Forbes

How Obamacare Tackled the Pitfalls of Employer-Sponsored Insurance Reform

Avik Roy | May 14, 2012

Last weekend, I explained why the discriminatory tax treatment of employer-sponsored insurance is the original sin behind America's exceedingly expensive health-care system. I also described why reforming this tax break is politically difficult, because lots of industry stakeholders have an economic interest in the status quo. Today, I'll leave those political considerations aside, and engage the most credible policy critiques of ESI tax reform. The good news is that the authors of Obamacare's "Cadillac tax" did most of the legwork for us.

On November 4, 2011, Reps. Joe Courtney (D., Conn.) and Tom Cole (R., Okla.) sent a letter to the Congressional Supercommittee on federal debt reduction, urging the committee "to oppose new taxes on employer-sponsored health benefits." The letter was signed by 146 Democrats and 14 Republicans. The Republicans included Richard Hanna (N.Y.), Tim Johnson (Ill.), James Lankford (Okla.), Steve Latourette (Ohio), Frank Lucas (Okla.), David McKinley (W.Va.), Tim Murphy (Penn.), Alan Nunnelee (Miss.), Ron Paul (Tex.), Bill Posey (Fla.), David Schweikert (Ariz.), and Don Young (Ark.).

The letter argues that employer-sponsored insurance reform is unfair, because it disproportionately affects those who, by virtue of being older or living in the Northeast, face higher health costs:

> Despite claims that premiums are based only on the benefits provided, longstanding actuarial practices confirm that factors largely outside of one's personal control have a great impact on health plan costs. A study on the high-cost health plan tax conducted by the American Academy of Actuaries concluded that the proposal would disproportionately impact early retirees by a striking margin, not because their plans are more generous, but because they are actuarially more expensive to cover. The report also concluded that small businesses and high-risk professions would also be disproportionately impacted, again, not based on generosity of benefits, but because of longstanding actuarial realities.
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> Another report produced by Mercer found significant geographic and demographic components to the cost of employer-sponsored plans. An average employer-sponsored plan in the Northeast is approximately 23 percent more expensive than in the South. In firms where the average employee age is 45 or older, coverage is seven percent more expensive than the average employer-sponsored plan. Capping or eliminating this tax exclusion, would have the greatest consequences on our older workforce, those in high-cost regions, in high-risk fields, for women, and on small businesses.
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> Erosion of employer-sponsored health plans would also dissolve savings that have been built into this system of coverage. Employer-sponsored coverage is generally less costly than individual coverage because firms are able to capitalize on lower administrative costs associated with economies of scale. Employers have also been able to drive costs

savings through health management plans. If the tax exclusion were to be eliminated, savings that employer's plans generate from economies of scale and adoption of health management plans would diminish as they drop coverage.

Employer insurance reform faces legitimate critiques

These critiques are worth considering. Fortunately, Obamacare's "Cadillac tax" on high-value health plans* worked out a number of these issues. Let's go through them one-by-one.

If other reforms such as association health plans allowed **small businesses** to pool their risk, they would not necessarily face higher administrative costs. The key to keeping administrative costs low is to take advantage of economies of scale, in which large numbers of people are enrolled in the same insurance pool. Properly-designed health insurance exchanges are another device with which to achieve this. Another option would be to offer a slightly higher exemption to smaller businesses relative to larger ones. An offsetting point is that equalizing the tax treatment of employer-sponsored and individually-purchased insurance makes small businesses *more* competitive, by giving them the opportunity to offer their workers higher wages, so as to compete with large firms that offer generous health benefits.

High-risk professions like firefighters could also gain a statutory exception to the rule, or a higher deduction. The Obamacare "Cadillac tax" (Section 9001 of the Affordable Care Act) contains just such a provision, establishing a higher threshold for "law enforcement officers…employees in fire protection activities…individuals who provide out-of-hospital emergency medical care (including emergency medical technicians, paramedics, and first-responders), individuals whose primary work is longshore work…and indviduals engaged in the construction, mining, agriculture (not including food processing), forestry and fishing industries."

The **cost of living** argument is partially overwrought. A big part of the reason why insurance costs more in Northeastern states is because those states have enacted misguided mandates that drive up the cost of insurance. Taxpayers in low-cost states shouldn't be forced to pay for the regulatory mistakes of high-cost states. Nonetheless, if you really wanted to, you could adjust the deduction so that it would be higher in high-cost states relative to low-cost states; ACA Section 9001 assigns a 20 percent-higher threshold in 2013, 10 percent in 2014, and 5 percent in 2015 for the 17 states with the highest average employer-plan costs.

