WebMemo
Published by The Heritage Foundation

No. 1317
January 22, 2007

The Schwarzenegger Health Plan: A Great Leap Forward for Bigger Government

Robert E. Moffit, Ph.D., and Nina Owcharenko

Governor Arnold Schwarzenegger wants to make California's health care system "accessible, efficient, and affordable." But the Governor's proposed health plan is a mélange of bad health policy (including subsidies to illegal aliens), unwise tax increases, and missed opportunities. There are indeed some promising provisions: a state-wide pool for the purchase of private health insurance; direct assistance to low-income Californians to help them buy coverage; and a proper alignment between the state and federal tax treatment of health savings accounts. On the whole, however, the proposal is a great leap forward for bigger government and increased bureaucratic decision-making and control.

Bad Policies

- **Imposing new taxes and red tape on doctors and hospitals:** While the proposal would provide additional payment to doctors and hospitals serving California's Medicaid program, MediCal, providers would also face new taxes, thus diminishing the effect of increased government payments. Doctors and other medical professionals would be required to pay a 2 percent tax and hospitals a 4 percent tax to help pay for the Governor's proposal.

  Furthermore, payment increases would be linked to medical professionals' compliance with "performance" measures. This is intrusive and unnecessary. A key objective of sound health policy should be the restoration of the traditional doctor–patient relationship, as well as the preservation of the professional independence and integrity of the medical profession. Price transparency, combined with consumer information on quality of care, within a framework of free-market competition would lead to both innovation and superior medical performance. In any case, doctors and hospitals in California and elsewhere are already burdened with massive and counterproductive regulation and paperwork. Adding more red tape and new taxes will merely add to the administrative costs of the system, increasing prices for patients and further demoralizing the medical profession.
- **Imposing new costs on employers and employees:** The proposal would impose several new employer mandates and legal requirements. First, all employers not contributing to their employees' health insurance plan would be forced to pay an additional 4 percent payroll tax. The level of contribution that an employer would have to make to comply with this requirement is unclear. While the proposal would exempt employers with fewer than 10 workers—reportedly about 8 out of 10 small businesses in California—this would be a bad precedent. Regardless of its reach, virtually all economists concur that mandatory employer health benefits are not free

This paper, in its entirety, can be found at:
www.heritage.org/research/healthcare/wm1317.cfm

Produced by the Center for Health Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

to employees but rather result in a proportional reduction in wages and other compensation. In other words, this would be an additional tax on California's workers.

The proposal would also undercut an employer's ability to vary premium contributions by class, except for variations contained in collective bargaining arrangements. This requirement is designed to prevent discrimination among classes of workers, but it would also reduce the flexibility of employers in providing compensation to employees. For example, it appears that the provision would prohibit an employer from contributing more to lower-income workers than to higher-paid workers. Congress recently enacted legislation that would advance policy in exactly the opposite direction by giving employers greater flexibility in contributing more towards the health savings accounts (HSAs) of lower compensated workers.

- **Crowding out private coverage:** The proposal would change the eligibility requirements of California's Health Families, the state children's health insurance program, to reach children in families with incomes up to 300 percent of the federal poverty line—roughly $60,000. This public program expansion would, based on previous experience, "crowd out" private, family coverage options and separate children from their parents' private coverage, thus encouraging a long-term dependency on the government for health care throughout their lives. This expansion would also further jeopardize an already fragile safety net for the poor, who need help the most, by redirecting scarce resources toward middle-income families. The proposal should be changed to allow California parents to use SCHIP funds to help purchase the private, family health coverage of their choice.
- **Denying individuals' right to self-insure:** The proposal would require individuals to buy a minimum health care plan. Although the minimum benefit is defined as a catastrophic $5,000 policy, the government would determine the benefit package. This kind of government control would not only limit personal choice, but would also stifle future market innovation. While Governor Schwarzenegger is absolutely correct that individuals do have a personal responsibility to pay for their own health care, the imposition of a legal responsibility to buy health insurance without a right to self-insure constitutes an unnecessary violation of personal freedom. A far better approach would be to allow persons to self-insure, if they wish to do so, but require that they demonstrate in some tangible way, such as posting a bond, that they would not be a financial burden on taxpayers if expensive hospital or major medical treatment were needed. Such a "personal responsibility" proposal was originally advanced by former Governor Mitt Romney in his initial health care proposal for Massachusetts.[1]

Promising Provisions

- **Tax fairness for health savings accounts:** The Governor wants to harmonize state and federal tax law governing the establishment of HSAs. Under federal law, individuals are able to contribute to an HSA using pre-tax funds. The Governor's proposal would permit the same pre-tax contributions under state tax law. This is a long overdue and much needed change. The *status quo* is profoundly unfair to California consumers who wish to enroll in health savings account plans. California is one of only a handful of states that has yet to enact basic tax changes to accommodate HSAs.
- **A state "purchasing" pool:** The proposal calls for a statewide purchasing pool. The basic idea of a statewide market is that it would create a level playing field for insurance. But with the proposal's scarcity of detail, it is hard to determine whether this proposed arrangement would be a platform for a robust system of consumer choice and competition or whether it would be yet another instrument to define and limit the kinds of insurance products and health benefits available to indi-

1. For a discussion of this point, see Nina Owcharenko and Robert E. Moffit, Ph.D., "The Massachusetts Health Plan: Lessons for the States," Heritage Foundation *Backgrounder,* No. 1953, July 18, 2006, pp. 8-9., at *www.heritage.org/research/healthcare/bg1953.cfm*.

viduals and families. The proposal appears to favor the latter approach.

