

# Curing California Health Care: Five Steps Towards Universal Choice in 2007

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## The Healthy California Series

This is a briefing paper in the Pacific Research Institute's *Healthy California* series. *Healthy California* is a line of health policy research that addresses issues of immediate concern to Californians. These occasional papers look at the effects of government intervention in Californians' health care, and propose reforms based on individual choice and competitive markets.





## Key Points

On January 9, Governor Arnold Schwarzenegger will make the first State of the State speech of his second term. Health care will be the major theme, and he has committed to a major vision of reform to improve Californians' access to high-quality health services. To help the Governor achieve that worthy objective, this briefing paper proposes five precise steps.

1. **Repeal the California "Sick Tax".** California is one of the last states that continues to tax residents for their out-of-pocket health spending. Since January 2004, the federal government has allowed every working age American to deposit pre-tax dollars into a Health Savings Account (HSA) – "401(k)s for your health." This money is never taxed as long as you spend it on health care – the key word being "you." Patients, not government bureaucrats or health plan employees decide how it's spent. Californians need the same tax break from their state government.
2. **Health Opportunity Accounts (HOAs) for Medi-Cal.** California has some innovative Med-Cal programs, but the state has not signaled a willingness to take advantage of HOAs – basically HSAs for Medicaid. The federal government recently authorized these as pilot projects for 10 states seeking to empower Medicaid beneficiaries to make good health decisions. Let's make sure California is one of them.
3. **Free Low-Cost Medical Clinics to Compete.** In other states, entrepreneurs are opening hundreds of convenient "storefront" medical clinics where straightforward, transparent pricing makes health care more accessible and affordable. In California, excessive regulation of nurse practitioners prevents these innovators from competing – and denies important choices to California patients.
4. **Free Health Insurers to Compete.** California's excessive regulation of health insurance increases prices by about 30 percent, contributing greatly to the increasing numbers of uninsured in our state, especially among the middle class, who could and likely would buy health insurance if it were more price competitive.
5. **Design a "California Connector" to Increase Choice in Health Insurance.** The federal tax code connects health insurance to employment – something Americans would likely not tolerate for any other area of their private lives. Massachusetts has recently instituted a "Commonwealth Connector," or Health Insurance Exchange, into which employers' contributions can be credited to a worker's choice of individual health insurance. The Massachusetts plan has many drawbacks, including a significant tax increase, also called a "mandate" or "pay or play," but a narrowly defined "Connector" that allows uninsured, employed, Californians to use pre-tax dollars to pay premiums has significant merit.

## Setting the Stage

Governor Schwarzenegger will start his second term with California health reform as his top priority. Hopefully, the Governor will take a fresh turn towards universal choice in health care, which requires breaking free from the inflexible and expensive status quo but does not impose more government power. So far, his policy approach remains unclear.

Last year, the Governor rightly vetoed Senator Sheila Kuehl's SB-840, which would have imposed government monopoly health care in California. However, he also collaborated with the Democratic legislative majority to introduce a plan for state control over prescription drug prices for uninsured Californians – a plan likely in violation of federal Medicaid laws. According to the plan, Medi-Cal will no longer supply patients with medicines from drug companies that don't sell to the uninsured at government-imposed discounts. Unfortunately, Governor Schwarzenegger ignored PRI's proposal to create incentives for drug makers to reduce prices voluntarily, at little or no cost to taxpayers.<sup>1</sup>

Governor Schwarzenegger's pre-election platform consisted largely of potentially reckless promises to spend more money expanding government programs. He especially emphasized the idea of covering all uninsured children in the state. Since the Governor's re-election, he appears to be teetering between expanding state power in health care and finding ways to improve it without raising taxes. Unfortunately, by continuing to push the simplistic notion of "covering the uninsured" (or at least half of them) he signals the threat of even more government control over our health care.

These five steps strongly emphasize that the state is actually responsible for most of our health-care troubles, and recognize that expanding state power will only aggravate those troubles. The state cannot replace the market in solving existing problems, but freeing the market will provide Californians with the high quality, choice, and innovation they value and deserve, in addition to the incentives they need to improve healthy behavior.

# 1. Repeal the California “Sick Tax”

California can increase the adoption of Health Savings Accounts (HSAs) by giving Californians the same tax break on health spending that the federal government and almost every other state does. HSAs are a kind of “401(k) for health.” If you use the money in your HSA for health spending, it is never taxed. HSA owners age 65 and older can spend their money for non-health purposes but that money is added to their taxable income when they withdraw it. Your HSA is your property for life.

