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Senate "Free Rider" Penalties: Taxing the Poor to Pay for Health Care

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Congress's mad scramble to turn health care buzzwords and bumper stickers into legislation last week careened off in yet another direction.

Senators on the Finance Committee revealed that they are now considering a variant of the "play or pay" employer mandate idea—imposing so-called "free rider" penalties on businesses whose workers receive coverage through Medicaid or take advantage of new subsidies to buy health insurance elsewhere.

It is unclear whether the "free rider" penalties would to be in addition to, or a substitute for, the payroll tax "pay" part of a play-or-pay employer mandate. Either way, such penalties would in practice act as an extremely regressive tax on the working poor, reducing their cash wages and in some cases eliminating their jobs altogether.

Displacing Private Coverage. The Finance Committee seems to be engaged in the classic exercise of making new errors that compound previous ones. They are trying to solve a problem made by their proposal to create new subsidies for the currently uninsured that are larger than the existing subsides for those already insured.

Workers with employer-sponsored health insurance already get a substantial implicit subsidy because their coverage is treated as tax-free income. If Congress offers even bigger subsidies to the uninsured, many in the eligible income range who currently have coverage will try to switch to the new, more heavily subsidized coverage, meaning that new, more-subsidized coverage would "crowd-out" existing, less-subsidized coverage.

It seems that when presented by the Congressional Budget Office with enormous and unfunded cost estimates for their subsidy design—partially attributable to its significant crowd-out effects—committee members opted for a second mistake.

Unequal Treatment. Rather than equalizing the new subsidies to eliminate potential crowd-out, the committee apparently decided to enact a generous subsidy design while adding a so-called "free rider" penalty, imposed on businesses whose workers take advantage of the new subsidies or sign up for Medicaid. Presumably, the idea is to discourage employers from dropping their current health plans if enough of their employees become eligible for expanded government benefits—or at least to defray the cost to the government if they do so.

It is unclear whether the committee envisions these penalties to apply only to employers who currently offer coverage but later drop it, or to all employers who do not offer coverage after the law is enacted.

Furthermore, it is also unclear if these penalties would apply in cases where an employer offered coverage, but some employees decline it and enroll in Medicaid or other government-subsidized coverage options instead. For example, if an employee

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qualifies for Medicaid and signs up, would the employer be assessed a penalty? Taking that approach would effectively punish employers for decisions taken by Congress (to expand Medicaid eligibility) and workers (to sign up for coverage for which they become newly eligible) over which the employers have no control.

Taxing Workers. Of course, the biggest fallacy in all of this is the belief that somehow it will be employers, rather than workers, that bear the cost of any "play or pay" mandate or "free rider" penalty.

The reality is that either or both of these provisions will act as an extremely regressive tax on the working poor, substantially reducing their take-home pay and in some cases eliminating their jobs altogether.

When an employer decides whether to hire an employee and how much to pay, the employer has to consider the full cost of employing that person. That full cost includes not only cash wages and the employer's cost of providing benefits but also the employer's share of any employment-related taxes, such as the Social Security and Medicare taxes. When the costs of benefits or payroll taxes increase, their slices of the total compensation pie expand—forcing the cash wage slice to shrink.

Thus, if an employer is required to pay a "penalty" or "tax" for not providing health insurance, that too will reduce the amount available to pay the employee as cash wages. If the employer instead satisfies the mandate by spending more on health insurance, the effect is the same. Either way, the employee's take-home pay has to be cut.

If reports about some of the ideas being considered by the Finance Committee are correct, the actual effects could be dramatic and disastrous for low-income workers. In particular, the committee is reported to be considering "free rider" penalties that are equal to half of the national average cost of Medicaid or to the full cost of the federal subsidies for individuals with incomes above the (new, higher) Medicaid eligibility threshold.

That would, in effect, be a massively regressive tax—and one that applied only to people on the lower end of the income distribution scale. Furthermore, it would be regressive even within that subgroup. For employees eligible for Medicaid, the tax would be a fixed amount per employee (and therefore a larger percentage of income for lower-income employees). For those with incomes too high for Medicaid but low enough to quality for a health insurance subsidy, the subsidy will likely be reduced as the employee's income rises, with the "free rider" penalty being equal to the amount of the subsidy.

Consequently, the "free rider" tax will take more money—not just a higher percentage, but more actual dollars—from workers with *lower* incomes than from those with higher incomes. And for workers whose incomes are high enough, the tax would disappear entirely.

In essence, the Senators would be telling the poor: "If you now have to choose between food and health insurance, from now on you no longer have that choice—you have to buy the health insurance."

For some employees, the situation would be even worse. After all, what if the employee is earning only minimum wage? Or close enough to it that cutting cash wages by the amount of the tax would put the employee's pay below the minimum wage? In that case, there would be only one way for the employer to comply with the law: lay off all employees whose wages are too low.

Back to the Drawing Board. Businesses do not meet their payrolls out of magic pots of unlimited money that they dole out based on their own level of beneficence. They have to pay employees out of money they get from customers based on their employees' work. If that work does not generate enough revenue to pay at least the minimum wage plus the cost of benefits plus the taxes, then the business loses money and the employees have to be laid off. Like gravity, it is just that simple and that unalterable.

A large and regressive tax increase on low-income workers is not the solution to America's health care problems. Some people might gain coverage, but all will lose take-home pay, and many will lose their jobs entirely.

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