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The Simple Logic of Health Care Inflation

by Gerry G. Smedinghoff

Health care inflation is picking up again. The persistent preoccupation among actuaries, economists, policy wonks, and politicians is the perplexing problem of why health care inflation has consistently exceeded the Consumer Price Index (CPI) for several decades. Counting the number of angels that can dance on the head of a pin is a no-brainer compared to the divine mystery of health care inflation. Actually, the answer to the health care inflation puzzle is a simple matter of doing the math.

Consider the decision facing a growing company of how to distribute the fruits of its incremental success. Does it give each employee a $5,000 raise, or should it buy health care benefits for them? If it increases salaries by $5,000:

- 15%, or $750, will go to pay Social Security and Medicare taxes.
- 28%, or $1,400, will go to pay federal income tax.
- 7%, or $350 (and often more), will go to pay state and local income taxes.

This leaves employees with an after-tax raise of $2,500, or half the initial amount.

But, if the employer decides to buy health care benefits instead, none of these taxes has to be paid. Essentially, the employer has two options: (1) allocate profits in cash as salary, half of which will be taxed away, or (2) allocate profits as employer-sponsored health care benefits, and the employees get to keep it all.

The choice between 50 cents in cash after taxes, or an entire dollar in tax-exempt health care, is one of those offers that most people can't refuse. The ultimate effect of this economic perversion is that "health care dollars" are nominally worth twice as much as "taxable income dollars." But, since there are artificially twice as many health care dollars, they're worth half as much.

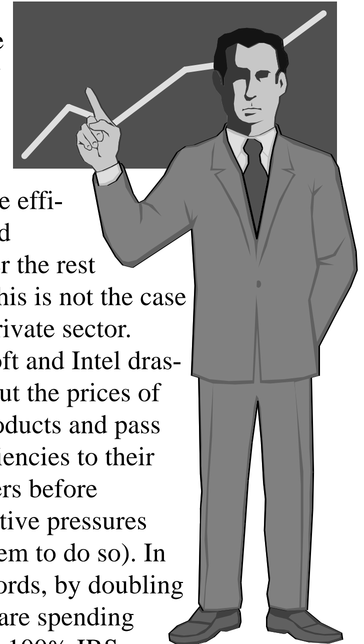
To see why, imagine this scenario: tonight the IRS seizes the assets of an insolvent shopping mall. The IRS reopens the mall tomorrow morning as the "IRS Mall" with two new rules that separate it from all the other malls and stores.

The first rule states that the IRS will double the amount of money in the wallets of shoppers entering the mall. If you show up at the mall tomorrow morning with $500, the IRS will give you $500 more. So you now have $1,000. The second rule states that the IRS will confiscate half of the cash left in your wallet as you leave the mall. So if you buy $900 worth of goods, the IRS confiscates $50 of the $100 you have left, leaving you with $900 worth of goods and $50 in cash. The net result of your shopping trip is that you are able to buy $900 worth of goods for only $450 of the money you left home with.

Sounds like a great deal, doesn't it? If this actually happened, wouldn't you like to shop at the IRS mall? Do you think some other people wouldn't also like to shop there? As the trickle of new customers turns into a torrent, and then a flood — as the IRS pumps mountains of cash into its new mall — what do you think will happen to the prices of the goods at this mall? If you owned a business, wouldn't you like to set up shop there? So what do you think will happen to the cost of retail space at the mall and the cost of doing business at the mall?

Before you jump to the answers to these questions, here's a hint. What does health care have in common with single-family homes and higher education? Just like the goods at the new IRS mall, all three are subsidized via the Internal Revenue Code (IRC); all three have experienced inflation far in excess of the CPI.

This inflationary subsidy is what I refer to as "Gold's Law" (named in honor of Jeremy Gold, an actuary, to explain the gross inefficiencies of the insurance industry), which states that 95% of a legally mandated cost advantage will end up as waste. If the government grants an industry a 100% cost advantage, the industry will become about 5% more efficient and squander the rest (Note: this is not the case in the private sector. Microsoft and Intel drastically cut the prices of their products and pass on efficiencies to their customers before competitive pressures force them to do so). In other words, by doubling health care spending with the 100% IRS subsidy, insured employees get about 5% more health care at greatly inflated prices, with the uninsured foregoing significantly more, resulting in a net loss of total health care overall.



