

**On the Efficiency of a Public Insurance Monopoly:  
The Case of Natural Hazard Insurance in Switzerland**

by

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**Summary**

In nineteen Swiss cantons there still exist public monopolies for housing insurance for fire and elementary damages. During recent years, there has been a public debate which finally showed that these public monopolies are more efficient than the private insurance companies which are acting in the remaining seven cantons. After a short presentation of this discussion three reasons for the higher efficiency of the public monopolies are given. Then, arguments in favour of their privatisation are discussed. These arguments are, however, not convincing: It does neither economically nor politically make sense to abolish the cantonal monopolies in order to introduce competition in these markets.

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## 1 Introduction

[1] Economists often claim that they have no or at best a minor impact on economic policy: other disciplines like law or political science are assumed to have much more impact.<sup>1)</sup> This is insofar true as academic economics is often of little help to solve real economic policy problems, while other disciplines provide answers to the politicians' questions which seem to be much straightforward in this respect. On the other hand, in recent decades, economic ideas have changed the world in a dramatic way. Since the Second World War, we see a continuous increase in international trade and a tremendous reduction of trade barriers, in Europe especially within the ever increasing European Union, but also on a world wide scale first through the GATT and since 1995 through the WTO. Moreover, since the eighties, a wave of deregulation and privatisation of former public enterprises gushed over the Western industrialised countries. Its aim was and is the reduction of the political sphere and the strengthening of the private sphere. In the 'Washington Consensus', this strategy was also recommended to the developing world.

[2] The hope connected with the deregulation and privatisation activities was that they would lead to an increase in efficiency which finally should benefit all citizens. At least partly, this has come true: in recent years there are numerous survey papers which demonstrate that privatisation actually lead to an increase in efficiency.<sup>2)</sup> A good example are the traditional post companies, for which CH.B. BLANKART (1982, 1987) demanded privatisation already many years ago. In many countries the telecom services have been separated and transformed into profitable independent private shareholder companies. That this is possible is (not only) demonstrated by the example of the German Telecom. There, the privatisation led to a reduction of consumer prices, but also to an expansion and a qualitative improvement of the supply of consumer services. It must be kept in mind, however, that some part of the efficiency gain has to be used to finance a regulation institution. Thus, there was doubtless an economic improvement due to the privatisation, but it was smaller than it might appear at first glance.

[3] Not all privatisations are, however, as successful as those of the telecom companies. It is not only that the Washington Consensus is broken as the policies based on it did not provide the desired results for the developing countries.<sup>3)</sup> The results in the industrial countries did also only partly meet the expectations. There are, e.g., large problems privatising railway companies. First, even if we separate the railway system and the trains into different enterprises, it is difficult to make them profitable. In many cases this is only possible if – as in Switzerland – parts of their services are still heavily subsidised by the government. Otherwise, there might be a development as in the United States where today the railway system is totally unimportant and has been almost totally substituted by private cars and aviation. At least from an environmentalist point of view (and also considering the higher number of casu-

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1. See, e.g., B.S. FREY (2006).

2. See, e.g., W.L. MEGGINSON and J.M. NETTER (2001), E. SHESHINSKI and L.F. LÓPEZ-CALVA (2003) or J.M. GONZÁLES-PÁRAMO and P.H. DE COS (2005).

3. See, e.g., D. RODRIK (2006).

alties) this is highly problematic. Second, the examples of the German and especially the British Railways show that severe reductions of the quality of services might take place, even if the railway network is not reduced. Thus, *The Economist* which usually is much in favour of privatisation described the privatisation of British Rail as a “disastrous failure”.<sup>4)</sup> In order to avoid this, in many cases we need ‘re-regulation’ again.<sup>5)</sup> It is still an open question today how the structure of an efficient railway system might look like.

[4] The general public, however, seems to be much less in favour of privatisation than the politicians. For example, voters rejected in a referendum in the canton Basel-City in 1995 the privatisation of a waste incinerator, despite the fact that there existed a large majority in the cantonal parliament in favour of it. In 2001, the citizens of the canton Zurich rejected the privatisation of the canton’s electricity company. And in 2002, the Swiss citizens rejected the new electricity market law which implied considerable deregulations of this market. In all these (and also some other) cases, the Swiss citizens rejected privatisations and/or deregulation projects which were favoured not only by a majority of economists but also of politicians. It is – at least *prima facie* – an interesting result that a majority of the citizens wants to extend the area of public decisions further than their elected representatives do. Applying the Leviathan model of government, Public Choice economists usually assume the opposite: that politicians and bureaucrats have a genuine interest to extend government activities far beyond the limits which are demanded by the citizens.<sup>6)</sup>

[5] One reason for the resistance of the general public (or at least large parts of it) is the fact that the benefits and costs of liberalisations, be it with respect to trade of goods and services, mobility of production factors or previously publicly provided services, are often very unequally distributed: considerable parts of the population are losers without hope for compensating benefits in the long-run. They try to protect themselves against these losses as far as possible by defending the traditional area of public decisions. Economists who are only considering the maximisation of producer and consumer rents disregard these aspects which are very important for the welfare of large parts of the population. It is, therefore, no surprise that these people are hardly addressable by the economists’ recommendations.<sup>7)</sup> Moreover, politicians who want to be re-elected should be rather reluctant to follow these advices. It is the more astonishing that (and demands additional research why) politicians in so many cases favoured projects proposed by economists which were against the revealed interests of their electorate.<sup>8)</sup>

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4. See: Britain’s Railways: The Rail Billionaires, *The Economist*, July 3, 1999, pp. 67 – 70. A somewhat more positive evaluation of Britain’s Railway privatisation is given in A. KNORR and A. EICHINGER (2002).

