Microeconomics, Module 7: “Competition in the Short Run (Chapter 7)

(Application of microeconomic theory to the insurance industry. You may post the solution on the discussion forum for comparison with that of other candidates.)

(The attached PDF file has better formatting.)

Discussion Forum Exercise: The Insurance Industry and Competition

We compare the auto insurance industry with the auto manufacturing industry of 20 years ago (before foreign auto companies entered the U.S. market):

A. Which industry had more firms providing the goods and services? (In 1980, how many firms produced cars in the U.S.? How many firms wrote auto insurance policies?)
B. For which industry is entry easier? (How easy is it to start an auto manufacturing plant? How easy is it to start an auto insurance firm? Compare the number of new U.S. based auto manufacturers with new U.S. based auto insurers in the 1960’s and 1970’s.)
C. Which industry has greater economies of scale? (An industry with large economies of scale has only large firms and no small firms. The most common reason for the mergers of auto firms around the world is that the firm can not compete unless it produces a high volume of cars. The minimum volume increases each year, as firms become more efficient.) Why do auto manufacturers have large economies of scale? Do auto insurers have significant economies of scale? (Economists differ on the last question; no answer is correct. Direct writers seem to have some economies of scale.)
D. How similar are the goods and services produced by different firms? (Is a car from Ford just like a car from General Motors? Is an auto insurance policy from Allstate just like an auto insurance policy from State Farm? The firms do not sell *exactly* the same service, but how different are the services of Allstate vs State Farm compared to the differences in the vehicles produced by Ford vs General Motors?)

Question: Auto insurance has many firms entering and leaving each year; auto manufacturing has few firms entering or leaving. What causes this?

Answer: Entering the automobile manufacturing industry requires high volume and a long commitment. The industry has high economies of scale. Unless a firm can sell 50,000 cars a year for ten years, it doesn’t recover its costs.

Question: Do these economies of scale stem from buying items in bulk?

Answer: Large auto manufacturers can negotiate lower prices from suppliers, but these are not the primary economies of scale. Designing and manufacturing a new vehicle takes five years for experienced firms. Research and development, testing of prototypes, design work, fixing errors, and initial marketing are large costs. A new entrant into the market does not expect to earn a profit for ten or fifteen years.

Question: Do auto insurers have barriers to entry? Do they have economies of scale?

Answer: It is sometimes said that all one needs to sell insurance is a shingle and a copier. This is an exaggeration, but it is easier to sell auto insurance than to make autos.

Some economies of scale exist. Setting up an exclusive agency system is an expensive and long process. Independent agents are not a cost efficient distribution system.