



The Unintended Effects of HB
5284 and HB 5285: Market
Power and Politicization of the
Michigan Economy

Gary Wolfram, Ph.D.
January 25, 2008



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Executive Summary

House Bills 5284 and HB 5285, which would allow Blue Cross Blue Shield of Michigan (BCBSM) to purchase nearly any other company and allow the Accident Fund to enter any line of insurance, would appear to increase the competitiveness of Michigan's insurance markets and reduce government intervention in the state's economy. But as Frederic Bastiat wrote in the mid 19th century, the difference between a good economist and a bad economist is the bad economist recognizes only the seen and the good economist also recognizes the unseen, the result of the bad economist's failure being what a modern economist would call the law of unintended consequences. The effect of HB 5284 and HB 5285 will actually be to cause distortions in not only the insurance markets in Michigan, but conceivably every portion of the economy. It will also increase government intervention in the markets rather than decrease it.

The summary reason for this counterintuitive result lies in the special tax status of BCBSM. BCBSM is exempt from Michigan state and local taxes. This provides it with a distinct advantage when competing with other Michigan and non-Michigan firms that are subject to these taxes. BCBSM has already established significant market power in the health portion of the insurance market and it has the potential of using this market power to its advantage in other industries if allowed to enter them as under the proposed legislation.

BCBSM has been able to build up reserves in excess of \$2.5 billion and assets in excess of \$5.2 billion, tax-free. (The Tax Reform Act of 1986 repealed the federal tax exempt status of Blue Cross beginning in 1987, but the previous decades of federal tax exemption helped immensely in building BCBSM reserves.) The accumulated reserves and assets could be used under the proposed legislation to bid for companies not only in the insurance business, but in any other industry. Competing bidders would have paid taxes as they attempted to accumulate reserves. *Ceteris paribus*, this would be a distinct advantage for BCBSM, since the state and local tax advantage is worth more than \$100 million per year. BCBSM has shown a strong desire to expand its holdings rather than reduce rates as it accumulates reserves. Since 2005 BCBSM and its subsidiaries have spent nearly \$450 million in acquisitions and forming new firms.

In 1994 BCBSM was able to purchase the Accident Fund, which it operates as a for-profit subsidiary. It was argued at the time that the tax advantage of BCBSM would be used to expand the Accident Fund's share of the workers' compensation market. Since the Accident Fund is a subsidiary of BCBSM, which can build its surplus tax-free, the

Accident Fund can operate with lower profits than it would otherwise be able to. This would allow it to offer rates to undercut competitors, currently in the workers' compensation industry, but in every sector of insurance if HB 5284 and HB 5285 were to pass. The market share of workers' compensation held by the Accident Fund has more than doubled since its purchase by BCBSM. Allowing the Accident Fund to move into other lines of insurance with the current tax-exempt status of BCBSM could lead to consolidation of other lines of insurance as well.

If all firms had lower taxes, this would indeed reduce prices for consumers. However, in the case of BCBSM, *one firm* with established market power is allowed tax-free status. This leads to market distortions and the potential for the favored firm, BCBSM, to gain market power and eventually manipulate the market. An indication that this is happening is the accumulation of BCBSM reserves at the same time that BCBSM rates have averaged annual increases of more than 10% over the past six years, and a further major rate increase is pending. Rather than lower rates in its primary market, health insurance, BCBSM is expanding into other markets.

Perhaps the strongest argument against HB 5284 and HB 5285 is that they would further extend politics into Michigan's insurance industry. This is because BCBSM is not a private company. As the Michigan Supreme Court noted in *Westland Convalescent Center v Blue Cross & Blue Shield of Michigan*, "We recognize the unique position held by BCBSM. Created by special legislation, it functions as a quasi-public, tax exempt institution." In his dissent in a later case, *Blue Cross & Blue Shield of Michigan v Governor*, Justice Levin added: "BCBSM has in effect become a controlled subsidiary of the State of Michigan."

BCBSM has become a health care service provider that is subject to political pressures and state intervention as legislation has over the last 68 years expanded the role of the legislature and the insurance commissioner in the operations of BCBSM. The fact that BCBSM's political action committee is among the largest in the state and its individual contributions were the largest or second largest in the 2005-06 election cycle for one-half of Michigan's state senators is an indication that BCBSM recognizes the strong interrelationship between it and the legislative process. Extending its reach into all lines of insurance and allowing it to become owner of companies in any industry will create a system where a holding company governed by a board appointed through the political process and regulated by the state government, owns a series of private companies whose pricing structure and behavior cannot fail to be affected by the political process. As the noted Austrian economist Ludwig von Mises pointed out, this will lead to unintended consequences that result in economic inefficiencies. These inefficiencies will result in further government intervention, which will exacerbate the problems.

It is undoubtedly an improvement to increase competition in the insurance industry by allowing consumer-driven market forces to generate economic efficiency. This will not be accomplished by expanding the number of firms under the umbrella of a quasi-government agency as would HB 5284 and HB 5285.

