Health Care and the Tax System

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Background

- Current health care system shaped by incentives embedded in tax code
- One proposal to reform the system developed by Cogan, Hubbard and Kessler (2005):
  - Full deduction of out-of-pocket medical expenses on federal income taxes *if insurance is purchased*
- Policy context for their proposal may provide useful background for consideration of House Bill 2729

Outline of presentation

- Overview of tax expenditures for health care
- Incentives created by tax expenditures
- Overview of policy debate about proposal to allow full deduction of medical expenses on *federal* income taxes

Health benefit tax expenditures: Definition

- Tax revenue forgone by federal and state governments for health benefit tax preferences/subsidies
- Health benefit tax expenditures include:
  - Exclusions and deductions from income taxes
  - Exemptions from payroll taxes

Health benefit tax expenditures: Income taxes

- Employer health benefit income tax exclusion
  - Employer contribution
  - Employee spending if through Section 125 cafeteria plans and Flexible Spending Accounts (FSAs)
- Retiree exclusion
- Self-employed deduction
- Out-of-pocket deduction
- Health savings accounts (HSAs)
- Health coverage tax credit
- Health reimbursement accounts (HRAs)

Health benefit tax expenditures: Payroll taxes

- Social Security OASDI tax exempt and Medicare HI tax exempt:
  - Employer share of premiums
  - Employee share of premiums if through Section 125 plan
  - Employee medical expenses paid for through Section 125 FSA or HRA
  - Employer contribution to an HSA

Health benefit tax expenditures: Cost estimates (2004)

Federal tax expenditures	Expenditure amount, billions
Social Security OASDI	52.2
Medicare HI	14.2
Income tax health benefit exclusion	101.0
Retiree exclusion	7.5
Self-employed deduction	4.6
Health reimbursement account	1.6
Out-of-pocket deduction	7.4

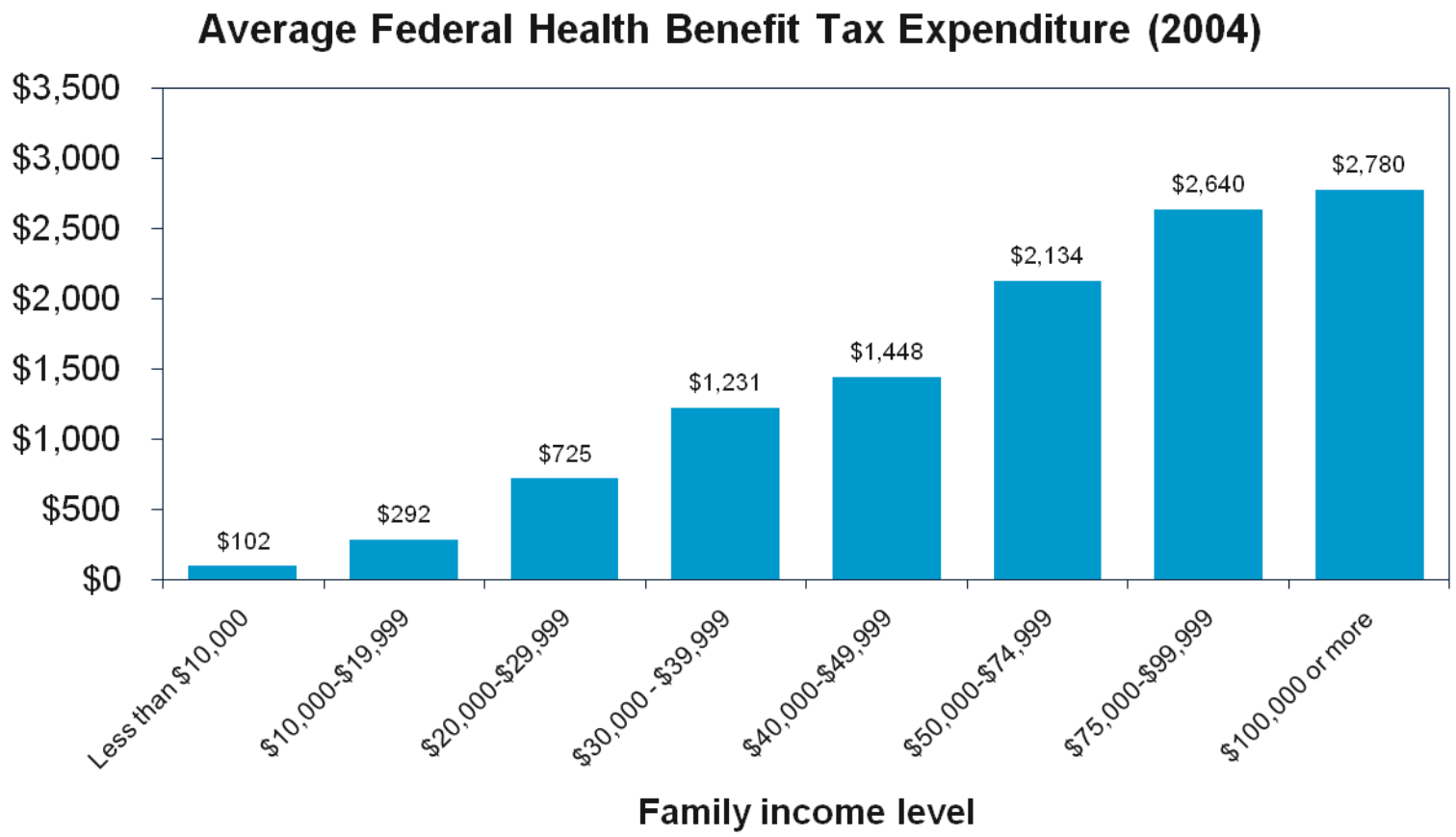
Source: Lewin Group estimates using the Health Benefits Simulator Model (HBSM), Sheils and Haught (2004)

