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A dangerous secret to the Baucus health bill

Two in a series: Hidden in the Senate's health-care bill are huge incentives for corporate America to stop covering their workers. If that happens, the deficit could skyrocket.

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Last Updated: October 9, 2009: 9:27 AM ET

NEW YORK (Fortune) -- Now that the Congressional Budget Office has concluded that the health-care bill proposed by Sen. Max Baucus will shrink the federal deficit over the next ten years, its champions are heralding the legislation as a model of fiscal responsibility.

But the CBO's comforting analysis relies on a big assumption that's highly questionable, an assumption that virtually no one on either side of the debate -- politicians, pundits, even economists -- is even challenging.

The assumption is that America's employers will keep providing coverage for their workers. But, in fact, the Baucus bill severely undermines the employer rationale for offering insurance. Economist Michael Tanner of the conservative Cato Institute points out two main reasons.

First, the Baucus bill would substantially increase the costs of coverage, for example by requiring rich benefits packages and coverage for Americans with pre-existing conditions at far less than their actual expense. At some point, employers will decide that the appeal of offering insurance as a tool for recruiting and retaining employees no longer compensates for its soaring cost.

Second, the bill is based on perverse incentives that no one is even discussing. The subsidies it offers to citizens are so rich that if companies were to drop their plans, the majority of workers would get the same lavish coverage, and extra cash in their paychecks to boot. "Those two factors will change the equilibrium," says Tanner. "With the government providing huge credits, employers will feel a lot less guilty about dumping their plans."

In fact, the Baucus bill is practically inviting employers to do just that: It imposes a fine of just $400 per employee on companies that shed their plans.

So what happens if corporate America exits the health-care field? The foundation of the Baucus bill would pretty much collapse. Upper-middle-class earners, who today make $65,000 and up, would suffer the equivalent of a huge tax increase. And the extra revenue the government would collect from those families wouldn't remotely pay for the millions of relatively low earners who would absorb big subsidies in lieu of the premiums their employers now pay.

The corporate exodus from health care would mean that the Baucus plan, far from reducing the deficit, would actually increase it, perhaps sharply.

To understand how the math works, let's examine two typical families of three, the average household size in the U.S. The Smiths earn $43,000 a year, around the U.S. median, and the Joneses make $80,000. As we'll see, the Smiths far outnumber the Joneses, and the extra taxes the Joneses pay won't come close to paying for the lavish tax credits the Baucus bill promises the Joneses.

Here's how the Smiths fare when employer, Acme Enterprises, drops Bob Smith's plan. Say Bob gets insurance worth $13,000, and pays $3,000 himself, with Acme covering $10,000. Since the $3,000 is tax deductible, Bob earns $40,450 a year after paying his share for a lavish plan. Call that $40,450 the "benchmark."

When Acme drops its coverage, his pay should rise by $10,000, less the $400 penalty, or $9,600. That's what Acme needs to pay to stay competitive, even in this weak labor market. Bob is in a 15% tax bracket, so he takes home an extra $8,160 to pay for insurance.

Here's what really counts: Under the Baucus bill, his health-care costs are capped at around $6,000, with the government paying the rest for the coverage Bob will now buy from a private insurer through the exchange envisaged in the Baucus bill.

So Bob gets an effective raise of over $2,100, plus the $2,550 he used to pay out of his own pocket. So he effectively pockets a pay increase of $4,700 raise -- or 12% -- and keeps his premium plan.

The regime that brought the Smiths good fortune is a disaster for the Jones family. The main reason is that at $80,000, Mike Jones earns too much at Acme to merit a health-care subsidy. Indeed, Mike gets his $9,600 raise, but after paying taxes on it in a higher bracket (30%), he doesn't have nearly enough left over to buy a $13,000 family plan. In fact, he's $4,200 worse off after paying for coverage. That's an effective pay hit of over 5%.

The big tax on people like the Jones family is only the first of the two problems. The second is the lacerating effect on spending and the deficit. The Smiths do pay higher taxes than before, around $1,800 more, in fact. But they're also getting $7,000 in subsidies, so they're imposing a net cost on the system of over $5,000.

By contrast, the Joneses are paying around $2,700 extra in taxes, plus they're absorbing the $400 penalty that Acme pays when it drops their policy. So the Joneses are contributing around $3,000 to to help pay for the Smiths.

Around two-thirds of America's workers earn less than $65,000 a year, and it's those employees who are getting far more in subsidies than they're paying in taxes.

So let's imagine the worst: that all 40 million employees covered by expensive corporate plans (that's over 120 million people, including their dependents), lose their coverage. By my calculations, the two-thirds who earn less than $65,000 would cost around $5,000 per family, for a total of $135 billion. The families earning over that number would contribute around $30 billion, and the government would collect another $16 billion from the $400 fine, bringing the extra revenues to $46 billion.

Hence, the extra subsidies, minus the additional tax receipts, would run about $90 billion a year. That would double the figure that the CBO is projecting to around $180 billion, a number big enough to totally erase the shrinkage in the deficit. In fact, it would immensely swell both the spending and the deficit in the years beyond 2019.

It gets worse. Middle-class earners will never tolerate a 5% tax hike. They, too, will demand big subsidies, and Congress is likely to oblige. A new middle-class bailout will quickly swamp all the current budget projections.

Even if employers simply accelerate what they're doing already, in many cases dropping their plans or scaling them back, it's a recipe for higher taxes and bigger deficits. The mystery is why the Baucus plan offers corporate America such a tempting, if not irresistible, invitation to get out.

Read Shawn Tully's other installment in this series:
How the Baucus bill contradicts Obama's goals ■

First Published: October 9, 2009: 9:25 AM ET