5. See for this also W.W. POMMEREHNE (1990) and F. SCHNEIDER (1998).

6. See for this also L.P. FELD and G. KIRCHGÄSSNER (2003). For the traditional view see, e.g., M. BOYCKO, A. SHLEIFER and R. VISHNY (1996).

7. For the difference between (Public Choice) economists and ordinary people see also G. KIRCHGÄSSNER (2005).

8. R. FERNANDEZ and D. RODRIK (1991) show that people might resist reforms *ex ante* even if they would be supported by a clear majority once they are in effect. – For some recent papers about political incentives for governments to privatise see B. BORTOLOTTI, M. FANTINI and D. SINISCALO (2003), B. BORTOLOTTI

[6] It is an advantage of the Swiss direct democratic system that it lays open such conflicts. In a pure representative political system like the German one (at the federal level) deregulations and/or privatisations might be decided by the political elite without asking whether this is in the interest of the citizens or not. This holds the more, if liberalisations and/or privatisations are enacted by supra-national institutions like the European Commission or the European Court of Justice which have no or at best very weak political connections with the population. Thus, it is no surprise that the process of liberalisation and privatisation is less developed in Switzerland than in its surrounding countries which are all members of the European Union.<sup>9)</sup>

[7] An argument which is often used in the debate about deregulation and privatisation is that they will reduce the quality of the services supplied to the citizens. As, e.g. D. BÖS (1989) has shown, there might well be a trade-off between efficiency and quality of publicly provided services. In such cases, the main arguments in favour of privatisation may be more of an ideological than of an economic nature.<sup>10)</sup> Of course, whether (productive) efficiency comes at the cost of quality, is an empirical question. Using road maintenance in Denmark as an example, J. BLOM-HANSEN (2003) shows that private firms might be more efficient even if differences in quality are taken into account.<sup>11)</sup> However, he does not investigate whether there actually exists such a trade-off. Moreover, as A. CAVALIERE and S. SCABROSETTI (2006) have shown, higher productive efficiency does not necessarily imply higher allocative efficiency.<sup>12)</sup>

[8] All arguments discussed so far assume that privatisation at least increases productive efficiency. This is different for housing insurance companies which in Switzerland are responsible for fire and elementary damages. In 19 out of 26 cantons there exist public (cantonal) monopolies as at the beginning of the 1990's it was also the case in the German states of Baden-Württemberg and Hamburg. These companies were and are profitable; there is no need for any subsidy. On the other hand, the situation in the remaining 7 cantons shows that private firms can insure fire and elementary damages as well. Compared to telecommunication, e.g., there is, moreover, much less need for regulation in this field. Thus, we have well operating and profitable public firms with regional monopolies, without any necessity to keep these monopolies or to provide the respective services publicly.<sup>13)</sup> Insofar, it is no surprise that the

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and P. PINOTTI (2003), K. BÖRNER (2004) or A. BELKE et al. (2005). The results of these papers are, however, conflicting and do not provide a clear picture.

9. Nevertheless, as A. AFONSO, L. SCHUHKNECHT and V. TANZI (2005) show, Switzerland has a rather efficient public sector.
10. See also M. PRISCHING (1988), who shows that a main aspect of privatisation often is 'symbolic policy'. This is not necessarily an argument against privatisation, but this aspect is often overlooked.
11. This has much earlier already been shown by W.W. POMMEREHNE (1976, 1983) for the case of garbage collection in Swiss municipalities. In the latter paper it is, however, shown, that the question of direct versus purely representative decision making in the local community is much more important for the efficiency of these services than the question of public versus private provision.
12. In addition, G. CORNEO and R. BOB (2003) show that labour productivity might be higher, but also lower in a private compared with a publicly owned form.
13. The regional monopolies are also responsible for the prevention of fire damages. There we have the character of a public good (or at least very important positive external effects). However, this minor part of their activity could easily be separated and taken over by the (general) public bureaucracy.

Commission of the European Communities decided on June 18, 1992, that these public monopolies are not compatible with European Competition Law. This led to the abolition of this monopolies in Germany on July 1, 1994; the respective companies were sold to private insurance companies, i.e. privatised.<sup>14)</sup> The private insurers in Switzerland also demand the abolition of the cantonal monopolies and the privatisation of the public insurance enterprises since many years.<sup>15)</sup>

[9] On the other hand, the public monopolies in Germany had significantly lower premia than the private insurance companies which existed in the other German states, and the abolition of the public monopolies resulted in a considerable increase of the premia and their adaptation to the general German level.<sup>16)</sup> The cantonal monopolies in Switzerland also have significantly lower premia than the private companies in the other cantons. At the beginning of the discussion it was disputed whether this is due to a systematic cost advantage of the public monopolies or due to special environmental conditions, because the private insurances mainly operate in the (small) mountain cantons where the risk of elementary damages is much higher than, e.g., in the canton Zürich where we have a cantonal monopoly with very low premia. To present evidence in favour of their position, the cantonal monopolies asked THOMAS VON UNGERN STERNBERG, who is Professor of Economics at the University of Lausanne, to write an expert report, and – in a counter move – the private insurance companies asked for an expertise by BERND SCHIPS, at that time Professor of Economics at the Swiss Federal Institute of Technology, Zürich.<sup>17)</sup> As was to be expected, both experts came to quite different conclusions, in both cases in favour of their customers. Thus, the question whether the cantonal monopolies or the private insurance companies operate more efficiently in the area of fire and elementary damages seemed to be open again.

