



P O L I C Y   R E P O R T

# North Carolina's Unfair Auto Insurance System

ELI LEHRER  
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July, 2008

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## Executive Summary

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North Carolina's government-controlled auto insurance system is unfair to good drivers because it overcharges them in order to subsidize some of the state's more risky and dangerous drivers.

Every auto insurance policy written in the state has a hidden tax – which averages 6 percent – that goes to the government-mandated, privately run insurance pool. This pool uses the tax to subsidize the policies of risky drivers who should, but don't, pay higher rates because of a legal cap. Current regulations place a maximum on auto insurance rates. Insurance companies are allowed to dump into a risk pool anyone whose risk factors are such that a rate below the maximum would be unprofitable. Even though these people are placed in the high-risk pool, the rates that they pay are still subject to the cap. The tax money is used to make up the difference between the capped rate and the amount that the high-risk driver should pay.

Some private insurance companies like the system because it guarantees them a profit by allowing them to dump risky drivers into the government-mandated tax-subsidized pool. In fact, 25 percent of N.C. policyholders are in the pool compared to less than 2 percent nationally. Not only is the tax hidden, the pool is hidden because risky drivers in the pool continue to receive bills from their private insurance company. This allows the private company to sell these customers other types of insurance, such as life and home insurance.

Who are these risky drivers who receive unfair subsidies from good drivers? Nobody knows for certain since companies can cede any risky driver they want into the pool. But it's highly likely that many are teenage males who may have clean driving records, but as a group are more prone to tickets and accidents. Since the government-controlled rate

setting process does not allow insurance companies to use age as a factor, the 18-year-old who drives a red sports car pays a rate that does not reflect his risk of an accident. (Drivers with multiple tickets or serious accidents regardless of age also end up in the government-mandated pool, but, on balance, they do pay rates that reflect their risks)

While average rates in North Carolina are in line with other states in the Southeast, good drivers are still paying more than they should. The reforms suggested below would simplify the current bureaucratic system and lower rates for many, if not most, drivers in the state.

### **FIXING THIS UNJUST SYSTEM**

First, abolish the 6 percent tax on all insurance policies that unfairly penalizes good drivers to subsidize many risky drivers.

Second, abolish the Rate Bureau and replace it with a system that allows market forces – rather than a government-mandated agency – to set rates.

Third, instead of guaranteeing insurance companies a profit, repeal the laws that prevent them from using proven risk factors such as age and gender and limit their use of credit scores. These factors accurately assess risks so drivers who pose the greatest risks of accidents pay the highest rates. When drivers pay rates based on their risk of accident, it makes the roads safer for all of us.

Fourth, change the burdensome “prior approval” system that prevents insurance companies from offering innovative products such as rebate checks for good drivers and quote comparison for insurers. These products are available in almost all other states but are not offered to N.C. drivers because the current bureaucratic system makes it very difficult for insurers to offer them in North Carolina.

## Introduction

North Carolina's automobile insurance market does not work. It does not allow customers to purchase the products they want and does not allow insurers to sell them. About one North Carolina resident in four cannot find coverage in the private market at any price and purchase it instead through a government-mandated insurance pool. Although hidden from the state's public via a system that keeps private companies' names on every insurance policy in the state, the sheer size of this government-run market has consequences for almost everyone who drives in North Carolina.

This paper analyzes North Carolina's current automobile insurance system and outlines its consequences for the consumer. The paper consists of three sections: the first describes how the system works today, the second examines its consequences for the state, and the third considers a number of ways to improve and change the system. The paper reaches a simple bottom line: North Carolina's insurance system is unjust, expensive for good drivers, choice-limiting for all drivers, burdensome on insurers, and, in the end, needs to change.

### CHART 1: NORTH CAROLINA'S RESIDUAL MARKET IN NATIONAL PERSPECTIVE

All fifty states and the District of Columbia have residual market laws to provide coverage for people unable to secure insurance in the private market. A few states have no policies at all in their residual markets; others, like South Carolina's are quite small. North Carolina's residual market—the state reinsurance facility—stands as the largest in the nation by a significant margin. Six out of ten Americans who take part in residual—that is, statutorily created—auto insurance markets live in North Carolina. Some states by market size—number-percentage of auto policies:

State	Residual market size	% of auto policies
Ohio	0	0%
South Carolina	2	.000006%
Georgia	41	.0002%
Tennessee	96	.002%
Florida	283	.002%
New Jersey	88, 921	1.8 %
North Carolina	1,546,437	23.5%

*Source: Automobile Insurance Plans Service Office.*

## I. How the System Works

Five parties play major roles in setting North Carolina's automobile rates: a rate bureau, the insurance commissioner, the court system, the Reinsurance Facility, and private insurers. The resulting system is inflexible and resistant to innovation. Understanding the role that each party plays can illuminate the workings of the system and explain why the system remains unclear to consumers.

The North Carolina Rate Bureau, a state agency independent of the insurance department and largely under the control of the insurance industry, begins the rate-setting process. Under state law, the Rate Bureau develops a rate plan that all insurers must use as the basis for their rates. In creating the rate plan it creates a single rating matrix that impacts the rates for every person in the state. Although it considers

things like driving history, driving experience, and geographic location, the rate plan must exclude factors like age and gender that many insurers would use if the state would allow it. The rate plan also contains actuarial justifications showing why the rates make sense. It also builds in a degree of profit for insurance company shareholders and policyholders. Each rate plan contains an overall increase or decrease in rates based on changes in insurers' underlying costs as well macroeconomic risk factors like the costs of car repairs and the number of traffic accidents during the previous year.

The insurance commissioner receives the plan from the Bureau and reviews it. He or she can accept it without changes – something that has never happened – or request changes. If the commissioner requests changes, then he or she must also hold

hearings unless he can settle with the insurance industry before the hearings take place. The public hearings, a process that can often last more than a week, require the commissioner to play a dual role as both hearing officer and advocate. While the law requires the commissioner to serve an impartial role as a hearing officer, the commissioner also has an obligation to speak for his or her department. Following the hearings, the commissioner makes a decision and, if the Rate Bureau – which represents the industry – does not like the decision, it may take the matter to court. In the meantime, the insurers may charge based on the Bureau's rate plan (or another one that takes some, but not all of the commissioner's concerns into account) but must escrow the difference between the commissioner's approved rate plan and their own and pay back money at the prime lending rate plus 3 percent to anybody to whom they refund.

