

Testimony of Gary Wolfram, Ph.D.  
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Senate Health Policy Committee  
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Mr. Chairman and Members of the Committee:

I would like to thank you for taking the time and effort to analyze HB 5284 and HB 5285, two bills which have until now received little attention. These bills, as passed the House, present significant philosophical, practical, and economic issues that ought to be fully explored. Your efforts are to be commended.

First, I would like to say that Blue Cross Blue Shield of Michigan (BCBSM) is a fine company that has served Michigan citizens well for seven decades. These bills are no doubt in the best interest of the Board of BCBSM and the management. While often it is the case that legislation proposed by BCBSM will also be in the interest of the people of the state of Michigan, unfortunately, HB 5284 and HB 5285 are not in the interest of the Michigan citizenry. They will create unintended consequences that will distort the insurance market leading to less competition and higher rates for health care and other insurance. These effects will also seep into the Michigan economy as a whole and place a drag on our economy.

Mr. Hertz of BCBSM was quoted in the April 14 *Crain's* as saying that the coalition "Will come to the committee meeting with guns loaded and empty every chamber." This frames the debate as if it were a battle of special interest groups and whoever has loaded guns will win. It is important to emphasize that the question is rather about public policy and in particular the mission of BCBSM. First we must decide if its mission has changed to the point where it needs to operate as a parent company for profit-making entities, and second, if its mission has changed, then what is the correct method of dealing with this.

I would like first to address briefly the philosophical issue regarding the purpose of BCBSM and why it is not regulated under the Insurance Code, but rather has its own statute as a tax-exempt organization. The Committee, I believe, has my paper discussing these bills and so I will here briefly summarize the points. It is important to understand the history of Blue Cross to see that these bills, as passed the House, would have completely changed the mission of the corporation, and in the substitute would still lead to a significant change in its mission.

BCBSM has its origins in the Great Depression. In 1929 the President of Baylor University was faced with the closure of the university's hospital. He hit upon the idea of organizing the local teachers, having them pay 50 cents per month to the hospital and in return the hospital would guarantee 21 days of hospital care for the teachers. This was adopted by the teachers and other local employer groups and resulted in cash flow that saved the hospital and guaranteed hospital care for the subscribers. Soon the concept spread throughout the country. In 1935 there arose questions about whether these organizations of subscribers were insurance companies. If so, it would create all sorts of

regulatory problems. In 1935 New York enacted a statute that said these associations were charitable non-profit entities outside of the insurance code. Michigan adopted two similar statutes in 1939, one for hospital subscribers and one for doctors. In 1974 the Legislature enacted a statute combining the two organizations and in 1980 a further major change altered the board, giving control of Blue Cross Blue Shield of Michigan firmly to subscribers. Section 102 of that Act states: "Each corporation subject to this act is declared to be a charitable and benevolent institution."

Two points are to be made from this history. First, the purpose of BCBSM is to be a charitable organization designed to provide low cost health care for an organization of subscribers. Second, the 1980 change in the Board led to a Supreme Court decision that determined that BCBSM, to quote the majority, "functions as a quasi-public, tax exempt institution." In a later case, Justice Levin added, "BCBSM has in effect become a controlled subsidiary of the State of Michigan." This ensured that BCBSM will be intimately tied into the political process.

These are important points because allowing BCBSM to own subsidiaries, any company in the case of HB 5284 as passed the House, a provision wisely removed by the current substitute, moves BCBSM well beyond its mission and entraps any of the subsidiaries into the political arena to an extent that is not healthy for the political or economic systems of Michigan. As passed the House, BCBSM could purchase American Axle, for example. Once American Axle is a wholly owned subsidiary of BCBSM, then there will be every incentive for BCBSM to lobby for legislation to assist American Axle, particularly if losses at American Axle reduce BCBSM reserves. If BCBSM wants to move beyond a non-profit organization that allows individuals to contract with providers for health services, then the legislature should consider if the mission is outdated and if so move BCBSM under the insurance code, treating it like any other insurance company.

To do this an economic question jumps to the forefront. BCBSM because of its tax-exempt status is able to accumulate surplus more easily than if it were taxed. Take a simple example. Company A and company B both earn \$100,000 per year. Company A does not pay taxes, while Company B pays 10% of its income per year in taxes. At the end of 5 years, Company A will have \$500,000 to use to bid for Company C, whereas Company B only has \$450,000 to bid for Company C.

This is one of the reasons that I testified against allowing BCBSM to purchase the Accident Fund in 1993. I felt that my former boss, John Engler, was not truly privatizing the Accident Fund and allowing BCBSM to purchase it would allow BCBSM to use its tax exempt earnings to affect the workers compensation market. The Legislature at least recognized the problem by inserting Section 418.701a(7), which required BCBSM to pay to the Treasurer an amount equal to the SBT taxes it would have paid in earning the money used to acquire the Accident Fund. In my opinion this was not sufficient.

If BCBSM were to be treated as a regular insurance company it should pay the state an amount equivalent to the taxes it would have paid in building up its assets over the years. When California privatized its Blue Cross, Blue Cross surrendered the value of its assets,

\$3.2 billion to create two charitable foundations. According to a recent article in *Forbes Magazine*, in the ensuing years 15 Blue Cross Blue Shield plans gave up their tax-exempt status and surrendered the value of their assets. If BCBSM of Michigan were to follow suit, it would give up over \$6 billion to be used to provide additional health care to Michigan citizens.

