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## Groundhog Day: Reliving Deregulation Debates

By Peter J. Wallison

*When Congress begins to consider an optional federal charter for insurance companies next year, one of the most intense debates will surround the question of whether the federal chartering authority, or the charter itself, should preempt state rate regulation of personal lines such as auto or homeowners insurance. Rate deregulation has been successful in virtually every market sector in which it has been tried—from securities brokerage to airlines and trucking—and has even been successful in the few states where insurance rates are lightly regulated or not regulated at all. Nevertheless, one can expect to hear familiar arguments for continued regulation, none of which are supported by empirical data or based on accepted economic theory.*

In the iconic film *Groundhog Day*, the bewildered character played by Bill Murray—a weatherman assigned by his television station to cover Punxsutawney Phil's appearance—finds that he has been condemned to relive the experience over and over, apparently forever. The same eerie feeling will probably fall upon economists and policymakers during the coming debate in Congress over an optional federal charter for insurance companies; since one of the key issues in that debate—especially for property and casualty insurers offering personal lines such as homeowners and auto insurance—will be whether a federally chartered company should be subject to state or federal rate regulation.

In any world but Washington, this would not be an issue. Rate deregulation has already demonstrated, through the wide variety of industries in which it has been adopted and has succeeded, that the resulting competition drives down rates, improves services, and has other benefits for both consumers and firms. This essay will review experience in some of the industries in which rate deregulation has occurred—securities brokerage, banking, and trucking—and it will briefly review

the experience in those states where insurance rates themselves are not regulated or where limited deregulation has occurred. These industries are only a few of the many economic sectors in which deregulation of rates has been adopted; others include air transportation, long distance telephone service, intercity buses, oil and natural gas, and interstate river barge traffic. In all these cases, deregulation has stabilized markets, improved or assured the availability of supplies, lowered consumer costs or increased the quality of services. In some cases it has achieved all of these benefits.

Yet every time the issue of rate deregulation is raised, the same self-contradictory arguments are made—that rate deregulation will result in higher prices for consumers or in destructive competition that will leave competing firms financially weakened and unable to provide necessary services. Since neither of these outcomes seems to occur when markets are deregulated, it is remarkable that they continue to be advanced by the opponents of rate deregulation. But we may be sure we will hear them again when Congress debates the legislation to create an optional federal charter for insurance companies, introduced in the Senate by Senators John E. Sununu (R-N.H.) and Tim Johnson (D-S.Dak.) and in the House of Representatives by Congressman Ed Royce (R-Calif.).<sup>1</sup>

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## Regulation and Economic Theory

Economic regulation began in the United States with the Interstate Commerce Act in 1887, which placed the then-burgeoning railroad industry under regulatory control. When initially built, railroads had substantial market power in vast areas of the country where they operated without competition. Regulation was imposed in an effort to prevent exploitation of shippers without alternative means of getting their products to eastern U.S. markets. Gradually, the idea came to be accepted—especially during the Depression years—that government intervention in private markets could enhance or preserve a public interest that would not be otherwise served by competition. The argument was strongest in cases in which a so-called natural monopoly was thought to exist—for example, in the local supply of electric power or water—but the original rationale gradually extended to other fields in which no natural monopoly could be said to exist. As late as the 1980s, for example, the comptroller of the currency, the chartering authority for national banks, required a showing of community need before a new bank could be chartered, and the rates that banks and savings and loans could pay on deposits were fixed by federal regulation.

Although students of political economy attempt to explain spreading regulation as a result of industry efforts to limit internal or external competition, these are never the reasons given for extending regulation to new areas, and few policymakers would adopt policies that were explicitly framed in these terms. As the banking example makes clear, policymakers seemed to believe that competition could be destructive. It was argued that too many banks in one community could result in a lot of weak banks. Regulation of railroads and telecommunications was imposed because policymakers accepted a different argument—that there were natural monopolies in cases in which substantial fixed equipment costs were necessary to provide service, and consumers had to be protected against price increases flowing from these unusual circumstances. Insurance rate regulation had its own justifications. For historical reasons, there has never been federal regulation of insurance, but state regulation was imposed for at least two wholly different and inconsistent purposes—to set a floor under premiums in order to prevent destructive competition and to shield consumers against premium increases during periods of rising claims.

