AMERICAN ACTION FORUM

Higher Costs and the Affordable Care Act:

The Case of the Premium Tax

Douglas Holtz-Eakin | *March 9, 2011*

Introduction

The healthcare reform law flunks the test of real healthcare reform. Real reform would: encourage providers to offer higher-quality care at lower costs; reduce the cost pressures that threaten to bankrupt Medicare and Medicaid; and give every American access to more options for quality insurance. To enact real healthcare reform, and help to restore fiscal balance to the nation's budget, the next Congress should pursue substantial changes to the Patient Protection and Affordable Care Act (PPACA). We recommend the following five healthcare objectives for the 112th Congress.

President Obama ran on the promise that American families will save $2,500 on their health insurance every year. He signed the Patient Protection and Affordable Care Act (ACA) while maintaining that it would bend the health care cost curve and provide affordable insurance options for Americans.

As the first anniversary of the ACA nears, it is becoming clear that the reality is quite different. Objective analysts have uniformly concluded that the new law raises – not lowers – national health-care spending.[i] The rising bill for national health care spending will produce sustained upward pressures on health insurance premiums.

Executive Summary

As the first anniversary of the Patient Protection and Affordable Care Act (ACA) nears, it is becoming clear that new law raises – not lowers – national health-care spending and health insurance premiums. This paper focuses on the economic impacts of fees totaling nearly $90 billion dollars on insurance companies. The analysis indicates that:

- Consumers – small businesses and families – will shoulder the burden of these disguised taxes in the form of higher premiums for health insurance, reduced wages, and fewer resources available for hiring.
- The detrimental impact on premiums is exacerbated by the peculiar policy decision to make the fees non-deductible for income tax purposes.
- The anticipated impact is as much as 3 percent or nearly $5,000 per family over a decade.

In addition, the law's array of insurance market reforms will increase premiums. Barring limits on annual and lifetime out-of-pocket spending, coverage of children's pre-existing conditions and the ability for children to stay on parents' policies are all initiatives that enhance benefits. These benefits must necessarily be covered by higher premiums.

These features of the law are increasingly well understood, much to the dismay of insurance consumers. However, other aspects of the new law are less appreciated. In particular, the financing of the health care law will have significant implications for purchasers of insurance as well.

Douglas Holtz-Eakin (dholtzeakin@americanactionnetwork.org) is the President of the American Action Forum.

AMERICAN ACTION FORUM

This short paper examines in detail the likely insurance and economic impact of the fees levied on U.S. health insurance companies. We conclude that the structure of the fees will substantially raise premiums for small businesses and households. The anticipated impact is as much as 3 percent or nearly $5,000 per family over a decade.

The Health Insurance Premium Tax

The Affordable 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, with the intent of raising nearly $90 billion over the budget window. As shown in Table 1, the aggregate annual fee for all U.S. health insurance providers begins at $8 billion in 2014 and rises thereafter.

Table 1: Aggregate Insurance Fees[ii]

Year	Fee
2014	$ 8 billion
2015	$11.3 billion
2016	$11.3 billion
2017	$13.9 billion
2018 & Beyond [iii]	$14.3 billion
Total through 2020	$87.4 billion

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 2. 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 $62.5 million ($12.5 million from the 50 percent component between $25 million and $50 million, and $50 million from the remainder).[1] The aggregate fee is apportioned among the insurers based on their shares of the affected premiums. Importantly, the fees are not deductible for income tax purposes.

Table 2: 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

The Economics of Premium Taxation

Taken at face value, insurers have to pay this new "health insurance premium tax." Unfortunately, this ignores the influence of market forces. For any company, as it sells more insurance policies it will incur a greater market share, and thus a greater share of the $87 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.

[1] There is some ambiguity as to whether the reduced percentages to the first $50 million apply to all firms. If it applies only to those with revenue below the threshold, the overall analysis is little changed, but the premium pressures will differ across market segments and products.

