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Health Care Tax Credits: The Right Prescription for Expanded Health Care Coverage

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The State Children's Health Insurance Program (SCHIP) is up for extension, and Congress threatens to more than double the program, to be financed in part by higher taxes. This would raise taxes even further above the modern historical average, add even more spending to the federal government's already unaffordable health care obligations, and take another risky step toward a government-run health care system.

A better strategy to broaden health care coverage for kids is to rationalize the federal tax treatment of health insurance in two integrated steps:

1. First, cap the amount of health insurance-related tax relief at some generous, but fixed, amount. This would reduce the incentive that currently exists to overinsure, either by overextending health care coverage or by purchasing health insurance policies with minimal deductibles and co-pays.
2. Second, extend income and payroll tax relief to all individuals and families who purchase health insurance irrespective of whether they purchase it on their own or through their employers. Accomplished through a tax deduction or, preferably, a refundable tax credit or related mechanism, this policy would rapidly expand access to private health care coverage and encourage the emergence of a robust and consumer-friendly system of private health insurance.

Though the refundable credit and similar proposals have their shortcomings, they can achieve the same objectives as an SCHIP expansion without

the drawbacks of increased spending and taxes and the movement toward a government-run health care system.

A Step Toward Government Control. SCHIP was created to provide health insurance to children of families whose earnings were too high to qualify for Medicaid but below 200 percent of the federal poverty level. Like Medicaid, it is jointly funded by the federal and state governments. Since its creation a decade ago, SCHIP has been a battleground between those favoring private health insurance and those favoring an expansion of government control over the health care system.

Having failed to achieve the big victory for government-run health care with the collapse of the Clinton health care plan in 1994, President Clinton and his congressional allies focused on images of poor children without health insurance to regain the initiative and to achieve—incrementally and through different means—the same end of increased government control over health care financing and delivery.

Many states have expanded SCHIP to cover children in families with increasingly higher incomes and, in some cases, to cover the parents of the chil-

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dren. With SCHIP up for reauthorization, Congress is threatening to more than double the size of the program. Under the Senate Finance Committee's bill, sponsored by Senators Max Baucus (D-MO) and Chuck Grassley (R-IA), children in families with incomes of approximately \$62,000 (family of four) would qualify for SCHIP coverage; apparently, children in some families with incomes up to \$82,600 would also qualify. Promoting a new health care entitlement for the upper-middle class would be a major step toward government-run health insurance for everyone.

Tax Policy: A Better Alternative Than SCHIP Expansion. A better alternative for expanding health care coverage is extending favorable tax treatment for private health coverage. There are numerous options available to policymakers, each with strengths and weaknesses, all of which center on some kind of health insurance tax deduction or credit.

Tax deductions are common under an income tax because some expenses are deducted from gross income to determine taxable income. The calculated amount of taxable income is then multiplied by a tax rate to determine the amount of tax owed. Exclusions and exemptions, like deductions, likewise reduce taxable income, but they typically do not reflect the principle of recognizing expenses incurred to generate income. Under current law, for example, businesses may deduct the costs of the insurance they provide their employees as a normal business expense, while as a matter of health policy their employees are allowed to exclude the costs of their health insurance policy from their own taxable income.

In contrast to deductions, tax credits reduce the amount of tax owed rather than the amount of taxable income. Tax credits can be a flat rate, as with the child tax credit, or they can vary with income. One perceived advantage of flat tax credits is that (for most eligible taxpayers) a flat tax credit provides a fixed amount of tax relief, while the amount of tax relief from a deduction increases with the taxpayer's income due to the progressivity of the federal income tax system.

A problem arises when using the tax code for non-tax policy purposes in that many U.S. residents receive little or none of the tax benefit

because they pay little or no income tax. The tax code remains a viable policy tool, however, either by making tax credits refundable—which means the tax filer can receive the full value of the credit even if he or she owes no income tax—or by combining a tax credit for taxpayers with a voucher for low-income residents.

In the case of a refundable credit, for example, suppose that a taxpayer owes \$400 in income tax and qualifies for a \$1,000 tax credit. If the credit is non-refundable, then the taxpayer can use \$400 of the \$1,000 credit to eliminate his tax liability but is unable to use the remaining \$600 of the credit. If the credit is refundable, however, the taxpayer can eliminate his tax liability and also receive a check from the Treasury for the remainder of the credit—\$600 in this example.

