

# Giving Motorists a Choice Between Fault and No-Fault Insurance: An Economic Critique

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Jeffrey O'Connell and Robert Joost have proposed an automobile insurance scheme in which consumers freely choose between fault and no-fault plans.<sup>1</sup>

Why not allow individual motorists to select the kind of insurance they want? Why not let the consumer decide?

. . . Individual motorists should have the same right to choose, in a free-enterprise economy, whether they want traditional or no-fault protection, as they now have to choose whether they want an automatic or a manual transmission in their automobile. Allowing individual choice between insurance systems would satisfy motorists who prefer the traditional liability system as well as those who believe that no-fault offers a superior method of claims resolution. . . .

In addition to increasing the consumers' alternatives, a system providing individual choice would allow the no-fault and traditional systems to compete in the marketplace.<sup>2</sup>

The idea of choice is very appealing, especially to economists. However there are important situations where free choice is inappropriate. This paper will examine these situations and argue that free choice of liability rules and insurance regimes will be socially harmful. Section I examines the case where free choice for economic agents is the preferable system. Section II examines why a regime of free choice is *not* applicable to the choice of liability rules and insurance regimes. In this section it is shown that the choice between fault and no-fault insurance is not, as O'Connell and Joost argue, the

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1. See O'Connell & Joost, *Giving Motorists a Choice Between Fault and No-Fault Insurance*, 72 VA. L. REV. 61 (1986).

2. *Id.* at 76.

same as the choice between manual and automatic transmissions. The key difference is the phenomenon of externalities. In Section III, the conclusions are presented.

## I. THE SUPERIORITY OF FREE CHOICE IN THE ABSENCE OF EXTERNALITIES

In general, economists prefer a system where economic agents are free to choose the goods and services they purchase. The reason is economists assume individual agents know their tastes and preferences better than anyone else. Hence, when individuals are free to choose, they choose the bundle of goods which will lead to maximum satisfaction. Consider the example of consumers being able to choose between manual and automatic transmissions given by O'Connell and Joost. An alternative system would be one in which the government decides that automatic transmissions are superior and mandates that only automatic transmissions be produced. In that situation, consumers are clearly worse off because choice does not exist in the marketplace.

In the above example, free choice is the optimal policy. What is crucial about that example is the lack of externalities. In the case of choosing automobile transmissions, an individual consumer's choice of an automatic or manual transmission does not impose costs on other consumers. Economists would describe this situation as one in which there are no third party effects (or no externalities). In the vast majority of consumer decisionmaking situations there are no externalities. That is why our general intuition leads us to favor schemes allowing maximum choice.

However where externalities do exist, the costs imposed on third parties must be considered. In such a world, free choice does not lead to the maximum welfare of economic agents.

## II. WHY FREE CHOICE IS INAPPROPRIATE FOR THE SELECTION OF INSURANCE REGIMES

When a consumer chooses between fault and no-fault auto insurance there are external effects on other consumers. These external effects must be considered in any choice scheme. There are basically two distinct externalities which are important in the choice between fault and no-fault. It is important to note that a choice of no-fault is not merely a choice of first party insurance over third party insurance. No-fault also involves a major change in the liability rules applied to automobile accidents.<sup>3</sup> One externality in the choice system

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3. The extent of change in liability rules depends on the handling of the insurance companies' subrogation rights. For purposes of this analysis, it will be assumed that no

comes from the change in liability rules; another externality is due to the operation of an insurance market with a choice between first and third party insurance. Let us examine each of these externalities.

*A. The Need for a Universally Applied Liability Rule*

When a negligent automobile driver has an accident and injures another automobile driver, the negligent driver has imposed costs on innocent third parties. In other words, automobile accidents impose external costs. Under current fault based systems, negligent drivers are legally responsible for the harm imposed on innocent accident victims. Under a no-fault system, negligent drivers are relieved of responsibility for those external costs imposed on innocent third parties.