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I. Introduction

House Bills 5284 and HB 5285, which would allow Blue Cross Blue Shield of Michigan (BCBSM) to purchase nearly any other company and allow the Accident Fund to enter any line of insurance, would appear to increase the competitiveness of Michigan's insurance markets and reduce government intervention in the state's economy. But as Frederic Bastiat wrote in the mid 19th century, the difference between a good economist and a bad economist is the bad economist recognizes only the seen and the good economist also recognizes the unseen.¹ This is what a modern economist would call the law of unintended consequences. The effect of HB 5284 and HB 5285 would actually be to cause distortions in not only the insurance markets in Michigan, but conceivably every portion of the economy. It would also increase government intervention in the markets rather than decrease it.

The summary reason for this counterintuitive result lies in the special tax status of BCBSM. BCBSM is exempt from Michigan state and local taxes, including property taxes.² This provides it with a distinct advantage when competing with other Michigan and non-Michigan firms that are subject to these taxes. BCBSM has already established significant market power in the health portion of the insurance market and it has the potential of using this market power to its advantage in other industries if allowed to enter them as under the proposed legislation.

When the state of Michigan put the Accident Fund up for sale and it became apparent that BCBSM would make the highest offer, the Legislature recognized the inherent tax advantage and attempted to create a firewall between BCBSM's operations and those of the Accident Fund. Some opponents of the sale argued that the economic incentives to overcome the legislated barriers were sufficiently great that BCBSM would still be able to use its non-taxable status to unfair advantage to allow the Accident Fund to expand its share of the workers' compensation market. Data offered below indicate that these arguments were probably correct. Common sense would lead one to wonder why, if there were a complete firewall between BCBSM and the Accident Fund, BCBSM would bother to bid for the Accident Fund in the first place, much less be the highest bidder. The new legislation would not only allow the non-taxable status of BCBSM to be used in the workers' compensation market, but every market in Michigan.

¹ F. Bastiat, "What is Seen and What is Not Seen," (1848) in G. Bu de Huszar (ed.), *Selected Essays on Political Economy by Frederic Basitat*, (Princeton: Van Nostrand, 1964).

² Since the Federal tax reform acts of 1986, BCBSM has been subject to federal taxation.

To see the implications of HB 5284 and HB 5285, imagine the following. ACME Motors is granted tax exempt status in Michigan but it must operate as a non-profit. A firm that is a non-profit does not have to generate losses, it must only make sure that its revenues are spent or added to its surplus. This can entail large salaries for its officers, expensive buildings, any number of ways of retaining what would have normally been distributed as profits through dividends if it were a for-profit corporation. ACME, since it does not pay taxes while its competitors do, then accumulates surplus and assets faster than its taxed competitors over a twenty-year period. Then special legislation is passed to allow it to use its accumulated untaxed revenues and built-up surplus to bid against taxed businesses, and ultimately purchase Allstate Insurance. The untaxed revenue stream from ACME can then be used to allow Allstate Insurance to offer insurance rates that are below what it would otherwise have to charge to remain profitable. The unfair competition is compound – first untaxed capital is used for the initial purchase and then untaxed dividends, loans or services can be provided to the newly acquired subsidiary. Since other insurance companies do not have a parent company that has tax-exempt status, they cannot match the rates charged by Allstate. This would allow Allstate to expand its market share due to the tax advantage of its parent, ACME Motors.

It is a likely scenario that ACME Motors will expand market share because its board of directors and management are not concerned with maximizing stockholder returns as is the case with for-profit entities, but rather with gaining power and prestige by operating a large company. The tendency of managers and directors to expand market share at the expense of profits is part of what is known as the principal-agent problem in the economics literature. The principal-agent problem, in brief, is that the manager of a firm, unless the firm is structured correctly, will have incentives to operate the firm in a way that benefits the manager rather than the owner of the firm.³ In the case described, AMCE Motors would not only attempt to expand its market share in its own industry, but also operate its subsidiary in a way that would expand market share in the insurance industry as well. The managers would trade off profits for the firm and economic efficiency for personal prestige of operating a large company.

This is what has been the happening in the case of BCBSM. It has used its tax-exempt status to dominate the health insurance market. It purchased the Accident Fund and expanded its market share in the workers' compensation market, acquired other health industry firms and now seeks to expand its reaches into all other markets. Since 2005, BCBSM and its subsidiaries have spent nearly \$450 million in acquiring new companies and forming additional subsidiaries.

While it might appear at first blush that this is beneficial to consumers, as rates might be lower for subsidiaries of BCBSM since it does not pay state and local taxes and it will be using lower rates to expand market share, this is an illusion. Eliminating state and local taxes on *every firm* will result in lower prices for consumers. In the case of BCBSM, *one firm* with established market power is allowed tax-free status. This leads to market distortions and the potential for the favored firm, BCBSM, to gain market power and

³ For an analysis of the principal-agent problem see S. Grossman and O. Hart, "An Analysis of the Principal-Agent Problem," *Econometrica*, Vol. 51, No. 1, January 1983, pp. 7-45.

eventually manipulate the market. Once it has erected sufficient barriers to entry BCBSM can raise its rates. An indication that this is happening is the accumulation of BCBSM reserves and its acquisition of new companies at the same time that BCBSM rates have averaged annual increases of more than 10% over the past six years, and a further major rate increase is pending.⁴ Rather than lower rates in its primary market, health insurance, BCBSM is expanding into other markets.

