

## **TAX TREATMENT OF HEALTH EXPENSES**

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Creating an economic and revenue analysis of any legislative proposals typically compares the present economic state to a proposed state. This simple approach provides only the changes holding everything else constant. To capture the full range of responses to any proposed change, it is necessary to understand the current state, proposed state, and desired objectives for moving from one to the other.

We apply this approach to the tax credits for health insurance proposal. The following sections detail the (1) present law tax treatment of health expenses, (2) reasons for change, (3) proposed treatment of health expenses, (4) the design and policy issues raised by those changes and (5) alternative proposals.

### **I. Description of Present Law Tax Treatment of Health Expenses**

The Federal tax treatment of health expenses, including premiums and out-of-pocket spending, depends upon whether the individual purchases directly their health benefits or receives them through an employer plan. Generally, if an individual is covered under an employer plan, those health benefits are excludable from the employee's income. If an individual purchases directly their health benefits, those expenses are deductible within certain limits.

***Employer Provided Health Benefits*** – When an individual receives health coverage through an employer, the cost of that health coverage is excludable from the individual's gross income for Federal income and employment tax purposes. The exclusion applies to health benefits that cover employees, their spouses, and dependents.<sup>1</sup> Benefits paid through the health plan are also excluded from income, as long as they represent payments for medical care.<sup>2</sup>

Some employers may provide health insurance coverage and services through a cafeteria plan. Cafeteria plans are those plans that offer employees a choice between taking cash or receiving qualified benefits. Contributions to the cafeteria plan also are excludible from income, but if the individual takes cash, it is includible in income. Qualified benefits include accident, health, or group-term life insurance and coverage under a dependent care programs. However, qualified benefits do not include long-term care insurance or services.

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<sup>1</sup> The exclusion applies to coverage provided to former employees and the employee's survivors.

<sup>2</sup> Code Section 105 requires that certain highly compensated individuals must meet certain nondiscrimination rules before allowing the exclusion. Medical care is defined under section 213 and includes amounts paid for qualified long-term care insurance and services.

***Flexible Spending Arrangements*** – A flexible spending arrangements (FSA) is a plan that provides coverage for specified, incurred expenses eligible for reimbursement. The reimbursements are subject to maximums and certain reasonable conditions. Contributions to the FSA are excludible from income (as a salary reduction) for Federal income and employment tax purposes. However, amounts that remain in the account at the end of the year do not carry forward to the following year. The FSA is typically part of a cafeteria plan.

***Health Reimbursement Arrangements*** – Health reimbursement arrangements (HRAs) are a plan through which employers may reimburse employees for medical expenses. Contributions to the HRA may not be made on a tax-preferred basis. However, amounts paid or accrued by an employer for its employees are generally deductible as ordinary and necessary business expense. Payments received by individuals for medical expense are not includible in income.

***Self-employed Health Benefits*** – Exclusions for employer-provided health coverage does not apply to self-employed individuals (sole proprietors or partners in a partnership). For tax years prior to 2003, self-employed individuals were allowed a limited deduction. However, self-employed individuals may deduct 100 percent of amounts paid for health insurance coverage in tax year 2003 and thereafter. The deduction does not require that the individual itemize deductions as it is available above-the-line (for purposes of computing adjusted gross income).

***Schedule A – Itemized deductions for medical expenses*** – Individuals that itemize deductions on Schedule A of Form 1040 may deduct medical expenses that exceed 7.5 percent of their adjusted gross income. Tax returns filed jointly for married individuals may deduct medical expenses that exceed 7.5 percent of their total adjusted gross income. The deduction is available for any person that is the taxpayer's dependent, or spouse when the services are rendered or when the expenses are paid. The deduction is limited to medical expenses for which the individual received no reimbursement.

Allowable medical expenses include amounts paid for diagnosis or treatment of disease or of affecting any bodily structure or function. In addition to the direct medical care expenses, transportation and lodging costs on trips necessary for medical care are also deductible. Qualified long-term care services and medical insurance may also be deducted, subject to the adjusted gross income limitation.

***Archer Medical Savings Accounts*** – Medical savings accounts (MSA) are tax-exempt accounts used solely to pay medical expenses (not previously reimbursed) of the account holder. The MSA is subject to rules that are similar to those applicable to individual retirement arrangements.

Within limits, eligible individuals may deduct their contributions to an MSA before determining adjusted gross income. If the employer of an eligible individual makes the contribution to the MSA, the amounts are excluded from Federal income and employment taxes. Earnings on amounts in the MSA may accumulate tax-free.

