Federal tax subsidies for employer-sponsored insurance (ESI) provide over $100 billion in tax benefits annually.

HOW DOES THE FEDERAL GOVERNMENT SUBSIDIZE PRIVATE HEALTH INSURANCE?

- **The largest subsidy is the tax exemption for employer contributions to ESI.** When employers purchase or provide insurance for their employees, their contributions to the premium are exempt from income and payroll taxes.

- **Employees’ contributions to ESI are also tax-exempt if workers use flexible spending accounts (FSAs).** Once established by employers, workers can use these tax-exempt accounts to set aside a portion of their income to pay for health insurance and expected medical expenses.

- **People who buy insurance outside of work do not have the same tax advantages.** They can deduct medical expenses, including premiums, that exceed 7.5 percent of their adjusted gross income. However, many people never reach that threshold. Special rules apply to self-employed people, who can deduct a portion of their health insurance costs without meeting the threshold. This year, these costs become fully deductible.

ALL TOGETHER, HOW MUCH ARE THESE SUBSIDIES WORTH?

- **The tax exemption for ESI provided more than $100 billion in income and payroll tax subsidies in 2002.**

- **Other tax subsidies for health insurance, primarily for the self-employed and others purchasing nongroup coverage, amounted to about $7 billion dollars—less than 10 percent of the value of the ESI subsidy.**
Higher-income workers benefit the most from the current tax subsidies.

**DISCUSSION**

Higher-income workers benefit far more from the current ESI tax subsidy than lower-income workers.

First of all, they are in higher tax brackets. A worker in the 28 percent tax bracket saves 28 percent of the premium cost, while a worker in the 15 percent bracket saves only 15 percent.

They also are more likely to have ESI. Almost 90 percent of workers with income three times the poverty level or higher have ESI, compared to less than one-third of workers with income below the poverty level.

In addition, employers of higher-income workers pay a larger percentage of the premium on average, translating into a larger tax exemption for those employees.

Finally, higher-income workers tend to have more coverage—multiple policies, richer benefits, and family rather than individual coverage—increasing premiums and the value of the tax exemption.

Lower-income workers benefit only slightly from the income tax exemption and the Medicare payroll tax exemption. They benefit in the short run from the Social Security payroll tax exemption, but it hurts them in the long run by reducing their retirement income.

**WHO BENEFITS FROM THE CURRENT TAX EXCLUSIONS?**

- **Higher-income workers benefit the most from current tax subsidies because:**
  - They are in higher tax brackets so the tax exclusion is worth more to them.
  - They are more likely to have ESI coverage (FIGURE 1).
  - Their employers pay a higher share of their premiums, on average (FIGURE 2).
  - They typically have more comprehensive health coverage.

- **Lower-income workers who have ESI receive only a small benefit from current subsidies.**

- **Workers do not benefit from current subsidies if their firms do not offer coverage or if they are ineligible for coverage that is offered.** Low-income workers are more likely to be in these situations.

- **People who purchase private nongroup coverage do not receive the ESI exemption, and receive little benefit from other tax subsidies.** Lower-income workers are slightly more likely to have this type of coverage (FIGURE 1).
The ESI subsidy is upside down.

**WHAT IS THE VALUE OF THE ESI TAX EXEMPTION FOR HIGH AND LOW-INCOME WORKERS?**

- The ESI subsidy provides the greatest benefit to the highest income workers, who need it least.
- Families with income above $200,000 get a subsidy worth one-third of the premium (FIGURE 3).
- The value of the tax subsidy is lowest for families at the bottom of the income scale. These families get the smallest subsidy, but pay the highest share of their income on health insurance (FIGURE 3).

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### DISCUSSION

The overall impact of the upside down subsidy is striking.

Many economists argue that employers pass on the costs of their contributions for health insurance to workers in the form of lower wages. Under that assumption, the tax subsidy is worth one-third of the premium for families with income above $200,000. These families pay only two percent of their income for health coverage.

