The Cost Of Tax-Exempt Health Benefits In 2004

Tax policies for health insurance will cost the federal government $188.5 billion in lost revenue in 2004, and most of the benefit goes to those with the highest incomes.

by John Sheils and Randall Haught

ABSTRACT: The tax expenditure for health benefits is the amount of revenues that the federal government forgoes by exempting health benefits and spending from the federal income and Social Security taxes, including (1) employer health benefit contributions for workers and retirees, (2) health benefit deductions for the self-employed, (3) health spending under flexible spending plans, and (4) the tax deduction for health expenses. We estimate that this expenditure will be $188.5 billion in 2004. Families with incomes of $100,000 or more (14 percent of the population) account for 26.7 percent of all health benefit tax expenditures.

UNDER CURRENT TAX LAW, health insurance premiums are largely tax-exempt if the insurance is provided through an employer but generally are not deductible when a person purchases insurance directly. The share of the premium paid by the employer is not counted as income to workers and retirees under the federal income and Social Security payroll taxes. The employee's share of the premium also can be tax-exempt in firms with flexible spending plans (such as Section 125 cafeteria plans). Out-of-pocket health spending in excess of 7.5 percent of adjusted gross income is tax-deductible for all individuals. Also, many employees have access to a reimbursement account under their employer's flexible spending plan, through which out-of-pocket health costs can be paid in pretax dollars.

The amount of tax revenues forgone by federal and state governments for these tax preferences is known as "health benefit tax expenditures." These tax expenditures have effectively subsidized the purchase of employer-based insurance, which has encouraged employers to offer coverage. However, despite the recent trend for employers to shift costs to workers, these tax preferences are widely believed to have encouraged employers to provide more comprehensive coverage than they otherwise would have done, resulting in higher levels of health spending. Moreover, these tax preferences result in sizable reductions in tax revenues,

John Sheils (john.sheils@lewin.com) is vice president of the Lewin Group in Falls Church, Virginia; Randall Haught is a senior scientist there.

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which tend to favor the higher-income groups that are most likely to have employer-sponsored coverage. In this DataWatch we present estimates of the magnitude of the tax expenditure resulting from the special tax treatment of health insurance premiums and health spending in the current tax system.

The Tax Expenditure For Health Benefits

It is important to understand that the tax expenditure for health benefits accrues to workers rather than employers. The tax expenditure arises from the fact that the value of workers' health benefits is specifically excluded from taxation as income to the worker. For example, workers who receive an automobile or a residence as part of their compensation are typically required to pay taxes on the imputed value of these in-kind benefits as a form of income. The value of health benefits would be included in taxable income as well, except that the tax code specifically exempts it from taxation.[1] We have defined "tax expenditure" as the additional taxes that would be paid if these benefits were included in taxable income. This depends on the marginal tax rate of the workers receiving these benefits (which varies with personal income and filer type) rather than that of the employer providing them.

There are no health benefit tax expenditures for employers, although some proposals would create one with an employer health benefit tax credit. Taxes for employers are based on their net income, which is defined as revenues less the costs of doing business, including materials costs, wages, pensions, health benefits, Social Security taxes (the employer share), and other labor-related costs. Thus, health benefit costs to the employer are subtracted from revenues along with all other costs of doing business to arrive at a net income figure that is then subject to the tax. The subtraction for health benefits is no more a tax expenditure than is the subtraction for materials costs or wages.

Policymakers must understand that the health benefit tax expenditure resides with the worker, not the employer. For example, some reform proposals would eliminate the employer deduction for health benefits. For most insuring employers, this would greatly overstate net income to the employer and would make some firms with negative net income (as currently defined) appear to have a positive net income. This would create a powerful incentive for employers to discontinue coverage. Most such proposals would replace the employer deduction for health benefits with a tax credit designed to offset this increase in taxes and strengthen incentives for employers to offer coverage. However, such an approach would require careful program design and detailed analyses of employer impacts.

