

Implications of Choice and Guaranteed Issue in Insurance Markets

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1 Description

The Congressional Budget Office estimates the Patient Protection and Affordable Care Act will reduce the federal deficit by \$143 billion within ten years. After this period, the estimated benefit is expected to equal between one quarter percent and one-half percent of gross domestic product (Elmendorf, 2010). To achieve such spending reductions comes at a price for both consumers and state policy makers.

For states, the price of reform is the logistical costs of structuring state-based health insurance exchanges by 2014. These Exchanges are intended to provide a direct medium for buyers to select health insurance plans from the carriers. In designing the exchanges, states will need to provide protections for both individuals and carriers. Insurance carriers face the risks of asymmetric information and adverse selection due to limitations on underwriting and regulations on guaranteed re-issuance. Zeckhauser & Cutler model the destabilizing effects of adverse selection and the repercussions on insurance plan choice. Adverse selection results in information asymmetries between the insurance carriers and consumers, risk sharing losses, and cream-skimming. Therefore, even if high-risk agents have a high willingness to pay for a generous plan, there may be a market failure because insurers either do not offer correspondingly generous coverage or use utilization management and risk selection to limit access (Cutler and Zeckhauser, 1997).

For individuals, this price is the premium of mandatory health insurance coverage. While expanding coverage is intended to increase access to medical care, information asymmetries may result in high-risk agents imposing a negative externality on their low-risk counterparts (Rothschild and Stiglitz, 1976). No stable equilibrium can be expected when pooling costs to the low-risk agent are low. Low pooling costs can result from a scarcity of high-risk agents that need to be subsidized, low per-agent subsidies, or high separating costs/risk aversion (Rothschild and Stiglitz, 1976). While the policy solution would be to have separate pools based on risk profile, the thresholds for these groups will likely impact the overall efficiency gains of this policy mechanism and the expected premiums. States which opt for a tiered exchange structure and separate high-risk, young-people groups will need to consider these factors.

Aside from pooling concerns, the exchanges may potentially increase efficiency and matching between consumers and carriers. Exchanges potentially lower transaction costs related to employer

administration, job-switching frictions, search costs, and brokerage fees. Exchange designs that include standardization based on plan actuarial value increase transparency and result in efficient matching and increased competition. This feature may generate gains in surplus and alleviate adverse selection effects. There is a potential to exploit the current variation in state insurance markets to estimate these effects using New Hampshire and Vermont. State-based insurance markets vary in terms of protections for individual and small group markets, as well as high-risk pools. In both New Hampshire and Vermont, protections in the individual market include minimum coverage requirements, standardization of plans; though the number of tiers vary, rate review and limitations; age bands and community rating, respectively. These states differ in that issuance of products is guaranteed in Vermont, but not in New Hampshire. These differences would allow us a natural setting to estimate the effects of these protections.

I hope to utilize the support of the Ackof Fellowship to purchase claims data from Vermont and New Hampshire to estimate a demand function for insurance and determine the additional surplus to consumers living in states with different levels of protections in the individual health insurance market. This study will contribute insights to a model of health exchanges in differing regulatory environments.

References

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