options, modems, network interfaces, wireless systems, multimedia options, printers and accessories, and warranty and support options.

In today's technological age, consumers can feel overwhelmed by the variety of choices available, and many understand little of the consequences. However, we see no initiatives to protect consumers in these and other areas.

Finding: In contrast to the complexity of these products, insurance might be viewed as relatively straightforward. While it is true that consumers must make choices when purchasing insurance, such as the types and amounts of coverage to buy, the level of deductibles and the like, it is also the case that insurance policies (particularly for personal lines) are largely standardized, the product is purchased at least annually, and there is substantial consumer information as to price and service quality across companies. These characteristics suggest that, if anything, the purchase of insurance is subject to greater information and less complexity than the purchase of an auto or home.

In our view, the purchase of an automobile or a home is at least as complex as that of auto and home insurance, and both are "mandatory" if one is to be in a position to buy such insurance. To our knowledge, however, the proponents of intensive regulatory oversight of insurance products have not recommended the same level of oversight for the prices of autos and homes, nor have they argued that a local authority should be established to monitor the activities of local providers of such products. Insurance does not differ fundamentally from these types of economic goods and services and therefore requires no greater regulatory scrutiny at the "local" level.

The Critical Role of Competition in the Marketplace

Many of the reform solutions currently being proffered, such as government pricing of insurance products, are based fundamentally on misunderstandings of the role of competition and how the market process operates. Insurance markets are extremely competitive in terms of the number of insurers, the relative market power of leading insurers, and ease of entry and exit. When there are many providers and the market shares of the largest companies are relatively small, sellers are forced to set prices at the lowest possible level in order to attract and hold customers. In addition, insurers are constantly entering and leaving particular insurance markets, so that the number of companies active at any given time is in flux. The greater the number of competitors active in a market, the stronger the presumption of sufficient competition.

If anything, competition has sometimes been too severe in insurance markets, leading to insufficient pricing and insolvencies of insurance companies. In fact, the rash of insolvencies that occurred in the early history of the industry led virtually all of the states to enact the regulatory requirement that rates should not be inadequate. The industry was prone to such competition because premiums are generally collected in advance, and since costs are only estimates of future losses, there is a tendency to underestimate their magnitude when striving to win the business of a potential customer. A valuable role that

regulation can play is to prevent such failures to ensure that policyholder claims are paid.

Regarding market structure, there are roughly 960 groups (consisting of 2,400 companies) writing insurance nationwide. Of these, 310 groups (consisting of 740 companies) write in California, while 360 groups (consisting of 860 companies) write in Illinois. Very few important industries in the US have such a large number of competitors. Information available on the internet makes these markets even more competitive. In addition, since the volume of complaints filed to insurance companies is relatively low and consumers generally feel capable of shopping and making insurance choices on their own, there is little need for local oversight of the industry.

What economics has to teach us about the role of competition and the market process has profound implications in the context of regulatory policymaking. Indeed, regulation that may appear to be rational and politically appealing at a superficial level can have unintended and adverse consequences on the insurance marketplace, especially on the quantity and quality of insurance products that can be supplied and their affordability for consumers. Many types of government intervention in the marketplace produce different outcomes than had been expected and end up reducing efficiency, stability and consumer welfare. Regulations that try to set market parameters, such as prices, are artificial attempts to micromanage a dynamic process that is inherently self-regulating.

Summary

Milliman was asked to follow up on our earlier study regarding Proposition 103, since its relevance has recently resurfaced in discussions about regulatory modernization of the insurance marketplace. In order to bring much-needed clarity to the issues, we updated our analysis and reconfirmed the basic conclusions we reported in our original research study. Our findings argue *against* the claims (1) that a Proposition 103-form of rate regulation can provide benefits to consumers in the form of lower insurance rates, and that (2) the nature of insurance, and the complexity of insurance products, create a unique need for price regulation at the local level.

While proponents of government price controls have continued to insist that Proposition 103 was responsible for bringing down auto insurance premiums in California, we found that other factors related to reducing exorbitant liability costs actually brought down loss costs and led to decreasing premiums. Contrary to the alleged pro-consumer description of Proposition 103, consumers actually suffer as a result of such regulation because insurers are not able to quickly pass through cost increases or decreases. Consequently, firms will tend to withdraw from the market when costs go up, and consumers will pay more when costs go down. This was the case with the enactment of Proposition 103.

With regard to the need for regulatory micromanagement at the “local” level, we believe that the standardization of insurance

products and the widespread availability of information about these products argue against the need for greater regulatory scrutiny at this level. Moreover, from an economic perspective and contrary to the claims of some proponents of rigid rate and form regulation, insurance as a product has no salient characteristics or added complexity that necessitate being regulated at the “local” level. Finally, it is critical that policymakers appreciate the nature of competition and the market process when thinking about regulatory modernization of the insurance marketplace. The interaction of hundreds of firms in a competitive market in setting prices is to be preferred to that of a single regulatory authority, who can be influenced by political considerations. It is to the benefit of all that the costs of insurance be quickly and appropriately reflected in the prices that are paid by consumers. Attempts to micromanage the dynamic competitive market process can make consumers much worse off than simply letting the marketplace perform the positive role it can play in a free society.

(Endnotes)

¹ “Analysis of the Consumer Federation of America Report ‘Why Not the Best,’” David Appel, Milliman, Inc., New York, NY, October, 2001.

² Subsequent to the release of the 2001 CFA study, Milliman, Inc. was retained by a number of insurance trade associations to review and comment on the claims made in that report.

³ “Analysis of the Consumer Federation of America Report ‘Why Not the Best,’” David Appel, Milliman, Inc., New York, NY, October, 2001, (In particular, see p. 12 on Jaffe and Russell).

⁴ Source: “State Average Expenditures and Premiums for Personal Automobile Insurance in 2001”, and previous editions of the same publication, National Association of Insurance Commissioners.

⁵ Sources: “Trends in Auto Injury Claims: 2002 Edition,” Insurance Research Council, and “Fast Track Monitoring System,” National Association of Independent Insurers, Insurance Services Office, and National Independent Statistical Service.