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Optimizing Employee Benefit Costs Under PPACA: Avoid False Dichotomies

BY DAVID R. GODOFSKY

Summary: Most employers will find that the optimal financial choice is to continue to provide access to employer-sponsored health insurance after PPACA is fully implemented. However, many employers will be able to improve the cost effectiveness of their benefits plans by passing more costs on to employees in the form of pretax premiums, and increasing salaries or wages. PPACA leaves intact, and adds to, the reasons for providing access to coverage, while at the same time strengthens the reasons for requiring substantial employee pretax premiums. Avoiding PPACA's excise taxes entirely will not normally produce the best result, but most employers will want to avoid the ''sledgehammer'' penalty.

David R. Godofsky is a partner of Alston & Bird, LLP, Washington, D.C., and leader of its Employee Benefits and Executive Compensation Practice Group, and a Fellow of the Society of Actuaries.

Ever since the enactment of the Patient Protection and Affordable Care Act (PPACA) (Pub. L. No. 111-148) in March of 2010, the literature in the both the popular press and the trade press has been filled with a false choice for employers: shoulder the additional costs associated with PPACA mandates on the one hand, or, on the other hand, exit the healthcare system, pay the associated excise taxes, and let your employees buy subsidized health insurance on the new exchanges that will be available in 2014.[1]

As the narrative goes, it will cost less to pay the excise taxes ($2,000 per employee) than to continue to provide health insurance coverage, and so employers will exit the market. However, this narrative is based on two false assumptions:

1. that the $2,000 excise tax is the only cost that would be incurred as a result of exiting the healthcare system; and
2. that these are the only two options.

The truth is that there are many reasons for employers to continue to offer health insurance to their employees, and there are many ways of dealing with the additional costs that PPACA imposes.[2] Most employers

[1] The analysis in this article is based on PPACA provisions in effect as of Jan. 1, 2014, and does not assume any amendments to the statute before then. Amendments are likely, but the direction of those amendments is unknown at this time.

[2] In order to avoid excise taxes, employers will generally be forced to eliminate exclusions for pre-existing conditions, cover adult children to age 26, limit deductibles and co-insurance, eliminate annual dollar limits and lifetime dollar limits, and extend coverage availability to all full-time employees. Each of these mandates will increase costs. Proponents of PPACA claim that modification of incentives will reduce costs, but such reductions are speculative, while the cost increases from the mandates are clear and obvious. Whether the net result will be cost increases or decreases in the long run is beyond the scope of this article. For purposes of this article, it is

will discover that eliminating coverage entirely will not be the optimal financial choice.

We All Work for Food

As I go to work, I often pass (seemingly) homeless people with signs saying, ''I will work for food.'' Every day, when I go to work, I work for food. However, my firm does not pay me in chickens. It pays me in dollars, which I then trade for chickens as well as other foods and other goods. Why, if my employer pays me dollars instead of chickens, should it offer me insurance as part of my compensation package? And why health insurance, when it does not include, as part of my pay package, homeowners insurance or car insurance? The answers are both deceptively simple and extremely complex, depending on how deeply you probe:

- **Employees are willing to work for lower dollar wages when an employer offers health insurance; and**
- **Employers derive other economic benefits from having insured employees.**

Why would employees trade wages for insurance, when they clearly would not prefer chickens over dollars? Reasons include the following:

- Health insurance purchased by the employer is not taxable income, and employee premiums are generally pretax. This form of wage also avoids FICA tax of 15.3 percent. This means that employer-sponsored health insurance has a much lower after-tax cost than insurance purchased by an individual, even in an exchange after PPACA. (Employer provided chickens enjoy no such tax subsidy.)
- The incidence of anti-selection (sick people buy insurance, healthy people do not) is much less with employer-provided coverage. Consequently, even healthy individuals who want insurance will pay a higher price if it is purchased on the individual market.
- Health insurance is extremely complex and an individual purchasing coverage is more likely to purchase an inappropriate product or a rip-off.
- Paying for medical care is more effective through insurance than if you pay for your care directly. This is because insurers negotiate discounts with providers. Consequently, providers greatly over-charge individual purchasers. (Because of the prevalence of insurance, the term ''discount'' may be slightly misleading—it may be more accurate to say that insurers negotiate with providers to overcharge uninsured individuals.) The net effect is that you do not want to pay for medical care from your own wallet, because paying through insurance is less expensive.