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The trend toward deregulation, begun under President Gerald R. Ford and continued under President Jimmy Carter, was a triumph of research and analysis by academic economists. Substantial theoretical research suggested that deregulated rates in securities brokerage and transportation would result in lower prices, and that airlines in particular—with rates regulated by the now defunct Civil Aeronautics Board—were competing through inefficient and occasionally trivial service supplements rather than on price. Fixed brokerage fees on the New York Stock Exchange (NYSE) were eliminated in 1975, and rate regulation ended for airlines in 1978 and for trucking in 1980. By 1988, goods and services produced by regulated industries—which had been 17 percent of the U.S. gross national product in 1977—fell to 6.6 percent of GNP.<sup>2</sup>

Ultimately, rate deregulation was successful in virtually every area of the economy in which it was tried. Indeed, it is difficult to think of a policy idea that has had such complete success in the real world. In the end, the fact that academic and theoretical work was the motivating force for a major change in the government's economic policies was a demonstration of the power of ideas and suggests that theories of political economy, in which government policy is thought to be shaped by the special interests of contending forces, do not always furnish adequate explanations for government action.

## Why Deregulation Works

Although the academic work that influenced deregulation policy was empirical, it was based on classical microeconomics—particularly theories about how firms behave in a competitive market. In a competitive environment, these theories suggest, prices fall to the level of the marginal cost of the most efficient firm.<sup>3</sup> This is because every firm will produce as many goods or services as it can sell at a profit, and profit is defined as a price that exceeds its marginal cost (i.e., its cost of producing the last item). Thus, the most efficient firm sets the price that others have to meet.

Rate regulation changes this analysis by affecting the number and incentives of competing firms. When rate regulation requires all firms in a market to offer goods or services at the same price, it eliminates the incentive for a firm to reduce its costs through more efficient operations. This is because the firm cannot expand its market

share by offering a lower price and thus cannot increase its profits by making further investments in efficiency. In a famous essay, Friedrich Hayek referred to competition as a “discovery procedure.”<sup>4</sup> What he meant was that only through competition could economic players discover the most efficient way for products to be manufactured or services delivered. Regulation of rates, he noted, by removing the incentive to find these efficiencies, inevitably keeps prices high. Similarly, the regulatory economist Alfred Kahn wrote:

[R]egulation as such contains no built-in mechanism for assuring efficiency. To the extent that it effectively restrains public utility companies from fully exploiting their potential monopoly power, it tends to take away any supernormal returns they might earn as a result of improvements in efficiency, thereby diminishing their incentive to try.<sup>5</sup>

Although Kahn was referring to public utility regulation, his point is that no business will ever become efficient in the presence of rate regulation because regulation, by definition, limits or removes the opportunity—and thus the incentive—to seek higher profits by reducing costs.

Real markets are admittedly imperfect and far more complicated than the simplified market on which microeconomic theory is based. Inefficient producers survive, sometimes for long periods, by differentiating themselves from the most efficient producers. They might offer a slightly better product or service at a higher price or other benefits that consumers find desirable, but the fact remains that where competition is allowed to occur, it places relentless pressure on competitors to become more efficient, through innovation or otherwise, in order to profit or survive. In general, if they do not set their prices at the marginal cost of the most efficient producer, they must find some other way to attract that last customer who will pay more than their own marginal cost of production. This is the reason that deregulated or unregulated markets produce the lowest prices for consumers—and the highest quality goods and services for the price at which they are offered.

