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Addressing Adverse Selection Concerns Under the President's Health Care Proposal

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In his State of the Union address, President Bush proposed a bold approach to neutralize the long distorted tax treatment of health insurance between those with employer-based coverage and those without it. Some skeptics have voiced concern that this would erode the existing employer-based system. But these are not new concerns and apply to many approaches to helping the uninsured. Moreover, the concerns can be addressed by amendments to the basic Bush approach. Rather than dismiss the proposal and ignore its worthy objectives, policymakers should seize the opportunity for a fresh conversation about coverage and fix the disparity in the tax code.

Today, individuals who obtain health care coverage through their place of work receive an unlimited tax break by excluding the value of this benefit from their taxable income. This policy perpetuates the growing cost of health care by encouraging workers to take more generous (and expensive) health care benefits in lieu of taxable income. However, individuals purchasing or wishing to purchase coverage on their own do not receive such a tax break and must use after-tax dollars to do so.

Unlike today's system, the President's health care proposal would give every American tax relief for their health insurance. The President's plan would provide a $15,000 standard deduction for families and a $7,500 deduction for individuals. This deduction would replace the current, open-ended tax exclusion that exclusively favors employer-based coverage.

Employer-Sponsored Coverage Does Not Work for Everyone. Today's workforce is very different than during World War II when the health care tax exclusion came to be. It is no longer the standard for individuals to have the same employer throughout their career until retirement. The workforce is more mobile, and each time an individual changes employers, he or she changes health insurance or risks losing it altogether.

There are a variety of reasons why an individual may not have employer-sponsored coverage, according to analysis by the Employee Benefit Research Institute. First, not all employers offer coverage. About 54 percent of uninsured workers are not covered by their employer's plan because their employer does not offer coverage.[1] Second, not all workers qualify for employer coverage. About 19 percent of uninsured workers were ineligible for their employer's coverage.[2] Finally, not all workers can afford their employer's coverage. Fully 64 percent of uninsured workers who chose not to participate in an employer plan cited cost as the reason.3

These issues are even more pronounced for workers in smaller firms and lower-income workers. A study by researchers at the Commonwealth

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Fund found that, among workers earning less than $10 per hour, 53 percent did not have health care coverage through their employer; among workers with incomes below the federal poverty level, 74 percent did not have employer coverage.[4]

The "Risk" of Adverse Selection. Although the employer-based system falls short for many workers, it still provides coverage to the majority of Americans. So whenever a proposal is made to provide help for families who lack adequate or any insurance, some worry that the effect will be to weaken the employer-based system. This concern applies to proposals to allow working families to acquire public coverage, such as Medicaid, or private coverage, such as under the President's plan.

The concern raised about the President's plan is that it might induce some younger, healthier workers to exit the employment-based system, leaving employers with only older and costlier workers—a pattern known as "adverse selection." This could drive up employer group insurance costs and, so, may cause some employers to drop coverage. Thus, leveling the tax-subsidy playing field for workers with employer-sponsored coverage and other private coverage options, such as coverage in the individual market, may cause some employers to discontinue health care coverage for their workers altogether.

While these may be reasonable concerns, and should be recognized, there are other reasons why an employer-based system would continue, and there are steps that can be taken to amend the basic Bush plan to avoid adverse selection.

Employer-Based Coverage Would Continue. For at least three strong reasons, employer-based coverage would continue under the President's proposal to change the tax treatment of health care coverage:

- Employers do not provide coverage as an act of generosity. In a tight labor market, employers must compete for workers based on overall compensation, not just wages. Thus, even though the tax treatment would be level, an employer's offer of coverage would remain a key competitive advantage.
- Employers are natural pooling agents and, so, help to reduce the overall cost of health insurance. The larger the employer pool, the more negotiating power the employer has to strike better deals for its workers with insurers. Moreover, many employers have participation-rate requirements to ensure that their pools reflect a balance of their workforces. So employers have a strong incentive to make their plans attractive to younger workers.
- Workers' basic familiarity with employer-sponsored coverage will continue to be an advantage for employers. Purchasing health insurance can be complicated. Workers may feel more comfortable having a trusted employer assist them and facilitate these transactions, as with retirement savings.

Addressing Adverse Selection. Despite the natural advantages employers have as sponsors of insurance, giving assistance to families without such coverage still raises the legitimate concern of adverse selection—younger, healthier workers leaving employer-based group plans because they can find cheaper individual insurance elsewhere. But steps can be taken to avoid this potential problem, while still offering tax-break assistance to families without employer-based insurance:

- **Link the individual deduction to access to employer-sponsored coverage.** While this would not be ideal, workers with access to employer-based coverage could be required to

1. Paul Fronstin, "Sources of Health Insurance and Characteristics of the Uninsured: Analysis of the March 2006 Current Population Survey," Employee Benefit Research Institute, *Issue Brief* No. 287, November 2005, p. 16, at *www.ebri.org/pdf/briefspdf/EBRI_IB_11-20051.pdf*.
2. *Ibid.*
3. *Ibid.*
4. Sara R. Collins, Karen Davis, and Alice Ho, "A Shared Responsibility: U.S. Employers and the Provision of Health Insurance to Employees," Commonwealth Fund, *In the Literature* Publication No. 839, June 2005, at *www.cmwf.org/usr_doc/Shared_responsibility_Inquiry_Spring_2005.pdf*.

enroll in their employer plan in order to receive the deduction. Younger, healthier employees with coverage today would have no incentive to leave their employers' plan because they would not be eligible for a deduction for non-employment based coverage. Families without access to employer-sponsored coverage, however, would be eligible for the individual deduction.

- **Create a marketplace that combines employer-sponsored and individual coverage.** The employer-based system need not be in competition with the individual market; there are ways to blend the two markets together. The Massachusetts Connector and other state "health insurance exchange" proposals, for example, preserve the benefits of employer-sponsored coverage but also facilitate individual choice and ownership of personal, portable policies. In fact, these approaches could entice more employers to participate in facilitating coverage for their workers and so to create personal, portable coverage for workers and their families.
- **Adopt policies to improve overall insurance market access, stability, and affordability.** With or without the proposed tax changes, if the employer-based system continues to decline, the troubles with the individual market will need to be addressed. States are exploring insurance reforms and introducing policies such as high-risk pools and risk adjustment. These mechanisms are important tools to accomplish stability in health care coverage. The President's proposal recognizes that change is needed to properly accommodate the growing individual market, and state insurance initiatives should develop in parallel to the tax fairness measure in the President's proposal.

Conclusion. The President's plan would alleviate the disparities of the tax code by giving all workers, regardless of job or job status, the same health care tax benefits. Even with this change, the employer-based system will continue to be of value to its workers. To the extent that adverse selection becomes a problem, however, there are tools that could be used to address it within the context of the President's plan. Policymakers thus should not shun the President's proposal because it shakes up the status quo, which has resulted in millions of uninsured Americans. Instead they should find ways to build on its fundamental principle of tax equity for all Americans.

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