

Microeconomics, Module 13, "Market Power"

Resale Price Maintenance

(The attached PDF file has better formatting.)

Resale price maintenance has long been a disputed issue in the insurance industry: should agents' rebates be legal?

Illustration: The Jacob & Rachel life insurance company has 12 agents (Rueben, Shimon, Levi, Yehuda, ..., Joseph, and Binyamin). The first year premium is given to the agent as his commission. Suppose Joseph is about to sell a policy to Dinah. Binyamin says: If I offer a 20% rebate on the first year premium, I will get the policy. Since I get nothing if I don't offer a rebate, let me offer 20% off the first year commission and at least get the remaining 80% of the premium.

The insurance industry tries to prohibit agent rebates. Economists offer two explanations:

- Jacob and Rachel don't care if the agents offer rebates. Each agent offers rebates when he might profit from it, and each is upset when one of the other 11 agents offers a rebate. Each agent wants to set a rule that rebates are prohibited. But they can't agree among themselves on this rule, since they would all cheat. Instead, they get Jacob and Rachel to lay down the law and prohibit rebates. If this is the explanation is correct, consumers are the *losers* from anti-rebate laws.
- Landsburg offers a second interpretation, where consumers *gain* from anti-rebate laws. Suppose Joseph offers full services: when an applicant comes in to his office, he analyzes the full insurance needs of the applicant, explains how the applicant profits from a sound insurance program, and always makes a sale. Binyamin offers discount policies with a 20% rebate on the agent's commission, but he provides no services, and only a few of the applicants who come into his office end up buying policies. When consumers learn about these two agents, they come to Joseph for the analysis and then walk over to Binyamin's office to buy the policy. Joseph stops selling insurance and takes up a second career as Prime Minister of Egypt; Binyamin finds that few applicants come into his office anymore, so he quits his job and stays home as his father's favorite son. Jacob can't sell insurance anymore, so he advocates an anti-rebate law. Consumers *gain* from the anti-rebate law.