Without specific restrictions on the regulatory authority of this entity, this could be a serious problem. Californians, like other Americans, do not need another government agency that controls their insurance coverage, benefit levels, or premiums or that decides what medical treatments and procedures will be covered by their health insurance. Health insurance is already over-regulated.

A much better idea would be to create a statewide health insurance exchange—what the Pacific Research Institute has called a California "connector"[2]—that would simply facilitate the transactions between insurers and individuals, especially those who work for small businesses. In this model, health insurance would operate on a level playing field, a free and open market for any willing carriers to sell health plans and plan designs in response to consumer demand. A connector, unlike another regulatory body, would maximize both freedom of choice and free market competition.[3]

- **Help for low-income individuals and families:** The proposal would subsidize health insurance coverage for adults who have incomes between 100 and 250 percent of the federal poverty line (FPL). Individual premium contributions would be based on gross income, and it appears that the government subsidy would be available only for health coverage purchased through the statewide purchasing pool. For example, individuals earning between 201 to 250 percent of the FPL would have to pay only 6 percent of their income towards the premium. It remains unclear, however, whether this would be a direct subsidy to the individual or whether the subsidy would be embedded in the insurance premiums offered to these individuals.

  The Governor's proposal would be far better, however, if individuals received a direct subsidy and were allowed to choose from the wide array of existing market choices, rather than depend on the government to organize health care choices and premiums on their behalf. In revamped form, the proposal could retain its income thresholds but simply cap the government subsidy at a maximum, fixed-dollar amount. This would limit the exposure of taxpayers and prevent over-subsidizing health insurance.

  Beyond that, there is no reason why subsidized individuals should have the government artificially limit their selection of health insurance. They, too, should have choices and be mainstreamed into the private system with the rest of their fellow citizens. In any case, subsidizing lower-income individuals' purchase of private insurance is certainly preferable to expanding government-run health or welfare programs. Without direct assistance, such programs will expand.

- **An expansion of flexible spending accounts:** The proposal would require all businesses to adopt Section 125 arrangements that would allow employees to pay for their health insurance with pre-tax dollars. The objective behind this proposal is laudable: It is a direct attempt to rectify the profound inequities of the federal tax code that heavily penalize the purchase of health insurance by individual employees. The use of Section 125 of the IRS Code is thus a valuable tool for employers to leverage the existing federal tax breaks for the benefit of their workers.

2. See Diana Ernst and John Graham, "Curing California Health Care: Five Steps Towards Universal Choice in 2007," The Pacific Research Institute, January 2007, at *www.pacificresearch.org*. Ernst and Graham offer Governor Schwarzenegger and California policymakers a variety of positive policy changes that would improve California's health care system beyond the creation of a "California Connector" for health insurance, including reform of the tax treatment of health savings accounts, the creation of "health opportunity accounts" for Medicaid beneficiaries, the promotion of low-cost medical clinics, and a reduction in California's excessive and costly health insurance regulation.

3. For a discussion of the rationale and structure of a statewide health insurance exchange, or "connector," see Robert E. Moffit, Ph.D., "The Rationale For A Statewide Health Insurance Exchange," Heritage Foundation *WebMemo* No. 1230, October 5, 2006, at *www.heritage.org/research/healthcare/wm1230.cfm*.

For a variety of reasons, however, a government mandate requiring employers to set up Section 125 accounts, even if they do not have to deposit funds in such accounts, is not the best approach. Instead, California officials should focus on ways to make it easier for employers, especially small businesses, to adopt such arrangements *voluntarily.* Moreover, the proposal could also make the Section 125 requirement a condition for employers who wish to participate in a statewide health insurance exchange, which would be voluntary. In this case, employers could choose to facilitate the tax-free purchase of health coverage by their employees, including part time and contract employees.

- **Incentives for healthy lifestyles:** The Governor's proposal includes a "Healthy Action Incentives/Reward" program. Individuals enrolled in public health programs could earn rewards, such as gym membership, for maintaining a healthy lifestyle. In the private sector, health insurers could reduce premiums for Californians who pursue a healthy lifestyle. This would be a welcome break from the practice of state governments that impose insurance rules that inhibit such premium variation. Premium discounts for those who enroll in wellness programs, for example, make sense, economically and clinically.

  From the proposal, it is unclear whether these arrangements would be mandatory or voluntary for all insurers. Increasingly, health insurers are already experimenting with such approaches on a voluntary basis. This is another area where California officials should champion personal freedom.

Conclusion

With little or no progress on health care reform in Washington, states are taking the lead. Governor Schwarzenegger's big and ambitious plan for California includes some promising provisions, such as improved tax rules for health savings accounts, help for low-income persons to buy private insurance, and, potentially, a statewide level playing field for health insurance. But the proposal is burdened with bad policies, particularly new taxes on doctors and hospitals and an unnecessary and costly employer mandate, a throwback to the discredited Clinton Health Plan of 1993.

California policymakers should go back to the drawing board and design a plan that is innovative in promoting personal choice and robust free-market competition. It should reflect California's traditional spirit of imagination, experimentation, and personal freedom.

—Robert E. Moffit, Ph.D., is Director of, and Nina Owcharenko is Senior Policy Analyst for Health Care in, the Center for Health Policy Studies at The Heritage Foundation.