

# The ACA's "Cadillac" Tax Versus a Cap on the Tax Exclusion of Employer-Based Health Benefits: Is This a Battle Worth Fighting?

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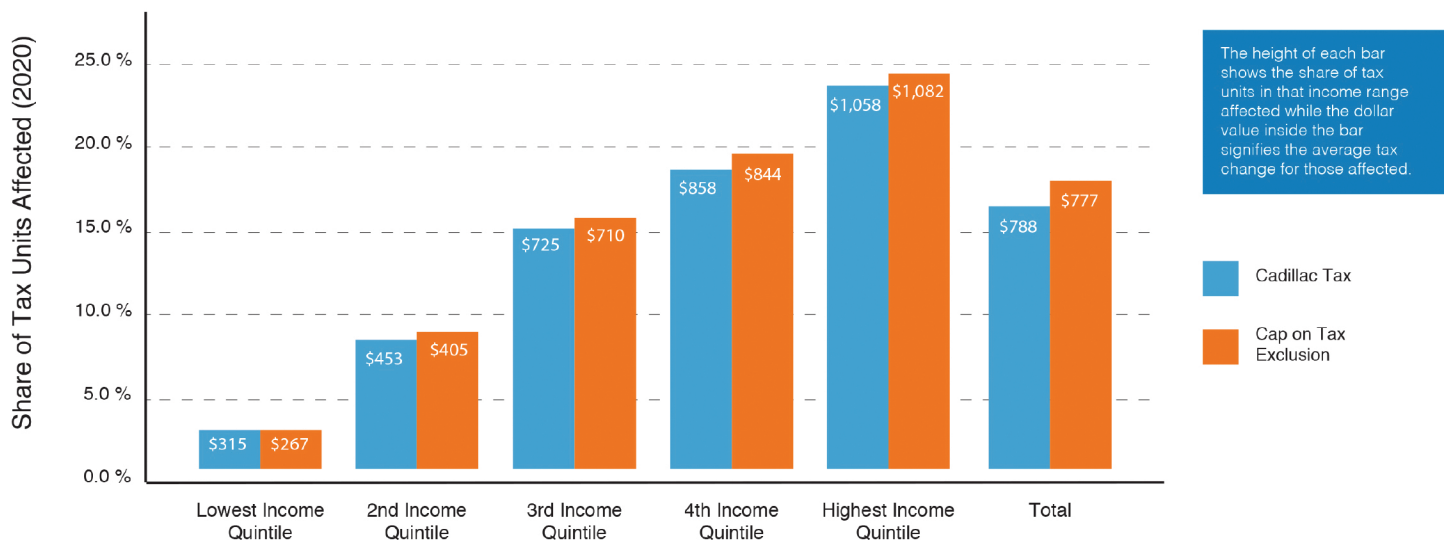
Timely Analysis of Immediate Health Policy Issues

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## In-Brief

In recent weeks, business sectors, political leaders in both parties, and labor groups have called to repeal the Affordable Care Act's (ACA's) "Cadillac" tax. This excise tax equals 40 percent of the cost of employer contributions to health benefits above specified thresholds (\$10,200 for individuals and \$27,500 for families in 2018, indexed for inflation in future years). The tax applies to health insurance premiums plus employer and employee contributions to both health savings accounts and medical flexible saving accounts. Its effects are similar to those of a cap on the current exclusion of employer contributions to health insurance from income and payroll taxes. The latter policy has had bipartisan support over the years, including from many who now want to repeal the tax. The argument for both approaches is that they promote cost containment, affect high-income people more than low-income people, and provide an important source of revenue. We show that the distributional effects of the excise tax and a cap on the exclusion are similar, except when firms choose to pay the excise tax instead of reducing benefits to avoid it (very few employers are expected to leave benefits at prior levels and pay the tax). We conclude that replacing the excise tax with a cap on the exclusion would be a better policy because the cap has more certain distributional effects. If that swap is politically impossible, however, it is essential to retain the excise tax both for its cost containment effects and for the revenue it provides.

### Cadillac Tax Versus Cap on Tax Exclusion for Health Benefits: Distributional Effects are Very Similar



Source: Tax Policy Center microsimulation model.

Note: Cadillac Tax results assume most employers reduce benefits to avoid the tax. The cap on the tax exclusion for employer provided health benefits is designed to raise roughly equivalent revenue to the Cadillac Tax.

## Introduction

The ACA imposes an excise tax on high-cost health insurance benefits as a major financing and cost-control mechanism. The tax will generate an estimated \$87 billion in revenues from 2018 to 2025. Starting in 2018, the excise tax, sometimes termed the “Cadillac tax,” will equal 40 percent of the value of health benefits exceeding \$10,200 for individuals and \$27,500 for families. The excise tax will apply not only to employer and employee contributions to health insurance premiums but also to contributions to health savings accounts, health reimbursement arrangements, and Medical flexible spending accounts. Thresholds are indexed to increase with the consumer price index and are higher for plans with more-expensive than-average demographics, retirees ages 55 to 64, and workers in high-risk professions. Some analysts predict that the tax will have at least a small effect on as many as 26 percent of firms in 2018.<sup>1</sup> Because health costs are likely to increase at a faster rate than general inflation, the excise tax will affect more employers and their workers over time.

