Tax Expenditures and Health Insurance: Limiting Employer-Paid Premiums

GAIL R. WILENSKY, PhD
AMY K. TAYLOR, PhD

ATTEMPTS TO CONTROL INFLATION in the health care sector, until very recently, have focused on regulation. General dissatisfaction with this approach and with specific regulatory attempts has led to interest in strategies for increasing the awareness of consumers and providers of the costs entailed in using health services. These strategies propose cost-sharing provisions, reducing benefit coverage, and encouraging enrollment in health maintenance organizations (HMOs), which are believed to deliver services more efficiently. Since such mechanisms for increasing cost consciousness would operate through the types of health insurance that people purchase, a key to these strategies is to offer a choice among private health insurance options.

One mechanism for influencing consumer purchases of insurance is by way of employer-provided health insurance, since this constitutes the bulk of private health insurance. Recent estimates indicate, for example, that almost 85 percent of private health insurance is employment related (*1*). Although there are several reasons for this predominance of employment-related health insurance, such as the lower premium rates associated with group insurance, a major factor is that employer contributions to health insurance are excluded from employees' taxable income. Thus, for any given amount spent by employers, employees are provided with more health insurance than they would be able to purchase if they were to use after-tax wages. The value of this tax saving increases with the employee's taxable income and corresponding marginal tax rates. Although it is worth nothing for those with

Dr. Wilensky is senior research manager, Division of Intramural Research, and Dr. Taylor is service fellow, Division of Intramural Research, in the National Center for Health Services Research, Public Health Service. Allen Kendall of Social and Scientific Systems, Inc., Washington, D.C., assisted with the programing of the data and Pamela Farley of the National Center for Health Services Research provided analytical assistance. The paper was presented at the annual meeting of the Eastern Economic Association in Washington, D.C., on May 1, 1982. Tearsheet requests to Dr. Gail R. Wilensky, Division of Intramural Research, National Center for Health Services Research, Room 8–50B, 3700 East-West Highway, Hyattsville, Md. 20782.

incomes so low that they owe no income taxes, it is worth 50 percent of the employer contribution for those in the highest tax brackets. The total value of this tax expenditure is large: it was estimated at about $8 billion in 1977 (*2*) and perhaps as much as $20 billion in 1981.

The revenue losses resulting from tax savings by certain groups of taxpayers are greater than just the losses in Federal income tax revenue. Not considering employer-paid insurance premiums as income also reduces the base that is used in calculating social security, or the Federal Insurance Contributions Act (FICA), liabilities, although this results in a tax saving—and thus a revenue loss—only for employees whose wages are below the social security ceiling. A third component of revenue loss is the exclusion of employer contributions from the taxable income underlying State and local income tax liabilities. These three components not only represent large losses of revenue but there is some evidence that they have been growing rapidly. According to a Treasury Department estimate, tax expenditures associated with Federal revenue losses grew at an annual average rate of 19 percent between 1975 and 1979, which is considerably higher than the rates for Medicare and Medicaid (*2*).

Although the amounts involved are large, the current tax treatment of employer-provided health insurance is not only a matter of revenue loss. Rather, by effectively reducing the price of insurance, the exclusion of employer-paid insurance premiums from taxable income has encouraged the purchase of more comprehensive insurance coverage, resulting in higher levels of expenditures on health care. While the precise relationship between insurance, health care use, and expenditures has been debated, there is ample evidence that such a relationship exists (*3–5*).

Placing limits on the amounts of health insurance premiums that employers can provide on a tax-free basis, or taxing all health insurance premiums as ordinary income, has been discussed during the past decade and has been a key element in several legislative proposals. The Durenberger bill (S.433), for example, would place limits on these amounts. The Gephardt-Stockman bill (H.R.850) would allow employees who

choose cheaper plans to receive the difference between high- and low-cost plans as a tax-free rebate, an approach which also effectively removes the incentive for employees to increase the share of their wages that is taken as health insurance rather than as taxable wages, although it is obviously more costly to the Treasury.

In this paper, we examine some of the effects of placing limits on the amounts of health insurance premiums that employers can provide on a tax-free basis. Primarily, we show the numbers and characteristics of people who would be affected, the amounts of additional taxes they would have to pay, changes in the additional taxes relative to income, and the total amounts of revenue at risk under various tax-free limits.

