

The Special Case of Health Insurance

By William C. Wood

Health insurance is like other insurance in that premiums are collected and payments are made—but it's also very different because health care is so personal. Health insurance has been the subject of major political action in Congress and the courts, including the Patient Protection and Affordable Care Act of 2010 and the regulations and court decisions that followed its adoption.

Most of the time, health insurance payments are only partial. The amounts not paid by health insurance are separately named and defined:

- The deductible is the part you have to pay annually before coverage kicks in. If you have a \$3000 deductible on an individual policy, you have to come up with the first \$3000 in paying for your health care (with a few exceptions).
- The additional fee per doctor visit or prescription is known as the copayment or copay. Copays for doctor visits often fall in the \$25 to \$100 range.
- Most policies do not pay 100 percent even after copayments and deductibles are met. The percentage you then pay is called coinsurance. Frequently you will pay 20 percent, while the insurance pays 80 percent, on the amounts subject to coinsurance.

These costs faced by the consumer provide an incentive to avoid accidents and avoid filing unnecessary claims.

Unlike other forms of insurance, health insurance traditionally was provided as part of a benefit package by employers. Under the Affordable Care Act, as implemented and modified by regulation, you must purchase approved health insurance or pay a penalty. Coverage and requirements are more closely regulated by the federal government than for other forms of insurance.

But just like the other forms of insurance, health insurance is part of an overall risk management strategy. A smart consumer would:

- Assume small risks, such as the risk that you will need to pay for an Ace bandage.
- Assume the small risks represented by your copay per doctor visit.
- Reduce other risks, by good health habits.
- Share the risk of big medical expenses by carrying appropriate coverage.

More so than in other forms of insurance, you may be asked to consider a much higher deductible—so that you pay more medical costs out of pocket before coverage takes over. A high deductible presents a tradeoff: You pay more out-of-pocket but also have lower premiums. A smart decision involves trying to anticipate upcoming medical expenses and deciding accordingly. Since medical expenses frequently are unanticipated, you cannot always know whether a high deductible is better, but you can try to make a good guess.

It's important to know that health insurance markets are highly regulated. Competition has not been allowed to operate to the same degree as in other markets. Insurance companies respond to incentives, and therefore there may be unusually bad deals not extinguished by competition—for example, a high-deductible plan with only slightly lower premiums. Shopping carefully for health insurance can save you a lot of money.

Challenges to Health Insurance Markets

Especially in the case of health insurance, the normal operation of markets is challenged by two conditions of special interest to consumers and policymakers, both of which result from the incentives created by insurance:

- Moral hazard occurs when someone assumes additional risk because of insurance. Someone with full coverage might leave a car unlocked, putting the car's premium sound system at risk. Or someone might be careless with a newly installed fireplace, knowing that homeowner's insurance covers fire losses.
- Adverse selection occurs when someone avoids buying insurance unless it is sure to be needed. A homeowner might see a flood forecast, and so run out and buy flood insurance. Someone else learns from the dentist that orthodontic work will be necessary, and therefore adds expanded dental coverage to a health insurance policy.

Moral hazard and adverse selection can upset the calculation of premiums. If the insurer sets premiums assuming a certain level of claims, higher-than-expected claims end up making the insurance unprofitable. Here are some ways that insurers deal with these challenges:

- Charging more to insure custom sound systems in cars.
- Requiring additional on-site inspections of homes with wood-burning fireplaces or stoves.
- Requiring a 30-day wait for flood insurance coverage.
- Charging higher premiums for expanded dental coverage.

Health insurance policymakers have a particular worry called the “death spiral.” This unfortunate condition would start when insurers responded to moral hazard or adverse selection by raising rates. Then the moral hazard might become worse. People would be paying more, and therefore feel justified in taking more risk. Adverse selection also might become worse—the only buyers would be the people who were truly sure they would need the coverage. Losses would again be higher than expected, and rates

would be raised again. If the market totally disappeared, that would be the full “death spiral.”

Health policy experts typically have two conflicting sets of recommendations for improving health insurance markets and preventing a death spiral. First, there are those who recommend greater government intervention. Such policies would include mandates, regulations, and central control of premiums and specification of coverage. Improving health insurance markets through mandates and regulation is not easy, as the experience with the Affordable Care Act has shown. Worse results lead to calls for more regulation, which leads to still worse results.

A second and opposite approach is to rely on greater competition. Specific policies include reduction of subsidies, equalization of tax treatments of competing forms of health insurance, and encouraging interstate sales of health insurance.

Shopping for Insurance

Now that we have surveyed types of insurance and how they work, we can easily see how to save money on insurance. Here are three sound strategies:

1. Shop around and check different insurers. There are always additional benefits and costs of extending a search for alternatives. The costs are reflected in your time and effort. But in insurance, more so than for many other products, there is a large variation between the highest and lowest rates available. That large variation makes it more likely that you will score major savings by shopping around.
2. Concentrate on guarding against large losses. You can do this by paying attention to health and safety in your daily life. If you are prudent with risks, and maintain good emergency savings, you can also save a lot of money by going for high deductibles when they are available.
3. Reduce risks, especially those noticed by insurers, such as driving a fast car.

Risk cannot be eliminated. However, with smart behavior by consumers and reasonable policies from governments, insurance can go a long way toward managing it.

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