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Journal of Public Economics 88 (2004) 2515–2547

JOURNAL OF PUBLIC ECONOMICS

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Minimum standards, insurance regulation and adverse selection: evidence from the Medigap market

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Received 3 May 2003; received in revised form 27 January 2004; accepted 1 February 2004
Available online 19 May 2004

Abstract

This paper examines the implications of minimum standards for insurance markets. I study the imposition of binding minimum standards on the market for voluntary private health insurance for the elderly. The central estimates suggest that the introduction of the standards was associated with an 8 percentage point (25%) decrease in the proportion of the population with coverage in the affected market, with no evidence of substitution toward other, unregulated sources of insurance coverage. To explore possible factors contributing to the impact of the minimum standards, I develop comparative static predictions of the impact of imposing minimum standards in an insurance market with adverse selection. The observed changes in market equilibrium associated with the minimum standards are broadly consistent with these predictions, providing evidence of the existence of adverse selection in this insurance market. More importantly, they suggest that the presence of adverse selection—which in principle may provide an economic rationale for minimum standards—in practice may have exacerbated the declines in insurance coverage associated with the minimum standards.
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JEL classification: I18; I11; H51
Keywords: Minimum standards; Insurance regulation; Health insurance; Adverse selection

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doi:10.1016/j.jpubeco.2004.02.003

1. Introduction

Government intervention in insurance markets is both pervasive and varied. It runs the gamut from direct government provision of insurance to regulation of private insurance markets. A substantial theoretical literature has emphasized the potential for market failures in insurance markets—particularly adverse selection—that may provide an economic rationale for this extensive government intervention.

Economists have devoted considerably less attention, however, to considering how the consequences of the government intervention may themselves be affected by the nature of any market failures in the private market. This paper represents an attempt to investigate this issue by considering the imposition of minimum standards in private insurance markets. In principle, minimum standards may be a way to counteract the tendency for insufficient insurance coverage that market failures such as consumer misinformation or adverse selection can produce. In practice, I find the opposite: minimum standards appear to aggravate the insufficient insurance problem rather than to ameliorate it. Moreover, the very presence of adverse selection, whose effects the minimum standards might have in principle been able to counteract, may help explain the reduction in insurance coverage associated with the minimum standards. These findings highlight the importance of considering the nature of the private market equilibrium when evaluating alternative public policy designs.

Minimum standards are an increasingly common form of government regulation. They have been applied and proposed in homeowner's, automobile, and health insurance markets. Examples in health insurance markets include state requirements that mental health benefits be included in employer-provided health insurance packages and Federal proposals for a ''Patients' Bill of Rights'' that would impose minimum standards on HMOs. Yet we have virtually no empirical evidence on the effect of minimum standards in insurance markets.[1]

I study the effect of minimum standards by examining the imposition of large, binding minimum standards in the voluntary, private supplementary health insurance market for the elderly. Such insurance is commonly known as ''Medigap'' or ''Medicare supplement insurance''. These insurance policies cover some portion of the considerable medical costs not covered by Medicare, the public health insurance program for the elderly in the United States. In the late 1970s and early 1980s, almost all states followed a federal ''recommendation'' to impose minimum standards on the non-group Medigap market. The regulations specified certain gaps in Medicare coverage that any non-group Medigap policy must cover. They did not require that individuals purchase these policies, nor did they regulate their price. The coverage of other gaps was left to the market.

The paper has two main components. First, I examine the effect of the minimum standards for insurance coverage. I present robust evidence of a large ''quality–quantity'' tradeoff. The imposition of minimum standards is associated with a long-run decline in

[1] An exception is Gruber (1994) who finds no evidence of an effect of state-mandated benefits for employer-provided health insurance on insurance coverage. He notes, however, that the mandates were not binding, and that this may explain the absence of an effect.

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