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Case Study #6: The Exclusion for Employer Provided Health Insurance

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These results are part of an eleven-part series, *The Economics of the Blank Slate*, created to discuss the economic effects of repealing various individual tax expenditures. In these reports, Tax Foundation economists use our macroeconomic model to answer two questions lawmakers are considering:

1. **What effect does eliminating these expenditures have on GDP, jobs, and federal revenue?**
2. **What would be the effect on GDP, jobs, and federal revenue if the static savings were used to finance tax cuts on a revenue neutral basis?**

Key Points:

Eliminating the exclusion for employer provided health insurance would:

- Increase tax revenues by $160 billion on a static basis;
- Reduce GDP by $107 billion;
- Generate slightly less revenues ($133 billion) on a dynamic basis;
- Reduce employment by the equivalent of approximately 519,000 full-time workers; and
- Reduce hourly wages by 0.3 percent.

Eliminating the exclusion and trading the static revenue gains for individual rate cuts would:

- Allow for an across-the-board rate cut of 14.6 percent;
- Boost GDP by $125 billion per year;
- Boost federal revenues by $29 billion on a dynamic basis;
- Increase employment by the equivalent of approximately 826,000 full-time workers; and
- Increase hourly wages by 0.1 percent.

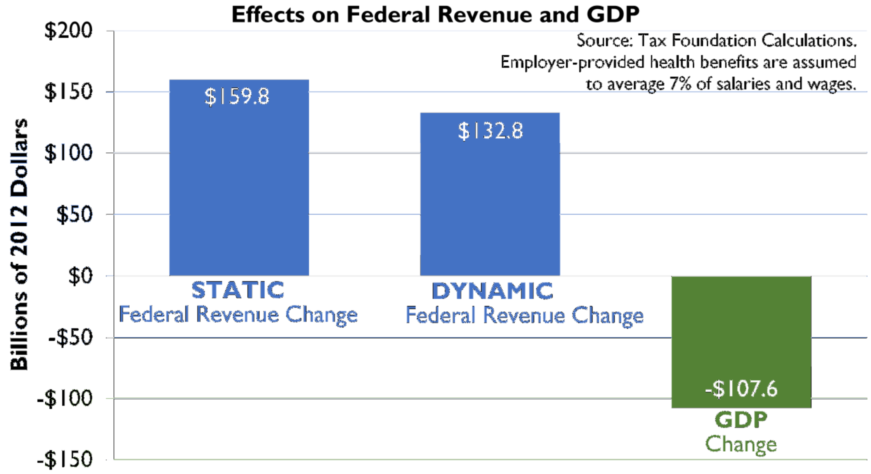
Workers are not required to include employer-provided health insurance and employer-provided care in taxable income, unlike most other forms of labor compensation. Employers properly deduct the cost of those benefits because they are a legitimate form of labor compensation. As a result, this income is tax free. The tax-free status of employer-provided health insurance and care arose seventy years ago as a way of mitigating the overly rigorous wage controls during World War II. This special treatment distorts the mix of compensation packages, contributes to overconsumption of health care, and raises the price of health care. The focus on employer-provided policies ties many workers who wish to retain health insurance to their jobs or puts them at risk of loss of coverage or a large increase in premiums for pre-existing conditions if they change employment. The tax exemption for this form of compensation is the largest single item on both the Joint Committee on Taxation and the Treasury tax expenditure lists.

Until recently, employers were generally not required to put the value of health care premiums on employees' W-2 yearend tax forms.[1] Consequently, the JCT and the Treasury have looked to other data sources and studies to infer it. This may partially explain why the two government entities have very different estimates of this tax expenditure's dollar amount, although they both show it to be extremely large.[2] In examining this tax-free fringe benefit, we made the approximation that employer-provided health coverage averages 7 percent of salaries and wages.

In a conventional revenue estimate that holds the economy's total sized fixed, the Tax Foundation's model estimates that removing the tax exemption for employer-provided health coverage would have boosted federal individual income tax collections by $160 billion in 2012. This is above the JCT's estimate of $117.3 billion but slightly below the Treasury's estimate.[3]

The revenue gain is smaller in a dynamic simulation that accounts for the impact of taxes on growth. Eliminating the exemption would bump many people into higher tax brackets. With a heavier tax bite and smaller after-tax returns at the margin, those people would find it less rewarding to work and invest. Both the supply of production inputs and the nation's output would decline. The model

Chart 1. Including Employer-Provided Health Benefits in the Tax Base



[1] The Patient Protection and Affordable Care Act (PPACA) will require that this information appear on most employees' W-2s, but the mandate is being implemented slowly.