With all these advantages, it would seem that an employee would be willing to trade more than $100 of wages for $100 worth of insurance coverage. Indeed, some employees would gladly take salaries reduced by much more than the cost to the employer of purchasing insurance. (How many companies in the US manage to employ a highly skilled workforce without offering insurance?) However, many employees do not need insurance, or do not particularly want it. Some have insurance through a spouse, parents, or Medicare. So, it is not clear that paying $100 for insurance will save an employer as much as $100 in direct wages. The actual conversion ratio will vary from one employer to another based on the demographics of its workforce, competitive factors, and many other factors. However, it is fair to say the conversion ratio is well above zero.

PPACA modifies this balance in several ways:

- The cost of not providing insurance is increased by $2,000 per year per employee,[3] which is the same as saying the cost of providing insurance is decreased by $2,000. However, assuming some employees will turn down the employer-sponsored option (because they are covered by Medicare, a spouse or parent's policy, or just do not want it), the net cost of providing insurance to the remaining employees is decreased by more than $2,000 each.[4]
- The cost of insurance is increased by the costs of the mandates: no pre-existing condition exclusion, no annual or lifetime dollar limit, etc.
- Employees will be able to buy insurance on the exchanges, and in *some* cases, that coverage will be subsidized by the government. However, even after the subsidy, costs will be substantial (and not tax-subsidized) and many employees will not find exchange-coverage to be cost effective or affordable.
- Demand for insurance by individuals may increase slightly or decrease slightly due to the misnamed ''individual mandate.'' In actuality, PPACA imposes a rather modest tax on some, but not all, individuals who choose to be uninsured. The amount of the tax is not nearly enough to induce someone to buy insurance if they do not want it or can not afford it. However, a few individuals who are on the fence will certainly be induced to purchase insurance. On the flip side, the availability on the exchange of insurance with no exclusion for pre-existing conditions will convince some individuals that purchasing insurance is not necessary as long as they remain healthy. Experts do not agree on whether the net effect will be an increase or a decrease in coverage, but the net effect is likely to be modest in either direction.
- For certain employees, the employer must offer a ''free choice voucher'' equal to the amount of the employer subsidy if the employee purchases coverage on the exchange instead of from the employer.

As we will see, the net effect of these changes is likely to leave intact, for almost all employers, the basic premise that employer-sponsored insurance is a cost-effective part of a pay package. However, the degree of subsidy provided by the employer may change drastically due to PPACA.

Structure of the 'Penalties'

The structure and amount of the excise taxes (also referred to as ''penalties'') is important in the analysis.

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assumed that costs will increase. If costs decrease, the logic of staying in the health insurance system is even stronger.

[3] This is what is colloquially referred to as the ''sledgehammer penalty.'' Actually, the penalty applies to the number of full time employees minus 30. So, if you have 10,000 full time employees, the sledgehammer penalty is $2,000 x 9,970. However, for large employers, the subtraction of 30 is insignificant, and for the sake of convenience, in the remainder of this article we simply use the approximation of # of employees x $2,000.

[4] Suppose, for example, that you have 10,000 employees, but if you offer insurance, only 5,000 employees will take it. The sledgehammer penalty (if you do not offer insurance at all) is $20 million. So, the cost of providing insurance to 5,000 is reduced by $20 million, or $4,000 each.

