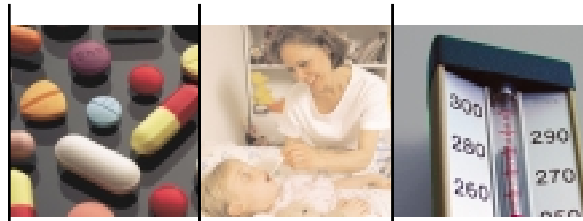
Issue Brief
Findings from HSC



DEFINED CONTRIBUTIONS: THE SEARCH FOR A NEW VISION

Proponents of defined contributions for health benefits seek to broaden choice and control costs by raising employees' cost awareness. Although defined contributions for health benefits have sparked considerable debate, they have not yet caught on with large employers. Given the tight labor market and consumer resistance to paying more for health care, employers are not expected to adopt defined contributions in the short term, according to a panel of business and union representatives at a recent Center for Studying Health System Change (HSC) conference. This Issue Brief presents experts' outlooks on how likely employers are to embrace defined contributions, their views on the advantages and disadvantages and the potential for Internet solutions. Implications for policy makers are discussed.

Looking for a New Vision

With recent premium increases, employers are looking for a new vision for health benefits. Consumer backlash against managed care and loosening of plan restrictions have left employers without a mechanism to control rising costs. David S. Blitzstein, director of the Negotiated Benefits Department of the United Food & Commercial Workers International Union, said, "There's a desperation because we have not fixed the health care problem in this country. Medical costs are coming back with a vengeance, and the low-lying fruit for savings has already been picked. Employers are now looking for something that's going to protect us for the next five years."

In addition to reducing costs, employers are anxious to reduce the heavy administrative burden associated with managing health benefits. Employers that offer choice must select health plans, assess plan performance and convey this information to employees. More recently, employers have found themselves serving as middlemen between plans and employees. "With a consumer choice model, the concept is to get the employer back out of being in the middle and let employees make the decisions and be more responsible for adjudicating what happens," said Lawrence Atkins, president of Health Policy Analysts.

Defined contributions for health benefits borrow from the defined-contributions model for pensions. Similar to retirement benefits, the employer contributes a dollar amount toward health benefits and shifts the risk associated with and the responsibility for those dollars to the employee.[1] In addition to making costs more predictable, employers expect to reduce their administrative burden, expand choice, empower consumers and avoid being accountable for plan management decisions. The advantages and challenges of defined contributions depend on the approach taken.

- Under a cash-out option, the employer pays workers higher wages in lieu of insurance. The worker can choose to buy health insurance on the individual market or use the cash for other purposes.
- Under a fixed-dollar approach, the employer continues to pool risk and administer the payroll deductions and plan options.

This Issue Brief is based on a roundtable discussion, "Defining 'Defined Contributions': New Directions for Employer-Sponsored Health Insurance Coverage," sponsored by HSC on October 10, 2000, in Washington, D.C.

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- The more likely defined-contribution alternative is for the employer to issue a voucher ensuring the money is used for health benefits and preserving tax benefits.

It is unclear whether defined contributions for either pensions or health benefits really let employers off the hook. "You've got to keep your employees happy. If two or three 401(k) options plummet for some reason, depending on how profitable and paternalistic the company is, the company is going to go in there and do something about it. Employers do not necessarily get out of playing a role just because of a defined-contribution approach," cautioned Helen Darling, senior consultant for Group Benefits and Health Care for Watson Wyatt & Company and former manager of international compensation and benefits for Xerox Corp.

Tight Labor Market Hinders Change

Despite recent premium increases, the panelists thought it unlikely that employers would move to defined-contribution approaches in the short term. "Given the war for talent" affecting every market and every employer, Darling suggested that employers will do "whatever makes their employees happy." Defined-contribution approaches are apt to be perceived as a take-away. Instead, over the next two to three years, as long as the economy stays strong, employers can be expected to absorb most of the premium increases. Employers are making small changes to copayments and formularies but not to their contribution strategies.

Employers are wary of what the future holds, however, and are beginning to think strategically about next steps. Atkins expects that health benefit managers will have developed alternative approaches within the next three to four years but will implement them over a longer period. In particular, employers will want employees to have "more skin in the game" because employers are very worried about long-term costs. According to Pamela Krol, director of health benefits at Lucent Technologies, employers are emphasizing health promotion and working to increase the flexibility of benefits over time, allowing individuals to decide which benefits are most important to them. Blitzstein's survey of his union members found that health insurance benefits rank second to wages in financial importance.