The tax will be levied on insurance companies, but the burden will likely translate into higher premiums that are passed on to workers through reduced wages.<sup>2</sup> Because the excise tax is not deductible at the corporate level, the effective tax levied on insurance companies and consequent increase in premiums exceeds 40 percent of excess health benefits. In many cases, employers will avoid the tax by switching to less expensive health plans, consequently increasing wages and workers’ income and payroll taxes. The Joint Committee on Taxation and the Congressional Budget Office predict that three-quarters of the revenue raised by the excise tax will be through this indirect channel (higher income and payroll taxes) rather than through excise taxes collected from insurers.

The effects of this type of excise tax are similar in many ways to the effects of capping the current-law exclusion of employer-based insurance premiums

from income and payroll taxes. Policy-makers and analysts from across the political spectrum have proposed limits on or even complete elimination of the exclusion, and many economists across the political spectrum support such a change.<sup>3</sup> Several prominent Republicans have called for scaling back the exclusion as part of health reform proposals.<sup>4</sup> Yet despite this strong support in a number of quarters for limiting the exclusion, the excise tax, intended to serve a similar purpose, has been under attack. Senator Dean Heller (R-NV) and Representatives Frank Guinta (R-NH) and Joe Courtney (D-CT) have all introduced bills to repeal the tax. Presidential candidates Bernie Sanders and Hillary Clinton have also supported repeal,<sup>5</sup> as have the Republican presidential candidates endorsing a complete repeal of the ACA.

The current tax exclusion allows employers to provide their workers a portion of their compensation tax free; a comparable amount of salary would be subject to both income and payroll taxes. It is the largest federal tax expenditure, costing over \$250 billion in federal income and payroll taxes in 2015 and projected to cost \$3.2 trillion from 2016 to 2025.<sup>6</sup> Critics complain that the exclusion disproportionately benefits high-income workers because the tax savings are greater for those in higher tax brackets; lower-income workers receive little or no benefit from it. Many analysts also argue that the exclusion encourages individuals to over-insure and thus overuse health services, contributing to rapidly rising health care expenditures.

Because limits on the exclusion have had long-standing support among a significant cadre of politicians and the broad community of economists, and because the ACA’s excise tax has an equally broad array of opponents, we compare the distributional implications of the two options. Using the Urban-Brookings Tax Policy Center (TPC) microsimulation model, we find that an excise tax and an exclusion cap that raise approximately the same amount of revenue would have generally equivalent distributional effects. Another recent analysis came to a similar conclusion,

although that analysis did not consider payroll taxes or the nondeductibility of the excise tax, leading them to somewhat different results.<sup>7</sup> Because an excise tax can be more regressive in particular circumstances, however, we argue that the exclusion limit is somewhat superior. But given that these policy options would generally have similar effects, eliminating the excise tax with the uncertain hope of replacing it with a marginally superior exclusion cap is risky in today’s political climate.

## The Incidence of the Excise Tax Versus a Cap on the Employer Tax Exclusion

We use a simple example to compare the incidence of the excise tax and a cap on the employer tax exclusion under different employer responses (Figure 1). In this and subsequent estimates, we assume full wage pass-back of any changes in taxes or benefits to affected workers. We assume in this example that health insurance premiums plus health savings account, health reimbursement arrangement, and flexible spending account contributions exceed the excise tax threshold and the exclusion cap by \$250. We assume the firm has two workers. Worker 1, who has low income, is in the 10 percent income tax bracket and is subject to a payroll tax rate of 7.65 percent on both the worker and the employer, leading to an effective marginal tax rate of 23.5 percent.<sup>8</sup> Worker 2, who has high income, is in the 35 percent income tax bracket and is subject to a lower payroll tax rate of 1.45 percent because of earnings exceeding the maximum for the Social Security tax. Her resulting effective marginal tax rate is 37.4 percent. We also assume that employers either maintain their insurance benefits at the level preceding the tax or they reduce them just enough to avoid the tax imposed by each policy.

