



DEBATING HEALTH REFORM: The Pre-existing Condition Problem

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EXECUTIVE SUMMARY

Whether Americans with pre-existing conditions will be able to qualify for health insurance at a reasonable price without the benefit of new provisions contained in the Patient Protection and Affordable Care Act, so called Obamacare, has emerged as a major issue in the presidential campaign. This paper analyzes both the effectiveness and the long term consequences of the approach to pre-existing conditions under Obamacare and contrasts it with the consequences of the alternative replacement plan proposed by Republican challenger Mitt Romney. It finds that, although the Obamacare approach guarantees coverage in the short term, it poses long term risks to the U.S. health care system. In contrast, the Romney approach holds the potential to solve the pre-existing condition problem by offering inexpensive individual insurance plans, and deals with problems faced by those who may currently lack insurance due to pre-existing conditions by extending and reforming current federal rules.

There are two root causes of the pre-existing conditions problem, a problem that affects less than 1 percent of Americans. The first is that our tax code ties health insurance to employment, creating gaps in coverage when people change or lose their jobs. The second is that health insurance is too costly

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in America, making it difficult for people to maintain their coverage over time.

ROOT CAUSES

First, it's important to understand why we have a pre-existing condition problem in America. The root of the problem is an act passed by Congress under the Roosevelt administration called the Economic Stabilization Act of 1942.

Because much of America's workforce was off fighting World War II, the Roosevelt administration feared that domestic demand for workers would outpace labor supply, leading to a spiral of higher wages and runaway inflation. The 1942 law mandated wage ceilings for a broad range of occupations, and required federal approval for any changes.

But fringe benefits, such as health insurance, were not covered under the 1942 wage controls. As a result, many employers started offering health benefits as a way around the new federal wage limits. This loophole gained further strength when, in 1943, a federal court held that employer-sponsored health insurance was exempt from taxation.

In the early postwar years, courts and the IRS continued to struggle with how to treat the tax status of health insurance. Then, under President Eisenhower, Congress passed a comprehensive revision of the federal tax code called the Internal Revenue Act of 1954. Section 106(a) of the 1954 Internal Revenue Code officially excluded employer-sponsored health insurance from taxation:

“General rule — Except as otherwise provided in this section, gross income of an employee does not include employer-provided coverage under an accident or health plan.”

THE EMPLOYER TAX EXCLUSION DISPROPORTIONATELY BENEFITS HIGH EARNERS

The enshrinement of health insurance as non-taxable income meant that employers and their workers now had an incentive to divert dollars of salary into dollars of health insurance. For example, a worker who pays

federal and state income taxes at a combined rate of 30 percent will receive \$7,000 for every \$10,000 his employer provides in gross salary. But the same employee will receive \$10,000 in benefits for every \$10,000 his employer spends on health insurance—a 43 percent improvement.

This subsidy is even greater for the highest earners. A Wall Street banker who pays federal and state income taxes of 50 percent will receive \$5,000 for every \$10,000 his employer provides in gross salary. But by receiving \$10,000 in benefits, he gets a 100 percent improvement on his taxable income. And because he's a high earner to begin with, he's likely to benefit from an especially generous health insurance plan.

This exclusion of employer-sponsored insurance from taxable income—known as “the employer tax exclusion”—is what ties Americans' health insurance to their jobs. If you lose your job, stop paying for health insurance on your own, and then get sick, an insurer is under no obligation to cover you, due to what is now your “pre-existing condition”—and, in rare cases, the insurer may do just that.

THE PRIMARY PROBLEM: DISCONTINUOUS HEALTH COVERAGE

People fall victim to pre-existing condition problems due to gaps in coverage. A person who gets injured at one job, and tries to switch jobs, has to switch health plans. The new insurer is stuck with the costs of treating the injured worker, and has to charge enough to not lose money on that enrollee.

The same goes for someone who stays uninsured for a prolonged period, waiting to buy insurance after he gets sick. Insurers can't provide affordable health insurance if the only people they cover with their policies are already sick.

