

HEALTH CARE 2009

A Win-Win Approach to Financing Health Care Reform

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No hurdle facing health care reform in the United States today is more daunting than the problem of financing universal coverage. There is an inescapable logic of reform that lies behind the search for financing sources. First, moving to universal coverage is now widely acknowledged to require a mandate that individuals carry insurance coverage. Second, such a requirement is unacceptable without subsidies to make health insurance affordable for lower-income people. Third, these subsidies will require new financing on the order of \$1 trillion or more over the next decade. How can the government finance such a sizeable new expenditure?

There are a number of possible sources. One is reductions in existing government spending on health care through cost controls. President Barack Obama proposed more than \$300 billion of such cost controls in his budget, but it is not clear that either politicians or providers have the appetite to go further. Another is increased taxation of “sin goods” — cigarettes, alcohol, and high-sugar or high-fat foods that cause obesity — whose use raises the cost of health care for all Americans. These taxes make sense, yet it is difficult to raise sufficient revenues from them. The government can also look outside the health care system to increased revenues from taxes on carbon emissions or on other goods and services. But this approach would involve expanding the fight over health care into other realms, compounding the difficulty of passing any legislation.

There is one final potential source: the elimination or limiting of the income-tax exclusion for expenditures on employer-sponsored insurance. Ending the massive tax subsidy for such insurance would result in both the most natural source of financing for health care reform and one of the few that is clearly large enough to finance the necessary subsidies.

The \$250 billion per year in foregone revenues attributable to the tax exclusion of employers' health insurance expenditures represents the federal government's second-largest health insurance expenditure (after Medicare). When my employer pays me in cash wages, I am taxed on those wages. But the roughly \$10,000 per year that my employer spends on my health insurance is not taxed, and it translates into a tax break for me of about \$4,000. To be clear, this exclusion represents a tax break for individuals, not for firms; firms are largely indifferent about whether they pay employees in wages or in health insurance. But employees are not indifferent: they pay taxes on the former but not on the latter.

This tax exclusion has three flaws. First, the forgone tax revenue is an enormous sum of money that could be more effectively deployed elsewhere, especially through new approaches to increasing insurance coverage. Just taxing health benefits through the income tax as we do wages would raise \$2.3 trillion in federal revenues over the next decade. Second, the exclusion is a regressive entitlement, since higher-income

families with higher tax rates get a bigger tax break; about three quarters of these dollars go to Americans in the top half of the income distribution. Third, this tax subsidy makes health insurance, which is bought with tax-sheltered dollars, artificially cheap relative to goods bought with taxed dollars — a phenomenon that leads to overinsurance for most Americans and overspending on medical care.

Given these limitations, no health care expert today would ever set up a health care system with such an enormous tax subsidy for a particular form of insurance coverage. So why don't we just remove it? There are four counterarguments to using limits on the exclusion to create a financing source, but each can be effectively addressed.

First, some argue that it would be administratively infeasible to reduce this tax subsidy. But the process of including spending on employer-sponsored insurance in individual income taxation is actually quite straightforward. Employers would simply report the amount they paid for each employee's insurance coverage on the employee's W-2 form. If the employer is self-insured, it would simply use the premium amount it is already required to calculate in providing continuation coverage (or Consolidated Omnibus Budget Reconciliation Act [COBRA] coverage) to displaced workers.

The second argument is that since the current predominance of employer-sponsored insurance is predicated on this tax exclusion, policymakers must be wary

about removing it: many employers offer health insurance only because of this “tax bribe,” and sicker and older persons are treated much more fairly in employer groups than they will be in today’s nongroup insurance market. As the provision of employer-sponsored insurance declines, we could end up with a large new uninsured population that either cannot afford nongroup insurance or cannot obtain it at any price. This possibility would certainly be cause for concern if we were reducing the tax exclusion in a vacuum — but not when the policy would be financing a universal coverage plan in which all individuals would get group rates and would be subsidized as necessary. Thus, any displacement from employer-sponsored insurance will lead not to uninsurance but merely to a shift to a new insurance exchange.

The third concern is that removing the exclusion would mean an across-the-board tax increase. I prefer to view this as a progressive tax increase, with 62% of the revenues raised from families with annual incomes of more than \$100,000. Yet there would still be a sizeable increase in taxation for middle-income families, with 10% of revenues coming from families with annual incomes below \$50,000 and 28% from those with annual incomes of \$50,000 to \$100,000. For this reason, and because not all the revenues to be gained by removing the exclusion would be needed to finance reform, we should reduce, rather than remove, the exclusion.

The exclusion can be reduced,

for example, by capping the amount of employer-sponsored premiums that is excluded from taxation, so that individuals are not taxed on premiums below some level (say, the average value of premiums for employer-sponsored insurance) and pay tax only on premiums in excess of that level. This approach has the advantage of addressing the bias toward excessively generous insurance without raising the taxes of people who have basic insurance. Moreover, it would be more progressive than an across-the-board removal of the exclusion, since higher-income people tend to have more expensive insurance than lower-income people. Alternatively, we could scale back the exclusion only for those in higher income groups; such a strategy could be designed to protect middle-income taxpayers from any tax increase.

Either way, the dollars involved are substantial. For example, suppose the government capped the exclusion at the level of the typical employer-sponsored insurance premium (currently \$4,700 for an individual and \$12,800 for a family), starting in 2012, and indexed that cap at the rate of growth of the consumer price index (so that the cap rose, but more slowly than the premiums). Such a policy would raise \$500 billion by 2019. Considerable revenues would be raised even with a higher cap. A cap set at the 75th percentile of the premium distribution, so that only insurance plans in the top quarter of the price range were subject to taxation, would raise \$330 billion between 2012 and 2019. Or, more

progressively, capping the tax exclusion at the level of the typical premium but only for families with annual incomes above \$125,000 would raise \$340 billion between 2012 and 2019.

A final criticism of reducing the tax exclusion is that it would be unfair to high-cost groups — for example, people living in states where insurance is particularly expensive or those working for employers with an older workforce. But this problem can be readily addressed by adjusting the cap to account for differences among firms in underlying cost factors. Employers, for example, could easily compute an adjustment factor, based on their firm’s location or their workers’ ages, that could be used to set the cap.

Despite the resistance to changing the status quo, I believe that the most sensible source of financing for universal coverage would come from reducing the expensive, regressive, and inefficient subsidization of employer-sponsored insurance. Scaling back the exclusion would be highly progressive and would have the added benefit of reducing the incentives for overinsurance and excessive health care spending. This win-win solution would ameliorate a fundamental flaw in our current system while raising the revenues required to cover the uninsured.

No potential conflict of interest relevant to this article was reported.

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This article (10.1056/NEJMp0904855) was published on June 10, 2009, at NEJM.org.

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