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Fairness in the Federal Tax Treatment of Health Insurance: The Linchpin of Real Reform

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When Congress addresses Obamacare's punitive and disruptive "Cadillac tax" on more expensive employer-based plans, it should not do so without beginning to address the inequity inherent in the federal tax treatment of health insurance.

The first step Congress should take is to set a limit on the tax exclusion for employer-provided health insurance. Support for a cap on this tax exclusion has a long history of bipartisan support. It is the most fiscally responsible and least disruptive way to begin addressing the long-standing inequity in the tax treatment of health benefits. In addition, Congress should create an alternative health care tax relief option that is available to all taxpayers, regardless of income or source of coverage.

These interlocking reforms, whether simultaneous or subsequent, should be created in a way that leads to equal treatment by the federal tax code no matter where health insurance is purchased. Forgoing this opportunity would be a significant setback to achieving patient-centered health care reform.

Background

Federal tax policy is the most important factor shaping America's health insurance markets. There are a variety of different tax provisions concerning health insurance, but the most significant is the unlimited exclusion of the cost of employer-sponsored insurance from taxable income when calculating a worker's federal income and payroll taxes. Approximately 150 million people benefit from this tax provision, valued at about $275 billion in 2016.[1] While this tax policy is very advantageous to workers, contrary to a common misperception, it actually offers little or no benefit to employers because businesses are able to deduct the cost of employee compensation as a business expense, regardless of the form the compensation takes.

Americans today can get an unlimited tax break for health insurance if, and only if, they get health insurance through the place of work. If they do not or cannot get health insurance through the place of work, they often must pay for their insurance coverage with *after-tax* dollars, which means that they could pay anywhere from 20 percent to 50 percent more for health insurance.[2] This is profoundly inequitable.

Not only does federal tax policy discriminate against Americans based on their job status, but it also distorts the normal functioning of the health care markets. The absence of limits on the amount of health benefits that may be excluded from taxable income creates incentives for overinsurance and overconsumption of health care and induces consumers to be indifferent with respect to the prices charged by competing medical providers. That, in turn, drives up the cost of health care across the board.

The current tax treatment also frustrates personal ownership and portability of health coverage, which means that when persons leave their jobs, they lose their coverage. Moreover, it is profoundly regressive

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because it offers more value to high-income employees enrolled in expensive health plans. There is an enormous intellectual consensus among prominent health care economists and policy analysts regarding the distortionary effects of the current system.[3]

Obamacare's Cadillac Tax

Obamacare set an indirect limit on the existing tax exclusion for employer-sponsored coverage by imposing a punitive 40 percent excise tax on high-cost health plans, commonly referred to as the "Cadillac tax." For purposes of the excise tax, Obamacare defines "high cost" as any plan exceeding $10,200 for single coverage and $27,500 for family coverage. The 40 percent excise tax applies to any health insurance spending above those thresholds. Originally, this tax was slated for implementation in 2018, but Congress subsequently delayed the effective date until 2020.

The Cadillac tax aims to limit the tax exclusion for employer-provided health plans through a punitive excise tax mechanism, a circuitous and disruptive way of trying to control costs. Specifically, in order to avoid the Cadillac tax penalty, employers must modify their health plans by cutting benefits and increasing out-of-pocket costs for enrollees.

In contrast, if Congress simply set a limit on the pre-tax amount of health plan funding similar to the existing limit on the pre-tax amount of 401(k) retirement plan funding, there would be no need for employers to change their plans. If an employer and workers wanted a plan that cost more than the limit, the only consequence would be that the extra spending would show up at the end of the year on the worker's W-2 form as taxable income. Group life insurance, offered by many employers, currently works this way.

What Needs to Be Done

Neutrality in the federal tax treatment of health insurance is the single most important policy change that could improve the functioning of America's health insurance markets. To bring greater fairness and neutrality to the insurance market, Congress should move the tax treatment of health insurance in a direction that is impartial with regard to where coverage is purchased.

A necessary first step is to repeal the Cadillac tax while at the same time taking the fiscally responsible step of capping the amount that can be spent pre-tax on employee health benefits. This is similar to the pre-tax limits placed on other employee benefits, such as retirement plans, life insurance, and dependent care. This is an important opportunity to achieve a major bipartisan goal for health care reform. Capping or eliminating the exclusion has been a staple of proposed health policy reforms for many years and enjoys bipartisan support among health economists and analysts.[4]

