

Summary: *Advocates for tax reform must confront the current tax subsidy for employer-based health insurance, which distorts the market for private health insurance and penalizes those who do not obtain health insurance through an employer. The current scheme should be changed to a straightforward system of credits to empower individuals to make their own health care choices. This would eliminate the current discrimination and tear down this barrier to fundamental tax reform.*



THE ROAD MAP TO TAX REFORM™

HEALTH CARE:

Avoiding the Achilles Heel of Tax Reform

By Grace-Marie Turner

INTRODUCTION

Almost all working Americans are constrained in their health insurance decisions, either by an employment-based insurance policy or by a public health program. There is practically no competitive market for individual insurance policies, as most negotiations and decisions take place at a corporate, bureaucratic level. This state of affairs, which hurts health care at every level, stems from a dated tax subsidy that was instituted because of wartime wage controls. When we consider how the government subsidizes private health care today, we can see how unequal, inefficient and illusory it really is in its “benefits” to workers.

The first move toward better health care actually coincides with a move toward fundamental tax reform. Government tax subsidies for personal health care should be taken out of the sphere of employment. Just as we do not depend on our employers to pay our mortgage or our car insurance, Americans should not have to depend on employers for health care decisions. Giving tax subsidies directly to individuals would give

them freedom of choice. It would also prevent discrimination against those who do not have access to affordable insurance at their workplace.

Before we can close the books on our highly burdensome, overwhelmingly complex, internally inconsistent income tax system to create a flatter, fairer tax system, we must take a hard look at the current tax treatment of health insurance. Unless a careful strategy is developed, the favored tax treatment of employment-based health insurance could well be the Achilles Heel of overall tax reform.

THE HISTORICAL ACCIDENT OF JOB-BASED INSURANCE

To sidestep wage controls during World War II, employers found they could compete for scarce workers and boost compensation by offering health insurance as a benefit in lieu of cash wages. In 1943, the Internal Revenue Service ruled that employers’ contributions to group health insurance would not count as taxable income for employees.

That ruling, its codification by Congress in 1954, rising tax rates on middle class incomes, and the rising demand for health insurance all combined to create a strong incentive for obtaining health insurance through the workplace.

The generous tax preference accorded job-based health insurance is, unfortunately, a historical accident and has increased automatically over the decades without legislative authorization. It has percolated through the economy for nearly 60 years to become the foundation for a system that provides subsidies to employers. The result is clear: working and retired Americans are forced to seek health insurance for themselves and their families through their jobs.

HOW THE CURRENT SYSTEM WORKS AGAINST WORKERS

Employment-based health insurance is part of the compensation package many employers provide to their employees—a form of non-cash wage. What makes health insurance different from cash wages or salary compensation, however, is that workers do not pay taxes on the part of their compensation package they receive in the form of health benefits. A key element in the problems associated with job-based health insurance is visibility.

As long as Americans remain under the mistaken illusion that they are getting “free” or heavily subsidized health insurance at work, they will be shielded from the full cost of their health care consumption decisions. They will not understand that their cash compensation is lower because of high health insurance costs. And they will not see the generous tax break they are getting for their job-based health coverage.

From the employers’ perspective, the tax deduction given for their employees’ health insurance does not hide the cost of the insurance. When deductions are taken, either by a business or an individual, they are visible because the entity receiving the tax deduction must first pay the full cost of the purchase before deducting it from total income. We hear the cries of employers complaining about the rising cost of health insurance because they are paying the bill. Employees may be receiving smaller raises as a result, but this is a less visible consequence.

OTHER FAILINGS OF EMPLOYMENT-BASED INSURANCE

More than 80 percent of the uninsured are working Americans or their dependents. They either can’t afford to purchase health coverage on their own with after-tax dollars, or they can’t afford to pay their share of the premium costs for health insurance their employers may offer.

Furthermore, the tax break for employment-based insurance is inherently regressive. It provides generous benefits to those who have higher incomes and receive health insurance through the workplace. Yet it offers little or no assistance to those at the lower end of the income scale. A taxpayer earning

\$100,000 a year or more gets an annual subsidy worth \$2,638 while one earning \$15,000 gets only \$79 a year in assistance toward the purchase of health insurance.

Finally, based as it is on a system of exclusions and deductions, the tax subsidy for health insurance has little to no effect for lower-income families. Due to the combined effects of the standard deduction, personal exemptions, and child tax credit, these families often pay no federal income taxes. Even a full deduction would mean a savings of only 15 percent off the cost of health insurance—far too little to be of help to the uninsured.

