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### Embracing Risk, Sharing Responsibility

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# EMBRACING RISK, SHARING RESPONSIBILITY<sup>†</sup>

*Tom Baker\**

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### I. INTRODUCTION

I will begin with my conclusion. The title to this Article—*Embracing Risk, Sharing Responsibility*—is the way that I would revise the *Embracing Risk* thesis after 9/11, Iraq, and Katrina.

This statement is, I hope, somewhat enigmatic. Like a Zen koan, it is not supposed to be immediately and intuitively understandable. Instead, it is supposed to point the way toward a new understanding and, afterwards, to serve as a mental hook for that understanding. A real Zen koan is supposed to point the way to enlightenment. I am not that ambitious. I will be happy if by the end of the Article you will understand what the title means.

### II. NOT JUST EMBRACING RISK

The book to which the title refers, *Embracing Risk*, is a collection of essays written by historians, sociologists, and lawyers who are non-traditional students of risk that Jonathan Simon and I finished editing in 2001, shortly before 9/11. In the first chapter, we pulled together some of the strands from the essays in the book, along with our own observations, to make the following claim:

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<sup>†</sup> Adapted from a speech given at the Risk and Responsibility Symposium, Drake University Law School, Sept. 7, 2007.

<sup>\*</sup> Connecticut Mutual Professor of Law, University of Connecticut. This Article is a revised and updated version of an address given in the spring of 2002 and published as: *Liability and Insurance After September 11th: Embracing Risk Meets the Precautionary Principle*, 27 GENEVA PAPERS ON RISK & INS. 342 (2002).

Western Society is “embracing risk” in two distinct senses.

First, people increasingly use concepts of risk to describe and manage social problems. As we wrote, “money management, social services, policing, environmental policy, tort law, national defense, and a host of otherwise unrelated fields have all come to share a common vocabulary of risk.”<sup>1</sup> This aspect of the embracing risk thesis is unassailable. Later events only strengthen the claim. September 11 raised the profile of the risk of terrorism. The Bush Administration told us we needed to go to war in Iraq because of the risks posed by weapons of mass destruction. Katrina put catastrophic risk on the national agenda.

Second, Western society has not only embraced risk as a useful conceptual framework, but has also embraced risk as a matter of social policy. Governments, large employers, and other big institutions that used to spread risks are encouraging and sometimes requiring individuals to embrace the actual risks that they encounter in their lives. Across Western society, governments and other big institutions are to a degree cutting people loose from social structures that spread risk, exposing individuals to more risk, making them more individually responsible—all in the name of creating a more dynamic, entrepreneurial, and creative society.

This second sense of embracing risk is more controversial. The core idea here is the recognition that too much protection against loss can produce too much loss. Not all risks should be spread. For their own and society’s good, individuals should embrace some risks. As we wrote, “as more of life is understood in terms of risk, *taking* risks increasingly becomes what one does with risk.”<sup>2</sup>

Here are three examples of this kind of embracing risk phenomena in the United States context. First is the shift from a “defined benefit” approach to a “defined contribution” approach for employment based insurance. With defined benefits the employer guarantees the employee a specific retirement and health benefit. With defined contribution, the employer provides the employee with a specific amount of money and leaves the employee with the responsibility of investing funds for retirement and the selection of health benefits. Second is the proposed shift in Social Security retirement benefits in which individuals will have a

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1. Tom Baker & Jonathan Simon, *Embracing Risk*, in *EMBRACING RISK: THE CHANGING CULTURE OF INSURANCE AND RESPONSIBILITY* 1 (Tom Baker & Jonathan Simon eds., 2002).

2. *Id.*

similar amount of control over a portion of the Social Security taxes they pay. Third, and most important is the redesign of private and social welfare benefits to encourage individuals to use fewer benefits, to go back to work sooner, and in general to place fewer demand on social resources. This redesign happened to welfare benefits in the United States as epitomized in the renaming of Aid to Families With Dependent Children to Temporary Assistance to Needy Families.<sup>3</sup> It happened to workers' compensation benefits, which were consciously cut so that people would stay out of work for shorter periods. It also happened to health insurance, with the increase in out of pocket payments, the rise of medical savings accounts and the call for consumer directed healthcare. Indeed, some people advocate what amounts to defined contribution health benefits: health savings accounts. In each of these examples, we ask individuals to take more risk—investment risk, income risk, health cost risk—to reduce the demand on social resources.

This “taking risks” aspect of embracing risk is what events like 9/11, Iraq, and Hurricane Katrina suggest we should reconsider. Taking risks does not sound like a very good approach to terrorism, weapons of mass destruction, or natural disasters.

