COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON OVERSIGHT
HEARING ON TAX-RELATED PROVISIONS IN THE PRESIDENT'S HEALTH CARE LAW

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Questions and Answers for the Record

<u>Question for ALL Panelists</u>

Q:

I have heard from numerous small businesses in New York who are frustrated and confused regarding the employer mandate tax and the new definition of what exactly a full-time employee is. Already, the law has incentivized employers to shift employee's below the 30-hour weekly mark to legally avoid penalties and the high cost of health insurance. Employees themselves are being removed from employer-sponsored care on top of being bumped to part-time status. Can the witnesses comment on the degree to which the employer mandate tax discourages full-time employment, employer-covered health coverage and what this might mean for both employees and the economic recovery?

A:

Douglas Holtz-Eakin
Among the key aspects of the ACA is its mandate to cover employees with health insurance. Focusing first on those employers with more than 50 workers, beginning in 2014, those firms must pay a penalty if any of their full-time workers receive subsidies for coverage through the exchange. The penalty is equal to the lesser of $3,000 for each full-time worker receiving a premium credit, or $2,000 for each full-time worker, excluding the first 30 full-time workers. The fees are paid monthly in the amount of 1/12th of the specified fee amounts. Firms with fewer than 50 employees are exempt from the so-called employer "play or pay" penalties if they do not offer coverage and their workers receive a subsidy in the exchange.
From the perspective of economic performance, the most important point is that the *best* possible impact is that the firm is already offering insurance, no individual ends up receiving subsidies and triggering penalties, and thus costs are unaffected. In every other instance, health insurance costs will compete with hiring and growth for the scarce resources of those firms.

One might think that the same situation prevails for the smallest firms – those under 50 employees – who are exempt from the coverage mandate. Unfortunately, for these firms, the greatest impact is the tremendous impediment to expansion. Suppose for example that a firm does not provide health benefits. Hiring one more worker to raise employment to 51 will trigger a penalty of $2,000 per worker multiplied by *the entire* *workforce*, after subtracting the first 30 workers. In this case the fine would be $42,000 (21 (51-30) workers times $2,000). How many firms will choose not to expand?

Alternatively, the labor market is already witnessing firms responding to the incentive to avoid full time employment. As a result, the ACA may result in considerable underemployment of those seeking full-time work.

Proponents of the ACA like to point toward the fact that small businesses will receive aid in the form of a small businesses tax credit, ostensibly offsetting the burdens outlined above. Unfortunately, the credit is available only for employers with fewer than 25 workers and those in which average wages are under $50,000. Thus, the cost and growth impacts for those with 26 to 50 employees remains unchanged. Moreover, the credit is not a permanent part of the small business landscape. An employer may receive the credit only until 2013 and then for two consecutive tax years thereafter. Thus, the credit is available for a maximum of six years.

Turning to the credit itself, to be eligible the employer must pay at least 50 percent of the premium. The credit is equal to 35 percent of employer contributions for qualified coverage beginning in 2010, increasing to 50 percent of the premium in 2014 and thereafter. The amount of the credit is phased-out for firms with average annual earnings per worker between $25,000 and $50,000. The amount of the credit is also phased-out for employers with between 10 and 25 employees.

In the same way that the mandate provides an implicit tax on growth, the structure of the small business tax credit will raise the effective marginal tax rate on small business expansion. For this reason, the credit may discourage firms from hiring more workers or higher-paid workers. Consider two examples.

In the first, employers will have an incentive to avoid increases in the average rate of pay in their firm. Suppose that the average wage in a small (3 worker) firm is $25,000 and the owner decides to add a more highly paid supervisor being paid $50,000. This will raise the average wages in the firm to $31,250 there by *reducing* the tax credit per worker from $2,100 to $1,596.[1] In effect, the structure of the credit raises the effective cost of adding valuable supervisory capacity.

In this example, total credits to the firm are essentially unchanged ($6,300 to $6,384) by raising the average wage. If the new supervisor were paid $75,000 however, total credit payments would fall from $6,300 to $4,368. The lesson is clear in that the structure of the credit can impose large effective tax rates on raising the quality of the labor force for those receiving the small business credit.

Similar incentives affect the decision to hire additional workers because the overall tax credit falls by 6.7 percent for each additional employee beyond 10 workers. This is a very strong disincentive to expanding the size of the firm. Using the example above,

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[1] This example assumes the employer contributes $6,000 toward insurance for each employer.

suppose that the firm has 10 employees and total credits received were $21,000. The firm's total subsidy will peak at $21,840 with the hiring of the 13th worker. Thus, a firm employing 13 workers would get a total tax credit of $21,840 while a firm employing 24 workers would receive a total credit of only $3,360.[2]

The upshot is that the small business tax credit is a mixed economic blessing. Relatively few firms will qualify for the credit and be able to offset the costs of health insurance. For those that do qualify, receipt of the credit imposes a new regime of hidden effective marginal tax increase on improvements in scale and quality. Even more broadly, the credit does little to offset the overall impact of the mandate costs on the disincentives for full-time employment.

