Backgrounder

Published by The Heritage Foundation

No. 2214
December 5, 2008

Employer-Based Health Insurance: Why Congress Should Cap Tax Benefits Consistently

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Too many Americans do not fully understand how the health insurance they receive through their employer is financed. Health insurance is, of course, a "fringe" benefit. Formal premium payments to health insurance companies are made by employers, just as employers pay for other fringe benefits, such as paid vacation, child care, education and training, or retirement plans.

Technically, however, the employer is not "giving" the employee anything: The employees pay for these benefits through a reduction in their wages or an employer's reduction of full-time staff. The number of part-time jobs is increased to accommodate workload without offering any additional fringe benefits. As professors Katherine Baicker and Amitabh Chandra of Harvard University note:

> Employees ultimately pay for the health insurance they get through their employer, no matter who writes the check to the insurance company. The view that we can get employers to shoulder the cost of providing health insurance stems from the misconception that employers pay for benefits out of a reservoir of profits. Regardless of a firm's profits, valued benefits are paid for primarily out of workers' wages. Workers may not even be aware of how much their total health premium is; however, employers make hiring and salary decisions based on the total cost of employment, including both wages and benefits such as health insurance, maternity leave, disability insur-

Talking Points

- Too many Americans do not fully understand how the health insurance they receive through their employer is financed. Formal premium payments to health insurance companies are made by employers, just as employers pay for other fringe benefits, such as paid vacation, child care, education and training, or retirement plans.
- Costs for health benefits provided through the employer under the current tax system are rising significantly faster than any other fringe benefits.
- Placing a cap on tax benefits for employer-sponsored health insurance increases health plan transparency and places a greater emphasis on plan quality, not size.
- Capping employer-sponsored tax benefits for health coverage and offering similar benefits to individuals independent of their jobs is a major progressive step toward a more competitive market for health insurance.

This paper, in its entirety, can be found at:
www.heritage.org/Research/HealthCare/bg2214.cfm

Produced by the Center for Health Policy Studies

Published by The Heritage Foundation
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Washington, DC 20002–4999
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The Heritage Foundation
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ance, and retirement benefits. They provide health insurance not out of a generosity of spirit, but as a way to attract workers—just like wages. When the cost of benefits rises, wages fall (or rise more slowly than they would have otherwise), leaving workers to bear the cost of their benefits in the form of lower wages.[1]

Because many working Americans do not grasp this economic relationship—or what Baicker and Chandra call the "uncomfortable arithmetic" of the necessary trade-off between benefits and wages—they are particularly vulnerable to political appeals based on attractive rhetoric. Proposals for employer mandates for health insurance or "shared responsibility" are ultimately just taxes on employees.

The Big Difference. There is one sense in which the employer provision of health insurance as a fringe benefit differs radically from all other fringe benefits offered at the place of work. Unlike typical benefits offered through employers, such as retirement plans, child care, and tuition reimbursement, health care benefits do not have a limit on tax-free contributions by the employer or the employee. For the employee, the value of these health benefits is excluded from the calculation of the employee's income and payroll tax liability, and there is no limit to this special employee tax break called the employee tax *exclusion.* As professors Baicker and Chandra further note:

> This tax preference drives both the predominance of employment based policies and the prevalence of policies with low cost sharing, because care paid for in the form of higher employer premiums comes at a lower after-tax price than care paid for out-of-pocket. Of course, this tie between employment and insurance comes at a cost: workers who leave or lose a job risk losing their insurance or facing much higher premiums, sometimes forcing them to stay in a job to retain health insurance.[2]

Thus, the current congressional tax policy has a two-fold effect: First, because the tax break for employment-based health insurance itself is unlimited, it is a powerful factor driving up health care costs; and, second, precisely because the unlimited tax break is narrowly confined to the place of work, it undercuts portability of coverage and thus directly contributes to non-insurance among millions of Americans. Not surprisingly, health care expenditures have skyrocketed at alarming and disproportionately heightened rates compared to other benefits, while large numbers of Americans who lose coverage remain uninsured.

A More Rational Policy. Congress and the Administration should pursue a more rational policy. The right policy would be to replace the existing health care tax policy with a universal health care tax credit. If Congress and the Administration insist, however, on retaining an exclusively favorable tax break for employment-based health insurance, at the very least they should place a cap on tax-free health benefits.

