CHAPTER ONE

Fear and Loathing of Defined Benefit Health Insurance

My heart sank when I spied the familiar large envelope, emblazoned with Harvard's classic maroon and white colors, on my mail table. The words "Benefit Selection" were gaily festooned on the face of the envelope, as if it were an invitation to a party. But selecting benefits was no party.

Inside the envelope an ominously fat booklet listed the many benefits offered by my employer, Harvard University: investment options for the money the University and I were setting aside for my retirement and insurance choices for my life, disability, teeth, and health.

Do not get me wrong: I do not dislike most of the benefit selection process. For one thing, the process is easy, requiring only a phone call on my part to log in my choices. A booming baritone male voice or a silkily seductive female one then guides me. And the selection of disability, life, and dental benefits is relatively straightforward, one of those many chores we mindlessly perform to get through life, like brushing our teeth.

I even enjoy one part of the process—that of picking investment vehicles for my retirement benefits. Like many other Americans, I have benefited from my freedom to choose the mutual funds that best meets my needs. Sure, I took a hit when the overheated U.S. stock markets cooled down, but even with that hit, many still have substantial unrealized gains in their retirement assets. Most

I deeply appreciate John Bogle's review of the section "My Heart Belongs to Vanguard."

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Americans recognize this as a temporary lull. They are in the market for the long run. No wonder the number of households invested in the stock markets rose from 1999 to 2001.[1]

So what was my problem?

My fear and loathing of health insurance benefits overwhelmed my feelings about the rest of the process.

The lack of real choice among the policies made me feel powerless.

The lack of information about my health care insurers and providers made me feel dumb.

And the lack of coverage for the benefits and providers I wanted and the high prices of the insurance made me worry about my future were I ever to become sick or change my job.

Why do I feel so good about the selection of retirement benefits? Why do I feel so bad about my health insurance options?

MY HEART BELONGS TO VANGUARD

I found the process of selecting investment options for my retirement kind of fun because it made me feel smart and powerful. This process goes by the moniker of *defined contribution,* an unappealing name for a very appealing concept—my direct management of the investments in my retirement funds, using a pretax "contribution" by my employer and me and a vast array of choices vetted by my employer.

With good reason, I do not normally feel smart and powerful. But the plethora of good information about each of my choices made me feel smart. And to me, as to most other people, choice equals power. A quirky study underscores the correlation between these qualities and consumer satisfaction—it found that people who were donating blood felt less pain when they controlled the choice of the arm from which the blood was drawn.[2] (Who thinks up these studies?)

Talk about choice. I could pick from many different types of investments: mutual funds for money markets, bonds, and equities were all readily available. More than 90 percent of employers with these plans offer seven or more distinctly different investment options to their employees, ranging from index funds to microcap equity funds, and 58 percent offer more than eleven.[3] In some firms, employees can even specify their retirement desires and a "lifestyle fund," tailored to their needs, is dispatched to them. And I could allocate my money largely as I chose. If I felt ill at ease about the future of the stock market, I could invest my funds in other types of securities, including money markets. But if I felt exuberant about the future of stocks, I could readily invest a large chunk of

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my money in them.[4] Indeed, investors can now design their own investment portfolios—baskets of stocks whose future they manage.[5]

I even had a personal favorite among the choices. For its sheer smarts, my heart belonged to Vanguard. The Vanguard Group was created by John Bogle, a crusty, brilliant man, whose 1951 college thesis proposed the formation of mutual funds that followed stock market indices. Bogle asserted that these passively managed index funds (funds with a broad portfolio linked to a stock index such as the Standard & Poor's 500 Index) would outearn actively managed ones, over the long run, and require much lower administrative costs. He also proposed that these funds be sold directly to consumers.[6]

Like many other consumer-driven advocates, Bogle was derided as a kook by the members of the establishment.[7] After all, he espoused two heretical ideas that deeply threatened them: indexing and consumer focus. At the time, most retirement funds were managed by professionals who picked the securities in which your retirement funds were invested, absent any guidance from you. *Defined benefit* (DB) is the title for retirement funds like these, run by smart-money investors and promising retirees a "defined" level of retirement "benefits."

In the heyday of defined benefits, consumer-focused index funds were hard to find. The clubby money managers pooh-poohed the notion that the stock market as a whole was smarter, or at least a better performer, than they. Notes one historical account, "The indexing concept went against the best interests of the professional fraternity—securities analysts, Wall Street firms, pension consultants."[8] And this fraternity considered the idea that consumers would buy mutual funds to be ludicrous. What did consumers know about the mysteries of finance? Because we are so stupid, ordinary people like you and me are appropriately timid about buying mutual funds. Only the smart-money managers of the pension and endowment funds of institutions would buy such funds with intelligence and confidence. Or so they said.

When Bogle introduced his first indexed mutual fund, in 1976, he noted that it "went nowhere." It drew only $11.4 million—less than 10 percent of the amount he had hoped to raise. But the advent of the consumer-controlled, defined contribution concept in pension funds accelerated the growth of index funds. Employers found that employees liked them.[9]

Ultimately, Bogle triumphed over the naysayers. In 2000, The Vanguard Group accounted for about 20 percent of the $1.5 trillion in U.S. index assets. Thirty-plus years after the first index fund was sold, indexing is so well accepted that benefit consultants find the likelihood that "active management will outperform [it] over the long term a dubious prospect at best."[10] By March 2001, Vanguard's index fund had outperformed "large blend" stock funds and diversified funds by 2 percent a year over a twenty-year period.[11] Vanguard's fund

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family, which now includes more than a hundred investment choices, ranging from bonds to foreign securities, manages $550 billion in assets and generally achieves among the top rankings in performance, administrative expense, and customer satisfaction.[12]

Unfortunately, like all of us, Bogle has not been totally immune from life's cruel twists. Although he lived long enough to savor the triumph of becoming a lionized, wealthy man, he also experienced an Oedipal fate. He was ousted from the board of the company he created by his hand-picked successor. Enough about that.