PUBLIC HEALTH CARE GIVES NO LATITUDE FOR INDIVIDUAL NEEDS

Private sector options should be available to those in lower-income categories by providing them direct subsidies or tax incentives rather than creating new open-ended entitlement programs. If it gave individuals real incentive to purchase a private policy, the government could allow a more diverse and complex market to evolve that would cater to the needs of consumers and provide a broader range of choices. Many, for instance, would see the value of purchasing a relatively inexpensive health insurance policy that protects them against the costs of major accidents or illnesses. They could use the premium savings from this less costly “catastrophic insurance” to pay for routine medical bills out-of-pocket or to establish Medical Savings Accounts.

“Health insurance” that pays all medical bills after a deductible of a few hundred dollars isn’t insurance at all; it is a prepayment plan for medical bills. Individuals may choose to purchase this type of coverage, but it is an individual choice that should neither be rewarded nor restricted by the federal government. Instead of attempting to require everyone to fit into the same package, people can tailor the package to fit their individual and family needs.

WHAT ARE THE HIDDEN COSTS OF THE CURRENT SYSTEM?

By one estimate, the average American family pays about \$11,000 a year toward the total \$1.2 trillion in American health care expenditures. Unfortunately, most of that spending is invisible. The figure includes pre-tax wages used to pay job-based health insurance premiums, taxes paid to fund federal health programs like Medicare and Medicaid, cost-shifting among private and public payers, and other expenses.

The only way for Americans to get back in control of costs and choices is to get control of the money. When that happens, consumers can choose the doctors and medical care that *they*, and not an insurance clerk or government bureaucrat, deem necessary. *They*, not a bureaucrat or employer, will decide what compromises they are or are not willing to make to get medical care and health insurance.

The political process has thankfully struggled with and so far rejected a sweeping reform proposal that would address the needs of 280 million Americans through a single government-designed program. No one single solution will ever work. Coupling tax reform with health care reform could correct some of the distortions by helping those in need with *a new form of assistance to purchase private health coverage*.

an understanding of its politically volatility and alternatives that are being developed. For fundamental tax reform to proceed, there needs to first be a viable and equitable alternative to today's system of health care subsidies.

Coupling tax reform with free-market health reform could finally make a win-win political scenario possible.

MAKING REFORM A REALITY

During the last major health care reform debate in the 1990s, Americans consistently said they wanted universal access to health care but just as consistently said they did not want the government bureaucracy that accompanied a centralized government solution. The American people, committed to the imperative of equality, want everyone to have access to the medical care they need and want, but they want it done in a way that does not compromise the strength of the health care system, the economy, or place an undue burden on individual or government resources.

The coincidence of frustration with the tax system and frustration with the health care system may provide a historic opportunity for change. In 1999, the average household paid nearly 40 percent of its income in federal, state, and local taxes. This high tax rate during peacetime and prosperity, coupled with growing disaffection with centralized government, leads many political analysts to believe that the country is ripe for tax reform.

However, a debate over a major simplification or restructuring of the federal tax system would necessarily focus attention on the generous tax benefit provided for employment-based health insurance. It is imperative that tax reform advocates approach changes to the tax treatment of health insurance with

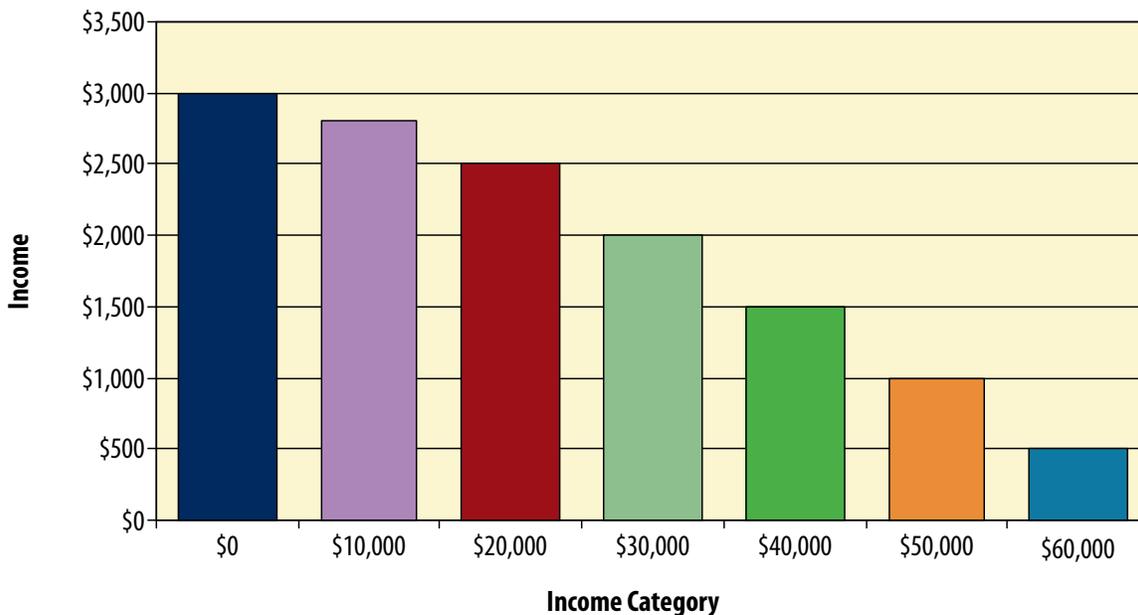
TAX CREDITS ARE A MOVE IN THE RIGHT DIRECTION