Then the case goes to court. The courts, although important in the process, rarely decide things in a final fashion. One 1996 case provides a typical outcome. The bureau had asked for a 10.8 percent increase in private automobile rates, and the commissioner wanted a 13.8 percent decrease. The court faulted the commissioner for failing to take dividends (payments to policy holders) and deviations (lower rates granted to people with preferred risk characteristics) into account. In addition, it ruled that the commissioner calculated the insurers' total rate of return correctly and acted within his powers to use accounting measures different from those the Rate Bureau used. The court also faulted the Rate Bureau for using data and trend models that "lack credibility." As a result, the court upheld some parts of the decision, vacated (overturned) others, and remanded others to the insurance commissioner for further consideration. Eventually, the Rate Bureau and the commissioner settled the case in 2000 (perhaps not coincidentally, an election year), resulting in partial refunds to nearly all North Carolina drivers. Between 2003 and 2007, the commissioner and Rate Bureau have always settled without going to court. Hearings for 2008, however, took place in late June and early July with the commissioner and Rate Bureau a good distance apart. The commissioner wanted to cut rates 20 percent, and the Bureau

#### CHART 2: RATE HEARING OUTCOMES BY YEAR

When a rate case goes to court, insurers charge rates that the rate bureau devises but escrow the difference between the commissioners' mandated rates and the rates they want to charge. When the commissioner reaches a settlement, some or all of the funds are returned to policyholders. Some recent years include:

YEAR	OUTCOME
1987	Companies kept all of the escrowed funds
1989	Companies returned all of the escrowed funds
1994	Companies returned some of the escrowed funds
1996	Companies kept all of the escrowed funds
2001	Companies refunded all of the escrowed funds
2002	Companies refunded some of the escrowed funds

avored raising them 13 percent. In every case, however, the difference doesn't matter: neither the Rate Bureau, nor the insurance commissioner, nor the courts actually make the rate plan. Instead, legal settlements between the insurance commissioner and Rate Bureau – conducted out of the public eye – largely create the rates ultimately approved.

But even these compromises do not result in the final rates. Instead, the rates that most North Carolina residents actually pay come from "rate deviations" that insurance companies file – rating plans that depart from the criteria in the Bureau plan that the commissioner approves. Under North Carolina's current system, insurers can always charge less than the Bureau rates but not more. A few deviations, most importantly the safe-driver discount for people who have avoided serious accidents and speeding tickets, exist in long-standing statute law. All other deviations that exist come from other underwriting criteria that insurers decide to use. Some insurers, for example, might extend special discounts to people with very long accident-free periods or particularly desirable risk characteristics like good credit scores. The rates that result from the system thus almost always fall below the rate plan approved by the bureau. Although current insurance statutes allow deviations upward or downward, the

current insurance commissioner has approved only downward deviations. Drivers with particularly undesirable risk characteristics – young male drivers in high density areas who own sports cars, for example – still do not pay private rates above those in the approved plan.

These drivers, and many others, end up in the state's so-called residual insurance market – the market of last resort. The North Carolina Reinsurance Facility, which shares staff and offices with the Rate Bureau, remains opaque to most people – even those who receive insurance coverage through it. Drivers covered by the Facility get statements that look almost identical to those other drivers receive, do business with the same agents, and call the same 800 numbers for policy questions. “Many of my students are in it,” says Professor David

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*“Drivers with particularly undesirable risk characteristics – young male drivers in high density areas who own sports cars, for example – still do not pay private rates above those in the approved plan.”*

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Marlett of Appalachian State University. “But they don't know it until I actually tell them about it – and they're *insurance* students.” In all cases, however, their actual insurance comes through the facility. On its official Web page – and in very similar language found in its annual report, the Facility makes its own views clear:

There appears to be a common misconception that an insurance company somehow benefits from placing business in the Facility. First, there is no financial benefit to any company in ceding a profitable risk to the Facility. Any opportunity for making a profit on that risk is forfeited by the company once it is ceded. The only profit a company can make is on that business that it retains on its own books through the voluntary market.

Although none of this is untrue on its face, it requires a certain amount of explanation: while not a major profit center, the Reinsurance Facility's existence – and the openness of access to it – *does*

benefit portions of the insurance industry.

The Facility – the only one of its type in the country – allows any insurer with doubts about the profitability of any policy to transfer it (cede in insurance parlance) to the Facility. The insurer does give up its fundamental business profitability when it does this. It still collects fees for servicing the policy: the fees it receives for day-to-day service are calibrated to its own costs or industry averages—whichever is lower. The fees it receives for claims service, on the other hand, draws on overall industry averages or its own costs. While it may technically be possible for some insurers to make small profits off of claims service in a given year, no company can count on these profits or incorporate them into a business model.

On the other hand, insurers do derive two benefits from the Facility. First, insurers maintain business relationships as a result of the Facility's existence. An insurer that cannot profitably write an auto insurance policy for a consumer can still keep the consumer on its books and use the relationship to sell homeowners' insurance, investments, life insurance, or other products. In other words, insurers never need to send anyone a formal “non-renewal” notice. Second, some insurers may use the facility to help them deploy capital more efficiently in the North Carolina market. Most larger insurers cede almost exactly the “state average” percentage of business – 25 percent – to the Facility. A few, most of them mutual insurers, however, cede significantly smaller percentages of business to the Facility. No insurer would talk to the author on the record about the manner in which it transfers, but one executive gave the author a general overview of who it transfers to the Facility: “It's mostly teenage boys, people with sports cars, and old people,” he said.

Two factors may explain the current situation. First, some insurers serve distinctly different populations. USAA, for example, focuses heavily on people who have served in the military, and it's possible that they may simply be insurable at lower rates. Second, some insurers may have different business models. An insurer that believes it can get a 10 percent return on capital might not tie it up writing a profitable insurance policy that would return only 3 percent. “We don't need to know and, in fact,

can't really know why companies cede business to the Facility," explains Ray Evans of the North Carolina Rate Bureau (which operates together with the Reinsurance Facility).

**A CONFUSING, EXPENSIVE SYSTEM**

Drivers sent into the Facility – few of whom likely even know of its existence – fall into two groups: one called “clean risks” and the other called “other than clean” or “dirty” risks. Essentially, “dirty risks” are people who have committed traffic offenses or made insurance claims that “count” under state law, while clean risks have not done these things. By any objective standard, clean risks do not necessarily have clean driving records, nor is there any lack of proof that they pose a risk. Likewise, even though the very worst drivers are all “dirty risks,” a given “dirty risk” is not necessarily a worse driver than a given “clean risk.”

For all intents and purposes, the two categories are the product of state law rather than any calculation of actuarial risks. Clean risks can commit quite a few traffic offenses. Many may have multiple speeding tickets, gotten into accidents, and had tickets dealt with under “prayer for judgment continued” (a simple continuance that a judge grants without making a decision). Although nearly all truly awful drivers – people with DUI and reckless driving convictions – are “dirty” risks, many not-so-bad drivers also may fall into the dirty risk category.

