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# EXCISE TAX ON VERY HIGH-COST HEALTH PLANS IS A SOUND ELEMENT OF HEALTH REFORM

## Congress Should Retain Tax, But Improve It Further

By Paul N. Van de Water

An excise tax on very high-cost health plans, which the Senate Finance Committee included in its health reform bill, represents a sound way to help pay for health reform. The excise tax finances nearly a quarter of the costs of the Finance Committee bill over the first ten years ($201 billion out of $829 billion) and makes a major contribution to the deficit reduction that the bill would achieve in later decades. It would help to slow the rate of health care cost growth, without which health care reform is not likely to be sustainable over time.

Of particular note, the excise tax produces savings that rise over time at least as fast as the costs of providing health insurance to those now uninsured. Without such a tax, Congress will be hard-pressed to comply with the President's pledge — and Senate rules — that the bill not increase the deficit in future decades.

The proposed tax has attracted a spate of criticism. Many of the charges and the numbers cited in these criticisms are based on an earlier version of the tax, rather than on what the Finance Committee adopted. The committee's changes to the tax addressed various shortcomings with the earlier version; as a result, many fewer health plans would be affected.

To be sure, some legitimate concerns remain. Congress can address them, however, with further refinements in the tax's design, as outlined below. Congress thus should not jettison the tax, but instead make the remaining needed improvements.

Some important aspects of the tax are widely misunderstood. For one thing, an October 20 press release cites the Congressional Joint Committee on Taxation (JCT) as finding that the total number of individual and family plans impacted by the excise tax grows to 34% and 31% respectively by 2019. These numbers overstate the tax's impact (see the box on page 2). For another, as the JCT analysis shows, over 80 percent of the revenue generated would come *not* from the tax on insurance premiums itself, but from income and payroll tax revenue on the tens of billions of dollars of higher wages that workers would receive — as employers modified their health plans to avoid the excise tax and converted what they had been spending for health coverage in excess of the tax thresholds into

### The Joint Tax Committee's Analysis of the Excise Tax

The Joint Committee on Taxation (JCT) analysis of the Senate Finance Committee excise tax provision is causing some confusion. That analysis forms the basis for much of this paper. But an October 20 press release presents the analysis in a very different light, describing the JCT as finding that "the total number of individual and family plans impacted by the excise tax grows from 19% to [34]% and 14% [to] 31% respectively between 2013 and 2019."[a] These numbers overstate the tax's impact. They also should be understood in the context of JCT's overall analysis and findings.

- The figures do *not* account for the higher tax thresholds for health plans that cover retirees, workers in high-risk occupations, or (on a transitional basis) workers in high-cost states. These JCT figures reflect *only* the base threshold amounts of $8,000 for coverage of single individuals and $21,000 for family coverage in 2013.

- These figures count health insurance *plans*, rather than *beneficiaries*. The difference is significant because many of the plans that would be affected apparently are smaller plans with a below-average number of enrollees. JCT estimates that only 7.7 percent of tax filing units would be affected by the excise tax in 2013 and 17.6 percent in 2019. (A tax filing unit consists of an individual or married couple that would, if their income were above the filing thresholds, file an individual income tax return, along with their dependents.)

- Furthermore, JCT reports that most of the affected health insurance plans *would not actually pay the excise tax*. Employers would modify their health plans to stay within the thresholds for the excise tax, and they would convert the resulting savings into higher wages or other fringe benefits for their employees. JCT estimates that over 80 percent of the revenue raised by the proposal would stem from income and payroll taxes on these higher wages.

[a] Office of Congressman Joe Courtney, *Nonpartisan Analysis Shows Proposed Excise Tax on Health Care Benefits Will Burden Families, Individuals*, October 20, 2009.

higher wages and salaries. Indeed, one largely overlooked side benefit of the proposal is that by receiving higher wages and paying somewhat more in payroll taxes, most affected workers would qualify for higher Social Security payments when they retire.

