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Health Policy Brief

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Tax Debate: Workers who get health coverage from their employers don't pay income or payroll taxes on it. Should some of it be taxed to help spread coverage to others?

What's the issue?

The plans that Congress is exploring to expand health coverage for uninsured Americans could cost $1 trillion or more over the next decade. One way to help pay for that would be to limit the so-called tax exclusion of employer-based health coverage.

Here is how the tax exclusion works. When workers are paid wages or salaries by their employers, they have to pay federal income taxes on that money, as well as payroll taxes that support Social Security and Medicare. However, when those same workers receive contributions to health coverage from their employers, they don't have to pay federal taxes on those sums. (In most cases, they don't pay state income taxes, either, but changes in state tax policy aren't the subject of this brief.)

A lot of money is on the line, for a lot of people. An estimated 162.5 million U.S. employees and their dependents receive health insurance that is partly or wholly paid for by employers. That makes employer-sponsored coverage the largest source of health insurance in the country. Because of the tax exclusion, the amount of forgone income and payroll taxes in 2008 was $226 billion, according to the congressional Joint Committee on Taxation. The Urban Institute's Tax Policy Center estimates next year's revenue loss at $240.5 billion and $3.5 trillion through the next decade. Thus, the tax exclusion for employment-based health coverage is the single biggest subsidy in the federal tax code.

For years, economists of all political persuasions have pointed out the pluses and minuses of this tax exclusion. On the one hand, it has undoubtedly encouraged employers to offer health coverage and workers to want it. That in turn has encouraged "risk pooling" at the workplace: by covering all of their full-time workers, employers can spread the costs of coverage more evenly across sicker and healthier workers alike.

On the other hand, the tax exclusion doesn't help people who do not get coverage through their job, or their spouse's or parent's job. The exclusion may also encourage people to opt for more health insurance over higher wages, and may indirectly be driving up the cost of both health coverage and health care.

The Senate Finance Committee has been considering capping the amount of employer-sponsored insurance that a worker and his or her dependents could receive without having to pay taxes on it. There are various ways to set a cap.

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Some of the options under consideration by the Finance Committee, as well as the arguments for and against capping the exclusion, are detailed below.

What's the background?

During World War II, the federal government froze wages and prices as a means of controlling wartime inflation. To attract workers, employers began offering health insurance as a fringe benefit since the coverage wasn't subject to wage restrictions. For workers, these benefits also had the advantage of not being subject to federal income or payroll taxes, a situation that has prevailed over time. There is consensus among economists that the tax exclusion has contributed to the growth of employer-provided health insurance as a result.

Nonetheless, some policymakers have been pressing to change the tax-exempt status of employer-sponsored health insurance for several decades. The administrations of Ronald Reagan and George W. Bush proposed capping the exclusion, or eliminating it and substituting a new type of tax break, a so-called standard deduction, that everybody could use to help pay for health insurance. Even the idea of taxing some health benefits as a means of paying for health reform is not new. In 1993, the Clinton administration briefly considered the idea before abandoning it in favor of other financing options.

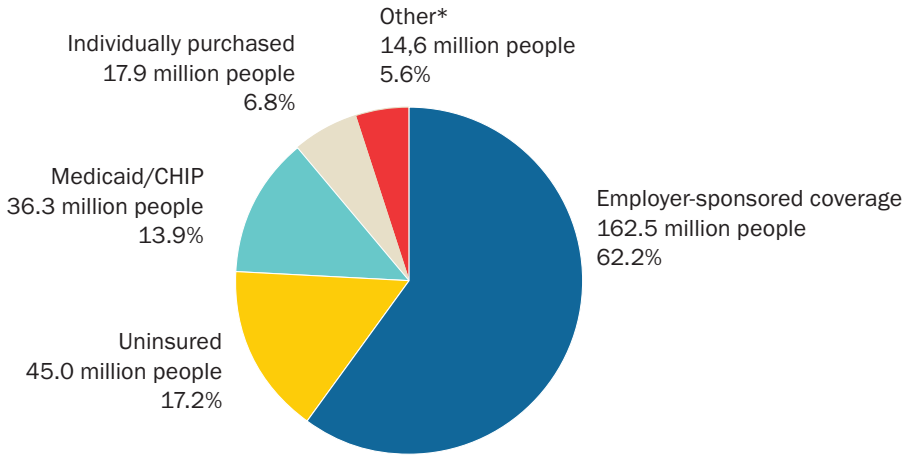
The issue of modifying the tax exclusion generated controversy once again during the 2008 presidential campaign. The Republican nominee, Sen. John McCain of Arizona, proposed taxing the full cost of employer-sponsored health insurance — and then replacing the tax exclusion with fixed-dollar tax credits. The credits would offset taxes due on employment-based coverage and in effect help workers pay for insurance offered by their employers. If workers did not have employer-provided coverage, they could use the tax credits to help pay for insurance they acquired by themselves in the individual health insurance market.