Dan Moore

I understand that small businesses that cannot afford to provide and thus do not already provide medical benefits for their employees may actually decrease the working hours for current employees below 30 hours per week to avoid penalties and the requirement to provide high-cost health insurance. As the leading association of small medical device companies, our member companies compete for professionals and skilled hourly manufacturing workers and, accordingly, must provide health care benefits to remain competitive. Certain aspects of the PPACA employer mandate directed to the scope of required coverage could limit the flexibility available to our member companies and drive up the cost of employer plans. Like the medical device tax, these additional costs discourage investment in other endeavors, like research and development, and limit the ability of a business to grow.

Walt Humann

Pursuant to interest on how the Affordable Care Act (ACA) employer mandate will impact OsteoMed and its employees, OsteoMed management provides the following response.

The ACA employer mandate has discouraged OsteoMed's business development and growth as we now have very strong disincentives to expand and hire full time employees and provide quality healthcare coverage at the levels currently provided to our employees. OsteoMed has already reduced spending on research and development, implemented a freeze on hiring, reduced permanent headcount and delayed plans for near term growth as a result of the pending impacts of healthcare reform. Our employees, both current and future, will ultimately suffer the consequences of the ACA through the loss of career growth opportunities and earnings.

At OsteoMed, we typically do not employ seasonal or part-time employees, however, the ACA has forced us to reconsider our current staffing models and we will likely employ more contract and/or outsourced labor as a way to mitigate costs and risks related to the new mandate and associated penalties in the future. OsteoMed currently employs approximately 260 employees, including positions that are often outsourced by other companies. We will evaluate options to reduce permanent headcount through outsourcing and contract labor structures. Customer service, accounts payable, payroll,

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[2] See, http://www.ncpa.org/pdfs/ba703.pdf

manufacturing and other positions we have considered critical to our business will be evaluated for outsourcing as we explore ways to mitigate the mandate and its related costs.

The employer mandate tax also discourages employer-covered health coverage because the penalties associated with moving employees to the exchanges are significantly less than the costs for businesses to maintain coverage. Based upon projections associated with the new mandate, it will be hard for OsteoMed to justify maintaining private health coverage for employees. We currently spend over $3 million to provide health and welfare coverage for employees which is estimated to exceed the penalties by more than $1.5 million next year. Given the additional burden we assumed at the beginning of the year with the new medical device excise tax, this is cannot be ignored and this money may be needed to fund projects that have been delayed or cut from our budget. Not offering healthcare benefits will negatively impact our employees in several ways. Employees will elect to purchase lesser coverage on the exchanges in order to minimize their out of pocket expenses or employees will be forced to come out of the their own pocket an estimated additional $5k-$10k in order to maintain the current level of coverage provided by OsteoMed's employer plan.

David Kautter

There is no doubt that the employer mandate tax is discouraging full time employment and employer-covered health insurance. This is not good news for employees or the economic recovery.

One of the biggest problems as the law is being implemented is a lack of understanding on the part of employers of all sizes, especially smaller employers, of the requirements of the Affordable Care Act (ACA). The law is so far reaching and complicated that most small employers do not have even the most basic understanding of its requirements. Not surprisingly, they do not have the time to figure out the law themselves nor the resources to hire consultants to advise them. In the absence of an understanding of the consequences of their potential actions, a great many small employers are simply refusing to add additional employees. This refusal to hire will continue until it is clear to a small employer that adding new workers will not have adverse business, economic and tax consequences.

Those small employers who have managed to become familiar with the rules have often responded in two ways: (1) refusing to hire additional employees so that they remain below the 50 employee level and (2) moving employees to part time status, i.e. reducing working hours to less than 30 hours per week. Reducing employee hours to less than 30 hours per week is becoming an increasing trend and in some industries is likely to become the norm before long. This trend will make life more challenging for many who will now have to work two jobs instead of one to make ends meet. These are often employees who are at the lower end of the wage scale. Based on my experience so far, it is my belief that the employer mandate is slowing the economic recovery and will serve as a drag on economic growth for the foreseeable future.

