Executive Summary

A simple reform to Colorado's insurance laws could save Colorado families hundreds of thousands of dollars each in lifelong health care costs.

? With simple changes to Colorado's archaic health insurance regulations, state legislators could save an average family of four almost half a million dollars in health care costs.

? Health insurance policies with higher deductibles offer people the chance to combine relatively inexpensive higher deductible health insurance policies with federally authorized medical savings accounts that would be accepted by preferred provider organizations (MSA PPOs).

? Medical savings accounts work like IRAs. People make tax-free deposits each year and withdraw funds as needed to pay for medical care not covered by their insurance policy. Excess deposits remain in the account where they compound tax-free for future use. Allowable medical expenses are defined by IRS rules, which are far more liberal than those used by insurers.

? An average Denver couple with two children that uses an MSA PPO for health insurance could save $500,000 on its cumulative health care costs between the ages of 23 and 65. At age 65, the couple would have more than $140,000 in its medical savings account. Under federal law, this nest egg could be used, tax-free, to defray long-term care expenses or other retirement needs.

? Single men and women could save about $250,000 and retire with more than $150,000.

Why Pay More?
Simple Insurance Reform Would Save Coloradans Millions

By Linda Gorman, Director, Health Care Policy Center

I. How Health Insurance Plans With Higher Deductibles Reduce Consumer Costs

MSAs coupled with higher deductible health insurance policies cost less because they let people use cash to pay for routine medical care. Rules that require low deductibles end up requiring insurers to charge higher premiums in order to cover routine expenses. In effect, consumers are required to prepay their health care when they buy insurance. This raises the cost of health care because prepayment makes consumers add the cost of insurer overhead to the cost of a routine test or visit to the doctor.

Higher deductible policies provide true insurance, protection against unexpected expenses, rather than prepaid health care. Consumers who understand this, and use their own money to pay for routine care, end up paying less overall. If they maintain a medical savings account as well as an insurance policy, they can also use tax-free money from the MSA to meet their expenses.

A large body of evidence suggests that people who use their own money to pay for health care try harder to avoid unnecessary spending. When everyone has already paid for a service, as is the case with prepaid health care, many people adopt a "use it or lose it" attitude.

The RAND Health Insurance Experiment[1] followed similar groups of people in six cities who received health insurance; the groups varied only in the amount of out-of-pocket costs. Though there were no detectible differences in health outcomes, insurance plans with high deductibles and relatively large out-of-pocket costs reduced expenditures by 31 percent relative to those that provided first dollar coverage. Economists Martin Feldstein and Jonathan Gruber used data from the National Medical Expenditure Survey to

[1] Willard G. Manning, *et al.* June 1987. "Health Insurance and the Demand for Medical Care: Evidence from a Randomized Experiment," *American Economic Review,* p. 251.

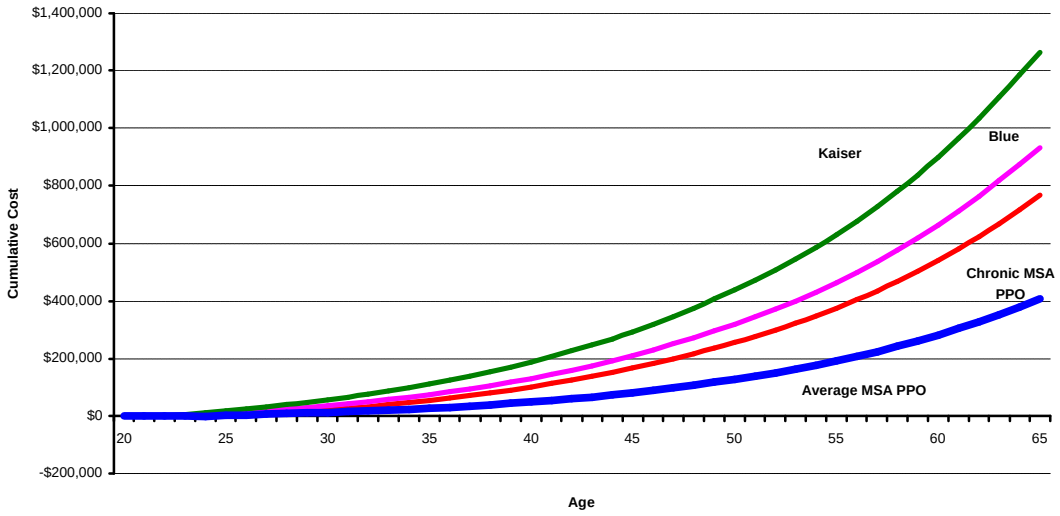
simulate health care spending. They found that encouraging people to shift to true insurance policies covering major risks could lower aggregate health spending by 20%.[2]