Data And Methods

We estimated the amount of the tax expenditure for health benefits and expenditures using the Lewin Group Health Benefits Simulation Model (HBSM), a microsimulation model of the U.S. health care system. The data used in the model are a representative sample of U.S. households from the March 2003 Current Population Survey (CPS), which provides information on health coverage, income, and income tax liability. These data are statistically matched with the 1996 Medical Expenditure Panel Survey (MEPS) data to provide additional information on health spending used to estimate the deduction for health expenses exceeding 7.5 percent of adjusted gross income. We updated these health spending data to reflect the Centers for Medicare and Medicaid Services (CMS) health spending projections for 2004, including spending for private health insurance.[2]

The HBSM estimates premium data for each person in the household data by statistically matching the covered workers in the household database to a representative sample of firms, surveyed by the Henry J. Kaiser Family Foundation and the Health Research and Educational Trust (HRET) in 1999.[3] We updated these employer data based on published results from the 2003 Kaiser/HRET data on the portion of the premium paid by the employer. We estimated the tax expenditure for each worker in the household database using the premium data and the marginal tax rate information reported in the household data. Marginal tax rates were modified to reflect the reduction in tax rates under the Economic Growth and Tax Relief Reconciliation Act of 2001.

Study Findings

■ **Tax expenditures.** Using the HBSM, we estimate that total spending for employer-sponsored coverage will be about $575.5 billion in 2004, including $519.7 billion for workers and dependents and $55.8 billion for retirees.[4] Of this, the employer will pay about $443.2 billion (77 percent), and employees and retirees will pay $132.3 billion (23 percent). All of the employer contribution for health benefits is exempt from taxation as income to employees and retirees. In addition, employees' and retirees' contributions are made using pretax dollars when paid through a flexible spending plan. We estimated the portion of workers making tax-exempt employee contributions based on employer surveys conducted by the Bureau of Labor Statistics (BLS). These surveys indicate that about 52 percent of employees in medium-size and large firms and about 23 percent of workers in small firms work for an employer with such a plan.[5]

We estimate a total federal and state tax expenditure of $209.9 billion for 2004 (Exhibit 1).[6] Our federal tax expenditure estimate of $188.5 billion includes the revenues forgone because of various deductions and exemptions for health benefits under the personal income tax ($122.1 billion); and revenues forgone from the Social Security and Medicare Hospital Insurance (HI) payroll taxes of $52.2 billion and $14.2 billion, respectively. The federal personal income tax expenditure of

EXHIBIT 1
Tax Expenditures For Employer Health Benefit Contributions, 2004

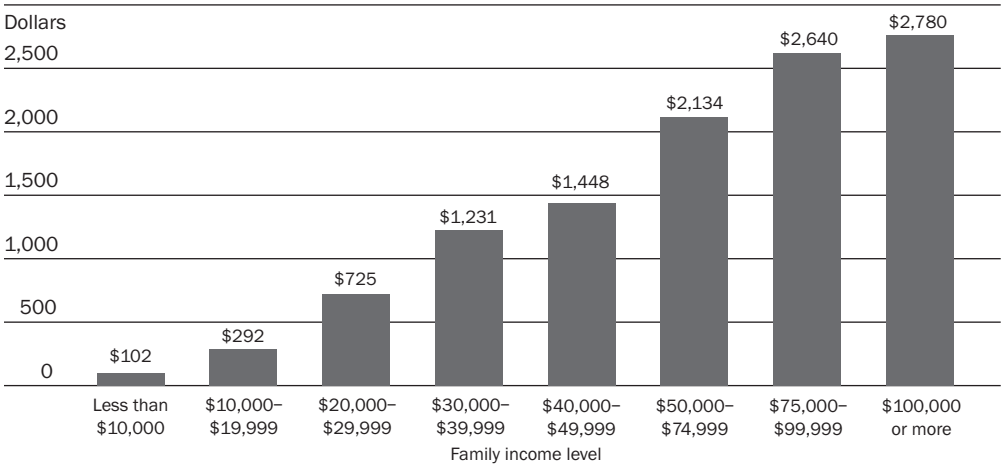
	Expenditure amount, billions ($)	Percent of total
State and federal	209.9	100.0
State	21.4	10.2
Federal	188.5	89.8
Federal tax expenditures		
Social Security OASDI tax	52.2	27.7
Medicare HI	14.2	7.5
Income tax health benefit exclusion	101.0	53.6
Retiree exclusion	7.5	4.0
Self-employed deduction	4.6	2.4
Health reimbursement accounts	1.6	0.8
Out-of-pocket deduction	7.4	3.9

SOURCE: Lewin Group estimates using the Health Benefits Simulation Model (HBSM).
NOTES: OASDI is Old Age, Survivors, and Disability Insurance. HI is Hospital Insurance.

