THE HAMILTON PROJECT

Advancing Opportunity, Prosperity and Growth

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Evolving Beyond Traditional Employer-Sponsored Health Insurance

HEALTH CARE RECONSIDERED

Options For Change

One of four approaches to achieving universal coverage released by The Hamilton Project

TODAY'S EMPLOYER-BASED health insurance system has created two very different worlds. In one, long-serving employees of generally larger firms receive adequate and dependable health care coverage. In the other—where workers are generally more mobile, part-time, self-employed, or employed by smaller firms—coverage is far less predictable and often more costly. The challenges experienced within this burgeoning second world are growing more urgent, as increased labor mobility and escalating health care spending strain the nation's fraying employer-based health infrastructure, leaving more workers facing dire health care burdens or uninsured.

In a discussion paper for The Hamilton Project, Stuart Butler of The Heritage Foundation addresses this growing mismatch between the current health insurance system and the realities of today's workforce through a proposed reform called the Health Exchange Plan. Operating in parallel with—rather than replacing—the employer-sponsored system, the plan is designed to fill in the present system's gaps. In short, it would provide portable and universally available coverage options through state-chartered "insurance exchanges," convert non-sponsoring employers into facilitators of employee coverage, and reform the tax treatment of health care to promote efficiency and fairness. By partly de-linking the availability and subsidy of health coverage from the workplace, Butler's plan aims at evolutionary reform of the current system that would enhance economic and health security for all working families.

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THE CHALLENGE

America's employer-based health system fails to deliver accessible, dependable, and affordable health coverage to the full working population. Most nonelderly Americans receive health insurance through their employer, but the Census Bureau reports that 17.7 percent of full-time workers and 23.5 percent of part-time workers remained uninsured in 2005. The share of Americans covered by employer-sponsored insurance has been declining steadily in recent decades, from 70.1 percent in 1987 to 62.0 percent in 2005.

America's unique employer-based health system emerged largely by historical accident. Most notably, the wage controls imposed during World War II, along with regulations providing tax exemptions for employer-sponsored health insurance, encouraged employers to substitute health coverage for wages. For some this system operates well. It can successfully pool health insurance risks across large, diverse groups, because people do not generally choose their workplace based on their health status. This stabilizes costs for both individuals and insurance providers, insulating them from any unusually costly medical problems of a few members. Many employers, especially the largest, have also become effective insurance agents for their employees, with experience and infrastructure for handling employment benefits programs as well as potential economies of scale. All these strengths are worth preserving. However, four significant shortcomings of the present system make it insufficient for the needs of today's workforce.

1. Weakening ties to the career workplace. The traditional case for employer-sponsored insurance implicitly assumes that families have a strong and continuous link with their workplace. But this is becoming less and less true in the United States. Whereas in 1983 almost two-thirds of men in their fifties had spent ten or more years with the same employer, by 2004 that ratio had fallen to about one-half. Today as much as a quarter of the workforce changes jobs every year. Meanwhile the number of workers with alternative working arrangements, such as independent contractors, has grown to about 11 percent of the workforce, and another 17 percent are classified as part-time.

2. Lack of insurance portability. Although workers today are more mobile, their health insurance is not. Changing jobs may mean giving up a preferred physician, forgoing access to specific drugs, or even losing coverage altogether. Health benefits have also become an influential factor in employment decisions, as workers become increasingly reluctant to leave jobs with good health care coverage or to take jobs with insufficient health benefits, decreasing the efficiency of labor markets.

3. Difficulties and disincentives faced by firms. Rising health care costs impede the efforts of some firms, especially small ones, to offer employee health care benefits. A small employee base limits a firm's ability to spread risk, and such firms may also have trouble shouldering the administrative burdens of health insurance sponsorship. Accordingly, firm size is a dominant factor in explaining whether coverage is offered: under half of firms with 3 to 9 employees offered coverage in 2005, compared with 98 percent of firms employing 200 or more. Disincentives also exist: firms with relatively high turnover have little incentive to invest in the long-term health of their employees, and firms must often weigh business imperatives more heavily than employee health benefits, especially when profits are tight.

4. Unequal tax treatment. Employers receive a tax deduction for contributing to insurance coverage for their employees, as they do for most forms of employee compensation. But health insurance premium contributions are also excludable from the employee's taxable income, at an estimated cost to the government of $210 billion in 2006. Butler points out that this tax break can be both unfair and inefficient. It is unavailable to the millions of work-

ing families who do not have employer-sponsored insurance, and it disproportionately subsidizes employees in higher tax brackets, who typically also receive more generous coverage. Whereas families with incomes of $100,000 or more received an average subsidy of $2,780 in 2004, families making $40,000 to $50,000 received only $1,448, and families making under $10,000 received a meager $102.

