AMERICAN ACTION FORUM

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The Honorable Dave Camp
Chairman
Committee on Ways and Means
1101 Longworth House Office Building
Washington, D.C. 20515

The Honorable Sander Levin
Ranking Member
Committee on Ways and Means
1106 Longworth House Office Building
Washington, D.C. 20515

Re: Comments: Income and Tax Distribution Tax Reform Working Group

Dear Chairman Camp and Ranking Member Levin:

I'm writing to express my sincere concern regarding the application of the health insurance premium tax contained in the Affordable Care Act. I encourage your committee, and its appropriate appointed working group to re-evaluate the wisdom of this tax, given its expected impact on consumers and overall health care costs.
As you know, the Affordable Care Act imposes a fee on health insurers that amounts to a *de facto* "health insurance premium tax" that will raise the cost of health insurance for American families and small employers. Specifically, under the law, an annual fee applies to any U.S. health insurance provider. In 2012, the Joint Committee on Taxation indicated that the revenue impact of these taxes would total $101.7 billion over the 2014 to 2022 window.

To see the implications for insurance costs, one must examine how it affects individual insurers. Each firm will be liable for a share of the aggregate fee that is calculated in two steps. First, each company will compute the total premiums affected by the law using the formula outlined in Table 1. For example, an insurer with net premium revenues of $10 million is unaffected. In contrast, an insurer with net premiums of $100 million will have a $62.5 million ($12.5 million from the 50 percent component between $25 million and $50 million, and $50 million from the remainder) taxable total. The aggregate fee is apportioned among the insurers based on their shares of the affected premiums.

Table 1: Fraction of Premiums Counted

Annual Net Premiums	Fraction
Less than $25 million	0
$25 million to $50 million	50 percent
$50 million or more	100 percent

While insurers will be paying this new "health insurance premium tax", the true cost will ultimately be borne by their customers. Accordingly, the Congressional Budget Office, Joint Committee of Taxation, and the Centers for Medicare and Medicaid Services have acknowledged that this tax in particular would largely be passed on to consumers.

For any company, as it sells more insurance policies it will incur a greater market share, and thus a greater share of the $101.7 billion. That is, with each policy sold, the firm's total tax liability rises; precisely the structure of an excise tax. And as with any excise tax, firms don't really pay taxes; they are shifted to suppliers, workers, or customers. Thus, it is important to distinguish between the *statutory incidence* of the premium tax – the legal responsibility to remit the tax to the Treasury – and the *economic incidence* – the loss in real income as a result of the tax.

Insurance companies will have to send the premium tax payments to the Treasury, so the statutory incidence is obvious. However, a basic lesson of tax policy is that people pay taxes; firms do not. The imposition of the premium tax will upset the cost structure of insurance companies, raising costs per policy and reducing net income (or exacerbating losses). Some might argue that the firms will simply "eat the tax" – that is simply accept the reduction in net income. For a short time, this may well be the case. Unfortunately, to make no changes whatsoever will directly impact companies' abilities to make investments in health IT programs, wellness initiatives and disease management tools. Ultimately, this hurts individuals and small employers who won't have access to the types of tools and programs that can improve the quality of care and lower costs. Trying to retain the *status quo* also hurts the return on equity invested in the firm. Because insurance companies compete for investor dollars in competitive, global capital markets, they will be unable to both offer a permanently lower return and raise the equity capital necessary to service their policyholders.

In short, all insurers will seek to restructure in an attempt to restore profitability, with the main opportunity lying in the area of labor compensation costs. To the extent possible, firms will either reduce compensation growth, squeeze labor expansion plans (or even lay off workers), or both. However, there are sharp limits on the ability of companies to shift the effective burden of excise taxes on to either shareholders (capital) or employees (labor). Moreover, their ability to do so diminishes over time as capital and labor seek out better market opportunities.

There are important exceptions to this tax that may further distort the makeup of the industry, the equity of the tax over time, and the potential for corresponding premium increases to hit some consumers harder than others. Importantly, certain tax-exempt insurers are treated differently under the tax. Instead of calculating their taxable premium amount according to the table above, their liability amounts to 50 percent of their net premium amount. Plans receiving more than 80 percent of their premium total from government programs are exempt altogether. Self-insured plans, a common employee health insurance preference of large employers, are largely exempt as well. Furthermore, the fees paid by insurers in this case are not deductible for income tax purposes. This non-standard tax treatment matters a lot. If an insurance company passes along $1 of premium taxes in higher premiums and cannot deduct the cost (fee), it will pay another $0.35 in taxes. Accordingly the impact on the insurer is $0.65 in net revenue *minus* the $1 fee. Bottom line: a loss of $0.35. (The problem gets worse when you consider that the $1 of additional premium is also subject to other state-level premium taxes and in some cases a state income tax.)

To break even, each insurer will have to raise prices by $1/(1-0.35) or $1.54. If it does this, the after-tax revenue is the full $1 needed to offset the fee. This has dramatic implications for the overall impact of the premium taxes. Instead of an upward pressure on premiums of $87.4 billion in fees through 2020, the upward pressure will be as much as $156.6 billion.

Health insurance premium cost increases, encouraged upward by the health insurance premium tax, will hit those just beyond the reach of the 400 percent federal poverty level subsidy threshold the hardest. This is particularly true if an employer no longer provides coverage, or discontinues family coverage. In previous work, I have estimated that up to 35 million Americans currently covered by employer-sponsored coverage would be moved onto the exchanges as a result of employer incentives to discontinue coverage under the law. In the event that a significant number of Americans currently covered by an employer policy or a spouse's employer policy lose that coverage and do not qualify for substantial subsidies due to income, taxes and regulations like the health insurance premium tax will make it that much harder for families to find affordable coverage.

The health insurance premium tax is a sector-specific, narrow tax policy that will shift labor, financial capital and innovation resources toward the Treasury. It discriminates among insurers subject to the tax based on their structure and tax-exempt status. It further discriminates on the basis of the composition of lines of business. It represents a tax-based distortion of economic scale and composition that is difficult to defend. Like several other taxes in the ACA, the premium tax is in violation of the standard notion that taxes should be as broadly-based as possible, treat similar activities similarly, and have minimal impact on decisions to save, allocate investment, market products, and spend incomes. I encourage you to consider significant alterations to this ill-conceived tax.

As always, I would be delighted to assist you and the rest of your committee in your efforts to put forward a broad, equitable, and pro-growth tax reform proposal.

Sincerely,

Douglas Holtz Eakin

Douglas Holtz-Eakin
President, American Action Forum