A cap on the employer tax exclusion would require workers to pay income and payroll taxes on employer contributions above the cap.<sup>9</sup> If a firm maintains the same insurance premium payments when such a cap applies, workers will pay more tax in proportion to their effective

**Figure 1. Example to Illustrate Incidence of the ACA's Excise Tax and Cap on the Employer Insurance Tax Exclusion**

Firm with Two Workers, Premium Exceeds the Excise Tax Threshold and the Employer Exclusion Cap Threshold by \$250		
	Firm does not change level of health insurance benefits provided to workers	Firm reduces the level of health insurance benefits provided to workers to just below threshold
<b>Cap on employer insurance tax exclusion</b>	<b>A</b>	<b>B</b>
	Each covered worker has to pay additional taxes calculated as their effective marginal tax rate times the value of health benefits over the threshold (\$250)	Firm reduces premiums by \$250 and increases wages by \$250 per worker. Each worker then pays additional taxes on the increased wages
Lower-income worker 10% income tax bracket Payroll tax rate = 7.65% Effective marginal tax rate = 23.5% <sup>a</sup>	The additional tax cost to this person is: $\$250 \times (23.5\%) = \$58.75$	This person loses \$250 in health insurance benefits but receives an additional $\$250 \times (100\% - 23.5\%)$ in take-home pay. Her total after tax compensation has decreased by $\$250 \times (23.5\%) = \$58.75$
Higher-income worker 35% income tax bracket Payroll tax rate = 1.45% (earnings exceed max for Social Security) Effective marginal tax rate = 37.4% <sup>a</sup>	The additional tax cost to this person is: $\$250 \times (37.4\%) = \$93.50$  Total net new revenue collected = \$152.25	This person loses \$250 in health insurance benefits but receives an additional $\$250 \times (100\% - 37.4\%)$ in take-home pay. Her total after tax compensation has decreased by $\$250 \times (37.4\%) = \$93.50$  Total net new revenue collected = \$152.25
<b>40% excise tax on health insurance benefits exceeding a threshold</b>	<b>D</b>	<b>C</b>
Excise tax rate = 40% 35% corporate income tax bracket Effective excise tax rate = 61.5% <sup>b</sup>	Insurer must pay $250 \times 61.5\% = \$153.75$ per covered worker Insurer increases premium by \$153.75 and employer passes this increased cost to workers by lowering each one's wages by \$153.75.	Firm reduces premiums by \$250 and increases wages by \$250 per worker. Each worker then pays additional taxes on the increased wages.
Lower-income worker 10% income tax bracket Payroll tax rate = 7.65% Effective marginal tax rate = 23.5% <sup>a</sup>	This person loses $\$153.75 \times (100\% - 23.5\%)$ in take-home pay, and her health benefits stay the same. She would have had to pay 23.5% of that \$153.75, in taxes, so her after tax compensation decreases by: $\$153.75 \times (76.5\%) = \$117.62$	This person loses \$250 in health insurance benefits but receives an additional $\$250 \times (100\% - 23.5\%)$ in take-home pay. Her total after tax compensation has decreased by $\$250 \times (23.5\%) = \$58.75$
Higher-income worker 35% income tax bracket Payroll tax rate = 1.45% (earnings exceed max for Social Security) Effective marginal tax rate = 37.4% <sup>a</sup>	This person loses $\$153.75 \times (100\% - 37.4\%)$ in take-home pay, and her health benefits stay the same. She would have had to pay 37.4% of that \$153.75, in taxes, so her after tax compensation decreases by: $\$153.75 \times (62.6\%) = \$96.25$  Total net new revenue collected = \$213.87	This person loses \$250 in health insurance benefits but receives an additional $\$250 \times (100\% - 37.4\%)$ in take-home pay. Her total after tax compensation has decreased by $\$250 \times (37.4\%) = \$93.50$  Total net new revenue collected = \$152.25

<sup>a</sup> Accounting for changes in employer payroll taxes when taxable wages change, the effective marginal tax rate = (income tax rate + employee payroll tax rate + employer payroll tax rate) / (1 + employer payroll tax rate).

<sup>b</sup> Accounting for nondeductibility at the corporate level, the effective excise tax rate = excise tax rate / (1 - corporate income tax rate).

marginal tax rates and taxes will increase more for high-income people than for low-income people (box A of Figure 1).<sup>10</sup> In our example, worker 1 pays an additional \$58.75 in tax (.235\*\$250) on the \$250 of excess benefits, and worker 2 pays an additional \$93.50 (.374\*\$250).

If instead the firm reduces the health insurance premium (or other health benefits) it pays for its workers (e.g., by increasing cost-sharing requirements, reducing covered benefits, or moving to a lower-cost provider network) below the level of the cap and increases

workers' pay by a comparable amount, its workers would continue to pay no tax on their insurance benefits but would pay more tax on their now higher pay.<sup>11</sup> And because wages will ultimately increase to fully compensate the worker for the employers' reduced spending on benefits (less additional payroll tax), the increased tax liability is the same as if the benefits were kept in place and taxes paid on the amount over the cap (box B of Figure 1).