II. The Size of the Potential Savings

For individuals not covered by a group policy, the potential savings from higher deductible policies are huge. Figure 1 shows the cumulative cost of health care for three different individual insurance plans for a couple with average medical expenses, assuming that the couple marries after college and has two children.

The total costs were calculated by asking what premium payments would have been worth had they been invested in a savings account that paid a 6% compounded annual return. The MSA PPO option assumes that the couple makes the maximum allowable deposit to its MSA each month, that the underlying insurance policy has a $3,300 family deductible that does not include normal births, and that expenditures from the MSA are withdrawn at the end of each year.

Figure 1: Cumulative Costs for 4 Health Insurance Cases
6% Interest, Individual Non-Smoker, Denver Zip Code



Notes on Figure 1:
Actual costs are even higher than stated for Kaiser and BlueCross/BlueShield because their out-of-pocket costs are not zero and this chart shows premium costs only. Simulations begin at age 23.
Blue Preferred Plan PPO: Normal maternity not covered. Maximum out-of-pocket: $1,500 per person in network, $3,000 per person out of network. $25 office copays do not apply to deductible. Prescription drugs: $15 generic, $40 brand name, $60 Non-Formulary. Including two normal births would raise final costs by roughly $100,000. Dental is out-of-pocket.

[2] Martin Feldstein and Jonathan Gruber. September 1994. *A Major Risk Approach to Health Insurance Reform.* Working Paper No. 4825, National Bureau of Economic Research,, Cambridge, Massachusetts.

Kaiser Personal Advantage1 HMO: $300 per maternity admission. Maximum out-of-pocket: $4,500 per family per year. $15 copays. Prescription drugs: $15 copay, $30 name brand. Dental is out-of-pocket.
The MSA PPO: This plan has a $3,300 family deductible. The simulations assume that the MSA covers two normal births at $5,000 each. Chronic disease case assumes out-of-pocket expenditures of $4,300 annually, in addition to MSA deposits and premiums for higher deductible insurance, that begin at the birth of the second child, year six of the simulation. The cumulative MSA PPO cost matches that of the cumulative Blue Preferred premium cost at age 65 with annual spending of roughly $6,000.

With average medical spending, health care costs are about $400,000 through age 64 for the MSA and higher deductible insurance option. These costs include premiums for a policy that covers immunizations and well child checkups, out of pocket expenses for two normal births at $5,000 each, and average out-of-pocket costs for other health and dental expenses that are assumed to rise with age. All out-of-pocket costs are subtracted from the MSA at the end of each year.

Their premiums alone make the conventional health insurance policies far more expensive. At $1,250,000, the Kaiser Advantage1 policy is the most expensive. Premium costs for the Blue Preferred Plan PPO are more than $900,000 dollars. The Kaiser policy covers maternity and the Blue policy does not. Adding the out of pocket costs of two normal births to the premiums for the Blue PPO would increase its cumulative costs by about $100,000.

These results substantially underestimate the cost of conventional insurance policies because they do not include spending on copays, hospital admission fees, and out-of-pocket expenses that are not covered by the insurance plans but are covered by the medical savings account.

The cost of dental care is included in the medical savings account expenditures. It would add about $100,000 to the cumulative cost of the conventional plans assuming expenditures of $600 per year. Copays and deductibles for the conventional plans can be substantial. Kaiser Advantage1 caps family out-of-pocket costs at $4,500 a year. The Blue Preferred Plan caps them at $1,500 per person for in-plan providers and $3,000 per person for out-of-plan providers. The Kaiser Advantage1 plan is an HMO. Patients who choose to go out of network at Kaiser lose their insurance coverage and are liable for all costs.