Shelly Sun

First, I do not believe this is at all about incentivizing employers to reduce hours to avoid costs that they can afford as the question may imply. Many small business owners, like BrightStar franchisees, invested more than $100,000 to start their business, and many took on debt to start and grow their businesses. It's highly unlikely that the SBA loan applications banks approved for these small business owners included costs of compliance or the cost of health insurance or penalties. These business owners — like many across the country — are trying to be responsible to ensure they first repay their debts, and second, where possible, avoid cutting entire jobs that can result from complying with the increased costs of these burdening regulations. Once business owners repay their debt and earn a reasonable return, many look at opportunities to attract and retain the best employees by offering those working full-time (defined as 40 hours before ACA attempted to redefine full-time) with benefits. To force businesses to take on this significant cost before debt is repaid and the business has solid cash flow is irresponsible.

Despite employers' best efforts and intentions to offer coverage to workers, the result of the employer mandate is that both employers and employees lose. Take, for example, a real BrightStar employee that I will refer to as "Sarah Johnson." Currently, Sarah works an average of 36.5 hours per week. Her employer, a multi-unit BrightStar franchisee, is considered a "large employer" under the ACA, and has decided to reduce the impact of the employer mandate on his business by managing some variable-hour employees to stay under the 30-hour threshold. As a result, Sarah's hours will be reduced to 28 hours per week or less, which will reduce her annual wages by at least $5,400. If you combine wages lost with the cost of Sarah's individual mandate to purchase health insurance that has an annual premium of over $3,500, the total financial impact on Sarah is nearly $9,000 annually.

Sarah will not receive insurance coverage through her employer, but she also will be less able to afford her own coverage through the state insurance exchange. As much as small business owners and job creators are negatively impacted by the employer mandate, the ones who really suffer are the workers themselves.

The unintended impact of the employer mandate is devastating: fewer workers will receive health insurance, and they will be less able to afford their own coverage. Franchise small business owners are faced with a choice between either paying higher premiums or paying tax penalties for not offering coverage, and neither option is a good option.

The Affordable Care Act is anything but affordable. It adds taxes, costs, and fees, while threatening the economic viability and job creation opportunities for many of our nation's small businesses. To define a "large employer" as one with 50 employees is too low a ceiling and is crippling and irresponsible.

Hugh Joyce
The employer mandate absolutely will affect how and when employers switch employees from full time to part time status. We are hearing of significant numbers of businesses and even the state of Virginia reclassifying employees to 29 hours and part time staff to

avoid or prepare to avoid health care costs. There are so many unintended consequences regarding this part of the law, including:

1. Full time workers being forced to part time, causing serious pay reductions and negative family economic consequences.

2. Workers losing coverage all together and being forced to the exchange, as companies re-position.

3. Part time workers and workers losing coverage, who may now be paying for care themselves may become government subsidized. Driving costs up for our government.

4. The potential for employees to become highly disenfranchised from their employers. We see the potential for employees to battle their employers by creating threats to go to the exchange to trigger penalties for their employers.

5. The State of Virginia is actually cutting the state owned ABC store and Community College workers back to 29 hours to avoid health care costs.

6. The Senior VP of the consulting firm Mercer, Inc., the nation's largest benefit firm, stated and I quote, when asked what he thought the cost to American businesses would be: 'I have no "_____" Idea'. This guy is an expert and he can't interpret the rules and regulations and their impact.

7. Regulations: The Healthcare law is 2400 pages. I am told there are over 20,000 pages of support rules, regulations, clarifications, and mandates. This will cause great harm to our businesses, citizens and even our government entities if it is allowed to be fully implemented.

Bottom Line: The Healthcare Law in its current form is strangling American small, medium and large businesses with new costs, new taxes and difficult and extreme rules and regulations. We must establish a better plan.

Paul N. Van de Water
Any possible effect of health reform on encouraging part-time employment is too small to appear in the aggregate economic data. To the contrary, since the trough of the recession, the number of people working part-time for economic reasons has dropped, and average weekly hours have increased.

<u>Questions for Dr. Holtz-Eakin of the American Action Forum</u>

Q:

Thank you for your testimony before the Ways & Means Subcommittee on Oversight. Several experts, as well as the Congressional Budget Office and the Joint Committee on Taxation, have estimated that the health insurance tax will result in higher health insurance premiums for individuals and families. Could you please explain why the tax will lead to higher premiums and how the tax is at odds with the Affordable Care Act's stated goal of making coverage affordable?

A:

The imposition of the premium tax will upset the cost structure of insurance companies, raising costs per policy and reducing net income (or exacerbating losses). Some might argue that the firms will simply "eat the tax" – that is simply accept the reduction in net income. For a short time, this may well be the case. Unfortunately, to make no changes whatsoever will directly impact companies' abilities to make investments in health IT programs, wellness initiatives and disease management tools. Ultimately, this hurts individuals and small employers who won't have access to the types of tools and programs that can improve the quality of care and lower costs. Trying to retain the *status quo* also hurts the return on equity invested in the firm. Because insurance companies compete for investor dollars in competitive, global capital markets, they will be unable to both offer a permanently lower return and raise the equity capital necessary to service their policyholders.