> The share of Americans covered by employer-sponsored insurance has declined steadily, from 70.1 percent in 1987 to just 62.0 percent in 2005.

The Health Exchange Plan

A NEW APPROACH

Butler argues that these structural weaknesses of the employer-sponsored system are likely to get worse over time, given the increasing mobility of the workforce and rising health care costs. His proposed Health Exchange Plan would address these weaknesses by giving workers access to portable health insurance coverage, effective insurance pools, and tax benefits targeted to those that need them most.

Importantly, however, Butler envisions the plan as supplementing—not replacing—the existing system. Employers currently regulated under the Employee Retirement Income Security Act (ERISA) could keep their company-sponsored plans, and their employees would retain their current coverage without any change. The main difference would be expanded choice: employers would have the option of offering plans through an insurance exchange rather than taking on the full burden of insurance sponsorship, and the exchange would provide portable insurance options for workers not offered insurance through their workplace.

Butler's proposal is thus evolutionary, not revolutionary—a gradual, bottom-up approach rather than a top-to-bottom, full-scale reform. He notes that the complexity, uncertainty, and political challenges associated with making radical changes to such a large sector of the economy counsel caution and reflection. Therefore he proposes that reforms start at the state level to allow for smaller-scale experimentation and evaluation before any sweeping national changes are contemplated. Butler also recommends that such reforms be further focused to initially target those most marginalized by the current system, namely low-income working families in the small business sector.

Butler's proposal has three parts: the creation of insurance exchanges, a change in many employers' role from sponsor to facilitator of insurance coverage, and fairer and more efficient tax treatment of health benefits.

Insurance Exchanges

Insurance exchanges would be chartered in each state as single-market clearinghouses offering menus of portable health plans to families via their employers. The exchanges would not operate insurance plans but would serve as the central venue for insurance transactions. An existing example of such an exchange is the Massachusetts' "Connector," and the Federal Employee Health Benefits Program (FEHBP) also functions like an exchange in important ways, providing complete plan portability across federal jobs for approximately 8 million federal employees and retirees nationwide.

The State's Role. States already take the lead in establishing the rules and regulations governing health insurance. They would also regulate the functioning of the new exchanges, as well as set requirements, if any, regarding employer participation (though ERISA-regulated employers choosing to sponsor

Key Highlights

The Challenge

Several problems beset the current employer-sponsored health insurance system:

- **The nature of the workforce is changing,** moving away from traditional, long-standing employer-employee relationships.
- **Insurance is not sufficiently portable,** endangering coverage when workers switch jobs or work arrangements and eroding labor market efficiency.
- **Firms face difficulties and disincentives** and may lack the capacity or incentive to offer insurance.
- **Unequal tax treatment skews the system,** benefiting those in employer-sponsored plans to the exclusion of others and offering little relief to low-income working families.

This system fails to serve all working Americans: though 70.1 percent of Americans were covered by employer-sponsored insurance in 1987, only 62.0 percent were covered in 2005. In addition, 17.7 percent of nonelderly full-time workers and 23.5 percent of part-time workers remained uninsured in 2005.

A New Approach

Butler's proposal aims to provide better health insurance opportunities for all working Americans by

- **Creating insurance exchanges.** These would offer menus of portable health plans and facilitate the development of large, diverse insurance pools with stable and predictable premiums.
- **Transforming employers into facilitators, not sponsors, of coverage.** Employers choosing not to sponsor coverage would instead facilitate it by arranging payroll deductions, tax withholding, and premium payments.
- **Reforming tax treatment.** Insurance exchanges would be explicitly given the same tax exemptions enjoyed by employer-sponsors today. A cap on the exemption for health benefits and a refundable, advanceable, assignable credit for low-income families would be introduced to promote fairness.

health insurance would be exempt from such requirements). According to Butler, this state-based approach has three advantages: states are better able to custom design exchanges to meet local conditions and needs; variations from state to state would provide useful data about which models work; and state control would sidestep many logistically and politically difficult issues a federal system would raise.

Alternative Pooling Groups. Under the exchange system, many nonemployer organizations—unions and religious organizations, for example—would be able to offer insurance under the same tax exemptions that employer-sponsored insurance receives today. These groups could also offer coverage to workers outside their regular membership, expanding choice and further untying coverage from the workplace. Typically, they would negotiate with insurance carriers to provide insurance rather than underwrite the risk themselves. Self-employed workers would be able to join insurance pools simply by virtue of being state residents, and the exchange would provide all participating working families with large and stable insurance pools that would spread risk more effectively than many employers could.

