When a Tax Break Is Actually a Tax Penalty

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When is a tax break actually a tax penalty? When it's the tax exclusion for employer-sponsored health insurance.

That's what Michael Cannon, Cato Institute's director of health policy studies, convincingly argues in his recent paper, *End the Tax Exclusion for Employer-Sponsored Health Insurance*. His paper is a compact lesson in the ways that some supposed tax breaks can effectively function as tax penalties, not only distorting markets, but invisibly penalizing people for their choices. And it's a reminder of the ways that seemingly minor, offhanded policy decisions, made with little thought to long-term consequences, can exert a haunting influence long after they are made.

The tax exclusion for employer-sponsored health insurance is exactly what it sounds like: a carve-out for health coverage offered through the workplace.

If an employer were to pay an employee $10,000 in cash, that money would be taxed at an average rate of about 33 percent, meaning that the employee would only see about $6,666. If, on the other hand, the employer were to compensate an employee with $10,000 in health insurance purchased by the employer, the value of that plan would be exempt from federal income and payroll taxes. The employee would receive the full value of the plan.

This makes workplace health benefits more valuable, on a dollar-for-dollar basis, than cash compensation, and thus incentivizes purchasing more of it than if the tax treatment of cash and health benefits were equal. It acts as a subsidy.

In his paper, Cannon allows that "from an accounting perspective, the exclusion is a tax break: It reduces the tax liability of workers who enroll in employer-sponsored coverage."

But he argues that, in practical terms, this tax break actually acts as a stealth penalty on workers who want to make their own health insurance choices. Typically even a generous employer only

offers a handful of health plans, and those plans are unlikely to take the exact form an employee would otherwise choose on his or her own. If an employee wants to purchase any other plan, however, he or she would have to do it with money first received—and taxed—as cash compensation. Thanks to taxation, it would be worth a lot less. Thus the tax exclusion acts as a tax penalty on any employee who wants to choose their own health insurance.

The existence of a penalty implies a kind of coercion. Recall that when the Supreme Court blessed Obamacare's individual mandate to purchase health insurance as constitutional, it was by construing the mandate as a tax penalty for not purchasing health insurance rather than a direct economic command. That ruling highlighted the thin line between tax penalties and coercive mandates; Cannon's argument draws out the logical linkage even further: So while the tax exclusion for employer-provided insurance might look, on paper, like a tax break, viewed from an economic perspective it is functionally similar to a mandate.

And yet it was never explicitly intended as such. Rather, the exclusion stems from a complicated series of bureaucratic decisions dating back more than 100 years. Following the creation of the income tax, Treasury officials had to decide how to treat health insurance that sometimes included wage payments for sick time, a minor issue at most since few people had health coverage at the time.

In 1942, however, with World War II raging, the federal government froze wages as part of the war effort, but ruled that pension and health benefits were exempt. That meant that employers had to rely heavily on such benefits to attract talent. Not surprisingly, employer-provided health insurance became much more common. A little more than a decade later, Congress formally codified the exemption. By the 1970s, the large majority of American workers obtained health insurance through their employers.

So what seemed at first to be a minor bureaucratic decision of little consequence eventually became the primary vehicle by which Americans received private health coverage, and, consequently, a huge determinant of American health care spending.

By Cannon's calculation, the tax exclusion effectively removes control of nearly $1 trillion worth of compensation from workers—the total value of the employer share of workplace health coverage. His paper is a call to end the coercive policy that created this situation and replace it with a system of large health savings accounts that would let workers control that money and be free to make their own health insurance choices.

The tax exclusion for employer-sponsored health insurance is the original sin of the U.S. health care system. To unwind its effects, we must first see it clearly for what it is: not a harmless tax break, but a coercive policy mechanism that undermines a core economic freedom.