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The Cost of Taxing Health Benefits

By James Klein and John Sweeney
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Congressional discussions over how to pay for health-care reform are being hindered by several myths that obscure the value of the employer-sponsored health plans covering more than 160 million Americans. Persistent misconceptions about the "tax-favored treatment" of employer-sponsored coverage are that it (1) leads to overconsumption of health services and (2) favors the wealthy.

With rising health costs burdening businesses and families alike, does anyone really believe that employers or workers lack incentive to hold down costs? The tax treatment of health benefits no more contributes to high health-care costs than the deduction for mortgage interest is responsible for housing costs. Clearly, both are affected by far more complex factors.

The cost of health coverage varies enormously based on geographic region and the age and health status of those in an insured group. Were benefits to be taxed, these common variations would lead to highly inequitable results, with some workers being taxed while their co-workers in other areas -- or those who are part of a group with a different demographic composition but who are receiving the exact same coverage -- would not. Those arguing about this should recall the extraordinary complexity created when the Tax Reform Act of 1986 similarly compelled employers to make difficult valuations of coverage and led Congress to an embarrassing repeal of that requirement.

The criticism that lower-paid workers with coverage get less value from the tax benefit than those in higher tax brackets is plain wrong. One of the great success stories of labor-management relations over the past several decades is that workers have negotiated for and received comprehensive coverage every bit as valuable as that extended to higher-income Americans. It is hard to think of a tax preference that is enjoyed more equitably across the income spectrum than the exclusion for employer-sponsored coverage. As a Commonwealth Fund [report](#) concludes, low-income households with employer coverage receive a larger tax break as a percentage of income than those in higher income households. And the related claim that the current tax exclusion favors those with coverage at the expense of those without -- even if it were true -- is completely inapplicable when everyone is covered -- an essential goal of reform.

A number of unintended consequences could result from taxing benefits. Removing the tax preference could well lead young workers to "opt out" of employer coverage, thereby destabilizing employer-sponsored "group" insurance. Moreover, a failure to adequately index the exclusion would lead to more and more Americans becoming subject to the tax over time -- just as the alternative minimum tax now captures far more people than originally contemplated.

Other health-related benefits such as dental, vision and supplemental policies for particularly high-cost conditions such as cancer, as well as popular medical flexible spending arrangements, might need to be purchased on an after-tax basis -- effectively making them much more expensive.

President Obama has rightly set forth "[shared responsibility](#)" as a fundamental component of health reform. According to the [Kaiser Family Foundation](#), in 2008 employers spent, on average, \$9,325 per employee for coverage for a family of four, and hard-working Americans contributed an additional \$3,354 in the direct employee share of premiums for that coverage. Clearly, workers and their employers sponsoring coverage already bear a tremendous burden.

While some argue for setting a limit on the tax exclusion, it bears noting that the entire exclusion equates to about 10 percent of the nation's staggering \$2.4 trillion annual bill for all health-care expenses. That confirms at least two irrefutable facts. First, the tax exclusion is not responsible for high health costs. Second, for an amount that is roughly equal to one-tenth of the country's health tab, enlightened tax policy makes possible essential health-care coverage to more than 160 million Americans.

The employer-based health coverage system is crucial not only for the vital financial protection it accords most Americans but also for its role in improving health care. Unions and businesses, working together, are leading the way in developing and implementing strategies to transform how we pay for health services to encourage high-quality care and better outcomes.

The idea, now widely accepted, that we should change from a payment system based on volume of services to one based on value -- demanding from health providers evidence-based outcome measurements and implementing chronic disease management and wellness promotion programs -- was championed by private purchasers long before it became mainstream. A crowning achievement of health-care reform would be to build on that success rather than impose a new tax that could destabilize the employer-based system and the innovation it helps make possible.

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