Keep Government Out
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Should health-care reform increase our reliance on markets, or on direct government involvement? The debate is often cast as a struggle between employers or insurance companies on one side and workers on the other, with workers getting the short end of the free-market stick. This view results from a fundamental misunderstanding of basic economics. A handful of policy changes that harness the power of markets for health services have the potential to give patients and their physicians more control over health-care choices, create more health-insurance options, lower health costs, reduce the number of uninsured persons -- and give workers a pay increase to boot.

Last year, on these pages, we argued that health-care policy should limit, not expand, government intervention. Greater reliance on individual choice and free markets are the solutions to what ails our health-care system. As a starter, we recommended three main proposals to correct the harmful effects of current government policy:

-- Make all out-of-pocket health-care expenses deductible against income taxes for everyone who has at least catastrophic insurance -- whether or not they itemize their deductions;

-- Allow qualified insurance companies to sell insurance nationwide, free from politically motivated state mandates and other costly state-imposed regulatory practices; and

-- Set reasonable caps on damages for pain and suffering in medical malpractice cases.

Making out-of-pocket health-care expenses tax deductible would go a long way toward undoing the effects of the most misguided U.S. health-care policy -- the exemption of employer-provided health care from income and payroll taxation. The current tax exemption has helped create a health-care system dominated by low-co-payment, employer-sponsored health plans. The tax exemption is the principle reason that five out of every six health-care dollars are spent by someone other than the person receiving the care. Quite naturally, this system has evolved into one that is excessively costly and wasteful.

Tax deductibility, by expanding on Health Savings Accounts, would further help level the tax-playing field between insured and out-of-pocket spending. It would thereby encourage individuals to rely more on out-of-pocket spending instead of overly generous insurance to finance their routine health-care purchases. With more "skin in the game," individuals would exert more control over their health-care services. And, as the results of the much-analyzed RAND Health Insurance Experiment and a host of non-experimental academic studies demonstrate, these savings could be achieved without significant adverse consequences for health outcomes.

But how do higher health-plan co-payments from such a policy benefit workers? The answer lies in the U.S. economy's highly competitive labor market. A worker's total compensation, wages and salaries plus benefits, is determined by the value of the additional output the worker contributes to the firm. An employer who offers a job applicant less than the value of the worker's output will be outbid for that worker's services by another employer. An employer who pays workers more than the value of their output will lose money and ultimately be driven out of business.

One consequence of competitive labor markets is that workers -- not employers and not insurance companies -- bear the burden of paying for employer-provided health-insurance premiums, as well as out-of-pocket co-payments. Although employers might write the check for premiums, workers pay in the end by foregoing money wages. This is not just an assumption of economic theory. As Jonathan Gruber writes in the Handbook of Health Economics, empirical evidence shows that the costs of health-insurance premiums are fully shifted out of the wages workers receive.

If out-of-pocket health-care expenses are made tax deductible, workers would demand that employers provide health plans with lower health-insurance premiums and higher co-payments. The premium savings will accrue to workers in the form of higher money wages. In the past, workers have borne the higher cost of health-insurance premiums by receiving smaller wage increases. In the future, under the proposed policy, they will reap the benefit of reduced premiums by receiving larger wage increases.

We estimate that, in response to making out-of-pocket expenses tax deductible, the typical worker will shift from a health plan with a 25% coinsurance rate to one with a 35% coinsurance rate. Coupled with our other reforms, this shift will reduce the premiums of the average employer-provided family health plan by around $2,300 per year. The economics of competitive labor markets ensures that this amount will accrue to the worker in the form of higher wages. To be sure, higher out-of-pocket expenses will offset part of this increase -- $1,000 of it. But this still leaves the worker, on net, $1,300 ahead.

Tax deductibility will give all persons who purchase health insurance directly the same tax advantages that are now available to workers who have employer-provided health insurance. The new tax treatment will also make insurance less costly for unemployed persons and workers in firms that don't offer insurance coverage. Under current law, such persons cannot now deduct either the cost of health insurance they individually purchase or their out-of-pocket health-care expenses. Under our proposal, a person would be able to deduct both, but only if he or she purchased insurance. Thus, a person in a 15% tax bracket who purchases a health-insurance plan for $2,000 and has an additional $700 in out-of-pocket expenses would realize a tax savings of $405, effectively reducing the net cost of buying insurance by 20%. This lower cost provides a significant financial incentive for currently uninsured individuals to buy insurance that protects them against catastrophic health-care expenses.

The same reasoning applies to our other policy reforms. We propose to allow insurance companies to sell insurance nationwide, free from politically-motivated state benefits mandates and other forms of excessive regulation. A national market will make health insurance less costly and more portable. There are more than 1,500 specific coverage requirements imposed on insurance markets by state legislatures. Although some of these benefits would be freely chosen by consumers, others, such as chiropractic care, might not be. According to the Congressional Budget Office, state benefit mandates have raised the cost of a typical insurance plan by 5% to 15%. Allowing individuals instead of state legislatures to decide their insurance coverage will give them the best value for their money.

We also recommend the adoption of reasonable caps on damages for pain and suffering in medical malpractice cases. This will reduce the practice of "defensive medicine" -- expensive tests and procedures that have minimal or no medical benefit undertaken out of fear of legal liability. As these reforms take effect, premiums will decline. For those with employer-provided insurance, wages will rise; for the currently uninsured, insurance will become more affordable.

Reductions in insurance costs, accompanied by increases in deductibles and co-payments, may look like a redistribution from workers to employers. Competitive labor markets, however, ensure that workers will ultimately receive the benefits. Politicians and policy makers on both sides of the aisle would be wise to keep this fact in mind when considering the direction of health-care reform. And the simple observation suggests clear routes for the Bush administration to put forth reforms that make markets work better. Absent such changes, high rates of uninsurance and rising health-care costs will ultimately lead to a government-directed health care program, with adverse consequences for choice and innovation.

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