

Would the Senate Democrats' proposed excise tax on "high-cost" employer-paid health insurance benefits be progressive?

Summary

Senate Democrats have proposed a new, very-high-rate excise tax on employer-paid health insurance benefits that exceed certain levels. The goal is to force employers to eliminate such "excessive" benefits. Congressional analysts assume that employers then will replace their employees' lost health insurance benefits with increased taxable cash wages. Proponents of the plan argue that this trade-off would be a progressive reform to the tax code.

Based on data from the Joint Committee on Taxation (JCT) and our own separate analysis, we conclude the following:

- Even if employers do replace all of the dropped health insurance benefits with taxable wages, the result will be to make the overall federal tax system less progressive than it is now.
- While the excise tax proposal would impose only modest burdens on the wealthy, it would noticeably lower living standards, not to mention health security, for tens of millions of Americans.
- By 2019 about 58 million people would be adversely affected by the excise tax. That number would continue to rise rapidly in subsequent years.
- As shares of income, the proposed tax increases would be 10-20 times as high on middle-income families as on the very rich.

There are other options to pay for health insurance reform that would actually be fair and progressive, such as the high-income surcharge on the richest 0.5 percent of taxpayers included in the House of Representatives health reform bill.

A. Background

Senate Democrats have proposed a new tax on a portion of employer-paid health insurance. Under the plan, health insurance benefits in excess of certain amounts would be subject to an extremely high excise tax. The rate is nominally 40 percent. Unlike health benefits or wages, however, the excise tax would not be deductible by taxable employers in computing their federal and state taxable income. So for most employers, the real excise tax rate is about 66 percent.

Congressional analysts at the Congressional Budget Office and the Joint Committee on Taxation are confident that the vast majority of employers, public or private, will be unwilling to pay such an onerous tax. Instead, they predict that all but a handful of employers will instead reduce their employees' health benefits to avoid the excise tax.

What will employers do with the money that they used to spend on so-called "excessive" employee health benefits? Congressional analysts argue that all of it will be used to increase workers' taxable wages. That theory is not universally accepted.¹ But even if it is true, it does not

¹Congressional analysts offer the plausible argument that employers have a fixed amount they are willing and able to pay their workers, whether in cash wages or benefits, and that if health benefits are reduced by a certain amount, then wages will inevitably go up by the same amount. But the real world may not work so neatly. For example, employers may be more willing to fund health insurance than to pay higher cash wages, since employers directly benefit from having healthier employees. Or take the case of public employees, where increases in cash wages are typically subject to more serious political constraints than generous health benefits.

mean that affected workers will be just as well off. The after-tax increase in their wages will be considerably less than the value of their lost, untaxed health insurance benefits.²

The caps above which the proposed health insurance excise tax will apply are set at \$23,000 for family plans and \$8,500 for individual plans, starting in 2013. These might seem like very high amounts, but they will dwindle rapidly in real terms over time. That's because the caps will be indexed only for general inflation plus one percent, rather than for the much higher rate of expected health care inflation. As a result, according to the Joint Committee on Taxation, the number of families and individuals who will be affected by the new tax will grow rapidly. from 9.1 million couples, single parents and singles without children in 2013 to 24.6 million "tax units" by 2019, with continued rapid growth thereafter. According to our estimate, those 24.6 million tax units hit by the excise tax in 2019 will include about 58 million men, women and children.³

B. Would the proposed health excise tax be progressive?

Tax breaks are termed "regressive" — and their elimination is called "progressive" — if they provide a disproportionate benefit to high-income people compared to the less well-off. This can be true for several reasons.

