

Key Elements of the U.S. Tax System

How might the tax exclusion for employer-sponsored health insurance (ESI) be reformed?

TAXES AND HEALTH CARE

Q. How might the tax exclusion for employer-sponsored health insurance (ESI) be reformed?

A. Options for reform should consider the impacts on health insurance coverage, the deficit, and the distribution of the tax burden.

A CASE FOR REFORMING THE ESI EXCLUSION

The exclusion of employer-paid premiums for health insurance from federal income and payroll taxes is the single largest tax expenditure, costing the federal government an estimated \$273 billion in fiscal year 2019. Further, because the employer-sponsored health insurance (ESI) exclusion reduces taxable income, it is worth more to taxpayers in higher tax brackets than to those in lower brackets, who are less likely to be covered by ESI in the first place. In subsidizing the after-tax cost of employer-sponsored coverage, the ESI exclusion encourages employers to offer coverage, but may also contribute to higher health care outlays.

For these reasons, policy analysts have long suggested reform of the ESI exclusion. In fact, the Affordable Care Act's "Cadillac tax" would have effectively limited the ESI exclusion starting in 2022. The Cadillac excise tax would have equaled 40 percent of the value of employer-provided health benefits exceeding certain thresholds. But the tax, which was originally scheduled to take effect in 2018, was twice delayed and ultimately repealed by legislation before ever taking effect.

Three alternative reform options include repealing the ESI exclusion, limiting the ESI exclusion above certain levels, and replacing the ESI exclusion with a refundable income tax credit. In weighing these options, policymakers ought to consider their effects on health insurance coverage, the deficit, the distribution of the tax burden, and incentives to control health care costs.

REPEAL THE ESI EXCLUSION

Repeal of the ESI exclusion would generate substantial revenue to reduce the deficit or pursue other policy priorities and eliminate incentives for employers to choose more expensive health plans. But it would also eliminate a strong incentive for employers to offer ESI.

Repealing the exclusion would increase combined federal income and payroll tax revenues by nearly \$300 billion per year. It would increase taxes more for taxpayers in the top income quintiles of the income distribution and reduce after-tax income the most in percentage terms for the middle and fourth quintiles. However, repealing the exclusion would also reduce ESI coverage by an estimated 16 million people. While approximately half of this group would obtain coverage from other sources, (Medicaid and non-group coverage) the remaining 8 million would become uninsured.

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LIMIT THE ESI EXCLUSION

The current ESI exclusion could be scaled back by limiting the exclusion above the 50th percentile of premiums (\$7,150 for single coverage and \$18,500 for family coverage in 2020). The portion of premiums above this threshold would be subject to income and payroll taxes, generating government revenue and reducing incentives for higher-cost health plans.

Limiting the exclusion would reduce increase federal revenues by about \$50 billion per year and reduce incentives for employers to choose more expensive health plans. Like repealing the exclusion, limiting the exclusion would reduce the after-tax income the most for the middle and fourth income quintiles and the least for the bottom quintile. Limiting the exclusion would reduce ESI coverage by an estimated 8 million people. Again, half of these people would switch to a different form of coverage, leading to a reduction in overall coverage by 4 million people.

REPLACE THE ESI EXCLUSION WITH A CREDIT

The ESI exclusion could be replaced with a refundable individual income tax credit for ESI coverage. The credit would be roughly the same value as the average income and payroll tax exclusion (in 2020, \$2,275 for single coverage and \$5,700 for family coverage). Workers could claim the credit if they receive ESI from their employers that meets certain standards, but the size of the credit would not depend on the cost of the insurance.

A credit for ESI coverage would be roughly budget neutral by design. However, it would be more progressive than an exclusion as its value would not increase with income, and it would be refundable for workers without income tax liability. With such a credit, after-tax income would increase for the bottom three income quintiles and increase for the top two income quintiles. Replacing the exclusion with a credit would eliminate incentives for employers to choose more expensive health plans, but unlike repeal or limitation of the exclusion, would not lead to a reduction in overall insurance coverage.

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Data Sources

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Further Reading

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