

Health Insurance Tax Credits for Workers: An Efficient and Effective Administrative System

Lynn Etheredge

Summary—This paper proposes an administrative system for health insurance tax credits for workers that would be efficient and effective. It features payroll deductions and automatic enrollment, which are proven methods to yield high enrollments at low cost.

Administrative issues have become an important legislative concern in the debate over the use of health insurance tax credits for workers. Because of this concern, health insurance tax credits have been criticized as an inefficient and ineffective way to assist the uninsured. Indeed, some ways of administering them would be inefficient, for example, (a) to vastly expand the individual income tax filing system to pay out a modest health insurance tax credit or (b) to mail tens of millions of insurance purchase vouchers to individuals who would then be required to re-mail them to insurance companies. Similarly, the individual insurance market, with 30% sales and administrative costs, is not an optimal arrangement for workers to purchase health insurance with modest tax credits.

Nevertheless, health insurance tax credits can be efficiently and effectively administered. A number of widely used practices in the private and public sectors can be drawn upon to administer new health insurance tax credits for workers efficiently and effectively.

For illustration, this paper describes model features that could be used to implement a \$1,000 per worker tax credit for workers who do not have employer-offered health insurance. The tax credits would be phased down at income levels above where individuals now begin to have income tax liabilities.¹

AN EFFICIENT MODEL SYSTEM

An efficient model system for workers to use \$1,000 tax credits to purchase health insurance would have three elements: Workers would elect their choice of health plan and amount of payroll deductions, above their \$1,000 tax credit, at their workplace. Their

employers would then notify the health plans and send payroll deductions (a single check with a list of individuals, Social Security numbers, and amounts) to a service center, for transmittal to the individual health plans. In turn, the selected health plans would notify the Treasury Department and be paid the portion of a \$1,000 tax credit due for the payroll period.

Figure 1 An Efficient Model System

- A new worker elects a health insurance plan and the amount of payroll deduction (above the \$1,000 tax credit) at his/her worksite.
- The employer notifies the health plan and sends payroll deductions (via a service center).
- The health plan notifies the Treasury Department and is paid a \$1,000 tax credit.

This system draws on the best private-sector practices. Election by individuals of health plans at their worksite, for example, is the standard practice for group health insurance plans, which now cover more than 155 million individuals. It is used successfully, through the Federal Employees Health Benefits Program, for 9 million federal government workers, including members of Congress, and their dependents. Information packets about health plan choices for workers could be made available from the service centers, as well as from health plans, brokers and other sources. All an employer would need to do would be to note the workers' choices and transmit the payroll deductions. This system makes health plan enrollment available to new workers in a timely way—when they are starting a new job and thus are likely increasing their disposable income—and offers a simple, convenient arrangement for making informed choices.

Why use the payroll deduction approach? One reason is that most of the uninsured are workers or members of families with workers

(75% to 80%). A worksite-based sign-up and payment system for new workers can thus efficiently serve most of the uninsured. A second reason is that automatic payroll deductions are an exceptionally efficient way to handle routine, regular payments—and payroll deductions make sure funds are channeled to preselected uses before they become spendable income and are spent on other things. A third reason is that all business firms and workers are already part of this payroll deduction system. As shown below, for example, employer payroll processes already handle a minimum of eight standard payroll-based deductions (and required reports).

Standard Payroll Deductions

- Employer Social Security
- Employer Medicare
- Worker Social Security
- Worker Medicare
- Federal individual income tax
- State individual income tax
- State unemployment insurance
- State workers' compensation/disability

In addition, many employers offer a number of voluntary payroll deduction options—sometimes with employer contributions—for their workers. Most employer health insurance and pension/savings plans are funded in this way, as are many contributions to charitable organizations.

Optional Payroll Deductions

- Employer health insurance
- Worker health insurance
- Employer pension/savings plan
- Worker pension/savings plan
- Charitable contributions
- Union dues

Thus, payroll deductions are the nation's most widely used method for many financing purposes, including voluntary charitable donations, health insurance, and savings plans, as well as government finance and social insurance contributions. It is a proven system. Over \$2 trillion of financing is now allocated through this system each year.²

The proposal to include a service center to which an employer could remit payroll deductions would simplify the employers' task. Without a service center, an employer might have to send a separate check to each selected health plan. If an employer elected to use a service center, it would need to send only one additional check per pay period, along with a list of workers, their Social Security numbers, health plans, and payroll deduction amounts.

The widespread use of office computers and business software has made the payroll deduction system exceptionally efficient. A small business software program that will keep all payroll records, calculate deductions, prepare reports, and write checks now costs about \$30. The most widely used integrated business management, accounting, invoicing and payroll software programs for small business now sell for \$90 to \$200.³ Business accounting services can now be accessed through the Internet. Business accounting programs are normally updated at least annually (and often quarterly), so they could readily incorporate new payroll deduction options.⁴

Employers that do not now offer health insurance benefits would gain from helping to administer a new health insurance tax credit. As employers, they would become more competitive in the labor market vis-à-vis firms that offer group health insurance to workers. They would make their workers better off by enabling them to receive health insurance and a tax credit worth up to \$1,000 toward the costs of these benefits, and by transferring their premium payments through payroll deductions. In comparison to these benefits, having to add one payroll deduction per worker and send one additional check per pay period would be a modest inconvenience.

