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EYE ON WASHINGTON

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changing the tax code for health insurance

In his State of the Union address, President Bush proposed major changes in the tax treatment of health insurance coverage. These changes, which are included in the president's FY08 budget, would eliminate the current employee tax exclusion for employer-sponsored health insurance and replace it with a new deduction for all individuals who purchase health insurance.

Under the president's plan, health insurance contributions by employers would be considered taxable income to employees starting in 2009. The president proposes that, instead, individuals who purchase health insurance coverage be allowed to deduct $7,500 for single individual coverage and $15,000 for family coverage, irrespective of the cost of the insurance. The deduction would be against both the federal income tax and the payroll tax and would be indexed against the Consumer Price Index. Employers would continue to be able to deduct both health insurance expenditures and wages as business expenses.

Why Is the Tax Treatment of Insurance an Issue?

The president's proposal addresses several defects of the current tax treatment of employer-sponsored insurance. Under current law, employer contributions to employer-sponsored insurance do not count as taxable income to the employee, and these contributions differ from many other employee fringe benefits in that there are no limits on the amount that can be excluded. As a result, the employees have a distorted choice between after-tax wages and before-tax fringe benefits that encourages them to spend more on health care than they might otherwise. High-income individuals, in particular, who can afford to spend more on health insurance, have an incentive to choose very generous health benefits.

Overspending on tax-free benefits has undesirable consequences. For one, the high cost of these benefits forces employers to limit wage increases for their employees, particularly during periods when health insurance costs are increasing rapidly, as happened during the early part of this decade. An even more insidious consequence, however, is that having more insurance than they need encourages employees to access more healthcare services than they actually require, thereby contributing to the rapid rise in healthcare spending and, in turn, raising the cost of health insurance both for those with employer-sponsored insurance and for those who must purchase it on their own. Thus, the current tax treatment indirectly contributes to the ranks of the uninsured.

The current tax code has one more significant defect. It not only makes health insurance more expensive for people who do not have employer-sponsored health insurance, but also unfairly requires them, unless they are self-employed, to use after-tax income to purchase their own insurance. Even the self-employed, who have been able to deduct their insurance premiums against the federal income tax, have not been able to deduct their premiums against payroll taxes.

Effects of President Bush's Proposal

The president's proposed changes would correct the most perverse features of the current tax treatment of employer-sponsored insurance and create different incentives for people purchasing health insurance. By limiting the amount of the health insurance deduction, disconnecting the amount of the deduction from the cost of the insurance, and making the deduction equally available for people with employer-sponsored or individually purchased insurance, the changes would encourage the purchase of more cost-conscious coverage and "level the playing field" between those with employer-sponsored coverage and those who purchase insurance on their own. By including the amount that the employer contributes to insurance in the employee's taxable income, the proposal also would help make explicit the cost of health insurance. And making people more aware of the cost of insurance would encourage them to become more cost-conscious consumers.

Some provisions of the proposal would likely have an immediate effect on people's insurance purchasing behavior. The most important near-term effects would come from the limits on the deduction and the extension of the deduction to those who buy their own insurance. People with a choice of health insurance plans would have a strong incentive to purchase health insurance that is below the limits of the deduction and some incentive to choose lower-cost insurance because they would continue to receive the deduction irrespective of the cost of the insurance. Most people with employer-sponsored insurance would experience lower taxes immediately. People who must buy their own insurance would experience a substantial reduction in taxes.

Other effects of the proposal would occur more gradually over time. Because the deduction would be indexed to the CPI, and medical expenditures have tended to increase several percentage points faster than the CPI, the value of the deduction relative to the cost of insurance would slowly erode over time, leading people to become increasingly more cost conscious when purchasing health insurance coverage. This feature makes the proposal tax neutral over the longer term as more individuals begin to exceed the limit of the deduction. Extending the deduction to individually purchased insurance is intended to help develop and make that market more competitive over time. The greater cost consciousness of health insurance purchasers would help keep down the growing cost of health care.

The Counterargument

Policy wonks and economists of all political persuasions have argued against the current tax treatment of employer-sponsored insurance for decades. So what is the argument against the proposal?

For some, the proposal does not go far enough. Many have advocated using a refundable credit rather than a deduction for the purchase of health insurance. The president had in fact previously proposed using a limited refundable credit as a way of encouraging low-income individuals who did not have employer-sponsored insurance to buy insurance coverage.

The decision between the use of a deduction and a credit is a policy choice. Most allowances against taxes are deductions and exemptions rather than credits. This treatment maintains the symmetry between expenditures and additions to income associated with a progressive income tax. A credit equalizes the tax offset for all individuals, irrespective of their income, and would represent much more change to the system than what has been proposed.

Some critics have expressed concern that individual markets might not make affordable insurance policies available without additional regulation. Others have criticized the plan for not including more funding to expand coverage for the lowest-income populations. Still others have worried that equalizing the tax treatment between employer-sponsored and individually purchased insurance would undermine employer-sponsored insurance.

An Answer to the Critics

Some of the critics' concerns seem more valid to me than others, and no one would claim that the president's proposal is the perfect solution. Additional funding to help cover the costs of the poorest uninsured will clearly be needed. But letting the perfect be the enemy of the good is generally a bad idea in public policy. And, in this case, it is important that we act now. ●

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