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RESEARCH SUMMARY

TAXING HEALTH INSURANCE AND LOWERING MARGINAL INCOME TAX RATES: Why Americans Would Be Better Off

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The Federal government does not tax health insurance when employers provide it to their employees as part of a compensation package. This tax expenditure is the largest "loophole" in the federal tax code, resulting in nearly $300 billion in forgone revenue in Fiscal Year 2012, according to the Office of Management and Budget. Even worse for the economy, **the tax exemption for employer-provided health insurance creates significant distortions in the labor and health insurance markets.**

A new study from the Mercatus Center at George Mason University looks at the major unintended consequences of the tax exemption of employer-provided health insurance and the problems created by its market distortions. The study concludes that taxing health insurance and simultaneously lowering marginal tax rates would better serve most Americans and the overall economy.

To read the study in its entirety and learn more about the authors, see "The Tax Exemption of Employer-Provided Health Insurance."

KEY FINDINGS

Many of the United States' current health-care-related problems—from lack of choice and competition to rising costs—stem in part from the tax exemption for employer-provided health insurance.

Eliminating the tax exemption cannot be a stand-alone change; the resulting tax increase on all working Americans should be offset with an equivalent reduction in tax rates.

- This would eliminate many distortions to the health insurance market *without* a net increase in taxes.
- This combination of reforms would also yield higher economic growth and a more flexible labor market, which in turn would *increase* tax revenue in the long run.

Eliminating the tax exemption would allow employers to increase employees' pay by the same amount (about $12,000 annually, on average) that they currently spend on health insurance.

- Workers could use this extra income to shop for health insurance that best meets their individual needs.

- It would eliminate "job lock," where employees feel "locked in" to their current job because they will lose their health insurance if they quit to search for a new job, by allowing workers to keep their health insurance if they change jobs.
- It would also likely leave workers with *more* money, even after buying insurance.

SUMMARY

Among the greatest economic distortions created by the tax exemption for employee-provided health care: restricting workers' freedom to leave one job to find another better suited to their capabilities; limiting workers' ability to choose the health insurance that best suits their needs; and limiting competition and driving up costs in the health insurance market.

Labor Market Distortions

Job Lock. Americans fear how losing or changing jobs will affect their health care and are thus less likely to leave one job to search for another that better suits their skills. Negative effects include: The ultimate result is lower returns for investors, including retirees.

- Employers have more leverage over employees; voluntary employee turnover is reduced by 25 percent in businesses providing health insurance, one study found.
- Small businesses are at a competitive disadvantage in recruiting labor, as they typically must pay more for insurance benefits, and therefore are less likely to provide health insurance than large firms.
- Businesses and workers are less efficient, as resources are unable to flow to their most productive outlets.

Higher Health Care Demand, Higher Costs

The tax exemption for employer-provided health insurance has increased the number of employers that provide health insurance; it has also increased the amount of health coverage purchased.

- This increase in demand for health insurance and health care has contributed to the rise in health care prices in recent decades and further increases the job lock effect.

Less Choice, Less Competition

American workers have little direct involvement in decisions about purchasing their health insurance. Instead, large employers, representing large segments of the population, purchase health insurance for employees.

- This reduces health insurance choices for all Americans and introduces equity concerns about who makes important economic decisions.
- It also makes the health insurance market less competitive.

Recommendations

Reform the tax code to eliminate the tax exemption for employer-provided health insurance. Offset the significant tax increase that results from closing this loophole with an equivalent decrease in marginal rates.

- To make the elimination of the exemption tax neutral, marginal tax rates would need to be lowered significantly.

- For a hypothetical family making $75,000 per year (roughly the median household income for a family of four) and currently in the 10- and 15-percent brackets (see table in full study), marginal rates would need to be lowered to about 7 percent and 12 percent, respectively, to keep the level of tax revenue the same.
- Similarly, the payroll tax rate would be applied to a larger base of income and, therefore, should also be lowered from 7.7 percent to 6.7 percent to raise the same revenue.

Interactions with the Affordable Care Act

This study's proposed reforms should be beneficial regardless of the future status and outcome of the Affordable Care Act (ACA).

- **If the ACA remains law**: the stated goals of the ACA include increasing transparency and controlling costs in the health care market, both of which are furthered by the reforms proposed in this study.
- **If the ACA is repealed**: the study's proposals will be beneficial for correcting labor- and health care-market distortions.

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