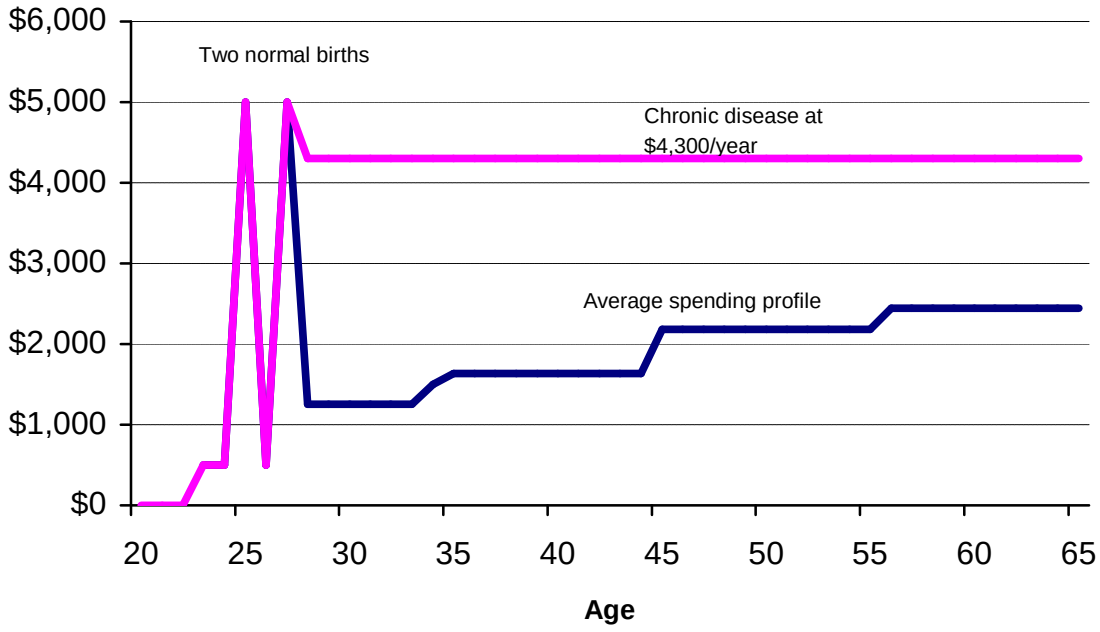
Interest groups opposed to reforming Colorado's health insurance laws claim that higher deductible policies harm consumers because higher out-of-pocket costs cause consumers to skimp on necessary medical care. Although the RAND study suggests that this claim is unfounded, this Issue Paper explicitly assumes that an average family of four meets regular expenses by withdrawing money from its MSA.

Figure 2, on the next page, shows the age profile of the assumed expenditures for an average family that pays for two normal births using its medical savings account. Taken from Consumer Expenditure Survey data, out-of-pocket expenditures from the medical savings account rise from $1,200 a year to $2,450 a year as the family ages. With well child visits and immunizations prepaid by the insurance premiums as required by

Colorado health insurance mandates, the assumption is that an average couple in their thirties spends $1,200 a year on doctor visits for minor illness, dental care, and routine adult check-ups.

A chronic disease case is also plotted in Figure 2. It assumes that the family pays the full MSA PPO deductible of $3,300 each year plus an additional $1,000 from its MSA deposits and income stream.

Figure 2: Annual Out-of-Pocket Spending Profiles for Family of Four: Average MSA Spending, and Chronic Disease Case



In the Denver area, a woman's complete annual gynecological exam costs about $200 at a private physician. One hundred and fifty dollars buys a visit for a routine dental exam with x-rays and cleaning at a private dentist. A sick child can have a nurse visit for a throat culture and rapid strep test at private pediatrician for about $60. Note that spending on dental care is included in the MSA expenditure estimates, but is assumed to be zero for the conventional insurance options.