$122.1 billion includes several components: (1) the health benefits exclusion for workers and dependents ($101.0 billion); (2) the exclusion for retiree benefits ($7.5 billion); (3) the health insurance deduction for the self-employed ($4.6 billion); (4) the exclusion for health reimbursement accounts ($1.6 billion); and (5) the deduction for out-of-pocket health spending ($7.4 billion).[7]

■ **Distribution by income.** We estimate that the average health benefit tax expenditure will be about $1,482 per family in 2004.[8] However, it is heavily skewed toward high-income groups (Exhibit 2). The average will be $2,780 for families with incomes of $100,000 or more per year, but only $102 for families with incomes of less

EXHIBIT 2
Average Federal Health Benefit Tax Expenditure, By Family Income Level, 2004



SOURCE: Lewin Group estimates using the Health Benefits Simulation Model (HBSM). Average per family is $1,482.

than $10,000 per year. This reflects the fact that families with relatively higher incomes are more likely to have employer coverage and are in higher tax brackets.

About 26.7 percent of all federal tax expenditures are attributed to families with annual incomes of $100,000 or more, even though this group accounts for only about 14 percent of the population (Exhibit 3). Only 28.4 percent of all tax expenditures will go to families with incomes below $50,000, even though this group contains 57.5 percent of all U.S. families.

Estimation Issues

The U.S. Department of the Treasury and the Joint Committee on Taxation (JCT) have both developed estimates of the personal income tax expenditure for health care, but they have not estimated the tax expenditure for Social Security and HI payroll taxes. Our estimate of the personal income tax expenditure for health care is about $122.1 billion. This compares with a Treasury Department estimate of $130.2 billion and a JCT estimate of about $106.9 billion for the same tax expenditure components.[9]

The JCT estimate is lower than the Treasury figures because the JCT assumes that if health benefits are taxed as income, premium costs would automatically become deductible under the health expense deduction (health spending in excess of 7.5 percent of AGI), which would result in a partially offsetting reduction in tax liability. By comparison, both the Treasury estimates and ours assume no change in the value of the health expense deduction. This assumption is more appropriate for estimating combined tax expenditure for all of the various health benefits exclusions and deductions.

Still, our estimate of the federal personal income tax expenditure is about $8.1 billion lower than that of the Treasury. This difference appears to occur because we estimate the tax expenditure for retiree health benefits based on the marginal tax rates of retirees receiving these benefits, whereas the Treasury uses the mar-

EXHIBIT 3
Distribution Of Federal Health Benefit Tax Expenditures, By Family Income, 2004

Family income	Expenditure amount, billions ($)	Percent of total
$150,000 or more	25.9	13.7
$100,000–$149,999	24.1	12.8
$75,000–$99,999	40.8	21.6
$50,000–$74,999	44.2	23.4
$40,000–$49,999	17.9	9.5
$30,000–$39,999	17.1	9.1
$20,000–$29,999	12.2	6.5
$10,000–$19,999	5.0	2.7
Less than $10,000	1.3	0.7
Total	188.5	100.0

SOURCE: Lewin Group estimates using the Health Benefits Simulation Model (HBSM).

ginal tax rates of active workers with employer coverage. This lowers our tax expenditure estimate for retiree health benefits vis-à-vis the Treasury estimates, since retirees are typically in lower tax brackets than active workers because of lower incomes and additional exemptions for the aged.

Comparisons With Earlier Estimates

The estimates presented here update the tax expenditure estimates for 1998 that we presented in an earlier *Health Affairs* paper.[10] Our estimates of the total federal tax expenditure for health benefits rose from $111.2 billion in 1998 to $188.5 billion in 2004. This is an annual rate of increase of about 9.2 percent, which tracks with our estimate of the growth in employer health care costs over this period (about 9.8 percent per year).[11] The growth in the tax expenditure is a bit slower than the rate of growth in employer health care costs over this period, in part because of the reduction in tax rates that is being phased in between 2001 and 2006 under recent tax legislation. The percentage of the tax expenditure going to families with incomes of $100,000 or more increased from 23.6 percent in 1998 to 26.7 percent in 2004.

Reforming The Tax Expenditure

These results raise important equity issues concerning the current distribution of tax benefits. Because 43.6 million Americans, most of whom are in relatively low income groups, are uninsured, it is important to ask whether it is appropriate that 26.7 percent of federal health benefits tax expenditures goes to the 14 percent of the population with the highest incomes. Moreover, these tax expenditures should be reevaluated in terms of their tendency to encourage overuse of the health care system.

