



# Making Coverage Affordable for Lower Income Workers: Alternative Tax Policies Could Reduce Net Federal Spending\*

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## Contents

Executive Summary .....	iv
A Low-Income-Only Tax Credit .....	iv
A Sliding Scale “Replacement” Tax Credit .....	iv
Making Coverage Affordable for Lower Income Workers: Alternative Tax Policies Could Reduce Net Federal Spending .....	1
The Problem .....	1
Subsidy Eligibility for Low-Income People with Access to Employer Coverage .....	1
A Possible Solution: An “Affordability” Tax Credit for Low-Income Workers’ Share of Employer Plan Premiums .....	4
“Low-Income Credit” .....	5
Offsetting Savings .....	7
“Replacement Credit” .....	8
Tax Credits in the Context of a Tax on Expensive Health Plans .....	12
Administering the Tax Credit .....	13
Addressing Potential Problems .....	13
Avoiding Incentives for Employers to Reduce Their Contributions .....	13
Addressing High Cost-Sharing in Some Employer Plans .....	14
Continuity and Stability of Coverage While Temporarily Unemployed .....	15
Conclusion .....	16
Appendix A: Why Lower Income Workers Eligible for Employer Coverage Constitute a Big Issue; Why Federal Subsidy Costs Could Escalate .....	17
Appendix B: Assessing the “Portable Employer Contribution” Approach .....	19
What Available Research Says .....	20
NOTES .....	23

## **Tables and Figures**

Figure 1:	Illustrative Workers' Out-of-Pocket Premium Costs for Family Coverage, After Tax Savings, as a Percent of Family Income for a Family of Four, 2009 .....	2
Table 2:	Tax Credit Percentages (as a Percent of Worker-Paid Premium) under an Illustrative "Low-Income Credit," at Varying Incomes Relative to the Federal Poverty Level (FPL), at 2009 Tax Rates .....	5
Figure 3:	Worker's Out-of-Pocket Premium Payments for <i>Average-Cost</i> Employment-Based Family Coverage, Net of Available Tax Savings, as a Percent of Family Income at Different Income Levels Relative to Poverty, Family of Four, 2009 .....	6
Table 4:	Tax Savings to Workers as a Percent of Worker-Paid Premium under Three Alternative Progressive "Replacement Credit" Schedules, Compared to Typical Savings Using a Section 125 Plan under Current Law, for Four Family Types at Varying Incomes Relative to the Federal Poverty Level (FPL), at 2009 Tax Rates.....	9
Figure 5:	Worker's Out-of-Pocket Premium Payments for <i>Average-Cost</i> Employment-Based Family Coverage, Net of Available Tax Savings, as a Percent of Family Income at Different Income Levels Relative to Poverty, Family of Four, 2009 .....	10
Table 6:	Federal Revenue Loss under Alternative Tax Credit Designs, Compared to Current Law (IRC Section 125), 2008 .....	12
Table A-1:	Percent of People with Employment-Based Coverage Who Have Incomes Below 400% and 300% of the Federal Poverty Level (FPL), United States, 2007.....	17
Figure A-2:	Millions of People with Employment-Based Insurance (EBI) and Millions Uninsured, in the 150%-300% of Poverty Income Range, United States, 2007 ...	18
Figure B-1:	Distribution of Businesses with 10 or More Employees by Ratio of Expected Health Care Costs for Low-Income Workers to High-Income Workers Eligible for Employer-Sponsored Health Coverage, California, 2006 .....	21
Table B-2:	Distribution by Self-Reported Health Status of People Ages 0-64 with Employment-Based Coverage Who Have Incomes Above and Below 250% of the Federal Poverty Level (FPL), California and United States, 2007 .....	22

# Making Coverage Affordable for Lower Income Workers: Alternative Tax Policies Could Reduce Net Federal Spending

## Executive Summary

A critical challenge for health coverage reforms is to make coverage affordable for low-income workers eligible for employer coverage without inviting a major shift from employer to public financing. To avoid such a shift, current Senate HELP Committee and House Tri-Committee proposals would establish a “firewall” blocking subsidized coverage in the Exchange unless the worker share of employer plan premiums exceeds 12.5% (or 12%) of family income.

Figure 1 on page 2 illustrates the high out-of-pocket premium costs these workers would face, compared to workers eligible for subsidized Exchange coverage. (The total disparity would be greater if wage concessions that often offset employer contribution costs were taken into account. Without additional affordability measures, the proposed firewall could be self-defeating, as it would create major systemic incentives to shift employment arrangements to jobs without health coverage that afford access to Exchange subsidies and higher wages.)

Alternative tax policies could make coverage affordable for these workers, while reducing incentives for shifts from employer to public financing. The approaches outlined here are designed to reduce net federal tax expenditures in the process:

### *A Low-Income-Only Tax Credit*

A sliding-scale tax credit for 35% to 80% of low-income workers’ contribution costs could be targeted to workers up to 250% of the federal poverty level (FPL), with illustrative credits. Workers above that level would continue to receive current tax savings on their contributions. *The costs of such a tax credit could be (more than) offset by restructuring current policies so that employers no longer realize a tax savings on their workers’ contributions towards coverage. (Employers now realize a 7.65% tax savings on workers’ contributions.)*

- Estimated net federal savings: \$2.1 billion in 2008; more than \$25 billion over 10 years.

### *A Sliding Scale “Replacement” Tax Credit*

This would replace current Section 125 plan tax sheltering of worker contributions towards coverage. Alternative variations we analyzed would provide a credit of 80% of worker contributions for those under poverty (who would also have access to Medicaid) and would range:

1. Down to 10% of worker contributions for those up to 450% of poverty, with no credits for incomes above that level.
  - Estimated net federal savings: \$17.1 billion in 2008; more than \$200 billion over 10 years.
2. Down to 20% of worker contributions for those at 251% FPL and above.
  - Estimated net federal savings: \$8.3 billion in 2008; more than \$100 billion over 10 years.
3. Down to 15% of worker contributions for those above 400% FPL.
  - Estimated net federal savings: \$6.0 billion in 2008; more than \$80 billion over 10 years.

Table 4 on page 9 outlines these alternative tax credit schedules, while Figure 5 on page 10 illustrates net worker costs at different incomes. (Note that the Low-Income Credit uses Alternative 2 up to 250% FPL, then switches to current law, Section 125.)

Note that a progressive tax credit could still make policy sense in the context of an excise tax on expensive health plans. Complementary policies such as approaches to assure adequate benefit plans for this population are also outlined in the attached report, as are reasons the proposed credit would not reduce employer contributions (pp. 13-14).

# Making Coverage Affordable for Lower Income Workers: Alternative Tax Policies Could Reduce Net Federal Spending \*

## The Problem

A critical goal for national health reform this year is to assure affordable access to coverage for modest-income workers and their families. Proposals under development in the key Committees of Congress<sup>1</sup> address this affordability question primarily by making sliding-scale subsidies available to people whose income falls below a specified threshold and who purchase coverage through an authorized “Exchange” or “Gateway.”<sup>2</sup> The premium subsidies are variously called tax credits (Senate Finance Committee), premium credits (Senate HELP Committee) or affordability credits (House).

But more affordable access is not extended to many modest-income workers who are eligible for employer coverage under these proposals. Their need for assistance is underscored by recent findings that 38% of low-income workers who are eligible for employer coverage decline to participate, and over 20% are uninsured.<sup>3</sup> (“Low-income” means under 200% of the federal poverty level (FPL)—\$21,660 for an individual, \$44,100 for a family of four.) A key policy problem has been the apparent conflict between providing needed assistance and avoiding major shifts from employer to government financing of coverage for these workers.

### *Subsidy Eligibility for Low-Income People with Access to Employer Coverage*

Under the various current proposals, workers and dependents who are eligible for employer coverage in many cases would not be eligible for these new premium subsidies. They would receive the tax benefits that apply to all employment-based coverage, including the ability to pay their share of the premium with “pre-tax” dollars by using a Section 125 plan. But the value of this tax-sheltering is less for lower income workers, who face lower tax rates. Thus, even net of these tax benefits, out-of-pocket premium costs for low-income workers would often be considerably greater for those enrolled in employer coverage than for those with comparable incomes enrolled in subsidized Exchange coverage.

