

The Future of Employer-Sponsored Health Care

On December 8, 2000, the Cato Institute sponsored a Policy Forum on the future of employer-sponsored health care. The speakers included Gary Ahlquist, senior vice president and managing partner of Booz-Allen & Hamilton's Health and Insurance Group, and Gerry Smedinghoff, director of market awareness for UniversalCIO. Excerpts from their remarks follow.

Gary Ahlquist: Here we are predicting the future. And those of you who follow baseball, as I do, remember Yogi Berra's once saying, "Never make predictions, especially about the future." That's certainly true of health care.

The managed-care system is a \$600 million industry in the United States. Few of the system's users are particularly happy with it. Consumers are unhappy with the restrictiveness of the system and the process they have to go through to get health care. They have no market signals to use to tell the system what they actually want.

Suppliers of health care also are very unhappy with the current system. They feel that their practices have been interfered with time and again. Employers are not particularly happy. They are now in the third year of double-digit price increases. And the health plans themselves feel like everybody's scapegoat. They are getting it from all sides.

So we have a system of managed care that has had some benefit and delivered some one-time cost savings but has not been particularly easy to live within, and people are asking, "What's next? Is there a next?" A consumer-driven market for employer-based individually selected insurance is a probable answer.

A consumer-driven, or defined-contribution, market would have several key features. First, there would be an annual allowance of, or voucher for, an amount of money for each employee to use to enter the market and purchase health insurance with pretax dollars.

Second, that amount of money would be risk adjusted to take into account the medical risk of the individual.

Third, multiyear contracts are a possibility. Why buy health insurance for just a year? We don't buy life insurance for just a year. Why don't we have three-year, four-year, or five-year contracts, which might assume some inflation but would protect against medical risks in some predetermined way?

And fourth, if a catastrophic event occurred at any point in time, there would be some stop-loss coverage to protect us, much the way commercial insurance or auto insurance protects against the big event, but we don't insure against it on a regular out-of-pocket, or premium, basis.

There are clearly some forces, especially consumer interest, that are pushing in that direction. Employers are beginning to look for alternatives, and innovation has come with that: segmentation of the market, defining products and solutions so indi-



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viduals can meet their needs, as opposed to the one-size-fits-all insurance proposition we have today—you take the policy that is offered or you don't, and there is no way of really tailoring coverage to your individual needs.

And then, finally, on the driving side, is the supply-side stimulus. There is a fair amount of innovation going on now in the market. Something on the order of \$300 million to \$400 million of venture capital has found its way into this niche, even after the market decline last spring. And so we expect to see some success, at least some real experimentation, on the supply side, and we

will see just how this works and how it needs to be adjusted to make it work better.

Booz-Allen & Hamilton has done a survey of the Fortune 100 best employers to work for. Seventy-four percent of the benefits executives in those companies would be interested, likely, or very likely to look at a shift to defined-contribution health benefits in the next three to five years. KPMG surveyed employees of Fortune 1000 companies. They reported that 73 percent were interested in having defined-contribution health benefits.

There are several new entrants, largely Internet-enabled, who are making runs at this space. The first are what I would call defined-contribution health plans. There are about 10 to 12 companies that are looking to be risk-bearing insurance plans, Internet-based, with individually tailored choices for consumers.

There are what we might call aggregators, who will offer other people's products through their pipeline but pool the risk and the funds at the front end. And so they will be risk bearers but not necessarily product manufacturers in this space.

And there are a number of e-health players who are looking at vertical slices in the value chain, either making a market in information, making a market in provider services and then offering those to insurers, or making a market as a utility for processing transactions and outsourcing.

We have said that within the next two years we will see Fortune 500 companies entering this new world and trying it out. We actually believe that is too long an estimate. While they haven't gone public with it yet, we expect that in the spring or summer of 2001 we will start to hear more about it. And we will see if it works.

Gerry Smedinghoff: U.S. employers should get out of the health care business. The reason is simple: there is absolutely nothing employers can do about the failing health care sector. The health care economy violates the laws of economics, and employers trying to provide health care in the cur-

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rent system are like pilots ignoring the laws of gravity.

