

Good Medicine for the Tax Code

By Joseph Antos
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The President's health care proposal would put patients in charge of buying their health care, and eliminate today's perverse incentive to overspend.

To the surprise of nearly everyone, George W. Bush has once again taken up health policy in his State of the Union address. His bold proposal would help lower-income people buy health insurance while putting the brakes on runaway health spending. Unlike his last big initiative—the Medicare drug benefit—the new proposal will have the support of conservatives and deserves the support of liberals.

The President's proposal does not create a new kind of account or special program. Instead, the proposal eliminates an open-ended tax break for employers purchasing health care, and replaces it with a new tax deduction of exactly \$7,500 for a single person and \$15,000 for a family, regardless of the cost of insurance.

The new plan corrects a long-standing defect of tax policy. Today, employees who receive health insurance through their workplaces are not taxed on the employer's contribution (which is excluded from taxable income). They can also shelter their own premium payments from income and payroll taxes. For an average worker in the 15 percent income tax bracket paying 15.3 percent in payroll taxes (counting both the employee and employer contribution), that translates into a 30% tax reduction.

As a result, the more income workers receive as health care, the more income they get to keep free of taxes. An additional dollar in wages is worth only 70 cents after taxes to the worker—but an additional dollar in employer-provided health care is worth a full dollar. That differential has led to a shift in employee compensation away from taxable wages, toward non-taxable health benefits. Consequently, workers are not seeing their wages increase despite a booming economy. Most of the increase in labor productivity over the past few years has been eaten up by health benefits.

This generous tax break has encouraged employers to provide health insurance for their workers. But it has also led to bloated plans that have more benefits and higher costs than would be optimal. Company executives and human resources managers often buy coverage that will apply to a wide range of employees. As a result, many employees have (and use) coverage that they would not buy for themselves if they had full control over their own health spending.

Perversely, the value of the current tax exclusion is greater for workers with higher incomes, who also have the financial wherewithal to purchase more health coverage. A family with an annual income of \$200,000 is in the top income tax bracket, paying a marginal tax rate of 33 percent. That family could purchase a \$20,000 policy from their employer for \$10,400 after taxes, leaving them ample resources for food, housing, private schools, vacations, and other consumer goods. In contrast, a middle-income family earning \$40,000 would have difficulty buying a \$10,000 policy even with \$3,000 it currently receives in tax savings.

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By uniformly reducing taxable income for every person purchasing health insurance, the new proposal eliminates the current incentive to overspend on health care. Those who spend less on their health care will still enjoy the same amount of tax relief. Individuals would get the same tax benefit whether they purchase insurance through an employer or in the non-group market.

Limiting the tax subsidy for employer-sponsored insurance is an idea long promoted by policy wonks, and long ignored by everyone else. What has changed is the realization that a well-tuned policy to reduce the tax incentives for over-insurance does not have to mandate how individuals buy their health coverage.

The new plan is mildly redistributive, favoring those with lower incomes. Low-wage employees who do not have coverage, either because their firm does not offer it or because they can't find an affordable policy, could realize enough of a tax savings to make health insurance attractive. Additional help for the low-income uninsured would be offered through new state programs, including subsidies for private insurance.

The new proposal would not achieve universal coverage. Wisely, the White House is not claiming that it has the entire answer to a problem that we have been struggling with for many decades. Critics, content to let the perfect be the enemy of the good, want to reject it on the grounds that it does not go far enough. But Jason Furman and other leading Democratic experts have acknowledged that the new policy can begin to chip away at the inefficiency that plagues our health system.

No one wants to give up a generous subsidy, and no one wants to go to the hard work of redesigning a health plan, unless they have no other choice. The President's proposal gives workers and firms a new reason to ask whether their insurance is right for them, but it would not impose change from above. The proposal gives the uninsured a new reason to ask whether they could buy coverage with a more generous tax subsidy, but it does not require them to purchase if they decide not to.

The President has decided that he is not going to sit on the health policy sidelines for the next two years. The new proposal invites Democrats to sit down for serious negotiations on practical solutions to increase access to health coverage and slow the health care spending. Whether the idea advanced this week will be acted upon in any form is uncertain, but it should start the policy discussion. The President has extended an offer; let's see how the Democrats respond.

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