As Figure 1 shows, out-of-pocket premium costs for low-income workers, net of tax benefits and premium subsidies, are often considerably higher for employer coverage than for subsidized Exchange coverage under current proposals. This result raises two policy questions:

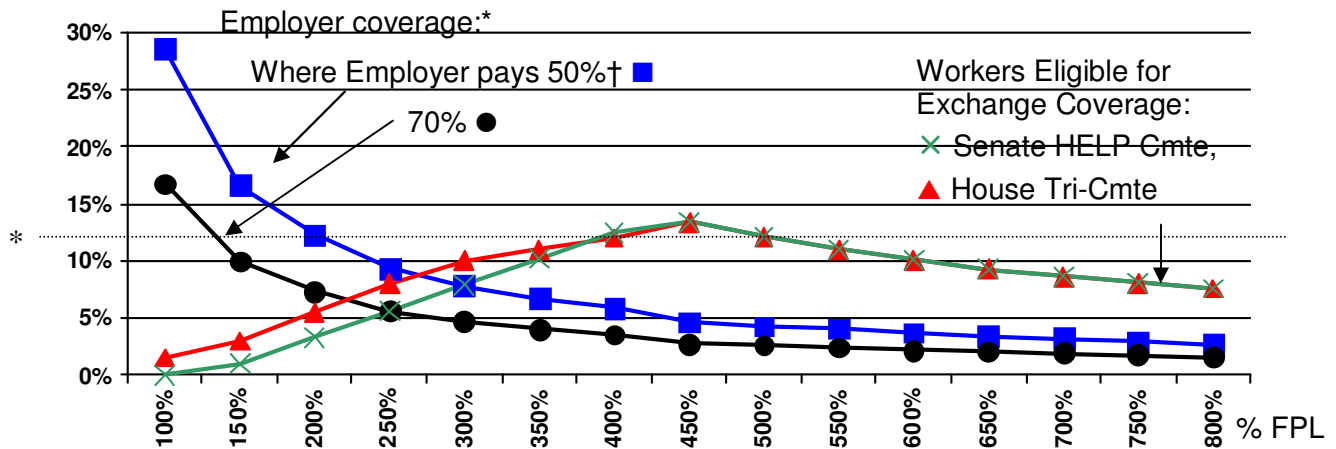
- **“Horizontal Equity”**: Is it fair for workers at the same income level (relative to poverty) to pay more out of pocket toward their premium if they get coverage through their employer rather than through a publicly authorized Exchange? (And this comparison understates the problem, because benefits for low-income workers will often be better with Exchange coverage than with employer coverage and because of the hidden, though substantial, wage concession typically made to offset employer contributions toward benefits.)
- **“Crowd-Out” Risk**: Under this subsidy structure, low-income workers have strong financial incentives to decline their employer’s coverage offer and instead enroll in coverage through the Exchange. If they were allowed to and did do so, their employers would be better off, too (i.e., where the employer would pay less toward health coverage). But public subsidy costs would increase, perhaps significantly. And, even if workers were denied subsidies in the

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\* Prepared under a grant from the California HealthCare Foundation. Updated to include “Blue Dog” amendments adopted by the House Energy and Commerce Committee on July 31, 2009.

Exchange if they decline an employer's offer of coverage, there would still be strong incentives for such workers and their employers to alter employment arrangements (e.g., convert to part-time or out-sourced positions with higher wages but not eligible for health insurance) in order to qualify for subsidized coverage in the Exchange.

**Figure 1: Illustrative Workers' Out-of-Pocket Premium Costs for Family Coverage, After Tax Savings, as a Percent of Family Income for a Family of Four, 2009**



**Notes:** Shown at various incomes relative to the federal poverty level (FPL). Compares worker costs (not including wage reductions) for employer coverage (using a Section 125 Plan) and Exchange Coverage (with subsidies per the House Tri-Committee and Senate HELP Committee bills).

Assumes that typical employment-based family coverage costs \$13,340 per year in 2009 (5.2% increase over rates found the Kaiser/HRET Survey of Employer-Sponsored Health Benefits, 2008). Further assumes that non-subsidized people pay this amount for family coverage purchased through the Exchange, which may be unlikely.

† Only about 10% of workers enrolled for family coverage pay more than the dollar amount that results when the employer pays only 50% of the premium in this illustration (per data from the 2008 MEPS-IC Employer Survey).

\* Note that the (“Blue-Dog”-modified) House bill would allow workers facing premiums in excess of 12% of income to decline employer coverage and access subsidies through the Exchange. The similar HELP Committee provision sets the threshold at 12.5% of income.

**Source:** Illustration by Institute for Health Policy Solutions using 2009 tax rates.

- The risk that large numbers of low-income workers and their dependents would shift from employer-financed to publicly financed coverage is a particularly critical challenge, because substantially more low-income workers and dependents now have employer coverage than are uninsured, and they would pay less out of pocket if they switched to Exchange coverage. Of people in the Committees' core (common) Exchange subsidy eligibility range of 150% to 300% FPL, 38 million had employer coverage—2.5 times the 15 million who were uninsured. (An analysis of relevant data is presented in detail in Appendix A.)

- Given that (as shown in Appendix Table A-1) up to 47% of those with employer coverage have incomes under 400% FPL (the Exchange subsidy eligibility threshold under the House and Senate HELP proposals), the incentive for such shifts could be huge. But the extent of this incentive would also depend on whether and how much employers would be required to pay in lieu of providing coverage to the worker.
  - » (400% FPL is \$43,320 for a single individual and \$88,200 for a family of four.)
- The amount of employer savings—which might be passed through to workers as a wage increase—would depend on how large a payment (if any) employers are required to make for workers not covered by the employer’s plan.

Different proposals take different approaches to these questions. Some emphasize avoiding the risk of crowd-out at the expense of horizontal equity. Others seek horizontal equity but risk the loss of a portion of current employer contributions.

- Massachusetts simply denies access to subsidized coverage for workers and dependents who are offered employer coverage, whether or not they enroll in it. (This approach is sometimes called a “firewall.”) Where the employee’s share of premium is higher than the state’s affordability standard, the penalty for being uninsured is waived. Thus, Massachusetts emphasized discouraging crowd-out over providing horizontal equity and coverage for low-income workers affected by this policy.
  - Firewalls have not caused “crowd-out” to date in Massachusetts, where very few workers on employer coverage have incomes low enough to qualify for subsidies.<sup>4</sup> But employer groups are far more likely to respond to incentives to reduce costs for the substantial share such workers represent nationally. Note also that workers with mainstream employer plans may be reluctant to switch to the Medicaid-network plans offered by Commonwealth Care, Massachusetts’ subsidized program for people under 300% FPL—\$32,490 for an individual, \$66,150 for a family of four.
- The final version of California’s shared-responsibility reform bill (ABx1-1) sought to give low-income workers access to public subsidies, even if they were offered coverage by their employer, but did not specify a mechanism for doing so.
  - (States’ ability to achieve this goal is severely limited by federal ERISA and Medicaid constraints, as well as by the structure of current federal tax subsidies. Given the uncertainties involved, California’s final compromise merely directed state administrative agencies to seek some way of achieving this goal.)<sup>5</sup>
- Both the Senate HELP Committee bill (July 2<sup>nd</sup> discussion draft, adopted July 15, 2009) and the House bill (H.R. 3200, as modified in the Energy and Commerce Committee, July 31, 2009) take a Massachusetts-like approach. (And the Senate Finance Committee is reportedly considering a similar provision.)
  - Workers (or dependents) who are offered employer coverage can enroll in subsidized coverage through the Exchange or Gateway only if the employer coverage would cost them more than a specified percentage of their income, or if the employer plan does not meet minimum standards. The percentage is 12.5% in the HELP bill and 12% in the (amended) House bill, and the House “firewall” applies only to full-time employees.

- To prevent gaming and generate revenue, both the HELP bill and the House bill require employers either to offer coverage and contribute a minimum percentage of the premium or to pay an assessment. The HELP bill also requires that employers not discriminate against low-wage workers (compared to higher wage workers) with respect to eligibility or contributions for employer coverage.

The proposed firewalls are intended to avoid unfunded cost shifts from employer to public financing. But they would unfairly leave many lower income workers in a continued struggle to make both the out-of-pocket contributions and wage concessions associated with their employer coverage. And both these workers and their employers would have strong financial incentives to alter their employment arrangements in order to qualify for coverage in the Exchange. Given the high premium costs relative to wages for these workers, it seems likely that in the longer run, many would find a way to do so. For example, lower wage positions could be shifted over time to contracted firms that do not offer coverage or to part-time positions ineligible for the employer's plan.

### **A Possible Solution: An “Affordability” Tax Credit for Low-Income Workers’ Share of Employer Plan Premiums**

As already noted, under current policy, lower income workers often cannot afford their share of employer plan premiums. (And, unless other changes are made, a cap on the amount of employer plan premiums that can be excluded from taxable income would exacerbate this problem.)

At present, workers facing unaffordable premiums can decline coverage. Unfortunately, an increasing number of lower income workers and families are forced to do so and become uninsured. To fairly achieve coverage of these workers under health reform, they need to have access to coverage they can afford. As discussed, solving this affordability problem is likely to be very expensive if low-income workers can simply decline coverage offered by their employer and instead enroll in subsidized Exchange coverage, or if their jobs are restructured to make them ineligible for employer coverage.

