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Assessing the American Health Care Act: Moving Toward a Fair Federal Tax Treatment of Health Insurance

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In assessing the proposed American Health Care Act (AHCA), H.R. 162,[1] the tax policy provisions should be evaluated in terms of their impact on health care costs, particularly the premium costs facing individuals and families.

The federal tax treatment of health insurance is a central issue in health insurance market reform.[2] Under current law, rooted in World War II–era tax policy, Americans enjoy unlimited tax relief if—and only if—they get their health insurance coverage through the place of work. Technically, this tax break is referred to as the "tax exclusion" for employees with job-based health insurance, meaning that for purposes of calculating a worker's tax liability (federal income and payroll tax liability), their group health insurance coverage is excluded from their taxable compensation. The Congressional Budget Office (CBO) estimates the value of the federal tax exclusion at $275 billion annually (in 2016 dollars), identifying it as the "largest single tax expenditure by the federal government."[3]

In 2010, the Obama Administration and its allies in Congress focused laser-like on the revenue potential of taxing employer-based plans, as one of the many tax measures used to finance the law's major entitlement expansions. Thus, in enacting Obamacare, they included a "Cadillac tax" on "high cost employer-sponsored health coverage."[4] That provision imposes a 40 percent excise tax on the portion of health-plan spending that exceeds specified maximum levels—projected to be $10,800 for self-only coverage and $29,100 for family coverage in 2020. The tax was originally scheduled to take effect in 2018, but Congress subsequently delayed the effective date until 2020. According to the CBO, by 2025, the cumulative revenue from the tax would amount to $70 billion.[5]

What the AHCA Does

Concerning tax policy, the House bill would repeal 12 specific Obamacare taxes, effective in 2017, as well as the individual and employer mandate tax penalties. According to the CBO, between 2017 and 2026, revenue reductions from the bill's tax cuts would amount to $882.8 billion.[6] However, the bill leaves the Cadillac tax intact.

The House bill does not repeal Obamacare's 40 percent excise tax on "high-cost" employer health plans, but merely further delays its implementation until 2026. In other words, any amount above the statutory thresholds would, beginning in 2026, be subject to this punitive tax. Because the thresholds for this tax on health plans are indexed to general inflation, as measured by the Consumer Price Index (CPI), which increases more slowly than growth in health spending, the number of workers in employer coverage that would be affected by the tax is projected to increase rapidly over time. The major purpose of Obamacare's insurance excise tax was to raise revenue to finance Obamacare programs, not to initiate any comprehensive reform of federal health insurance tax policy that would control the growth of health care costs.

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Furthermore, the AHCA does not address the inequitable and inefficient federal tax treatment of health insurance, especially the tax exclusion. The federal tax exclusion on insurance is the major policy-driven contributor to increased cost growth. The CBO notes that it contributes to increased health care spending because the "open-ended" tax break encourages people to enroll in health plans that cover a large number of medical services while encouraging employees to pay "a smaller share of the costs."[7] In short, it drives over-insurance, and thus the excessive reliance on third-party payment for medical services.

The fact that current federal tax policy is a systemic driver of health insurance costs is attested to by independent analysts and top economists across the political spectrum.[8] Because it is offered only to those who obtain health insurance through their place of work, this federal tax policy also undermines portability of coverage, and contributes to the opacity of health care costs. It is inefficient and regressive in its application to American workers and their families, and it profoundly distorts the health insurance markets and directly undercuts consumer choice and competition. Thus, the retention of current law has a major negative impact on the health care sector of the economy.

In an earlier draft of the AHCA in February, House leaders proposed to repeal the unpopular Cadillac tax and replace it with a cap on the unlimited tax exclusion on employer-sponsored health insurance. This would have been a major contribution to health care cost control. As Dr. Hanming Fang, professor of economics at the University of Pennsylvania, observes, "A cap would be designed to incentivize workers to select plans that offer fewer benefits and include more cost-sharing, which economists generally endorse because cost-sharing helps to reduce unnecessary health care spending, *which in turn could drive down costs throughout the entire system*."[9] (Emphasis added.)

Capping the exclusion would, over time, also generate a substantial portion of revenue, and help achieve the longtime conservative goal of establishing a competitive, consumer-driven market for health insurance through the provision of individual tax relief for persons who do not, and cannot, get health insurance at their place of work. As an illustrative example: The CBO has previously scored different versions of the cap on the exclusion, with different 10-year revenue estimates, ranging from $193 billion to $476 billion.[10] Capping the exclusion, as Congress caps every other employee tax-favored benefit, would also be less disruptive than implementing the Cadillac tax. Additionally, it would be more equitable, efficient, and would make the overall legislative product less expensive.

