

We are facing a major national recession with high unemployment rates and collapsing state revenues. California's tax revenues from the state income tax, the state sales tax and the corporations tax are down by nearly \$11 billion more than budget projections earlier this year and \$13 billion for the 2009-10 fiscal year – well over 10%. Unemployment is projected to grow from 7.5% in 2008 to over 9.0% next year, to 9.7% in 2010 – a huge growth in unemployment rates that not too long ago were 5.5%; this will add large numbers to the ranks of the uninsured. Property values are down over 40% from last year.

The economists of all stripes agree that in a recession government must increase spending and run a deficit to offset the slowdown in private economic activity. California's constitution prohibits annual deficits – taking the best economic medicine off the table for state policy makers.

Federal government officials however can run a deficit and the federal government is increasingly doing so, at least to shore up the nation's financial institutions. A stimulus package is under discussion to enhance infrastructure spending, extend unemployment insurance and help state and local governments. California heading for 9% unemployment needs to seek its fair share of the stimulus and more<sup>1</sup>; something will be enacted and signed by the President or the President-elect.

California's Republican legislative leaders are adamantly opposed to state tax increases (saying they would hurt the economy and slow its recovery) and would therefore choose to solve the state's deficit with spending cuts to state and local programs. California's Democratic legislative leaders emphasize the need for new revenues to avoid deep cuts in funding for schools and health care and other social programs (saying they would harm our most vulnerable citizens at a time when they have the least ability to help themselves) and suggest raising income tax rates for the state's wealthiest who did indeed benefit most from the strong economy but whose capital losses from the collapse in the stock market are now exacerbating the state's budget shortfall.

Our state's post partisan Governor proposes equal doses of pain – \$5 billion in tax increases and \$5 billion in spending cuts. Governor Schwarzenegger's tax increases primarily increase state sales taxes, and his program cuts are centered on education funding, which unlike health mostly escaped the first round of cuts agreed to by the Legislature in September.

His proposed Medi-Cal cuts include an end to coverage for two-parent full-time working families, a reduction in eligibility levels for parents from 100% of FPL to 72% of FPL (roughly \$20,000 for a family of four to \$14,000 for a family of four and elimination of all but emergency care services for new legal immigrants. MediCal cuts that slash eligibility do double damage: to the families themselves who become uninsured and to

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<sup>1</sup> As mentioned in our last memo, we think California needs to submit a far-reaching 1115 waiver to cover Medically Indigent Adults for basic health services through Medi-Cal.

the state's economy as we lose federal matching funds. A far better design would be reducing somewhat utilization<sup>2</sup> of program services.

The Governor also suggests accelerating spending on infrastructure improvements (such as roads and hospitals) to create jobs and imposing a moratorium on foreclosures with incentives to refashion loan agreements as housing prices collapse and families are unable to meet their mortgage commitments. This part of the package is imperative.

With Assembly Speaker Bass, he has called for a commission to suggest revisions to the state's archaic tax codes. California is far too dependent on taxes whose revenues spike in boom times and collapse when the economy runs into tough times. We need a more balanced tax system that applies more broadly and equitably to economic activity and assets, and lowers marginal tax rates. It is also time to apply the sales tax to services and cut the rates on goods so that consumers' purchases of goods or services are treated equally.

The Legislative Analyst has compiled a list of alternative revenue enhancements<sup>3</sup> and spending reductions<sup>4</sup> for the Legislature to consider. He points out that the magnitude of the budget deficit demands immediate action, that delay means deeper cuts later and posits that the proposed spending reductions and tax increases are too small to have any measurable impacts on the state's economic growth.<sup>5</sup> He suggests that the proposed sales tax increases be scaled back and that alternatives such as an increase in the vehicle license fee to 1%, or a 0.5% income tax surcharge be considered. These taxes can be deducted on federal tax returns, lessening the impacts on California taxpayers. In our view, an increase (restoration) in the vehicle license fee would be better for economic growth than an increase in the sales tax as it applies primarily to existing assets rather than a future discretionary purchase.

