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LENGTH: 37015 words**ARTICLE:** INSURER MORAL HAZARD IN THE WORKERS' COMPENSATION CRISIS: REFORMING COST INFLATION, NOT RATE SUPPRESSION**NAME:** By Martha T. McCluskey*

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SUMMARY:

... In the late 1980s and early 1990s, most workers' compensation programs in the United States faced an unprecedented crisis. ... In the early 1980s in Maine, while insurers unsuccessfully battled the state for control over ratesetting standards, insurers sought temporary protection from the risk of rising costs by moving many of their policies into the residual market. ... Up until the 1985 law reforms, Maine law authorized the NCCI to manage Maine's assigned risk pool as part of the NCCI's National Workers' Compensation Reinsurance Pool (NWCRP) (which also operated the assigned risk pools of most other states). ... In Maine's 1992 ratesetting proceeding, NCCI witness and economist John Worrall acknowledged that in order for insurers to return to the voluntary market, rates would have to be high enough not only to profitably cover voluntary market risks, but also to cover any individual insurers' risk of disproportionate residual market assessments – an extra charge that Worrall agreed "might have to be very high. ... Rather than being an example of insurer victimization through regulator (and employer) moral hazard, these deficit assessments were an attempt to internalize the costs insurers had implicitly agreed to bear as the costs of doing business in a predominantly residual market under their control and insulated from competition or underwriting risk. ...

TEXT:

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I. Introduction

In the late 1980s and early 1990s, most workers' compensation programs in the United States faced an unprecedented crisis. According to the messages that dominated media, politics, and scholarship, employers' insurance premiums "skyrocketed" because of increased workers' compensation benefit costs. n1 In response, most states enacted wide-ranging legislative reforms that substantially restricted workers' benefits. n2 This view placed the insurance companies who financed most states' benefit systems strictly in the background, caught between the workers' demands for adequate benefits and employers' demands for affordable insurance premiums.

The conventional wisdom holds that insurance costs inevitably reflect political choices about the amount of benefits paid to workers. In this view, states can best control employers' insurance costs by controlling benefits. Following this theory, the overriding focus of reform efforts was reducing workers' "moral hazard" – more popularly described as benefit fraud, waste and abuse. n3 The insurance industry developed the term moral hazard to describe the problem that people who are protected (insured) against costs tend to take less care to reduce those costs. n4 In the dominant view, expanded [*57] benefit protection for workers during the 1970s increased costs of the system by providing incentives

and opportunities for workers to file claims for questionable injuries. n5 Accordingly, states focused on containing costs through legislation aimed at controlling benefit fraud, restricting the types of injuries covered, restricting benefit amounts, and limiting workers' ability to contest claim denials. n6 As most states enacted these benefit reforms during the 1990s, insurance costs generally stabilized or even decreased. n7

Some critics of these benefit reforms attempted to shift the blame for high insurance costs from workers to insurance companies by questioning whether rising insurance premiums were caused by excessive insurer profits instead of (or in addition to) excessive benefit claims. n8 However, insurers and scholars have countered this criticism by portraying the insurance industry as victims, not perpetrators, of the crisis. n9 In the prevailing version of the story, states initially addressed the problem of rising insurance costs with mis-guided attempts to control insurance rates. This story describes the problem as government moral hazard: by denying rate increases for insurers faced with rising benefit costs, states sought protection from the political and economic consequences of expanded workers' compensation benefits. According to the prevailing story, this "rate suppression" forced insurers to lose money on workers' compensation and, as a result, to decrease their insurance supply. Threatened with the loss of a viable insurance supply, states finally acknowledged the need to reduce benefit costs to bring insurance rates under control.

[*58] This article offers an alternative story of the workers' compensation crisis and reforms by shifting the focus from worker and regulator moral hazard to insurer moral hazard. Contrary to the standard view, insurers are active players in benefit systems with ample opportunities to shape, rather than merely reflect, rising costs paid by employers (and in-directly by workers). In particular, insurers often responded to the benefit changes of the 1970s and early 1980s by seeking cost protections that allowed them to avoid confronting and controlling the costs of doing business in this new risk environment. In this alternative view, rates were excessive, not inadequate, during the period of crisis even though insurers sometimes lost money – because insurers inflated costs. And the 1990s reforms reduced insurance costs not only because of benefit cuts but also because of insurance market reforms in some states that partly reduced these insurer protections and instead encouraged insurers to more effectively control losses and expenses.

II. The Conventional Wisdom

A. Workers' Compensation: Background to the Crisis

Workers' compensation was established by state law in the early twentieth century United States to replace state tort law governing industrial accidents. n10 In the conventional wisdom, workers' compensation was a compromise in which workers gave up their right to sue in tort for workplace injuries in exchange for no-fault, non-adversarial insurance coverage by employers. n11

Virtually all states require most employers to purchase workers' compensation insurance coverage. n12 Most states have relied primarily on private commercial insurance companies to provide insurance coverage. In five states, however, [*59] state funds are the exclusive insurance provider. n13 Most states also permit self-insurance for businesses that can satisfy criteria for financial stability. n14 States with private insurance providers license and regulate workers' compensation insurance carriers and provide for an insurer of last resort (public or private) to cover those businesses unable to purchase insurance in the general market.

Despite its reputation as a well-balanced bargain, n15 workers and employers have continually challenged and changed workers' compensation benefit laws. By the end of the 1960s, decades of inflation had reduced the value of benefits below 1940 levels. n16 Political pressure from groups concerned about inadequate benefits led Congress to establish the National Commission on State Workmen's Compensation Laws as part of the 1970 Occupational Safety and Health Act. n17 In 1972, this bipartisan commission issued an influential report criticizing state benefits as seriously inadequate. n18 The Commission recommended that the system be federalized if states failed to implement a list of comprehensive benefit enhancements. n19 In the following decade, many states enacted legislation improving benefits and benefit access; also during this period, administrators and judges in many states interpreted state laws in ways that expanded workers' rights to benefits. n20 Nonetheless, the benefit expansions fell far short, overall, of the National Commission recommendations. n21

This period of benefit expansion set the stage for the cost crisis of the 1980s. Nationwide, the costs of workers' compensation [*60] premiums to employers rose in the late 1970s (as a percent of payroll), then dropped from 1980–1984, and then rose steeply from 1985 through 1990. n22 In the mid 1990s employers' costs dropped n23 and then did not increase for the rest of the decade. n24 Benefit payments to workers increased from 1984 through about 1991, and then

dropped substantially as statutory benefit changes took effect in the early and mid 1990s. n25

Taken as a group nationwide, insurers lost money in workers' compensation from 1984 to 1992. n26 Beginning in 1993, insurer profits increased dramatically, reaching record levels by the middle of the decade. n27 During 1995, for example, insurers' took in over \$124 for every \$100 of net expenses; n28 in comparison, insurers' worst year of losses in 1992 left them with just under \$109 in net expenses for every \$100 of income. n29

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B. Maine as the Crisis "Poster Child" n30

In the conventional story of the workers' compensation crisis, Maine was the leading example of the purported problem of excessive benefits and inadequate insurance rates. n31 For example, in 1992 the New York Times reported on the crisis with an article featuring insurers' complaints that Maine was "the most egregious offender" violating sound principles of benefit financing. n32 The article reported that Maine's workers' compensation system was about to become the first ever to collapse because the private workers' compensation insurers who provided the state's coverage were planning to withdraw their business. n33 It traced this problem to the state's refusal to grant insurers' requested premium increases during the 1980s. n34 In particular, the article reported that regulators refused to grant any rate increases from 1981 to 1987, and even mandated an 8 percent rate reduction in 1985. n35

The article further reported that, during the 1980s, insurers responded to this rate squeeze by dropping most employers from regular "voluntary market" coverage, instead relegating them to what was known as the "residual market" insurance pool. n36 The "voluntary market" consists of policies in which employers purchase (state-mandated) policies in the competitive market through voluntary contracts with insurers. n37 The "residual" or "assigned risk" market, in contrast, is the insurance source states set up to cover employers unable to find an insurer to "voluntarily" sell them a policy. n38 Like most states, Maine required private insurers participating in the state's market to operate this pool for employers unable to obtain mandatory workers' compensation insurance elsewhere. [*62] All of these insurers traditionally pooled the risk that the residual market premium and other income would fail to cover losses and expenses.

The New York Times article reported that insurers first attempted to leave the state in 1987, but were enticed back by legislation that not only cut benefits, but also allowed regulators to raise rates and required employers to share half the risk of residual market losses. n39 However, despite rate increases totalling nearly 50 percent in 1988 and 1989, insurers still complained that rate increases and benefit cuts fell short of the amount necessary to profitably underwrite most employers. n40 As a result, by 1992, the state's residual market had grown to insure more than 90 percent of the state's employers. n41

Even worse, the Times reported that this pool was running up a deficit estimated at \$574 million. n42 With employers and insurers both facing steep surcharges to cover this deficit, virtually all workers' compensation insurers in the state again began regulatory procedures to relinquish their licenses and withdraw from the state. The Times warned that workers' compensation insurance costs were already unbearable for many businesses in the state, and that, like insurers, many employers were making plans to leave the state to avoid the high costs of the workers' compensation system. n43 This report drew a picture which left benefit cuts as the only answer to the state's crisis. Indeed, shortly afterward, the Maine Legislature enacted a package of far-reaching benefit restrictions and also deregulated insurance rates. By the late 1990s, the state's voluntary insurance market was flourishing and employers' insurance costs had decreased significantly. n44

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C. Rate Suppression Theory: Government Moral Hazard

In explaining the workers' compensation crisis nation-wide, many workers' compensation experts paint a picture of government moral hazard that resulted in rate suppression. For example, in a book on the workers' compensation crisis (published by the insurance industry), Orin Kramer and Richard Briffault argue that state regulators in the 1980s sought to use insurers as protection from the political and economic costs of expanding benefits. n45 They suggest that states imposed rate controls on insurers as a way of avoiding the tough choice between labor's demand for adequate benefits and employers' demand for low insurance rates. n46 They note that, in the thirty states that authorize the National Council on Compensation Insurance (NCCI) as insurers' rate advocate, from 1985 to 1988 the regulators awarded rates that averaged 6-15 percent below NCCI requests. n47

Kramer and Briffault explain that regulatory attempts to shift the price of high benefits from employers and workers to insurers ultimately fail. "Holding rates artificially below the levels implied by claim costs has seductive short-term appeal but devastating long-term consequences." n48 Following basic principles of supply and demand, insurers will decrease their supply of insurance, perhaps even leaving a state's market completely, if the price is not adequate to make the business profitable. Many analysts cite the growing size of residual markets during the 1980s as evidence of rate inadequacy. n49 In the thirty-three states with residual markets operated by the NCCI, the residual market covered less than 10 percent of total workers' compensation premium in 1982-84, but then began to grow in 1985, reaching an average of 24.7 percent in 1992. n50 Several states shared Maine's experience of having the residual market grow to become the insurer for the majority or even almost all of the state's employers. n51

[*64] Kramer and Briffault assume the residual market consists of policies which insurers have decided cannot profitably be insured at voluntary market rates. n52 As a result, insurance coverage in the residual market requires either higher premiums to cover those policies or more rate suppression. If residual market rates are insufficient to cover insurance costs, losses typically are spread among insurers according to their share of that state's voluntary market. n53 But if inadequate residual market rates persist, resulting assessments will further increase insurers' costs and further erode their voluntary market earnings. n54 If regulators do not allow insurers to recoup those residual market losses from employers through higher voluntary market rates, then insurers are likely to further restrict their voluntary market policies (even when the voluntary market, taken alone, contains opportunities for profitable underwriting). n55 As residual market deficit costs are absorbed by a smaller and smaller voluntary market, insurers begin to withdraw from the market altogether to avoid being left with the bulk of the residual market risk. In a downward spiral of cost pressures, a growing residual market with growing deficits therefore exacerbates insurance supply problems in the "voluntary" market and threatens complete market collapse, as happened in Maine in 1992 and in several other states. n56

In the rate suppression analysis, if regulators raise voluntary market rates to keep insurers in the voluntary market despite residual market losses, employers (and indirectly their employees) in the voluntary market will in effect be forced to subsidize higher-cost businesses in the residual market. n57 "Taxing" those businesses least costly to insure to [*65] protect more costly businesses could result in fewer businesses with low losses and more businesses with high losses. n58 And by protecting higher-cost businesses in the residual market, those businesses would have less incentive to engage in loss control efforts, like improved safety measures. n59 Or, if safer businesses leave the market to self-insure, as many did during the 1980s, the voluntary insurance market will be left with costlier businesses likely to cause further problems of rate inadequacy. n60 If, on the other hand, regulators try to recognize higher costs of residual market policies by charging higher residual market rates (as many states did for workers' compensation during the late 1980s), then insurers will be reluctant to move these purportedly costlier policies out of the residual market pool at lower voluntary market rates.

Some analysts also suggest that rate suppression during the 1980s drove up overall costs because inadequate rates forced insurers to minimize loss control expenditures, including safety promotion. n61 Scott Harrington and Patricia Danzon studied workers' compensation loss growth from 1984-1990 and found that losses were higher in states with indications of what they interpreted as rate suppression (larger residual markets and larger gaps between requested rates and approved rates). n62 Another study of states that substituted competitive pricing for rate regulation in the 1980s and early 1990s found that these deregulated states tended to have decreased reported injury rates compared to states with more strictly regulated rates. n63 However, others have found little evidence that injury rates are related to differences in regulatory [*66] systems. n64

D. Assumptions Underlying the Rate Suppression Story

The term "moral hazard" describes a simple incentive effect: protection from costs changes behavior under certain conditions. n65 However, the term is used to interpret those incentive effects negatively. The rate suppression theory relies on two baseline assumptions to interpret the incentive effects of regulators' controls on insurance costs as a problem of moral hazard harmful to the public.

First, the label "moral hazard" implies a judgment that the costs at issue should be the responsibility of the protected party - the "insured." n66 In neoclassical economic terms, "moral hazard" describes one type of "externality" - a situation where one party shifts some of the costs of its actions onto others. n67 Conversely, if a party gets protection from costs that belong to others, then those costs are "internalized." n68 The rate suppression theory assumes that the high insurance costs from which regulators (and their employer constituents) sought relief were the responsibility of the state (and its employers and workers), not insurers. The standard story of the workers' compensation crisis assumes that regulators took

advantage of their control over the highly uncertain ratesetting process to externalize costs onto insurers—not to internalize costs which were insurers' responsibility.

Second, and following from the first assumption, the label "moral hazard" implies a judgment that the behavior change resulting from cost protection is harmful, rather than helpful, to society overall. n69 When someone is protected from the [*67] costs of their actions, they will have incentives to engage in more of those actions than they would otherwise. Whether that behavior change is good or bad – efficient or inefficient—depends on whether that change in costs counts as cost-internalizing or cost-externalizing. By neoclassical economic definition, cost-internalizing provides incentives for maximiz-ing aggregate welfare. It means that a person's self-interested cost-benefit calculations reflect the public interest because the person takes into account (internalizes) the aggregate social costs in her decisionmaking. n70 Conversely, in the classic economic analysis, cost-externalizing creates incentives that decrease aggregate welfare, because a person's private cost-benefit calculation fails to include all the relevant costs to society.

In the rate suppression theory, the cost protection allowed by regulatory constraints on insurers resulted in more benefits for workers and more earnings for employers than would have otherwise occurred. How do they know this is rate suppression rather than appropriate pricing? They assume this incentive effect is harmful government interference with the market (regulatory moral hazard) rather than helpful government correction of the market (efficient cost-internalization) by pointing to the decrease in insurance supply. If rate controls, and the resulting protection for workers and employers, represented an accurate calculation of the costs of providing insurance, then rational insurers would have been willing to offer their underwriting services for that price. In the standard theory, the fact that insurers withdrew their supply and operated their business at a loss during the 1980s indicates that regulatory controls were externalizing costs onto insurers, forcing them to subsidize workers and employers, rather than internalizing costs. n71

But why are insurers' demands for higher prices good while states' demands for lower prices for benefits are bad? [*68] In circular reasoning, the rate suppression story assumes that insurers' demands represent internalized market prices while state regulators' demands (reflecting workers' and employers' demands) represent cost-externalizing market intervention. That is, the rate suppression story essentially relies on the political and moral judgment that insurers self-interest in higher rates reflects the public interest while workers' and employers' interests reflect their own private (special) interests.

E. Alternative Story: Rate Inflation from Insurer Moral Hazard

In Part III of this article, I examine the Maine example more closely to challenge both assumptions underlying the rate suppression theory. First, I explain arguments and evidence supporting the assumption that the rate controls of the crisis era were cost-internalizing rather than cost-externalizing. Rather than protecting states (and their workers and employers) from costs they were obligated to bear, these rate controls can be seen as one of many (often unsuccessful) attempts to counter regulatory capture by insurers and to hold insurers to their cost-bearing obligations.

The events leading up to the crisis of the 1980s and early 1990s show a series of strategies by insurers to seek government protection from the risks of insurance. This protection from responsibility for cost control allowed insurers to externalize costs to employers (and workers) for many years. Insurers' first strategy, which lasted until the crisis period, involved a regulatory system designed to protect insurers from price competition and to allow cartel control of cost information. n72 This system facilitated high insurer profits – but for decades employers' costs were kept relatively low at the expense of inadequate benefits for workers.

After political attention to workers' interests in the late 1960s and 1970s brought increased benefit levels, insurers' political power to shift costs to employers began to erode. Under criticism from employers and others, regulators considered lifting some of insurers' regulatory protections from competition. Substantial opposition from insurers defeated [*69] this movement for deregulation in most states in the early 1980s, however. n73

Next, employers and labor groups mobilized to change the regulatory process that insurers established and defended. As insurance costs continued to rise, pressure from these groups encouraged regulators to revise the largely self-regulated ratesetting process to facilitate greater public participation and to require more objective evidence of insurance costs. Using the model of public utility regulation, regulators in many states tried to increase scrutiny of rate filings to prevent insurers from taking advantage of their protection from competition and their control over cost data to externalize costs onto workers and employers. n74 However, these new standards for ratesetting sparked resistance from insurers and resulted in disputes between regulators and insurers over requested rate increases. n75

As insurers began to lose primary control over the regulatory system, they adopted a second set of strategies for seeking protection from risk instead of increasing their attention to cost control. Without the security of virtually automatic cost increases (or meager benefits), individual insurers moved many of their policyholders into "residual market" pools that shifted much of the risk of high losses to other insurers (and sometimes to employers and taxpayers) but which offered opportunities for high, short-term profits. n76

In conjunction with this strategy, insurers mobilized employers and others to blame workers for the continuing high costs and growing residual markets. In this alternative story, benefit-cutting reforms of the early 1990s are a further instance of insurer moral hazard rather than the cost-internalizing answer to a crisis sparked by regulatory and worker moral hazard. Faced with increased demands from regulators and employers to provide more cost-effective insurance, the private insurance industry aggressively lobbied state politicians for benefit cuts that would help shift responsibility for reducing system costs from insurers (and employers) [*70] to workers. n77 Insurers devoted substantial resources to publicity campaigns blaming worker moral hazard for high benefit costs, sometimes using misleading or groundless statistics inflating the evidence of worker fraud. n78 The NCCI denied reports of substantial opportunities for insurers and employers to reduce costs through improved safety promotion; instead, the NCCI argued that "raising rates and cracking down on fraud are much more important" than injury prevention in alleviating the cost crisis. n79 By blaming worker and regulator moral hazard for falling profits and declining market share, insurers could once again avoid scrutiny of their own cost-inflating practices by their customers, the media and politicians. With the protection of restricted benefits, insurers could enjoy substantial profits throughout the 1990s. n80

My alternative account of the crisis also challenges the second assumption underlying the rate suppression story of regulator and worker moral hazard. In this alternative picture, the long-term behavior changes caused by the rate caps were beneficial rather than harmful to the public in general. First, insurers' failure to supply insurance at the price regulators demanded was in part a sign of insurers' inefficiency – their failure to reduce costs effectively – rather than a sign that regulators acted inefficiently by avoiding the costs of the system. After all, in a market economy, declining sales and profits may indicate that a business is not competitive rather [*71] than that buyers are too demanding. In fact, the decline of traditional insurance markets of the late 1980s and early 1990s actually marked a change in insurance markets that involved a dramatic increase in some forms of insurance supply. New state funds and self-insurance structures successfully replaced traditional insurers – and traditional insurers restructured their operations in response to this heightened competition from more cost-effective providers. n81 These new insurance forms make those with responsibility for financing and processing workers' compensation benefit claims more directly accountable for the costs of those benefits – reducing insurer moral hazard.

