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FACTORS CONTRIBUTING TO AUTO INSURANCE COST INCREASES

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"The current $100 billion per year automobile insurance system has been the subject of increasing consumer rage. In states such as California and New Jersey and major urban areas, such as Los Angeles, Philadelphia, Washington, DC and New Orleans, insurance rates have been dramatically rising while coverages have been simultaneously declining. Polls repeatedly indicate that, in such states as California, Massachusetts, New Jersey, few issues are more important to voters than auto insurance reform." (O'Connell and Horowitz, 1993, p. 15)

Few issues of immediate, personal economic import have aroused consumers' passions as those surrounding the dramatic escalation of auto insurance premiums. While current accident compensation systems and proposals for reform are complex almost to the point of stupification, consumers' awareness of the rapid rises in their premiums could hardly be more pronounced. Political responses have been equally dramatic.

Given the complexity of the issues and the myriad of proposed "solutions," the task of the consumer educator in communicating relevant information is enormous. The intention here is to identify and quantify some of the particular components of existing compensation systems that most directly drive premium increases. An understanding of the forces increasing **costs** puts into perspective the reasons why **prices**, i.e., premiums, have been increasing so rapidly. This process in turn focuses attention on those components that might be "reformed" to most effectively ameliorate the price concerns, and on the tradeoffs for consumers involved in any such reform efforts.

Claiming Behavior

Among the major components driving increases in auto premiums faster than the general level of consumer prices are **changes in claiming behavior**. Historically there has been a strong correlation

between property damage claims filed by consumers and the overall accident frequency rate. Property damage (PD) claims, being much more numerous than claims for bodily injury (BI), can accordingly be viewed as a surrogate for overall accident frequency rates.

From 1980 to 1989, the number of PD claims per 100 vehicles insured in traditional tort states (where liability for damages is ascribed based on notions of "fault") **declined** by 12% (Insurance Research Council [IRC], 1990). This reflected a number of factors, such as increased enforcement of drunken driving laws, improved bumper ability to withstand minor collisions without damage, etc. During the same period, in the same states, however, BI claims **increased** by 15%. This increase occurred despite reduced accident frequency, wider public utilization of safety belts, and improvements in vehicle design characteristics associated with reduced likelihood of physical injury.

Simply put, consumers in tort states (such as Illinois) are making more claims and insurers are paying more for bodily injuries even though fewer accidents are occurring.

Geographical Claiming Behavior

Bodily Injury Claims

While claiming frequency has increased substantially in virtually all areas, this has been especially true in large urban areas. Residents of major cities make more BI claims **per 100 accidents** than do residents of other areas. For example, in 1991, residents of Chicago filed 52 BI claims per 100 PD claims, while residents of Illinois as a group filed 34 BI claims per 100 PD claims. Similarly, statewide in California, the number of BI claims per 100 PD claims was 35, while the same ratio was 61/100 in Los Angeles. In Pennsylvania, the ratio was 21/100 statewide against 75/100 in the City of Philadelphia (IRC, 1990).

This claiming activity is somewhat counterintuitive. While larger urban areas, because of their greater congestion, would be expected to have more accidents, one might reasonably also expect **fewer** BI claims. Congestion should lead to lowered speeds which in turn should reduce the frequency of personal injury. Catastrophic bodily injury cases, those with medical expenses exceeding $100,000, are more frequent in rural areas than in more urbanized areas. Catastrophic injuries, of course, are more likely in accidents involving higher speeds, which are more likely in less congested areas. Yet, the unexpected occurs, for, as noted, residents of large cities are significantly more likely to file BI claims when involved in accidents than are residents of other areas. Claiming behavior has caused insurance rates to be higher in urban compared to more rural areas, which is exemplified by the examples provided in the Appendix (Jensen, 1993).

High Risk Drivers

Another factor which has driven premium costs higher is the development of assigned risk pools, typically under varying degrees of state supervision. Assigned risk pools enable individuals who find traditional private-market insurance unavailable or unaffordable to obtain basic insurance coverage. The premiums charged for such coverage rarely are sufficient to pay the cost. Insurers are assessed any differences and, in turn, pass the costs on to other insured drivers.

Since many lower-income consumers tend to congregate in large urban areas, there is a pronounced tendency for assigned risk pool insureds to come predominately from urban areas. As the costs of traditional insurance rise in urban areas (driven in part by increased and concentrated claiming behavior), more individuals find private-market insurance unaffordable or unavailable and increasingly turn to assigned risk pools. As the number of participants increases, the costs and assessments against insurers increase, which in turn raises private-market premiums.

Additionally, regulators resist efforts by insurers to raise prices, causing insurers to respond by tightening their underwriting criteria and rejecting more marginal risks. These individuals, often in urban areas, are thus forced into the assigned risk pool, increasing its costs. These factors combine to decrease affordability, thereby renewing the cyclical impacts of this spiral.

To give perspective to the impact of this phenomenon, consider that from 1983 to 1987, assigned risk program losses nationally rose from $1.87 billion to $6.59 billion, in constant 1983 dollars. These "losses" are ultimately paid by insureds purchasing insurance from private market carriers.

