

POLICY

PRESCRIPTIONS

DON'T TAX MY 'LAC

Lawmakers are considering the controversial revenue stream that would come from taxing employer-sponsored health insurance. Many liberal groups and labor unions oppose such a tax on the premise that it will affect many union members and middle class Americans.

Health economists have long argued that the tax exclusion of employer-sponsored health insurance (ESHI) benefits skews an already imperfect health insurance market. Such tax free benefits encourage the maximization of expenditures on health insurance coverage in exchange for lower take home pay. For instance, a worker in the 33 percent tax bracket could get an additional \$1 of health insurance coverage versus 67 cents of extra take home pay. In addition to distorting incentives to purchase insurance coverage as opposed to higher pay, the tax exclusion poses two major inequalities: (1) self-

employed individuals cannot enjoy such benefits and (2) greater benefits accrue to wealthier individuals, that is, those in higher tax brackets.

The authors of this study estimated effects of the tax exclusion for ESHI based on a standard deduction for health insurance up to \$7,500 for individuals and \$15,000 for families (based on a proposal by the Bush administration in 2007). Analysis was based on the 2007 Kaiser Family Foundation/Health Research and Educational Trust (KFF/HRET) Employer Benefits



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Survey. The currently debated 40 percent tax on “Cadillac health plans” differs from the Bush administration plan and would impact individuals plans costing above \$8,500 and family plans above \$23,000. Therefore, a direct analysis relevant to today’s policy debate is unavailable.

When looking at plan characteristics, those plans above the cutoff had statistically significant increased premium cost compared to plans below the tax cutoff (\$16,266 versus \$9,874). The actuarial value of plans above the proposed tax cutoff were statistically richer than those below the cutoff, but only marginally so (81 percent versus 79 percent). When investigating plan types, only high

deductible plans were unevenly distributed across the taxation threshold; high deductible plans such as Health Savings Accounts and Health Reimbursement Accounts comprised 1 percent of the expensive plans and 6 percent of the less costly plans. In that same vein, the average deductible for plans above the tax threshold was \$319 versus \$473 for plans below the threshold.

The authors then sought to determine what explains such variability between premiums. Actuarial value explained only about 4 percent of the variability. When firm type, market characteristics, and plan type were factored into the equation, only 16 percent of premium variation could be

Key Points

- Actuarial value only explains 4% of health plan cost
- High deductible plans are more likely to be under the tax penalty.

[Health Affairs, 2010; 29 \(1\): 174-181.](#)

explained. Thus, 84 percent of the variability in health plan expense remains largely unexplained and requires additional research.

Commentary

Senate Democrats have proposed a 40 percent tax on health plans whose cost exceeds the \$8,500 threshold for individuals and \$23,000 for families. In this analysis and [others](#) by the Commonwealth Fund, analysts perceive the taxation of “Cadillac health plans” as a crude and likely ineffective way to reduce health care costs. While it remains true that the current tax exemption for ESHI serves as lost revenue to the government and skews

employees’ incentives to maximize health coverage at the expense of additional wages, the neglected issue is one of equity. Individuals who obtain their health insurance in any other fashion besides through their employer must do so with after-tax dollars instead of pre-tax funds. As [we have mentioned before](#), health is something to incentivize and not penalize. Therefore, as negotiations proceed between the House and Senate, priority should be given to equalizing the treatment of health

insurance benefits in the tax code. Secondly, efforts should be made to encourage the purchase of health insurance - likely by exempting both ESHI and individually purchased insurance plans. A crude cap on tax free benefits may encourage a reduction in over-insurance, but only if employees truly understand the actual cost of the health plans. Therefore, Congress should require employers to report the cost of ESHI on an individual’s W-2 form, just as it does for wage income.