A choice between fault and no-fault allows individual economic agents a choice of whether they will be responsible for their negligent actions or whether they will be relieved of this responsibility.<sup>4</sup> Clearly, those agents most likely to act negligently will choose not to be liable for their actions (they will choose no-fault). This elimination of liability will reduce the standard of care taken by some drivers and will result in increased accident rates. This clearly is not a socially optimal situation. It is because of these externalities that O'Connell and Joost are incorrect to think "[i]ndividual motorists should have the same right to choose . . . whether they want traditional or no-fault protection, as they now have to choose whether they want an automatic or a manual transmission in their automobile."<sup>5</sup> O'Connell and Joost fail to realize that choice of liability rules is not the same type of choice as choice of transmissions. Can it ever make sense to allow individuals to choose the liability rules applicable to them? The answer is a resounding no. No legal system

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subrogation rights exist. One could have a choice system with a variety of subrogation rights.

4. Professor Brown argues that allowing people to choose liability rules in effect allows individuals to buy immunity from a suit, much like liability insurance protects individuals from risk of a suit. He then implies that if one does not object to liability insurance one should not object to choice no-fault systems. This argument confuses elimination of responsibility for an action with insuring against such a risk. What no-fault does is completely eliminate financial responsibility for the harm negligent drivers impose on innocent accident victims. There is no objection under our current system to individuals insuring against certain contingencies. In such a world, high risk individuals face appropriate premiums and still have the correct incentives to take due care. This is not the case under no-fault. Brown, *A Choice of Choice: Adding Postaccident Choice to the Menu of No-Fault Models*, 26 SAN DIEGO L. REV. 1095 (1989).

5. O'Connell & Joost, *supra* note 1, at 76.

can let individuals choose the legal rule under which they will operate. There is a need for one rule of law which will apply to all members of society.

If choice is the superior option, would O'Connell and Joost consider allowing their choice model of liability to be applied to the harm caused by polluters? Can we let polluters decide whether they will be responsible for the harm they impose on others? Free choice between a fault or a no-fault system in this situation does exactly that. Those companies who will do more damage to others than others will do to them will choose a no-fault system. Such free choice will lead to *too* much pollution, to damage to our environment, and ultimately, to a lower level of economic well-being. Would O'Connell and Joost extend their choice system to the criminal law? Would we ever give criminals the choice of whether they will be liable for their criminal acts? Clearly, where the actions of some members of society impose costs on other members, free choice of liability regimes are completely inappropriate.

When externalities are present (as they are in the case of automobile accidents), the state must decide on the legal rules which apply to everyone and lead to a socially optimal situation. The state should adopt a legal rule which minimizes the costs of accidents plus the costs of accident avoidance (such a legal rule would be economically efficient). Hence, the question becomes not one of choice but one of which regime, fault or no-fault, leads to lower overall costs of accidents. From a theoretical point of view, the standard of care observed by drivers is reduced when they are no longer responsible for the harm they do to others. In addition, the no-fault option, with its lower premiums for high risk drivers, may allow high risk drivers on the road who, under a fault system, would have been priced out of the market. A large body of empirical evidence demonstrates that jurisdictions which have implemented no-fault car insurance have experienced generally increased accident rates, involving increases in property damage, increases in personal injuries, and increases in death. The strongest evidence comes from Quebec. Professor Gaudry found the implementation of no-fault in that province resulted in an eleven percent increase in accidents with property damage only, a 27.7% increase in accidents with at least one injury, and a 6.8% increase in fatalities.<sup>6</sup> Another study of the Quebec situation was recently completed by Professor Rose Anne Devlin.<sup>7</sup> In contrast to the Gaudry study, the Devlin study better separates the pure no-fault

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6. Gaudry, *Un Modèle de la Demande Routière des Accidents et leur Gravité appliqué au Québec de 1956 à 1982*, CAHIER No. 8432 (Université de Montréal 1984).

