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Benefits of the President's Proposed Standard Deduction for Health Insurance

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In his fiscal year 2009 budget request, President Bush once again proposes to reform America's private health insurance system by widening the availability of affordable and portable health insurance.¹ The President's initiative would largely correct the tax treatment of private health insurance and would eliminate the unwarranted subsidies enjoyed mostly by a small number of upper-income workers.

By giving individuals and families greater incentives to watch their health insurance and health care purchases, this proposal would strengthen the consumer-driven market forces that should discipline health care prices. Putting more effective downward pressure on health care inflation is important to families' budgets and U.S. businesses' competitiveness. It is also vital to restraining the growing costs of Medicare and Medicaid. These health care entitlements are unaffordable in their current form, in no small part because the cost of health care is projected to grow at a much faster rate than the economy in coming years.

The Tax Code: The Heart of Health Policy Reform. America's health care system is badly distorted by numerous government policies, but at the heart of the matter is the tax treatment of health insurance. Americans participating in company-sponsored health care plans receive an unlimited exclusion from both income and payroll taxes for whatever amounts their employers spend on their health insurance. Because employer-sponsored health insurance is tax-free, employees have a powerful economic incentive to take much of their earnings in the form of health insurance rather than cash wages. This depresses cash

wages and induces many workers to buy far more insurance than they would absent the unlimited tax subsidy, such as plans with low deductibles, low copayment rates, and overly generous benefits.

The President's proposal would replace the current unlimited exclusion available only to those with employer-sponsored coverage with a standard deduction for health insurance (SDHI) available to anyone with health insurance. The standard deduction would be worth up to \$15,000 for families and \$7,500 for individuals and, like the current exclusion, would apply to both income and payroll taxes.

The specific mechanics of the SDHI remain open to debate. A simple option would be for most taxpayers with qualifying health insurance plans simply to reduce the amount of income and payroll tax withheld from their paychecks over the course of the year to reflect the new SDHI and apply the flow of tax savings to their insurance premiums. Alternatively, to ensure premiums are paid and to minimize tax fraud, the tax savings could be sent directly to the insurance company once an individual or family has purchased a qualifying plan.

Seven Advantages of the SDHI over Current Law. The President's SDHI proposal has at least seven important advantages over current law:

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Advantage 1: It would encourage the purchase of health insurance. For many Americans who are currently uninsured, the tax savings alone from the SDHI would be sufficient to cover most of the cost of a robust health insurance policy. According to White House estimates, the SDHI would reduce the after-tax cost of an average-cost health insurance policy for a family of four from \$6,100 to just \$1,555—just over \$100 per month.²

Advantage 2: It would end unfair tax discrimination. This proposal would give all Americans a significant tax incentive to purchase health insurance, ending tax discrimination against those who purchase their own insurance or go without. Furthermore, many taxpayers who currently receive employer-sponsored health insurance would share in the tax relief to a lesser extent because the premiums for their current policies are below the SDHI amount.

Advantage 3: It would reduce the ranks of the uninsured. The proposal would permanently reduce the ranks of the uninsured in America by millions. While estimates vary and are subject to numerous debatable assumptions, the Congressional Budget Office estimates the proposal would reduce the number of uninsured by nearly 7 million.³

Advantage 4: It would reform health care without raising taxes. The proposal is designed to be roughly revenue neutral. The tax revenues foregone primarily by providing tax relief to individuals and families who currently lack employer-sponsored health care would be offset by the revenue gains from capping the standard deduction.

Advantage 5: It would increase choice in the non-group market. The SDHI would increase by millions the number of individuals and families purchasing health insurance in non-employer group markets. Broadening and deepening this market would increase the range of choices available. Further, as health insurance markets expand and mature, the increasing range of choices and

competition for insurance customers would bring additional downward pressure to bear on health insurance and health care costs.

Advantage 6: It would give individuals and families the power to purchase and maintain coverage regardless of their employment status. The SDHI would give individuals and families the financial incentive and opportunity to buy health insurance on their own whether or not it is offered through an employer. Giving individuals and families the option of buying health insurance on their own gives them greater control over their own health insurance coverage independent of whether they change jobs or experience a period of unemployment. This independence would relieve families of the concern that they could lose their coverage or would be unable to obtain affordable new coverage due to a pre-existing condition.

