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The Simple Economics Of Voluntary Versus Mandated Drug Benefits For Medicare

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ABSTRACT

There is intense interest in proposals to expand seniors' access to drug insurance. At the same time, there is debate on how best to accomplish this expansion. Advocates of optional drug coverage point to the benefits of free customer choice and the virtues of encouraging innovation in the private sector. Advocates of universally mandated benefits worry about adverse selection leading to collapse of voluntary coverage and about insurers' desire to avoid bad risks distorting the products available. In addition, they argue that voluntary purchase runs counter to their basic goal of health insurance – to offer all senior citizens full and equal access to needed medications.

This paper analyzes voluntary and mandated drug insurance from the perspective of economic theory. It offers a simple graphical analysis that is designed to bring out several features of the market for drug insurance in the presence of adverse selection and the constraint that insurers charge a single premium to all policy-holders. While the underlying theory is well-known, this particular form of presentation is new, to our knowledge, and highlights certain key issues in the design of a Medicare benefit for outpatient prescription drugs. First and most important, economic theory does not offer a clear prediction regarding whether voluntary or mandated benefits produce a superior outcome. That is an empirical question. However, the analysis does have certain implications for how each kind of insurance option should be implemented. In the case of voluntary benefits, policies that raise total enrollment, promote risk neutral enrollment, and lower the price of insurance mitigate the effects of adverse selection. In the case of mandated benefits, benefits should be designed to be as appealing as possible to the people with the least demand for drug insurance.