The HIT Hit: PPACA's Health Insurance Tax (6/14/11)
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The 2010 health care law, the Patient Protection and Affordable Care Act (PPACA), hits small business with a barrage of inequities. Among the most egregious is the health insurance tax (HIT) launched by the law's Section 9010. Ostensibly a tax on insurers, its real effect will be hundreds of billions of dollars of taxation on people who purchase coverage in the fully-insured market – mostly small business employers and employees and the self-employed. These are the people who usually generate around two-thirds of America's new jobs.

In contrast, the HIT bypasses those who have coverage through self-insured plans – mostly big business, labor unions, and governments. Like PPACA's essential health benefits and longstanding state benefit mandates, the HIT puts an anchor around the neck of small business while leaving larger organizations free to swim unburdened. And the anchor is a heavy one.

Over the first decade, the HIT will hit the fully-insured market with an estimated $87.4 billion tab, but that figure greatly understates the long-run financial impact. The tax is not implemented until the fourth year of the decade (2014) and is only fully implemented in 2018. The tax rises from $8 billion in 2014 to $14.3 billion in 2018 and in later years, even higher according to a complex (and at this point opaque) index, discussed below.

To put this in perspective, that $14.3 billion equals around 15 percent of the total small business expenditures on employee benefits in 2007. According to IRS data, proprietorships, partnerships, and corporations with up to $10 million in annual receipts deducted $96.8 billion that year for Employee Benefit Programs. An extra 15 percent or so constitutes an enormous blow to the ability of small businesses to compete against larger entities.

The HIT's full magnitude will only become apparent in the second decade (2021-2030), when businesses and consumers experience 10 years of a premium-indexed, fully-implemented HIT. The second-decade cost is difficult to forecast, but may exceed $200 billion or even $300 billion. It all depends on how rapidly the law's arcane index lifts the HIT beyond its $14.3 billion base in later years. There are two major sources of uncertainty in that index.

First, after 2018, the size of the tax depends on how fast health insurance premiums rise, and no one can forecast that rate of increase with any confidence. In Essential Health Benefits: The Secretary's Joystick, I explained the uncertainty that the essential health benefits structure poses for premium forecasts. PPACA was supposed to moderate the increase in health insurance premiums, but that talking point has been killed by pronouncements from the Congressional Budget Office, the Chief Actuary of Medicare and Medicaid, and a rash of private forecasters. Even a White House-sponsored teleconference in summer 2010 warned participants to stop arguing that PPACA would reduce costs. There are few reasons to think that premiums will rise more slowly, but many reasons to think they will increase more rapidly – the essential health benefits package, the health insurance tax, the slew of other new taxes imbedded in the premiums, elimination of coverage limits, mandatory preventive services, giving more people insurance while creating no new doctors or nurses, and demographic trends.

Second, the precise mathematical structure of the index is uncertain. The index consists of a complex set of equations that incorporate not only premium increases, but also each year's number of policyholders, size of U.S. gross domestic product, Consumer Price Index, and certain tax credits contained in PPACA. The provision says of the index (PPACA, Section 9010):

> "In the case of any calendar year beginning after 2018, the applicable amount shall be the applicable amount for the preceding calendar year increased by the rate of premium growth (within the meaning of section 36B(b)(3)(A)(ii) of the Internal Revenue Code of 1986) for such preceding calendar year."

For readers who enjoy solving puzzles, I suggest that they turn to Section 36B(b)(3)(A)(ii) of the Internal Revenue Code and try to figure out how the IRS will calculate the post-2018 tax increases. With the help of some taxation and insurance industry experts, I think I have it figured out. But we'll see. Meaningful forecasts will have to await future IRS rulings and other regulatory interpretations.

Nevertheless, we can explore some plausible scenarios. Health insurance premiums for the average family grew by around 5 percent between 2005 and 2010 (see Exhibit 1.1 here.). If the HIT were to rise by 5 percent per year after 2018, the tax would total $208 billion between 2021 and 2030. Family premiums rose by over 10 percent between 2000 and 2005. If the HIT were to rise by 10 percent per year, the second-decade cost would be $303 billion.

In addition, the HIT will cascade on itself. Insurers will pass the HIT along to purchasers in the form of higher premiums. In turn, those premium increases will enter into the index and raise the tax in later years, and insurers will have to pass those increases along to purchasers, as well. So the HIT violates a common principle of fairness in taxation – that one should not be taxed on a tax.

And interactions between the HIT and the corporate income tax will augment the total effect by over 50 percent. Former Congressional Budget Office Director Douglas Holtz-Eakin explained how the first-decade costs will actually be $134.6 billion, rather than $87.4 billion ("Higher Costs and the Affordable Care Act: The Case of the Premium Tax," available on the web.) By the same logic, a $208 billion second-decade HIT would really mean a $320 billion impact on health insurance consumers.

Finally, the impact on those in the fully-insured market is likely to be even worse because of the peculiar structure of the HIT. If some businesses switch from the fully-insured market to self-insured plans, those remaining in the fully-insured market will have to pick up the tax bill for those who have switched to self-insurance. And because of the inequity of the tax, it will certainly drive some businesses to self-insure – even if such a switch may be imprudent from a risk standpoint.

In short, this tax will bludgeon small business.

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