An alternative would be to change the current structure of tax subsidies for worker-paid premiums for employer coverage. (This paper does not address the overall tax treatment of employer health benefits *per se*, but does comment on the potential interaction between the tax treatment of worker-paid premiums and proposals to tax “expensive” health plans, whether through an excise tax or a “tax cap.”)

A *progressive “affordability” tax credit* to offset lower income workers’ contribution costs for employer coverage could both make such coverage more affordable for these workers and reduce federal costs by discouraging crowd-out of employer contributions. The credit could be used in lieu of Section 125 tax exclusions, which are of limited value to lower income workers.

We present and discuss two major variants of this basic concept. Under the first (“Low-Income Credit”), low-income workers would be given the option to choose a progressive tax credit in lieu of tax-sheltering their premium contributions through a Section 125 plan under current law. (Section 125, with modifications, would remain in place for higher income workers.) Under the second variant (“Replacement Credit”), a progressive tax credit would completely replace the use of Section 125 plans to tax-shelter worker premium payments. Three different credit schedules are analyzed for this variant.

In developing the progressive credit schedules presented below, we sought to identify simple schedules that would reduce lower income workers’ net out-of-pocket premium costs, as a percent of family income, to levels similar—though not necessarily identical—to those proposed for workers receiving subsidized coverage through the Exchange / Gateway under current Congressional proposals. At the same time, we sought to reduce, rather increase, net federal costs. And the design takes into account the fact that, under both the House and the HELP bills, workers under the poverty level would have unrestricted access to Medicaid.<sup>6</sup>

*“Low-Income Credit”*

The “Low-Income Credit” would allow lower income workers to choose a progressive tax credit in lieu of tax-sheltering their premium contributions through a Section 125 plan under current law. Because higher income workers would still be able to use Section 125 to tax-shelter their premiums, and because the credit would be more advantageous to lower income workers than Section 125, this approach alone would not be budget neutral. But changes in how Section 125 is applied could help to finance much of the additional cost.

The credit outlined here would be 80% of the worker-paid premium up to 100% FPL (\$10,830 for an individual, \$22,050 for a family of four), and then would step down in 15%-of-premium increments for each additional 50% FPL. (See Table 2.) Workers above 250% FPL (\$27,075 for an individual, \$55,125 for a family of four) would not be eligible for the credit and would use Section 125 instead (potentially with modifications to be discussed shortly). (Above 250% FPL, savings under Section 125 would exceed savings from the stepped-down value of the credit.<sup>7</sup>)

**Table 2: Tax Credit Percentages (as a Percent of Worker-Paid Premium) under an Illustrative “Low-Income Credit,” at Varying Incomes Relative to the Federal Poverty Level (FPL), at 2009 Tax Rates**

Family Income as a Percent of Poverty	Tax-Credit Percentage (Percent of Worker-Paid Premium)
<=100%*	80%
101-150%	65%
151-200%	50%
201-250%†	35%
251% and over	22.65% or more (per Section 125 Savings under Current Law.)

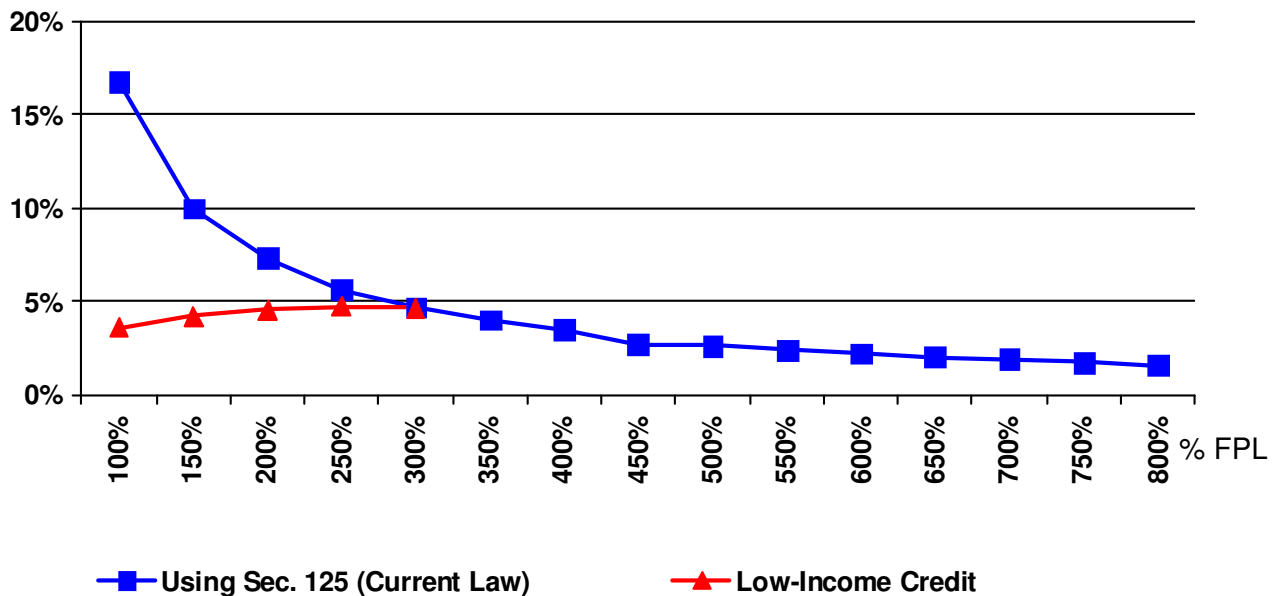
\* 100% FPL is \$10,830 for an individual, \$22,050 for a family of four.

† 250% FPL is \$27,075 for an individual, \$55,125 for a family of four.

Source: Illustration by Institute for Health Policy Solutions using 2009 tax rates.

The impact of the Low-Income Credit on worker’s out-of-pocket premium costs—net of tax savings—relative to income is illustrated in Figure 3. The illustration is for a family of four purchasing employment-based family coverage at average premiums and typical employer contribution rates in 2009 (projected based on the Kaiser/HRET Survey of Employer-Sponsored Health Benefits, 2008).

**Figure 3: Worker’s Out-of-Pocket Premium Payments for Average-Cost Employment-Based Family Coverage, Net of Available Tax Savings, as a Percent of Family Income at Different Income Levels Relative to Poverty, Family of Four, 2009**



Note: Assumes that typical employment-based family coverage costing \$13,340 per year in 2009 (5.2% increase over rates found the Kaiser/HRET Survey of Employer-Sponsored Health Benefits, 2008). Further assumes that the employer contributes 70% of the premium (slightly less than the 2008 average).

Source: Illustration by Institute for Health Policy Solutions using 2009 tax rates.

Sophisticated micro-simulation modeling is beyond the scope of this analysis, but we developed a spreadsheet model to get a rough sense of the change in revenue losses under the proposed tax credits.<sup>8</sup> We estimate the total federal revenue loss due to use of Section 125 for worker-paid health insurance premiums to have been about \$45.2 billion in 2008.

Using this spreadsheet model, we estimate that, if the Low-Income Credit had been in place in 2008, if Section 125 remained available to higher income workers in its current form, and if there was no change in enrollment in employer plans, then the total federal revenue loss would have been \$50.7 billion in 2008, or about \$5.5 billion more than under current law.

### Offsetting Savings

The additional cost of the Low-Income Credit could be more than offset by making changes so that employers no longer realize tax savings for worker contributions under Section 125.

Under current law, when a Section 125 plan is in use, the amount of premium payments withheld from workers' pay is completely excluded from the worker's income for both income-tax and FICA payroll-tax purposes. The worker thus pays neither income taxes nor Social Security (6.2%) and Medicare (1.45%) payroll taxes on earnings deducted from their paycheck to pay health insurance premiums. Importantly, this also means that the worker's employer does not pay payroll taxes (total 7.65%) on the amount the worker pays for premiums through a Section 125 plan. (This policy is an artifact of the rationale developed to allow existing Section 125 tax sheltering of premium payments withheld from workers' pay—the “legal fiction” that these worker contributions are employer contributions and therefore can receive the same tax exclusions.) But in the context of health reform and coverage of uninsured workers who cannot afford coverage, it would be sensible to reform these policies so that federal tax expenditures are more progressively targeted to offset lower income workers' costs.

We estimate federal spending on the existing employer tax shelter on worker contributions to be about \$9.4 billion in 2008. (Or well over \$100 billion over 10 years!) Part of this tax spending (\$1.8 billion) would be automatically recaptured by the basic design of the Low-Income Credit, because low-income workers using the credit would *not* be using Section 125. Recapturing the remaining \$7.6 billion would exceed the estimated \$5.5 billion net cost increase for the new Low-Income Credit by \$2.1 billion (in 2008).

The \$2.1 billion net savings (more than \$25 billion over the 10-year period 2010-2019) could finance tax credits for other low-income workers who now decline coverage but would be “firewalled” from assistance under current proposals. Any remaining net savings would reduce affordability credit costs for other workers receiving credits for Exchange coverage. (We do not have data adequate to estimate these respective costs.)