The ACA's excise tax works in the same way as the exclusion cap when the

employer reduces insurance premiums to avoid paying the tax. Health insurance benefits decrease, taxable compensation (e.g., wages) ultimately increases by an equivalent amount, and workers' income and payroll tax liability increase (box C of Figure 1). The Congressional Budget Office and the Joint Committee on Taxation predict that a substantial majority of employers facing the excise tax will do just that: reduce benefits to a level below the threshold at which the tax is imposed.<sup>12</sup>

The excise tax and the exclusion cap differ if the employer maintains benefits that exceed the threshold amount, triggering the excise tax (box D of Figure 1). The insurer effectively pays 61.5 percent of the amount of benefits exceeding the threshold amounts for each insurance policy: the 40 percent excise tax plus additional corporate income tax because the excise tax is not deductible.<sup>13</sup> In our simple example, the premium exceeds the threshold by \$250 and the insurer must pay 61.5 percent of this excess or \$153.75 of combined excise and corporate income tax for each policy issued. The insurer passes that cost on to firms by boosting premiums by \$153.75. The employer in turn recoups the additional cost of providing health insurance to the workers by lowering each worker's compensation by \$153.75.

The effect on workers depends on their income. Worker 1's take-home wage drops \$117.62: the \$153.75 cut in wages offset by a \$36.13 reduction in income and payroll taxes on that income. Worker 2 loses only \$96.25 because she faces a higher combined income and payroll tax rate. The 40 percent excise tax is thus more regressive if the employer maintains insurance coverage than if the employer reduces insurance plans to avoid the excise tax or if a cap were imposed on the exclusion; lower-income workers incur a bigger tax increase than higher-income workers. Note that analysts believe that most employers would avoid the excise tax by reducing premiums. If so, the excise tax and the cap on the tax exclusion, scaled to raise the same amount of revenue, would have similar distributional effects. If many firms choose to pay the excise tax, though, the excise tax would disproportionately hit lower-income workers.

Whether reducing employer health insurance benefits would lead to an increase in wages is disputed. Economists argue that individuals are paid according to their contribution to the firm's marginal revenue. If a firm responds to a law change by cutting health insurance benefits and does not compensate by adjusting wages, the firm would pay less than the worker's

contribution to marginal revenue. Other firms would make higher offers and workers would move to better-compensating firms. The reverse would occur if the firm pays the tax or increases health benefits and thus overpays the worker. Competition for labor assures that reductions in health insurance benefits without compensating increases in wages are not sustainable, and the empirical literature strongly supports that idea.<sup>14</sup> In the case of the excise tax, paying the tax acts as an increase in the worker's compensation that firms must offset by reducing wages; providing less health insurance to avoid the tax is a reduction in compensation that firms must offset by increasing wages.

Many noneconomists, however, doubt that reductions in benefits will lead to

increases in wages. One problem is that the wage increases may not be immediate. It is unclear how long it takes for the competitive process to push wages up after the reduction in health benefits, and the speed of adjustment is likely strongly related to economic conditions such as the unemployment rate and the extent of competition in the local labor market. How wage increases in response to a cut in health benefits are distributed among workers is also not well understood. For example, we know little about whether costs are passed back evenly across workers of different wage levels.<sup>15</sup> Although the details are unclear, abundant empirical evidence shows that decreases (or increases) in health benefits are eventually passed back to workers in the form of increased (or reduced) wages.

**Table 1. Enact Cadillac Tax, Most Employers with Excess Benefits Avoid Tax, 2020<sup>a</sup> Distribution of Federal Tax Change by Expanded Cash Income Quintile**

Expanded Cash Income Percentile <sup>b</sup>	Tax Units with Change in Tax <sup>c</sup>		Percent change in after-tax income <sup>d</sup>	Share of total federal tax change	Average federal tax change (\$)
	Percentage of tax units	Average tax change (\$)			
Lowest quintile	2.0	315	-0.04	1.9	6
Second quintile	7.9	453	-0.10	8.6	36
Middle quintile	15.8	725	-0.19	24.6	114
Fourth quintile	19.0	858	-0.16	29.2	163
Top quintile	22.5	1,058	-0.08	35.5	238
All	11.7	788	-0.12	100.0	92

Source: Urban-Brookings Tax Policy Center microsimulation model (version 0515-1b).

<sup>a</sup> Calendar year. Baseline is current law without Cadillac tax. Assumes 85 percent of employers with affected plans reduce generosity and increase taxable wages. Cadillac tax thresholds in 2020 are \$10,750 for single coverage and \$29,050 for family coverage.

<sup>b</sup> Includes both filing and nonfiling units but excludes those that are dependents of other tax units. Tax units with negative adjusted gross income are excluded from their respective income class but are included in the totals. For a description of expanded cash income, see: Tax topics. Urban Institute. <http://www.taxpolicycenter.org/TaxModel/income.cfm>; accessed October 15, 2015. The income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks are (in 2015 dollars): 20% \$24,151; 40% \$47,282; 60% \$83,361; 80% \$144,141.

<sup>c</sup> Includes tax units with a change in after-tax income of \$10 or more in absolute value.

<sup>d</sup> After-tax income is expanded cash income, minus individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); estate tax; and excise taxes.



