

INSURANCE AND PREVENTION

BY

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Insurance and Prevention are two processes that have much in common and that influence each other in intimate and important ways. They both have to do with the same thing, misfortune, but their primary objects are quite distinct. Prevention undertakes to avoid misfortune itself while insurance undertakes to avoid or ameliorate the evil effects of misfortune.

Anything that avoids misfortune is prevention but anything that avoids the evil effects of misfortune is not necessarily insurance; that is, insurance is only one of a number of ways of accomplishing the same thing. Philanthropy and good neighborliness for instance are methods of alleviating misfortune that accomplish the same results as insurance.

The distinction between philanthropy on the one hand and insurance on the other is cleancut and significant. Philanthropy (and good neighborliness) comes into effect only after the misfortune is an accomplished fact. This obviously is not prevention, for the misfortune has already occurred. The Widow Maginty's cow has died and the neighbors get together and buy her another. Philanthropy and good neighborliness, since they come into operation after the misfortune has happened, require good-will and a social consciousness.

The distinguishing characteristic of insurance is that the relief of the misfortune is undertaken before the misfortune is an accomplished fact, and while its incidence is still uncertain. It does not, therefore, require good-will but only enlightened self-interest. The Widow Maginty's neighbors get together and say, "What's happened to Bridget may happen to any of us; let's now bind ourselves to come to the help of anyone of us that has a misfortune." Each one goes into the undertaking knowing that he may be the one to profit by the bargain. This simple understanding contains the essence of insurance; for insurance is fundamentally an agreement on the basis of self-interest before the misfortune occurs. Incidentally, it may be noticed that insurance, since it comes before the misfortune instead of after it as in the case of philanthropy, admits of the possibility of being used preventively.

It is evident that the insurance that is practiced by the Widow Maginty's neighbors is very primitive. In actual practice the agreement with each other is usually replaced by an agreement with a third party who either acts as agent for all or who for profit undertakes to handle the transaction, taking the chance of securing a sufficient number who will come into the undertaking to afford the average upon which insurance is based.

Obviously there must be important relations between two things that are so much alike, prevention of misfortune on the one hand and prevention of the effects of misfortune on the other. The principal purpose of this paper is to point out two of these relations.

Insurance is a process which in the nature of things produces an unstable equilibrium. Those who go into an insurance agreement will tend to exercise a selection which will be adverse to the others; that is, the insurance will be taken more readily by the poorer risks. This is avoided if the insurance is compulsory, or if by some other means a fair average is had. Otherwise it is necessary to grade the risks by some system of classification which will serve as a basis either for underwriting or for rating.

But often it is not possible to differentiate sufficiently to avoid adverse selection. In that case the result of such a selection will be an increased loss-cost; this will require the raising of the rates; this will in turn make the operation of an adverse selection still more potent and so on indefinitely in a vicious circle. This is the unstable equilibrium that I referred to.

This is to some extent the situation in the automobile field today in such a city as New York. The increasing congestion of the streets has resulted in an increased number of accidents; this increased cost when reflected in the rates has led to a selection against the companies. This in turn has been followed by still more accidents owing to the poorer quality of the risks insured and so on.

Such at least is the theory of the situation. It is well known, however, that adverse selection does not operate in practice to the extent which might be expected, due to the fact that carefulness in securing insurance protection and financial ability to secure insurance protection are correlated to a considerable extent with qualities that characterize a good risk.

However, this fundamental instability by which the poorer risks tend to come to the top, in much the same way that the large

stones in a pile work to the top, does undoubtedly operate to a greater or less extent throughout the whole field of insurance. That is, the system of insurance by itself seems to have an innate tendency to cause its own destruction and there is nothing within the system that is sufficiently strong to restore the equilibrium. In that case we must resort to force from the outside to break the vicious circle. In theory we may attack either the increased losses that are causing the adverse selection or the adverse selection that is causing the increased losses. Something can be done through underwriting to overcome the effect of adverse selection but in general the most hopeful point of attack and the one that brings the most far-reaching results is upon the loss side of the circle, that is, prevention.

I may sum up, therefore, by saying that there is intrinsic in insurance a fundamental instability. This may be overcome by restricting its scope through classification and it may be neutralized through the counteracting effect of other correlated forces and it may to some extent be overcome by underwriting but certainly in many cases it will be necessary or advisable to go to the real heart of the matter by undertaking direct action to prevent the misfortune itself.

There are, however, social as well as economic reasons for prevention in insurance. The purpose of insurance is relief from the effects of misfortune. There is in addition to this wholly good effect a secondary effect which is bad, namely, the loss of individual responsibility. If my house is insured I shall not be quite so squeamish about taking a lighted candle into the attic or about having a defect in the electric wiring go uncorrected; if my car is insured I shall not be quite so concerned at letting my son or nephews drive it. In the development of insurance this secondary bad effect must be taken into account as well as the primary good effect; the problem of insurance is evidently to maximize the good effect and at the same time to minimize the bad effect.

Now it is impossible to restore individual responsibility and the best therefore that the insurance company can do is to put something preventive in its place. The key to what this may be is found in the very nature of insurance. Insurance is a plan for bringing mass-action into play upon individual misfortune. The individual misfortune is shared by the mass and so is made bear-

able. Advantage should evidently be taken, in seeking for something to make up for the loss of individual responsibility, of this opportunity for mobilized action. The insurance company is able to carry on collectively for its members preventive work that will in the majority of cases more than make up for the lessened personal responsibility.

If this analysis is correct the insurance companies have a social obligation to the community to take part directly in preventive work, wherever insurance develops a lessened degree of responsibility in the individual.

An insurance company organized for the primary purpose of avoiding the evil effects of misfortune may, therefore, be forced for business reasons such as these to enter the field of prevention. There are many examples of this. Preventive work on a large scale is being carried on by the fire insurance companies, to some extent by the life insurance companies and more recently the stock casualty insurance companies have definitely come to the conclusion that they must attack the problem of the automobile hazard and have taken positive steps in that direction.

In what I have said I refer to direct preventive work. There is in addition the indirect preventive work that comes out of insurance through the operation of the merit-rating systems. When a classification system is used by which the rate is graded to fit the hazard of the individual risk a pecuniary incentive is immediately produced for raising the risk through preventive work to the level of a class that has a lower rate. The influence of this indirect preventive work is very great.

There is a test which can obviously be applied to preventive work, whatever the basis upon which it is undertaken, namely, that the savings in losses shall at least equal the cost of the preventive work. Insurance as an institution can hardly be asked to do preventive work that does not pay for itself; but if the work is rightly managed it will pay for itself.

There are, therefore, three reasons why insurance companies should carry on direct preventive work:

1. In order to overcome adverse selection and thus place the insurance system upon a stable basis.
2. To fulfill a social obligation to the community to offset the lessening of the responsibility of the individual.
3. On economic grounds because the saving in losses more than pays for the expense.

The question may be raised whether the insurance companies by doing preventive work will not put themselves out of business. Theoretically, perhaps yes; practically, no! It is exactly the same question that faces the doctors: Shall the doctors go into preventive work when by doing so they will lessen the need for their services! In a still larger sense it is a problem that runs through all of life. In a general way the answer is that institutions must accommodate themselves to that course of action which is best for society. Prevention of misfortune is desirable. Insurance companies and doctors and all the rest of us must make our plans accordingly!

In general, however, it is true that what works for the good of society as a whole works also for the good of its parts; both the doctors and the insurance companies are likely to find that the work of conservation will bring them into quite as large a field as the work of alleviation.