The federal government allowed HSAs as of January 2004, and over the past three years a growing number of employers have offered qualifying, low-premium health plans necessary for an individual to open one. According to current estimates, about 3.6 million Americans have opened HSAs, and almost twice as many have enrolled in the low-premium health plans necessary to qualify to open an HSA. Preliminary evidence shows that HSAs foster personal autonomy in an otherwise crippled system that leaves Americans far too dependent on employers and restrained by government regulations to take responsibility for their own health.

Opponents of HSAs often claim that those who subscribe will be mainly healthy and wealthy, while the sick and less well-off will opt for traditional health insurance that requires fewer out-of-pocket costs. Early data on HSAs, however, shows that about half of HSA purchasers in the individual market are more than 40 years old, and 23 percent are under 20. Surveys suggest that 31 to 45 percent of Americans with HSA-qualified health plans earn less than \$50,000 a year, and 25 percent have incomes of \$35,000 or less. Between one third and one half of HSA owners were previously uninsured.

President Bush has just made HSAs even more attractive by signing a law last month to increase contribution limits to \$2,850 (single) or \$5,650 (family) for 2007, deregulating employers’ right to make higher contributions to lower earning employees, and allowing a once-only transfer of balances from a HRA or IRA to an HSA, among other changes.<sup>2</sup>

HSAs are not the definitive solution to all health-care problems. Even with last month’s reforms, the federal government over-regulates them, but they are a smart step in the right direction. California has one of the most punitive income taxes in the country but Democratic legislators have blocked efforts to make HSAs tax deductible. Governor Schwarzenegger would serve California well by making repeal of the California “Sick Tax” a prerequisite for co-operating further with Democrats on health reform. This is long overdue. Californians should be rewarded, not penalized, for taking responsibility for their own health spending.

## 2. Health Opportunity Accounts (HOAs) for Medi-Cal

California can also make personal choice in health care attainable for beneficiaries of Medi-Cal, California's Medicaid program. Medicaid consumes an increasing portion of taxpayer dollars, and the Governor should not be tempted to expand Medi-Cal as a short-term way to increase the number of insured Californians. Instead, he should try to maximize private coverage of individuals, and increase their freedom of choice in health-care services.

Medicaid is currently a black hole of perverse incentives that keep beneficiaries dependent on government care rather helping them become self-sufficient health-care consumers. For state politicians, Medicaid's primary incentive is to *maximize* that dynamic in order to keep federal matching funds flowing at an ever increasing rate. States have become dependent on federal paychecks, rather than effectively managing their own Medicaid programs in taxpayers' and beneficiaries' interests.

Some states, however, are developing "consumer-directed Medicaid," which the federal government has just made easier through Health Opportunity Accounts (HOAs), similar to HSAs for Medicaid, authorized by the federal Deficit Reduction Act of 2005.

HOAs would put money under beneficiaries' control by creating an account into which they and the state can contribute money. Patients would control the spending and keep any savings, which carry over each year, in anticipation of a beneficiary's escape from this welfare program. When they leave, they may take half the remaining balance, and contribute it to private, individual coverage. HOAs will enable Medi-Cal beneficiaries to engage the health services they need while bypassing government bureaucracy, rather than being dependent on it.

Disabled and housebound beneficiaries, an important population within Medicaid, deserve greater choice and responsibility in determining their own health needs. Some states have experienced significant success with "cash and counseling" and other such "self-directed" plans that increase individual autonomy in health care. Their measurable success so far with Medicaid enrollees achieves patient satisfaction and anticipates long-term cost savings as well.

The key purpose of cash and counseling is to allow individuals, rather than a government bureaucrat, to make personal, life-impacting decisions. The program allows disabled and housebound individuals to have a personal budget to manage and use for the particular health-care services and provider of their choice. Beneficiaries may request the help and guidance of family members, and even request that a family member be their representative caretaker. HOAs are essentially an expansion of this successful initiative to the rest of the Medicaid population.

Governor Schwarzenegger should allow current Medicaid recipients to take more control of their health, and increase the opportunity for them to move into the privately insured population, rather than embrace the conventional method of simply expanding eligibility for Medicaid enrollment. California has neither HOAs nor cash and counseling programs, but these positive, patient-centered reforms will empower individuals to choose physicians and insurers that serve their specific needs. This change will help Medicaid participants to stop passively relying on government by allowing them individualized options in Medi-Cal.<sup>3</sup>

### 3. Free Low-Cost Medical Clinics to Compete

If the Governor achieves the first two steps, newly empowered Californians will want to spend their health dollars in a timely, effective manner. They deserve the freedom to choose physician-owned or even “retail” clinics rather than acute-care hospitals for a variety of health services.

