Employer-Sponsored Health Plans and the Tax Exclusion

A number of economists point to the rise of tax-favored, employer-sponsored health insurance as "an accident of wage and price controls during WWII." Although this may be historically correct, over the years, employer-sponsored health plans have provided stable healthcare coverage for millions of employees and their families.[1]

Employer-sponsored health plans refer to healthcare coverage paid for by a business on behalf of its employees. The employer tax exclusion is used to reference the tax benefit that excludes employer-paid contributions for an employee's health insurance from that employee's compensation for income and payroll tax purposes. This tax benefit makes employer-sponsored health coverage a valuable benefit for workers. According to a new poll from Accenture, three-quarters of workers see health benefits as a "vital reason" for continuing to work for their employers, and one-third would quit if their employers stopped offering insurance. A similar percentage said they wouldn't work as hard if their benefits disappeared.[2]

Employer-sponsored coverage continues to be the bedrock of private insurance coverage in the United States. According the Bureau of Labor Statistics, about 175 million Americans have employer-sponsored coverage, and they are statistically more likely to maintain coverage year after year.[3]

One of the advantages of employer-sponsored health plans that we most often hear discussed is the "large numbers" concept, whereby a larger number of people necessarily equate to a lower cost due to volume purchasing. In fact, this notion is so prevalent that the concept has

[1] https://www.census.gov/content/dam/Census/library/publications/2015/demo/p60-253.pdf
[2] http://www.plansponsor.com/Health-Insurance-Critical-for-Retaining-Employees/
[3] https://www.census.gov/content/dam/Census/library/publications/2015/demo/p60-253.pdf, Table 1

often been transferred to other settings, such as purchasing pools or other groupings of people who voluntarily come together to join a group. When it comes to health insurance, group volume does not always equal lower cost. Whether costs are lower for a large group of insured individuals depends entirely on who is in the group and how they use healthcare. If the group consists of people who are older or sicker, costs will not be lower. An example of this dynamic is the large numbers of people who enroll in the individual health insurance market under special enrollment provisions outside of the normal open enrollment period. They are seeking coverage because they have experienced a triggering event and know they need healthcare, and that means that, as a group, they will incur higher medical expenses. No matter how many of them there are, the group will still be a high-cost group.

While it is true that theoretically a large group of insured individuals should include a mix of different levels of health risk, we can see that does not always happen. However, when it comes to employer-sponsored health insurance, adverse selection is often avoided and better risk spreading occurs. This is due to the controlled entry and exit found in employer-sponsored health insurance coverage. When an employee is hired, he or she is offered coverage at that time, and the employer contributes significantly to the cost of that coverage, making it much more likely that the employee will elect coverage regardless of his or her health status. This means that employer-sponsored plans are much more likely to have a mix of health risks and, in this case, the volume of individuals allows the costs associated with higher risks to be spread over that mixed population of high and low risks. This same setting for obtaining coverage is also simpler for employees and allows employers to provide equitable contributions for their employees.

Several recent health insurance and tax-reform proposals have suggested eliminating or capping the tax exclusion provided to individuals who have employer-sponsored group coverage and perhaps substituting it for some other tax preference. If this were to happen, most middle-class Americans would see a significant increase in their taxable income due to the new tax status of their employer’s contributions toward their health insurance coverage. Even capping the exclusion would be harmful for employees and would likely result in a race to the bottom in terms of benefit offerings as employers resorted to coverage offerings that fell below the cap.

Another unfortunate consequence of eliminating or capping the exclusion would be new costs to employers. When employees' taxable income increased due to the new taxable status of employer contributions, the employer's FICA match would also increase. For every new dollar of taxable income due to newly taxable employer contributions or employee contributions previously made on a pre-tax basis under Section 125, employers would be on the hook for 7.65% in new costs until the employee reached the Social Security wage base.

Ultimately, eliminating the exclusion would mean that employer-sponsored coverage would be less attractive and many employer dollars that today help employees pay for the cost of coverage would not just become taxable, they would go away. Employers would look at the significantly decreased value proposition of offering coverage to employees and decide to put their dollars elsewhere. Although some economists have assumed that employers would immediately put the dollars they formerly allotted to health insurance premiums to the employee's salary, it is unlikely that would be done on a dollar-for-dollar basis. Employers have already incurred significant costs in recent years as a result of offering health plans for their employees, and most would attempt to recoup some of their losses. In a recent survey, almost 90%of businesses reported that their costs had increased because of the Affordable Care Act.[4]

Not only would employers' financial participation be lost, many of the other advantages of risk spreading found only in employer-sponsored coverage would no longer exist: No longer would there be a potent means for spreading risk among healthy and unhealthy individuals; employers and individuals would lose many group purchasing efficiencies; workers would be less likely to have their employer as an advocate in coverage disputes; employers would be less likely to involve themselves in matters of quality assessment and innovation; and employers could suffer in terms of worker productivity and labor costs because employer-sponsored insurance leads far more workers to purchase health insurance than they would on their own.

