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The Rationale for a Statewide Health Insurance Exchange

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U.S. health insurance markets are governed by a complex system of state and federal laws and regulations, many of which are outdated and counterproductive. The most important of these laws is the federal tax code. Americans get unlimited federal tax breaks for the purchase of health insurance if they receive that coverage through their workplace. Outside of the workplace, however, they almost always pay for coverage with after-tax dollars. Statewide health insurance exchanges are a solution to this inefficient inconsistency, giving individuals and families the opportunity to secure the health plans of their choice without losing tax benefits.

The Federal Tax Code

The federal tax code profoundly distorts health insurance markets. By law, Congress ties the enormous tax benefits of health insurance almost exclusively to the place of work. Workers who buy health coverage outside of the employer-based system often have to cope not only with high administrative costs and inflexible government mandates, but also with the loss of federal and state tax breaks. The loss of these tax breaks could add 40 to 50 percent to the cost of a policy purchased through the place of work.

Employers do not own auto, life, homeowners', or property and casualty insurance policies on behalf of their employees. Indeed, most Americans would find such arrangements strange. But in contrast to every other type of insurance in the private market, health insurance in the United States sticks to the job, not the person. Employers own health insurance policies; individuals and families do not.

The current tax law also directly affects coverage. Recent empirical data shows that among the total number of the uninsured, the proportion of long-term uninsured is small—only slightly more than one out of ten over a four-year period. The overwhelming majority of the uninsured are in and out of coverage, usually due to changes in their job situation. They had access to insurance but lost it. Without personal ownership of health insurance policies, there is not any real portability in coverage. The problem is not simply access to health insurance coverage; it is also keeping that coverage. The right policy, then, would have health insurance stick to the person, not the job.

Congressional Inaction

Congress could simply change the federal tax code to give individuals and families tax relief for the purchase of health insurance regardless of where they work so that they can buy and own the coverage they want at competitive prices. In other words, by changing the tax code, Congress could take a dramatic step to creating a real, consumer-driven health insurance market. Going even further, if Congress allowed interstate commerce in health insurance—letting individuals and families

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to buy coverage across state lines from any state in the United States—it would create a single national market for insurance coverage. In this large market, with large health insurance pools, individuals and families would own and control their own health insurance. These reforms would create a robust system of consumer choice and competition.

Enter the State Health Insurance Exchange

Short of congressional action to reform the tax code, the burden to improve health coverage rests with state officials. The best way to enable individuals and families to buy, own, and keep health insurance from job to job—without losing the tax advantages of the employment-based coverage—is to transform the balkanized and dysfunctional state health insurance market into a single health insurance market. This new market would function well for all sorts of individuals and small businesses, not just workers employed by large companies.

A sound legal framework is necessary to secure fully functioning and efficient markets. Current law governing health insurance in many states does not work well to control costs or to expand personal access to coverage. Accordingly, state officials who are serious about creating new, consumer-based systems need to create a new legal framework for health insurance.

The best option is a health insurance market exchange. A properly designed health insurance exchange would function as a single market for all kinds of health insurance plans, including traditional insurance plans, health maintenance organizations, health savings accounts, and other new coverage options that might emerge in response to consumer demand. In principle, it would function like a stock exchange, which is a single market for all varieties of stocks and reduces the costs of buying, selling, and trading stocks. For the same reasons, other types of market transactions are also centralized, such as farmers' markets, single locations where shoppers can purchase a variety of fresh fruits and vegetables, and Carmax, where consumers can choose from among all kinds of makes and models of automobiles.

In the case of a statewide health insurance exchange, employers would designate the health insurance exchange itself as their "plan" for the purpose of the federal and state tax codes. Thus all defined contributions would be tax free, just as they would be for conventional employer-based health insurance. The major benefits of this arrangement for employers, particularly small employers, are a reduction in administrative costs and paperwork and the ability to make defined contributions to their employees' preferred plans.

As a vehicle for a defined-contribution approach to health care financing, an exchange would expand coverage and choice. Rather than have to decide whether to pay for full coverage or not, employers could make defined contributions of any size to the exchange. Moreover, employers could also enable employees, including those working part-time and on contract, to buy health insurance with pre-tax dollars. Under a Section 125 plan, any premium payments made by workers, even part-time workers or contract employees, would be 100 percent tax-free. This is especially important for workers in firms that require them to pay part of the health insurance premium. Employees, not employers, would buy the health care coverage with *pre-tax* dollars, would own their own health plans, and would take them from job to job without the loss of the generous tax benefits of conventional employer-based coverage. This is a revolutionary change in the health insurance market.

Unlike other state-based initiatives, the creation of a statewide health insurance exchange would not violate the Employee Retirement Income Security Act of 1974 (ERISA). This approach complies with ERISA because employer participation in an exchange is *voluntary*—though, given the benefits of an exchange, few small businesses would turn down the option. An exchange can be designed within the existing framework of other federal insurance laws, including the Consolidated Omnibus Budget Reconciliation Act (COBRA) and the Health Insurance Portability and Accountability Act (HIPAA).

Limited Functions

A health insurance exchange could be the basis of a new legal framework for health insurance at the state level. It could replace much of the existing state law, which creates separate individual and small group markets and governs balkanized and overregulated state health insurance markets. Ideally, an exchange should be open to all state residents and all interested employers, regardless of the size of the firm, who want to arrange health insurance through the exchange.

The specific functions of an exchange would be mechanical, not regulatory. An exchange should not license or standardize health plans or impose underwriting rules or benefit mandates. The focus should be on processing paperwork—mostly processing employer and employee contributions or independent premium payments—and administering enrollment and coverage selection through an annual open season. It should function just like the human resources department of a very large employer. An exchange could also be a mechanism for the administration of government subsidies for low-income persons, if state officials wanted to extend that help. Similarly, it could be a mechanism for the administration of federal health care tax credits for individuals and families, if Congress should ever decide to enact individual tax relief for health care and help individuals and families without employer-based coverage.

An exchange should be administered by a non-governmental entity operating under a special state government charter. Irrespective of the organizational structure, the functions of an exchange could be contracted out to private entities or private third-party administrators. From the perspective of health policy, the issue of governance is of secondary importance.

Conclusion

State-level health insurance exchanges would increase health insurance coverage, significantly lower prices in the individual coverage market, give individuals and families access to more choice, allow coverage portability, and increase employers' flexibility in offering health benefits.

Congress should reform the tax treatment of health insurance. But short of congressional action to rectify the inequities of the federal tax code, a health insurance exchange is the best way for individuals and families to secure personal and portable health insurance without incurring heavy tax penalties.

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