Cash-Out: An Unlikely Solution

Although the option of exchanging employee benefits for higher wages has caused the greatest controversy, the panelists considered it impractical. "The cash-out option is highly unlikely for quite some time because of huge technical issues," said Atkins. Under a cash-out, employers pay higher wages, and employees purchase health insurance in the individual market. The panelists highlighted the myriad issues facing an employer that adopts this approach. Not only would the employer face tax consequences from losing the exclusion of health benefits from income tax, Atkins noted, but the employer also would have a higher Social Security tax contribution. Darling added that due to the difficulties of premium collection, the cost of individual insurance would be higher because of greater administration costs. Employers are unlikely to pay the higher wages required to offset these costs just to step out of their role as health benefits manager.

Krol and Darling explained how the cash-out approach to defined contributions also raises equity issues and puts the employer in the role of risk adjuster. The employer has to decide whether to provide higher wages to older and sicker employees who would face higher health insurance costs in the individual market. National employers also face the challenge of establishing equity across geographic regions.

Furthermore, offering employees cash instead of health benefits may increase the number of uninsured workers, and companies may have reservations about how wisely workers would spend the extra cash. Already, about 20 percent of all uninsured Americans are workers who are eligible for health insurance from their employer.[2] Many have modest incomes and may genuinely feel they cannot afford it, but others are young adults who may be in good health and would prefer to forgo health insurance to buy other things. "To assume that people will take the money and do the wise thing is a risk I personally would not want to take," Darling warned.

Pros and Cons of Defined-Contribution Approaches

Many of the goals of defined contributions resonated strongly with the panel. In particular, the experts mentioned the need to increase cost consciousness by employees having more of an economic stake in their decisions. With their own money at risk, employees would be more likely to engage in the medical decision-making process. Panelists also thought that cost consciousness would be enhanced if tax laws were changed to allow portability of health benefits and the ability to accrue a health spending account over time.

According to Krol, "As a large employer, the solution we'd like to see is medical savings accounts. I think portability is important, as is the ability for people to have money earmarked like a 401(k) plan for medical expenses with options within that account." Darling added, "People could feel, whether it's a medical savings account or another approach, that if you don't spend, you still get it."

The panelists also valued the potential for expanding choice and flexibility by allowing customization to meet individual needs. This was viewed as crucial for recruiting and retaining employees. Increased choice and customization also might spur new models of delivery. Darling explained, "If employees are given more choices and have the ability to control the payment in a different way and go wherever they want, that's going to appeal to employees."

The panelists did not look to defined contributions as a way for employers to get out of managing health benefits and cautioned against throwing the baby out with the bath water. Employers play a crucial role in pooling risks so sicker workers pay the same amount for health insurance as healthier workers. Darling warned that before moving to defined contributions, proper risk adjustment should be in place so that "people who are seriously ill are not harmed in any way. If not implemented correctly, the seriously ill might not get care. Risk adjustment would be crucial to ensure that the seriously ill are not left out."

In addition, employees value employers' leverage. "The one thing employees all value and understand is the power of a group-purchasing model. Employees know that, as a company, we can leverage price and quality on their behalf, noted Krol. She also explained, "A good part of my day now is dealing with hospital and physician network disruption. So those roles are things that our employees value."

Role of the Internet

An upsurge in Internet ventures offering health plan innovations has fueled expectations for a movement to defined contributions. Some ventures are developing a health marketplace online to allow employees to customize health benefits and reduce employers' management role (see box). For example, some companies allow employees to comparison shop for physicians based on capitation rates or prices for particular services. Other alternatives include risk-adjusted payments to health plans to reduce plans' fear of adverse selection and improve competition. Companies using this approach establish a marketplace for health plans by risk adjusting payments to health plans or by pooling risk across employers.

Internet ventures could make significant contributions toward expanding consumer choice, enhancing individual decision-making and making information easier to access. "From the technological standpoint," Blitzstein said, "there are tremendous potentials for price and quality transparency and using information to make employees better and stronger purchasers of health care." Darling concurred, "The more we open up the system, and the more we allow choice, the more we will see new models of delivery." She also noted, however, that employees don't want to do a lot of work to figure out their benefits.