As a way to simplify taxes and stimulate the market for health insurance, government could offer, instead of tax deductions and exclusions to businesses, a refundable tax credit to individuals for the purchase of health insurance. The tax credit would be *a direct subtraction from taxes owed*. If taxpayers owe less than the credit for which they are eligible, they can claim the difference as a refundable subsidy. This refundable tax credit would give families meaningful help in purchasing private health insurance.

To remedy the inequality of the current system, these tax credits could be based on a sliding income scale, providing more generous assistance to those in lower income categories, with reduced subsidies as the recipient's income rises. [See Figure 1] Higher-income individuals who now receive generous subsidies for health insurance may be willing to trade some of these subsidies for a flatter, lower tax rate. To advance the case for tax reform, this could actually help balance the demographic tables, which would otherwise show higher-income people gaining more through a flatter tax system.

Tax credits are not a permanent solution. They are, however, an incremental step toward a system of subsidies that would help eliminate many of the current distortions, give more

Figure 1 SLIDING SCALE CREDITS FOR HEALTH COVERAGE



workers access to health care, and allow a simpler, more efficient system of taxation. The new tax credit subsidies would be visible to the recipients, empowering them to make decisions about how to obtain the best value for their health insurance dollar in a competitive marketplace. This is a vision for the future, one that will be not achieved without legislative change.

Tax credits could eventually be converted into direct subsidies, moving the expenditure to the spending side of the budget (where it belongs) rather than being run through the tax code with all of its complexity and confusion. The key to this new refundable tax credit system is that individuals know they have a specific subsidy for health insurance qualified in dollars rather than in an open entitlement to benefits. In the new system, consumers—not government bureaucrats, politicians, or human resource directors—decide how the money will be spent.

THE BENEFITS OF A TAX CREDIT

Under this new system, individuals and families would not be required to give up their health coverage when they lose or change jobs, any more than they would be required to refinance their mortgage or get new auto or life insurance when they get a new job. Tax credits would answer many of the questions raised in the health care reform debate: security, portability, eliminating job-lock, providing broader access to coverage, and creating incentives for cost control, to name a few.

In a true free-market of health insurance, costs would be controlled, not by government restrictions, but by individual consumers seeking the best value for their premium dollars in a competitive marketplace. Those who have information to compare can make choices, and informed choices drive the market to restructure. All consumers benefit from this free-market dynamic.

Subsidies to individuals to make their own health care arrangements would inject new vitality into the market for individually purchased health insurance. Because more than four-fifths of Americans get their health coverage either through the workplace or through government programs, the market for individual health insurance is not nearly as vibrant as it could or should be.

A redesigned health care subsidy could encourage medical care providers, hospitals, and groups to implement programs and medical treatment that specifically address the needs of underserved populations. A special commission could be established to investigate the most effective local programs and find out what makes them work, and an information clearinghouse could facilitate duplication of the best programs.

The challenge for the federal government is to stay out of the way of creative local initiatives while setting up a climate in

which more of them can flourish. These programs will succeed only if they are encouraged by incentives, not driven by federal mandates, controls, and red tape.

TIME FOR CHANGE

The changes that are needed in the health sector will come not through the collective solutions that have been attempted again and again in this century to expand government control of the health system. Rather, they will come through solutions that focus on individual authority, competition, diversity, and freedom of choice that will drive the economy in the twenty-first century.

The goal is to expand freedom by limiting the role of government in the health sector, which is, by the number of pages of regulation governing it, the most heavily regulated sector of the U.S. economy. In order to restore competition and freedom for patients and doctors, we must begin to move away from a system that would bring more and more Americans under the authority of politicians and government regulators in directing health care. Limiting the role of government will expand freedom and promote individual responsibility, competition, and diversity.

This study is a summary of IPI Policy Report # 167, *Health Care: Avoiding the Achilles Heel of Tax Reform*, by Grace-Marie Turner, President of the Galen Institute.

WANT MORE INFO?

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