Patients often have to wait for long periods at the doctor’s office or in hospital emergency rooms, an inefficient approach to health-care delivery. The growing success of health clinics in states such as New Jersey shows that the market has another solution to the wastefulness of our health-care system: convenient clinics, where nurse practitioners (NPs) provide basic health services at reasonable cost. Unfortunately, California’s heavy regulations prevent more than four nurse practitioners working under one supervising physician at a time, a restriction that limits this great opportunity.

As more primary-care physicians enter specialty fields, nurse practitioners offer new hope for patients. They provide quality care comparable to physicians and enjoy wide-ranging prescribing and billing ability. They also cost patients less. A recent study in the *American Journal of Medical Quality* shows that physicians and nurse practitioners alike believe that increasing the role of nurse practitioners would have a positive impact on the supply of care for the chronically ill.<sup>4</sup> This illustrates that NPs are more than qualified to provide the type of primary medical care supplied in these health clinics.”

The Governor should call for reform of current law requiring a supervising physician to look after no more than four NPs at any given time. This harmful rule limits NPs’ autonomy and has effectively prevented the growth of these much needed clinics in our state, where the number of uninsured patients causes great concern. California should allow these health clinics to thrive.

If deregulated, NP independence would allow health clinics to flourish and offer greater choice in care for many Californians who currently crowd emergency rooms, to the detriment of both hospitals and patients.<sup>5</sup>

## 4. Free Health Insurers to Compete

California needs to deregulate its health-insurance market so that insurers can compete more effectively, which will reduce prices and increase choice. To reduce the number of uninsured we advocate deregulation, rather than compulsory private health insurance (as Massachusetts has done), because the latter effectively requires a tax increase on small businesses and individuals without adequately correcting the perverse incentives that currently exist. This will encourage cost-conscious Californians to choose insurance plans that best suit their health-care needs, rather than satisfy the priorities of politicians, career bureaucrats, and special interests who impose wasteful mandates on health insurance.

Newly elected Insurance Commissioner Steve Poizner appreciates the need for competitive and flexible private health insurance. He opposes mandated health insurance benefits, which limit choice and increase the cost of health insurance.

California has a whopping 49 mandated benefits including acupuncture and chiropractor care, and ranks in the bottom 10 states when it comes to gratuitous mandates for individual insurance coverage, according to a recent report from the Council for Affordable Health Insurance.

Some may prefer such all-inclusive coverage, but consider a health plan that doesn't cover chiropractic service, acupuncture, in-vitro fertilization, or alcohol and drug treatment, which increase the price of a policy by as much as 30 percent in California, according to the Council for Affordable Health Insurance. Many Californians would undoubtedly prefer not to have a policy jam-packed with benefits that they don't need and the charges that accompany them. Left free to choose, they would purchase less-expensive policies and have more of their own money left for savings or other goods and services.

The objective of deregulation of health insurance in California is to return "insurance" to its original meaning: to insulate the beneficiary against unexpected financial hardship. A pure, private insurance market should only transfer *unexpected* risks from individuals to groups and beneficiaries must pay premiums according to their expected risk. Other insurance markets operate this way, without a state of continuous crisis, and so should health insurance.

Prices for life insurance, for example, are finely graded for age, family health history, and individual health status, and other factors. Young people who purchase life insurance don't subsidize the premiums of older people, and healthy people don't subsidize the premiums of the unhealthy. If an unlikely event should occur that would be financially catastrophic for an individual, only then does the risk transfer to a third party, or a pool.

Hopefully the Governor will work closely with Insurance Commissioner Poizner to reduce unnecessary regulation in health insurance. This will allow a spectrum of health insurance plans offering a variety of benefits, from which individuals – not the state – will choose.<sup>6</sup>

## 5. Design a “California Connector” to Increase Choice in Health Insurance

Governor Schwarzenegger should tread carefully with any California version of the much-discussed Massachusetts health-care plan. Even though Massachusetts Governor Mitt Romney anticipated a tax cut and deregulation of health insurance in conjunction with the individual and employer mandates, his vision did not become reality. By the time he signed the new plan into legislation it included a tax increase and left most of the burdensome health insurance over-regulation in place.

Governor Schwarzenegger has reiterated that he will not support tax increases. Therefore, he cannot follow in Massachusetts’ footsteps by imposing mandates on individuals and businesses, because these are only tax increases by another name. And even though Governor Romney did not anticipate a “pay or play” provision in his health-care plan, that’s exactly what he got, thanks to the heavily Democratic legislature.

