Tax-Based Reform of U.S. Health Care

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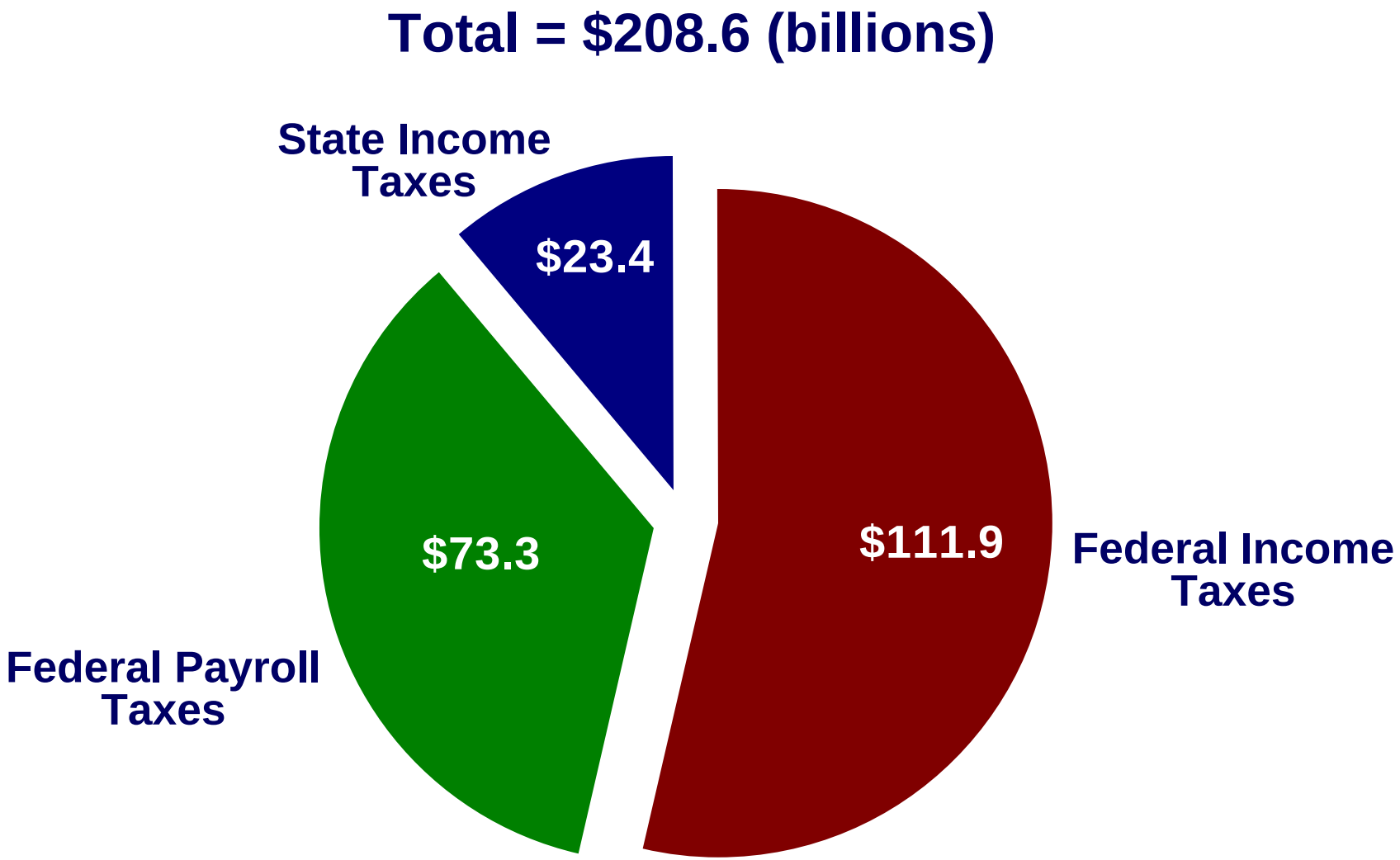
Background

