HCR Solutions

Defined Contribution

Defined benefit (DB) and defined contribution (DC) plans are different. Since employer sponsored insurance (ESI) became common in the 1940s, DB plans have dominated the market. With a DB plan, the employer offers employees an insurance policy (or several policies) with a specific range of healthcare benefits. With DB, the employer is an active participant, and employee is mostly passive.

With DB the employer chooses and administers the insurance plan. In contrast, with a DC plan, the employer provides the employees with a fixed quantity of money; the employee uses these funds to purchase a health insurance policy of his or her own choice.

World War II era policies led to today's DB dominance. Wartime and postwar price controls made it unlawful to give raises to employees. Employers discovered that they could circumvent these controls by providing insurance rather than additional money. Later tax and labor regulations cemented this scheme into place. Employers have little bargaining power in the small group market and usually have a narrow range of plans from which to choose. Among firms with 1-199 workers, 86% of those who offer coverage can only offer one plan. DC would introduce a new element of contribution to this market.

Tax and insurance regulations should allow for a defined contribution health insurance option for employers. This makes health insurance simple for employers and gives employees a broad range of choices. Small businesses generally like the option of contributing dollars to employees' health insurance without actively choosing, purchasing, or managing the plan. With defined contribution, an employer could contribute pre-tax funds toward employees' insurance. This amount should remain deductible to the employer. Employees could then purchase their own insurance policies.

DC health insurance could benefit employers significantly. DC can free employers from a heavy load of administrative time. Employers would no longer have to choose their employees' insurance plans. Nor would the employer have to manage the plan or at least play a large role in its management. Less red tape means more time to build the business.

With DC, an employer can determine up-front how much to contribute to employees' health insurance. This gives financial predictability, making it easier to plan and grow the business.

Done correctly, DC can improve employer-employee relations by offering employees more choices and better choices than they currently have. Employees would no longer be limited to their employer's one size fits all insurance choice. The portability of DC plans removes a source of tension between employers and employees.

DC would be especially valuable to small businesses.

In general, small businesses have no special expertise in the area of health insurance. There is little reason to believe that the small business owner can make better insurance choices for his employees than the employees can make for themselves. Few small businesses have human resource departments. The time burden of comparing policies, talking with brokers, dealing with complaints, and managing the plan fall on the business owner. The owner's time is diverted away from the business and into something in which they have no special expertise.

A common argument for DB health insurance is that a business can use its size to negotiate better rates and better coverage for its employees. Small businesses are by definition small, and they have little capacity to exert such market power.

DC could improve life for employees as well. DC can give employees portability, If an employee moves from one employer to another, they can keep their current policy. This reduces the likelihood that the employee will have to change doctors, will be stuck in an undesirable job, or will be left uninsured during transition periods.

A central idea behind DC health insurance is to promote competition among insurers. DC allows employees to vote with their feet- to change insurers when they find a better price or are dissatisfied with the service they are receiving.

Current laws and regulations discourage DC today.

Today, a business can use a Section 125 cafeteria plan to provide employees with DC coverage, but it is easy for a small business to trip over the intricacies of 125s. The business must take steps to avoid violating anti-discrimination privileges as related to highly compensated employees or high-cost health coverage. Also, Section 125 plans cannot be used to purchase insurance offered through an exchange or if the employer is exchange eligible under PPACA. Also, 125 plans are restricted to employees; business owners cannot obtain coverage through these plans.

Other than the Section 125 option, there are currently no tailored vehicles that allow DC health insurance coverage. The 2010 healthcare law does allow a limited DC capability in the SHOP exchanges. However, the choices will be limited, and the employee will not be able to carry these policies from one employer to another. The make DC truly viable, Congress and state legislatures must create new vehicles. DC is also inhibited by today's feeble individual market, a situation arising from the unequal tax treatment of group and individual markets.

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