[10] In the meantime, however, this question has been answered. From all what we know today, the cantonal monopolies operate more efficiently, i.e. they provide their services – *ceteris paribus* – at lower costs than the private insurance companies do or can do, respectively. Correspondingly, they charge lower premia. This has been shown in several papers in national and international scientific journals like G. KIRCHGÄSSNER (1996), ST. FELDER (1996) or ST. FELDER and H. BRINKMANN (1996). In the dispute between TH. V. UNGERN-STERNBERG und B. SCHIPS they have strengthened the position of TH. V. UNGERN-STERNBERG.<sup>18)</sup> There is not a single paper which has been published in a scientific journal which comes to a different conclusion.

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14. It is interesting that despite of its membership in the European Union Spain was able to keep its public monopoly with respect to the insurance of elementary damages. This insurance covers, however, only damages which usually are thought to be ‘non-insurable’ like floods, earthquakes, landslips, hurricanes, or attacks by terrorism, but not fire damages. See for this TH. v. UNGERN-STERNBERG (2002, pp. 63ff.).

15. See, e.g., R. SCHÄUBLE (1993) or M. GRETENER (1993), but also R. LEU et al. (1993, pp. 71ff.).

16. See for this ST. FELDER (1996) as well as K. EPPLE and R. SCHÄFER (1996).

17. See TH. V. UNGERN-STERNBERG (1994, 1995) and B. SCHIPS (1995, 1997).

18. See also TH. V. UNGERN-STERNBERG (1996, 2001, 2002).

[11] In the meantime, this result is widely accepted. The ‘Price Inspector’, a special Swiss institution who is mainly responsible for the monitoring of (publicly) administrated prices, wrote in his report of July 19, 1996, that the cantonal monopolies have – on the average – a smaller mark-up on their costs than the private companies. A diploma thesis of I. PROELLER (1996) comes to the same result for the canton St. Gallen. And finally, even the Swiss Supreme Court in Lausanne which had to decide on this matter shared the same view in its decision of February 27, 1998.<sup>19)</sup>

[12] Thus, the abolition of the cantonal monopolies is no longer a politically relevant question. For Switzerland, this holds at least as long as Switzerland is not joining the European Union.<sup>20)</sup> This becomes evident as soon as we consider the development in the canton Zürich. There, in the 1990s, the ‘law of the cantonal housing insurance company’ has been modified. The government as well as the parliament voted for maintaining the monopoly, despite a large non-socialist majority in both institutions. When they were asked, 120 out of 129 local communities pled for maintaining the monopoly.<sup>21)</sup> Finally, in the referendum of February 7, 1999, 77.4 percent of the people voted in the same direction. Thus, the cantonal monopolies will at least for some time survive, as it hardly makes sense to start new efforts to abolish them if such a large majority of the population wants to keep them.<sup>22)</sup>

[13] In the following, first the empirical evidence is to be presented on which the conclusion that the cantonal monopolies operate more efficiently is based (*Section 2*). In *Section 3* we ask for the reasons for this cost advantage. Then we discuss possible arguments for the abolition of the cantonal monopolies despite their efficiency (*Section 4*). These arguments are, however, far from being convincing. We conclude in *Section 5* with some more general remarks.

## 2 The Empirical Evidence

[14] The data TH. V. UNGERN-STERNBERG (1994) used and which cover the years from 1984 to 1993 are given in *Table 1*. The private insurers use a mark-up over the damage costs of 53.9 ct. / 1000 Frs. insurance value (IV), whereas the cantonal monopolies only use 31.1 ct. / 1000 Frs. IV. Thus, in absolute terms the mark-up of the private insurance companies is 73 percent higher than the one of the cantonal monopolies. If we add prevention and damage costs, the mark-up of the private insurers is with 47.9 ct. / 1000 Frs. IV even 170 percent higher than the one of the public monopolies with 17.7 ct. / 1000 Frs. IV.

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19. Bundesgerichtsentscheid 124 I 25.

20. The bilateral treaties between Switzerland and the European Union which have been signed since 1999 are not relevant in this respect.

21. See for this the statement of M. FEHR in the debate of the Zürich cantonal parliament about the modification of the law of the cantonal housing insurance company, reprinted in *Neue Zürcher Zeitung* No. 219 of September 22, 1998, p. 57.

22. In the canton St. Gallen, there was a popular initiative for the privatisation of the cantonal insurance company. However, shortly before the referendum was to take place in summer 1996, the proponents withdraw the initiative because they recognised that they had no chance at all.

[15] Contrary to TH. V. UNGERN-STERNBERG (1994), B. Schips (1995) did not look at absolute but at relative mark-ups. With *unweighted averages* he calculated for the monopolies a mark-up of 95.4 percent, but for the private insurers a mark-up of only of 64.3 percent, which is 32.6 percent smaller.<sup>23)</sup> From this he concluded that the private insurers provide their services cheaper than the public monopolies.

