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Making Health Care Affordable: Bush's Bold Health Tax Reform Plan

Stuart M. Butler and Nina Owcharenko

President Bush's proposal to reform the tax treatment of health care takes a bold step toward fixing America's health care system by widening the availability of affordable and "portable" health plans available to Americans and by defusing some of the pressure that currently leads to higher health costs. It is a sound basis for a serious discussion on how the tax treatment of health care should be reformed, consistent with good tax policy.

No Tax Increase. The President proposes a revenue-neutral reform that would give all Americans a new "standard deduction" for buying health insurance somewhat like the standard deduction for dependents. This would replace the unlimited "tax exclusion" currently available only to Americans who participate in company-sponsored plans. The current exclusion helps primarily those who do not really need a tax break and gives nothing to Americans without plans arranged by their employer. The proposal would make the tax treatment of health care fairer and more consistent with the goal of fundamental tax reform. Although some Americans would have more of their compensation subject to taxes, this revenue-neutral proposal is no more a tax increase than limiting or ending tax deductions to move toward a flatter tax system. It would remove distortions and inequities and make tax relief for health insurance more widely available.

While the proposal can be improved in ways that would further reduce uninsurance, it is a big step toward sound tax and health policy. It would treat all Americans equally by ending the tax discrimination against families who buy their own health

insurance, either because they do not have insurance offered by employers or because they prefer other coverage. Ending that discrimination would have the added advantage of stimulating wider choice and greater competition in health coverage, which will help moderate the growth in health care costs. Such tax neutrality would also make it easier for families to keep their chosen plan from job to job, and this improved coverage portability would reduce the gaps in coverage and loss of coverage that often accompany job changes.

Today's tax exclusion means that any amount of an employee's compensation earmarked by the employer for the purchase of health insurance is not subject to income or payroll taxes. There are no limits on this tax break. The proposal would replace this exclusion with a new, limited standard deduction that would apply to company-sponsored plans and to any health insurance purchases by families. This deduction would eliminate payroll taxes and income taxes on insurance worth up to \$15,000 for families and \$7,500 for individuals—well above the cost of typical plans.

Higher Cash Earnings. Today's unlimited tax exclusion especially benefits well-paid workers, such as those in the boardroom who avoid all taxes

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on their Cadillac health plans. But there are two big downsides with the unlimited exclusion that the President's proposal would begin to fix.

First, forgone tax revenue due to the exclusion on this form of compensation means that taxes are imposed elsewhere—namely on those who buy their health coverage directly. So giving the same standard deduction to all Americans would achieve a more neutral and fairer tax system.

Moreover, by reforming and limiting the tax exclusion, the reform actually means that many Americans would see an increase in their paychecks. This is because workers with expensive plans—often loaded with unnecessary but seemingly “free” additional services—would bargain for more of their compensation to come in cash income rather than Cadillac health coverage. In fact, more and more worker compensation has taken the form of tax-free fringe benefits—especially health insurance—in recent years, at the expense of taxable cash earnings.¹ Under the President's reform, employees and employers would have less incentive to bargain for compensation such as top-of-the-line tax-free health plans. Rather, they would face greater incentives to bargain for higher cash earnings to pay for other needs, such as housing and education.

Second, the unlimited tax exclusion for health insurance actually means that compensation spent on health care is invisible to almost all employees, because it is not even identified on paycheck stubs, year-end W-2 forms, or tax returns. Employers and health economists know that one of the effects of this invisibility is that employees have little incentive to question medical costs, or even to review bills from the hospital, because they do not see these costs directly showing up in reduced cash compensation. Employees grumble about slow wage growth, but few link wages to their desire for their employer to “pay for” better health benefits.

Placing a limit on the tax-free status of the health insurance part of worker compensation will lead employers to disclose health costs to employees and prompt more workers to question these costs and to

demand more value for money, just as they do when buying a car or negotiating a mortgage package. That would put greater consumer pressure on the health industry to taper down the growth in costs, to everyone's advantage.

Encouraging State-Based Innovation. The proposal would have another, related advantage for families. By giving families a new tax break to purchase their own health coverage, it would encourage more states to create an insurance “Connector” like that being set up in Massachusetts. A Connector is a state-chartered exchange that organizes the offering of a broad menu of private health insurance plans, much like the wide selection available to Members of Congress and other federal employees in the Federal Employees Health Benefits Program (FEHBP). With a Connector in place, families could choose a plan and keep it from job to job without interruption. With the proposed standard deduction for such plans, families using the Connector option—particularly attractive to those in small firms without coverage—would receive the same tax benefits as those with company-sponsored coverage.

Some Room for Improvement. The President's proposal could be improved. While replacing the current tax treatment with a new standard deduction is a big step in the right direction, an even better step would be to replace it with a tax credit more like the current child tax credit—at least for those buying health coverage outside the place of work. A tax credit would especially help lower-income families. The problem is that many families would still be unable to afford basic coverage with a deduction, while a credit set at a flat dollar amount or a high percentage of premium costs would make coverage more affordable to these families.

The President has previously proposed a tax credit for lower-income families. And recently a wide coalition of organizations—including the U.S. Chamber of Commerce, the American Medical Association, and Families USA—made a tax credit the central part of its proposal to boost health coverage. A tax credit could be grafted onto the President's current proposal and would strengthen it considerably.

1. See James Sherk, “Shared Prosperity: Debunking Pessimistic Claims About Wages, Profits, and Wealth,” Heritage Foundation *Background* No. 1978, October 16, 2006, at www.heritage.org/Research/Economy/bg1978.cfm.

Congress should refine the Bush proposal by incorporating a tax credit and should explore a transition over time from today's tax deductions to a tax credit-based treatment of health care. With the laudable goal of a simple tax system with low rates on all income, a tax credit would be a more targeted and efficient way to assure basic health coverage with the least distortions in the tax code.

The President has taken a bold step toward an essential overhaul of the tax treatment of health care. By taking this step, especially if improvements

are added, Congress can help make the tax treatment of health care more equitable and efficient, help more Americans to choose the coverage they want and retain it from job to job, and begin to reduce the tax break-induced pressure that is a factor in rising health costs.

—*Stuart M. Butler, Ph.D., is Vice President for Domestic and Economic Policy, and Nina Owcharenko is Senior Policy Analyst for Health Care in the Center for Health Policy Studies, at The Heritage Foundation.*