Private employers in Massachusetts are faced with either providing a health plan, or paying the government \$295 a year. And the individual mandate requires that all residents of Massachusetts purchase insurance through either an employer or the newly established Commonwealth Connector, a clearinghouse for purchasing individual and small group policies.

Governor Romney originally advertised the program at a cost of \$125 million, but a few months after it passed, the administration revealed that it would actually cost \$276 million. The Massachusetts plan also manages to do everything we’ve warned Governor Schwarzenegger against – expanding Medicaid, and increasing mandatory insurance benefits. It increases dependency in the already burdened Massachusetts Medicaid program and creates a new mandate on insurance companies to cover clients’ dependents until age 26, or for two full years after they became independent of their parents.

The restrictions and mandates of the Massachusetts plan are much more like a socialized system than a free-market one. While it continues to be funded by taxes and tax penalties, it may very well evolve into the government monopoly health care proponents prefer to describe as “single-payer.” Governor Schwarzenegger needs to avoid falling into the same trap as Governor Romney. California’s Democrat-dominated legislature would like nothing more than a complete government takeover of health care in order to present a “bipartisan solution” with conflicted objectives.

Positive reforms in the Massachusetts plan include state income tax deductions for the deposits into Health Savings Accounts (HSAs) that accompany HMOs offering high deductible plans, and a new insurance policy with slightly less expensive benefits for younger (and usually healthy) people ages 19 to 26.

The Commonwealth Connector also offers some hope, because it facilitates buying and selling among participants, but it is not a pure marketplace. The insurers will offer limited, state-mandated products,

and buyers within a range of income limits will pay a capped price below the cost of services they are expected to consume. There will be some exceptions in product design for young adults ages 19 to 26, but overall, consumers will not pay the total of their costs and will not have the freedom to select less expensive offerings. Nevertheless, the Connector is an innovative way of overcoming the federal tax bias in favor of employer-sponsored rather than individually purchased health insurance, a bias that hinders employed Americans' ability to buy insurance that best suits their needs.

Imagine a person with three part-time jobs, none of which offers health benefits, able to bundle pre-tax payments from each job into one premium, via the Connector, and shop for individual health care in a competitive, de-regulated market. Small businesses would be relieved of the paternalistic obligation of choosing health plans for their employees, and their employees would be more free to choose health insurance that suits their needs. With more people entering such an individual market, the volume of demand itself would attract new insurers to compete.

The mechanism for this "tax laundering" is a Section 125 "cafeteria plan," so called after its exemption in the federal Internal Revenue Code. This concept of a Connector, narrowly defined, holds potential for any state that can implement it correctly. If Governor Schwarzenegger could propose a narrow Connector without the same heavy regulations as Massachusetts, he could provide us with a great opportunity to reduce the cost and improve the quality of individual health insurance. However, this may not be possible under current federal law, because California's market for individual health insurance does not appear to fit the requirements necessary to take advantage of Section 125 for this purpose.<sup>7</sup> Therefore, the Governor would be well advised to invest resources in understanding and overcoming the complexities of the tax code that could prevent a "California Connector," and even lobby the federal government for changes, if necessary.

If executed properly, a "California Connector" could assist in creating markets for the type of private health insurance that would provide real protection for catastrophic costs over a lifetime – which is what real health insurance would accomplish.<sup>8</sup>

## Connecting California with Universal Choice in Health Care

Governor Schwarzenegger holds a positive vision of California as an innovative state of great potential, an example to the rest of the nation. Now the Governor can apply his vision to health care. Last term, he rejected an old-style government monopoly system. That leaves the way open for universal *choice* in health care. The Golden State is ready for creative change that liberates and empowers Californians.

In 2007 California has the opportunity to reduce dependency on government programs by making health care more patient-focused and less bureaucratic. The Governor should promote competition among providers and empower Californians with tax deductible savings, choice, and quality health care.