The other result of HB 5284 and HB 5285 is the expansion of government into markets beyond the insurance industry. This is because BCBSM is not a private company. As the Michigan Supreme Court noted in *Westland Convalescent Center v Blue Cross & Blue Shield of Michigan*, "We recognize the unique position held by BCBSM. Created by special legislation, it functions as a quasi-public, tax-exempt institution."⁵ In his dissent in a later case, *Blue Cross & Blue Shield of Michigan v Governor*, Justice Levin added: "BCBSM has in effect become a controlled subsidiary of the State of Michigan."⁶

BCBSM has become a health care service provider that is subject to political pressures and state intervention as legislation has over the last 68 years expanded the role of the legislature, the attorney general, and the insurance commissioner in the operations of BCBSM. The history of this intervention is discussed below, but the point is that HB 5284 and HB 5285 would extend the political pressures that affect BCBSM into all sectors of the economy. For example, suppose BCBSM purchases Delphi and Delphi then loses \$600 million. This reduces the assets of BCBSM and in order to maintain its surplus and assets, BCBSM has to increase its health service premiums. If past is prologue, this will lead to political pressures for BCBSM to attempt to sell Delphi or for the state government to intervene in the operations of Delphi as well. This is but one example of how allowing a corporation whose board is controlled through the political process (as evidenced by changing the makeup of the BCBSM board through PA 350 of 1980) to own other companies will lead to further government intervention in the market economy. The fact that BCBSM's political action committee is the largest single-entity PAC in the state is another indication that BCBSM recognizes the strong interrelationship between it and the legislative process.

The above arguments against the passage of HB 5284 and HB 5285 are best understood in the context of the history of BCBSM and its acquisition of the Accident Fund, and a detailed discussion of how the tax-exempt status of BCBSM currently affects the market for workers' compensation. It is important to understand this history and how these bills would lead to further distortions in this market and markets in general.

⁴ See Table 3 below.

⁵ 414 Mich. 247 at 264.

⁶ 422 Mich. 1, at 59

*II. History of BCBSM and Accident Fund*⁷

A. BCBSM History

The thirty-nine companies that currently comprise the Blue Cross Blue Shield Association have their origins in a teacher-based system of pre-paid hospitalization organized by the President of Baylor University, Justin Kimball, in 1929. In response to the inability of teachers and others to pay for hospital care and financial problems at Baylor University's hospital, Kimball devised a program whereby teachers would be guaranteed 21 days of hospital care per year at the University hospital and a discount on the other days in return for a monthly payment of 50 cents. This plan was adopted by the teachers and other employer groups around Dallas. Soon the concept spread throughout the country under the Blue Cross symbol. Notice that Blue Cross was a plan whereby an association would contract with hospitals to accept patients for hospitalization and would contract with subscribers to receive a monthly payment. The goal was to stabilize hospital revenues and provide the ability of subscribers to obtain hospital care.

During the Great Depression the hospitals found themselves in financial difficulty as patients could not afford hospital care. The Blue Cross plans were able to reduce the problems associated with this by providing a stable source of funds to hospitals and guaranteed access for patients. However, these plans created a legal problem. Were these associations insurance companies and thus subject to asset and reserve requirements that bound insurance companies under state law? If so, then they would not be viable since the associations did not have the required amounts of capital to start up and the hospitals were generally non-profit entities that weren't interested in becoming a mutual or stock company.

Rather than imposing the same solvency standards that applied to insurance companies, New York enacted legislation in 1935 that allowed for the creation of these health service associations outside of the insurance law. The boards of the companies were to be made up of representatives of the hospitals, and the rates were subject to regulation by the insurance commissioner. The success of the New York statute led other states to follow suit.

In 1938, the Michigan Hospital Association led the drive to enact Michigan's first statute allowing the formation of a Blue Cross association in Michigan, the Michigan Hospital Service. Two enabling acts were passed in 1939, one to allow the formation of an association for prepaid hospital care and one for prepaid physician care as a mechanism for providing a flow of funds to medical service providers and keeping medical care costs reasonable.⁸ These Acts required the Michigan Hospital Service to be a non-profit

⁷ For a history of Blue Cross and Blue Shield nationally and in Michigan see S. Payton and R. Owsner, "Regulation Through the Looking Glass: Hospitals, Blue Cross, and Certificate of Need," *Michigan Law Review*, Vol. 79, December 1980, pp. 203-277, and R. Cunningham III and R. Cunningham, Jr., *The Blues: A History of the Blue Cross and Blue Shield System*, (De Kalb: Northern Illinois Press, 1997)

⁸ 1939 PA 108 and 109.

organization. The program was so successful that by 1941, after enrolling the employees of the automobile companies, Michigan had the second largest association in the United States. The problem was that hospital costs were rising substantially. Michigan Hospital Insurance rates were raised several times and hospitals still felt the reimbursements were not enough to cover costs. In 1955, Governor G. Mennen Williams established a Commission on Pre-paid Hospital and Medical Care Plans in response to a request by the Michigan Hospital Insurance Service (Blue Cross) for a 23.1 percent increase in rates. This was the eighth such request since the formation of the association.⁹ The Commission eventually released a two-volume study, *Hospitals and Medical Economics*, in 1962.

