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Why Does My Insurance Cost So Much?

Abstract

"There are no easy complete solutions to the challenges we face in insurance costs, but there are many small things we can do based on the model of how insurance works."

Posting about health care issues from *In All Things* - an online hub committed to the claim that the life, death, and resurrection of Jesus Christ has implications for the entire world.

<http://inallthings.org/why-does-my-insurance-cost-so-much/>

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Why Does My Insurance Cost So Much?

 [inallthings.org/why-does-my-insurance-cost-so-much/](https://allthings.org/why-does-my-insurance-cost-so-much/)

Donald Roth

“Since 2010, my premiums have doubled – 99.8% to be precise,” a friend of mine lamented on Facebook a few months back. As someone buying insurance individually, he’s one of the worst cases I’ve heard of, but he’s far from alone in wondering exactly what it is that seems to keep driving up the cost of health insurance for Americans; concerns over these rising costs have many voters in this election season scrambling for solutions ranging from repealing the Affordable Care Act to nationalizing the provision of healthcare. In my life before Dordt, I did some work in the tax side of the insurance industry, and I did some coursework specifically focusing on the economics of healthcare, so this has been an issue close to my heart for some time. Although I don’t think there are any magical solutions to the whole situation that leave me terribly satisfied, I do think there are some ideas that might be headed in the right direction, yet I don’t see general public discourse dealing with these issues in particularly nuanced ways. What follows, then, is my humble attempt to help correct the latter issue.

How Insurance Works

In order to talk about healthcare reform, particularly with respect to insurance, it has always surprised me that few public figures talk about this in terms of the basic mechanism that drives insurance: risk pooling. While the word may sound complicated, the basic principle is not. Risk pooling works by a group of people (policyholders) who are concerned about some unexpected, relatively unlikely cost (say, unexpected medical bills) pooling their money together and agreeing to pay those costs for anyone who incurs them, essentially making a bet that enough people won’t see those costs in a given year that the pot of money will cover the payouts. Of course, the goal is that the pot

will cover payouts and not a lot more, since people aren’t looking to just throw away money. This means that someone (the insurer) has to look at the likelihood that the pool will have to pay out and set everyone’s contributions (premiums) accordingly. That is, a primary job of insurers is to adjust premiums to reflect the degree of risk that the pool is taking on. The simplest way of visualizing this might be to think of balancing scales: heavier risk on one side will mean higher premiums on the other.

Of course, the real world is more complicated than this explanation, but the essential principle holds. Just like the pool mentioned above, people don’t want to throw away money, so economic pressure keeps profit margins in

insurance relatively low.¹ At the same time, since it’s essential that the pool have enough money, insurance companies are [very financially stable](#). Overall, while there are specific exceptions, the insurance industry is generally not the villain it is [sometimes made out to be](#).

What Drives Insurance Costs

When using the basic mechanism above, things that cause a plan to take on increased risks will naturally translate into higher premiums. Since the largest risk that health insurance deals with is the cost of the care that it pays for, it follows both naturally and in reality that the [largest driver of rising insurance premiums is increased healthcare](#)

costs. In turn, the largest drivers of increased care costs are related to [upgrading medical technology, the development and use of new drugs, and administration-related costs](#). Contrary to popular belief, diagnosis of unnecessary treatment due to fear of litigation (so-called “defensive medicine”) is [not a likely major driver of costs](#). At the same time, the rising rate of many chronic diseases, particularly those related to obesity, is a [significant driver of increased costs](#).

The lesson to take from this, then, is that fixing rising insurance costs is primarily about fixing the underlying cost issues, particularly those related to over-utilization of high cost services.²

Can We Blame the (un)Affordable Care Act?

President Obama famously claimed that the ACA would reduce people’s premiums by an average of \$2,500. This claim has been [largely discredited](#), but what has been the overall effect of the law? Again, using our model of how insurance works, some effects are predictable. The Act [eliminates several cost control mechanisms](#) like coverage maximums and pre-existing condition exclusions, both of which led to increased premiums for many people. At the same time, the Act did little to affect the fact that [most Americans get insurance either through their employer or Medicare/Medicaid](#), leaving a small population in the individual market. As our model suggests, this small pool of people, many of whom are relatively high-risk due to chronic issues, will have higher relative costs because the risk of payment can’t be spread over as many people.

However, the ACA is far from a universally bad idea. The increased coverage of preventive care, hand in hand with increased initiatives to encourage healthy lifestyles, has actually seen [continued slowing in the rate of cost increases](#). At the same time, encouragements for administrative reforms in Medicare payment processes and other minor features of the bill are aimed at improved efficiency in the administrative process, a frequent time headache and significant driver of costs.

