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Baucus Health Insurance Excise Tax Misses the Mark

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The Senate Finance Committee proposes to substantially raise taxes on middle- and low-income taxpayers through a misguided excise tax on insurance plans in order to pay for a portion of its massive health care bill. The Congressional Budget Office (CBO) estimates that this steep tax hike would cost taxpayers more than $200 billion over 10 years, about a quarter of the bill's $829 billion cost.[1]

Despite the intention to hit only high-priced "Cadillac" health insurance plans, the excise tax would fall mostly on low- and middle-income workers in the near future.

A better tax policy solution would be to cap the exclusion for employer-provided health care benefits for individuals and use the revenue to provide offsetting tax reductions. This solution would also restructure incentives facing health insurance consumers and ultimately reduce health care costs without growing government further.

Hidden Tax on Workers. Under the Senate Finance plan, providers of health insurance plans that cost more than $8,000 a year for individuals ($21,000 for families) would pay a 40 percent tax on their value above that threshold. For instance, a plan that costs $10,000 a year for an individual would face this 40 percent tax on the $2,000 over the $8,000 threshold. The health insurer would have to pay $800 (40 percent of $2,000).

Although the insurance companies would technically make the tax payment, they would undoubtedly pass this cost along to employers purchasing the plans for their workers in the form of higher premiums. Employers, in turn, would pass that cost on to their workers by lowering other forms of compensation like wages. Once the excise tax is passed on to workers, the result is no different than an increase in their income taxes.

Passing the tax on to workers would result in an effective tax rate that is even higher than the specified 40 percent. When the insurance companies embed the cost of the excise tax in premiums, the prices of plans will rise. A higher price means the excise tax would be higher, too.

For instance, using the example above, if a $10,000 plan rises to $10,800 because insurers embed the excise tax in the price, insurers would then calculate the excise tax on top of the $10,800. This adds an extra $320 on to the price of the plan. When insurers embed that additional cost in to the plan, its total cost rises to $11,120 and the cycle would start again. If insurers are able to push the full cost of the tax on to purchasers, this cascading effect could raise the effective rate for the excise tax to 67 percent according to one estimate—considerably higher than the 40 percent specified in the bill.[2]

This series of events highlights the first great flaw with the health plan excise tax, a flaw regarded ironically by its proponents as one of its finest features: The tax itself is invisible to those on whom it will

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fall. It fails miserably the test of transparency on which the President has put so much emphasis.

No Way to Avoid Higher Taxes. Faced with the possibility of paying substantially higher taxes, many workers would logically look for ways to avoid the tax. The first way they could avoid it would be by reducing the value of their health benefits below the threshold. If workers take less expensive health care coverage, they would want higher wages so as not to experience a reduction in total compensation. But this would not allow them to escape higher taxes completely, since higher wages would also be taxed.

Choosing lower coverage is a better tax option since the top marginal income tax rate today is 35 percent. Even under Obama and Congress's stated plans to hike the top income tax rate to 39.6 percent, most workers would still pay income tax rates far less than the top rate. Faced with a 40 percent excise tax rate (before cascading) on the value of their health care plan above the threshold, workers would likely trade off health benefits for higher wages and pay a lower marginal income tax rate.

Workers could also agree to plans that have higher co-pays and deductibles to avoid the excise tax. This would lower the price of their plans without reducing their benefits, but they would pay more out of pocket for their health expenses. They would then receive the money saved by their employers because of reduced premiums in the form of higher wages.

The additional wages in both scenarios were previously untaxed income, because they were devoted to paying for employer-provided health care. Those additional wages would be subject to tax at the worker's highest marginal rate—not at the 40 percent rate plus cascading. Regardless if they pay the excise tax or choose less expensive health insurance coverage, workers would still pay higher taxes because of the excise tax.

Excise Tax Breaks President Obama's Pledge. President Obama has repeatedly pledged that no one making under $250,000 a year will see their taxes increase. The excise tax would break this pledge. It would soon fall on low- and middle-income workers that make considerably less than $250,000 a year, since the tax would be indexed to inflation rather than the higher health inflation rate.[3]

Changing the indexing formula is an important feature of many health and entitlement reform proposals. But taxpayers should not be fooled into thinking they will not bear the substantial additional costs of the excise tax. Given the problematic features of the excise tax, this tax increase would be far in excess of the income tax rates most Americans pay today.