This downturn is likely to be steep and longer than earlier projected. There is a wide difference of opinion among economists on the form of the national economic stimulus package that will best re-stimulate the economy.<sup>6</sup> Some suggest improvements in infrastructure; others propose increased aid to hard-pressed state and local governments;

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<sup>2</sup> An estimated 30% of medical services are of little or no medical utility. Medi-Cal is a low use program as compared to other states; however that does not mean there are no opportunities to reduce inappropriate use of care. A recent report on Medicare found it had reduced inappropriate services from 14% to less than 3.5% of program services. Utilization can be reduced through copays, utilization review, primary care case management and/or moving the disabled into managed care. The much-criticized Treatment Authorization Requests (TARs) could be simplified, streamlined, consolidated in a single office and the criteria tightened.

<sup>3</sup> Vehicle license fees, income tax surcharges, reductions in the senior credit and dependent credit, repeal of the like kind exchange exclusion.

<sup>4</sup> The proposed health reductions include: reductions on the scope of dental services, discontinuation of coverage for over the counter medications, capture federal match for minor consent beneficiaries, suspending the county administration COLA, cut the rate increase for family planning in half and including Medicare revenue in the calculation of the nursing home quality assurance fee.

<sup>5</sup> The state's deficit is equal to about 1% of state GDP (Gross Domestic Product).

<sup>6</sup> See New York Times, Business Section, Sunday November 9, 2008 for a compendium of economists' views on a stimulus package.

some suggest assistance to mortgage-beleaguered homeowners; others favor another round of tax cuts and rebates.

The advantages of infrastructure investments (such as subways, rail, roads, ports, bridges) are 1) to create a good foundation for future growth and 2) new jobs although they are not the same jobs as those from which individuals were laid off. The disadvantage is they can be slow to implement and can be pork-laden with political favorites which diminish their long term economic impacts.

Increasing aid to state and local governments (California and its 58 counties) would allow states and counties to maintain vital social programs at a time of severe economic distress for their state and local budgets and their citizens. This investment does not have the same type of impacts for future economic growth as infrastructure spending on the bricks and mortar foundations does. However, state investments in a better-educated, healthier citizenry (our social infrastructure) have large long term pay-offs for the competitiveness of our state and our nation in the global economy.<sup>7</sup>

Helping homeowners will inhibit the rash of foreclosures plaguing California and other states and help put a floor under plummeting home values, which are the biggest driver in our credit freeze and collapses of our financial institutions.

Another round of tax cuts and rebates is likely to help consumers pay off accumulated consumer debt, but is less likely to increase consumer consumption. On the other hand extending unemployment benefits or increasing food stamps will most directly increase consumption, which is essential to re-starting economic growth.

So the best combination of national and state policies are those that create jobs quickly, establish the hard and soft foundations for future economic growth, protect homeownership, restart consumer spending and retrain those citizens most impacted by job and income losses.

The appeal of incentives for the development of American alternative energy is its combination of goods: for job creation, for development of new cutting edge technologies, for the environment and for our foreign policy. Does health reform offer anything comparable?

Recessions, when the state budget is in tatters, are difficult times to make incremental expansions in coverage, but could be the right time and opportunity to make major health reforms. We believe the downturn is the right time to set the health policy framework for the nation's recovery, understanding that it will need to be implemented over a number of years. It's the right time to make politically difficult policy decisions that put the state

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<sup>7</sup> For an excellent discussion of stimulus alternatives, see Freidman How to Fix a Flat, New York Times 11/12/08; Kristof, Obama and Our Schools, New York Times, 11/13/08; Kinsley, Let's Have Another Cup of Coffee, Krugman, Depression Economics Returns, and Brooks, Bailout to Nowhere, New York Times, 11/14/08.

and nation's economy not only on the road to recovery, but on a more sustainable long-term road than the boom and bust economic cycles of the last 24 years.<sup>8</sup>

Just as there is a better economic and environmental transportation model than the proliferation of SUVs, there are better ways to educate our state's children to compete in the global economy, and there is a better health care model that is healthier for our economy and the productivity of our nation's citizens.