THE STARS TOLD ME

How did I know that the Vanguard funds were so good?

Simple.

The stars told me.

The Morningstar stars, that is, that indicate evaluations of mutual funds. With a five-star rating system, Morningstar evaluates the following dimensions of each fund it analyzes: performance, risk, ownership, management, and cost. As you can guess I am a Morningstar fan. I like the clarity and expertise of its presentations. Like a bantamweight boxer, those little stars pack a big wallop.

Morningstar's history is similar to Vanguard's. It too was formed by an eccentric, competent visionary. In this case the founder, Joe Manseuto, was no MBA. Instead, he had earned a degree in American literature from the University of Chicago. His literary leanings are apparent in Morningstar's name, borrowed from Thoreau's *Walden*—"The sun is but a morning star"[13]—and its clarity of exposition. His University of Chicago background also brought an expertise gained from the university's brilliant business school—packed with Nobel economics prize laureates—to the rating process.

One of the university faculty's major contributions was to demystify the measurement of risk. In theory a mutual fund manager who invests in risky ventures can earn a better return than more risk-averse managers. More risk, more reward. But suppose you do not like risk. Suppose you want your investments to be the risk equivalent of a Raisin Bran-eating, Volvo-driving, suburb-living, golf-playing kind of life. How can you separate the go-go players from their conservative siblings? Considerable hand-wringing accompanied the pre-risk measurement days.[14] Once again, the smart-money, leave-the-investments-to-us crowd worried that ordinary investors would be raped and pillaged if they could not identify the risk-return relationship. (Left unexplained was the question of how the smart money could evaluate risk in the absence of good measures.)

Enter Harry Markowitz, one of the University of Chicago's stellar products.[15] He popularized *beta,* a measure of the riskiness of an investment. The risk of a

stock with a beta of 1 is equal to the risk of the market as a whole; a stock with a beta much greater than 1 is for an investor on steroids; and one with a beta much lower than 1 hints that the investor is your grandfather. The first measure of beta, limited to one variable, was suggested in Markowitz's 1952 University of Chicago doctoral thesis in economics. Although Milton Friedman, later to be a Nobel laureate in economic science, voted against accepting the thesis, Markowitz too ultimately won the Nobel prize. The model was then refined by yet another Nobel laureate and used as the basis of the capital asset pricing model that serves as the theoretical foundation for index funds. Since then, the measure of beta has been sharpened to incorporate more than one variable and in other ways.[16] As the refinement of this measure of financial risk continued, investors had access to ever-better data with which to evaluate the performance of their mutual funds and stocks.

Sure, there are shortcomings to the beta measure. For one thing, like all statistical measures, it is a historian rather than a futurist. And there was endless nitpicking about and improvement in the measurement process.[17] But on the whole it does the job. It enables people to compare risk-adjusted measures of investment performance.

These measures of investment performance are vitally important to the success of consumer-driven retirement funds. They enable people who cannot differentiate a debit from a credit to choose investments competently.

Many credit Morningstar with enabling "democratized investing."[18] Morningstar's accessible rating system changed information from an institutional business to a consumer one.[19]

The current pervasiveness of measures of investment performance underscores their importance. If I were not a believer in reading the stars, I could turn to many other sources of information. I could tune into the many talking financial heads—fat, thin; plain, attractive; old, young; bald, hirsute—who are televised round-the-clock, worldwide. Or I could read the fund evaluations in the *Wall Street Journal, Consumer Reports, Forbes,* or *USA Today.* Or I could target Vanguard with evaluations written by a self-styled Bogle's Bogle, who bird-dogs the funds.[20] Or, if I were an Internet propeller-head, I could query the hundreds of certified financial planners and accountants or the message board staffed by pros at various Internet sites.[21] Or, being the old accounting hot dog that I am, I could read the annual reports of the mutual funds.[22]

IMPACT OF CONSUMERISM ON THE U.S. FINANCIAL SYSTEM

Consumer-driven information and control created enormous wealth for investors. The Dow-Jones index zoomed from 777 in 1982 to more than 10,000 a decade later.[23] From 1980 to 1998, the total annual return on stocks exceeded

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17 percent, whereas the treasury bill return averaged a meager 5 percent from 1990 to 1998.[24]

These benefits accrued to average consumers, not only to Big Bops. By 2002, millions of Americans, nearly 50 percent of all households and 84 percent of adults, were invested in the stock markets, as compared to 19 percent of households and individuals in 1983.[25] In 1980, Americans saved most of their money, $160 billion, in low-interest-earning bank accounts and money market funds and placed only $2 billion in mutual funds, but by 1996, they had reversed these strategies: investments in the low-earning funds increased by only $40 billion, and mutual fund investments grew by $195 billion.[26] In 1998, the median family with the head of the household aged fifty-five to sixty-four held $58,000 in mutual funds and $21,000 in stocks.[27]

The benefits were widely spread. All income classes invested. In 1998, middle-class households, earning less than $100,000 a year, accounted for half of all the households owning mutual funds. Low-income households, earning less than $25,000, accounted for 10 percent, and lower-middle-income ones, earning more than $25,000 but less than $50,000, accounted for another 14 percent.[28]