As Senator Max Baucus (D–MT), chairman of the Senate Finance Committee, has observed, "more targeted" reforms of the existing tax exclusion for health benefits would make the system "more equitable" and would "reduce spending in the health care system."[3] As a reform option, Chairman Baucus suggests a cap on the amount of health insurance premiums that can be excluded from workers' wages for calculating both income and payroll taxes.[4]

A cap, then, would bring these benefits in line with other benefits and promote greater transparency, resulting in greater value and slower yearly growth. Moreover, it would be a key step in achieving a more equitable tax treatment of health insurance for all Americans.

1. Katherine Baicker and Amitabh Chandra, "Myths and Misconceptions About U.S. Health Insurance," *Health Affairs*, Web Exclusive, October 21, 2008, p. w539.
2. *Ibid.*
3. Senator Max Baucus (D–MT), Chairman, Senate Finance Committee, "Call To Action: Health Reform 2009," November 12, 2008, p. 82, at *http://www.finance.senate.gov/healthreform2009/finalwhitepaper.pdf* (November 24, 2008).
4. *Ibid.*

How Employer-Based Health Insurance Works

Today, the money spent on health plans obtained through the employer is excluded entirely from taxable income. The cumulative effect of this exclusion is more than $150 billion per year in federal income tax losses, a number that rises substantially each year. If payroll tax reductions from income are also included, this figure exceeds $200 billion.[5]

Part of the reason for these large numbers is that, unlike many other fringe benefits, there is no limit on how much money that is spent on employer-based health care can qualify for the tax exemption. Not surprisingly, the tax policy for the employer-sponsored health system gives even more tax benefits to higher-income employees. Routine studies by independent economists, including the Lewin Group, a prominent econometrics firm based in Virginia, consistently show that lower-income families receive much less assistance from the tax code than do higher-income families.[6] In other words, it is a highly regressive tax policy.

While many employees take advantage of these tax breaks, simply having a full-time job does not necessarily entitle an employee to health care through his employer. Once again, only employees whose employers purchase health plans receive the tax benefit. All other employees are left with taxed, individually purchased insurance or no coverage at all. As the costs of health plans continue to grow, the discrepancy in health care costs between the "haves" and "have nots" similarly widens. A cap on health care tax exclusions helps to curb this growing inequality.

The Kaiser Family Foundation estimates that for single coverage, the average annual total premium is $4,479. This increases to $12,106 for family coverage. Kaiser also found that between spring 2006 and spring 2007, employer-sponsored health care premiums increased an average of 6.1 percent, which is greater than the percentage increases of worker's earnings and inflation over the same time period.[7] In fact, employer-based health benefits are projected to reach a new high of $168.5 billion in 2009.[8] The inequalities in tax benefits based on income and annual premium-rate increases both seem to contribute to a reduction in enrollment rates, a trend verified by the U.S. Department of Health and Human Services.[9]

The Big Difference to Other Benefits

Among fringe benefits, employer-based health insurance is unique in its federal tax treatment. Child care, education, and retirement all operate under very different tax rules.

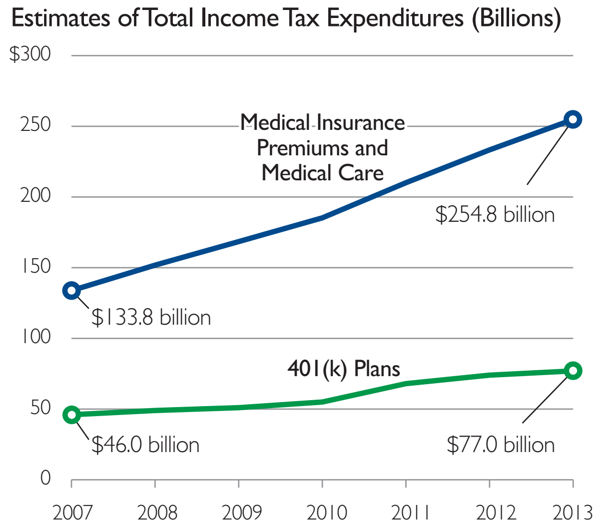
Retirement Plans. One of the most popular types of fringe benefits offered through employers is retirement plans. Under the Revenue Act of 1978, Internal Revenue Code Section 401(k) states that an employee can elect to withhold immediate compensation as a tax-deferred contribution to a 401(k) pension plan. This means that the employee does not pay federal income taxes on the funds contributed to the plan during the financial year of contribution. Taxes are made on both the contributions and earnings upon withdrawal of the funds, and are based on the income-level of the individual at the time of withdrawal.