As the Democratic nominee for president at the time, Barack Obama strongly opposed McCain's proposal. But since then, Obama, now president, has softened his views. He now says that although he would prefer using other sources of revenue to finance expansion of health coverage, he would not rule out the idea of limiting the tax exclusion for employment-based coverage.

As this policy brief is published, it appears that the Finance Committee may include a limit

EXHIBIT 1

Sources of Health Coverage for the U.S. Population under Age 65, 2007



Source: Employee Benefit Research Institute estimate of the 2008 U.S. Census Current Population Survey.
Note: Total exceeds 100% because some individuals may have multiple sources of health insurance.
* Includes Tricare, 7.5 million; and Medicare (disability), 7.1 million.

on the tax exclusion as part of its proposal for broad-based health reform. One proposal under consideration by the committee would tax the portion of health insurance premiums that cost more than $6,780 for an individual, or $17,280 for a family, beginning in 2013. A worker or family who received employer contributions to coverage above those caps would have to pay federal income taxes — but not payroll taxes — on the amount that exceeded the cap. According to projections, fewer than 25 percent of workers and their families would be affected, since only they would have employer-sponsored coverage above these levels in 2013.

The amounts of the caps would be indexed so that they would rise in future years, at the rate either of general price inflation or of medical spending growth. What's more, health insurance policies currently covered by collective bargaining agreements would be exempt from the tax cap until those agreements expire.

As of the publication of this brief, it's not clear how much revenue the proposal would raise to put toward health reform. But a slightly different proposal has been analyzed by Congress's Joint Committee on Taxation. Beginning in 2010, the exclusion would be limited to the cost of basic health insurance for federal employees, and indexed over time at the rate of medical cost growth. Taxing employment-based health coverage under this proposal would raise an estimated $418 billion over ten years, the Joint Committee says.

Still another alternative under consideration by the Finance Committee would also adopt the caps described above — $6,780 for an individual and $17,280 for family coverage, beginning in 2013 — but would also relate them to individual and family incomes. Under this proposal, only those individuals with incomes above roughly $100,000, or couples with incomes above $200,000, would have to pay taxes on their employment-based health coverage. The Joint Committee on Taxation estimated that an option similar to, but not identical to, this one would generate about $162 billion over 10 years. That amount is less in revenue than supporters of a tax cap originally hoped to raise through the provision. This approach would also be more difficult to administer than a tax cap linked to premium levels, because of the challenges in matching up information about individuals' private insurance premiums and their taxable income.

Urban Institute researchers Lisa Clemans-Cope, Stephen Zuckerman, and Roberton Williams recently estimated the amount of revenue that could be raised from a range of proposals to cap or eliminate the tax exclusion, as well as which households would bear the brunt of taxation. Their report is listed in the "Resources" section.

EXHIBIT 2

Federal Tax Breaks for Health Insurance and Health Care, 2008

	Billions not collected
Exclusion of employer-sponsored health insurance	$226
Exclusion of Medicare benefits from income tax	42
Tax deduction for medical expenses	11
Self-employed health insurance deduction	5
Other*	4
Total	$289

Source: Joint Committee on Taxation, 2009.

* Includes military benefits, health savings accounts, and tax credits.

What's the argument?

In favor of taxing some health benefits: Supporters say that scaling back the tax exclusion would raise revenue to expand health coverage — for example, by helping finance tax credits or subsidies to assist people in buying health insurance, or to pay for direct coverage expansions through programs such as Medicaid. They also say that limiting the exclusion would address inequities and inefficiencies in the tax code; discourage the purchase of ever-more-expensive health insurance; and possibly serve as a brake on the growth of runaway health spending.

Supporters of a cap also say that the current unlimited tax exclusion for employer-sponsored coverage is inequitable because it only benefits people with employment-based coverage. It doesn't apply to people whose employers don't offer coverage, or to employees who for other reasons purchase health insurance on their own.

What's more, as with any unlimited tax deduction or exclusion, the highest-income people in the highest tax brackets get the greatest benefit from the tax exclusion, while the lowest-income individuals get the least benefit. The value

Taxing employer-sponsored health insurance:

Should it be done at all?

What's the purpose — efficiency, cost containment, fairness, paying for health reform — and what's the balance between those objectives?

Should the threshold be based on workers' incomes or the value of health insurance premiums?

Should the threshold(s) reflect geographic variations in insurance costs?

For workers, should any cap on the tax exclusion apply to federal payroll taxes as well as federal income taxes?

Should employers have to pay their share of payroll taxes on the value of contributions to coverage above the cap?

Should a cap apply to or exclude retirees who still get some help from employers with health coverage?