These savings could be captured without increasing higher income workers' net contribution costs, and without varying from the conventional 50-50 FICA share for workers and employers. First, Section 125 could be changed to parallel treatment of worker contributions to section 401(k) plans—worker-paid premiums would be excluded from income only for income tax purposes and not for payroll tax purposes.

Then, to compensate higher-income workers for their loss of payroll-tax savings (the credit for low-income workers would already substantially exceed their loss of payroll-tax savings), workers above 250% FPL could be given a credit equal to 7.65% of the premiums they pay—the amount of payroll taxes they would have saved through Section 125 under current law—in addition to whatever income tax savings are generated by use of a revised Section 125 plan. (For workers earning more than the Social Security wage base—currently \$106,800—this credit would be reduced to 1.45%, since the 6.2% Social Security tax does not apply to earnings above that level.)

The tax credit outlined above would make coverage affordable for low-income workers while leaving current tax benefits in place for higher income workers. Federal savings would be greater if a progressive tax credit replaced Section 125 tax sheltering entirely (as discussed next). The

amount of savings for any approach will, of course, reflect the tax credit schedule and eligibility levels.

*“Replacement Credit”*

A “Replacement Credit” approach would completely eliminate the use of Section 125 plans to tax-shelter worker premium payments and would substitute a progressive tax credit. (Use of flexible spending accounts and other “cafeteria plan” benefits under Section 125 would not be affected by this proposal.)

By varying the progressive sliding scale for the credit, this approach could be designed to be budget neutral or to generate savings that could be used to offset health reform costs. Three possible schedules are illustrated:

- Under Alternative 1, the credit for workers under 100% FPL (\$10,830 for an individual, \$22,050 for a family of four) would be 80% of the worker-paid premium. Above 100% FPL, the credit percentage would step down 10% of premium for each additional 50% FPL, until the credit was eliminated entirely above 450% FPL.
- Alternative 2 would follow the Low-Income Credit schedule under 250% FPL, starting the credit at 80% of the worker-paid premium up to 100% FPL and stepping down in 15%-of-premium increments for each additional 50% FPL, reaching 20% of premium at 251% FPL. But workers above that level would also receive a 20% credit.
- Alternative 3 would follow the schedule for Alternative 1, but the credit would never be eliminated entirely. Instead, all workers would receive at least a 15% credit. (The 15% credit would apply above 400% FPL—\$43,320 for a single individual, \$88,200 for a family of four.)

Tax credits of this magnitude could create strong incentives for employers to reduce their percentage contributions for low-income workers. To obviate those incentives, it will be important to adopt related policies, including:

- a nondiscrimination provision requiring that employers contribute no less to lower wage than higher wage workers (such as in the HELP Committee bill); and
- a limit on the total share of premium to which the credit could apply (e.g., 50%).

Table 4 compares the proposed Replacement Credit percentages with the savings available by using a Section 125 plan (under current law) to families at different income levels, as a percentage of premium.

Figure 5 shows the worker’s out-of-pocket cost for premiums, net of the tax savings available under the proposed three alternative Replacements Credits compared with using a Section 125 plan under current law, as a percent of family income at different income levels relative to poverty. The illustration is for a family of four purchasing employment-based family coverage at average premiums and typical employer contribution rates in 2009 (projected based on the Kaiser/HRET Survey of Employer-Sponsored Health Benefits, 2008).

**Table 4: Tax Savings to Workers as a Percent of Worker-Paid Premium under Three Alternative Progressive “Replacement Credit” Schedules, Compared to Typical Savings Using a Section 125 Plan under Current Law, for Four Family Types at Varying Incomes Relative to the Federal Poverty Level (FPL), at 2009 Tax Rates**

Family Income as a Percent of Poverty	Replacement Credit Percentage (Percent of Worker-Paid Premium)			Tax Savings (as a Percent of Worker-Paid Premium) from Using Section 125 under Current Law (measured at high end of income range)			
	Alternative 1	Alternative 2	Alternative 3	Childless Single	Childless Couple	Single Parent with 2 Children	Married Couple with 2 Children
<=100%*	80%	80%	80%	17.65%	7.65%	17.65%	7.65%
101-150%	70%	65%	70%	17.65%	17.65%	21.27%	17.65%
151-200%	60%	50%	60%	22.65%	17.65%	22.65%	19.40%
201-250%†	50%	35%	50%	22.65%	19.38%	22.65%	22.65%
251-300%	40%	20%	40%	22.65%	22.65%	28.00%	22.65%
301-350%	30%	20%	30%	22.65%	22.65%	32.65%	22.65%
351-400%‡	20%	20%	20%	22.92%	22.65%	32.65%	22.65%
401-450%	10%	20%	15%	32.65%	22.65%	32.65%	32.65%
451-500%	-0-	20%	15%	32.65%	22.65%	26.45%	27.31%
551-600%	-0-	20%	15%	32.65%	25.41%	26.45%	26.45%
651-700%	-0-	20%	15%	32.65%	32.65%	29.45%	26.45%
751-800%	-0-	20%	15%	32.65%	26.45%	29.45%	29.45%

**Notes:** Tax savings under current law assume typical premiums for employment-based coverage costs in 2009 (based on approximately a 5% increase over rates found the Kaiser/HRET Survey of Employer-Sponsored Health Benefits, 2008), and average employer contribution percentages.

Tax savings shown under current law do not include payroll-tax savings that accrue to the employer—an additional 7.65% of premium up to the Social Security wage base (\$106,800 in 2009) and 1.45% of premium above that earnings level.

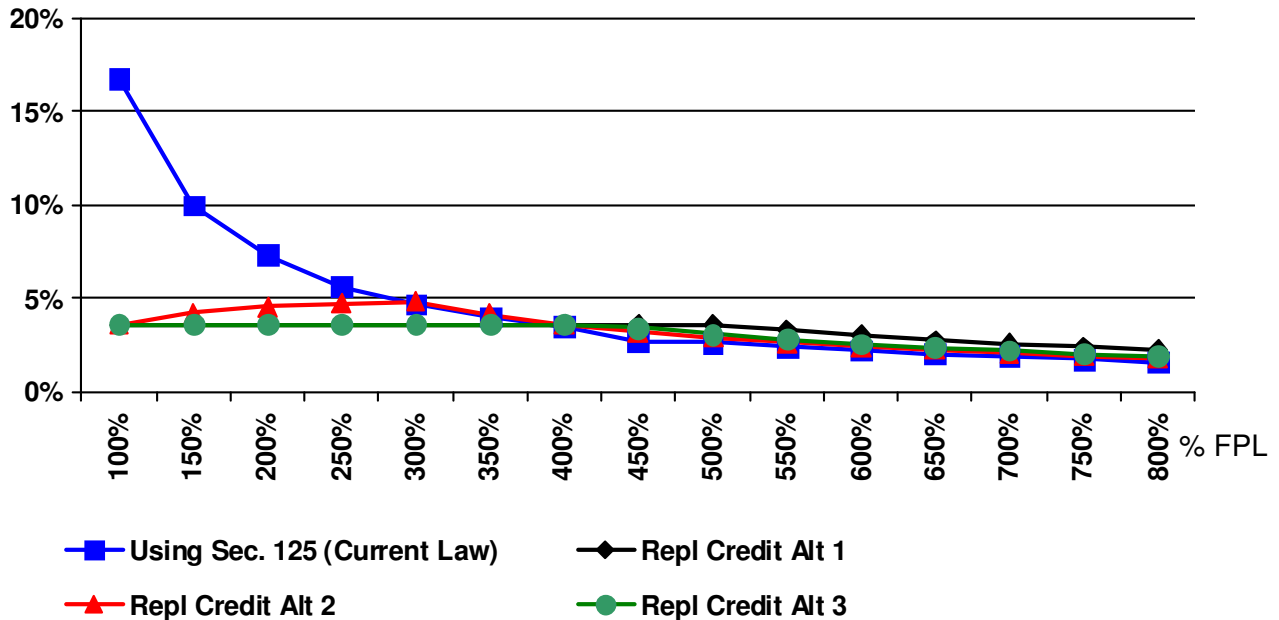
\* 100% FPL is \$10,830 for an individual, \$22,050 for a family of four.

† 250% FPL is \$27,075 for an individual, \$55,125 for a family of four.

‡ 400% FPL is \$43,320 for an individual, \$88,200 for a family of four.

**Source:** Illustration by Institute for Health Policy Solutions using 2009 tax rates.

**Figure 5: Worker’s Out-of-Pocket Premium Payments for Average-Cost Employment-Based Family Coverage, Net of Available Tax Savings, as a Percent of Family Income at Different Income Levels Relative to Poverty, Family of Four, 2009**



**Note:** Assumes that typical employment-based family coverage costing \$13,340 per year in 2009 (5.2% increase over rates found the Kaiser/HRET Survey of Employer-Sponsored Health Benefits, 2008). Further assumes that the employer contributes 70% of the premium (slightly less than the 2008 average).

