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The President's Health Care Proposal: All Risk, No Reward

In his State of the Union Address, President Bush announced a new health care proposal that he claims will "help more Americans afford their own insurance." In fact, however, the President's proposal is more likely to weaken the nation's health care system than it is to make things better. It will not help the vast majority of the 47 million uninsured and will not address the inefficiencies in health care that contribute to skyrocketing costs. What it will do is undermine our country's most reliable source of health care coverage—the employer-sponsored system—and put more and more people into the individual market where the risks are much greater.

The President's Proposal

In this year's State of the Union address, President Bush proposed changes in the tax treatment of health insurance costs and families' out-of-pocket medical expenses. In essence, his plan would replace the current tax exclusions and deductions for those costs with a standard deduction (set at $15,000 for family coverage or $7,500 for single coverage) for anyone who obtains qualifying health insurance. The deduction would be the same, regardless of actual expenditures and would apply to both employer-provided insurance and insurance purchased in the individual market. Employer contributions to health care insurance would count as part of taxable earnings, but workers could deduct the new standard deduction for purposes of both the income tax and the payroll tax.

In the President's plan, a family whose current health insurance costs less than $15,000 (including the employer contribution) would see their after-tax income increase, because their new standard deduction for health insurance would be larger than the actual cost of the insurance. In contrast, a family with current coverage worth more than $15,000 would have the difference added to their taxable income and would pay higher taxes. The President's plan aims at leveling the playing field between individuals and families insured by employers and those who purchase health care insurance for themselves.

Many Middle-Class Americans Will Face a Tax Increase

Limiting the deduction to $15,000 ($7,500 for individuals) keeps the proposal revenue-neutral over 10 years, according to preliminary Treasury Department estimates. In essence, the existence of a fixed deduction imposes a tax increase on households that obtain generous coverage, which offsets the revenue loss from households whose coverage costs less than the deduction. For example, if a family's plan costs $17,000 and they are in the 25 percent tax bracket, they would pay $653 in additional taxes out-of-pocket for their health care coverage [$2,000 x (25 percent income tax + 7.65 percent for payroll taxes for Social Security and Medicare)].[1] A family in the same bracket with $13,000 in coverage would receive a similarly sized tax cut.

Initially, the White House estimates that only 20 percent of those who are covered through their employers will see a tax increase. But that number is expected to increase over time because the new deduction is indexed only to inflation, and not to health care costs—which have *risen at five times the rate of inflation since 2000*.[2] This design will cause more and more plan costs to exceed the deduction within a few years of its implementation, which is anticipated in January 2009. According to the Tax Policy Center, 40 percent of plans will exceed the standard deduction ten years after the proposal is in effect.[3] If fewer plans than expected exceed the standard deduction in future years, either because insurers restructure existing plans or because workers opt for lower-cost coverage, expected revenues will be lower and the proposal will not be revenue-neutral.

The fixed-deduction structure of the president's proposal is more problematic for American families living in high-cost states in the Northeast. In those states, plan costs are more likely to exceed the deduction from the time the program is implemented, which means that those families would be taxed on their excess plan costs.

In addition, families would no longer be able to pay for out-of-pocket medical expenses from tax-free flexible spending accounts (FSAs) or to claim the existing itemized deduction for medical expenses (unless they are covered by Medicare). The loss of those benefits would increase taxes for some middle-income families. An estimated 21 percent of employers with 10 or more employees offer health care FSAs, and an estimated 34 percent of eligible employees participate.[4]

Most Uninsured Americans Will Not Be Helped

The most glaring problem with the President's proposal is that many of America's 47 million uninsured will *still be unable to afford basic health coverage*. Tax deductions like the one that President Bush has proposed are most valuable to people in high tax brackets. Those who already purchase insurance in the individual market, for example, would save an estimated $3,650 in taxes according to the White House estimates. But lower-income households, many of whom lack health insurance, would not be able to take advantage of a tax deduction. In fact, 43 percent of uninsured Americans have no income tax liability, according to the Kaiser Family Foundation.[5] And even though some of these workers would get a partial payroll tax exemption if they purchase health insurance, many uninsured would not be able to afford the up-front cost of insurance premiums and wait to get a refund after they file their tax returns.

The President could have made his proposal more effective by structuring the proposal as a refundable tax credit rather than a deduction so that lower-income households could benefit. Recently, a broad coalition of U.S. physician, hospital, business, insurance, pharmaceutical, and consumer organizations—including the American Medical Association, the AARP, Families USA, and the U.S. Chamber of Commerce—made a tax credit the central component of their plan to expand health insurance.[6]

The Administration's failure to base its proposal on a credit rather than a deduction is no surprise. President Bush's past health care proposals typically have targeted households that are likely to have ample health care coverage already, rather than the uninsured. Once again in his State of the Union speech, the President pushed for the creation of associated health plans (AHPs), which would allow small businesses to circumvent regulation to provide new health care offerings to their employees. The non-partisan Congressional Budget Office has estimated that past AHP proposals would have ultimately raised premiums for three-quarters of small business employers and their employees, while having a negligible impact on expanding coverage for the uninsured.[7] Health Savings Accounts (HSAs), which were enacted in 2003, are another key element of the President's health policy that primarily benefit high-income households. In fact, only 6 percent of the private American workforce has access to HSAs[8] and only 3 million Americans have accounts.[9] Most who benefit are in high income-tax brackets.