Despite their advantages, refundable credits also have some major shortcomings. First, there is great danger to our democracy when any but the poorest residents pay no income tax whatsoever. The income tax is the primary means by which U.S. residents contribute to the financing of the federal government, sharing the burden of the cost for all that government does. The tax collected from lower-income residents should be commensurately modest, but they should be asked to contribute at least some minimal amount to the operations of the government for the services they receive. These concerns are magnified when significant numbers of residents not only pay no income tax, but are net beneficiaries of the tax system.

A second major shortcoming arises when refundable tax credits transform the income tax from a means of collecting revenue into an administrative mechanism for distributing government subsidies to targeted individuals. Refundable tax credits complicate an already overly complicated tax code and are often subject to serious abuse and fraud, such as with the Earned-Income Tax Credit today. Any reforms to the tax treatment of private health insurance should ensure that the policy is administrable by the tax service and easily understood by the taxpayer, and this is especially so for refundable tax credits.

Third, refundable tax credits give rise to “tax spending,” obscuring the true level of total federal

spending. The bulk of federal spending is shown explicitly in the federal budget, but a significant portion occurs out of sight through the income tax-based welfare system. Tax spending, therefore, hides the true size of government in terms of the programs administered, the resources claimed, the lives touched, and the markets distorted. One option policymakers could consider to address this issue is to marry the non-refundable portion of the tax credit with alternatives that would appear in the budget, such as some form of voucher for non-tax-paying residents that is funded by redirecting funds from existing spending programs.

To be clear, a capped health care deduction does not represent good tax policy, and neither do a tax exclusion nor a refundable credit; each would be yet another instance of using the tax system for non-tax policy purposes. But this has to be weighed against the other goals involved. The income tax is used today to address a long list of non-tax-related policies because the tax code allows these policies to be pursued without creating new, expensive, cumbersome government bureaucracies. Fortunately—and sometimes unfortunately—the income tax system is a relatively cost-effective mechanism for collecting revenues as well as for encouraging certain behaviors, discouraging others, and sometimes for distributing cash support payments. Relative to current law, reforming the tax treatment of health insurance as described here would arguably be a modest step toward better tax policy—and a major step toward better health care policy.

Refundable Credits for Health Insurance Expansion. As a general rule, refundable tax credits should only be adopted to achieve extraordinary policy goals. Given the problems in our health care delivery and financing systems, and given the threat of government-run health insurance, the expansion of private health insurance coverage for individuals and families qualifies as an extraordinary policy goal.

America's health care system suffers from a long list of ailments, real and perceived, many of which can be directly traced to government intervention in the health insurance and health care services mar-

kets. One problem is that health care prices continue to grow significantly faster than other prices in the economy. In recent years, health care prices have generally risen twice as fast as other consumer prices.

Many argue that a second problem is the approximately 45 million Americans who lack primary health insurance coverage for at least some part of each year.¹ Many of the uninsured do not receive coverage from their employers and lack the income to purchase health insurance on their own. Many are uninsured for only part of the year, and some simply choose not to buy insurance even though they could afford it.

A third problem is that the federal government may someday attempt to address the first two problems by taking over the whole health care financing system. The proposed SCHIP expansion into the middle class is a big step in this direction.

The best tax policy solution would be to eliminate all deductions, exclusions, and credits associated with purchasing health insurance in return for lower income tax rates. In many respects, this would also be the best health policy because patients would gain greater control over—and sensitivity to—their health care decisions without tax policy distorting those decisions. This ideal solution, however, is simply not on the political horizon and, so, provides no practical alternative either to SCHIP as it operates today or to proposals for SCHIP expansion.

Theoretically, a second best solution—still far preferable to a creeping expansion of government control over health care—would be to allow every taxpayer a tax benefit for the purchase of health insurance. This benefit would be available against income tax, and possibly against payroll tax as well—similar to the current exclusion for employer-sponsored health insurance. The tax benefit would be available to any individual or family purchasing at least a basic health insurance policy. The amount of the benefit should be fixed each year, it should not depend on the income of the policyholder, and it should not depend on the amount of the insur-

1. Census Bureau, "Census Bureau Revises 2004 and 2005 Health Insurance Coverage Estimates," Press Release, March 23, 2007, at www.census.gov/Press-Release/www/releases/archives/health_care_insurance/009789.html.

ance policy's premiums to avoid creating an adverse incentive to purchase more expensive insurance.