<b>Table 1: Premium Rates of Public Monopolies and Private Insurance Companies</b> <i>ct. / 1000 Frs. insurance value, ten-years average 1984 – 1993</i>				
	Public Monopolies		Private Insurers	
	absolute	relative (in percent)	absolute	relative (in percent)
Damages	32.8 ct.	51.3	55.1 ct.	50.6
Administration	6.0 ct.	9.4	14.1 ct.	12.9
Commission	—	0.0	16.9 ct.	15.5
Prevention	13.4 ct.	21.0	6.0 ct.	5.5
Reserves	11.7 ct.	18.3	16.9 ct.	15.5
Total Premia	63.9 ct.	100.0	109.0 ct.	100.0

Source: TH. V. UNGERN-STERNBERG (1995), p. 3a.

[16] The first problem is that B. SCHIPS used unweighted averages. Thus, to calculate the average for the cantons with public monopolies the cantons Zürich and Nidwalden got the same weights, despite the fact that the insurance value in Zürich is about 40 times higher than in Nidwalden. With respect to the private insurers the cantons Geneva and Appenzell Innerrhoden got the same weights, despite the fact that their insurance values are in relation 30 to one. Such large discrepancies can lead to severe biases. Using weighted averages TH. V. UNGERN-STERNBERG (1995) concluded that the relative mark-ups of the private insurers are even 3 percent above those of the cantonal monopolies. If the costs for prevention are again added to the damage costs, the relative mark-up of the private insurers is even more than twice as high as that of the cantonal monopolies.

[17] The second problem with the arguments of B. SCHIPS is that he used the proportional mark-up as the relevant criterion. He argued that a good of higher quality justifies a higher absolute mark-up. Where, as in the mountain cantons, average damages are higher, he argued that the insurance has a higher quality. Therefore, one should look at the relative mark-up. TH.

23. He also includes the Fürstentum Liechtenstein in his sample, where private insurers are in place. But this has no effect on the results.

V. UNGERN-STERNBERG, on the other side, primarily looked at the absolute mark-up. Thus, part of the discussion between the two experts is whether absolute or relative mark-ups should be considered. Usually, there should be no difference between the two measures. The problem in Switzerland is, however, that, as mentioned above, the private insurers work mainly in the mountain cantons and have, therefore, higher damage costs. Thus, looking at the relative mark-ups gives a (relative) better picture for the private insurers, while looking at the absolute mark-ups favours the public monopolies.

[18] Theoretically it is open which of the two measures is more appropriate. There are arguments for both measures. An empirical analysis of the data used in B. SCHIPS (1995) which are averages over the years 1984 – 1993 shows, however, that the proportionality assumption has to be rejected. Let PR be the premium rate, DR the damage rate, and DMC a dummy variable which takes on the value 1.0 for the cantons with a public monopoly and zero elsewhere. Using weighted regression we get the following result:<sup>24)</sup>

$$\ln(\text{PR}) = 0.382 + 0.555 \ln(\text{DR}) - 0.196 \text{ DMC} + \hat{u},$$

(5.56)      (7.89)      (3.42)

$$\bar{R}^2 = 0.662, \text{ SER} = 0.183, \text{ J.-B.} = 0.579, \text{ DF} = 23,$$

where  $\ln(\cdot)$  denotes the natural logarithm. If the proportionality assumption would hold, the coefficient of  $\ln(\text{DR})$  should be 1.0. Actually, it is significantly below this value.<sup>25)</sup> Thus, the proportionality assumption has to be rejected. The dummy variable for the cantons with public monopolies is highly significant. Its coefficient shows that the premia of the public monopolies are – ceteris paribus – 19 percent below those of the private insurances. Thus, we can conclude that not only the proportionality assumption has to be rejected but also that the cantonal monopolies had significantly lower premia.

[19] Especially with respect to the private insurers, the problem is that they use the same premia for elementary damages all over in Switzerland, quite independent in which canton a building is located and, correspondingly, independent of the risk which is connected with its location.<sup>26)</sup> Therefore, the premia are not related to the risk in the different cantons. Thus, as *Figure 1* shows, the mark-up is necessarily the lower the higher the damage rate is. This implies a cross-subsidy between the cantons. Taking this behaviour as given, in the canton Zurich the abolition of the cantonal monopoly would lead to a mark-up of about 200 percent. Thus, compared to today the mark-up would increase by about 55 percent and the total pre-

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24. The numbers in parentheses are the absolute values of the t-statistics of the estimated parameters. To take account of the different sizes of the cantons, not only a weighted regression is used but also heteroskedasticity consistent standard errors are estimated. SER is the standard error of the regression, J.-B. the value of the Jarque-Bera-Test of normality of the residuals, and DF the number of degrees of freedom of the t-test. – For a detailed description of the weights used and for additional estimates see G. KIRCHGÄSSNER (1996).

25. The corresponding t-value is 6.32.

26. See for this: R. KIELHOLZ, Privatversicherer: Solidarität bei Unwetterschäden, advertisement in: *Neue Zürcher Zeitung* No. 216, September 18, 1997, p. 17.



mium rate by about 32 percent. Therefore, it is no surprise that in the referendum of February 7, 1999, a large majority of the voters wanted to keep the public monopoly.