A closer look at this changing insurance market suggests that another alleged harmful effect of supposed rate suppression, inadequate loss control, may result from excessive cost protection for insurers rather than from inadequate insurance rates. Danzon and Harrington's findings of higher losses in states with large residual markets or greater rate increase denials n82 may indicate that insurers were particularly ineffective at controlling costs in states with costly benefits. Price competition rather than rate regulation may better reduce losses not because regulated rates leave insurers with too little money for loss control, but because regulated rates pay insurers too much for failing to control losses.

Of course, the reduced losses in the Danzon and Harrington study may simply indicate more denials of legitimate claims, not necessarily more safety or successful reemployment of injured workers – and therefore may not benefit workers. n83 But evidence that deregulating insurance ratesetting corresponds with lower injury rates n84 (rather than simply lower claims rates) also could suggest that the traditional regulatory system inflated rather than suppressed insurance prices. Again, traditional rate regulation may have decreased safety not because insurers received rates too low to cover [*72] safety or return-to-work programs, but because insurers used rate regulation to try to spread the costs of workplace injuries to others (even though they were not always successful in doing so). By increasing insurers' accountability for the costs of workplace injuries and illnesses, the restructured insurance market may have helped induce more effective loss prevention measures in some states.

III. Alternative Story of Insurer Moral Hazard

A. Traditional Rate Regulation Before the Crisis

In the prevailing rate suppression theory, regulators changed insurance pricing during the crisis of the 1980s and early 1990s from a process based on objective evidence of actual costs to a process of special-interest politics driven by employers' demands for affordable rates and workers' demands for benefits. n85 A closer look at the pre-existing approach

to workers' compensation insurance pricing shows instead a highly politicized system where insurers orchestrated and institutionalized government intervention in the market to further their particular interests. The crisis-era regulatory controls intervened not in a system of "free market" prices, but in a system structured to protect insurers from price competition through state-controlled ratesetting and state-sanctioned price collusion.

1. Maine's Example of Pre-1980s Ratesetting

In the 1970s, before it became the leading example of the crisis period, Maine followed the national trend of expanding workers' compensation benefit protection. In Maine, as in many other states, insurers responded to this benefit expansion with a series of price increases. From 1972 through 1981, Maine's workers' compensation insurance rates charged to employers (before adjustment for industry class and employers' individual loss experience) n86 increased an average [*73] of more than 16 percent a year. n87 From 1978 to 1981, insurers received three rate increases of 20 percent or more. n88

Before the late 1970s, Maine regulators authorized these rate increases through a process that basically amounted to rubber-stamping prices determined by insurers acting in concert through the nationwide insurance industry association, the NCCI. Maine law authorized a state administrative agency (the Bureau of Insurance) to ensure that insurance rates were not "excessive, inadequate or unfairly discriminatory." n89 The NCCI, to which all Maine insurers were required to belong, submitted insurers' rate requests in the aggregate, typically in the form of a twenty to thirty page summary of cost data. n90 Maine's Insurance Superintendent traditionally approved the NCCI's rate requests in a one-page administrative order issued several days after receiving the NCCI's rate filing with minimal independent state analysis or involvement from outside parties. n91

Maine's approach tracked the established regulatory practices in most states that relied on a private insurance market for workers' compensation coverage prior to the 1980s. Before 1981, all of these states required prior regulatory approval of premium prices. n92 During this time, thirty-two states gave the NCCI primary (and typically exclusive) authority to supply cost data and to represent insurers as a group in rate regulatory proceedings. n93 A number of other states have state-specific rating bureaus, similarly made up [*74] of insurance company members, but many of these worked closely with the NCCI to share cost and pricing information. n94 States typically required insurers to belong to the NCCI or a comparable state-specific rating bureau and to comply with its standardized practices for data collection. Moreover, Maine, like other states, required insurers to charge these regulated, uniform rates, based on statewide aggregate cost estimates adjusted for industry class and (sometimes) individual employer loss experience. n95 While a few states permitted insurers to offer deviations or discounts for individual employers on a limited basis subject to prior approval, and while some insurers paid dividends to policyholders, price competition in workers' compensation was virtually non-existent before the 1980s. n96

2. Development of Regulatory Price Protection

Although this regulatory system was supposed to protect the public interest, n97 the historical practice of workers' compensation insurance regulation developed in substantial part through self-interested political and legal maneuvering by insurers and regulators (and others). When workers' compensation was established in the early 1900s, federal antitrust laws did not reach private insurers because of a Supreme Court ruling denying Congress's authority to regulate insurance. n98 As in other lines of insurance, workers' compensation insurers joined together in private membership organizations, called rating bureaus, to fix prices. n99 Insurers formed the NCCI in 1921 at the time when most states were in the process of establishing their workers' compensation systems. n100 Throughout the early 1940s, states were largely unsuccessful [*75] in their attempts to enforce state antitrust laws and other protections against insurers' price fixing. n101

In 1944, the Supreme Court changed course and held that federal antitrust laws did apply to insurance (in a case alleging anticompetitive activity by a rating bureau). n102 In response, however, Congress enacted the McCarran-Ferguson Act n103 under pressure from insurers and the National Association of Insurance Commissioners (NAIC). n104 This act gave insurers immunity from federal antitrust law "to the extent that such business is regulated by state law." n105 To activate this federal immunity, most states adopted insurance regulatory systems following an "All Industry" model law developed by the NAIC in close cooperation with industry officials. n106 This legislation allowed insurers' private rating bureaus to propose premium rates by submitting requested prices with state regulators for prior approval. n107

In this system of state-administered uniform pricing, regulators rarely disapproved insurers' workers' compensation

rates prior to the late 1970s and early 1980s. n108 In general, this regulatory approach had the effect of delegating state rate setting oversight to the NCCI, or other insurer rating bureaus, in a system of national industry self-regulation (or price-fixing) operating in cooperation with the NAIC. n109 In the early years of this system, insurers' actual earnings from premiums often exceeded reported losses and expenses by hefty margins. n110 From the start, labor and employer critics raised concerns that insurers were using their protection [*76] from competition and from regulatory scrutiny to inflate prices, thereby draining resources from workers' benefits or from employers' earnings, n111 creating a classic moral hazard problem. Not surprisingly, when the benefit expansions of the 1970s led to substantial rate increases, employers, labor groups, and state officials became more active in questioning this rating system.

This increased concern about insurer moral hazard from the administered price-fixing system not surprisingly produced efforts to reduce regulatory price protections in workers' compensation (following similar deregulation of other insurance lines). n112 From 1981 to 1985, ten states eliminated the prior approval system and introduced some form of competitive rating scheme. n113 Consistent with critics' suspicions that the traditional system had allowed insurers to capture the regulatory process to inflate rates, several studies suggest that these initial deregulation attempts did reduce employers' insurance prices. n114

However, insurers often defended this administered pricing system, arguing that instead of producing moral hazard, the protection from price competition was necessary to keep costs down for both employers and workers due to the special nature of workers' compensation. n115 For example, in response [*77] to an NAIC study recommending open competition in pricing, Liberty Mutual executive Gary L. Countryman argued that "the present regulatory system has adequately assured the financial integrity of the system and has assured the availability and delivery of a high quality product in a way which has fairly balanced the interests of employers and employees ..." n116 In the conventional rationale for state-administered pricing, the compulsory nature of workers' compensation and the third-party interests of workers in secure funding justifies unusual regulatory oversight to prevent both excessive and insufficient pricing. n117 In addition, many analysts justify cooperative data collection and rate filing on the theory that, due to the unique need in workers' compensation insurance for standardized cost information and large databases, rating bureau monopolies rather than competition can best reduce premium costs and maintain market stability. n118

Insurers' arguments defending these regulatory protections tend to portray insurance costs as beyond insurers control. Moral hazard only drives up costs when those who are protected from costs have some control over costs. If insurers' role is simply to finance workers' compensation benefits by pooling premiums based on actuarial calculations of expected risk, then protection from competition might produce the most cost-effective insurance by reducing pressures to skimp on technical expertise or on high quality data. n119 For example, the NCCI concluded in a 1952 report that the ratemaking system had largely achieved its goal of establishing prices on a "scientific and non-competitive" basis. n120 The rate [*78] suppression theory of the 1980s crisis builds on this assumption that insurers passively and neutrally reflect exogenously determined benefit costs – unless regulators interfere by rejecting insurers' rate requests. As one insurance executive explained in the 1992 New York Times article on Maine's market collapse, when insurers demand rate increases, they act simply as the "messengers who deliver the bad news about what is going on in society." n121

But workers' compensation insurance costs are not simply an exogenous and fixed fact of nature waiting to be discovered. Instead, to a large extent, insurance costs are produced endogenously. For example, these costs depend on insurers' subjective choices made in the process of administering claims, servicing policies, and gathering, interpreting, and disseminating highly uncertain information about cost. A closer look at insurers' opportunities for strategic (or inadvertent) influence on insurance costs reveals two forms of moral hazard.

3. Opportunities for Insurer Cost Inflation

First, under the traditional system, rating bureau control of highly uncertain data combined with regulatory protection from price competition probably induced rating bureaus like the NCCI to increase reported costs. The NCCI's revenue and payroll has far outstripped that of individual state regulatory agencies or even the NAIC; n122 these superior resources probably give it informational advantages over regulators that limit the effectiveness of regulatory monitoring. Aside from outright inaccuracy or fraud, plenty of uncertainty about anticipated losses and expenses would have provided ample opportunities for the NCCI to shape data reporting to support insurers' collective interest in seeking high insurance rates.

Compared to other lines of insurance, the long-tailed nature of workers' compensation poses particular challenges for insurers and regulators attempting to project future costs. [*79] The total costs of losses covered by insurance policies for the year 1979, for instance, might not be fully known until well into the twenty-first century, because a worker injured

in that policy year might collect benefits for a permanent injury over the course of thirty years. Moreover, for ongoing or anticipated claims, reported benefit costs rest on insurers' highly subjective and changeable practice of reserving, in which they estimate how much money to set aside for paying claims made (or expected to be made) during a particular policy year. Rating bureaus' projections of future losses (benefit claims) depend on complex assumptions about the relevance of past experience and the need for adjustments for changes in the legal and economic environment in which claims are made. n123 In most states during the 1970s and 1980s, substantial changes in both legislated benefit levels and in claims adjudication (such as increased participation by claimants' attorneys and medical experts) probably increased this uncertainty about claims costs.

Rating bureaus and individual insurers also had plenty of opportunity under the traditional ratesetting system to increase the amount of reported expenses and profit. n124 For example, insurers typically reported general overhead expenses to the NCCI not by submitting any detailed records of actual expenditures, but by estimating the percentage of countrywide overhead expenses attributable to workers' compensation (as opposed to other lines) and to a particular state. n125 Moreover, prior to the 1980s, the NCCI factored formulaic profit allowances into rate requests that had no meaningful relationship to insurers' expected return on capital. n126

[*80] Second, the traditional system of collective ratesetting and data production seems likely to have encouraged insurers to increase their actual losses and other costs during the period of benefit expansion that led to the crisis. Insurers have substantial control not only over their expenses (such as general overhead and claims processing costs) and profit demands, but also over actual benefit costs. Insurers can challenge benefit claims more or less aggressively; they can influence employers' control over benefit claims; and they can provide information, equipment and training designed to reduce benefit claims through safety and re-employment of injured workers. In addition, insurers can alter benefit costs by using their political power and public relations resources to change benefit legislation and to stigmatize and otherwise penalize benefit claims.

Insurers and others sometimes defended the noncompetitive regulatory scheme by acknowledging that price protection creates incentives that often change insurers' behavior, but explaining these resulting behavior changes as beneficial. Based on evidence that the workers' compensation insurance market was relatively open and unconcentrated, a number of economists have argued that the cooperative ratesetting scheme did not eliminate competition but instead shifted the focus of competition from prices to non-price service. n127 This theory reconstructs the higher insurance costs of rate regulation as caused not by insurer moral hazard but by a desirable improvement in service quality that, in the long run, leads to lower costs. In particular, some have argued that the traditional regulatory scheme reduced long-run workers' compensation costs because it encouraged insurers to compete to provide superior loss control services such as safety and re-employment programs. n128

[*81] However, others have argued that, in fact, competition for safety services was more likely to result from price competition than from price protection. For example, Aetna insurance executive William O. Bailey has noted that, in the traditional administered pricing system, insurers concentrated their competition for loss control services on large employers, the only segment of the market where some price competition had taken place (in the form of special deviations, dividends, or individualized risk-sharing contracts). n129

Indeed, before the crisis of the 1980s, the relatively low and fixed costs of workers' compensation meant many managers often paid little attention to workers' compensation costs and often purchased workers' compensation as a package with other forms of commercial insurance. n130 Without an upfront price benefit, and with only an uncertain, indirect, and long-term payoff from many loss control services, many employers probably did not devote significant resources to shopping for improved loss prevention services from insurers. Experience rating – adjustments to premiums based on an individual firm's loss experience – is generally only available for a relatively small group of large employers with at least several years of loss history and at best only imperfectly tracks safety (or other loss control) efforts. n131 Since many employers would not likely have the expertise or data sufficient to identify cheaply expected long-term savings from up-front loss control measures, insurers probably would have to develop and provide this information and to devote substantial resources to marketing it to employers to make such services salient to employers' insurance shopping.

A further look at the pre-1980s ratesetting system shows additional problems with this theory of loss-control competition. In the face of changing benefit laws and rising benefit [*82] costs in the 1970s, insurers probably would not have been able to compete by improving loss control services, without devoting increased resources to developing and marketing new cost containment strategies, based on new information. In a highly uncertain cost context, higher than average expenses on such service would make it more difficult for insurers to predict whether lower profits would

be offset by increased market share. It seems likely that many insurers instead followed the easier strategy of relying on regulated price increases and employers' inattention to their individual losses to maintain their profits in the face of rising costs. Insurance defense attorney Douglas Stevenson explained his experience of insurance managers' typical response to rising benefit costs:

Each year's losses just became the target for next year's sales revenue. After all, there was a government-mandated market... . Government fixed the prices on the basis of figures submitted by the insurance industry and approved by insurance commissioners. So long as this cycle continued, management was a pretty simple matter. n132

Even though some insurance managers may have taken a more entrepreneurial approach to loss control in some instances, the traditional system constrained individual insurers' loss control efforts to some extent by limiting not only price competition but also by limiting competition to produce high-quality information about losses. Information about loss patterns can help promote long-term loss prevention efforts like safety and re-employment in workers' compensation. n133 With its state-mandated monopoly on data collection and distribution, the NCCI had opportunities to shape loss data not only because of its choices about how to project future costs from past data in a changing present, but also because of its choices about what kinds of data about losses should be produced. The NCCI's (or other rating bureaus') [*83] dual role as ratesetting advocate and "statistical agent" (or information source) for insurers created particular incentives for producing information designed not to control costs but to increase them.

During the crisis of the 1980s and 1990s, critics faulted the NCCI for producing data rooted in an "outdated" rate cartel system. n134 One insurance executive explained:

The NCCI and other rating bureau] databases were created for the sole purpose of supporting insurer efforts to (collectively) raise rates to match costs. Since rating bureaus are controlled by insurance companies, these databases weren't designed for analyzing cost trends and managing the costs of the system in order to obviate the need for rate increases. Rating bureaus have no vested interest in helping employers control workers' compensation costs (that would limit the growth of their own industry), unless insurance regulators place some limits on their ability to raise rates. n135

To address these concerns, in the late 1990s, some state regulators took steps toward introducing competition into the data process, for example by putting out to bid the data collection services formerly controlled by the NCCI. n136 Facing this competition, the NCCI finally responded to critics by separating its regulatory and statistical functions into two subsidiaries. n137 In addition, it offered insurers new forms of data, for example, by investing in database systems geared particularly toward improving individual insurers' loss control efforts – such as a "benchmarking" system that allows insurers to measure outcomes by medical provider and to compare losses among firms. n138

[*84]

B. 1980s Rate Controls

Proponents of the rate suppression story tend to gloss over or minimize the anticompetitive nature of the pre-1980s system to present the subsequent regulatory controls as political disruption of market-based pricing. n139 The rate suppression story implicitly identifies insurers' interest in higher premium rates with the economic forces of the market. In that construction, insurers' demands for rate increases are necessary and neutral – a simple reflection of economic facts beyond their control. In contrast, the rate suppression story of the 1980s rate controls identifies regulators' interests (and the interests of the workers and employers they represent) in lower premium rates as unnecessary and partisan – a strategic manipulation of political power to avoid cost control.

Once again, by challenging the assumption that insurers are passive in the face of increasing costs, we can develop an alternative picture of insurer moral hazard as the problem behind rate controls. The Maine example of the 1980s rate controls shows insurers as political actors seeking protection for excessive rates at the expense of others, rather than as victims of others' political scapegoating. First, Maine's long rate freeze during the 1980s resulted in part from insurers' active struggle for control over the regulatory process. Insurers refused to comply with state demands for meaningful evidence of insurers' earnings, forgoing the regulatory process in favor of judicial and political intervention. Second, even

when insurers faced substantial losses from continued rate controls in the mid 1980s, these losses resulted from insurers' choices about doing business in a volatile and regulated market. Insurers relied on regulatory protection, rather than on their own loss control efforts, to manage the risk of uncertain benefit costs. In the face of highly speculative insurance costs, and a regulatory system no longer controlled by insurers, reasonable regulators could be expected to require insurers [*85] to share the risk of uncertain costs.

1. Maine's Early 1980s Ratesetting Controversy

In 1981, Maine's legislature responded to increasing rates by revising the workers' compensation insurance ratesetting law. The reforms required the NCCI's rate filings to include more substantial evidence. In particular, the law required regulators to change the method of calculating insurers' profits to include consideration of insurers' investment income. n140 The law also included an all-or-nothing provision requiring the Superintendent of Insurance to either approve or disapprove the NCCI's rate request as whole. n141 A legislative committee statement explained that this provision aimed to "prohibit the current practice under which the superintendent, after a public hearing and disapproval of a filing, later approves a lesser increase, at a point in time substantially after the filing in question, without the opportunity for cross-examination and public participation provided by a public hearing." n142

With these legislative reforms, however, the ratesetting process broke down. The NCCI resisted the new requirements in its 1982 rate filing by refusing to include data on investment income in order to show the projected rate of return on investment expected from its requested rate increase. n143 Instead, it continued the traditional industry practice of simply adding a 2.5 percent "underwriting profit factor" designed to provide a margin of earnings over underwriting costs without considering the effect of investment income. n144 In addition, the NCCI resisted the attempt in the all-or-nothing requirement to ensure rational evidence, subject to public scrutiny, for the rates actually granted. n145 The 1982 NCCI rate filing provided data supporting a 110.1 percent average increase, while limiting its formal request, subject to [*86] the public rate hearing, to an average 27.5 percent increase – without supporting this lower number. n146

After a public hearing in early 1983 involving participation by the AFL-CIO and several employers, the Superintendent of Insurance denied the NCCI's rate request. The Superintendent found that the NCCI had failed to provide sufficient evidence to support the 27.5 percent figure, and also that the NCCI had failed to satisfy its statutory burden of proving that the profit factor included in the rate filing would produce only a reasonable return on investment (since it failed to include investment income data). n147

Rather than submitting a new rate filing that complied with the Superintendent's standards, the NCCI challenged the Superintendent's decision in state court. In 1984, Maine's highest court upheld the Superintendent's decision, explaining that requiring evidence of investment income was consistent with the statutory purpose of ensuring that rates provide insurers with a "just and reasonable" return. n148 The court reasoned that the insurance industry can achieve net profits from investments even when underwriting costs exceed underwriting income exclusive of interest. n149 Furthermore, the court noted that public utility cases had established that regulators can properly consider interest income in determining appropriate rates. n150

Maine's example reflects a broader trend during the early 1980s to move insurance ratesetting toward a public utility ratemaking model where interested parties participated in scrutinizing underlying cost data and industry performance and where the goal of ratesetting was to provide a reasonable, but not excessive, return on capital. n151 The central issue in Maine's ratesetting dispute of the early 1980s, how to calculate insurers' profitability, reflects regulators' nationwide struggle to give insurance ratemaking a more rational, cost- [*87] based ground than it had had traditionally.

