AMERICAN ACTION FORUM

Labor Markets and Health Care Reform: New Results

Douglas Holtz-Eakin & Cameron Smith l May 27, 2010

Executive Summary

The Patient Protection and Affordable Care Act (PPACA) will have profound implications for U.S. labor markets. The PPACA is fiscally dangerous, raising the risk of higher labor (and other) taxes at a time when the job market is struggling.

It provides strong incentives for employers—with the agreement of their employees—to drop employer-sponsored health insurance for as many as 35 million Americans, perhaps leading to widespread turmoil in labor compensation and employee insurance coverage—and raising the gross taxpayer cost of the subsidies to roughly $1.4 trillion in the first 10 years.

Finally, the bill exacerbates the already-high effective marginal tax rates on low-income workers. Every worker forced onto the subsidized exchanges will face higher barriers to upward mobility and the pursuit of the American Dream.

Introduction

The Patient Protection and Affordable Care Act (PPACA) is massive legislation that will have profound implications for U.S. labor markets. This short paper reviews its likely fiscal implications, highlights incentives for employers to drop their offer of insurance coverage leading to turmoil in both employee compensation and insurance, and focuses on the detrimental impact of the bill's subsidy structure on the upward mobility of workers.

Fiscal Implications of PPACA

The Congressional Budget Office projected that the PPACA would reduce federal deficits by $143 billion over its first 10 years. A rough extrapolation suggests further savings of an additional $681 billion in deficit reduction in the subsequent 10 years. Unfortunately, a closer scrutiny of a bill that creates two new entitlement programs (insurance subsidies and long-term care insurance) suggests that it will increase, not reduce, the deficit by $554 billion in the first ten years and $1.4 trillion over the succeeding ten years[i].

The key implication for labor markets is that deficits represent a commitment to either raise taxes or reduce outlays in the future. To the extent that it is the former, new taxes on labor will be an impediment to smooth functioning of labor markets by interfering with decisions on education, career choice, hiring, job-switching, second-jobs, and a myriad of aspects of the most crucial economic activity in the United States today. Large deficits are bad news for labor markets and the PPACA is a commitment to that bad news.

Incentives for Employers to Drop Insurance Coverage

Today about 163 million workers and their families receive health insurance coverage from their employers. Proponents of the PPACA insisted that a key tenet was to build on this system of employer-sponsored coverage; importantly President Obama himself repeatedly promised that individuals would get to keep their own health insurance if they liked it.

Roughly one-half of the $900 billion of spending in the PPACA is devoted to subsidies for individuals who do not receive health insurance from their employers. These subsidies are remarkably generous, even for those with relatively high incomes. For example a family earning about $59,000 a year in 2014 would receive a premium

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subsidy of about $7,200. A family making $71,000 would receive about $5,200; and even a family earning about $95,000 would receive a subsidy of almost $3,000.

By 2018, subsidy amounts and the income levels to qualify for those subsidies would grow substantially: a family earning about $64,000 would receive a subsidy of over $10,000, a family earning $77,000 would receive a subsidy of $7,800 and families earning $102,000 would receive a subsidy of almost $5,000.

An obvious question is how employers will react to the presence of an alternative - subsidized source of insurance for their workers - which can be accessed if they drop coverage for their employees. The most simple calculation focuses on the tradeoff between employer savings and the $2,000 penalty (per employee) imposed by the PPACA on employers whose employees move to subsidized exchange coverage. Consider a $12,000 policy in 2014, of which the employer would bear roughly three-quarters or $9,000. A simple comparison of $9,000 in savings versus a $2,000 penalty would seemingly suggest large-scale incentives to drop insurance.

Caterpillar recently noted that it could save 70 percent on health care costs by dropping coverage and paying the penalties; AT&T's $2.4 billion cost of coverage would drop to just $600 million for the penalties. And the list could go on[1].

Unfortunately, the economics of the compensation decision are a bit more subtle than this simple calculation. Health insurance is only one portion of the overall compensation package employees receive as a result of competitive pressures. And the evidence suggests that if one portion of that package is reduced or eliminated – health insurance – another aspect – wages – will ultimately be increased as a competitive necessity to retain and attract valuable labor. Thus, the key question is whether the employer can keep the employee "happy" – appropriately compensated and insured – and save money.