Seven years after finishing *Embracing Risk*, I stand by the descriptive accuracy of our story. In all the ways that we described, people are being encouraged or forced to take more risk. What I am not ready to stand behind is the implicit message that the taking risks aspect of embracing risk is almost always and almost everywhere a good thing. Not quite.

Before explaining how I would refine the embracing risk thesis today, I would like to spend a few minutes on the spreading risk paradigm to which embracing risk is a reaction.

After all, leaders all over the West did not just wake up from a collective dream and say, “Now we should embrace risk.” Instead, they were reacting to a century long encounter with a very different paradigm—spreading risk. To understand the limits of embracing risk, we need to consider that history.

### III. FROM SPREADING RISK TO EMBRACING RISK

When future historians reflect on the developments that transformed

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3. United States Department of Health & Human Services, Office of the Assistant Secretary for Planning and Evaluation, <http://aspe.hhs.gov/HSP/abbrev/afdc-tanf.htm> (last visited Feb. 6, 2008).

the world during the 100 years between 1890 and 1990, they are of course going to emphasize the internal combustion engine, the telephone, airplanes, nuclear weapons, and the computer, but they are also going to emphasize insurance.

Insurance was not invented in the twentieth century, but the history of the twentieth century is one in which insurance institutions protected more and more people from more and more kinds of risk. Pick almost any kind of private or social insurance in almost any developed country and one will find, well into the late twentieth century, a steady expansion in the degree of protection that insurance provided.

The West never approached the frictionless, complete insurance of economists' theoretical model, but each kind of insurance became more "complete" in at least three senses. First, it protected a steadily increasing percentage of the population. Second, it protected that population against an increasingly broad range of risks. Finally, it provided compensation for an increasingly large fraction of an insured loss. While of course there were people and risks left out, domestic social policy of the West for most of the twentieth century could be summed up in the phrase: "More insurance for more people."

Of course anyone transported from 1890 to 1990 would have been utterly amazed by the phones, planes, cars, medicines, and overall opulence. They also would have been nearly as amazed by the degree to which ordinary workers were protected from the hard corners of life. This protection comes from what Francois Ewald has praised, and others have decried, as the "insurance state"—an approach to governing in which the main objective of government is protecting citizens from risk.

A passage from a nineteenth century essay written by a French-American lawyer named Jacques best illustrates the term "insurance state." The essay is called *Society on the Basis of Mutual Life Insurance*, and it appeared in a prominent business journal in 1849.<sup>4</sup> Keep in mind that date—1849 was before railroads, before the Civil War, but at an explosive point in the second Industrial Revolution

Consciously written against the French socialists who had so influenced the young Karl Marx, Jacques' essay imagines a world in which brotherhood and security come, not through collective ownership of the means of production, but rather through institutions that protect against

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4. D.R. Jacques, *Society on the Basis of Mutual Life Insurance*, 16 HUNT'S MAG. & COM. REV. 152 (1849).

the inevitable misfortunes of industrial society.

Jacques imagined a society on the basis of mutual life insurance that, unlike Marx's communism, would not require revolutionary changes in the ownership or control of private property. What this new society would require was only the expansion of insurance beyond the narrow confines of marine, fire and life insurance.

Jacques wrote:

Insurance . . . takes from all a contribution; from those who will not need its aid, as well as from those who will . . . . But as it is uncertain who will, and who will not, it demands this tribute from all to the uncertainty of fate. And it is precisely the moneys thus given away by some, and these only, which supply the fund out of which the misfortunes of those whose bad luck it is that their moneys have not been thrown away, are repaired. . . . From this point of view the whole beauty of the system of insurance is seen. It is from this point of view that it presents society a union for mutual aid, of the fortunate and unfortunate, where those only who need it receive aid, and those only who can afford it are put to expense. Thus, while the aggregate of human suffering and calamity remains undiminished—thus, while the uncertainty of their visitation remains unremoved—human ingenuity and co-operation equalize the distribution of this fearful aggregate, and alleviate the terrors of uncertainty.

. . . .

. . . By a system of mutual insurance thus generally established, embracing all callings, a great fund, as it were, for the benefit of society, would be created; a fund to which none could be said to contribute gratuitously, from which none but the needy should be aided; a great reserve fund, held in readiness for the uncertain case of want. We thus have the mechanic, the laborer, and the merchant, joined hand in hand in mutual protection against the risks of their callings; we have the masses, above all, shielded from the most blighting evil of the inequality of human condition, the danger of destitution; we have society united on the basis of mutual insurance.<sup>5</sup>

This is a far cry from Karl Marx's slogans of the same era: "working men of all countries unite"<sup>6</sup> and "[f]rom each according to his ability, to

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5. *Id.* at 158.