## The Excise Tax Provision, as the Finance Committee Modified It

Starting in 2013, the Finance Committee bill would impose a 40-percent excise tax on the portion of the value of health insurance coverage that exceeds $8,000 for single individuals and $21,000 for families.[1] In the 17 states with the nation's highest health insurance premiums, the thresholds would be 20 percent, 10 percent, and 5 percent higher than these national thresholds for the first three years, respectively. The tax would be levied on a non-deductible basis on insurance companies or insurance administrators; it would apply to plans sold in the group insurance market and to self-insured plans but not to plans purchased in the individual market.

[1] For purposes of comparison with the thresholds, the value of coverage would include the cost of basic health insurance and reimbursements under a health flexible spending account (FSA), employer contributions to a health savings account or health reimbursement arrangement, and supplementary health insurance coverage.

The Finance Committee significantly improved the original excise tax proposal during its consideration of the legislation. Its changes substantially reduced the number of plans and enrollees that the excise tax would affect.

- *Higher thresholds.* Under the revised proposal, plans that cover retired people over the age of 55 and people in high-risk professions would have significantly higher thresholds. (High-risk professions include law enforcement, firefighting, rescue/ambulance squads, construction, mining, agriculture, forestry, and fishing.) For each person in one of these categories, the threshold would be increased by $1,850 — to $9,850 — for individual coverage, and by $5,000 — to $26,000 — for family coverage. The threshold for a plan would, in effect, be the average of the thresholds for each of its enrollees.

- *Increased inflation factor.* Under the original proposal, the thresholds would have risen annually after 2013 with the rate of change in the consumer price index (CPI). Under the current proposal, the thresholds would rise with the CPI *plus one percentage point*. For example, if consumer prices rose 3 percent in a given year, the thresholds would rise by 4 percent. This change in indexing compounds over time and substantially reduces the number of taxpayers and health insurance plans affected by the excise tax in later years.

## Bending the Cost Curve

The proposed excise tax would make a major contribution to slowing the growth of health care costs by discouraging insurers from offering, and firms from purchasing, extremely generous health insurance coverage that can encourage excess health care utilization. That, in turn, would reduce incentives for excessive health care spending.

Congressional Budget Office (CBO) Director Douglas Elmendorf has stated that changing the tax treatment of high-cost health insurance to reduce its attraction is one of "two powerful policy levers" the federal government has available to encourage changes in medical practice and thereby slow the increase in health care costs. (Changing Medicare's payment rules is the other.) "Nearly all analysts agree," CBO has reported, "that the current tax treatment of employer-based health insurance — which exempts most payments for such insurance from both income and payroll taxes — dampens incentives for cost control because it is open-ended."[2] (For a further discussion of these issues, see the box on page 7.)

An important feature of the excise tax is that, according to CBO, the revenues it raises will more than keep pace with the cost of health coverage expansions in future decades. Pay-as-you-go rules in the House and the Senate require that a bill be fully paid for over the next ten years. In addition, a bill is subject to a 60-vote point of order in the Senate if it adds more than $5 billion to the federal deficit in any of the following four decades.[3] Also, President Obama has pledged that health reform legislation will not increase the deficit at all in future decades. Without the excise tax or a comparable provision, health reform may well fail to meet these budgetary tests.

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[2] Douglas W. Elmendorf, Letter to the Honorable Kent Conrad, June 16, 2009.

[3] S. Con. Res. 70, 100th Congress, section 311.

## Most People and Plans Not Affected

The thresholds for the proposed excise tax are sufficiently high that most health insurance plans would not be affected.

- In 2009, the average employer-sponsored health insurance plan is valued at $4,824 for a single individual and $13,375 for a family, far below the thresholds for the excise tax.[4]

- The health insurance plan most commonly chosen by federal employees — including Members of Congress — costs $5,872 for individual coverage and $13,446 for a family.[5]

- Under the Finance Committee's plan, the threshold for taxation would be at least $21,000 for family coverage in 2013. A plan costing $21,000 in 2013 (the equivalent of about $17,550 in 2009) would be about *a third more generous* than the plan that most Members of Congress have. It also would be about *a third more generous* than the typical employer-sponsored health insurance plan.