Investors also benefited from the increasing efficiency of the market. As the volume of transactions rose, fueled by broader participation, the cost of executing these transactions declined. In 1980, the commission earned per share traded was roughly $.44; by 1997, these charges had decreased to $.02 per share.[29] Put another way, the commissions earned by the securities industry declined from 1.4 percent of the value of the stocks exchanged in 1980 to .05 percent in 1997.[30]

As a result of this broad participation and efficiency, the capital markets in the United States became the envy of other developed countries. A reporter noted of his meeting with Jiang Zemin, the president of China, "[He] spoke wistfully of the Nasdaq . . . being the crown jewel of all that is great about America."[31] The U.S. securities industry grew increasingly efficient. For example, in 2000, New York Stock Exchange fees and commissions for an average trade were 38 percent of the average figure for forty-two countries.[32]

Those who had predicted that consumers would be raped and pillaged in the investment field were disproved in a landmark study that compared the returns earned by consumers in defined contribution plans and by smart-money investors in defined benefit plans.[33] Study coauthor Andrew Samwick summarized the results this way: "When control was devolved from the central fund to the individuals, they organized their compensation, contributions, and . . . choice in such a way as to increase their own retirement security relative to the DB regime."[34] Watson Wyatt Worldwide determined that the returns of 401(k) plans outperformed the smart-money DBs not only in the boom period from 1995 to 1998 but also in the down market years of 1990

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and 1993 to 1994.[35] These results are all the more remarkable because they were achieved by employees who were operating with one hand tied behind their back as their employers stuffed their 401(k)s with company stock, a matching employer contribution that participants often could not readily sell. In 1999, 19 percent of their assets were allocated to company stock.[36]

Why did the returns earned by consumer-led retirement plans outperform those supervised by their employers? Simply put, agents whom you do not directly supervise may not necessarily work in your best interests. For one thing, they cannot know your individual preferences. Further, the interests of some agents may differ from yours, and in the absence of your direct input, you cannot steer them right.

Consider this hypothetical example, drawn from my experiences while serving on the boards of directors of twelve publicly traded companies. An old-line, New York City firm invested its defined benefit retirement funds through an old-line, New York City money management firm. The two institutions enjoyed historical ties, a tradition maintained by the firm's CFO and the money manager, who regularly played squash together. Unfortunately, the money manager's results were abysmal. Yet the CFO was reluctant to dismiss him. He worried that his squash partner would lose his job and was concerned about disrupting the historical relationships between the firms. Such conflicts are rife in public pension management.[37] One public pension official notes, "In places where politicians are up to their eyeballs in handling investment operations, there's always the potential for a conflict of interest."[38] For example, the California state treasurer's decision, made on social grounds, to sell some $800 million of tobacco stocks owned by public retirement funds may have cost retirees nearly half a billion dollars in lost appreciation. A *Business Week* editorial noted that "state pension funds are steered into treacherous waters when political grandstanding forces them to mix controversial social goals with their clear financial mandate."[39]

Last, the absence of direct oversight by investors may also tempt managers to commit out-and-out fraud. Pension scandals abound, including the kickbacks paid a Connecticut treasurer by private equity firms for his outsize investments in them and the free patio furniture given to an Ohio public pension fund manager who bought 8,258 imported lightbulbs and fifty-gallon drums of floor wax for his largely carpeted office space in return.[40]

This is not to say that agents are unnecessary; to the contrary they can be invaluable. One analysis pegged the savings achieved by the customers of the automobile information aggregator Autobytel at $20 million, for example.[41] Similarly, *Consumer Reports* found substantial savings, up to $54 a night, between the rates hotels quote to on-line brokers and those quoted to individual consumers. Two of the brokers achieved better rates 60 percent or more of the time.[42] In pension investing too, most investors rely on mutual funds as agents that select stocks on their behalf. Reliance on them can be well rewarded: for

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example, a dollar invested in large company stock funds in 1980 was worth $14 in 2000.[43]

The critical question is who controls the agent? In consumer-controlled retirement plans it is the investor. In defined benefit plans, in contrast, the mutual funds are selected by an agent who is acting on your behalf but who is not directly controlled by you.

To observe the same agent effect in health insurance, consider the following vignette:

In the first year of performance measurement of hospital outcomes in the Cleveland, Ohio, area, the only hospital to achieve better-than-expected ratings was the Mount Sinai Medical Center. Though little known, it expected major shifts as a result. "We thought for sure that if we were on top of the heap that, by golly, it should direct some business to us," noted its then CEO.

Guess what? The shifts did not happen.

To understand the reason, consider the response of Lubrizol Corp., a 3,000-person local employer. Although it included Mount Sinai among the five hospitals its employees could use under their insurance, it also included some that achieved "worse-than-expected" mortality ratings. "We were not all that aggressive" on the quality issue, noted Lubrizol's global quality manager.[44]

This manager is not alone. Although employers aver that quality of care is very important in selecting health plans, only one-third obtain quality information, and health plans say that employers are much more concerned with cost than with quality.[45] Although the range of employers that formed the Leapfrog Group are working valiantly to improve this situation by paying the providers who meet their selected quality criteria more than those who do not, would employees choosing for themselves be more "aggressive" on the quality issue?[46] The success of high-quality foreign car firms in decimating low-quality U.S. manufacturers' domestic market share testifies to the American public's interest in that characteristic.

