

WebMemo



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How Reforms to the Tax Treatment of Health Insurance Benefit the Middle Class

Greg D'Angelo, Rea S. Hederman, Jr., and Paul L. Winfree

Health economists have long considered changing the tax treatment of health insurance a key component of any serious health care reform. A relic of the World War II era, the federal tax code currently excludes, without limit, the value of employer-sponsored health insurance from an individual's taxable income for the purposes of both income and payroll taxes. This tax exclusion is a huge, but hidden, tax subsidy. The Joint Committee on Taxation recently estimated that in 2008 this tax expenditure amounted to \$226.2 billion in foregone tax revenues.¹

Aside from its sheer size—and the unfairness inherent in the fact that it only offers tax relief to those with employer-based coverage—if the tax exclusion's goal is covering the uninsured, then it is poorly targeted. While the exclusion does encourage individuals to buy coverage by lowering the after-tax price of employer-sponsored health insurance, it also provides the largest tax subsidies to those who need them least and little or nothing to millions of middle-income families who need help buying health insurance. Under current law, more than 45 percent of these income tax expenditures go to households with incomes above \$100,000, while only roughly 10 percent go to households with incomes below \$40,000.²

Fortunately, health reform proposals recently introduced in Congress—such as the Patients' Choice Act of 2009, sponsored by Senators Tom Coburn (R-OK) and Richard Burr (R-NC) and Representatives Paul Ryan (R-WI) and Devin Nunes

(R-CA)—seek to replace the current income tax exclusion with a fairer, flatter form of tax relief for all Americans regardless of job status.

Tax Relief for All Americans. Under the Patients' Choice Act, tax-paying households would receive tax credits to offset the cost of a significant portion of a health plan's premium. These tax credits would offset some, but not all, of a taxpayer's income tax liability so that no taxpayer would be removed from the tax rolls. The credit component of the proposal is combined with a voucher to provide assistance to households with limited or no tax liability in order to help them purchase their own private health insurance just as their counterparts in taxpaying households.

This voucher component would function much like a traditional refundable tax credit, except that it would not be financed by changes in the tax treatment of health insurance but rather through reductions in spending by the federal government. The revenue raised by ending the current income tax exclusion would be used exclusively to finance health care tax credits for taxpaying households. Any excess tax revenue generated in the process of replacing the exclusion with tax credits would be

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(202) 546-4400 • heritage.org

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dedicated to supporting broader tax reform efforts in the future.

With the Patients' Choice Act, almost all households with incomes under \$100,000 would benefit from replacing the current income tax exclusion with a health insurance tax credit. The tax credits under the plan—worth \$2,290 for individuals and \$5,710 for families—would represent a net tax reduction for these households and, in effect, increase their after-tax incomes. Although compensation in the form of health insurance would now be subject to the federal income tax, the tax credits that would replace the exclusion would, in most cases, more than offset any new federal income tax liability resulting from this change in the tax treatment of health insurance.

If the tax exclusion were replaced with tax credits, those who would potentially pay more in federal income taxes would do so because of the high value or cost of their health insurance. However, these individuals and families would likely be able to purchase a more basic health plan to avoid any new tax liability while demanding more compensation in the form of wages from their employers, or if they like their current coverage they could always keep it and pay more in federal income taxes.

Replacing the tax exclusion with a health care tax credit would not only help the middle class buy insurance and extend coverage to the uninsured; it would also set in place powerful incentives to reduce the rapid growth in health care expenditures. Instead of an open-ended tax subsidy tied to employer-sponsored insurance, individuals and families will have the ability to choose the health plan they want, own it, and take it with them from job to job. This tax credit would also have the added

Almost Every Household with Income Less than \$100K Could Be Better Off with a Health Insurance Tax Credit

Percent of households who benefit more from a health insurance tax credit than the current income tax exclusion for employer-sponsored insurance

Income	Single	Head of Household	Married/ Joint
Less than \$20,000	99.8%	99.9%	100.0%
\$20,000–\$40,000	98.5%	99.8%	98.5%
\$40,000–\$60,000	97.9%	99.7%	97.8%
\$60,000–\$80,000	97.8%	90.9%	94.5%
\$80,000–\$100,000	95.0%	89.3%	96.8%
\$100,000–\$150,000	52.8%	80.4%	89.3%
\$150,000–\$200,000	11.9%	52.9%	49.7%
More than \$200,000	4.2%	9.9%	9.6%

Notes: This analysis assumes that the income tax exclusion is replaced by a tax credit of \$5,710 for families and \$2,290 for individuals. Some lower-income households are better off with the income tax exclusion because their insurance premiums are abnormally high. However, as evidenced by the above data, these households are the exception and not the rule.

Sources: U.S. Census Bureau, 2008 Current Population Survey, August 27, 2008, at <http://www.census.gov/cps> (July 1, 2009); Agency for Healthcare Research and Quality, Insurance/Employer Component of the Medical Expenditure Panel Survey, U.S. Department of Health and Human Services, 2001-2003, at http://www.meps.ahrq.gov/mepsweb/survey_comp/Insurance.jsp (July 1, 2009).

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benefit of allowing individuals and families to decide how much of their compensation comes to them in the form of health insurance.³

Methodology. The Heritage Foundation's analysis of the percentage of households that would be better off with a tax credit rather than the current health insurance exclusion uses data from the 2008 Current Population Survey (CPS) as well as the

1. Estimate includes forgone income and payroll tax revenues. See "Background Materials for Senate Committee on Finance Roundtable on Health Care Financing," Joint Committee on Taxation, Senate Committee on Finance, U.S. Senate, May 12, 2009, at <http://finance.senate.gov/JCT.pdf> (July 1, 2009).
2. For an estimate of the distribution of income tax expenditures in 2010, see the Lewin Group, "McCain and Obama Health Care Policies: Cost and Coverage Compared," October 15, 2008, Appendix A (A-4), at <http://www.lewin.com/content/publications/TheLewinGroupMcCain-ObamaHealthReformAnalysisRev10-15-08.pdf> (June 30, 2009).
3. Employers should be indifferent to whether an employee chooses to receive compensation in either health insurance or wages. If employers provide less compensation in the form of health insurance, they will provide more compensation in the form of wages. While the forms of employee compensation might differ, in a competitive labor market the overall level of employee compensation would not change.

Insurance Component of the Medical Expenditure Panel Survey (MEPS-IC) from the years 2001 through 2003. An estimation of adjusted gross income for each tax filing unit was constructed using data on individual income and other tax information from the CPS so as to avoid top coding. Health insurance premiums for individuals were simulated using data on the distribution of health insurance from the MEPS-IC. Furthermore, the

analysis assumes that the tax exclusion is replaced by a credit of \$5,710 for a family plan and \$2,290 for a single plan.

—Greg D'Angelo is Policy Analyst in the Center for Health Policy Studies, Rea S. Hederman, Jr. is Assistant Director of and a Senior Policy Analyst in the Center for Data Analysis, and Paul L. Winfree is a Policy Analyst in the Center for Data Analysis, at The Heritage Foundation.