The Congressional Joint Committee on Taxation (JCT) estimates that only 7.7 percent of tax filing units would be affected by the excise tax in 2013 and 17.6 percent by 2019. For those plans that would actually pay the excise tax, that tax would apply to only a portion of the plan's value — the amount above the threshold.

Moreover, most of the affected plans and households would *not* actually pay the excise tax or higher premiums that reflected that tax. The JCT, as well as most economists and health analysts who have examined the proposal, concludes that health insurance plans and employers generally would respond by modifying their health plans to stay within the thresholds and avoid the excise tax; employers would convert the savings produced by modifying the health plans into higher wages or other compensation for employees. (Economic analysis finds that *employees* ultimately bear the employer share of health care premiums by receiving lower wages than they otherwise would. If an employer with a high-cost insurance plan scales back the plan to avoid the excise tax, the employer generally will move the savings to another form of employee compensation. If employers scaled back health plans to avoid the excise tax *without* passing the savings through in this manner, they would put themselves at a disadvantage with other employers in competing for workers.)

Indeed, the JCT estimates that more than four fifths of the revenue that the government would collect as a result of the excise tax would come from income and payroll tax revenue on the billions of dollars in higher wages and salaries that employees would be paid. Of the $201.4 billion in increased revenue over ten years, only $37.8 billion would come from the excise tax itself, the JCT estimates.

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[4] Kaiser Family Foundation and Health Research & Educational Trust, *Employer Health Benefits: 2009 Summary of Findings*, September 2009. The figures cited exclude the cost of coverage for retired workers.

[5] U.S. Office of Personnel Management, "Non-Postal Premium Rates for the Federal Employees Health Benefits Program," http://www.opm.gov/insure/health/rates/nonpostalffs2009.pdf, accessed October 15, 2009. Premiums for Blue Cross Blue Shield standard option. The figures cited include the cost of coverage for retired workers.

## What Insurance Plans Would the Tax Affect?

The high-cost insurance plans that the tax would affect generally offer unusually generous benefits that are not available to most Americans. The executive medical and dental program at Goldman Sachs, one of the nation's largest banks, has become the poster child for lavish health insurance plans. Goldman's top executives participate in a medical and dental plan that costs $40,543 a year for each participant's family — *three times* the national average, according to the *New York Times*. Paul Fronstin, director of the health research and education program at the Employee Benefit Research Institute, suggests that such extremely expensive plans are likely to have *no* co-payments or deductibles, *no* limits of virtually any sort on doctors or procedures, and *no* requirements for referrals.[6]

As another example, the *Boston Globe* recently described a plan that costs $20,400 a year in 2009 for family coverage — far less than the Goldman Sachs plan, but still 50 percent more than the national average. The plan provides $450 annually towards gym memberships, or $200 for home exercise equipment, and $150 for yoga classes or nutritional counseling. It also requires no cost sharing for many procedures and services and only modest cost sharing for others.[7]

Similarly, the National Education Association recently identified a dozen other costly insurance plans that might be affected by the excise tax.[8] These plans, too, generally have small or no deductibles, low copayments, and other features that tend to raise costs.

To be sure, not all concerns about the excise tax lack merit. To the contrary, some health insurance plans may have high costs not because they provide very generous benefits but for other reasons. But since it originally surfaced, the proposal has been modified to make allowance for some of these circumstances, and these changes have substantially improved the proposal. Some legitimate criticisms do remain. They, too, can — and should — be addressed.

- *High-Cost Regions.* Health insurance costs more in certain parts of the country. For example, some areas are marked by above-average wages and prices, less competitive markets, or an intensive style of medical practice. The Finance Committee proposal provides higher tax thresholds for high-cost states during a three-year transitional period. Three years is a modest period of time in which to address these factors, and Congress probably should make the transition period somewhat longer.

- *Age of the Workforce.* Some plans are costly because they cover workers who are older than average. Older workers tend to be less healthy and thus costlier to insure than younger workers. In fact, age is probably the single biggest reason why some plans' enrollees are less healthy, on average, than others'.[9] The Finance Committee proposal responds to this problem

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[6] Leslie Wayne and David M. Herszenhorn, "A Bid to Tax Health Plans of Executives," *New York Times*, July 27, 2009.

