

Assessing Policy Options for Subsidies to Improve the Affordable Care Act

One Approach Could Insure More People, Reduce Premiums, and Save \$14 Billion per Year

One of the key challenges addressed by the Affordable Care Act (ACA) is to make health insurance affordable for uninsured Americans without harming those who are already insured—and without increasing federal spending. To address this challenge, the ACA provides tax subsidies for qualified individuals purchasing health insurance in the ACA marketplaces and retains the existing tax exemptions for employer and employee contributions to employer-sponsored insurance. However, the two subsidy structures are quite different: Low-income individuals are eligible for the largest ACA marketplace subsidies, while higher-income workers benefit most from subsidies for employer-sponsored insurance. Could the subsidies be reallocated more efficiently to maximize coverage, minimize premiums, and hold costs in check?

“Improving the Affordable Care Act: An Assessment of Policy Options for Providing Subsidies,” recently published in *Health Affairs*, analyzed three options for leveling the financial playing field between the employer and individual markets by reallocating the value of the benefits of employer coverage, which total about \$250 billion. The research found that one option—using the ACA subsidy formula for both the individual and employer-sponsored insurance markets, requiring the subsidy to be at least \$1,250, and imposing no upper income limit on subsidy eligibility—could expand coverage and reduce individual market premiums compared with the ACA today with no additional federal spending.

Subsidy Design Involves Economic Trade-Offs

Under the ACA, qualified individuals who purchase health insurance in the ACA marketplaces receive tax subsidies. These subsidies are progressive, providing the largest amounts to low-income individuals. Under the U.S. tax code, employee and employer contributions toward the cost

Key findings:

- This research examined three alternatives for expanding health insurance and lowering premiums, using tax revenue recovered by eliminating tax exemptions for employers and the employees who buy health insurance through their workplaces.
- Of the three alternatives, extending the Affordable Care Act’s subsidies to all consumers and placing a floor on subsidies would have the greatest benefit: coverage for an additional 4 million people, premiums that would be 10 percent lower, and \$14 billion saved annually in federal spending.

of employer-sponsored insurance are not taxed. Under this regressive approach, the value of a tax exemption is based on a person’s marginal tax rate, and high-income workers receive the largest subsidies.

This difference in structure results in discrepancies. For instance, a 27-year-old earning \$35,000 might be eligible for a tax exemption of \$1,260 in the employer-sponsored market but would receive no subsidy in the individual market. In addition, subsidies under the ACA are the same regardless of the plan the person chooses, but the tax exclusions for employer-sponsored coverage increase if a more generous plan is selected. Consequently, the tax exclusion encourages firms to offer more generous plans, resulting in overuse of health care.

Replacing this approach with a subsidy design that expands coverage at minimal cost involves various economic trade-offs.

This research highlight summarizes RAND Health research reported in the following publication: Saltzman EA, Eibner C, and Enthoven AC, “Improving the Affordable Care Act: An Assessment of Policy Options for Providing Subsidies,” *Health Affairs*, Vol. 34, No. 12, December 2015, pp. 2095–2103 (EP-50982, available at www.rand.org/t/EP50982).

Progressive approach to subsidies: Targeting low-income groups by basing the subsidies on the buyer's income, as the ACA does, could be cost-effective in encouraging them to buy insurance. However, it may create a work disincentive because the extra income from working longer hours could result in both a higher tax rate and a considerably lower subsidy. This approach may also contain income "cliffs"; under the ACA's formula, households with incomes below 400 percent of the poverty level can receive subsidies, while those above that level cannot.

Linking subsidies to premiums: Under the ACA, a person's premium for the benchmark marketplace plan (the second-lowest-cost silver plan available in the individual's ACA marketplace) is capped at a percentage of their income. Enrollees receive a dollar in subsidies for every dollar by which the benchmark plan premium exceeds the cap. This approach limits an enrollee's exposure to annual premium increases, unlike a regressive approach, such as a flat tax credit, that does not adjust to the premium. However, this approach increases the government's exposure to premium fluctuations. Furthermore, young people, who face lower premiums, receive a much smaller subsidy or no subsidy at all if the premium falls short of the income-based cap. While they may be deemed to have the ability to pay, they may not be willing to buy insurance at the unsubsidized premium.