The version of the House bill unveiled on March 6, 2017, dropped the proposed cap on the tax exclusion and kept the Cadillac tax, rescheduling its imple-

1. The American Health Care Act of 2017, https://www.gpo.gov/fdsys/pkg/BILLS-115hr1628rh/pdf/BILLS-115hr1628rh.pdf (accessed April 17, 2017).
2. Edmund Haislmaier, Robert E. Moffit, and Alyene Senger, "Fairness in the Federal Tax Treatment of Health Insurance: The Linchpin of Real Reform," Heritage Foundation *Issue Brief*, No. 4659, February 24, 2017, http://www.heritage.org/sites/default/files/2017-02/IB4659_0.pdf.
3. Congressional Budget Office, Options for Reducing the Deficit: 2017–2026, December 2016, https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/52142-budgetoptions2.pdf (accessed April 17, 2017).
4. 26 U.S. Code § 4980I.
5. Congressional Budget Office, "Private Health Insurance Premiums and Federal Policy," February 11, 2016, https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51130-Health_Insurance_Premiums.pdf (accessed April 17, 2017).
6. Congressional Budget Office, "Cost Estimate of the American Health Care Act," Tables 2 and 3, March 13, 2017, https://www.cbo.gov/publication/52486 (accessed April 17, 2017).
7. Congressional Budget Office, "Options for Reducing the Deficit: 2017–2026," p. 271.
8. Grace Marie Arnett, ed., *Empowering Health Care Consumers Through Tax Reform* (Ann Arbor, MI: University of Michigan Press, 1999). See also, Joseph R. Antos and James C. Capretta," Republicans Should Take the Time Necessary to Improve the American Health Care Act," American Enterprise Institute, March 10, 2017, https://www.aei.org/publication/republicans-should-take-the-time-necessary-to-improve-the-american-health-care-act/ (accessed April 17, 2017).
9. Hanming Fang, "The Economic Realities of Replacing the Affordable Care Act," Penn Wharton Public Policy Initiative *Issue Brief* Vol. 5, No. 3 (March 2017), p. 7, https://publicpolicy.wharton.upenn.edu/live/files/271-a (accessed April 17, 2017).
10. Congressional Budget Office, "Options for Reducing the Deficit: 2017–2026," p. 269.

mentation in 2026.[11] This was a significant retreat. As Joseph Antos and James Capretta remarked, "Removing the tax cap eliminates the most effective tool to discipline cost growth and perpetuates a significant distortion in tax and health care policy."[12]

The result is a serious missed opportunity. Though Congress might revisit the federal tax exclusion in future tax reform legislation, both organized labor and powerful corporate interests are likely to remain strongly opposed to change. Congress should nonetheless resist the preservation of the status quo, especially in light of its inequity, inefficiency, and utter incompatibility with the creation of a revitalized health insurance market driven by consumer choice and real free-market competition.

Repeal the Cadillac Tax and Cap the Exclusion

Congress should repeal the Cadillac tax effective in 2020 and establish a cap on the tax exclusion for group coverage. For the cap, Congress could set the base at the estimated level for the imposition of the Cadillac tax on "high cost" health plans beginning in 2018: $10,200 for individual coverage, $27,500 for family coverage, and index these thresholds to inflation. This would be superior to the Cadillac tax as a cost control measure because, unlike the cap, it would not force employers to alter their benefit plans, but would simply limit the amount of employer-sponsored benefits counted as employees' pre-tax compensation. Workers could still buy additional coverage with after-tax dollars, just as employers could still offer richer coverage that exceeds the capped amount. In either case, a cap would encourage both employees and employers to explore a more rational balance between health care spending and wage increases: Every one-dollar increase in health benefits is roughly equal to a dollar decrease in wages and other compensation.[13]

Conclusion

The AHCA's repeal of the tax penalties that accompany Obamacare's individual and employer mandates are important steps in the right direction. The bill falls short, however, by failing to address the central tax policy issue that dominates American health care policy. By failing to apply a cap to the unlimited tax exclusion, the latest version of the House bill guts a crucial component of health reform.

If congressional leaders are serious about controlling the growth of health care costs, and thus making insurance premiums more affordable for millions of Americans, they must reform the health insurance markets. Congress cannot accomplish that goal effectively, and lay the groundwork for a genuine consumer-driven market in health insurance and health care, unless it reforms the tax treatment of health insurance. That begins with capping the exclusion, and creating an equitable system of individual tax relief.

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11. The American Health Care Act, Section 207.
12. Antos and Capretta, "Republicans Should Take the Time Necessary to Improve the American Health Care Act," p. 3.
13. Edmund F. Haislmaier, "House Republican Health Care Bill Misses the Mark," The Daily Signal, March 7, 2017, http://dailysignal.com/2017/03/07/house-republican-health-care-bill-misses-the-mark/.