Some examples may help clarify things. A male 18-year-old with a new Porsche who gets two speeding tickets in a year (one for going 15 miles over the speed limit the other for going 9 miles over the speed limit) can stay in the “clean risk” category. He would do this by getting the 15-mph ticket dealt with under “prayer for judgment continued” and paying the

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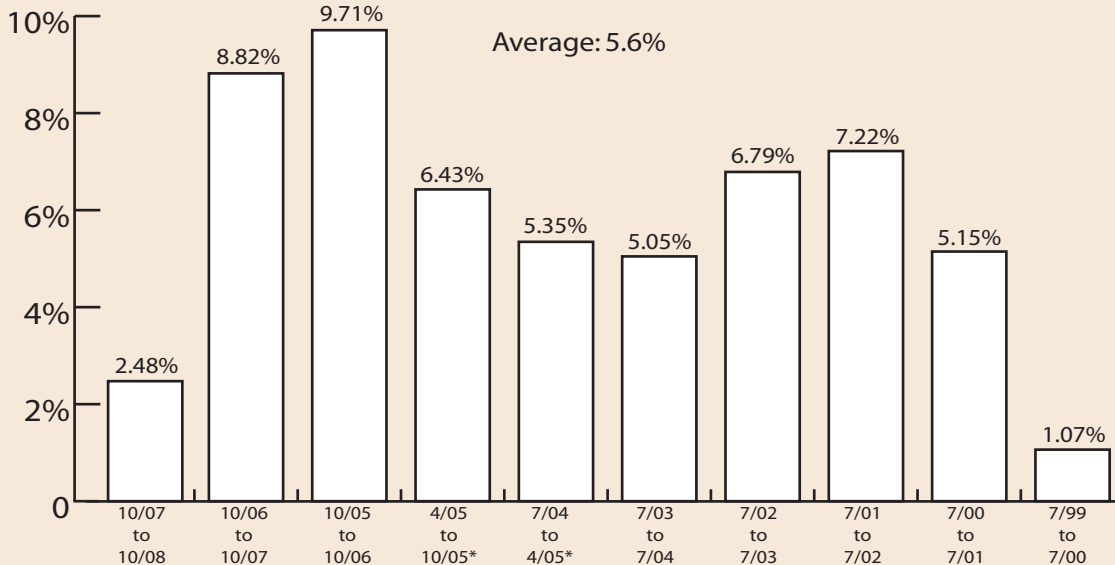
*“Thus, all of North Carolina pays a special tax to subsidize the “clean” risks in the Facility. This tax, officially the “Reinsurance Facility clean risk surcharge,” averages about 6 percent a year on every auto insurance policy in the state.”*

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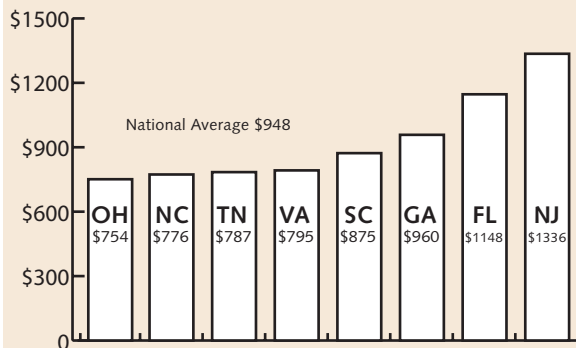
fine on the other. A female 60-year-old who drives an underpowered Buick and has a perfect driving record will very likely get counted as a “dirty risk” the day she backs into a Mercedes in a parking garage and dents its expensive \$1,900 headlights.

This has significant fiscal implications because, in 2007, 68 percent of people in the Facility remained in the “clean risk” category. In general, “clean” risks in the facility pay the maximum rates allowed under the approved rate plan for private liability coverage. “Dirty” risks, on the other hand, pay much higher rates. The crucial difference is this: “Dirty” risks cover their own way, and clean risks

**CHART 3: THE “TEENAGER TAX” BY YEAR**



**CHART 4: AVERAGE AUTO INSURANCE PREMIUMS AND EXPENDITURES BY STATE FOR SELECTED STATES**



Source: National Association of Insurance Commissioners, 2004/2005 Auto Insurance Database Report. (North Carolina Figure Includes Teenager Tax.)

do not. Everybody in the state pays a rate for the clean risks.

#### THE "TEENAGER TAX"

Thus, all of North Carolina pays a special tax to subsidize the "clean" risks in the Facility. This tax, officially the "Reinsurance Facility clean risk surcharge," averages about 6 percent a year on every auto insurance policy in the state. It provides a yearly reminder that the government-authorized underwriting criteria do not provide a proper assessment of the risks. If "clean" risks really were clean and actually had good driving records, then, in the aggregate, the Facility would break even writing insurance for them. Since they do not, the Facility loses money each year, and the state as a whole must pay for it.

Few North Carolina residents know about the tax because, for more than 20 years, insurers have been forbidden to disclose it on statements. Insurance agents were behind the change. "Agents found it very difficult to explain, everyone was asking," says Bob Bird of the Independent Insurance Agents of North Carolina. "So it was just easier to leave it out." Bird adds that many people did not pay the surcharge (contending they hadn't "ordered it") and, thus, under state law, found themselves dropped by their insurers for non-payment of premiums. Thus he concluded, "not having the surcharge is really a consumer benefit."

Whatever one thinks of the surcharge, it surely raises automobile insurance rates for everyone in

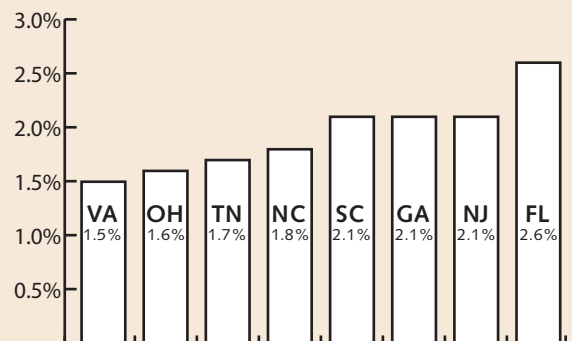
the state. The chart below shows its size in recent years. It has averaged 6 percent a year over the last ten years.

#### THE VOLUNTARY MARKET

Most auto policies – about 75 percent – do not end up in the Facility. Instead, insurers write them in the private market. While any insurer operating in the state can simply use the Bureau's rate plan, nearly all file "deviations." Although no law or official written policy says so, Jim Long – Commissioner of Insurance since 1985 – has made it clear that he will not allow insurers to charge anyone more than the Bureau rates for liability coverage. (Physical damage coverage – which pays for damage to one's own car -- operates in a reasonably free market. Essentially, insurers can charge whatever rate consumers consent to.) On average, motorists pay less than the Bureau Rates, 12 percent less to be exact. These rates are very similar to those in nearby states in absolute dollars (see chart Page 7). When compared to household income, they remain similar. North Carolina residents—who make less money and drive less expensive cars than the wealthier population of Virginia – actually devote a larger percentage of their income to auto insurance than

**CHART 5: AVERAGE PREMIUM AS A PERCENTAGE OF MEDIAN HOUSEHOLD INCOME FOR SELECTED STATES**

Raw premiums don't provide a full picture. Wealthier states often have higher costs of doing business—agents and claims adjusters need to earn more—higher traffic densities and involve residents who drive more expensive cars. Thus, it's often useful to compare



Source: Authors' calculations based on United States Bureau of the Census, "Two Year Average Median Household Income By State 2004-2005."

their neighbors.