WHY 401(K)S ARE A GOOD MODEL FOR CONSUMER-DRIVEN HEALTH CARE

During a recent briefing on the subject of consumer-driven health care, the members of the *Boston Globe*'s editorial board listened to me with interest, courtesy, and some sympathy. But they cringed when I used 401(k)s as an example of a consumer-driven product. "These plans are a disaster, workers have lost their shirts, how will their retirements be funded?" they correctly noted. When we left the meeting, James Aisner, the brilliant communication director for the Harvard Business School, advised me to drop the analogy. I typically treasure his advice. But this time I decided not to follow it.

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Sure, 401(k) assets dropped as the stock market declined in the early 2000s; but in the long run, they have performed well. And the "expertly" managed assets of the defined benefit plans declined as well. Real life is never a straight uphill climb. Neither 401(k)s nor DBs are foolproof. In down stock markets, both lose value. Many DB plans were underfunded: by as much as $4.5 billion at General Motors, $1.2 billion at Ford, and $1.4 billion at United Technologies.[47] Between 1999 and September 2001, the liabilities of DB plans outstripped their assets by 45 percent.[48] A 2002 study indicated a staggering $243 billion shortfall among 360 firms in the Standard & Poor's 500 Index.[49] The assets of consumer-controlled plans also dropped.[50] But of the $1.1 trillion increase in the value of 401(k) plans between 1995 and 2000, $846 billion was earned through the market appreciation of the assets that consumers selected.[51]

Of course, 401(k) plans must be reformed to ensure that participants receive adequate retirement income. Who can ignore the plight of employees in stumbling companies like Lucent, whose 401(k)s shriveled as the stock plummeted from a price of $63 in December of 2000 to $1 in August of 2002? But concerns about the adequacy of 401(k)s to fund retirement income do not negate the fundamental point of my analogy. These are important concerns, to be sure; but my interest is to demonstrate that when consumers invest for themselves, they do a good job of it: *to my mind, 401(k)s demonstrate the ability of consumers to manage their financial affairs.*

HOW CONSUMERISM IMPROVES THE ECONOMY

The explosion of U.S. productivity from 1995 to 1999 also illustrates the impact of consumerism. A 2002 McKinsey report revealed that six sectors accounted for virtually all the growth. When I ask my lecture audiences to identify them, most correctly cite the high-tech manufacturers—companies that produce computers, semiconductors, and telecommunications equipment. But the primary contributors to productivity were three low-tech sectors that virtually nobody names: wholesale trade, retail trade, and securities and commodity brokerages.[52] Two of these three sectors that jump-started U.S. productivity are consumer driven, and all are service providers.

The ferociously competitive retailing sector illustrates how consumers drive productivity. Challenged by customers who demanded more, better, and cheaper services, smart companies, like Wal-Mart, responded with numerous innovations such as everyday low pricing and cross-training of employees that enabled the company to simultaneously control prices, increase profits, and grow sales volume. Savvy competitors emulated Wal-Mart.[53] An explosion of choice in consumer products helped consumers get their way: in 1997, there were 77,000 book titles, 790 magazines, and 1,742 community colleges. The choice in each of these categories has increased by at least 150 percent from 1970.[54]

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How can these essential productivity-creating characteristics be replicated in health care?

Consumer-driven health care requires that employees have two "C"s and an "I": substantially greater *choice* of highly differentiated health plans, *control* over how much they spend for various health care needs, and *information* to aid their choices. The expansion in choice and control responds to the employees angered by managed care's just-say-no constraints. Competition among newly differentiated products helps to control health care costs, and direct selection by informed employees ensures that costs are moderated by improving quality and not by jettisoning appropriate standards of care.

HOW MARKETS WORK

How does all this happen? After all, the average person is not an expert about most of his or her purchases.

One reason that average people can reshape whole industries is that markets are guided not by the average consumer but by the marginal one. In English, this economic jargon means that producers respond to their *last* customers, not to their *average* customers. Typically the last ones to buy drive the toughest bargain; they are the show-me crowd. These hard-nosed buyers are heavy consumers of information and are adept in interpreting and using that information.

To understand how this market mechanism works, consider my purchase of a car. I confess: I have only the dimmest notion of how a car functions. After all, a car is a high-tech device, studded with microchips. My notions of the mechanical compression and ignition of gasoline that lead to an explosion whose energy ultimately rotates the wheels of a car are as dated as my first car, the 1957 Dodge that I purchased in 1966. It got seven miles to the gallon, rivaled a stretch limo in length, and belched pollutants.

I do not think that I am alone in my ignorance. When I see someone in an automobile showroom peering under the hood of a car, I think to myself, "What the heck are you looking at?" Nevertheless, like all Americans, I can now readily find the kind of car I want at a price I am willing to pay. My quality choices have increased substantially since 1966, at the same time as the cost of a car has decreased as a proportion of income.

How is it that an ignoramus like me can easily find cars that are better and cheaper?

And as only one person in a vast sea, why am I not pillaged in the automobile market?

The answer to these questions illuminates how markets work so that even ignorant solo participants, like me, are offered better and cheaper products.

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Two ingredients are crucial to an effective market.

One of these ingredients is information.

Information enables me to be an intelligent car shopper, despite my ignorance.

How does it work? It's simple. I review the rating literature to look for a car that embodies the attributes I seek: safety, reliability, and price. Thus, when I studied *Consumer Reports* for cars with these attributes, two brands caught my eye: Volvo and Buick. I confess. I skipped the earnest reviews of how the engines work, the fuel efficiency, the comfort, the handling, the styling, and so forth. These attributes of an automobile are important to many people, but I am not among them. Safety, reliability, and price—that is what interests me. And objective information about the attributes in which I am interested is easily available to me.

I opted for the Buick. Although it was not as reliable as the Volvo, it was cheaper and had more of the heft that I associate with safety.

