Growth in the Exclusion of Employer Health Premiums

By Adam Carasso

The single largest tax expenditure in the federal budget is the employer exclusion of contributions for medical insurance premiums and medical care from employee income taxes. In fiscal year 2005, the Office of Management and Budget estimates this exclusion is worth $112 billion. If the payroll tax exclusion component were also counted here, the total would be significantly higher. (For details, please see Len Burman, Cori Uccello, Laura Wheaton, and Deborah Kobes, “Tax Incentives for Health Insurance,” Discussion Paper No. 12, Washington, DC: The Urban-Brookings Tax Policy Center, May 2003.)

The chart below shows Consumer Price Index-adjusted and medical-price-adjusted growth in the cost of this health tax subsidy. Adjusting just for the CPI, the employer exclusion has seen sizeable growth between 1987 and 2005. Even when we adjust for medical price inflation as recorded by increases in medical insurance premiums — which has far outstripped overall price growth — the employer exclusion still grows in real terms between 1988 and 2002 (a 36 percent rise). The period of fastest growth, over the late 1980s and early 1990s, was driven in large part by soaring health premium costs, but may also have been due to the 1990 and 1993 increases in marginal tax rates. This growth is particularly noteworthy as marginal income tax rates fell after the 1986 tax reform. The recent leveling-off or dip (around 2002) in this tax exclusion stems in part from another drop in marginal tax rates, following the 2001-2003 tax cuts.

It is important to note that those tax expenditures are not just driven by increases in health prices over time, but also in the quantity of health services demanded — that is, patients in 1984 could not purchase the services of today’s more advanced, more intensive medical technology or pharmaceuticals. Yet, as health tax expenditures for employer-sponsored insurance have grown, the uninsured population has also grown, both in absolute numbers and as a percentage of the nonelderly population — from about 31 million in 1987 (14.4 percent) to 45 million in 2003 (17.6 percent) — according to the U.S. Census Bureau.