Two points warrant mentioning at this point in the analysis. First, the original law was designed to give hospitals a controlling interest on the board of Blue Cross. They controlled twenty-one of the forty-one board positions and nominated many of the public members. Second, the rates charged to subscribers quickly became a political issue. As Payton and Owsner put it in their *Michigan Law Review* article, "Blue Cross was particularly vulnerable to public outrage because it was the creature of state enabling legislation."¹⁰

Over time it became obvious that there was a conflict of interest between the subscribers, such as the automobile manufacturer employers, and the hospitals. The hospitals wished to fully cover costs and allow for expansion of equipment and means of treatment, while the subscribers wanted lower premiums. Since Blue Cross was a creature of the state, political pressure built on the Legislature to amend the statute to alter the board representation towards subscribers and away from hospitals. In 1974 the Legislature enacted legislation that allowed for the consolidation of Blue Cross (hospital) and Blue Shield (physician) corporations and altered the composition of the boards in response to the political conditions of the time.

In 1978, in addressing an attempt by the insurance commissioner to impose cost controls on BCBSM contracts, the Michigan Supreme Court ruled that the insurance commissioner was limited in his ability to regulate BCBSM.¹¹ Again, there was political pressure from the various special interest groups to gain control of what was the dominant firm in the health care industry. In 1980, the Legislature passed PA 350 and substantially altered the composition of the board of BCBSM to shift control firmly to the subscribers. When BCBSM brought suit to argue that the 1980 statute abrogated private contracts by changing substantially the governing structure of the corporation, the Supreme Court held that BCBSM was a quasi-public entity and had been so regulated in the past that the Legislature was free to further regulate it for a public interest.¹² This confirmed that BCBSM is not a private corporation and is fully subject to political control.

⁹ See Walter Polner, "Studies Without Economics," *Journal of Health and Human Behavior*, Vol. 5, No. 2/3, Summer 1964, pg. 119

¹⁰ Op. cit., pg. 244.

¹¹ *BCBSM v Ins Comm'r* 403 Mich 399.

¹² *BCBSM v Governor* 422 Mich 1

This symbiotic relationship between the Legislature and BCBSM has led and will lead to BCBSM engaging in what economists call “rent-seeking.” Rent-seeking occurs when individuals and firms use resources to affect political outcomes that will inure to their benefits.¹³ Given the history of state interference in BCBSM and the power of the state to direct BCBSM's activities, the incentive of the system is for BCBSM to spend a substantial amount of resources in attempting to influence legislative behavior. Once BCBSM is given the ability to use its reserves to purchase any business, and the Accident Fund is allowed to expand into insurance beyond workers' compensation, we should expect further government intrusion into Michigan's economy as BCBSM attempts to affect the rules of the game for its subsidiaries. One can imagine BCBSM using the argument that if a subsidiary it owns in the auto supply industry is given special provisions the extra profit could be used to reduce health care premiums for the indigent. The Legislature would be tempted to interfere in marketplace activities in which it would not ordinarily interfere.

Evidence of the politicization of BCBSM can be seen from data on its campaign contributions. According to Michigan Secretary of State data reported by MIRS News Service, only six of the 110 sitting House members have not received a campaign contribution from BCBSM since 2005 and all but 18 House members have received contributions in 2007.¹⁴ BCBSM's political action committee has raised enough money in 2007 to make it the third largest PAC in the state excluding the four legislative PACs, and the largest single entity PAC. In 2007 the BCBSM PAC contributed at least \$1000 to 34 of the state's 38 Senators and \$500 to another. The other three Senators received money in the 2005-2006 cycle. Half of the Senators reported that the BCBSM PAC was their first or second largest contributor in the 2005-06 election cycle. These figures are not surprising, given what the Michigan Supreme Court has recognized about the independence of BCBSM and the incentives for BCBSM to attempt to influence its regulators.¹⁵ This is further evidence that HB 5284 and HB 5285 will increase government intervention and create economic inefficiencies.

*B. Accident Fund History*¹⁶

The Accident Fund of Michigan was created by the Legislature in 1912 to provide workers' compensation insurance to Michigan employees.¹⁷ The Fund essentially operated as a mutual company with an advisory board elected by the policy holders acting as its board of directors. In 1976 the Attorney General ruled that the Accident

¹³ The classic article on rent seeking is Gordon Tullock, "The Welfare Costs of Tariffs, Monopolies, and Theft," *Western Economic Journal*, 1967, 224-32

¹⁴ Data on BCBSM campaign contributions comes from Rich Robinson, "Blue Cross PAC Touches Everyone," MIRS News Service, December 4, 2007.

