Statement of Professor Jonathan Gruber
Before the Senate Finance Committee

July 31, 2008

Thank you for inviting me to testify today on the interaction of health insurance and the tax code. In my testimony today I would like to do three things: describe the existing treatment of employer-sponsored insurance (ESI) by the tax code; review the problems caused by that treatment; and discuss complementary policies to blunt the effects of changing this tax treatment.

We all know the two largest government health insurance expenditures, on Medicare and Medicaid. Less well known, and even less well understood, is the government's third largest health insurance expenditure: the $250 billion/year in foregone tax revenues from excluding employer expenditures on health insurance from taxation. When MIT pays me in cash wages, I am taxed on those wages. But the roughly $10,000 that MIT will spend this year on my health insurance is not taxed, amounting to a tax break of about $4000 to me. To be clear, this exclusion is a tax break to individuals, not to firms; firms are indifferent between paying me in wages and in health insurance. But I am not indifferent about getting paid in wages or health insurance; I pay taxes on the former but not the latter.

The tax exclusion of employer expenditures from individual taxation has three flaws. First, $250 billion/year is an enormous sum of money which could be more effectively deployed elsewhere, especially through alternative approaches to increasing insurance coverage. Second, this is a regressive entitlement, since higher income families with higher tax rates get a bigger tax break; about three-quarters of these dollars go to the top half of the income distribution. Third, this tax subsidy makes health insurance, which is bought with tax-sheltered dollars, artificially cheap relative to other goods bought with taxed dollars, leading to over-insurance for most Americans.

As result of these limitations, *no health expert today* would ever set up a health system with such an enormous tax subsidy to a particular form of insurance coverage. So why don't we just remove it? Administratively, this would be straightforward: employers would report their spending on insurance as taxable wages on W-2 forms, and the government would raise the resulting revenues.

The problem is that the existing system is predicated on this tax exclusion, so policy makers must be wary about simply removing it. Many employers currently only offer health insurance because of this "tax bribe", and ending the exclusion would lead to a large erosion of employer-sponsored insurance.

There are two reasons why this might be a problem – one is wrong and one is right. The one that is wrong is the concern that we will "lose employer dollars" when ESI erodes. Both economic theory and a large body of economic evidence show that t*here are no employer dollars*: the money that employers spend on insurance would otherwise just be spent on worker wages. If MIT stopped offering insurance, over a several year period my wages would rise by $10,000 to offset the lost insurance compensation, and MIT's bottom line would remain the same. The notions of "shared responsibility" or "keeping employers in the game" are political notions, not economic ones.

The right reason to worry about the erosion of ESI is that sick and older individuals are treated much more fairly in employer groups than they will be in today's non-group insurance market. Under ESI, all individuals pay the same for insurance regardless of age or health. But in most states those who are sick or older must pay much more for their non-group insurance, and in many cases it is simply unavailable. So as employer-sponsored insurance falls we could end up with a large new set of uninsured who cannot afford, or cannot obtain at any price, non-group insurance.

Let me conclude, then, with four different things we could do to mitigate the problems caused by removing the exclusion of ESI from taxation. The first is to remove the exclusion either slowly or partially. For example, President Bush's 2005 tax policy panel suggested capping the exclusion, only subjecting insurance premiums above the national average to taxation. Alternatively, all individuals could be taxed on a portion of their employer-sponsored insurance premiums. There are a variety of alternative steps to take here and I would be happy to discuss them.

The second is to reform the outside market so that those who lose ESI are not subject to the existing vagaries of this unfair market. If health insurance companies were precluded from charging the sick much more for their insurance then it would reduce those risks. Of course, this reform cannot happen in a vacuum, as forced community rating on insurers would lead to higher prices for all.

This leads to my third suggestion, a mandate on individuals to buy health insurance. As we have shown in my home state of Massachusetts, such a mandate can lead to low prices for non-group insurance side-by-side with regulations that keep prices the same for the sick and the healthy. Moreover, one of the most striking findings from early analysis of our plan is that not only have we cut the number of uninsured more than in half, but we have *raised* the number with ESI. I would be happy to discuss our experience in Massachusetts more fully with you.

Finally, a natural alternative to existing exclusion would be to move from subsidizing *individuals* to subsidizing *firms*. The key to expanding insurance coverage in today's world is to get employers to offer that insurance – once offered, the vast majority of employees will enroll. Moreover, there are clear groups of employers who don't offer insurance – small and low wage firms. Therefore, a tax credit targeted to those small and low wage firms could expand insurance coverage. Such a credit must be well targeted, however, or it can be quite expensive. A credit that focuses its spending on those firms below 25 employees and in firms with average wages below $30,000 per year would be most effective in expanding coverage.

Thank you again for allowing me to testify today and I look forward to your questions and to helping the committee further as you tackle these difficult issues.