Until the 1981 reforms, Maine's workers' compensation ratesetting formula followed the standard insurance industry practice of accounting for a fair profit basically by adding up aggregate underwriting premium income and subtracting aggregate loss costs and operating expenses, and then increasing this underwriting cost ratio by a fixed percentage to give insurers an earnings margin above net underwriting costs. The precursor to the NAIC set this "profit and contingency factor" at 5 percent in 1921, based on negotiation with insurers without any cost-based rationale or supporting data, and applied it to a range of insurance lines for decades. n152 Insurers originally explained that this calculation excluded investment income in determining insurers' profits because of practical difficulties and because "investment income is simply not part of underwriting, it is not the property of policyholders." n153

Analyzing property-liability insurance in general in 1973, economist Paul L. Jaskow noted that this profit factor "appears to have been picked out of thin air," and described the technique's exclusion of investment income as "a priori

nonsensical." n154 Regulators and other critics repeatedly attempted to change this method of determining profitability, and during the 1970s, many states replaced the 5 percent underwriting profit factor in at least some lines of insurance with an analysis of return on net worth including income from investments. n155 The particularly long-tailed nature of workers' compensation's makes investment income even more likely to have a substantial impact on profitability. Especially in the high-interest rate years of the early 1980s, n156 net underwriting losses might nonetheless produce ample insurance industry profits because of offsetting investment earnings. n157 [*88] Indeed, from 1980-1984 (during Maine's ratesetting standoff), nationwide data on workers' compensation insurance profitability showed a substantial margin of earnings (from premium and investment income) over losses and expenses. n158

Nonetheless, discussions of the rate suppression story typically adopt insurers' premise that investment income is irrelevant to insurers' profitability. For example, in their book criticizing price controls in workers' compensation, Patricia Danzon and Scott Harrington discuss insurers' financial results during the crisis period by looking only at net underwriting results, excluding the investment income that substantially reduced (although not always eliminated) insurers' losses. n159

In an attempt to defend insurers' resistance to regulatory scrutiny of profitability, Orin Kramer criticizes the public utility rate of return model for creating incentives to increase capital. n160 He also argues that, unlike utilities, insurers' earnings cannot readily be separated by state or line of business—most workers' compensation insurers at that time operated nationally as part of multiline insurance companies. n161 These criticisms (and plenty of others) correctly point to shortcomings of regulatory attempts to monitor profitability. Yet these problems hardly justify insurers' continued use of the even more irrational traditional profit allowance or the rate suppression story that 1980s regulatory changes replaced ratemaking based on "economics" with ratemaking based on "politics."

2. Maine's Mid 1980s Rate Caps

When insurers lost their judicial challenge to Maine's ratesetting revisions in 1984, they resisted complying by moving much of their business to the residual market pool and threatening to withdraw from the state entirely unless they received new protections from the risk of rising benefit costs.

[*89] During the early 1980s standoff between the state and the NCCI, no further ratesetting proceedings were completed. Meanwhile, the sense of crisis had been heightened among insurers, who feared the mounting costs suggested by the failed 110.1 percent 1982 rate filing; and among employers and workers, who feared the accumulated rate increase looming once the dispute over investment income was resolved. Anticipating further ratesetting controversies, in 1983, the legislature amended the rating law to provide for a state agency, the Public Advocate Office (established to represent public utility ratepayers) to intervene in workers' compensation insurance ratesetting and other regulatory proceedings on behalf of employers. n162

By 1985, the crisis came to a head. In 1985, insurers had responded to the long period without a rate increase by refusing to cover 85 percent of the state's employers (representing 30 percent of the state premium), leaving most of these businesses in the residual market pool. n163 Nonetheless, insurers retained many larger companies as policyholders, in part because some of these were now insured on a retrospective rating basis which transferred much of the risk onto the insureds and perhaps also because of the importance of large businesses to maintaining insurers' market share in other highly profitable commercial insurance lines.

The state's early 1980s efforts to revise the ratesetting process to reduce insurer's regulatory capture therefore ended in failure. Lawmakers responded in early 1985 by taking a new approach to controlling insurers' moral hazard. n164 This time, the goal was to substitute market competition for government ratesetting as a way of restraining insurers' interest in inflating prices. n165 In addition, lawmakers enacted benefit cuts in response to insurer and employer lobbying for [*90] reduced benefit costs. n166

To implement the plan for price competition, the 1985 "Workers' Compensation Competitive Rating Act" required insurers to file their own rate requests individually and prohibited the NCCI from filing or distributing rate proposals. n167 The 1985 law removed the requirement for prior approval of rate increases and substituted a "file and use" approach that allowed insurers' proposed rate changes to take effect five days after filing as long as the proposed rates met minimal standards designed to allow the Superintendent to protect against insolvency. n168 In addition, the law gave the state insurance department somewhat more control over the NCCI-managed residual market pool.

However, the legislature also enacted a plan for temporary regulatory control of rates from 1985-1987 as a transition to a competitive pricing system, given that most employers were then in the non-competitive residual market where they

were simply assigned to an insurer. This transition plan led to a further standoff between insurers and regulators that derailed the deregulation. The law required insurers filing rate changes to include an 8 percent reduction from the rates in effect since 1981, the period of the ratesetting standoff; if insurers failed to file these rate decreases, the law authorized the Superintendent to promulgate the reduced rates in August 1985. n169 Next, the law required that these reduced rates remain in effect through the next year, 1986. n170 Finally, the new law capped rate increases for 1987 and 1988 at 10 percent. n171

These rate controls effectively aimed to keep insurers' earnings at the level established in 1981 rates, the time of the last approved rate increase before the stalemate over ratesetting evidence. The rate suppression story explains Maine's failure to grant rate increases from 1981–1986 as the result of regulatory capture by employers' interests – a government [*91] attempt to externalize rising benefit costs onto insurers. n172 But, again, by broadening the picture to recognize insurers' control over the pre-existing ratesetting process and resistance to evidence-based rates, these rate limits can instead be viewed as an imperfect attempt to restrain insurers from externalizing costs onto employers (and workers).

Maine's 1985 law stated that the purpose of the transition period of rate controls was to reflect the insurance cost savings from benefit cuts included in the 1985 law changes and to account for insurers' investment income not previously considered in rates. n173 The mandatory 8 percent reduction in 1985, which matched initial actuarial predictions of expected savings from the laws' benefit cuts, in effect required insurers to pass on these savings to employers. At this time, of course, the state was faced with great uncertainty about insurance costs and profitability, due to the ratesetting stalemate since 1981 and the lack of meaningful information about insurer earnings under existing rates. During the 1980–1984 period, workers' compensation insurance rates had fallen on average nationwide, and insurers' nationwide workers' compensation profits had risen. The mandated rate caps effectively required insurers to temporarily assume the risk that benefit costs would be greater than anticipated and that existing rates of return were inadequate.

But once again, the state failed in its efforts to require insurers to take more responsibility for the risks of a highly uncertain benefit system. After the rate caps took effect in 1985, and insurers failed to file the required rate reduction, the Insurance Superintendent initiated a ratesetting proceeding that for the first time heard insurers' evidence on expected rates of return and found that the rate decrease would produce an inadequate (but still positive) aggregate rate of return for insurers. n174 Nonetheless, due to the statutory mandate, the Superintendent ordered the rate reduction.

Insurers were not powerless victims in the face of this expected rate inadequacy, however. They pursued two strategies [*92] of resistance. First, insurers challenged the decision in court as an unconstitutional confiscation of their property and denial of due process. n175 Second, they began to withdraw from the market, refusing residual market servicing as well as continuing to abstain from voluntary market underwriting and to lobby for further law changes.

In 1987, a Maine Superior Court judge ruled that, even if the statute deprived insurers of a reasonable opportunity to earn a profit on future business, there was no constitutional violation. n176 The court reasoned that insurers were free to avoid expected losses by withdrawing from the workers' compensation market in Maine by simply complying with Bureau of Insurance filing requirements. n177 The court further reasoned that, unlike electric utilities with high sunk capital costs, insurers could escape the risk of confiscatory rates by exiting the state's market at relatively little cost. "Their withdrawal leaves no useless wires in the air, pipes in the ground or power plants on the land." n178 The court ruled, however, that if an insurer chose to withdraw from the market as a whole, the state could not require that insurer to participate in residual market servicing (thereby remaining subject to pooled residual market losses) at rates insufficient to provide a reasonable return. n179

In response, insurers stepped up their efforts to withdraw from the market, n180 while lobbying state lawmakers to reduce benefit costs and rate controls. In 1987, again facing a collapsed market, Maine repealed the 1985 law and enacted a new law that imposed new benefits, eliminated the never-implemented competitive rating plan and reinstated the pre-1985 ratesetting process. n181 Meanwhile, the NCCI and several individual insurers appealed the Superior Court decision to the state's highest court, which ruled that the case was moot because of the 1987 law changes and because the insurers had not pled or presented evidence of confiscation under the [*93] 1985 law before the 1987 changes. n182 After this ruling, a group of insurers again sued to challenge the 1985 law, this time presenting evidence of losses, but the Maine Supreme Court ruled that their claims were barred by res judicata because they could have been asserted in the earlier appeal. n183

In the end, although it is likely that at least some insurers lost money under Maine's mid 1980s rate caps, those insurers made a business choice to assume the risk of operating in the regulated market under conditions where employers

had asserted political power to hold down rates and where most insurance was written in the residual market pool. In the New York Times report on Maine's crisis, the chair of the American International Group (AIG, one of the largest national insurers) complained that his company paid \$61 million for its share of Maine's residual market losses in 1987, despite collecting a far smaller amount in voluntary market premiums that year. n184 He did not say whether his company earned residual market servicing fees, which would have provided substantial opportunities for gains that might partially offset residual market losses (typically ignored in discussions of rate suppression). n185 Nor did he explain why he took the risk of assuming those pooled residual market losses if he believed rates were inadequate or that his voluntary market earnings would be small – especially given the pool's incentives for driving up costs, discussed in the next section.

The rate suppression story of this rate cap period assumes that insurers, but not workers and employers, have the right to do business on their terms. The lesson of this story is that states must face the tough choice, dictated by the economics of limited resources, between workers' interest in adequate benefits and employers' interest in affordable rates. This story claims that by attempting to control rates to satisfy both at once, states externalized costs onto insurers and, in the end, hurt both workers and employers by bringing the insurance market to collapse – the regulatory moral hazard problem. This lesson assumes that workers can (and [*94] should) bear the risk of losses from inadequate benefits as the price of a job; or that employers can (and should) bear the risk of losses from high insurance costs as the price of doing business under a mandatory workers' compensation scheme. In contrast, this lesson implies that insurers should not bear the risk of losses from inadequate rates as the price of doing business in a regulated market responsive to the political interests of workers and employers as well as insurers.

Why aren't insurers' interests as expendable as workers' and employers' interests? Because the rate suppression story constructs insurers, but not employers and workers, as having (and deserving) the economic and political power to shape the market in their favor. When insurers try to avoid the tough choice between forgoing business in a state and assuming the risk of inadequate rates, this story assumes they are not denying the economic reality of scarce resources but instead are reflecting the economic reality that insurance market supply depends on satisfying insurers' price demands. But, contrary to this story's assumption, these insurer interests were not quite so inevitable. Looking next at how the Maine market changed in response to further insurer demands for risk protection shows that insurance markets can be differently constructed. Although the Maine example shows critics are right that rate controls that hurt insurers are likely to backfire, Maine's later experience shows that this failure may be a result of insufficient and ineffective rather than excessive restraints on insurers' interest in rate inflation.

C Residual Market Crisis

1. Residual Market Growth

The "explosion" n186 of residual markets in the 1980s and early 1990s in many states seems to present strong evidence of rate suppression during that period. n187 For the thirty-three states using the NCCI as data source and residual market [*95] manager during this period, the share of premium insured through residual market pools increased steadily from 16.3 percent in 1986 to a peak of 24.7 percent in 1992. n188 More striking than these aggregate figures, however, are data showing residual markets of more than 50 percent in five states in 1992 (Maine, Rhode Island, Massachusetts, Louisiana and New Mexico) and several others with a residual market insuring more than 30 percent of total premium. n189 In Maine, the vast majority of employers were insured through the "residual" market from at least 1986 through the end of 1992 (when the residual market was restructured as a self-supporting quasi-state fund). n190

In their book criticizing rate controls, Danzon and Harrington explain:

The major cause of large residual markets is the inadequacy of regulated prices, which prevents voluntary market supply to employers insured in the residual market. In a competitive environment without significant regulatory restrictions on price, there is little reason to expect that a significant proportion of employers will be persistently unable to find coverage at any price; that is, relatively few employers are chronically uninsurable. n191

Similarly, Orin Kramer asserts, "Large residual markets for workers' compensation insurance are caused primarily by restrictions on overall rate increases in the presence of increasing claims costs." n192 These conclusions seem to be a simple application of basic principles of supply and demand: other things being equal, inadequate prices will decrease supply.

[*96] If regulation caused excessive profits due to insurer moral hazard, then why would insurance supply have declined so dramatically in states like Maine? Growing residual markets represented a change in private commercial insurance supply during the crisis period, not just a decline in voluntary market coverage. In the early 1980s in Maine, while insurers unsuccessfully battled the state for control over ratesetting standards, insurers sought temporary protection from the risk of rising costs by moving many of their policies into the residual market. No doubt the ensuing 1985 law reforms could have induced insurers to increase their voluntary market writings if these reforms had satisfied insurers' demand for sufficiently high regulated rate increases in place of rate controls and eventual price competition. Yet many insurers in Maine presumably made calculated choices not to withdraw their business from the state, but to switch their Maine business from underwriting to residual market servicing. In the mid 1980s, reasonable insurers and regulators probably perceived not so much that rates were clearly inadequate but that the costs of the Maine market were highly uncertain, after a period of expanding benefits followed by the 1985 benefit cuts. Compared to the potentially high underwriting risks of the voluntary market, the residual market offered some insurers the potential for virtually guaranteed high short-run profits with deferred and diluted risk. n193

As was typical in most states, Maine had traditionally required insurers licensed to write workers' compensation insurance in the state to participate in the "assigned risk plan" or "residual market pool." Up until the 1985 law reforms, Maine law authorized the NCCI to manage Maine's assigned risk pool as part of the NCCI's National Workers' Compensation Reinsurance Pool (NWCRP) (which also operated the assigned risk pools of most other states). n194 Unlike typical reinsurance, in which the reinsurer assumes a portion of an insurers' [*97] risk, the NCCI's NWCRP assumed the entire underwriting risk for assigned risk policies. If pool losses exceeded pool gains for a particular policy year in a particular state, the NCCI assessed insurers a percentage based on their share of the "voluntary" market in that state. n195 As long as the pool was a small - truly "residual" - portion of the market, any losses in the pool would be likely to have a relatively small impact on any particular insurer.

In the traditional NWCRP in the 1980s, the NCCI assigned residual market policies on a voluntary non-competitive basis to insurers. n196 Individual insurers assigned to cover pool policies as "servicing carriers" did not bear the risk associated with that policy (except as spread across pool members generally), but instead simply performed the administrative functions of collecting premium and processing claims. Insurers acting as servicing carriers retained a fixed percentage of premium collected from employers as an up-front "servicing fee" to cover their expenses of administering the policies. The NCCI traditionally set the fee at 30 percent of premium. Servicing carriers remitted the remaining 70 percent of premium to the pool where the NCCI invested and managed the funds used to pay out benefit claims.

Maine's 1985 law reforms failed to reduce the residual market in Maine not simply because of rate controls, but because these reforms retained - and even increased - incentives for insurers to remain in the residual market as servicing carriers to ensure insurance coverage in the anticipated transitional period before deregulation. The 1985 reforms separated Maine's residual market from the NCCI's national pool and gave the state Insurance Bureau regulatory power over the pool (although the Insurance Bureau delegated most management responsibilities to the NCCI). In 1985 in Maine, the NCCI negotiated with the state Insurance Bureau to increase the servicing fee to 40 percent to keep insurers in the residual market, a level that probably provided servicing carriers with lavish short-term gains.

This fee level was far higher than the amounts insurers [*98] typically spent on expenses, particularly for pool policies, n197 and particularly when pool policies were no longer limited to the most costly risks in a class. n198 After Maine's 1987 reforms offered alternative inducements to keep insurers in the residual market, Maine's Insurance Superintendent reduced its residual market servicing carrier fees from 40 percent to 30 percent in 1988 and then to 25.6 percent in 1989. n199 In a 1991 Maine ratesetting proceeding, the Public Advocate's actuarial witness, Allan I. Schwartz, calculated that the 25.6 percent servicing allowance would allow a 50 percent return on investment for servicing carriers based on a generous estimate of capital requirements. n200 And competitive servicing firms that handled Maine's self-insured business in the 1990s often charged about 11.5 percent of premium for comparable (or even far superior) claims processing, loss control, financial management, and general administrative services. n201

The growth of residual market pools, therefore, might be evidence of excessive prices in these pools - for servicing, not for underwriting - rather than of inadequate insurance prices in the general voluntary market. Insurers decided whether to stay in Maine's predominantly residual market by considering the opportunities for gain from servicing fees. n202 Of course, these servicing gains were offset by the long term risk of assessments for residual market deficits, so that insurers were likely to use residual market servicing only as a temporary and partial strategy for avoiding the risks of underwriting. For example, in 1987 Maine's insurers again decided to withdraw from the market as a whole under the rising threat of

residual market deficits combined with the judicial ruling that rate controls could not be confiscatory if insurers could [*99] leave. n203 Again, however, rather than carrying out threats to withdraw from the state, insurers worked with state lawmakers to design an alternative set of protections for insurer profit. n204

Perhaps more important than individual insurers' opportunity for short-term profit from servicing fees, residual markets offered another longer-term opportunity for insurers to increase their share of the gains from the system. Residual markets offered insurers in the aggregate a kind of market share "insurance" that offered them some of the benefits of a regulated market – freedom from competitive pressures, guaranteed customers, and short-term profit protection – without some of the risks of newly enhanced rate controls. By shifting their business into the residual market, individual servicing carriers and the NCCI avoided ceding the state's insurance market to competitors, particularly to new alternative insurance forms such as state funds or self-insurance pools. n205

Although the large residual market's risk protection was necessarily short-lived, n206 its unstable nature gave private commercial insurers the political leverage to extract further concessions from state lawmakers and competing political interests (employers and workers). In Maine in 1987 and again in 1991 and 1992, the state's reliance on a collapsing and costly residual market as the dominant insurance source created an immediate crisis that made it more difficult for state lawmakers and regulators to resist insurers' pressure for benefit cuts or rate increases. If insurers had simply left the market at the start of the 1985 rate controls, waiting out the crisis period for higher rates or reduced benefits, they would have run the risk that competitors with better cost-control would prove that the problem was the inefficiency of the traditional insurance system, not inadequate rates. In Maine, employers brought a federal antitrust action claiming that insurers, [*100] through the NCCI, colluded to use withdrawal threats in an illegal boycott to force the state to enact unreasonable price hikes. The United States Court of Appeals for the First Circuit rejected these claims on the ground the alleged harm was caused by legislative action exempt from antitrust law. n207

2. Residual Market Deficits

Nonetheless, the rate suppression story points to the evidence of large residual market operating deficits in Maine and elsewhere during the crisis period to show that insurers were the victims, not the beneficiaries, of residual market growth. For example, Orin Kramer argues that the total nationwide deficit for NCCI-run residual markets, at \$2.3 billion for policy year 1990, shows severe rate suppression. n208 Once again, Maine was the leading example of this problem. In 1992, insurers estimated Maine's residual market deficit at \$574 million. n209

However, the conventional assumption that high residual market deficits in the 1980s reflect rate suppression during that time oversimplifies the picture. These deficits resulted from insurers' cost-increasing actions as well as (or even more than) from government attempts to keep insurance "affordable," as Kramer charges. n210 First, deficit projections relied on highly uncertain information primarily in the NCCI's control; the NCCI's projections may have exaggerated these deficit projections in order to support its case for rate increases or benefit cuts (later data showed the Maine deficit at less than half the 1992 estimate). n211 Nonetheless, substantial deficits undoubtedly existed in many of the NCCI-run pools.