**Table 2. Enact Cadillac Tax, All Employers with Excess Benefits Pay Tax, 2020<sup>a</sup> Distribution of Federal Tax Change by Expanded Cash Income Quintile**

Expanded Cash Income Percentile <sup>b</sup>	Tax Units with Change in Tax <sup>c</sup>		Percent change in after-tax income <sup>d</sup>	Share of total federal tax change	Average federal tax change (\$)
	Percentage of tax units	Average tax change (\$)			
Lowest quintile	2.1	990	-0.14	4.6	21
Second quintile	8.0	894	-0.20	13.1	71
Middle quintile	15.9	956	-0.25	24.8	152
Fourth quintile	19.1	1,087	-0.20	28.3	208
Top quintile	22.6	1,118	-0.09	28.6	252
All	11.8	1,029	-0.15	100.0	121

Source: Urban-Brookings Tax Policy Center microsimulation model (version 0515-1b).

<sup>a</sup> Calendar year. Baseline is current law without Cadillac tax. Assumes all employers with affected plans maintain generosity of health benefits. Cadillac tax thresholds in 2020 are \$10,750 for single coverage and \$29,050 for family coverage.

<sup>b</sup> Includes both filing and nonfiling units but excludes those that are dependents of other tax units. Tax units with negative adjusted gross income are excluded from their respective income class but are included in the totals. For a description of expanded cash income, see: Tax topics. Urban Institute. <http://www.taxpolicycenter.org/TaxModel/income.cfm>; accessed October 15, 2015. The income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks are (in 2015 dollars): 20% \$24,151; 40% \$47,282; 60% \$83,361; 80% \$144,141.

<sup>c</sup> Includes tax units with a change in after-tax income of \$10 or more in absolute value.

<sup>d</sup> After-tax income is expanded cash income, minus individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); estate tax; and excise taxes.

## Methods

We compare the distributional effects of the excise tax and a revenue-equivalent cap on the exclusion using the TPC microsimulation model.<sup>16</sup> We simulate both policies in 2020 relative to a baseline consistent with current law without the excise tax. Because the excise tax expands rapidly over time we analyze the policies in 2020 rather than when first implemented in 2018, at which time the effects will be very small.

### Comparing the Distributional Effects of the Excise Tax and a Cap on the Employer Tax Exclusion

We compare the distributional effects of the excise tax and a cap on the exclusion by simulating each option on the TPC microsimulation model. For the excise tax, we assume that 85 percent of employers offering health benefits above the thresholds will reduce benefits to avoid the tax. Consistent with the estimates by the Congressional Budget

Office and Joint Committee on Taxation, the compensating wage increases yield 75 percent of the revenue gain coming from increased income and payroll taxes; 25 percent comes from additional excise and corporate income taxes.<sup>17</sup> Individuals working for employers that cut benefits to avoid the tax are affected in proportion to their marginal tax rates. For the workers in the 15 percent of the firms offering benefits that cost more than the threshold and that do not reduce benefits, the insurer pays the 40 percent excise tax on the excess and additional corporate income taxes, and that cost is eventually passed back to the worker through reduced wages.

In 2020, 11.7 percent of tax units would be affected by employers either reducing benefits to avoid the tax or paying the tax and passing the cost back to workers through lower wages (Table 1). On average, these tax units would pay nearly \$800 in additional taxes. Higher-income households are more likely to pay more tax than lower-income households,

and their average tax increase would be greater for those whose taxes rise. Just 2 percent of tax units in the lowest-income (first) quintile would be affected, compared with 22.5 percent of those in the highest-income (fifth) quintile. Affected units in the first quintile would see an average tax increase of \$315; for the fifth quintile, the average increase would be \$1058. The percentage of households affected by the tax rises with income because higher-income units are more likely to have employer-provided health benefits. The average tax increase for affected households also increases with income; that is in part because higher-income units face higher tax rates and in part because higher-income households with health benefits are more likely to have family coverage than those with low income.<sup>18</sup> Most of the additional federal tax revenue would come from the top two income quintiles: the fourth quintile would pay 29.2 percent and the fifth quintile would pay 35.5 percent, compared with just 1.9 percent for the first quintile.

Similar percentages of households would be affected, but the tax increases would be larger if all employers chose to pay the excise tax rather than reduce benefits to avoid it (Table 2). We show this scenario only for illustrative purposes; some firms will surely choose to pay the tax, but that number will likely be small. Only about 2 percent of low-income units would incur tax increases, but the average increase would be more than three times what those units would pay if most firms cut benefits to avoid the tax. Those units' \$990 average tax increase would exceed the \$894 increase for the second quintile and be not much less than the \$1118 average for the fifth quintile. Units in the fifth quintile would face roughly similar tax increases under either scenario.