- 1. Regressive subsidy rates:* Tax deductions that reduce income subject to income tax are often called regressive because they are worth more per dollar deducted to people in high tax brackets than they are to people in lower tax breaks. An example of this would be the itemized deduction for mortgage interest payments, which saves top-bracket homeowners 35 cents for every dollar deducted, compared to only 15-25 cents per dollar deducted for most homeowners.
- 2. Concentration of benefits:* Tax breaks for kinds of income that are concentrated among the highest income people are also considered regressive. An example of this is the special low tax rates on capital gains and dividends. More than 70 percent of this tax break is enjoyed by the best-off one percent of all taxpayers.
- 3. Effects on overall tax progressivity:* Another measure of regressivity asks whether a tax break reduces the overall progressivity of the tax system. For example, a tax break that cuts the effective tax rate on the wealthy by 10 percentage points, but only lowers effective rates on most people by a small percentage would be considered regressive. Tax breaks for capital gains would be regressive by this measure, while the regressivity of the deduction for mortgage interest would be less clear.

After a detailed analysis, we conclude that converting a portion of health insurance benefits into taxable wages would not be significantly progressive by *any* of these measures, and would be regressive by most. **On balance, it would make the overall tax system less progressive than it is today.**

²The analysis in the rest of this report follows the congressional analysts' assumption that lost health benefits will translate into higher taxable wages, but that should be treated as the best-case scenario. The analysis also reflects the analysts' conclusion that, contrary to claims by some commentators, the excise tax will *not* lead to reduced health care inflation over the next decade.

³The 24.6 million "tax units" that the Joint Committee on Taxation (JCT) says would be affected by the excise tax include 12.6 million married couples, 3 million single parents, and 9.1 million childless single people. We took the average family sizes for each of these categories, by income group, and multiplied that by JCT's estimate of the number of tax units affected by income group for each category. (Married couples average about 3.3 people per tax unit, with slight variations by income level; single-parent families average about 2.5 people; and childless-single tax units average about 1 person.)

1. Regressive subsidy rates? Not Really.

Converting a portion of tax-free health insurance to taxable wages (if in fact that is the result of the proposed excise tax), will mean not just higher income taxes but also higher payroll taxes on the affected employees. And when we look at the combined income taxes and payroll taxes that people will pay on their additional taxable wages, those rates are hardly, if at all, progressive.

Simply put, for workers in the 15 percent income tax bracket, the payroll tax adds another 15 percent, for a total federal tax rate on additional taxable earnings of 30 percent.⁴ Better-off workers in the 25 percent income tax bracket have a combined “marginal” tax rate on additional taxable earnings of 40 percent. But at the highest income levels, where earnings are above the Social Security wage cap, the payroll tax is only the 2.9 percent Medicare tax. So even for the highest earners, currently in the 35 percent income tax bracket, the total federal marginal rate on additional taxable earnings is 37.9 percent. Thus, even these simplified examples show that there is only a small (and wobbly) amount of progressivity in federal marginal tax rates on earnings.

The tax code, however, is not quite that simple. A look at a few real-world examples calls into question even the just-described shaky bit of progressivity. For example:

- Take a single parent with two children and \$35,000 in wages. If, say, \$4,000 of this family’s health insurance benefits are converted into taxable wages, the family will pay an additional \$2,046 in federal taxes, including \$557 in additional income tax before credits, \$569 in increased payroll taxes, \$138 in reduced child care credit, and \$783 in reduced earned-income tax credit. That’s a tax rate of 51 percent on the additional cash wages.⁵
- Now look at a married couple with two children with joint wages of \$110,000. If \$4,000 of their health insurance becomes taxable wages, they’ll pay an additional \$1,673 in federal taxes. That’s a tax rate of 42 percent on the additional cash wages.
- For a couple making \$250,000, the tax rate on \$4,000 in additional taxable wages falls to 31 percent.
- And for the very rich, the actual federal tax rate would be about 36 percent.

Bumpy, to be sure, but more regressive than progressive.