Insurance reform opponents also argue that policies with higher deductibles should continue to be outlawed because they would harm the chronically ill by requiring higher out-of-pocket spending. In reality, a relatively small fraction of the population under 65 suffers from an acute illness that requires expensive medical treatment. In the population

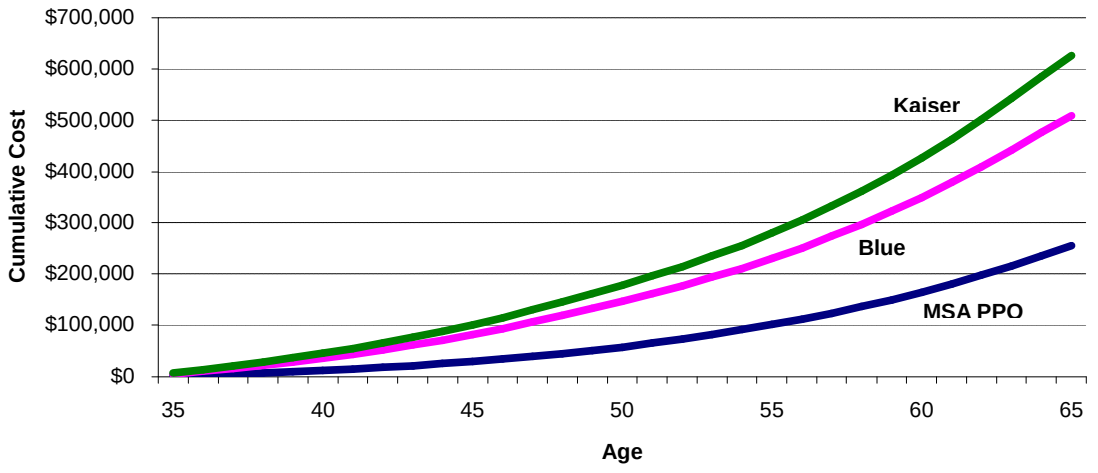
as a whole, 20% of insured households are responsible for 80% of spending on physician and hospital services, including maternity care.

Even if MSA PPOs were not a good deal for the chronically ill, the vast majority of families in the individual market would benefit from higher deductible because it makes health insurance more affordable. Denying them affordable insurance based on the concerns of a few is unfair.

In fact, however, higher deductible insurance policies coupled with medical savings accounts are a good deal even for those who are chronically ill. The "Chronic" case in Figure 1 also shows the cumulative health care costs for a family of four that pays $4,300 a year out of its pocket and its medical savings account after the birth of its second child. Even if the family pays its deductible of $3,300 each year plus an additional $1,000 to cover dental care and other uninsured expenses, the cumulative costs under the MSA PPO option are about $770,000 -- still over $200,000 less than the premium cost for the least expensive conventional insurance policy. At age 65, the cumulative costs of the MSA PPO option slightly exceed the cumulative costs of the premiums of the Blue PPO only when annual expenditures exceed roughly $6,000.

Figures 3 and 4 compare conventional premiums with MSA PPO policies for families that begin MSAs at ages 35 and 45. Even without the 20 years of saving, the MSA PPO policies remain substantially less expensive.

Figure 3: Cumulative Costs for 3 Family Health Insurance Cases Beginning at Age 35
6% Interest, Individual Non-Smoker, Denver Zip Code



