Individual Health Insurance Reform without Side Effects

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Theme of talk

• Individual insurance in some form is likely to be a vehicle for expanded insurance coverage.
• But one of the “problematic” features of individual insurance is how it deals with variation in risk across people and over time.
• Reform proposals would intensively regulate premiums and underwriting, requiring modified community rating and no exclusions.
• I will argue that this is a bad way to do a good thing, and provide the theory & evidence for better alternatives.
Plan of talk

• Efficiency and equity objectives for insurance.
• Review of pros and cons of individual coverage.
• Focus on how insurers treat risk variation, with emphasis on “guaranteed renewability at class average rates.”
• New theory: “Original guaranteed renewability” (OGR) is the unique stable schedule in competitive markets for a wide variety of assumptions about information.
• Suggested policy: Combining GR and high risks pools is better than community rating/no exclusions.
Efficiency and equity goals for insurance

- Risk averse people should all have insurance if its administrative cost is not “too high.”
- Ideal insurance market charges premiums proportional to risk, and all buy.
- Specious objections: risk rating interferes with risk pooling; high risks can’t afford higher premiums.
- But single period risk rating exposes people to reclassification risk over their (pre-Medicare) lifetime.
Why CR and no exclusions are dumb

• CR cross subsidizes high risks with an excise tax on insurance premiums for low risks, a distortive and inequitable tax.
• Causes low risks to avoid coverage
• Causes insurers to cream skim against high risks.
• And causes any rational person to wait until they get sick to seek insurance coverage.
Some obvious and less obvious stylized facts about individual insurance

• Only bought by 6-8% of privately insured but the likely vehicle for the uninsured.

• Allows more choice of portable coverage than group insurance.

• Premiums vary widely and administrative costs are high—about 25-30% if you search (vs. 20% for small group and 5% for very large group). Underwriting costs <1% but selling/billing cost is high. (Catch 22)

• Not tax subsidized as group insurance is.
Sure, it works in practice but can it work in theory? GR in individual ins.

• Almost all individual coverage is forbidden to re-underwrite or raise premium based on individual’s risk or loss experience. True even before HIPAA.

• GR in theory: part of the premium goes for current claims but part goes to make up the difference between high risk expense and low risk premium for those who become high risks. Sometimes called “health status insurance.”
Male GR premium schedule. *Note: These estimates are given in 2005 dollars.*

Source: Herring and Pauly, “Incentive-Compatible Guaranteed Renewable Health Insurance Premiums,” *Journal of Health Economics* 25, no. 3 (2006), pg. 407 (Figure 3B).
Male actual CTS individual insurance premiums. Note: These values are given in 2005 dollars.

Source: Herring and Pauly, “Incentive-Compatible Guaranteed Renewable Health Insurance Premiums,” Journal of Health Economics 25, no. 3 (2006), pg. 409 (Figure 4B).
GR in theory

• If all insurers know risk perfectly but agents begin at the same level of risk, they will prefer coverage with GR and choose high coverage.
• Incentive compatible insurance charges a premium attractive to low risks in every period.
• But no harm is done if low risks leave; they already gave.
• Mini-controversy: bundle in one firm or separate GR coverage? Marry or argue?
Downsides and defects

- Frontloading of premiums may burden young buyers.
- Insurers can cancel whole classes, can try to draw off low risks and then increase premium for high risks.
- Reputation should prevent backsliding, but maybe not if insurer is leaving a market.
Circumstantial evidence that GR is pretty good in actual markets

- Premiums frontloaded and match OGR profile.
- Elasticity of premiums paid with respect to risk is less than 60% for demographic (age) risk and less than 16% for chronic condition risk.
- High risks are not substantially less likely to have individual coverage than lower risks, and CR regulation makes only a small difference.
- Actuaries worry about reserves and commitments, but are conflicted.
- Individual insurance not highly profitable.
Theory: OGR, and only OGR, is adverse selection proof

• Change information structure so outside insurers do not know individual’s risk (but person and current insurer does): RS adverse selection model.

• This might allow a reduction in the burden of high early premiums since outside insurers must get low risks to self-select and therefore utility of low risks is lower than under perfect knowledge.
Proposition 1: GR prevents adverse selection

• No way an outside insurer can offer low risks a higher level of welfare than in OGR.
• So no way to offer a (temporarily) separating contract.
Proposition 2: Only OGR is adverse selection proof

- Intuition: any policy trajectory other than OGR involves pooling and a pooled policy cannot be an equilibrium.
- This is true of the optimal pooled policy (RS) but is also true of any policy which charges low risks more than PDV of their expected expenses.
- The diagram (hopefully) explains.
Figure 1
Individual insurance reform without side effects

• Do what you can to lower administrative cost. Exchanges unlikely to help much but may increase efficiency of search.
• Set up unlovely high risk pools to mop up current high risks.
• And get all normal risks to take GR coverage.
Advantages of OGR

• Compared to high risk pools it does not require tax finance.
• Compared to CR with no exclusions it encourages low risks to take coverage. And CR requires heavy regulation of cost containing policies to plug holes in self-selection. Deadly for insurance innovation (not that there has been much yet).
• Compared to both, coverage is not limited to avoid transfers.
Practical issues

• OGR works best if insurance is offered nationally.
• Could allow changes in coverage in response to specific changes in circumstances (marriage, births).
• Need to deal with turnover (see next slide) and chiseling
Group insurance makes individual insurance take the blame

- No GR for the person in group insurance
- People with individual insurance who are high risk do not lose coverage like small group does.
- So worker who changes/loses job and becomes high risk faces high individual premiums.
- For which group insurance is responsible, but individual insurance will be blamed.
- Solution: mandatory group-to-individual conversion in small group insurance.
Tough love

- Combination of mildly punishing mandate and big subsidies may allow CR to limp along.
- People who do not take coverage on “insurance day” will have to wait without coverage.
- But OGR is better, in all dimensions.
- Still, it does require that people who, despite all reason, do not take coverage until they get sick will be treated somewhat harshly.
- “You should have thought of that beforehand.”
- The dilemma of individual compassion and bad incentives.
Conclusion

• Policies for universal CR without exclusions should be scrapped.
• Allow states to experiment with ways to protect high risks without driving out low risks.
• A little imagination wouldn’t hurt.