Example:

Single parent with 2 children and \$35,000 in taxable wages

Federal taxes now	
Adjusted Gross Income	\$ 35,000
Deductions	8,350
Exemptions	10,950
Taxable income	15,700
Income tax before credits	1,758
Per child credit	2,000
Child care credit	1,476
Earned-income tax credit	1,115
Income tax after credits	-2,834
Social security tax (worker & employer)	4,340
Medicare tax (worker & employer)	1,015
Income & payroll taxes	\$ 2,521

Reduce health insurance benefits by \$4,000 and add \$3,716 to taxable wages*

Revised federal taxes		changes
Adjusted Gross Income	\$ 38,716	\$ +3,716
Deductions	8,350	—
Exemptions	10,950	—
Taxable income	19,416	+3,716
Income tax before credits	2,315	+557
Per child credit	2,000	—
Child care credit	1,338	-138
Earned-income tax credit	333	-783
Income tax after credits	-1,356	+1,478
Social security tax (worker & employer)	4,801	+461
Medicare tax (worker & employer)	1,123	+108
Income & payroll taxes	\$ 4,568	\$ +2,046
Tax rate (on \$4,000 in lost health benefits)		51%

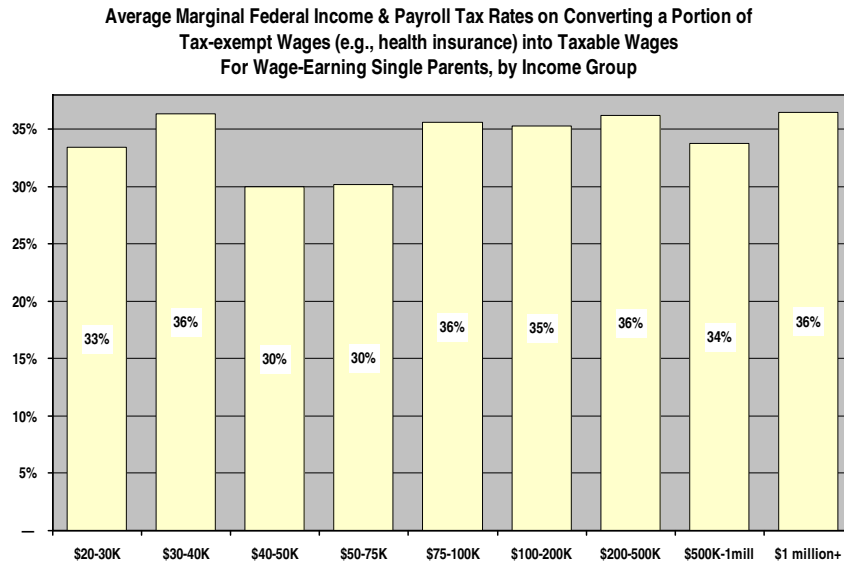
*The \$284 employer payroll tax on the \$4,000 in reduced health benefits and increased taxable wages will be subtracted before taxable wages are paid.

⁴The payroll tax includes the Social Security tax, which applies to earnings up to a cap (currently \$106,800) and the Medicare tax (which applies to all earned income). The Social Security tax rate is 12.4% and the Medicare tax rate is 2.9%, for a total of 15.3% for the vast majority of workers whose wages are below the Social Security wage cap. Nominally, the payroll tax is split evenly between employers and workers (7.65% each, for workers below the wage cap). But analysts universally conclude that workers ultimately bear the full amount of the tax, even though the payments to the government (for both worker and employer taxes) are made by employers. (Self-employed people, who have no employer, pay the full 15.3% tax themselves.)

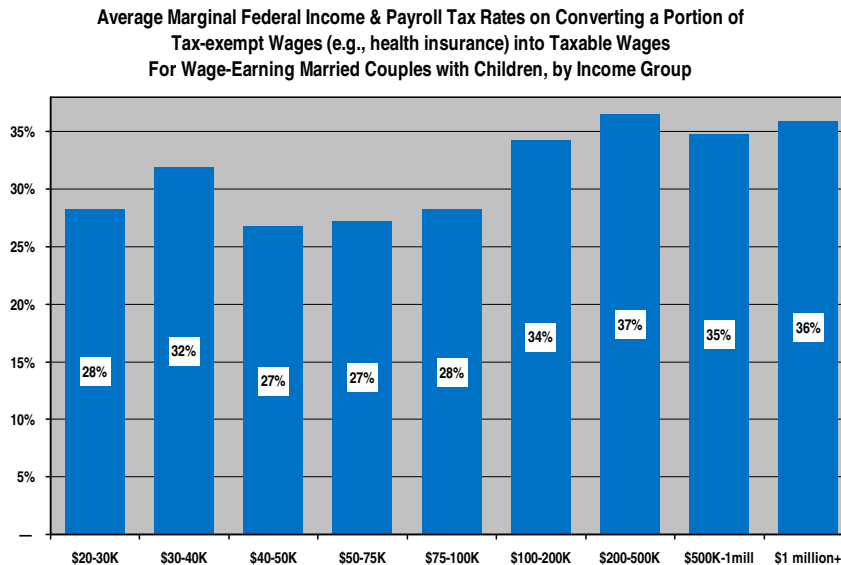
⁵It may surprise many people, but this is the federal income and payroll tax rate such a family would pay on *any* \$4,000 increase in taxable wages.

