

Searle Civil Justice Institute

STATE CONSUMER PROTECTION ACTS AND COSTS TO CONSUMERS The Impact of State Consumer Protection Acts on Automobile Insurance Premiums

Preliminary Policy Report

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Law & Economics Center

George Mason University School of Law

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Executive Summary

Issues and Background

State consumer protection legislation has increased dramatically over the last few decades. In addition to federal regulation, every state now has its own Consumer Protection Act (CPA), each of which provides for a private cause of action to supplement public enforcement. Subsequent amendments to CPAs have generally expanded access to the courts. Such amendments have expanded the class of eligible plaintiffs, reduced evidentiary burdens facing prospective plaintiffs, and increased the scope and magnitude of available remedies. These trends in consumer protection law have contributed to a significant increase in litigation.

As a matter of economic theory, CPA liability could force sellers to internalize social costs associated with deceptive selling or marketing practices and thereby enhance efficiency. For example, CPA liability could increase economic efficiency and consumer welfare by granting recourse to consumers who would otherwise bear the cost of a producer's deceptive statements. Proponents of more expansive consumer protection legislation contend that "gaps" in FTC enforcement, irrational consumer behavior, and insufficient incentive for plaintiffs to bring small, but meritorious claims justify expanded CPA liability. Proponents also claim that CPAs can correct problems that arise in markets in which sellers uniquely possess information on the quality of the products sold to consumers.

However, economic theory also identifies potential social harms associated with such liability expansion. Specifically, if CPAs sufficiently increase expected liability for business activities associated with the production, marketing, and sale of consumer goods and services, consumers can be harmed in the form of higher prices. CPA liability, like excise taxes, can raise the marginal costs of production for the firm and result in reduced competition and output as well as higher product prices. Consumers may benefit initially from being afforded both more consumer protection rights and greater recourse to assert those rights, but they may ultimately suffer from overdeterrence of business activity that is economically efficient and socially beneficial.

Prior empirical research has documented that CPAs have become considerably more favorable to potential plaintiffs over time and that those states with more plaintiff-friendly CPAs also tend to have more litigation. In addition, prior research has also established that private state CPA enforcement appears to condemn business conduct that would be lawful under the FTC consumer protection policy standard.

Whether consumers actually benefit, on balance, from the expanded rights and increased litigation associated with CPAs frames an important policy debate. To date there has been no reliable empirical data available to facilitate that debate. In order to comprehensively evaluate the effects of expanding CPAs, one must consider overall consumer welfare, including the important effect of changes in CPAs on consumer prices.

Searle Civil Justice Institute Task Force on State Consumer Protection Acts and Costs to Consumers

To shed light on these issues, the Searle Civil Justice Institute (SCJI) undertook a large-scale, empirical study on state CPAs. SCJI commissioned a Task Force on State Consumer Protection Acts and Costs to Consumers (the Task Force) to advise and lead this study. The research and empirical analysis conducted for this Preliminary Report targeted the following policy issue: *What is the impact of expanded CPA liability on consumer prices?*

Data and Methodology

The Task Force engaged in an extensive data collection effort and undertook a comprehensive analysis of the statutory language in all 68 CPAs and subsequent amendments from the time of their adoption through 2009. The Task Force then identified and documented each CPA amendment to identify changes in several statutory attributes that emerged as key CPA provisions that could encourage (or discourage) potential plaintiffs from filing suit. The Task Force used this information to construct a CPA Index that tracked a potential plaintiff's willingness or ability to file a suit under the state's CPA over time.

The Task Force used a set of standard econometric models to evaluate the effects of changes in CPAs on automobile insurance premiums. The automobile insurance market has several unique features that render it useful for addressing some of these important policy concerns. First, insurance prices can be isolated by state to determine the impact of CPA law changes on prices. Second, laws that alter automobile insurance premiums have a substantial impact on consumers because automobile insurance is the largest of the property casualty lines of insurance. Third, sufficient data from CPA litigation are available to construct a test of the impact of CPAs on the insurance premiums. Fourth, automobile insurance prices are arguably the closest the insurance market has to a market price because they are not as highly regulated as other lines of insurance.