¹⁵ For the classic article on the regulatory body being captured by the regulated industry, see G. Stigler, "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science*, Vol. 2, No. 1, Spring 1971, pp. 1-21.

¹⁶ For a history of the Accident Fund, see Bradley Smith, *The Michigan Accident Fund: A Need for Privatization*, The Mackinac Center, September 23, 1987.

¹⁷ 1912 PA 10

Fund was a state agency.¹⁸ This began a series of maneuvers regarding the status of the Fund. By 1984 the Fund had become the largest writer of workers' compensation insurance and the Insurance Commissioner brought suit seeking a declaration of whether the Fund was a state agency or not. The case was finally resolved in 1989 when the Michigan Supreme Court declined to hear an appeal of a decision that the Fund was a state agency.¹⁹

In 1993, procedures for the sale of the State Accident Funds were established by a series of enactments.²⁰ These included amendments to the BCBSM enabling legislation to allow it to bid for the Accident Fund as it was made clear that BCBSM would offer the highest amount for the Fund. The Accident Fund, now known as the Accident Fund Insurance Company of America was sold to BCBSM for \$262 million in 1994. While it should be relatively clear that this was the sale of a state agency to what Justice Levin called "a controlled subsidiary of the State of Michigan" many thought of the sale as "privatizing" the Accident Fund. A similar situation faces the Legislature in the case of HB 5284 and HB 5285. Once again, it appears that legislation may reduce government intervention in the market when it would actually increase it.

The history of BCBSM is of legislation that began with the Legislature protecting the ability of individuals to form associations to contract with providers and subscribers. Gradually the Legislature became more and more involved in shaping BCBSM. The 1993 legislation combined two state agencies into one, with one retaining its tax-exempt status and the subsidiary being taxed. If Accident Fund of Michigan is allowed to expand its insurance coverage beyond workers' compensation and BCBSM is allowed to purchase more subsidiary corporations with its surplus and assets, the result can only be unintended government encroachment into the Michigan economy the degree of which cannot be easily foreseen but which would certainly lead to further politicization of Michigan's corporate structure and additional distortions in the state's economy.

III. Effect on Insurance and other Markets from HB 5284 and HB 5285

As noted above, the tax-exempt status of BCBSM provides it with an advantage over other firms in the same industry. The fact that BCBSM and its HMO subsidiaries, Blue Care Network of Michigan and M-Care, control 43.67 percent of the accident and health Michigan premium, while its two nearest competitors, Health Alliance Plan and Priority Health control 8.75 percent and 6.00 percent, respectively, might indicate that BCBSM has advantages that other companies do not.²¹ As further evidence of the power of BCBSM, these figures significantly understate the degree of market share that BCBSM

¹⁸ AOG, 1975-1976, No. 5147 (December 7, 1976).

¹⁹ *Comm'r of Ins v Advisory Bd of the Michigan State Accident Fund*, 173 Mich App 566, 434 NW2d 433 (1988), lv den 433 Mich 872 (1989).

²⁰ 1993 PA 195 through 200.

²¹ See 2006 OFIS Annual Report pg. 82.

has, since they do not include administrative service contract (ASC) fees, an area that BCBSM dominates.²²

To see the effect of excluding ASC fees from premiums, one can look to the Office of Financial and Insurance Services (OFIS) 2000 and 2001 reports. In 2000, OFIS included in its annual report ASC fees in determining market share. In 2000, BCBSM alone (not including its subsidiaries) had 51.66 percent of the total ASC fees plus accident and health direct written premium. In 2001, OFIS excluded ASC fees from its calculation and the market share of BCBSM fell to 36.57 percent²³. Clearly, the exclusion of ASC fees severely understates the market share of BCBSM in the accident and health industry. Evidence that including ASC fees gives a clearer picture of the degree of dominance of BCBSM is that BCBSM has seven out of ten subscribers in the commercial health insurance market.²⁴

To be fair, as an entity controlled by the state, BCBSM has to comply with some requirements to provide service that will give it a disadvantage. However, there is strong evidence that the tax-exempt benefit is an advantage far in excess of any regulatory burden. Allowing BCBSM to purchase other businesses and to expand its Accident Fund subsidiary could have a substantial effect on the insurance industry and the rest of the economy. There is some indication that this advantage has been used in expanding the market share of the Accident Fund and that it would be used to affect the performance of any other subsidiaries it would be allowed to purchase under HB 5284 and HB 5285.

Anderson Economic Group has estimated the benefits of the tax exemption that BCBSM has under Michigan law at \$112 million for the year 2008. It estimates the costs of the statutory requirements, such as being the insurer of last resort and having to community rate its products to be \$7.7 million.²⁵ The order of magnitude of these estimates suggests that BCBSM has a considerable advantage from its tax-exempt status.