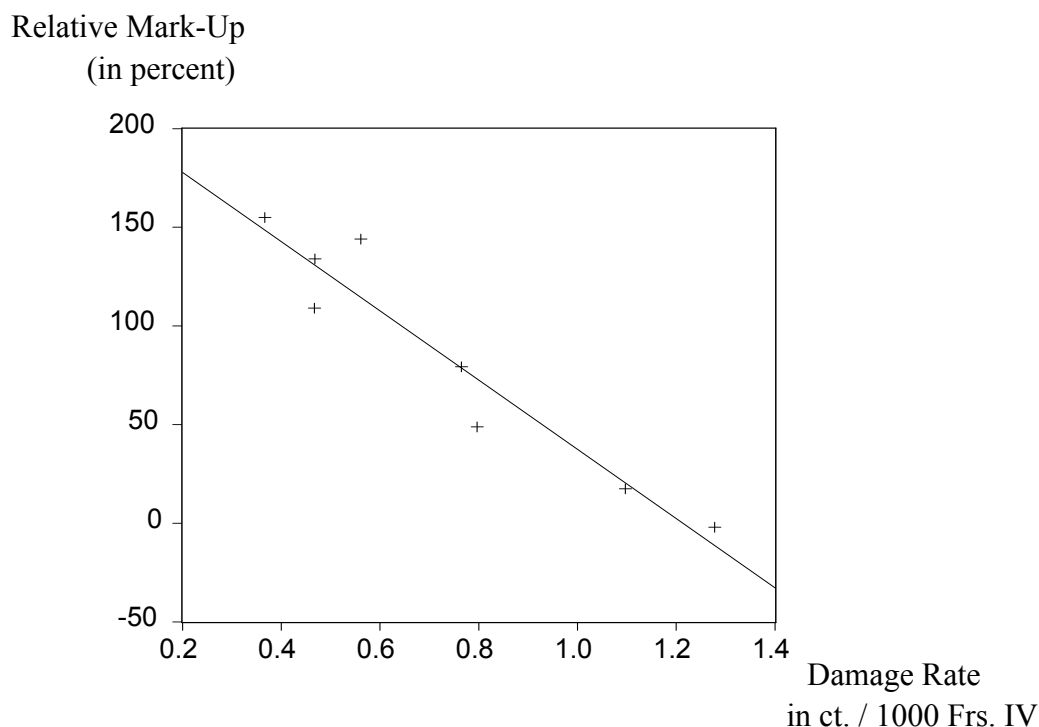


Figure 1: *Proportional mark-ups in relation to the damage rates in the seven cantons with private insurances and in the Principality of Liechtenstein*

[20] The discussion whether one should use absolute or relative mark-ups as the relevant criterion has lost much of its importance, however, because the official price inspector in his report of July 19, 1996 also stated that – on average – the public monopolies have lower proportional mark-ups. Thus, he supported the position of TH. V. UNGERN-STERNBERG (1995). The same result was obtained by ST. FELDER and H. BRINKMANN (1996). Contrary to the other studies mentioned they did not use cantonal averages of the premium rates but looked at the different contracts the public and private insurers offer. They conclude that the mark-ups of the public monopolies are about 47 percentage points below those of the private insurers. Moreover, they get a very interesting result for the differentiation between small and industry customers. The difference in the mark-ups is 110 percentage points and it is statistically highly significant for the small customers, whereas it is only 6 percentage points higher and at no (conventional) level significant for the industry customers. This underlines the conjecture of TH. V. UNGERN-STERNBERG (1995, 1996) that the abolition of the public monopolies might be in the interest of (few) industry customers, but not in the interest of the many small customers, especially not of the owners of small houses or small farms. They would face considerable increases of the premium rates to be paid.

[21] In addition, I. PROELLER (1996) has made a projection of the situation in the canton St. Gallen if the cantonal monopoly were to be abolished. For this comparison she uses the premia of the Helvetia-Patria-Group. As Table 2 shows, the abolition would lead to an increase of 22.2

ct. / Frs. IV or of about 30 percent. The mark-up on the damage costs would be 107 percent higher than today.

<b>Table 2: Premium Rates of the Cantonal and Private Housing Insurance</b> <i>ct. / 1000 Frs. Insurance Value, Comparison for the Canton St. Gallen</i>				
	public monopoly		Private insurers	
	absolute	relative (in percent)	absolute	relative (in percent)
Damages	54.1 ct.	72.2	54.1 ct.	55.7
Prevention	17.9 ct.	23.9	17.9 ct.	18.4
Administration (including Acquisition)	6.3 ct.	8.4	30.2 ct.	31.1
Re-Insurance	4.2 ct.	5.6	2.8 ct.	2.9
Total Expenditure	82.5 ct.	110.1	105.0 ct.	108.1
./. Revenue Without Premium	7.6 ct.	10.1	7.9 ct.	8.1
Necessary Premium	74.9 ct.	100.0	97.1 ct.	100.0
<u>Source:</u> I. PROELLER (1996), p. 66.				

[22] If one takes all these results together there can be hardly any serious doubts that the abolition of the cantonal monopolies would – at least for the large majority of the insured – lead to significantly higher premium rates. But then we have to ask why the premium rates of the private insurances are – *ceteris paribus* – higher than those of the cantonal monopolies.