The tax revenue collected is considerably greater in the scenario where all employers pay the tax. After accounting for nondeductibility at the corporate level and reduced income and payroll taxes at the worker level, the average effective excise tax rate is substantially higher than the average effective marginal tax rate for families with health benefits. But

**Table 3. Enact Exclusion Limit, 2020<sup>a</sup> Distribution of Federal Tax Change by Expanded Cash Income Quintile**

Expanded Cash Income Percentile <sup>b</sup>	Tax Units with Change in Tax <sup>c</sup>				
	Percentage of tax units	Average tax change (\$)	Percent change in after-tax income <sup>d</sup>	Share of total federal tax change	Average federal tax change (\$)
Lowest quintile	2.1	267	-0.04	1.6	6
Second quintile	8.0	405	-0.09	7.7	32
Middle quintile	16.0	710	-0.19	24.4	114
Fourth quintile	19.4	844	-0.16	29.2	164
Top quintile	23.0	1,082	-0.09	36.9	249
All	11.9	777	-0.12	100.0	92

Source: Urban-Brookings Tax Policy Center microsimulation model (version 0515-1b).

<sup>a</sup> Calendar year. Baseline is current law without Cadillac tax. Exclusion limit thresholds in 2020 are \$10,746 for single coverage and \$28,930 for family coverage.

<sup>b</sup> Includes both filing and nonfiling units but excludes those that are dependents of other tax units. Tax units with negative adjusted gross income are excluded from their respective income class but are included in the totals. For a description of expanded cash income see: Tax topics. Urban Institute. <http://www.taxpolicycenter.org/TaxModel/income.cfm>; accessed October 15, 2015. The income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks are (in 2015 dollars): 20% \$24,151; 40% \$47,282; 60% \$83,361; 80% \$144,141.

<sup>c</sup> Includes tax units with a change in after-tax income of \$10 or more in absolute value.

<sup>d</sup> After-tax income is expanded cash income, minus individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); estate tax; and excise taxes.

the main finding is that the incidence of the excise tax is far more regressive if the firm keeps benefits fixed and pays the tax than it would be if the firm reduces benefits and avoids the tax.

An alternative policy would impose a cap on the current exclusion of employer-paid health benefits (Table 3). Such a policy sets the cap at a level that raises the same amount of revenue as the excise tax scenario in which most employers reduce benefits to avoid the tax (Table 1). As noted, the cap has the same effects whether or not the firm reduces health benefits. This policy would have distributional effects similar to the first scenario described (most employers reduce benefits to avoid the tax), but a slightly larger percentage of households would be affected and their average tax increase would be a bit smaller. Those differences stem from the assumption in the first scenario that some firms would maintain their benefits and pay the tax. Only 2.1 percent of those in the first quintile are affected by the cap on the tax exclusion compared with 23 percent in the fifth quintile. The average amount of

the tax incurred by those affected is \$267 for the first quintile and \$1082 for the fifth quintile. Those in the fourth and fifth quintiles pay the bulk of the total taxes raised by the cap on the exclusion: 29.2 percent and 36.9 percent, respectively.

### Other Distributional Effects

Our analyses have not considered the distributional implications of reduced health insurance benefits. We expect that a majority of affected employers will reduce benefits in the face of the ACA's excise tax, and similar proportions would likely do so under a cap on the exclusion that would raise similar aggregate revenue. Measuring the implications of more-limited benefits or higher cost-sharing requirements is challenging.

We expect cuts in employer-provided health benefits under all of our scenarios, but we know little about how those benefits would change. Would employers first reduce benefits that mostly accrue to higher-income workers, such as flexible spending accounts, or would they first increase deductibles

and co-pays or coinsurance that could disproportionately affect low-income households and people with greater medical needs? Would they adopt more-aggressively managed care that does not impose higher out-of-pocket costs but does limit provider networks and more carefully monitor the kinds of procedures and medications that are covered by the plan? For example, if deductibles are increased significantly, low-income households are likely to reduce their use of medical services more than higher-income households because they cannot as easily afford to initiate care. Although we would expect that low-income households would receive increased wages to compensate for reduced premium payments by employers, the increase may not be sufficient after taxes to make up for increased out-of-pocket costs, particularly for those with significant medical needs. And although tighter provider networks (as opposed to increases in out-of-pocket costs) could reduce the access implications of a tax for lower-income workers, such changes may be unattractive to higher-income workers, and the latter may have more sway in employer decision-making. Employers might respond to the excise tax differently than they would to a cap on the tax exclusion, perhaps more aggressively reducing higher-cost coverage options available to their workers. We have not attempted to estimate these types of distributional consequences here, but they are worthy of future attention.

### Conclusion

In recent weeks, prominent business and labor groups and leaders across the political spectrum have called to repeal the "Cadillac tax," which is an important source of funding for the ACA's coverage expansion. This excise tax is similar in practical effect to a cap on the current-law tax exclusion of employer contributions to health insurance. The employer exclusion has been criticized for many years for contributing to the rapid rise in health care costs and for its benefits going disproportionately to higher-income people. Eliminating the Cadillac tax would cut revenues \$87 billion

through 2025. Without an agreed-upon replacement for the revenue that has the same cost-containment properties, eliminating the tax would endanger the financial soundness of the ACA.