So the policy solution to the pre-existing condition problem is to make sure that people own their own insurance policies, and don't have to change plans when they change or lose their jobs. This is known as “continuous coverage.”

THE SECONDARY PROBLEM: HEALTH INSURANCE IS TOO EXPENSIVE

The second most important reason why we have a pre-existing condition problem is the high cost of insurance. This is largely driven by the employer tax exclusion.

Because people don't buy insurance for themselves, they have no incentive to shop for value and buy the plans that meet their needs without extraneous coverage. This fourth-party system in which third parties buy insurance on behalf of others makes people insensitive to the cost of care. Individuals simply expect their costs to be covered. There is little incentive to think about how much one hospital costs compared to another.

The private insurance market can be divided into three subgroups: the large-group market, for employers with more than 50 workers; the small-group market, for those with two to 50 employees; and the individual or non-group market.

The individual market is dysfunctional in America because few Americans use it. Insurers have a hard time building economically viable risk pools with a heterogeneous group that consists primarily of young people.

Economists of all ideological stripes agree that the employer-sponsored system in America is a key reason why health insurance is so costly here. In turn, because insurance is so costly, people with low incomes can't afford it, and go without it for long periods. If they get sick while uninsured, they have a pre-existing condition.

THE 1996 HIPAA LAW ADDRESSED PRE-EXISTING CONDITIONS, SORT OF

A 1996 law called the Health Insurance Portability and Accountability Act (HIPAA), patched up some of the issues with pre-existing conditions. HIPAA banned small-group health plans from denying coverage to

those who had maintained creditable coverage in the recent past, without any significant breaks; i.e., coverage gaps of 63 days or longer. HIPAA also applied this provision to any employer plan, regardless of size, if a worker was eligible under the terms of the plan.

For those who do have "significant" coverage gaps, insurers must still offer insurance, but can refuse to provide benefits specifically related to pre-existing conditions for 12 months after enrollment. Most importantly, HIPAA doesn't dictate what insurers charge for covering those with pre-existing conditions, though plans may not ask a worker to "pay a premium or contribution which is greater than such premium or contribution for a similarly situated individual enrolled in the plan on the basis of any health status-related factor in relation to the individual."¹

So, contrary to what Obamacare's advocates say, most people already can't be denied coverage because of a pre-existing condition. However, people who switch jobs, and fall ill before switching, can be charged higher premiums at their new place of employment. The new insurer has no economically viable option but to charge the sick patient what it costs to cover his condition.

In addition, if a person loses his job, HIPAA requires that insurers offer coverage regardless of pre-existing conditions—a policy known as guaranteed-issue—but only if he sticks with the COBRA plan offered by his employer. (The Consolidated Omnibus Budget Reconciliation Act of 1985 allows employers to offer group coverage to workers who have lost their jobs for 18 months, though workers usually have to pay the premiums themselves.) HIPAA protections don't apply to the individual market, so switching plans is costly.

Moreover, because HIPAA's guaranteed issue provision doesn't apply to the individual market, there is no guaranteed-issue mandate for the 5 percent of Americans who purchase health insurance on the individual market until Obamacare's mandate begins in 2014.

¹ Text of the statute can be found online here: <http://www.law.cornell.edu/uscode/text/29/1182>.