It's true that **older and sicker people** have higher insurance costs than younger and healthier. **Women** also typically have higher health costs than men do. "Age is by far the largest factor that can cause substantial variations in costs of comparable health plans for different groups of enrollees," notes Paul Van de Water of the liberal Center on Budget and Policy Priorities.

Again, the ACA excise tax can be our guide. The law risk-adjusts the excise tax based on health status, age, and gender, by adjusting the tax threshold by the actuarial cost of an individual relative to the average cost under the "Blue Cross/Blue Shield standard benefit option under the Federal Employees health Benefits Plan for plan year 2018."

One pitfall of adjusting the deduction for health status is that it will incentivize people to exaggerate how sick they are, in order to gain a greater deduction. Hence, any such risk-adjustment provision would need to account for mischief: either by capping the amount of health-related risk adjustment, or by some other yet-to-be-conceived certification process. The last thing we need is to put the IRS in charge of monitoring our health status.

In addition, if you adjust too much for health status, you introduce moral hazard. People have no incentive to stay healthy, if they get a bigger tax subsidy even if they smoke, eat Fritos all day, etc. Limiting (or omitting) the variation in the deduction for health status, and instead focusing on age and gender, encourages people to save for their own future care, using health savings accounts and other methods.

Other concerns raised by insurance professionals

The American Academy of Actuaries report cited in the Courtney-Cole letter highlights a couple of other credible concerns, responses to which were also incorporated into the Obamacare excise tax.

The actuaries worried that there would be unequal allocation and pass-through of the tax between **different types of coverage** (medical, prescription-drug, dental, vision, HSAs, et al.). If your employer offers you these multiple forms of insurance, how does the excise tax break down between each? If you replace the employer tax exclusion with a standard deduction, as in the Bush 2007 plan, these problems are not as relevant. However, Obamacare exempted dental and vision coverage from the excise tax, so as to simplify its administration.

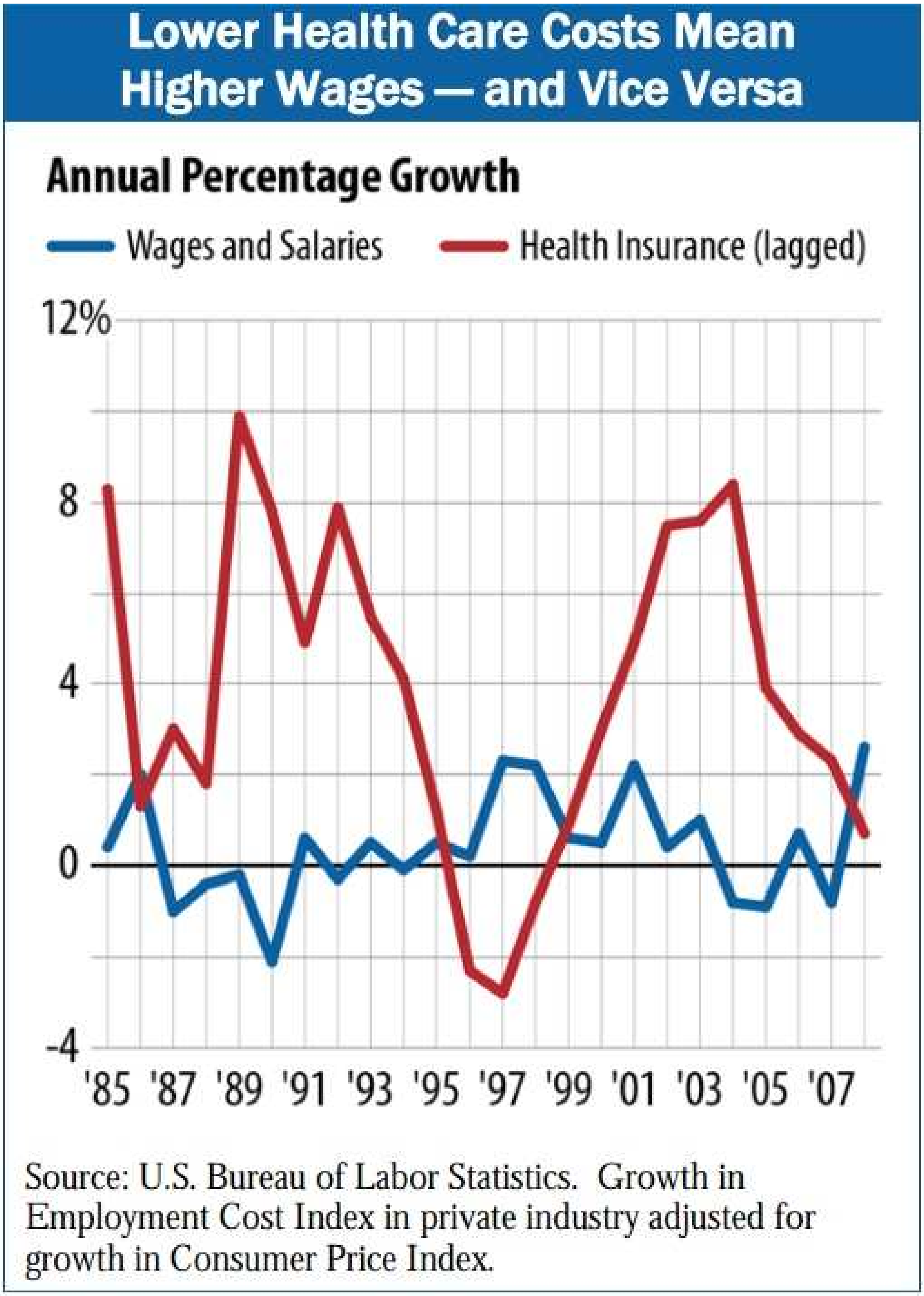
As the Courtney-Cole letter notes, another problem is that reform could encourage employers to terminate coverage for **retirees below the age of 65**, because those younger retirees could drive an employer's plan above the excise-tax threshold. This problem is addressed in ACA Section 9001 in two ways: first, with the age-based risk adjustment described above, and also by increasing the excise-tax threshold for early retirees by $1,650 for self-only coverage and $3,450 for family coverage.

