

# WebMemo



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## Health Care Reform: Changing the Tax Treatment of Health Insurance

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Leading Members of Congress and certain officials in the Obama Administration are reportedly considering changes to the federal tax treatment of health insurance as a means of financing health reform.<sup>1</sup>

If there is one area in health policy where there is a powerful consensus among serious analysts, conservative and liberal alike, it is the need to change the existing tax treatment of health insurance.<sup>2</sup> President Ronald Reagan first proposed a change to the tax law governing health insurance in 1983, but Congress never acted on the proposal. Six years later, analysts at The Heritage Foundation unveiled a national health reform proposal grounded in comprehensive tax reform.<sup>3</sup> Now, the idea could—depending on its details—potentially serve as the basis of a bipartisan compromise on health reform in the coming months.

**The Current Tax Treatment.** The current tax treatment of health insurance is a byproduct of wage and price controls imposed by the Roosevelt Administration during the World War II era. The federal tax code currently excludes, without limit, the value of employer-sponsored health insurance from an individual's income for the purposes of both income and payroll taxes. This tax exclusion for employer-sponsored insurance is a huge, but hidden, tax subsidy. The Joint Committee on Taxation estimated that value of the tax exclusion in 2007 was \$246.1 billion in foregone income and payroll taxes.<sup>4</sup> The exclusion represents the largest federal tax expenditure as well as the third largest health care expenditure, following only

Medicare and Medicaid, the nation's two largest entitlement programs.

Health economists generally agree that this Roosevelt-era policy is poorly designed and has many perverse incentives.<sup>5</sup> The employee exclusion is inherently unfair, inefficient, and inequitable.

It is unfair because only individuals with employer-sponsored insurance are able to receive tax relief, while individuals without access to such coverage typically pay for health insurance with after-tax dollars and, in effect, face a sizeable tax penalty. It is inefficient and inequitable because the largest tax benefits go to those who need them least; given the progressive structure of the tax code, the exclusion is regressive since it is worth less to taxpayers in lower marginal tax rates and more to those in higher marginal tax rates. Therefore, if the goal is to extend coverage to the uninsured, the tax break is poorly targeted because it provides little or no tax relief to those with low incomes, who are least able to afford health insurance.

The tax treatment of health insurance also has the perverse effect of increasing health care spending and driving up costs by essentially lowering the effective price of employer-sponsored health insur-

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ance. The exclusion does encourage individuals to obtain insurance. But it also encourages many individuals to have more generous insurance than they typically need, because the higher the cost of the insurance and the higher the person's income, the bigger the tax benefit for the individual.<sup>6</sup> The exclusion creates a bias toward overly generous insurance—even first-dollar coverage—with low cost-sharing in the form of co-payments, coinsurance, and deductibles because out-of-pocket expenditures, for the most part, do not enjoy a similar tax preference. This incentive reduces the price sensitivity of health care consumers and leads to higher prices and greater utilization, which in turn puts a strain on resources and makes health care more expensive for those who lack insurance.

### The Right Way to Change the Tax Treatment.

The best way to change the current tax treatment would be to replace the existing tax exclusion with a more equitable and efficient system of individual tax relief, leveling the playing field for robust competition among insurers and creating a level of consumer choice that is routine in every other sector of the American economy.

Short of that, Congress could limit or cap the exclusion, perhaps only for income tax purposes, while simultaneously using the new revenue to provide health care tax credits for taxpaying

households. The government could also provide vouchers—which, for lower-income households, could be combined with the credit—so that more individuals and families can afford health insurance.

Under this scenario, any revenue generated from the value of premiums that either exceeds the cap or is no longer excluded from taxable income should be used exclusively to finance tax credits to individuals and families to offset their federal taxes. The existing tax exclusion on health benefits should be gradually phased out over time while the new system of health care tax credits for individuals and families is phased in. The health care tax credits should apply to a significant portion of a health plan's premium—but not all of it (consumers should have some “skin in the game”)—and be used to offset some of a taxpayer's income tax liability.

Americans with no tax liability, or tax liability that is currently less than the value of the credit, should receive vouchers to purchase their own insurance. The voucher component would be somewhat like a traditional refundable tax credit (such as the earned income tax credit), although with a key difference: These health care vouchers should be paid for entirely by reductions in other government spending in the budget—and there are plenty of options available to finance such direct assistance to low-income persons. But assistance to

1. Lori Montgomery, “Workers’ Health Benefits Eyed for Taxation: Revenue Would Fund Expansion of Coverage,” *The Washington Post*, March 12, 2009, at [http://www.washingtonpost.com/wp-dyn/content/article/2009/03/11/AR2009031103827\\_pf.html](http://www.washingtonpost.com/wp-dyn/content/article/2009/03/11/AR2009031103827_pf.html) (March 13, 2009); see also Jackie Calmes and Robert Pear, “To Pay for Health Care, Obama Looks to Taxes on Affluent,” *The New York Times*, February 25, 2009, at <http://www.nytimes.com/2009/02/26/us/politics/26budget.html?pagewanted=1&r=1> (March 13, 2009); see also Jackie Calmes and Robert Pear, “Administration Is Open to Taxing Health Benefits,” *The New York Times*, March 15, 2009, at <http://www.nytimes.com/2009/03/15/us/politics/15health.html?ref=politics> (March 16, 2009).
2. See John Holahan and Linda J. Blumberg, “An Analysis of the Obama Health Care Proposal,” Urban Institute, 2008, at [http://www.urban.org/UploadedPDF/411754\\_obama\\_health\\_proposal.pdf](http://www.urban.org/UploadedPDF/411754_obama_health_proposal.pdf) (March 13, 2009). See also Henry J. Aaron and Leonard E. Burman, eds., *Using Taxes to Reform Health Insurance: Promises and Pitfalls* (Washington, D.C.: Brookings Institution Press, 2008).
3. Stuart M. Butler and Edmund F. Haislmaier, eds., *A National Health System for America* (Washington, D.C.: The Heritage Foundation, 1989).
4. Joint Committee on Taxation, “Tax Expenditures for Health Care,” July 30, 2008.
5. See for instance Katherine Baicker, testimony before the Committee on Finance, U.S. Senate, July 31, 2008, and Jonathan Gruber, testimony before the Committee on Finance, U.S. Senate, July 31, 2008, at <http://finance.senate.gov/site/pages/hearing073108.htm> (March 13, 2009).
6. Jason Furman, “Reforming the Tax Treatment of Health Care: Right Ways and Wrong Ways,” in Aaron and Burman, *Using Taxes to Reform Health Insurance*.

families currently not paying taxes should *not* be funded by the revenue raised from changes in the tax treatment of health insurance for taxpaying Americans.

**Essential to Bipartisan Reform.** Changing the tax treatment of employer-sponsored health insurance has for years enjoyed support from across the political spectrum. Although President Obama has not yet included tax treatment reforms in his health care plan, it is not too late. Senate Finance Chairman Max Baucus (D-MT) has proposed limiting the current tax exclusion, which suggests there is still some room for a compromise on this front. If President Obama and leaders in Congress are sincere about passing—and fully financing—comprehensive health care reform legislation with broad

bipartisan support, changes to the tax treatment are essential.

There are several ways to design a new system of health care financing that is more efficient and more equitable than what Americans have today. The right way is to restructure the tax code to promote competition among health plans and give Americans real personal choice of health care options. A proposal that gradually phases out the current income tax exclusion while phasing in a more equitable and efficient tax treatment will achieve serious bipartisan health care reform.

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