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RESEARCH SUMMARY

Replacing the Cadillac Tax: Options and Considerations

The employer-sponsored health insurance (ESI) system that provides coverage to over 150 million Americans exists, at least in part, because of a wasteful and regressive policy that exempts employer-provided insurance from taxation. In an attempt to combat the effects of this exemption, the Affordable Care Act introduced a tax on the value of ESI plans with premiums exceeding a certain amount, known as the Cadillac tax.

In "Replacing the Cadillac Tax: Options and Considerations," Yevgeniy Feyman, a senior research assistant at the Harvard T. H. Chan School of Public Health, and Charles Blahous, the J. Fish and Lillian F. Smith Chair at the Mercatus Center at George Mason University, examine the problems created by the tax-exempt status of ESI, the flaws with the current Cadillac tax, and options for replacing both the current ESI system and the Cadillac tax with policies better suited to addressing the challenges of health insurance provision.

PROBLEMS WITH THE ESI TAX EXEMPTION

ESI tax exemption causes five major problems:

- Because employment agreements are based on total compensation, tax exemption encourages employers to substitute health insurance for wages.
- The tax exemption encourages higher demand for more generous health insurance plans.
- The tax exemption is regressive, benefiting those with high incomes more than those with low incomes.
- Tying health insurance to employment discourages self-employment, job switching, and retirement, and it decreases labor mobility.
- Finally, the exemption results in foregone tax revenue, which essentially makes it equivalent to a $300 billion government insurance program.

The Cadillac tax was designed to address these problems, but it creates other distortions and is somewhat regressive in its effects. For example, for-profit businesses can deduct the tax as a cost of doing business, but individuals, governments, and nonprofits cannot. Thus, the burden of the Cadillac tax does not fall on all workers and businesses equally.

POSSIBLE SOLUTIONS

Policies that might replace the Cadillac tax should seek to restore neutrality between employer-sponsored and individually purchased plans, reduce or eliminate the regressive effects of the current policy, and minimize the disruption of health insurance and employment contracts. Policymakers will also need to determine whether all

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health benefits or only traditional insurance plans will be covered by a change in the Cadillac tax. The paper examines three alternatives:

- *Eliminate the Cadillac tax and the ESI tax exclusion.* This is the most administratively simple option with the highest net benefits. Its main disadvantage is that such a large change would be disruptive, and so it should be phased in over the medium term.
- *Eliminate the Cadillac tax and cap the ESI tax exclusion.* This would eliminate the regressive nature of the Cadillac tax because above the cap, existing progressive marginal tax rates would apply. If the capped deduction were extended to individual nongroup plans, it would ameliorate labor market distortions. One challenge policymakers would face with this approach is that a cap may penalize employers insuring populations with more expensive health insurance needs, even if they are not overinsured.
- *Replace the Cadillac tax and the ESI tax exclusion with income-based subsidies.* Directly subsidizing health coverage is more targeted and may increase the number of Americans who are covered by insurance. These subsidies would be used to pay for ESI, and they could be tied to both a benchmark cost for insurance and the income of the individual receiving the subsidy. Although this policy would no longer be regressive and would address neutrality concerns, a poorly designed subsidy could maintain labor market distortions, create too large a penalty for working harder, and may be complex to administer.