Sledgehammer Penalty: One penalty applies if coverage is not offered to all full-time employees. If even one full-time employee (1) lacks coverage *availability* from the employer; (2) purchases insurance through an exchange; *and* (3) receives an income-based government subsidy, then the employer pays a penalty of $2,000 per year multiplied by the number of full-time employees minus 30. To avoid the sledgehammer penalty, the employer must offer minimum essential coverage. However, the employer can pass nearly the entire cost of coverage on to employees in the form of pretax employee premiums, without incurring the sledgehammer penalty.

Example: XYZ Company employs 10,000 full-time employees. Its health insurance plan covers 9,999 employees. One full time employee is ineligible. That employee purchases insurance on an exchange and receives a subsidy. XYZ pays the sledgehammer penalty equal to $2,000 x 9,970 or approximately $20 million.

Tack Hammer Penalty: The tack hammer penalty is $3,000 per employee per year, but applies only to those employees who purchase insurance on the exchange and receive a government subsidy. Thus, the employee count for the tack hammer penalty excludes all of the following:

- Employees who choose not to purchase insurance.
- Employees who choose to purchase the employer provided coverage, or any other coverage besides the exchange.
- Employees who do not purchase insurance on the exchange because they have coverage from a spouse's policy or parent's policy.
- Employees who do not purchase insurance on the exchange because they are covered by Medicare or Medicaid.
- Employees who cannot afford insurance on the exchange, even with the government subsidy.
- Employees whose family income exceeds four times the poverty level (approximately $43,000 for a single employee; approximately $88,000 for a family of four).
- Employees for whom the employer premium is less than 9.5 percent of income.

The exclusions above will eliminate the vast majority of employees from the tack hammer penalty. Thus, even if the employer raises employee premiums enough to cause many employees to opt-out, the availability of employer provided insurance reduces the penalty from the sledgehammer to the tack hammer.

Employer Subsidies—Which Direction?

Traditionally it has been thought that, as costs rise, the employer subsidy also rises. Indeed, most employers have been unable or reluctant to pass on to employees the full cost increases. This may continue to be true. However, for those employers who are considering exiting the insurance market (that is, reducing employer subsidies to zero), a significant reduction in the subsidy may be preferable to complete elimination.

Increasing the Employee Pretax Premium

Increasing the employee pretax premium will have the following advantages and disadvantages.

- **Disadvantage: More employees will choose to be uninsured**. Many employers prefer their employees to have health insurance, for a variety of reasons, including positive effects on morale and absenteeism, community reputation, goodwill, and moral reasons. However, the degree to which an employer values this benefit varies greatly depending on the demographics of its workforce, the nature of the business, the state of its government relations, and the locations of its operations.
- **Advantage: Fewer employees will choose employer-coverage**. Increasing the employee premium saves much more than the direct reduction of the subsidy. It eliminates the subsidy entirely for those employees who choose to remain uninsured and for many employees who choose to purchase their insurance elsewhere. For example, some employees will have lower-cost coverage through a spouse or parent.
- **Advantage: Employees can choose the form of wage they value most**. Many employees do not need or do not want insurance (at least not as much as the money it costs), or have it available at a lower cost elsewhere. Simultaneously increasing the employee premium and the employee's wages will give some employees much greater satisfaction.
- **Advantage: The higher wage is more visible**. When accepting a job, most employees ask if there is insurance, but not the amount of the employee premium. For many non-economic reasons (such as status), employees value having a high salary. Further, most employees vastly underestimate the cost of health insurance, and so have no idea how much their actual pay package is. For these reasons, employees may be more likely to accept a higher salary over a lower premium.
- **Advantage: Ameliorates the sticky wage problem**. In our low-inflation environment, it is difficult to lower an employee's salary when the employee is less productive than anticipated or than he was previously, or when there is downward pressure on the price of the employer's products. (Economists refer to this phenomenon as "stickiness" in the wage.) However, when increasing the employee premium, it is not necessary to increase the salary by the same amount. This gives the employer the opportunity to adjust the overall wage package downward for some employees.