In contrast, the subsidy is worth about 10 percent of the premium for families with ESI making less than $10,000. These families pay about 40 percent of their income (including what their employers pay in premiums) for health coverage.

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**Tax Subsidies Vs. Burden of Health Insurance**

*FIGURE 3.* Health insurance subsidy rate and premium burden for families with ESI, by family income, 1998*

| Subsidy rate (%): tax subsidy as % of premium | 9 | 19 | 23 | 23 | 23 | 25 | 28 | 29 | 33 |
| Premium burden (%): premium less tax subsidy as % of after-tax income | 37 | 19 | 14 | 11 | 11 | 9 | 7 | 5 | 2 |
| Average subsidy ($) | 177 | 515 | 747 | 863 | 1,005 | 1,251 | 1,648 | 1,770 | 1,926 |

* These estimates treat employer contributions toward health insurance as the employee’s income, which is spent on premiums. Thus, an employee who earns $10,000 in cash wages and whose employer pays $4,000 for ESI is assumed to have total income of $14,000 and a pre-subsidy premium burden of $4,000.
ESI pools risks well, but some workers and employers lose out.

**DISCUSSION**

The substantial subsidy for ESI has made it the primary mechanism for purchasing health insurance and pooling risks among nonelderly people in the US.

Tying coverage to work has a number of advantages. Employment is a natural way to pool risks because job choice usually is not tied to expected use of health care. Further, deducting premiums from pay, rather than billing individuals, is efficient. It may also increase participation because it breaks payments into smaller and more manageable increments.

However, ESI also poses problems. First, it is not available to all workers. The most vulnerable low-income workers are much less likely to work for an employer offering coverage. Second, job transitions or employers' decisions to drop coverage may result in workers becoming uninsured. Last, subsidies for ESI affect the labor force decisions of both employers and employees.

**WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF THE CURRENT APPROACH?**

- **The current tax subsidy is the foundation of ESI.** The subsidy has worked in that ESI covers more than two-thirds of workers and their families.

- **As a way to pool risks and purchase insurance ESI has advantages:**
  - Employment is a natural way to pool risks.
  - Collecting premiums through the payroll process is efficient and may encourage participation.
  - ESI is a reasonable way to create large groups, which may have lower administrative costs and more bargaining power.

- **However, ESI is problematic because it:**
  - Is not available to all workers.
  - Creates gaps in coverage when workers switch jobs or employers drop coverage.
  - Affects employer decisions about outsourcing and employee decisions about work and retirement.

- **To address those problems and provide more equal access to tax benefits, a number of reform proposals would create new tax subsidies for nongroup coverage.** These proposals help some workers without access to ESI, but also create new risks.
New tax credits for nongroup coverage would level the playing field but could also create risks for ESI.

POLICY IMPLICATIONS

Some new tax credit proposals provide subsidies for low-income people purchasing nongroup coverage. These could provide broader access to coverage and tax benefits, but might also disrupt ESI without producing a viable alternative to replace it.

• Some workers, especially younger ones with lower health risks, would have a financial incentive to drop ESI and purchase nongroup coverage. This could cause employers’ premiums to increase, if their risk pools deteriorated.

• These new subsidies could also change employers’ attitudes toward offering coverage. Some employers might decide to discontinue coverage and raise wages, leaving workers on their own to purchase nongroup coverage or become uninsured.

• In either case, workers purchasing nongroup policies would face an individual insurance market that does not work well and offers expensive coverage.

To avoid disrupting ESI, new tax subsidies could be used for both ESI and nongroup coverage.

• Letting workers use a new tax credit for ESI coverage could prevent disruption. However, this approach is costly as credits would be available to many low-income workers and would be layered on top of existing ESI subsidies. In addition, disruption might still occur if employers (especially those with a large number of workers eligible for a new credit) reduced their premium contributions. A few proposals attempt to mitigate those unintended consequences by providing smaller tax credits to individuals with ESI than with nongroup coverage.
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