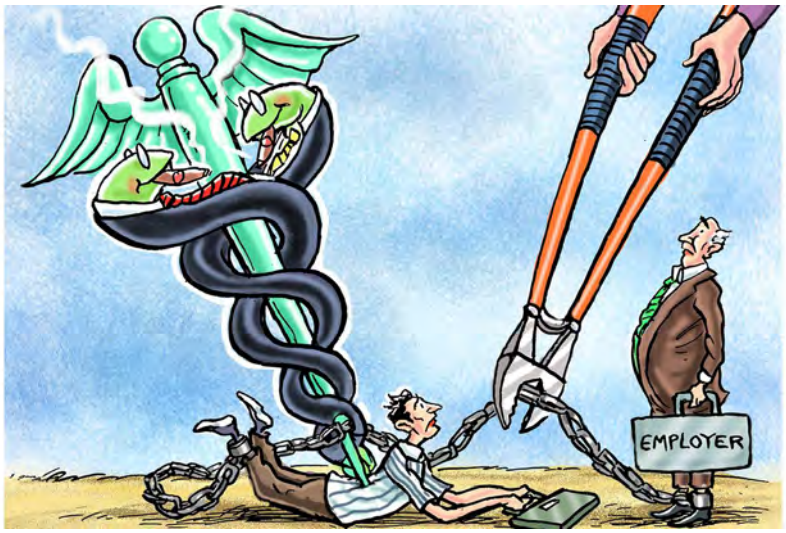
OPINION | COMMENTARY

The IRS Can Save American Health Care

Letting workers spend pretax dollars on insurance would do a lot—without requiring Congress to act.

By Regina Herzlinger and Joel Klein

July 1, 2018 4:41 p.m. ET



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Health care is fast becoming an unsustainable expense for American families. This year the total cost of insurance for the typical family of four eclipsed $28,000, according to the Milliman Medical Index. Rising insurance premiums are also eroding worker compensation, as companies shift increased costs to employees.

Health care in the U.S. suffers symptoms of what Justice Louis Brandeis once termed the problem of "Other People's Money." Often a patient ordering and receiving medical care mistakenly believes he is not the one paying for it. This misconception is due in large part to the employer tax exemption for health insurance, which conceals the true cost of coverage from most workers.

Companies that buy health insurance on behalf of workers are, in effect, giving them some of their compensation in the form of benefits. But employers get to use pretax dollars when they purchase this insurance. If workers try to buy their own policies, most don't get the same tax break. This inequity has cemented the dominance of employer-sponsored insurance in the U.S.

It might seem like a small question, but who is buying makes all the difference. Employer-based coverage subtly drives up health-care costs by enhancing the bargaining power of medical providers. A large company must include nearly all local doctors and hospitals in its health plan's network, since different workers will need different services. Only 8% of employers even offer a choice of a tighter network, the Kaiser Family Foundation reported last year. This gives major hospital chains that dominate local markets carte blanche to charge high prices.

The solution is simple: The Internal Revenue Service should give all workers the chance to purchase health insurance with pretax dollars—just as employers do—using Health Reimbursement Arrangements. Companies would give employees a fixed amount of money in these HRAs to go out and buy the best plans for their families on the ObamaCare exchanges. The plans there would be subject to the Affordable Care Act's requirements on essential health benefits and cost-sharing limits. Employees could use this tax-free money only for the purchase of health insurance, but would pocket any leftover savings as taxable income.

We have run separate simulations, at Harvard Business School and Oscar Health, to project the implications of this policy, and the conclusions are similar. Giving employees the tax break would result in their buying cheaper, more-tailored policies compared with the employer plans in which they are currently enrolled. After doing so, workers would take home the extra income: $129 billion, after tax, in Oscar Health's study and $160 billion in the Harvard Business School's. The federal government, now taxing that additional income, would receive between $46 billion and $65 billion in new tax revenue.

The benefits would be significant. Increased competition from the influx of new consumers in the individual market would drive down premiums. Workers would have more policy options (today 81% of employers offer a "choice" of only one type of plan, Kaiser reports). Employers would be freed from the hassle of administering health benefits, a fast-growing line item, allowing them to focus on their core businesses.

If these results sound too good to be true, it's only because the depth of inefficiency in American health care is worse than you imagine. This proposal would create a more efficient health-care system in three principal ways.

First, when employees are free to keep the savings after choosing a policy that works for them, most will pick a more-tailored group of providers than is currently on offer. They won't aim to have every doctor and hospital in their policy's network, only the ones they need. The insurer then would be empowered to negotiate lower prices with hospitals, which know that exclusive networks can make or break patient volume. On the ObamaCare exchanges, policies with tighter provider networks are at least 18% cheaper without sacrificing hospital quality, according to a McKinsey analysis last year. In its own markets, Oscar Health has observed cost differences of up to 25%.

Second, this proposal would alter the consumer mindset in health care. Today, when care becomes more efficient, the principal beneficiaries are employers. Thus employees lack a strong financial incentive to seek out cheaper options, such as using a telemedicine service to diagnose pinkeye or having a hip replaced at an ambulatory surgery center instead of a hospital. But if patients start getting to keep the money they save, more will act as dogged consumers. Outpatient care constitutes nearly 60% of all health expenditures for adults with commercial insurance. Since there are many alternative options, giving people an incentive to shop around can bring down costs.

Third, competition means health-care companies would have to improve to survive. In a Gallup poll last year, only 38% of Americans had a positive view of the health-care industry, which beat only the pharmaceutical industry and the federal government. But if insurers were forced to compete, they would embrace innovations that seem foreign today: free telemedicine, cost transparency, instant appointment scheduling, smartphone health records, and the like. In turn, insurers would demand a better consumer focus from the doctors and hospital chains they work with.

Gridlock in Washington often relegates proposals like this to the political dustbin. But Congress need not act here, as Duke Law School's Barak Richman has pointed out. Under current law, the IRS can simply adjust its technical definition of Health Reimbursement Arrangements so that they can be used to pay insurance premiums and to satisfy the ObamaCare employer mandate. Once that is done, the Department of Health and Human Services, along with the Treasury, could work with enterprising governors and employers to offer these HRAs to workers.

This is a straightforward proposal, but a powerful one. It would finally begin to address the rising cost of health care, and it isn't subject to a Senate filibuster. For the sake of millions of American families, the IRS should act—and soon.

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