For example, a worker who earns $34,000 in taxable income today pays a top income tax rate of 15 percent. But the effect of the 40 percent excise tax on this worker's wages is the equivalent of a top marginal hike of 167 percent (assuming he or she does not accept lower health care benefits to avoid the excise tax). And this does not even account for the cascading effect.

AMT Flashback. The squeezing of the middle class by the excise tax is reminiscent of another tax that was not supposed to hit middle-income taxpayers. Congress created the alternative minimum tax (AMT) to ensure that high-income taxpayers paid a minimum amount of taxes after taking advantage of the various deductions, credits, and exemptions allowed through the income tax code.

When Congress passed the AMT, it failed to index the minimum income threshold for inflation. As time passed and the threshold's value declined relative to current incomes, more and more middle-

1. Congressional Budget Office, "Preliminary Analysis of the Insurance Coverage Provisions Contained in the Amended Chairman's Mark, as Amended," October 7, 2009, at *http://www.cbo.gov/ftpdocs/106xx/doc10642/10-7-Baucus_letter.pdf* (October 9, 2009).
2. Joint Economic Committee, "The Tax Man Cometh—Taxing Health Insurance Plans," September 30, 2009 at *http://jec.senate.gov/republicans/public/_files/TheTaxManComethSeptember302009.pdf* (October 2, 2009).
3. Joint Economic Committee, "When Will Your Federal Employee Health Benefit Plan (FEHB) Be Taxed?," September 18, 2009, at *http://jec.senate.gov/republicans/public/_files/WhenWillYourFederalEmployeeHealthBenefitPlanbeTaxed091809.pdf* (September 23, 2009).

income taxpayers were subject to the AMT. In response, Congress passes a temporary "patch" each year to prevent most middle-income taxpayers from paying the AMT, but many taxpayers that were never originally intended to pay it still do. The same thing will happen with the health insurance excise tax over time.

Cap on Exclusion a Better Way to Go. In place of this misguided and problematic excise tax, the Senate should seriously consider capping the exclusion on employer-provided health insurance. Currently, employer-sponsored health insurance is an untaxed benefit for workers—a benefit excluded from taxable income. The cap would work much like the cap on a 401(k), limiting the amount of the benefit that is excluded from taxable income.[4] Economists on both the right and the left agree that the exclusion is a major distortion in the tax code and that capping it is necessary to slow the rapid increase in health care costs.[5]

Capping the exclusion would change the incentives facing the recipients of employer-sponsored health insurance because they, for the first time, would bear some of the cost of their coverage. When the full costs are transparent—unlike the excise tax—consumers will make better decisions about their health care insurance and services.

Capping the exclusion would likely increase the amount of income subject to taxation for many low- and middle-income taxpayers. But unlike the excise tax, a cap would not increase the marginal tax rate of those taxpayers. Taxpayers would pay the same top marginal tax rate on the cost of their health insurance premium above the cap as they pay on their wage income—instead of a much higher, cascading rate. So a taxpayer who pays a top rate of 28 percent today would pay only 28 percent on the premiums above the cap.

This reform would also generate additional tax revenue. But rather than growing government's share of the health sector, any additional revenues should be used toward a credit for individuals to purchase insurance on their own.

Reform That Does Not Grow Government. The health insurance excise tax is not a free ride that insurance companies alone would bear. American taxpayers should not be fooled into thinking they will not have to bear costs of this poorly structured tax.

The better option is to equalize the tax treatment of health insurance by capping the exclusion on employer-sponsored health insurance and using the revenues to create a credit for individuals to purchase insurance on their own—without growing the government.

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4. Stuart M. Butler, "How to Design a Tax Cap in Health Care Reform," Heritage Foundation *WebMemo* No. 2517, July 1, 2009, at *http://www.heritage.org/Research/HealthCare/wm2517.cfm*.
5. Jason Furman, "Health Reform through Tax Reform: A Primer," *Health Affairs*, Vol. 27, No. 3 (2008), pp. 622–632, at *http://www.brookings.edu/~/media/Files/rc/articles/2008/05_health_reform_furman/05_health_reform_furman.pdf* (October 9, 2009).