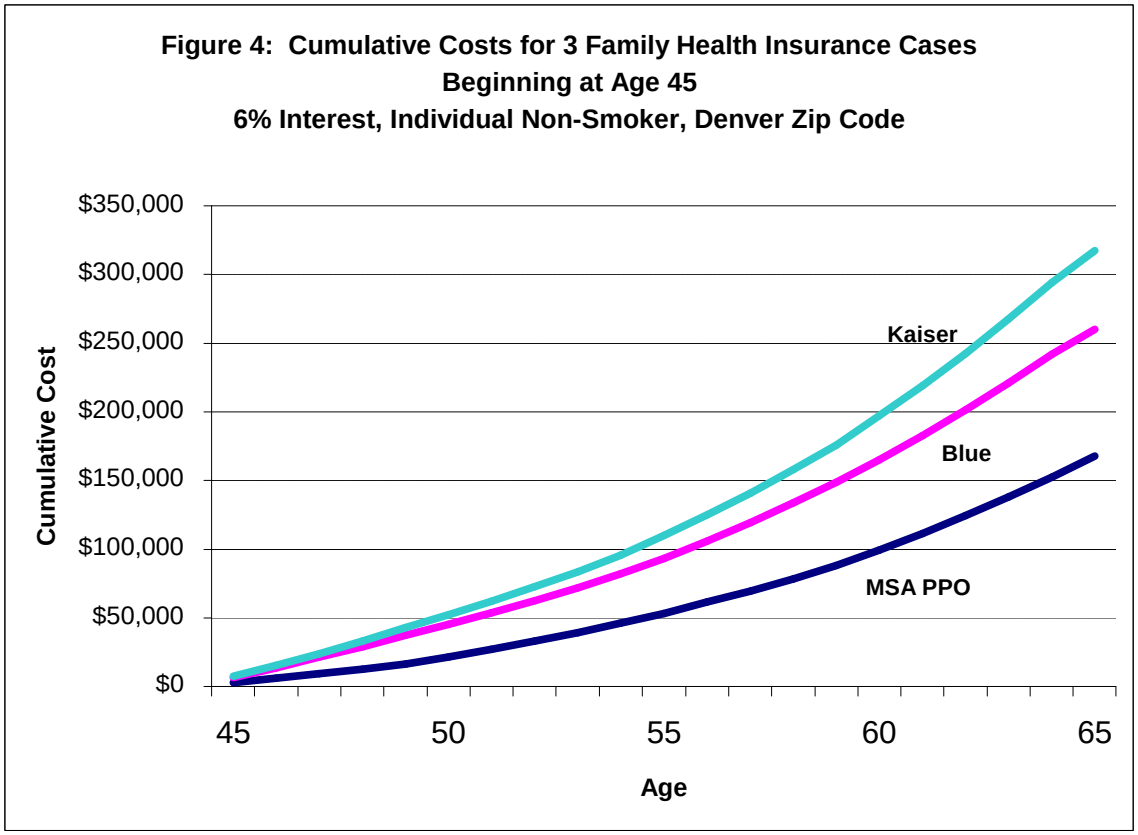
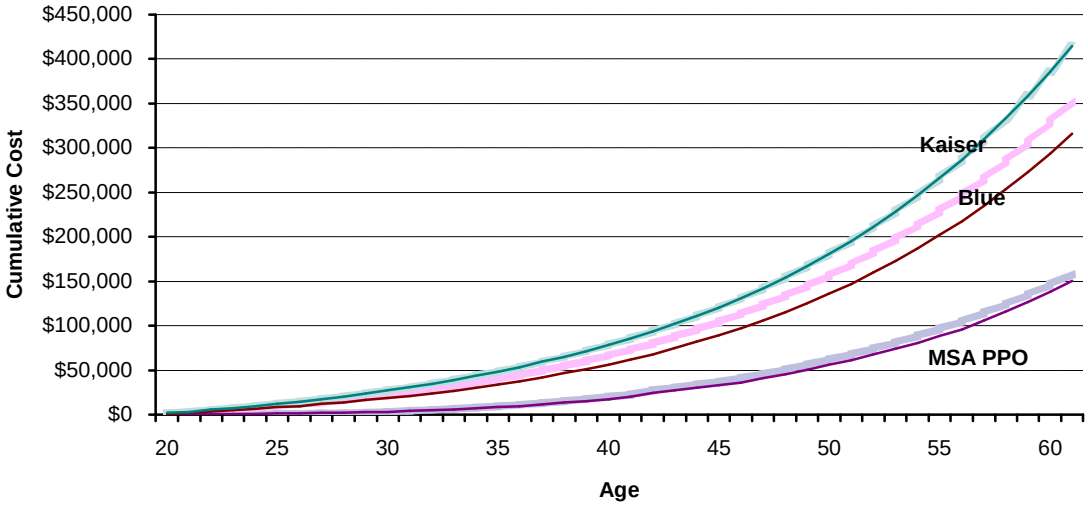


Figure 5 compares cumulative conventional costs with cumulative MSA PPO costs for single men and women beginning at age 23. The results show that everyone could expect to save by using MSAs.

Figure 5: Cumulative Costs for 3 Health Insurance Cases,
Single Men and Women Beginning at Age 23
6 % Interest, Individual Non-Smoker, Denver Zip Code



Notes for Figure 5: Cumulative costs for men are solid lines. Cumulative costs for women are shaded. Spending profile assumes one year of major illness that requires $3,300 out of pocket spending at age 45.