Importantly, these impacts will be felt equally by the not-for-profit insurers. Non-profits have comparable resource needs for disease management, wellness efforts, or IT equipment. They also have equity capital demands, as they rely on retained earnings as reserves to augment their capital base. Bearing the burden of the tax means lower access to these reserves and diminished capital, harming their ability to continue to serve policyholders effectively.

In short, all insurers – for profit and non-profit alike – will seek to restructure in an attempt to restore net income levels, with the main opportunity lying in the area of labor compensation costs. To the extent possible, firms will either reduce compensation growth, squeeze labor expansion plans (or even lay off workers), or both. However, there are sharp limits on the ability of companies to shift the effective burden of excise taxes on to either shareholders (capital) or employees (labor). Moreover, their ability to do so diminishes over time as capital and labor seek out better market opportunities.

The only other place to shift the tax cost is onto customers – i.e., families and small businesses. If market conditions make it impossible for insurers to absorb the economic burden of the premium tax, they will have no choice but to build the new, higher costs into the pricing structure of policies. In this way, the economic burden of the tax is shifted to the purchasers of health insurance. In particular, the more competitive are markets for equity capital and hired labor, the greater the fraction of the burden that will be borne by consumers.

The implications for purchasers of health insurance are obvious and unambiguously negative. In addition, as employers pay more for health insurance, they will have to shave back on cash wage increases, and thus taxable compensation. Thus the health insurance premium tax will have the perverse effect of lowering personal income and payroll taxes.

To top things off, the new law has an especially unpleasant feature for those facing higher premiums: the fees are not tax-deductible but higher premiums will be taxable. This non-standard tax treatment matters a lot. If an insurance company passes along $1 of premium taxes in higher premiums and cannot deduct the cost (fee), it will pay another

$0.35 in taxes. Accordingly the impact on the insurer is $0.65 in net revenue *minus* the $1 fee. Bottom line: a loss of $0.35. (The problem gets worse when you consider that the $1 of additional premium is also subject to other state-level premium taxes and in some cases a state income tax.)

To break even, each insurer will have to raise prices by $1/(1-0.35) or $1.54. If it does this, the after-tax revenue is the full $1 needed to offset the fee. This has dramatic implications for the overall impact of the premium taxes.

The upshot is clear. The health insurance tax will make insurance more, not less, expensive. This fact is at odds with reducing the cost of insurance, reducing the number of uninsured, and increasing the access to health care.

Q:

Due to the nature of the private insurance sector and the health insurance tax requirements set forth under the Affordable Care Act, the health insurance tax impacts insurers differently, depending on their federal tax status. I was hoping you could provide feedback on regulatory actions available to the Administration to reduce the premium impact of the Affordable Care Act tax on consumers. Further, if the Administration fails to act, what will the impact of the Health Insurance Tax be on consumers? What actions can Congress take to mitigate the impact of the health premium tax, short of full repeal?

A:

Broadly speaking, the health insurance tax ("premium tax") will have the least disruption if it is as broadly and evenly applied as possible. To the extent that the Administration chooses definitions of products and market shares with this in mind the effects of the tax will be minimized. Past that, Congress could choose to eliminate the tax entirely or undertake a reform of the premium tax to transform it into a tax at a fixed rate on a more conventional base (e.g., income, profits, or revenues).

Question for Mr. Van de Water of the Center for Budget and Policy Priorities

Q:

Thank you for your testimony before the Ways & Means Subcommittee on Oversight. I was hoping that you could comment on the effects of the health insurance tax as it applies to the Medicare Advantage and Medicaid Managed Care Programs. I've heard this has inadvertently set up a dynamic where the government is taxing itself. To your knowledge is this the case? Has OMB or the Treasury assessed how federal expenditures on Medicare and Medicaid will increase as a result of this tax?

A:

The health insurance tax applies broadly to most businesses that sell health insurance coverage, including those that provide coverage through Medicare Advantage, Medicare Part D, and Medicaid. Under the Medicare Advantage payment system, however, only a small portion of the tax can be passed on to the Medicare program. And since budgets are tight, states are likely to be tough negotiators and not allow Medicaid managed care plans to pass through the entire amount of the tax. The Congressional Budget Office has presumably accounted for these effects in its overall cost estimates of the Affordable Care Act, but I am not aware of any official estimate of these individual items.