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. Accordingly, the economic burden of the $87 billion in premium taxes must be borne by individuals. Which individuals will bear the economic cost?

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.

Importantly, these impacts will be felt equally by the not-for-profit insurers. Non-profits have comparable resource needs for disease management, wellness efforts, or IT equipment. They also have equity capital demands, as they rely on retained earnings as reserves to augment their capital base. Bearing the burden of the tax means lower access to these reserves and diminished capital, harming their ability to continue to serve policyholders effectively.

In short, all insurers – for profit and non-profit alike – 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.

The only other place to shift the tax cost is onto customers – i.e., families and small businesses. This economic reality is reflected in the Congressional Budget Office and Joint Committee on Taxation revenue estimating procedures. Specifically, they apply a 25 percent "offset" to the estimated gross receipts of any excise tax. In terms of the premium tax, this convention has two important implications. First, if the aggregate fee were recognized as a premium excise tax that carried incentives to shift some of the burden via lower dividends, capital gains, and wages, then the aggregate fee will overstate the net budget receipts. To the extent this happens, receipts of income-based taxes will fall; hence the need for an offset to the gross receipts of the excise tax.

The second implication is that the remainder of the tax is passed on to consumers. That is, the offset is not 100 percent meaning that the non-partisan consensus-based revenue estimators have concluded that the vast majority of the burden of excise taxes will *not* be borne by shareholders or workers.

If market conditions make it impossible for insurers to absorb the economic burden of the premium tax, they will have no choice but to build the new, higher costs into the pricing structure of policies. In this way, the economic burden of the tax is shifted to the purchasers of health insurance. In particular, the more competitive are markets for equity capital and hired labor, the greater the fraction of the burden that will be borne by consumers.

The implications for purchasers of health insurance are obvious and unambiguously negative. In addition, as employers pay more for health insurance, they will have to shave back on cash wage increases, and thus taxable compensation. Thus the health insurance premium tax will have the perverse effect of lowering personal income and payroll taxes.

To top things off, the new law has an especially unpleasant feature for those facing higher premiums: the fees are not tax-deductible but higher premiums will be taxable.

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 over the budget window, the upward pressure will be $134.6 billion.

Empirical Implications of Premium Tax Economics

The line of reasoning outlined above is sometimes met with skepticism, and countered with the notion that consumers will simply be unwilling to accept a higher price. Evidence suggests that this is not true, but suppose the counter-argument is taken at face value. To the extent that firms accept a lower rate of return, they will be unable to attract capital. Similarly, to the extent they reduce employment in response to the tax (or cut wages and lose skilled employees to better opportunities), they will again suffer in their ability raise their scale of operations. In short, for insurers that attempt to adjust entirely on the cost side will be unable to maintain their operations at a competitive level, and will lose market share or even depart the industry entirely. For health insurance markets as a whole, this reduces competition. The bottom line for consumers is the same: higher prices.

To gain a rough empirical feel of an average $87 billion health insurance premium tax, I employ publicly-available data on Yahoo! Finance.[iv] Those data indicate that the earnings for the industry called "Health Care Plans" were roughly $16 billion. The average annual aggregate fee of $8.7 billion is a substantial impact on the cost structure and profitability of the companies; roughly one-half of the net earnings.

Could insurers absorb the fee and remain competitive in the market for equity capital? As a whole, the overall profit margin is shown as 4.2 percent.[v] Assuming no change in behavior, a 50 percent decline on a sustained basis would make it impossible to obtain the financing needed to compete. Accordingly, it will be a matter of competitive reality for the insurers to pass the fee to consumers in the form of higher health insurance premiums.

In short, the health insurance fee will likely quickly and nearly completely be incorporated into higher insurance premiums. To get a feel for the implications, I adopt the projected changes in insurance coverage by Medicaid and SCHIP; employers, and non-group and others contained in the Congressional Budget Office letter to Nancy Pelosi

on March 20 2010.[vi] Using the rough assumptions that 55 percent of employer coverage is self-funded and that 66 percent of Medicaid and SCHIP is private coverage yields an estimate of the insured coverage in each year.