Our analysis shows that the incidence of the ACA's excise tax is identical in most circumstances to a cap on the employer exclusion that would raise the same revenue. If firms choose to maintain their benefit levels and pay it, the excise tax could be more regressive than a cap on the exclusion, but we expect that only a small percentage of firms would elect that option. Because capping the exclusion would have the same distributional effects regardless of employer benefit decisions and would be more progressive than the scenario in which employers choose to pay the excise tax, the cap might be the preferred option. But the modest improvement in

practical progressivity might not be worth the risk of losing a significant source of financing in a highly contentious political environment.

Both the ACA's excise tax and a cap on the exclusion surely share some problems. They both affect some industries more than others: some industries face somewhat higher average costs because they have either richer benefits or a workforce with higher average health care costs (e.g. public sector employers, financial services and real estate industry employers, and unionized firms).<sup>19</sup> Other evidence suggests that both policies would affect firms and their workers in the Northeast more than those in other regions because firms in the Northeast have higher health costs.<sup>20</sup> And as noted, both approaches' implications for use of medical care may vary significantly across family incomes

and by the extent of medical needs. But no policy is perfect, and some of these issues could be ameliorated through creative approaches not explored here. Many tax and spending policies (e.g. Social Security and the federal income tax) have problematic distributional effects (e.g. benefits and tax rates do not vary with geographic differences in cost of living). No policy can completely avoid these complexities. In this circumstance, however, the diverse political support for limiting the exclusion should transfer to support for maintaining the ACA's Cadillac tax. The two approaches would have nearly identical distributional effects, and keeping the excise tax would be easier and less risky than trying to gather sufficient political support to replace it with an exclusion cap or other policy that would raise at least as much revenue.

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For more than 40 years the Robert Wood Johnson Foundation has worked to improve health and health care. We are striving to build a national Culture of Health that will enable all to live longer, healthier lives now and for generations to come. For more information, visit [www.rwjf.org](http://www.rwjf.org). Follow the Foundation on Twitter at [www.rwjf.org/twitter](http://www.rwjf.org/twitter) or on Facebook at [www.rwjf.org/facebook](http://www.rwjf.org/facebook).