[7] Lisa Wangsness, "Healthcare overhaul could limit tax breaks on benefits," *Boston Globe*, July 4, 2009.

[8] Diane Shust, Director of Government Relations, National Education Association, Letter to Committee on Finance, United States Senate, October 5, 2009.

[9] The Finance Committee bill would limit the extent to which insurers could charge higher premiums to small firms with older workers; this is an important insurance-market reform. Insurers would still be able to charge such firms

by increasing the tax threshold for plans that enroll retirees over age 55. Congress should apply this adjustment as well to plans that cover workers over 55 who are not retired, since the key factor here is age rather than retirement status. Many public employee plans likely have higher costs in substantial part because they have a disproportionate share of older enrollees.

- *Collectively Bargained Plans*. Workers covered by collective bargaining agreements have given up cash wages, pension contributions, or other fringe benefits in exchange for more generous health insurance coverage. When these agreements come up for renewal, health benefits above the tax threshold can be converted into additional wages or pension benefits if the workers so desire. Although many current labor contracts will expire before 2013 when the excise tax provision would take effect, Congress should exempt collectively bargained plans that are now in place from the excise tax until the labor contract is renegotiated.

## Wages Will Rise, Not Premiums

Contrary to some reports, the excise tax is unlikely to generate much of an increase in health insurance premiums. Although insurers will try to pass along the cost of the excise tax to consumers by raising the price of health coverage, analysts generally expect that health insurance providers, employers, and consumers will modify their behavior to avoid paying the tax. For example, even the recent, widely criticized report from the consulting firm PricewaterhouseCoopers, commissioned by the insurance industry's trade association, admitted, "We expect employers to respond to the tax by restructuring their benefits to avoid it."[10]

Similarly, the JCT writes, "We expect that consumers will seek less costly policies that will reduce their exposure to the excise tax. Cost reductions could be achieved through several strategies, ranging from managed care plans and limited provider networks to more out-of-pocket cost sharing by consumers. When employers offer employees less costly plans, the employees will have less compensation in the form of non-taxable health care benefits and more in the form of [taxable] cash compensation."

JCT projects that only 20 percent of the revenues from the proposal in 2014 will come from the excise tax itself, with the remaining 80 percent coming from additional income and payroll taxes on the increased cash compensation that workers will receive. By 2019, fully 83 percent of the additional revenues will come from taxes on higher wages and salaries, not the excise tax.[11]

Based on the JCT figures, the excise tax will reduce spending on employer-sponsored insurance in 2019 by an estimated nearly $74 billion, or about 6 percent — an impressive amount that indicates the measure would be successful in helping to "bend the curve" — and lead to a commensurate increase of nearly $74 billion in wages and other fringe benefits.[12]

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significantly more than firms with younger workers, however, and medium-size firms with a disproportionately older workforce would not be affected by the reform.

[10] PricewaterhouseCoopers, *Potential Impact of Health Reform on the Cost of Private Health Insurance Coverage*, October 2009.

[11] Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation, "Memorandum: 40-Percent Excise Tax on High Coverage Health Plans," October 13, 2009.

[12] Jonathan Gruber, "Implications of the JCT Score of the High-Cost Insurance Tax," November 5, 2009.

### *New York Times'* Economics Writer David Leonhardt Examines the Excise Tax and Explains Why It Would Reduce Health Costs[a]

In a September 30 analysis of the proposed excise tax, the *New York Times'* David Leonhardt wrote:

"Insurance companies — technically the targets of the tax — would pass on the cost to employers, and employers would presumably pass it on to workers. The cost of insurance would rise. Or perhaps more likely, companies would stop offering such generous plans.

"Here's the big question, though: Would that be so bad?

"Currently, the health insurance you get from your employer isn't taxed, unlike almost all the rest of your compensation. So employers and workers have both fallen in love with generous plans. If an employer pays a worker an extra $100 in income, the worker may keep only $75 of it, while the government will get $25 in taxes. But if the employer puts that $100 toward health insurance, the worker will get all of it.

