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The Upshot

Uniting Behind the Divisive 'Cadillac' Tax on Health Plans

Economic View

By N. GREGORY MANKIW and LAWRENCE H. SUMMERS OCT. 24, 2015

One of us, a former member of the Obama administration, remains a fan of the president. The other, not so much. But we agree on one thing: The excise tax on high-cost health care plans, the so-called Cadillac tax, is good policy. Congress should side with President Obama and resist calls to scrap it.

Let's start with the basics. Health insurance should be an ingredient of every family's financial plan. Medical expenses are necessary and unpredictable, and they can be large. When a family receives an adverse health surprise, the emotional toll is unavoidable, but the risks of financial insecurity, personal bankruptcy and forgone essential care are not. Health insurance solves these problems by protecting people from the cost of expensive treatments.

But as with a glass of red wine with dinner, too much of a good thing creates new problems. If people have insurance that pays for too much, they don't have enough skin in the game. They may be too quick to seek professional medical care. They may too easily accede when physicians recommend superfluous tests and treatments. They may not try hard enough to buy services from the lowest-cost

provider. Such behavior can drive national health spending beyond what is necessary and desirable.

An optimal insurance policy strikes the right balance. It protects people against large financial risks but still has them pay enough to be smart consumers. That's why most insurance policies include deductibles and co-payments.

Here is where the tax code enters the story. Compensation in the form of wages and salaries is subject to the income tax and the payroll tax. But compensation in the form of employer-provided health insurance is not subject to either. If a firm gives a dollar in wages to a typical worker, the worker keeps only about 65 cents; if the firm gives a dollar in health coverage to the same worker, the worker keeps the full dollar.

This asymmetry tilts the playing field in favor of paying workers in insurance rather than in cash. As a result, people end up with insurance that is excessive and wages that are too low. The nation ends up spending too much on health care.

The Cadillac tax helps level the playing field by curbing this subsidy for the most generous insurance plans, which do the most to drive up health costs. Starting in 2018, the policy will tax the excess of health insurance costs above a threshold (\$10,200 for individual coverage and \$27,500 for family coverage). Once it is in effect, companies that have paid workers in the form of expansive health coverage will have an incentive to scale back this insurance and pay more in the form of wages and salaries.

Health care costs have grown much more slowly in recent years than was anticipated, resulting in substantial savings for the federal government, businesses and consumers. The reason for the decrease in the rate of growth is widely debated. Some experts say it happened because of President Obama's policies, while others say it happened in spite of them. But almost every expert agrees that containing health care costs is essential and that the Cadillac tax will help in the future. A recent study by the Congressional Research Service estimates that the policy will reduce annual health spending by 2.5 to 3.6 percent in 2024.

Might companies use the Cadillac tax as an excuse to reduce health coverage and, instead of increasing wages, simply pocket the savings? Some may try, but the

success of this strategy would be fleeting. In the long run, the compensation of labor, like most prices in the economy, is governed by supply and demand. Any employer that tries to pay less than the market requires will struggle to recruit and retain workers.

The resulting wage increases from this policy are sizable. Jason Furman, chairman of the Council of Economic Advisers, estimates that take-home pay will increase by \$45 billion a year by 2025. By comparison, according to a 2014 report by the Congressional Budget Office, increasing the minimum wage to \$10.10 an hour, from \$7.25, would raise wages for low- and middle-income families by only half as much by the time the incremental increase would have been completed.

To some, the Cadillac tax is unpopular simply because they see it as a tax increase. We prefer to think of it as limiting a government subsidy that stems from the tax exclusion of employer-provided health insurance. The government recognizes this subsidy in its annual budget as a tax expenditure. Though the Cadillac tax reduces the deficit modestly, its main objective is not to increase government revenue but to move the nation toward a more efficient system of health insurance.

To some, the Cadillac tax is unpopular because unions oppose it, having negotiated especially generous health plans. But legislators should not let special interests stand in the way of a more rational health care system for all Americans.

To some, the Cadillac tax is unpopular because it was passed as part of the Affordable Care Act, a.k.a. Obamacare. But the Cadillac tax can be evaluated as a stand-alone measure. Both fans and critics of Obamacare should see the merits in a more level playing field between alternative forms of compensation.

One of us worked for President Obama when the Affordable Care Act was passed. One of us worked for President George W. Bush and supported John McCain and Mitt Romney in their attempts to defeat Mr. Obama. We disagree on many things, but we agree that health policy is too important to treat as if it were nothing more than another political battlefield.

Some policies deserve bipartisan support. The Cadillac tax is one of them.

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