Second, and more importantly, substantial operating deficits could arise from excessive residual market costs rather than from inadequate rates. By acting as "insurance" for insurers who write policies in the pool, the NCCI-managed [*101] residual market pool system used in most states created potential for insurer moral hazard. Individual servicing carriers retained substantial control over costs associated with their policies in the pool, but the pool spread the losses associated with those policies to insurers generally. Servicing carriers' effectiveness in calculating correct premium charges for a policy and in collecting that premium affected the pool's income. Most critically, their effectiveness in providing loss control services to improve safety and return-to-work policies and in processing claims could have a major impact on the pool's loss costs. Yet servicing carriers made more money the less they spent on servicing: their profit came from whatever was left from their up-front servicing fee after servicing expenses. And high servicing fees (typically higher than reported expense levels for voluntary market policies) meant less premium income available for the pool to cover the underwriting losses (benefit claims).

In addition, the NCCI as pool manager had substantial control over the costs of residual market pools through decisions about investing pool funds and overseeing servicing performance, but was subject to little or no regulatory oversight in these functions and, as an entity, bore no direct responsibility for any pool operating losses. Before 1993, the NCCI did not require insurers who acted as pool servicing carriers to bid for this business nor to submit to any meaningful system for enforcing performance standards. n212 Companies active in servicing the pool often played a major role on the NCCI's NWCRP Board of Governors, which had authority to set the servicing fee and to monitor pool servicing.

n213 "The NWCRP [NCCI's residual market pool] functions simply as a cost pass-through mechanism in which safety requirements are not enforced; there are no underwriters to ensure that rates are adequate to cover expected costs for each employer and investment income is not used to offset claim [*102] costs." n214

In short, the lack of accountability for pool costs, combined with incentives for profiting through poor cost management, encouraged insurers and the NCCI to take little care to reduce residual market costs. n215 As a result, residual market pools would be likely to experience shortfalls under rates designed to be adequate for the more cost-effective voluntary market. Residual market underwriting losses may show not that regulators artificially suppressed rates below "real costs," but that insurers' actions, due to the costs protection structured into the NCCI's residual market design, "artificially" inflated pool costs above what a competitive market would have produced. n216 An insurance executive who analyzed cost trends in the 1980s reported that in states where the NCCI's NWCRP operated the residual market, "costs were generally much higher than in states where state-run insurance companies (state funds) served as the 'market of last resort.'" n217

3. Residual Market Death Spiral

In the rate suppression story, inadequate rates caused several state markets to reach the brink of collapse as mounting residual market deficits combined with a shrinking voluntary market created a "death spiral." Assessments for residual market pool losses act as a kind of tax on voluntary market earnings that makes underwriting less profitable for insurers, therefore creating additional incentives for insurers to reduce their voluntary market exposure even more. As the residual market increases, along with the possibility of even more deficit assessments, insurers have incentives to further reduce their voluntary market exposure and then to leave the market altogether.

But this death spiral process follows from perverse incentives [*103] of the residual market system and not necessarily from rate inadequacy. Once a badly managed residual market reaches a certain size, rates that amply or even lavishly cover projected voluntary market risks in a state may not be sufficient to entice insurers back into the voluntary market because of the disproportionate risk of assessment for residual market deficits. Although servicing carrier profits may offset that risk, once the number of insurers in the market as a whole begins to shrink, the potential for bearing a large share of pool costs will threaten to outweigh the gains from servicing – and will come due after those gains have been collected.

By portraying rate adequacy as the answer to the death spirals in workers' compensation insurance markets in the 1980s and early 1990s, the rate suppression story leaves out the central problem. Maine's example shows how increasing rates and reducing benefits failed to solve the insurance market crisis. Instead, Maine's insurance market crisis persisted until the state restructured the residual market to avoid its incentives for moral hazard and self-destruction.

Insurers used the temporary risk protection of the residual market combined with Maine's unusually high servicing fees to maintain their market control during the period of controversy over rate regulation from the early 1980s until 1987, when the state court upheld the 1985 rate controls. Because that court ruling dashed insurers' hopes of judicial protection from the risks of residual market liability, insurers followed an alternative strategy for protection against the uncertain costs of insurance in the state. While making plans to withdraw from the market in 1987, n218 insurers sought legislative intervention to reduce their risks.

Faced with the collapse of the market, the state legislature responded to insurers' demands by repealing the 1985 reforms and enacting a different set of comprehensive benefit and insurance reforms. n219 These 1987 reforms aimed to reduce insurers' costs by restricting benefits. In addition, these reforms eliminated benefit caps as well as the deregulation [*104] plan so that the Insurance Superintendent was once again authorized to set rates "based only on a just and reasonable profit." n220

Under the new law, in 1988, the first full ratesetting proceeding since 1981, a new superintendent allowed a 25 percent rate increase (raised to 30 percent for high-risk residual market policies) after counting estimated savings from benefit cuts of 41.9 percent. n221 The superintendent noted that a higher increase might have been authorized had the NCCI presented better evidence of its costs. n222 The superintendent granted a second increase of 22.5 percent in 1989, n223 and another of 4 percent in 1990. n224 In 1991, state lawmakers, again under threat of a collapsing insurance market and with heavy lobbying by insurers, enacted an additional package of benefit cuts. n225 In the 1991 ratesetting proceeding, the superintendent estimated the cost savings from these reforms at 15.3 percent, but reduced insurance rates only 5.8 percent based on findings that insurers' costs were somewhat higher than previously expected. n226 When these changes failed to solve the insurance crisis, in 1992 state lawmakers enacted a much more dramatic and comprehensive system of

benefit reforms. In the 1992 rate proceeding, the superintendent estimated those benefit cuts would save insurers 16.1 percent; along with this savings, the superintendent authorized a rate increase of 8.9 percent. n227

But benefit cuts and rate increases designed to improve [*105] rate adequacy could not stabilize (or even improve) Maine's insurance market after 1987 because the central problem was the risk of residual market deficits. The fact that virtually the entire market consisted of the poorly managed residual market created a kind of collective action problem. If insurers acted collectively to take advantage of potential profit opportunities, many or most policies could be profitably written in the voluntary market. But each individual insurer would nonetheless avoid re-entering the voluntary market out of fear that they would be stuck with a share of the residual market deficit that far outstripped any profits, if other insurers stayed out. n228

Recognizing this problem, and working with insurers' lobbyists to come up with a deal that would satisfy them, in 1987 state lawmakers established a new residual market pool n229 managed by the NCCI under (nominal) state supervision. The critical "Fresh Start" provision for this pool offered insurers the central protection they had been seeking: the opportunity to avoid the risk of residual market deficits. Beginning with policies written in 1988, any deficits incurred in the pool would be assessed not to insurers, but to employers (policyholders), through retroactive premium surcharges. n230 Correspondingly, any pool gains (premium and investment income exceeding benefits and expenses) would be credited retroactively to employers. In exchange for this new risk protection, the "Fresh Start" law required insurers to make "good faith efforts" to depopulate the residual market pool. n231 If they failed to do so, the Superintendent of Insurance was authorized to charge up to 50 percent of any residual market deficit [*106] to insurers, beginning with 1989 policies to allow for some transition time. n232

This deal basically envisioned a brief transition period where employers would effectively act as reinsurers, assuming the risk of residual market losses, until insurers could re-establish the voluntary market – which was made more attractive due to new benefit cuts and rate increases. The Fresh Start law worked to temporarily prop up the residual market, but failed miserably as a long term solution to Maine's workers' compensation insurance crisis. This 1987 reform strategy failed because it exacerbated rather than eliminated the incentives for insurer moral hazard in the residual market, not because Maine's rates were insufficient to cover voluntary market costs. Despite repeated rate increases and benefit cuts, the 1987 "Fresh Start" plan not only failed to restore the voluntary market but also set the stage for a second and more severe "death spiral" that brought Maine into the national spotlight for its supposed rate suppression. By 1990, the residual market constituted about 87 percent of the total premium in the Maine market; n233 the residual market share remained near or above that level during the entire period the 1987 "Fresh Start" law reforms remained in effect.

Once again, insurers responded by taking advantage of the 1987 reforms' latest grant of government protection from risk – the new system of employer reinsurance – while resisting the state's efforts to require that insurers use this protection to benefit others as well. Although many insurers (not all) revoked their withdrawal plans after Maine's 1987 reforms, most concentrated on remaining in the residual market as servicing carriers rather than on using their temporary freedom from residual market deficits to return to the voluntary market once benefit cuts and rate increases had taken effect. The NCCI, with approval of the state Insurance Superintendent, granted one insurer (a subsidiary of the American International Group) permanent protection from risk (including immunity from penalties for failure to repopulate the pool) [*107] as a special inducement to service a large northern portion of the state that other carriers did not want. n234

By requiring employers to "insure" insurers against the risk of residual market losses, the new "Fresh Start" system gave servicing carriers (with the help of the NCCI) even more incentives to seek profits through reduced servicing quality at the expense of pool funds. Although the 1987 reforms shifted to employers a substantial portion of the costs of the pool, these reforms left the control over pool costs largely in the self-regulating hands of insurers and the NCCI, which basically continued the traditional practices it used in its other pools. n235 The state created a governing board for the pool with twelve insurer representatives (elected by insurers) and three employer representatives (appointed by the state Insurance Superintendent). The three employer representatives lacked sufficient voting power to shape pool policy n236 and often were denied timely access to pool information; n237 one employer representative described the Board as a "very sad, sorry joke." n238

From the start of this new residual market system, regulators found evidence that insurers' poor management inflated insurance costs. In the 1988 rate proceeding, the NCCI admitted insurers had sometimes reduced or even eliminated safety engineering and other loss control services to compensate for (prior) underwriting losses. n239 However, at that time the Superintendent of Insurance reasoned that as the new benefit cuts and rate increases of the 1987 law reforms were beginning to take effect, "carriers should now have the resources to devote to safety." n240 But then in the 1990 ratesetting

proceeding, the superintendent of Insurance found "ample [*108] evidence that some residual market servicing carriers have failed to meet their legal and contractual obligations" ... creating a "systemic problem" of "pervasively inflated" costs. n241 The superintendent estimated that poor claims handling inflated residual market costs by 30 percent, and imposed a 1.5 percent rate penalty to account for these excessive costs. n242 That rate penalty had little immediate impact on insurers, however, because virtually all premium remained in the residual market so that at least half of the burden of this rate reduction fell on employers (as pool reinsurers).

Again in the 1992 rate hearing, the superintendent found substantial evidence of "widespread servicing deficiencies" in the residual market, resulting in losses provisionally estimated at 2.5 percent of overall premium costs (\$ 21 million) along with "inadequate investment practices" by the NCCI resulting in a \$19 million loss to the pool. n243 The NCCI's limited internal audits found pervasive servicing performance at levels the it rated "marginal" or "unacceptable." n244 The superintendent explained the moral hazard problem: "With the protection provided by the potential for fresh start [employer] surcharges, the insurance companies have caused, to a significant degree, the very deficits for which they now seek indemnification." n245 These practices included failing to collect premiums, failing to maintain accurate loss records and other claims-related data, failure to provide safety or other loss control services, failing to hire or support adequate servicing staff, failure to manage claims adequately, and failing to adopt or follow a reasonable pool investment policy. n246 Employers presented evidence of particularly incompetent and deficient servicing by the one insurer with complete immunity from pool liability.

Not surprisingly, the residual market began to accumulate a potentially large deficit. Beginning with policies written in 1989, insurers risked sharing responsibility for any deficits [*109] if they failed to make "good faith" efforts to repopulate the voluntary market. But that risk of liability was not effective until several years after 1989 because of the time lag in data about the costs of claims for policies written in that year (since many benefit payments for 1989 injuries would not be completed for several years at least). n247 In 1991, the Insurance Superintendent found that NCCI witnesses "appear to concede" that insurers were liable for half of the post-1988 deficits because they had failed to satisfy requirements for repopulating the pool, but the superintendent did not charge insurers yet because of insufficient data on amount of the deficit for 1989. n248 That decision, however, made clear that insurers would soon face the danger of assessments for any deficits. In 1992, as the threat of deficit liability became real, insurers again filed plans to withdraw from the entire market.

In the rate suppression story, these impending insurer deficit assessments for possibly enormous deficits were the final death blow dealt to Maine's private insurers by a state bent on denying them fair rates. n249 If insurers could have profitably underwritten voluntary market policies after the 1987 reforms, why would they have stayed in the obviously cost-inflating residual market at the risk of exposure to deficit liability after 1988? A closer look shows two reasons.

First, when insurers' 1988 window of unconditional immunity from residual market deficits closed, insurers once again faced the risk of deficit assessments – his time enhanced by even greater incentives for poor servicing and management – recreating the collective action problem that deterred individual insurers from pursuing voluntary market profits. Without this problem, even if rates still remained somewhat inadequate overall, the substantial rate increases and benefit cuts during the 1987-1992 period would have made at least a portion of the market profitable for at least some insurers (and indeed, as discussed below, it did for a [*110] different group of insurers). Instead, the traditional insurers' residual market share remained virtually unchanged or even grew during this time. In Maine's 1992 ratesetting proceeding, NCCI witness and economist John Worrall acknowledged that in order for insurers to return to the voluntary market, rates would have to be high enough not only to profitably cover voluntary market risks, but also to cover any individual insurers' risk of disproportionate residual market assessments – an extra charge that Worrall agreed "might have to be very high." n250 Insurers' failure to avoid this problem by taking advantage of the 1988 immunity period could have been due to a number of factors other than rate inadequacy, such as insurers' managerial sluggishness, unwillingness to take any significant risk in the face of changing benefit conditions, preference for short-term servicing profits, strategic boycotting to obtain further benefit cuts or rate hikes, or poor information from the NCCI about projected costs.

Second, the insurers remaining in Maine's market after 1987 to take advantage of residual market servicing opportunities appear to have calculated that they could once again resist the state's conditions on the protection against risk afforded by the residual market and the new Fresh Start immunity. The (temporary) opportunity for high gains from low-risk servicing profits, and insurers' political and economic power to prevent the state from enforcing the deficit-sharing provision, could have induced some insurers to continue to focus their business in the residual market. Indeed, some insurers who benefited from the residual market servicing opportunities succeeded to a large extent in shifting their post-1989 residual market liability to others.

In 1992, insurers confronted the impending threat of the first assessment for the 1989 residual market deficit. Shortly after the 1987 residual market plan was established, the Bureau of Insurance had issued regulations specifying that 90 percent of insurers' portion of the deficit would be the responsibility of servicing carriers on an "equal share basis," while the other 10 percent would be assessed on insurers not [*111] acting as servicing carriers but licensed to write workers' compensation, again on an "equal share basis." n251 In addition, an individual insurer could receive a reduced assessment share based on the degree to which the insurer had increased its voluntary market writings over the 1983–1986 base period. n252 To keep their deficit liability small, most insurers with only a small portion of the market, either residual or voluntary, took steps to terminate their Maine business at the end of 1991, leaving them with only a minimal share of the 1989–1991 deficits.

Although the major servicing carriers who faced the bulk of the liability also filed plans to withdraw from the state by the end of 1991, n253 four of these insurers agreed to stay after negotiating with the Bureau of Insurance for an emergency rule change that would protect them from the impending deficit assessment. n254 This new rule protected servicing carriers by shifting the majority of the deficit burden to insurers not involved in the residual market n255 – many of whom were not doing any workers' compensation business in the state but simply held a state license. n256 Although those other insurers of course then took steps to withdraw from the market, the timing of the rule change nonetheless forced these carriers to unwittingly assume the bulk of liability for any 1992 deficits. n257 Later in 1992, a state court ruled that this emergency rule change was unconstitutional. n258

Even without judicial intervention, however, this rule change was only a stop-gap attempt to hold together a market [*112] on the course toward complete collapse at the end of 1992, when the non-participating insurers could withdraw to escape liability. This impending withdrawal, once again, required dramatic legislative intervention. But, contrary to the New York Times' and other commentators' account of the crisis, insurers' withdrawal had little to do with the relationship between voluntary market costs compared to rates. Instead, in 1992, insurers' withdrew specifically from the residual market, or (for those not involved in the residual market) from residual market liability. What changed suddenly for the worse in 1992 was not voluntary market profitability but the beginning of insurers' residual market deficit liability.

Rather than being an example of insurer victimization through regulator (and employer) moral hazard, these deficit assessments were an attempt to internalize the costs insurers had implicitly agreed to bear as the costs of doing business in a predominantly residual market under their control and insulated from competition or underwriting risk. In the 1992 rate proceeding, the superintendent ordered direct insurer assessments not only to enforce the "Fresh Start" law's penalty for failure to make "good faith" efforts to depopulate the pool, but also to compensate employers for the portion of the pool deficits that the superintendent attributed to insurers' extensive pool mismanagement. n259

No longer able to shift the risk to other non-participating insurers, the servicing carriers reverted to their familiar strategy of challenging this regulatory decision in state court. n260 The NCCI refused to comply with the superintendent's order for administering the pool assessments. n261 Late in 1994, a lower court upheld the assessment for lack of "good faith," but ruled that the superintendent lacked statutory authority to consider the effect of insurer mismanagement in calculating the deficit (although the superintendent could consider mismanagement in determining insurers' rate of return). n262

Finally, in 1995, as that case was being appealed, insurers [*113] turned to the state legislature for protection against the risk of an unfavorable court ruling. Together with business representatives, several insurers negotiated a settlement in which the insurers agreed to withdraw their litigation in exchange for state legislation that would bail out the residual market deficit. n263 The state enacted this bailout law, which divided the deficit for 1989–1992, estimated at \$220 million, between insurers and employers. n264 The residual market pool had terminated its prospective insurance functions at the end of 1992, and at this point existed only to continue paying out ongoing obligations under old policies. The deal required insurers to pay \$65 million at the beginning of 1996, with the majority of this assessment coming from carriers with major responsibilities for servicing the pool. The law charged an additional \$45 million from the state's guaranty fund for insolvent insurers (an amount designed to "refund" residual market pool's payments to the guaranty fund from 1988–1992). n265 Employers were responsible for \$110 million, to be paid through surcharges over ten years. Although a national insurance publication portrayed the bailout law as a "money grabbing scheme" by the state against insurers, n266 it essentially allowed major servicing carriers to escape with less than a third of the estimated deficit – even though the Fresh Start statute had imposed a penalty of half the deficits from 1989–1992, and even though the superintendent had imposed additional penalties for mismanagement and excessive fees. n267

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D. Competition from Self-Insurance

The 1980s-1990s crisis period was a time not only of large residual markets in Maine and elsewhere, but also of strong growth in a type of "voluntary" insurance supply. In fact, Maine's residual market was actually shrinking rapidly during the late 1980s and early 1990s, even though the traditional voluntary commercial insurance market remained near or below a minuscule 10 percent level from the 1987 reforms until that state's market collapsed in 1992. The rate suppression picture leaves out or misrepresents the dramatic growth of self-insurance during the crisis period, in Maine and in many other states.

Most states permit employers to self-insure if they satisfy strict regulatory requirements designed to ensure financial capacity to cover future benefit costs. n268 That option traditionally was exercised mainly by large employers who could better manage the high transaction costs and steep capital requirements imposed by states to ensure self-insurers' long-term capacity to pay benefits. When rates increased and servicing quality declined during the crisis period, more businesses sought opportunities for saving money through self-insurance, n269 even though during that period most states tightened regulatory monitoring and financial requirements for self-insurance. n270 In Maine and other states, regulators responded to employers' demand for more opportunities for self-insurance by authorizing group programs through which small businesses could pool capital, liability and administrative costs. n271 From 1991 to 1993, self-insurers' nationwide share of the market increased by 4.2 percent. n272 In Maine in particular, while the commercial insurance market floundered, the group self-insurance market flourished despite extensive regulation, high organizational costs and lengthy [*115] start-up processes.

