Government must put right health insurance pains

By Joshua Gans
The Age, March 28, 2006

AS IS the case every year, the Federal Government has announced how much it will allow private health insurance companies to increase their premiums. One might wonder why the Government should play a role in setting private health insurance premiums. And the answer is simple: it is paying for 30 per cent of them and so has an interest in what they are.

But why, you might ask, can't competition between insurers regulate the price? And the answer again is: the Government is paying a 30 per cent premium.

That means that if individual households search around for lower premiums, in effect, they only keep 70 per cent of the savings. Not surprisingly, the Government distrusts that households will use their powers of consumer choice to allow competition to work.

Add to that the possibility that consumers aren't necessarily so shrewd and rational when it comes to such things and the fact that it is hard to compare health insurance offerings anyway (it is a good example of a "confusopoly") and we can't expect competition to be effective.

What we are left with is a terrible regulatory regime where the health insurers petition the Government for a fee rise based on their own cost increases and usually get it. This reduces incentives to contain costs, and lo and behold we are footing the bill. Not just the average $150 rise in premiums but an additional $45 in public expenditures.

This is not the sort of regulatory deal we put up with in other sectors such as energy and even telecommunications. (Boy, would Telstra love the health insurance deal!)

There are several simple options at the Government's disposal to change this situation. One option is to change the health insurance rebate. As Stephen King and I demonstrate in our book *Finishing the Job* (Melbourne University Publishing, 2004), a lump sum (or dollar) payment rather than a percentage would remove many distortions.

Among these distortions are the incentives for consumers to search for lower premiums.

Another option would be to move to a modern system of price regulation. Incentive regulation sets the caps on prices (or in this case premiums) independent of short-run changes in the costs of individual companies.

This is usually done by referencing some benchmark. While the choice of benchmark can often be contentious, in health care, benchmarking for the Government is easy. It could base the annual rise in private health insurance costs on the increase (if any) in Government expenditures on relevant public health services, something it not only observes but can control.

Better still, the Government could get rid of the rebate entirely and subsidise private hospitals and medical expenses based on the same cost benchmarks as the public system. This would eliminate the need for regulation altogether and put the annual round of increases into the past.

And this is only one of the benefits that might come from this more major type of reform. As described in *Finishing the Job*, this might improve Government incentives to support a quality health care system.

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