No-Fault Cost Savings: Reality or Myth?

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Abstract:

The authors report the results of a study of no-fault insurance premiums. They conclude that premiums are no higher in fault states than in no-fault states. They suggest that it is not clear whether no-fault is "less costly" as proponents claim, and argue that the abrogation of tort rights should be weighed against any purported cost savings.

Article:

No-fault automobile insurance is an issue that received a great deal of attention in the 1970s. After a period of relative quiescence, there has been a resurgence of interest in the adop¬tion of no-fault, particularly in California. In 1988, when California voters passed Proposition 103 mandating insurance rollbacks, they rejected Proposition 104, which would have mandated a verbal threshold no-fault system despite vigorous support and heavy lobbying by the insurance companies and producers groups as well as other business groups. Republican California Governor Pete Wilson recently advocated a $15,000 threshold no-fault system. The Risk and Insurance Management Society (RIMS), which is regarded as a representative of business insurance consumer interests, recently signed on to the no-fault team by advocating no-fault as part of their "tort reform" agenda. RIMS' reason for support of no-fault is the belief that there are "cost savings" to be realized. The purpose of this article is to address the "cost savings" issue. Members of the profession need to ask themselves whether, as professionals, they can say to friends, neighbors, and associates, "no-fault will save you money."

History of No-Fault Automobile Insurance

The notion of applying the no-fault approach to auto- mobile insurance had its inception in 1925, when Judge Robert S. Marx proposed such a reparations system as a remedy for alleged deficiencies in the tort based compensation system. In 1932, the Committee to Study Compensation for Automobile Accidents recommended a no-fault compensation approach, following an examination of Judge Marx's no-fault reform proposal. One Canadian province, Saskatchewan, adopted a no-fault plan in 1946. Interest in the concept was slight until two law professors, Robert Keeton and Jeffrey O'Connell, published *Basic Protection for the Traffic Victim* in 1965. Their work ignited interest in automobile accident victim compensation reform and Massachusetts adopted a no-fault scheme for automobile accident victims in 1971. Between 1971 and 1977 another fifteen states adopted a form of no-fault. In the process a number of reparation systems variations evolved:

1. *Verbal threshold no-fault states:* where injured parties are barred from any recovery in tort actions except when permanent injury, death, or disfigurement results or when some economic losses (as distinguished from pain and suffering losses) remain uncompensated; this group includes New York, Florida, and Michigan.
2. *Dollar threshold no-fault states:* where injured parties are barred from any recovery in tort except when the dollar amount of their injuries exceeds a specified "threshold."
3. *Add-on no-fault states:* where the tort system is retained but no-fault benefits are added on, that is, there is more first-party coverage required. There are no limitations on recovery in tort in add-on states.
4. *Optional add-on no-fault states:* where each insured is offered the opportunity to buy no-fault insurance benefits, however, there is no change in the underlying tort system.
5. *Traditional tort states:* where there are no limitations on the right to seek recovery.

Despite the movement towards no-fault during the 1970s and current strong interest, there have been some reversals. Nevada and Georgia have repealed their no-fault systems effective January 1980 and October 1991, respectively. Of the fourteen remaining no-fault system states as of January, 1992, three states have a verbal threshold, eight states have a dollar threshold, one state offers a choice of the tort system or a dollar threshold (Kentucky), and two states (New Jersey and Pennsylvania) offer the choice between tort or a verbal threshold. (Carroll, 1991). The New Jersey, Pennsylvania, and Kentucky arrangements are coming to be known as "optional no-fault."

Keeton and O'Connell, the early advocates of an automobile no-fault system, suggested the tort system inadequately served the needs of automobile accident victims with bodily injuries. They argued that transaction costs were high under tort because of the need for lawyers' services. In addition they contended that during the assessment of fault under a tort system, the delay in reparations payments often created financial hardship. Finally, the tort system often inadequately compensated some while overcompensating others. Studies by the United States Department of Transportation (1970, 1971) gave impetus to the no-fault movement and recommended no-fault compensation to victims as a means of alleviating these problems. The advocates of change almost universally based their recommendations on efficiency, adequacy, and equity in compensating victims. Cost was an issue in the debates, but in the absence of experience the most prevalent cost feature accompanying no-fault adoption was the concomitant requirement that rates be reduced on the assumption that actual savings would be realized.