In Maine's 1992 rate proceeding, the director of the Maine Council of Self-Insurers questioned insurers' claims of rate inadequacy by describing how, after the 1987 reforms, Maine's residual market pool emptied out into self-insurance rather than into voluntary market commercial insurance. He reported that in 1989, self-insurance accounted for 29 percent of the total premium written in the Maine market, growing to 35 percent in 1990 and 40 percent in 1991, and was continuing to grow rapidly. n273 These new self-insured businesses faced the same benefit system as commercial insurers and comparable or higher insurance "prices." State regulations required self-insured groups to set aside "premiums" based on the level of existing NCCI rates in addition to other capital requirements.

With comparable or higher costs, why did so many businesses in Maine (and in other states) rush to take on the underwriting risk that commercial insurers refused to assume? In Maine, no evidence seems to have surfaced of widespread inadequate financing by naive or opportunistic businesses under lax solvency regulation, although this may have occurred in some states to some extent. Instead, by 1992, when the Maine residual market was showing enormous deficits for the post-1988 period, self-insurance pools operating with similar "premium" charges for the same period were showing ample surpluses. n274 In place of the high deficit assessments facing residual market employers and insurers, these self-insured groups were planning to return "dividends" to their employer members because of excessive "rates." n275

If insurance rates were being suppressed during this time of large residual markets, one would expect the opposite result: that self-insured employers would turn to commercial insurance to take advantage of insurer subsidies. n276 Advocates of the rate suppression theory implicitly acknowledge that this flight to self-insurance shows inflated commercial [*116] market rates, but they attribute that rate inflation to rate suppression in other parts of the market. n277 That is, they explain that self-insured employers can profitably assume underwriting risk because of cross-subsidies: commercial insurance companies charged these (now) self-insured employers excessive rates to offset inadequate rates for other, costlier employers. This could happen if insurers' risk classifications imperfectly reflected costs, so that within a particular class rates were ample to cover some employers' insurance costs, even though average rates fell short of expected costs. Some expert accounts of rate suppression portray the exodus to self-insurance by low-risk employers as adverse selection that victimized insurers by leaving them with higher cost risks that further depressed their profits. n278

But if allegedly suppressed rates nonetheless allowed selective opportunities for profit, why did commercial insurers surrender those opportunities? In the 1980s, many states began to allow insurers to deviate from regulated rates by offering discounts, dividends, and risk-sharing arrangements to desirable employers, n279 which should have increased opportunities for price competition between commercial insurance and self-insurance. The rise in self-insurance during the 1980s and early 1990s therefore suggests more that commercial insurers failed to pursue available profits, and that lower-risk employers refused to subsidize insurers by paying for overpriced coverage - rather than that insurers were forced to subsidize employers.

Proponents of the rate suppression theory tend to put more weight on a second cross-subsidy theory that instead explains self-insurance growth as voluntary market employers' refusal to subsidize residual market deficits. In this theory, when rate suppression led to large deficit-producing residual markets, insurers recovered those residual market deficits by "taxing" voluntary market employers through inflated voluntary market rates. n280 Voluntary market employers [*117] then turned to self-insurance to avoid subsidizing the higher-cost residual market, again leaving insurers to bear the high residual market losses. n281 Kramer explains, "In short, the larger the underpriced residual market, the more costs shift to the voluntary market, which in turn reduces the attractiveness of the voluntary market for insureds." n282

This explanation acknowledges that voluntary market rates were excessive, not inadequate, compared to voluntary market costs, and instead makes the problem of rate suppression mainly an issue of residual market rates. But during the crisis period, states typically used the same risk classifications and the same system of experience rating for individual firms in both markets, and often charged the same or higher rates per classification for residual market coverage compared to voluntary market coverage. n283 That means rate inadequacy in the residual market but not the voluntary market could come from two problems: first, the residual market could have the most costly employers within each risk classification; or second, the residual market could have the most costly insurance practices because of a structure designed to encourage insurer moral hazard.

This first explanation does not explain the large residual markets of the 1980s and early 1990s. When residual markets grew to substantial or majority portions of the market during that crisis period, they were no longer composed of only the riskiest employers within each category; insurers themselves explained this growth as a problem of overall rate inadequacy, not imperfect risk classifications that made riskier employers difficult to insure profitably. n284 But if increased self-insurance shows that the problem was not overall rate inadequacy, but cross-subsidies that inflated voluntary market [*118] rates, then those cross-subsidies probably came from costlier residual market insurance practices rather than from costlier residual market employers.

In short, the growth of self-insurance during the crisis period shows not that rate controls forced insurers to cover unprofitable risks, but that insurers lost profitable business because they tried to make employers bear the costs of insurers' residual market risk-spreading. However, the rate suppression story is not inconsistent when it complains both of overall rate inadequacy (causing growing residual markets) and of inflated rates (causing growing self-insurance) if it means that "rate adequacy" requires rates high enough to cover not just prospective voluntary market underwriting costs but also insurers' past residual market deficits. The standard approach to regulated ratesetting, however, was based on the theory that rates should be sufficient to cover projected costs. Rate regulation traditionally has presumed that private insurers are paid to assume the risk that prospective rates will fall short of projected costs; if they lose money, their remedy is to seek prospective rate increases (or to exit the market), not to get repaid for lost profits from retrospectively inadequate rates – otherwise, they would not be assuming any insurance risk. Maine's 1987 "Fresh Start" provision that (temporarily) guaranteed compensation for past shortfalls was an unusual exception to this standard rule.

If, outside of Maine's "Fresh Start" system, insurers were trying to use prospective voluntary market rate inflation to cover past residual market deficits, then they generally would have had to do so by disguising these residual market charges as prospective voluntary market cost estimates. Regulators may have been controlling for this surreptitious cost-shifting when they granted rates below insurers' requests. In many states, insurers appear to have attempted to recover residual market losses by adding covert, unauthorized surcharges to policies for voluntary market employers. n285 A number of class action lawsuits filed in the late 1990s alleged [*119] that this practice of insurer fraud cost employers as much as \$1 billion. n286 The growth of self-insurance may have served to partly reduce these opportunities for insurer moral hazard.

The example of Maine's self-insurance boom shows how excessive rather than inadequate residual market charges drove employers to reject commercial insurance. n287 Contrary to the cross-subsidy theory, in Maine the mass exodus to self-insurance came from the residual, rather than the voluntary market. High-risk manufacturing industries rather than lower-risk financial services industries dominated Maine's self-insurance market, suggesting that industries with the highest costs found the greatest opportunities for savings. n288 Contrary to the adverse selection theory, self-insurance tended to attract employers with a range of individual risk ratings within each classification, not just the lowest-risk businesses. The Maine self-insurance market showed an average individual experience rating of 1.22 in 1990, on a scale where more than 1 represents an above-average cost history within an industry classification. n289

Many Maine employers were able to save money by self-insuring during that state's crisis period not just because commercial insurers overestimated employers' underwriting costs, but also because commercial insurers (especially in

the residual market) increased employers' underwriting costs. For example, one large manufacturing company that left the residual market for self-insurance in 1990 had an individual [*120] risk experience rating of 2.47, compared to an average risk of 1 for the same industry classification. n290 An executive from the company testified in Maine's 1992 ratesetting hearing that in the residual market they received no loss control services, and indeed were unable to obtain accurate records of claims paid from their servicing insurer so that they could attempt to control losses on their own. n291 The company was able to profitably self-insure because of "excellent loss control services" (at less than half the cost of residual market servicing fees) from an independent servicing contractor that helped them achieve a "drastic decrease in lost-time accidents." n292 Similarly, the manager of a group self-insurance program for public schools testified that, despite including many employers with above-average risks when the pool began in 1990, the group's insurance fund had enough money to pay dividends to members in the near future. n293 "We wonder why [the NCCI's residual market pool shows a deficit], if we can use the same basic rates they are charging, provide what we think is superior service to their previous carriers, and yet we still develop a surplus." n294

The director of the Maine Council of Self-Insurers explained that better management allowed self-insureds to dramatically reduce employers' claims costs, administrative expenses, n295 and litigation expenses. n296 He explained three advantages of self-insurance lacking in the residual market: an emphasis on safety and loss control, better medical management and medical cost containment, and an emphasis on returning injured workers to work promptly. n297 In Maine and in many other states during the crisis period, "third party administrators," who contracted with self-insurers to manage their [*121] workers' compensation claims, enjoyed a booming business by marketing innovative loss control services to high-cost businesses frustrated with high insurance rates. As a result, during the period in which the NCCI-run residual market in Maine projected astronomical deficits, n298 the overall record of self-insurers showed adequate or even excessive rates for comparable or even costlier businesses. n299

Finally, employers' rejection of commercial insurance for self-insurance was not a temporary phenomenon, further refuting the theory that this self-insurance trend was a problem of employers taking advantage of cross-subsidies produced by rate suppression during the crisis period. An insurance industry report estimated the "alternative" market (comprised of traditional self-insurance, group self-insurance, and commercial policies with large deductibles) at 40 percent of the market in early 2001 n300 compared to 36 percent at the start of 1996. n301

E. Competition from State Funds

Those who questioned the rising insurance costs of the 1980s as a problem of excessive charges by insurers sometimes proposed replacing private markets with state insurance funds. Indeed, as a critical part of the 1990s reforms, a number of states established state funds to compete with private insurers and to provide an alternative to insurer-managed residual markets. In 1984, Minnesota established the first new state fund for workers' compensation since 1933. n302 Between 1991 and 1997, amidst a political climate favoring privatization, eight more states added competitive state funds. n303 Government insurance funds as a whole (including the six longstanding exclusive state funds, competitive [*122] funds and federal funds) increased their share of the national market by 3.5 percent between 1991 and 1993. n304

Following the rate suppression theory, insurers and others argued that new state funds would exacerbate rather than solve the crisis by transferring liability for rate shortfalls to taxpayers in general and by encouraging additional politically-motivated cost-shifting that would eventually lead to financial disaster. n305 Furthermore, critics argued that state funds would fall short of private insurers in management skills, insurance expertise, and in safety and loss prevention services. n306

Although some longstanding state funds during the 1980s did face deficits and management problems, n307 just like private insurers, some of the new state funds that replaced insurer-run residual markets appear to have thrived where private insurers failed. As insurers of last resort, these new state funds have successfully assumed the residual market risk that private insurers had abandoned or driven to high deficits. Contrary to the conventional industry view, these state funds have not shown a continuing effort to avoid the costs of the system through political protection of employers - more regulatory moral hazard. Instead, at least some state funds have successfully controlled workers' compensation insurance costs for employers (though perhaps not for workers), without operating at a deficit, by better controlling costs.

In Maine, for example, when insurers made plans to leave the state with a large residual market deficit in 1992, state lawmakers finally responded to this last insurer withdrawal [*123] threat by reducing insurers' control over the market. With previous reforms, the state unsuccessfully tried numerous ways of regulating the risk of insurer moral hazard while accommodating insurers' demands for lower costs. In 1992, by replacing the insurer-run residual market with a new

semi-independent state fund, the state was able to turn around Maine's insurance market. This new fund, called the Maine Employers' Mutual Insurance Company (MEMIC), inherited the policies from the infamous residual market pool – which at the time was virtually the entire market – and, as the insurer of last resort, was charged with covering all employers undesired by private insurers.

Maine's second major insurance reform in 1992 was to open up insurance rates to price competition by eliminating requirements for prior approval of rates. These reforms limit the NCCI to filing NCCI advisory data on loss costs only (leaving out expense, profit and investment data), and require individual insurers to seek rate changes by filing their own final rates subject to minimal review by regulators.

In the conventional wisdom, Maine's dramatic turn-around in the 1990s resulted from its comprehensive and tough 1992 benefit-cutting legislation that finally reduced costs sufficiently to make the insurance system both sustainable and affordable. n308 Sorting out the effects of the benefit reforms from insurance reforms is difficult, and beyond the scope of this paper. Nonetheless, if rate suppression had been the primary problem in Maine's private commercial insurance market in the 1980s and early 1990s, then those private commercial insurers should have taken back the market after the 1992 reforms cut benefits, lifted rate controls, and eliminated prospective residual market liability (and after the subsequent bailout and settlement of retrospective residual market deficits).

Instead, these reforms left Maine with a strikingly different insurance market structure in which private commercial insurers have a far more limited role than they did at the start of the 1980s crisis. Although by the late 1990s, private [*124] insurers had picked up a significant portion of the Maine market, n309 MEMIC remains highly competitive, with a hefty 45 percent of the market in 2000 (not including self-insurance), down from a peak of 67 percent in 1995. n310 Self-insurance programs also have retained a large portion of the market ceded by private insurers: in Maine in 2000, 45 percent of the state's premium was self-insured, down from a peak of 52 percent in 1995. n311

The alternative story of Maine's insurance crisis as a problem of insurer moral hazard better explains this insurance market restructuring. Like the expanded self-insurance market – and unlike the traditional regulated insurance market, and especially the NCCI-managed residual market – the new state fund is structured on the model of group self-insurance to encourage workers' compensation insurance gains to come from reducing employers' costs rather than from spreading costs to employers. The law establishing MEMIC aimed to make the fund primarily accountable to its insured employers, for example, by requiring that its nine member board of directors consist of at least six MEMIC policyholders along with two public members appointed by the Governor, none of whom can be workers' compensation "service providers" or lobbyists. n312 Furthermore, the law establishes advisory boards for each of several subdivisions of the company, based geographically or by industry, with members elected from both policyholders and workers in that subdivision. n313 These advisory boards have power to review MEMIC performance in premium collection, safety services, and claims administration (among other things), and to bring policyholder grievances to the central Board. n314 Like a self-insurance plan, MEMIC is self-funded through initial employer capital contributions and ongoing premiums and is insulated [*125] from the state's general fund. n315

In contrast to the previous insurance system, MEMIC and several of the new competitive state funds in other states have focused on loss prevention and intensive claims management (rather than legislative intervention or risk selection) as a central strategy for covering costs. n316 MEMIC's self-promotional materials stress its competitive advantages in loss control over other insurers. Its opening web page statement reads:

Looking for a workers' comp company that answers to Main Street, not Wall Street?... you can count on MEMIC to help you improve workplace safety and to provide quality, compassionate care, as well as timely benefits, when an injury does occur. It's simple, its innovative and it works. It's the MEMIC Way. n317

Beyond this rhetoric, MEMIC offers a detailed safety-promotion web site with tools for employers to improve their loss prevention. n318

The President and Chief Executive Officer of MEMIC, John Leonard, explains MEMIC's success: "When MEMIC was established, the Maine employers' injury rates and workers comp premiums were double the national average... . But a series of industry-specific loss control programs greatly reduced the frequency and severity of injuries." n319 Leonard distinguished his company from commercial insurers by noting its safety education and training programs: MEMIC runs

thousands of safety advertisements, hundreds of training seminars, and thousands of on-site visits for safety training. n320 For example, MEMIC developed a loss control program specifically for Maine's high-risk logging industry that included a five-day training program for workers. n321 In another [*126] example of the company's innovative hands-on approach to safety, it mailed bags of ice-melting pellets to 2,000 of its policyholders with information on reducing winter slip-and-fall injuries. n322 In 1998, company executives reported that "MEMIC has led the charge for workplace safety since we began five years ago and today the results are self-evident. Thirty percent fewer people are losing time from work." n323

Despite its role as insurer of last resort, MEMIC also has been able to successfully compete with private commercial insurers in holding down costs for employers. n324 In the first five years of its operation, from 1993-1998, MEMIC reduced rates by 55 percent, while building up capital reserves faster than anticipated. n325 In 1998, MEMIC rates were below the NCCI's recommended cost levels. n326 In 1999, MEMIC was able to repay employers for capital contributions made to start up the company, after reducing rates for six straight years. n327 While the NCCI's advisory filing requested a 13.5 percent rate increase for the year 2000, MEMIC saw no need for "anything close to that for a rate increase." n328 Contrary to commercial insurers' predictions, and contrary to their example in the previous decade, MEMIC has achieved these reduced rates for employers without financial instability, political intervention, or bailouts. MEMIC earned an A (excellent) rating for financial [*127] strength and performance by A.M. Best, which rarely gives such high ratings to single-line single-state insurers. n329 In addition, Maine's Workers' Compensation Board rated MEMIC 46 percent better than competing commercial insurers in complying with state requirements for paying benefits on time to injured workers. n330

Besides reducing costs for their own policyholders, MEMIC and other new competitive state funds have the potential to control moral hazard in commercial insurance better than did direct rate regulation. Rate controls were ineffective in the long run in controlling insurer moral hazard because, first, insurers retained control over critical information about highly uncertain costs, making excessive rates difficult to distinguish from suppressed rates. Second, rate controls were ineffective because insurers could escape those controls through their power over insurance supply in a market dependent on private insurance.

As the history of workers' compensation regulation suggests, rate regulation is subject to capture by the industry. With increased price competition and reduced cartel pricing in the 1990s, Maine and many other states removed some opportunities for insurer moral hazard by removing price protections that dampened incentives for insurer cost control. Even so, the complexity and uncertainty of projecting and monitoring costs and servicing quality in workers' compensation in particular provide continuing opportunities for commercial insurers to take less care to reduce insurance costs than employers would prefer.

By setting a competitive benchmark based on more direct accountability to workers' compensation policyholders in a specific state, new competitive state funds exemplify one version of an innovative approach to regulation described by Ian Ayres and John Braithwaite. n331 Ayres and Braithwaite sketch out a model of "partial-industry intervention" that has potential [*128] to avoid some of the problems of regulatory capture. n332 They explain that by entering (or subsidizing) a cartelized or otherwise imperfect market as a competitive producer, governments may improve market performance more than they can by attempting to directly monitor and control the behavior of incumbent inefficient producers. n333 The new competitive state funds reflect a situation where a government provider can overcome some of the high organizational and information costs that would have discouraged many employers from forming self-insurance groups. n334

In the case of Maine's state fund, it seems likely that MEMIC's unusual emphasis on safety and other forms of loss prevention could have served as a competitive benchmark that ratcheted up the loss control efforts of commercial insurers who previously relied more on risk selection, risk pooling, and rate increases to respond to uncertain benefit costs. As an insurer limited (initially) to Maine workers' compensation and required to serve all employers, n335 MEMIC might have been able to gain a competitive advantage over traditional multiline, multistate or multinational insurance companies by specializing in controlling the particular risks of Maine's benefit system, legal and business culture, and industry mix. Commercial insurers may have adopted some of MEMIC's successful loss control tactics as they attempted to regain some of MEMIC's market share in the late 1990s. In addition, new state funds like MEMIC along with group self-insurance plans provided a comparative benchmark that contributed to pressure to change the NCCI's residual market management practices in the states where it retained its residual market business. For example, in 1993, the NCCI opened up residual market servicing to competitive bidding from insurers, for the first time introducing incentives to control [*129] fees and

performance. n336

The apparent competitive success of MEMIC and some other new state funds does not mean that state funds necessarily outperform private insurers. Indeed, Maine's disastrous 1987–1992 residual market was essentially a state-established insurance fund in which the state simply delegated management responsibility with little oversight to the NCCI and required participating employers and insurers to share the underwriting risk. A recent empirical analysis by leading workers' compensation economists showed that states with competitive state funds had higher costs for employers between 1975–1995. n337 The authors of this study note that they could not control for the possibility that high employer costs cause states to adopt state funds, rather than that these funds cause higher costs. n338 As the authors suggest, this reverse causation seems particularly likely in the case of the states (like Maine, Rhode Island, and Louisiana) that established these funds in the 1990s in the midst of crises to replace large residual markets. n339 But the authors also note that an earlier study of competitive state funds before the 1990s also showed these had higher costs. n340

However, these findings are not inconsistent with the theory that, in states where insurers particularly inflated costs in the 1980s and early 1990s, new state funds can be particularly effective in reducing those high costs. This study's 1995 data would have been too early to reflect MEMIC's substantial cost reductions, and it is not surprising that at this time Maine's costs from its years of a badly managed residual market would still have been high compared to other states. n341 Although Maine's workers' compensation [*130] rates were well above the national average in 1995, n342 from 1996–1999 Maine's rates fell by 34.1 percent n343 and by 2000 they were at average levels compared to other states. n344 Some of the long-established state funds like New York's have many of the characteristics of the inefficient residual markets, and allow for insurer rather than policyholder or worker control. n345 The New York State Insurance Fund, for example, does not compete with private insurers (at least based on price), but instead must adopt rates established (with regulatory prior approval) by the insurer-controlled New York State Compensation Insurance Rating Board. n346

Additional evidence of the success of some of the state funds comes from private insurers' response to this new competition. When Missouri established a new state fund in 1995 to cover employers relegated to a large residual market, private insurers sued to prohibit the state from financing a company to compete with private carriers. n347 The state fund won the court battle and went on to become the largest insurer in the state, with a hefty surplus and plans for further expansion in 2000. n348 When predicted failures of new state funds did not materialize by the late 1990s, the American Insurance Association, an industry advocacy group, launched a nationwide campaign to impose government restraints on further state fund growth. n349 A 1999 position paper supporting such action from another coalition of large property-casualty [*131] insurers warned of "the rapidly improving financial position of many of the funds, and the destructive pricing environment that has followed" because newer state fund managers "have tended to be very aggressive in the market." n350

For the most part, these insurer efforts to politically con-strain state fund competition have failed. In 2000, Maine's MEMIC overcame "intense private carrier opposition" to win regulatory approval for expanding its business into New Hampshire. n351 In 2001, insurance industry lobbyists failed to dissuade Utah lawmakers from approving expansion of that state's fund's business to other states, after the fund successfully developed for-profit subsidiaries to provide claims management for self-insured businesses. n352 One multistate business manager supporting the Utah fund's expansion argued that businesses had benefitted from increased competition from state funds and explained that his firm had switched from a private insurer to the state fund after suspecting the private insurer of increasing rates in other states to make up for losses in its California policies. n353 In 2000, insurance industry trade groups convinced Oregon's legislature to form a task force to study whether Oregon's state fund was engaging in predatory pricing; private insurers complained that if the state fund didn't raise its prices they would have to leave the state. n354 In California, when legislators held a hearing to investigate insurers' claims of predatory pricing by the state fund, state regulators reported that despite its growth and low prices the state fund was in sound financial condition and had avoided the signs of financial deterioration common among private insurers in the state. n355

[*132]

IV. Conclusion

In conventional economic theory, the advantage of a private competitive insurance market is that insurers' self-interest in maximizing profit from financing workers' compensation risk can also promote employers' and workers' interest in reducing the risks of workplace accidents. n356 In the ideal free-market, insurers gain more the more their premium exceeds what they have to spend on injury claims – thereby giving them incentives to control losses. But, as this story

of workers' compensation shows, insurers often have been able to achieve that gain not by reducing injury costs for employers and workers, but by shifting more of the risk of work injuries to employers or workers (or both) – the problem of insurer moral hazard.

