Goodman Institute

Turning Ideas Into Policy

How the Government Subsidizes Private Health Insurance

The Healthcare Fairness for All Act is a fairer system that would give every family the same government financial support.

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Although the U.S. federal tax system is judged to be the most progressive among all developed countries, the way the federal government subsidizes private health insurance is surely the most regressive.

Since 1943, employer payments for employee health insurance in the United States have been excluded from employees' taxable income. This has been the primary way the federal government has subsidized private health insurance for 80 years. It is also the way roughly 90 percent of people who have private health insurance obtain it, even today.

When an employee benefit is not taxed, the higher the worker's tax bracket, the larger the tax subsidy. Take a worker who earns too little to pay income taxes, a situation that describes roughly half of the population. When this worker's employer pays wages, the government takes out 15.3% in the form of a (FICA) payroll tax. If the employer pays health insurance premiums on behalf of the employee instead, there is no tax, however. That amounts to a health insurance subsidy equal to 15.3% of the cost of the insurance.

By contrast, consider a worker whose income is taxed at a 45% marginal income tax rate. If this worker receives the same employer-paid health insurance instead of wages, the subsidy in this case is equal to 45% of the cost of the insurance.

Add to these differential subsidies the fact that higher-income individuals are more likely to have employer-paid insurance and the fact that the insurance they have is likely to be more generous. This adds up to a highly regressive government policy – perhaps more regressive than any other feature of the income tax system.

The accompanying graph shows the most recent assessment of these subsidies by the Congressional Budget Office. As the graph shows, families in the top fifth of the income distribution are getting four times as much help from the federal government as families in the bottom fifth when they obtain private health insurance from an employer.

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Government Subsidies for Health Insurance

Family of 4 (35-year-old couple with 2 children).
Annual health insurance premium = $16,331 for a standard silver plan.

Federal Poverty Level	Income	Subsidy When Plan Is Obtained Online	Subsidy When Plan Is Obtained at Work
150%	$45,000	$16,331	$3,149
200%	$60,000	$12,955	$3,209
400%	$120,000	$6,145	$4,817
600%	$180,000	$0	$4,842
800%	$240,000	$0	$5,169
1000%	$300,000	$0	$5,021

Source: Author calculations based on HHS and IRS data.
Note: The subsidy on the left is only available to people who are not eligible for the subsidy on the right. Does not include temporary "enhanced subsidies."

At the time the Affordable Care Act (ACA) was passed in 2010, the self-employed could deduct health insurance premiums from their income taxes and all families could deduct insurance costs above a certain percent of their income. Although these tax breaks were not as generous as the treatment of employer-purchased insurance, they were similarly regressive – providing the largest benefit to the highest income taxpayers.

Reform proposals.

The politics of government subsidies for private insurance have been almost as upside down as the subsidies themselves. On the left (where you would expect heightened concern about "equity"), there has been almost no interest in equalizing government subsidies for employer-provided health insurance, let alone actually making them progressive. All of the proposed reforms have come from the right.

In the 2008 presidential campaign for example, Republican John McCain proposed to replace the current system with tax credits – which would have given the same tax relief to all, regardless of income and regardless of where the insurance was purchased. About the same time, a Ryan/Nunes/Coburn/Burr bill proposed to codify this approach in Congress.

About a decade later, a similar approach was proposed by Congressman Pete Sessions and Senator Bill Cassidy. This year, Sessions has proposed a new version of the same idea.

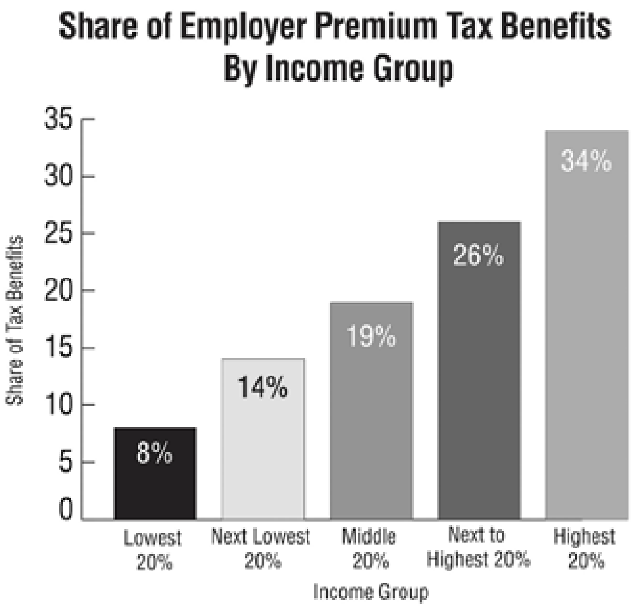
The most important feature of the ACA was not that it got more people covered with private insurance. It didn't. The most important change was a radically new way of subsidizing private purchase by individuals. The Democratic ACA replaced the deductibility of premiums in the individual market with tax credits (long favored by Republicans) and did so in a highly progressive way.