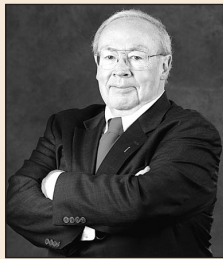
For all its complexity, North Carolina's auto insurance system seems to do little for the state's residents. It's not clear at all if it saves money for anyone. Given that 75 percent of the state can get insurance at costs less than the bureau/court/insurance commissioner-imposed rate cap, little evidence exists that the rate cap stops insurers from "soaking" good drivers. If the rate cap actually suppressed rates, then insurers would either leave the state (since they would be losing money) or, at minimum, charge everyone the maximum rate the insurance commissioner would allow. Since neither of these

things has happened, it's logical to conclude that the system does not keep rates down. Most North Carolina drivers pay the same rates they would elsewhere.

Whatever its flaws, the system seems stable. If it does not save money, the system does not seem unduly expensive for the state's drivers. Insurers have not fled the state, and most North Carolina residents pay reasonably low insurance rates. Thus, a question arises: does the system need change?

### IS THIS ALL A MATTER OF PERSONALITY?

All discussions of North Carolina's insurance system eventually come to touch on Insurance Commissioner Jim Long. First elected in 1984 and set to retire in January 2009, Long currently stands as the nation's longest-serving elected insurance commissioner.



**Jim Long**

By all accounts, Long is charismatic, always cordial in social situations, a master politician, honest, and competent at his administrative duties. And, given his lopsided election victories, it's clear that voters either love him or his political party.

The insurance industry has a mixed impression of Long. Some people in the insurance industry, particularly insurance agents, like him quite a lot. "We have an open door with Jim Long," says Bob Bird, President of the Independent Insurance Agents of North Carolina. "He's always responsive. Sometimes he agrees with us, sometimes he disagrees with us. But he always listens." Others in the industry — mostly insurers — have less kind comments. "The insurance department is an

example of management by mood," says Alan Bentley, a leadership development associate for State Farm. "Sometimes things will be great. Sometimes, we'll have to fight to get the simplest filing out of" the insurance department.

On one issue — his steadfast refusal to grant any upward deviations in insurance rates — Long has clearly had a direct impact on the rates some individuals pay in North Carolina. But it's not clear that Long himself has changed the system that much. The fundamentals of the state's insurance law — the Rate Bureau, the hearings, and the insurance Facility — pre-date Long's election. Barring some unforeseen developments, they will almost certainly outlast him.

Approving upward deviations in liability rates — which Long has refused to do — would change the North Carolina system and reduce the size of the Reinsurance Facility. But, so long as "free ceding" (the ability to transfer any policy to the Facility) exists in North Carolina, the system will still remain cumbersome relative to that in every other state. Simply electing a new person will not change the fundamentals of the system. Only the legislature can.

## II. Consequences for the State

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North Carolina's auto insurance system does indeed need change because it harms consumers. It has at least four negative effects:

- 1) It guarantees profits to private insurers.
- 2) It denies the best rates to good drivers.
- 3) It hurts women and older residents.
- 4) It hampers product innovation.

Although its defenders – quite possibly out of sincere belief – claim that North Carolina's cumbersome system benefits consumers, it appears to bring the greatest benefit to privately run insurers. The unique-in-the country system of “free ceding” to a state-backed, statutorily defined Reinsurance Facility guarantees that no company needs to take a risk writing insurance in North Carolina. This keeps business in the state and provides assurance that profits continue to flow. If a company has the slightest doubt about a given policy, it can always take it off its books. For certain companies – particularly regulated utilities with significant infrastructure costs – some economists believe that a form of profit guarantee makes some sense. The theories of guaranteed profits, however, always rely on the idea that the industry is a “natural monopoly” (most

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*“The safest North Carolina drivers, furthermore, do not get the best rates under the current system. Insurance industry sources freely admit this.”*

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efficiently served by a single provider) and that a return on investment simply provides a continued inflow of new capital for investment. Neither of these factors appears true of automobile insurance. Nobody in the United States contends that auto insurance is a natural monopoly, and, aside from a few Canadian provinces – where it's had poor results – nobody outside the United States does, either. While economies of scale exist in the insurance business, furthermore, there's no theoretical advantage to having just one company. Automobile insurance does not need enormous investments in infrastructure: a few computer programs and some capital reserves provide all one needs to begin writing

insurance policies. Thus, while it may limit the total amount of profits, the current system assures that only a company with truly awful management could ever lose money writing automobile insurance in North Carolina. Thus, through government regulation, the North Carolina government guarantees profits to private business.

The safest North Carolina drivers, furthermore, do not get the best rates under the current system. Insurance industry sources freely admit this. “There's no way that a woman in her 40s with a perfect driving record is paying the best rate here,” says Joe Stewart of the Insurance Federation of North Carolina. “It simply isn't possible given the system. Insurers can't give the best rates to the best customers” Bob Hurlong of Property and Casualty Insurers Association of America – a national trade association – echoes Stewart. “In that situation, it just isn't possible to extend the lowest rates to the people who deserve them,” he says. “Good drivers subsidize the bad drivers.” This happens because of the practice of free ceding to the Facility: a driver with a few speeding tickets will pay a higher rate and, because of the risks, produce more profits for a well-run insurer. Some of these profits will go to lower premiums for desirable good drivers. (Companies don't do this because they are nice – they do it because good drivers are the most profitable and worth competing for.) In North Carolina, insurers are guaranteed a profit on good drivers but cannot write policies to riskier drivers. Thus, a subsidy that good drivers would typically receive from bad drivers simply disappears.

To make up for the fact that they cannot charge moderately risky drivers sufficient premiums, North Carolina insurers jack up premiums on the state's best drivers. The “teenager tax” alone assures that roughly 75 percent of the state pays an extra 6 percent (on average) in their auto premiums each year.