Under traditional rate regulation, insurers often maxi-mized the gap between insurance premiums and benefit costs by simply increasing premiums through government-administered price collusion. When rising benefit costs made that traditional regulatory capture less politically palatable to employers, resulting in tighter regulatory control of rates, insurers withdrew to residual markets: first, to achieve short-term gains from risk-free servicing fees and substandard loss control, and second, to achieve longer-term gains in a kind of "strike" for legislation shifting work injury risks to workers or shifting residual market deficit risks to employers (or to non-participating insurers). And when some states and some employers responded to insurers' voluntary market "strike" by turning to "replacement" financing from self-insurance and from competitive state funds, insurers sometimes sought government protection against their lower-cost replacements.

This alternative story of the workers' compensation insurance crisis as insurer moral hazard shows that benefit financing systems change the costs of employee benefits in the process of covering those costs. But how the insurance market structure affects benefit costs is not determined simply by [*133] whether the insurers are nominally "public" or "private." n357 More critical is how closely and effectively those who gain from financing workplace risks are held accountable for reducing the costs of those risks to others. Some of the insurance market reforms of the late 1980s and 1990s appear to have succeeded in increasing insurers' cost accountability to employers: self-insurance, employer-run competitive state funds, and price competition have made employers' interest in reducing insurance costs more central to the benefit financing scheme – thereby reducing insurer moral hazard to some extent. n358

But these insurance market reforms have perpetuated and often exacerbated insurer moral hazard toward workers. Because the insurance financing system in most states is least accountable to workers' interests, benefit financing costs (for insurers and employers) are often likely to be reduced by shifting costs to workers. Employers and insurers continue to use their joint political power to maintain benefit cuts that hold workers responsible for much of the risk of serious occupational injuries or illnesses. n359 Employers' and insurers' new emphasis on loss control often means preventing and minimizing benefit claims rather than preventing workers' injuries or mitigating their effects through good medical care and appropriate re-employment.

In the prevailing account of the workers' compensation crisis and reforms, if states now attempt to restore some of the benefit cuts that have left many injured workers in devastation, they risk reinstating the escalating insurance costs and collapsing markets of the 1980s. But the alternative story of the crisis debunks that theory of a simple tradeoff between insurance costs and benefit levels. By recognizing the importance of financing structures, not just benefit levels, in determining benefit costs, better choices can be made about how to distribute the costs of work accidents.

[*134] One lesson of this alternative story of the workers' compensation crisis is that who bears more of the costs of work accidents depends on who has the power to hold the benefit financing system accountable to their interests. For workers to gain more protection against the risks of work accidents, they should probably seek not just better benefits, but also better control over benefit financing. For example, competitive state funds could be structured so that governance is shared equally between employee and employer representatives. Perhaps regulatory requirements for self-insurance could be designed to include greater employee control over claims management. Perhaps states could require more public control over or oversight of the monopolistic process of collecting and compiling loss cost data shared by insurers. Such changes might improve the extent to which loss control is achieved through safety and effective re-employment without necessarily driving up either employers' or insurers' benefit costs.

Whether the prevailing rate suppression story or this alternative story of cost inflation better explains the crisis is a question not answerable simply by weighing empirical evidence or applying objective economic principles. Whether insurers' cost-shifting during the crisis was moral hazard or simply desirable profit-seeking depends on the underlying political and moral questions of how much responsibility insurers, rather than workers or employers, should have for controlling the expanded benefit costs of previous decades. The rate suppression story assumes that workers should have sacrificed their interest in more generous and easily obtained benefits to maintain employer and insurer earnings. My alternative account assumes that insurers should have sacrificed their interest in more generous and easily obtained profits to maintain employer and worker earnings. By telling this alternative story, I hope to bring to the surface the hidden assumptions and missing perspectives of the prevailing rate suppression story to encourage more careful and open debate about the problems and possibilities of workers' compensation reforms.

FOOTNOTES:

n1. See, e.g., Orin Kramer & Richard Briffault, *Workers' Compensation: Strengthening the Social Compact* 3 (1991); Peter Kerr, *A Showdown on Workers' Compensation in Maine*, N.Y. Times, Aug. 9, 1992, at 36.

n2. For a description and critique of the major reforms, see generally, Martha T. McCluskey, *The Illusion of Efficiency in Workers' Compensation "Reform,"* 50 Rutgers L. Rev. 657 (1998) [hereinafter *Mcclusky, Illusion*].

n3. See, e.g., Gary T. Schwartz, *Waste, Fraud, and Abuse in Workers' Compensation: The Recent California Experience*, 52 Md. L. Rev. 983 (1993); Peter Kerr, *Vast Amount of Fraud Discovered in Workers' Compensation System*, N.Y. Times, Dec. 29, 1991, at A1; but see McCluskey, *Illusion*, supra note 2, at 873-93 (criticizing this focus on worker fraud).

n4. For discussions of the historical development of the term, see Carol A. Heimer, *Reactive Risk and Rational Action: Managing Moral Hazard in Insurance Contracts* (1985); Tom Baker, *On the Genealogy of Moral Hazard*, 75 Tex. L. Rev. 237 (1996).

n5. See McCluskey, *Illusion*, supra note 2, at 767-86 (analyzing and criticizing this view).

n6. See *id.* at 787-92 (describing and criticizing predominant benefit reform trends).

n7. *Id.* at 710.

n8. See, e.g., Daniel Hays, *N.Y. Governor Pushes WC Reform Proposal*, 103 Nat'l Underwriter, May 24, 1999, at 1 (quoting N.Y. AFL-CIO leader's argument that poli-ticians are wrongly blaming rate increases on injured workers instead of on insurers' profits and control over rate regulation).

n9. For some of the most prominent writers promoting this theory, both with insurance industry funding, see Patricia M. Danzon & Scott E. Harrington, *Rate Regulation of Workers' Compensation Insurance: How Price Controls Increase Costs* (1998); Orin S. Kramer, *Rate Suppression & Its Consequences: The Private Passenger Auto and Workers Compensation Experience* (1991).

n10. In addition, the federal government established several occupational accident compensation schemes for certain categories of workers.

n11. See McCluskey, *Illusion*, supra note 2, at 668-77 (analyzing and questioning this idea of an historic bargain).

n12. See Ruth Gastel, *Workers' Compensation, Insurance Information Inst.* (Dec. 2000) (in practice, Texas is the only state in which coverage is optional).

n13. See Terry Thomason, et al., *Workers' Compensation: Benefits Costs, and Safety under Alternative Insurance Arrangements* 304 tbl. A.8 (Upjohn Inst. 2001) (North Dakota, Ohio, Washington, West Virginia, Wyoming).

n14. For a good background discussion of self-insurance, see John F. Burton, Jr., *Workers' Compensation Self-Insurance*, in *Workers Compensation Desk Book* I-39 to I-44 (John F. Burton, Jr. & Timothy P. Schmidle eds., 1992) [hereinafter *Desk Book*].

n15. See McCluskey, *Illusion*, supra note 2, at 677-78 & nn. 63-67.

n16. See Report of the National Commission on State Workmen's Compensation Laws 19 (1972) [hereinafter *Nat'l Comm'n Rep.*] (noting that in 1940, most states' maximum benefits were at least two-thirds of the state's average weekly wage, but most were below that level in 1972).

n17. See 29 U.S.C. 651-78 (1994).

n18. *Nat'l Comm'n Rep.*, supra note 16, at 18.

n19. *Id.* at 26-27.

n20. See Thomason et al., supra note 13, at 23.

n21. See McCluskey, *Illusion*, supra note 2, at 698-99 & n.153; *National Commission Compliance*, in *Desk Book*, supra note 14, at IV-1, IV-3 tbl. 2.

n22. John F. Burton, Jr., *Workers' Compensation Benefits and Costs: Significant Developments in the Early 1990s*, 8 *John Burton's Workers' Compensation Monitor*, May/June 1995, at fig. A (relying on data from the Social Security Administration).

n23. John F. Burton, Jr., *Workers' Compensation Benefits, Costs, and Profits: An Overview of Developments in the 1990s*, 9 *John Burton's Workers' Compensation Monitor*, Nov./Dec. 1996, at 4 tbl. 3, [hereinafter *Burton, Benefits, Costs and Profits Overview*] (showing a decrease in employer expenditures in 1995 and no increase or

decrease in 1995).

n24. See American Academy of Actuaries, *The Workers' Compensation System: An Analysis of Past, Present and Potential Future Crises* (Spring 2000) (stating that in the late 1990s employers enjoyed decreasing or flat prices); Gastel, *supra* note 12 (describing a nationwide pattern of sharply falling rates through 1999).

n25. John F. Burton, Jr., *Workers' Compensation Benefits and Costs: Significant Developments in the Early 1990s*, in *1996 Workers' Compensation Year Book I-2* (John F. Burton, Jr. & Timothy P. Schmidle, eds., 1992) [hereinafter *1996 Year Book*]; Burton, *Benefits, Costs and Profits Overview*, *supra* note 23, at 3 fig. C (showing a 4.8% drop in total benefits paid per 100,000 workers in 1991-92, and a 10.7% drop in 1992-93).

n26. John F. Burton, Jr., *Workers' Compensation Costs, 1960-1992: The Increases, the Causes, and the Consequences*, in *1994 Workers' Compensation Year Book* (John F. Burton, Jr. & Timothy P. Schmidle, eds., 1993) [hereinafter *Burton, 1994 Year Book*] I-19, tbl. A9 (A.M. Best Co. data showing overall operating ratios greater than 100 from 1984 through 1992).

n27. Burton, *Benefits, Costs and Profits Overview* *supra* note 23, at 5 fig. E, tbl. 4 (showing operating ratios of 92.4, 86.9 and 80.2 for the years 1993 through 1995 respectively).

n28. *Id.* at 5.

n29. Burton, *1994 Year Book*, *supra* note 26, at I-19 tbl. A9.

n30. See Brian K. Atchinson, *Maine Defends Plan To Save Workers' Comp. Pool*, 99 *Nat'l Underwriter*, July 24, 1995, at 27 (letter from Maine's Insurance Superintendent noting that Maine was ridiculed as the poster child for workers' compensation reform).

n31. See, e.g., Danzon & Harrington, *supra* note 9, at ix (mentioning Maine's collapse in the opening sentence of the book's forward).

n32. Kerr, *supra* note 1, at 36.

n33. *Id.*

n34. *Id.*

n35. Id.

n36. Id.

n37. See Thomason et al., *supra* note 13, at 322.

n38. See *id.*

n39. Kerr, *supra* note 1, at 36.

n40. Id.

n41. Id.

n42. Id.

n43. Id.

n44. See Maine Dep't of Prof. & Financial Regulation, *The State of Competition in the Maine Worker's Compensation Market* (Nov. 1, 2000) (reporting that the market remains competitive and that, prior to 2000, insurers' loss costs declined for six consecutive years); William D. Hagar, *Workers' Comp. Reforms Save Lives, Not Just Money*, 99 *Nat'l Underwriter*, Aug. 21, 1995, at 25 (reporting that, due to reforms, Maine's workers' compensation system "went from shambles to success"); *Maine WC Rates Heading Down*, 103 *Nat'l Underwriter*, Nov. 30, 1998, at 31.

n45. See Kramer & Briffault, *supra* note 1, at 52.

n46. Id. at 52.

n47. Id.

n48. Id. at 11.

n49. *Id.* at 50–51; Harrington & Danzon, *supra* note 9, at 15; Burton, 1994 Year Book, *supra* note 26, at I–9.

n50. Burton, 1994 Year Book, *supra* note 26, at I–9 fig. M.

n51. In 1990, the NCCI reported Rhode Island and Louisiana as having residual markets exceeding 50% of total premium; seven other states' residual markets exceeded 20% of the total market premium. NCCI, Management Summary 1990: The Workers Compensation Reinsurance Pools, at 18; see also, Danzon & Harrington, *supra* note 9, at 7 fig. 1–4 (showing residual market share for NCCI-managed pools in 1992).

n52. Kramer & Briffault, *supra* note 1, at 51.

n53. See Thomason et al., *supra* note 13, at 44.

n54. Kramer & Briffault, *supra* note 1, at 51.

n55. *Id.*

n56. See Harrington & Danzon, *supra* note 9, at 18–19; see also *infra* Part III(c)(3) (my analysis of the Maine collapse).

n57. See Kramer & Briffault, *supra* note 1, at 52; see also *infra* text accompanying notes 277–89 (criticizing this theory).

n58. See Harrington & Danzon, *supra* note 9, at 72; see also *infra* text accompanying notes 283–87 (criticizing this theory); Kramer, *supra* note 9, at 80.

n59. See Scott E. Harrington & Patricia M. Danzon, Rate Regulation, Safety Incentives, and Loss Growth in Workers' Compensation Insurance, 73 J. Bus 569, 577 (2000).

n60. Kramer & Briffault, *supra* note 1, at 52.

n61. Danzon & Harrington, *supra* note 9, at 3–32; Harrington & Danzon, *supra* note 59, at 569, 570, 577.

n62. See Harrington & Danzon, *supra* note 59, at 580–82.

n63. Anthony J. Barkume & John W. Ruser, *Deregulating Property-Casualty Insurance Pricing: The Case of Workers' Compensation* (unpublished paper, Bureau of Labor Statistics, copy on file with author) (studying injury rates from 1987-1997 using Bureau of Labor Statistics data from employer reports). For a discussions of shortcomings of the Bureau of Labor Statistics injury rate data, see Marc Linder, *Labor Statistics and Class Struggle* 71-78 (1994).

n64. See Thomason et al., *supra* note 13, at 264-67 (study of injury rates from 1975-1995, finding "little relationship between the statutory regulatory environment and the frequency of lost-time injuries").

n65. Martha T. McCluskey, *Subsidized Lives and the Ideology of Efficiency*, 8 *Am. U. J. Gender, Soc. Pol'y & L.* 115, 138 (2000) [hereinafter McClusky, *Subsidized Lives*].

n66. See McCluskey, *Illusion*, *supra* note 2, at 747 (explaining that whether one assumes the gains or losses from risk protection are positive or negative depends on distributive assumptions about who deserves the gains or losses).

n67. *Id.* at 746 n. 345.

n68. For an analysis and critique of the concept of "cost internalization," see *id.* at 724-30.

n69. McCluskey, *Subsidized Lives*, *supra* note 65, at 139-40; see also Deborah A. Stone, *Beyond Moral Hazard: Insurance as Moral Opportunity*, 6 *Conn. Ins. L.J.* 11 (2000) (arguing that behavior changes induced by some protections from risk should be viewed as positive "moral opportunities" instead of negative "moral hazard").

n70. See, e.g., Jon D. Hanson & Kyle D. Logue, *The First-Party Insurance Externality: An Economic Justification for Enterprise Liability*, 76 *Cornell L. Rev.* 129, 161 n.138 (1990).

n71. See, e.g., Burton, *1994 Year Book*, *supra* note 26, at I-9 (citing growing residual markets as evidence that "carriers are being forced to subsidize the workers compensation program").

n72. See *infra* notes 85-138 and accompanying text.

n73. See *infra* notes 112-18 and accompany text.

n74. See *infra* notes 150-51 and accompany text.

n75. See *infra* notes 140–63 and accompany text.

n76. See *infra* notes 186–207 and accompany text.

n77. See, e.g., Steven D. Millikan & Colette A. Lemke, 1993 Annual Legislative Review, Workers Compensation Legislation 1, 3 (1994) (describing insurance industry group's "proactive" legislative reform action plan); NCCI Task Force Adds Four States to Cost Containment 'Action' List, 2 Workers' Comp. Rep. (BNA), June 10, 1991 (reporting on insurance industry organization's coordinated efforts to target 12 states for benefit reform).

n78. See McCluskey, *Illusion*, *supra* note 2, at 873–88 (criticizing reform arguments and legislation focusing on claimant fraud); Labor Research Ass'n, Workers' Compensation Fraud: The Real Story (June 1998), available at <<http://www.laborresearch.org/ind<uscore>temps/work<uscore>comp<uscore>fraud<uscore>rpt.html>> (last visited June 3, 2001) (summarizing critiques of insurers' exaggerated reports of claimant fraud); Ted Rohrlich & Evelyn Larrubia, Anti-Fraud Drive Proves Costly for Employees Benefits, L.A. Times, Aug. 7, 2000, at A1 (investigating California's anti-fraud campaign as part of "a national trend to shift workers' comp costs from employers and insurers to workers").

n79. Michael Schachner, Seeking an End to the Work Comp Crisis, *Bus. Ins.*, Jan. 4, 1993, at 11 (reporting comments of William Hager, NCCI president and CEO at an insurance industry conference).

n80. See McCluskey, *Illusion*, *supra* note 2, at 708–10.

n81. See *infra* Parts III(D) & III(E).

n82. See *supra* text accompanying notes 61–62.

n83. See Emily A. Spieler, Perpetuating Risk? Workers' Compensation and the Persistence of Occupational Injuries, 31 *Houston L. Rev.*, 119, 249–263 (1994) (explaining how incentives for loss control are likely to result in claims prevention rather than injury prevention).

n84. See Ruser & Barkume, *supra* note 63.

n85. See Kramer, *supra* note 9, at 2, 14.

n86. See National Council on Compensation Insurance, *Ratemaking... The Pricing of Workers' Compensation*

Insurance 16-17 (1993) (explaining how baseline average rate changes are adjusted for industry classification and individual employer experience and discounts).

n87. See National Council on Compensation Insurance, Changes in Manual Premium Level by State Since 1-1-62, Maine data (Feb. 1984) (unpublished document submitted to regulators, on file with the author).

n88. Id. (20.9% in 1987, 20% in 1979, and 25% in 1981).

n89. See Me. Rev. Stat. Ann. tit. 24-A, 2303 (West 2000) (giving current version of this provision).

n90. See Testimony of William Black and Martha McCluskey, [Maine] Public Advocate Office, To the [Maine] Blue Ribbon Commission on Workers' Compensation, June 8, 1992, at 2.

n91. Id.

n92. U.S. Gen'l Accounting Office, Workers' Compensation: Initial Experiences with Competitive Rating 2 (1986) [hereinafter GAO].

n93. Robert W. Klein, Market Effects of Loss Cost Systems in Workers' Compensation 23 (unpublished draft, Nov. 14, 1991, on file with author). NCCI held this dominant rate advisor and advocacy position for decades. See Monroe Berkowitz, Workmen's Compensation: The New Jersey Experience 143 (1960) (writing that through the 1950s NCCI served as insurers' rating agent in all but eight states with private insurance markets).

n94. Klein, *supra* note 93, at 23; see also Berkowitz, *supra* note 93, at 143 (explaining that New Jersey's rating bureau cooperated with the NCCI).

n95. See Klein, *supra* note 93, at 23.

n96. See Robert W. Klein et al., Market Conditions in Workers' Compensation Insurance: Interim Report Presented to the NAIC Workers' Compensation (D) Task Force 26 (July 9, 1993).

n97. See *infra* note 116.

n98. *Paul v. Virginia*, 75 U.S. (8 Wall.) 168 (1869) (ruling that Congress had no authority under the commerce clause to regulate insurance).

n99. Douglas Caddy, *Legislative Trends in Insurance Regulation* 154 (1986) (citing John G. Day, *Economic Regulation of Insurance in the United States* (U.S. Dep't of Transp. 1970)).

n100. See Berkowitz, *supra* note 93, at 143.

n101. See Caddy, *supra* note 99, at 154.

n102. *United States v. South-eastern Underwriters Ass'n*, 322 U.S. 533 (1944) (applying Sherman Antitrust Act to insurance rating bureau accused of fixing prices and boycotting non-members).

n103. Ch. 20, 59 Stat. 33 (1945), (codified at 15 U.S.C. 1011-15 (1994)).

n104. See Kenneth S. Abraham, *Insurance Law and Regulation: Cases and Materials* 97 (2d ed. 1995); Spencer L. Kimball, & Barbara P. Heaney, *Emasculation of the McCarran-Ferguson Act: A Study in Judicial Activism*, 1985 *Utah L. Rev.* 1, 9 (citing 91 Cong. Rec. 1085-94 (1945)).

n105. 15 U.S.C. 1012 (1994).