As Table 1 outlines, the answer is frequently "yes" – thanks to the generosity of federal subsidies. To see the logic, consider the first row of the table, which shows the implications for a worker at 133 percent of the Federal Poverty Level (FPL) or $31,521 in 2014. We project that this worker will be in the 15 percent federal tax bracket, which means that $100 of wages (which yields $85) is needed to offset the loss of $85 dollars of untaxed employer-provided health insurance. Consider now a health insurance policy worth $15,921, of which the employer picks up 75 percent of the cost. The employer's contribution to health insurance of $11,941 is the equivalent of a wage increase of $14,048 to the worker.

Do the economics of PPACA ever suggest that employer's could drop? Yes. The employee would receive $14,176 in federal subsidies – more than the value of the lost health insurance. On paper, they could take a pay cut and be better off. Clearly, the employer comes out way ahead – $11,941 less the penalty. Obviously, there is room for the employer to actually improve the worker's life by having a small pay raise and the same insurance and still save money. This is a powerful, mutual incentive to eliminate employer-sponsored insurance.

The remaining rows of Table 1 repeat this calculation for workers at ascending levels of affluence. For example, at 200 percent of the FPL, the "surplus" between the pay raise required to hold a worker harmless ($4,936) and the firm's cash-flow benefit from dropping coverage ($9,941) has narrowed, but the bottom line decision in the final

[1] See: http://money.cnn.com/2010/05/05/news/companies/dropping_benefits.fortune/
http://www.scribd.com/doc/30954524/FORTUNE-Caterpillar-Serious-Consideration
http://www.politico.com/news/stories/0510/36926.html

column is the same. Indeed, the incentives are quite powerful up to 250 percent of FPL, or $59,250. Only for higher-income workers do the advantages of untaxed health insurance make it infeasible to drop insurance and re-work the compensation package. Appendix Table 1 repeats this analysis and checks the robustness of this conclusion if one assumes that health care costs are significantly higher and the employer's contribution to the insurance plan rises to $15,000. In this instance the decision holds for up to 200 percent of FPL.

Table 1: Health Care Reform and Employer-Sponsored Insurance in 2014 (Employer Health Plan = $11,941)

Percent of Federal Poverty Level	Income[2]	Tax Bracket[3]	Wage Equivalent of Employer Health Plan[4]	Federal Subsidies[5]	Required Pay Raise[6]	Employer Free Cash Flow[7]	Employer Drop Decision[8]
133%	$31,521	15%	$14,048	$14,176	-$128	$9,941	Drop
150%	$35,550	15%	$14,048	$13,385	$663	$9,941	Drop
200%	$47,400	25%	$15,921	$10,985	$4,936	$9,941	Drop
250%	$59,250	25%	$15,921	$7,530	$8,391	$9,941	Drop
300%	$71,100	25%	$15,921	$5,187	$10,734	$9,941	Keep
400%	$94,800	28%	$16,585	$2,935	$13,650	$9,941	Keep

How big could this impact be? In round numbers, at present there are 123 million Americans under 250 percent of the FPL. Roughly 60 percent of Americans work (the employment-population ratio is 58.8 percent) and about 60 percent of those receive employer-sponsored insurance. This suggests that there are about 43 million workers for whom it makes sense to drop insurance if the health plan costs the employer $11,941.

CBO estimated that only 19 million residents would receive subsidies, at a cost of about $450 billion over the first 10 years. This analysis suggests that the number could easily be triple that (19 million plus an additional 38 million in 2014) – the gross price tag would be roughly $1.4 trillion[9].

In contrast, the CBO predicted that only 3 million individuals who previously received coverage through their employers will get subsidized coverage through the new exchanges. One mechanism that would reduce employer drop is if high-wage workers continue to receive insurance and non-discrimination rules force employers to offer insurance to all workers – even those for whom it makes sense to drop coverage. For those firms dominated by lower-wage workers this is unlikely to succeed as it will be possible to use the accumulated savings to retain the few high-wage workers. Or, there may be incentives for firms to "out-source" their low-wage workers to specialist firms (that do not offer coverage) and contract for their skills. In any event, the massive federal subsidies are money on the table inviting a vast reworking of compensation packages, insurance coverage, and labor market relations.