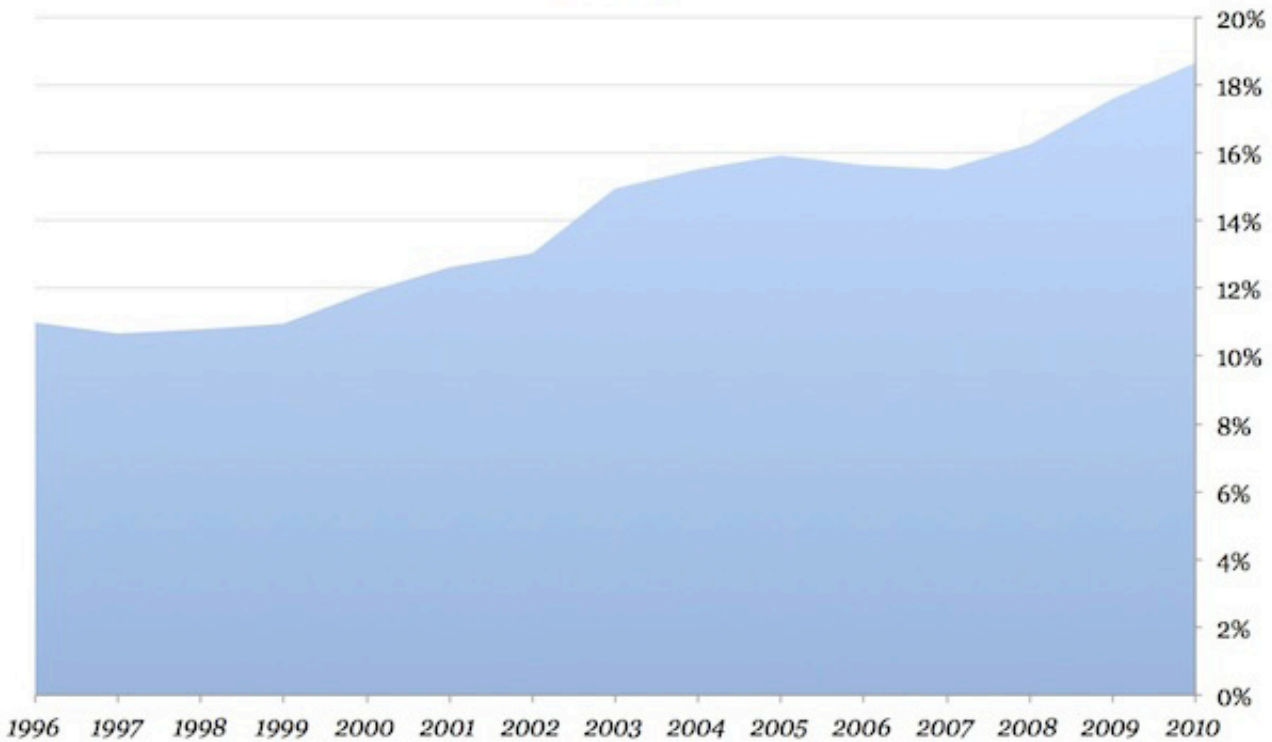
There's a good reason why HIPAA didn't impose guaranteed issue in the individual market. If it had, individuals would have had an incentive to avoid paying for insurance until they got sick, creating the adverse selection death spiral that would destroy the individual insurance market.

But HIPAA, whatever its merits, didn't address the two underlying causes of the pre-existing conditions problem: the lack of true portability of health insurance from job to job and the increasing number of Americans who can't afford insurance.

gest problem with our health-care system. But it isn't, not by a long shot. In the post-HIPAA environment, very few people—less than one percent of Americans—are denied coverage because of a pre-existing condition.

These individuals fall into a fairly narrow bucket: they're too well-off to qualify for Medicaid and too young to qualify for Medicare. They're either unemployed, or don't get insurance through their employers. They've elected not to maintain coverage on the individual market, either because they couldn't afford it, or because they didn't want to; then they got sick.

Individual Health Insurance as a Percentage of Per-Capita Income, 1996-2010



DO ONLY 82,000 AMERICANS SUFFER FROM THE PRE-EXISTING CONDITION PROBLEM?

Given how often supporters of Obamacare talk about pre-existing conditions, it would appear to be the big-

A Congressional Budget Office (CBO) study found that only 3.5 percent of the 55 million uninsured were uninsured because their health was too poor to qualify. On the other hand, 71 percent blamed the high cost of insurance for their lack of it. 3.5 percent of 55 million is 1.9 million, or 0.6 percent of the U.S. population. It's

both a big number (1.9 million) and a small number (0.6 percent). If the CBO's numbers are right, the pre-existing condition problem is one that we should pay attention to, and try to fix, but without making things worse for the other 99.4 percent of the population.