**Source:** Illustration by Institute for Health Policy Solutions using 2009 tax rates.

We used our spreadsheet model to get a rough sense of the change in revenue losses under the alternative Replacement Credit schedules. As noted earlier, our estimate of the total federal revenue loss due to use of Section 125 for worker-paid health insurance premiums in 2008 is \$45.2 billion.

If Replacement Credit Alternative 1 had been in place in 2008 instead of Section 125 tax sheltering of worker-paid premiums, and there was no change in enrollment in employer plans, we estimate the federal revenue loss would have been only about \$28.1 billion in 2008—a substantial savings of about \$ 17.1 billion. Over the 10-year period 2010-2019, savings could total over \$200 billion.

- These substantial savings are generated in large part by the elimination of any tax savings—both income tax and payroll tax—for workers above 450% FPL (\$48,735 for an individual, \$99,225 for a family of four), who constitute half of all workers currently enrolled in coverage through their own employer. Tax savings are reduced for another one in six currently enrolled workers.

- Despite the elimination of tax savings for higher income workers and families, their net contribution costs would increase by less than 1% of income for workers at 500% FPL who face typical employee premium shares, and less for higher income workers.
- Additional savings come from reclaiming the employer share of payroll taxes on worker-paid premium amounts, which happens automatically under a Replacement Credit approach because Section 125 is no longer used for premium payments.

If Replacement Credit Alternative 2 had been in place in 2008, the federal revenue loss would have been about \$36.9 billion—a savings of about \$8.3 billion. Over the 10-year period 2010-2019, savings could total over \$100 billion.

- Savings are generated because all enrolled workers above 250% FPL get smaller tax savings—as a percentage of premium—under Alternative 2 than under Section 125. That’s about 5/6s (83%) of all workers currently enrolled in coverage through their own employer.

If Replacement Credit Alternative 3 had been in place, the federal revenue loss would have been about \$39.2 billion in 2008—a savings of about \$6.0 billion. Over the 10-year period 2010-2019, savings could total over \$80 billion.

- The savings under Alternative 3 are smaller than under Alternative 2 because only about 17% of currently covered workers get a credit under Alternative 2 that is worth more than their current savings under Section 125. That figure is twice as high—34%—under Alternative 3. And the credit phases out more quickly under Alternative 2 than under Alternative 3.
- But savings are generated under Alternative 3 because all enrolled workers above 350% FPL (about two-thirds of the total) get smaller tax savings—as a percentage of premium—under Alternative 3 than under Section 125.

Thus, based on this admittedly rough model, it appears that all three alternative Replacement Credits could save the federal government considerable sums—based on currently enrolled workers (and ignoring the distinction between income taxes and payroll taxes).<sup>9</sup> Those savings could then be applied to the cost of subsidizing newly enrolled low-income workers and dependents—either in employer coverage (with the new tax credits) or through the Exchange (with a different subsidy structure). Under Alternatives 2 and 3, where credits continue above the Exchange subsidy level (300% or 400% FPL), the savings could potentially be used to improve horizontal equity by making the credit available to people—including the self-employed and early retirees—who purchase coverage through the Exchange but do not qualify for income-based premium subsidies.

The purpose of a progressive tax credit would be to make employer coverage more affordable for low-income workers, who could then afford to enroll in it. So, if this change was made in isolation, it would cost money. However, in the context of health system reforms which provide significant subsidies for low-income people who enroll through an Exchange / Gateway, the relevant question is whether the progressive tax credit for employer coverage would cost the government more or less than the subsidy for Exchange coverage. Given that the credit will apply to at most half of the total premium for employer coverage, while subsidies in the Exchange will have to cover the entire premium (less the income-based worker’s share), it seems likely that in most cases the tax credit cost will be less than the Exchange subsidy cost.

Table 6 summarizes the estimated revenue losses under the three alternative Replacement Credit schedules presented above, and compares them to the Low-Income Credit discussed earlier. It is worth emphasizing that these estimates are very rough. For example, they assume that workers at different income levels face the same average premiums for coverage of themselves, their spouses and their children. If these alternatives are of interest, more thorough and sophisticated estimates will be required.

**Table 6: Federal Revenue Loss under Alternative Tax Credit Designs, Compared to Current Law (IRC Section 125), 2008 and 2010-2019**

Tax Scenario	Estimated Federal Revenue Loss in 2008 (billions)	Savings or (Cost) Compared to Current Law (billions)	
Section 125 (Current Law)—for health insurance premiums <u>only</u>	\$45.2	n/a	
“Replacement Credit”		[in 2008]	[over the 10-year <sup>†</sup> period 2010-2019]
--Alternative 1 (complete phase-out)	\$28.1	\$17.1	\$239
--Alternative 2 (20% minimum credit)	\$36.9	\$8.3	\$116
--Alternative 3 (15% minimum credit)	\$39.2	\$6.0	\$ 84
“Low-Income Credit”			
--If no change in Section 125	\$50.7	(\$5.5)	(\$77)
--If employer tax savings on worker premium payments are recaptured*	\$43.1	\$2.1	\$ 29

**Notes:** Tax savings under Section 125 assume typical premiums for employment-based coverage costs in 2009 (based on approximately a 5% increase over rates found the Kaiser/HRET Survey of Employer-Sponsored Health Benefits, 2008), and average employer contribution percentages.

<sup>†</sup> 10-year projections assume savings/costs grow at the same rate as private health insurance spending in the national health expenditures projections.

\* See earlier discussion of the Low-Income Credit for a full explanation.

Savings estimates assume no change in current enrollment in employer coverage. But note that increased enrollment among low-income workers—who would receive higher tax credits—is a specific intent of the policy. That additional cost should be compared with the cost of subsidizing such workers enrolled in Exchange-based coverage, but is expected to be considerably less.

**Source:** Illustration by Institute for Health Policy Solutions using 2009 tax rates applied to 2007 population data and 2008 premium levels.

*Tax Credits in the Context of a Tax on Expensive Health Plans*

A “tax cap” or limit on the amount of premium payments (by both employer and employee) that can be excluded from (all) workers’ taxable wages may no be longer under consideration. Instead, lawmakers are considering the idea of an “excise tax” on the most expensive health

plans. Either approach would raise the net cost of health coverage and care for low- and modest-income workers who work for an employer that currently offers only expensive plans.

An example cited by policymakers considering an excise tax is extraordinarily rich benefit plans provided to highly compensated executives. But if premium price is the determinant of what is considered “expensive,” some plans may meet that criterion more because of the health-risk profile of the employer group than because of overly rich benefits. In that case, there could be a number of low- and modest-income workers enrolled in the plan, and an excise tax would exacerbate their unfair cost burden.

A sliding-scale progressive tax credit for the worker’s share of the premium could help assure that all workers employed in less healthy groups or in more expensive geographic areas could afford coverage even with such an additional tax, and provide substantial relief from the otherwise unfair effects of the additional tax. If anything, the need for a low-income tax credit would be greater with such an excise tax.

#### *Administering the Tax Credit*

In order to be helpful to low-income workers, these tax credits would have to be available on a current basis, just as the tax savings under Section 125 are. When Section 125 is used, worker-paid premiums are deducted (“excluded”) from the worker’s taxable income on each paycheck. Thus, payroll taxes and income tax withholding are automatically reduced, paycheck by paycheck. A tax credit could also be administered on a current basis through the employer’s payroll system, using a mechanism like that recently established for COBRA premium subsidies under the federal stimulus bill.

The stimulus bill established a 65% federal subsidy for COBRA premiums. Employers bill COBRA enrollees for 35% of the applicable premium, instead of 100%. They reclaim the 65% subsidy by offsetting it against the federal payroll taxes and income-tax withholding that they are required to transmit to the government on a regular basis (at least quarterly).

The tax credit proposed here could be administered in a similar fashion. The one complicating item is that the credit percentage varies with the worker’s (family) income. But it should not be difficult to create a simple form that workers could complete and file with their employer stating what percentage credit they qualify for based on, for example, the income reported on their most recent federal income tax return. Employers would rely on that information, provide the tax credit at the stated rate, and report the total tax credit amount received for the year on the worker’s W-2. Further consideration would need to be given to whether or not the tax credit amount should be adjusted on their tax return based on the taxpayer’s actual income for the year.

### **Addressing Potential Problems**

Several potential problems need to be addressed under such a tax credit approach.

#### *Avoiding Incentives for Employers to Reduce Their Contributions*

High percentage credits for all workers’ contribution costs would create a strong incentive for employers to reduce their premium contributions. But especially in light of other reform provisions, targeting the credits towards low-income workers should avoid such perverse incentives. (Only 7% of all persons with employer coverage have incomes under 150% FPL—

the level that qualifies for the two highest subsidy rates. Under the “Low-Income Credit” schedule, the 35% tax credit for incomes between 200%-250% FPL is no higher than the combined federal and state tax subsidies often realized under Section 125 plans for the majority of workers on employer coverage.)