We obtained our data from the 1977 National Medical Care Expenditure Survey (NMCES), which provided detailed national estimates of the use of health services, health expenditures, and health insurance coverage. The survey was undertaken to provide data for a major research effort in the National Center for Health Services Research and was co-sponsored by the National Center for Health Statistics. The sample and design of the surveys and the instruments and procedures are described elsewhere (*6–8*). The characteristics of subscribers, including income and tax filing status, were derived from the household survey. The data on employer contributions and the presence of employment-related insurance and type of coverage were derived from employer and insurance carrier reports in the Health Insurance/Employer Survey.

Table 1. Average employer contribution to health insurance for subscribers by family income, 1977

Family income	Number of subscribers (in thousands)	Average contribution by employer
Total	[1]54,090	$623
$1–$9,999	7,236	490
$10,000–$19,999	20,598	596
$20,000–$29,999	14,640	686
$30,000–$39,999	6,335	696
$40,000 or more	5,202	641

[1] Excludes all subscribers with zero employer contributions.
SOURCE: National Medical Care Expenditure Survey, National Center for Health Services Research, unpublished data.

Employer Contributions to Health Insurance

Employer contributions to health insurance premiums in 1977 were estimated to be about $34 billion for almost 55 million subscribers. The average employer contribution per subscriber was $623 (table 1). Although this contribution increased with subscriber family income, the highest income class being the exception, the relationship between employer contribution and family income was not strong.

The range of employer contributions to health insurance at each level of subscriber income is shown in

Table 2. Employer insurance contributions for family and individual coverage by family income, in percentages

Family income	Number of subscribers (in thousands)	Employer insurance contributions						
		$0	$1–$99	$100–$299	$300–$499	$500–$799	$800–$1,199	$1,200 or more
		Family coverage						
Total	[1]41,757	12.0	2.6	11.0	12.2	23.8	26.0	12.5
$1 to $9,999	4,946	16.2	4.8	16.0	14.0	20.0	21.3	7.8
$10,000 to $19,999	16,176	12.8	2.5	12.1	13.6	23.8	25.7	9.6
$20,000 to $29,999	11,693	10.2	1.7	8.7	11.8	24.6	26.7	16.4
$30,000 to $39,999	5,006	9.8	2.2	9.6	6.9	26.7	29.3	15.4
$40,000 or more	3,890	11.7	3.5	9.1	11.7	23.0	26.4	14.8
		Individual coverage						
Total	[1]24,089	24.9	5.5	31.8	24.3	9.3	2.9	1.3
$1 to $9,999	6,933	36.0	4.7	30.2	19.9	5.8	2.3	1.0
$10,000 to $19,999	8,050	21.5	6.8	31.5	25.8	10.5	2.8	0.9
$20,000 to $29,999	4,734	18.4	5.9	32.4	26.0	13.1	2.8	1.4
$30,000 to $39,999	2,101	17.9	4.5	32.3	30.4	7.2	5.2	2.6
$40,000 or more	2,148	22.7	2.6	36.6	23.5	9.6	2.4	2.6

[1] Components do not add to total because subscribers with income less than $1 have been excluded.

SOURCE: National Medical Care Expenditure Survey, National Center for Health Services Research, unpublished data.

table 2 by family and individual coverage. These distributions are shown separately because legislative proposals to limit employer contributions place different limits on individual coverage and family coverage policies.

The total number of subscribers to employment-related insurance was 65 million, 41.8 million with family coverage and 24 million with individual coverage. (Of these 65 million, about 11 million reported zero—less than $1—employer contributions. The number seems unreasonably high. An analysis of the employment status, total premium expenditures, and other characteristics of the 11 million indicated that a small number were retired, most worked full year, and almost all had very low total premium expenditures. The insurance status of some of these people may have been reported erroneously by their employers or carriers as being employment related. Since these cases are not affected by any limitations on employer contributions, however, any possible misclassification does not affect the subsequent analysis.)

More than half of the subscribers with family coverage had employer contributions greater than $500 in 1977, and almost 40 percent had employer contributions greater than $800. From table 2, it is also clear that the correlation between family income and employer contributions to insurance would be low. Although there was a slight tendency in the lower income groups to have higher percentages of subscribers with less than $300 in employer contributions and for the higher income groups to have a higher percentage of subscribers in the $1,200 or more category, 50 percent of family subscribers had contributions between $500 and $1,200. There was essentially no variation according to income.

