The “Cadillac Tax” on Health Benefits in the United States Will Hit the Middle Class Hardest: Refuting the Myth That Health Benefit Tax Subsidies Are Regressive

Steffie Woolhandler¹,² and David U. Himmelstein¹,²

Abstract
U.S. employment-based health benefits are exempt from income and payroll taxes, an exemption that provided tax subsidies of $326.2 billion in 2015. Both liberal and conservative economists have denounced these subsidies as “regressive” and lauded a provision of the Affordable Care Act—the Cadillac Tax—that would curtail them. The claim that the subsidies are regressive rests on estimates showing that the affluent receive the largest subsidies in absolute dollars. But this claim ignores the standard definition of regressivity, which is based on the share of income paid by the wealthy versus the poor, rather than on dollar amounts. In this study, we calculate the value of tax subsidies in 2009 as a share of income for each income quintile and for the wealthiest Americans. In absolute dollars, tax subsidies were highest for families between the 80th and 95th percentiles of family income and lowest for the poorest 20%. However, as shares of income, subsidies were largest for the middle and fourth income quintiles and smallest for the wealthiest 0.5% of Americans. We conclude that the tax subsidy to employment-based insurance is neither markedly regressive, nor progressive. The Cadillac Tax will disproportionately harm families with (2009) incomes between $38,550 and $100,000, while sparing the wealthy.

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Most Americans are covered by employment-based health insurance. Both employers’ and employees’ payments for such coverage are exempt from income and payroll taxes, an exemption that provided a tax subsidy of $326.2 billion (all dollar amounts in U.S. dollars) in 2015.\(^1\)

For years, economists and health policy analysts have criticized these subsidies on two grounds, claiming: (1) they encourage over-insurance, resulting in the frivolous use of unneeded care, and (2) that the subsidies are regressive, that is, disproportionately benefiting the rich.

These claims lay behind a provision of the Affordable Care Act (ACA) that imposed a new tax on employment-related health benefits. This new levy, a non-deductible 40% excise tax, was originally scheduled to apply to employees’ health benefits (including employees’ own contributions for premiums and flexible spending accounts) that exceed $10,200 for individuals or $27,500 for family coverage in 2018. (The tax has recently been delayed until 2020.)

Although the tax was labeled a “Cadillac Tax” to imply that it will apply only to luxurious benefits, because the cap will be indexed to overall inflation rather than to health care inflation (which is almost always faster), over time more and more employee groups will be hit by the tax, or by a cut in benefits to avoid it. Indeed, Massachusetts Institute of Technology economist Jonathan Gruber, who helped design the Cadillac Tax, claimed privately that it will eventually phase out most employer-sponsored insurance (ESI).\(^2\)

The new tax brought howls of protest from labor unions and some businesses. But economists have remained virtually unanimous in supporting it. For instance, Larry Summers (treasury secretary under President Bill Clinton) and Gregory Mankiw (chairman of the Council of Economic Advisors under President George W. Bush) coauthored a *New York Times* opinion piece hailing the Cadillac Tax.\(^3\) More than 100 other health economists—a virtual Who's Who of both liberals and conservatives in the field—signed an open letter lauding the tax for ending subsidies they described as “economically inefficient and regressive”.\(^4\)

But the claim that the tax subsidies for ESI are regressive is flat-out wrong. It rests on estimates showing eye-popping amounts of subsidy for the affluent. For instance, Jonathan Gruber estimated that in 2009 the richest quintile (fifth) of the population received $112 billion in ESI tax subsidies, while the middle quintile received only $46 billion.\(^5\)

But such analyses ignore the standard definition of tax (and tax subsidy) regressivity. Regressivity is not defined based on dollar amounts but on shares of income.

For instance, the rich pay more dollars in sales taxes than the poor, but sales taxes are regressive because poor families spend a bigger share of their incomes...
buying consumption goods that are subject to sales taxes, whereas the wealthy put more into savings and investments that are not. With a sales tax of 5%, a financier earning $2 million who spends $1 million on taxable purchases pays sales taxes of $50,000, whereas a janitor earning $20,000 and spending $15,000 pays $750. But the $50,000 in sales tax the financier pays is only 2.5% of her income, whereas the janitor’s $750 is 3.75% of hers. In sum, sales taxes are regressive because they take a larger share of poor families’ incomes, even though poor families pay less in absolute dollar terms.

So what happens when we apply the standard metric of regressivity (i.e., shares of income rather than dollar amounts) to the tax subsidy for ESI?

