ELSEVIER

Journal of Health Economics 19 (2000) 513–528

JOURNAL OF HEALTH ECONOMICS

www.elsevier.nl/locate/econbase

# An efficient employer strategy for dealing with adverse selection in multiple-plan offerings: an MSA example

Mark V. Pauly *, Bradley J. Herring

*The Health Care Systems Department, The Wharton School, University of Pennsylvania, 3641 Locust Walk, Philadelphia, PA 19104-6218 USA*

Received 1 January 2000; accepted 1 March 2000

**Abstract**

This paper outlines a feasible employee premium contribution policy, which would reduce the inefficiency associated with adverse selection when a limited coverage insurance policy is offered alongside a more generous policy. The ''efficient premium contribution'' is defined and is shown to lead to an efficient allocation across plans of persons who differ by risk, but it may also redistribute against higher risks. A simulation of the additional option of a catastrophic health plan (CHP) accompanied by a medical savings account (MSA) is presented. The efficiency gains from adding the MSA/catastrophic health insurance plan (CHP) option are positive but small, and the adverse consequences for high risks under an efficient employee premium are also small. 

*JEL classification:* I1; J3; L1
*Keywords:* Insurance; Adverse selection

## 1. Introduction

More and more employers who offer health insurance are offering their employees choices among different plans. It is virtually inevitable that some new plan options will appeal more to employees at some risk levels than at others —

* Corresponding author. Tel.: +1-215-898-5411; fax: +1-215-573-7025.
*E-mail address:* pauly@wharton.upenn.edu (M.V. Pauly).

0167-6296/00/$ - see front matter 
PII: S0167-6296(00)00049-7

even when risk is not the major reason why one plan is chosen rather than another. In such circumstances, even the best designed program can lead, inevitably and inexorably, to a process of plan selection that ends up concentrating higher risk employees more in some plans than in others. It may also lead, if not perfectly managed, to higher employer payments for health insurance than were made in the initial state.

Neither of these phenomena is necessarily a problem for the employer. Whether such selection is regarded as undesirable by the employer depends on employer attitudes toward changing the compensation structure to favor employees at some risk levels rather than others. Also, whether a process that concentrates employees in either a more comprehensive or less comprehensive plan is inefficient or not depends on the level and distribution of worker risk preferences, and of the effect of insurance on the use of care. If risk aversion is relatively low and moral hazard is relatively high, a ‘‘death spiral’’ against an inefficient low deductible indemnity plan may be desirable. The problem, of course, is that with adverse selection, one cannot be sure that the outcome will be desirable.

In this paper, we argue that employers can choose to take actions, which can prevent ‘‘death spirals’’ and achieve an efficient allocation of employees to plans. What the employer should do and, presumably, what the employer will do depends on both the tradeoffs employment groups face and what the employer (or union) objectives are. We do not at present know much about objectives in such situations, but we may be able to make some progress by describing and simplifying the tradeoffs. This is necessary but not sufficient knowledge for employer choices, but observing employer choices may be the best way to learn about objectives.

We provide this summary of tradeoffs or options in a specific context: the offering of a tax-neutral medical savings account (MSA) linked to a catastrophic health insurance plan (CHP) in addition to a more generous indemnity plan (GP). This option generates controversy because of the possibility that it will cause risk segmentation through adverse selection. The actual amount and type of such selection among a set of employees of varying risks depends on more than just the properties of insurance plans; it also depends on the policies the employer adopts to price out both the new MSA/CHP and the old alternative plan.

There have been a number of conjectures and simulations to show that, under reasonable assumptions about employee and employer behavior, offering of MSAs will be likely to lead a substantial jump in premiums for more comprehensive plans (Nichols et al., 1996; Burman, 1997); the possibility of a ‘‘death spiral’’ cannot be ruled out (Zabinski et al., 1999). This conclusion is surely correct under some assumptions about employer behavior and objectives. But is there an employer behavior that cannot only prevent a death spiral but can lead to an efficient outcome? And will employers choose this behavior? We show that the answers are ‘‘always yes’’ and ‘‘they might’’. For this reason, the predictions of death spirals, ominous as they sound, may be overly gloomy.