To get beyond anecdotal examples, we ran the effects of converting a portion of tax-exempt health insurance benefits into taxable wages through the Institute on Taxation & Economic Policy’s computer model, which takes account of all the various elements of the income tax, such as phase-ins, phase-outs, alternative minimum tax effects, and so forth.⁶ Here are the findings (using 2009 income tax rates):

(a) For wage-earning single parents, the tax rate on the increased taxable wages would be essentially flat across all income groups from \$20,000 to over a million dollars. Single parents making \$30-40,000 would pay the same 36 percent rate as those making more than \$1 million.

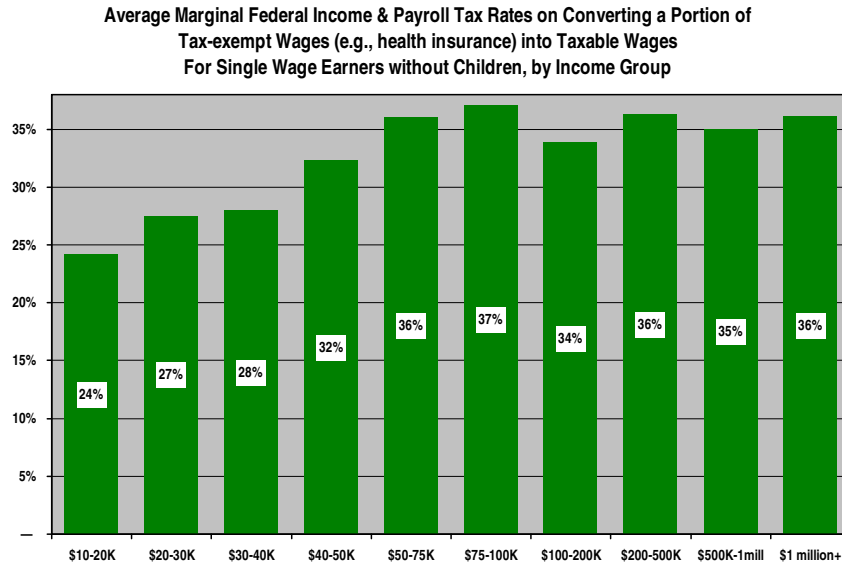


(b) For wage-earning married couples with children, the tax rates on the increased taxable wages would be only slightly progressive, averaging about 28 percent in the \$20-100,000 income ranges, and about 35 percent above that.



⁶Technically, we added \$2,000 to the taxable wages of all wage-earning tax units, and asked the model to calculate how much additional federal income and payroll taxes would be owed on that \$2,000 (and from that we calculated the “marginal” tax rate). For married couples, we assigned the additional wages to the spouse with the higher wages, because that spouse is more likely to have the more expensive (or sole) health insurance policy.

(c) For single wage earners without children, the marginal tax rates would be an essentially flat rate of about 35 percent for all groups from \$40,000 up. And even for those making less than \$40,000, the marginal rate percentages would be in the mid to high twenties.



Of course, one could find a modest amount of progressivity in at least one of the tax-rate graphs shown here. But it's very modest at most. And even that will be reduced once state income taxes, which will almost certainly apply, are counted, too.⁷

2. Will the new taxes from limiting the tax break for health insurance be primarily paid by the rich? No.

A new tax that by 2019 will hit 25 million families and individuals (representing 58 million people) cannot by definition be concentrated solely or even primarily on the wealthy.