N106. See Robert H. Jerry, *Understanding Insurance Law* 54 (1987).

n107. See Caddy, *supra* note 99, at 155.

n108. See Herman Miles Somers & Anne Ramsay Somers, *Workers' Compensation* 105 (1954); Douglas Stevenson, *Look Homeward Angels, The Fault for Soaring Losses*, 7 *NCCI Digest*, Feb. 1992, at 7.

n109. See Somers & Somers, *supra* note 108, at 102.

n110. *Id.* at 110-112; Berkowitz, *supra* note 93, at 164-65.

n111. See Berkowitz, *supra* note 93, at 171; Caddy, *supra* note 99, at 174.

n112. The NAIC began formally reviewing its model rating laws to promote competition in 1978. William O.

Bailey, Competitive Rating and Workers' Compensation, 1 J. Ins. Reg. [unpaginated manuscript at 4] (1983). In 1983, the NAIC adopted a model competitive rating act for workers' compensation which recommended replacing prior approval with a "file and use" system for individual insurers and limiting rating bureaus' role to providing aggregate loss data. Klein et al., *supra* note 96, at 28.

n113. GAO, *supra* note 92, at 2, 12.

n114. *Id.* (finding that from 1982-1984 employers' costs declined more in states with competitive rating than with prior approval rating); Thomson et al., *supra* note 13, at 176-81 (evaluating these and other studies and concluding that the evidence is inconclusive); Anne Carroll & Robert Kaestner, The Relationship Between Regulation and Prices in the Workers' Compensation Insurance Market, 8 J. Reg. Econ. 149-66 (1995) (finding tendency toward lower prices in deregulated states from 1980-1987); H. Allan Hunt et al., The Impact of Open Competition on the Employers' Costs of Workers' Compensation, in Workers' Compensation Insurance Pricing 140-41 (David Appel & Philip S. Borba eds. 1988) (finding that Michigan's move to open competition in 1982 produced a "substantial" savings for employers from 1983-1985). In a study of the relationship between regulation and employers costs for the period 1975-1995, Thomason, Schmidle & Burton found decreased employer costs under comprehensive (but not partial) deregulation. Thomason et al., *supra*. at 281-82.

n115. See Bailey, *supra* note 12, at [4] (noting that although most of the property/casualty industry supported increased competition in other lines, the industry was significantly split on the question of competition in workers' compensation). In 1989, in response to an NAIC task force on rating bureaus in workers' compensation, insurers testified in opposition to limiting rating bureau pricing. Klein, *supra* note 93, at 4.

n116. Gary L. Countryman, Counterpoint: Open Competition Rating for Workers' Compensation, 1 J. Ins. Reg. [unpaginated manuscript at 2] (1983).

n117. See Berkowitz, *supra* note 93, at 142.; Klein et al., *supra* note 86, at 25; Countryman, *supra* note 116, at [1].

n118. See Klein, *supra* note 93, at 8-9 (comparing this "service model" of rating organizations to the "cartel model"); see also Danzon & Harrington, *supra* note 9, at 147 (describing possible benefits from promoting insurer cooperation).

n119. Countryman, *supra* note 116, at [3].

n120. Somers & Somers, *supra* note 108, at 102 & n.13 (quoting 1952 NCCI Annual Report, at 3).

n121. Kerr, *supra* note 1 (quoting Grover Czech, vice president of Maryland Insurance Group, one of the insurers withdrawing from the Maine market in 1992).

n122. In 1996, for example, the NCCI had about 1,000 staff and a payroll of more than \$57 million—more than the NAIC's entire budget. Dan Lonkevich, For-Profit Conversion Debate Puts NCCI Under Microscope, Nat'l Underwriter, Mar. 31, 1997, at 3.

n123. For example, the choice of number of years of historical data, or of state versus countrywide data can influence projected loss costs. See Robert W. Klein, Regulation, Competition and Profitability in Workers' Compensation Insurance, John Burton's Workers' Compensation Monitor, March/April 1992, at 7, 11, 13 (discussing uncertainty in ratesetting process).

n124. See Meg Fletcher, Bus. Ins., Mar. 19, 1990, at 1 (reporting criticism from the chief casualty actuary working for South Carolina's Department of Insurance that the "NCCI tends to overestimate expense factors like general expenses, overhead expenses, loss adjustment expenses and assessments for guaranty funds and second-injury funds," for example by using expense data from more costly stock companies rather than mutual companies).

n125. See Klein, et al., supra note 96, at 130; McCluskey, Illusion, supra note 2, at 695, n.141.

n126. See infra notes 152–60 and accompany text.

n127. See Scott Harrington, The Impact of Rate Regulation on Prices and Under-writing Results in the Property-Liability Insurance Industry: A Survey, 51 J. Risk & Ins. 577, 583–84 (1984) (summarizing theoretical and empirical research on nonprice competition in property and liability insurance in general); Joseph C. Samprone, Jr., Rate Regulation and Nonprice Competition in the Property and Liability Insurance Industry, 46 J. Risk & Ins. 683 (1979) (finding support for this hypothesis in study of auto insurance).

n128. Countryman, supra note 116; see also Danzon & Harrington, supra note 9, at 16 (describing pre-1980s ratesetting as a time when workers' compensation insurers competed on the basis of dividends and "service quality").

n129. Bailey, supra note 112.

n130. See, e.g., Michael Schachner, National Workers Comp System Looms, Bus. Ins., May 6, 1991, at 62 (reporting risk manager's comment that employers are just beginning to realize the importance of loss control in workers' compensation); Joanne Wojcik, The Risk Manager's Many New Hats, Bus. Ins., July 23, 1993, at 3 (explaining that the cost of risk was not central to high level corporate management prior to 1980s cost increases).

n131. See Spieler, supra note 83, at 189–93 (describing experience rating methods). Writing in 1983, an insurance executive pegged the portion of experience rated policyholders at 15% of the workers' compensation market. Bailey, supra note 112.

n132. Douglas Stevenson, Look Homeward Angels: The Fault for Soaring Losses, 7 NCCI Digest, Feb. 1992,

at 17, 18.

n133. Meg Fletcher, NCCI Works Against Workers: AFL-CIO, *Bus. Ins.*, Nov. 1, 1993, at 91 (quoting AFL-CIO representative James Ellenberger's comment that "Public policy makers, regulators and employers as well as workers and their union must have confidence in the facts and figures collected and used by NCCI and other rating organizations to price workers' compensation insurance and to give us important information about the frequency, nature and source of occupational injuries and illnesses.").

n134. Miles Maguire, NAIC Eyes 'Sweeping' Stat Agent Changes, *Ins. Accountant*, Feb. 13, 1995, at 1 (quoting Alan E. Wickman, chair of the NAIC's Statistical Strategic Planning Working Group) ("Regulators have not exercised much control ... over what data are collected, how the data are collected, or how the compiled data are made available to regulators and others.").

n135. Richard A. Hofmann, *The Workers' Compensation Crisis: How to Control Costs by Managing the System, Contingencies*, Nov./Dec. 1991, at 20.

n136. Regulators Need to Set Stage for Competition in Rate Making, 8 *Workers' Compensation Rep.* (BNA) 328 (June 23, 1997) (reporting that first competitor to NCCI in 70 years had entered the market).

n137. Meg Fletcher, Changing Structure: NCCI Reshaping Will Create Three Units, *Bus. Ins.*, May 8, 2000 at, 53.

n138. NCCI Buys Industry Benchmarking System, 9 *Workers' Comp. Executive* No. 18, Oct. 6, 1999.

n139. See e.g., Danzon & Harrington, *supra* note 9, at 16 (giving little detail about the pre-1980s regulatory system but characterizing it as having "competitive pressures" from dividend payments); Kramer, *supra* note 9, at 20 (insisting that despite strict price regulation, pre-1980s workers' compensation regulation promoted competition through dividends and service). Kramer concedes that "most economists" would now view the prior approval system of the 1950s as "an unnecessary accommodation to solvency goals." *Id.* at 13-14.

n140. Me. Rev. Stat. Ann. tit.39, 22(3)(B)(1) (repealed).

n141. *Id.* 22(6) (repealed and replaced by P.L. 1983, c.509 1, 2).

n142. Statement of Fact, Comm. Amend. A to L.D. 760, No. H-254 (109th Legis., 1979) (cited in *Nat'l Council on Compensation Ins. v. Superintendent of Ins.*, 481 A.2d 775, 781 (Me. 1984)).

n143. See Nat'l Council on Compensation Ins., 481 A.2d at 779–80.

n144. Id. at 779.

n145. Id. at 780.

n146. Id. at 778.

n147. Id.

n148. Id. at 779–80.

n149. Id. at 780.

n150. Id. at 779–80 (citing *Casco Bay Lines v. Public Utilities Comm'n*, 390 A.2d 483, 491 (Me. 1978)).

n151. For criticism of this move to a public utility model of insurance rate regulation, see Kramer, *supra* note 9, at 93–118.

n152. See Caddy, *supra* note 99, at 172 (citing 1947 report of Roy C. McCullough of the New York Ins. Dept. to the NAIC).

n153. Id. at 170 (citing National Board of Fire Underwriters, *Proceedings*, at 51 (1921)).

n154. Paul L Jaskow, *Cartels, Competition and Regulation in the Property–Liability Insurance Industry*, 4 Bell J. Econ. & Mgmt. Sci. 375, 394 (1973).

n155. See Caddy, *supra* note 99, at 172–75.

n156. See *id.* at 172.

n157. See Nat'l Council on Compensation Ins., 481 A.2d. at 780 (citing *Massachusetts Automobile Rating and Accident Prevention Bureau v. Comm'r of Ins.*, 411 N.E.2d 762, 769–79 (1980)).

n158. Burton, 1994 Year Book, *supra* note 26, at 1-9 & fig. L (showing overall operating ratio of 90.7 in 1980 and 88.9 in 1982).

n159. Danzon & Harrington, *supra* note 9, at 4, 5, fig. 1-2.

n160. Kramer, *supra* note 9, at 98.

n161. *Id.* at 97.

n162. Me. Rev. Stat. Ann. tit.24-A, 2387-A (West 2000) (current version of this provision). The author was a staff attorney in the Public Advocate Office from 1989 to 1993.

n163. See Black & McCluskey testimony, *supra* note 90, at 4.

n164. See An Act to Improve the Workers' Compensation System and Reform the Rate-Making Process, P.L. 1985 c. 372, codified at Me. Rev. Stat. Ann. tit.24-A, 2331-2357 (1985) (repealed).

n165. See *supra* note 114 (discussing deregulation as means to reducing rates in other states in the 1980s).

n166. See *Sandy River Nursing Care v. Aetna Cas.*, 985 F.2d 1138, 1146 (1st Cir. 1993) (mentioning insurers' early 1980s lobbying efforts for benefit cuts).

n167. See Me. Rev. Stat. Ann. tit.24-A, 2338 (repealed).

n168. *Id.* 2338 (repealed).

n169. *Id.* 2355 (repealed).

n170. *Id.* 2355 (3) (repealed).

n171. *Id.* 2355(4) (repealed).

n172. See Kerr, *supra* note 1.

n173. Me. Rev. Stat. Ann. tit.24-A, 2355 (2) (repealed).

n174. Nat'l Council on Compensation Ins. v. Superintendent of Ins., Docket No. CV-85-459, at 8-9 24; (Kennebec Cnty. Super. Ct. May 14, 1987) (discussing this regulatory proceeding) [hereinafter 1987 Superior Court Decision].

n175. *Id.*

n176. *Id.*

n177. *Id.* at 36.

n178. *Id.* at 37.

n179. *Id.* at 43.

n180. See *AIU Ins. Co. v. Superintendent. of Ins.*, 600 A.2d 1115, 1116 (Me. 1991).

n181. P.L. 1987, chs. 559-60.

n182. *Nat'l Council on Compensation Ins. v. Superintendent of Ins.*, 538 A.2d 759 (Me. 1988).

n183. *AIU Ins. Co. v. Superintendent of Ins.*, 600 A.2d. 1115 (Me. 1991).

n184. Kerr, *supra* note 1 (quoting Maurice Greenberg).

n185. See *id.*

n186. Burton, 1994 Year Book, *supra* note 26, at I-9.

n187. Kramer, *supra* note 9, at 80 ("residual market deficits indicate inadequate rates"); Burton, 1994 Year Book *supra* note 26, at I-9.

n188. Burton, 1994 Year Book, *supra* note 26, at I-9 fig. M (using NCCI data). In 1980, the residual market was 12% of total premium; during a period of increased profitability for workers' compensation insurance from 1981-84, the residual market share fell to a low of 5.5%. *Id.* See also Danzon & Harrington, *supra* note 9, at 6 fig. 1-3 (using slightly different method to show a residual market peak of just under 30% in 1992).

n189. See Danzon & Harrington, *supra* note 9, at 7 fig. I-4.

n190. See 1987 Superior Court Decision, *supra* note 174, at 12 (citing reports that about 76% of employers were insured through the residual market in April 1986 and 85% in 1987). Even after 1992, a large portion of employers have remained in the "residual market" system. See *infra* text accompanying note 310 (discussing MEMIC's large market share).

n191. Danzon & Harrington, *supra* note 9, at 15. They acknowledge that, in addition to rate suppression, some growth during the crisis period in the residual market's share of total market premium resulted from higher residual market rates and lower voluntary market rates. *Id.* at 14.

n192. Kramer, *supra* note 9, at 84.

n193. See Brief of the Public Advocate, Re: Workers' Compensation Rate Adjustment, Maine Bureau of Ins. Docket No INS-90-60, June 10, 1991 at 69-70 [hereinafter 1991 Public Advocate Brief] (citing Milliman & Robertson study describing how high servicing fees can create cross-subsidies from voluntary market insurers to residual market insurers).

n194. Me. Rev. Stat. Ann. tit.24-A, 2325(1) (1974); see also Report of the [Maine] Governor's Task Force on Workers' Compensation Reform 8 (April 1991) (Susan M. Collins, Chair).

n195. National Council on Compensation Insurance, *Residual Market Overview: An Introduction to the Residual Market* (1994).

n196. Hofmann, *supra* note 135, at 24.

n197. See *id.*

n198. See 1991 Public Advocate Brief, *supra* note 193, at 69-70 (arguing that the NCCI overstated Maine's

residual market expenses by using national expense figures developed for small, high-risk residual markets).

n199. See *id.* at 57 n.13.

n200. *Id.* at 64.

n201. Testimony of Ted Jellison for the Maine School Management Ass'n, Workers' Compensation 1992 Rate Filing Hearings, Me. Bureau of Ins. Docket No. INS 91-66 [hereinafter 1992 Rate Hearings], transcript at 399; see also *infra* note, 342 (noting that NCCI's servicing fees dropped 35% when later opened to competitive bidding).

n202. See 1991 Public Advocate Brief, *supra* note 193, at 56 (citing testimony of Travelers' Ins. Co.).

n203. See *Sandy River Nursing Care v. Aetna Cas.*, 985 F.2d 1138, 1142 (1st Cir. 1993); see also *AIU Ins. Co. v. Superintendent of Ins.*, 600 A.2d 1115, 1120 (Me. 1991) (denying insurers' claim for damages due to confiscation from 1985 rating law on grounds of *res judicata*).

n204. See *infra* note 230 (discussing "Fresh Start" provision).

n205. See *infra* Parts III D. & E.

n206. See *infra* (Part III (C)(3)).

n207. *Sandy River Nursing Care v. Aetna Cas.*, 985 F. 2d 1138 (1st Cir. 1993).

n208. *Kramer*, *supra* note 9, at 80; see also *Danzon & Harrington*, *supra* note 9, at 18-19 (discussing high residual market deficits).

n209. *Kerr*, *supra* note 1.

n210. See *id.* (quoting *Kramer*).

n211. See *infra* Part III (C)(3) (discussing final residual market deficit settlement of \$220 million).

n212. See Hofmann, *supra* note 135, at 24; see also testimony of Lew Hayden, 1992 Rate Hearing, *supra* note 201, at 739–40 (employer representative to the board charged with governing Maine's residual market pool, explaining that the NCCI's oversight of servicing carriers is "like the wolves checking out Grandma's house for Little Red Riding Hood."). See also *infra* note 336 and accompany text (discussing the NCCI's changes to these policies under pressure from competition).

n213. Hofmann, *supra* note 135, at 24.

n214. *Id.*

n215. See Kramer, *supra* note 9, at 85 ("large residual markets generally involve pooling of claim costs across insurers and may affect insurer incentives for investigating and monitoring claims.").

n216. "The expansion of these [residual market] plans is not caused solely by inadequate voluntary market rates. In states where the [NCCI]... administers the National Workers' Compensation Reinsurance Pool (NWCRP), overall cost increases and high residual market burdens have been unnecessarily high." Hofmann, *supra* note 135, at 24.

n217. *Id.*

n218. See *supra* text accompanying note 203.

n219. An Act to Improve the Maine Workers' Compensation System, P.L. 1987, chs. 559–560 (repealing in its entirety the 1985 Rating Act, Me. Rev. Stat. Ann. tit.24–A, 2331–57.).

n220. See *National Council on Compensation Ins. v. Superintendent of Ins.*, 538 A.2d 759, 768 (Me. 1988).

n221. *In re: Workers' Compensation Voluntary and Residual Market Rate Proceeding*, Docket #INS–88–1 (Me. Bureau of Ins. April 27, 1988) [hereinafter 1988 Rate Decision].

n222. *Id.* at 12 (chiding the NCCI for failing to present witnesses knowledgeable about the data).

n223. *In re: Workers' Compensation Voluntary and Residual Market Rate Proceeding*, Docket No. INS–88–2, (Me. Bureau of Ins. Mar. 16, 1989).

n224. *Workers' Compensation Voluntary and Residual Market Rate Proceeding*, Docket No. INS–89–2, (Me.

