



Risk adjustment in Health Insurance and its long-term effectiveness

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Risk adjustment as currently implemented has its weaknesses. Insurers do not invest in selection unless profits are sufficiently large, and since their planning horizon exceeds one year, they target permanently favorable risks that are permanent members. This paper estimates *long-run* profits of risk selection in four scenarios (no risk adjustment, demographic risk adjustment, including prior hospitalization, and PCGs). The data base covers 180,000 individuals over eight years. Estimated profits due to selection prove to be very high without risk adjustment, substantial with demographic risk adjustment, but surprisingly low given a crude morbidity indicator. These results clearly indicate the need for health status – related risk adjustment in an insurance market with community rating.

This paper seeks to analyze the effectiveness and sustainability of risk adjustment by estimating *long-run* profits of risk selection in four scenarios (no risk adjustment, demographic only, including prior hospitalization, and including prior hospitalization and Pharmaceutical Cost Groups). The data base covers 180,000 individuals over eight years. Estimated profits prove to be very high without risk adjustment, substantial with demographic risk adjustment, but surprisingly low given even a crude morbidity indicator. These results clearly show the need for and the long-run effectiveness of health status – related risk adjustment in an insurance market with community rating.