Should a cap exclude union-negotiated health benefits, at least until current collective bargaining arrangements expire?

of the exclusion also in effect rises with income because workers in higher tax brackets are more likely than lower-income workers to have coverage through their employers. In an analysis for the Kaiser Family Foundation, economist Jonathan Gruber of the Massachusetts Institute of Technology found that the exclusion provides an average of $319 in tax benefit to workers earning less than $20,000 a year and an average benefit of $1,002 for workers with incomes between $20,000 and $40,000. For workers with incomes of $150,000 and above, the average tax benefit from the exclusion is $2,823.

The tax exclusion is also inefficient in the broadest economic sense, some economists argue. Health coverage that is in effect "bought" with tax-free dollars is artificially cheap. That serves to increase demand for health care, raises prices of health services, and leads to excessive health spending. Economist Mark Pauly of the University of Pennsylvania has argued that upper-income workers in particular are more likely to demand more comprehensive and generous health benefits, and that the open-ended tax exclusion tends to encourage this. In effect, says Pauly, these upper-income workers end up "imposing" their more expensive preferences on lower-income workers when they are covered in employer-sponsored group coverage plans.

Supporters of capping the tax exclusion say that doing so would in effect lower the subsidy and encourage employers and employees to be more cost-conscious when buying health insurance. However, as detailed below, there is debate among economists as to how big an impact on the prices of health services or overall health spending would result.

Against capping the tax exclusion: Opponents have a variety of objections to the tax cap. Some simply don't like tax increases of any kind. Others see the cap as increasing the cost of health insurance to workers, since some would in effect pay more for coverage that currently isn't taxed.

But perhaps the top concern of many who oppose scaling back the tax exclusion is that capping it would over time result in less generous health coverage for workers. Employers and workers alike, they argue, would be motivated to provide or seek relatively less expensive health insurance coverage. The effects might not be entirely salutary. As more out-of-pocket costs were shifted to individuals, contends economist Elise Gould of the Economic Policy Institute, chronically ill individuals might forgo care and see their health status worsen as a result.

There are also concerns that some people could be more likely to face a tax increase than others. For example, high-income workers or unionized workers may have generous health benefits valued above the cap. In many cases, union members have "traded wages for health benefits" when they've negotiated collective bargaining agreements, according to Gerald Shea, assistant to the president of the AFL-CIO.

What's more, health insurance policies cost more in areas of the country where medical costs are high. As a result, people in high-cost states like New York, New Jersey, and Massachusetts may be more likely to have coverage at levels greater than the cap, and therefore more likely to pay taxes on some of their coverage if the exclusion is limited. And some companies in high-risk industries or with a large share of older workers may have higher insurance costs than other firms. Setting a tax cap at a specific dollar level could thus affect different firms with different workforces very differently, and produce unintended consequences as a result.

In addition to voicing these concerns, opponents of a tax cap question whether limiting the tax exclusion would have some of the other effects supporters claim. There are many factors besides the tax exclusion that contribute to rapidly rising health spending, they point out. What's more, any reduction in the incentives for higher health spending that would result from limiting the tax exclusion could well be offset if the revenue is used to buy health coverage for those who are now uninsured.

Finally, some skeptics dispute the fact that the overall effect of the tax exclusion for health insurance is as "regressive" as some claim, benefiting higher-income taxpayers more so than those with lower incomes. In the Autumn 2006 issue of the *Journal of Law and Contemporary Problems*, for example, Clark C. Havighurst and Barak Richman of Duke University School of Law argued that government simply replaces the revenue lost through the tax exclusion by imposing higher progressive rates on taxpayers' other sources of income.

What's next?

Senate Finance Committee chairman Max Baucus, a Montana Democrat, has said that his committee's health reform bill would include a provision taxing some employer-sponsored health benefits. However, as this brief is published, it is unclear what proposal will end up in the committee's bill — or in any final reform plan agreed to by the president and Congress.

An obstacle to wider consideration of a change in the tax exclusion is the fact that it isn't very popular among senators who are not on the Finance Committee. Pointing to polls showing that most Americans oppose changing the exclusion, key Democrats are pressing committee members to drop the tax cap proposal and find other revenue sources for health reform. The tax proposal has been rejected outright by key House members, including Rep. Charles Rangel of New York, who heads the tax-writing House Ways and Means Committee. Accordingly, a change in the exclusion isn't part of the draft legislation produced by three House committees.

If the Senate eventually passes legislation with the tax cap, a conference committee would have to work out the differences between the House and Senate bills, and it's unclear whether the provision would survive. Congress and the Obama administration could face a trade-off: retain a tax cap and weaken employers' and workers' support for the health reform package, or jettison the tax cap and be forced to find other sources of revenue to pay for health reform.

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