



## Taxing Health Insurance: A Tax Designed to Be Avoided

By Robert B. Helms

*The tax exclusion for employer-sponsored health insurance grew out of wartime wage rules to become a permanent fixture in U.S. labor markets, such that President Barack Obama ruled out lifting the exemption during the presidential campaign last fall. But the effort to limit fast-growing health spending—and to fund new health care initiatives—requires the tax money lost to the exemption. Not only will capping the exemption bend the curve of health care costs, it will also make it more feasible for smaller firms to offer more cost-effective insurance to their workers.*

Proposals to place a limit or cap on the value of health insurance provided by an employer are getting significant attention in the crucible of health reform discussion. Proposals of this type have been around for more than thirty years but are receiving renewed attention because Congress desperately needs new revenues to pay for the expanded health coverage promised by President Obama and several congressional leaders.<sup>1</sup>

Capping the value of employer-provided health insurance is not without controversy, even within the Obama administration. Office of Management and Budget director Peter R. Orszag has stated repeatedly that a change in tax policy is “on the table,”<sup>2</sup> while Health and Human Services Secretary Kathleen Sebelius recently told a congressional panel that the president opposes this policy and believes that taxing health benefits “would dismantle that market that so many rely on.”<sup>3</sup> Proponents, like me, praise it as a necessary condition for efficient health reform. Meanwhile, there is an alarming shortage of careful analysis of the probable effects of what its opponents characterize as a “tax on health insurance.” A more realistic assessment of the effects

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of a limit on the tax exclusion will reveal that this policy is highly consistent with the objective of creating a more efficient and quality-enhancing health care system.

### The Tax Treatment of Employer-Sponsored Health Insurance

During World War II, the War Labor Board—the government agency responsible for enforcing the wage component of wartime price and wage

#### Key points in this Outlook:

- The tax exclusion for employer-sponsored health care makes up nearly 80 percent of current health-related tax revenue lost to the government.
- Capping the tax exclusion would encourage employers to offer more cost-effective health insurance plans.
- Lifting or capping the tax exclusion is one of Congress’s few options for finding money for health reform.

controls—ruled that company-provided fringe benefits (mostly pensions and health insurance) were to be excluded from wartime wage controls. Since companies were unable to raise wages, this gave them an incentive to expand health insurance and pensions as a way to compete for scarce labor. The exclusion of company-sponsored health insurance from taxable income was continued by the Internal Revenue Service (IRS) after the war and written into legislation by Congress in 1954. This favorable tax policy was a major factor in the rapid growth of employer-sector health insurance in the postwar period.<sup>4</sup> While it helped to increase the number of people with health insurance, it has also been identified as a source of distorted incentives for efficient care and increased national expenditures on health care.<sup>5</sup>

There are several tax policies that affect health insurance. Table 1 shows the Joint Committee on Taxation’s (JCT) estimates of health-related tax expenditures (that is, revenue lost to the federal government) for 2008. Approximately 80 percent of the total is due to the exclusion of employer-sponsored health insurance from federal income taxes and payroll taxes. Using JCT estimates, the Congressional Budget Office finds that a limit on the tax exclusion set at the seventy-fifth percentile of health insurance premiums (\$1,440 per month for family coverage) paid by or through an employer would bring in approximately \$452 billion over the 2009–2018 period.<sup>6</sup>

### What Is a Tax Cap?

In its simplest form, a tax cap is a limit on the value of health insurance provided by an employer that can be excluded from an employee’s taxable income. If an employer were providing a health insurance policy costing \$15,000 per year and a limit of \$12,000 were placed on the tax exclusion, the employee would have an additional \$3,000 added to the taxable income reported on his W-2 form. The actual limit could be set near the average of private-sector premiums or as a high or low percentile of the distribution of premiums or actuarial estimates of the cost of such plans. In 1984, the tax cap

TABLE 1  
HEALTH-RELATED FEDERAL TAX EXPENDITURES, 2008

TAX EXPENDITURE	TAX PROVISION IN	
	BILLIONS OF DOLLARS	PERCENTAGE
Exclusion of employer-sponsored health insurance	226.2	78.6
• From income taxes	132.7	46.1
• From FICA taxes	93.5	32.5
Deduction of medical expenses greater than 7.5 percent of adjusted gross income	10.7	3.7
Self-employed health insurance deduction	5.2	1.8
Other tax expenditures	45.7	15.9
Total	287.8	100.0

SOURCE: Joint Committee on Taxation, “Background Material for Senate Committee on Finance Roundtable on Health Care Financing,” Senate Committee on Finance, May 12, 2009, table 1, available at <http://finance.senate.gov/JCT.pdf> (accessed June 5, 2009). Other tax expenditures are for Medicare benefits, military benefits, health savings accounts, and tax credits.

proposed by the Reagan administration was set at approximately the eighty-fifth percentile of premiums.

A simple tax cap of this nature would not eliminate the tax exclusion for employer-provided health insurance or replace it with a tax deduction or a tax credit, variations of which were proposed by both former president George W. Bush and Senator John McCain (R-Ariz.). While a tax cap set at the upper ranges of existing premiums may have more limited effects than a complete elimination of the tax exclusion, such a tax cap could still have important incentive effects that could complement other provisions designed to improve the efficiency of health delivery.