### Deregulation in Practice

When it occurred, deregulation worked differently in different market sectors, depending mostly on the particular

circumstances in the market. But as outlined below, deregulation was successful everywhere it was adopted. At an AEI conference on September 21, 2006, panelists addressed rate deregulation in several industries—including securities brokerage, banking, trucking, and insurance—and the following section is drawn in part from that conference. These market sectors were chosen at random, but similar results would have been observed if telecommunications, natural gas, oil, interstate bus transportation, airlines, or many other industries had been considered.

**Securities brokerage: Allowing rates to fall stimulates transaction volume.**<sup>6</sup> Until its recent conversion to corporate form, the NYSE was a mutual organization that fixed the rates for brokerage commissions charged to non-members from 1792 until 1975. It is easy to understand why a cartel would fix its rates—especially when, as in the case of the NYSE, it has no significant competition. It is less clear why the Securities and Exchange Commission (SEC) would countenance this anticompetitive activity for the forty-two years between its establishment in 1933 and final elimination of fixed rates in 1975. The most

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likely reason, apart from the speculations of political economy, is that the fixed commission system allowed a cross-subsidy arrangement in which large institutional investors paid far more than cost for their transactions and small investors paid less. Opponents of deregulation, which included the brokerage firms that were its principal beneficiaries, argued that rates would rise for the small investor if fixed commissions were abolished. This argument has power in Congress and thus at the politically sensitive SEC. It came back again in the debate over Regulation NMS, the 2004 regulation that extended the “trade-through rule” to the electronic markets. In the debate over that regulation, those who favored extension cited the alleged plight of the small investor, whose limit order might be bypassed (or, in industry jargon, “traded through”) by large institutional investors buying or selling large orders in a fast moving market. Once again, the SEC succumbed to this argument, imposing regulation where none was necessary.

Virtually all investors, efficient securities firms, and the securities market itself prospered after the abolition of fixed commissions. Transaction volume on the NYSE rose approximately 100 percent between 1975 and 1980, providing investors with increased liquidity, and commission rates for institutional customers declined by

50 percent during the same period. Commissions rose slightly on average for small individual investors—reflecting the loss of the cross-subsidy and the effect of the inflationary economy of the late 1970s—but a wide variety of new services appeared, including a large number of discount brokers that offered individual investors as well as institutions considerably lower commission rates than those that prevailed under the fixed rate system. And much of the volume that had migrated to the over-the-counter or third market returned to the floor of the NYSE.

The losers were inefficient firms, which were compelled to leave the market, and holders of NYSE seats, who lost 50 percent of their value between 1974 and 1976, as deregulation of commission rates—and the loss of the rents made available by government-backed fixed rates—were anticipated and came to pass. In the succeeding years, trading volumes on the NYSE and elsewhere in the securities market have soared, and NASDAQ and a large number of innovative computer-based trading venues known as electronic communications networks have come into being. It is unlikely that any of this would have happened if fixed commissions had remained in effect.

**Banking: Deregulation contributes to financial market stability.**<sup>7</sup> Deposit interest rate ceilings were introduced into banking in 1933, during the Great Depression. Initially, they were thought to benefit the banking industry and borrowers by limiting the competition for deposits, keeping interest rates down by reducing banks' cost of funds, and helping small rural banks to compete for deposits against the large city banks.

But in the high inflation environment of the late 1970s, this regulation began taking a toll. Previously, when inflation or other factors drove interest rates above deposit ceilings, the banks found it difficult to gather deposits; their depositors found other places to put their funds. This hurt the economy, as it reduced the availability of bank credit for businesses and consumers as well as for residential mortgages. In some cases, banks demanded repayment of loans so they could meet their cash needs. These factors contributed to recession and unemployment but seldom seriously

impaired the financial condition of the banks themselves. The inflation of the late 1970s, however, was different. By that time, technology had permitted the development of money-market mutual funds, and depositors were withdrawing their funds from banks and putting them in mutual funds where they could get returns

that kept up with inflation. The scale of this trend—known as disintermediation—was much larger and potentially more destructive than in the past and drove the banking industry to seek a removal of deposit rate ceilings.