At businesses with workforces that include many higher wage workers, as most firms offering coverage do, the proposed nondiscrimination provisions discussed earlier will prevent employers from reducing their contributions for low-income workers unless they also reduce their contributions for their larger numbers of higher income workers as well.

Given that higher wage workers would receive the same or lower tax subsidies under these tax credit alternatives as they do under current policy, and given that employers would no longer receive an exclusion from FICA taxes on worker earnings spent on health insurance, such employers should be strongly discouraged from shifting contribution costs to their workers as a response to worker tax credits.

Further, minimum-percent-of-premium contribution requirements, such as those in both the House bill and the HELP bill, should keep all offering employers, regardless of their wage profile, from reducing contributions below the levels specified. If such contribution minimums were dropped from final legislation, a cap on the worker’s share of premium to which the tax credit could apply might be needed. This cap might be set such that workers facing contributions that are higher than this limit would generally be those who qualify for the “firewall” exceptions of, e.g., 12% or 12.5% of income.

Those (few) businesses with low average wages that now make a high percentage contribution, and cover most of their workers, would have strong incentives to reduce their contributions. But most such employers do not offer coverage, and those that do tend to cover a low proportion of their workers. According to the 2008 MEPS-IC employer survey, only 39% of business establishments in the lowest average wage quartile offer coverage, and where they do offer coverage, only 36% of their workers are enrolled (compared to 61% across all employers that offer coverage).

Furthermore, the assessments proposed to be imposed on non-offering low-wage firms are relatively low: the 8%-of-payroll assessment in the House bill translates to \$1,600 per year for a worker earning \$20,000, while the HELP bill would assess just \$750 per year per full-time worker. In 2008, even low-wage employers—if they offered coverage at all—typically contributed more than \$3,000 to worker-only single coverage.<sup>10</sup> Given these assessment levels, and given that workers of non-offering firms would have full access to subsidized coverage in the Exchange, low-wage businesses would have strong incentives to drop coverage entirely and pay such an assessment instead. But other provisions provide the option for small, low-wage employers to receive sliding-scale tax credits for providing and contributing toward coverage. These other options would provide more relief to low-wage employer groups than would a reduction in the employer contribution down to the minimum allowed for purposes of the sliding-scale worker credit.

#### *Addressing High Cost-Sharing in Some Employer Plans*

Some employer plans impose relatively high deductibles and/or copayments and coinsurance. Such plans might not provide adequate financial protection for low-income workers and their

families. Therefore, rather than provide tax credits to finance keeping such workers in their employer's plan, it would be more appropriate to let them enroll through the Exchange, where they will have access to plans with cost-sharing more suitable to their situation.

These concerns could be addressed in several ways.

- ▶ One approach would give low-income workers a choice between staying with their employer plan, with a tax credit, or enrolling in subsidized coverage through the Exchange. In the latter case, however, the employer would be required to make a contribution to the Exchange. That contribution might be the same as the formula-based payment required by employers that do not offer coverage at all. Or it might be the normal contribution the employer would make if that worker enrolled in the employer's plan. A formula-based contribution would probably be lower than the employer's normal contribution in most cases, so public subsidy costs would be greater. But it would be fairer across all employers of low-income workers. Requiring the employer to transmit their normal contribution to the Exchange would probably generate more revenue.

Depending on the relative health-cost profiles of lower v. higher income workers in particular employer groups, the employer's "normal" contribution would often not reflect expected costs for those workers who go to the Exchange. (See Appendix B for a discussion of this issue.) But, if the substantial tax credits proposed here were available toward employer coverage, the number of low-income workers leaving employer coverage for the Exchange should be small enough that any cost-contribution mismatch would not have a significant fiscal impact.

- ▶ If employers objected to sending their normal contribution to the Exchange "with the worker," they could be given the following alternative: Make available to tax-credit-eligible workers a benefit package with lower cost-sharing—one that meets the same actuarial-value requirements as Exchange plans will have to meet for subsidy recipients—and pay the same percentage of the premium that the employer pays for its standard plan.

By choosing to provide this upgraded benefit, the employer would not be required to transmit contributions to the Exchange and its workers would not be eligible for subsidized coverage through the Exchange, but they would be eligible for a tax credit as outlined above.

### **Continuity and Stability of Coverage While Temporarily Unemployed**

Health reform should ideally facilitate rather than impede people's ability to afford stable sources of coverage.

For example, when a family enrolled in a worker's employer plan suffers an extended income cut because the (secondary worker) spouse is laid off, it should be able to get needed assistance for continued coverage in their current (the primary worker's) plan rather than being forced to switch to Exchange coverage (often temporarily) to get assistance, or being "firewalled" from assistance altogether. Under Committee-approved bills, however, workers would have to switch to coverage through the Exchange in order to obtain public subsidies, only to switch back to an employer plan after their spouse has regained employment and income.

Similarly, laid-off (primary) workers should be able to afford to pay COBRA premiums to remain in their employer's plan. But, under the Committee bills (once the stimulus package

subsidies for COBRA continuation coverage expire next year), laid-off workers would most likely not be able to afford to remain in their employer's plan and would have to purchase coverage through the Exchange in order to obtain public subsidies.

Then, when the worker's situation changes—they find a new job that offers health benefits, or their spouse finds a new job that restores their former income level—they would have to switch plans again. Thus, two plan and enrollment source switches, often entailing provider changes, could be a financial imperative (given individual responsibility) within a relatively short period of time (typically 10-14 weeks).

That is not the easy access that reforms are billed to achieve. Given the importance people place on improving stability and simplicity under reforms, such a confusing, burdensome requirement should be avoided. And, unless an alternative is adopted, it seems inevitable that a large number of the temporarily unemployed will continue to be uninsured.

Implementing the tax credits outlined above would address these problems when family income is reduced because the (secondary worker) spouse loses a job or has hours reduced. But to address the continuity-of-coverage problem when the primary worker is laid off, sliding-scale subsidies would have to be provided for COBRA coverage on a permanent basis.

The tax-credit regime outlined above provides a method for doing so. Instead of the flat 65% COBRA subsidy under the stimulus bill, the same sliding-scale credit structure adopted for the active-worker tax credit could be applied. Laid-off workers would declare the credit percentage they qualify for, just as active workers would, and the subsidies would be paid by the employer and claimed against income and payroll taxes due, just as they are for the current temporary COBRA subsidies.

## **Conclusion**

A critical challenge for health reform involving individual responsibility is finding a way to assure affordable access to coverage for the large number of modest-income workers eligible for employer coverage. The growing proportion of low-income workers who decline employer coverage available to them reflects the existing affordability problem for many such workers.

The firewalls proposed in the July versions of the House and Senate HELP Committee legislation are intended to protect against a major shift from employer-financed to federally financed coverage for such workers. But they would require many near-poor workers to pay unreasonably high portions of their income compared to others at the same income level who, because they are not eligible for employer coverage, have access to subsidized coverage through the Exchange. That is clearly unfair, and in the longer run would encourage all modest-income workers and their employers to arrange for employment that does not include health coverage.

The sliding-scale tax credits and associated policies outlined herein could assure convenient, affordable and more stable coverage for many modest-income workers who have suffered disproportionate costs and wage concessions to participate in employer coverage, or have remained uninsured due to unaffordable contribution requirements. They could be packaged with other changes in the tax treatment of worker contributions so as to reduce net federal expenditures (compared to health reform proposals that do not include them).

## **Appendix A: Why Lower Income Workers Eligible for Employer Coverage Constitute a Big Issue; Why Federal Subsidy Costs Could Escalate**

The risk that public subsidies (only) for Exchange coverage could cause large numbers of low-income workers and their dependents to shift from employer-financed to publicly financed coverage is a significant policy concern, due to the potential impact on the budgetary cost of the proposal. That impact is potentially large, for several reasons:

- First, a significant share of people who currently have employment-based coverage have incomes below the subsidy eligibility levels suggested in current federal proposals. More than 25% of adults now on employer coverage have incomes less than 3 times the poverty level, and the figure reaches 30% when children are included along with adults. And more than 42% of non-elderly adults with employer coverage—50 million out of 118 million—have incomes below 400% FPL. (See Table A-1.)

**Table A-1: Percent of People with Employment-Based Coverage Who Have Incomes Below 400% and 300% of the Federal Poverty Level (FPL), United States, 2007**

Population Group:	Percent with Income Below:	
	300% FPL*	400% FPL†
Ages 0-64 covered by <u>any</u> employer	29.8%	46.6%
Ages 19-64 covered by <u>any</u> employer	26.2%	42.6%
Ages 19-64 covered by <u>own</u> employer	27.3%	43.9%

\* 300% FPL is \$32,490 for an individual, \$66,150 for a family of four.

