Who Loses if We Limit the Tax Exclusion for Health Insurance?

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A. Introduction

The tax exclusion for employment-based health insurance encourages people to purchase insurance, but it is expensive. Limiting the exclusion would raise revenues at a time of growing deficits. However, little is known about which workers make large tax-preferred premium contributions. Our analysis finds that the likelihood of large tax-preferred premium contributions is highest for insured workers at firms that are small, have an older workforce, or have high average wages. The fraction with increased tax liability over time, and thus also the revenue effect of limiting the exclusion, depends on choice of index.

Employer contributions to health insurance premiums are excluded, without limit, from workers' taxable income, while employee contributions are excluded if the employees work at firms with cafeteria plans, plans that allow employees to choose between taxable and nontaxable fringe benefits. Subsidizing compensation paid in the form of health insurance encourages employers to offer health insurance, increasing the number of insured workers. Nevertheless, it has long been recognized that limiting the tax exclusion would provide incentives for cost containment[1] and would raise revenue. The Joint Committee on Taxation estimates a $108 billion increase in federal tax revenue over the 2009-2013 period from capping the exclusion at the 75th percentile for health insurance premiums, with the cap indexed by the Consumer Price Index for All-Urban Consumers (CPI-U).

Proposals to increase taxes are generally unpopular, but the growing federal deficit makes limiting this expensive tax subsidy more viable. The healthcare reform plan by Senate Finance Committee member Ron Wyden, D-Ore., removes the tax exclusion, while Finance Committee Chair Max Baucus, D-Mont., suggests a restructuring through a benefit or income-based cap.[2] This article highlights the distributional impact of limiting the tax preference.

Little is known about which workers make large tax-preferred premium contributions, although it is well known that average premiums vary with firm size, geographic region, worker compensation, and plan generosity. Our analysis fills this gap by characterizing the affected population for a well-known proposal to cap the tax exclusion for employer-based insurance premiums, but our results could be extrapolated to a variety of proposals that set a fixed value limit on the tax preference, such as a flat tax deduction or credit.[3]

Our findings contradict the unsubstantiated, often repeated claim that those with overly generous plans — "Cadillac plans" — are the biggest winners under the current tax treatment. Even after controlling for the comprehensiveness of a health insurance plan, we find that age of workers and size of firm matter. Workers' health risks and small firms' higher administrative costs and inability to effectively pool risks play an important role in determining who benefits from an unlimited tax exclusion for employer-sponsored insurance. Therefore, although this is not suggested in the public discourse, enrollees in firms with those characteristics stand to lose the most from a change in the tax treatment of premiums.

B. Background

Employer-sponsored plans are the predominant form of health insurance in the United States. Nearly 63 percent of Americans under 65 years old have employment-based coverage through the workplace, either as an employee, dependent, or retiree. One reason that employment-based insurance is so appealing is that workplaces pool large groups of people along dimensions unrelated to health, ensuring more predictable medical costs and allowing insurers to take advantage of

[1]In papers published during the 1970s, Feldstein and his colleagues forcefully argued that the tax exclusion led to "overinsurance" and excessive demand for medical services.

[2]Baucus, "Call to Action: Health Reform 2009," p. 82, *available at* http://finance.senate.gov/healthreform2009/finalwhitepaper.pdf (accessed on Jan. 29, 2009); Wyden, "Guaranteeing Health Care for All Americans," *available at* http://wyden.senate.gov/issues/Health_Care.cfm (accessed on Apr. 16, 2008).

[3]The subsidy from a tax credit, unlike an exclusion or deduction, does not depend on tax rate. Because tax rates are unobserved in our data, the extrapolation is less straightforward but still informative.

the economies of scale. Legislative changes also have contributed to the dominance of the employment-based system.

Group policies began varying widely in response to tax changes in the 1940s and 1950s. An administrative tax ruling in 1943 that resulted in code clarifications in 1954 stated that an employer's contributions for its employees' group medical and hospitalization premiums are tax exempt. As a result, employers' contributions to health insurance premiums were excluded from individuals' income and payroll taxes. Further, laws passed in the late 1970s and 1980s, including section 125, allow employee contributions to be excluded when the employer has a qualifying section 125 plan (often called a cafeteria plan). This combination of tax exemptions encourages the use of group policies through the employer.[4] Effectively a government subsidy, those laws reduce after-tax insurance premiums, further encouraging healthy employees to enroll, forming sustainable (stable) risk pools among employees and attracting insurance companies into the market.