Such a tax benefit is, in effect, the substance of the President's health care proposal. Any family purchasing a basic health care policy would qualify for a \$15,000 standard deduction for health insurance against their income and payroll tax liabilities. According to the Congressional Budget Office, this policy would reduce the number of uninsured in America by about 6.8 million.² The Lewin Group, a prominent consultancy, estimated that the President's plan would reduce the number of uninsured by 9.2 million.³

A shortcoming of proposals like the President's is that many of the uninsured are poor and pay little or no income tax or payroll tax, and consequently would receive little or no benefit from a health insurance tax deduction. They would, however, receive the full benefit, the full incentive, and the full financial support to purchase health insurance if they were eligible for a refundable tax credit. According to one analysis, a refundable tax credit would generate "substantially more [health insurance] coverage because low-income families would have a greater incentive to get coverage while higher-income families would likely still retain their coverage."⁴

One major advantage of the tax-based approach to expanding health care coverage is that it can be achieved through reforms to existing tax and spending programs, rather than by expanding the size of government through more spending and more taxation. Some observers might question whether replacing the current exclusion for employer-sponsored health care with a refundable tax credit is also a tax increase and a spending increase. The source of the concern is the refundable portion of the credit, which many regard as a spending increase.

A possible means of addressing this concern would be, in part, to cap and eventually eliminate the employer-sponsored health exclusion in favor of a non-refundable tax credit to individuals and families who pay income tax, and to set the credit rate so there is no net change in overall tax receipts. By construction, this policy is revenue-neutral.

For individuals and families who pay no income tax, the second part of the solution would be to create a mechanism such as a voucher. Such a policy would appear explicitly in the budget as a spending item, and the cost should be offset with reductions in SCHIP spending or other federal health spending. Furthermore, since the combined tax credit/voucher system would significantly reduce the number of uninsured according to the estimates noted above, federal health care spending pressures should abate naturally. By construction, such a policy would then be budget-neutral on both the tax and spending sides of the ledger.

Conclusion. In general, the tax code should be used to raise revenue, not as a convenient mechanism for diverting private resources and channeling private behavior. The federal government should also avoid expanding the ranks of those who pay no income tax or who are net beneficiaries of the income tax system. The activities of the federal government are not free, and U.S. residents should not be led to believe otherwise by receiving those services at no perceptible cost.

However, Congress is at a pivotal moment in the health care debate and must decide whether it will expand private health insurance options or grow government. If Congress chooses to expand private options for individuals and families, then it must, of necessity, address tax policy.

Although in general the tax code should be used only to raise revenue, health care is already an

2. Congressional Budget Office, "An Analysis of the President's Budgetary Proposals for Fiscal Year 2008," Pub. No. 2909, March 2007.
3. See John Sheils and Randy Haught, "President Bush's Health Care Tax Deduction Proposal: Coverage, Costs and Distributional Impacts," The Lewin Group, at www.lewin.com/NR/rdonlyres/B45E2670-8A65-4817-B68B-83B818616DDF/0/BushHealthCarePlanAnalysisRev.pdf.
4. Leonard E. Burman, Jason Furman, Greg Leiserson, Robertson Williams, "The President's Proposed Standard Deduction for Health Insurance: An Evaluation," Tax Policy Center, February 15, 2007, at www.taxpolicycenter.org/publications/template.cfm?PubID=10028.

exception to the rule, and that exception is unlikely to be erased any time soon. Consequently, Congress should look to sensible, revenue-neutral or tax-reducing policies to expand private health insurance options.

A capped, universally available refundable health insurance tax credit or credit/voucher combination policy offers advantages that, on balance, make them superior to a standard deduction for health insurance and far superior to current law. Chief among those advantages is its large impact among lower-income residents who today lack health insurance. Rapidly building up the ranks of the pri-

vately insured and the depth of the individual health insurance market would act as a vital bulwark against the ever-present danger of government-run health insurance. Despite their shortcomings, a refundable tax credit or credit/voucher policy offer the best means of advancing private health insurance and fending off government-run health care.

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