### 3 Why are the Cantonal Monopolies Cheaper?

[23] There are three main reasons why the cantonal monopolies charge – *ceteris paribus* – lower premium rates than the private insurances:<sup>27)</sup>

- (i) The most important and well documented reason is the lower administrative costs. A regional monopoly has no acquisition costs. No commission has to be paid which is, as *Table 1* shows, with 16.9 ct. / Frs. 1000 IV about 15.5 percent of the total premium. Together with the other administrative costs this adds to 31 ct. / Frs. 1000 IV and, thus, 28.4 percent of the premium. The administrative costs of the cantonal monopolies are, on the

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27. Further arguments why the cantonal monopolies might be more efficient are presented in the (theoretical) paper by W. EMONS (2001).

other hand, below 20 percent of those of the private insurances: they are only 6 ct. / Frs. 1000 IV and, thus, only 9.4 percent of the total premium. The private insurers have no possibility to overcome this cost-disadvantage. It is important to notice that the disadvantage is not due to especially inefficient private insurance companies in Switzerland. These costs arise whenever there is competition in the area of fire and natural damages insurance. TH. v. UNGERN-STERNBERG (2002, p. 119) has shown that in France the administrative costs of natural damage insurances are about one third of the total premium.<sup>28)</sup>

- (ii) Second, it is important to take into account that prevention expenditure of the public monopolies is – especially with respect to fire damages – significantly higher than those of the private insurers. If higher prevention expenditure are effective, they reduce the (expected) damages. From an economic point of view this is efficient as long as the marginal costs of prevention are below the marginal costs of damages which are avoided by prevention. This reduces the total premium, but over proportionally the damage costs. Despite the fact that the total burden for the insured declines, the relation between the total premium and the damage costs increases. As long as such expenditure makes economically sense it should, therefore, be added to the damage costs if the mark-up is to be calculated.

But why is prevention expenditure of the public monopolies higher than that of the private insurers? The reason might be due to positive external effects. If the probability of a fire is reduced, not only those buildings benefit where (potentially) a fire breaks out but also neighbouring buildings are better protected because the probability is reduced that a fire will spread to those. A private insurer in competition with others who is interested in reducing the premium as much as possible will not take into account this effect and, therefore, have sub-optimal low prevention (from an economic point of view). For a regional monopoly there is, however, no external effect. Thus, compared to insurance companies in competition it will have higher prevention expenditure.

- (iii) Finally, there is at least some evidence that once a damage has happened the agents of private insurers are more obliging than those of the public monopolies. This leads to higher officially recorded damages. Of course, this is more difficult to show than the difference in the administrative costs. One of the reasons for this is that the private insurers are primarily working in the mountain cantons where the elementary damages are higher. Thus, it is meaningless to compare the damage costs of different cantons without taking into account their different structure. On the other hand, *Figure 2* shows that there are clear differences of the officially reported damages between cantons with very similar structures; those with a cantonal monopoly report considerably lower damage costs. In Appenzell Innerrhoden (IR) (with private insurance) the damages were with 56.1 ct. / 1000 Frs. IV about 70 percent higher than in Appenzell Ausserrhoden (AR) (with public

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28. In Spain, the administrative costs count for even 47 percent of the premium rates of the private insurances. See for this TH. v. UNGERN-STERNBERG (2002, p. 65). – For a further discussion of the French situation see M. JAMETTI and TH. v. UNGERN-STERNBERG (2004).

monopoly) with 33.1 ct. / 1000 Frs. IV, in Obwalden (OW) (with private insurance) with 76.5 ct. / 1000 Frs. IV about 34 percent higher than in Nidwalden (NW) (with public monopoly) with 56.9 ct. / 1000 Frs. IV, and in the mainly urban canton Geneva (GE) (with private insurance) with 36.7 ct. / 1000 Frs. IV about 37 percent higher than in the more rural canton Vaud (VD) with 26.9 ct. / 1000 Frs. IV and even twice as high as in Zürich (ZH) with 18.3 ct. / 1000 Frs. IV (both with public monopolies). There is at least no obvious reason for such extreme differences of the damages between those cantons. The reason for the differences in the reported damages might (at least partially) be due to the fact that after a damage has happened the agent of a private insurer is obliged to be more generous to his/her client. Otherwise the customer might switch to another insurer. This is impossible if there is a public monopoly. Thus, the agent of a public monopoly might be stricter.