[2] Income calculated based on 2009 FPL for a family of four of $22,050 (HHS), indexed to CPI projections (CBO).
[3] Tax bracket calculated based on 2010 tax brackets, indexed to CPI projections (CBO).
[4] Computed as CBO estimate of Silver Plan in 2016, indexed to 2014 ($11,941), and divided by (1-Tax Rate).
[5] Estimated federal insurance subsidy.
[6] Wage equivalent minus subsidies.
[7] Value of insurance plan minus $2,000 penalty.
[8] Drop if required pay raise is greater than free cash flow.
[9] The gross cost would be partially offset by the receipt of the $2,000 penalties.

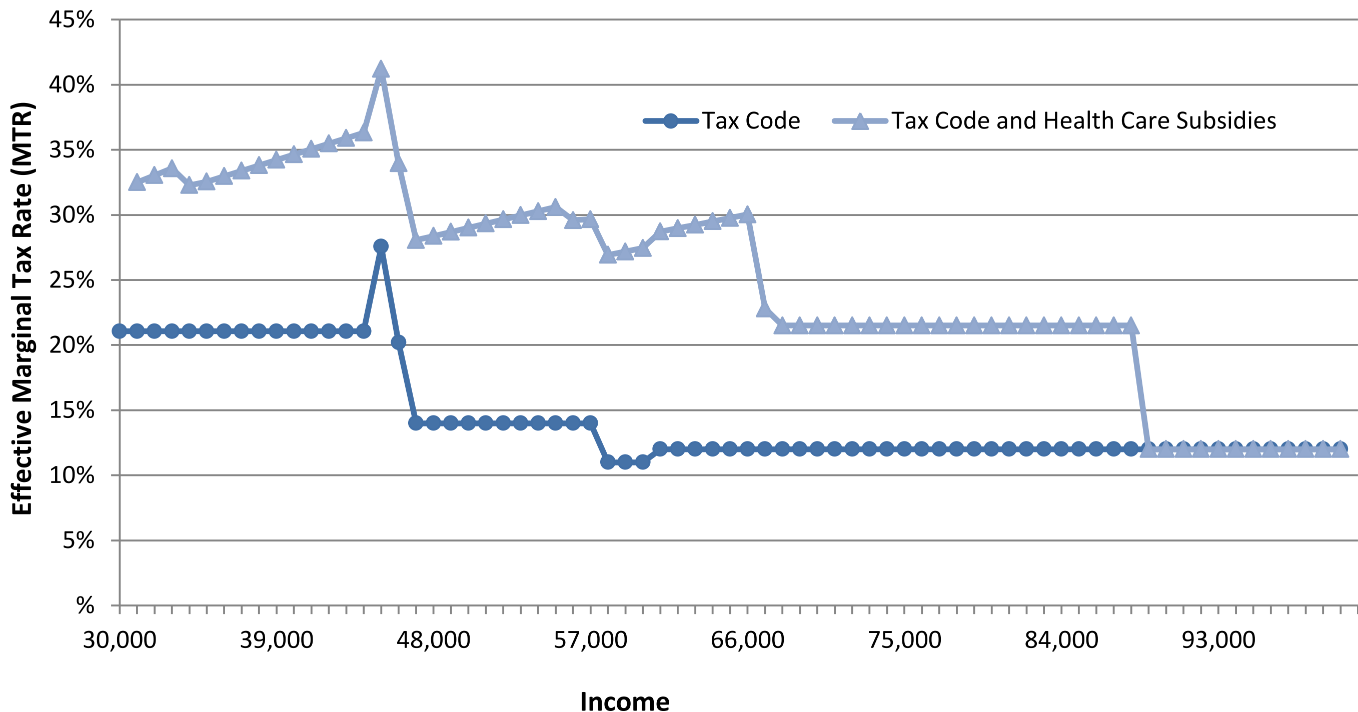
PPACA Subsidies and Hidden Taxes on Mobility[ii]

The analysis thus far might suggest that shifting a worker to federal subsidies is relatively benign – at least from his or her perspective. But it is in fact bad news for their ability to climb up the ladder of American prosperity. The PPACA raises to shocking levels the effective marginal tax rates (EMTR) on lower and middle-income singles and families.