[2] The estimate is sensitive to the assumed pattern of distribution of the benefits across income levels. Also, Treasury may more fully include care paid for directly by employers; JCT may limit its estimate more to premiums.

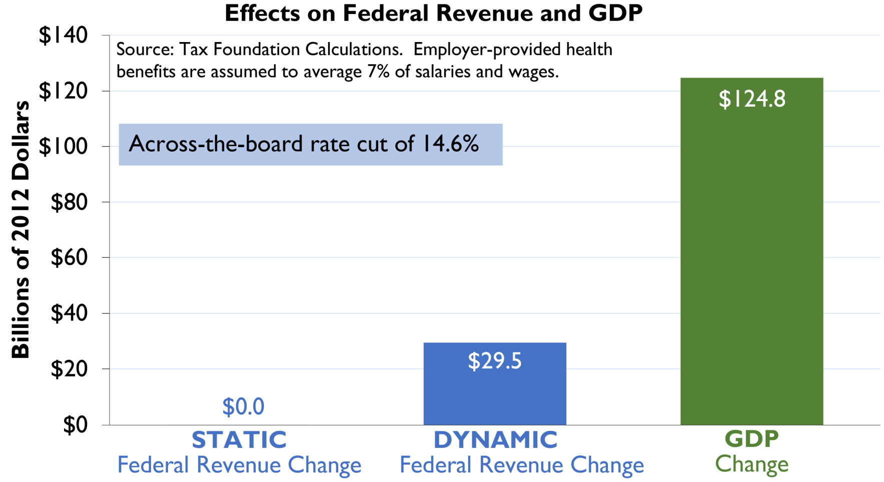
[3] These numbers estimate the effect on federal income tax receipts of eliminating the tax exclusion for employer-provided health care. They do not include the increase in payroll taxes if employer-provided health care were treated as ordinary compensation. The U.S. Treasury estimates that the additional effect on payroll tax receipts would have been approximately $110 billion in 2012. *See* Office of Management and Budget, *Analytical Perspectives-Budget of the U.S. Government, FY 2014* at 247, http://www.whitehouse.gov/sites/default/files/omb/budget/fy2014/assets/spec.pdf.

estimates that GDP would fall by $108 billion, and because of the negative economic feedback, our dynamic revenue estimate is $133 billion, which is $27 billion below our static estimate. (See Chart 1, above.)

It should be noted that our model does not incorporate the efficiency gains that would flow from removing the tax bias now favoring health coverage over other forms of employee compensation. That would provide some assistance to growth, although the model is not currently able to predict how much.

Chart 2. Using the Static Revenue Gain from Including Employer-Provided Health Benefits in the Tax Base to Pay for an Across-the-Board Rate Cut

Effects on Federal Revenue and GDP



It would definitely aid growth if the added revenue were recycled in the form of an across-the-board rate cut, as depicted in Chart 2.[4] Based on the conventional revenue estimate, rates could be lowered 14.6 percent (for instance, the 15 percent bracket would become 12.8 percent). The model estimates that people would work and invest more due to the lower marginal tax rates, leading to a rise in GDP of $125 billion. The model also predicts that federal revenue would be $29 billion higher than if the employer-provided health-coverage exemption remains in place and income tax rates are not lowered. In terms of growth effects, it would make excellent sense to trade away the current tax exemption for lower tax rates.

Finally, we determined the impact of these scenarios on employment and wages. We found that the elimination of the health insurance exclusion would reduce employment by the equivalent of about 519,000 full-time workers and cut hourly wages by 0.3 percent. With the rate cut offset, employment would increase by the equivalent of about 826,000 full-time workers and hourly wages would rise by 0.1 percent.

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About the Tax Foundation
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[4] We assume proportional cuts in all of the ordinary income tax bracket rates but no cuts in the lower tax rates on capital gains and qualified dividends.