NEED TO KNOW

AMERICANS FOR PROSPERITY FOUNDATION

HEALTH CARE INSURANCE: GUARANTEED ISSUE AND COMMUNITY RATING

HOW DOES INSURANCE WORK?

Insurance allows individuals to pool their risk and protect themselves from large, unexpected costs. Fire insurance is a good example. Homeowners pool their money together through annual fire insurance premium payments. If one homeowner suffers the misfortune of a fire, that aggregated pool of funds is available to help the homeowner rebuild her home. Each homeowner is protected from the risk of catastrophic costs related to fire damage, and they pay for this peace of mind with their annual premium payments. Health care insurance works in a similar manner, protecting consumers from the risk of unexpected costs of treatments when they get sick.

QUICK FACTS

- Insurance premiums tripled in New York after the state passed guaranteed issue and community rating laws.

NOTABLE & QUOTABLE

"You basically can't have a functioning insurance market if people can buy insurance on the way to the hospital."

\- **Mark Hall**, Wake Forest University

In any insurance market, assessing risk levels is important. The more likely a consumer is to consume resources out of the pool of funds, the higher the premium the consumer should pay to mitigate their risks. When underwriting health care insurance policies, the insurance company takes care to assess how likely an individual is to need expensive treatment and file a claim for reimbursement, and the company charges the consumer a premium accordingly.

ADVERSE SELECTION

Insurance markets can suffer from a problem called "adverse selection." Adverse selection occurs when the riskiest individuals (those who need the protection of insurance the most) are the only ones who seek out insurance and pay premium into the pool. This can cause an "adverse selection price spiral": when only the riskiest purchase insurance, this drives up the cost of premiums for everyone else because the expense of paying out so many claims overwhelms the pool of funds. This encourages the less risky individuals to drop out of the insurance pool when the price gets too high.

Insurance markets are highly dependent on market forces like risk assessment and price signals in order to function properly. Yet even before President Obama's new health care law was enacted in March 2010, insurance markets were far from free and open. Policymakers placed restrictions on the types of insurance products that could be sold and the amount insurance companies could charge consumers for purchasing their products. Two restrictions in particular, guaranteed issue and community rating, have been used to manipulate insurance markets, which has predictably led to higher premiums and less access to health insurance.

GUARANTEED ISSUE

Guaranteed issue rules require companies to insure all consumers regardless of their health care risks. In practice, this means that insurance companies must cover individuals with pre-existing health conditions – even if those individuals will have a disproportionately high number of claims. This could create the "adverse selection price spiral" mentioned above. Moreover, an individual would be better off to wait until he is sick to purchase insurance.

After all, since a guaranteed-issue policy forces companies to provide insurance no matter what, an individual can save money by not paying insurance premiums over the long-run when he or she isn't sick and doesn't need assistance paying for health care.

This policy results in a huge transfer of wealth from the young and the healthy to the old and the sick.

Clearly this would be a broken market. As Wake Forest University economist Mark Hall explained, "You basically can't have a functioning insurance market if people can buy insurance on the way to the hospital" (1). Nevertheless, guaranteed issue was one of the centerpieces of President Obama's new health care law that will take effect in 2014.

COMMUNITY RATING

Community rating, generally a complement to guaranteed issue, prohibits insurance companies from charging individuals different premiums for insurance. Whether you are healthy or sick, whether you are young or old, everyone is charged the same premium. Under the new health care law, starting in 2014 insurance companies will only be able to charge differential premiums according to four factors: age, tobacco use, number of individuals on a family policy, and geographic area. (2). Additionally, there are caps on how much a company may vary premiums based on those factors. The elderly can only pay 3 times more than the young; tobacco users can only pay 1.5 times more than non-users (3).

This policy results in a huge transfer of wealth from the young and the healthy to the old and the sick. It also removes one of the incentives to stay healthy, since bad health decisions don't result in higher health care premiums. Just like with guaranteed issue, this policy causes insurance companies to raise premiums on everyone to offset the increased risk.

ECONOMIC EFFECTS OF GUARANTEED ISSUE AND COMMUNITY RATING

Even before the new health care law, various states experimented with these insurance regulations with devastating effects. New York passed both provisions nearly two decades ago and now is home to some of the highest premiums in the country. Since 2001, premiums in the state have tripled and in many areas individuals are unable to purchase insurance for less than $12,000 per year (4). Kentucky and Washington passed similar reforms in the 1990's but removed them shortly after because premiums skyrocketed and insurance companies fled the two states.

In an attempt to solve these issues, President Obama's health care law includes an individual mandate, requiring most people to carry insurance or face a fine from the IRS. By forcing everyone to purchase insurance, the size of the risk pool is increased, helping insurance companies control the costs of premiums. However, as noted in our "Need to Know" on the individual mandate, many Constitutional concerns exist with such a requirement.

Endnotes:

1. Noam Levey, A Cautionary Tale in Health Reform, LOS ANGELES TIMES (February 21, 2010) (online at http://articles.latimes.com/2010/feb/21/nation/la-na-health-insurance21-2010feb21).
2. Patient Protection and Affordable Care Act, Pub. L. No. 111-148 (2010) as amended by the Health Care and Education Reconciliation Act, Pub. L. No. 111–152 (2010).
3. Affordable Care Act, supra note 2, at §2701(a).
4. Levey Article, supra note 1.