PACIFIC RESEARCH INSTITUTE

HEALTH POLICY prescriptions

Why Health Exchanges Don't Work

By John R. Graham

In a recent article, I reported and discussed the lackluster—basically non-existent—results of the Utah Health Exchange.[1] As a critic has pointed out, I used to be much more accomodating of the Utah exchange.[2] However, Utah's experience demonstrates why unsubsidized exchanges are unlikely to attract significant numbers of beneficiaries from the small-group market.

The failure of the Utah Health Exchange is not idiosyncratic. It is the destiny of any unsubsidized and voluntary exchange. The reason is pretty straightforward: The administrative costs of operating an exchange *plus* the administrative costs to a small business of migrating to the exchange are almost certainly greater than the administrative costs of participating in the traditional small-group market (or taking a chance on other "work arounds" promoted by some insurance producers, as described below). Therefore, unless an exchange is subsidized from non-exchange sources (as per Obamacare), it will not attract many participants.

While straightforward, this conclusion is not necessarily intuitive. Indeed, the primary goal of an exchange is to free small businesses and their employees from the Internal Revenue Code's perverse provisions that exclude employer-based benefits from taxable income, but not individually owned health insurance bought by an employee. Because Congress has never made any serious attempt to correct this malformation of the tax code, certain states have considered arguments to create exchanges or "connectors" to wriggle around the provision.

Imagine if a state could create an exchange whereby an individual working a number of part-time jobs, none of which offered health benefits, could get each of his employers to contribute some pre-tax income to the exchange, allowing him to buy his own health insurance from a large "menu" of choices. Or even an exchange

Key Points:

- The Utah Health Exchange is failing to meet its goals.
- It is almost certainly true that the administrative costs of operating an exchange are greater than the administrative costs of the traditional small-group market.
- Any exchange that offers unsubsidized, voluntary coverage will likely have the same poor results as the Utah Health Exchange.
- Reformers who believe that they can overcome the federal government's discrimination against individually owned health insurance by establishing such exchanges are misguided.
- Only federal tax reform can remove the impediment to individually owned health insurance.

whereby people with full-time jobs could move from one employer to another within the same state without disrupting their coverage. That would be a great achievement.

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Consider a counter-example: Suppose the Internal Revenue Code did not grant people a mortgage-interest tax deduction, but instead defined employer-based housing as a non-taxable benefit. Most employed people would live in homes arranged and paid for by their employers. The situation would clearly be overly bureaucratized and ineffective at satisfying people's residential needs, but we would suffer it nevertheless, because of the tax benefit. If a well governed state established a housing exchange, into which employers made fixed contributions, that allowed employees to choose their own homes, surely employers would stampede into the exchange.

Or would they?

First, the exchange would threaten the livelihoods of the realtors and other intermediaries who profit from employer-based housing. Why would they want people living in their own homes for years, maybe decades, instead of relying on housing chosen by their employers via arrangements negotiated annually with high friction costs? Therefore, to minimize political resistance, the state would have to satisfy the income needs of the intermediaries, by ensuring that the exchange pays their commissions and other fees.

Second, the federal law would not be as simple as described above. Thousands of pages of regulations would be emitted by the U.S. Department of Labor, the U.S. Department of Housing and Urban Development, the Internal Revenue Service, *et cetera*, and the state's exchange would not be able to indemnify employers from these regulations—which are in constant flux. So, employers would still have to pay some species of consultant (either directly or indirectly) to ensure compliance with federal laws and regulations.

These two conditions appear to prevail in the Utah Health Exchange. Reading (between the lines) the memoir of the exchange's first leader, one can only conclude that the exchange increased complexity, and protected (or, at least, did not challenge) the turf of those who profit from the *status quo*.[3] In summary, the Utah Exchange almost certainly adds administrative costs to small businesses' decisions to offer health benefits, without subtracting administrative costs from the old way of doing business.

Outside exchanges, there may be ways for employers to make legal contributions to Flexible Savings Arrangements (FSAs) or Health Reimbursement Arrangements (HSAs) without providing group health benefits.[4] This frees up employees' own income to buy individual health insurance. This appears to be the business model of Bloom Health or the Independent Association of Businesses (which refer to themselves as "private exchanges," but I view that as simply a promotional term in sync with the times), LyfeBank, and certain individual brokers and advisers.[5] However, some industry experts of my acquaintance suggest that these folks are not quite "coloring within the lines" and might face regulatory retaliation. Furthermore, this platform appears not to have achieved significant market share.

Eliminating employer-monopoly health benefits in favor of individually owned health plans is a critical goal of health reform. The evidence strongly suggests that this can only be done through federal tax reform. Unfortunately, those brave souls who attempt it through non-Obamacare, state-based exchanges are engaged in a fruitless quest.

Endnotes

1 John R. Graham, "Why the Utah Health Exchange is No Model for Health Reform," *Capital Ideas* (San Francisco, CA: Pacific Research Institute, July 27, 2011).

2 Norman K. Thurston, "Why Utah's Exchange is a Free-Market Model," *Forbes.com: The Apothecary* (August 3, 2011).

3 Norman K. Thurston, *The Utah Health Exchange: A Look in The Rearview Mirror*, working draft white paper (Salt Lake City, Utah: Utah Health Exchange, February 15, 2011). Available at http://www.exchange.utah.gov/images/stories/Rearview_Mirror_on_the_Utah_Health_Exchange__4_.pdf.

4 Health Savings Accounts and Other Tax-Favored Health Plans , Publication 969 (Washington, DC: Internal Revenue Service, January 14, 2011).

5 Sarah Kliff, Private Exchanges Offer Alternative," *Politico Pro* (July 11, 2011); http://www.lyfebank.com/home/, ;"IAB Builds a National Small Business Healthcare Exchange," press release (Washington, DC: Independent Association of Businesses, August 17, 2011).

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