Later studies by Lily and Webb (1983) and Johnson, Flanigan, and Weeks (1983) of tort and no-fault reparations systems during the 1970s suggested that pure premiums under no-fault systems were no less than under tort. In addition, a 1985 DOT report suggests that no-fault states had higher average premium increases from 1976 to 1983. According to the DOT study, the cost of no-fault is strongly influenced by whether the compensation system is "in-balance" or "out-of-balance." An "out-of-balance" no-fault law results in no-fault premium payments that exceed the reduction in tort liability payments, while an "in-balance" no-fault law has the two payments approximately equal. From 1976 to 1983, average premiums in no-fault states with "in-balance" and "out-of balance" systems increased 54 percent and 126 percent, respectively, compared with 50 percent for tort states (DOT, 1985). Given that premiums during the 1980s have grown at

approximately three times the consumer price index (Weiss and Cummins, 1989), a resolution of discrepancies between no-fault and tort system costs is imperative.

Modern proponents of no-fault include the Alliance of American Insurers. An article by Brian Smith entitled "Reexamining the Cost Benefits of No-Fault" appeared in the *CPCU Journal* in March 1989. Smith reiterates the traditional no-fault argument that by removing the costs of the legal system and not paying for pain and suffering losses, two highly beneficial outcomes will result. First, persons with losses who are not compensated under the tort system because they are at fault (or for some other reasons, such as uninsured motorists) will be compensated. Second, the cost of automobile insurance will be reduced for all. Proponents present this no-fault scenario as a near win-win situation. The obvious losers are the lawyers, who are hardly sympathetic characters. The "lawyer bashing" dimension of no-fault gets a good deal of attention. The other losers are the victims of negligence who under a no-fault system would recover special damages only (that is, no compensation for pain and suffering and other noneconomic losses). The impact that no-fault visits upon this second group has not been effectively measured.

METHODOLOGICAL ISSUES

Single Factor Studies

The Smith (1989) article purports to present evidence that "cost savings" derive from the adoption of no-fault. Smith's study, which summarizes research studies by the Alliance of American Insurers, "compares" insurance costs under no-fault to an estimate of what insurance costs would have been had the tort system not been replaced. The estimate is based on the cost of insurance in the last year before each of the no-fault states adopted no-fault and on the cost increase trends in the tort states in the years subsequent to adoption. Smith asserts that the difference between the actual no-fault premium and the "estimated tort premiums" (that is, what the premium would have been in the no-fault states had they not changed from tort) provides evidence that the cost savings often asserted as being forthcoming from no-fault have been realized by those states adopting it. Smith finds that the savings are especially attractive in states where there are verbal thresholds. Smith suggests "an unmistakable relationship" between verbal threshold no-fault and lower insurance costs.

Caution should be exercised in evaluating Smith's conclusions. He does not compare fault states with no-fault states. He compares actual costs in no-fault states with what he estimates the costs would have been in those states had they remained tort. All three verbal states (Florida, New York, and Michigan) show no-fault very favorably but the results are decidedly mixed with dollar threshold states.

One problem with the type of analysis Smith conducts is that it excludes the effects of different conditions in various states. These conditions do change over time. It is not reasonable to estimate the insurance costs of one group of states using the cost experience of another group of states which have (1) substantially different price, wage, and cost characteristics; (2) different negligence systems (comparative or contributory negligence); and (3) different population densities as well as traffic safety conditions such as drivers training, law enforcement, road conditions, and so on. These specific state characteristics can easily overwhelm the effect of a no-fault system on insurance costs.

The result of such a "single factor explains all" approach is the astonishing volatility of the cost changes reported by Smith. His numbers show extremely large variations. For the verbal states, differences from 19 percent to 47 percent between estimated and actual premiums are reported. The other categories show even larger variations. For example, high threshold states show differences ranging from —31 percent (31 percent lower "estimated tort premiums" than no-fault premiums for Colorado) to +33 percent (33 percent higher "estimated tort premiums" than no-fault premiums for North Dakota). These widely inconsistent patterns are apparent in low threshold states as well. For example, estimated savings from no-fault are as much as 33 percent for Massachusetts. In contrast, Smith estimates a cost increase for no-fault for New Jersey of 19 percent. Such wide variations in outcomes is consistent with the use of a simplistic approach that does not allow for omitted causal influences.