Women and older residents also lose under the current system. North Carolina, unique in the country, bans the use of both gender and age in setting automobile rates. As a result, even the bureau rates often get prices “wrong.” Every study done on the topic shows what most people know: men are

worse drivers than women, and young people are worse drivers than older ones. The most significant and detailed analysis done to date came to some simple conclusions: men are about 1.5 times more likely to get into fatal auto accidents than women, and teenagers are about three times more likely to get into serious crashes than more mature adults. Instead of using age, North Carolina insurers typically use the length of time that an individual has had a license, and the state has typically allowed them to raise rates for newly licensed drivers for three years. This makes it possible to raise rates on 16- to 19-year-olds (who, by definition, have less than three years experience) but makes it impossible to take age as such into account per se. No easy-to-use, state-approved surrogate exists for gender, but one insurer told the author that it uses data on car make and model as a rough surrogate for gender (since men and women tend to prefer different types of cars) and tends to reduce rates across the board for cars strongly preferred by women while raising them for cars driven largely by men. Nonetheless, the consequences are sometimes perverse. Since age and gender cannot be taken into account, insurers can't differentiate between a 45-year-old female New York City transplant who always took the subway and let her license lapse in New York and a 16-year-old male who just started driving. Common sense and a wealth of research suggest that middle-aged women drive better than young males, but, under current law, insurers must charge the two almost the same premium if they drive the same type of car. In this case, the 45-year-old woman almost certainly pays too much.

Finally, the current system hampers product innovation. The state mandate that all insurers use a bureau rate plan as the basis for their own products coupled with a long approval cycle for new products means that insurers are not eager to offer new or innovative products in North Carolina. Progressive, for example, widely advertises its willingness to offer its competitors rate quotes on its Web site: customers in Virginia, South Carolina, and almost every other state can find rate quotes. North Carolina customers can't. State Farm, likewise, does not offer its nationally advertised "good driver" rebate checks to North Carolina residents. No specific bar exists on offering these products, but the burden of the system makes it difficult to do so. Some companies do work their way through the morass and offer North Carolina product lineups that are, for all intents and purposes, the same as those offered elsewhere. For the most part, this is an exception. Cutting-edge products like pay-per-mile auto insurance (which charges a per-mile rather than per-year premium) simply don't exist anywhere in North Carolina's personal automobile insurance market. No law forbids companies from offering these products, but the difficulty of filing additional rates (on top of the bureau's rates) and lack of flexibility to earn profits from the worst risks make it very unattractive for many companies to offer products like these. While many companies operate in North Carolina, in other words, many products are not available. The government, for the most part, decides what products North Carolina citizens can and cannot buy. And this limits choice.

### III. Reform Proposals

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North Carolina's automobile insurance system needs to change. Although it has undergone a variety of incremental changes, the most important sections of the state's auto insurance law date back to 1957. Three major categories of changes seem worth consideration: modifications to the North Carolina Reinsurance Facility, changes to the specific insurance rates approved, and modifications in the state's overall insurance laws. The next few pages of this

report examine various recommendations in each category.

#### **FACILITY MODIFICATIONS**

The North Carolina Reinsurance Facility provides a crucial "safety valve" within the context of the current system by providing insurance to people to whom no company would write insurance under the caps imposed on the private market. Changes to

the facility system would have ripple consequences throughout the insurance system. Discussion of a few potential changes follows.

***Require “Clean Risks” to Pay Their Own Way in the Facility***

Current “clean” risks pay voluntary market rates within the Reinsurance Facility – the maximum rates allowed under the approved rate plan. Private companies transfer them to the Facility because they do not want to write insurance policies for these drivers at the approved bureau rates. In the aggregate, insurers appear to be right to give up these risky drivers: 75 percent of the state’s drivers pay a yearly surcharge – the teenager tax, which averages about 6 percent – in order to support these supposedly “clean” drivers. In other words, these drivers get into more accidents, have more tickets, and incur more costs than other drivers in the private market. This system has little value for the state. It lowers premiums for people who insurers know will not drive well while raising them for everyone else. Right now, the

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*“This system has little value for the state: it lowers premiums for people who insurers know will not drive well while raising them for everyone else.”*

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Facility surcharge is kept secret from motorists, and insurers cannot put it on their bills. House Majority Leader Hugh Holliman has introduced legislation that would disclose the fee.

In the North Carolina legislature, furthermore, support exists for abolishing the surcharge altogether and forcing these drivers to pay for their own coverage. Holliman holds an impression that appears to be quite widespread. “I very much think that the individuals should pay their own way,” he says. “I think that the Facility just protects the insurance companies.” Amy Bason, counsel to Senate Majority Leader Tony Rand – who headed the Joint Study Committee on Auto Insurance Modernization – expresses a similar point of view. “It’s really a good question why we still have this surcharge,” she says. Commissioner Long has also expressed approval for eliminating the “clean risk” surcharge, as does

Republican candidate for insurance commissioner John Odom.

The measure did not move forward in the 2008 legislative session. Holliman, in fact, says that the procedural rules of the short session made it almost impossible even to consider a “clean” bill to repeal the surcharge during 2008. Like some others, he also expresses reluctance to move quickly. “We have a good system,” he says. “We don’t want to mess with it too much.”

And, in fact, a degree of caution does make sense. A repeal of the “teenager tax” would certainly “mess with” insurance rates. On one hand, rates would go down about 6 percent for a majority of the drivers in the state. On the other hand, they would rise – Rate Bureau head Ray Evans estimates 35 to 40 percent – for roughly 17 percent of all North Carolina drivers, about 68 percent of the Facility’s participants, who are “clean” risks. (“Dirty risks” in the facility would see their rates remain more or less the same.) This would fundamentally change the nature of the system by relating rates much more closely to actual risks. In addition, the rates charged to “clean risks” in the Facility would, in most cases, be higher than those they would pay in the private market.

Nonetheless, repealing the “teenager tax” is a good idea. It does, however, have implications for the future of the state’s insurance system and, as discussed below, would work best if done in conjunction with an insurance commissioner willing to let insurers write policies for these. (More on this below.)

**Recommendation:** Repeal the teenager tax immediately and require clean risks to pay their own way.

***Look for Ways to Reduce the Size of the Facility Without Driving Insurers Out of the State***

The current policy of “free ceding,” as discussed above, serves to guarantee that insurance companies will make profits in North Carolina. It essentially removes the risk of operating in the market. Therefore, Holliman makes an important point when he mentions the Facility’s benefits for the insurance industry. Although all states have some sort of residual market law – and, indeed, a residual market is a corollary to any sort of mandatory insurance – North Carolina’s serves as a particularly strong form of profit guarantee. Insurers can always keep

someone on their own books, sell them other products, and let others take the real insurance risk.

But, at the end of the day, the Facility is a symptom rather than the problem itself. Limiting insurance company transfer to the residual (state-run) market while maintaining caps on overall prices is a recipe for disaster. States like New Jersey and Massachusetts tried it and found themselves stuck in an unenviable situation of rising rates and less availability as insurers fled the state. When insurers cannot raise their rates and cannot charge market prices, many will leave the market rather than write policies.

Instead, the Facility – insofar as it exists at all – should be redesigned as a true “market of last resort” for those unable to purchase insurance coverage in the private market at any price. Through a variety of measures – many of them discussed below – consumers should have the freedom to buy any product that an insurer is willing to sell them. Once a greater degree of rating freedom exists, the legislature may wish to consider bars on ceding certain types of risks to the Facility. In the short term, however, the Facility is a necessary part of the system. The legislature should make other reforms before explicitly addressing the size of the Facility.

