

Let Employers Decide How Health Insurance Should be Subsidized at Work

The ability to convert a very wasteful tax system into one with much better incentives can solve a huge social problem and leave just about everyone better off.

There are two things almost all health economists are in agreement about: (1) you cannot have successful reform of the health care system if you ignore the 150 million people who get health insurance through an employer, and (2) the way we currently subsidize employer-provided health insurance is very wasteful and inefficient.

There have been a number of suggestions for change: Sen. John McCain's proposal to switch to a fixed-sum tax credit, the Affordable Care Act's "Cadillac plan tax," and various versions of the same idea in proposed Republican alternatives to the ACA.

Yet there is one big problem with all of this. Every proposed change has been vigorously resisted by management and labor. The most recent example of the political power of the resisters is the two-year delay in the imposition of the Cadillac plan tax. Many are predicting that the tax will be delayed indefinitely.

Does this mean that fundamental health reform is impossible? Not necessarily. If the economists are right about the waste in the current system,

we should be able to make the same number of subsidy dollars available in a way that leaves both employers and employees better off. Further, we don't have to convince every company and every union to go along with the change all at once. We could give every health plan a choice: stay in the current system or switch to a non-wasteful alternative.

If people have the choice to remain in the current system, no one should feel threatened and no one should resist the proposal.

We should be able to make the same number of subsidy dollars available in a way that leaves employers and employees better off.

But it will not take long before just about everyone switches.

Why is the current system so wasteful? When an employer pays an employee

a dollar in wages, that dollar is subject to federal, state and local income taxes, in addition to the

Let employers decide

(FICA) payroll tax. Yet if the employer spends that same dollar on health insurance, the dollar gets spent tax free.

Suppose the employee is facing a 15 percent payroll tax and a 15 percent federal income tax. If the employer pays a dollar of wages, the employee gets only 70 cents in take-home pay. That can make additional health insurance attractive even if it is worth less than the premium the employer pays.

The health insurance market offers us all kinds of tradeoffs. Do you want a network that includes every doctor in town or would you accept a narrower network? How much are you willing to pay to have the former rather than the latter? These are the choices that the tax law biases.

Moreover, the higher the marginal tax rate, the more wasteful health insurance can be and still be preferable to wages. High-paid Silicon Valley employees facing California's state income tax, for example, are actually paying less than half the cost of their insurance — after the tax breaks are taken into account. These folks are likely to prefer a dollar of insurance to a dollar of wages, even if the insurance is worth less than 50 cents!

The ACA's Cadillac plan tax and the Republican versions of the same idea are designed to address this problem by limiting the tax subsidy for health insurance. Under the ACA, for example, there is to be a 40 percent tax on high-cost health plans, to the degree they exceed certain thresholds. Unfortunately, this is an eat-your-spinach reform that is all pain and no gain for the private sector. Every business or union that pays the tax loses, yet no one else gains other than the IRS. No wonder management and

labor hate the idea.

Suppose, however, that we give the employer (or the union) a choice. They can continue under the current tax regime, or they can have a dollar-for-dollar tax credit up to an amount equal to the average subsidy under the current system. The current subsidy averages about \$1,800 per person, but to save readers from having to reach for a pocket calculator in the following examples, let's round that up to \$2,000. If the employer chooses the credit approach, the first \$2,000 is tax free to the employee and any expense beyond that must be made with after-tax dollars.

The credit approach pushes the tax benefits up front — presumably funding the core insurance we want everyone to have. All additional insurance is purchased with after-tax dollars and is on the same footing with take-home pay. This means that workers on the average can have the same tax relief they had before without

perverse incentives to over-consume health care at the margin.

Our prediction: almost every employer and every union will choose the credit. Here's why.

We predict almost every employer and every union will choose the credit approach, pushing the tax benefits up front.

Case 1: The credit equals the current subsidy.

Suppose an employee with a family of three is getting insurance (all paid by the employer) that costs \$20,000 a year. Under the current system, the implicit subsidy is \$6,000, given a 30 percent marginal tax rate. Under the tax credit approach, the family gets same tax benefit (\$2,000 X 3). Since the next \$14,000 of spending is effectively done with after-tax dollars, that spending is on a level playing field with take-home pay as far as the tax law



is concerned. Over this entire range, there is no more tax reward for waste.

Suppose the employee and the employer find a way to cut that \$14,000 in half – say by choosing a narrow, but high quality provider network and getting rid of some benefits of marginal value. Then the employee potentially can have \$7,000 more in take-home pay without paying any additional taxes.

Case 2: The credit is more than the current subsidy.

Suppose the employee has a really lavish plan, costing, say, \$30,000. The implicit subsidy under the current system is \$9,000. But the tax credit subsidy (again) is only \$6,000. A switch to the credit with no other change would increase the employee tax burden by \$3,000. On the other hand, a switch to the credit system liberates \$24,000 — which now will potentially trade dollar for dollar against take home pay. If the employer and the employee can't find at least \$3,000 of waste (to be converted into cash to pay the employee's new tax burden), in a plan like this there is something seriously wrong with both of them. Beyond, that any additional savings can be converted dollar-for-dollar into take-home pay.

Case 3: The credit is less than the current subsidy.

If the employee's plan costs only \$15,000, the current system subsidy is \$4,500 versus a \$6,000 tax credit. With the credit, the employee could have a \$1,500 tax refund next April 15th. Or, the funds could be deposited in

a Roth-type health savings account to be used for medical expenses not covered by the health plan. Funds remaining in the account at year end could be withdrawn tax free.

Remember, in all these examples the cost to the Treasury is the same (based on static forecasting). The ability to convert a very wasteful tax system into one with much better incentives can solve a huge social problem and at the same time leave just about everyone better off.

When Mark Pauly and John Goodman described the tax credit approach in *Health Affairs* more than 20 years ago we called the subsidy a “fixed dollar tax credit.” And although many of us object to a lot of the particulars, this is the way the government subsidizes private insurance through the (Obamacare) exchanges. In a health insurance exchange, the subsidy available to an individual is determined by his income and the premium for the second cheapest silver plan. The individual is free to choose any plan. But the tax credit remains fixed, regardless of the choice.

So why not extend the idea to health insurance at work? We would if we followed the advice of the president's chief economic advisor, Jason Furman. And we would if we followed the advice of Ezekiel Emanuel, the White House medical doctor who helped create the Affordable Care Act.

Given widespread support across the political spectrum, perhaps this is one type of health reform on which all sides can come together and agree.

A version of this document was originally posted by John Goodman at *Forbes*.



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