An indication that the AEG study is correct lies in the recent economic performance of BCBSM. Over the past five years BCBSM has more than doubled its surplus, from \$1.30 billion in 2001 to \$2.84 billion in 2006.²⁶ In addition, over the last five years BCBSM has earned more than \$1.81 billion in income before taxes. This includes underwriting profits of \$592.1 million, investment and other income of \$751.3 million, and subsidiary income of \$466.9 million.²⁷ These data mean that allowing BCBSM to purchase other corporations is no small matter. BCBSM is a large entity with substantial surplus and

²² Under a typical administrative services contract, BCBSM would be responsible for handling all administrative functions, such as: processing policyholder claims, managing plan enrollment, managing the premium and deductible subsidy program, and collecting insurer assessments.

²³ OFIS Annual Report 2000 and 2001.

²⁴ 70.14% of residents that are insured commercially are insured by BCBSM. This commercial market share is basically the share of those with insurance who are not enrolled in Medicare, Medicaid, or dual eligible. Calculated from various data sources. Calculation available upon request.

²⁵ Caroline Sallee, et. al., *Role of Blue Cross in Michigan's Health Insurance Market*, (Lansing: Anderson Economic Group, 2007).

²⁶ OFIS Reports, 2001 and 2006.

²⁷ Source of data is BCBSM Annual Statements (Nuyen, Tomtishen and Aoun.)

substantial income to allow it to aggressively enter whatever industry it chooses. BCBSM's desire and ability to expand its reach into other businesses can be seen by looking at recent history. Public Act 59 of 2003 permitted BCBSM to acquire under certain circumstances an insurer in the disability insurance market. Public Act 58 of 2003 allowed BCBSM the ability to offer long term care through a subsidiary. These amendments to PA 350 have resulted in the formation of the BCBSM subsidiary LifeSecure, the purchase of the Michigan Health Insurance Company and M-Care and M-Caid by BCBSM, and the acquisition of United Wisconsin Insurance Company and CWI Holdings by the Accident Fund, and LifeSecure's purchase of Verde Financial Corporation.²⁸

The state already has some evidence of unintended effects of allowing BCBSM to expand into other markets — the purchase by BCBSM in 1994 of the Accident Fund. The Office of Financial Insurance Services provided some information on workers' compensation market share in an annual report on competition until 2003. It has offered an annual one page statement since then. These data allow the calculation of the Accident Fund's workers' compensation market share for select years, as set out in Table 1. The annual OFIS report provides the Michigan direct premiums written for Accident Fund and U.S. direct premiums, which are also included in Table 1

Table 1

ACCIDENT FUND INSURANCE OF MICHIGAN 1995 – 2006*			
YEAR	MICHIGAN DIRECT PREMIUMS WRITTEN (IN MILLIONS)	WORKERS' COMPENSATION MARKET SHARE (%)	REMAINDER OF U.S. DIRECT PREMIUMS WRITTEN (IN MILLIONS)
1995	186.6	--	0
1996	150.8	12.2	0
1997	132.6	--	0
1998	123.0	11.6	0
1999	120.5	13.5	0
2000	209.5	16.7	0.4
2001	240.4	22.8	21.8
2002	306.6	--	62.6
2003	332.4	27.0	117.4
2004	349.6	--	173.3
2005	334.5	27.0	213.5
2006	267.5	--	252.1

Source: OFIS Annual Reports and Workers' Compensation Degree of Competition Reports (2000-2001) and Statements (2003 and 2005).

²⁸ For details see Notes to Financial Statements from BCBSM and LifeSecure 2006 Annual Statements. The Accident Fund's agreement to purchase CWI is subject to state and federal regulatory approval. See *San Francisco Business Times*, "Worker's Comp Company to be Sold" (August 28, 2007).

Note that the Accident Fund has managed a substantial growth in workers' compensation market share, from 12.2 percent in 1996 to 27.0 percent in 2005.²⁹ It is also clear that Accident Fund Insurance of Michigan has moved into other U.S. markets, beginning with less than one half million dollars in 2000, and expanding to \$252 million in 2006.³⁰ It turns out, then, that allowing BCBSM to use the Accident Fund as a subsidiary has been accompanied by more concentration in the workers' compensation market.

There are two major reasons for this. First, BCBSM has 70.14% of the Michigan residents with commercial insurance coverage.³¹ It also has a vast network of providers with whom it has contracts for the provision of medical services at rates below what other insurance companies can obtain. These lower rates are available because BCBSM can deliver many more customers than its closest competitors, yet these rates are not translated into lower rates for subscribers. Again, this network of subscribers and providers has been built up over almost six decades of state and local tax-exempt status and more than four decades of exemption from federal income taxes. This combination of subscribers and providers would give the Accident Fund a distinct advantage in selling workers' compensation. As in the telecommunications industry, consumers prefer to have their services bundled, allowing them to receive a bill for various services from one company. Having the ability to have your workers' compensation handled by a subsidiary of your health insurance carrier would be preferable than having to deal with two separate companies.³² It is also possible that the Accident Fund would be able to make use of the provider agreements that BCBSM has negotiated. While BCBSM's license agreement with the national association currently would prohibit this, there is no certainty that this agreement will continue to hold in the future, nor is there a sufficiently strong provision in current law or in HB-5284 or HB 5285 that would prohibit or limit the Accident Fund's access to BCBSM agreements.³³

