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The Tax Code and Health Insurance Coverage

On October 18, 2007, the House Budget Committee held a hearing titled "The Tax Code and Health Insurance Coverage." The purpose of the hearing was to explore the potential and limitations of using tax policy as a tool to expand health insurance coverage. Below are some highlights from the hearing.

Employers Are an Important Source of Health Insurance Coverage and Risk-Pooling — The tax code excludes employer-provided contributions toward a worker's health insurance from that worker's compensation for income and payroll tax purposes. This exclusion makes employer-provided health coverage a relatively attractive form of compensation for workers. As a result, nearly 70 percent of American workers receive health coverage through their employers. Covering all workers at a firm is an effective way to pool health risks (especially for large firms), which keeps insurance accessible to people with health problems. Providing coverage through employers or other group arrangements also presents advantages in terms of lower administrative costs and better bargaining power when dealing with insurers and health service providers.

Witnesses Testified that Relying on Employers As the Primary Source of Coverage Also Presents Some Drawbacks — Workers can lose coverage if their employers decide to drop it, or if they lose or change their jobs. Relying on employers to provide health coverage can distort workers' decisions and lead to "job lock" – the phenomenon of workers staying with a firm because they need the health insurance, said Leonard Burman, director of the Urban-Brookings Tax Policy Center. Another problem is that small firms can experience a jump in costs if one person gets sick.

The Tax Subsidy for Employer-Sponsored Coverage Could Be Improved for Low-Income Workers — Both Dr. Burman and Grace-Marie Turner, president of the Galen Institute, testified that the current tax exclusion provides little help to lower-income workers. These workers face low marginal tax rates, so the tax exclusion provides only a small subsidy to these workers. Dr. Burman recommended replacing the current exclusion with a refundable tax credit, which would better target the tax subsidy to lower-income workers who most need assistance with purchasing health coverage. He also noted that expanding existing public insurance programs, such as SCHIP, may be more cost-effective than a tax credit because such programs are more effective in targeting the uninsured.

The Nongroup Health Insurance Market As Currently Configured Is No Substitute for Employer-provided Coverage — Many workers who are covered by employer health plans would not be able to find affordable health coverage on the individual market as it currently exists, witnesses testified. The fundamental problem with the nongroup market is adverse selection – that is, people who expect high medical costs are the ones most likely to want insurance. Insurers profit most by attracting a healthy clientele and by avoiding enrolling sick people. Even if people start out with insurance while healthy, subsequent medical expenses can quickly drive their premiums to unaffordable levels. "The nongroup health insurance market, ironically, only works for healthy people," Dr. Burman said.

Witnesses Testified That Changes to the Tax Treatment of Health Insurance Must Be Paired with Insurance Market Reforms — A new tax subsidy for individuals would reduce employers' incentive to provide health coverage, because workers would theoretically have the option to purchase a health insurance policy on their own. But without reforms to the nongroup market and substantial subsidies for low-income households, many who are currently insured through their employers – especially those with low incomes and serious health problems – would likely lose coverage altogether, Dr. Burman said. One nongroup market reform idea he described would require that to sell health insurance that qualifies for an individual tax credit, insurers must join a pool that will take all applicants, similar to the Federal Employees Health Benefits Program. Another reform would give healthy individuals an incentive to buy insurance by providing that individuals who maintain continuous coverage could purchase insurance from any participating insurer at the lowest rates available, even if their health status worsens. "If you're going to offer tax credits, tax credits ought to pay for ... something the market's not doing now, and not just provide a subsidy to people who are buying insurance in the dysfunctional market" Dr. Burman said.

The complete testimony of all witnesses is posted on the Budget Committee's website at <http://budget.house.gov/hearings.htm>.