Will we as better-informed citizens allow unregulated and little understood financial instruments to run up the price of homes only to crash and freeze the whole economy? Would we as tax payers agree to bail out the American auto industry without an agreement to drastically improve the fuel efficiency of American designed cars? Would we as citizens want to continue health policies that make our health system the highest cost and least efficient at producing good health outcomes (healthy births, long healthy lives) of any developed nation?

Health reform will need to be supported by both business and labor and will need bi-partisan support in Congress. Serious questions must be asked and satisfactorily answered before reform of the health system can proceed. Here is an outline of our suggestions.

- First, who's covered? Everyone. It makes no sense to continue to bounce people on and off coverage as they change jobs or hours, get married, get laid off, get divorced, graduate from school, decide to go bare and all the other myriad life changes we all experience.
  - What are they covered for? Basic health care services, but if individuals want more, they can buy more coverage (supplementary coverage). What is basic health care? It includes doctors, hospitals, lab tests and prescriptions. It excludes cosmetic surgery and services of little medical effectiveness. It's an open question as to whether we need insurance coverage for routine vision services or could buy them more effectively out of pocket rather than through health coverage.<sup>9</sup>
- Second, who's paying? Everyone. We think everyone should pay something, except those with incomes below poverty (\$10,000 for an individual, \$20,000 for a family of four), and that government should subsidize those who cannot afford the costs of basic coverage.
  - The extraordinarily regressive tax subsidy that helps subsidize employment based coverage should be turned on its head so that the tax

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<sup>8</sup> In the last 24 years, we have been through the savings and loan debacles, junk bond orgies, housing bubble and stock market crash of the late 80's leading to the recession of '90 and '91, the internet and Enron bubble and energy market manipulations of the late '90's and a second stock market crash and recession in 2000 and 2001, then the second housing bubble, a run-up in the price of foreign oil, another stock market and home values crash and credit freeze over the past year. Each financial crash had a bubble preceding it where the available funds from economic growth could have been put to more productive uses than the run up in home prices, internet stocks, gas prices and financial manipulations.

<sup>9</sup> Low-income citizens need this coverage; high income citizens do not. Do middle class families need vision coverage or can they buy their glasses out of pocket? What other services are comparable?

subsidies are greatest for low wage workers and then scale down as wages rise.<sup>10</sup>

- Employers should pay a fixed percentage of employee wages to pay for the basic benefits package.<sup>11</sup> Those employers who wish to pay for more coverage (supplementary coverage), should be free to do so. Should the actuarial value of the supplementary benefits be treated as income to the employee? That is a close question, but without redirecting the tax subsidy as discussed above, our recommendation is “yes, it should be taxed as income”.
- The biggest affordability challenges that must be solved are for working families with children and individuals over the age of 50. Family coverage is three times as costly as coverage for a single worker and coverage costs more than three times as much for workers over 60 as it does for workers under the age of 30.<sup>12</sup> We recommend that employee contributions be set and capped as a percent of their wages.
- Third, how do you control (reduce) rising costs and improve declining quality? Information, incentives and integrated delivery systems. Rising health costs hurt employers, employees, individual patients and our national economic competitiveness. On the other hand they help hospitals, doctors, nurses, health care unions, pharmaceutical companies, bio-tech companies, health insurers and the manufacturers of medical equipment, and create health care jobs which is why reform is difficult.
  - The necessary first steps are health information technology, health technology assessments and transparency of information on price, quality and effectiveness.
  - The second steps are changing incentives for providers from the piecework inflationary incentives of fee for service medicine to reimbursement incentives to improve quality, clinical effectiveness and price. We need to change incentives for consumers as well so that they face some of the incremental cost consequences of their decisions, but in

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<sup>10</sup> This tax subsidy contributes very little to low wage workers’ coverage and pays for nearly half the cost of coverage for high wage workers in California.