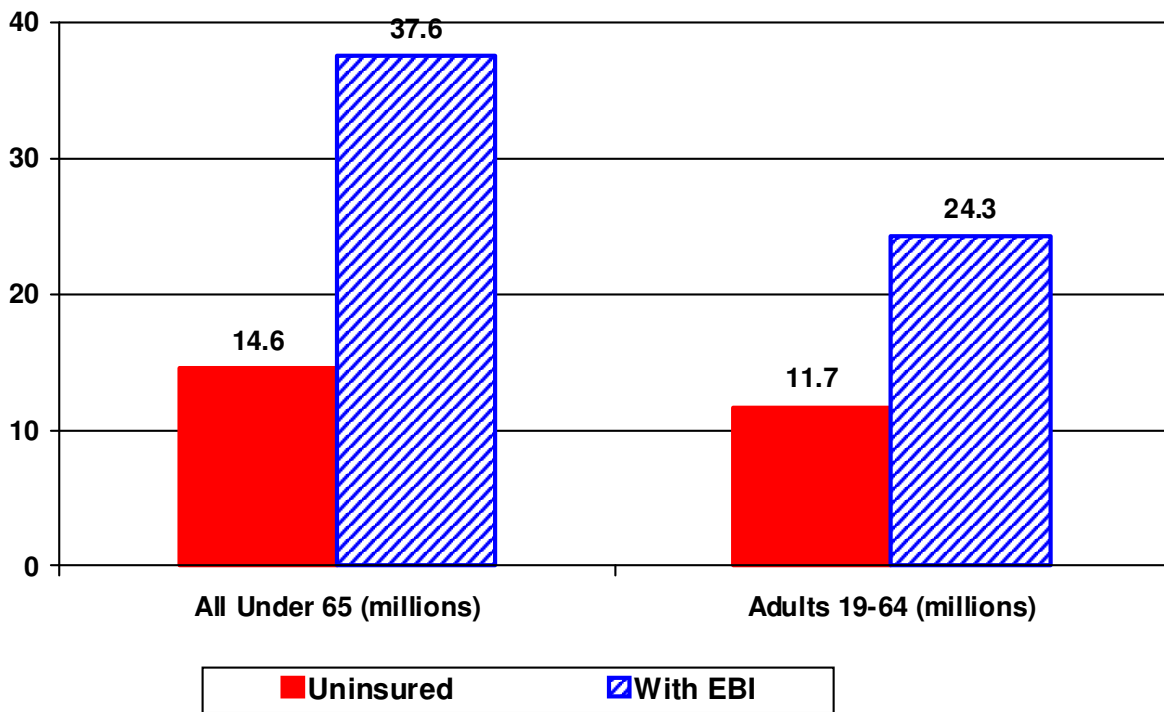
† 400% FPL is \$43,320 for an individual, \$88,200 for a family of four.

Source: U.S. Census Bureau, Current Population Survey, Annual Social and Economic Supplement, 2008. Data extracted using the online CPS Table Creator at [http://www.census.gov/hhes/www/cpssc/cps\\_table\\_creator.html](http://www.census.gov/hhes/www/cpssc/cps_table_creator.html).

- Second, above proposed Medicaid income levels, many more low-income workers and dependents have employer coverage than are uninsured.
  - In the 150%-to-300%-of-poverty range—the core target range for sliding-scale premium subsidies through the Exchange across current proposals—about two-and-a-half times as many people under age 65 have employer coverage as are uninsured. (See Figure A-2.)
    - » Nonelderly people in the 300%-to-400%-of-poverty range—who are eligible for sliding-scale Exchange subsidies under both the House bill and the HELP Committee bill—are six times as likely to have employer coverage as to be uninsured. (Not shown in Figure.)
  - Among adults 19-64 between 150% and 300% FPL, more than twice as many have employer coverage as are uninsured. (Excluding children lowers the ratio because their overall uninsured rate is lower than that of adults.)

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**Figure A-2: Millions of People with Employment-Based Insurance (EBI) and Millions Uninsured, in the 150%-300% of Poverty Income Range, United States, 2007**



Source: U.S. Census Bureau, Current Population Survey, Annual Social and Economic Supplement, 2008. Data extracted using the online CPS Table Creator at [http://www.census.gov/hhes/www/cpstc/cps\\_table\\_creator.html](http://www.census.gov/hhes/www/cpstc/cps_table_creator.html).

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## **Appendix B: Assessing the “Portable Employer Contribution” Approach**

One alternative approach, which could be combined with other alternatives, was included in the Senate Finance Committee’s mid-May Coverage Options paper. Low-income workers who were offered employer coverage would be allowed to enroll in subsidized coverage through the Exchange rather than in their employer’s plan. Where this occurred, the employer would be required to transmit its “normal” employer plan contribution to the Exchange (rather than an amount based on a formula such as a percentage of wages or a dollar amount per worker).

If combined with a minimum percent-of-premium standard for employer contributions (as in both the House bill and the HELP Committee bill) and/or with a prohibition against discrimination based on wage level (as in the HELP Committee bill), this approach could allow all low-income workers to access coverage with cost sharing appropriate to their incomes (assuring horizontal equity) while maintaining current levels of employer contributions toward health coverage (avoiding crowd-out of employer contributions)—at least at wage-heterogeneous employers. (Employers with a high percentage of low-income workers, however, would still have a strong financial incentive to drop coverage entirely and reduce their costs by instead paying no more than 8% of payroll—or even less under the HELP bill—for their low-wage workers. So some crowd-out would still be likely.)

The intent here is to make the employer economically neutral with respect to which coverage choice the worker makes. But in many employer groups, low-income eligible workers have significantly different health cost profiles than other workers. If those low-income workers tend to be younger and healthier than the employer group as a whole, then the employer would be paying too much if it paid its average “normal contribution” for them. Average costs for workers remaining in the employer group would be higher, and total employer costs would increase.

If, on the other hand, the low-income workers switching to the Exchange were older and/or less healthy than average for the employer group, then the employer group would have an incentive to encourage them to leave (its average costs would go down), and the Exchange would experience adverse selection. So, to protect both employer groups and the Exchange from considerable adverse selection costs, it could be helpful to adjust the employer’s “normal contribution” based on the characteristics of workers who choose the Exchange rather than the employer’s plan. However, no simple way of adequately doing so appears to be available.

- Available research (detailed below) suggests that low-income workers eligible for employer coverage are on average younger, but less healthy for their age, than higher income workers. But this varies considerably across employer groups.
- The same research indicates that age-adjusting the employer’s contribution would generally make “portable” contributions financially favorable to employers but unfavorable to the Exchange.

Also, determining an employer’s “normal” contribution would be considerably more difficult than using a simple per-worker or percent-of-wages approach. And health- and/or age-adjusting the normal contribution would add considerable administrative complexity.

*What Available Research Says*

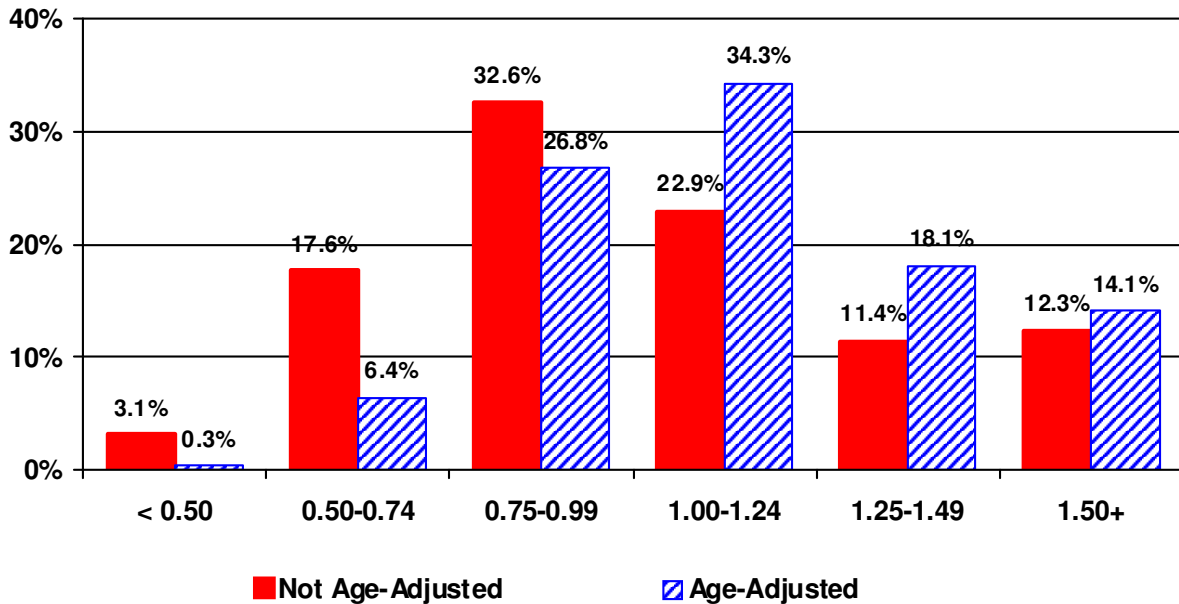
The question of how expected health care costs for low-income workers compare to expected costs for higher income workers was examined for California in 2006 by RAND Senior Economist Susan Marquis, Ph.D. (since retired).<sup>11</sup> Specifically to estimate such risk-profile effects, she developed a robust database that matched worker characteristics from population surveys, including their health cost experience, with employer characteristics from employer surveys and from state employer databases. Using this database, Dr. Marquis estimated the proportion of California businesses that offer health coverage in which expected health care costs differed for the low-income workers eligible for that coverage compared to the higher income workers in the same firm. (In this study, “low-income” meant workers with family incomes under 250% of poverty, and “higher income” meant all other workers.)

