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Congress of the United States

JOINT COMMITTEE ON TAXATION

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JUN 10 2009

Honorable Ron Wyden
United States Senate
SD-230
Washington, DC 20510

Dear Senator Wyden:

This letter is in response to your letter of May 27, 2009, in which you ask questions relating to possible economic impacts of various health reform proposals. Your primary questions were the following:

1. Would a fixed dollar cap on the tax exclusion for employer provided health coverage create the same incentives for cost containment as replacing the exclusion with a standard deduction against adjusted gross income ("AGI") or credit designed to provide a subsidy of comparable value to an exclusion up to a dollar cap?
2. On average will health insurance expenditures be lower if the tax exclusion for employer provided health insurance coverage is capped or if the exclusion is converted to a comparable standard deduction/credit conditional on purchase of qualified health insurance?
3. If the tax benefit for employer-provided health coverage were phased out for those with higher earnings, would there be a major difference in administrability of phasing out a standard deduction relative to the tax exclusion?

In answer to Question 1: *Would a fixed dollar health insurance value cap on the tax exclusion create the same incentives for cost containment as replacing the exclusion with a standard deduction or comparable credit at the level of the cap?* No. A standard deduction or credit would provide a greater incentive for reducing spending on health insurance than would capping the exclusion at a level above the cost of a minimum benefits package.

For a capped exclusion for employer-provided health coverage, the marginal cost of health insurance depends on whether the marginal expense is above the cap or below the cap. For plan premiums above the cap, the cost of each additional dollar of health insurance will be equivalent to the cost of other consumption. However, for plan premiums below the cap, the individual will benefit from the tax exclusion for every dollar of health insurance purchased up to the cap. For those with plan premiums below the cap, because the after-tax cost of health insurance is less than the after-tax cost of other goods, there will continue to be an incentive for over-consumption of health insurance relative to the consumption of other goods.

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For example, if the tax exclusion were capped at FEHBP Blue Cross Blue Shield Standard plan for families, (\$14,373 in 2009), a family purchasing a \$14,373 plan would receive the maximum tax benefit and anyone purchasing a less expensive health plan would receive a lower tax benefit. Under an exclusion capped at \$14,373, if that family were offered an alternative health plan costing \$12,000, the extra after-tax cost of purchasing the \$14,373 health plan would be less than the \$2,373 pre-tax price differential since both plans would be purchased with pre-tax dollars. If the family were taxed in the 28 percent marginal income tax bracket, the after tax cost of purchasing the extra \$2,373 in health insurance would be $(1-0.28)*\$2,373 = \$1,709$. Thus health insurance below the cap is purchased at a cost of \$0.72 per dollar of health insurance.

In contrast, a standard deduction that is conditional on the purchase of a qualified health plan would be expected to encourage individuals to obtain insurance, but would not be expected to distort the level of health insurance consumption conditional upon purchasing a qualifying plan. Economically, the standard deduction is a lump sum tax rebate for the purchase of a minimum plan, and does not subsidize the purchase of additional health insurance at the margin because it does not affect the price of an additional dollar of health insurance. That is, the individual receives the same dollar of tax benefits regardless of the premium of the health plan purchased.

For example, if the standard deduction were \$14,373, the same as the cap in the health exclusion above, the individual would receive a tax benefit on \$14,373 whether a qualifying health plan worth \$10,000, \$12,000 or \$16,000 were purchased. Because the tax benefit is a fixed amount regardless of the health plan purchased, the individual bears the full cost of the health insurance plan chosen and will only choose to purchase an extra dollar of health insurance if health insurance has a greater value to the individual than other consumption.

In answer to Question 2: *On average will health insurance expenditures be lower if the employer exclusion is capped or if the employer exclusion is converted to a comparable standard deduction/credit conditional on purchase of qualified health insurance?* JCT expects that total health insurance expenditures would be lower if the exclusion for employer provided health coverage were converted to a comparable deduction or credit rather than capped at a similar level due to marginal dollar incentives to over-consume health insurance below the cap of an employer exclusion.