To compute the baseline premium income, I assume that premiums per person will grow at an average rate of 3 percent. When combined with the coverage growth implicit in the CBO projections, the result is projected growth in overall premium income. In 2009, overall premium income was $1.005 trillion, providing a starting point for a projection of premium income in each year.[vii]

Table 3 shows the impact of the ACA on premiums. As shown at the bottom of the table, the premium tax in isolation will raise premiums from between 2.4 percent (in 2014) to over 3 percent (in 2015). If one factors in a second assessment on insurers that covers the transitional reinsurance program, the effect will be as large as 3.5 percent.

Table 3: Impact of PPACA on Insurance Premiums

Year	2014	2015	2016	2017	2018	2019
Fees: Fully Insured Plans Only ($B)						
Premium Tax (PPACA Section 9010)	$8.0	$11.3	$11.3	$13.9	$14.3	$14.3
Reinsurance (PPACA Section 1341)	$2.0	$2.0	$1.0			
Fees: Fully Insured & Self-Funded ($B)						
Reinsurance Transition (Section 1341)	$10.0	$6.0	$4.0			
Total Fees and Assessments ($B)	$20.0	$19.3	$16.3	$13.9	$14.3	$14.3
Impact: Fully Insured Premiums (pct.)						
Premium Tax	2.40%	3.03%	2.69%	3.02%	2.98%	2.89%
Premium Tax and Reinsurance	3.16%	3.45%	2.96%	3.02%	2.98%	2.89%

Data from the Kaiser Family Foundation show that the average overall family premium in 2010 is $13,770.[viii] Using this as a rough guide, the ACA premium tax will add as much as $475 to the costs, or nearly $5,000 per family over a decade.

Conclusions

The ACA contains insurance reforms, medical device taxes, pharmaceutical fees, and insurance company fees that will raise the cost of insurance for millions of individuals, small businesses and households. This analysis suggests that the insurance tax in isolation will raise premiums by roughly 3 percent. An important topic for future research is to perform similar analyses for the other cost-raising aspects of the ACA in order to assess the overall pressure on premiums.

AMERICAN ACTION FORUM

The American Action Forum is a forward-looking policy institute. The Forum produces real-time, fact-based, innovative policy analysis and solutions for policy makers and the public alike. Our mission is to promote common-sense, innovative and solutions-based policies that will reform government, challenge outdated assumptions, and create a smaller, smarter government.

Operation Healthcare Choice is the Forum's public policy center focused on promoting high-value healthcare and higher quality health insurance that expands consumer choice. Operation Healthcare Choice experts conduct research, offer commentary, and develop policies aimed at eliminating healthcare's burden on the economy.

References

[i] See http://www1.cms.gov/ActuarialStudies/Downloads/S_PPACA_2010-01-08.pdf or http://www.cbo.gov/ftpdocs/117xx/doc11705/08-18-Update.pdf.

[ii] The non-deductibility of the Insurance fees raises their economic impact. See text for discussion.

[iii] The statute provides that after 2018 the insurance fee is equal to the amount of the fee in the preceding year increased by the rate of premium growth for the preceding calendar year.

[iv] See http://biz.yahoo.com/p/522qpmd.html.

[v] See also, "Health Care-Managed Care," Barclays Capital, November 19, 2009 which indicates an overall profit margin of 4.42 percent.

[vi] See http://www.cbo.gov/ftpdocs/113xx/doc11379/AmendReconProp.pdf.

[vii] See also, "Health Care-Managed Care," Barclays Capital, November 19, 2009 which indicates an overall profit margin of 4.42 percent.

[viii] http://ehbs.kff.org/pdf/2010/8085.pdf .