Finally, the actuaries were concerned that the preliminary version of the Cadillac tax oversimplified things by providing **one threshold for family coverage**, instead of providing "separate rates for…employee-plus-spouse, employee-plus-children and employee-plus family" coverage. To my knowledge, ACA Section 9001 doesn't address this concern, which at the end of the day is a relatively minor problem.

Accommodating the objections of labor unions

Finally, an argument raised by Paul Van de Water and others is that labor unions negotiate **multi-year collective bargaining contracts** that can't be immediately changed to reflect a new tax regime. Unions argued that this need for a transition was the reason why the Cadillac tax needed to begin in 2018, rather than 2014. I haven't taken the time to assess whether or not unions deserved special treatment on this account. (At the time, as the above video shows, many people saw this provision as a special-interest buy-off.)

Either way, ESI reform could accommodate these concerns, if labor unions found a way to play ball with reformers. After all, union workers would stand to benefit from reform, by replacing overly generous health plans with higher wages. After a thorough review of the economic literature, Austin Frakt concluded, "Clearly, the notion that premiums and wages offset one another has an impressive pedigree."



Source: U.S. Bureau of Labor Statistics. Growth in Employment Cost Index in private industry adjusted for growth in Consumer Price Index.

Thanks, Obamacare

In sum, we can profit from the targeted ways in which Obamacare addressed the legitimate policy critiques of employer-sponsored insurance reform. We can begin by offering a higher exemption to those in high-risk professions, and to those with higher health costs, such as women and the elderly. Other factors, like the higher costs of insurance for smaller firms and northeastern states, can optionally be addressed via similar means.

A reform plan that takes these critiques into account loses its simplicity, and tax reformers in general like to increase, not reduce, the simplicity of the code. But reform of the employer tax exclusion is so important that this small cost in increased complexity is—by far—worth it.

Leading progressive economists agree. The Cadillac tax "offers the most promising approach to reducing private-sector health costs while also giving a much needed raise to the tens of millions of Americans who receive insurance through their employers," wrote Henry Aaron, Ken Arrow, Brad DeLong, Jonathan Gruber, Uwe Reinhardt, Robert Reischauer, Alice Rivlin, Laura D'Andrea Tyson, and 15 others in a 2009 letter to President Obama.

I'll leave you with these thoughts by the most critical left-wing critic of them all, Paul Krugman. "Should there be a limit to the tax deductibility of employer-provided health insurance?" Krugman asked in January 2010. "My answer is yes…the details of the excise tax should be fixed, but it's on balance a good idea."

If Paul Krugman and the Cato Institute can agree upon the value of these reforms, we should all be paying attention.

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*(As a reminder, the Obamacare "Cadillac tax" imposes a 40% excise tax on the relevant premiums charged by any insurer that, beginning in 2018, offers a health insurance policy whose value is in excess of $10,200 for individual coverage and $27,500 for family coverage. In contrast to this punitive approach, the Bush 2007 plan replaced the unlimited employer tax exclusion with a standard deduction for all workers of $7,500 for an individual plan, and $15,000 for a family plan, starting in 2009. If you assume premiums grow by 6 percent a year, the equivalent Bush deduction in 2018 would have been $12,671 for an individual plan and $25,342 for a family plan.)