Advantage 7: It would strengthen labor markets and the economy. Allowing individuals and families an SDHI that is independent of employment would improve the flexibility of U.S. labor markets, which would enhance international competitiveness and prosperity. Workers with pre-existing conditions and employer-sponsored insurance often consider themselves locked into their current jobs, because they risk being denied health insurance if they quit and take a new job. But if they first acquire health insurance on their own, then they are free to move from job to job as economic conditions and opportunities arise.

The Employer-Based System Would Continue. One criticism sometimes leveled at the President's general approach is that it would destroy the employer-based health insurance system. This criticism is misplaced. Employer-sponsored health insurance would continue because it would still offer employees advantages, where available.

All insurance involves the pooling of risk. With a sizable group of individuals and families, it is gener-

1. See "Analytical Perspectives, Budget of the United States Government, Fiscal Year 2009," Office of Management and Budget, the White House, February 3, 2008, Chapter 17.
2. "Setting the Record Straight: President Bush's Standard Deduction for Health Insurance Would Save Money for More Than 100 Million Americans," the White House, January 2007, at www.whitehouse.gov/news/releases/2007/01/20070122-9.html.
3. "An Analysis of the President's Budgetary Proposals for Fiscal Year 2008," Congressional Budget Office, March 2007, at www.cbo.gov/ftpdocs/78xx/doc7878/03-21-PresidentsBudget.pdf.

ally impossible to predict who will suffer an illness over a given period of time, but one can, with some confidence, predict the odds that at least one member of the group will suffer a covered illness, as well as the odds that two, three, or more will do so.

Insurance works best when insurers create well-defined groups of covered individuals, known as “risk pools.” Individuals purchasing health insurance on their own become part of an ad hoc, general, and often higher-cost risk pool. Employers that sponsor health insurance, on the other hand, often have relatively stable workforces that, over time, build health histories that can be used to refine the pricing of health insurance—usually in a downward direction. Thus, employers would often be able to offer health insurance at lower cost than individuals and families could buy in the individual market.

Beyond a certain size, employers also enjoy some economies of scale in the management and operation of their employees’ health coverage. Individuals generally do not want to spend vast amounts of time and energy shopping for and managing their health insurance policies. But employers often have enough covered employees that they can dedicate a modest amount of resources to perform these tasks effectively.

Employers would be unlikely to take advantage of the SDHI to dump their own employee health plans. Some would do so, of course. But as long as employers must compete for quality employees, competitive pressures will encourage them to offer health insurance as an employee benefit when and where it makes sense to do so.

The Next Steps. The President first proposed an SDHI as part of his fiscal year 2008 budget request. After initial favorable reactions from across the political spectrum in 2007, the proposal received little subsequent public attention. However, that does not make the current proposal a non-starter. The increasingly popular Health Savings Account (HSA) was debated for years before becoming law. Similarly, the proposal for a single-payer health care system has been around for decades and remains a very real threat. Big ideas often take time to gain

traction, and they require the right legislative environment to move forward. This was not the case in 2007 and will likely not be the case in 2008, but the right conditions will arise in the near future.

Health care systems, both public and private, are increasingly complex, increasingly expensive, and directly relevant to the lives of Americans. The health care debate has a long history and could go in many directions. The President’s proposal for an SDHI is one of a class of proposals that also includes a health insurance tax credit and expansions of the high-deductible health plan/HSA combination.⁴ These proposals, each of which enjoys its own relative advantages, represent a fundamental change in tax and health care policy that would give individuals and families more control over their finances, their health care coverage, and their health care decisions, in stark contrast to risky proposals that would expand the role of government in health care. The President’s proposal represents an important and positive contribution to a debate that will continue long after his term of office expires.

Conclusion. The President’s proposal would replace the unlimited exclusion with a generous standard deduction for health insurance. It represents an important step forward in tax reform and toward resolving one of the great failings of health care policy. Among its advantages, the proposal would eliminate unfair tax discrimination against those who are not offered employer-sponsored health insurance; encourage millions of individuals and families to purchase health insurance; thin the ranks of the uninsured; achieve significant reform without raising taxes or otherwise increasing the government’s role in health care markets; and give health insurance purchasers much greater control over their health insurance purchasing decisions. When health care reform again rises to the level of a serious national debate, the President’s proposal deserves serious consideration.

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4. The President’s budget for fiscal year 2007 included many important reforms of the Health Savings Account model. In many respects, these reforms would have had the effect of building out the current-law HSA system. These were mostly dropped in 2008 in favor of the SDHI, but they remain an interesting and viable alternative.