To be sure, the new excise tax will affect a higher percentage of better-off people than others. But data from the Joint Committee on Taxation indicate that:

- Only about 3.4 percent of the total new taxes produced by the excise tax will be paid by the top 0.8 percent of all taxpayers.
- In contrast, 36 percent of the new taxes would be paid by the 27 percent of individuals and families making between \$50,000 and \$100,000.

Who will pay more taxes in 2019 under the Senate Democrats health insurance excise tax?

	% of all tax units	% affected by excise tax	% of total number affected	% of total tax paid
<\$20K	27.7%	2%	3.5%	0.5%
\$20-50K	26.9%	12%	23.0%	12.3%
\$50-75K	15.9%	19%	22.0%	19.9%
\$75-100K	10.9%	20%	15.9%	16.1%
\$100-200K	14.4%	26%	26.4%	35.5%
\$200-500K	3.4%	31%	7.5%	12.2%
\$500K-\$1m	0.5%	31%	1.1%	2.1%
\$1million+	0.3%	31%	0.6%	1.3%
All	100.0%	14%	100.0%	100.0%
Addendum:				
<\$100K	81.5%	11%	64.3%	48.8%

Source: Joint Committee on Taxation, Nov. 19, 2009, with CTJ calculations.

⁷Because state income tax rates generally are not very progressive, if at all, to start with, and because state income taxes are deductible by itemizers in computing federal taxable income, effective marginal state income tax rates generally decline at high income levels.

3. Favorable effects on overall tax progressivity? Quite the contrary.

Rather obviously, the value of employer-paid health insurance, as a share of income, is much higher for middle-income people with coverage than it is for the wealthy. That reflects the fact that one can only spend so much on health insurance, no matter how rich one may be.

As a result, taxing a portion of previously tax-free health insurance will take a much larger share of income from average families than from the wealthy. Figures from the congressional Joint Committee on Taxation show that the Senate Democrats’ proposal to tax health insurance would take 10 to 20 times as high a share of income from middle-income workers as it would take from the rich. And by doing so, it will reduce the overall progressivity of the tax system.

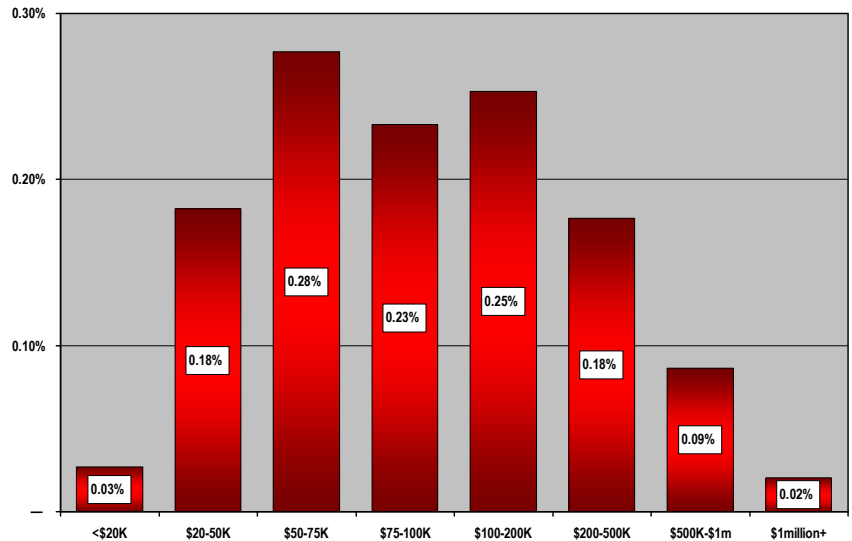
4. The bottom line on fairness

If a portion of tax-free health benefits are converted into taxable wages, the combined federal and state tax rate on the additional cash wages will typically be about 35 percent.

