

BRIEF ANALYSIS

No. 263

For immediate release:

Wednesday, April 29, 1998

Health Plan for the GOP

House Ways and Means Chairman Bill Archer (R-Texas) has proposed giving tax deductions to people who purchase their own health insurance. House Health Subcommittee Chairman Bill Thomas (R-Calif.) has proposed an even more radical idea: making health insurance personal and portable for everyone. These proposals would make health insurance more affordable, reduce the number of uninsured and give people more control over their health care.

New Options for

Individuals.

Federal tax policy encourages employers to provide health insurance instead of paying employees all their compensation in the form of taxable wages. Under current law, every dollar of health insurance premiums paid by an employer escapes a federal income tax that reaches as high as 39.6 percent, a 15.3 percent Social Security (FICA) tax and perhaps a 4, 5 or 6 percent state and local income tax. By contrast, the self-employed can deduct 45 percent of the cost of health insurance (increasing to 100 percent by 2007). The unemployed and those whose employers do not provide health insurance get virtually no tax break. [See the figure.]

Republican proposals would level the playing field, giving more equitable tax relief to people who purchase their own health insurance.

giving more equitable tax relief to people who purchase their own health insurance.

Tax Deduction or Tax Credit? Deductions have some advantages. For example, deductions tend to be

uniform for all taxpayers and are harder for special interests to manipulate through subsequent legislation. Since the higher the cost, the higher the tax break, deductions provide more relief for people who live in high health care cost areas or who must pay high premiums because they are at higher risk of incurring medical expenses.

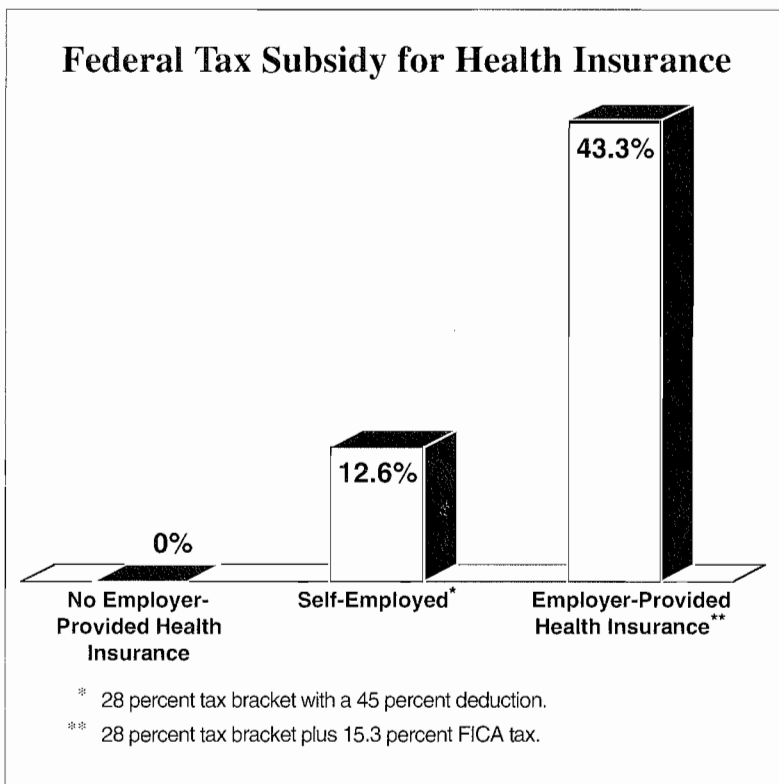
However, deductions have their disadvantages. For example, a tax deduction benefits high-income people

more than those with low incomes. (A taxpayer in the 40 percent tax bracket gets a subsidy worth 40 cents on the dollar, while a taxpayer in the 15 percent bracket gets only 15 cents.) Under the current system, families in the top one-fifth of the income distribution get six times the subsidy that families in the bottom one-fifth get for the purchase of health insurance. A deduction for individual purchase would extend this pattern, giving the most tax relief to people who would likely purchase coverage

anyway and the least relief to people who need help the most. A deduction also only helps families who itemize. Yet 73 percent of taxpayers don't itemize, probably including most who are currently uninsured.

In addition, a tax deduction encourages people to overinsure because the more they spend on health insurance, the more tax subsidy they receive.

A dollar-for-dollar tax credit under which health insurance costs are subtracted directly from taxes owed — up to, say, \$2,000 for a family — avoids these



BRIEF ANALYSIS

No. 263

Page 2

problems but has others. On the positive side, a tax credit would provide moderate-income families the same tax relief as higher-income families. The credit also could be “refundable,” so low-income families with little or no tax liability would receive the same subsidy. Further, such a tax credit would cover the cost of core, catastrophic insurance, leaving people the option of paying for more extensive or elaborate coverage with their own money.

On the other hand, a uniform tax credit providing the same subsidy for all families would give no extra help to people who face high health care costs. Conceivably, the credit could be varied by geographical region, giving more relief to higher cost areas of the country, but this would invite special-interest manipulation. Even without such variation, tax credits are more easily manipulated by special interests than a deduction. For example, advocates for diabetics or the disabled could press for larger credits for their groups.

New Options for Employers. The ability to exercise the new option should not be limited to individuals. Employees as a group should be able to move to the new tax system. Employers could continue to pay premiums, but their payments would be included in the taxable income of the employees, who would receive tax relief on their personal income tax returns. Employers could also move to a defined contribution system — giving each employee a fixed number of dollars with which to shop in the health insurance marketplace. With this option, employees could benefit from the economies of group purchase, but their insurance would be personal (belonging to the individual) and portable (traveling with them from job to job).

New Options for Out-of-Pocket Spending. Under current law, each dollar an employer spends on third-party insurance is excluded from taxable income. But the federal government taxes income individuals set aside as self-insurance to pay bills directly. This encourages overreliance on third-party insurance. An excep-

tion to this rule is the tax-free Medical Savings Account (MSA) now available to the self-employed and employees of small businesses. Another exception is that people who itemize can deduct out-of-pocket expenses above 7.5 percent of their adjusted gross income (AGI). Republican proposals would expand one or the other of these two options.

MSAs or Tax Deductions? The biggest problem with lowering the threshold for deductibility, say from 7.5 percent to 2.5 percent of AGI, is that the change would encourage people to consume too much health care. For example, a person in a 28 percent tax bracket would have only 72 cents out of a dollar after taxes to spend on most goods and services but would have a whole dollar to spend on health care. This would make health care artificially more attractive relative to other goods and services.

A better approach is to expand self-insurance through a type of Medical Savings Account (MSA) called a Patient Protection Account (PPA). This account would be structured like the new Roth IRA: deposits would be aftertax and withdrawals for any purpose would be tax-free. Current law permits small employers and the self-employed to make deposits to tax-free MSAs for use in conjunction with high-deductible health insurance, making them unattractive to many people, including members of HMOs. However, anyone could have and use a PPA.

PPA funds could be used to pay for health care not covered by health plans, giving people more freedom of access and choice. This option would allow them to take advantage of the lower premiums offered by restrictive HMOs and put the savings in a PPA. Funds in the PPA could be used to pay for visits to out-of-network doctors, for drugs an HMO does not cover and for diagnostic tests the HMO does not provide.

This Brief Analysis was prepared by NCPA President John C. Goodman and NCPA Vice President of Domestic Policy Merrill Matthews Jr.