III. What Colorado Legislators Can Do to Make These Savings Available to the Public

An ironic summary of Colorado health insurance law is available on the web site of the Colorado Office of Economic Development and International Trade.[3] State law requires that any insurance company that makes coverage available to business with fewer than 51 employees also make it available to an individual, as long as that individual works at least 24 hours a week on a "regular basis." The insurer must issue basic or standard coverage no matter what; rates may not be adjusted based on the health status of the people in the "group" or on whether they are male or female. Any pre-existing condition must be included after six months. The summary says that "insurance options range from traditional comprehensive major medical plans, to PPO plans, to HMO plans with very high deductibles." Obviously the Office of Economic Development hasn't tried buying health insurance on Colorado's small group market lately.

In practice, Colorado's health insurance laws ensure that financially responsible companies selling true health insurance, as opposed to prepaid health care, will eventually be forced to leave the state. Colorado law requires insurers in the small group market to issue policies to business groups of one. This guaranteed issue requirement

[3]Colorado Office of Economic Development and International Trade, http://www.state.co.us/oed/sbdc/advic_01.html as of 22 February 2002. Information presented is attributed to the Colorado Department of Regulatory Agencies, Division of Insurance.

means that a person can go without health insurance until he faces a big expense knowing that he can still buy insurance. All he has to do is declare that his hobby of buying and selling baseball cards is a part-time business that he works at for at least 24 hours a week on a "regular basis" and everyone else in the risk pool ends up paying for his selfish behavior.

With laws like this, it comes as no surprise that households with incomes over $50,000 are the fastest growing segment of the uninsured market. Guaranteed issue also hikes premiums by making it impossible for insurers to keep the irresponsible out of their risk pools. Those who buy insurance responsibly and pay into the insurance pool for long periods of time are penalized. Those who act selfishly are rewarded.

When people can make others pay the costs of their illness, financially responsible underwriting becomes impossible. As a result, many reputable insurers have left Colorado's small group market out of concern for their financial health. Under federal law, they cannot return for five years, making state residents easy prey for less reputable companies.

At a minimum, the business group of one needs to be eliminated, so that state government stops aiding and abetting irresponsible cheats who game the system. One of the largest sellers of MSA PPOs in the United States refuses to offer policies that could save individual families hundreds of thousands of dollars in premiums, precisely because Colorado law does not allow the company to protect its policy holders from Colorado cheats.

In the last decade the Colorado legislature has, with little study, passed laws that have unfairly favored prepaid health care over true health insurance. Some legislators remain studiously unconcerned about the huge costs that this ideological rampage has imposed on the state's citizens. Such legislators doggedly maintain, in spite of all the evidence to the contrary, that higher deductible policies are somehow dangerous to the average citizen.

A one-size-fits-all plan seldom fits anyone very well. In Colorado, government mandates for one-size-fits-all are adding hundreds of thousands of unnecessary dollars to the average family's lifetime health care costs.

Legislators who care about their constituents can show their commitment by taking steps to reform the state and federal laws that make Colorado's health insurance market unfair and inhospitable to reputable companies. Legislators can begin by eliminating the unfairness implicit in the business group of one and by reinstating pricing flexibility based on sex and health status. Legislators can rewrite the law to get rid of prepayment mandates and to let insurance companies rather than health bureaucrats design health insurance plans -- plans that fit the needs of responsible individuals who want true insurance rather than prepaid health care. Legislators can pressure federal officials to institute the same reforms at the federal level.

In short, public officials should stop micro-managing insurance companies, and should instead return the state to its traditional role of determining whether or not individual insurance companies have the financial strength to meet their contractual obligations.¦

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ADDITIONAL RESOURCES on this subject can be found at:
http://independenceinstitute.org/Centers/HealthCare/index.htm

APPENDIX:
Technical details

Insurance premiums for the two standard policies are those quoted on the ColoradoHealth.com website and were current at of January 2002. All quotes are for individual policies for non-smokers living in the Denver zip code. Because Colorado legislators have instituted insurance regulations for small group policies make it practically impossible for reputable insurance companies to calculate their underwriting risks for small groups in Colorado, many insurers are unwilling to sell MSA policies to small employers or individuals in the state. The premiums quoted are rates available in other states with fairer regulatory climates and medical costs equivalent to those in the Denver area. For now, Colorado consumers in the small group market must be content with the rapidly diminishing choice, and high prices, brought about by the state legislatures ill-conceived regulatory policy.