Figures from the Joint Committee on Taxation indicate that in 2019 the typical increase in taxable income for those affected by the proposed excise tax will be about \$3,700. That means 24.6 million families and individuals (representing about 58 million people) will lose an average of about \$4,000 in health benefits and, in theory, get about \$2,600 in after-tax wages in exchange.⁸

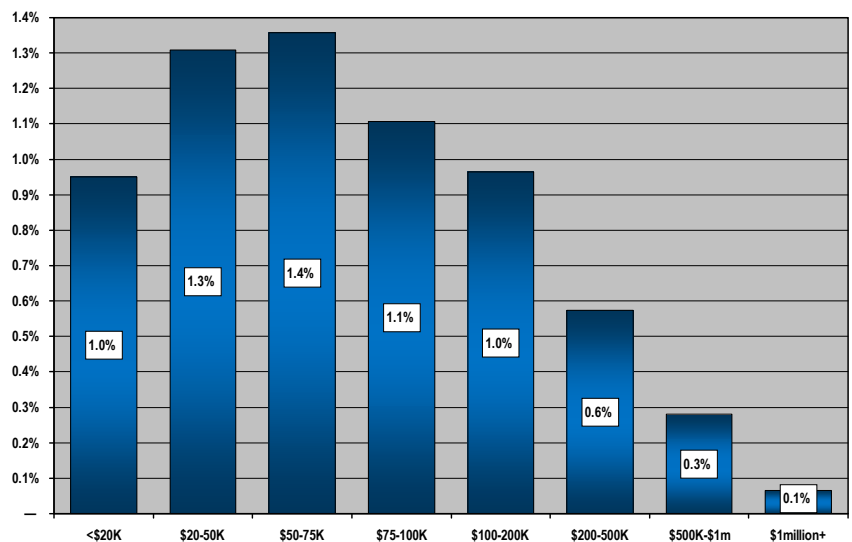
Such a trade-off will not noticeably bother the rich, of course. But it will be a significant reduction in living standards, not to mention health security, for tens of millions of ordinary Americans.

Senate Democrats Health Insurance Excise Tax as Shares of Income in 2019
(for taxpayers affected and unaffected)



Source: Citizens for Tax Justice, Dec. 11, 2009, based on Joint Committee on Taxation data (Nov. 19, 2009).

Senate Democrats Health Insurance Excise Tax as Shares of Income in 2019
(for taxpayers affected only)



Source: Citizens for Tax Justice, Dec. 11, 2009, based on Joint Committee on Taxation data (Nov. 19, 2009).

⁸The arithmetic works this way: Take a worker who is currently getting \$4,000 in what Senate Democrats deem to be “excessive” health insurance benefits. If the employer converts that into taxable wages, then the cash wages after the employer side of the payroll tax is subtracted will be about \$3,700 ($\$4,000 - 7.65\% \times \$3,700$). Then the worker will pay additional payroll and income taxes of about \$1,100, and net about \$2,600 after-tax.

C. There are progressive options to pay for health insurance reform

Taxing a portion of employer-paid health insurance, in a way that will lead to reduced health coverage for tens of millions of Americans, is not the only proposed way to pay for health insurance reform.

- The House of Representatives has passed a health insurance reform bill that is primarily financed by a surcharge on couples making more than \$1,000,000 and singles making more than \$500,000. Only the best-off 0.5 percent of all taxpayers would be subject to the House's proposed tax, yet it would raise \$460 billion over 10 years, more than three times as much as the \$149 billion the Senate Democrats' proposed excise tax would raise.
- Alternatively, extending half of the 2.9 percent Medicare tax to investment income (which is currently exempt from the Medicare tax), while limiting this change to couples making more than \$250,000 a year (\$200,000 for singles), would affect only 2 percent of all taxpayers. Yet according to the Joint Committee on Taxation, it would raise \$111 billion over 10 years, enough to replace three-quarters of the revenues from the Senate Democrats' proposed excise tax on health insurance benefits.

Senate Democrats may have reasons why they prefer a new tax primarily on middle-income Americans to these progressive tax options. But enhancing tax progressivity cannot be one of them.