IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

IRET is a non-profit 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote growth and efficient operation of the market economy.

January 25, 2007 **Advisory No. 218**

PRESIDENT'S HEALTH INITIATIVE CURES MANY ILLS

President Bush has proposed a new tax treatment for health insurance. It would improve tax policy and would partially address several major concerns about health insurance coverage.

The President's plan would help many taxpayers who cannot use the current tax incentives for purchasing health insurance. It would make insurance more affordable for people who do not have access to tax-favored employer-provided health insurance. The plan would tend to reduce the incentive in current law to over-consume health care among people below retirement age and not on Medicaid, and would thus somewhat reduce the demand-driven price pressure on medical costs. The plan would increase participation in and the efficiency of the individual insurance market.

On the negative side, the plan would involve some administrative complexity. Also, it would pre-empt some potential revenue that might have smoothed the way for tax reform. It cannot, and is not intended to, solve the problems created by the major medical entitlement programs.

The President's proposal

Under the President's proposal, all working families who buy health insurance that meets certain basic coverage requirements would receive a tax deduction of $15,000 against the first dollars of wage, salary, or self-employment income. Single individuals would get a deduction of $7,500.

Unlike an ordinary income tax deduction, the first $15,000 (or $7,500) of earnings would be free from both the income tax and the payroll tax. Most taxpayers would save money on both taxes. The plan would benefit workers via payroll tax relief even if they have no income tax liability.

In exchange, the plan would eliminate the exclusion of employer-provided health insurance from tax. These now-excluded amounts would be added to taxable income.

About 80 percent of working-age taxpayers who are insured through their employers would see a reduction in taxable income and tax liability, making the cost of insurance cheaper.

About 20 percent of working-age taxpayers who have very generous employer-provided plans costing more than $15,000 or $7,500 a year would face an increase in taxable income and an increase in tax liability.

For people who work at jobs that do not provide health insurance, the income tax and payroll tax deductions would give them more after-tax income to buy health insurance on their own.

The deductible amounts would be adjusted annually for inflation using the consumer price index.

A second portion of the plan would reallocate some federal money to states that help the poor and

other persons having difficulty getting private insurance to obtain coverage.

Discrimination and price distortion in the current system

Under current law, people who get their health insurance as a fringe benefit at work are not taxed on the value of the employer's contribution to the premiums, either under the income tax or the payroll tax. Similarly, the self-employed get a tax deduction for the insurance they buy. But people who have to buy their own health insurance must do so with after-tax dollars. The current exclusion is worth more per dollar for people in the higher income tax brackets than in the lower brackets.

The current system favors employer-provided health care over the individual insurance market. It deprives the individual market of customers, reducing economies of scale in risk pooling and marketing, and raising costs. The reliance on employment-based insurance leads to trouble when people change jobs.

The tax subsidy for employer-provided health insurance encourages people to spend more on lower-deductible, lower-copayment policies with richer benefits. Such policies make it seem to the employee that each additional doctor's visit, medical test, or procedure costs nothing, or only 10 or 20 cents on the dollar. This masking of the true price of the care boosts the demand for health services beyond natural levels, driving up costs.

Reducing distortions

The President's plan would provide the same non-refundable deduction to all workers regardless of where they buy their insurance. It would treat equally workers who buy their own insurance either in the individual market or through groups other than at work, and those who get it through their employers. (We assume the deductions do not apply to people age 65 and over who are getting federally subsidized Medicare, and who are usually not benefitting from an exclusion of employer-provided insurance. Many Medicare recipients have wage income. The Administration's fact sheet does not address this point.)

It would not discriminate according to what insurance plan was purchased (among those that meet at least some basic level of coverage). Unlike the current exclusion, the deduction would not rise if one bought a richer plan. Therefore, the full cost of more comprehensive insurance would be borne by the consumer. It would improve the functioning of the health care market by making working-age consumers more aware of the marginal cost of buying richer policies. By encouraging a switch to plans with higher deductibles and copayments, it would make patients more aware of the true additional cost of more doctor's visits, or of extra tests and procedures.