6. KARL MARX & FRIEDRICH ENGELS, COMMUNIST MANIFESTO 58

each according to his needs.”<sup>7</sup>

Looking back, it is very easy to see who had the better crystal ball. Marx had quite a run, but Jacques’s idea of insurance was far more lasting. The institutional structure of late twentieth century insurance institutions was not that of mid-nineteenth century mutual life insurance companies. For example, the government played a much larger role. But, the West is far closer to a society united on the basis of mutual insurance than even Jacques might have thought possible.

Yet, despite the successes of the insurance state, during the last two or three decades of the twentieth century there grew an increasing dissatisfaction with the call for “more insurance for more people.”

We discovered that the more people are protected from loss, the more social resources are consumed by loss—this is the crisis of the welfare state that led to the “third way” and the “end of welfare as we know it” and that explains why people were ready to believe that compassionate conservatism meant something more than protecting the haves and the have mores.

This discovery was not really new. People in the early nineteenth century insurance industry worried about “moral hazard,” just as the authors of the poor laws worried about the related problem of “pauperization.” But, historically, moral hazard and pauperization were localized concerns. What was new was the widespread recognition that moral hazard is a systemic problem embedded in the foundations of the insurance state.

Insurance cannot spread all losses because some losses grow with the insurance. Not dollar for dollar, but over time they grow enough to reduce our willingness, and maybe even our ability, to keep spreading them.

The obvious example in the United States today is Medicare. We are keeping our head above water for now—in large part because of all the young immigrants who pay taxes—but the trajectory is not good. I will be happy when we get to the point when Medicare funding ranks higher on the public agenda than Iraq, but when that happens, things are not going to be pretty for the healthcare industry.

The embracing risk paradigm grew in large part out of this decline in

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(ElecBook London 1998) (1848).

7. KARL MARX, CRITIQUE OF THE GOTH PROGRAM 20 (ElecBook 2001) (1875).

the belief in the risk spreading power of large institutions, but it also grew out of a desire for individual control and autonomy. Think of Nike's "Just Do It," McDonald's "Your Way," and the Army's "An Army of One." On this point, be sure to read Jonathan Simon's essay in the book about mountain climbing, which illustrates the appeal of taking risks.<sup>8</sup>

Looking back at our book seven years later, I have the following reaction: I think we over-emphasized the limits on insurance institutions' ability to spread risk. We did not emphasize enough the negative consequences of taking risks, especially when people do not choose to do so. We also did not emphasize enough the degree to which the embracing risk paradigm threatens the social glue that holds our society together.

Although the United States is supposed to be the land of the free and the brave—the rugged, competitive individual who rejects solidarity—in fact, the enormous public and private insurance institutions built over the last 100 years represent a tremendous social commitment to solidarity. The solidarities in many cases are narrower than they might be, and typically they are the collective result of relatively autonomous individuals acting in their self-interest rather than an expression of fraternal responsibility, but they are solidarities nonetheless.

Embracing risk threatens to break apart these huge insurance pools so that the social policy of "more insurance for more people" becomes one of "more insurance for some, but less for others." More insurance for the haves and the have mores, less insurance for everyone else.

Some embracing risk developments may be very beneficial, but the embrace of risk can lead to competition on the basis of risk in which insurance companies and even states compete by developing new ways to identify "good" risks and shut out the "bad." The increased emphasis on risk-rating in health insurance and the corresponding decline in community rating are both very real examples of the retreat from solidarity in the United States health insurance market. The shift to defined contribution health insurance benefits threatens to accelerate this de-pooling.

Embracing risk can be beneficial when it provides manageable incentives to people who are in a position to control risk and prevent loss. It is counterproductive when it becomes an excuse for leaving expensive losses on people with little or no control over those losses. This is why embracing some risks can be beneficial in health insurance design—for

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8. Jonathan Simon, *Taking Risks: Extreme Sports and the Embrace of Risk in Advanced Liberal Societies*, in *EMBRACING RISK*, *supra* note 1, at 177–202.



example, higher co-pays for name brand drugs than generics—and why embracing other risks is harmful—for example, making people with chronic disease pay more than the healthy.