- **During World War II, the federal government allowed firms to offer health coverage as a fringe benefit -- cash wages were subject to wartime controls.**
- **The IRS followed with a ruling that health insurance premiums paid by employers would not count as employee compensation for tax purposes.**
- **Thus, current federal tax law excludes all *employer-paid* premiums from income and payroll taxes owed by workers, but premiums paid directly by individual purchasers of private health insurance are generally not deductible.**
- **The favorable tax treatment conferred nearly exclusively on employer-based group plans is the main reason employer coverage is the dominant form of private insurance in the U.S. -- and it is the reason other, non-employer pools are nearly non-existent.**

The Value of the Tax Expenditure, 2006

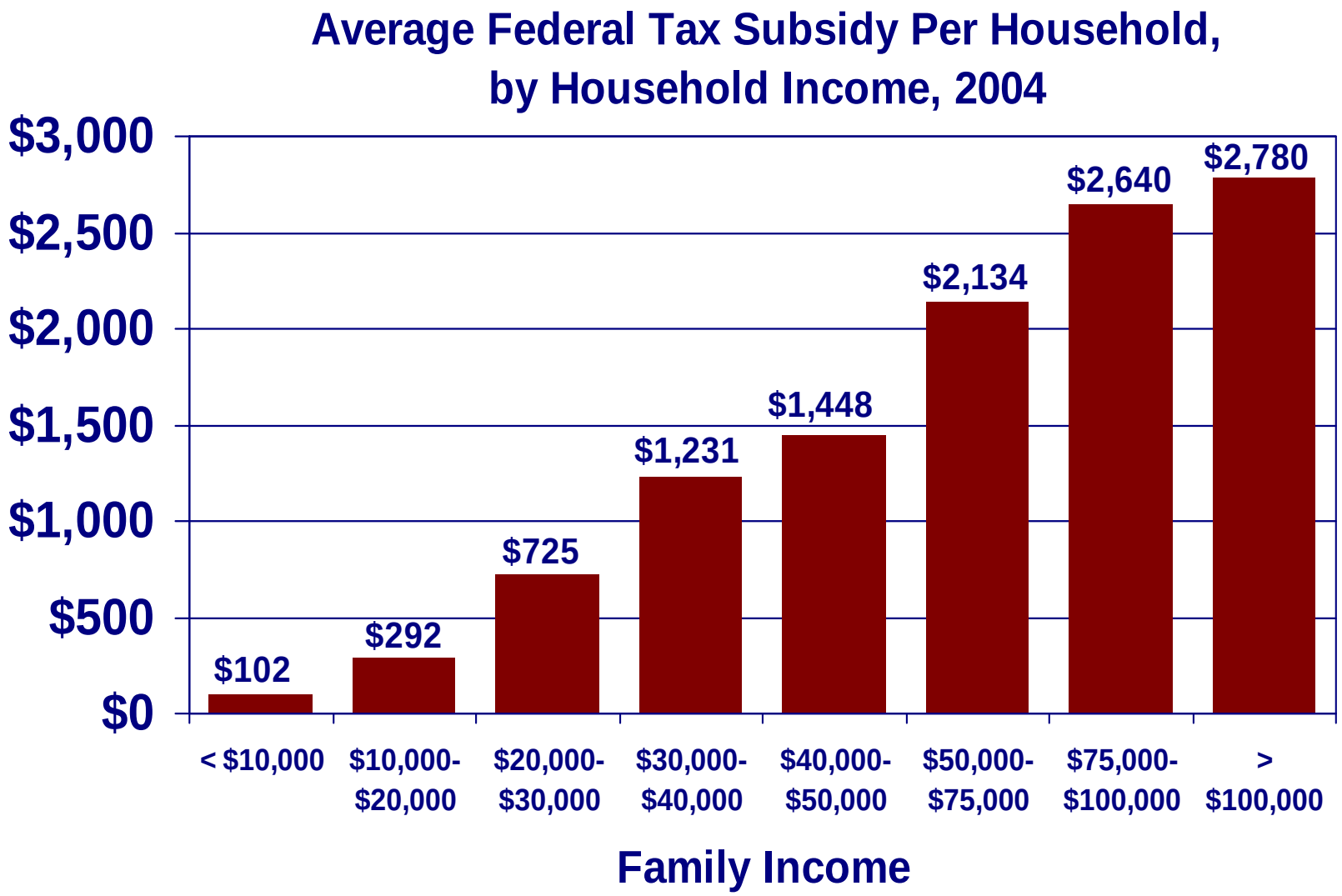


Source: "Tax Subsidies for Employment-Related Health Insurance: Estimates for 2006," Thomas M. Selden and Bradley M. Gray, Health Affairs, November/December 2006, p. 1571.

Employment-Based Coverage

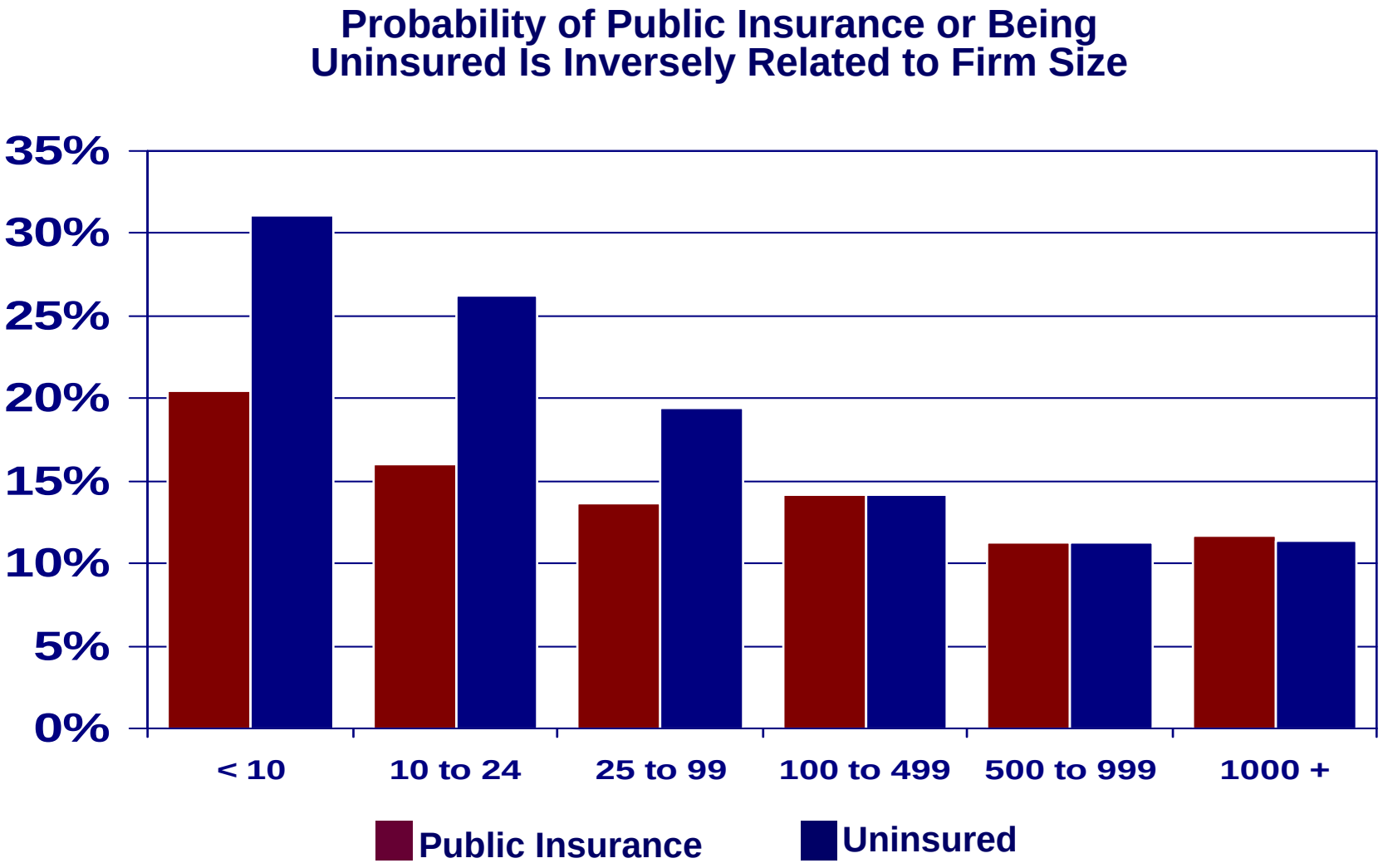
- **Advantages:**
  - **Group insurance sales have lower administrative costs.**
  - **Convenient risk pools.**
- **Disadvantages:**
  - **Lack of portability. Employers, not individuals own the insurance, leaving gaps in coverage for in-between jobs.**
  - ***Dominance of employer-based coverage makes it difficult to establish stable risk pools outside of employment.***
  - **Economic inefficiency associated with job lock.**