Employers as Facilitators, Not Sponsors

Insurance exchanges would coordinate coverage options and facilitate the development of insurance pools, both of which the current structure fails to do consistently. In addition, Butler's proposal would change the role of many employers from one of sponsoring health insurance to one of providing an access point to the exchange. Although in theory individuals could be allowed to join the insurance exchanges directly, Butler argues that employers would be useful intermediaries. Employers already have payroll deduction and tax withholding infrastructures in place and have generally become, through long experience, efficient payment facilitators. Employers' proximity to their workers could also boost enrollment, as workers could more easily sign up for benefits at their workplace than almost

anywhere else. In addition, retaining an employer role would enhance the plan's compatibility with the current system; this could reduce potential opposition and prevent disruptions to well-functioning employer-sponsored structures already in place.

Employers using the exchange would have two key functions: handling the tax subsidy and organizing the collection and payment of premiums. Butler notes that this facilitative role would be nothing new for most firms. Employers of all sizes today are required to distribute tax withholding forms, deduct taxes from paychecks, and remit money to the government. Employers also commonly facilitate employee payments into retirement and college savings plans, many of which are portable. Their new roles under the insurance exchange would thus represent a minimal additional burden—a point supported by survey data: the Commonwealth Fund recently found that some 73 percent of large firms and 88 percent of small firms expressed willingness to organize payroll deductions and to coordinate premium payments for government-administered health programs.

Under this system, employers would benefit from more choice and flexibility. They could offer health benefits to their workers through the insurance exchanges without taking on the full burden of sponsorship, and in doing so could offer a much wider variety of plans than most small businesses can dream of offering today. Employers could also contribute to insurance, as many currently do—and could do so more flexibly, including offering prorated plans to part-time workers. An additional benefit would be the freeing up of labor markets, as employees would no longer need to consider health benefits in making career decisions, and employers would no longer have an incentive to avoid potential hires based on their health status.

Reform of Tax Treatment

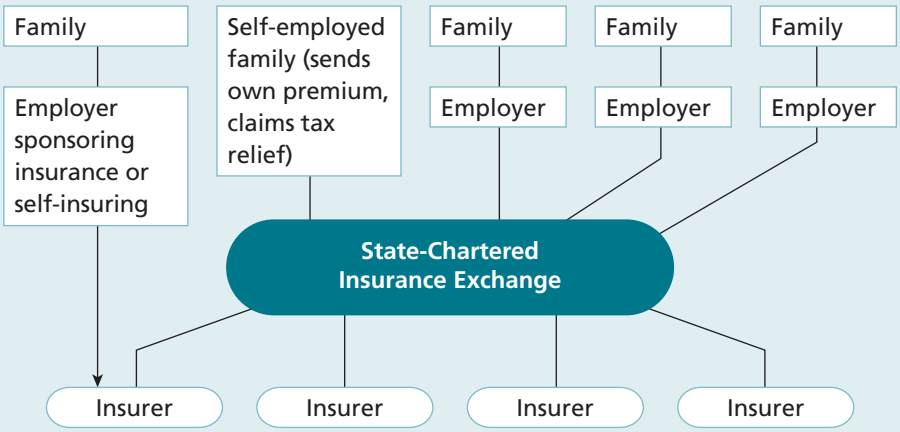
Although states do not need federal legislation to create insurance exchanges, Butler recommends a clarification of federal rules to ensure that exchanges can function as valid and equal alternatives to employer-sponsored insurance. Specifically, federal regulatory language should explicitly allow qualified state exchanges to receive the same tax exemption that currently applies to employer and employee contributions. Although this is generally possible today, ambiguity remains in various areas.

> The Health Exchange Plan would enable employers to offer a wider variety of health coverage options than would be conceivable for most small businesses today.

In addition, Butler presents a blueprint for wider tax reform to make tax subsidies for health coverage fairer and more efficient. Congress would enact a gradually tightening cap on the value of the tax exclusion for employer-sponsored insurance while simultaneously introducing a tax credit for low-income families. Sponsored benefits above the cap would be taxed as cash compensation for families above a certain income. To minimize economic disruption and political opposition, the cap would be structured to affect relatively few Americans initially, but a gradually increasing number over time. This cap would limit the present inefficient incentive for employers to provide compensation in the form of health benefits (rather than other benefits or wages) and could encourage employees and employers alike to press for more economical health services.

The tax credit would be available to families below 200 percent of the poverty level. It would be designed to offset most of the cost of a base plan and would be refundable, advanceable, and assign-

How the Health Exchange Plan Would Work



Family picks plan from exchange menu

Employer arranges payroll deduction, tax withholding, and premium payment

Exchange aggregates and distributes premiums, provides plan information, implements the state insurance framework, and facilitates insurance pools

able. As many have noted, a credit is more efficient and vertically equitable than a deduction or an exclusion. The federal government would bear primary responsibility for funding the tax credit, which could be funded, in part, by revenue from the cap.