There are some indications that the number of people with this problem may actually be lower than the CBO's estimate. Obamacare created a set of high-risk pools that would provide subsidized insurance to people who have a pre-existing condition and have been without health coverage for the last six months: a reasonable definition of the population. The CBO estimated that up to 700,000 individuals would enroll in the program. As of July 31, 2012, only 82,000 had signed up.

Do only 82,000 Americans without insurance have pre-existing conditions? Possibly. Another explanation might be that Obamacare's high-risk pools were underfunded and poorly structured, leading few people to sign up for them.

OBAMACARE'S SOLUTION: GUARANTEED ISSUE WITH HIGHER PREMIUMS, INDIVIDUAL MANDATE, TRILLIONS IN NEW SPENDING

Obamacare's solution to the pre-existing condition problem is to go where HIPAA did not: forcing insurers

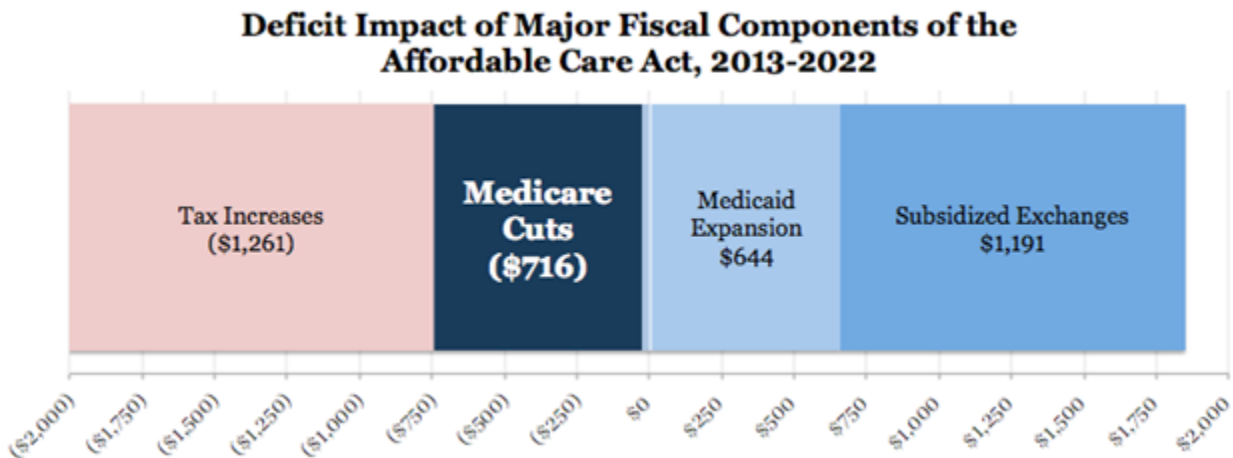
in the individual market to accept all comers, regardless of pre-existing conditions.

Obamacare requires most Americans to buy health insurance—the infamous individual mandate—to discourage people from waiting until they're sick to buy insurance. If only sick people buy insurance, but insurers are forced to accept all comers and charge healthy and sick people the same rate, insurance would rapidly become too expensive for anyone to afford.

For the government to enforce that mandate, it had to redefine health insurance. Obamacare defines health insurance expansively, so that insurance plans that qualify for the mandate are costly and comprehensive, driving up non-group premiums by 19 to 30 percent.

Because it's unfair to force poor people to buy a costly insurance product that they can't afford. So Obamacare spends \$1.9 trillion over the next ten years to subsidize insurance for those with lower incomes.

Obamacare does make insurance cheaper for the small number of Americans who have pre-existing conditions and have been denied coverage by insurers. But the price of that "solution" is to drive up the cost of insurance for everyone else, and fund \$1.9 trillion in new spending over the next decade with \$1.2 trillion in tax increases and \$716 billion in Medicare cuts.



Obamacare doesn't make coverage more portable. Indeed, the law includes an employer mandate that forces employers to cover health insurance for their workers or pay a steep fine. And it doesn't make insurance cheaper, because its regulations will drive up the cost of insurance, and already have.

