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The Tax Exemption of Employer-Provided Health Insurance

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The Federal government currently does not tax health insurance when employers provide it to their employees as part of the employee's compensation package. The income tax revenue forgone due to this practice is the single largest "tax expenditure" in the federal income tax code. But the lost tax revenue is not the main economic concern with this or other tax expenditures. Instead, a major unintended consequence of this policy is to drastically distort both the labor market and the health insurance market. While changing the tax code to tax employer-provided health insurance would mean a major tax increase on all working Americans, if it were coupled with a reduction in marginal tax rates many of the distortions to the health insurance market would be eliminated without a net increase in taxes.

The exclusion of employer-provided health insurance from taxation lowers federal tax revenue significantly. According to the Office of Management and Budget, the federal government missed out on over $170 billion in income tax revenue and another $108 billion in payroll tax revenue in fiscal year 2012 due to the exclusion.[1] Over the next five fiscal years, the federal government would collect around $1 trillion in income tax revenue if employer-provided health benefits were taxed, plus another $600 billion payroll tax revenue. Given the large deficits that the federal government continues to accumulate, this exclusion is a tempting source of new revenue. But closing this loophole would also mean a significant tax increase on all working Americans that currently receive health insurance from their employer.

Table 1 on the next page describes the different tax treatments of wages and employer-provided health insurance for a married couple with two children earning $75,000 in wages (roughly the median household income for a family of four according to the Census Bureau) that would result from either closing the

TABLE 1: FEDERAL TAXES FOR A MARRIED COUPLE WITH TWO CHILDREN, 2013

	Wages + Insurance	Wages Only	Tax Increase	With Lower Tax Rates*
Annual Income	$75,000	$87,000		$87,000
Health Insurance	$12,000	$0		$0
Taxable Income	$47,200	$59,200		$59,200
Federal Income Tax	$4,188	$5,988	$1,800	$4,212
Federal Payroll Tax	$5,738	$6,656	$918	$5,655
Total Federal Tax	$9,926	$12,644	$2,718	$9,867
"Income" After Taxes	$77,074	$74,356		$77,134

** This scenario involves lowering the 10% and 15% brackets to 7% and 12% and the payroll tax rate from 7.65% to 6.65%*

loophole or not. The first column shows their tax situation if the employer provides them with $12,000 of health insurance, roughly the national average according to the Milliman Medical Index.[2] The second column shows their tax situation if the employer instead chose to pay them an additional $12,000 in wages in lieu of income. The taxes imposed on this family would be about $2,700 higher in the second column.[3]

The $2,700 additional tax burden can be thought of in two ways. First, it encourages employers to provide a large share of the compensation in the form of health insurance. By doing so, they can provide employees with an extra $2,700 of "income" at the same cost to the employer, provided that the employees value the $12,000 in health insurance at or near its cost. Second, the $2,700 also represents the additional federal tax burden that would be imposed on workers if the tax-exemption were removed.

To make the removal of the exemption tax-neutral for this family, marginal tax rates could be lowered significantly. In this hypothetical case, the family is currently in the 10 percent and 15 percent brackets, and these brackets would need to be lowered to about 7 percent and 12 percent to keep the level of taxation on them the same. Similarly, the payroll tax rate could be lowered from 7.65 percent to 6.65 percent. The final column in Table 1 shows this alternative, lower-rate scenario. This hypothetical situation implies another hidden cost of the current tax treatment of health insurance: an increase in marginal tax rates compared with the alternative scenario. These higher tax rates distort incentives for individuals to be productive and create a bias for more leisure over labor.

In addition to the household and federal budgetary issues, there are real economic distortions created by the exclusion of these benefits from employees' income. One distortion is "job lock," where employees feel "locked in" to their current job because they will lose their health insurance if they quit to search for a new job. Brigitte Madrian found that effect was quite large, with voluntary turnover reduced by 25 percent for those with employer-provided health care.[4] There are at least two reasons to be concerned of job lock from health insurance. First, it gives employers more power over employees, raising equity concerns since for financial reasons employees will be less likely to leave a job that they are unhappy with. Second, it makes the labor market work less well, an efficiency concern, since employees will be less likely to leave a position in order to search out a job that better suits their skills.