Could Taxpayers Get More Bang for the Buck?

To illustrate the various economic trade-offs involved in designing a subsidy scheme, RAND modeled the outcomes of three approaches intended to reallocate the lost revenue from the employer and employee tax exemptions to maximize coverage, minimize premiums, and hold costs in check.

1. Subsidy Floor

This approach extends the ACA's subsidies to all qualified insurance consumers in the individual and employer-sponsored insurance markets and establishes a minimum subsidy amount. Any eligible consumer would receive a subsidy of no less than \$1,250 per year. Larger subsidies would be allowed based on the income-based contribution cap formula used in the ACA marketplaces.

Under the ACA, the subsidy equals the amount required to limit an individual's premium contribution to a certain percentage of his or her income for the benchmark plan. For example, the premium for a single person earning \$17,500 is capped at 4 percent of income, which is \$700, so a 27-year-old facing a benchmark premium of \$2,680 would receive a \$1,980 subsidy, while a 60-year-old with the same income and a premium of \$6,940 would receive a \$6,240 subsidy.

What distinguishes the option proposed here from the ACA is the \$1,250 subsidy floor. Under the ACA, a 27-year-old earning \$35,000 receives no assistance. This is because

the percentage cap on the individual's \$35,000 income is 9.5 percent (\$3,325), so the benchmark premium of about \$2,680 is less than the cap. But under the subsidy floor, this person would receive \$1,250. The floor ensures that the majority of workers would continue to receive assistance, but some high earners with employer-sponsored plans could see a substantial decline; for instance, a 60-year-old couple earning \$94,500 currently receives a \$3,590 tax exemption but would receive a subsidy of \$2,500 with the subsidy floor.

2. Silver Subsidy

This approach uses the progressivity of the tax code to allocate subsidies. Each individual or family would receive a gross subsidy equal to 60 percent of the benchmark silver plan premium but would pay federal income tax on that subsidy. Higher-income individuals generally would receive larger subsidies than under the subsidy floor alternative, and lower-income individuals would receive smaller ones. For example, the subsidy for a 60-year-old earning \$17,500 would decline from \$6,240 to \$3,220, but the subsidy for a 60-year-old earning \$70,000 would rise from \$1,250 to \$2,810.

3. Flat Tax Credit

Implementing a flat tax credit, as proposed in several Republican alternatives to the ACA, would provide a \$2,000 subsidy per person. This scenario would generally benefit higher-income and younger households but could prove inadequate to help lower-income and older households afford insurance. For example, a 60-year-old married couple earning \$23,500, facing a combined benchmark plan premium of \$13,890, would receive just \$4,000.