7. R. Devlin, *Liability versus No-Fault Automobile Insurance Regimes: An Analysis of the Experience in Quebec* (Oct. 1988) (Ph.D. thesis) (available in the University of Toronto library).

effects of the Quebec scheme from the particular pricing scheme which was adopted in Quebec. Professor Devlin concluded that "the care taken by drivers is shown to have decreased significantly after no-fault, resulting, for instance in a 9.62% increase in fatal accidents. The conclusion reached is the liability system in the presence of liability insurance does indeed deter accidents."<sup>8</sup>

R.I. McEwin recently completed a study of the introduction of no-fault insurance in the Northern Territories of Australia and in New Zealand.<sup>9</sup> The study concluded that "the abolition of the common-law tort of negligence action was associated with a *sixteen per cent* increase in the number of road fatalities per head of population. . . . The results should concern those who discount the role a negligence liability rule plays in promoting safety."<sup>10</sup>

### *B. The Adverse Selection Problem*

There is another externality involved in the pricing of fault and no-fault insurance policies in a choice regime.<sup>11</sup> In a choice system, the fault plan will better be able to identify high risk drivers than the no-fault plan. This is because the fault plan records payouts of accidents where the insured is negligent while the no-fault plan simply records payouts involving accidents in which the insured driver makes a claim. Under the fault system substantial resources are devoted to finding fault. Under no-fault plans there is no need to devote resources to finding fault since payouts are independent of fault. As a consequence, high risk drivers will be charged higher premiums under the fault plan and therefore will tend to select a no-fault option. These high risk drivers will enter the no-fault insurance pool and eventually cause average premiums in this pool to increase. In this way, high risk drivers impose external costs on the existing

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8. *Id.* Professor Devlin also concluded:

[T]he total social cost of the increase in accidents arising from the switch to public no-fault insurance in Quebec using conservative estimates is 259.6 million (1981 dollars) per year. The social benefits resulting from administration cost savings is \$39.21 to \$94.10 million. Thus there is clearly a net social loss of \$220.39 to \$165.5 million dollars per year.

*Id.* at 263.

9. McEwin, *No-Fault and Road Accidents: Some Australian Evidence*, 9 INT'L REV. L. & ECON. 13 (1989).

10. *Id.* at 17.

11. For a discussion of this externality, see G. Priest, *Allowing Drivers a Choice Between No-Fault and Fault-Based Auto Insurance: An Analytical Critique* (Nov. 1988) (copies available from author).

low risk drivers.<sup>12</sup> This is the nature of the externality and the adverse selection problem.

There is another aspect to this adverse selection problem. Whenever possible, drivers who have chosen the no-fault option will have incentives to make claims against private or public health insurers rather than against the no-fault carrier (since claims against the no-fault carrier would result in premium increases).

Consider the example of an injured driver requiring both physical and psychological rehabilitation services and whose accident occurred in Ontario where there is public health insurance. Currently, patients in Ontario in need of rehabilitation services have the option of using Ontario Hospital Insurance Plan (OHIP) covered physiotherapists and psychiatrists or non-OHIP covered private physiotherapy clinics or psychologists. The reason private services can co-exist in the marketplace with "free" OHIP services is there are substantial waiting lists for the OHIP provided services. Under a "fault" system, innocent accident victims will utilize the more readily available private rehabilitation services which will be charged to the third party insurer. Under a no-fault system, accident victims have an incentive to utilize OHIP services. This has a number of undesirable effects. It will increase the demand on the already overburdened OHIP system, therefore increasing the costs of running the system.

In addition, waiting periods for rehabilitation services will increase. These greater waiting periods may substantially decrease the effectiveness of rehabilitation programs. As Judge Osborne noted in his inquiry, "[a]ll submissions relating to rehabilitation suggested that rehabilitation must be undertaken at an optimum time (usually early) to be most effective."<sup>13</sup>

Hence, if the no-fault option hinders early intervention, it will probably result in greater levels of disability and greater drains on already overtaxed OHIP funded medical and hospital facilities. This will increase the costs to first party insurance carriers (resulting in higher premiums) and certainly will increase the social cost of accidents.