5. Jason Furman, "Health Reform Through Tax Reform: A Primer," *Health Affairs*, Vol. 27, No. 3 (May/June 2008).
6. For example, a 1999 Lewin Group study revealed that families earning less than $15,000 a year receive an average annual tax subsidy of just $79, whereas families with an annual income exceeding $100,000 receive an average of $2,638 a year in tax subsidies. The Lewin Group, Inc., "Health Insurance and Taxes: The Impact of Proposed Changes in Current Federal Policy," October 18, 1999, at *http://www.nchc.org/releases/healthinstaxes_10_18_99.html#_Toc463787379* (November 11, 2008).
7. Kaiser Family Foundation, "Employer Health Benefits: 2007 Summary of Findings," at *http://www.kff.org/insurance/7672/upload/Summary-of-Findings-EHBS-2007.pdf* (November 11, 2008).
8. U.S. Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2009* (Washington, D.C.: U.S. Government Printing Office, 2008), pp. 290–291, at *http://www.whitehouse.gov/omb/budget/fy2009/pdf/spec.pdf* (December 2, 2008).
9. U.S. Department of Health and Human Services, "Employer-Sponsored Health Insurance: Trends in Cost and Access," Research in Action Issue 17, 2004.

The current allowable maximum tax-free contribution limit is $15,500 a year. Employers can compete with one another by offering varying levels of contributions to their employees' 401(k) plans as well. For example, some employers may offer to match the amount contributed to the fund by the employee. Any combination of employee and employer contributions cannot exceed the lesser of 100 percent of the employee's compensation or $46,000, and cannot be withdrawn without penalty before 59.5 years of age.[10] Structurally, 403(b) and 457 plans are very similar to 401(k) plans, but with slightly different limitations on employee contributions and withdrawals. The estimated total federal income tax expenditure due to 401(k) plans (and similarly structured plans) is $49 billion for 2008.[4] This number is expected to increase to $51 billion in 2009.[11]

Health Care Spending Outpaces Retirement Spending

Tax breaks for employer-sponsored health care increase at a faster rate than tax breaks for 401(k) retirement plans.



Source: U.S. Office of Management and Budget, Analytical Perspectives, Budget of the United States Government, Fiscal Year 2009 (Washington, D.C.: U.S. Government Printing Office, 2008), pp. 290–291, at *http://www.whitehouse.gov/omb/budget/fy2009/pdf/spec.pdf* (December 2, 2008).

Chart 1 • B 2214 heritage.org

Keogh plans demonstrate another retirement plan offered to unincorporated businesses or self-employed individuals. This is an interesting subset of employees, as they are often not participants in employer-based health care. The annual contribution limit for Keogh plans is $46,000, or 25 percent of annual income, whichever is less.[12] An advantage to Keogh plans is that they can offer similar tax benefits to employed individuals independent of their employers. Keogh plans are expected to account for $13 billion in federal income tax expenditures in 2009, representing a $1 billion growth (less than 8 percent) compared to the over $16 billion growth of health benefits (nearly 10 percent).[13]

Education Benefits. Limits are also placed on education assistance. Education assistance contributions from an employer to an employee are exempt up to $5,250 a year.[6] Of course, the program of study must have a sensible relationship to the job position. Additionally, any education benefit must not favor highly compensated employees. There are several additional factors further limiting which employees are eligible and which courses qualify for the tax benefit.

Other Benefits. Child care and other *de minimis* (minimal) benefits also have limitations. Dependent care may be excluded up to $5,000 from gross income. Employer offerings such as meals and employee discounts (up to 20 percent) are tax exempt to a certain maximum limit. Even *de minimis* benefits, which are defined by the IRS as "any property or service…to an employee that has so little value that accounting for it would be unreasonable or administratively impracticable,"[14] are classified so as not to

10. U.S. Internal Revenue Service, "Employer's Tax Guide to Fringe Benefits," Publication 15-B, 2008, at *http://www.irs.gov/publications/p15b/index.html* (November 11, 2008).
11. U.S. Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2009*.
12. U.S. Internal Revenue Service, "Employer's Tax Guide to Fringe Benefits."
13. U.S. Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2009*.

allow unreasonable, uncapped benefits. Most nearly anything offered by the employer to the employee that is less than this value qualifies for exemption. Regardless of the size of the employer-sponsored fringe benefit, from the multi-billion dollar retirement plans to the complimentary water cooler, there are specific caps and limits to promoting manageable annual cost increases of these offerings.