## Notes

- <sup>1</sup> Claxton G and Levitt L. *How Many Employers Could be Affected by the Cadillac Plan Tax?* Menlo Park, CA: Kaiser Family Foundation; 2015. <http://files.kff.org/attachment/issue-brief-how-many-employers-could-be-affected-by-the-cadillac-plan-tax>. Accessed October 15, 2015.
- <sup>2</sup> In the case where an employer provides health insurance benefits to workers through a self-insured health plan, the employer is the de facto insurer.
- <sup>3</sup> See Aaron H et al., Letter to Orrin G. Hatch, Ron Wyden, Paul D. Ryan, and Sander M. Levin. October 1, 2015. [http://www.cbpp.org/sites/default/files/atoms/files/cadillac\\_tax\\_letter.pdf](http://www.cbpp.org/sites/default/files/atoms/files/cadillac_tax_letter.pdf). Accessed October 16, 2015.
- <sup>4</sup> Faler B. GOP plans to curb health care costs look a lot like Obama's Cadillac tax. *Politico*. September 9, 2015. <https://www.politicopro.com/>. Accessed October 15, 2015. See also, Jeb Bush. Background: Health Care Plan, October 2015. <https://jeb2016.com/backgrounder-health-care-plan/?lang=en>. Accessed October 19, 2015.
- <sup>5</sup> Middle Class Health Benefits Tax Repeal Act of 2015, H.R. 2050, 114th Cong. (2014). <https://www.congress.gov/bill/114th-congress/house-bill/2050>; Ax the Tax on Middle Class Americans' Health Plans Act. H.R. 879, 114th Cong. (2014). <https://www.congress.gov/bill/114th-congress/house-bill/879> Middle Class Health Benefits Tax Repeal Act of 2015, S. 2045, 114th Cong. (2014). <https://www.congress.gov/bill/114th-congress/senate-bill/2045/actions>; Haberman M. Hillary Clinton to propose scrapping health law's Cadillac tax. *New York Times*. September 29, 2015. <http://www.nytimes.com/politics/first-draft/2015/09/29/hillary-clinton-plans-to-question-health-laws-cadillac-tax/>. Accessed October 16, 2015.
- <sup>6</sup> Calculations from Urban-Brookings Tax Policy Center microsimulation model (version 0515-2).
- <sup>7</sup> Ginsburg PB, et al. *Limiting Tax Breaks for Employer-Sponsored Health Insurance: Cadillac Tax vs. Capping the Tax Exclusion*. Brief 20. Washington: National Institute for Health Care Reform Research; 2015. [http://www.nihcr.org/Cadillac\\_Tax](http://www.nihcr.org/Cadillac_Tax)
- <sup>8</sup> Accounting for changes in employer payroll taxes when taxable wages change, the effective marginal tax rate = (income tax rate + employee payroll tax rate + employer payroll tax rate) / (1 + employer payroll tax rate).
- <sup>9</sup> An alternative policy could apply the tax cap only for income taxes.
- <sup>10</sup> The firm could also adjust pre-tax insurance benefits other than premiums, for example by reducing contributions to health savings accounts or flexible spending accounts, with equivalent implications. We refer in the paper to changes in premiums for simplicity.
- <sup>11</sup> This increased tax liability would occur because employers would not simply reduce workers' total compensation; doing so would mean that the firm was paying its workers less than the value it (and the rest of the labor market) had previously attributed to them. If an employer does not pay the workers their value to the firm (whether in wages alone or some combination of wages and benefits) then the workers are likely to leave the firm for another willing to pay their full value. Consequently, if benefits are cut, ultimately the firm will increase wages by an equivalent amount in order to keep their workers. It is possible that employers might increase other benefits or a combination of wages and benefits.
- <sup>12</sup> Congressional Budget Office, *The Budget and Economic Outlook: 2015 to 2025*. Washington: Congressional Budget Office; 2015, 124. <https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/49892-Outlook2015.pdf>. Accessed October 16, 2015.
- <sup>13</sup> If health benefits exceed the threshold by \$1, the insurer pays \$0.40 in tax and raises premiums by \$0.40. Since the excise tax is nondeductible but the premium change increases revenue, corporate tax liability increases by \$0.40 multiplied by the corporate tax rate. The insurer then passes on the additional corporate tax into premiums, and the process continues until the effective excise tax rate = .40 / (1 - corporate tax rate). In figure 1, the assumed corporate tax rate is 35 percent, leading to an effective excise tax rate on insurers of 61.5 percent.
- <sup>14</sup> Blumberg L. Perspective: Who pays for employer-sponsored health insurance? *Health Affairs*. 1999;18(6): 58–61; Gruber J. Health insurance and the labor market. In: Anthony J. Culyer and Joseph Newhouse. *Handbook of Health Economics, Volume 1*. Amsterdam: Elsevier, 2000: 645–706; Jensen GA and Morrissey MA. Endogenous fringe benefits, compensating wage differentials and older workers. *International Journal of Health Care Finance and Economics*. 2001;1(3/4): 203–226.
- <sup>15</sup> At least one paper suggests that benefit costs are passed back to workers partially in proportion to their value to workers as opposed to average cost. See Toder E and Smith KE. *Do Low-Income Workers Benefit from 401(k) Plans?* Program on Retirement Policy Discussion Paper 11-03. Washington: Urban Institute; 2011. <http://www.taxpolicycenter.org/UploadedPDF/412463-Do-Low-Income-Workers-Benefit-from-401k-Plans.pdf>. Accessed October 2015.
- <sup>16</sup> The TPC model produces revenue and distribution estimates of the U.S. federal tax system. The model is based primarily on a file of public-use tax records produced by Statistics of Income division of the Internal Revenue Service. The base file is augmented with nonfilers from the Current Population Survey and imputations of wealth, student characteristics, consumption, and retirement benefits based on many household surveys. Imputations for health insurance coverage and employer provided health benefits come from statistical matches to the Current Population Survey and Kaiser/Health Research and Educational Trust employer surveys. The database is aged into the future based on forecasts from the Congressional Budget Office, Joint Committee on Taxation, and Internal Revenue Service. For more information on the TPC Model see: Tax topics. Urban Institute. <http://www.taxpolicycenter.org/taxtopics/Brief-Description-of-the-Model-2013.cfm>. Accessed October 16, 2015.
- <sup>17</sup> In cases where the excise tax is paid, income and payroll taxes decline. Thus, more than 75 percent of employers must avoid the tax for 75 percent of the net revenue gain to come from income and payroll taxes.
- <sup>18</sup> Because average family coverage costs close to three times more than single coverage, the average premium in excess of the threshold for affected tax units is substantially higher for units with family coverage than for those with single coverage. The excise tax thresholds are set at similar relative positions in the distribution of single and family health benefits. The average excess premium is higher for family coverage simply because family coverage costs more than single coverage.
- <sup>19</sup> Clemans-Cope L, Zuckerman S, and Resnick D. *Limiting the Tax Exclusion of Employer-Sponsored Health Insurance Premiums: Revenue Potential and Distributional Consequences*. Washington: Urban Institute; 2013. <http://www.urban.org/research/publication/limiting-tax-exclusion-employer-sponsored-health-insurance-premiums-revenue>. Accessed October 16, 2015.
- <sup>20</sup> The Medical Expenditure Panel Survey offers a table of insurance component data sorted by geographic region. See: Table II.C.1 (2013): Average total single premium (in dollars) per enrolled employee at private-sector establishments that offer health insurance by firm size and state: United States, 2013. Agency for Healthcare Research and Quality. [http://meps.ahrq.gov/mepsweb/data\\_stats/summ\\_tables/insr/state/series\\_2/2013/tiic1.htm](http://meps.ahrq.gov/mepsweb/data_stats/summ_tables/insr/state/series_2/2013/tiic1.htm). Accessed October 16, 2015.