After a century of U.S. innovations in medical procedures, technologies and pharmaceuticals, the quality of American medical care is the envy of the world. Yet our health-care system is in deep trouble. Annual health-care costs are posting double-digit increases, the number of uninsured is at an all-time high, and public satisfaction is sinking rapidly. For these reasons, the status quo health policy is not likely to endure. Without a viable alternative policy, politicians will seek to “fix” our health-care system by recourse to the heavy hand of government.

Free markets are a proven way to discipline costs, encourage innovation and increase quality. The starting point to fixing the health-care system is recognizing that a handful of existing public policies prevent markets from working, and then changing them. Poorly conceived federal tax policies, insurance regulation, and barriers to entry, in particular, have insulated consumers from costs and inhibited competition.

Rising costs lie at the heart of the health-care problem. Each percentage-point rise in health-insurance costs increases the number of uninsured by 300,000 people. This also creates a vicious cost spiral because when healthy individuals opt out of insurance, the costs for the remaining insured rise. The recent increase in costs also has impacts beyond the health-care market. For many employees, rising insurance costs have become a serious drain on their disposable income. The typical worker now pays $750 more per year for insurance than just three years ago.

Efforts by employers to stem the cost escalation have not only failed to succeed, they have also sharply diminished patient satisfaction and raised patient frustration. In a recent nationwide poll by Market Strategies, 86% of those surveyed expressed deep concerns about rising costs; two-thirds worried about the difficulties of obtaining the best medical treatment; and six out of 10 regarded the likelihood of bankruptcy due to major illness as a serious problem. Health-care consumers feel that they are losing their freedom to choose doctors and specialists.

Having sketched a portrait of the problems, we offer some suggestions for an overhaul:

-- Reform the tax treatment of health-care expenses. The most far-reaching and misguided government policy, established more than 60 years ago, allowed employer-provided health care to be exempt from taxation. Under this policy, medical care purchased through an employer’s insurance plan is tax-free, while direct medical-care purchases by patients must be made with after-tax income. The tax preference for employer health insurance has been instrumental in creating today’s third-party payment system. In this perverse world, true insurance, in the form of coverage for catastrophic health events, is the exception; prepaid health care, in the form of coverage with low deductibles and copayments, is the rule. The tax preference for insurance is the primary reason five out of every six dollars of health-care spending are paid by third parties.

Using third parties to pay for health care is so pervasive that we accept it as a natural part of the health-care system. Yet there’s nothing natural about it. Food and shelter are even more basic to our well-being, but we don’t use insurance to buy bread or repair broken windows.

Low copayments and deductibles fuel excessive cost growth and breed wasteful medical practice. The reason is, as Milton Friedman put it, “Nobody spends somebody else’s money as wisely as he spends his own.” Medical care is no exception; when it is purchased through a low-copayment employer-
sponsored health-insurance plan, the patient thinks he or she is paying only a fraction of the costs. Somebody else is paying the rest. As a result, consumers have little incentive to limit their use of unnecessary medical-care services, little incentive to shop for the health plan that best suits their needs in a cost effective way, and little incentive to evaluate their care on the basis of value.

Leveling the playing field between employer-provided insurance and out-of-pocket payments is an essential step to fixing health care. Either the tax exemption for employer-provided health insurance must be repealed or a broad-based tax deduction for out-of-pocket expenses must be created. The former faces enormous political barriers (it would add about $1,500 to the typical family's annual tax burden) and would ignore a positive effect of encouraging everyone to have private insurance coverage.

We propose a simple change that will fundamentally alter the way people buy health care. All individually purchased insurance and out-of-pocket expenses would become tax deductible for persons who have at least catastrophic insurance coverage. The tax deduction could be taken by persons who claim the standard deduction on their tax returns and those who itemize deductions. All purchases of health care would receive the same income-tax treatment.

With a level playing field, workers will no longer have a tax incentive to take their compensation in the form of expensive health insurance with low copayments, and will shift to health plans with higher deductibles and higher coinsurance rates. Market forces will ensure that the insurance-premium savings will be passed on to workers in the form of higher money wages. Just as workers have borne the burden of rising health-care costs, so will they reap the benefits when costs are brought under control.

Higher copayments will give consumers more "skin in the game," making them more cost-conscious and more willing to take greater control of health-care decisions. Ultimately, consumers will make better health-care choices, achieving improved health-care outcomes and considerable savings. Based on the RAND Corporation's National Health Insurance Experiment, if the average annual health-plan deductible were to rise from its current level of $250 to even $500 and the typical coinsurance rate were to rise from 20% to 25%, we estimate that annual health-care spending would decline by $65 billion per year. Furthermore, such savings could be achieved without significant adverse consequences for health outcomes.