The defined-contribution model is not a solution to the problem. That model brings to mind something Tom Peters said about the American quality movement of the 1980s. The bad news, he said, was that in 1980 Americans were making lousy products that customers didn't want. And by 1990, he said, we were making great products that customers don't want. The defined-contribution model offers the same thing. Instead of having no choice with a lousy health maintenance organization that you don't want, defined contribution gives you a limited choice among several lousy HMOs that you still don't want.

This is the primary reason for our current crisis in health care. The main mechanism for delivery of health care, the managed-care-HMO model, does not exist anywhere else in our economy. The HMO says that we are going to provide all products to all people at all places at all times at the highest quality and at the best price. The HMO model has been tried only twice in the last 20 years by major U.S. companies. It was a disastrous failure both times.

The first time was in the early 1980s, when United Airlines tried to do this with travel. You might call it a TMO, or a travel maintenance organization. They were going to cover the traveler's every need from door to door: the flight, the hotel, the rental car, the cruise, all the way on down. Does anybody remember the name of the company that United Airlines formed for its TMO? It was Allegis. Not many people recall it because it lasted for only about 18 months. The other trial of the HMO concept was Sears' ill-fated foray into offering comprehensive financial services in the early 1980s under the heading of the Sears Financial Network.

The only place today where you will still see a remote resemblance to any HMO model is the new car dealership. When we buy a new car, the salesperson tries to convince us to bring the car back to that dealer for all service. But since there is no tax code coercing us and there are no real incentives for the car owner to return to the dealership for all maintenance and service, what do we do? We get our oil changed



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at Jiffy Lube; we get our mufflers from Midas, our batteries from Sears, and our tires at Goodyear. The good news is we don't need to get a referral from Mr. Goodwrench, our primary care mechanic, to go there.

Here's what the HMO-type system does to our economy. Let's say you are a small business owner with 10 employees, and you are paying them each about \$50,000 a year. If you have a good year and you want to reward your employees for their efforts, you could give them an additional \$5,000 in wages. But what happens to that money, before the employee gets any of it?

The first \$750 of that \$5,000 is going to pay Social Security taxes. The next \$1,400, or 28 percent, is going to pay federal income tax. And the next \$350, or 7 percent, is going to pay state and local taxes. So your employees are going to be left with about half of the \$5,000 that you originally intended to give them.

However, if you decide to buy health care for your employees, none of those taxes have to be paid. So, given a choice of \$2,500 in after-tax income or \$5,000 in health care, most people feel the latter is an offer they can't refuse. Employers think they can double employees' money by buying health care instead of giving them cash. Well, what is the effect of doubling our spending on health care? I will give you a

hint, with another question. What do health care, single-family homes, and higher education have in common?

The answer is that single-family homes, higher education, and health care are all subsidized by some form of tax exemption. They have all experienced inflation far in excess of the consumer price index since World War II, and they are all examples of what I call Gold's law of economics. (named after an actuary turned economist, Jeremy Gold.)

Essentially, what Gold's law says is that 95 percent of a legally mandated cost advantage will end up as waste. What that means is that doubling the amount of money we spend on health care doesn't double the amount of resources. Resources available do not change because we segregate our money through the tax code. All we do by doubling the amount of money is double the cost of the goods. Since resources don't change when you move to a segregated economy, all you do is double the prices.

Another issue is choice. Economists broadly divide goods and services into two categories, public goods and private goods. A public good, like a public road, is one that provides everybody the same thing in the same way. A private good is one that provides us each what we want, individually tailored products and services. What differentiates the public good from the private good is the answer to this question: Can different people satisfy their personal preferences simultaneously without any negative consequences?

Obviously, with food and clothing, the answer is yes. We all wore different clothing here today, we ate different things for breakfast, and nobody suffered from somebody else's decision. With public roads and traffic laws, the answer is obviously no. I can't decide I am just going to ignore all the red lights on my drive back to the airport this afternoon.

The logic of public choice theory holds that people engage in “rational ignorance” when everyone gets the same goods and services despite his desires. Take something very simple, motor oil. If you drive into a Jiffy Lube to get your oil changed, the first question the person that works there is going to ask you is something like “do you

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“If industry and labour are left to take their own course, they will generally be directed to those objects which are the most productive.”