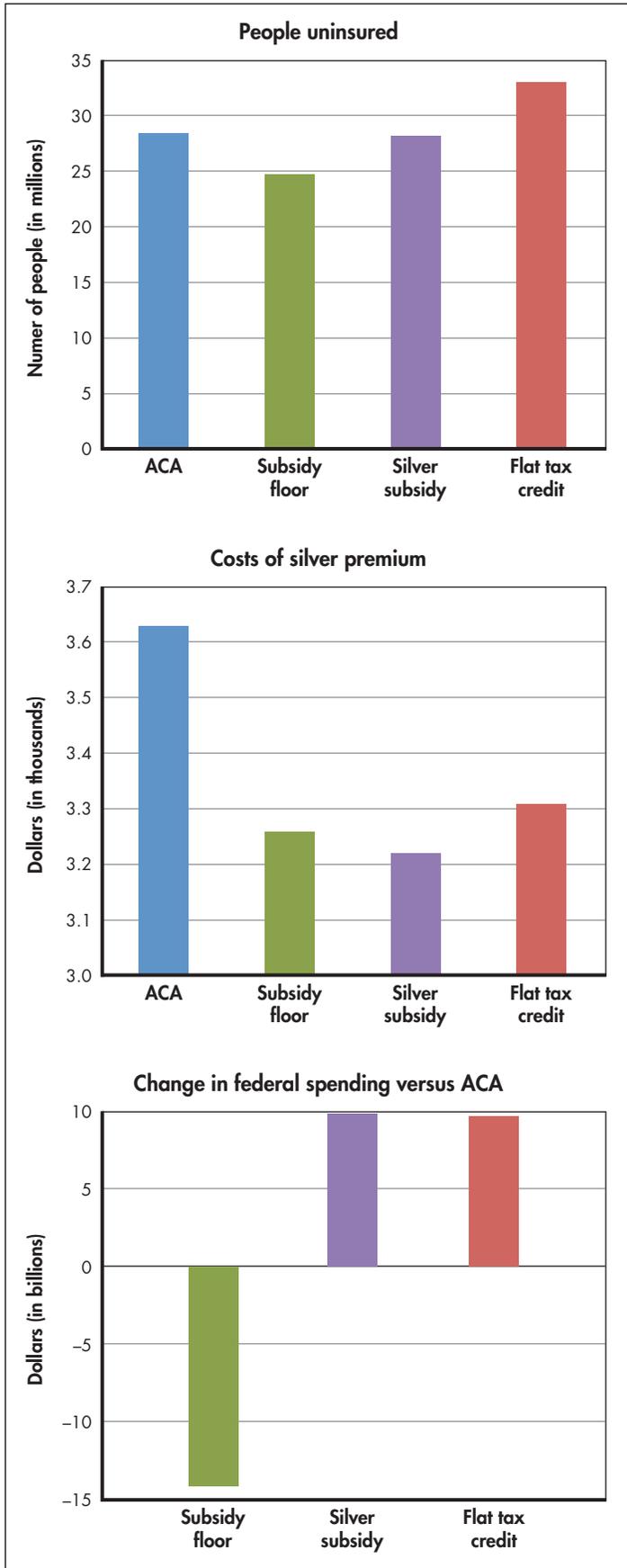
The Subsidy Floor Achieves the Most Savings and the Best Outcomes

To assess the three alternatives, we used the RAND Comprehensive Assessment of Reform Efforts (COMPARE) microsimulation model, a tool that models the decisions of individuals and firms and assesses the impact of health policy changes. All figures are for 2017, when most key ACA provisions will be fully phased in.

Subsidy floor: Under this scenario, an additional 4 million people gain coverage, and marketplace premiums plummet 10 percent because younger, healthier individuals who benefit from the subsidy floor would buy insurance. This approach yields about \$14 billion per year in savings compared with the ACA.

Silver subsidy: This approach results in a net increase of 500,000 insured people, with the largest gains among high and moderate earners, but about 4.5 million lower-income people lose coverage. Premium reductions in the ACA marketplace are similar to those in the subsidy floor scenario

Impacts of the Three Scenarios on Enrollment, Premiums, and Spending



because of the influx of young people. This approach costs \$9.9 billion more than the ACA.

Flat tax credit: This scenario insures about 5 million fewer people than the ACA does, with low-income groups sustaining the largest losses. Coverage among high earners would grow by a sizable amount, primarily because the subsidy for high earners increases from \$0 under the ACA to a \$2,000 tax credit. Premium reductions in the individual market are similar to the other two alternatives. This approach costs an additional \$9.8 billion.

Political Trade-Offs Loom Large

While the study examined many trade-offs, it largely ignored a political one. A great number of Americans benefit from the employer coverage tax preference, particularly high-income people and unions that have negotiated generous health plans. Leveling the playing field in the two markets makes for a good sound bite but implies that someone's subsidy will decline. Policymakers will need to address this political trade-off if constructive reforms are to be made.

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