A related cost of the current tax treatment of health insurance may be a bias against small firms. Small firms are less likely to provide health insurance than large firms, putting them at a competitive disadvantage in recruiting labor. There is some evidence that this fact is due to the higher cost of providing insurance for small firms, potentially leading to a bias towards larger firms.[5]

Another economic distortion is the effect on the number of employers that provide health insurance and the amount of health insurance purchased. While some tax deductibility of medical expense has existed since the

inception of the income tax in the United States, a 1954 change to the Internal Revenue Code made it explicit that employer contributions were not part of taxable income. This change came from wage and price controls during World War II, which led more employers to provide insurance as a form of compensation since they could not increase wages. A temporary ruling by the IRS allowed this compensation to be tax-free, but in the post-war period there was confusion about the tax treatment of health insurance. Hence, the 1954 IRS ruling was necessary to clarify tax law and to establish the legality of the practice.[6]

Melissa Thomasson used this change to examine the effects on employer-provided health insurance and found that this change "led workers to purchase more group health insurance coverage from their employer and encouraged the expansion of employment-based, group health insurance." The amount of coverage purchased increased by about 9.5 percent.[7] As a result of this distortion, the demand for health insurance and health care increased in the United States, contributing to the rise in health care prices in recent decades. This change also further increased the effect of job lock described above and meant that fewer Americans were directly involved in decisions about purchasing their health insurance.

A final economic distortion is that the nontaxation of health benefits means that the health insurance market will be less competitive since employees have less say in what health insurance plan they get. Employers purchase group coverage for a large number of employees, and employees typically have little or no say in the process of selecting a health insurance plan. This means that employees will not be shopping around for the health insurance that best fits their needs in terms of price and features, as they do for auto or home insurance. Most employees are also unlikely to choose their employer based primarily on the type of health insurance offered, even if it is a partial consideration. The effects of excluding employee-provided health insurance from taxation thus raise equity concerns about who holds the power in this important economic decision.

Going forward, if this loophole were to be closed and medical benefits were included as part of taxable income, it would mean that taxes would dramatically increase for all Americans receiving these benefits. Thus, any move to scale back or completely remove this exclusion needs to be paired with an offsetting decrease in marginal tax rates, as described above. Doing so would also make explicit the real economic cost of current policy: not the lost government revenue, but the distortions to the health care and labor markets.

In the end, employer-provided health insurance is currently tax-exempt by the federal government in order to encourage its provision by employers. Not only does this have the result of reducing federal revenue by $278 billion in FY 2012 alone, it also creates distortions within the economy that introduce concerns about efficiency and justice. Included among them are whether employees will have the capability to tailor their health insurance to best fit their own needs and whether employer-provided health insurance creates incentives that encourage employees to stick with their current jobs rather than searching for jobs that better suit their capabilities. All of these are certainly troublesome, but if we are to close the deduction, then we must also remember that this would constitute an increase in taxation for American workers. An offsetting decrease in marginal tax rates would mean that the federal government does not receive any more revenue this year, but the higher economic growth from the lower tax rates and more flexible labor market would increase tax revenue in the long run.

Finally, any discussion of reforms related to health care today must consider the interaction effects with the Patient Protection and Affordable Care Act (PPACA). While there is not space here for a full discussion, the reforms we have proposed in this article should be beneficial regardless of the future status and outcome of the PPACA. If the PPACA is a failure or is repealed, our proposals would be preferred for all the reasons stated above. And if the PPACA remains law, our reforms would still make economic sense. The stated goals of the PPACA are, among other things, to increase transparency and control costs in the health care market. The reforms we have proposed move the market further in that direction. One consequence of our reforms would be that without the tax subsidy, fewer employers would offer health insurance, thus pushing more employees into the PPACA exchanges. While this can be seen as a downside to our reforms, it may also have the benefit of more quickly learning if the PPACA is a success or failure overall by truly testing the new health care system.

ENDNOTES

1. The Joint Committee on Taxation has a smaller estimate of the impact on federal income tax revenue, at around $117 billion in FY 2012. The JCT's estimates can be found at Joint Committee on Taxation, Estimates for Federal Tax Expenditures for Fiscal Years 2012–2017 (2013), https://www.jct.gov/publications.html?func=startdown&id=4503; OMB's estimates can be found in the "Tax Expenditures Spreadsheet" at http://www.whitehouse.gov/omb/budget/supplemental.

2. Beginning in Tax Year 2012, the Affordable Care Act began requiring employers to explicitly list the dollar value of health care benefits on employees' W-2 forms (in Box 12, with the code DD). This was presumably done in order to increase transparency for the employee regarding their total compensation package.

3. These calculations assume that the married couple files jointly, that the couple only takes the standard deduction, and that the only credit they receive is the child tax credit.

4. Brigitte Madrian, "Employment Based Health Insurance and Job Mobility: Is there Evidence of Job-Lock?" *Quarterly Journal of Economics* 109, no. 1 (February 1994): 27–54.

5. Michael A. Morrisey, Gail A. Jensen, and Robert J. Morlock, "Small Employers and the Health Insurance Market," *Health Affairs* 13, no. 5 (1994): 149–161.

6. "Taxation of Employee Accident and Health Plans before and under the 1954 Code," *Yale Law Journal* 64, no. 2 (December 1954): 222–247.

7. Melissa A. Thomasson, "The Importance of Group Coverage: How Tax Policy Shaped U.S. Health Insurance," *American Economic Review* 93, no. 4 (September 2003): 1373–1384. Quotation from p. 1374.

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