AN EFFECTIVE MODEL SYSTEM

A model system for health insurance tax credits can be judged on effectiveness by its enrollment rates among eligible workers. Obviously, a critical element for effectiveness is to have a very convenient arrangement for informing workers of insurance options, executing enrollment choices, and making payments, as was described in the previous section. Achieving a high voluntary enrollment rate will still be particularly challenging, however, with modest tax credits, for example, \$1,000 per worker.

One of the effective strategies for achieving a high take-up rate, with a voluntary choice system, is to use “automatic enrollment” and a well-subsidized benefit. Using “automatic enrollment” and an attractive subsidy, new workers would be automatically enrolled in a health plan, with a \$1,000 tax credit to pay most (or all) of the costs. Workers would also be able to choose any other health plan. Or they could elect, in writing, to decline enrollment in any health plan and forgo use of their \$1,000 tax credit.

Figure 2
An Effective Model System

- Automatic enrollment—worker is automatically enrolled in a “default” health insurance plan.
- Worker may choose another health plan.
- Worker may decline health insurance, in writing, and lose \$1,000 tax credit.

Thus, an automatic enrollment model preserves a voluntary choice system, while at the same time it strongly “cues” the individual to accept the \$1,000 tax credit and use it to elect a health plan.

Automatic enrollment is a proven method. The Medicare Part B (SMI) program

has successfully used automatic enrollment for more than three decades. It now enrolls 38 million persons. As they near age 65, senior citizens are advised that they will be automatically enrolled in Medicare Part B and that the premiums—now \$50 per month—will be automatically deducted from their monthly Social Security checks, unless they decline in writing. Approximately 95% of eligible retirees now elect SMI enrollment, which is 75% subsidized by general revenues. This high acceptance rate was the same even in earlier Medicare years, when there was a less generous 50% subsidy.

In the private sector, automatic enrollment—even without an employer contribution—has been shown to produce high worker enrollment in 401(k) plans. A recent study, published by the National Bureau for Economic Research, showed that the enrollment rate for new workers—with an (unmatched) worker contribution of 3% of wages—rose from 37% to 86% after introduction of automatic enrollment. The study found particularly impressive improvements for younger workers (a rise from 25% to 83% participation for workers under age 25), for lower income workers (a rise from 12.5% to 79.5% for workers with incomes below \$20,000), and among Hispanic workers (a rise from 19% to 75% participation).⁵ Since these population groups also tend to have low health insurance coverage, it is significant that automatic enrollment alone was so successful in influencing their choices.

Automatic Enrollment Options

If automatic enrollment is applied for new workers who are eligible for health insurance, a policy decision will be needed as to the “default” option. There are two approaches, which differ in worker financial contribution and the generosity of the benefit package:

- A “*zero premium*” plan: whatever benefits can be offered for health insurance tax credits alone, for example, \$1,000 (no cost to worker).
- A “*basic*” plan: whatever benefits can be offered for health insurance tax credit plus a standard worker contribution, for

example, $\$1,000 + \$500 = \$1,500$
(Medicare equivalent).

Under the first option, workers would be automatically enrolled in a free health insurance plan with a \$1,000 premium, unless they declined. Few individuals are likely to decline a \$1,000 benefit, so there could be near-universal coverage of uninsured workers. On the other hand, this option would offer sub-par benefits. Under the second option, workers would be enrolled in plans that offered a higher benefit level, for example, \$1,500, but also included a standard worker contribution, via an automatic payroll deduction—for example, \$500 (about \$10 per pay period)—to qualify for a \$1,000 tax credit matching payment). A \$1,500 premium would be sufficient to finance Medicare-level benefits for uninsured full-time workers, as a national average.⁶ Health plans that offered Medicare benefits would likely be seen by workers as offering good basic benefits. Since Medicare enrollees now pay \$600 per year for Medicare SMI benefits—often from Social Security checks that average only about \$10,000 per year—it does not seem unreasonable to ask workers to pay \$500 for such health insurance coverage. Nevertheless, the takeup rates for a health benefit, with a two-thirds subsidy (a \$1,000 tax credit for a \$1,500 premium), would likely be lower than under the “zero premium” option.⁷

This use of automatic enrollment and subsidized coverage, plus an efficient workplace signup system, should achieve high take-up rates among new workers. Automatic enrollment can also be used to fill other gaps in health insurance coverage, most notably those that occur when a worker and his/her family lose their eligibility for employer health insurance. Presently, these workers qualify (under the COBRA legislation) for up to 18 months of continuing coverage, but their only option is to pay the full premiums themselves for the same benefit plan. This is usually expensive coverage with a “sticker shock”; a worker who has paid \$1,000 for a \$5,000 family policy (with the employer paying \$4,000) is faced with a decision, at a time when he/she is about to stop getting a paycheck, to pay the

full \$5,000 or drop coverage. Faced with this choice, the overwhelming majority of workers, over 80%, do not elect to continue COBRA coverage.

