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Are Employer Tax Credits the Most Effect Way to Expand Health Coverage for California's Uninsured?

Concern over the 7.3 million uninsured Californians has prompted a number of measures aimed at expanding access to health coverage. The fact that more than eight out of every ten uninsured Californians are workers or have working family members has prompted efforts to explore ways of boosting employment-based coverage. To that end, several measures pending before the legislature create tax credits for employers that purchase employment-based coverage. This paper examines whether tax credits are an effective means to expand coverage.

A number of factors affect an employer's decision to provide health coverage for their employees including the competitiveness of the labor market, the characteristics of the firm's employees, whether it is unionized, the price of health insurance, and the firm's ability to afford coverage. Tax credits aim to encourage health coverage by reducing its after-tax cost. Research findings, however, suggest that tax credits will have a minimal impact on employers' decision to purchase coverage. Specifically:

- Research on the relationship between the price of health insurance and an employer's decision to provide coverage suggests that a tax credit would have to cover over 50 percent of the employer's cost to have a significant impact on the number of businesses providing coverage. A 1992 study of eleven different state-level projects designed to expand coverage found that premium reductions between 25 and 50 percent expanded coverage to less than 7 percent of eligible firms. In only three cases did enrollment exceed 10 percent of eligible businesses.[1] A more recent study concluded that a 10 percent price reduction would induce only about 3 percent of businesses not currently providing health coverage to begin to offer it.[2] The impact on smaller businesses, those with fewer than 100 employees, is somewhat greater at 6 percent but still too small to recommend a tax credit as the most effective policy to expand health coverage to the state's uninsured.

- Most of the benefits of a tax credit for small businesses will go to employers that already purchase health coverage: 41 percent of employers with 3-9 workers and 62 percent with 10-50 workers already purchase coverage. Unless the tax credit is carefully targeted to employers that do not currently provide coverage the state will subsidize businesses for doing what they already do at a significant cost to the state's coffers.

- Most small businesses pay little or no state income taxes and thus will not have sufficient income to take advantage of the credit. In 1997, 71 percent of the state's corporations had less than $20,000 in net income. A corporation with taxable net income of $20,000 would

[1] Helms, W. David, Anne K. Gauthier, and Daniel M. Campion, *Mending the Flaws in the Small-Group Market,* Health Affairs, Summer 1992.
[2] Gruber, Jonathan and Michael Lettau, *How Elastic is the Firm's Demand for Health Insurance?*, March 2000.

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owe $1,768 in state corporate income taxes.[3] In other words, with a 25 percent tax credit, over 70 percent of the state's corporations do not pay enough in corporate income taxes to utilize the credits generated by insuring six employees. Insuring just three employees with a 50 percent credit would exhaust the benefit provided by the tax credit. Also, since state corporate income taxes are deductible for federal tax purposes, a significant fraction of the benefits of a state tax credits would be shifted to the federal government in the form of increased federal income taxes.

- In addition to insufficient tax liability, research shows that the tax credits are an inefficient means to encourage the purchase of insurance due to cash flow considerations. While businesses are required to pay up front for coverage, they do not receive a tax break until much later when they file their tax return. Research suggests that cash flow considerations are a significant factor for taxpayers whose income fluctuates from year to year and who are thus unable to accurately assess whether they will have sufficient income to utilize the tax credit at the end of the year.

- Finally, there is evidence that low-wage workers are hesitant to take up health benefits even when offered by their employers.[4] The primary reason is their inability to pay for co-payments, deductibles, and any contributions toward premiums that may be required. Assistance that reduces the employer's cost of providing coverage without reducing employees' costs will not address this barrier to coverage.

What Are Other Options?

Direct expenditure programs can be better targeted and can be structured to take advantage of federal matching funds through the Medicaid and State Child Health Insurance Programs. Options for expanding health coverage to the uninsured include:

- Extending the income eligibility levels for the Medi-Cal programs.

- Subsidizing employer purchase of health coverage through a small group pooling mechanism.

The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low and middle income Californians. Support for the California Budget Project comes from foundation grants and individual donations and subscriptions.

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[3] AB 2765 would create a tax credit equal to $75 per month per eligible individual or 25 percent of the total amount paid or incurred each month by employers for health coverage during the taxable year.
[4] Congressional Budget Office, *Increasing Small-Firm Health Insurance Coverage Through Association Health Plans and Healthmarts,* January 2000.