EMPLOYER-SPONSORED HEALTH INSURANCE: THE SINGLE LARGEST TAX SUBSIDY IN THE FEDERAL BUDGET

The U.S. health care system rests on an employment-based insurance approach begun during World War II. Employer-sponsored insurance is the dominant source of individual health insurance. Sixty-two percent of insured Americans are covered by employer-sponsored insurance.

The federal government supports the provision of employee health benefits through preferential tax provisions in the Internal Revenue Code. Health benefits are tax-exempt; the value of the benefit is excluded from the determination of the employee's taxable income.[1] The employer's health care contribution is a deductible business cost similar to wages and materials. Because of the theoretical loss of tax revenue to the government relative to what would be received at the same tax rate in the absence of such a deduction or exemption, such provisions in the tax code are sometimes referred to as "tax expenditures."[2]

The employer health benefit exclusion affects payroll or FICA taxes. The value of the health benefit is excludable from both the employer and employee portions of the payroll tax. (One implication of the exclusion from paying FICA on the value of the employer-sponsored benefit is that the individual's lower tax contributions will result in lower Social Security and Medicare benefits at retirement.)

Employer-sponsored health benefits can be excludable from personal income taxes at the state level as well. These tax expenditures are not counted in the lost revenue to the federal treasury—though adding this sum to the federal tax expenditure would give a comprehensive assessment of the magnitude of dollars involved with the employer health benefit.

Tax expenditures for health care related to, but separate from, the exclusion for employer-sponsored health benefits include Health Care Flexible Spending arrangements, or health FSAs (as an option of a "cafeteria" plan) and Health Reimbursement Arrangements (HRAs), which help with the employee's out-of-pocket expenses (including insurance premiums). Another, much smaller tax

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(excluding from taxable income medical expenses above 7.5 percent of adjusted gross income), which is used for out-of-pocket expenses. More recently there is the tax expenditure for Health Savings Accounts (HSAs). These function like personal savings accounts except that deposits into the accounts, as well as interest accrual on the amounts in the accounts, are tax-free. Individuals can pay current medical bills and save for future medical expenses. The HSA must be combined with a high deductible, comprehensive insurance policy.

The U.S. Department of Treasury estimates the tax expenditures for the employer health benefit exclusion and other employer-related health benefits to be $132.6 billion in 2006, making the exclusion the *single largest* tax expenditure in the federal budget.[3] The exclusion is 66 percent larger than the deduction for home mortgage interest ($79.9 billion), which is a distant second, followed by capital gains on home sales ($43.9 billion), the child tax credit ($42.1 billion), and contributions to personal retirement savings.

There are several estimates of the size of the tax expenditure involved in employer-sponsored health benefits. The Joint Commission on Taxation's estimate is $90.6 billion. More recently, researchers Thomas Selden and Bradley Gray estimated the size to be $119.9 billion. Although basic differences in the items counted complicate direct comparison of the studies, a recent analysis by Selden and Gray[4] concludes that after adjusting for comparative assumptions, the estimates are relatively compatible.

The federal tax expenditure is only part of the picture. Factoring in state personnel and federal payroll taxes, Selden and Gray estimate the total annual tax expenditure for just the exclusion of employer-related health insurance in 2006 to be $208.6 billion. (This figure is still an underestimate by several billions because it does not include tax expenditures for FSA, HRAs, and HSAs.)

- Federal personal income tax $111.9 billion
- FICA payroll taxes (7.65 percent) $ 73.3 billion
- State personal income tax $ 23.4 billion

The average tax subsidy for family coverage is $3,825 or about 35.6 percent of the premiums. Some drawbacks of the current tax subsidy are:

- The tax expenditure is regressive, in that its value is greater for wealthier families (who are in higher tax brackets).
- It promotes the purchase of excessive insurance coverage.[5]
- It perpetuates the faults of the employer-based insurance system, (e.g., favoring groups over individuals).
- It widens the gap between the relatively high premiums and relatively low claims of low-risk employees.[6]

Notes

[1]They differ from other types of tax expenditures that represent tax-deferred expenditures, such as pensions. Personal income set aside for a future use is not counted as current income. The tax liability is assessed at the time the funds are paid to the individual.

[2]The Congressional Budget Act of 1974 (P.L. 93-344) requires that the federal budget list all "tax expenditures." Section 3(a)(3) defines tax expenditures as "those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."

[3]Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2007* (Washington: U.S. Government Printing Office; 2006): Tables 19-2 and 19-3.

[4]Thomas M. Selden and Bradley M. Gray, "Tax subsidies for employment-related health insurance: estimates for 2006," *Health Affairs* 25 (November-December, 2006): 1568-1579. The $208.6 billion dollars is probably an underestimate. It does not include the tax expenditures from health savings accounts, flexible health spending accounts, nor health reimbursement accounts.

[5] "All observers of health policy agree that tax preference for employer-provided health insurance – under which employer contributions to employee health insurance are deductible to the employer and non-taxable to the employee – encourages overconsumption of health services in the United States. By making health spending in general, and insured health spending in particular, appear less costly than they are, the tax preference gives employees the incentive to take compensation as health insurance rather than cash, even if they would otherwise prefer not to." John F. Cogan, R. Glenn Hubbard, and Daniel P. Kessler, "Evaluating Effects of Tax Preferences on Health Care Spending and Federal Revenues," Working Paper 12733 American Enterprise Institute (December 2006): 1. Accessed on February 22, 2007 at http://www.aei.org/publications/filter.all,pubID.25278/pub_detail.asp

[6]Selden and Gray, p. 1578.