***Myth-buster: Insuring fewer employees will NOT increase the cost of coverage**. A common myth is that insurance costs go down when you are able to insure most of your employees. The average cost goes down; the total cost goes up. Consider: Jill costs $1,000; Jack costs $9,000; together, their average cost is $5,000. If Jill drops coverage, the average cost goes up from $5,000 to $9,000, but the total cost still goes down by $1,000.*

Family Pricing Is Obsolete

PPACA requires that employer coverage include children up to age 26, regardless of the availability of other insurance. Consider the 23 year old child of your employee who is employed and can purchase insurance through work for $100 per month. If your company offers a "family" premium and the employee also has a minor child, then the adult child's coverage is free to the employee. Why would that adult child pay $100 per month when he could stay on his parents' coverage for free? More to the point, why would *your* company choose to subsidize the child's employer in this manner? PPACA will drive many if not all companies to charge on a ''per insured individual'' basis, not to lump coverage into a ''family'' premium.

Examples The following examples illustrate the point that, typically, it will be more cost effective under PPACA to increase employee premiums rather than exit the insurance market entirely.

Example 1 Consider XYZ company, which employs 10,000 individuals in the United States. XYZ provides health insurance at an average cost of $6,000 per employee, and charges the employee $150 per month in pretax premiums ($1,800 per year), and therefore has a subsidy of $4,200 per year per employee. Most employees choose to be insured.

XYZ estimates that the PPACA mandates will increase the cost of health insurance by $1,000 per employee. Its workforce is not highly paid, and that cost increase is unsustainable. Thus, XYZ is considering eliminating its insurance altogether, on the theory that employees can buy insurance on an exchange. As an alternative, it is considering raising the employee premium.

Scenario 1—Drop Insurance In scenario 1, XYZ company drops insurance entirely. Cost impacts are as follows:

- Eliminate employer subsidy: $4,200 x 10,000 = $42 million savings
- Increase direct wages: employees demand higher wages as alternate employment is more attractive. Additional cost: $18 million.[5]
- Sledgehammer penalty: $2,000 x (10,000-30) = approximately $20 million.
- Net effect: **$4 million** in savings. (And, many employees are left uninsured.)

Scenario 2—Increase Employee Premium In scenario 2, XYZ increases the average employee premium to $500 per month ($6,000 per year), leaving the employer subsidy at $1,000 (as compared with the new $7,000 average cost). XYZ also increases wages by $15 million to compensate for the reduction in the employer subsidy.[6]

In scenario 2, 70 percent of the employees drop employer coverage, leaving 3,000 insured. Those 3,000 are not the healthiest, so the new employer subsidy increases from $1,000 per employee to $2,000 per employee, but applies to only 3,000 employees.

Of the 7,000 employees who drop coverage:

- 3,500 choose to be uninsured
- 1,500 add coverage through a spouse or parent (now available to age 26)
- 1,000 end up on Medicare or Medicaid
- 1,000 purchase subsidized coverage on an exchange[7]

Cost impacts are as follows:

- Cost of new employer subsidy: $2,000 x 3,000 = $6 million. Prior subsidy was $42 million. Cost savings = $36 million.
- Increased direct wages = $15 million.
- Tack hammer penalty = $3,000 x 1,000 = $3 million.
- Free choice vouchers = 1,000 x $2,000 = $2 million
- Net effect: cost savings of **$16 million**. (And, many employees are left uninsured.)

Note, in scenario 2, the cost savings is $12 million more than in scenario 1. The difference between the sledgehammer penalty and the tack hammer penalty, in these scenarios, is $17 million.

One might argue that, under the facts above, XYZ should have eliminated its health insurance coverage even before passage of PPACA, but now PPACA gives the employer an incentive not to eliminate coverage.

For some employers, the conversion of benefits to wages is more efficient—that is, a greater wage increase is needed as benefits are eliminated. However, that factor will affect both scenarios. Almost any reasonable adjustment to the assumptions above is going to leave the basic result intact—less subsidized coverage is more cost effective for the employer than no coverage, because of the huge disparity between the sledgehammer penalty and the tack hammer penalty.

