



## Choice, price competition and complexity in markets for health insurance<sup>☆</sup>

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### ARTICLE INFO

#### Article history:

Received 12 March 2007

Received in revised form 5 April 2009

Accepted 15 April 2009

Available online 23 April 2009

#### JEL classification:

I11

#### Keywords:

Health insurance

Consumer choice

Price dispersion

### ABSTRACT

The United States and other nations rely on consumer choice and price competition between competing health plans to allocate resources in the health sector. While a great deal of research has examined the efficiency consequences of adverse selection in health insurance markets, less attention has been devoted to other aspects of consumer choice. The nation of Switzerland offers a unique opportunity to study price competition in health insurance markets. Switzerland regulates health insurance markets with the aim of minimizing adverse selection and encouraging strong price competition. We examine consumer responses to price differences in local markets and the degree of price variation in local markets. Using both survey data and observations on local markets we obtain evidence suggesting that as the number of choices offered to individuals grows, their willingness to switch plans given a set of price dispersion differences declines, which allows large price differences for relatively homogeneous products to persist. We consider explanations for this phenomenon from economics and psychology.

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### 1. Introduction

The U.S. and other nations rely on consumer choice and price competition between competing health insurance plans to allocate resources in the health sector. Policy makers have an efficiency impulse to offer larger numbers of choices and greater variety of health insurance products. But expanded choices also carry efficiency problems for selecting a health plan, even if these additional choices also result in price competition (Cutler and Reber, 1998).

Switzerland offers a unique opportunity to study price competition in health insurance markets. All residents are required to have health insurance. The government regulates the terms of competition, to encourage price competition and minimize adverse selection. They accomplish this by defining a standard benefit for the mandated individual coverage, prohibiting insurers from turning away potential enrollees, providing public information on prices, and risk-adjusting payments to insurers. Households face the full price of coverage and may also purchase supplementary coverage, and many do. Swiss residents all have a choice of at least 35 different sellers from which to purchase coverage.

<sup>☆</sup> We gratefully acknowledge financial support from the AHRQ (P01-HS10803), the Alfred P Sloan Foundation, the Swiss National Science Foundation (Fellowships and Exchange Programmes) and the Franco-American Fulbright program. We thank Jacob Glazer, Sherry Glied, Tom McGuire, Joe Newhouse, Mike Grossman, Friedrich Breyer, an anonymous referee, the editor and seminar participants at the CUNY-Columbia NBER Health Economics Seminar, the NBER 2007 Summer Institute, the London School of Economics Social Policy seminar, the European Health Economics Workshop (EHEW) in Magdeburg and the HEC-DEEP seminar at the University of Lausanne.

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In principle, one might expect this set of market arrangements to lead to active price competition. Yet Swiss health insurance markets are characterized by large, persistent price differences in local markets and little switching by consumers to plans with better prices. This has been the case even when local health insurance markets offer more choice.

These market outcomes contrast sharply with simple models of consumer behavior and competitive markets. We therefore explore several explanations for consumers' health plan switching behavior. Specifically, we focus on the response of consumers to an expanding health insurance choice set, using panel data based on Swiss health insurance markets and a survey of insured individuals to explore switching behavior and consumer satisfaction with health insurance.

The paper is organized into six sections. Following this introduction, Section 2 describes the market for health insurance in Switzerland and reports basic facts about the market with respect to the amount of choice, consumer mobility and price patterns. Section 3 explores explanations for the apparent disconnect between what one might expect based on the standard competitive model and the observed outcomes. Section 4 describes the empirical analysis aimed at producing evidence to assess the proposed explanations. We report results in Section 5 and our concluding remarks in Section 6.

## 2. Background

### 2.1. Swiss health insurance markets: regulatory framework

Switzerland (population 7.4 million) is divided into 26 cantons, with each canton responsible for the organization of its own health care system. The overall health care system is regulated by the Federal Law on Social Health Insurance (LAMal).

These are the main regulatory features of Swiss health insurance markets. (1) An individual mandate requires all residents to have health insurance coverage.<sup>2</sup> (2) A standardized basic benefit package covers outpatient and inpatient care and services such as nursing home care. The level of cost sharing (deductible, coinsurance) is defined by the law and is the same for all insurers. (3) Premiums are community-rated; premiums can differ between health plans but an insurer must offer uniform premiums for people in the same age groups (0–18, 19–25 and >25), in the same geographic area, with the same type of coverage. Three types of basic health insurance are available. In 2003 the most frequent choice was ordinary deductible health insurance (49.7 percent), followed by plans with higher deductibles (42.0 percent). Insurance with limited choice of providers (HMO-contracts) accounted for 8.2 percent of enrollees. (4) Health insurers must accept every applicant for basic insurance. During the open enrollment period every June and December, individuals can switch insurance providers. (5) Premiums paid to health plans are risk-adjusted. Risk adjustment is based on location, gender and age.

Clear-cut regulatory separation exists between basic statutory coverage and optional supplementary insurance. Consumers can purchase basic and supplementary insurance from two different providers or from the same provider. Supplementary insurance is not regulated by LAMal but by Insurance Contract Law (LCA). In the supplementary insurance market, insurers may refuse bad risks and offer risk-rated premiums.

These features suggest that changing health insurers for basic coverage involves very low switching costs. Indeed, the basic insurance coverage is virtually identical from one health insurer to the other, and the enrollee generally can remain with the same physician or hospital regardless of insurer. Furthermore, the actual switching procedure is simple: the individual must write a letter to their health insurer, prototypes of which can be downloaded from a website. Also, search costs are low. All premiums are published officially every year by the Federal Office for Public Health (OFSP) and distributed to households that request them. Furthermore, the most competitive premiums can be found easily on the Internet and in newspapers.

In a health insurance market with community-rated premiums for each health plan, homogenous benefits, open enrollment and low switching costs, one might expect that individuals would migrate toward the insurance plans offering the lowest premiums, and thus premium differences across insurance plans would be very small. However, the observed facts depart from these expectations.

### 2.2. Stylized facts on market performance

#### 2.2.1. Market structure

In the aggregate, the number of health insurers (all nonprofit) that offer mandatory health care insurance in Switzerland decreased over the past decade. In 1994, 178 authorized health insurers were operating; by 2004, there were only 92 (Statistics in Health Insurance, OFSP, 2004, Table 8.01).

At the canton level, where the competition takes place, the individual choice set increased over the same period (Table 1). In 1998 the mean number of health plans per canton was 39; consumers could choose from more than 40 health plans in only two cantons. The mean number of health plans per canton rose to 52 in 2003; in eight cantons, more than 55 insurers provided basic insurance.<sup>3,4</sup>

<sup>2</sup> Each family member must contract on an individual basis.

<sup>3</sup> Supporting data is available from the authors.

<sup>4</sup> A look at the six largest health plans reveals that the group was stable from 1998 to 2004. About 61 percent of enrollees were enrolled with these companies in 1998. After a slight decline between 1998 and 2004, these firms regained market share in 2005.

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