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undergo such incessant chances that no man who knows what the law is today can guess what it will be tomorrow.”

Federalist no. 62,
February 27, 1788

Passion in Politics

“In all very numerous assemblies, of whatever characters composed, passion never fails to wrest the scepter from reason. Had every Athenian citizen been a Socrates, every Athenian assembly would still have been a mob.”

Federalist no. 55,
February 13, 1788

Majority Rule

“Wherever the real power in a Government lies, there is the danger of oppression. In our Governments the real power lies in the majority of the Community, and the invasion of private rights is chiefly to be apprehended, not from acts of Government contrary to the sense of its constituents, but from acts in which the Government is the mere instrument of the major number of the constituents.”

Letter to Thomas Jefferson,
October 17, 1788

Power

“All men having power ought to be trusted to a certain degree.”

Speech in the Constitutional
Convention, July 11, 1787

Property

“Government is instituted to protect property of every sort; as well that which lies in the various rights of individuals, as that which the term particularly expresses. This being the end of government, that alone is a just government, which impartially secures to every man, whatever is his own.”

National Gazette essay,
March 27, 1792

Public Servants

“If neither gratitude for the honor of the trust, nor responsibility for use of it, be sufficient to curb the unruly passions of public functionaries, add new bits to the

bridle rather than to take it off altogether. This is the precept of common sense illustrated and enforced by experience—uncontrolled power, ever has been, and ever will be administered by the passions more than by reason.”

“Political Reflections,”
February 23, 1799

Religious Freedom

“Religious bondage shackles and debilitates the mind and unfits it for every noble enterprise.”

Letter to William Bradford,
April 1, 1774

Republicanism

“When the people have formed a constitution, they retain those rights which they have not expressly delegated. It is a question whether what is thus retained can be legislated upon. Opinion are not the objects of legislation... If we advert to the nature of republican government, we shall find that the censorial power is in the people over the government, and not in the government over the people.”

Speech in Congress,
November 27, 1794

Slavery

“We have seen the mere distinction of colour made in the most enlightened period of time, a ground of the most oppressive dominion ever exercised by man over man.”

Speech at the Constitutional
Convention, June 6, 1787

Military Establishments

“A standing military force, with an overgrown Executive will not long be safe companions to liberty. The means of defence against foreign danger, have been always the instruments of tyranny at home.”

Speech at the Constitutional
Convention, June 29, 1787

Liberty at Home

“The fetters imposed on liberty at home have ever been forged out of the weapons provided for defence against real, pretended, or imaginary dangers from abroad.”

“Political Reflections,”
February 23, 1799 ■

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want Pennzoil 10W30?” Well, most of us are rationally ignorant about motor oil. Despite that, we get a choice of motor oil.

Let’s take something that’s much more important than motor oil, the education of children. Unfortunately, education is a public good. You are stuck with the public schools in your neighborhood whether you like them or not. If you want to make a choice and go outside that system, the cost can be prohibitively high. So we remain rationally ignorant about choices that we can’t really exercise. Unfortunately, health care, like education, is primarily distributed as a public good in this country.

You will notice that we have our priorities upside down. About the things that are the least important in our lives, like our motor oil, we have the most choices. About the things that are the most important, like the education of our children and our health, we have limited choices, if any.

Our health care system serves best those who have the least interest in and place the least value on their health. Consider the business consequences of rationally ignorant health care. Essentially, employers are giving their employees the company credit card, with no spending limit, to buy items that have no price tags on them. How many businesses or households operate that way? Yet that is the way we are operating at least 90 percent of our health care economy.

So, what is the road to recovery? We need to repeal the Employee Retirement Income Security Act and put choices about health care back on the individual level where they belong. What is more personal and private than your health care?

We also need to repeal the Internal Revenue Code. Not only are we segregating our money through the Internal Revenue Code; we are segregating it a second time by making our employers responsible for making health care decisions for us.

Clemenceau noted that “war is too important to be left to the generals.” Likewise, the education of your children is too important to be left to the government, and your health and health care are way too important to be left to your employer. ■