This was fortunate for the economy, since opposition to deregulation by the regulated industries themselves was often the most serious obstacle to reform. Responding to bank pressure and studies showing the adverse economic effects of deposit interest caps, Congress adopted the Deregulation and Monetary Control Act of 1980, which authorized federal bank regulators to remove interest rate ceilings gradually, a process completed by 1986. The banks did not then engage in a destructive competition for deposits, the big city banks did not deprive the small rural banks of necessary funds, and lending

rates fluctuated with the interest rates determined by supply and demand in the wider capital markets. Depositors and savers returned to the banks, where they could find rates of interest that protected their savings against inflation. The banking industry benefited from a more stable source of deposit funding, which could now be attracted by offering market rates; consumers and business benefited by having a stable source of financing; and the economy benefited by avoiding the cyclical credit crunches that arose periodically when inflation or other events drove interest rates over the deposit ceilings.

Though the banking industry sought deregulation in this case, the benefits of eliminating rate ceilings flowed to the wider economy and specifically to businesses and consumers through the stable availability of bank credit.

**Trucking: Rate deregulation lowers shippers' costs.**<sup>8</sup> It is something of a mystery why trucking was ever regulated in the first place. The industry is not burdened by the high fixed costs that led some to consider railroads and telecommunications systems natural monopolies, trucking services were not thought to be affected with a public

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interest as banks had been, nor was the solvency of truck companies such an important factor in their services that they had to be protected from “destructive competition.” One possibility is that the railroad companies saw the trucking companies as potential competitors and succeeded in persuading Congress that trucks had to be regulated in order to protect the financial health of the railroads themselves.

By the late twentieth century, both the industry and its labor union, the powerful Teamsters, were dead set against deregulation. The arguments they marshaled should by now be familiar. They are the same as those used by securities brokers, local telephone companies, airlines, small banks, and others when deregulation threatened: If regulation is ended, the ones who will suffer will be the supposedly powerless—small investors, local telephone users, and grannies hoping to visit their grandchildren for Christmas. In the case of trucking, the claim was that it would not be profitable to serve small communities off the beaten track unless trucking companies could make up their losses on the rich and protected routes.

But Congress, influenced in part by voluminous academic research on the wastefulness and inefficiency of trucking regulation, voted narrowly for the Motor Carrier Act of 1980, which partially eliminated federal regulation of truck rates, routes, and entry. The process was completed in 1994 with federal preemption of the remaining state regulation of intrastate trucking and the abolition of the Interstate Commerce Commission itself.

The result was a highly competitive market in which trucking rates fell sharply, shippers saved billions of dollars, new entrants to the industry proliferated, and service to small communities either improved or, at the very least, did not diminish. Studies suggest that operating costs per vehicle mile fell anywhere from 35 to 75 percent by 1996. This can only be the result of enhanced competition, which—as Hayek suggested—is a way to uncover more efficient ways of performing the same functions.

**Insurance: Consumers in states without rate regulation do better.**<sup>9</sup> Insurance is not regulated at the federal level. Most states, however, currently impose some form of rate

regulation on personal property and casualty lines—such as auto and homeowners insurance—either by requiring the advance filing of rates for approval or asserting the right to modify rates that companies have already put into effect. The reason given for rate regulation is the usual one: insurance companies must remain solvent in order to perform their function, so states claim an interest in preventing them from engaging in destructive competition. Rate regulation is also justified for the opposite reason: without rate controls, insurance companies will raise premiums excessively when they experience a rise in claims.

Other rationales are also advanced: the scope of insurance coverage is highly technical and detailed, and customers cannot be expected to know whether they are getting the coverage for which they are paying. In addition, in some cases such as auto insurance, coverage is mandatory, so rates must be held to a level that will keep insurance accessible to all drivers. Finally, it is possible for insurance companies to “slice and dice” risk classifications so as to advantage some groups and disadvantage others. States believe they should be able to inject public interest considerations into this calculus.

