Study points to importance of subsidy structure in Affordable Care Act

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One of the challenges for Congressional Republicans looking to replace the Affordable Care Act is how to address federal subsidies, which millions of Americans use to pay for health insurance.

In a new study, economists at the University of Chicago and Harvard

University examine how the structure of subsidies can ripple through health care markets, affecting both incentives for insurers and market competition. Their findings were released as a National Bureau of Economic Research working paper in January.

"A few years ago some key economic concepts were missing from much of the debate around the Affordable Care Act," said Sonia Jaffe, an author of the working paper and postdoctoral scholar at UChicago's Becker Friedman Institute for Research in Economics. "We wanted to revisit this question of the optimal subsidy structure from a framework of how economists think about incentives."

Jaffe and co-author Mark Shepard, assistant professor of public policy at Harvard's Kennedy School, consider the theoretical and practical implications of linking subsidies to prices set by insurers versus setting subsidies fixed at a specific level based on external benchmarks.

Through health insurance exchanges, the Affordable Care Act offers a variety of subsidized, private plans. Federal subsidies provided to millions of low-income Americans are linked to the pricing of such plans.

The researchers said the price-linked approach can help buffer consumers against shocks and uncertainties in the market because subsidies change in tandem with insurance prices. But it also can produce some unintended consequences: When there is only a single insurer present in a market, price-linked subsidies can encourage large markups to prices without any loss of demand. Even in less extreme cases, competition can be muted, leading to increased prices and higher government spending on subsidies.

In legislation proposed to replace the Affordable Care Act, the federal government would shift to fixed subsidies indexed to measures of health care inflation. This approach can lead to lower prices and avoid the competitive distortion of their price-linked counterparts. However, the health care market is often uncertain, so unanticipated price changes could hurt consumers in the case of higher-than-expected costs or lead to unnecessary government spending on subsidies if market prices decrease. Still, the benefits of fixed subsidies often outweigh those of price-linking in mature markets where uncertainty is low, the researchers said.

In an effort to tease out tradeoffs between the two alternatives, Jaffe and Shepard used data from the Massachusetts exchange to simulate insurance market competition. They first assumed that costs—and therefore prices—behave as expected by regulators. Their second analysis considered conditions in which market costs differ from regulators' expectations.

The simulations reveal that price-linked subsidies create distortions, with prices higher than they would have been under a fixed subsidy. Using estimates from Massachusetts in 2011, they find that when regulators tied subsidies to prices in a market where uncertainty is low and prices perform as expected, the result is up to 6 percent higher prices for the cheapest health insurance plan. That's likely because insurance companies can raise prices without losing as many customers, the researchers said.

Such an increase may sound modest, but it translates into $46 million in annual subsidy costs in Massachusetts and more than $3 billion if extrapolated nationally under the Affordable Care Act.

When costs are as expected, fixed subsidies result in a combination of higher consumer surplus and lower government costs. However, as market prices diverge from regulators' expectations, price-linked subsidies begin to perform better. Price-linked subsidies automatically rise and fall in response to cost shocks, ensuring that low-income enrollees are protected when prices unexpectedly increase.

"There are tradeoffs between the two subsidy policies. If set intelligently and adjusted yearly to reflect local health care prices, fixed subsidies could lower costs. However, if fixed subsidies are set too broadly or just linked to inflation, they will likely be worse than price-linked subsidies in the long run," Jaffe said.

More information: Price-linked subsidies and health insurance markups. www.nber.org/papers/w23104.pdf

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