In addition to its market dominance and bundling advantage, the tax advantage of BCBSM can be used to expand the Accident Fund's share of the workers' compensation market. Since the Accident Fund is a subsidiary of BCBSM, which can build its surplus tax-free, the Accident Fund can operate at lower profits than it would otherwise. As explained in Section I above, this will allow it to offer rates to undercut competitors, currently in the workers' compensation industry, but in every sector of insurance if HB 5284 and HB 5285 were to pass.

²⁹ This would contradict arguments that The Accident Fund cannot compete as a mono-line insurance company.

³⁰ OFIS Reports

³¹ See footnote 24, *supra*.

³² As noted above, strictly speaking BCBSM is not an insurance company, however, most people do not make that distinction.

³³ While MCL 550.1207 and 550.1008 place some limitations on BCBSM's ability to package insurance, these are easily overcome.

IV. Competitiveness Argument

An argument in favor of the Accident Fund being able to enter other lines of insurance is that this will create further competition. The discussion of Section III demonstrates that rather than increasing competition, the ability to use indirectly the tax-exempt status of its parent company will more likely lead to concentration in the other insurance lines. This risk might be undertaken if the other lines of commercial insurance were heavily concentrated. However, this is not the case.

In order to get a picture of the competitiveness of the Michigan insurance markets it is useful to use AMBest data to examine market concentration. Table 2 shows the result of this analysis for workers' compensation, commercial multi-peril liability, and commercial auto liability. The top ten company groups are listed with their percentage share of Michigan direct written premium in 2006.

Table 2

Workers' Comp		Comm Multi-Peril Liability		Comm Auto Liability	
Company	Market Share	Company	Market Share	Company	Market Share
Accident Fund Group	24.84%	Auto-Owners Insurance	13.36%	Travelers Insurance	8.75%
Liberty Mutual Insurance	7.37%	Hanover Insurance	7.57%	Auto-Owners Insurance	8.41%
American International	6.92%	Travelers Insurance	6.35%	American International	7.37%
Amerisure	4.29%	Frankenmuth Financial	5.17%	Zurich Financial	5.27%
Travelers Insurance	4.27%	CAN Insurance	4.36%	Hanover Insurance	5.02%
Hartford Insurance	4.08%	Cincinnati Insurance	4.01%	CNA Insurance	4.15%
Auto-Owners Insurance	3.67%	Nationwide Group	3.86%	Liberty Mutual Insurance	3.80%
Zurich Financial	3.62%	Liberty Mutual Insurance	3.68%	Progressive Insurance	3.73%
Frankenmuth Financial	3.45%	Hastings Mutual Insurance	3.65%	Michigan Farm Bureau	2.82%
Hanover Insurance	3.45%	Chubb Group	3.42%	State Farm	2.70%

In 2006, the Accident Fund and its subsidiaries had a market share for direct written premiums in Michigan for worker's compensation of 24.8%. This is more than three times the market share of its next competitor, the Liberty Mutual companies, at 7.37%. The market share of the tenth largest group of companies, Hanover Insurance Property and Casualty, was 3.45%. One can calculate a standard measure of industry concentration, the Herfindahl-Hirschman Index (HHI), which takes into account the number of firms in the industry and the inequality of market shares as a way to measure competitiveness.³⁴ While there are a number of difficulties with this measure, it provides a general picture of the concentration of an industry. The HHI for a perfectly competitive industry approaches 0, while the HHI for a monopoly is 10,000.³⁵ For Michigan's workers' compensation market, the HHI for 2006 was 867.9. This reflects a relatively competitive industry. Indeed, any lack of competitiveness stems from the high market share of the Accident Fund group.

The largest firm in the commercial multi-peril liability market was Auto-Owners Insurance Group, with a 13.36% market share. The tenth largest firm is the Chubb Group of Insurance Companies with 3.42%. The HHI for commercial multi-peril is 463.66, reflecting a competitive industry.

The commercial auto liability market is even more competitive. Travelers Insurance Companies had the largest market share in 2006, at 8.75%. The tenth largest firm was State Farm Group with 2.70%. The HHI was 381.74, again indicating a competitive industry.

This data indicates that there is not a problem of lack of competitiveness in lines of insurance that needs to be rectified by allowing the Accident Fund to write insurance lines other than workers' compensation. On the other hand, the risk that the passage HB 5285 will result in greater concentration in not only workers' compensation but also other lines of insurance is significant.