Among subscribers with individual coverage, two-thirds had contributions of less than $300. Excluding the large number with zero contributions, about half had contributions of more than $300. Low-income subscribers with individual coverage also tended to be somewhat clustered at the lower end of employer contributions, while higher income subscribers tended to be at the high end of employer contributions, but the relationship is obviously not strong.

To determine why some low-income subscribers have high employer contributions (above $800 for family coverage), their employment status, retirement status, and the inclusion of negative income components were analyzed. In general, most of these subscribers worked all year and almost none had negative components of income. Negative income was considered because of the concern that some of these subscribers were only temporarily in the low-income class because of capital or other types of property income losses. Instead, it appears that these persons were primarily low-wage workers in high-benefit industries, for example, entry level Federal Government workers, or low-wage workers in manufacturing industries, rather than part-year workers or those affected by income losses in 1977.

Effect of the Current Exclusion

The effect of the current exclusion of employer contributions from taxable income depends on the employee's taxable income—higher incomes are associated with higher tax rates, and higher marginal tax rates produce greater tax savings. Of the 54.1 million subscribers with employer contributions, all received tax savings from the exclusion. Most received savings from Federal or State income taxes, or both, and a small number of lower income subscribers received savings from social security taxes. The average saving in Federal income tax for those who received any type of tax savings in 1977 was $157 (this average excluded families without any Federal or State tax liability). This saving varied substantially by income: subscribers with a family income less than $10,000 saved an average of $60 per family, and subscribers with a family income of more than $40,000 saved an average of $265. With regard to all three types of tax savings, the average was $206; families with less than $10,000 income received an average saving of $97, and those with income greater than $40,000 received an average saving of $315.

Limits on Tax-Free Employer Contributions

Four hypothetical plans with different ceilings on tax-free employer contributions to health insurance premiums were analyzed. These ceilings are based on legislative proposals currently before Congress. Because the NMCES data represent the population in 1977, limits were chosen that are equivalent to those discussed for enactment in 1983. In the first plan analyzed, all employer contributions to health plans would be fully taxable. Plan 2 would place a tax-free ceiling of $500 per year on family plans and $200 per year on individual plans, equivalent to $1,125 and $450, respectively, in 1983. Under plan 3, tax-free employer contributions would be limited to $805 for family coverage and $320 for individual coverage, or $1,800 and $720 in 1983 dollars. The limitations for plan 4 would be $1,075 and $430, equivalent to $2,400 and $975 in 1983.

Tables 3 and 4 present a summary of the impact of imposing these limits on tax-free employer contributions to employment-related health benefit plans. The number of subscribers affected and average tax in-

Table 3. Number of subscribers who would be affected and average tax liability for four hypothetical plans with specified limitations on tax-free employer contributions to health insurance, 1977

Plan for tax status of insurance premium	Number of subscribers affected (In thousands)	Average increase in—			
		Federal income taxes [1]	FICA [1]	State income taxes [1]	All taxes
Plan 1: No exemption	54,090	$157	$22	$27	$206
Plan 2: $500 for family, $200 for individual policies exemption	41,250	91	13	16	120
Plan 3: $805 for family, $320 for individual policies exemption	25,805	71	10	13	93
Plan 4: $1,075 for family, $430 for individual policies exemption	13,675	65	8	12	86

[1] Excludes subscribers not affected by any tax changes.
SOURCE: National Medical Care Expenditure Survey, National Center for Health Services Research, unpublished 1977 data.
NOTE: FICA is the Federal Insurance Contributions Act.

creases are given in table 3, and table 4 shows the total tax revenues that would be raised by each of these plans.

As expected, plan 1, which would treat all employer contributions for health insurance premiums as taxable income, results in the largest increase in taxes (by $206 per subscriber) and would affect more than 54 million people, or 82 percent of all subscribers with employment-related health insurance. For each subscriber so affected, Federal income taxes would be raised by $157 on average, the employee's share of social security (FICA) taxes by $22, and State taxes by $27. If there were a limit of $500 on tax-free employer contributions for family coverage, the number of affected subscribers would be reduced to 41 million, or 63 percent of all those with employment-related health insurance. The average total tax increase per affected subscriber would be much smaller than in plan 1—only $120. Under plans 3 and 4 (with family limits of $805 and $1,075, respectively), tax increases would be reduced still further. Although the average tax increase for these two plans is quite similar, nearly twice as many subscribers would be affected by plan 3 as by plan 4. The implications of these average figures for aggregate revenue increases are shown in table 4.

