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The Uncertain Future of the Affordable Care Act's Cadillac Tax

EYE ON WASHINGTON: GAIL R. WILENSKY

THE AFFORDABLE CARE ACT (ACA) HAS BEEN CHARACTERIZED BY SOME AS "COMPREHENSIVE HEALTHCARE REFORM." IN REALITY, HOWEVER, ITS FOCUS IS MORE LIMITED, BEING PRIMARILY CONCERNED WITH HEALTHCARE COVERAGE EXPANSION AND INSURANCE REFORM, WITH SOME FUNDING FOR PILOT PROJECTS AIMED AT DEVELOPING INNOVATIVE PAYMENT STRATEGIES FOR POSSIBLE USE BY MEDICARE AND MEDICAID.

Most of the claims crediting the ACA with lower observed spending seem to me to be wishful thinking—especially given the timing of the spending slowdown, which points to another, more plausible cause. The Organization for Economic Co-operation and Development (OECD) recently published a study that found evidence of dramatic slowing in healthcare spending since 2009 across all OECD countries, presumably a consequence of the "Great Recession" and the sluggish recovery that has kept wages low"

Nonetheless, two of the ACA's provisions are aimed directly at slowing spending: the 15 member Independent Payment Advisory Board (IPAB), and the Cadillac tax, a 40 percent excise tax on employer-provided healthcare coverage where total premiums exceed $27,500 for a family or $10,200 for an individual, to be paid by employers starting in 2018. The focus here is on the Cadillac tax.

Related Sidebar: The Independent Payment Advisory Board and Related Concerns

The Cadillac tax is a politically expedient version of a tax cap—i.e., a limit on the value of employer- sponsored insurance that an employer can provide to an employee free of income and social security taxes. Within the initial healthcare reform package proposed by the Senate, this provision was intended to place a limit on the amount of an employer's contribution to insurance that employees would be permitted to exclude from their personal income tax. The legislation as signed into law, however, placed the tax on the employer. Employers clearly are expected to adjust their insurance offerings to stay below the limit or pass on the excise tax to the employee in the form of lower wages.

Unions and other groups that have negotiated expansive insurance packages have been opposed to the Cadillac tax since the beginning, but because the legislation delayed the tax's effective date until 2018, other, more immediate issues have claimed political attention. Over the past year, however, the Cadillac tax has garnered increased attention as employers have begun to consider the effects of a 40 percent tax on total premiums above the specified limits for families and individuals. Current estimates are that 25 percent of employers will exceed the limit by 2018 unless they change their offerings to reduce their total cost for the coverage—which, of course, is the whole point of having such a limit.

Support for the Tax—or a Viable Alternative

Putting limits on the amount of employer- provided insurance that can be offered tax-free has become a mantra for almost all economists for the past several decades. The reason is that by offering health insurance as a tax-preferred type of compensation relative to wages, employees are encouraged to take more of their compensation as insurance than they would if the choice between insurance and wages were tax-neutral.

The current approach has two consequences. First, people with broader or more comprehensive insurance are inclined to spend more on health care because they have little incentive to look for cost-effective, high-value care. Second, the benefit is largest for those with the highest incomes. Sheltering compensation from taxes means little to people with low incomes, and the value of the exclusion increases as a person's income increases. For these reasons, economists have tended to regard the current tax treatment as being inequitable and inefficient.

I was a part of a group of 101 economists and policy analysts from across the political spectrum who signed a letter sent on Oct. 1 to the chairs and ranking members of the Senate Committee on Finance and the House Committee on Ways and Means urging them not weaken or delay the Cadillac tax unless an alternative tax change is enacted that would effectively curtail cost growth.[b]

Like many economists, I would prefer to limit the tax exclusion so that any excess contribution from an employer becomes ordinary taxable income to the employee. It is much clearer and cleaner when individuals have a fixed limit on the amount of coverage they can receive tax-free, with any overage being taxed at the appropriate marginal tax rate. This approach also is more progressive because the marginal tax rate for individuals rises as income rises, and most employees will fall well short of the premium amounts that would make them subject to the 40 percent excise tax.[c]

Nonetheless, in the absence of such an approach, I believe the Cadillac tax offers an acceptable alternative.

Opposition to the Tax

Unfortunately, notwithstanding the support from economists, overall support for the Cadillac tax appears to be declining, including among the public—although the public's perspective depends on how the question is framed. According to a September Kaiser Tracking Poll, 60 percent of respondents initially said that they oppose the Cadillac tax, but a majority of respondents (55 percent) said they favor the tax after hearing the tax could help lower healthcare costs.

Republicans and Democrats have introduced bills to repeal the tax, without paying for it. Among the 2016 presidential candidates, former Sen. Hillary Clinton (D-N.Y.) and Sen. Bernie Sanders (I-Vt.) both have come out against it, with Clinton urging Congress to pay for its repeal, while former Gov. Jeb Bush (R-Fla.) has proposed replacing the tax with a more traditional tax cap.

Objections have been raised that the ceiling that triggers the excise tax provides very different levels of insurance in different parts of the country. Although it would be unusual for a tax allowance to be adjusted for cost of living, there's no reason it couldn't be done.

Rationale for Retaining the Tax

The $91 billion price tag over eight years associated with the Cadillac tax may be its biggest "insurance policy" to date. Removing it without replacing the lost revenue will be a tough sell to a Republican Congress. But the best rationale for retaining the Cadillac tax is that it removes the inefficient, regressive distortion between health insurance and wages introduced during World War II, when fringe benefits become a popular means for circumventing the wage controls that were in place at that time.

Meanwhile, the OECD is projecting an increase in healthcare spending over the next two decades. That means measures that are designed to help slow spending—including the Cadillac tax—may become increasingly attractive.

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Footnotes

a. "The Pause Before Fast Forward," *The Economist*, Oct. 10, 2015.

b. To read the letter, go to www.cbpp.org/sites/default/files/atoms/files/cadillac_tax_letter.pdf.

c. Ginsberg, P.B., White, C., Ebner, C., and Nowak, S., "Limiting Tax Breaks for Employer-Sponsored Health Insurance: Cadillac Tax vs. Capping the Tax Exclusion," National Institute for Health Care Reform, October 2015.

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