While Obamacare does make insurance more available for the minority of Americans who have a tough time finding coverage today, it does so by dramatically decreasing the affordability of that insurance for everyone. Over time, Obamacare will fail to protect those with pre-existing conditions and those without them from the law's impact on rising insurance premiums.

ROMNEY'S SOLUTION: ADDRESS THE ROOT CAUSE OF THE PROBLEM

Governor Romney's plan, by contrast, takes on the underlying causes of the pre-existing condition problem. The plan finally addresses the tax-code legacy of World War II, by equalizing the tax treatment of employer-sponsored and individually-purchased health insurance.

Under Romney's plan, anyone who purchases insurance for himself, and maintains that coverage from job to job, will never have to fear losing his coverage because he becomes ill. Moreover, if other insurers want his business, they will have to compete for it.

In addition, if people are assured of being able to keep their plans, they can sign long-term insurance contracts, aligning everyone's incentives. An insurer could offer a lower premium if he is assured that enrollees are guaranteed to keep their coverage for, say, five years. Today, there is no such assurance, because people can drop out or change jobs.

Romney's plan will, through choice and competition, make insurance cheaper, rather than forcing carriers to offer costly, over-regulated products. That will encourage more people to maintain their coverage, because it will be more affordable. The Romney plan will also guarantee that health insurance is truly portable, ensuring that no one who maintains coverage will lose it.

In concert with these fundamental reforms that address the root cause of the pre-existing condition problem, the Romney plan contains patches for people who are currently stuck with a pre-existing condition. The Romney plan extends HIPAA's guaranteed-issue and health status protections to people in the individual market, so long as they have maintained creditable coverage.

In addition, for those who haven't maintained creditable coverage, Romney proposes offering federal subsidies to states to provide high-risk pools. As noted earlier, Obamacare creates its own, limited high-risk pools; but Romney's plan would incorporate them as a central feature, and put significantly more money behind them.

Something that is not explicitly in candidate Romney's plan, but could become part of a bill that a President Romney would sign, is a one-time transition – an open enrollment period – whereby those who haven't maintained creditable coverage could, for a specified period of time, enroll in any plan regardless of their medical history. From that point onward, it would be up to them to maintain that coverage in a reformed system.

CONCLUSION

Obamacare's approach to pre-existing conditions helps a small number of people gain coverage in the short term, but the law makes the fundamental problems worse by driving up the cost of health insurance and requiring employers to sponsor health coverage for their workers, even when workers would be better off owning their own policies.

The Romney plan, by contrast, addresses both the short-term and long-term aspects of the pre-existing conditions problem. Romney's plan extends existing legal protections regarding pre-existing conditions to all Americans who maintain their health coverage, and funds high-risk pools for those who have been denied coverage due to a pre-existing condition. Most importantly, the Romney approach fixes the root cause of the pre-existing conditions problem, by equalizing the tax treatment of employer-sponsored and individually

purchased insurance, giving Americans the freedom to own their own policies.

Obamacare's approach to pre-existing conditions may help a small number with pre-existing conditions to gain coverage in the short term by driving up the cost of insurance for everyone else, leading to adverse selection and higher premiums for all. And the price of Obamacare is steep: the individual mandate; trillions in new spending and taxes; deep cuts to Medicare providers.

The Romney approach is the far superior one. Romney's plan allows Americans to own their health insurance, continuously, as opposed to remaining dependent upon their employers. It reduces the cost of insurance, making it more affordable for Americans to maintain

their coverage. Depending on how his plan was structured, it could involve minimal new spending while also reducing the deficit.

Pro-Obamacare partisans will claim that Romney's plan is somehow not a real plan, because it doesn't force all insurers to take all comers in all circumstances, no matter what. But the Obamacare approach will unravel over time, as its web of mandates, regulations, and subsidies drives the cost of insurance skyward.

Making sure that all Americans have high-quality health insurance doesn't require a \$2-trillion government takeover of the health-care system. Free markets can do a better job, if we give them the chance.

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