Most of the uninsured become uninsured because of these gaps in coverage, not because they are permanently uninsured (or uninsurable). A straightforward way to handle such potential problems is to extend eligibility for the \$1,000 tax credit through the 18-month COBRA period (if a worker does not qualify for new employer-offered health benefits), and to offer workers a range of affordable options—with automatic enrollment. Similar tax credit, health plan options, and automatic enrollment provisions could be offered for students who lose parental coverage.

Figure 3
Automatic Enrollment at End of
Previous Coverage

- Modify COBRA (which now provides the sole option of a fully-worker paid premium for previous benefits) to offer a choice of affordable health plans with a \$1,000 tax credit.
- Also offer affordable health plan choices for students when coverage runs out on a parent’s policy.
- Use “automatic enrollment” to raise takeup rates and prevent coverage lapses.

Presenting a person with a menu of affordable options at the point when she/he is about to lose previous coverage (and financing) takes advantage of an opportune moment for making new arrangements. There are already employer “notification” requirements under COBRA, and an expanded set of affordable options and financing could be made part of that notification and signup process. This would also be an opportune time to inform workers of SCHIP coverage for their children and to provide application

forms. If insurers were required to notify a service center of when a student was going to age off a parent's family coverage, the service centers could notify the students of their eligibility for tax credits, health plan options, and automatic enrollment.⁸

STATE RESPONSIBILITIES

Federal tax credits can provide basic financing for uninsured workers, but they will need to be supplemented to cover the nearly 40 million uninsured. State-administered efforts could assist (a) to expand SCHIP, Medicaid, or other financing for low-income children and nonworkers; (b) to coordinate these means-tested programs with the tax credits and private insurance coverage; and (c) to supplement the tax credit for some workers. Issues of health insurance market regulation will also need to be resolved.⁹ With respect to federal tax credits for workers, this paper shows that payroll withholding and automatic enrollment offer proven methods for efficient and effective administration. The possibilities for bipartisan agreement on expanding health insurance coverage should not be impeded by concerns over these administrative issues.

ENDNOTES

1. This avoids raising taxes for individuals who do not now have income tax liabilities, and it avoids an administrative system that requires individuals to prepare, and for government to process, tens of millions of new tax reports.

2. Author's estimates from *Economic Report of the President*, Council of Economic Advisers, 2001, and *EBRI Databook on Employer Benefits*, 4th ed., Employee Benefit Research Institute, 1997; accessed July 26, 2001, at <http://www.ebri.org>.

3. The prices cited are those quoted on amazon.com for the software programs Payroll for Contractors 1.0, Peachtree First Accounting 2002, and QuickBooks Pro 2001; accessed August 20, 2001, at <http://www.amazon.com>.

4. Final reconciliation of tax liabilities and payments would take place in the normal income tax process. Higher-wage workers could adjust their W-4 income tax withholding to the extent they incur higher tax liabilities from using a health insurance tax credit.

5. Brigitte Madrian and Dennis Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," Table 5, Working Paper 7682, National Bureau of Economic Research, May 2000. A proposal to use automatic enrollment to expand health insurance coverage is contained in Karen Davis, Cathy Schoen, and Steve Schoenbaum "A 2020 Vision for American Health Care," *Archives of Internal Medicine*, 160, no. 22 (December 11-25, 2000).

6. See Lynn Etheredge and Stanley Jones "Affordable Health Benefits for Workers without Employer Coverage," Health Insurance Reform Project, George Washington University, February 1998. These premium estimates define eligible individuals as workers who work at least three days per week and those who are receiving unemployment insurance benefits, and their spouses. Subsidized coverage for children and other nonworking adults, as well as supplemental health benefits, would be financed through SCHIP, Medicaid, and other public programs.

7. With a significant potential enrollment in "default" plans, health plans are likely to offer these benefits. If they do not, government could contract for such health plans or offer public program coverage. If more than one default plan were available, a worker could be asked to choose among them, to exercise his/her other options to select another plan (with a different payroll deduction) or to decline coverage, in writing. If a worker declined to use his/her tax credit, the tax credit could be assigned to state government for "safety net" coverage or revert to the Treasury Department.

8. Students are unlikely to have surplus earnings, so their default enrollment plan should likely be a "zero premium" plan.

9. A proposal to resolve these health insurance market regulation issues, using federal-state models that have been adopted in recent legislation, are discussed in Lynn Etheredge "Tax Credits for Uninsured Workers," Health Insurance Reform Project, George Washington University, September 1999. This proposal covers issuance and non-discrimination rules, as well as health insurance market regulation and related financing issues.