What Barack Obama And The Democratic Party Can Learn From The CO-OP Failures

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Mistakes were made. Yet mistakes can teach us valuable lessons if we are willing to learn from them. In this case, there is an opportunity for those who gave us the Obamacare insurance cooperatives (the White House and the Democrats in Congress) and those who led the cheerleading from the sidelines (the editors of the *New York Times*, e.g.) to learn some basic facts about economics, simple arithmetic and crony capitalism.

From the beginning, the idea of a health insurance cooperative sprang from the minds of folks who reject economics and the economic way of thinking. A health insurance CO-OP, it was said, would be less expensive to operate because it would not have to earn a profit. Any surplus earned could be reinvested in the business. In this way, the CO-OP would serve people rather than the profit motive. It would put patients first, rather than shareholders.

Also, these folks believed that you don't need to know anything about a business in order to be successful running it. The law in fact forbids health insurance executives and employees of health insurance industry trade groups from serving on CO-OP boards. (I'm not making this up. See here.)

The results of this experiment are now well known. Of the 23 CO-OPs set up under Obamacare, 12 have already collapsed. These CO-OPs were established with generous low-interest loans from the federal government and the failure to repay them has already cost the Treasury $1.3 billion. Of the CO-Ops that remain, it is likely that only a handful will survive until this time next year. (Every single coop, except one, had a loss in 2014.)

In the meantime, more than 800,000 CO-OP customers now find themselves without health insurance coverage and are scrambling to find new policies from other insurers. The consequences for many of them are grave. An editorial in the *New York Post* angrily noted: Add 250 New York cancer patients to the long list of victims of ObamaCare's lies — just one more snapshot of the program's ongoing death spiral.

These New Yorkers are getting treatment at world-renowned Memorial Sloan-Kettering Cancer Center — but their ObamaCare policies are about to vanish, as Health Republic, one of the largest health insurers on New York state’s exchange, and the only one to cover Sloan-Kettering treatment, is shutting down at month’s end after losing $130 million.

The state exchange’s “solution”: It’ll give them an extra two weeks to find a new policy — but it has nothing that will save them from having to change hospitals and medical teams. (It is in talks with the hospital about trying to give them an extra year of coverage there — but with no word on who’ll pay.)

Ed Crane, the founder of the Cato Institute, once said that Washington, DC is an unnatural place. In ordinary life people are free to hold any looney idea that appeals to them and others are free to ignore their looney-ness. But once elected representatives get to Washington, microphones appear in front of them, cameras are focused on them and they begin to think that their ideas are actually profound. So profound that they ought to be codified.

That’s what happened here.

Lesson Number 1: Basic Economics. Capital is valuable. It has alternative uses. The opportunity cost of capital loaned to CO-OPs is the value of its use elsewhere in the economy. In general, a normal rate of return, adjusted for risk, is the cost of capital. It’s the sacrifice society must make for investing in one enterprise rather than some other enterprise. In the for-profit world, this profit is explicitly accounted for. It is also taxed and distributed – by way of interest payments, dividends and returns to the owners.

In the public sector and in the non-profit world, accountants do not usually include the words “profit” or “cost of capital” on the financial statements. But that doesn’t mean that capital is free or that its use is costless. Nor would it be a bad thing if the accountants made explicit reference to it. As I wrote in “Why Making a Profit in Health Care is Good”:

You can’t be successful in the medical marketplace unless you are meeting other peoples’ needs. The more needs you meet, the more successful you will be. Profit is one measure of how much good you are doing.

A profitable medical enterprise is one that takes resources that have a value elsewhere in the economy (as measured by the cost) and creates even greater value for consumers/patients (as measured by the revenue). By contrast, a loss implies that resources are being used in a way that is less valuable than their use in producing something else.

With respect to the CO-OPs, we the taxpayers are the venture capitalists. Our money is being placed at risk and we are certainly entitled to a return on our investment. What should that return be?

Lesson Number 2: Simple Arithmetic. Here is an exercise for the reader. Suppose you are making the same, one-year loan to similar businesses and you know in advance that one in three will fail and pay you back nothing. What interest rate do you need to charge in order to make sure your capital will be fully returned? ….. (waiting) ….. Okay, times up. Answer: 50%

I didn't just make up this example. It turns out that the CMS (the agency that administers Obamacare, along with Medicare and Medicaid) predicted from the get-go that one in three CO-OPs would fail. No. that's not a misprint. They fully expected one in three to go kaput.

Let's say that a typical government loan covered one-half of one-year's operating costs and that the CO-OP earns sufficient revenue to just break even. (Even though, as noted, only one CO-OP actually did well enough to break even.) That would mean that 25% of the CO-OP's revenue would go for one year's interest payment on its loan – provided we taxpayers are getting the interest payment we should be getting.

If that doesn't immediately knock your socks off, you need to know that an Obamacare regulation requires health insurance companies to spend at least 85% of their revenues on medical care – leaving only 15% for administration, management and return on capital. If Aetna or Cigna or any other commercial insurer spent 25% of its revenues on interest payments to investors, the administration would cry "foul" and Democrats in Congress would be outraged.

It gets worse. The one-in-three estimate, we now know, was way too optimistic. Suppose we knew in advance that fully half of the borrowers would fail. Then we taxpayers should be charging a 100% rate of interest on our loans. (Yes, I know – worse than the pay day loans the left keeps complaining about.) And, at a more realistic estimate of two-in-three failures, the appropriate rate of interest is 200%.

Lending to organizations that put people before profit, then, is a risky proposition. If the borrowers are charged a fair rate of interest, they will end up spending far more of their premium dollars making payments to greedy money lenders than the commercial insurers ever will.

Lesson Number 3: Crony Capitalism. It's too early to know all the reasons why the co-ops are failing. Incompetent management would have to rank high as a probable factor. (See this extensive overview by Grace-Marie Turner and Tom Miller.) But unsavory behavior is a possibility as well. Take Susan L. Donegan, the Vermont insurance commissioner who nixed a CO-OP in her state — even after the Obama administration had pre-approved a $33 million loan. As Richard Pollock explained at the *Daily Caller*:

Donegan sensed trouble as soon as she read the co-op's application. There were optimistic and questionable forecasts, a board filled with friends, sweetheart deals, high salaries, deep conflicts of interest and a staff with little business expertise….

Among the first deficiencies Donegan discovered was that as a federally designed model, the co-op immediately would be burdened with $33 million liability in federal loans despite having no cash flow, no customers and no tangible assets.

This wasn't an easy decision, by the way. Vermont is heavily Democratic and President Obama is very popular. He won 67% of the vote in the last two presidential elections.

I now have a much higher opinion of Vermont, even as l wonder what the insurance commissioners were doing in 23 other states.