But many of those who shared my views of a car's desired characteristics opted for the Volvo. The car grew from an obscure Swedish brand to a substantial one with sales of 100,000 cars in 2001.[55] During this period of growth, Volvo's rivals came to understand that a meaningful number of their customers were interested in safety and reliability and introduced these qualities into their cars. In the quest for safety, some of them acquired rival brands. Thus, *Business Week* labeled Ford's 1999 acquisition of Volvo as an attempt to obtain "cars for safety-minded yuppies."[56] Other automobile manufacturers improved their reliability. By 2000, U.S. cars equaled European ones in reliability, and the Japanese cars had only a small edge. Quite a change from 1980 when U.S. cars were three times as unreliable as Japanese ones and twice as unreliable as European vehicles.[57]

So that is how cars became better even when the consumer is a doofus like me.

Information makes dumb people like me smart.

But what stops the car manufacturers from refusing to cut their prices?

After all, I am only one person.

I buy only one car.

Why should they reduce their prices for me?

The answer is that in the competition for my business, they will continue to cut their price up to the point where the revenue from the extra volume they bring in is equal to the extra cost of making and selling that additional car.

Do you smell something in the air? It is the stale aroma of your freshman college economics course. Price equilibrium is achieved at the point where marginal revenue equals marginal cost.

Yes, the second key ingredient in a competitive market is a downward-sloping demand curve, the old standby of Economics 101. The psychology behind a downward-sloping demand curve demonstrates the importance of the last few buyers in determining the price.

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At a high price, there are only a few buyers and they are more or less indifferent to price. The good news is that they are willing to pay a very high price. The bad news is that there are only a few of them. As providers reduce their prices, they attract more and more customers. The increased volume of customers more than compensates for the cut in price. Providers continue to reduce their price until they hit a brick wall: the last picky, tough-minded customers who set the price. At this price, the extra revenue the providers generate from sales to the hard-bargain drivers is roughly equal to the extra cost of manufacturing their purchases. All the rest of us benefit from the assertiveness of the last-to-buy crowd.

This relatively small group of demanding consumers seek out the suppliers who will reduce price and improve quality. For example, a fascinating McKinsey study showed that a small group, only one hundred investors, "significantly affect the share prices of most large companies."[58]

The car market also illustrates their prowess. Currently, automobile prices are the lowest they have been in two decades. In 1991, for example, the average family had to spend thirty weeks of income to purchase a new vehicle, but by 1999, a new vehicle required only twenty-four weeks of their income—a 20 percent decline.[59] Simultaneously, automobile quality is at an all-time high. The range of choices is better too, as the quality differences between the best and worst manufacturers have declined.

How did automobiles become both better and cheaper?

Ford Motor's ex-CEO knows the answer:

> Automobile prices are at all-time relative lows as customer affordability and values are at best-ever levels. This situation is primarily driven by excess worldwide production capacity, more open global competition, and much better informed customers. In this environment, prices are relatively stable while quality, technology, safety, and upgraded features improve customer value. Additionally, although the power of the brand remains a strong customer differentiator, it is important that the promise of the brand is absolutely delivered.
>
> The customer is the clear winner.[60]

In the auto market and most other markets, these two characteristics—information and a group of picky consumers—enable the rest of us to obtain a good product at a good price.

ARE AVERAGE JANES AND JOES SMART ENOUGH TO BUY CONSUMER-DRIVEN HEALTH INSURANCE POLICIES?

Some policy analysts argue that a consumer-driven health care system cannot work because average consumers will be stymied by the process of selecting among differentiated health insurance products. Instead, they say, the process must be increasingly centralized into the analysts' able hands. As one notes, "The

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approach of trying to give people the purchasing power to operate in the current insurance market assumes too much about individual purchasing abilities."[61]

Like some others who denigrate the astuteness of consumers, the author of this statement, Lawrence Lewin, is hardly a disinterested observer. As the leading industry journal *Modern Healthcare* has noted, his firm, The Lewin Group, is known for its "very very expensive" studies, often used by the health care organizations that commission them "to advance the client's political positions."[62] A consumer-driven health care system, in contrast, depoliticizes the environment because it relies on consumers, not politicians, to allocate resources. It also threatens the interests of those who rely on the status quo.

Although it is hard to understand why we should continue to entrust the selection of health insurance to those who have made such a hash of 15 percent of our GNP to date, critics like Lewin raise an interesting question: how do average consumers fare when they buy other complicated products, such as computers, cars, and mutual funds? After all, most of us have little idea of how high-tech computers and cars work, and as an old accounting teacher, I can personally attest to the fact that most people lack the expertise needed to evaluate the performance of mutual funds. Yet average consumers do surprisingly well in buying complex products. The price of cars and computers, as a percentage of income, has steadily decreased while their power, safety, quality, and reliability has increased. And when it comes to mutual funds, even after the downturn in the U.S. stock market, the American public was sitting on billions of dollars in unrealized stock market gains in their defined contribution funds.

How do consumers who are baffled by the functioning of a microcircuit, an internal combustion engine, and an investment portfolio, nevertheless obtain better and cheaper products over time?

