



POLICY PERSPECTIVE

A GROWING PERCENTAGE OF THE UNINSURED ARE MIDDLE-CLASS PEOPLE WHO WORK BY CONTRACT OR FOR SMALL BUSINESSES. THEY COULD AFFORD TO PAY SOME AMOUNT OF MONEY FOR HEALTH INSURANCE, BUT USUALLY FACE PROHIBITIVELY HIGH PREMIUMS IN THE MARKET. ECONOMIST KATHERINE SWARTZ PROPOSES GOVERNMENT-SPONSORED REINSURANCE OF HEALTH PLANS FOR THIS GROUP. BY TAKING ON THE MEDICAL COSTS OF THE MOST EXPENSIVE HEALTH PLAN ENROLLEES, THE GOVERNMENT COULD REDUCE THE RISK THAT INSURERS BEAR, MAKING HEALTH INSURANCE MORE AFFORDABLE AND ACCESSIBLE.

Background

Conventional wisdom holds that most uninsured Americans are poor or unemployed. While this is true, an increasing fraction of the middle class is also uninsured. The share of the middle class with employer-sponsored coverage has been declining for two main reasons. First, many firms increasingly hire temporary workers instead of permanent employees to reduce their fringe benefits costs. Second, more people are working in small firms, which are less likely than large firms to provide coverage. At the same time, the rapidly rising cost of health insurance makes it difficult for those without employer-sponsored insurance to purchase coverage themselves.

This research highlight summarizes Katherine Swartz's book, *Reinsuring Health: Why More Middle-Class People Are Uninsured and What Government Can Do*, funded in part by the Robert Wood Johnson Foundation. The book explains why health insurance is cheaper for large employer groups and outlines a proposal to make health insurance less expensive for individuals and small groups through government reinsurance.¹

With a reinsurance program, the government would cover the medical expenses for the highest-cost people covered by individual or small group insurance, thereby reducing the risks and costs of providing insurance. Swartz estimates that if the government accepted responsibility for people with the top 1 percent of all medical expenses, it could reduce premiums by 20 to 40 percent. Depending on the program's design, it would cost the government between \$5 billion and \$20 billion per year and help at least 15 million uninsured people purchase coverage.

Why Health Insurance Is Cheaper for Large Employer Groups

Swartz explains why it costs less for health insurance companies to provide policies to large employer groups:

- **Greater efficiency in administrative and marketing costs.** When insurance companies sell a policy to a large employer group, the fixed costs of administering and marketing are spread across a greater number of people, resulting in lower per person costs.
- **Lower risk of adverse selection.** When enrollment is voluntary, adverse selection occurs because insurance plans are more attractive to people who expect higher-than-average medical costs. Meanwhile, healthy people who expect to have low medical costs are less likely to pursue health insurance. This phenomenon makes insurers wary of individuals and small companies that are highly motivated to obtain insurance. Adverse selection is less likely in large employer groups (those with over 100 employees) where, if offered coverage, almost 85 percent of people enroll (and most of those who do not enroll have coverage through their spouse's employer). Thus, insurers can assume that these enrollees are not disproportionately motivated by an expectation of high medical expenses.

- **Lower risk of bad predictions.** Insurers price their policies based on the predicted expenditure plus an additional amount to compensate the insurer for the risk involved. The more people covered under a policy, the more certain the insurer can be that its estimated costs will be close to actual costs. With a policy for an individual or a small group, the insurer faces greater risk of a severe loss and requires compensation for that increased risk through a higher premium.

How Reinsurance for Individuals and Small Groups Would Work

By reducing the cost and risk of insuring individuals and small groups, reinsurance could lower premiums and reduce insurers' incentives to price higher-risk applicants out of coverage.

As Swartz puts it, "reinsurance is insurance for insurers." Insurers often purchase reinsurance to share some of the risk of their policies and protect themselves from events that are unlikely to occur, but that would ruin them financially. Reinsurance contracts operate in several ways. For example, the reinsurer may pay a fixed percentage of all losses or may pay for a fixed portion of losses that exceed a certain threshold.

In some cases, where the private market will not offer reinsurance, the government has stepped in. A prominent example is the federal government's assumption of the worst risks in catastrophes such as floods and hurricanes, which enables insurers to offer these types of insurance. Similarly, Swartz proposes that the federal government reinsure health insurance policies for the individual and small-group markets. By paying the actual medical expenses for the people with the highest medical costs, the government could reduce the risks and costs of providing insurance in these markets, making health insurance premiums more affordable.

Swartz outlines three necessary features of a government reinsurance program:

1. **Standardized benefits and cost-sharing across insurance policies.** With a government promise to cover expenses for people with the highest medical costs, there comes potential for abuse. Standardized benefits and cost-sharing across insurance policies will ensure that the people with the most costly medical needs are those covered by the government. Otherwise, insurers with the most generous policies, so-called "Cadillac" policies, could claim the highest costs, even though they did not provide the most health care.
2. **Requirement that insurers accept all applicants.** The objective of government reinsurance is to increase access to health insurance by reducing the risk to insurers that people will incur extremely high costs. Nevertheless, there will remain some incentive for insurers to deny coverage to applicants they suspect will have higher-than-average medical costs. Insurers must be required to accept all applicants and renew all policies. Otherwise, high-risk people may not be able to obtain health insurance at any price.
3. **Requirement of community-rated premiums.** Even if an insurer has to accept all applicants, it could still decrease its risk by quoting higher premiums to high-risk applicants and discouraging their enrollment. Requiring insurers to use "community rating," or to charge a fixed price within a certain geographic area, will ensure that those who need health insurance most will not be denied.

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1 Swartz K. *Reinsuring Health: Why More Middle-Class People Are Uninsured and What Government Can Do*. New York: Russell Sage Foundation, 2006.