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Obamacare's Federalist Opportunity

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Last month's Supreme Court ruling was a loss for opponents of Obamacare, which remains mostly intact. But the ruling, in combination with another little-noticed provision governing its exchanges, may pave the way for an unexpected partial victory: the opportunity for a federalist implementation of the law, in which some states can essentially opt out of the bulk of the law's requirements. It's not just an opportunity for states to resist the law's federally designed strictures. It's a rare opportunity to run a nationwide health policy experiment, testing the health and budgetary outcomes in states that choose to implement the law against those that don't.

There are two keys to this opportunity, and, like high-security safes, they must be turned simultaneously in order to truly work. The first is the part of the high court's ruling allowing states to opt out of the health law's Medicaid expansion without fear of losing their existing federal matching funds.

Technically, Medicaid has always been optional. But under the law's original language, any state that did not fully comply with the law's expansion of the program to an estimated 17 million new beneficiaries could lose its entire federal Medicaid match. Given that the federal government already pays for more than half of Medicaid's cost, and that on average the federal share makes up about 10 percent of state budgets, opting out would have been plainly impossible.

It was meant as an offer that states couldn't refuse. The risk of losing 10 percent of its annual funding in one fell swoop was not one that any state could reasonably afford to take. The threat was so severe that in his majority opinion, Chief Justice John Roberts described this as "a gun to the head"—and directed the federal government to holster its weapon. States now have the option to decline the expansion, and keep their former Medicaid deal.

The second key is the opportunity presented by the legislative provisions governing the creation of state-based health exchanges, the primary vehicle for the law's considerable private health insurance subsidies. The law says that states can choose to build and operate their own government-run health insurance marketplaces, subject to federal scrutiny, but does not require states to do so. Because the law gives states a choice, it also provides a backstop should any state decline to run its own exchange: The federal government will step in and create the exchange on its own.

There's just one problem with the federal backstop: The clear legislative language governing the law's health insurance subsidies does not allow the Internal Revenue Service (IRS) to provide tax credits to individuals who purchase health insurance in a federally run exchange.

The IRS has already written a rule that ignores the law's plain language on this matter and allows subsidies and credits to go toward insurance purchased through federal exchanges. The Obama administration and its allies have referred to the language as a minor glitch, easily papered over in the IRS rulemaking process. But in a recently published working paper, Michael Cannon, the health policy directory at the Cato Institute, and Jonathan Adler, a law professor at Case Western Reserve University, have argued convincingly that the language governing the application of the subsidies was not a drafting error but an intentional inducement to states to create their own exchanges. As Cannon notes, "during congressional consideration of the bill, its lead author, Sen. Max Baucus (D-MT), acknowledged that he intentionally and purposefully made that bailout conditional on states implementing their own Exchanges." The law's congressional masterminds wanted to entice states to create exchanges, and built the language governing the subsidies accordingly.

Because the law's tax credits and subsidies are tied to a tax on employers, the IRS rule will almost certainly be challenged for imposing a penalty on employers that should be exempt.

Nor is this the only challenge to building federally run exchanges. While the law provides the Department of Health and Human Services the authority to set up federal fallback exchanges, it does not provide funding by which to do so. As John Kingsdale, who is advising the federal government on exchange creation, told Politico last year, the law is "sort of silent" on the issue of federal exchange funding. Which means that HHS may have difficulty setting up any sort of exchange at all.

In conjunction with the Supreme Court's Medicaid ruling, that gives states an interesting opportunity. If they choose to turn both keys, opting of Medicaid and declining to create their own exchanges, they will be largely exempt from the federal grip of Obamacare.

How many states will take this opportunity? It's not yet clear. HHS Secretary Kathleen Sebelius has indicated that as many as 30 states could decline to run health exchanges. Some two-dozen states led by Republican governors are currently negotiating the details of the Medicaid expansion. Some may opt out. Others will likely use the threat of opting out as leverage to gain a more favorable deal on the program.

A full-scale rebellion is not likely, at least not at first. But a prudent approach to accepting the law's additional layers of federal strictures is in order. Many of the governors threatening to buck the system so far are Republican, but politics are not the only thing at stake. The Supreme Court's ruling describes the Medicaid expansion as a "transformation" of the program—"a shift in kind, not merely degree." States that cautiously choose to hold off on this transformation will not only be following their own interests, but will be providing other observers with testing grounds illustrating what happens when states choose to avoid Washington's latest power grab. The law may have been written as a gun to the head. But Roberts ruling, paired with the exchange provisions, may provide some ammunition with which to fire back.

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