Information and a group of assertive consumers, as I have discussed, are key. Another critical element is the changing face of the American consumer. Current generations of Americans are much better educated than prior ones. In 2000, 25.6 percent of the population had attained a college education or more and 84.1 percent were high school graduates. In 1960, in contrast, fewer than half the people were high school graduates and only 7 percent had a college education.[63] These higher levels of educational attainment have increased individuals' ability to obtain and interpret information as well as their self-confidence. One example of this change is manifested by the Christians who increasingly stand rather than kneel at church, likely to express their notion that the service provides an opportunity for a personal encounter with God rather than an opportunity only to reverentially worship him. About 80 percent of the pews ordered from the country's largest manufacturer now come without kneelers.[64]

Affluent Web surfers also typify the characteristics of this better-educated group—they spend much more time than others searching for information on the net before making a purchase and are much more likely to buy, once they

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have found a good value for the money.[65] Policy analysts who focus on their affluence miss the point. Affluent or not, they eat the same bread, buy the same appliances, wear the same t-shirts, and use the same gasoline and oil as we. Their activism improves these products for the rest of us.

Do not get me wrong. If I were queen, I would push hard to ensure universal literacy. But markets function well even when consumers have very mixed abilities, as long as they contain information and a small group of smart, picky, I-want-what-I-want-when-I-want-it-at-a-rock-bottom-price consumers who force providers of goods and services to offer many choices from which they can select.

Health care consumers who typify these characteristics abound. Some express their activism directly by mastering medical skills, such as CPR and the use of external defibrillators.[66] Others search for information, such as the 1.8 million people who spent an average of twenty minutes each at the government's National Institutes of Health Web site, studded with highly technical medical journal articles, in September of 2000.[67] A 2002 report found that seventy-three million people in the United States had used the Internet for health information, six million of them daily.[68]

The assertiveness and self-confidence that typify American consumers are even more strongly evident among health care Internet users. They agree more than average U.S. adults with the following statements: "I like to investigate all options, rather than just ask for a doctor's advice," and, "people should take primary responsibility and not rely so much on doctors."[69] Their pragmatism is apparent too. They do not search idly. More than 70 percent want on-line evaluations of physicians,[70] and when they obtain the information, they use it.[71] Nor is consumer assertiveness limited to the United States. For example, 70 percent of Canadian doctors say that their patients are briefed by Internet information.[72]

Although the characteristics of these Internet health care users mirror those of general users—they are primarily affluent and college educated—interest in health care information crosses all demographic categories; thus the percentage of non-college-educated users who searched for health care information, 40 percent, almost equaled the percentage of college-educated users, 50 percent.[73]

In response, some nascent sources of helpful information about heath care and insurance have already emerged. For example, the Massachusetts firm Consumer's Medical Resource provides information on forty-three medical conditions, derived from sources such as the Harvard Medical School and the *New England Journal of Medicine.* This information "helps you know everything about a disease," notes the company's founder. The service has helped individuals locate additional medical advice that aided one to avoid a heart transplant for her child and another to disprove a diagnosis of Parkinson's disease.[74] Similarly, CareCounsel, of San Rafael, California, helps mediate and

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expedite HMO or insurance-related questions and problems. For example, it gave one employee guidelines for writing an appeal of Kaiser's denial of coverage. Kaiser officials agreed with his appeal arguments and paid the bills. "The only thing I had to pay were some charges on my deductible," he reported.[75]

Nevertheless, as the old blues song noted about men, good sources for health care information "are hard to find. You always get the other kind."[76] Sure, plenty of data are available, but the information about the quality of health care providers, which is what people want and need to make intelligent decisions, is notable for its absence. (For a fuller discussion, see Part Five and the section of Chapter Six entitled "Health Care Policy Revolutionaries: The Role of Government," which discusses how government can ensure data availability, relevance, and integrity.)

LESSONS FROM CONSUMER-DRIVEN RETIREMENT PLANS

The very scale of the shift to consumer-driven health care is worrisome. Its monumental size creates opportunities for more and bigger mistakes than a smaller, more modest shift would offer. Those who have already been badly burned by the large-scale shift to managed care are rightly concerned about yet another mistake.

Fortunately, we can learn from the similar change that took place in the retirement benefits area more than two decades ago, when many employers expanded their pension plans from defined benefits (DB) options to include defined contribution (DC) as a choice. This shift was propelled by forces similar to those prompting a shift in health care benefits. For one thing, employers became ensnarled in spiraling mountains of red tape as the U.S. Congress increased regulations on the pension field, causing potentially embarrassing full disclosure of underfunding of DB plans. The 1974 Employee Retirement Income Security Act gave employers a way out of these administrative and financial nightmares by increasing the tax advantages of DC plans. Then too, the changing face of U.S. business was evident even back then, and newer, smaller firms naturally gravitated toward the administrative simplicity of DC plans. And last, mobile U.S. employees welcomed the portability of DC plans and, likely, the personal control they enabled.[77]

Although not precisely analogous, the characteristics of DC plans are similar to those of consumer-driven health care in the following ways:

1. *Both have similar roles for employers.* The employer's role is to enable a contribution to the employee's retirement plan, provide a menu of pretax investment options, and support the employee's decision-making process about these

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options. Similarly, under consumer-driven health care, the employer's role is that of enabling contribution of pretax money and providing a rich menu of choices and support to the employee. (The employer's role in health insurance is fostered by our tax laws. Under 2002 U.S. income tax laws, the employer's payments for health insurance are tax deductible, and the employee does not pay income taxes for them. Conversely, individuals who purchase health insurance must pay for it with after-tax funds and, in most cases, cannot deduct these expenses from their taxes. The 2003 Medicare Drug Reform Act also changed the status of health-savings accounts, as discussed in Chapter Fifteen.)

2. *Both have similar roles for employees.* The employee has primary responsibility for selecting specific investment vehicles in DC plans. Similarly, under consumer-driven health care, employees choose the health options that best meet their needs.