Proposals have emerged that would replace the current health benefit tax expenditure with a refundable tax credit. Workers would be required to count the value of employer-sponsored health benefits as income when computing their taxes, which would increase their incentives to enroll in less costly health plans. A refundable tax credit of perhaps $1,500 for individuals and $3,500 for families would be provided to all Americans and would be phased out as income rises. This would refocus the health benefit tax expenditure on lower-income people to help the uninsured obtain coverage. The tax credit also would be available for all health insurance including nongroup coverage (excluding Medigap), which does not now qualify for tax preferences.

However, these proposals raise several concerns. For example, eliminating the relative tax advantages of employer coverage could cause some employers to stop offering coverage, assuming that their workers will purchase their own nongroup coverage with the help of the tax credit. Without a mandate for all to offer coverage, this could result in a partially offsetting increase in the number of uninsured people, as the convenience and economy of employer-group coverage disappears.

Also, nongroup insurance, which is difficult to obtain in many areas, is much more costly to administer than group coverage, so overall costs would increase. These problems must be addressed before these types of tax credit models can be a viable alternative.

The authors thank Paul Hogan for his assistance in developing these simulations. The opinions expressed here are the authors' and do not necessarily represent those of the Lewin Group.

NOTES

1. Employer pension contributions and some other employee benefits are exempted in the same way.
2. S. Heffler et al., "Health Spending Projections through 2013," *Health Affairs*, 11 February 2004, content .healthaffairs.org/cgi/content/abstract/hlthaff.w4.79 (17 February 2004).
3. Each worker in the household data is matched to one of the firms in the Kaiser/HRET database to form a unique "synthetic" employer. We then "populate" each firm with other workers in household data with similar workforce characteristics. Premiums for self-funded and experience-rated firms are calculated based on health spending for the workers and dependents assigned to each synthetic firm. Premiums for fully insured firms are determined by creating risk pools from these synthetic firms based upon the rating regulations in each state. See J. Sheils and R. Haught, "Cost and Coverage Analysis of Ten Proposals to Expand Health Insurance Coverage," Report to the Robert Wood Johnson Foundation (Falls Church, Va.: Lewin Group, October 2003), Appendix A.
4. Estimates based upon the distribution of employer-sponsored benefits in the Medical Expenditure Panel Survey (MEPS) across workers, dependents, and retirees.
5. Bureau of Labor Statistics, *Employee Benefits in Medium and Large Private Establishments, 1997* (Washington: BLS, 1999); and BLS, *Employee Benefits in Small Private Establishments, 1996* (Washington: BLS, 1999).
6. We assume that the value of the benefit for each worker is equal to the average premium cost per worker in his or her plan, regardless of age or sex. The tax expenditure estimate increases if we actuarially adjust the benefit value by age, because older workers tend to have both higher health costs and higher marginal tax rates.
7. Estimates reflect the Economic Growth and Tax Relief Reconciliation act of 2001, which phases down the marginal tax rates of 28 percent, 31 percent, 36 percent, and 39.6 percent to 25 percent, 28 percent, 33 percent, and 35 percent over six years beginning in 2001. Changes are also made to reduce taxes in the 15 percent tax bracket. This reflects the phase-in of the health benefits deduction for small employers.
8. The definition of *families* used in this analysis includes family units composed of people living together who are related by blood kinship or marriage and single people living alone or in group quarters.
9. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2004–2008*, Pub. no. JCS-8-03 (Washington: JCT, 22 December 2003) (includes health tax expenditures for the employer exclusion [$96.0 billion], which includes payments through cafeteria plans, deductions for health insurance premiums by the self-employed [$3.3 billion], and deductions for medical expenses [$5.9 billion]); and Office of Management and Budget, *Budget of the U.S. Government: Analytical Perspectives, Fiscal Year 2004* (Washington: OMB, 2003). Estimates include the exemption for employer-sponsored benefits and the deduction for the self-employed.
10. J. Sheils and P. Hogan, "Cost of Tax-Exempt Health Benefits in 1998," *Health Affairs* (Mar/Apr 1999): 176–181.
11. These are HBSM estimates of the growth in total spending, which includes both medical inflation and population growth over this period.