The Income Distribution of the Tax Subsidy



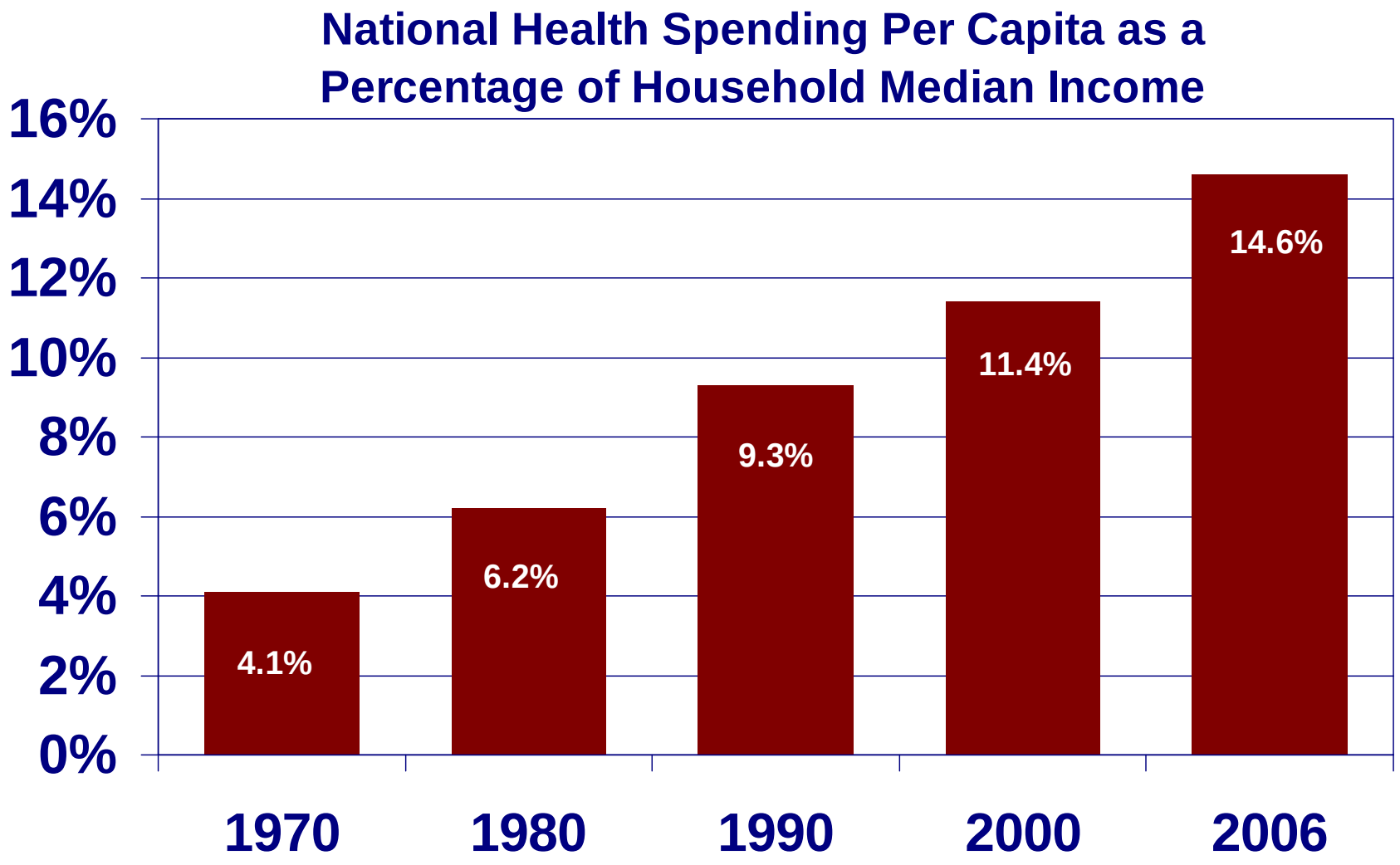
Source: "The Cost of Tax Exempt Health Benefits in 2004," John Sheils and Randall Haught, Health Affairs, February 25, 2004 (web exclusive).