Gold's Law is the reason why, on average, single-family homes appreciate in value far in excess of the CPI — caused by the additional money pumped into the housing market due to the mortgage interest deduction. It's also the reason why parents have to take out a second mortgage on their home just to put their kids through college — caused by all the tax-subsidized school loans and government scholarships. And it's why we have a "health care crisis" and an "education crisis," but not a "furniture crisis" or a "clothing crisis."

In essence, the IRS Mall is the "Health Care Shopping Mall" (HCSM). You pick up your paycheck — without having to pay any taxes — in the HCSM. And you can spend as much of your paycheck in the mall as you please. The problem is, the only thing you can buy is health care. As you try to exit the mall to buy what you really want (food, clothing

and housing) the IRS lightens your load by half. The only way to avoid the IRS is to buy as much health care as you can — even if it's much more than you want or need. By doubling your money when you enter the HCSM, the IRC fuels health care inflation. And by confiscating half of your income when you exit the HCSM, the IRC promotes unnecessary use of health care among those insured through their employer.

If you work for a company with health benefits, the 5% net subsidy of the HCSM dictated by Gold's Law is hardly worth the bother. But if you don't, if you're one of the uninsured and on your own in the HCSM, without the 100% IRS nominal subsidy, it doubles the cost of buying health care. The unintended effect of Section 105 of the IRC is to create a "Jim Crow" market for health care, with a privileged class that has access to the tax subsidy and a disenfranchised class which does not. Those in the disenfranchised class are allowed to shop in the HCSM, but the IRS will not double their money when they enter. Hence they must effectively pay twice as much for health care.

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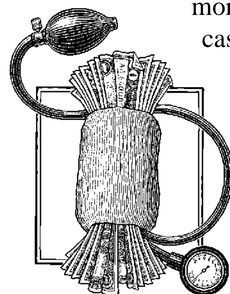
The privileged class is generally composed of higher income, with employment stability, salaried, skilled, professional and unionized labor. They purchase health care through their employer on an all-or-nothing basis. Either they buy the full array of health care services (typically costing $5,000 a year or more for family coverage) with the benefit of the tax subsidy, or they buy none at all. Given these two options, most who might represent a $50,000 expense to an employer, prefer to receive a $45,000 taxable salary with $5,000 in tax-exempt health benefits.



The disenfranchised class, on the other hand, is mostly composed of lower in-come, hourly, variable, unskilled, manual labor and the unemployed. They cannot purchase health care through their employer because to be eligible for the employer subsidy, health care must be purchased on an all-or-nothing basis. And the price of the full array of health care services does not change to accommodate their lower incomes. They are faced with the choice of, say, a $17,000 salary, or $12,000 in taxable income and $5,000 in tax-free health benefits. Since most of these people have very little discretionary income, they prefer to have as much of their pay in cash and are forced to take their chances with their future health care needs. But their individual preferences are ignored anyway, because their employer makes this *fait accompli* decision for them.

In any economic market, wealthy people have two immutable advantages over poor people. First, because they have more money, they are able to buy more than the poor, and in select cases, outbid them for scarce items. Second, because a greater share of their income is discretionary, they have greater negotiating leverage in the marketplace. They can get a lower price via volume discounts. And they have better access to information about the best price available.

The IRC Section 105 tax-exemption gives the wealthy an unnatural third advantage over the poor. It prices the poor out of the health care market in a two-step process. First, it raises the ante by reducing the tax-exempt purchase of health care to an "all-or-nothing" option with a price tag of $5,000. Then it penalizes the poor locked-out of the employer-sponsored health care market by effectively charging them twice as much when they attempt to purchase health care on an after-tax incremental basis in the HCSM.

So relax. Health care inflation can be explained by the laws of economics as easily as falling apples can be explained by the laws of gravity. The real problem is not inflation, but the fact that tax exemptions for health care, housing and education have the opposite effect from the original intention. They only take resources from one group (generally poorer) and redistribute it to another (generally wealthier), resulting in less health care, housing and education for everyone.

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