Keeping Private Health Insurance Affordable – Is it Time for the Least Bad Option?

If Private Health Insurance (PHI) is to be kept affordable to Australians, the industry will need to find a way to keep the young, healthy people taking up PHI cover. Having older people, rather than the younger generation, pay a bit more than they do today, whilst difficult, may be the least bad option...

THE CLASSIC PHI CONUNDRUM

Imagine you're Joe. You're 30 years old and in good health but you know you will eventually need health care one day. You know the government wants you to purchase private health insurance (PHI) so that health costs are transferred from the public system to you and your insurer.

In fact you know the government wants you to take up PHI so much they will even give you a tax break for taking up health insurance – and the sooner you do it the better off you are.

So in theory, the value proposition is pretty simple. You know a bit about insurance. You already insure your car and your house, even Chloe your pet poodle. You understand that the premiums you're charged generally reflect the risk of you claiming on your policy. You do some quick sums in your head and you reckon you can expect a premium of around $30 a month based on what you might cost your insurer.

So imagine the shock when you call up a health insurer and find out full cover is going to cost you $160 per month! You're just about to hang up when the insurer mentions a couple of things to you:

- You might get a premium rebate from the government: The government's private health insurance rebate could cover up to 30% of the premium, depending on Joe's income.
- Limited cover: Joe can save money by choosing a product with exclusions and an excess.

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The insurer might recommend its 'Cross Your Fingers' product, with a premium of only $50 per month. The insurer admits the policy doesn't really provide any hospital benefits, but has two reasons why you should buy:

- Medicare Levy Surcharge (MLS): buying insurance could save Joe more than $50 per month in tax, depending on your income.
- Lifetime Health Cover (LHC): if Joe doesn't purchase PHI now, he will have to pay a penalty if he wants insurance later in life.

What do you do? In all likelihood you reluctantly stump up for the $50 product, and forget about your cover until you need to claim. If you're really fired up you might write an angry letter to your MP.

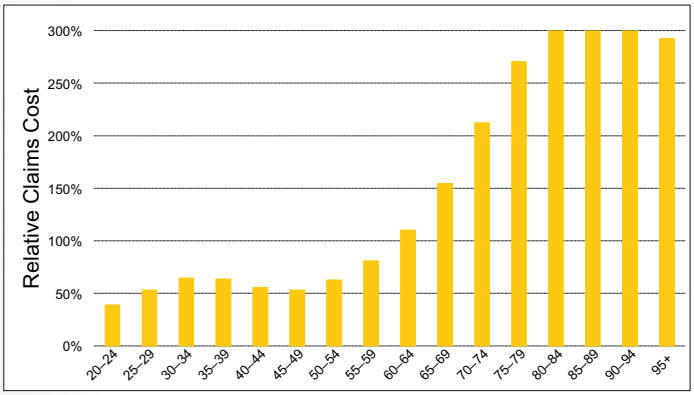
This is the classic conundrum for most first time PHI purchasers. For most people it's confusing and difficult. So why are things the way they are? In short; community rating.

COMMUNITY RATING

Unlike much other insurance, health insurance is 'community-rated'. This means two people on the same product pay the same premium, regardless of differences in expected claim cost.

Community rating exists to support our government's policy objective that health insurance should be affordable to most Australians, irrespective of expected claim costs. PHI also allows Australians to finance a greater share of their own health care costs, reducing the cost to government. These are worthy objectives which most Australians support.

The figure below puts the impact of community rating in context. The chart shows the relative claim cost of each age group to the overall population. Clearly younger people cost a lot less to insure than older people. The most elderly cost six to seven times as much to insure as the youngest group. Yet everyone pays the same, regardless of age.



On average then, older people pay a premium that is less than their expected claims costs, and younger people pay a higher premium than their expected claims costs.

Community rating therefore depends on younger people choosing to insure. This explains the complicated array of carrots and sticks in place (the PHI rebate, LHC loadings, MLS) to incentivise people to take up PHI cover.

SO WHAT'S THE TROUBLE?

So we know the conundrum many Australians buying PHI face is due to community rating and government policy objectives. So what's the problem?

Community rating is sustained by an array of government 'carrots and sticks', which force healthy people to buy insurance they wouldn't otherwise want. Without the carrots and sticks, Australia could not have community rated PHI, or a high PHI participation rate.

Experience shows that consistent government support of PHI cannot be guaranteed. Consider means testing of the rebate and change to the MLS in recent years. Last month, Parliament passed legislation to remove the rebate for LHC premium loadings, and to reduce the rebate proportion over time (by linking the rebate amount to CPI, rather than medical inflation, which tends to run at double the rate of CPI inflation).

As aging and new technology increases the cost of PHI, the government's spend on the carrots becomes bigger each year. It has become unusual for Federal budgets not to include some change to PHI support.