V. Premium Reduction Argument

An argument might be made that allowing BCBSM to use its reserves to purchase other companies and operate them as for-profit subsidiaries will lead to lowered rates for BCBSM subscribers. This would be contradicted by the evidence. BCBSM purchased the Accident Fund in 1994 and yet subscriber rates continue to escalate. BCBSM has most recently requested a 24.3% increase in individual coverage rates. This is being challenged, but if this rate increase is granted, the cost of an individual policy will more than double since 2002. Individual coverage rates rose 23.0% effective March 1, 2003, 15.0% effective March 1, 2005, and 15.0% effective April 1, 2006.

³⁴ For a discussion of this index see, for example, D. Waldman and E. Jensen, *Industrial Organization: Theory and Practice*, 2nd edition, (Boston: Addison Wesley, 2001), pp 96-97.

³⁵ For a discussion of the problems with the HHI, see D. Armentano, *Antitrust: The Case for Repeal*, 2nd edition, (Auburn: Ludwig von Mises Institute, 1999), pp. 85-86.

Average rate increases for employer groups exhibit a similar pattern as shown in Table 3.

Table 3
Average Rate Increases BCBSM Group

Year	Under 100 Employees	Over 100 Employees
2001	16.1%	14.6%
2002	17.2%	17.8%
2003	17.9%	17.3%
2004	10.2%	12.5%
2005	7.7%	9.7%
2006	6.2%	4.2%
2007/Q1	7.2%	7.2%

Source: Nuyen, Tomtishen and Aoun, P.C., Northville, MI

Employer group rates increased by double digits for the first four years of the period and surpassed the rate of inflation in the remaining three. These rate increases are consistent with the doubling of the surplus of BCBSM during the same period. It is thus hard to argue that the purchase of the Accident Fund has resulted in lower subscriber premiums or that the movement of the Accident Fund into other lines of insurance and the expansion of BCBSM into any line of business it chooses will lead to lower premiums.

VI. Conclusion

While HB 5284 and HB 5285, by allowing BCBSM to purchase other companies and the Accident Fund to expand its line of insurance, may appear improve competition and efficiency in Michigan insurance markets, they would do just the opposite. These bills would extend the ability of a tax exempt corporation to further compete with tax paying firms, allowing it to further concentrate the health insurance industry that it dominates and expand this domination into other insurance lines that are currently competitive.

The bills would likely to further increase government intervention and politicize the Michigan economy. The Michigan Supreme Court acknowledged BCBSM functions "as a quasi-public, tax exempt institution." The makeup of its board of directors is set by statute in a very detailed way, reflecting the political climate at the time the legislation was passed.³⁶ When political pressures mount due to unanticipated results of the investment strategies of BCBSM under HB 5284 the Legislature will be pressured into further unanticipated intervention in the Michigan economy.

As a result of prior legislation, the Accident Fund, which competes against other private insurers, became a private insurer owned wholly by the quasi-private BCBSM. This created a conundrum, as the competitors of the Accident Fund and their parent companies pay taxes and its parent does not. While there was an attempt to segregate the workings of Accident Fund from BCBC, the fact that BCBS bid hundreds of millions of dollars for the Accident Fund would indicate the separation was not intended to be complete. If it

³⁶ See MCL 550.1301.

were, there would have been no reason for BCBS to buy the Accident Fund in the first place. Data on the Accident Fund's market share is consistent with its ability to use its association with BCBSM to expand its position in the workers' compensation area. HB 5285 would further exacerbate the issue by allowing the Accident Fund to move into other insurance lines.

The end result of the passage of HB 5284 and HB 5285 would be a complicated amalgam of private insurance companies that pay taxes and are regulated in one fashion, and a tax-exempt, non-profit health care corporation that owns private insurance companies. It would be very difficult to keep the entity that does not pay taxes from competing directly with companies that do pay taxes and maintain a level playing field. Any attempt to do so would result in further government intervention

Creating a chain of insurance and other companies owned by a tax-exempt, non-profit health care corporation governed by statute creates at least two problems. The most obvious is that this would produce an insurance market where competing companies face different tax liabilities, giving an advantage to the untaxed company. This, of course, distorts consumer choice and results in an inefficient market. But perhaps the more important is that it would create a system where a holding company governed by a board appointed through the political process and regulated by the state government, owns a series of private companies whose pricing structure and behavior cannot fail to be affected by the political process.

It is undoubtedly an improvement to increase competition in the insurance industry by allowing consumer-driven market forces to achieve economic efficiency. This will not be accomplished by expanding the number of firms under the umbrella of a quasi-government agency as would HB 5284 and HB 5285.

About the Author: The author is President of Hillsdale Policy Group, Ltd, the George Munson Professor of Political Economy at Hillsdale College, and a member of the Board of Trustees of Lake Superior State University. He is the author of *Towards a Free Society: An Introduction to Political Economy* and has published numerous works on public policy issues. He has served in numerous policy positions, including Michigan's Deputy State Treasurer, as a member of the Michigan State Board of Education, and Congressman Nick Smith's Washington Chief-of-Staff. Dr. Wolfram received his Ph.D. in Economics from the University of California at Berkeley and has previously taught at the University of California at Davis, Mount Holyoke College, Washington State University, and the University of Michigan at Dearborn.