<sup>11</sup> This could be structured as a mandate, pay or play or an employer tax. An employer tax is the easiest to administer, but may be the hardest to achieve politically. Pay or play allows those employers who wish to continue to offer coverage to do so and is more politically viable for those employers and employees who already offer coverage. It can be designed to afford important protections to small low wage employers who experience the greatest difficulty with affordability of coverage. An employer mandate keeps coverage at the greatest remove from “government”, but poses the greatest affordability challenges for small employers and low wage workforces.

<sup>12</sup> One solution to the age affordability issue is pure community rating, but this would increase the costs of coverage for young workers, subsidizing the on average higher paid older workers. It may be preferable to subsidize the older workers whose costs of coverage exceed a specific share of wages with refundable tax credits received in a fashion to coordinate with premium payments.

In order to deal with the affordability of family coverage, some countries fund coverage for children through taxes and the workers themselves through the employer. A variant on this that would resolve affordability of family coverage is to use S-CHIP and Medicaid to help pay for dependent coverage of low and moderate income working families.

an affordable fashion with transparent options. What does that mean? If you have a choice between an HMO (health maintenance organization) that costs \$4000 a year, a PPO (preferred provider organization) that costs \$4500 a year and a POS (point of service) plan for \$5000, you as consumer pay for the incremental cost above \$4000. If you have a choice between a brand name and a generic drug equivalent, you as patient would pay out of pocket for the higher copay of the brand name equivalent.

- Integrated delivery systems are necessary to repair our badly fragmented delivery system and create provider networks where primary care doctors, specialists and hospitals have compatible incentives to improve quality in a cost effective manner.
- Pooled purchasing, while not the panacea first imagined<sup>13</sup>, would help individuals and small employers to collectively bargain for coverage with the same efficiency as large employers do, and is a cost effective mechanism to distribute subsidies needed by small low wage workforces. In Massachusetts and several of the federal reforms these are known as exchanges.
  
- Fourth, what is the role of HMOs and private insurance<sup>14</sup> in the reformed system and how do we improve their value under system reform? The reform will maintain the mixed public private system that characterizes American health care.
  - Under any reform, all participating insurers would have to guarantee issuance and renewal of basic coverage to every employer, employee and consumer<sup>15</sup>, and their prices and medical loss ratios would be transparent and posted by a neutral third party on the web.
  - Premiums would be set and disclosed annually<sup>16</sup>, and consumers could choose their plan, upgrade coverage and change coverage annually.<sup>17</sup> There would be an inter-plan risk adjustment by neutral experts for those plans that receive the sicker and more costly patients.

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<sup>13</sup> Among the challenges experienced by the California pool for small employers was the ability of plans operating outside the pool to vary their premiums such that the pool attracted higher risk small employers than those plans operated outside and in competition with the pool.

<sup>14</sup> Some will argue for elimination of private insurance as their administration is costly and some compete on their ability to cherry pick the healthiest lives, rather than effectively controlling costs and improving quality. Others will argue that they are dynamic and flexible instruments for change that can adjust more rapidly and in more targeted ways than government can and does. The reality is they are not going to be eliminated in any of the politically viable reform proposals.

<sup>15</sup> California already has enacted such reforms for small employers, but not for individuals or for mid-sized employers.

<sup>16</sup> Some will argue for regulation of health insurance premiums, provider rates and acquisitions of new and costly technology. If the reimbursement and system reforms are adopted with adequate transparency, strong bargaining authority and proper incentives, rate regulation should not be necessary. However in communities without adequate competition due to their small size or market concentration of a single dominant system, rate regulations may be needed.

<sup>17</sup> Choice of plan and provider are critical elements for consumers and providers.

- The market should be open to new innovations that offer less costly and higher quality delivery systems. That includes both public<sup>18</sup> and private<sup>19</sup> insurance systems that want to participate. There should be strong pay for performance incentives for those plans and provider networks delivering superior and inferior quality of care and services and transparency of this information to assist consumer choice.

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<sup>18</sup> California, for example, has several strong local public health plans.

<sup>19</sup> Although provider run health plans have historically had difficulties making the difficult decisions to control health spending, they have better information to make informed decisions on controlling their costs.