The economic problem created by HB 5824 and HB 5825 is by allowing BCBSM to own subsidiaries you alter the economic outcomes in the insurance industry and grant an advantage to BCBSM subsidiaries. The advantage is both in the ability to use tax exempt earnings to aid subsidiaries and to bundle services in a way that insurance companies cannot. As noted in my report, BCBSM has 70% of the commercial health insurance subscribers. If BCBSM and/or its subsidiaries are able to enter any line of insurance, it would allow BCBSM to use its dominance in the health insurance industry to capture substantial portions of other lines of insurance. This is not just because the parent company operates tax free, but is also due to its ability to bundle insurance products. As SBC noted in its 1999 annual report, companies that can bundle services will eventually dominate the market. BCBSM would be able to go to Hillsdale Flower Shop and offer the owner health insurance, worker's compensation insurance, car insurance, fire insurance, property and casualty insurance...all on one bill. Other companies, lacking market power in any line of insurance, would not be able to do so.

These advantages will lead to consolidation in those lines that the subsidiaries sell, leading to less competition. This was also recognized by the 1993 Legislature, when it only allowed the purchase of the Accident Fund by BCBSM if the Accident Fund remained solely in the workers compensation market. Since the purchase of the Accident Fund by BCBSM the Accident Fund has doubled its market share in Michigan. Indeed, in my report I demonstrate that workers compensation is now less competitive than any of the other lines that I examined, and that these other lines of insurance are highly competitive. To argue that HB 5285 is needed to increase competition in insurance is not true in theory nor empirically.

If it is determined that the Accident Fund should be allowed to move into other lines of insurance, then it should not be a subsidiary of a tax-exempt company. If BCBSM sold the Accident Fund, I would have no objection to the Accident Fund selling any type of insurance that it wants. The problem is that the Accident Fund can use the assets of BCBSM, which were accumulated tax free, to compete against all the other companies that are paying taxes.

It is obvious that this is happening. If one looks at the Schedule Y of BCBSM Annual Report, you will see that in 2007, BCBSM made a capital contribution of \$125 million to the Accident Fund. You then notice in the Management's Discussion and Analysis of Operations that the Accident Fund purchased CompWest, a California based workers compensation company for \$127.4 million. So while it might appear that the taxable entity, the Accident Fund, bought CompWest, using dollars that it had paid taxes on, in reality BCBSM purchased CompWest with dollars that had been accumulated tax free. Lest we think this is an isolated incident, if you look to the 2006 Annual Statement of

LifeSecure, another Blue Cross subsidiary, you will see in the notes “BCBSM contributed \$13 million in cash to the Company on December 4, 2006. In December 6, 2006 the majority of this amount, \$12.1 million, was used to purchase Verde Financial Corporation.”

Allowing the Accident Fund to cross over into other lines of insurance invites more subsidization of the Accident Fund by its parent. Rather than just buying out-of-state companies, Accident Fund would be able to enter other lines of insurance using BCBSM reserves and notes, and access BCBSM provider networks and market power over providers. Notice that the capital contributions to Accident Fund and LifeSecure happened despite the best efforts of the Legislature to create a “firewall” of some kind between BCBSM and its tax paying subsidiaries.

The practical problem is that BCBSM has argued that by allowing it to operate for profit subsidiaries it can use this revenue to increase its surplus and to reduce rates for BCBSM subscribers. In my report I document that rather than this happening, rates have increased for subscribers while at the same time BCBSM as a holding company has spent more than \$450 million acquiring other companies. Kurt Gallinger will speak more eloquently than I on this matter. I just want to make two points. First, not all investments in subsidiaries make money. By allowing BCBSM or its subsidiary, the Accident Fund, to branch out into other lines of insurance, one adds the risk that these investments will be unprofitable. As I mentioned, the substitute wisely removed the provision that allowed BCBSM to own any company. But suppose the Accident Fund purchases a Property Casualty company that insures property in Florida. Then suppose a hurricane does \$3 billion of damage to property insured by this company and the company sustains several hundred million dollars in losses. This would have a negative feedback into the rates of BCBSM subscribers.

Even worse from a political economy point of view, suppose an Accident Fund subsidiary that is a Michigan domiciled insurance company loses \$45 million in 2009. Is it not likely that there will be political pressure to give this subsidiary some form of tax break or subsidy in order to reduce the need for the Accident Fund and in turn BCBSM to raise rates? The bills before you invite a host of unintended government interventions into the Michigan market place that will create more and more distortions that will cause successful firms to exit and further depress economic growth in Michigan.

To summarize, BCBSM has offered bills that would significantly change its mission and character. If BCBSM is to no longer be a charitable benevolent organization than Michigan should follow the lead of California, have it donate its assets of some \$6 billion to another charitable organization dealing with health care, and let BCBSM sell insurance and pay taxes like any other insurance company. If the Accident Fund is to move beyond workers compensation than it should not be a wholly owned subsidiary of a company that is tax exempt. BCBSM should divest itself of the Accident Fund, which, if its value has grown at 8% per year, would fetch about three-quarters of a billion dollars. This could be used to reduce the premiums of subscribers of BCBSM.

The substitute for HB 5284 has made a good deal of progress from the House-passed legislation, and Senator George, you are to be commended for your efforts. But the substitute would still allow the Accident Fund to use the resources of its tax-exempt owner to create distortions in the insurance markets that will lead to less competition rather than more, and will over time lead to further political involvement in the insurance industry that will harm consumers, producers, and the economy as a whole.