FORTUNE

April 9, 2010

Health care act's two ticking bombs

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A week ago, a good friend -- let's call him Anthony -- related a remarkable story about shopping for health insurance in two states, New York and Arizona.

For Anthony and millions of other consumers, New York represents the ultimate nightmare for finding affordable coverage, pairing outrageously high prices with a tiny roster of offerings. By contrast, Anthony found fabulous bargains and a rich variety of policies in Arizona's desert sun.

So it would be wonderful for folks like Anthony if the historic health-care reform law scuttled the rules that created the disaster in New York, and made America's insurance markets a lot more like Arizona's.

But amazingly, the bill imposes a New York-style regime on the rest of the nation, then makes a gigantic bet that the results won't mimic those of the Empire State.

That's the problem with Obamacare: It's staking its entire success on a complex web of subsidies and penalties designed to pull young and healthy Americans into the insurance system, even as their policies get more expensive. As we'll see, that's an extremely risky wager.

Let's look at the great deals Anthony found, then handicap whether they'll flourish, or more likely, vanish under the new law. Anthony commutes back and forth from New York City to the Phoenix area, where he started a real estate business. He's a handsome, strapping six-footer in his early 40s.

Anthony first looked for individual health insurance in New York. The rates shocked him: around $1,200 a month for a basic HMO plan from carriers like Aetna and Empire, and over $1500 for a point-of-service policy that allow customers to choose out-of-network doctors in exchange for higher co-pays.

To make matters worse, Anthony wanted an inexpensive, high-deductible policy, but he couldn't find a suitable one in the New York individual market.

Crash diet

So Anthony went shopping where he works -- in Arizona. There, he found a far wider menu of offerings, including the inexpensive, high-deductible policies that best fit his needs. To obtain the lowest rates, Anthony needed a battery of tests to prove to the insurer that his health was excellent. From his annual checkup, Anthony learned his cholesterol was high.

So he went on a crash campaign to lower it, working out on the elliptical machine at his health club, swapping cheese omelets for oatmeal and raisins at breakfast, and

devouring Fage Greek yogurt, a favorite discovery on his adventure in healthy eating.

Last year, thanks to his youth, good health history and newly tamed cholesterol, Anthony qualified for a $5,500 deductible plan with a premium of just $100 a month. (The policy in Arizona closest to the New York point-of-service coverage costs around $300, versus $1500.) "The system in Arizona gave me a major financial incentive to improve my health," says Anthony.

New York's fair pricing problem

What accounts for the huge price differences between Arizona and New York?

Two regulations enormously inflate prices in New York (and, incidentally, rates aren't much lower in Albany or Syracuse than in Manhattan), especially for young, healthy folks such as Anthony -- just the kind of people who must buy in for the insurance pools to succeed.

The first regulation is Guaranteed Issue. In New York, and several other states including Vermont, Massachusetts, and New Jersey, carriers must accept all customers regardless of their medical condition. It would be illegal in New York to offer the deal Anthony got in Arizona -- a lower rate in exchange for lowering your cholesterol.

The second premium-swelling rule is Community Rating. In New York, all customers pay the same rate regardless of either their age or medical status. As a result, someone Anthony's age or younger pays an identical premium for the same policy as a 64-year-old customer, although they actually cost a fraction as much in medical claims. So older patients effectively get a big subsidy, and the young pay far more than their actual cost.

It gets worse. Because of guaranteed issue, patients know they can enroll in a plan anytime they get cancer or diabetes, so they have little incentive to sign up when they're healthy. Community rating assures that they can re-enroll at premiums far lower than the actual costs of the tests and procedures they require. Hence, the pools of the insured in states like New York and Vermont consist of an extremely high proportion of sick people. (This PricewaterhouseCoopers report describes how the guaranteed issue and community rating could drive up premiums.)

As the old and ill flood the plans, the rates rise even further, pushing out more and more of the young and healthy in a cycle of rapidly rising premiums and sicker and sicker customers.

"There is no question that the combination of community rating and guaranteed issue drives up premiums in states that now have those regulations," says Thomas Snook of actuarial consulting firm Milliman Inc.

The Arizona bargain

By contrast, Arizona -- and most other states, from Pennsylvania to Tennessee -- doesn't have guaranteed issue or strict community rating. "The individual market is a bargain in states without those regulations," says health care economist John Goodman of Dallas think-tank the National Center for Policy Analysis.

Young, healthy customers like Anthony get a good deal on insurance for a simple reason: They don't cost much. But their premiums flow into a big pool that supports the patients who are getting older and sicker. That's how classic insurance is supposed to work.

Starting in 2014, Obamacare will impose both Guaranteed Issue and Community Rating on the entire nation, including Arizona and the other states that don't have those regulations now. The Community Rating law will not be as strict at the one in New York: Insurers will be able to charge three times as much to a 64 year old, versus someone 18 or 20.

But that will still raise rates for the young, since they normally cost just one-sixth of patients in their 60s. (To gauge the huge difference in premiums between states, check this report from AHIP, the health insurers' industry association.)

The Administration is convinced that even though premiums rise for the young, more of them will buy insurance. Why? Well, first, Americans who don't buy coverage are fined. Second, lower and middle-income Americans get lavish subsidies to help pay for the inflated health insurance costs.

All carrot, no stick

Making sure the stick and carrot work will require enormous calibration.

"Rates will go up for young people in states like Arizona, not enough to make them leave the system, especially with the new fines and subsidies," says John Sheils of the Lewin Group, a research group owned by UnitedHealth. "But the fines may be too weak to prevent the young and healthy from dropping their plans."

For now, the penalties start at $600 and by 2016 they will rise to $1500 for someone making $60,000. And if the insuree can't find a policy that costs 8% of his income or less, he's exempted from all fines. That's just $400 a month.

Let's say Anthony's premium rises to over $300 a month by 2016. Will he keep his policy? First, he's earning too much as a single -- say $60,000 -- to get any subsidy at all. And second, even if he has to pay a fine, it's a lot less than paying almost $4000 a year for insurance.

So the success or failure of ObamaCare depends on how much premiums rise for the young and healthy under the new rules. Be warned: They could explode. That's what happened in New York.