**Recommendation:** Don't explicitly limit the size of the facility for the moment but instead increase rating freedom.

## RATE REGULATION CHANGES

Decreasing the size of the Facility without driving insurers out of state will require changes to the way the state regulates insurance rates. The state could do this by making it possible to raise rates on “clean risks,” making it possible to raise rates on “dirty risks,” and approving a significantly higher rate plan. All three options deserve serious consideration, and, unlike the options discussed in the next section, the insurance commissioner could make these changes autonomously.

### *Allow insurers to charge higher-than-bureau rates to “clean risks” following the repeal of the teenager tax*

Without the subsidy provided by the surcharge – the teenager tax – “clean” drivers in the Facility

would see their premiums rise 35 to 40 percent. This increase would be necessary to make sure that Facility drivers pay their own way. While nearly all drivers in the Facility currently pay less than they would in the private market, eliminating the tax would mean that almost all would pay more than the private market would charge.

In order to bring down rates for Facility drivers who would see their rates soar following the tax's repeal, the commissioner could allow insurers to offer these drivers coverage at rates higher than the Bureau rates but lower than the new facility rates. Insurers would almost certainly jump at the

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*“Limiting insurance company transfer to the residual (state-run) market while maintaining caps on overall prices is a recipe for disaster.”*

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opportunity to do this. While writing coverage at current Facility rates would force insurers to lose money, higher self-sustaining rates would almost be high enough to bring private companies into the market.

The next insurance commissioner could allow insurers to do this on his or her first day in office. Nothing in state law currently forbids the insurance commissioner from allowing insurers to charge more for problematic drivers. Indeed, Republican candidate for insurance commissioner John Odom has said he will “very strongly consider” allowing higher prices in order to cut insurance rates for “clean risks” in the Facility. Democratic candidate Wayne Goodwin, on the other hand, has not made his position clear.

**Recommendation:** Allow insurers to raise rates on “clean risks” and thereby reduce the rates these individuals pay.

### *Allow insurers to charge higher-than-Bureau rates for “dirty risks” currently in the Facility.*

“Dirty risks,” on the other hand, currently pay their way within the Facility. Since these drivers do not cost taxpayers, little harm accrues from keeping them in the Facility. Their insurance rates, however, are very high. While some may have serious prob-

lems that would cause many insurers to turn their backs immediately, many more may simply have a few accidents or traffic violations that make them risky but not uninsurable. Allowing insurers to charge higher-than-Bureau rates for these drivers would very likely serve to take them out of the Facility while

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*“A higher rate plan would simply result in higher rates for bad drivers. Given the opportunity to make profits off of bad drivers, furthermore, many insurers would almost certainly cut rates on the best risks.”*

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lowering their overall rates. Some insurers may be able to find ways to operate more efficiently than the Facility or simply manage their premiums differently and thereby make profits while requesting premiums well below Facility levels. In short, the state has nothing to lose by letting insurers compete for the business of the state’s subpar drivers.

**Recommendation:** Allow insurers to charge more for “dirty risks” within the facility.

### ***Approve a Significantly Higher Rate Plan***

Rather than letting insurers charge more for muddling to bad drivers, an insurance commissioner could keep the fundamentals of the current system intact – including Long’s refusal to grand “upward deviations” – and simply approve a higher rate plan from the Bureau. For all intents and purposes, a higher rate plan would have the same consequences as authorizing higher rates for certain classes of drivers. Being authorized to charge higher rates and actually charging those rates are two different things. So long as the market remains competitive, insurers will not raise rates on good drivers more than costs and inflation dictate.

Instead, a higher rate plan would simply result in higher rates for bad drivers. Given the opportunity to make profits off of bad drivers, furthermore, many insurers would almost certainly cut rates on the best risks (older women). Under a “higher” rate plan, things wouldn’t change that much. Rates would probably remain the same for most drivers, go up a little for drivers who currently fall in the Facility’s “clean risk”

category, go down a little for those with perfect driving records, and remain the same (or decrease slightly) for “dirty risks.”

That said, an elected commissioner may have a difficult time approving a “higher” rate plan and explaining it to voters. Particularly if rates went up, an insurance commissioner could take a lot of political heat.

Nonetheless, so long as North Carolina’s insurance system retains the same fundamental attributes, a higher rate plan would simplify matters for businesses and consumers. Rather than having to do extensive paperwork for each new category of risky drivers they want to serve, insurers could simply follow a “higher” rate plan overall and charge more to drivers who pose greater risks. In the medium term, an insurance commissioner might want to consider replacing individual “upward deviations” with a broad rate plan that authorizes – but does not require – higher rates for particularly risky drivers.

**Recommendation:** Approve a higher rate plan.

## **GENERAL INSURANCE LAW CHANGES**

The last section looked at actions an insurance commissioner could take by himself while still keeping the essentials of the current, burdensome system intact. This section reviews some possibilities for change that would rewrite North Carolina’s laws in a manner that would solve the problems of the current system in a lasting fashion. It reviews the possibilities of abolishing the Rate Bureau, letting insurers use a broader range of information in determining rates, and changing the state’s fundamental method of insurance regulation.

### ***Abolish the Rate Bureau***

Although most states once maintained rate bureaus – and a handful still exist on paper – North Carolina’s remains the only one in the country that actually establishes a rate plan for all automobile insurance in the state. There’s little efficiency gain for consumers or insurers from having a single rating structure or lengthy hearings intended to determine auto insurance rates. The costs of maintaining the

Bureau – although nominally paid by insurance companies – almost certainly do work their way into insurance rates. All companies already file significant rate plans on their own, so the Bureau’s work, in many cases, simply duplicates efforts that companies make anyway. Although the Bureau isn’t large, its existence likely does make insurance slightly more expensive in the state.

Within a system involving tight state control over rates, the Bureau provides a necessary counterweight. The Bureau’s work running the state guarantee fund and the Reinsurance Facility, furthermore, should continue in some form. But the Bureau itself should go.

**Recommendation:** Abolish the Rate Bureau. Retain the guarantee fund and a Reinsurance Facility.

#### *Allow insurers to use all traffic-related data in setting rates*

Some insurers suggest that North Carolina traffic safety laws make it difficult to collect accurate information about drivers. As discussed above, state laws let motorists plead down more serious offenses into less serious ones or receive “Prayer for Judgment Continued” (PJC) from a judge. (PJCs are common for traffic offenses and first-time minor crimes like petit larceny.) Under PJC the motorist is assessed court costs but has no violation attached, and, typically, the offense vanishes from a motorists’ insurance record provided that the motorist accumulates no more than two PJCs in a rolling three-year period. Likewise, judges can reduce other offenses to those that do not involve points assessed. Commonly, speeding tickets get reduced to equipment violations. Although the PJC – which, explicitly, involves no attached conditions – appears to exist only in North and South Carolina, all judges in common law systems can always grant continuances and dismiss cases. All of this matters because the state’s “safe driver incentive program” mandates rate cuts for people who remain “clean” under state law.

