

## Key Elements of the U.S. Tax System

How does the tax exclusion for employer-sponsored health insurance work?

TAXES AND HEALTH CARE

**Q. How does the tax exclusion for employer-sponsored health insurance work?**

**A. The exclusion lowers the after-tax cost of health insurance for most Americans.**

Employer-paid premiums for health insurance are exempt from federal income and payroll taxes. Additionally, the portion of premiums employees pay is typically excluded from taxable income. The exclusion of premiums lowers most workers' tax bills and thus reduces their after-tax cost of coverage. This tax subsidy partly explains why most American families have health insurance coverage through employers. Other factors play a role though, notably the economies of group coverage. Exclusion for employer contributions to health insurance

### ESI EXCLUSION IS WORTH MORE TO TAXPAYERS IN HIGHER TAX BRACKETS

Because the exclusion of premiums for employer-sponsored insurance (ESI) reduces taxable income, it is worth more to taxpayers in higher tax brackets than to those in lower brackets. Consider a worker in the 12 percent income-tax bracket who also faces a payroll tax of 15.3 percent (7.65 percent paid by the employer and 7.65 percent paid by the employee). If his employer-paid insurance premium is \$1,000, his taxes are \$254 less than they would be if the \$1,000 were paid as taxable compensation. His after-tax cost of health insurance is thus \$1,000 minus \$254, or \$746. In contrast, the after-tax cost of a \$1,000 premium for a worker in the 22 percent income-tax bracket is just \$653 (\$1,000 minus \$347). Savings on state and local income taxes typically lower the after-tax cost of health insurance even more.

These examples assume that workers bear the full burden of employer payroll taxes. Note that the effective marginal tax rates (25.4 percent for the worker in the 12 percent income-tax bracket and 34.6 percent for the worker in the 22 percent income-tax bracket) are less than the sum of the income-tax and payroll-tax rates (27.3 percent and 37.3 percent, respectively) because those rates are applied to compensation after the employer's share of payroll taxes has been deducted. Thus, for example, if the employer increases compensation by \$1,000, cash wages only increase by \$929 [calculated as  $\$1,000 / (1 + \text{employer payroll tax rate})$ ], because the employer would have to pay additional employer payroll taxes of \$71. The lower-wage worker's resulting combined income and payroll tax would be 27.3 percent of \$929, or \$254. The higher-wage worker's resulting combined income and payroll tax would be 37.3 percent of \$929, or \$347. The example assumes the higher-wage worker has earnings below the maximum amount subject to Social Security taxes.

### ESI EXCLUSION IS COSTLY

The ESI exclusion will cost the federal government an estimated \$273 billion in income and payroll taxes in

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2019, making it the single largest tax expenditure. Note, too, that the open-ended nature of the tax subsidy has likely increased health care costs by encouraging the purchase of more comprehensive health insurance policies with lower cost sharing or with less tightly managed care.

Replacing the ESI exclusion with a tax credit would equalize tax benefits across taxpayers in different tax brackets, as well as between those who get their insurance through their employers and those who obtain coverage from other sources. Making the credit refundable would extend that benefit to those whose tax liability falls below the value of the credit. And designing the credit so that it does not subsidize insurance on the margin (i.e., to be a fixed dollar amount as opposed to a percentage of the premium) could lower health care costs.

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### Data Sources

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### Further Reading

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