Thus, in order to inform the targeted policy issue with empirical data, the Task Force analyzed the following specific research question: *What is the impact of different CPA provisions on automobile insurance premiums by state and over time?*

Key Findings

On average, states have increased access to the courthouse by making it easier to sue under CPA statutes.

The CPA Index measures the net number of changes likely to increase a plaintiff's ability or willingness to file a CPA suit. The increase in the average CPA Index suggests that, from 1994 to 2006, state CPAs became more "pro-plaintiff."

States with relatively more “pro-plaintiff” CPAs are associated with higher automobile insurance premiums.

For states that do not exempt insurance from their CPAs, increases in the CPA Index scores are associated with higher combined average automobile insurance premiums. For example, a one standard deviation increase from the average CPA Index results in a 2.0% increase in combined average premiums. Given an overall combined average annual premium of \$838.72, a 2.0% increase translates to an additional \$17.81 the average consumer paid annually for automobile insurance.

Price increases occur after “pro-plaintiff” CPA statutes expand beyond a threshold level.

Initial changes that increase the CPA Index may lead to decreased combined average premiums, but additional changes ultimately result in higher premiums.

Many states have reached the threshold where additional CPA liability is likely to increase automobile insurance premiums.

For many states, CPA statutes have already been expanded to the point of increasing marginal costs and possibly diminishing marginal returns for consumers. At average CPA levels, a marginal expansion of CPA liability is likely associated with higher prices.

Changes in CPA provisions that allow for enhanced damages are associated with automobile insurance premium increases ranging from 10 – 16%.

Not all CPA provisions contribute equally to changes in automobile insurance premiums. The largest effect of CPA changes on insurance premiums involves provisions that allow for enhanced damages. These provisions, on their own, may increase the cost of premiums by \$80 per year.

Potential Policy Implications

The empirical observations in the SCJI Preliminary Policy Report on Consumer Protection Acts and Costs to Consumers have critical implications for state and federal policymakers:

1. **Continued expansion of CPAs may ultimately make consumers worse off.**
Consumer protection is no exception to the rule that there is no such thing as a free lunch. State consumer protection legislation and litigation can impose considerable financial costs on consumers. Although consumers may initially benefit from expansion of their legal rights, the continued expansion of liability is costly and may ultimately cause consumer harm.

2. **Policymakers considering incremental state consumer protection legislation or regulation should be required to articulate tangible benefits to justify the costs imposed on consumers.** Policymakers must remain mindful that no policy measure advances only benefits to the exclusion of any costs. Consumer protection provisions are no exception, and any perceived benefits must be balanced against any potential costs.
3. **Consumer protection reforms that allow enhanced or treble damages appear to create the greatest cost burden to consumers.** Not all consumer protection provisions have the same impact. While the benefits of CPA reform may outweigh the costs in some circumstances, the costs may clearly outweigh the benefits in others. Supplementing CPAs with enhanced or treble damage provisions must be accompanied with persuasive evidence that consumer benefits will exceed the likely increase in premiums.
4. **The analysis contained in this Preliminary Report could apply to other consumer protection enforcement efforts, including those at the federal level.** It is not unreasonable to extend this analysis to other consumer protection issues, such as those emerging from the Consumer Financial Protection Bureau and the Consumer Product Safety Commission.

This Preliminary Policy Report contributes new and useful information to the policy debates on CPAs. This new information must be read and interpreted with appropriate caution. Focusing on prices allows for the suggestion that expanded CPAs might have important negative consumer welfare effects holding non-price dimensions constant. However, the Report is not able to capture changes in non-price consumer welfare. Further, it is unclear how much of the total increase in costs associated with expanded liability under CPAs are borne by shareholders of automobile insurance providers rather than by consumers. Nevertheless, there is reason to suspect that consumers bear the bulk of the costs associated with CPA expansion. While these limitations suggest important areas for future research, the Report contributes valuable data to CPA policy debates by demonstrating that, at least in one major consumer product market, continued expansion of CPA liability is likely to result in increased costs to consumers in the form of higher product prices.

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