The result is an overall system that is hard to explain and even harder to justify. Here are some particulars.

A dual system of subsidies.

In 2023, the national average premium for a silver plan for a 35-year-old couple with two children is $16,331**.** The accompanying table shows the federal subsidy available at various levels of income if the family purchases the plan in a marketplace exchange. The table also shows the tax relief available if the family obtains that same insurance through an employer. The table is based on the well-established economic assumption that untaxed fringe benefits are a dollar-for-dollar substitute for taxable wages.

These subsidies reflect federal policy for the first seven years of the ACA. More recently, "enhanced subsidies" have been temporarily added, and I will address those next.



Source: Congressional Budget Office, *The Distribution of Major Tax Expenditures in the Individual Income Tax System. 2013.*

Unfairness.

It's hard to even glance at the numbers without being struck by how fundamentally unfair the government subsidies are. At 150 percent of the poverty level ($45,000), a family getting insurance in the exchange pays zero premium and is effectively getting the insurance for free. By contrast, federal help for a family at the same income level, getting the same insurance through an employer, comes to just $3,149, or only about 19 percent of the premium.

Help for the first family is five times the help for the second.

As noted above, fewer than 10 percent of people with private health insurance buy it on their own. Yet this tiny minority is enjoying lavish government largesse, while other low-income workers are straining under ACA's employer mandate, which may be making them worse off.

At higher levels of income (but still very middle-class levels), the unfairness is reversed. Above 400 percent of the poverty level ($120,000), families with employer-provided insurance get a subsidy ($4,817) that is roughly equal to 30 percent of the cost of their insurance. Families at this level who must buy their own insurance, by contrast, get no help at all.

Impact on the family budgets.

The table shows various levels of gross family income. After subtracting income and payroll taxes, the cost of health insurance comes close to more than half the family's entire take-home pay for those at the bottom end of the income ladder.

Readers may remember that the original ACA legislation mandated that individuals buy insurance and that employers provide it. Congress effectively eviscerated the individual mandate. But the employer mandate is still there.

One way to view the mandate is to see it as leading to a world in which either employers of low-wage workers have to face a 50 percent increase in their cost of labor or employees have to take more than half of their take-home pay in the form of a fringe benefit.

Fortunately for the economy, employers of low-wage workers quickly found loopholes to avoid the worst consequences of the Affordable Care Act. The top premium an employer can charge for ACA-compliant health insurance is 9.6 percent of the employee's wages, although the employee can be asked to pay the full premium for any dependents. When young, healthy, low-income employees are asked to pay these premiums for a plan with the maximum allowed deductible, more than 90 percent turn the offer down.

As a result, very few employees of fast-food restaurants actually have Obamacare health insurance. An estimated 3.8 million people have turned down "affordable insurance" from an employer.

Labor market incentives.

The cost of ACA-type health insurance is so large relative to the wages of most workers that it is almost certainly affecting the structure of the labor market. High-income workers are considerably better off getting insurance at work. Low- and moderate-income workers are much better off getting insurance on their own.

Critics of Uber, Lyft and other enterprises that rely on independent contractors complain that workers are missing out on nonwage benefits typically available to employees. What this critique misses is that the typical Uber driver can have comprehensive health insurance almost for free in the exchange because of her moderate income. If those same drivers were forced to become employees, they would have to endure a huge cut in take-home pay to enjoy the same insurance benefit.

Small wonder that the number of independent contractors and participants in the gig economy have been growing in recent years.

More unfairness.

The only major change Congress has made to the system of subsidies for private insurance is to spend more money. But rather than giving help to low-wage workers who are being squeezed out of the insurance market altogether, the new "enhanced subsidies" are going to high-income taxpayers who buy their own insurance. Health economist Brian Blase reports that the new subsidies give relief to families earning as much as $500,000, while giving no help to uninsured workers at fast food restaurants who cannot afford the insurance they are being offered.

A better way.

A new bill by Rep. Pete Sessions (R-TX) and his colleagues would allow families to buy insurance that meets their financial and medical needs. It would also give every family the same government financial support – $12,000 in the case of our illustrative family – regardless of where the insurance is purchased.

The Healthcare Fairness for All Act would grandfather existing employer plans and current participants in the exchanges – if you like your health plan, you can keep your health plan. Yet in time I expect that most employers, employees and participants in exchanges will willingly switch – finding that a fairer system is also a system that better meets their needs.

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