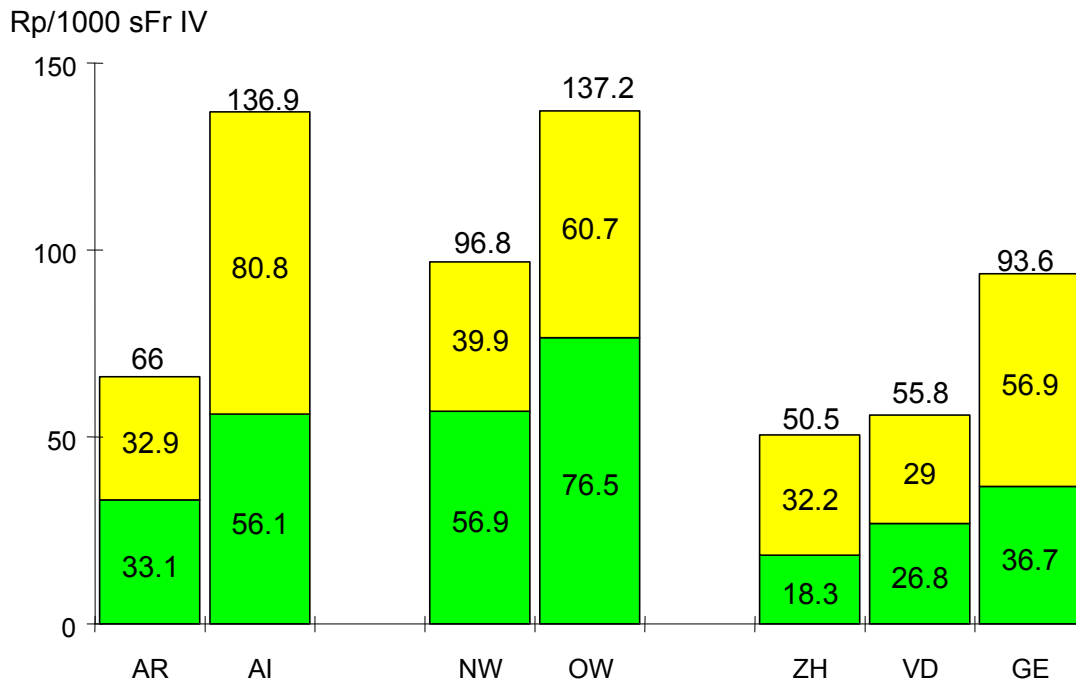


Figure 2: Damage costs, mark-ups, and total premium rate in selected cantons

If the private insurers are more generous than the public monopolies once a damage has happened it might be the case that the latter do not pay enough. But then, there will be legal disputes. In Switzerland, however, such disputes take place very rarely. Thus, one can assume that the public monopolies compensate fairly and that the higher compensations of the private insurers are individually rational for them or, at least, for their agents, but not from an economic point of view.

#### 4 Possible Reasons for Abolishing the Public Monopoly

[24] Despite of all this the supporters of a privatisation of the public monopolies provide some arguments in favour of their position. We shall discuss some of them:

- (i) Static Efficiency: Taking into account not only the empirical evidence but also the arguments in the preceding section it is obvious that the cantonal monopolies are (in a static sense) more efficient than the private insurances, i.e. that they are able to offer the same service cheaper. The reason for this does not lie in the publicness of the cantonal insurances but in the fact that they have regional monopolies. Only this allows to avoid the acquisition costs and, thus, to drastically reduce total administrative costs. An abolition of the monopolies would eliminate this advantage even if the cantonal insurances remained public enterprises but had to compete with private insurers. Of course, the premium rates of privatised public insurers would not have to be adjusted immediately to those of the existing private insurers. But with respect to new contracts the public insurers would also face acquisition costs and, therefore, in the long run they would have to face the very same costs as the private insurers which are today responsible for the higher premium rates of the private compared to the public insurers. But then there would be no reason to still have public enterprises in this area.

Of course, one could think of a private regional monopoly. Then, there would also result no acquisition costs. But then we would have the difficult problem to control such a monopoly. If it maximised its profit like other private firms it would demand monopoly prices which, due to inelastic demand, would be significantly above today's prices, because once a building is erected it is impossible to avoid high premium rates by moving into another region. Thus, a private monopoly has to be strongly regulated. Such regulation is, however, much easier if the firm is a public enterprise. Moreover, the motive of profit maximisation is much less important for managers of 'non profit-organisations' as which the cantonal monopolies can be considered.<sup>29)</sup> Thus, there is no argument in favour but there are many against the transformation of the public into private monopolies.

- (ii) Dynamic Efficiency: There is the question whether the lower premium rates of the cantonal monopolies are not (over-)compensated by some other disadvantage. Usually, it is assumed that private enterprises in competition are more efficient than public enterprises which do not face such competition. This refers not only to static efficiency but even more to a higher innovative power of private enterprises. Usually, the latter is the more important argument. However, with respect to such a homogenous product as the insurance of fire and natural damages where there is hardly any room for technical progress, the innovative power is of very little relevance. It might be possible to have somewhat more diversification by using a more refined bonus system. However, because moral hazard on behalf of the insured is hardly relevant before a damage occurs one should not expect too much of this. Moreover, as the recent development shows, such diversifications

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29. For the theory of non-profit organisations see, e.g., H.B. HANSMANN (1980).

are also offered by public insurers.<sup>30)</sup> As explained above, after a damage has occurred the possible moral hazard speaks, however, because of the more generous behaviour of their agents more against than in favour of private insurances.

- (iii) The third reason which is often mentioned is that private insurers would charge their premia according to the risk of the building while the public monopolies demand the same rates for all buildings. As explained above, this holds at best for fire insurance, because with respect to elementary damages the explicit policy of the insurers is not to charge premia according to the risk. Premium rates which reflect the true risk would, however, only mean an advantage for the insured if they were lower than today's rates. As ST. FELDER and H. BRINKMANN (1996) have shown, this does not hold, at least for the large majority of the clients, because the cantonal monopolies use significantly lower mark-ups than the private insurers for small customers. Thus, e.g., for owners of small houses (with a comparatively small risk) the possibility of lower premium rates would be overcompensated by the general increase of the rates while for small farms (with comparatively high risk) there would be a double additional burden: In addition to the general increase of the rates there would be an increase to cover their high risk.
- (iv) An additional justification for privatisation can be seen in the possibility to sell the cantonal monopoly and to use the revenue to cover at least some part of the cantonal debt. This argument has, e.g., been brought forward in the canton Luzern.<sup>31)</sup> If one does not take into account some possible legal problems this possibility really exists in some cantons. In Schaffhausen, e.g., total cantonal debt is lower than total reserves of the public insurance monopoly.<sup>32)</sup> This is, however, not in the interest of consumers or tax payers. First, the possible tax reduction due to smaller interest payments of the canton is at least partly compensated by the higher insurance premia. Second, this provides no sustainable solution for the cantonal budget. Sustainability demands that current expenditure and revenue are balanced. There is even the danger that such a transitory revenue delays the solution of the cantonal budget problems and, therefore, finally makes it even more difficult.
- (v) A further argument is the compatibility with EU-norms. If Switzerland joined the European Union, it would have to accept the 3<sup>rd</sup> EU-Damage-Rule which demands that public insurance monopolies have to be dissolved. This was the reason for the development in Germany mentioned above. This is, however, no subject of the bilateral treaties which have been negotiated between Switzerland and the EU. Thus, there is no need for any action at the moment. Whether Switzerland will ever join the European Union is a totally