1. Congressional Budget Office, *Options for Reducing the Deficit: 2017 to 2026*, December 2016, p. 269, https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/52142-budgetoptions2.pdf (accessed February 23, 2017).
2. Mark Hall and Amy B. Monahan, "Paying for Individual Health Insurance Through Tax-Sheltered Cafeteria Plans," *Inquiry*, Vol. 47, No. 3 (Fall 2010), pp. 252–261.
3. Conservative economists such as the late Nobel Laureate Professor Milton Friedman of the University of Chicago, Professors Martin Feldstein and Regina Herzlinger of Harvard University, Professor Mark Pauly of the University of Pennsylvania, and Professor Paul Feldstein of the University of California at Irvine have long criticized the current tax policy for health insurance. See, for example, Milton Friedman, "How to Cure Health Care," *Hoover Digest*, 2001 No. 3, July 1, 2001, http://www.hoover.org/research/how-cure-health-care-0 (accessed February 21, 2017); Martin Feldstein, "It's Time to Cap Tax Deductions," *The Washington Post*, March 12, 2013, https://www.washingtonpost.com/opinions/its-time-to-cap-tax-deductions/2013/03/12/af05081c-8a63-11e2-8d72-dc76641cb8d4_story.html?utm_term=.7b4b1a19fc67 (accessed February 21, 2017); Regina Herzlinger, *Market-Driven Health Care: Who Wins, Who Loses in the Transformation of America's Largest Service Industry* (Reading, MA: Addison-Wesley Publishing Company, Inc., 1997); Mark Pauly, "The Tax Subsidy to Employment-Based Health Insurance and the Distribution of Well-Being," *Journal of Law And Contemporary Problems*, Vol. 69, No. 83 (2006), pp. 83–101, http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=1395&context=lcp (accessed February 21, 2017); Paul J. Feldstein, *Health Care Economics*, 6th ed. (Clifton Park, NY: Delmar Learning, 2005). But prominent liberal or progressive academics such as Professor Uwe Reinhardt of Princeton University, Professor Jonathan Gruber of MIT, and Dr. Henry Aaron of the Brookings Institution also have criticized the existing tax policy. See, for example, Uwe Reinhardt, "Is Employer-Based Health Insurance Worth Saving?" *The New York Times*, May 22, 2009, https://economix.blogs.nytimes.com/2009/05/22/is-employer-based-health-insurance-worth-saving/ (accessed February 21, 2017); Jonathan Gruber, "The Tax Exclusion for Employer-Sponsored Health Insurance," *National Tax Journal*, Vol. 64, No. 2, Part 2 (June 2011), pp. 511–530, https://www.ntanet.org/NTJ/64/2/ntj-v64n02p511-30-tax-exclusion-for-employer.pdf (accessed February 21, 2017); and Henry J. Aaron and Leonard E. Burman, eds., *Using Taxes to Reform Health Insurance: Pitfalls and Promises* (Washington: Brookings Institution Press, 2008).
4. For an extensive discussion of the benefits of such a reform among economists and health policy analysts, see Grace Marie Arnett, ed., *Empowering Health Care Consumers Through Tax Reform* (Ann Arbor: University of Michigan Press, 1999).

The second step in achieving equity is creating an alternative health care tax relief option that is available to all taxpayers, regardless of income or source of coverage. Whatever form the tax relief takes, it must be on a path to equal the value of the capped employer exclusion over time.

Individuals with access to employer-sponsored coverage would be able to choose whether the tax exclusion or the new tax relief option should be applied to the value of their employer-sponsored benefits. The new cap on the employer exclusion should be indexed to decrease as needed in future years so as to maintain at a baseline level the aggregate amount of tax relief provided by both the new option and the exclusion.[5]

Such tax relief would foster personal choice, portability, and ownership of health plans. This would unleash competition among insurance carriers and create a level playing field so that the government would no longer favor, either through law or through regulation, one type of insurance over another or one class of consumers over another. A genuinely open and competitive market for health insurance fostered by individual tax relief would also exert a downward pressure on health care costs.

Conclusion

Current federal tax policy treats workers and their families who do not or cannot get health insurance through employment-based coverage unfairly and contributes to disruption in coverage when employees change jobs. Obamacare imposes a hefty excise tax on expensive employer coverage, a punitive measure that adds to the complexity of the current health care system.

Congress should repeal Obamacare's Cadillac tax and set a simple cap on the employer exclusion. In addition, Congress should create a new type of individual tax relief that would be available to everyone, regardless of where they purchase coverage. Together, these policies would help to ensure that the federal government is not favoring one type of coverage or consumer over another and would go a long way toward restoring a functioning market in health care that is responsive to consumers.

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5. For a more detailed discussion of these recommendations, see Edmund Haislmaier, Robert E. Moffit, PhD, and Alyene Senger, "A Plan to Repeal and Replace Obamacare," Heritage Foundation *Backgrounder* No. 3193, February 9, 2017, pp. 4–6, http://www.heritage.org/sites/default/files/2017-02/BG3193.pdf.