The particulars of traffic laws, however, may have less significance than they appear to on the surface. Tim Moore, a general practice attorney who serves in the state legislature and has been active on insurance issues, explains: “It doesn’t matter what

the law is,” he says. “In some places, there will always be ways to get tickets reduced or eliminated. In other places, you won’t be able to. . . and that’s the way it works now in the state.” Joe Stewart of the Insurance Federation of North Carolina largely agrees. “It’s not the courts per se,” he says. “It’s the fact that the current system doesn’t allow companies to file their own rating plans.” To the extent that

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*North Carolina’s remains the only one in the country that actually establishes a rate plan for all automobile insurance in the state. There’s little efficiency gain for consumers or insurers from having a single rating structure or lengthy hearings intended to determine auto insurance rates.*

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North Carolina judges give more breaks than those in other states, the problem lies with the judiciary rather than the laws. If judges are too lax, they will remain equally lax under new laws.

Thus, trying to modify traffic laws as such makes little sense. Instead, the legislature and insurance commissioner should follow Stewart’s advice and let insurers and consumers decide what data matters and what data does not. If insurers find that a single PJC results in higher accident rates, they should be able to raise the premiums following it. If, likewise, insurers chose to ignore convictions for speeding 11 miles over the limit – something that the safe driver incentive program makes it nearly impossible for them to do – they should also be able to do that.

The safe driver incentive program probably should be abolished as it currently exists. Rather than mandating rate cuts for people with certain types of traffic records (which aren’t always spotless), insurers should work to find ways of identifying safe drivers on their own.

**Recommendation:** Let insurers use traffic-related information as they see fit.

### ***Allow Broader Use of Data about Age and Gender***

North Carolina bans the use of gender and age in determining automobile insurance rates.

As discussed above, age and gender have a clearly established, almost universally agreed upon correlation with insurance risk: men are worse drivers than women, and younger people drive worse than older ones. Forbidding the use of these criteria raise rates on older people and women by denying

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*“Allowing insurers to distinguish good from bad drivers should have a major positive effect on insurance rates in the state and will reduce rates for women and older residents. It’s a good idea.”*

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them discounts. While insurers, as discussed above, do manage to find surrogates for age, it’s much more difficult to extend discounts on the basis of gender. Allowing insurers to distinguish good from bad drivers should have a major positive effect on insurance rates in the state and would reduce rates for women and older residents. It’s a good idea.

**Recommendation:** Allow unlimited use of age and gender in determining auto insurance rates.

### ***Modify the state’s fundamental method of insurance regulation in order to increase flexibility and bring new products to market***

Following a series of changes in Massachusetts’ auto insurance system earlier in 2008, North Carolina will stand as the only place in the United States where the government sets auto insurance rates. Massachusetts’ modification of its framework resulted in across-the-board rate cuts from all major insurers – as much as 15 percent – and the entry of a major new company with an aggressive pricing strategy of its own. Although dozens of slight permutations exist, most states use one of four fundamental types of insurance approval: prior approval/low deference “file and use,” flex rating, “true” file/use and file, and largely informational filing. All methods deserve consideration and a “largely information” filing system appears a worthy long-term goal if

North Carolina hopes to unleash market forces and improve choice to reform its insurance system.

Prior approval insurance rating would require no changes to North Carolina’s laws. The state-made-rate aspect of the current insurance laws stems from specific administrative actions and the existence of the “teenager tax” rather than the laws on the books. A conventional prior approval system would be similar to the one that exists in Alabama – one that allows upward deviations but still involves specific governmental review of almost all insurance rates. In states like Texas, likewise, so-called “file and use” systems allow a degree of upward and downward rating freedom but allow government regulators to disapprove rates for all sorts of reasons, thus making the system very similar to a prior approval for all intents and purposes.

Flex rating – which always exists in concert with file or prior approval system – allows insurers to change their rates within a certain “flex band” (a few percentage points difference) with little or no paperwork. Bureau or department-approved rates become only guidelines rather than strict price caps under this system. The actual flexibility of this system depends mostly on the breadth of the bands and the difficulty of getting rates approved in the first place. Most states with flex rating allow flexibility in a range of between 5 and 10 percent. Such a system typically makes it relatively easy to introduce new products to existing customers but rarely allows insurers to serve large classes of new customers by itself.

Finally, states can require insurers to file rates largely for informational purposes. If a filing appears fraudulent, actuarially inadequate (collects too little revenue for the company to actually provide insurance), or bases insurance rates on characteristics that the law prohibits, then states can take action. Otherwise, they largely defer to insurers’ own filings.

In general, systems like these – in states like Illinois, Nebraska, and Vermont – allow a wide degree of flexibility in insurance rates and speed the creation of new products. Rather than trying to pick in- and out-of-favor groups, likewise, insurance regulators can focus on enforcing whatever types of discrimination and fraud legislators and regulators

think most important.

Any more flexible system, furthermore, would allow North Carolina residents to purchase auto insurance products they currently can't. Although no state law specifically prohibits things like rebate checks (which State Farm offers in almost all other states) or comparative price quotes (which Progressive offers), the burdens of filing specific rate plans for each of these factors make it very unattractive for companies to offer them in North Carolina. Cutting-edge products like pay-per-mile auto insurance – available in Illinois – also will come to North Carolina late or not at all.

In the end, any system that gives insurers reasonable freedom to offer products and drivers reason-

able freedom to buy them will work reasonably well.

A “largely informational” filing system, however, may provide the best outcome for the state’s consumers. Because it creates a central repository of data, it lets an insurance department monitor companies to see if they’re engaging in fraud, charging rates that are too low, or using characteristics like race that the law bans. On the other hand, it lets consumers and insurers mutually decide what characteristics make sense to use and which ones make sense to ignore.

**Recommendation:** A “largely informational” use and file system seems to do the best job meeting consumer needs. North Carolina should move towards establishing one.

## Conclusion

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This paper has reviewed and described North Carolina’s messy, complex system for providing automobile insurance and examined a number of proposals for changing it. It has examined the labyrinthine approval process and described how it places many of North Carolina’s best and safest drivers at a disadvantage in its insurance market. It has argued that the system proves fundamentally unfair and needs to change quickly.

The paper proposes a number of measures for change. Some – such as a repeal of the “teenager

tax” – should come within the very near future. Others, more fundamental changes in the operation of the state’s insurance system, will take significantly longer. But, in time, fundamental reform is necessary.

North Carolina’s automobile insurance system has problems. But it is not a lost cause. It can change. In the end, North Carolina’s citizens should have the ability to purchase the insurance products they want at rates that reflect risks they take. Anything else is unfair.