Medical Costs

The current national debate over health care reform is driven in large measure by the dramatically greater rate of increase in medical and health care costs relative to general price levels. From 1981 to 1991, the medical component of the Consumer Price Index (CPI) increased 114% compared to a 50% increase in the overall CPI. Claims under the medical pay portion of traditional auto insurance policies are obviously affected. Similarly, claims under the bodily injury portion of traditional policies are also dramatically affected, both in terms of absolute amounts paid for medical expenses incurred and in payments for so-called "pain and suffering."

These payments are typically a multiple of actual explicit damages incurred, including, of course, medical expenses. Thus, for example, a $1,000 medical expense might be accompanied by an additional payment of perhaps $3,000 for "pain and suffering." As medical costs escalate, so do these claims.

To appreciate the dramatic rate of increase in auto insurance claim costs for bodily injury liability and medical pay claims, consider the experience of a representative major national insurance carrier (see Table 1). Clearly, the dramatic increase in medical and health care costs is affecting auto insurance costs profoundly.

Table 1. Claims Paid Per Insured Vehicle (in dollars)

Type of claim	1981	1991	Increase
With medical sub-components			
Medical pay	16.61	42.12	+153%
Bodily injury liability	45.10	116.55	+158%
Without medical sub-components			
Property damage liability	33.41	60.08	+80%
Collision payments	72.40	120.40	+66%

Cost Shifting

Dramatic developments in the medical and health arena further contribute to the precipitous rise in auto insurance premiums through cost shifting. This phenomena refers to the process whereby health care providers attempt to recoup shortfalls in their reimbursements that occur when payers, such as Medicare, Medicaid or various HMOs, reimburse only for specified or fractional amounts rather than for the total cost of the services provided. Part or all of the amounts of these reimbursement shortfalls are "shifted" to other health care payers who then pay greater portions of the actual costs of the services. These health care payers include auto insurance carriers and others. To the extent that auto insurance coverages most typically pay all (or nearly all) medical costs, shortfall amounts can be cost shifted against back through the auto insurance system to premium payers.

System Costs

Traditional tort-based auto insurance systems expend substantial dollars to allocate responsibility according to notions of fault. While the concept of assigning financial responsibility for losses according to fault is undoubtedly appealing, it carries with it costs which are substantial in the auto accident environment. Thus, it is fair to examine the costs involved in such a system and compare them with the purported benefits.

The assignment of liability according to fault is premised on the theory that doing so will induce less risky behavior and punish wrongdoers for their lack of care. Both notions are suspect in the context of auto accidents. If the prospect of avoiding the enormous, potentially fatal consequences of an auto accident is not sufficient to produce more careful driving, it is fanciful to contend that the prospect of possible financial liability for damages will do so. Such a contention is further discredited when one considers that the prospect of financial responsibility has been sold to another party, i.e., the insurance carrier. Similarly, if the notion is to punish careless drivers, it would be much more efficient to attempt to do so directly, rather than through some convoluted insurance mechanism. In short, the underlying purposes of personal responsibility are generally unserved by fault-based liability allocations in the context of auto accidents.

Yet, the tort-based system imposes enormous costs on the compensation system and thus on premium payers. In 1989, 10% of all insurance expenses were consumed by insurers' legal expenses. Similarly, a significant fraction of payments to individual victims was passed through to their legal counsel. And, the settlement of auto accidents is becoming increasingly formalized. In 1977, 31% of all auto injury claims involved legal representation on the part of claimants; by 1988, that percentage had risen to 45% and it continues to rise.

Possible Reforms

If the purposes of the tort-based system are being at best poorly served, and at significant and increasing cost, then the underlying structure of such a system is potentially the source for significant positive reform efforts. Reforming the auto accident system to achieve greater affordability and availability will involve tradeoffs--in benefits, coverages, and other forms (Carroll, Kakalik, Pace, & Adams, 1991). Simply decreeing a halt to rising prices without addressing underlying increases in costs will be fruitless. For meaningful reform to occur, we can most advantageously focus on those systemic components which are driving the cost increases. Consumer educators can play an important role in advancing the quality of the debates yet to come and consumer education classes can be engaged in these debates.

References

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Appendix

Automobile Insurance Cost Comparisons by Gender in Two Cities

Marital Status:	Single, no dependents
Driving Record:	Clear; licensed 2 years; no tickets or accidents
Vehicle Use:	10 mile, one-way commute to work; 12,000 total yearly miles
Vehicle:	1984 Ford Escort, 4 cylinder, 2 door

	Joe Joliet	Joe Winsor	Millie Joliet	Millie Winsor
Coverage (6 months):				
Bodily Injury Liability $20,000/$40,000 (mandatory minimum)	$273	$225	$201	$166
Property Damage $15,000 (mandatory minimum)	163	130	120	96
Personal Injury Protection	62	55	46	41
Uninsured/Underinsured	16	16	16	16
TOTAL PREMIUM	$514	$426	$383	$319

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