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30. In the canton Zürich which has – even in international comparison – extreme low premium rates the cantonal monopoly does not offer differentiated rates (e.g., with respect to the quality of the building) because, as the insurer states, the additional administrative costs would lead to a rise of all premia. Thus, finally all insured would be worse off.

31. See for this REGIERUNGSRAT DES KANTONS LUZERN (1997). – As B. BORTOLOTTI, M. FANTINI and D. SINISCALO (2003) show, the probability of privatisation is the higher the higher public debt of a country is.

32. See for this: „Teure kantonale Gebäudeversicherungen“, *Neue Zürcher Zeitung* No. 25 of January 31, 1995, p. 23.

open question today. Therefore, using a rational bargaining strategy it would not make sense to offer something in advance. On the contrary, from this perspective it really makes sense to keep the cantonal monopolies.

- (vi) Finally, one can argue that only those activities should be performed by public enterprises which cannot be performed by private ones, independent of whether public or private firms are more efficient in this respect. If one follows this argument, the cantonal monopolies should be privatised, because there is no doubt that private insurances can (satisfactorily) manage the insurance of fire and natural damages.

Taking into account the available evidence it is to be expected, however, that the privatisation leads to an increase of the premium rates. If the Swiss private insurers follow their current strategy, and there is at least no obvious reason why they should change it, this holds mainly for small customers: The owners of small houses and especially of small farms would face drastic premium rate increases. One might be in favour of a privatisation due to reasons of ‘Ordnungspolitik’, but then one should be so honest and concede that this would lead to premium rate increases especially in agriculture which is in no way compensated by better services.

It makes more sense and is politically more acceptable that we have public activities whenever – due to any reason whatsoever – such tasks are better performed than by private agents. Because this is the case with respect to housing insurance in Switzerland there are rather ideological and not economic reasons which support a privatisation of the cantonal monopolies.<sup>33)</sup>

## 5 Concluding Remarks

[25] From all this we can conclude that Switzerland should keep its cantonal monopolies for fire and natural damage insurance. There are no economic arguments for dissolving them: It is neither in the interest of house owners and tenants, nor of the farmers, nor of the majority of voters. They would all lose. Thus, it makes neither economically nor politically sense to abolish these monopolies. If one tries to justify the abolition with ideological reasons one should be so honest and admit that this would lead to a considerable increase of the premia: In the canton Zürich even a conservative estimate predicts an increase of about 20 percent.<sup>34)</sup>

[26] The data which are the base of this estimate are from the past, i.e. from the period 1984 to 1993, which also was the base of the investigations by B. SCHIPS (1995) and TH. V. UNGERN-STERBERG (1994, 1995). Because it hardly can be disputed that within this period the public monopolies were more efficient than the private insurers the supporters of privatisation argue that such a comparison is not very meaningful because during this period there

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33. See for this also D. BÖS (1989) who shows that by privatising public enterprises problems of economic efficiency often have to give room to purely ideological considerations. Moreover, as B. BORTOLOTTI and P. PINOTTI (2003) show, especially right-wing governments are in favour of privatisation.

34. This estimate is taken from the regression presented above.

was no real competition between private insurers. Today, however, we have competition, and this might lead to lower premia. Thus, one should place the privatisation of the monopolies on the political agenda. However, neither the experience in Baden-Württemberg since the mid nineties nor the recent Swiss experience does support this view. In recent years the premium rates of the public monopolies were decreasing (partly due to activities of the price inspector), while no similar development can be seen with respect to the rates of the private insurers. Even if one does not like to accept comparisons on the basis of past experiences more recent evidence does also not provide any reason why a privatisation should lead to a reduction of the rates in Switzerland.

[27] Often, however, it is suggested that competition can only exist between private enterprises. This is not true. There are many forms of competition, among which competition of firms in a market is just one (especially prominent) case. There is, e.g., also political (yardstick) competition between different fiscal units. Switzerland has a lot of positive experience with respect to this kind of competition. Despite the fact that they are regional monopolies there is competition between these enterprises because each canton has its own enterprise which allows consumers as well as politicians to compare their services. This kind of competition should be obtained because it is one of the reasons why the cantonal monopolies are more efficient than the private insurers. Thus, it would not make sense to have one large company for the whole of Switzerland.

[28] With respect to the German situation, there is one last question to be discussed: When the European Commission decided to abolish the regional monopolies in Baden-Württemberg and Hamburg, there was not a single German economist who defended the existing situation. It was then already obvious (and even easier to see than in Switzerland) that the regional monopolies were more efficient than the private insurance companies. Were all these economists simply uninformed, or ignorant, or not interested in efficiency considerations, or even ideologically biased? This question, which first has been raised by TH. v. UNGERN-STERNBERG (2001), still remains to be answered.



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