In 2005 President Bush established a bipartisan panel to recommend reforms that would make the tax code "simpler, fairer, and more pro-growth." In its final report, the President's Advisory Panel on Federal Tax Reform recommended substantially changing the tax subsidy for employment-based health insurance by setting a limit on the premium amount that could be excluded from an individual's taxable income. Including in taxable income premium contributions exceeding a cap might alleviate three drawbacks of current law treatment: The exclusion is expensive, distorts choices, and provides larger subsidies to higher-income taxpayers.

The cost of the federal income tax exclusion for employer-provided health insurance was $126 billion in 2006, having tripled in cost over the past 20 years. The tax exclusion also distorts choices. The tax reform panel argued that it "creates incentives that lead to inefficiencies in the market for health care."[5] The objective was to maintain the incentive for firms to still offer coverage, but reduce the incentive for them to purchase Cadillac plans, thereby lowering long-term health costs. The current tax exclusion provides a greater benefit to higher-income households because the value of a tax exclusion increases with marginal tax rates.[6]

Some empirical literature suggests that the benefits of the current tax treatment of health premiums favor higher-income workers.[7] Also, Tom Selden and Bradley Gray estimated the average tax subsidy by establishment characteristics[8] and found that the tax exclusion provides larger average subsidies to those in larger establishments and establishments with an older workforce. This article adds to the literature by analyzing the affected population for a proposal that sets a fixed dollar limit on the tax exclusion and by controlling for the generosity of the insurance plan.

C. Results

1. Percentage of private-sector insured workers above the cap. Using the Medical Expenditure Panel Survey Insurance Component, we examine the tax incidence by various characteristics of private-sector establishments using the cap values set out by the 2005 tax reform panel of $5,000 for single plans and $11,500 for family or plus-one plans. Among private establishments, 19.5 percent of single plan enrollees and 41.1 percent of family and plus-one plan enrollees have tax-preferred contributions in excess of the cap.

The increase in taxable income caused by the cap is substantial. The average tax-preferred premium is $5,796 for single plans and $14,368 for family plans. For family plans, this translates into an average of $2,868 subject to income and payroll taxes with the cap. Because the tax panel recommended subjecting amounts in excess of the cap to both income and payroll taxes, this newly taxable income of $2,868, for example, would increase tax liability by $650 for a taxpayer with a 15 percent marginal tax rate on income (over the range of the premium amount) and with earnings below the Social Security taxable maximum.

Typically, proposals that limit the exclusion index the fixed dollar amount by overall inflation, mimicking other inflation adjustments in the tax code. Yet historically, health insurance premiums have grown much faster than overall inflation. From 1998 to 2007, employer-provided health insurance premiums grew an average of 3.5 times faster than overall inflation.[9] Therefore, setting increases in cap values to overall inflation gradually increases the affected population each year. The share of enrollees with tax-preferred premiums exceeding the cap more than doubles over the 10-year horizon.

2. Characterizing the affected population. Insured workers in firms with fewer than 10 employees or with high concentrations of older workers are considerably more likely to have tax-preferred contributions exceeding the cap amount (see Table 1).[10] For example, enrollees working at establishments with 60 percent or more of their workers over age 50 are more than twice as likely to

[4]The self-employed eventually received an income tax preference for health insurance payments, although the subsidy for employment-based coverage remains more generous.

[5]President's Advisory Panel on Federal Tax Reform report, pp. 78-82.

[6]Higher-income people also have greater access to employer-provided health insurance. *See* Elise Gould, "The Erosion of Employment-Based Insurance: More Working Families Left Uninsured," *International Journal of Health Services*, 38(2) (2008), pp. 213-251.

[7]J. Sheils and R. Haught, "The Cost of Tax-Exempt Health Benefits in 2004," *Health Affairs* 23 (2004), w106-w112 (published online Feb. 25, 2004; *available at* http://content.healthaffairs.org/cgi/content/abstract/hlthaff.w4.106).

(Footnote continued in next column.)

[8]T. Selden and B. Gray, "Tax Subsidies for Employment-Related Health Insurance: Estimates for 2006," *Health Affairs* 25 (2006), pp. 1568-1579.

[9]"Employer Health Benefits 2007 Annual Survey," Kaiser Family Foundation and Health Research and Educational Trust.

[10]For a more extensive set of characteristics, see Gould and Minicozzi, "Who Is Adversely Affected by Limiting the Tax Exclusion of Employment-Based Premiums?" Economic Policy Institute Working Paper Number 281 (Mar. 2009).

