

ECONOMIC SCENE

The model doesn't quite fit Medicare drug insurance.

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ONE of the few things that Vice President Al Gore and Gov. George W. Bush agree on is that elderly citizens should have government-subsidized prescription drug insurance. The Gore plan is much more generous and gives more details than the Bush plan, but both proposals deviate from the ideal model of economic insurance. The reasons reveal as much about politics as they do about economics.

In a remarkable 1963 paper, Kenneth Arrow of Stanford University laid out what is now the conventional economic theory of insurance. Economists assume people do not like to take risks -- a guarantee that your prescription drug expenses next year will be \$1,000 is preferred to a 1-in-10 chance they will be \$10,000, even though the average is the same. Fair gambles over small stakes are acceptable, but large ones are to be avoided. Insurance is desired to counterbalance the negative consequences of unexpected events, like illnesses or natural disasters.

The ideal insurance plan would pay nothing for small expenses -- that is, it would have a deductible -- because small risks are tolerable. In addition, to give the insured an incentive to take adequate precautions and not overuse benefits, the plan would require a co-payment. Most important, insurance would provide unlimited coverage after a certain level of costs is incurred so the insured avoids financial ruin.

In short, the best insurance plan from an economist's perspective offers catastrophic coverage with a deductible and co-payment.

Professor Arrow's theory is prescriptive; it describes how people should behave. The problem is they do not behave that way. A new study by Howard Kunreuther and Mark Pauly of the University of Pennsylvania finds that people desire low deductibles and are ambivalent toward catastrophic coverage; tend to be cavalier in taking risks when the stakes are framed as losses and overly cautious when they are framed as gains; think of insurance as an investment rather than protection against catastrophic risk; and underestimate small risks while exaggerating larger ones.

Consequently, we buy too much of some insurance (like flight insurance) and too little of other insurance (like flood insurance).

These problems are compounded in the drug insurance market by a phenomenon known as adverse selection. Those who are most inclined to use prescription drugs buy the most insurance. The average Medicare beneficiary covered by drug insurance spends 66 percent more on prescriptions than his or her uninsured counterpart, despite getting lower prices. To stay afloat, insurers charge high premiums and cap benefits.

The private market for outpatient prescription drug insurance has failed miserably. The most common Medigap drug plan, for example, charges \$100 a month and caps benefits at \$1,250 a year. This is not insurance; it is prepaid medication. No wonder almost a third of Medicare beneficiaries lack drug insurance and many others have inadequate coverage.

Mandating that the elderly join an insurance plan would prevent adverse selection. This proved politically infeasible,

however, when it was tried in the quickly repealed Medicare Comprehensive Coverage Act of 1988 because the well-off elderly were already satisfied with their coverage and others were insufficiently impressed by catastrophic insurance.

So the candidates have devised voluntary plans that offer subsidized premiums to entice people to buy coverage. Mr. Gore would subsidize half the premium and Mr. Bush 25 percent. Many experts question whether Mr. Bush's subsidy is sufficiently generous to attract enough people to avoid crippling adverse selection problems.

Instead of a deductible, Mr. Gore's plan would reimburse beneficiaries for 50 percent of their first \$2,000 (rising to \$5,000 in 2008) of drug costs a year; none of their next \$3,000 (\$1,500 in 2008); and all of the rest. No participant would ever have to pay more than \$4,000 out of pocket.

Why tilt benefits to the front end and put the deductible in the middle? To attract enough older people -- who do not always act rationally when it comes to insurance -- and thereby skirt the problem of adverse selection. Almost everyone receives some reimbursement under the Gore plan because more than 85 percent of older people take at least one prescription drug annually. The politics are such that "the principle of making sure the median participant would benefit mattered more than the principles of optimal insurance," said Mark McClellan, a professor of economics and medicine at Stanford University who worked on the Clinton-Gore plan.

But front-loading benefits attracts participants at a high cost. Congressional Budget Office figures imply that the front-end coverage accounts for about two-thirds of gross outlays in President Clinton's proposal, a close cousin of Mr. Gore's plan.

Mr. Bush would initially hand off drug insurance for the poor elderly to the states -- a responsibility many governors don't want. (For a candidate running against "big government," this approach has the curious effect of creating 50 government bureaucracies.)

Most elderly people who lack insurance have incomes above 150 percent of the poverty line, so they would be unaffected by this part of the plan anyway. Mr. Bush said he would form a White House task force to devise a proposal that relies on private insurance plans, a government plan and H.M.O.'s to cover all the elderly. The voluntary sorting of the elderly with high expenses into the most generous plans would probably cause this market to eventually unravel.

Mr. Bush also said he would seek catastrophic coverage for all out-of-pocket Medicare costs, including drugs, in excess of \$6,000 a year, paid for by unspecified cuts elsewhere in Medicare. Although the instinct to provide catastrophic coverage is a good one, it is doubtful enough could be cut from Medicare to finance it. "An elderly person cannot possibly know what situation they would be in if Bush won and got his current ideas passed into law," said Uwe Reinhardt, a health economist at Princeton University.

Bismarck, the father of social insurance, was fond of paraphrasing Voltaire: the best should not be the enemy of the good. The Gore plan is very expensive but it would provide protection against escalating prescription drug costs and solve adverse-selection problems; the Bush plan is less expensive but probably unworkable. In this case, the best would be for the elderly to recognize that the goal of insurance is to provide a cushion against unexpected catastrophes, not a regular check for anticipated expenses.