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Consensus on Health Reform

A consensus is emerging on the right way to reform our health care system. The consensus stems from the recognition that the tax system has shaped and molded our health care system and is responsible for many of its problems. Health reform, therefore, requires tax reform.

Through the tax system, the federal government encourages people to spend too much of their incomes on medical care, thus contributing to spiraling health care costs. The government also encourages people to use third parties to pay medical bills they could easily pay out of pocket — a practice that encourages wasteful consumption of medical care. And tax policy increases the number of people who are uninsured by penalizing people who purchase their own health insurance rather than getting it through their employer.

Let's take a closer look at how these problems arise.

Problem: Encouraging Waste. Under current law, every dollar of health insurance premiums paid by an employer escapes, say, a 28 percent income tax, a 15.3 percent Social Security (FICA) tax and a 4, 5 or 6 percent state and local income tax, depending on where the employee lives. This means the government is effectively paying half the premium — a generous subsidy that encourages employees to prefer health insurance to taxable wages even when the insurance is wasteful. For an employee in the 50 percent tax bracket, for example, $2 of nontaxed health insurance need be worth only slightly more than $1 to be preferable to $2 of taxable wages.

Problem: Encouraging Third-Party Payment. A primary reason why health care spending is out of control is that most of the time when we enter the medical marketplace as patients we are spending someone else's money rather than our own. Economic studies — and common sense — confirm that we are less likely to be prudent shoppers if someone else is paying the bill. The explosion in health care spending over the past three decades parallels the rapid expansion of third-party payment of medical bills. The patient's share of the bill has declined from 48 percent in 1960 to 21 percent today.

The primary reason for the shift from out-of-pocket payment to third-party payment of medical bills is federal tax policy. Although employer payments for health insurance are excluded from taxable income, taxes take up to half of any amount employers give employees to pay their own small medical bills.

Problem: Penalizing the Purchase of Insurance by the Uninsured. The federal government currently "spends" about $84 billion a year in tax subsidies for employer-provided health insurance, and state and local governments spend another $10 billion. These subsidies arise because, as noted above, employer-paid health insurance is excluded from employees' taxable income.

At the same time, the self-employed, the unemployed and employees of small companies that do not provide health insurance must pay taxes first and buy health insurance with what's left over. This can make their health insurance cost twice as much after tax as it would if provided by an employer. Small wonder that almost 90 percent of nonelderly people who have health insurance are insured through an employer — and that 81 percent of uninsured workers are self-employed, unemployed or working for small companies.

Solution: Limit Tax Subsidies. The tax system should be changed so that it encourages people to obtain a basic amount of health insurance without encouraging them to overinsure. Beyond some minimum expenditure, people should not be able to lower their taxes by spending money on health insurance or on medical care. One way of achieving this result is through fixed-sum tax credits, described below.

Problems Caused by the Tax System:

- **Wasteful spending on health care**
- **Too much third-party insurance, too little direct payment of medical bills**
- **Penalties for people who purchase their own health insurance**

Solutions:

- **Fixed-Sum Tax Credits**
- **Medical Savings Accounts**
- **Tax Fairness**

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Solution: Medical Savings Accounts. Under traditional health insurance, people make monthly premium payments to an insurer such as Blue Cross, and the insurer pays medical bills as they are incurred. With Medical Savings Accounts (MSAs), people can confine health insurance to catastrophic coverage (say, expenses above $3,000), reduce their monthly insurance premium payments and make deposits to a savings account instead. Insurance pays for expensive treatments that occur infrequently, while individuals use their MSA funds to pay small bills covering routine services.

Ideally, Medical Savings Accounts should receive the same tax treatment as health insurance premiums. That way, people can make unbiased choices between self-insurance and third-party insurance. Government can encourage insurance as such, while remaining neutral with respect to the type that is chosen.

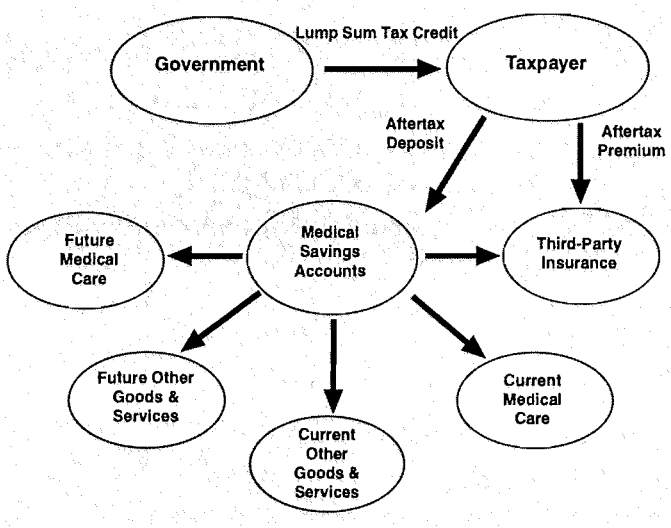
Solution: Tax Fairness. Equity in taxation requires that all Americans receive the same tax encouragement to purchase health insurance, regardless of employment. Accordingly, the self-employed, the unemployed and people who purchase health insurance on their own should be entitled to a tax deduction or tax credit that is just as generous as the tax treatment they would have received if their policies had been provided by an employer.

Fixed-Sum Tax Credits. One way to achieve tax fairness and at the same time remove the distorting effect of tax subsidies is to give every taxpayer a tax break that (a) is conditional upon the purchase of insurance but (b) does not increase if the taxpayer chooses more expensive coverage. Employers and their employees would make premium payments and MSA deposits with aftertax dollars, and employees would receive a tax credit for the purchase of insurance on their personal income tax returns.

Unlike a tax deduction (which benefits people more if they are in higher tax brackets), a tax credit can be structured to create more benefit for lower-income taxpayers. For those with very low incomes, the credit can be refundable — with government providing most of the funds for health insurance premiums through a system of vouchers.

FIGURE I

Ideal Taxation of Health Insurance and Medical Savings Accounts



Note: The taxpayer is given a tax credit for acquiring health insurance: an HMO, a conventional indemnity plan or catastrophic coverage combined with a Medical Savings Account. Since the credit is fixed, people cannot lower their taxes by obtaining more expensive coverage. MSA deposits grow tax free. But since MSA deposits are made with aftertax dollars, all withdrawals are tax free. This makes tax policy neutral with respect to all uses of MSA funds.

Backended MSAs. Under a frontended MSA, deposits are made with pretax dollars and the funds not spent on medical care are taxed upon withdrawal. Although these accounts are a substantial improvement over third-party payment of every medical bill, they still retain some of the current system's use-it-or-lose incentives that encourage overconsumption of medical care. Funds spent on medical care are tax free. But funds withdrawn to purchase other goods are subjected to taxes and (in some versions) penalties.

This problem is eliminated with a backended MSA, under which deposits are made with aftertax dollars and withdrawals are made tax free. As Figure I shows, this would allow people to make unbiased choices between medical care and all other uses of money, because they could withdraw the funds *at any time, for any reason, without penalty.*

Tax Reform. Tax credits and backended MSAs are consistent with a flat-tax proposal that eliminates the employee exemption for health insurance benefits. Under such a tax reform plan, employee benefits would be taxed, but the federal government could integrate the fixed-sum tax credit with personal exemptions, and all savings, including MSAs, would grow tax free.