ADDIMG EMPLOYER CONTRIBUTIONS TO HEALTH INSURANCE TO SOCIAL SECURITY’S EARNINGS AND TAX BASE

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The exclusion of employer-provided health insurance (ESI) from taxable income has long been the largest tax expenditure in the annual lists compiled by the Office of Management and Budget (OMB) and the Joint Committee on Taxation (JCT). OMB reports the loss in income tax revenue at $1.310 trillion between fiscal years 2012 and 2017; JCT estimates the loss at $941 billion between 2012 and 2017. The ESI exclusion will also cost the federal government an estimated $701 billion in lost payroll tax receipts between 2012 and 2017. Both estimates of income and payroll tax expenditures from the ESI exclusion are incomplete because they do not account for changes in future Social Security benefits that result from the increase in taxable earnings.

This paper fills this gap. We use the Urban Institute’s Dynamic Simulation of Income Model (DYNSIM3) to simulate the effects of including exempt ESI benefits in taxable income and earnings subject to payroll tax on federal income tax and payroll tax payments and on Social Security retirement and disability benefits through 2086. Based on these simulations, we estimate the effects on federal income and payroll tax receipts, Social Security retirement and disability benefits, OASDI trust fund balances, and the federal budget deficit.

We find that the increase in workers’ future Social Security retirement and disability benefits would offset a significant share of the additional payroll tax from including ESI in earnings. The increased future benefits attributable to any single year’s exclusion of ESI benefits would, however, be distributed unevenly across workers depending on their age, past and future earnings, past and future marital history, mortality, and the earnings and mortality of current, past, and future spouses. This would in turn produce substantial differences in both increased benefits and incremental benefits per additional dollar of taxes paid among different groups classified by income, lifetime earnings, and cohort.

The effects of including ESI in reported earnings beginning in 2014 on budget deficits and the balance of the OASDI trust fund varies over time. Including ESI in the tax base increases receipts from payroll taxes, the high income Medicare surtax, and federal income taxes in all years. At first, outlays for Social Security benefits decline because the retirement earnings test reduces benefits for working beneficiaries ages 62 to 66, but then benefits increase by growing amounts after 2020 as the lifetime earnings of addi-
tional cohorts of new beneficiaries increase. In 2014, taxable earnings increase by $827 billion by including the ESI premiums, payroll taxes increase by $103 billion, and federal income taxes increase by $157 billion, but Social Security benefits fall by $4 billion. The federal budget deficit declines by 1.6 percent of GDP in 2014, but the reduction in the annual deficits falls to about 1.1 percent of GDP annually after 2065 as the offsetting change in benefits rises. Taxing ESI premiums would also improve Social Security’s financing in every year compared to the baseline, as OASDI taxes exceed the increase in disability and retirement benefits, net of the portion of increased income taxes on benefits that go to OASDI. But taxing ESI would not eliminate the long-term OASDI financing deficit (see figure 2 of working paper).

The ratio of increased benefits to taxes varies substantially among income groups. Overall, the increased present value of OASDI benefits from including ESI in the wage base in 2014 offsets about 22 percent of the increase in income and payroll taxes, 57 percent of the increase in payroll taxes, and 72 percent of the increase in OASDI taxes. The bottom quintile recovers in higher benefits slightly over 100 percent of their increased taxes, 136 percent of their increased payroll taxes, and over 163 percent of their increased OASDI taxes. The ratio of increased benefits to higher payroll taxes is less than one for all other income groups, dropping to 51 percent for tax units in the 80-95th percentiles of the income distribution and to only 37 percent for tax units in the top 5 percent.

Both taxes and benefits increase as a share of income between the bottom and middle quintiles and then decline as a share of income for higher income taxpayers. But households in the bottom income quintiles receive a net benefit from including ESI in the tax base because their increase in OASDI benefits exceeds their increase in income and payroll taxes.

Over a lifetime perspective, all earnings groups experience net tax increases, but workers in the middle of the earnings distribution experience the largest net tax increases as a share of lifetime earnings. Higher benefits offset a larger share of tax increases for lower than for higher income groups.

As Congress considers policy options to address the current and long-term deficits, options that expand the tax base and help reduce the growth in health care costs are likely to be considered. Two recent deficit reduction panels have proposed capping and ultimately eliminating the ESI exclusion. Our analysis shows that including ESI in the payroll tax base would reduce the deficit and improve the OASDI trust fund balance, even after accounting for the long-term increase in OASDI benefits from increases in taxable earnings. But other reforms would still be necessary to make Social Security solvent in the long run. Net additional taxes would be highest as a share of income for middle income households, with both lower and upper income households paying less as a share of income.