Multi-Factor Studies

Another question resulting from Smith's analysis con- concerns the use of percentage increases. Percentage increases are very sensitive to the base cost. A better approach to measuring the cost effects of no-fault is to compare the costs in no-fault states with the costs in tort states after controlling for extraneous effects. If no-fault is effective, cost savings should be apparent in no-fault states when holding constant the effects of these causal factors.

Recent studies by Cummins and Weiss (1991) and Johnson, Flanigan, and Winkler (1992) have controlled for causal factors, and have addressed statistical problems of previous studies. Both studies find add-on no-fault to cost substantially more than the tort system. Johnson, Flanigan and Winkler report pure premiums (that is, that part of the premium based on expected losses, or "loss costs") for add-on are $35.73 to $54.87 higher than tort; Cummins and Weiss estimate pure premiums to be 7.9 percent to 14.7 percent higher. Cummins and Weiss also find evidence that the verbal threshold system might be less expensive than tort; however, only two of four models are statistically significant. Johnson, Flanigan, and Winkler report that the difference in total system costs for verbal and tort is not statistically significant. High threshold states (those with thresholds above $1,000) are found to be an average of $12.37 higher. The low threshold and optional systems are found to have costs not statistically different from tort. The conclusion is that while no-fault redirects money away from the legal system, the added costs of compensation consume the savings. No-fault will not save the average policyholder money.

Transaction Cost Issues

Neither the study by Cummins and Weiss nor the one by Johnson, Flanigan and Winkler examined transaction costs of the no-fault and tort systems. Carroll et al. (1991) examined the effects of 21 no-fault plans, and concluded that a no-fault approach reduces transaction costs, narrows the gap between compensation and economic loss, increases the compensation for economic loss, decreases the compensation for noneconomic loss, and provides compensation more quickly than the tort system. The Rand study (Carroll, 1991) contends that transaction costs account for about one-third of total injury coverage costs in the traditional system, and that no-fault systems have transaction costs on average about one-third less. Therefore, no-fault can decrease total injury coverage costs by no more than 10 percent (Carroll, et al., p. 46). This finding mirrors Johnson, Flanigan, and Winkler's finding that the use of no-fault reduces liability insurance costs but when total system costs are added in, the consumer of automobile insurance breaks even.

Carroll finds that a 39 percent decrease in transaction costs can be attributed to no-fault, but the transaction cost savings (legal costs) are accompanied by a 13 percent reduction in compensation (noneconomic losses). Thus Carroll finds that saving more than 10 percent of total injury coverage costs would require cutting net compensation. In general, compensation decreases as the threshold increases and increases as the PIP level increases.

CONCLUSIONS AND IMPLICATIONS

S tudies to date have reached different conclusions concerning the costs and benefits of no-fault systems for the compensation of automobile accident victims. Verbal systems have been found to be no more expensive than tort, and in some cases are reported to be less expensive. From the perspective of transaction cost savings, verbal systems appear to offer significant efficiency advantages in compensating victims but substantial savings come only with reduction of compensation. There is strong evidence that dollar threshold and add-on no-fault systems increase cost and therefore should not be supported.

More insightful analysis of the no-fault versus tort system cost-benefit issue should be possible from the experience of those states that require their citizens to choose between tort coverage and no-fault coverage. If cost savings materialize and the market responds through consumer choice of a predominant no-fault system, strong evidence of efficacy will become clear. Analysis of reparations system results and consumer choice in these states will indicate whether the advantages of reduced transaction costs, improved timeliness, and purportedly more adequate compensation of economic losses should be rigorously pursued.

To date the cost debate surrounding no-fault has ignored the disadvantage of the abrogation of a citizen's rights to receive sufficient compensation for noneconomic losses. These rights, established in the Anglo-American tradition of jurisprudence, survived the test of time and reside in our very reliance upon the jury system as the proper forum for resolving issues of fact, including the accurate measurement and compensation for damages.

On the issue of whether the benefits of no-fault are worth the cost, the jury is still out.

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