## Notes

1. Automobile Insurance Plans Service Offices. "Residual Markets, 2005," 2005. (AIPSO.org), <http://www.iii.org/media/facts/statsbyissue/auto/>.
2. The Rate Bureau actually consists of three interrelated organizations: the North Carolina Rate Bureau (which does the rate filings), the North Carolina Reinsurance Facility (which provides coverage to motorists), and the guarantee fund (which provides last-resort coverage for policy holders of failed insurance companies). The three organizations share staff, office space, members companies, and a Web page. In general, the organization is referred to as the Rate Bureau except where a distinction needs to be made.
3. NC Code 36 § 58-36-1 (1) for the bureau's existence se § 58-36-5 (1) for mandatory participation in the bureau and its corporate-owned structure and § 58-36-30 for the mandate to actually use the Bureau's rate plans.
4. NCC 36 § 58-36-20.
5. The statutes don't actually mandate that the commissioner create an alternate plan but, historically, the insurance commissioner always has done so. Theoretically, only the Rate Bureau creates plans in the first place.
6. § 58-36-25.
7. All cases have the State of North Carolina, Commissioner of Insurance as the appellee and the North Carolina Rate Bureau as the Appellant. The case in question is 124 N.C. App. 675, 478, S.E. 2d 792).
8. Refunds were also made in 1994.
9. Jim Long. "North Carolina Safe Driver Incentive Plan," [http://www.ncdoi.com/consumer/consumer\\_publications/automobile/safe%20driver%20incentive%20plan.pdf](http://www.ncdoi.com/consumer/consumer_publications/automobile/safe%20driver%20incentive%20plan.pdf).
10. North Carolina Reinsurance Facility. "About NCRF: Ceding To The Facility," <http://www.ncrb.org/ncrf/AboutNCRF/tabid/55/Default.aspx>, 2008.
11. Interview with Ray Evans, General Manager, North Carolina Reinsurance Facility, June 11, 2008.
12. North Carolina Reinsurance Facility. Ceded Premium by Volume by Company or Group. Circular Letter to All Member Companies, November 21, 2007. <http://www.ncrb.org/NCRF/Portals/0/ncrf/circular%20letters/RF-07-11.pdf>.
13. Interview, June 11, 2008.
14. North Carolina Reinsurance Facility. "About the North Carolina Reinsurance Facility," (Powerpoint Presentation,) 2008, 26-4.
15. Telephone interview, June 6, 2008.
16. Insurance Federation of North Carolina. Insurance 101: 2007-2008, 12.
17. National Association of Insurance Commissioners. 2003-2004 Auto Insurance Database. "2004 State Average Premiums for Personal Automobile Insurance," 2005. This is the most recent national data available.
18. Telephone interview, June 6, 2008.
19. Telephone interview, June 4, 2008.
20. Others disagree. For another perspective and a literature review see: Vernon L. Smith. "Regulatory Reform in the Electrical Power Industry," in Regulation: The Cato Review of Business and Government, Vol. 19. No. 1.
21. Brett Skinner. Auto Insurance Market Quality Index 2006. The Fraser Institute, October 2006, [http://www.fraserinstitute.org/COMMERCE.WEB/product\\_files/AIMQI06.pdf](http://www.fraserinstitute.org/COMMERCE.WEB/product_files/AIMQI06.pdf).
22. Interview, July 10, 2008.
23. Telephone interview, July 10, 2008.
24. An insurer also runs a risk of losing significant amounts of money writing insurance for a bad driver. Except in North Carolina, all insurers lose money on some drivers.
25. The state does allow "inexperienced driver" surcharges for people with three years or less of driving experience. Since residents cannot generally get an unrestricted license until age 16, this, in effect, raises rates on all those between 16 and 19.
26. Dawn L. Massie and Kenneth L. Campbell. Analysis of Accident Rates by Age, Gender, and Time of Day Based on the 1990 Nationwide Personal Transportation Survey, Insurance Institute for

Highway Safety, 1993, i.

27 Authors' own investigation, June 9, 2008.

28 State Farm Auto Insurance. Statefarm.com (June 18, 2008).

29 H 1298 (2007). S 900 is substantially the same bill.

30 Personal interview, June 11, 2008.

31 Personal interview, June 11, 2008.

32 Odum's comments came in a personal interview on July 11, 2008. For Jim Long's stated position see. Insurance Information Institute. "Regulation Modernization," <http://www.iii.org/media/hot-topics/insurance/ratereg/>. Democratic candidate Wayne Goodwin would not speak with the author of this report but, as he currently serves as Assistant Commissioner of the department, he presumably supports Long's position.

33 Personal interview with Ray Evans, June 11, 2008.

34 Of course, if rating freedom existed, few if any insurers would transfer policies anyway.

35 Interview with Ray Evans, June 11, 2008.

36 Interview with John Odom, June 11, 2008.

37 Autoinsurance.com, "What is a Prayer for Judgment?" <http://www.carinsurance.com/kb/content27086.aspx>.

38 NC Statutes 36 § 58-36-65.

39 Personal e-mail, June 18, 2008.

40 See Insurance Information Institute, "State Auto Insurance Laws," <http://www.iii.org/individuals/auto/a/stateautolaws/>. Law is at: NC Code 36 § 58-36- (2) and (6).

41 Insure.com, "Massachusetts Enters a Brave New World of Auto Insurance," March 18, 2008. <http://www.insure.com/articles/carinsurance/massachusetts-auto-reform.html>.

42 Ibid.

## About the Author

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Eli Lehrer is a senior fellow at the Competitive Enterprise Institute where he directs CEI's studies of insurance and credit markets. Prior to joining CEI, Lehrer worked as speechwriter to United States Senate Majority Leader Bill Frist (R.-Tenn.).

He has previously worked as a manager in the Unisys Corporation's Homeland Security Practice, Senior Editor of *The American Enterprise* magazine, and as a fellow for the Heritage Foundation. He has spoken at Yale and George Washington Universities. He holds a B.A. (Cum Laude) from Cornell University and a M.A. (with honors) from The Johns Hopkins University where his Master's thesis focused on the Federal Emergency Management Agency and Flood Insurance.

His work has appeared in the *New York Times*, *Washington Post*, *USA Today*, *Washington Times*, *Weekly Standard*, *National Review*, *The Public Interest*, *Salon.com*, and dozens of other publications. Lehrer lives in Oak Hill, Virginia with his wife Kari and son Andrew.

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*“To prejudge other men’s notions  
before we have looked into them  
is not to show their darkness  
but to put out our own eyes.”*

JOHN LOCKE (1632–1704)

AUTHOR, TWO TREATISES OF GOVERNMENT AND  
FUNDAMENTAL CONSTITUTIONS OF CAROLINA



200 West Morgan St.  
Raleigh, NC 27601  
V: 919-828-3876  
F: 919-821-5117  
[www.johnlocke.org](http://www.johnlocke.org)  
[info@johnlocke.org](mailto:info@johnlocke.org)