Health benefit tax expenditures: Cost estimates (2004)

Tax expenditures	Expenditure amount, billions
Federal	188.5
State	21.4
Total State and Federal	**209.9**

Source: Lewin Group estimates using the Health Benefits Simulator Model (HBSM), Sheils and Haught (2004)

Health benefit tax expenditures: Per family (2004)



Source: Lewin Group estimates using the Health Benefits Simulator Model (HBSM), Sheils and Haught (2004)

Health benefit tax expenditures: Per employee (2006)

	Average tax subsidy per employee	Average tax subsidy per covered employee	Tax subsidy as percent of premiums
Kansas	$1,586	$2,920	37.5
Iowa	$1,580	$2,936	37.5
Minnesota	$1,770	$3,304	39.3
Missouri	$1,474	$2,625	36.3
Nebraska	$1,691	$3,113	37.4

Source: Selden and Gray (2006) estimates using data from the Medical Expenditure Panel Survey.

Incentives created by health benefit tax expenditures: Theory

- More health insurance provided by employers (lower wages, less purchase of individual insurance)
- More health spending through insurance (less out-of-pocket health spending)
- More health spending in general

Tax incentives: Evidence

- More health insurance provided by employers (lower wages, less purchase of individual insurance)
  - Gruber (2001) found that the level of tax subsidy is an important determinant of employer decisions to offer insurance.
  - Some empirical evidence that workers pay for health insurance through lower wages

Tax incentives: Evidence

- More health spending through insurance (less out-of-pocket health spending)
  - Some evidence that tax subsidies cause employees to choose more expensive plans
  - However, people may choose insurance over out-of-pocket spending despite price incentives

Tax incentives: Evidence

- More health spending in general
  - Incentives to purchase more generous insurance, increase use of services
    - Classic RAND study (see next slide)
  - Tax advantages for out-of-pocket health spending also could encourage health spending over other spending
    - Limited evidence

Classic RAND Study

- Randomized experiment that examined effects of cost-sharing and free care (1971-1982)
- Participants with free care used more health services
- Cost sharing reduced use of services – both highly effective and less effective services
- No overall effect on health for most participants
- Free care improved health for sickest and poorest participants
- No impact of cost sharing on risky behaviors

Cogan, Hubbard and Kessler's proposal

- Full deduction of out-of-pocket medical expenses on federal income taxes *if insurance is purchased*
- Policy goals:
  - "Level the playing field"
  - Induce people to shift to insurance plans with greater cost-sharing: Higher deductibles and coinsurance
  - Reduce health care spending and contain costs

Would their proposal “level the playing field”?