Doubtless, when the issue of an optional federal charter comes before Congress, these factors will be cited to distinguish insurance from the other industries in which deregulation of rates has benefited both consumers and the industry itself. Proponents of continued state-level rate regulation cannot deny that the elimination of rate regulation has worked elsewhere, but they will argue that insurance is an exception. unregulated competition among insurance companies will be harmful, they will contend, at least to consumers.

These arguments might be more persuasive if there were no jurisdictions where insurance rates are unregulated and which exhibit the problems that regulation is supposed to prevent. However, there are several states in which insurers are left largely free to set their own rates, and in Illinois there is no rate regulation at all. In these jurisdictions, it turns out, there is vigorous price competition, no evidence of excessive profits exists, the competing companies have remained financially sound, and residual markets are small. Residual markets are those in

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which insurers are required, in order to do business in the state, to extend coverage to customers who could not otherwise obtain it at the rates insurers are allowed to charge. Thus, the existence of residual markets is an indication that rates have been excessively suppressed by regulation. If that were not the case, high-risk customers would be charged rates commensurate with the claim experience they present, and would be able to obtain insurance at that rate level. Residual or mandatory coverage exists because insurers refuse *voluntary* coverage to high-risk groups at the rates allowed. Of course, where high-risk groups are receiving coverage through residual pools, low-risk groups are subsidizing this coverage by paying more for their insurance than their risk profile would warrant. The higher claim incidence in states with larger residual markets drives out insurers and reduces competition.

Jurisdictions that do not regulate rates—or, if they do, regulate them weakly—do not have large residual pools; they also have more competing insurers, they generally have lower rates than rate-regulated states, and they show no evidence of either financial weakness or excess profits among insurers. Illinois, the one state with no rate regulation at all for personal lines such as auto insurance, has been extensively studied. As one academic observer has concluded, “Auto insurance [in Illinois] is widely available from a large number of competitors. Rate changes are frequent, modest and appear to follow claim experience. . . . Thirty years of experience suggests that the automobile insurance market functions effectively without any regulation.”<sup>10</sup> What we know about deregulated environments is that competition increases, to the benefit of consumers, so it should be no surprise that a 1992 study found 150 insurers writing auto coverage in Illinois—more than any other state—compared to an average of 97 insurers for all states. The Illinois example is strong evidence that rate regulation is not necessary in insurance markets.<sup>11</sup>

Although no state has adopted the completely unregulated market that prevails in Illinois, the experience of states that have reformed their rate regulation to encourage more rate competition is consistent with the idea that rate regulation is not necessary to protect either insurers or consumers. In the District of Columbia and South Carolina—two jurisdictions where insurance rate reform has occurred—relaxation of rate controls on auto insurance resulted in improvements in the market. Before a 1996 rate reform in the District of Columbia, nearly one in four drivers was in the residual market. After reform, which instituted a “file-and-use” rate system (in which insurers

can use any rate they choose after filing with the district), many new insurers entered the field, and the residual market declined by 80 percent.<sup>12</sup>

South Carolina had an even more dysfunctional system:

From the mid-1970s through 1998 South Carolina intensively regulated auto insurance. Rate levels and structures were restricted, insurers’ underwriting discretion was limited, and large cross-subsidies were channeled through its residual market. Contrary to political expectations, but consistent with economic theory, these regulatory measures worsened market conditions. The distortion of economic incentives escalated costs and prices and caused the residual market to balloon.<sup>13</sup>

Before it adopted reforms in 1999, South Carolina had the largest residual pool among all the states, involving 40 percent of all insured vehicles. In its reform, the state adopted a file-and-use plan within a flexible band—meaning that insurers did not have to seek prior approval for their rates. They could also set their own underwriting standards. After reform, the number of competing insurers in the state almost doubled, the size of the residual pool fell substantially, and average premiums declined in comparison with other states.<sup>14</sup>