The effective marginal tax rate is the answer to the question: "If I earn $1 more, how much less than $1 do I get to save or spend?" If you can keep that full dollar for your disposal, the effective marginal tax rate is zero. If earning another dollar does not raise your disposable income by even a penny, the effective marginal tax rate is 100 percent.

Figure 1 shows the EMTRs for a two-earner family with two school-age children, one of whom is in college. One line is the EMTR based on income tax law prior to the PPACA, while the second displays the damaging increases in the EMTR from the phase-outs in the EMTR. As a family's income rises above 133 percent of FPL, they will receive their subsidy to purchase health insurance in the exchanges. In turn, however, as their efforts yield higher income, subsidies are clawed back or effectively taxed away. The current law policies show that there are already some lower income families facing EMTRs above those in the middle class. But the barrier to success imposed by PPACA is even more striking. Thus, for every additional worker that faces a loss in employer coverage we have an additional worker who faces a greater difficulty in getting ahead when taking an extra shift, finding a way for a second parent to work, or investing in night school courses to qualify for a raise. Additional work will mean handing the government as much as 41 percent of the additional income earned. The bigger the EMTR, the higher the hurdle to moving up.

Figure 1: PPACA Raises Effective Marginal Tax Rates on Low-Income Workers



Conclusion

The Patient Protection and Affordable Care Act (PPACA) will have profound implications for U.S. labor markets. The PPACA is fiscally dangerous, raising the risk of higher labor (and other) taxes at a time when the job market is struggling. It provides strong incentives for employers - and their employees – to drop employer-sponsored health insurance for as many as 35 million Americans, perhaps leading to widespread turmoil in labor compensation and employee insurance coverage – and raising the taxpayer cost of the subsidies to $1.4 trillion in the first 10 years. Finally, the bill exacerbates the already-high effective marginal tax rates on low-income workers. Every worker forced onto the subsidized exchanges will face higher barriers to upward mobility and the pursuit of the American Dream.

Appendix Table 1: Health Care Reform and Employer-Sponsored Insurance in 2014 (Employer Health Plan = $15,000)

Percent of Federal Poverty Level	Income[10]	Tax Bracket[11]	Wage Equivalent of Employer Health Plan[12]	Federal Subsidies[13]	Required Pay Raise[14]	Employer Free Cash Flow[15]	Employer Drop Decision[16]
133%	$31,521	15%	$17,647	$14,176	$3,471	$13,000	Drop
150%	$35,550	15%	$17,647	$13,385	$4,262	$13,000	Drop
200%	$47,400	25%	$20,000	$10,985	$9,015	$13,000	Drop
250%	$59,250	25%	$20,000	$7,530	$12,470	$13,000	Drop
300%	$71,100	25%	$20,000	$5,187	$14,813	$13,000	Keep
400%	$94,800	28%	$20,833	$2,935	$17,898	$13,000	Keep

[10] Income calculated based on 2009 FPL for a family of four of $22,050 (HHS), indexed to CPI projections (CBO).
[11] Tax bracket calculated based on 2010 tax brackets, indexed to CPI projections (CBO).
[12] Computed as CBO estimate of Silver Plan in 2016, indexed to 2014 ($15,000), and divided by (1-Tax Rate).
[13] Estimated federal insurance subsidy.
[14] Wage equivalent minus subsidies.
[15] Value of insurance plan minus $2,000 penalty.
[16] Drop if required pay raise is greater than free cash flow.

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References

[i] Holtz-Eakin D and Ramlet M. "The Fiscal Implications of the Patient Protection and Affordable Care Act." *Health Affairs*. June 2010. Available at: http://americanactionforum.org/sites/default/files/health_reform_to_increase_deficit.pdf.

[ii] This section draws on and updates Brill, Alex & Holtz-Eakin, Douglas. "Another Obama Tax Hike." *Wall Street Journal*. [Updated February 4, 2010; Accessed May 27, 2010].
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