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New Research from EBRI:

Study Says Changing Tax Treatment of Health Benefits Could Mean the End of Employment-Based Coverage

WASHINGTON – Proposals to change the tax treatment of health insurance could mean the end of employment-based coverage as it now exists in the United States, according to a study released today by the nonpartisan Employee Benefit Research Institute (EBRI).

Currently, the vast majority of U.S. residents with health insurance receive coverage through an employer. The most recent data show that about 62 percent of workers and their dependents (161.7 million individuals under age 65) had some form of employment-based health benefits, while about 7 percent (17.7 million) bought insurance directly from an insurer, and 18 percent (46.5 million) were uninsured.

Of the various options to change the way health benefits are taxed, the EBRI report identifies the proposed “tax cap” on the health insurance exclusion that workers currently receive as most likely to cause the end of employment-based health benefits. This change would be likely to prompt younger and healthier workers to drop out of the employment-based system, causing adverse selection in the remaining pool of older and less healthy workers, thereby resulting in a so-called “death spiral” that makes employment-based group health insurance unsustainable.

Although the current Congress is expected to ignore President Bush’s 2007 State of the Union proposal for fundamentally changing how health insurance is taxed, his concept seems certain to survive the end of his administration, says the study in the September 2007 *EBRI Issue Brief,* available at www.ebri.org. Bipartisan tax plans have been introduced in the Senate, and several 2008 presidential candidates have proposed overhauling the taxation of health benefits.

Estimates vary widely on how tax treatment changes would affect the level of uninsured Americans, with advocates claiming 3 million to 9 million fewer uninsured as a result. But even if this is achieved, nearly 40 million individuals would remain uninsured. In fact, the study says, changing health insurance taxation will fundamentally change the way health care is financed in the United States.

“However the system is changed, the nation’s health may rest in the balance,” write the study authors, Paul Fronstin, director of the EBRI health research and education program, and Dallas Salisbury, EBRI president.

Currently, employers can deduct the cost of health insurance coverage they provide to their workers as a business expense (without limit), and the value of the health insurance coverage workers receive from their employers is excluded from their taxable income (without limit). The study examines in detail three proposals to change this tax treatment, who would be affected, and how:

- **A tax cap:** "Capping" employers' tax deductions for health coverage, and/or workers' exclusion for health care benefits, could mean the end of employment-based health benefits. A tax cap would mean a tax increase for some individuals, and the tax increase could be driven by health status and geography more than it is driven by the comprehensiveness of the insurance.
- **Tax caps and cost containment:** A cap on workers' exclusion for health insurance probably would not have much impact on the comprehensiveness of health benefits, at least initially. Over time, the impact of the cap on the tax exclusion should grow as long as insurance premium growth exceeds overall inflation, but it could be many years before the higher taxes are a large enough burden to drive people toward less comprehensive benefits.
- **Tax credits:** The ability of a tax credit to reduce the uninsured population depends heavily on several key design issues, such as the size of the tax credit relative to income and income levels overall. Previous research has shown that even very generous tax credits may not be large enough for a major portion of the low-income population to purchase health insurance.

At least two factors are driving calls to change the tax treatment of health benefits, the study says. The first is a longstanding debate over whether employers should be encouraged to provide health insurance with special tax preferences, or whether the emphasis should be on an individual market and individual choice. The intensity of this debate has increased in each of the last four decades and shows no signs of lessening, the study says.

In addition, as pressure grows to deal with long-term deficits and the pending insolvency of Social Security, Medicare, and Medicaid, fundamental tax reform is likely to find its way onto the national agenda. According to the study, health benefits loom as a big potential target for raising revenue in the future. President Bush's 2008 budget estimates all employee benefits-related "tax expenditures" (government revenue foregone due to special tax treatment) will amount to $328 billion next year, or 34 percent of the $961 billion worth of total tax expenditures in the federal budget. Tax-favored employment-based health insurance benefits account for the largest single tax expenditure: almost 17 percent of the total amount and almost 49 percent of all employee benefits-related tax expenditures.

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