The plan would create a bigger market for other types of group policies, and for individual insurance. The risk pool would be larger, and other economies of scale would drive down costs in these markets. Insurance purchased in this manner would be automatically portable between jobs.

People who cannot buy insurance through their employers would be the biggest winners. They would experience a tax reduction that would cover the bulk of the cost of a basic insurance plan with catastrophic coverage.

Taxpayers who have been encouraged to take a large amount of their compensation in the form of health care benefits would probably find it more satisfying to scale back on their no-longer-tax-favored health benefits and take more of their earnings in the form of cash. For those whose health policies exceed the deductible amounts, this would pull some of the sting of the higher tax liability, and reduce demand pressure on the price of health care.

Some differences among individuals would remain. This would still be a deduction, not a credit of fixed dollar value. Consequently, the value of the income tax deduction would be higher for people in

higher tax brackets than people in lower tax brackets. The differences would be less under the plan than under current law, however, because the deduction would not be open-ended like the current exclusion.

Workers earning less than the deductible amounts under the income tax or payroll tax would not be able to utilize the full deduction. This constraint would apply more to the income tax than to the payroll tax.

For example, a family of four is allowed a standard deduction of $10,700 in 2007, and personal exemptions totaling $13,600. (These numbers will be a bit higher in 2009.) An additional $15,000 health insurance deduction would bring their total deductions to $39,300. Suppose the parents only had cash wage income, and it totalled only $30,000, to which would be added the value of their employer's health plan worth $5,000, bringing their declared "wage" income to $35,000. Their income is $4,300 less than their total deductions. All of the new $15,000 health deduction could be taken against their wage income in determining their payroll tax, but they would only be able to use $10,700 of it against their augmented taxable wages under the income tax. (More accurately, they would lose some $4,300 out of their total deductions in some unspecified manner.)

There would be some non-trivial administrative costs in determining the value of an employer-provided group plan to each employee. Group plans are attractive because they have lower sales and administrative costs. However, they lump old and young workers together, and families with children, childless couples, and singles, under one umbrella. Except where the employers collect premiums from employees to account for the relative costs of insuring them, younger participants are generally getting less actuarial benefit from the plans than older employees, and single employees less than those with participating spouses and children. Some rule would have to be established to decide how much income in kind to report on each worker's W-2 form.

CPI versus medical cost inflation

Some might question whether the CPI would be the appropriate index to use in adjusting the deductions for inflation. It would be. The medical care component of the CPI has risen more rapidly than the rest of the price index. That is beside the point. It is important for consumers to be aware of an increase in price of one product versus another, so they can adjust their spending choices accordingly. They should not be protected against relative price shifts.

The Administration has also expressed the hope that the proposed tax changes would reduce price pressure in the medical field, and bring medical care inflation more in line with the over-all rate of growth of prices. There would be some modest reduction in demand pressure due to the reform. However, Federal, state, and local Medicare, Medicaid, and other health spending is seven times the size of the federal tax reduction associated with the health insurance exclusion, and is doing much more to boost health care demand than the federal tax incentive for employer-provided coverage. In the State of the Union message, the President urged, as he has done many times before, that the Congress begin a serious discussion of entitlement reform, including Medicare and Medicaid. He is right to remind us of that aspect of the problem.

Effect on tax rolls, revenues, and Social Security

Specific numbers have not yet been presented by the Treasury, but the Administration expects that the combination of the higher deductions and elimination of the health insurance exclusion would be revenue neutral over the ten year budget window. Taxable income, and the associated income and payroll tax revenues, would fall initially, but rise in later years.

Preliminary estimates by the Administration suggest that the higher deductions would remove about 2% of the adult working age population, or 3 million to 4 million people, from the income tax rolls

(even after adding the excluded value of the employer-provided insurance to taxable income). Initially, it would boost the percentage of the population owing no income tax from about 44% to about 46%. It is bad policy to allow too many people to think that general government is a free good. We are already close to a 50%-plus majority having that view. Ideally, everyone except the very poor should pay some income tax.