## Endnotes

- <sup>1</sup> John R. Graham, “Immediate Discounts versus Endless Lawsuits,” *Healthy California* briefing paper (San Francisco, CA: Pacific Research Institute, October 2005).
- <sup>2</sup> For more detailed analyses of HSAs, see John R. Graham, “Bulletproof? Health Savings Accounts in 2007 & 2008,” *Health Policy Prescriptions*, Vol. 5, No. 1, and references (San Francisco, CA: Pacific Research Institute, January 2007); and John R. Graham, “2006: The Year of the Health Savings Account,” *Health Policy Prescriptions*, Vol. 4, No. 1, and references (San Francisco, CA: Pacific Research Institute, January 2006).
- <sup>3</sup> For more detailed analyses of Medicaid reform, see: John R. Graham, “Taming the Medicaid Monster: The President Pushes Progress but States Shirk Solutions,” *Health Policy Prescriptions*, Vol. 4, No. 1, and references (San Francisco, CA: Pacific Research Institute, August 2006); Nina Owcharenko, “Options and Opportunities for State Medicaid Reform” and references, in *What States Can Do to Reform Health Care: A Free-Market Primer*, John R. Graham ed. (San Francisco, CA: Pacific Research Institute, 2006), pp. 5-19; and John R. Graham, “How Many Governors Does It Take to Reform Medicaid?,” *Health Policy Prescriptions*, Vol. 3, No. 1, and references (San Francisco, CA: Pacific Research Institute, August 2005).
- <sup>4</sup> Christopher N. Sciamanna *et al*, “Attitudes Toward Nurse Practitioner–Led Chronic Disease Management to Improve Outpatient Quality of Care,” *American Journal of Medical Quality*, Vol. 21, No. 6, (November/December 2006).
- <sup>5</sup> For more detailed analysis of deregulating the health professions, see Shirley V. Svoyny, “Physicians and Non-Physician Clinicians: Where Does Quality Assurance Come From?,” and references, in *What States Can Do to Reform Health Care: A Free-Market Primer*, John R. Graham ed. (San Francisco, CA: Pacific Research Institute, 2006), pp. 67-82.
- <sup>6</sup> For more detailed analyses of health insurance reform, see: Merrill Mathews, *et al.*, *State Health Insurance Index 2006: A 50-State Comparison of the Nation’s Health Insurance Market* (Alexandria, VA: Council for Affordable Health Insurance, October 2006); J.P. Wieske, “Health Insurance Reform in the States: Two Steps Backward in Some States, One Step Forward in Others,” and references, in *What States Can Do to Reform Health Care: A Free-Market Primer*, John R. Graham ed. (San Francisco, CA: Pacific Research Institute, 2006), pp. 21-35; and Sally C. Pipes, *Miracle Cure: How to Solve America’s Health Care Crisis and Why Canada Isn’t the Answer* (San Francisco, CA: Pacific Research Institute, 2004).
- <sup>7</sup> John C. Goodman, “Employer-Sponsored, Personal, And Portable Health Insurance,” *Health Affairs*, Vol. 25, No. 6 (November/December 2006), p. 1560, fn 12.
- <sup>8</sup> For a more detailed analysis of compulsory health insurance, see: Sally C. Pipes, *Questionable Cure for a Questionable Crisis: The Massachusetts Health Plan Takes Shape* (San Francisco, CA: Pacific Research Institute, November 2006).

## About the Authors

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**John R. Graham** is director of Health Care Studies at the Pacific Research Institute. He has worked as a health policy analyst, management consultant, and investment banker in Canada and Europe. He served as an infantry officer in the Canadian Army in Canada, Germany, and Cyprus. He received his B.A. (Hons) in Economics and Commerce from the Royal Military College of Canada and his M.B.A. from the London Business School in England. He directs the Institute's monthly *Health Policy Prescription* series of short papers on timely issues of health policy, and has written many papers and short articles on health-care reform, especially prescription drug regulation, for The Fraser Institute. He has also written on health policy for a number of newspapers, including the *Wall Street Journal*. Mr. Graham's latest book is *What States Can Do to Reform Health Care: A Free-Market Primer*. He speaks frequently about health-care reform on radio, television, and at conferences around the world.

## About the Pacific Research Institute

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Founded in 1979 and based in San Francisco, PRI is a non-profit, non-partisan organization supported by private contributions. Its activities include publications, public events, media commentary, community leadership, legislative testimony, and academic outreach.

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PRI works to restore to all parents the basic right to choose the best educational opportunities for their children. Through research and grassroots outreach, PRI promotes parental choice in education, high academic standards, teacher quality, charter school, and school finance reform.

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PRI shows how the entrepreneurial spirit—the engine of economic growth and opportunity—is stifled by onerous taxes and regulations. It advances policy reforms that promote a robust economy, consumer choice, and innovation.

### Health Care Studies

PRI proposes market-based reforms that would improve affordability, access, quality, and consumer choice. PRI also demonstrates why a single-payer, Canadian model would be detrimental to the health care of all Americans.

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PRI advances policies to defend individual liberty, foster high-tech growth and innovation, and limit regulation.

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PRI reveals the dramatic and long-term trend towards a cleaner, healthier environment. It also examines and promotes the essential ingredients for abundant resources and environmental quality property rights, markets, local actions, and private initiative.