Firm Size, Public Insurance, and the Uninsured



Source: Notes, Employee Benefit Research Institute, Vol. 26, No. 10, October 2005, Figure 3.

Cost Pressure



Sources: Income, Poverty, and Health Insurance Coverage in the United States: 2006, Census Bureau, Table A-1, and CMS National Health Expenditure Data (www.cms.gov).

Improving Efficiency in Health Care Delivery

- There is widespread agreement that U.S. health care delivery is highly inefficient, although with wide regional variation.
  - Wennberg et. al. estimate that about 30% of Medicare spending could be eliminated if the highest cost regions practiced medicine like the lowest cost regions.
- Current open-ended tax subsidy for employer-sponsored insurance contributes to rapidly rising costs:
  - It encourages substitution of insurance for cash wages.
  - And expansive insurance (low deductibles and cost-sharing) insulates purchasers too much from the cost of care, fueling increases in volume and intensity of care each year.
- Reform of current federal tax treatment of employer-paid insurance is central to plans which emphasize market incentives for greater efficiency.
  - Reforms generally would give individual workers more control over a limited (not open-ended) tax subsidy.
  - Workers would thus have a stronger financial incentive to enroll in lower cost insurance to avoid paying premiums with after-tax dollars.

Measured Steps

- **Moving fully toward individual ownership of insurance would improve portability but could de-stabilize existing insurance pools.**
- **Moreover, there is no compelling reason right now to force Americans enrolled in stable large employer plans to switch into a new system.**
- **Tax-based reform should therefore leave in place large employer coverage for the foreseeable future and focus changes on coverage for workers in small firms and those not attached to an employer at all.**

A Framework for Reform*

1. "Tax Cap" for Larger Employer Plans
   - Maintain employer coverage for workers in larger firms (perhaps 50+ employees).
   - Place an upper limit on the premium for coverage that enjoys tax subsidization.
2. Refundable Tax Credit
   - For workers in small firms and individuals ineligible for employer coverage, offer refundable tax credit to be used to offset the costs of health insurance premium.
3. State Regulation within Federal Framework
   - States must develop an acceptable regulatory structure that pools risk appropriately for those eligible for the tax credit.
   - States can consider moving segments of public insurance enrollees into the new structure.
4. Medicare Reform
   - Medicare fee-for-service insurance is the dominant force in most regions and must be reformed for there to be significant change in health care delivery.

* See "Evolving Beyond Traditional Employment-Sponsored Health Insurance," Stuart M. Butler, The Hamilton Project, Discussion Paper 2007-06, May 2007, for an excellent description of one version of tax-based reform.