- Relative tax advantage of employer-sponsored insurance reduced
  - Taxpayers who pay for individual insurance would not pay income taxes on income used to pay for insurance (would still pay payroll taxes)
- Relative tax advantage of insurance over out-of-pocket spending reduced

Would their proposal “level the playing field”? (continued)

- Cogan, Hubbard, Kessler argue that proposal increases progressivity of tax system
- Others argue that the subsidy would be regressive
  - Park and Furman (2006) estimate net result that government would pay:
    - 35 percent of medical costs for households in top tax bracket
    - 15 percent of medical costs for households in 15 percent bracket
    - No share of medical costs for households that do not pay taxes (half of the uninsured)

Would their proposal achieve shift in insurance coverage?

- Would people respond to changed tax incentives by purchasing insurance with higher cost-sharing?
- Would more or fewer people be uninsured?

Would their proposal reduce overall health spending?

- Two opposing effects (in theory)
  - Lowers relative price of health spending, increasing spending
  - Induces shift to less generous insurance, lowering health spending
- Cogan, Hubbard, Kessler predict private health spending reduced by 6.2 percent
- Furman estimates impact on health spending to be a range: 1.2 percent reduction to 1.5 percent increase

Other potential impacts

- Employer-sponsored insurance could decline
- Increased cost-sharing unlikely to affect growth rate in health care costs
- Health outcomes
  - Would use of preventive services decline if higher cost-sharing is achieved?

Cost of their proposal

- Reduction in tax revenue
  - Cogan, Hubbard, and Kessler estimate proposal would cost $28 billion a year (if assume their projected savings, would lower net cost to $6 billion)
  - Gruber estimates over $10 billion a year in lost revenue
  - Reinhardt estimates that cost in 2007 could be $50 billion to $72 billion.

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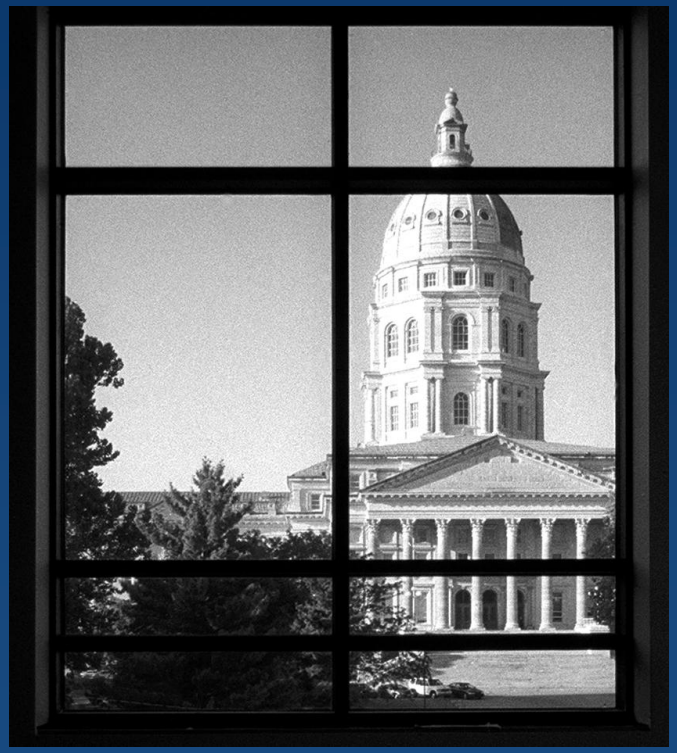

Information for policy makers. Health for Kansans.