3. *Both enable pretax employer contributions.* As in DC plans, in consumer-driven health care, contributions for the purchase of health insurance are made with pretax funds. And in the judgment of most experts, employer contributions to health savings accounts that fund discretionary purchases of health care are not taxable.

4. *Both support choices that are more portable.* Balances in DC retirement accounts belong to the employees and can be moved by them if and when they change their employment situation. Similarly, because the insurance policy in a consumer-driven health care system is tailored to the needs of individual employees, it can be more readily transferred if they change their employers, and deposits to the health savings accounts are portable.

Lessons About Investors and Employers

Many of those who worried about the shift from DB to DC plans were concerned about the investment acumen of employees and the integrity of employers. They feared that Americans would not participate or, conversely, that firms would seize the opportunity to abandon their support of employees' retirement needs. Others focused on the equity of the arrangement; they wondered if low-income employees or those in smaller firms would get locked out of the market. Last, some fretted that employees would misuse their ability, in some DC plans, to borrow against their savings or would fail to diversify their holdings.[78]

A Fidelity Investments study of its DC plans, which the firm claims are representative of the national average, disproved many of these concerns. The study showed that 75 percent of eligible employees participated. Participation rates varied inversely with plan size. Contrary to prior expectations, Fidelity found higher participation rates, 84 percent, in smaller plans. Highly compensated participants and less-well-paid participants defer approximately equal percentages of their income for retirement, regardless of the employer size.[79] A 2002 survey by another firm pegged the average percentage of income deferred at 9.[80] In the

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Fidelity study, 62 percent of lower-income earners, with incomes between $20,000 and $29,999, saved for the future. Overall, plan participants had healthy savings, with average balances of $60,000. Nonparticipants in DC plans cited their financial situation as their main reason for not enrolling, but they were more likely than plan participants to hold financial assets other than DC plans. For example, 24 percent of nonparticipants owned CDs as contrasted with 2 percent of DC participants.[81]

All in all, Fidelity concluded that "[p]articipants appear to approach retirement saving sensibly." They do not churn their investments: "only a small fraction make more than one exchange a year, and 80 percent do not borrow against their balances." Those who borrow likely do so for financing other investments for the future, such as the purchase of a home or education. They also diversify their holdings: "In plans with more than ten investment options . . . over half of the participants hold at least three funds and one-quarter hold five or more."[82]

As for the concern that employers would opt out of funding retirement plans, in the period between 1989 and 1998 employers increased their annual contributions to pensions by more than $20 billion.[83] Seventy-six percent of Fidelity's plans had some form of employer matching. A majority offered a 26 percent to 50 percent match of the participant's contribution, and a quarter offered a match of 75 percent or more. The effective match averaged between 2.1 percent and 3 percent of the participant's income. Matching was independent of the size of the firm.[84]

Many defined contribution plans offer their participants convenient, fair access to their services with withdrawal, conversion, and vesting features. Fidelity's analysis indicated that 83 percent of plans permit some form of in-service withdrawal (although partial withdrawal is generally forbidden by federal regulations), 90 percent allow participants loans against their balances, and 98 percent permit daily exchanges among funds.[85]

Lessons About Suppliers

Some critics also questioned the vaunted administrative simplicity of the switch. Who would provide employees with the choice, information, and support they required? After all, at that time, few investment vehicles were targeted to consumers. Most were aimed at institutional investors. Information was virtually nonexistent. And would small firms lock their employees out of the pension market because of the prohibitive cost of administering DC plans?

Most of these concerns proved unfounded.

To begin with, entrepreneurial, consumer-oriented mutual funds entered the market. Their number increased from 600 in 1980 to 5,800 in 1995.[86] "By making the capital markets easily accessible to ordinary citizens, mutual funds have made an important contribution to both the democratization and the strengthening of the U.S. economy," notes one expert.[87]

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The history of the entrepreneurial, DC mutual fund providers is instructive to the consumer-driven health care movement. In the early 1980s, a few mutual fund companies—Fidelity, Vanguard, and T. Rowe Price—targeted the new 401(k) market. Their decision to compete on the basis of their returns, services, and costs proved successful. For example, as Vanguard shaved its operating costs to become the low-cost producer and focused on its service, its assets boomed. Noted one Vanguard official, "The big thing we did differently . . . was to treat the participants in the 401(k) plan the same way as the other (institutional) investors in our funds. This meant valuing their accounts every night, giving them an 800 phone number, and allowing them to switch from one fund to another."[88]

These entrepreneurial providers took substantial market share away from the banks that in 1988 held 32 percent of all 401(k) assets while mutual funds accounted for only 14 percent. A decade later mutual funds commanded a 37 percent market share while the banks' share plummeted to 22 percent. Entrepreneurial mutual fund firms provided employers with a full spectrum of services that the banks struggled to match. Fidelity, for example, offered a number of different types of funds, a brand name, and record-keeping and administrative services. When banks tried to compete, they "started to blow up," noted one retirement services specialist. "They experienced substantial service problems and loss of personnel."[89]

A relentless focus on the consumer was critical to the success of the mutual fund firms. "[B]anks had no culture of dealing with the individual," said a Vanguard spokesperson. "What separated us . . . was putting emphasis on participants' needs, in addition to the corporate clients."[90] This focus is implemented through detailed management techniques. Vanguard's CEO checks daily on how fast the firm's telephone representatives respond to callers and sustains a corporate culture in which employees are called "crew members."[91]

