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RSC Policy Brief:
Tax Treatment of Health Insurance

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The RSC has prepared the following policy brief providing background and analysis on the tax treatment of health insurance.

History: The origins of the current income tax exclusion for employer-provided health insurance date back to World War II, when large employers successfully pressed the Internal Revenue Service (IRS) to exempt group health insurance from income and payroll taxes, thus allowing firms to offer health benefit policies as a means to circumvent wartime wage and price controls. The IRS ruling was codified as part of the re-write of the Internal Revenue Code that took place in 1954 (P.L. 83-591), and remains part of the Code at 26 U.S.C. 106(a). Largely as a result of this policy, employer-provided health insurance grew significantly during the postwar period, and in 2006 provided coverage to 177.1 million individuals, according to the U.S. Census Bureau.[1]

Budgetary Costs: The growth in the number of individuals enrolled in group health insurance over the past six decades led to a commensurate rise in the tax expenditures associated with the employee exclusion. The Office of Management and Budget estimates that, in Fiscal Year 2009, the federal government will forego more than $168 billion in income tax revenue due to the employee exclusion; tax expenditures over the next five years will total more than $1.05 trillion.[2] The Joint Committee on Taxation (JCT) estimates a lower income tax impact for the employee

[1] U.S. Census Bureau , "Income, Poverty, and Health Insurance Coverage in the United States: 2006," (Washington, DC, Report P60-233, August 2007), available online at http://www.census.gov/prod/2007pubs/p60-233.pdf (accessed July 2, 2008), Table C-1, p. 66.
[2] Table 19-1, Estimates of Total Income Tax Expenditures, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2009*, available online at http://www.whitehouse.gov/omb/budget/fy2009/pdf/spec.pdf (accessed July 1, 2008), p. 302.

exclusion, at $126 billion per year in FY09, largely because JCT assumes that individuals with high health costs will itemize their health costs over 7.5% of adjusted gross income (AGI).[3]

Employer-sponsored health insurance is also exempt from payroll taxes; however, the budgetary impact of this policy has been less accurately quantified.[4] A *Health Affairs* article published in 2006 estimated that in that year, the exclusion resulted in $73.3 billion in foregone payroll tax revenue, along with an additional $23.4 billion in state income tax revenues.[5] However, because a change in policy subjecting group health insurance coverage to payroll taxes would increase the Social Security wage base for many individuals—leading to a direct increase in promised benefits—the net impact on the federal government is likely significantly less than the estimates cited.

Economic Impact: Many conservative and liberal economists agree that the employee exclusion, while increasing access to insurance coverage for some populations, has had several adverse and unintended consequences. Because a marginal dollar of health insurance benefits is untaxed, whereas a marginal dollar of salary can be subject to total tax rates (income, payroll, and state/local taxes) in excess of 40%, additional health benefits are actually more lucrative to workers than an additional dollar's wages. Thus the employee exclusion, which is not capped, may encourage workers to consume all the health care they want, rather than the health care they need.

The disparity created by the employee exclusion may explain why the average premium for employer-sponsored insurance is $4,479 for an individual—roughly three times the average $1,500 paid for insurance coverage outside the group market, where premiums paid are generally subject to income and payroll taxes.[6] It also may help to explain the 157.6% rise in total tax subsidies for health insurance (adjusted for inflation) between 1987 and 2006—while total employment rose somewhat during the period, most of the increase can be attributed to rising premium costs, which an uncapped federal tax subsidy can exacerbate.[7]

The growth in group health insurance coverage, sparked in part by federal tax policy that encouraged employers to offer health benefits, has increased the amount of overall health expenditures made by third-party insurers. A report released by the Congressional Budget Office in November 2007, which examined both historical trends in health care spending and long-term

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[3] Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2007-2011," (Washington, DC, Committee Print JCS-3-07, September 2007), available online at http://www.jct.gov/s-3-07.pdf (accessed July 2, 2008), Table 1, p. 36. For comparison with Treasury estimations, see narrative section at pp. 24-25.

[4] The payroll tax exclusion can be found at 26 U.S.C. 3121(a)(2).

[5] Thomas Selden and Bradley Gray, "Tax Subsidies for Employment-Related Health Insurance: Estimates for 2006," *Health Affairs* 25(6), November/December 2006, pp. 1570-71.

[6] Kaiser Family Foundation, "Employer Health Benefits: 2007 Annual Survey," available online at http://kff.org/insurance/7672/upload/76723.pdf (accessed July 2, 2008), p. 2; eHealthInsurance, "The Cost and Benefits of Individual Health Insurance Plans: 2007," available online at http://www.ehealthinsurance.com/content/expertcenterNew/CostBenefitsReportSeptember2007.pdf (accessed July 2, 2008), p. 23. It should also be noted that in recent years, the average premium in the eHealthInsurance survey has remained nearly constant, while the average deductible has risen slightly; this would lend further confirmation to the concept that individuals purchasing health care on their own, particularly on an after-tax basis, make rational choices between potential out-of-pocket costs and overall premium levels when shopping for policies.