Focusing on businesses with 10 or more workers, she found that, for 4 of every 9 businesses (44.5%), expected average health care costs for low-income workers were more than 25% above or below expected average health care costs for higher income workers. At 23.8% of businesses, expected health care costs for low-income workers were more than 25% higher (and more than 50% higher for 12.3% of businesses). At 20.7% of businesses, expected health care costs for low-income workers were more than 25% lower, compared to higher income workers. (See “Not Age-Adjusted” entries in Figure B-1.)

To determine whether a simple adjustment for the age of low-income v. higher income workers would adequately address this problem, Dr. Marquis adjusted expected health care costs to account for the relative age distributions of the two populations (low-income and higher income eligible workers). After this adjustment, the percentage of businesses in which expected costs for the two populations differed significantly (i.e., the ratio of expected costs was under 0.75 or over 1.24) fell slightly to 38.9%. However, for these employer groups, expected costs for low-income workers were almost always more than 25% higher, rather than lower, than expected costs for higher income workers (32.2% of businesses v. 6.7% of businesses). (See “Age-Adjusted” entries in Figure B-1.)

These findings are consistent with other data showing that lower income workers with employer coverage report poorer health status, on average, than higher income workers with employer coverage. (See Table B-2.) And they suggest that, even with “age-adjusting,” a policy which required employers to transmit their “normal contribution” to the Exchange would result in a significant number of employers paying much less than actual costs for low-income workers who chose to enroll in the Exchange rather than in employer coverage.

**Figure B-1: Distribution of Businesses with 10 or More Employees by Ratio of Expected Health Care Costs for Low-Income Workers to High-Income Workers Eligible for Employer-Sponsored Health Coverage, California, 2006**



Notes: “Low-income” means under 250% of poverty. Comparison excludes firms with fewer than 10 employees, non-offering firms and firms with only low-income or only high-income eligible workers.

Source: Tabulations from the RAND California database by Susan Marquis, Ph.D.

Although Dr. Marquis analyzed California rather than national data, the distribution by self-reported health status of all non-elderly Californians who have employer coverage is very similar to the national distribution, both above and below 250% of poverty. (See Table B-2.) Therefore, we believe the main thrust of this analysis would hold true at the national level as well as in California.

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**Table B-2: Distribution by Self-Reported Health Status of People Ages 0-64 with Employment-Based Coverage Who Have Incomes Above and Below 250% of the Federal Poverty Level (FPL), California and United States, 2007**

Self-Reported Health Status	Income less than 250% FPL		Income 250% FPL or more	
	United States	California	United States	California
Excellent (=1)	35.9%	35.6%	42.4%	44.2%
Very Good (=2)	33.5%	32.0%	34.5%	31.9%
Good (=3)	23.0%	25.5%	18.7%	19.6%
Fair (=4)	5.8%	5.9%	3.6%	3.6%
Poor (=5)	1.8%	0.9%	0.9%	0.7%
Weighted Average	2.04	2.04	1.86	1.85

Source: U.S. Census Bureau, Current Population Survey, Annual Social and Economic Supplement, 2008. Data extracted using the online CPS Table Creator at [http://www.census.gov/hhes/www/cpstc/cps\\_table\\_creator.html](http://www.census.gov/hhes/www/cpstc/cps_table_creator.html).

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## NOTES

<sup>1</sup> The major proposals currently under active consideration include the Senate Finance Committee's May 14, 2009, Description of Policy Options, "Expanding Health Care Coverage: Proposals to Provide Affordable Coverage to All Americans" <Access through <http://www.finance.senate.gov/sitepages/legislation.htm>>; the Senate Health, Education, Labor and Pensions Committee's "HELP Health Reform Legislation – Section by Section Narrative with Options" and associated draft bill language, released June 9, 2009, <[http://www.help.senate.gov/BAI09A84\\_xml.pdf](http://www.help.senate.gov/BAI09A84_xml.pdf)> with a subsequent amendment released July 2, 2009 <[http://www.help.senate.gov/BAI09F54\\_xml.pdf](http://www.help.senate.gov/BAI09F54_xml.pdf)>; and the House Tri-Committee Health Reform Bill (H.R. 3200), released July 14, 2009, <http://edlabor.house.gov/blog/2009/07/americas-affordable-health-choices-act.shtml>, with amendments proposed by the "Blue Dog" Democrats and accepted by the Energy and Commerce Committee, July 31, 2009 <[http://energycommerce.house.gov/Press\\_111/20090731/hr3200\\_ross\\_2.pdf](http://energycommerce.house.gov/Press_111/20090731/hr3200_ross_2.pdf)>.

<sup>2</sup> People below a lower income threshold would either be covered through Medicaid or pay no premium for Exchange coverage. The Committee proposals vary on details.

<sup>3</sup> The remaining 18% are on Medicaid or some other coverage source. Peter Cunningham, Samantha Artiga and Karyn Schwartz, "The Fraying Link Between Work and Health Insurance: Trends in Employer-Sponsored Insurance for Employees, 2000-2007," Issue Paper, Kaiser Commission on Medicaid and the Uninsured, November 2008, <<http://www.kff.org/uninsured/7840.cfm>>.

<sup>4</sup> R.E. Curtis and E. Neuschler, "Affording Shared Responsibility for Universal Coverage: Insights from California," *Health Affairs* 28, no. 3 (2009): w417–w430 (published online 24 March 2009; 10.1377/hlthaff.28.3.w417).

<sup>5</sup> *Ibid.*

<sup>6</sup> The House bill extends Medicaid eligibility to everyone below 133% FPL. The Senate HELP bill assumes Medicaid will be extended to 150% FPL, but its bill does not include provisions to implement this assumption, because the Committee lacks jurisdiction over the Medicaid program.

<sup>7</sup> Workers who did not expect, at the beginning of a Section 125 plan year, that they would qualify for the credit might decide to use Section 125. We do not explore here whether it might be administrative feasible to allow them to change their choice when filing their tax return for the year in question.

<sup>8</sup> The spreadsheet model was developed using data from the Census Bureau's Current Population Survey (extracted using the online CPS Table Creator) and from the Internal Revenue Service's Statistics of Income. Using data from the Medical Expenditure Panel Survey – Insurance Component (the MEPS employer survey), we determined that about 20% of the tax expenditures associated with employer coverage are due to use of Section 125 plans to tax-shelter the employee share of premium. Specifically, special tabulations from the 2004 MEPS employer survey showed that about 21.2% of total health insurance premiums paid with respect to active workers (in both government and private-sector employers) were worker contributions. Further, 90.2% of those worker contributions were made on a pre-tax basis (i.e., using Section 125). Therefore, worker contributions constitute roughly 20% of the total premium payments that are the base for "tax expenditures" associated with employer coverage. It is often thought that many businesses do not make Section 125 plans available to their workers. This is true. The same 2004 MEPS survey data show that only 57.8% of business establishments that offered coverage also made pre-tax payment of health insurance premiums available to their workers. But the vast majority of businesses that don't offer Section 125 are small—fewer than 50 employees—and others pay 100% of the premium, making Section 125 moot. Hence, the percentage of actual worker contributions, in dollar terms, that are paid on a pre-tax basis is much higher. Based on this rationale, we calibrated our model to generate 20% of the total tax expenditures associated with employer coverage estimated by the Joint Committee on Taxation for 2008. (Background Materials for Senate Committee on Finance [May 12, 2009] Roundtable on Health Care Financing, May 8, 2009, JCX-27-09. Access through <<http://www.jct.gov/publications.html>>.)

<sup>9</sup> We did not explore the implications of the Replacement Credits being 100% income tax expenditures, while current tax expenditures associated with use of Section 125 plans to tax-shelter worker-paid premiums are split about 60% income tax and 40% payroll (Social Security and Medicare) taxes.

<sup>10</sup> Data from the 2008 MEPS-IC Employer Survey for firms with 50% or more low-wage employees.

<sup>11</sup> Dr. Marquis's work on this topic was funded by a grant from the California HealthCare Foundation, through the Institute for Health Policy Solutions.