Table 1. Share of Insured Workers With Tax-Preferred Contributions Exceeding the Cap, 2006

Establishment/Firm Characteristic	Insurance Plan Type	
	Single	Family
Total	**19.5%**	**41.1%**
Percent Women		
0-19%	14.2%	33.9%
20-39	15.3%	33.0%
40-59	24.2%	36.1%
60+	24.5%	46.9%
Share of Workers Over 50		
0-19%	16.0%	31.3%
20-39	20.9%	40.3%
40-59	29.9%	45.2%
60+	41.2%	45.8%
Percent Unionized		
0-19%	19.2%	39.6%
20-39	13.9%	37.9%
40-59	20.4%	50.2%
60+	27.9%	43.7%
Average Annual Salary		
0-$16,956	15.7%	38.5%
$16,957-$29,309	16.2%	32.6%
$29,310-$46,439	20.3%	40.7%
$46,440+	23.1%	46.8%
Firm Size		
< 10 employees	29.7%	39.5%
10-24	19.2%	31.1%
25-49	16.6%	37.7%
50-99	19.2%	39.3%
100-499	19.4%	39.7%
500-999	24.0%	37.2%
1000+	17.4%	43.6%

Source: Calculations provided by the Agency for Healthcare Research and Quality using data from the Medical Expenditure Panel Survey Insurance Component.

be affected by the cap as those in establishments with few older workers. For single plans, enrollees in the smallest firms have the greatest likelihood of contributions exceeding the cap, while for family plans, there is little variation by firm size.

Union penetration, fraction of female workers, and average wages also affect the likelihood of exceeding the cap, but to a lesser degree. Enrollees at establishments with high union density are more likely than those at low union density establishments to have tax-preferred premiums above the cap. Workers enrolled in a single plan at establishments with women accounting for more than 40 percent of the workforce are roughly 10 percent more likely to have contributions exceeding the cap than establishments that are less than 40 percent female. Across both single and family plans, the affected population is most likely to be found in establishments with average annual salaries exceeding $46,440 (high wage) rather than in places with low- or middle-wage averages. Our general conclusion that workers at higher-wage firms have higher tax-preferred premiums is consistent with findings that the employer contribution to health premiums increases with an employee's earnings.[11]

Our logit regression results reinforce the unconditional relationships observed in the cross tabulations. After controlling for a variety of establishment/firm characteristics, the likelihood of contributions exceeding the exclusion cap increases with the fraction of older workers, union penetration, fraction of female workers, and average wage rate. Enrollees in single plans in firms with fewer than 10 workers are more likely to have contributions that exceed the cap than those working at large firms, all else being equal.

To interpret the magnitude of our logit results, we define a prototypical establishment.[12] An enrollee in a single plan at the prototypical establishment has a 9

[11]M. Lettau, ''New Statistics for Health Insurance From the National Compensation Survey,'' *Monthly Labor Review* (Aug. 2004), pp. 46-50.

[12]For more, see *supra* note 10.

percent chance that his tax-preferred premium contributions exceed the cap amount. The likelihood of exceeding the cap increases by 6 percentage points if he works in a high average wage establishment, by 13 percentage points if he works in an establishment with 60 percent or more of the workforce over age 50, and by 10 percentage points if he works in a firm with fewer than 10 employees.

We also control for plan comprehensiveness when estimating the effects of establishment characteristics on the likelihood of being above the cap. Enrollees have high tax-preferred premium contributions for reasons directly related to firm characteristics (for example, high administrative costs or coworkers with expensive health problems) as well as for reasons only indirectly related (for example, insurance plan generosity and the individual's tax benefit from purchasing insurance). Even after controlling for plan generosity, our results hold.

D. Conclusions

This study has found that the beneficiaries of the unlimited exclusion for employer-sponsored insurance include many older workers as well as employees of small businesses. Establishment characteristics significantly and substantially affect the likelihood that a worker enrolled in employer-sponsored insurance has high tax-preferred premium contributions. Even after controlling for insurance plan generosity, enrollees at establishments with high average wages, with an older workforce, or at very small firms are more likely to have high tax-preferred premium contributions.

The marginal effects of workforce age and firm size are strikingly large and can be generalized to cap amounts 10 percent above or below those proposed by the tax reform panel. While eliminating or capping the tax exclusion can raise a sizable sum, tax proposals that raise revenue are bound to hurt some taxpayers. We find that the potential losers are not necessarily those with the most generous coverage. The administration of such a policy could be costly for employers and create unanticipated problems for affected workers.[13]

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[13]For a full discussion of those issues, see P. Fronstin, "Capping the Tax Exclusion for Employment-Based Health Coverage: Implications for Employers and Workers," Jan. 2009, Employee Benefits Research Institute Issue Brief No. 325.