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Community rating in health insurance and different benefit packages

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Abstract

This paper presents a model of a competitive health insurance market with two risk types and two health benefits. In the benchmark case, community rating insurers (CRIs) are only allowed to offer the basic benefit. The additional benefit is sold by risk rating insurers (RRIs). It is shown that low risk types can only be better off at the expense of high risk types if CRIs are allowed to offer the additional benefit and no additional measures are taken. However, high risk types can be made better off if CRIs must offer the additional benefit or if community rating health insurers offering the additional benefit are subsidized while those selling only the basic benefit are taxed.

JEL classification: H51; I18

Keywords: Health insurance; Community rating; Risk-selection

1. Introduction

Under *community rating*, health insurers must charge a uniform premium for all individuals who enroll in their health plans. This regulation is supposed to achieve an equity objective. To a large extent, the health status of individuals is regarded as beyond their responsibility. Risk-based premiums would unjustly put a higher burden on people with a poor health status while under community rating individuals with a good health status subsidize those with a bad health status. To reach this equity objective, community rating must be accompanied by open enrollment. Otherwise, high risk individuals might not find an insurer. In addition, health insurance has to be compulsory to make sure that low risks join and pay cross-subsidies to high risks.

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The aim of community rating, open enrollment and compulsory insurance is to combine the equitable finance of health care with competition among health insurers. This three-fold regulation can be found in Belgium, Germany, The Netherlands and Switzerland. It is also part of Enthoven's proposal to reform the health care system of the US.[1] The incentives given by community rating, however, may lead health insurers to focus on other activities. As Pauly (1984) has pointed out, forbidding risk-based premiums gives insurers an incentive to *cream-skim*, i.e. to attract low risks and to discourage high risks from joining them. The requirement to accept any applicant may not be sufficient to prevent cream-skimming. More subtle ways via advertising and designing the benefit package can be used by insurers.[2] This is likely to result in a discrimination of high risks which runs counter to the equity objective of community rating.

Several measures have been taken to avoid cream-skimming. Most prominent is the introduction of risk adjustment schemes, which adjust premium income for differences in the risk structure of patients between insurers.[3] Risk adjustment schemes thus try to remove the cause of risk-selection by closing the gap between expected costs and premium income. In the countries mentioned above, however, risk adjustment schemes rely on only few health related factors, in particular on age and gender. Unless further health indicators are included, the potential gains from cream-skimming still seem to be high.

A second approach to avoid risk-selection is to regulate the benefit package. Basic benefits packages are specified to ensure that insurers offer services that are especially important for high risks. While basic benefit packages are generally agreed upon, there is no consensus on whether the basic benefit package should be the uniform benefit package for all insurers or whether community rating insurers (CRIs) should be permitted to offer additional benefits as long as they charge uniform premiums. In Germany, for instance, all sickness funds have to offer the same basic benefit package. The Kohl administration, however, briefly allowed sickness funds to offer additional benefits before being voted out of office. The Schröder administration repealed the law and curtailed the freedom of sickness funds to vary their benefits. The main motive was the fear of cream-skimming via additional benefits.

In the academic discussion, the idea that sickness funds can offer additional benefits has been supported by Oberender and Fibelkorn-Bechert (1998), who argue that health insurers should be able to offer different benefit packages according to individual preferences. Once the basic benefit package has been defined and insurers are obliged to charge a uniform premium, so their argument goes, there is no more need to interfere in the market for equity purposes. Enthoven (1988) and Swartz (1995), however, maintain that uniform benefit packages are most effective in avoiding cream-skimming. For this reason Enthoven's consumer choice health plan relies on a standardized benefit package.

The aim of this paper is to shed more light on this controversy by analyzing the effects of allowing CRIs to offer additional benefits. A model of a competitive health insurance market is developed. Individuals have to buy the basic benefit package from a CRI. Taking into account the existence of risk rating insurers (RRIs), which may also offer additional benefits, two questions are examined. First, the consequences of allowing community rating

[1] See Enthoven (1988).

[2] See van de Ven and van Vliet (1992) for an overview over forms of cream-skimming.

[3] See van de Ven and Ellis (2000).