Overall, despite what both detractors and promoters of the law say, research is showing the impact of the ACA – whether it be positive or negative – to be [minimal at best](#).

So How Do We Fix Things?

If we’re holding with our model, then the issues that need to be addressed in looking at rising insurance costs are largely tied to rising care costs. The problem is that solving for these issues can be difficult, politically messy, or even distasteful.

For example, pharmaceuticals are one of [fastest growing aspects of medical care costs](#), but as of yet, they remain a smaller share of our overall health spending ([10% or so](#)). While it is true that the U.S. [spends more on prescription drugs than most foreign countries](#), this is partly due to what is essentially price fixing in many of those countries; a side effect of this artificial pressure on the market is that higher relative profits in the United States correlate with America [leading the world in pharmaceutical research](#).³ All this means that going after “Big Pharma” is not a silver bullet, because we’re not necessarily altering the biggest slices of the cost pie, and changes may have unintended consequences that we’re not totally comfortable with.

Similarly, advancing medical technology is [a major driver of medical costs](#). However, technological upgrades, while expensive, are sort of like investing in infrastructure. It’s expensive up front, but it [pays long-term dividends](#), and the rollout of upgrades throughout the industry both increased cost inflation in the early 2000s and slowed it down recently as the upgrades completed. This doesn’t mean that the push for things like Electronic Medical Records has been painless, as somewhat clunky implementation and regulation at the government level has actually [significantly increased administrative burdens in many cases](#). Similarly, the move to electronic records has seen a correlated [growth in cybersecurity costs for providers](#); however, technological innovations like virtual care are a [major driver in reducing care costs](#). Taken together, this means that technology is also not a panacea, and it must be implemented strategically and carefully, considering both unintended side effects and the relative balance of short-term cost

increases against long-term benefits.

Finally, the biggest aspect of the debate in this area is how we manage the decision to consume medical care services. Good research shows that while demand is quite flexible, supply is not.⁴ Additionally, we tend to be [relatively insulated](#) from the full cost of the care we consume, leading to overconsumption. There are really two major solutions to this: we can either make consumers more aware of actual costs through things like increasing deductibles and the employee share of premiums, or we can take the care management decision away from individuals, which is common in the single-payer systems of European countries. The current approach most widely implemented in the United States has been increased cost-sharing, and this has [slowed down cost inflation significantly](#); however, it is not without drawbacks, particularly when individuals find themselves unable to afford necessary care. Similarly, government-managed care is subject to [sharp fluctuations due to political](#) (rather than care-oriented) changes, and Europe, while generally spending less per capita than America, has found that single-payer systems still face [significant difficulties in terms of managing costs](#).

Overall, there are no easy complete solutions to the challenges we face in insurance costs, but there are many small things we can do based on the model of how insurance works. As a few quick examples, Americans spend significantly more on brand name medications, but we [use generics more than most other nations](#) as well, and that growing trend is helping to lower costs. Similarly, the exploding popularity of wearable health technology, like FitBit, has significant potential for helping people embrace healthier lifestyles, particularly when combined with employer-run wellness incentives; however, the bottom line remains that [people need to be willing to change in order for change to happen](#). Finally, the growing use of Employee Assistance Programs (EAPs) are [a significant positive force](#) in helping people make intelligent care management decisions and shop around for the best care.

If we work on the core issues of healthy living, preventive care, and knowledgeable decision-making, we can do a lot to reduce the growth of medical costs. While this is easy to say, it's not always easy to implement, and the reality on the ground is usually more complex than the punditry on the television. Hopefully this article has helped you begin to think differently about how to approach this problem, so what are some initiatives or changes that you think might hold exciting promise for tackling this important issue at its root causes?

Footnotes

1. While this is much lower than many other industries, it bears noting that Return On Equity (ROE), which is in some ways a better measure of profits, is [relatively healthy compared to other industries](#). This means that insurance companies aren't grubbing for pennies, but they're not generally riding high on ridiculous profits, either. [↩](#)
2. Of particular note, the United States spends about a [third of its healthcare dollars on hospital care](#), and our hospital expenses far outstrip other developed countries. [↩](#)
3. For example, from 2001-2010, the [United States was responsible for 57% of new chemicals developed](#) for medical treatment. [↩](#)
4. Studies have suggested that [every dollar spent on healthcare adds only 43 cents to services supplied while inflating costs by 57 cents](#). [↩](#)