Example 2 ABC company has 10,000 employees, primarily low wage, and does not presently offer any health insurance.

Scenario 1 – Continue to offer no insurance

- Sledgehammer penalty = $2,000 x (10,000-30) = approximately $20 million

Scenario 2 – Offer insurance with a low subsidy, like XYZ company in Scenario 1.

- Subsidy = $2,000 x 3,000 = $6 million
- Tack hammer penalty = $3,000 x 1,000 = $3 million
- Free choice vouchers = $2,000 x 1,000 = $2 million
- Decrease in direct wages—for purposes of this analysis, assume zero.[8]
- Reduced employer FICA taxes = (approximately) $1.5 million
- Total cost = $9.5 million

In this example, the cost of the tack hammer penalty and the cost of the employer subsidy, combined, is still less than the cost of the sledgehammer penalty. In addition, some of the employees benefit by being able to pay premiums on a pretax basis. This employer may decide to begin offering insurance with a relatively small subsidy.

Other Rational Responses to PPACA

Other ways that employers may react to PPACA include the following.

- **Outsourcing**. PPACA has nondiscrimination provisions that will make it much more difficult to optimize financial results if the employer has two distinctly different employee populations. For example, consider an

[5] Before PPACA, this cost would have been higher. However, as XYZ has a primarily low-wage workforce, the availability of subsidized exchange coverage reduces the demand by employees for employer coverage.

[6] One might argue that such a large increase in premium would require a greater wage increase. However, the wage increase required in scenario 2 is, by definition, less than the wage increase required in scenario 1.

[7] In this scenario, the increased employee premium is still much less expensive than unsubsidized exchange coverage. Therefore, no employees are assumed to buy exchange coverage unless they qualify for a subsidy.

[8] Clearly, over time, an employer that offers insurance will be able to offer lower wages, to some extent. However, because the outcome does not depend on this amount, and the amount is speculative, we have ignored it in this example.

employer with a large number of highly paid engineers, and a large number of low-paid factory workers. The optimal strategies for these two populations may be distinctly different. Consequently, the employer may choose to sell the factory and outsource the manufacturing. The two entities, once split, will each be able to pursue a financial strategy appropriate to its population.

■ **Move Jobs to Another Country**. By increasing the cost of employing people in the U.S., PPACA will make it more attractive for companies to start new operations, or move operations, to countries that have lower employment costs.[9]

■ **Reduce Employment Through Automation**. PPACA changes the relative balance between the cost of human labor and the cost of automation. Although automation often makes sense for purely economic reasons, PPACA puts a thumb on the scale in favor of automation, even in cases where it would not otherwise make economic sense. (Note that automation shifts jobs more than it eliminates jobs—someone has to build all those robots and computers. However, some of that job shifting will be to other countries that have lower wages, and some of the job shifting will move costs to higher paid jobs where a smaller percentage of the total cost consists of health insurance.)

■ **Reduce Hours for Summer Help and Other Seasonal/Hourly Employees**. In order to avoid the sledgehammer penalty, many employers will limit hours to fewer than 30 hours per week in order to avoid allowing student-interns, other seasonal employees, and many hourly employees from obtaining ''full-time'' status.

Conclusion

PPACA is a complex statute with numerous unintended consequences. Clearly, many of the strategies outlined in this article are results not intended by Congress. That, and the tremendous political controversy attendant to PPACA makes it likely that the statute will be amended and modified before 2014. However, it is clear that simplistic reactions to PPACA would be highly counterproductive for employers. Reaching optimal financial results will require a more thorough and refined analysis. The analysis will differ from one employer to the next, depending on workforce demographics, the employer's current benefit plans, the employer's business plans, and many other factors.

[9] This factor cannot be eliminated by taxing companies that move or have facilities outside the U.S. If a British company, for example, chooses to build a factory in India instead of the U.S., there is no way for the U.S. to tax that decision.