This idea builds on recently enacted Health Savings Accounts (HSAs), which offer similar treatment of out-of-pocket expenses for individuals with insurance that meets a specified minimum deductible. Full tax deductibility would be less prescriptive. It would permit individual decisions and the marketplace to decide the proper size of deductibles without the tax code's distorting influence. Full tax deductibility would keep the savings-account feature of HSAs, which creates a strong incentive for consumers to save for future medical expenses.

-- Promote portable, nationwide insurance. With the tax playing-field leveled, consumers would still face highly balkanized state insurance markets encumbered by politically motivated benefit mandates and other forms of excessive regulation. There are nearly 1,500 specific insurance coverage requirements imposed by state politicians in effect in the U.S. Although some of these benefits would be freely chosen by consumers, others, such as chiropractic care and acupuncture, have been enacted in response to political pressures by providers. Other state regulations reduce the variety of available health-insurance options and impede competition among insurers. Still others, through "any-willing-provider laws," infringe on the right of health plans to contract with physicians of their choice and thereby impair efforts by health plans to improve quality and reduce costs.

Consumers need an alternative market that is free to offer new health-care options that would take advantage of full tax deductibility. Therefore, insurance companies should be allowed to offer insurance plans on a nationwide basis, free from costly state benefit mandates and excessive regulations. Regulations should be uniform and cover only essential areas. The benefits of nationwide insurance are considerable. Health insurance will become more portable because people could switch jobs across state lines without risk of its being canceled. All people, but especially the uninsured,
would have access to lower-cost insurance options. Health-insurance plans free from state mandates and any-willing-provider laws could cost on average between 7% and 17% less; that's $600-$1,500 per year for the typical family health plan.

Finally, the policy would bring greater fairness to insurance markets. The burden of excessive state regulation falls mainly on employees of small businesses and persons who buy individual insurance. Large employers who self-insure are exempt from state regulation. Thus, nationwide insurance would permit employees of small firms and individuals who buy insurance on their own to purchase insurance on the same terms and conditions as employees of large firms.

-- Reduce barriers to entry. For decades, the medical industry and governments at all levels have acted to limit the supply of health professionals. Physician groups and hospitals restrict the number of medical-school entrants and residency positions. Advocates justify these restrictions on the basis of quality and cost control. Yet control by physicians and hospitals on the supply of new physicians -- through restrictions on the number of medical-school entrants and residency positions -- amounts to market participants acting in concert to restrict competition, a clear violation of antitrust law. Ensuring quality, the Supreme Court has already ruled, is no defense against such practices. The process for determining the supply of new physicians should be revised so that a better balance can be struck between the desire to assure quality and the benefits of greater competition. No new legislation is required. The government need only enforce the laws already on the books.

Furthermore, state governments have passed laws that prevent certain health professionals, such as nurse practitioners, from delivering care that they are perfectly qualified to provide. The significant shortages of physicians in rural areas and inner cities could be filled by such health professionals. And both state and local governments have enacted laws that prevent medical facilities from locating in certain areas. These laws need to be reviewed to ensure that the high quality of medical professionals is maintained without stifling meaningful competition.

-- Address head-on the costs of helping the chronically ill. Providing affordable health insurance for chronically ill persons who have predictably high medical expenses year-after-year and who lack sufficient resources to finance them is one of health policy's most vexing problems. Private catastrophic insurance, which provides financial protection for unforeseen major medical expenses, is not well-suited to deal with the long-term chronically ill. State government high-risk pools have been plagued by high cost and government-enforced waiting lines. State insurance-premium risk bands that limit the range of insurance premiums that can be offered have distorted insurance markets and raised insurance rates.

A more efficient policy would be for the states and the federal government to provide direct subsidies to assist insurance purchases by persistently high-cost, chronically ill people who have inadequate incomes. Such a policy would deliver affordable health insurance to those who need it with minimal distortion of insurance markets. This reform would not only reduce costs across the board; it would also increase access to health insurance and reduce the number of uninsured. Additional access to health insurance among low-income individuals could be provided through health-care tax credits as proposed by the Bush administration and others.

-- Allow market forces to work. America's health-care policy stands at the crossroads. Either we are going to continue the slow march toward a government-driven system, or we are going to choose a free-market solution that puts consumers in charge. The governmental system ultimately will lead to choice and a stifling of innovation. The free-market solution will enable America to solve its health-care cost problem and capture the promise of 21st-century medicine; a promise of new cures for diseases and longer lives made possible by the mapping of the human genome, and nanotechnology.

The ideas we have offered, when combined with existing proposals for reforming the medical-malpractice system and improving consumer education and health-care quality, are a first step to preserving the health-care system's strengths while addressing its weaknesses.
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