Cato Goes Off The Rails On Health Policy

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It's been five years since the passage of the Affordable Care Act (Obamacare). In all that time Republicans have not produced a single, credible alternative to it that they can unite behind. Have you ever wondered why?

Here's one reason. The minute anyone proposes an alternative vision for health reform, he will almost immediately be attacked by his ideological comrades for being insufficiently conservative.

The latest victims are Gov. Scott Walker and Sen. Marco Rubio – two Republican candidates for president who have proposed replacing the arbitrary and unfair tax subsidies in the current system with a fixed sum, health tax credit — very much like the child tax credit. For Walker, the credit would be available to people who purchase their own insurance. For Rubio, the credit would be universal, replacing even the tax subsidies that employer plans enjoy. Both proposals would make the credit refundable – people could get it even if they don't owe any taxes.

These ideas are not new. Sen John McCain proposed a universal health tax credit when he ran against Barack Obama in the 2008 presidential election. I don't recall anyone accusing McCain of being a liberal because of that.

Nonetheless, Michael Cannon, who directs health policy at the libertarian Cato Institute, calls the Walker and Rubio plans "Obamacare lite." In fact, to Cannon, any plan that is based on a refundable tax credit is Obamacare lite.

So where did the idea of a refundable tax credit come from? The Brookings Institution? A George Soros organization? Some other liberal think tank? No. None of those. The idea came from the Cato Institute!

I know. I proposed the idea along with the idea of Health Savings Accounts in my book *Patient Power*, published by Cato in 1992. Most think tanks like to brag a bit when their ideas find their way into public policy. For Cannon, HSAs are a “bedrock conservative” idea, while the tax credits are an idea he would apparently like to disown.

Why are tax credits such a good idea?

There are five reasons. They would (1) make tax relief for health insurance fair, (2) eliminate perverse incentives to over-consume health care, (3) minimize the role of government, (4) privatize a large part of the welfare state and (5) empower individuals rather than impersonal bureaucracies.

The current system of tax relief is arbitrary. People at work, in the individual marketplace and in the Obamacare exchanges get wildly different subsides depending on where they get their insurance. Outside the exchanges, the system is highly regressive. Families in the top fifth on the income distribution get six times as much tax relief as those in the bottom fifth.

With a uniform tax credit everyone would be treated the same. Bill Gates and a welfare mother would get exactly the same help from government when they purchase private health insurance.

Tax credits would get rid of the current system of subsidizing the over-consumption of health care. If you are in the 30 percent tax bracket, your employer’s ability to buy health insurance with pre-tax dollars means that government is effectively paying for almost one-third of the cost. Health insurance need only be worth 71 cents to be preferable to a dollar of taxable wages. Further, 150 million people who get insurance at work can always lower their taxes by choosing more health insurance rather than more wages. No wonder our health care system is so wasteful.

With a fixed sum tax credit, any additional spending would be done with after-tax dollars. Any money not spent on health care or health insurance would be available as an increase in take-home pay. People could enjoy 100 percent of the benefits of every dollar of waste they eliminate.

Tax credits minimize the role of government. Currently, government (through the tax system) is involved in every spending decision related to health insurance obtained at work. With a fixed sum tax credit, government makes a fixed amount of dollars available and then gets out of the way — allowing employees and employers to choose between health and non-health benefits with unsubsidized dollars.

Tax credits are the easiest way to privatize the health care system. Neither Michael Cannon nor any Republican candidate has suggested that if patients can’t pay their medical bills it’s okay for hospitals to throw them out on the sidewalk to fend for themselves. In this country, we have decided that if you need essential care and can’t pay for it, someone else will.

Right now we pay for charity care with funding by government agencies, non-profit organizations and cost shifting to paying patients by hospital bureaucracies. Yet these entities are largely immune from the pressures of a competitive marketplace. The tax credit puts funds in the hands of patients and allows individual choice and markets to determine how the care is delivered.

What's wrong with Michael Cannon's health reform?

Cannon would keep the current tax system in place, including the perverse incentives to over-devote resources to health care. However, he would require employers to put the dollars they now pay out in premiums into "large Health Savings Accounts," so that employees could make their own choices among insurance, direct purchase of care and saving for future care.

This apparent individual empowerment, comes with its own set of distortions, however. If you take a dollar out of an HSA and spend it on non-health care goods and services, you must pay income taxes and a 20 percent penalty. Someone in the 30 percent tax bracket would have to choose between spending a dollar on health care or 50 cents on other goods and services.

Of course that same distortion is present in the current system. Under large HSAs, however, the distortion would affect more money and more choices. (The economist's solution to these problems, by the way, is to make the HSAs Roth HSAs – more on that below.)

Now let's get practical. There are two huge problems and there is not a chance on God's green earth that Congress would overlook them.

First, there is no way that Congress would ever insist that employers convert from a system under which 150 million people have catastrophic insurance to a system where millions of them would have the option to save their share of the money and not buy insurance at all. The only argument for government involvement in this sector is the free rider problem. If people don't buy insurance and if they consume all their income instead, when they experience a catastrophic illness the rest of us will end up paying for their care.

So, people will never get a large HSA unless it is coupled with a requirement to buy a minimum amount of insurance. What would that minimum look like? It would almost certainly look very similar to the Obamacare restrictions that are imposed on employers right now. In other words, the large HSA world would involve far more government regulation than the pre-Obamacare world.

Why is that? Because the Cannon reform would create Obamacare-like problems for which Obamacare-like solutions are almost inevitable. Read on.