The Internet shows potential for providing a risk pool and risk adjustment that could extend the leverage of large employers. Ray Herschman of HealthSync explained that, under his model, the risk pool from the employer is maintained so that "the young subsidize the old and the healthy subsidize the sick, so the social contract of insurance is maintained." A young worker and an older worker going into this online marketplace may have the same defined contribution of $150 from their employer. When they each enroll in a health plan, $100 would follow the young worker, and $200 would follow the older worker. Atkins commented that "this is an intriguing model because it takes the

INTERNET COMPANIES

HealthSync establishes a marketplace of health plans by maintaining a risk pool and risk adjusting payments to health plans. According to Ray F. Herschman, the company's CEO, "Employers will not migrate to defined contributions if there's any risk that any of their employees would get priced out of the market."

Vivius, Inc., provides a supermarket of providers, ranging from primary care physicians to specialists, hospitals and pharmacies. Consumers make choices based on monthly capitation rates set by each participating provider. Lee N. Newcomer, M.D., executive vice president and chief medical officer, says, "Vivius brings the physician and patient back together again by taking out the third party."

HealthMarket, Inc., creates a self-directed health plan that provides pricing by provider and service or episodes of care that can be used by employees, the uninsured and those in the individual market. Stephen F. Wiggins, chairman and CEO, says, "HealthMarket will be the 'Intel inside' insurer that enables it to administer and execute a new family of insurance products."

Policy makers need to be concerned about the potential risk to the seriously ill if adequate risk adjustment is not part of any new defined-contribution approach.

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employer's pool, maintains it intact and then creates a risk-adjustment mechanism as individuals then move into plans."

The panelists warned, however, that these ventures were unlikely to provide the quality information for plans and providers that has been missing to date. Atkins cautioned, "There is a great danger that, in the absence of really good information on providers, which distinguishes them based on quality and health outcomes, the higher price that a provider charges would be used as a proxy for quality."

In addition, many of the challenges of a defined-contribution approach remain. "There is a big gap between the goals of the Internet ventures and what many of us hope would be the ideal set of solutions," Darling added. Blitzstein further warned, "Sophisticated actuarial models have often crashed, and we've seen many of these models fall apart on the managed care side in terms of pricing and capitation, especially over the last five years. And it is an incredibly difficult task to put networks back together for workers where you've had managed care products under contract and, all of a sudden, the next day they no longer exist. The chaos that creates with the provider community is phenomenal."

Implications for Policy Makers

Because most Americans have employer-based health insurance, policy makers need to be concerned about the erosion of such insurance, especially among large employers. According to the expert panel, large employers are unlikely to make radical changes in the short term and, given the tight labor market, are unwilling to shift costs to employees. The panelists also felt it was unlikely that employers would adopt the cash-out option and lose the tax advantages and cost savings associated with group purchasing. Therefore, a significant increase in the uninsured as a result of a move to defined contributions is unlikely in the short term.

Policy makers also need to be concerned about the potential risk to the seriously ill if adequate risk adjustment is not a part of any new defined-contribution approach. Blitzstein warned that sophisticated risk-adjustment technology or entities to manage risk do not currently exist. "It's wishful to think that you can have consumers go online, pick a health provider, give them an amount of money and that that's all going to work well without a substantial amount of risk selection."

Gaps in quality information were another key issue raised by the experts. They expressed some skepticism that new defined-contribution approaches, whether on the Internet or not, would be able to provide the quality and cost information that has been missing to date. Expanding choice and allowing customization of products require accurate information on price, quality of providers and outcomes. "Unfortunately," Krol said, "in this marketplace there is no information on cost readily available to consumers, and the information on quality is even poorer. We would love to be in a market-driven system, but a market has to provide that information."

Although employers play an important role in patient safety, quality improvement and ensuring accountability, they appear conflicted about this role. While they do not relish their role as middlemen between employee and health plan, employers do recognize their value to employees. "A primary aspect of my job is helping people navigate through this system. It is very complex, and I don't think that could be mitigated," Krol said. If employers move to defined contributions to avoid the managed care backlash or potential liability, there may be a call for the government to play a stronger role in patient protection and regulation to take up the slack employers leave behind. ●

Notes

1. Trude, Sally, and Paul B. Ginsburg, "Are Defined Contributions a New Direction for Employer-Sponsored Coverage?" *Issue Brief* No. 32 (October 2000).
2. Cunningham, Peter J., Elizabeth Schaefer and Christopher Hogan, "Who Declines Employer-Sponsored Health Insurance and Is Uninsured?" *Issue Brief* No. 22 (October 1999).

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