### The Effects of a Tax Cap

The primary advantage of a cap on the tax exclusion, an advantage touted by health policy experts for more than forty years,<sup>7</sup> is that it ends the open-ended tax policy that has induced expansive benefits and cost-inefficient health delivery. Under the tax policy started during the wartime period of wage and price controls, employers and employees (and their unions) have had strong incentives to expand tax-free health insurance relative to taxable cash wages. The result has been a gradual increase in the scope of benefits with little regard to the cost-effectiveness of the covered medical services. A limit on what could be treated as an exclusion to taxable income would make it mutually beneficial for both

employers and employees to redesign their health insurance policies to avoid any additional taxes. For companies offering only one health insurance option, this could involve any combination of cost-reducing changes, such as higher cost-sharing, incentives for care coordination and prevention, more use of managed care, and more careful selection of providers who place more emphasis on cost-effective outcomes. Firms offering more than one plan could arrange for at least one plan to be offered at a total cost underneath the tax cap. In both cases, the redesign of the company's health plan would be based on the company's own evaluation of the desires of its workers and the relative effectiveness of the cost-reducing strategies. In other words, any additional tax could be avoided if the employer were willing to offer its workers a more cost-effective policy that does not exceed the cap. Under the present, open-ended tax policy, there have been very weak incentives for employers or employees to consider such changes.

An additional advantage of the tax cap is that it might help expand health insurance coverage for a segment of the uninsured who now work for small or low-wage companies that cannot afford to offer health insurance in today's market. If a tax cap induces health insurance companies to offer cheaper and more cost-effective policies, it could make offering health insurance more attractive for firms not now offering coverage. Such lower-cost plan designs would also be available to firms that self-insure.

### Why Not a Tax Cap?

One common criticism of any change in the present tax treatment of health insurance is that it will cause firms to stop offering health insurance, destroying the employment-based system of health insurance as we know it. This is a highly misleading assertion, especially if one is talking about the effects of a simple tax cap set at a relatively high level. The development of modern health insurance started in the late 1930s and was given a major boost by wartime tax policies and the growth of income, population, and scientific improvements in medical delivery in the post-World War II period. During this seventy-year history, the provision of health insurance by employers has become an established part of labor markets. A cap on the amount of health insurance costs that can be treated as tax-free is not going to cause any wholesale change in this market. At most, it will create incentives at the margin for firms to redesign

their existing plans and give their employees more value for their money. Such bottom-up change is the only way we are going to "bend the curve" of the rising cost of health care. This is why a tax cap is unlikely to cause an increase in the number of people without health insurance—the induced change will be in the nature of the health insurance benefit, not a pure price effect of an unchanged insurance benefit.

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There is one change in tax policy that could backfire and cause companies to drop coverage precipitously. It is sometimes suggested that instead of placing a cap on the exclusion of employer-sponsored insurance, we should cap the company's tax deduction of the cost of health insurance as a business expense. Currently, health insurance costs are treated like other costs of production, such as wages, material inputs, and capital costs. Placing a limit on the firm's tax deduction would cause a major change in the tax treatment of business expenses and could be expected to give firms a strong incentive to drop coverage. This would increase the number of people without health insurance and the number of people on public programs, primarily Medicaid and Medicare. This is not a change in tax policy that would be consistent with the broader objective of health reform: to create a more efficient system of health delivery.

The bottom line is that there is much confusion and misleading information currently circulating in the health policy debate. A tax cap—that is, placing a limit on the amount of employer-provided health insurance that one can exclude from taxable income—is a sensible policy that will not disrupt current labor markets and has the potential to create stronger incentives to improve our health care system. This basic policy has been promoted by most health economists and health policy experts for at least four decades, not as a source of new revenue but as a means to promote more cost-effective incentives in insurance policy design and health delivery. If Congress adopts it as a needed source of revenue,

then at least it will have done something that will promote more efficient health policy. If one wants to call a tax cap a “tax on health insurance,” then this is truly a tax that is designed to be avoided.

When the War Labor Board decided to exclude company-sponsored fringe benefits from wartime wage controls, it also said that such benefits had to be “reasonable”—they could not exceed 5 percent of annual salary or wages. After the war, the IRS and Congress adopted the board’s exclusion policy but did not continue the board’s limit. Perhaps it is now time to reinstate the War Labor Board’s reasonable limit.

## Notes

1. See, for example, Alice M. Rivlin, “The Effect of the Tax Laws on Health Insurance and Medical Costs” (testimony, Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, July 9, 1979), available at [www.cbo.gov/doc.cfm?index=5228](http://www.cbo.gov/doc.cfm?index=5228) (accessed June 9, 2009).

2. BNA, Health Care Policy Report, March 23, 2009.

3. BNA, Health Care Policy Report, June 6, 2009.

4. For a more detailed history with numerous references, see Robert B. Helms, “Tax Policy and the History of the Health Insurance Industry,” in *Using Taxes to Reform Health Insurance: Promises and Pitfalls*, ed. Henry J. Aaron and Leonard E. Burman (Washington, DC: Brookings Institution Press, 2008), 13–35. An earlier version of this paper is available at [www.aei.org/paper/100022](http://www.aei.org/paper/100022).

5. Charles E. Phelps, *Health Economics* (Reading, MA: Addison-Wesley, 1997), 357.

6. Congressional Budget Office (CBO), *Budget Options*, vol. 1: *Health Care* (Washington, DC: CBO, December 2008), 24, available at [www.cbo.gov/doc.cfm?index=9925](http://www.cbo.gov/doc.cfm?index=9925) (accessed June 4, 2009). These estimates include some limits on contributions to flexible spending accounts and health savings accounts. The CBO also asserts that this policy will increase the number of the uninsured by 3.2 million in 2014, an assertion that I believe has no basis in fact.

7. The earliest known analysis of the effects of tax policy on health insurance was in Martin Feldstein and Elisabeth Allison, “Tax Subsidies of Private Health Insurance: Distribution, Revenue Loss, and Effects,” in *Hospital Costs and Health Insurance*, ed. Martin Feldstein (Cambridge, MA: Harvard University Press, 1981). This chapter was based on an article first submitted in 1971.