Insurance Exchanges in Practice

In sum, the proposed insurance exchanges would help aggregate consumers into insurance groups, whether by employer, union, or other scheme. The groups would pool large numbers of participants with diverse risk profiles and choose among the plans offered by insurers through the exchange to provide coverage options to their members. The insurance exchange would provide the venue for and regulate these transactions. The access point for most consumers would be their employer, who would also facilitate payroll deductions, tax withholding, and premium payments.

The benefits would be manifold. Premiums would be more stable and predictable because of effective pooling of risk. Consumers could choose among a variety of plans, which they could keep from job to job, while still being able to arrange insurance conveniently through their workplace. Employers could continue to offer their own coverage, but would have the option of instead facilitating their employees' health benefits through the exchange, while retaining the ability to contribute to their employees' plans. Furthermore, the development of more permanent relationships between workers and insurers would give insurance providers the incentive to craft policies designed and priced for long-term coverage, including more attention to lifelong wellness and preventive care.

Questions and Concerns

Why Not Include an Individual or Employer Mandate? Although Butler's proposal is compatible with either an employer mandate to offer insurance, or an individual mandate to carry insurance, he declines to include either. A mandate could engender political opposition, and it is not yet certain that everyone would have access to affordable insurance options. Moreover, Butler argues that his proposal could achieve near universal coverage even without a mandate, especially if the proposed tax reform and automatic enrollment options were established.

Would the Health Exchange Plan Weaken the Current Employment-Based System?

Butler believes that the plan would *strengthen*, not weaken, the existing system by making it more compatible with the nature of today's workplace. The successful parts of the system would be largely untouched, while the less successful parts would be revamped. Butler's plan would also protect insurance-sponsoring employers from being crowded out or facing "adverse selection" problems, which might occur if employees could choose between an exchange plan and their employer's plan according to their health status. Specifically, Butler stipulates that workers in a firm sponsoring insurance would be limited to joining their company's sponsored plans. If the exchange system worked well, however, one can imagine that more employers would join. Thus Butler's proposal would lead to more widespread change the better it works, but it would not impose change on those for whom the system is already working.

CONCLUSION

America's health system for working families is out of step with today's realities. Millions of working families have no coverage at all, and those with employer-sponsored insurance often face gaps or loss of coverage when they change their work situation. Unlike most decisions in life, those concerning health care coverage are too often controlled by employers, not by families themselves. And even as government subsidizes this system at over $200 billion annually, most of that goes to families who need help the least.

Butler's proposal could provide a reasonable roadmap for recasting the existing, haphazardly created system into one appropriate for a postindustrial world of high labor mobility and changing work arrangements. Butler argues that his plan would build pragmatically on the traditional foundations of employer-sponsored insurance to generate greater economic as well as health security for all working families.

Learn More About This Proposal

This policy brief is based on The Hamilton Project discussion paper, *Evolving Beyond Traditional Employer-Sponsored Health Insurance*, which was authored by:

STUART M. BUTLER
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Butler has played a major role in shaping the policy debate on a wide range of domestic policy issues, from health care and Social Security to welfare reform and budget control. Butler has been a leading proponent of finding bipartisan ways of widening health insurance coverage.

Additional Hamilton Project Proposals

This proposal is one of four approaches to achieving universal coverage released by The Hamilton Project

- **Gerard Anderson** and **Hugh Waters** present a model for a single-payer-style reform whereby all individuals without private employer or Medicaid coverage would be automatically enrolled in Medicare. The reform is designed to reduce costs while preserving choice.
- **Stuart Butler** proposes moving beyond employer-based insurance by creating state-chartered health insurance exchanges as alternatives to employment-based pooling, using employers to facilitate (rather than fully sponsor) health coverage, and reforming the tax treatment of health care.
- **Ezekiel Emanuel** and **Victor Fuchs** propose giving vouchers to every American to guarantee and pay for basic health insurance. They argue the vouchers, which would be funded by a value-added tax, would provide portability and promote greater cost effectiveness.
- **Jonathan Gruber** examines the feasibility, costs, and benefits of extending nationwide the "Massachusetts model," which provides universal coverage through a combination of individual mandates, subsidies to low- and moderate-income households, and alternative risk pools to purchase insurance.

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The Project is named after Alexander Hamilton, the nation's first treasury secretary, who laid the foundation for the modern American economy. Consistent with the guiding principles of the Project, Hamilton stood for sound fiscal policy, believed that broad-based opportunity for advancement would drive American economic growth, and recognized that "prudent aids and encouragements on the part of government" are necessary to enhance and guide market forces.

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