Perhaps in an effort to mitigate the failure of the tax proposal to meaningfully increase coverage among the uninsured, President Bush is also proposing a program called "Affordable Choices Initiative." But to pay for that effort, the President's 2007 budget reportedly will remove billions of dollars in federal payments to hospitals (most of them public) that are designated to care for uninsured patients, without guaranteeing that states will actually cover all of the uninsured. While not all states may choose to participate in the initiative, all hospitals would be subject to the funding cuts.

Traditional Employer-Sponsored Insurance Will Be Weakened

The Administration's proposal would weaken traditional employer-sponsored health insurance. Employers are the principal source of health insurance in the United States, providing health benefits to nearly 175 million Americans. Without the tax incentive for group coverage, some workers may opt out of employer plans and choose to purchase coverage in the nongroup individual market. Other workers may be forced into the high-cost individual market if small- and medium-sized companies decide to drop coverage entirely, exacerbating an existing trend.[10]

Those who must turn to the individual market for health insurance policies will find higher premium costs and difficulty getting coverage. For some young and healthy individuals who can find inexpensive coverage fairly easily, a tax deduction for individual insurance could make coverage more affordable. But premiums for nongroup coverage can be significantly more expensive for working families, and older and unhealthy people. Moreover, insurers in most states have the right to refuse coverage based on someone's past or present health problems, and they can also charge higher premiums and attach high deductibles. A recent study found that roughly 90 percent of applicants in less than perfect health were unable to buy individual coverage at standard rates, while 37 percent were rejected outright.[11]

As healthier individuals leave traditional plans, those remaining in the plans will be those who are more expensive to insure. Insurers will have to raise premiums to cover their expenses, a process known as "adverse selection." In the extreme, such a vicious cycle could result in a market in which the cost of employer-sponsored coverage approaches the higher costs in the individual market.

Because taxpayers can claim the same tax deduction regardless of what they pay in insurance premiums, there is an incentive for individuals to choose lower-cost plans with high deductibles and less comprehensive coverage. While this may generate apparent cost savings in the short run, over the longer term, health care costs could be higher if workers with minimal coverage forgo necessary preventive care or early intervention and treatment of medical problems.

Conclusion

To be successful in tackling our nation's health care crisis, reforms at the federal level must be designed to meaningfully decrease the ranks of uninsured Americans and reduce overall health care costs. Rather than promoting growth of the individual insurance market at the expense of employer-sponsored plans, the administration's first priorities should be structuring reform efforts to help the uninsured acquire health insurance and reducing overall health care spending. Until we have policy solutions that will accomplish these goals, the administration should refrain from introducing more risk into an already too risky system.

Endnotes

[1] If you include the portion of payroll taxes paid by employers (7.65%), which economists argue reduce employees' wages, then the total tax increase for families purchasing a $17,000 plan would be $806 in this example.
[2] Kaiser Family Foundation, *Employer Health Benefits: 2006 Summary of Findings*, available at http://www.kff.org/insurance/7527/upload/7528.pdf.
[3] Leonard Burman, Jason Furman, Roberton Williams, "The President's Health Insurance Proposal - A First Look," Tax Policy Center brief, January 23, 2007, available at http://www.taxpolicycenter.org/publications/template.cfm?PubID=9991.
[4] Employee Benefit Research Institute, *FACTS from EBRI*, available at http://www.ebri.org/pdf/publications/facts/1003fact.pdf.
[5] Jeanne Sahadi, "What Bush's Health Care Plan Means to You," *CNN Money*, January 23, 2007.
[6] For more information, see Families USA, "Health Coverage Coalition for the Uninsured (HCCU)," available at http://www.familiesusa.org/issues/uninsured/hccu/about-hccu.html.
[7] Michelle Andrews, "AHPs: Bad for Your Health," *Fortune Small Business*, October 1, 2003.
[8] U.S. Department of Labor, Bureau of Labor Statistics, "Health Savings Accounts in National Compensation Survey Data," November 26, 2006.
[9] Amy Goldstein, "Uncertain Cure: Early Reaction to Health Savings Accounts is Two-Sided," *Washington Post*, March 12, 2006.
[10] Since 2000, the percentage of workers covered by employer-sponsored health benefits in firms with fewer than 200 workers has decreased from 57 percent to 50 percent. (Kaiser Family Foundation, *Employer Health Benefits*, *2005 Annual Survey*).
[11] Kaiser Family Foundation, *How Accessible is Individual Health Insurance for Consumers in Less-Than Perfect Health?*, June 2001, available at http://www.kff.org/insurance/upload/How-Accessible-is-Individual-Health-Insurance-for-Consumers-in-Less-Than-Perfect-Health-Executive-Summary-June-2001.pdf.