Here is the second huge practical problem. Whenever you un-pool an insurance pool you face the problem of deciding how much money each enrollee gets. Over the life of a pool some people will stay healthy and others will get sick. Would employers be forced to put more money in the accounts of the latter? If not, how could they afford to buy new coverage? And if so, how much more should they get?

The obvious and inevitable alternative to complete government micromanagement of the way employers make these deposits is an Obamacare-like solution. Employers would give each employee an equal share of funds in the insurance pool because the new insurers would be required to take all comers and charge community rated premiums – the very kind of regulation Cannon has always been against.

Moreover, just as they did with Obamacare, the insurers would then argue for an individual mandate with strong penalties. Otherwise, individuals would game the system, remaining uninsured until they got sick. Also, the insurers would insist that every health plan be required to participate in a risk adjustment scheme – to protect plans that get more than their "fair share" of sick people. And that would produce the same kind of private sector socialism that is going to emerge in the insurance industry under Obamacare.

One more thing. Cannon has suggested from time to time that he is open to a limit on the amount employers can spend on employee health care with pre-tax dollars. Imposing such a limit would involve the imposition of a version of Obamacare's Cadillac plan tax. I have no idea why this appeals to people on the right – it is a highly inefficient way of trying to do something the tax credit does so much better. But most of the Republican replacement plans have a Cadillac plan tax of one sort or another.

Bottom line: converting employer plans into individually owned large HSAs is not a way to get government out of our lives, as libertarians are supposed to prefer. In order for such a policy to have any chance of working, government would have to be heavily involved in every aspect of it. In many ways, the incentives to over-consume health care would be worse than they are today – blunted perhaps by a Cadillac plan tax. The insurance plans that could be offered would likely be just as regulated as they are today and far more regulated than in the pre-Obamacare world. The pressure for an individual mandate would probably be irresistible and a private sector socialistic risk adjustment mechanism for the health plans would be inevitable.

In other words, the large HSA reform would, as a practical matter, push an additional 150 mililon people out of their employer plans and into Obamacare-like exchanges. If the Walker and Rubio plans are to be described as "Obamacare lite," surely this proposal is "Obamacare heavy."

Now let me address some of Cannon's complaints about the refundable tax credit.

Are tax credits like an individual mandate? All credits, deductions and every other form of tax relief encourage one kind of behavior and penalize another. Because of the mortgage interest deduction, you have to pay higher taxes if you don't buy a home. Because of the child tax credit, you have to pay $1,000 more in taxes for every child you don't have. You can call these "financial mandates," if you like. But that is a strange use of language. The health tax credit functions no differently in this respect than every other form of tax relief.

Do tax credits involve massive redistribution of income? Only to the extent that they would undo the massive redistribution under the current system – at least at the workplace. Right now, the federal government is "paying" for half the cost of health insurance for someone in the 50 percent bracket, but only 15 percent of the cost for a $15 an hour worker. This redistribution of the tax burden totals more than $300 billion every year. Why should someone like Bill Gates get to keep more of his income when he obtains health insurance than a worker at a fast food restaurant? I can't think of a good reason.

Are refundable tax credits welfare under a different name? If they are, then they are a way to privatize the welfare state. As noted, no one has seriously suggested that people who cannot afford health insurance should go without needed health care. One choice is to pay for their care with funding from government agencies, non-profit institutions and through cost shifting to paying patients by hospital bureaucracies. The other option is to empower individuals and let them make their own choices in a competitive marketplace.

Do tax credits require Congress to intrusively define what the insurance must look like? No. For roughly 70 years employer spending on employee health insurance was excluded from the employees' taxable income. For almost all that time the only requirement was the insurance be "creditable." That's a fancy way of saying it can't be a sham. Prior to Obamacare, there were only two or three mandates imposed at the federal level, including mental health parody. Strong pressure to regulate the content of health insurance at the federal level mainly arises when you create artificial insurance markets with perverse incentives – such as the ObamaCare exchanges.

How would the tax credits be paid for? With money already in the system. Obamacare revenues total almost $2 trillion over the next ten years. More than one-third of that comes from Medicare cuts. AARP agreed to them and AARP is not asking for them to be rescinded. Another third comes from taxes on special interests, including the drug companies, the insurance companies, etc. For the most part these sectors are not asking for their money back. So what is a conservative/libertarian thing to do with $2 trillion? Have a tax cut. But tie the tax cut to health care.

What should the tax cut look like? Mark Pauly and I answered this question 20 years ago in an article in *Health Affairs*. The tax credit should be a lump sum and should be combined with a Roth Health Savings Account. Beyond the credit amount, premium payments and deposits to the HSAs should be made with after-tax dollars. This removes the perverse incentives under the current system and under the large HSA system. I would set the credit at $2,500 per adult and $8,000 for a family of four. This is roughly the CBO's estimate of the cost of enrolling people in Medicaid. Therefore credits of this size would allow people to buy Medicaid-like insurance at a minimum.

How do we get from here to there? There is a huge transition problem and to my knowledge l am the only person who has addressed it. Any plan that would take insurance away from the 20 million or so people who have obtained it under Obamacare and leave them with no replacement insurance is self-evidently a non-starter. Any plan that would offer financial help only to people who pay income taxes and deny help to roughly half the population that pays little or no income taxes is clearly not politically acceptable. And any plan that seeks to insure the uninsured but has no funding source is obviously not a real plan.

We cannot repeal Obamacare and then start all over. Nor is that necessary. We can instead move from where we are now to where we want to be. Among other things, that means turning the

Obamacare exchanges into real markets with real health insurance premiums and turning tax credits that are arbitrary and unfair into a universal credit that treats all of us the same.

See my editorial on how that can be done. It's doable.