## Déjà Vu All Over Again

The debate over an optional federal charter for insurance companies will likely begin in earnest next year. In that debate, proponents of regulation, purportedly pleading the case of “defenseless” drivers and homeowners (not, of course, their own interests), will call for allowing the states to continue regulating the rates on personal lines—such as auto or homeowners insurance—offered by federally chartered companies. Their arguments will not differ significantly from the claims that have been made over the years by the opponents of rate deregulation in other economic sectors, all of which have proven to be unfounded. Because there is already one state where rates are not regulated and there are others where regulation is light, the case for insurance rate deregulation is stronger than the cases that were advanced in the past for the successful deregulation of airlines, trucking, securities brokerage, banking, and many other industries. Still, the fact that the same arguments will have to be addressed once again will make it difficult to shake that feeling of déjà vu when the issue is finally joined in Congress. As author Carl Hiaasen

once remarked: “In government, nothing dies harder than a spectacularly bad idea.”

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AEI research assistant Daniel Geary and editorial assistant Evan Sparks worked with Mr. Wallison to edit and produce this Financial Services Outlook. A summary, a transcript, and a video of the September 21, 2006, AEI conference on rate deregulation and consumers are available at [www.aei.org/event1397/](http://www.aei.org/event1397/).

## Notes

1. *National Insurance Act of 2006*, S 2509, 109th Cong., 2nd sess., *Congressional Record* (April 5, 2006): S 2901; and *National Insurance Act of 2006*, HR 2665, 109th Cong., 2nd sess., *Congressional Record* (September 26, 2006): H 7900.
2. Clifford Winston, “Economic Deregulation: Days of Reckoning for Microeconomists,” *Journal of Economic Literature* 31 (September 1993): 1263.
3. See Karl E. Case and Ray C. Fair, *Principles of Economics*, 3rd ed. (Englewood Cliffs, NJ: Prentice Hall, 1992), 446.
4. F. A. Hayek, *New Studies in Philosophy, Politics, Economics and the History of Ideas* (London: Routledge and K. Paul, 1982), 179.
5. Alfred Kahn, *The Economics of Regulation: Principles and Institutions*, vol. 2 (Cambridge, MA: MIT Press, 1988), 48.
6. See James K. Glassman, discussion of securities brokerage regulation (conference presentation, AEI, Washington, DC, September 21, 2006), available through [www.aei.org/event1397/](http://www.aei.org/event1397/).
7. See George G. Kaufman, “Regulation Q: A Retrospective” (conference presentation, AEI, Washington, DC, September 21, 2006), available through [www.aei.org/event1397/](http://www.aei.org/event1397/).
8. See Paul Teske, “Trucking Deregulation: Rates, Service, and Implications” (conference presentation, AEI, Washington, DC, September 21, 2006), available through [www.aei.org/event1397/](http://www.aei.org/event1397/).
9. See Scott E. Harrington, “Insurance Rate Deregulation” (conference presentation, AEI, Washington, DC, September 21, 2006), available through [www.aei.org/event1397/](http://www.aei.org/event1397/).
10. Stephen D’Arcy, “Insurance Price Deregulation: The Illinois Experience,” in *Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency*, ed. J. David Cummings (Washington, DC: AEI-Brookings Joint Center for Regulatory Studies, 2002), 281–82, available at <http://www.aei-brookings.org/admin/authorpdfs/page.php?id=47> (accessed October 6, 2006).
11. *Ibid.*, 260.
12. See Scott E. Harrington, “Insurance Rate Deregulation.”
13. Martin F. Grace, Robert W. Klein, and Richard D. Phillips, “Auto Insurance Reform: Salvation in South Carolina,” in *Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency*, 191, available at <http://www.aei-brookings.org/admin/authorpdfs/page.php?id=44> (accessed October 11, 2006)
14. See Scott E. Harrington, “Insurance Rate Deregulation.”