Letter: Current Insurance Pricing Unduly Limits Car Ownership

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Dear Editors:

Aaron Edlin's case for converting auto insurance to cents-per-odometer-mile prices builds on the assessment years ago by William Vickrey that auto insurance "fails miserably" to provide an appropriate incentive to control the amount of driving. The case could be made compelling, however, by building on Vickrey's further assessment that insurance as a cost of car owning actually creates perverse incentives.

Vickrey concluded that: "The premium structure thus has the general effect of promoting excessive use of a given stock of cars and undue stinting on the ownership of cars." Although he noted harm to the automobile industry, neither Vickrey nor any other economist since has identified the feedback effect the premium structure must have on premiums themselves and where this effect must be strongest.

The first description of how "stinting on ownership" and "excessive use" of some cars induces high insurance prices was included in an analysis I prepared for Texas legislators. Drivers needing to economize will buy fewer units of insurance.

Since the traditional purchase unit is a car year (divisible into car days), economizing drivers first take their less-driven cars out of insurance pools. They then share cars kept insured. But each action constitutes adverse selection against the pools: lapsing insurance on marginal cars takes more premium than miles out of insurance pools and sharing cars kept insured adds miles without premium to the pools.

The effect is evident on the cars owned by low-income drivers, both rural and urban. These cars produce the most liability (and other) claims per 100 car years for their insurers to pay. The insurers react by raising prices in what they call hard-to-serve zip codes. The higher prices result in fewer cars insured, and consequently must result in more miles per insured car, more claims per 100 car years, and still higher prices. Thus drivers are forced to give up needed cars or risk arrest for driving them uninsured.

Adding insult to injury, the prevailing assumption is that low-income drivers must be more negligent than other drivers. But serious attention to the inescapable consequences of the two perverse incentives noted by Vickrey could lead to broad demand for the change Edlin advocates.

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REFERENCES AND FURTHER READING

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