Based on data for 1977, the total tax increases under the proposed changes in the tax treatment of employer-provided health insurance range from $1.2 to $11.1 billion. These amounts are equivalent to $3.5 to $32 billion in 1983. Roughly 75 percent of these amounts are due to increases in Federal income taxes, and the remainder are almost equally divided between employee contributions to social security and State income taxes.

Again, plans 3 and 4, with relatively high limits on tax-free benefits, on average would affect large numbers of subscribers but not produce large aggregate tax increases (for both plans, an average of 36 percent of subscribers but only 16 percent of revenues projected under plan 1). For example, an $800 limit in 1977 would have affected 25 million people but raised only $2.4 billion in tax revenues. In contrast, taxing employer contributions to health insurance in full would affect twice as many subscribers, but tax revenues would be more than four times as high, or $11.1 billion. An intermediate limit, such as $500 for family

Table 4. Number of subscribers who would be affected and total increases in taxes for four hypothetical plans with specified limitations on tax-free employer contributions to health insurance, 1977

Plan for tax status of insurance premium	Number of subscribers affected (In thousands)	Total increase (In millions) in—			
		Federal income taxes	FICA	State income taxes	All taxes
Plan 1: No exemptions	54,090	$8,492	$1,205	$1,452	$11,150
Plan 2: $500 for family, $200 for individual policies exemption	41,250	3,769	519	655	4,943
Plan 3: $805 for family, $320 for individual policies exemption	25,805	1,834	245	324	2,403
Plan 4: $1,075 for family, $430 for individual policies exemption	13,675	894	115	161	1,170

SOURCE: National Medical Care Expenditure Survey, National Center for Health Services Research, unpublished data.
NOTE: FICA is the Federal Insurance Contributions Act.

coverage, would affect almost as many people (41 million) but raise less than half of the taxes ($4.9 billion).

Table 5 shows for each of the plans the number of subscribers affected, the average increase in Federal income tax, the average increase in total tax, and the tax increase as a proportion of income by family income class. In each case, the percentage of subscribers affected is lowest for the under $10,000 class because (*a*) a higher percentage in this category report zero employer contributions, which means that they would be unaffected by these limitations, and (*b*) a higher percentage have no tax liability as a result of their low income. The peaks at the $30,000 to $40,000 level in all plans are the result of high employer contributions (table 2).

Although the average increase in Federal income tax liability for those affected varies substantially—from $157 in plan 1 to $65 in plan 4—the variation across income groups is even greater. In plans 1 to 3, the average Federal income tax increase for the highest income group is about four times as large as the increase for the lowest group; in plan 4, it is about three times as large.

Because FICA is a regressive tax and State income taxes tend to be proportional or only slightly progressive, the average increase in total tax shows less variation. In plans 1 to 3, for the highest income group, the average increase is about three times that of the lowest group, and about 2.5 times in the case of plan 4. That this rise in the total tax, while still substantial, is less than the increase in income itself is evident when the increase in tax is shown as a proportion of family income, which falls as family income increases; the largest drop here is between incomes under $10,000

Table 5. Number of subscribers who would be affected and the average increased tax liability for four hypothetical plans with specified limitations on tax-free employer contributions to health insurance, 1977