Along with embracing risk, we need to re-invigorate a forgotten nineteenth century insurance idea—that of destructive competition. When insurance companies compete by “cream-skimming” the good risks and shutting out the bad risks, they destroy the safety net that insurance is supposed to provide. Yes, not all risks are the same. No, the answer to every potential loss is not the spreading risk approach of the past, but we need to distinguish risks for the right reasons so we do not de-pool ourselves out of the security net that has been one of the wonders of the twentieth century. We need to recognize that competition on the basis of risk selection, especially in personal lines of insurance and perhaps more broadly, is destructive and often pernicious—except when risk classification sends a useful signal that insureds can act upon to prevent loss, to their benefit and society’s benefit.

Embracing risk need not and should not mean a retreat from the ideal of protecting individuals from risk. It does mean recognizing that not all risks are the same—some risks should not be fully shifted to the insurance pool. At the same time, however, it demands that we carefully examine the risk-based distinctions made in the insurance market so they do not result in destructive competition. That is the biggest concern when reconsidering embracing risk seven years later. Embrace risks when it is socially responsible to do so. Spread risks over to areas in which people do not have control, and do not leave it only to the market to sort that out.

Reconsideration number two relates to the big problem that *Embracing Risk* mostly ignored: catastrophic risk. We ignored catastrophic risk because it did not fit easily into the embracing risk paradigm. Like embracing risk, catastrophic risk poses a challenge to the spreading risk paradigm, but it is a different challenge. Embracing risk says that we cannot spread all risks because the losses will increase with the insurance. Catastrophic risk challenges the spreading paradigm in a different way. With embracing risk we run away from insurance; with catastrophic risk, the insurance runs away from us. Insurance companies say that they cannot deal with catastrophic risk, not because people take advantage—though sometimes of course they do—but because insurance companies do not know how to price it. If they cannot price it, they cannot sell it, and if they cannot sell it, we cannot spread the risk. What does embracing risk have to say to that problem?

I have an answer, and like many of the answers in our book, it is based on history. Looking back at insurance history, we can see that the catastrophic risk problem is based on a false premise. That premise is based on the idea that we can only spread risk if we can predict it in advance. It is also based on the premise that insurance requires fixed premiums paid in advance. But if we look back at insurance history, we can see plenty of examples of insurance against losses that the insurers could not predict in advance, and those kinds of insurance did not involve fixed premiums paid in advance.

Insurance history is full of what people in the insurance trade call assessment insurance. With assessment insurance, the insurer does its best to calculate the correct premium in advance, but it has the ability to come back and collect more after a loss to help people who need it if the insurance fund runs dry. The amount that the insurer can collect after the fact from any one person is calculated based on the chance that this person would have been among those who suffered the loss and based on the amount of loss that this person would have suffered. The assessment approach recognizes that, “there but for the grace of God go I.” That we are all in this together.

With an assessment approach to insurance, you do not need to know in advance the amount of future loss. The assessment approach to insurance is tailor-made for the uncertainties of catastrophic risk. We need to embrace catastrophic risk, not as rugged individuals turning our homes into concrete bunkers mounted on stilts—though a little of that would be a good thing—but rather as a society, maybe even as a nation.

Embrace risk, share responsibility, take the leap into the unknown of catastrophic risk, but take that leap linked together. It is trite and clichéd I know, but “United we stand; divided we fall.”

#### IV. CONCLUSION

As Francois Ewald states in his wonderful essay at the end of *Embracing Risk*, “we are seeing the birth of a new paradigm, one that has not yet found its true name, but whose arrival is presaged by various signs.”<sup>9</sup> The only question is how insurance institutions will adapt. I have tried to suggest that insurance institutions should adapt in two complementary ways that are summed up in the phrase, “embracing risk,

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9. Francis Ewald, *The Return of Descartes's Malicious Demon: An Outline of a Philosophy of Precaution*, in *EMBRACING RISK*, *supra* note 1, at 273.

sharing responsibility.”

First, insurance institutions should adapt to increase the incentives for individuals and institutions to prevent harm. That is the embracing risk part. But at the same time, we need to work together—through government regulation—to prevent the destructive competition and de-pooling that will otherwise result. That is the sharing responsibility part.

Second, insurance institutions need to adapt to provide coverage for unpredictable, catastrophic risk. In other words, insurance institutions need to embrace catastrophic risk. That is the embracing risk part. We also need to increase the ability of our insurance system to make assessments. That is the sharing responsibility part. The assessment element can come in the form of a government backstop or perhaps it will come in more creative ways that lawyers and policymakers will invent.

Embrace risk, but share responsibility. That is my vision for risk and insurance in the twenty-first century.