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Tax subsidies for private health insurance: Who benefits and at what cost?

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KEY FINDINGS

- **Federal tax subsidies for employer sponsored insurance will amount to more than $240 billion in 2010.** The tax exclusion for ESI is the largest subsidy for private insurance.
- **Higher-income workers benefit the most from the current tax subsidies.** They are in a higher tax bracket, which makes the exclusion more valuable, are more likely to work for employers offering ESI and more likely to take up ESI than lower-income workers.
- **Lower-income families pay the largest percent of income on insurance, but receive the smallest tax subsidy.** These families spend more than a quarter of their income on health insurance coverage.

Policy-makers are considering modifications to the tax treatment of employer-sponsored insurance (ESI) as a way to raise revenue to help pay for health reform and provide incentives to reduce health care costs. Understanding how current subsidies work is important to assessing health reform proposals. This brief presents essential information about the structure and distribution of existing tax subsidies for ESI and the implications for policy options.

How does the federal government subsidize private health insurance?

The tax exclusion for employer contributions to ESI is the largest subsidy for private insurance. When employers purchase or provide insurance for employees, the employer contribution to the premium is excluded from income and payroll taxes.

Employees' contributions to ESI also are excluded from taxes if the premiums are paid through a flexible savings account (FSA). Once established by employers, workers can use FSAs to set aside a portion of their income to pay for health insurance and other expected medical expenses.

Employer contributions to Health Savings Accounts (HSAs) are excluded from income and payroll taxes. Employers pair HSAs with a high deductible health insurance plan and withdrawals are tax-free if used to pay for health care. Employee contributions to HSAs are excluded from income, but not payroll, tax.

People who purchase insurance outside of their employment do not enjoy all of the same tax advantages. They can deduct medical expenses, including premiums, only if the expenses exceed 7.5 percent of their adjusted gross income. However, most people never reach that threshold. Insurance purchased by self-employed individuals and contributions to HSAs are excluded from income, but not payroll, tax.

How much are federal subsidies worth?

The tax exclusion for ESI will provide $240 billion in income and payroll tax subsidies in 2010 (Reference 1). Other tax subsidies for health insurance amount to approximately $28 billion – less than 12 percent of the value of the ESI subsidy.

The subsidy overwhelmingly benefits higher-income workers.

DISCUSSION

Higher-income workers benefit far more from the current ESI tax subsidy than lower-income workers. For example, a worker in the 35 percent tax bracket saves $3,500 in income taxes on a policy with an annual premium of $10,000, while a worker in the 15 percent tax bracket saves only $1,500.

Higher-income workers also are more likely to have ESI than lower-income workers. Almost 90 percent of workers with income at least three times the poverty level have ESI compared with less than one quarter of workers with incomes below the poverty level.

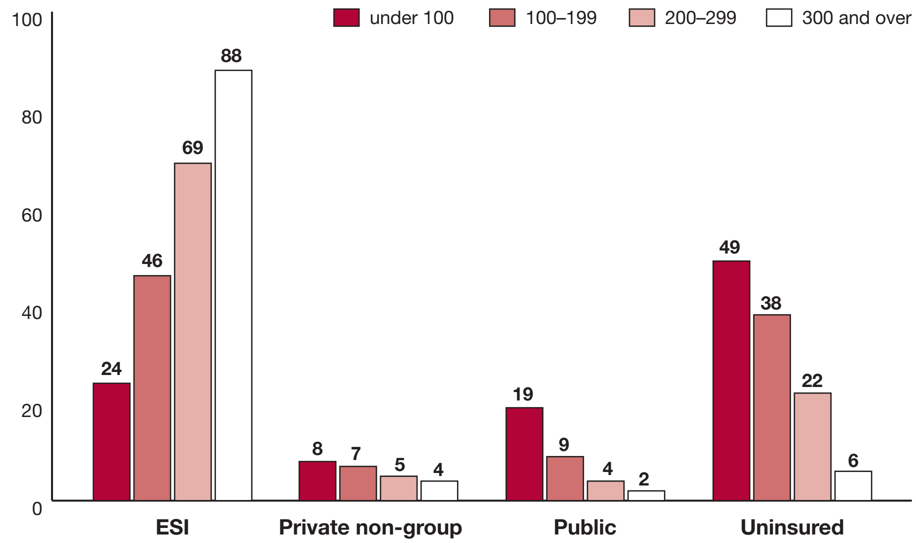
Lower-income workers benefit only slightly from the income tax exclusion and the Medicare payroll tax exclusion. Although they benefit in the short run from the Social Security payroll tax exclusion, in the long run it hurts them by reducing their retirement income.

Who benefits from the current tax exclusion?

Higher-income workers benefit the most from current tax subsidies for several reasons:

- They are in a higher tax bracket so the tax exclusion is worth more to them.
- They are more likely to work in jobs that offer ESI (figure 1).
- They are more likely to purchase insurance offered through their employer.

Figure 1: Worker health coverage: Percentage of nonelderly workers covered by different sources of health insurance, by income as a percent of poverty level, 2007



Source: Author estimates based on March 2008 Current Population Survey

Lower-income workers who have ESI receive only a small benefit from current subsidies.

- Workers do not benefit from current subsidies if their firms do not offer coverage of if they are ineligible for coverage that is offered. For example, part-time workers are often ineligible for ESI. Low-income workers are more likely to be in these situations.

- People who purchase private non-group coverage receive little or no benefit from tax subsidies. Lower-income workers are more likely to have non-group coverage (figure 1).