Bureau of Ins. April 17), 1990 [hereinafter 1990) Rate De-cision].

n225. An Act to Make Changes in the Workers' Compensation System, P.L. 1991, ch. 615.

n226. In re: Workers' Compensation 1991 Rate Filing, Docket No. INS-90-60, (Me. Bureau of Ins. Sept. 30, 1991) [hereinafter 1991 Rate Decision] at 2, 14.

n227. In re Workers' Compensation 1992 Rate Filing, Docket No. INS-91-66, (Me. Bureau of Ins. Nov. 16, 1992) [hereinafter 1992 Rate Decision].

n228. For example, one executive of a multistate business testified in a Maine rate proceeding that the insurer that covered his business in other states refused to provide a policy for his Maine business even under a "retrospectively rated" policy where his business would assume a major share of the underwriting risk. 1992 Rate Hearings, *supra* note 201, at Record of Proceedings Vol. VI p. 734 (testimony of Lew Hayden, co-founder of San Antonio Shoe). The insurer refused the policy not because of the expected costs of insuring that business, but to avoid having a Maine license that would open it to the risk of residual market assessments. *Id.*

n229. Me. Rev. Stat. Ann. tit.24-A, 2366.

n230. *Id.* 2367. Rhode Island also adopted a "Fresh Start" provision to protect insurers from residual market risk (requiring employers to assume 90% of residual market deficit liability in 1992 and 75% in 1993). See Thomason et al., *supra* note 13, at 2.

n231. Me. Rev. Stat. Ann. tit. 24-A, 2367(2)(C).

n232. *Id.* (setting schedule of increasing penalties based on percentage of voluntary market underwriting).

n233. 1992 Rate Decision, *supra* note 227, at 2.

n234. See 1990 Rate Decision, *supra* note 224, at 9. For a story about a subcontractor in that deal who made lucrative profits with disastrous servicing performance, see Donald M. Kreis, The 'King' of Workers' Comp, 23 Me. Times, Sept. 6, 1991, at 2.

n235. See 1992 Rate Hearing, *supra* note 201, at transcript p. 743 (testimony of Lew Hayden).

n236. See *id.* at VI Record of Proceedings 702 (testimony of Mitchell Sammons, employer representative to the

pool Board of Governors).

n237. *Id.* at 702.

n238. *Id.* at 740 (testimony of Lew Hayden, employer board representative and co-founder of San Antonio Shoe).

n239. 1988 Rate Decision, *supra* note 221, at 11-12.

n240. *Id.* at 12.

n241. 1990 Rate Decision, *supra* note 224, at 7.

n242. *Id.*

n243. 1992 Rate Decision, *supra* note 227, at 2.

n244. *Id.* at 18.

n245. *Id.* at 19.

n246. *Id.* at 19.

n247. See Me. Rev. Stat. Ann. tit.24-A, 2367(C) (insurers may be assessed beginning in 1991 for failure to increase voluntary market writings); 1991 Rate Decision, *supra* note 226, at 16 (stating that although insurers failed to make good faith efforts to depopulate the pool in 1989, the data for that year was not yet sufficiently developed to determine whether a deficit exists).

n248. 1991 Rate Decision, *supra* note 226, at 16.

n249. See Kerr, *supra* note 1.

n250. Public Advocate Brief, Workers' Compensation 1992 Rate Filing, Me. Bureau of Ins. Docket No. INS-

91-66, Apr. 10, 1992 [hereinafter 1992 Public Advocate Brief], at 47-48 (quoting cross examination from Tr. pp. 279-80).

n251. Bureau of Insurance Rule 440, 15(C) (Me. 1989) (later amended, repealed Nov. 5, 1995).

n252. *Id.* at 15(C)(4).

n253. *State Farm Fire & Cas. Co. v. Superintendent of Ins.*, No. CV-92-83, 1992 WL 898675, at 4 (Me. Super. Dec. 10, 1992).

n254. *Id.* See Notice of Emergency Rulemaking, Nov. 26, 1991, Proposed Rule Ch. 640, Workers' Compensation Ins. Residual Market Deficits.

n255. See *State Farm*, 1992 WL 898675 at 5 (finding that, with a deficit of \$50 million, "major carriers"- including most servicing carriers - would bear only 28% of the deficit leaving other carriers with 72% of the deficit cost).

n256. *Id.* at 5-6; see Notice of Emergency Rulemaking, Acting Superintendent of Insurance Richard E. Johnson, Nov. 26, 1991, Proposed Rule Ch. 640, Workers' Compensation Insurance Residual Market Deficits 4(A) ("major carriers" would be required to assume only 60% of the deficit, subject to a maximum assessment per carrier).

n257. See *State Farm*, 1992 WL 898675 at 6.

n258. *Id.*

n259. 1992 Rate Decision, *supra* note 227, at 21, 22.

n260. See *National Council on Compensation Ins. v. Superintendent of Ins.*, No. CV-93-161, (Me. Super. Oct. 17, 1994).

n261. *Id.*

n262. *Id.*

n263. See Governor's Workers' Compensation Advisory Comm., Fresh Start Settlement: Questions and Answers 3, 4 (Maine Council of Self-Insurers, June 1995).

n264. An Act to Create the Workers' Compensation Residual Market Deficit Resolution and Recovery Act, P.L. 1995 Ch. 289 L.D. 1578, codified at Me. Rev. Stat. Ann. tit. 24-A, 2391-96 (West 2000).

n265. The state treated this amount as improperly paid by the pool during those years because the pool's solvency was guaranteed by employers through surcharges.

n266. Maine's Money Grab Must be Stopped, Nat'l Underwriter, July 10, 1995, at 22 (editorial).

n267. The bailout law was challenged in court by several insurers who had little or no participation in the Maine market during the deficit period. To settle this litigation, in 1998 the pool and insurers with major responsibility for pool servicing agreed to refund \$8.5 million of the insurers' assessments to these non-participating insurers. See Meg Fletcher, Maine Regulators, Insurers Reach Comp Settlement, Bus. Ins., Oct. 19, 1998, at 27.

n268. See Burton, Desk Book, supra note 14, at I-39.

n269. National figures show a growth in self-insurance from less than 14.8% in 1970 to 25% in 1998. Thomason et al., supra note 13, at 33 fig. 2.10. However, individual state growth and self-insurance share varies widely. See Burton, Desk Book, supra note 14, at I-39.

n270. See Burton, Desk Book, supra note 14, at I-41.

n271. Many states changed regulatory requirements during the 1980s to permit group self-insurance. Id at I-40.

n272. See Burton, 1996 Year Book, supra note 25, at I-3.

n273. See 1992 Public Advocate Brief, supra note 250, at 5 (quoting testimony of John Melrose, transcript pp. 355-56).

n274. Id. at 6.

n275. Id.

n276. See Danzon & Harrington, *supra* note 9, at 76 (explaining that "lower prices compared with costs should encourage firms to buy commercial insurance").

n277. See *id.* at 43.

n278. See *id.* at 42–43 (discussing George Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 *Yale L.J.* 1521 (1987)); Kramer & Briffault, *supra* note 1, at 52.

n279. Thomason et al., *supra* note 13, at 39–40.

n280. Kramer, *supra* note 9, at 80.

n281. Danzon & Harrington, *supra* note 9, at 111; Kramer, *supra* note 9, at 80.

n282. Kramer, *supra* note 9, at 80.

n283. See *id.* at 84. As residual market deficits grew in the 1980s, many states imposed higher rate charges for residual market policies than for voluntary market policies. See NCCI Management Summary 1990: *The Workers' Compensation Reinsurance Pools 2*.

n284. See Danzon & Harrington, *supra* note 9, at 15; Thomason et al., *supra* note 13, at 44 (explaining the dominant factor in residual market growth during the 1980s was not risky employers, but general rate inadequacy); *The Workers' Compensation Reinsurance Pools*, *supra* note 283, at 2 (stating that rate inadequacy caused residual markets to deviate from their traditional role as market of last resort for high-risk employers).

n285. Most states prohibited voluntary market rates from including charges for residual market deficits. See Michael Bradford, *Hartford Offers to Settle, Bus. Ins.*, Jan. 18, 1999, at 2 (quoting attorney John Karaczynski).

n286. See *id.* (reporting on class actions pending in Alabama, Pennsylvania, California, Kentucky, Missouri, Tennessee, New Jersey, New York, Michigan, Georgia and Illinois). The Hartford Insurance Company offered to settle the claims it faced for \$12.6 million. *Id.* See also *Sandwich Chef of Texas, Inc. v. Reliance Nat'l Indemnity Ins. Co.*, 111 F. Supp. 2d 867 (S.D. Tex. 2000) (denying defendants' motion for summary judgment in RICO-based class action suit claiming insurers fraudulently charged voluntary market employers for residual market deficit assessments).

n287. In short insurers lost money not because of inadequate rates but "as a result of bad management." 1992 Rate Hearing, *supra* note 201, at 364 (testimony of John Melrose). He noted that the substantial impediments, *id.* at

356-57, and additional costs of self-insurance are outweighed in employers' minds "because of what they view as excessive charging in the residual market." *Id.* at 357.

n288. 1992 Public Advocate Brief, *supra* note 250, at 7-8 (quoting Melrose testimony, transcript p. 358).

n289. 1992 Rate Hearing, *supra* note 201, at 368 (testimony of John Melrose). In Maine, self-insurance tended to saturate the market of particular industries rather than to involve only the best risks. *Id.* at 358. Ninety percent of automobile dealers were self-insured – not best risks but majority of market. *Id.*

n290. 1992 Public Advocate Brief, *supra* note 250, at 7 (quoting testimony of Ben Dever, executive of Guilford of Maine, transcript at 320). However, this company's managers believed some of its high rating was due to inaccurate loss records by the servicing carrier. 1992 Rate Hearing, *supra* note 201, at 320 (testimony of Ben Dever).

n291. 1992 Rate Hearing, *supra* note 201, at 311-12 (testimony of Ben Dever).

n292. *Id.* at 312.

n293. *Id.* at 386 (testimony of Ted Jellison for the Maine School Management Ass'n).

n294. *Id.* at 399.

n295. *Id.* at 357 (testimony of John Melrose).

n296. *Id.* at 358.

n297. *Id.* at 365.

n298. See *supra* text accompany note 209.

n299. 1992 Rate Hearing, *supra* note 201, at 361, 369 (testimony of John Melrose).

n300. Ruth Gastel, *Residual Markets*, Insurance Information Institute, Jan. 2001.

n301. Ruth Gastel, *Workers' Compensation*, Insurance Information Institute, Jan. 1996. Using a different definition of self-insurance and including government funds in the total market share, the self-insured portion of the market grew from 19.7% in 1990 to 25% in 1998. Thomason et al., *supra* note 13, at 33 fig. 2.10.

n302. Thomason et al., *supra* note 13, at 34.

n303. See *id.* at 304 tbl. A.8. However, in 1994, Michigan privatized its state fund. *Id.* at 35.

n304. *Id.* at I-2.

n305. Kramer & Briffault, *supra* note 1, at 53-54. See also Roger K. Kenney, *Workers' Compensation State Funds: Disappearing Capital* (undated publication by the Alliance of American Insurers, based on data through 1991) (warning of insolvency dangers in state funds); William P. White, *Maine WC: What a Long, Difficult Trip It's Been*, *Nat'l Underwriter*, April 19, 1993, at 10 (reporting skepticism that MEMIC would stick to business, not politics); Landmark Legal Foundation, *Missouri Insurance Scheme Challenged; Pending 'Disaster' for Employers, Taxpayers*, *PR Newswire*, Nov. 2, 1995 (describing Missouri's new state fund as a "savings and loan-type disaster waiting to happen," and predicting it would fail, leaving employers, taxpayers, and private insurers "holding the bag").

n306. Kramer & Briffault, *supra* note 1, at 54.

n307. See, e.g., Emily A. Spieler, *Injured Workers, Workers' Compensation, and Work: New Perspectives on the Workers' Compensation Debate in West Virginia*, 95 *W. Va. L. Rev.* 333, 456 (1992-93) (discussing deficit in West Virginia's exclusive state fund).

n308. See, e.g., Meg Fletcher, *Maine Leads Comp Rate Turnaround: Voluntary Markets' Successful Reforms Benefit Employers*, *Bus. Ins.*, Jan. 9, 1995, at 3 (reporting NCCI's request for a 12.5% drop in loss costs).

n309. Maine Dept. of Prof. & Financial Regulation, *The State of Competition in the Maine Workers' Compensation Market* 10 (Nov. 1, 2000).

n310. *Id.* at 9, 10.

n311. *Id.* at 17.

n312. *Me. Stat. Ann. tit. 24-A, 3703(5)* (West 2000). Rhode Island incorporated a similar requirement into a new state fund replacing its insurer-controlled residual market. *R.I. Gen. Laws 27-7.2-3* (Michie 1994).

n313. Me. Rev. Stat. Ann. tit. 24-A, 3212-A (4) (West 2000).

n314. Id.

n315. Id. 3705.

n316. See White, *supra* note 305, at 10 (describing MEMIC's focus on loss control, safety and high standards of claims adjustment).

n317. Available at <<http://www.memic.com/memic<uscore>splash.html>> (last visit June 3, 2001).

n318. Available at <<http://www.memicsafetyservices.com>> (last visited June 3, 2001).

n319. Meg Fletcher, *New Programs Must Have Support of Key People*, *Bus. Ins.*, Oct. 30, 2000, at 20 (quoting John Leonard, President and CEO of MEMIC).

n320. Press Release, *Maine Employers' Mutual Observes Fifth Anniversary at Employee Appreciation Lunch*, available at <www.memic.com/News/press2<uscore>press.html> (last visited Apr. 15, 2001).

n321. Id. See also Beurmond Banville, *Work-related Injuries Costly for Town*, *Bangor Daily News*, May 11, 2000 (describing how MEMIC responded to a series of injuries in town ambulance workers by providing a loss control plan of mandatory employee fitness programs, safety training, equipment reviews, and worker screening).

n322. Press Release, *Memic Offers Winter Safety Advice That's Worth Its Salt*, available at <<http://www.memic.com/News/press1<uscore>press.html>> (last visited Apr. 19, 2001).

n323. Press Release, *Maine's Largest Workers' Comp Company Celebrates Fifth Anniversary with Largest-Ever Rate Decrease*, (Jan 5, 1998), available at <www.memic.com/News/press1<uscore>press.html> (last visited Apr. 15, 2001) [hereinafter 1998 MEMIC Press Release].

n324. See Peter M. Gore, *No Way State Can Mimic MEMIC for Health Insurance*, *Kennebec (Augusta, Me) J.*, Feb. 14, 2000, at A5 (stating, from perspective of Maine State Chamber of Commerce, that MEMIC "has certainly turned out to be a success story in the area of workers' compensation" but debating proposals for using MEMIC as a model for health insurance reform.").

n325. Press Release, State's Largest Workers' Comp Company Authorized to Provide Maine Employers Out-of-State Coverage, available at <www.memic.com/News/governor<uscore>press.html> (last visited Apr. 15, 2001).

n326. 1998 MEMIC Press Release, *supra* note 323.

n327. Dean Lunt, Workers' Comp Insurer to Return Funds, *Portland Press Herald*, Sept. 14, 1999, at 1A.

n328. *Id.* (quoting MEMIC President and Chief Executive Officer John Leonard).

n329. Press Release, Memic Earns an 'A' (Excellent) Rating from A. M. Best, available at <www.memic.com/News/bestrating> (last visited Apr. 15, 2001).

n330. Press Release, State's Largest Workers' Comp Company Authorized to Provide Maine Employers Out-of-State Coverage, available at <www.memic.com/News/governor<uscore>press.html> (last visited Apr. 15, 2001).

n331. See generally, Ian Ayres & John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* 133-57 (1992).

n332. *Id.* at 139.

n333. *Id.* at 139-40.

n334. See *id.* at 140 (describing situations where collective action problems may prevent private firms from similarly subsidizing or creating an alternative supply source).

n335. MEMIC does have the power (with approval of the Insurance Superintendent) to deny coverage to high-risk employers who refuse to comply with MEMIC's claims management or safety standards. *Me. Rev. Stat. Ann. tit. 24-A, 3712-A(3)(B)* (West 2000).

n336. See NCCI, *Residual Market Efforts Begin to Pay Off*, in *1995 Issues Report: Back from the Brink*, at 11, 12; Richard L. Katten, *Reforms Take Hold in Residual Market*, *Nat'l Underwriter*, June 19, 1995, at 13 (noting that servicing fees dropped by as much as 35% while servicing quality improved).

n337. Thomason et al., *supra* note 13, at 152-56, 279.

n338. Id. at 155.

n339. See id. at 155-56.

n340. Id. (citing Alan B. Krueger & John F. Burton, Jr., *The Employers' Costs of Workers' Compensation Insurance: Magnitudes, Determinants, and Public Policy*, 72 *Rev. Econ. & Stats.* 228-40 (1990)).

n341. Similarly, Rhode Island established its new competitive state fund in the fall of 1992, and that state's rate decreases began in 1996. See Thomason et al., *supra* note 13, at 2-3.

n342. See id. at 66 fig. 3.1, 371 tbl. 3.17 (calculating Maine's 1995 adjusted manual rates at \$3.37 per \$100 of payroll compared to an average of \$2.97).

n343. Dean Lunt, *Workers' Comp Rates Likely to Rise*, *Portland Press Herald*, Oct. 30, 1999, at 1A.

n344. See Dean Lunt, *Maine Insurer Expanding to N.H.* *Portland Press Herald*, May 11, 2000, at 8B.

n345. See New York State AFL-CIO, *Restoring the Promise: The Reform of Workers' Compensation in New York State* (May 1997) (criticizing New York state fund's lack of accountability to employers and workers and recommending that it be governed by a majority of business and labor representatives).

n346. See N.Y. Ins. Law 2339 (McKinney 2001) (forbidding any workers' compensation insurer from deviating from rates established by the rating service).

n347. See Landmark Legal Foundation *Challenges Government-Financed Insurance Company*, *PR Newswire*, Sept. 29, 1997.

n348. Manny Lopez, *State-Created Company Thriving Despite Court Challenge*, *Naysayers*, 19 *Kansas City Bus. J.*, Sept. 29, 2000, at 24 (reporting state Dept. of Ins. spokesperson's conclusion that the new fund "has been everything [Missouri's small businesses] wanted it to be").

n349. See Daniel Hays, *Insurers Resist Maine WC Fund Growth Bid*, *Nat'l Under-writer*, Nov. 1, 1999, at 4.

n350. Id.

n351. Daniel Hays, N.H. Regulator Relents on Maine WC Carrier, Nat'l Underwriter, Feb. 21, 2000, at 2.

n352. Roberto Cenicerros, Potential Competitors Cry Foul; Utah Comp Fund Seeks to Expand, Bus. Ins., Jan. 29, 2001, at 2.

n353. Id. (quoting Gene Denning, risk manager for Associated Food Stores, Inc.).

n354. Oregon State Fund Driving Market Into Turmoil?, 10 Workers' Comp. Executive, May 17, 2000.

n355. See State Fund Exonerated of Rumored Financial Problems and Predatory Pricing at Assembly, 11 Workers' Comp Executive, April 4, 2001; State Regulators Say SCIF is Adequately Reserved, 11 Calif. Workers' Comp Advisor, Mar. 28, 2001.

n356. See, e.g., Danzon & Harrington, *supra* note 9, at 28 (explaining that competitive insurance markets, with good information and experience-rated premiums, would produce "optimal" incentives for insurers and insureds to invest in loss control).

n357. See Thomason et al., *supra* note 13, at 286-87 (concluding that their empirical study of the effect of insurance arrangements shows that neither public nor private insurance is clearly correlated with lower costs).

n358. See *id.* at 287-90 (concluding that comprehensive deregulation of insurance markets reduces employers' costs).

n359. See, e.g., Workers Comp: Falling Down on the Job, Consumer Reports, Feb. 2000, at 28-33.