**Methods**

Using data from Gruber’s estimates of 2009 ESI-related tax subsidies and total family income data from the U.S. Census Bureau, we calculated the ESI tax subsidies as a share of income for persons in various income quintiles, from the poorest 20% of the population to the richest. In addition, we looked at ESI tax subsidies to the top 5% (above $200,000) and top 0.5% of earners (above about $500,000) using estimates of tax subsidies for high-income families from a report released by the Robert Wood Johnson Foundation and, for the top 0.5% income group, income estimates from the World Top Incomes Database.

**Results**

Table 1 and Figure 1 display the tax subsidies as a percent of family income for each income quintile and for the wealthiest 5% and the wealthiest 0.5% of families. (The table also provides data on the per capita dollar amounts of the subsidies.) The poorest 20% of families get little income boost from the subsidy (1.66% of income), mostly because so few of them have ESI. The second income quintile gets about twice as large a boost. The middle and fourth quintiles get the biggest boosts (about 5% of income) from the tax subsidy. However, for families with incomes above $100,000 (the 80th percentile), the value of the ESI subsidy begins to fall and is only 1.47% for the most affluent 5% of Americans and a mere 0.34% for the richest 0.5%.

In other words, the tax subsidy is a big help for people with (2009) family incomes of $38,550 to $100,000, but not for those with lower or higher incomes.

**Discussion**

The tax subsidy to ESI is neither markedly regressive, nor progressive. Hence, the same is true of the Cadillac Tax that will phase it out—it will hit the middle class hardest and the spare the wealthy.
Moreover, eliminating the subsidies (and “over-insurance”)—as the Cadillac Tax aims to do—has ripple effects that will disproportionately harm lower-income workers. Employers seeking to avoid the tax will probably increase copayments and deductibles. Even if most of employers’ premium savings

<table>
<thead>
<tr>
<th>Income Quantile</th>
<th>Mean Income</th>
<th>Mean Federal Health Benefit Tax Expenditure</th>
<th>Mean Federal Tax Expenditure As % of Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poorest 20%</td>
<td>$15,289</td>
<td>$253</td>
<td>1.66%</td>
</tr>
<tr>
<td>2nd 20%</td>
<td>$37,045</td>
<td>$1,205</td>
<td>3.25%</td>
</tr>
<tr>
<td>Middle 20%</td>
<td>$59,907</td>
<td>$2,916</td>
<td>4.87%</td>
</tr>
<tr>
<td>4th 20%</td>
<td>$90,962</td>
<td>$4,818</td>
<td>5.30%</td>
</tr>
<tr>
<td>Richest 20%</td>
<td>$189,486</td>
<td>$7,418</td>
<td>3.9%</td>
</tr>
<tr>
<td>Richest 5%</td>
<td>$325,023</td>
<td>$4,771</td>
<td>1.47%</td>
</tr>
<tr>
<td>Richest 0.5%</td>
<td>$1,348,287</td>
<td>$4,586</td>
<td>0.34%</td>
</tr>
</tbody>
</table>

Source: Income data from the U.S. Census Bureau (https://www.census.gov/hhes/www/income/data/historical/families/2014/f03AR.xls) and, for the richest 0.5%, the World Top Incomes Database (http://topincomes.parisschoolofeconomics.eu/).

Tax expenditure data from Gruber (http://www.nber.org/papers/w15766.pdf) and, for the richest 5% and 0.5%, from the Robert Wood Johnson Foundation (http://www.rwjf.org/content/dam/web-assets/2009/07/tax-subsidies-for-private-health-insurance).

Figure 1. Federal tax subsidies to health benefits, by income group, 2009.
were eventually passed on to workers as higher wages, the higher out-of-pocket costs would most discourage low-income families from seeking care—exacerbating inequalities in health and health care.\(^9\)

Finally, most economists have ignored the glaring unfairness of levying the Cadillac Tax based on the cost of benefits, rather than their richness. It is not merely (or even mostly) comprehensive benefits that push up premium costs. Premiums are much higher in high cost locations (e.g., Alaska), and in workplaces with sicker, older or mostly female workers\(^10\) (e.g., public schools).

In discussions of the Cadillac Tax, the alleged regressivity of tax subsidies provides a liberal veneer for policies that shift costs to the sick and care to the wealthy.

Declaration of Conflicting Interests

The authors declared no potential conflicts of interest with respect to the research, authorship, and/or publication of this article.

Funding

The authors received no financial support for the research, authorship, and/or publication of this article.

References


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