A focus on costs has been key too. Fund expenses declined steadily from 1993 to 1999. The reason? Investors rewarded low-cost firms. They understood that seemingly minor differences in costs can cumulate to substantial differences in returns. For example, $10,000 invested in a sample Vanguard fund in 1982 would have been worth $163,000 in 2002, with an expense ratio of .22 percent, and $110,000 in a general equity fund, with a ratio of 1.29 percent.[92] Last, most funds offered educational assistance to investors. Some even tailored their educational messages to the specific attributes of the audience. American Express, for example, segments its educational messages to forty-four classifications of investors. Its "East Coast" immigrant group, for instance, is targeted with video-based education because of the group's high rate of video rentals.[93]

These entrepreneurial firms turned to the small employer market. In 1999, Fidelity's entrance into that market reduced the costs of a 401(k) to a small company by an estimated 50 percent.[94] At that time only 32 percent of firms with

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fewer than one hundred employees had DC retirement plans;[95] but the rate was expected to grow at 15 percent a year.[96] The number of attractive vendors was one reason for the expected growth. For example, a plan jointly marketed by Fidelity and the U.S. Chamber of Commerce contained features equal to those offered to large employers: 24/7 access, daily valuation, ample information, and eight fund options. Similar plans were offered by the payroll processing firm ADP,[97] Travelers Insurance, Smith Barney, Metropolitan Life Insurance, and others.[98]

Once again, entrepreneurs gave the status quo providers a run for the money. The insurance companies and banks that once dominated the small-employer markets were forced to change their ways. For example, Aetna, then one of the largest providers of small plans, lowered its fees by as much as 33 percent and added many new investment options in response to Fidelity's planned entrance. Yet even with these decreases Aetna's expense ratio of 1.3 percent to 1.55 percent remained higher than Vanguard's.[99]

But the DC movement was not entirely successful.

For one thing, some of the employers who were permitted to match employees' contributions with stock did so with a vengeance. The 401(k) assets of a few large firms, such as Abbott Laboratories, Coca-Cola, and Procter & Gamble, were more than 80 percent invested in company stock and some firms locked their employees into long-term prohibitions against selling these stocks.[100] In 1999, 19 percent of the assets of all 401(k) participants were in company stock, but in plans that offered company stock, the percentage jumped to 36.[101] As the market value of firms such as Lucent collapsed, the value of the employees' underdiversified 401(k) assets took a commensurate nose-dive.

Then, too, the quality of the disclosure and oversight of corporate financial performance proved less than optimal. For example, when the energy trading firm Enron filed for the largest bankruptcy in U.S. history in 2001, a number of shenanigans were uncovered. For starters, major debts had been kept off the balance sheet, and self-dealing partnerships between the firm and purportedly independent corporations led by Enron's top management had been only murkily revealed.[102] In addition, the auditors and lawyers hired to protect Enron's shareholders with professional, expert oversight, appeared to be paper tigers.[103] Government oversight of corporate disclosure has already become much more aggressive as a result. In the first two months of 2002, the SEC more than doubled its financial accounting inquiries, for example.[104]

Applying These Lessons to Consumer-Driven Retirement Plans

What conclusions can we draw from all this?

On the plus side the DC retirement plans democratized investment. More than one hundred million Americans were able to participate in the booming equity markets through entrepreneurial, low-cost, high-performance mutual

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funds that tailored their services to these individuals' needs. Many participants benefited substantially from the process.

Employees demonstrated that they were sensible investors: they participated substantially in DC plans, made prudent investment choices, and employed their saved capital in useful ways. Employers too continued to contribute to DC plans, negating concerns that they would opt out of the retirement benefits area.

Competent entrepreneurial mutual funds firms, including well-regarded financial giants such as Fidelity and Vanguard, responded to this new market by providing excellent, low-cost services. These firms offered their services to small customers as well as large ones. Intense competition among them led to continuing cost decreases and quality improvements. In addition, raters, such as Morningstar, that provided authoritative, objective, easily comprehended evaluations made it possible for those who were not financial wizards to participate intelligently.

On the negative side the remaining corporate restrictions on the ability of employees to invest freely, in the form of company stock matches locked in for the long term, subjected these employees to great risk. And government must act more aggressively to ensure transparency and integrity in the market.

When these lessons are applied to consumer-driven health care, they imply that employers, employees, and entrepreneurial firms will behave rationally and responsibly. Specifically:

- Employers will continue to offer health insurance benefits and pay a share of the costs, in line with their economic circumstances. As the U.S. economy boomed from 1987 to 2000, U.S. employers increased their share of the payment of health insurance premiums from 69 percent to 76.4 percent.[105]
- Employees will purchase insurance and act to protect their health status. In a 2002 survey a majority considered the choice of health plans to be the most critical benefit decision they make.[106]
- Entrepreneurial firms will supply the innovative insurance and information products that consumer-driven health care requires. They will force status quo providers to shape up or ship out. The competition among them will continually improve products and reduce costs.
- Consumer-driven health care may well *expand* the number of small employers that offer insurance, just as many small employers are now offering 401(k) plans, and also expand the market for individuals. For example, by 2002, 800,000 Californians had already purchased the innovative consumer-driven insurance plans first offered by Blue Cross in the individual market in 2001.[107] One likely reason for their popularity is their low cost. For example, a mother in her early forties who lived in

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> Los Angeles could purchase a plan for her children and herself for as little as $1,400 a year.[108]

At the same time, consumer-driven retirement plans underscore the importance of the government's role in creating the performance disclosure and oversight that is the key to any consumer-driven activity. As *Business Week's* Michael J. Mandel notes, "while voluntary risk-taking in the pursuit of innovation and growth is both desirable and commendable . . . transparency is an essential [characteristic]."[109]

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