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NOT-SO-EASY MONEY Taxing health benefits comes with costs

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Unlike wages, health insurance premiums are not subject to taxation. Proposals to end this tax exclusion are emerging in the discussions of how to pay for health care reform. Recent articles from the *New York Times*, the *Washington Post*, and the *New Republic* have reported that top White House aides and members of congress want to keep the option of taxing employer health benefits firmly on the table. At the recent White House Forum on Health Reform, Senators Max Baucus and Ron Wyden continued their calls to change the tax treatment of health benefits in order to fund coverage expansions.

In a climate of substantial budget deficits, the prospect of recouping upwards of \$200 billion by taxing these benefits is enticing. But we should proceed with extreme caution before moving to cap or eliminate this tax exclusion. In trying to pay for coverage expansions, taxing health care benefits shouldn't be the first place we look, but rather the last, and only after large-scale health reform is in place to cover everyone.

The current policy of excluding health benefits from taxation provides employers with an incentive to offer health insurance to their workforce. When large groups of workers (and their families) sign-up for health insurance through employers, "risk pools" are formed. The key to these risk pools is that people are not grouped according to their health, creating a viable and stable insurance pool. Taxing health insurance benefits would encourage the young and healthy to opt out of these pools; upon their exit, premiums would likely rise for those remaining. Consequently, a policy that taxes health benefits would likely accelerate the substantial **erosion in employer-sponsored insurance** that has occurred since 2000 and thus cause more people to lose insurance coverage altogether.

We need to better understand who the losers are from taxing health benefits over a certain level (what policy experts call "capping the tax exclusion"). Some argue that a cap would primarily affect those with "Cadillac" or "gold-plated" coverage, but that isn't the whole story. *My research* (2009) published in *Tax Notes*, shows that taxing high-priced health coverage will heavily burden two groups: workers in small firms and workers in employer pools with higher health risks, such as those with a high percentage of older workers.

Small businesses are paying high premiums for the insurance they provide to their employees not because the plans are especially lavish, but because they have high administrative costs and include too few employees to constitute the broader risk pool that would qualify them for lower premiums. Employees whose characteristics cause them to be classified as higher risks make them more expensive to insure. Adding a tax on top of the cost of premiums they and their employers pay will likely drive more of them into the ranks of the uninsured.

It's worth noting that the high price of these plans may not stem from any bells and whistles (i.e., so-called Cadillac benefits) in their coverage but rather from a fundamental inequity in the way that insurance for these groups is currently priced. A policy of taxing health benefits over a certain dollar amount is a blunt instrument that may do great harm to the very people we should be striving to help. Furthermore, these problems would only be exacerbated by a cap that fails to keep pace with future health care costs.

Some argue that taxing health benefits would help to contain the growth of health care costs by encouraging people to buy cheaper, less-comprehensive coverage. The logic is that, if patients have to pay a higher share of the costs of visiting the doctor (through higher deductibles or higher co-payments), then they will consume health care services more cautiously (though, one should note, not necessarily more wisely). But the potential gains in cost containment from taxing health benefits are wildly overblown. We know that 80% of health costs are borne by 20% of the population. Serious cost containment measures should deal with bringing down the costs of the most expensive cases in our system (e.g., managing chronic diseases) rather than arguing over the much smaller amounts spent by the rest of the population. Policies fixated on reigning in the first few hundred dollars of health spending do not effectively or efficiently deal with what is driving the high costs of the U.S. health system.

To further complicate the issue, administering a policy of taxing health benefits is more difficult than many have considered. It would be costly for employers and create unanticipated problems for affected workers. It would require that employers assess the value of their contribution toward their workers' health insurance—not an easy task, particularly for those employers who self-insure. (For a full discussion of the challenges of implementation, see [the recent brief](#) by Paul Fronstin (2009) from the Employee Benefit Research Institute.)

President Obama's budget makes a realistic and substantial down-payment on health reform, and health policy makers know that there is more money out there to be saved through intelligent reforms that improve the quality and efficiency of the entire system. Taxing health benefits is, indeed, one way to bridge the funding gap, but it shouldn't be adopted without serious consideration of the losers from such a policy and without a viable system already firmly in place that covers everyone.

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