Why Congress Should Cap Tax Breaks for Health Benefits

If Congress wanted to establish an efficient, fair, and equitable tax policy for health insurance, it would replace the existing tax *exclusion* for health insurance benefits with a universal health care tax credit. The change would not affect the employers' *deduction* for health insurance, which would remain as it is today. The credit could be used for all types of health insurance, including employment and non-employment coverage. This has been the central recommendation, with variations in design, offered by a wide variety of prominent health care economists, liberal and conservative alike.[15]

Short of replacing the current tax exclusion entirely with a universal credit, Congress could at least cap the tax breaks for employer-based health insurance. Capping the tax preference on health care benefits would not only bring health care in line with other benefits, but would also have a positive impact on the health care system. Specifically, as noted by Senate Finance Committee Chairman Max Baucus, such a targeted reform would slow the rise of health care costs. The trends of capped employer-sponsored benefits are consistent with a slow, contained growth of federal income tax expenditures over time. Moreover, capping employer-sponsored health plans would increase transparency and promote value, as opposed to the currently unpredictable and heavily escalating costs that emphasize a health plan's size over substance.

Two-Step Process. Policymakers can take a variety of steps to bring health care benefits in line with other benefits offered to the employee by the employer, such as these two options:

- Establish a reasonable limit on tax subsidies for employer-sponsored health benefits. Health benefits obtained through the employer in the current tax system are increasing at a disproportionate and alarming rate. Nearly all other fringe benefits, regardless of size, have well-supported outlines for establishing capped employer-based health care benefits.
- Re-allocate the federal income tax revenue as tax credits toward purchasing individual health coverage. The role of the employer could then shift more toward that of a coverage facilitator for employees, providing administrative support and resources as opposed to sponsoring the health coverage entirely.[16]

There have been several legislative proposals that could accomplish this objective. One of the most prominent is the Tax Equity and Affordability Act (TEA Act, S. 3754), sponsored by Senator Mel Martinez (R–FL). The bill would establish a new system of income-based health care tax credits for individuals and families without employer-based health insurance, as well as cap the existing open-ended employment-based tax exclusion for health benefits.[17] The TEA Act would set initially generous caps ($11,500 for family coverage, $5,000 for individual coverage), which establish maximum amounts of contributions that can qualify for tax prefer-

14. U.S. Internal Revenue Service, "Employer's Tax Guide to Fringe Benefits."
15. Analysts from the American Enterprise Institute, the Galen Institute, The Heritage Foundation, the Progressive Policy Institute, and the Urban Institute have all proposed variations on this general policy. For a compendium of their views on this issue, see Grace-Marie Arnett, ed., *Empowering Health Care Consumers Through Tax Reform* (Ann Arbor: University of Michigan Press, 1999).
16. See Stuart M. Butler, "Evolving Beyond Traditional Employer-Sponsored Health Insurance," The Hamilton Project, May 2007, at *http://www3.brookings.edu/es/hamilton/200705butler.pdf* (November 11, 2008).
17. For a description of the legislation, see Nina Owcharenko, "The Tax Equity and Affordability Act: A Solution for the Uninsured," Heritage Foundation *Backgrounder* No. 1963, August 30, 2006, at *http://www.heritage.org/Research/HealthCare/bg1963.cfm*.

ences. Capping employer-sponsored tax benefits for health coverage and offering similar benefits to individuals independent of their jobs is a significant progressive step toward a more competitive market for health insurance.

Conclusion

Fringe benefits are at times called "perks" offered through an employer to employees in addition to their salaries. Many fringe benefits offer a complementary relationship with the federal tax code by granting tax-preferred treatment of these transactions. Most workplace fringe benefits incorporate a monetary limit on the amount of money that can qualify for the tax benefits, resulting in relatively predictable increases in federal income tax expenditures. The major exception to this limitation is in health care benefits.

Though the number of participants in defined-contribution pension plans and other fringe benefit programs is smaller than the number of participants in employer-sponsored health coverage, the tax expenditure estimates reflect very different trends. Employer-based fringe benefits with capped tax breaks consistently cost the federal government less in lost revenue than do uncapped benefits and their annual rate of increase is invariably lower than the growing rates of health insurance costs.

A cap on the tax breaks for employer-based health benefits would help restrain escalating health care costs. It would also facilitate the development of more innovative policies and would promote health plans with an emphasis on greater value for consumers, not only on the size of the benefit package. The cap would be a crucial component of future health reform, and it would lead to a more fiscally responsible system of tax-subsidized health benefits.

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