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The Case for Taxing Employer-Sponsored Health Insurance

As Congress continues its debate over healthcare reform, one of the central issues is how to expand access to health insurance while controlling skyrocketing costs. One proposal, which has partial endorsement from the President, involves taxing employer-based health insurance benefits. To understand the implications of such a tax, it is important to examine how employer-based health insurance has become ingrained in the American healthcare system.

The current employer-based system of health insurance has been in place for almost 70 years. During World War II, to combat the threat of inflation during and after the war, wage freezes were implemented by Congress.[1] A key ruling by the War Labor Board found that health insurance and other fringe benefits did not constitute wages and, as such, did not violate wage control laws.[1] Logically, firms began to offer health insurance as a way to attract skilled labor. In 1954, the IRS ruled that health insurance offered through employers would not be taxed.[2] This was a major policy decision with significant implications for employers, employees, and the US Treasury. The tax policies surrounding employer-based health insurance led to employer-based health insurance becoming deeply rooted in the American economy. By 2008, employer-sponsored health insurance covered 60% of the non-elderly and amounted to a subsidy of $200 billion annually.[3]

There are several implications of a tax code that allows for tax-free employer-sponsored health insurance. Foremost, a tax subsidy for employer-based health insurance creates an incentive to purchase the most expensive health insurance plans. This has two key consequences. First, employees have an incentive to devote more of their compensation to health insurance rather than cash wages and thus, must forgo other expenditures.[4] While employees have less money to consume other goods, they have health insurance plans that provide benefits they may not need. As a result, individuals may utilize more healthcare services, causing inflationary pressure in healthcare. Second, this tax subsidy is inequitable because it provides a larger tax break to individuals in higher marginal tax brackets. For example, it is estimated that the current tax subsidy will save $2,780 for a family with an income greater than $100,000 a year. However, the same subsidy will only save $102 for a family making less than $10,000 a year.[5]

The current system of employer-sponsored health insurance covers 60% of Americans.[6] The other Americans are either uninsured (16%) or are covered through Medicare or Medicaid (24%). Many individuals who do not have health insurance or are unable to pay for healthcare, still receive care. Yet, there are significant costs associated with the care that hospitals provide for those who are unable to pay. A study by the Urban Institute in 2001 showed that of the $35 billion dollars in uncompensated care delivered to the uninsured, $30 billion was financed by the government.[7] A report by the Heritage Foundation suggests that healthcare costs for the uninsured will raise the overall cost of health insurance premiums by $948 for families and $322 for individuals.[5] The issue of the tax subsidy greatly affects all US citizens.

As members of Congress debate the future of healthcare in America, they must seriously consider reforming the current tax policy. Although Congress has not determined at what amount to tax benefits, economists have argued that the tax benefit should be capped at $840 per person and $2,100 per family in a year.[8] Therefore, the additional benefit above the tax cap would be taxed and could then be used to finance healthcare services for the uninsured. The tax cap plan would also help control healthcare costs. A strong case can be made that with a tax cap, more people would shift to healthcare plans that require greater cost sharing. By adopting health plans in which there are high copayments, individuals will be more conscious of the services they purchase. This could ideally reduce unnecessary healthcare spending and thus help control cost.[8]

Tax reform can be a good start to overall healthcare reform. However, it is not a solution by itself and must be coupled with overarching reform of the entire system. ■

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