It seems increasingly unlikely that the government will continue to provide the level of support for PHI that it has in the past. It is then also quite likely that at some point a tipping point will be reached where fewer young people decide to insure.

Some 'grudge purchasers' insure largely to avoid the MLS tax penalty. The maths is quite simple for this group at the moment, as it generally costs less to take out PHI than to pay the MLS. At some point, with reducing rebates, the scales will tip such that buying PHI is no longer an economically beneficial decision for a number of individuals – particularly the youngest, who get the least benefit from it.

Unfortunately these are exactly the people you also want to stay in the system as they help to subsidise the cost of insuring older people. At some point, more will need to be done to make PHI worthwhile for younger people.

Without continued government support (which comes with increasing government expenditure or tax penalties) this can be achieved by charging younger people less, to keep them in the system and continue to subsidise older age groups.

CAN WE DO BETTER?

In all likelihood, yes. Our hypothesis is that by making PHI a bit cheaper for younger people, you could continue to keep them in the system even as government support reduces. The lost premium could be made up by charging older people a bit more. The premiums for older people would need to remain affordable, and could continue to be far less than expected claim costs.

The goal is that 'subsidisers' (younger people) are enticed to stay in the system, so that older people continue to have their PHI cover subsidised. While any price increases for older people will be unpopular, the alternative of no change could be a lot rougher once the subsidisers start to drop out of the system.

A couple of alternatives to the current system of community rating stand out:

- Risk rating, with rules to help address affordability concerns. For example, New Zealand health insurance premiums reflect the health of the customer when the policy is taken out, and then increase with age. However, policies are guaranteed renewable, so health problems emerging after the policy is taken out do not change the premium.
- Partial community rating, where premiums vary according to expected claim costs, but do not fully reflect differences in risk (for example, Compulsory Third Party motor insurance in New South Wales).

We have projected the cost of these alternatives compared to the current community rated system and summarise our findings in the table below as well as an assessment against three key criteria of affordability (both on average and the range of premiums paid), PHI participation and complexity.

For each alternative, we adjusted pricing by age group (and the level of the rebate), and then considered changes to participation by age group. Our modelled scenarios involved premium increases for those aged over 60, and premium reductions for those under 60.

There are no detailed studies on the effect of changes in price on health insurance participation. Our assumed participation changes reflect the view that younger customers will be more sensitive to price reductions than older customers, because older customers have most to gain from insuring (refer to the table below).

Risk rating would clearly result in a wider range of premiums. Most age groups would benefit from lower premiums, so overall participation rates would be likely to increase. Risk rating would allow some of the complexity of community rating to be removed and (potentially) lifetime health cover and the Medicare Levy Surcharge.

Risk rating would result in much higher premiums for older people, which is incompatible with public policy objectives. Restructuring the rebate could help reduce the range of premiums charged under this scenario. The partial community rating scenarios (with and without changes to rebate) have a similar effect on the range of prices.

The scenarios show the trade-off between a wider range of prices (lower premiums for young people) and increasing participation.

SOME FINAL FOOD FOR THOUGHT

Risk rating of PHI is a step too far for Australia. Risk rating would significantly reduce premiums for younger Australians, and remove some complexity including LHC and MLS. However, significant premium increases for older Australians are inconsistent with current public policy objectives.

That said, we feel it is reasonable for people who get the most benefit from PHI to contribute a greater share of the costs, while ensuring premiums remain affordable. Under partial community rating, premiums for older people would still be less than expected claim costs, but the subsidy from younger people would reduce.

Lower premiums for younger people would result in higher PHI participation and upgrades to comprehensive cover, reducing reliance on the public health system. Because younger people would still subsidise older policyholders, higher participation benefits everyone.

There have been a number of changes to the PHI rebate in recent years. Recent legislation linking rebate funding to CPI will phase out the rebate over many years. An alternative would be to combine partial risk rating with the reallocation of rebate funding to those with the highest premiums and claim costs. This could better link rebate funding to public policy objectives, while reducing the effect of higher premiums on older Australians.

If PHI is to be kept affordable to Australians, the industry will need to find a way to keep young, healthy people taking up PHI cover. Having older people pay a bit more than they do today, whilst difficult, may be the least bad option. We recommend that the industry considers ways to make PHI available to more Australians with less reliance on government. A

	Change in Participation Total	Change in Participation 'Subsidisers'	Change in Average Premium	$ Range of Premium	Complexity
Risk Rating					
Risk Rating	9%	31%	-283	Much wider ($400 to $3,000)	Reduced
Risk Rating w/ Rebate Changes	7%	13%	-80	Wider ($550 to $1,350)	Reduced
Partial Community Rating					
Partial Community Rating	8%	16%	-114	Wider ($600 to $1,300)	Similar
Partial Community Rating w/ Rebate Changes	2%	3%	-8	Slightly wider ($800 to $1,250)	Similar