However, the Administration estimates that this effect would be temporary. Under current law, untaxed fringe benefits (mostly health insurance) are rising faster than taxable cash wages, faster than total compensation, and faster than over-all inflation. As a result, taxable cash wages are rising more slowly than total compensation. By trading the rising tax break for health insurance for a set of deductions that would increase only with inflation and population, the proposal would increase the rate of growth of taxable income to match that of total compensation. The Administration says that the initial revenue loss would be reversed, and become an increase over time. (We hope to see more detail on these assumptions in the Budget submission.) Similarly, some taxpayers removed from the tax rolls initially would come back on in later years, and the percent of the population not paying income taxes might fall eventually.

A similar analysis would apply to the payroll tax. The Administration expects that taxable earnings would first dip and then increase, with little change in the Social Security accounts over the budget window, and some further revenue gains in later years.

There are considerations on the Social Security benefits side as well. Benefits are tied to one's earnings history, which is the amount of income on which one has paid payroll tax. People getting a reduction in the amount of taxable payroll would experience a reduction in their earnings histories and future benefits. However, as cash wages grow more rapidly due to the elimination of the health insurance exemption, taxable earnings and earnings histories would more than recover over time. People for whom the plan would raise taxable income would get higher benefits. The Administration expects revenue increases in advance of higher future benefits, resulting in a slight improvement in the Social Security system's long run balance.

Note, however, that people close to retirement might experience a few years of lower taxable income and earnings history without the subsequent rebound. Their benefits might be reduced. The effect should be slight, however, because one's earnings history stretches over 35 years, and the tax savings may offset the change in benefits. We must await more details from the Treasury and the Social Security Administration on all these points.

Effect on tax reform

Most tax reform plans would trade in such special tax provisions as the growing health insurance exclusion for lower tax rates and more even-handed treatment of saving and investment vis-a-vis consumption (including greatly expanded deferral of taxes on all saving, including the payment of insurance premiums). The elimination of the exclusion to fund the proposed deduction tied to the purchase of health insurance would take that money off the table for future tax reform efforts.

Some tax reform plans, such as the Flat Tax, would incorporate this type of trade, providing larger deductions in exchange for ending the health insurance exclusion. In that sense, this could be considered a down payment on a version of the Flat Tax with the added "mandate" that one purchase health insurance. However, the President's plan does not target marginal tax rates (as opposed to merely lowering the amount of tax owed), nor does it reduce the tax biases against saving and investment, as do the Flat Tax and most other fundamental tax reform proposals. Also, some other fundamental reforms do

not envision such large deductions and have much different arrangements for treating saving and insurance.

If the proposal were enacted, future tax reform efforts might need to wait for a period of budget surplus in which the reform could be a net revenue loser. We have no objection to a tax reform effort that involves a net tax cut, and suspect that elimination of the health insurance exclusion would be politically difficult without some tie-in to encouragement of the purchase of insurance. We also think that a shift to dynamic scoring of tax reform proposals would sharply reduce their apparent cost.

Voucher or credit alternative

In the past, we have preferred a voucher or refundable tax credit to help low income persons to purchase health insurance. We regard this issue as a poverty question, not a health insurance question. A voucher might be distributed by the Department of Health and Human Services, or be administered by the states. This would treat the issue as a federal outlay, and keep what is really a social program out of the tax code. The voucher or credit would not have different values due to differences in tax brackets, although it might be scaled according to the recipients' incomes.

Persons receiving a refundable credit would be just as opposed to tax rate increases (which would reduce their refunds) as would people paying income taxes. This is not the case for people whose deductions exceed their taxable incomes. We would trade the exclusion of employer-paid health insurance premiums from taxable incomes for lower tax rates or wider tax brackets as part of fundamental tax reform.

Nonetheless, the Administration proposal is on target in many ways. It effectively caps the current exclusion. Among working-age people, it creates more consumer awareness of the marginal cost of richer insurance and the marginal cost of additional medical treatment. It shows one possible way to use private insurance to deal with the issue of the uninsured. Bringing these concerns to the front of the health care debate is a valuable contribution.

Stephen J. Entin
President and Executive Director

Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.