"This tax break causes us to buy more health insurance than we would if the playing field for taxes were level, much as the tax breaks for housing helped inflate the real estate bubble. In effect, the tax-free treatment is a subsidy for health insurers, doctors and hospitals. It encourages wasteful spending — the extra M.R.I., the brand-name drug that's no better than a generic, the cardiac-stent procedure that has no evidence of extending life (but does have some risk).

"If the Cadillac tax started to eat away at this tax break, you could expect three things to happen.

"First, employees would shy away from the most expensive plans. The evidence is pretty clear on this: when workers bear some portion of the cost of insurance, their choices change.

"In the 1990s, the University of California began charging its janitors, secretaries, professors and others employees a monthly fee for their health insurance plan — unless they chose the least expensive one. Many switched out of the most expensive plans, often to save as little as $10 a month, notes the economist Thomas Buchmueller. The change also led insurers to compete harder for people's business, improving the quality of the cheapest plans at the expense of the insurers' profit margins.

"Second, the most generous insurance plans really would become less generous, but the change would probably do nothing to harm people's health. The distinguishing feature of these gold-plated plans tends to be their lack of co-payments. The $20,400 family plan that a typical New Hampshire state employee has, for instance, includes free M.R.I's, as *The Boston Globe* has reported. And when M.R.I.'s are free, people tend to get more of them than their well-being requires.

"The most comprehensive study of health insurance, by the RAND Corporation, bears this out. People with Cadillac plans are no healthier than people with Chevy Malibu plans. (Similarly, Americans are no healthier than citizens of rich countries that spend far less on medical care.) "Taking someone who's uninsured and giving them insurance unambiguously improves their health," says Jonathan Gruber, a health economist at M.I.T., "but taking someone who's well-insured and making them really well-insured doesn't make them any healthier."

"Finally, we can expect that a Cadillac tax will, in the long run, increase workers' incomes. The money companies spend on health insurance, after all, doesn't come from nowhere. The more they spend on insurance, the less that's available for wage increases. This is why wage increases are often meager when insurance premiums are growing quickly, as has been the case over the last seven years or so."

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[a] David Leonhardt, "How a Tax Can Cut Health Costs," *New York Times*, September 30, 2009.

As a result of these higher wages and the payroll taxes paid on them, affected workers will receive higher Social Security benefits when they retire or become disabled, and the solvency of Social Security will be modestly improved.

Even after the modifications to high-end health plans to fit under the threshold for the excise tax, participants in those plans will continue to have very good health coverage — they will still have coverage substantially more comprehensive than most other Americans do. And, as noted, they will receive higher wages.

## Conclusion

The Finance Committee took several significant steps to address legitimate concerns about the excise tax. To address the remaining issues, we recommend that Congress make targeted changes in the excise tax thresholds (rather than changes in the base thresholds) to resolve specific problems, while minimizing the loss in revenues:

- Increase the tax thresholds for plans that insure workers or dependents over age 55, not just retirees over 55.
- Lengthen the transition period for high-cost states beyond three years.
- Exempt collectively bargained plans from the excise tax until the contract is renegotiated.

With these changes, the excise tax can play a vital role in financing health care reform, avoiding increases in deficits in future decades, and slowing the growth of health care costs.

The Finance Committee's health reform bill represents a very substantial improvement over the current health insurance system. However, it also has some significant shortcomings. The biggest problem is that the premium tax credits in the bill need to be stronger to make insurance affordable for more people of modest means — and thereby to enable the mandate for people to have insurance to be strengthened. Otherwise, the new health insurance exchanges could be faced with a sicker-than-average pool of beneficiaries, which would drive up insurance premiums and threaten the ability of the exchanges to function effectively. This issue is at the heart of making health reform work. And addressing it will require increased expenditures for premium tax credits — which means that Congress will need to find more, not fewer, offsets. Removing or seriously weakening the excise tax would make it even more difficult to address this crucial issue and strengthen the premium credits, and thus would weaken the prospects for effective health reform.