Table 1, below, shows the Excel spreadsheet entries used for the detailed calculations of the cumulative cost of insurance premiums and the annual out-of-pocket spending costs assumed for the MSA policy. Cumulative costs are expressed as the total amount spent for health care and insurance through the end of each year. Amounts are compounded monthly with payments at the beginning of the period. The amounts spent on health care under the HMO and PPO policies are *understated* because the calculation assumes that copays and deductible amounts are zero under standard insurance.

For ease of calculation, it is assumed that MSA expenditures are made at the end of each year. This introduces a slight upward bias into the estimate of MSA returns. The bias will be higher with higher interest rates, though the rate would have to be high indeed to overcome the fact that expenditures for copays and deductibles under the standard policies are assumed to be zero.

The spending profile for people who begin buying their own policies at age 23 assumes two normal births at $5,000 each at ages 25 and 27. Children are covered by their parents' policy through age 22. Spending profiles that begin at age 35 and 45 are also available. They assume the children are older and do not include maternity costs. The cumulative costs for the MSA PPO option are still far less than the cumulative cost of the standard insurance premiums.

The estimated amounts spent from the MSA for out-of-pocket health care costs for the average case are those listed by age in the 2000 Consumer Expenditure Survey, Table 3, "Average annual expenditures and characteristics by age of reference person." This likely overstates health care spending from MSAs, since health insurance premiums, already accounted for in the premium cost of the higher deductible policy, are included in the Survey's health care category. The Consumer Expenditure Survey probably also contains some costs for maternity that are double-counted in the $5,000 quoted for each a normal birth.

As these comparisons depend on long-term returns, the rate of return chosen can affect the relative results. A 3% assumed return did not change the rank order. Cumulative costs for the MSA PPO, BlueCross BlueShield premiums, and the Kaiser Advantage1 plan were $116,000, $435,000, and $573,000 respectively. An annual rate of return of 6% is assumed in an environment without inflation because if inflation occurred presumably the amounts charged for health insurance in the three cases would rise more or less at the same rate. For comparison, the table below shows long-term returns on selected assets from 1926 through the end of 1996 from Ibbotson Associates' *Stocks, Bonds, Bills and Inflation.*

Asset	**Annual return**
Large company stocks	10.7%
Small company stocks	13.9%
Long-term corporate bonds	5.6%
Long-term government bonds	5.1%
U.S. Treasury Bills	3.7%
Inflation	3.1%

The premiums

Quoted premiums for the simulated MSA policy represent policies in states with medical costs that are comparable to those in the Denver zip code (802). The policy deductible is $3,300. The policy quoted includes for well child checkups and childhood immunizations mandated by Colorado law. It does not cover costs associated with a normal birth. Consequences of an abnormal birth are covered.

MSA contributions

People are assumed to contribute the maximum allowable amount to their MSAs based on the federally allowed maximums that applied in 2002: 65% of $1650 for individuals, and 75% of $3300 for families.

Calculations

The future value formula in Excel is used to compound premium payments. [FV(interest rate, nper, pmt, present value of lump sum, payment due at beginning of period).] Premium payments are treated as if they are paid into a savings account each month. The value of that stream of savings at the end of the year is calculated. It is added to the stream of payments in the next year and assumed to continue compounding.

MSA payments are assumed to be made at the end of the year. In any given year the "cost" of health insurance under an MSA plan is calculated as the amount in the MSA after spending that year minus the premiums paid for the higher deductible policy. The "cost" of health care under the standard policies is the amount that would have been

saved if their monthly premiums had been deposited into a savings account and carried over from year to year.

Taxes

The after-tax consequences for various insurance plans are complex due to the fact that the tax law treats employer-provided health insurance more favorably than that purchased by an individual. This comparison is limited to individuals buying policies in the individual market. It assumes no employer contribution, and that money deposited in the MSA compounds tax-free. It does not address the after tax costs of policy premiums.