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However, if the standard deduction and exclusion cap are set to provide the same tax benefit¹ at the same amount (e.g., both are set at the value of the FEHBP Blue Cross / Blue Shield standard plan), the standard deduction will result in a greater aggregate tax expenditure than the equivalent exclusion cap. If the standard deduction is \$14,373, the tax benefit is a deduction of \$14,373 for all with a qualifying plan. Alternatively, a cap on the exclusion of \$14,373 would provide a *maximum* exclusion of \$14,373, with those who have less expensive plans receiving less of a tax benefit, resulting in a lower total tax expenditure for the government.

Another difference between a capped exclusion and the standard deduction is who would be eligible for the tax benefit. The tax exclusion applies for health insurance purchased through employers. Generally, employers significantly reduce the number of health insurance options by offering a limited number of health plans to employees. Because employers negotiate the terms of the policies with health insurers and then offer those policies to their employees, with either a full or partial subsidy, it is the employers that make many of the decisions regarding the quantity of health insurance that is purchased.

A standard deduction, however, could be made available to any individual purchasing qualified health insurance, regardless of the source of that insurance. In the current regulatory environment of experience rating, where those with low expected health expenditures are eligible for low premiums, this could result in the fragmentation of employer groups. This fragmentation would result when individuals eligible for health insurance at rates lower than the cost at the employer opt out of their employer-provided insurance and purchase insurance in the individual market, potentially creating adverse selection in employer sponsored insurance. The presence of a non-fungible employer contribution may mitigate the significance of this issue in the short run.

In a pure community rating environment, where all individuals are treated as a part of the same national risk pool regardless of individual risk factors, it is less likely that the fragmentation of employer groups would be an issue as low risk individuals would be unable to purchase inexpensive insurance matching their risk. Employer groups provide value in health insurance markets because they reduce average administrative costs for health plans and provide risk stability. Even in a market of pure community rating where employers are not rated based

¹ Code Section 3121 (a)(2) provides an unlimited exclusion from the definition of wages subject to FICA for employer payments for medical or hospitalization expenses through insurance, or otherwise, for employees and employees' dependents.

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on their risk, employer groups will continue to have lower average health plan administrative costs.

In answer to Question 3: *If the tax benefit for health coverage were phased out for those with higher earnings, would there be a difference in the administrability of phasing out a standard deduction relative to a tax exclusion?* While a phase out of the standard deduction would be relatively straightforward to administer, a phaseout of the tax exclusion for employer provided health coverage would be substantially more complicated to administer. A phase out of the standard deduction could be administered through the individual income tax return, where the individual taxpayer computes his taxable income and is able to directly account for any income limitation on the deduction, as well as for health insurance benefits received by multiple family members.

A phase out of the tax exclusion would be far more complicated from an administrative perspective. Because the employer is excluding the value of health insurance from taxable income, an income-based phaseout would require the firm to have information as to where the employee is in the phaseout range in order to withhold the correct income tax and report the correct amount as taxable wages. This is a fundamental difference from the phaseout of the standard deduction, where the full cost of health insurance is initially included in income subject to income tax withholding and the standard deduction is applied later on the employee's income tax return. An adjustment to the W-4 withholding worksheet might be desirable to prevent those employees who should receive the full value of the standard deduction from being over-withheld. This adjustment would place the responsibility for accurate withholding with the employee, who has the necessary information about his family income and health insurance status.

In contrast, the level at which the exclusion is phased out is related to the adjusted gross income ("AGI") of the employee, which could include investment income, a second wage, or in the case of a joint return, a spouse's income, rather than only the employee's wages for the taxable year from the employer. In the higher income brackets, where the phaseout is likely to occur, non-wage sources of income are likely to be a greater portion of an employee's AGI. Limiting the employer exclusion would require the employer to have accurate information about these items during the tax year to administer reporting on the employer exclusion.

In addition, an income-based phaseout of the tax exclusion would cause an added difficulty if it were applied to payroll taxes, because they are paid by both the employer and the

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employee separately. The employer would have to collect information from the employees as to eligibility for the exclusion. This would require the employer to know the AGI of employees receiving health insurance.

I hope this information is helpful to you. If we can be of further assistance in this matter, please let me know.

Sincerely,

A handwritten signature in cursive script that reads "Thomas A. Barthold". The signature is written in black ink and is positioned above the printed name.

Thomas A. Barthold