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Obamacare's Nasty Surprise

By Martin Feldstein

Obamacare could have the unintended consequence of raising health insurance premiums and causing a decline in the number of people with insurance.

Here's why: A key feature of the House and Senate health bills would prevent insurance companies from denying coverage to anyone with preexisting conditions. The new coverage would start immediately, and the premium could not reflect the individual's health condition.

This well-intentioned feature would provide a strong incentive for someone who is healthy to drop his or her health insurance, saving the substantial premium costs. After all, if serious illness hit this person or a family member, he could immediately obtain coverage. As healthy individuals decline coverage in this way, insurance companies would come to have a sicker population. The higher cost of insuring that group would force insurers to raise their premiums. (Separate accident policies might develop to deal with the risk of high-cost care after accidents when there is insufficient time to buy insurance.)

The higher premium level would cause others who are currently insured to drop coverage, pushing premiums even higher. The result would be a spiral of rising premiums and shrinking numbers of insured.

In an attempt to prevent this, the draft legislation provides penalties for individuals who choose not to buy insurance and for employers that do not offer health insurance. But the levels of these fines are generally too low to cause a rational individual to insure.

Consider: 27 million people are covered by health insurance purchased directly, i.e. outside employer-based plans. The average cost of an insurance policy with family coverage in 2009 is $13,375. A married couple with a median family income of $75,000 who choose not to insure would be subject to a fine of 2.5 percent of that $75,000, or $1,875. So the family would save a net $11,500 by not insuring. If a serious illness occurs -- a chronic condition or a condition that requires surgery -- they could then buy insurance. Since fewer than one family in four has annual health-care costs that exceed $10,000, the decision to drop coverage looks like a good bet. For a lower-income family, the fine is smaller, and the incentive to be uninsured is even greater.

The story is similar for single people. The average cost of an individual policy is $4,800. An individual with earnings of $50,000 would face a fine of $1,250 and would therefore save $3,550 by not insuring.

The situation for the 176 million people who get their insurance through employer-based plans is more complex. To simplify, let's look at a family in which one adult earns $50,000 and receives the family plan that costs $13,375. Employees typically pay about 25 percent of the premium cost, or $3,340. The $10,035 remaining cost is deductible by the employer and not taxable to the employee. So the total net cost to the employer of this employee's compensation (taking into account the payroll tax and the corporate tax deduction) is $41,509. The employee would receive the $50,000 minus his part of the health insurance premium, or $46,660 as pretax income.

If that employer stopped providing insurance, he could be subject to a fine of 8 percent of payroll, or about $4,000 for

this individual. But even with this fine, he could pay a cash wage to the individual of $53,605 and still have the same net cost of $41,509 (because the cash wage would be subject to the 7.65 percent payroll tax and the combined amount would be deductible at the 35 percent corporate tax rate.) The employee's pay would therefore rise from $46,660 to $53,605, an increase of $6,945. That would be subject to income and payroll taxes, leaving a net increase of $4,677. Even after paying the 2.5 percent personal fine on his cash income of $53,605, he would have additional net income of $3,337, a substantial rise for someone who started with pretax income of $46,660.

In short, for those who are now privately insured through employers or by direct purchase, there would be substantial incentives to become uninsured until they become sick. The resulting rise in the cost to insurance companies as the insured population becomes sicker would raise the average premium, strengthening that incentive.

The proposed legislation would at the same time increase the number of people who would get coverage through Medicaid or the Children's Health Insurance Program. It would also provide subsidies that would limit the premium cost to some low- and middle-income individuals.

But as the number of those who are currently insured declines, a future Congress might respond by increasing subsidies to middle- and upper-income individuals to buy private insurance. More likely, it would subsidize a public insurance company -- whether or not such a public option is in the initial law -- just as it now subsidizes Medicare in a way that was not contemplated when the Medicare program was created.

The Congressional Budget Office is required to estimate the cost of the law as it is written, not as it may evolve. But we as taxpayers will have to pay those future costs.

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