

Controlling selection incentives when health insurance contracts are endogenous

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Abstract

The paper examines the nature of health insurance contracts when insurance companies pool high- and low-risk individuals. In a spatial product differentiation model, the normal forces of competition induce quality provision, but selection incentives induce insurers to under-provide quality. To offset selection incentives, the government can reimburse some of the insurers' costs. However, such a subsidy can in some cases reduce quality further, as well as discourage production efficiency. In such cases the optimal reimbursement rate is negative. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

The issue of risk selection in health insurance markets, and the design of policies to control it, has received growing attention in recent years (see, for example, Newhouse, 1996; Glazer and McGuire, 1998). Recognizing that financial incentives are central to the analysis of this phenomenon a number of authors (Ma, 1994; Newhouse, 1996) have adopted techniques from the optimal regulation literature of Laffont and Tirole (1994) to the health insurance context to examine the implications for optimal reimbursement policies.¹ However, it is arguable that the mechanism of risk selection requires somewhat more specific modelling than is available in the standard literature.

¹See Ellis and McGuire (1986) and Ma and McGuire (1997) for related models in the health economics literature.

Insurance companies have incentives to select good risks ahead of bad risks because the latter are more expensive to cover. A major strand of the literature on selection control examines the use of risk-adjusters to offset these incentives. Exogenous characteristics correlated with expected health care utilization are used to predict costs, and correspondingly adjust premiums paid to health plans. Glazer and McGuire have recently investigated the design of such risk adjusters in the context of the model of insurance under adverse selection of Rothschild and Stiglitz (1976) and Wilson (1977).

An alternative natural way for the government to remove these incentives is for it to pay for some of the realized costs of coverage: indeed, by reimbursing all of the insurance claims paid, a government would cause insurers to be indifferent between covering either risk type. The problem with such a solution is, of course, that insurers would have no incentive to provide insurance efficiently, since the signal upon which transfers are based is no longer exogenous. This is an example of the multi-task agency problem identified by Hölmstrom and Milgrom (1991). By reducing incentives to select good risks, the government also waters down incentives for production efficiency.

In this paper selection is socially undesirable because it can lead to low quality insurance. There is a sense in which this occurs in the standard Rothschild–Stiglitz model. An equilibrium in that model (if one exists) is characterized by full insurance of high-risk individuals, but with low-risk individuals being under-insured. One might interpret this as under-provision of quality (of insurance bought by low risks) in order to deter high risks from purchasing the wrong contract. However, the ‘quality’ of insurance purchased by high risks is not distorted. In addition, competition eliminates the possibility of cross subsidization of high risks by low risks (firms earn zero profits on each contract they sell in equilibrium), so insurers have no particular incentive to alter the risk mix of their insurance pools.

It is arguable that this kind of model misses a fundamental issue in the analysis of selection incentives, namely, that such incentives derive from the benefits associated with better risk pools, and that they can lead to under-provision of quality for *all* consumers. To allow the possibility of positive profits I endow insurers with some market power, specifically by use of a spatial model of product differentiation. I also assume that consumers cannot be quantity constrained, or more generally, that insurers cannot offer non-linear screening contracts. This second assumption, which induces a kind of pooling, means that insurers must earn positive profits on at least some of their clients if they are to remain in the market.² Insurers may then have incentives to reduce the terms of insurance (i.e., its quality) in order to increase the share of profit-generating low risks they cover.

Whenever insurers have access to information about the risk-types they cover,

²The adverse selection aspect of the model is thus closer to Akerlof’s (1970) lemons case than Rothschild and Stiglitz’s.

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