HealthAffairs Blog

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Do We Need An Individual Mandate?

Written by John Goodman

Should everyone be required to have health insurance? The short answer is no. There is nothing that can be achieved with a mandate to buy health insurance that cannot be better achieved by a carefully designed system of tax subsidies. Beyond that, a requirement that everyone obtain insurance (as the new health reform law dictates) creates problems greater than the problem it is designed to solve.

The most common argument for an individual mandate is based on the free rider problem. Jonathan Cohn made this argument in the New Republic the other day. Similar thinking can also be found on the political right.

So what is the free rider problem?

Imagine a community in which everyone dutifully pays health insurance premiums every month, except Joe — who spends his money instead on other consumption. Then one day Joe gets sick and finds that he cannot pay the full costs of his medical care. So the rest of us — being compassionate sorts — chip in and pay for the remainder of Joe's care. Upshot: When he was healthy, Joe got to consume all his income instead of paying premiums and after he got sick he managed to "free ride" on everyone else's generosity. You can think of this as both an ethical problem and as an economic problem. Ethically, Joe is getting an undeserved benefit paid for by others bearing an undeserved cost. Economically, Joe is imposing an external cost on others. If we let Joe get away with not paying his own way, others might emulate his example, and the cost could grow through time.

The "Mandate Solution": A Case Of Overkill

Turning to the "mandate solution," let's add a bit of realism here. On the average, people without health insurance consume only about half as much health care as everyone else — after adjusting for other characteristics; and of the amount of care they consume, they pay for about half from their own resources. So, roughly speaking, the "free ride" for the average uninsured person is equal to about one-fourth of what everyone else spends on health care.

With these facts in mind, it should be clear that forcing Joe to buy insurance that pays for the same amount of care everyone else gets would be overkill. It would be overkill four times over. To get Joe to pay his own way, we need to take from him an amount of money equal to one-fourth the average health care spending of insured people and either distribute it to everyone else or put it in a fund to pay for uncompensated care required by Joe and others like him.

How could that work? Let's say that $X is the average health care spending by insured people. Then, one solution would be to make Joe pay $X/4 in extra taxes each year. Or, we could achieve an equivalent outcome by giving everyone who has insurance a tax break equal to $X/4, but deny the break to Joe and everyone else who is uninsured.

Alert readers will realize that what I am describing is not all that different — at least in principle — from the current tax system. For people who get insurance at work, the employer's premium payments avoid income and payroll taxes, unlike the payment of wages. For a broad stretch of middle-income earners, that means avoiding a 15% FICA tax and a 10% federal income tax. If there are state and local income taxes, the subsidy is greater than 25%.

By contrast, families with similar incomes who are uninsured (and, therefore, receive extra compensation in the form of taxable wages rather than nontaxed health insurance) will face a tax bill that is higher by an amount roughly equal to one-fourth of the cost of employer-provided insurance.

Designing A Better Solution

If we want to build on this structure to create a much fairer and equitable answer to the free rider problem as well as one with better incentives, however, there are three fundamental flaws that need to be corrected.

First, although the subsidy/penalty system seems to be broadly adequate for the middle-class, it is far less so for the rest of the population. For the upper middle-income families, the subsidy for employer-provided health insurance approaches 50%; whereas for lower-income families it is as low as 15%. Generally speaking, we are over-subsidizing the health insurance of the wealthy and undersubsidizing it for the poor. A fixed-sum tax credit — essentially giving everyone the same subsidy, regardless of income — would solve this problem once and for all.

Second, there is no connection between the penalties and the subsidies. That is, the extra taxes paid by the uninsured for the most part go to Washington, while the uncompensated care must be delivered locally. In terms of our example, even though Joe is paying an appropriate penalty for being uninsured, his penalty is being spent on other things by another political jurisdiction. His neighbors will have to cough up additional amounts if he needs free care.

Third, although we subsidize employer-paid insurance — in some cases very generously — there is virtually no subsidy for people who obtain insurance on their own. Whereas employees through their employers can buy insurance with pretax dollars, people on their own must pay with aftertax dollars. (The self-insured get a partial subsidy.)

Now let's stop and take stock. We began with the free rider problem, which can generally be described as some people reaping benefits and other people bearing costs which are undeserved. Then, in thinking about how to solve this problem, we discovered that the health care system is riddled with undeserved benefits and undeserved costs. Fortunately, sensible reform can solve all these problems in one fell swoop.

Recently Passed Health Reform Legislation Makes Things Worse

But…and this will come as a surprise to some…the newly enacted health reform leaves intact all three flaws discussed above. Plus, it adds a new dimension — a bizarre system of new subsidies that give a whole new meaning to the idea of undeserved costs and benefits. As previously explained:

A $30,000-a-year worker with family will be forced to take a $14,000 health plan instead of wages (overkill four times over) and get a tax subsidy of little more than $2,000.

Someone at the same income level in a health insurance exchange, however, will get an identical plan almost completely paid for by Uncle Sam, plus reimbursement for most out-of-pocket expenses for a total subsidy in excess of $19,000.

A $60,000-a-year family getting insurance in the exchange will get a subsidy twice as large as a family earning half as much income ($30,000).

Thus, although the law has an individual mandate, it does not solve the problem of the undeserved benefits made possible by free-ridership. Instead, it creates even more undeserved costs and benefits — creating far more inequities than were there before.

Even more bizarre, it may not even reduce the number of uninsured. As Marty Feldstein has pointed out, the penalties are low and enforcement may be weak. We may end up with more free-riding uninsured people than ever before.