Employers that stopped offering coverage would likely expect their employees to secure affordable coverage in the individual market. For many people, particularly older and lower-income workers, that may be difficult, even with the implementation of the Affordable Care Act.

[4] https://www.ifebp.org/bookstore/aca2014/Pages/default.aspx

We have already seen evidence of this in lower-than-expected enrollment figures during annual open enrollments in the individual market. Although premium tax credits are available for some individuals, coverage is age-rated and expensive for older individuals and often gives the appearance of too high a cost for the benefits received by those who are younger when compared to the coverage and costs they had while covered by their employer-sponsored plans. Many people are not eligible for a premium tax credit at all due to their income. Even if they do have what is considered a higher income, their cost for coverage if they no longer have any assistance from their employer may be prohibitively high, resulting in those in better health deciding to sit it out and pay the tax penalties rather than the higher cost of the coverage itself.

There are a number of variations among proposals to remove the tax exclusion. Although not identical, most have common themes. One such plan would eliminate the tax exclusion for employer contributions towards health insurance and instead provide individuals with a tax deduction of $7,500 a year for buying insurance. Families would receive a deduction worth $20,500.[5] Whether employees would find this a better deal than their former employer-sponsored coverage is debatable. A deduction is, in general, not as attractive as a tax credit for the lower-paid worker because it simply reduces taxable income. For lower-paid workers, their only paycheck tax-related deduction is that for Social Security and Medicare – they don't have a deduction for income tax. A deduction from taxable income is not attractive at all since they don't have taxable income. For these workers, their former employer contribution reducing the cost of coverage was much more valuable. In fact, a deduction for this type of worker would likely cause them to forego coverage altogether since it would offer no immediate relief towards the cost of coverage.

For middle-income workers, the deduction might be valuable at the end of the year, if they were able to front the cost of coverage in the meantime. In either case, a refundable tax credit would offer a better solution. A tax credit is distinguished from a tax deduction in that it provides a credit against taxes owed. A refundable tax credit allows the credit to be advanced so that it can be used immediately. Middle- income workers do pay income taxes, and whether the deduction or the tax credit is worth more to them depends largely on the amount of the maximum

[5] http://eba.benefitnews.com/news/health-care-reform/republicans-propose-controversial-aca-fix-eliminating-employer-exclusion-2746596-1.html

deduction or maximum tax credit. Without a doubt, a refundable tax credit that can be used when premiums need to be paid is more valuable and more of an incentive to purchase coverage. Because of the high costs associated with a program of refundable tax credits, the credits would likely need to be income-adjusted, which is the current practice. As it is today, many people would not be eligible for the tax credit or any other assistance with the cost, and would face significant new costs without the benefit of their employer-sponsored coverage.

Even though refundable tax credits are a positive way to help people secure coverage in the individual market, employer-sponsored coverage and the employer tax exclusion provides a far greater benefit for many more people. An employer contribution toward coverage will almost always be more valuable for many more people, not just from a financial perspective but also from a coverage perspective. In spite of the guaranteed access created by the Affordable Care Act, there will always be a degree of subjectivity in the decision to purchase coverage in the individual market and this will affect the coverage that is available for purchase. Because this subjectivity creates an atmosphere ripe for adverse selection, losses to insurers that participate in the individual market will be higher and plan offerings will be fewer. To offset these losses, provider networks will be smaller and cost-sharing will be greater. This is the only way insurers can continue to offer coverage in these markets absent some other mechanism to offset losses from adverse risks. The bottom line is that people who have been covered by high-quality employer-sponsored plans may find themselves with far fewer options than they had in the past for their health insurance coverage.

Getting employers out of the healthcare business would be a mistake. Employers have an interest in providing coverage to their employees since the coverage ensures that employees have access to coverage and care, enhancing their productivity. There is no better option available to provide the highest-quality coverage at the lowest cost. There is no better mechanism to prevent cost-spiraling adverse selection from occurring. Employer-sponsored coverage has worked for Americans for decades, and preserving employer-sponsored health coverage and the continuation of the employer-sponsored plan tax exclusion should be a priority for policymakers.

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