The externalities caused by adverse selection will make pricing fault and no-fault options extremely difficult and will make administration of these plans very cumbersome. It should be noted that jurisdictions having rate regulation would find administration of the

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12. In addition, to the extent the pool of no-fault drivers is, on the average, higher risk, no-fault drivers will be responsible for more connector accidents than fault drivers. This will result in fault drivers subsidizing no-fault drivers because of the pricing of connector coverage.

13. C. OSBORNE, REPORT OF THE INQUIRY INTO MOTOR VEHICLE ACCIDENT COMPENSATION IN ONTARIO 162 (1988).

choice plan especially cumbersome. In Ontario, which has rate regulation, rate hearings before the Ontario Automobile Insurance Board would be required for both the fault option and the no-fault option. The Board would have to engage in the almost impossible task of allocating insurance company costs between these two types of insurance policies. Under regulation, the insurance industry could price the fault option so high no consumer would freely choose it. Any insurance company desiring to charge a lower rate for the fault option than the industry set rate would need specific Board approval.<sup>14</sup> If the fault option is priced out of the market, this action would convert a de jure choice system into a de facto pure no-fault system.

Finally, it should be noted that with consumers switching from one insurance pool to another, and insurance companies accordingly altering premiums, the insurance cycle may be made much worse than it is already.

### III. CONCLUSIONS

In situations where there are no externalities, giving consumers choice unambiguously improves welfare. However, in the case of automobile accidents, there are substantial externalities. In such a situation, it makes no sense to allow economic agents to choose the liability rule under which they operate. One cannot allow negligent drivers to decide whether or not they will be liable for the harm they cause to others. *One cannot allow drunk drivers the option of being relieved of the responsibility for the harm they cause to others.*

A choice system will cause high risk drivers to choose the no-fault plan. This choice cannot be considered socially optimal since high risk drivers will then impose costs on low risk drivers. This adverse selection problem will force good drivers to subsidize bad drivers, will make pricing of fault and no-fault plans very difficult, and will make administration of these plans very cumbersome. The interactions of a choice system with rate regulation will create a system which will be extremely difficult and costly to administer.

A choice system will result in a greater utilization of the already overburdened health insurance system. This may cause increased waiting periods for rehabilitation services for innocent accident victims resulting in decreased effectiveness of rehabilitation programs.

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14. To charge a rate outside the range set by the Board, the insurer must demonstrate that the proposed rate is just and reasonable and not excessive or inadequate and that the circumstances facing the insurer justify the use of the proposed rate. Presenting one's case before the Board may be very costly for individual insurance companies.

If this is the case, the social costs of accidents will increase.

When externalities are present, as is always the case in automobile accidents, choice makes no sense. The real question is the desirability of fault versus the desirability of no-fault. A system which frees economic agents from liability for the harm they impose on others results in a reduction in the driving standard of care. Two recently completed studies confirm earlier empirical results that adoption of no-fault insurance results in a substantial increase in automobile accident fatalities. For these reasons, as well as others, Judge Osborne rejected the no-fault option. "Threshold no fault should be rejected because it is relatively inefficient and unnecessarily arbitrary. . . . Pure no fault should be rejected on fairness and deterrence grounds and because it is manifest that few seem to want it."<sup>15</sup> It should be noted that under our current system of negligence laws, traditional fault systems do offer consumers choices. They do not offer consumers a choice of liability regimes under which to operate but they do offer individuals a choice of protection against losses from accidents. Automobile drivers already have the choice of health insurance coverage to protect against medical expenses arising from accidents. Automobile drivers can purchase accident and disability insurance to protect themselves against loss of income in the case of accidents in which they are the negligent party.

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15. C. OSBORNE, *supra* note 13, at 45.