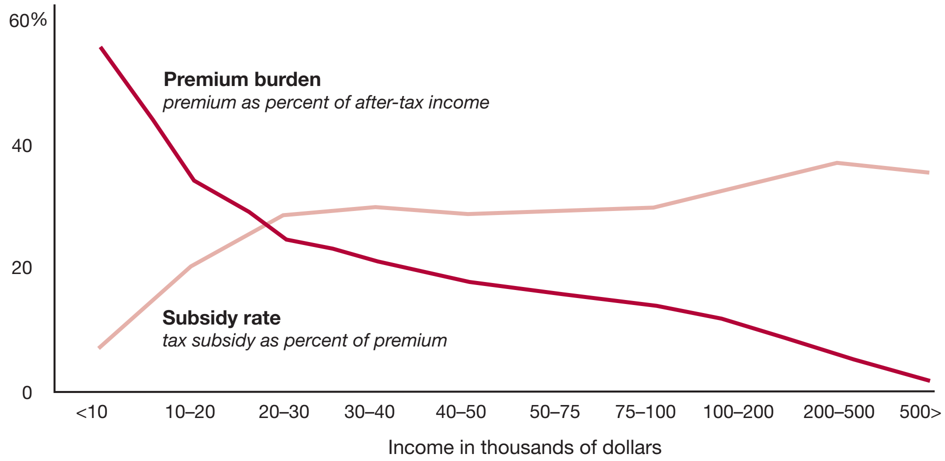
The subsidy for the highest income families is three times the subsidy for families earning less than $20,000.

What is the value of the federal subsidy for families?

Families with income over $200,000 get a subsidy worth more than one-third of the premium. The subsidy is worth more than $4,500 to the highest income families (figure 2, table 1).

The value of the subsidy is smallest for families at the bottom of the income scale, who pay the most for health insurance. Families earning $10,000 to $20,000 receive a subsidy of about $1,500, but spend more than one-quarter of their income on health insurance (figure 2, table 1).

Figure 2: ESI subsidy rate versus premium burden, 2009



Source: Urban-Brookings Tax Policy Center Microsimulation Model
Note: Income includes value of employer contributions to health insurance. Subsidy includes income and payroll tax savings.

Table 1: ESI subsidies

income (in thousands of dollars)	<10	10–20	20–30	30–40	40–50	50–75	75–100	100–200	200–500	500>
Subsidy rate (%)	7	20	28	30	29	29	30	34	37	35
Premium burden (%)	52	28	18	15	13	11	10	7	4	1
Average subsidy ($)	491	1,535	2,089	2,289	2,314	2,653	3,219	4,234	4,791	4,586

Source: Urban-Brookings Tax Policy Center Microsimulation Model
Note: Income includes value of employer contributions to health insurance. Subsidy includes income and payroll tax savings.

DISCUSSION

The overall impact of the upside down subsidy is striking. Many economists argue that employers pass on the costs of their contributions for health insurance to workers in the form of lower wages. Under that assumption, the tax subsidy is worth 35 percent of the premium for families with income over $200,000. These families pay less than 5 percent of their income for health coverage.

In contrast, the subsidy is worth 20 percent for families earning $10,000 to $20,000. These families pay more than a quarter of their income for health insurance (including what their employers pay in premiums).

The average subsidy for the highest income workers is three times the average subsidy for the lowest income workers.

Policy Implications

Employer sponsored insurance is an integral part of health insurance coverage in the United States. The federal subsidy for ESI, however, overwhelmingly benefits the highest-income workers and may encourage overly generous coverage. As a result, policy-makers may want to think about ways to level the playing field including:

> **Eliminating the tax exclusion for ESI.** Eliminating the exclusion would significantly raise payroll and income tax receipts which could be used to provide other subsidies to encourage the purchase of insurance. These other subsidies could take into account income and health status in order to assist hard-to-insure populations. Eliminating the exclusion altogether would increase the cost of insurance for workers, however, and result in far less employer coverage.

> **Capping the tax exclusion for ESI.** An alternative to eliminating the tax exclusion, is to cap the exclusion based on income, geography, or the cost of the insurance premium. For example, capping the exclusion at the median premium level would raise $22 billion in income and payroll taxes in 2010 while a cap at the 75th percentile of premiums would raise $12 billion (Reference 2).

> **Allowing non-group coverage to be purchased with pre-tax dollars.** This option does not have the revenue raising effect of eliminating or capping the exclusion for ESI – in fact it would increase the federal subsidy – but it would provide a similar tax advantage to those purchasing coverage outside of the employer system. This change may make non-group coverage more affordable to many, but it may encourage young, healthy people to forgo ESI in favor of individually purchased coverage, thereby making ESI more expensive for those remaining.

WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF ESI?

The substantial subsidy for ESI has made it the primary mechanism for purchasing insurance and pooling risks among non-elderly people in the U.S. ESI covers more than two-thirds of workers and their families.

Tying coverage to work has a number of advantages. Employment is a natural way to pool risks because job choice usually is not tied to expected use of health care. Further, deducting premiums from pay, rather than billing individuals, is efficient and may increase participation because it breaks payments into smaller and more manageable increments. In addition, ESI offers a way to create large groups, which may have lower administrative costs and increased bargaining power.

However, ESI also poses problems. First, it is not available to all workers. The most vulnerable low-income workers are much less likely to work for employers offering coverage. Second, job transitions or employers' decisions to drop coverage may result in workers becoming uninsured. Finally, subsidies for ESI affect employer decisions about outsourcing and employee decisions about work and retirement.

THE SYNTHESIS PROJECT (Synthesis) is an initiative of the Robert Wood Johnson Foundation to produce relevant, concise, and thought-provoking briefs and reports on today's important health policy issues.

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