Family income	Number of subscribers (In thousands)	Subscribers affected		Average increase in—		Increased total tax as a proportion of family income [1]
		Number	Percent	Federal income tax [1]	Total tax [1]	
		Plan 1. No tax free limitation				
Total	65,847	54,090	82	$157	$206	0.0106
$1–$9,999	11,879	7,236	61	60	97	0.0154
$10,000–$19,999	24,226	20,598	85	126	176	0.0118
$20,000–$29,999	16,427	14,640	89	183	237	0.0098
$30,000–$39,999	7,107	6,335	89	222	270	0.0080
$40,000 or more	6,039	5,202	86	265	315	0.0054
		Plan 2. Tax free limitation—$500 family, $200 individual				
Total	65,847	41,250	63	$91	$120	0.0059
$1–$9,999	11,879	4,813	41	36	57	0.0091
$10,000–$19,999	24,226	15,225	63	71	99	0.0066
$20,000–$29,999	16,427	11,729	71	105	136	0.0056
$30,000–$39,999	7,107	5,362	75	125	152	0.0045
$40,000 or more	6,039	4,006	66	155	185	0.0032
		Plan 3. Tax free limitation—$805 family, $320 individual				
Total	65,847	25,805	39	$71	$93	0.0045
$1–$9,999	11,879	2,825	24	29	47	0.0072
$10,000–$19,999	24,226	9,163	38	53	74	0.0049
$20,000–$29,999	16,427	7,671	47	80	104	0.0043
$30,000–$39,999	7,107	3,525	50	96	118	0.0035
$40,000 or more	6,039	2,581	43	121	146	0.0025
		Plan 4. Tax free limitation—$1,075 family, $430 individual				
Total	65,847	13,675	21	$65	$86	0.0041
$1–$9,999	11,879	1,332	11	32	52	0.0080
$10,000–$19,999	24,226	4,337	18	51	71	0.0047
$20,000–$29,999	16,427	4,383	27	69	89	0.0037
$30,000–$39,999	7,107	2,045	29	85	104	0.0031
$40,000 or more	6,039	1,552	26	99	121	0.0020

[1] Excludes subscribers not affected by any tax changes.

SOURCE: National Medical Care Expenditure Survey, National Center for Health Services Research, unpublished data.

and those between $10,000 and $20,000. As noted before, the percentage of subscribers affected in the lowest income class is substantially less than in other income groups, but for those affected, the increase would represent a larger proportion of their income.

Conclusions

Concern regarding the current tax treatment of employer contributions to health benefits has been twofold. First, this tax treatment has resulted in large revenue losses to the U.S. Treasury and, to a lesser extent, to State governments. Second and more important, the reduced price of health insurance has provided an incentive to purchase excessive amounts of health insurance, a trend which is thought to result in increased levels of health expenditures. Because of these concerns, several legislative proposals to eliminate or limit the current tax exclusion of employer contributions to employee health insurance have been introduced.

In 1977, about $34 billion in employer contributions went to about 55 million subscribers with employment-related insurance. The average employer contribution of $623 for those with any contribution tended to increase with the subscriber's family income, although this relationship was not strong. Under current exclusion principles, all of these 55 million subscribers received some tax savings—most from Federal or State income taxes and some from lower FICA taxes. The average Federal income tax savings for those with any type of savings was $157, ranging from an average of $60 for those with incomes under $10,000 to $265 for those with incomes of more than $40,000. For all types of taxes, the average saving was $206 (range $90 to $305).

Four limitations on tax benefits were considered, ranging from taxing all employer contributions to taxing the 25 percent of subscribers with the highest contribution. The number of subscribers affected ranged from 82 percent (or all subscribers with employer contributions) to 21 percent; the total tax increases that would have occurred in 1977 ranged from $11.1 to $1.2 billion. These amounts are equivalent to $32 billion and $3.5 billion for 1983 (exclusive of the employer's share of FICA).

Although the average increases in potential taxes varied substantially across plans, they varied even more across income groups. For Federal income tax, the average increase for those affected was about four times larger for the highest than for the lowest income class—when all tax increases were considered, the differential was about three times. Substantially fewer subscribers with incomes less than $10,000 were affected, but it should be noted that for those affected, the tax increase represented a somewhat larger proportion of their income than for the higher income groups.

The four plans considered had different effects in terms of the revenue at risk and the number of subscribers affected. If the purpose is to raise revenue, all or almost all employer contributions must be taxed. However, if the purpose is to promote cost consciousness in the purchase of insurance plans, higher caps ($1,800 for family coverage in 1983), which would affect a substantial number of subscribers without causing large increases in their tax burden, would be appropriate.

A related question is that of the immediate compared to the long-run effects of limiting the amounts of health insurance that employers can provide to their employees on a tax-free basis. We have described the immediate effects, that is, before affected employees have had an opportunity to respond to the changes in tax treatment. It is expected that limiting the exclusion will lead eventually to less first-dollar coverage and thus to lower medical care expenditures, but to respond to new incentives in the short run, subscribers must have options. Recent evidence from the NMCES (*1*) indicates, however, that fewer than 20 percent of subscribers with employment-related health insurance had more than one option. Lack of options will not affect the increase in revenues but implies that many subscribers would have difficulty in responding quickly to changes in the tax treatment of health benefits.

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