Implications of a Medicare Prescription Drug Benefit for Retiree Health Care Coverage

AN UPDATE BASED ON THE MEDICARE CONFERENCE AGREEMENT

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Overview

The congressional conference agreement on Medicare prescription drug proposals would provide employers that provide equivalent prescription drug coverage (i.e., to the standard benefit) with a subsidy.

Employers that sponsor a qualified prescription drug benefit would receive a federal payment equal to 28 percent of enrollee drug costs between $250 and $5,000 in spending.

If retirees receive their drug benefit under a Medicare drug plan, that plan would receive a higher federal subsidy for the qualified benefit. Such plans would receive both a direct and reinsurance subsidy financing about 73 percent of the costs of a typical plan.

The lower federal subsidy received by a retiree receiving coverage through their former employer or union creates a federal "subsidy wedge." This subsidy wedge creates strong incentives for employers to drop drug coverage and enroll retirees in less expensive drug plans.

The recent conference agreement has essentially adopted the subsidy structure outlined in H.R. 1. The agreement has not materially modified the subsidy, other than to clarify the point that federal subsidies to employers would not be treated as taxable income. Previous estimates of the impact of this provision by the Congressional Budget Office (CBO) had assumed the subsidies originally detailed in H.R. 1 and S. 1 would be treated as taxable income.

This note revises my previous estimate from September 13, 2003, and calculates the impact of this clarification. The results are presented in Tables 1 and 2.

Table 1.
Distribution of Retiree Drug Coverage by Sponsor, 2006

Plan Sponsor	Number of Beneficiaries (Millions)	% of Total
Federal government	1.8	15.4%
State governments	1.8	15.4%
Private sector*	8.1	69.1%
Total	11.7	100.0%

* Includes some local government retirees
SOURCE: OPM tabulations and Kaiser Family Foundation, 2003.

The clarification of retiree provisions in the recent conference agreement would affect about 8.1 million retirees who receive their benefits through private sector plan. Whether the subsidy is taxable or not has no impact on those receiving coverage through federal, state and local government plans.

Using data on the effective corporate tax rate, I have recalculated earlier estimates of the number of retirees potentially losing their current coverage. The results are displayed in Table 2.

If federal subsidies were not treated as taxable income, it would still provide incentives for employers with a quarter of employees with retiree coverage to drop.[1] That is because employers sponsoring retiree benefits receive fewer federal subsidies than other plans sponsoring qualified Medicare benefits.

Which employers face these incentives? If we assume that the federal government retirees retain their current coverage, approximately 2.1 million private sector retirees would likely lose their retiree benefits.

Of course, some states have considered scaling back, or even dropping (about 10 percent of states

Table 2.
Distribution of Average Monthly Employer and Retiree Premium Contributions for Retiree Coverage Compared to Medicare and Supplemental Benefits, 2006

Percent of Medicare Beneficiaries with Retiree Coverage	Dollar Value of Subsidy Wedge per Year	Percent Subsidy Wedge*	Percent of Total Employers Dropping Retiree Coverage
5%	$ 98	11.5%	0.5%
10%	$205	22.3%	2.2%
5%	$218	22.5%	1.1%
17%	$265	25.6%	4.3%
26%	$296	26.3%	6.8%
17%	$328	27.0%	4.6%
5%	$366	27.8%	1.4%
10%	$399	28.1%	2.8%
5%	$456	30.2%	1.5%
TOTALS	**$295**	**25.1%**	**25.3%**

* Assumes federal subsidies to employers are tax free

surveyed did not rule this out in a recent Kaiser Family Foundation survey[2]) even before this proposal. Since the conference agreement increases the financial incentives for states to drop coverage, the total number of retirees (when including state government retirees) could be as high as 2.7 million.

In short, since the federal government would contribute about $300 per year more to non-retiree plans to provide the Medicare benefit, the current agreement retains a substantial subsidy wedge.

Solutions

The current conference agreement still discriminates against employers that seek to sponsor qualified retiree drug benefits. Other plans that provide retirees the same qualified Medicare drug benefits would receive an average of $300 more per retiree in federal assistance. This federal subsidy wedge would provide strong incentives for employers to drop their current coverage.

Eliminating the subsidy wedge would require one of two solutions:

- Count all non-Medicare payments for prescribed drugs toward the out-of-pocket cap that attracts reinsurance payments (i.e., eliminate the true out-of-pocket provision).

- Provide employers a tax credit that effectively eliminates the federal subsidy wedge—this would total approximately $300 per year retiree with a drug benefit today.

[1] I assume that a 1 percent increase in the federal subsidy wedge is associated with a 1 percent increase in retirees losing their coverage. This is the same assumption used in my previous analysis from September 13, 2003.

[2] Kaiser Family Foundation, *How States are Responding to the Challenge of Financing Health Care for Retirees*, September 2003, p 35. About 10 percent of states surveyed note that it was somewhat likely or somewhat unlikely (compared to very unlikely) that they would terminate retiree coverage.