[7] Selden and Grey, p. 1577.

projections for its growth over the next 75 years, documented a significant shift in health care expenditures: out-of-pocket spending declined from 31% to 13% of all health expenditures (both private and public) between 1975 and 2005, while third-party payment by private insurance carriers increased from 25% to 37% of health spending nationwide.[8] Although new technologies and services have also helped drive the growth in health spending, the continued rise of third-party payment—which can insulate patients from the marginal costs associated with additional treatments—may well have had inflationary effects. This shift away from out-of-pocket spending occurred despite the findings of a landmark RAND Institute study, which concluded that higher cost-sharing helped constrain health care spending at little to no adverse effect on patients' health.

Additionally, the fact that tax policy generally favors employer-provided insurance when compared to health insurance purchased on the individual market tends to have distortionary effects on labor markets. Although policy-makers have established some other tax benefits for health insurance, these generally have more limitations than the expansive employee exclusion: the self-employed may deduct health insurance premiums from income tax, but are not exempt from 15.3% payroll tax on the cost of policies purchased; Health Savings Accounts (HSAs) allow for pre-tax savings for health expenses, but cannot be used for the purchase of health insurance, except in limited instances; and deductions for medical expenses in excess of 7.5% of AGI only apply to individuals who do not itemize.

The sum total of the effects of the employee exclusion is therefore material from both a fiscal and an economic perspective. Employees' inbuilt incentive to over-consume health care encourages rich insurance benefits that insulate consumers from the true costs of care—raising health care costs over time—while depressing cash wages paid. Moreover, the disparity in the tax treatment of insurance tends to perpetuate "job lock," whereby individuals gravitate towards positions and industries that offer health coverage to the detriment of those that do not—providing a disincentive for individuals to establish their own businesses and take the entrepreneurial risks that lead to robust economic growth.

Policy Solutions: In general, some conservatives may support reforms to the current tax treatment of health insurance that accomplish the twin goals of eliminating the disparity between health insurance offered by an employer and non-group coverage and imposing some threshold on the level of tax subsidies provided for health benefits in an attempt to slow the growth of health care costs. Proposals in this line have varied widely; in his first term, President Bush proposed a tax credit for low-income individuals and families without access to employer-sponsored insurance, as a means to incentivize these populations to purchase health coverage. Last year, the President proposed a new standard deduction for health insurance, similar to that first proposed by the Tax Reform Panel in 2005, that would provide tax subsidies for coverage purchased up to a set level premium ($7,500 in the case of the budget proposal submitted to Congress).[9]

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[8] Congressional Budget Office, "The Long-Term Outlook for Health Care Spending," (Washington, DC, Publication #3085, November 2007), available online at http://www.cbo.gov/ftpdocs/87xx/doc8758/11-13-LT-Health.pdf (accessed July 2, 2008), pp. 12-13.

[9] Information on the Standard Deduction for Health Insurance proposed as part of the Fiscal Year 2009 budget can be found in the Treasury Blue Book at http://www.ustreas.gov/offices/tax-policy/library/bluebk08.pdf (accessed July

Other proposals have looked to replace the current exclusion for health insurance with a tax credit available to all individuals, paid for by capping or repealing entirely the current tax subsidy for group health insurance. Policies in this vein include provisions in the first title of comprehensive health and entitlement reform legislation (H.R. 6110) introduced by Budget Committee Ranking Member Paul Ryan (R-WI), along with the health reform plan promoted by Sen. John McCain (R-AZ). In most cases, the credits would be refundable (i.e. paid to individuals with tax liability less than the amount of the credit) and advanceable (i.e. paid out on the same monthly basis as health insurance premiums, rather than in conjunction with the filing of an annual return).

Conclusion: Despite—or perhaps because of—the multitude of proposals designed to reform the current tax treatment of health insurance, most conservatives share the over-arching goal of improving an arguably archaic system of tax subsidies, rooted in a wartime bureaucratic decision, that has distorted America's more than $2 trillion health sector while inhibiting economic growth. Although the health plan released by Sen. Barack Obama omits any discussion of the damaging and perverse effects of current tax policies on both the health sector and the broader economy, some conservatives may believe that revisiting current tax policy should be at the top of any health reform agenda.

For further information on this issue see:

- *CRS Report on Tax Benefits for Health Insurance*

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2, 2008), pp. 22-25. Details on the Tax Reform Panel proposal can be found at http://www.taxreformpanel.gov/final-report/TaxReform_Ch5.pdf (accessed July 2, 2008), pp. 20-24.