Distributions for qualified medical expenses from an MSA are not includible in gross income. However, distributions not used for medical expenses are subject to a 15-percent penalty tax as well as includible in gross income. Distributions made after death, disability, or the individual becomes Medicare eligible are not subject to tax nor are they includible in income.

Qualified medical expenses are those expenses consistent with the itemized deduction definition. Except the MSA definition does not include expenses for health insurance other than long-term care insurance, premiums for COBRA coverage or for premiums paid while the individual is receiving unemployment compensation.

## **II. Reasons for Change**

Our present system of financing and delivering health care, though imperfect and often fragile, succeeds in the sense that approximately 85 percent of Americans have some form of health insurance. This coverage is accomplished through a loosely connected network that includes employer-based insurance, a well-functioning private insurance market and a system of public health care for our neediest citizens. But the system has gaps, and the 43 million individuals without access to health insurance constitute a social problem that needs to be addressed.

Most Americans receive health insurance through their employer. Many believe that a significant factor that contributes to this arrangement is the tax subsidy afforded employer sponsored insurance (ESI): premiums paid by employers on behalf of the individual are not taxable. In contrast, workers not covered by ESI who elect to purchase private, non-group insurance do so with after-tax dollars making this insurance option much more expensive.

The Administration's proposal to offer refundable tax credits to individuals for the purchase of private health insurance has several goals. The first is to make health insurance more affordable to low-wage workers whose incomes may be insufficient to cover the cost of a basic insurance policy. A second, related objective is to make health insurance more available to those already in the private insurance market. And third, to create a more level playing field in the market for private insurance by extending and enhancing existing tax benefits for obtaining health insurance.

***Uneven Coverage in the Health Insurance Market*** – Uneven coverage of health benefits creates a strain on our economy and especially on our health care system. Uninsured individuals are most likely to lack access to needed health care which will exacerbate existing medical conditions and result in higher future health care costs. Lack of insurance can also mean a huge financial burden for those that pay expenses out-of-pocket for needed treatment. By offering refundable tax credits for purchasing insurance, the Administration's proposal will reduce the number of uninsured and help control health care costs.

Most uninsured individuals are members of a family where someone is employed and most of these families have incomes that are well below the median. These constitute the “working poor” and the tax credit is designed to assist these long-term uninsured. A second group of individuals who will benefit from the credit are those who are temporarily uninsured either because of unemployment or a lapse in coverage due, say, to a job change. It is estimated that over the course of a year, in excess of 60 million individuals are without health insurance at some time.

***Rising Costs in the Employer-Provided Market*** – Spiraling health care costs are already creating strains in the employer-based market and are likely to result in increased numbers of uninsured over the next several years. Some recent trends that will magnify the problem include:

- *Premium cost sharing is increasing over time* – Individuals are being asked to contribute a larger share of the cost of ESI. This will eventually result in more workers opting out of employer-sponsored plans.
- *Availability of employer provided health insurance decreasing over time* – More and more firms are finding they cannot afford to offer health insurance to their employees. This is especially true for small businesses with fewer than 25 workers. With fewer companies offering health insurance, numbers of uninsured will surely rise.
- *Limitations on benefits and coverage increasing over time* – From the firm’s perspective, one way to contain rising health care costs is to limit the types and kinds of benefits that are offered. As benefits are reduced, workers will end up paying more expenses out-of-pocket creating a type of *de facto* uninsured population.

Refundable tax credits are but one way to address the issue of increasing numbers of uninsured individuals and the Administration believes it is the most practical and cost-effective solution to a growing social problem. This incremental approach relies on the present health care financing and delivery system to reduce the number of uninsured by making the purchase of private, non-group insurance more affordable to those with limited resources.

It is important to recognize that even after such a system is in place, there will still be “holes” in the social safety net – tax credits may have a limited ability to induce some groups of individuals to purchase health insurance. In addition, there are some concerns as to what the effect a tax subsidy will have on our existing, employer-based system. In particular, some companies may decide to drop existing health insurance plans and allow their workers to purchase their own coverage with the tax credit.

### **III. Administration’s Proposal**

***Policy direction*** – The objective is to provide affordable health insurance coverage to the uninsured population without imposing mandates. The target population includes lower income individuals or families without employer-provided coverage or without access to public programs. The proposal does not intend to draw individuals currently covered by an employer plan. The design or administration needs to consider ways to prevent this migration.

***Eligibility*** – Eligibility is limited to individuals under the age of 65, a resident of the United States or District of Columbia, and does not participate in a group health plan as of the first day of the year.

Eligibility also is determined by *prior*-year modified adjusted gross income (AGI). Single individuals with modified AGI up to \$15,000 are eligible for the full credit. The credit amount phases out for single individuals with modified AGI in excess of \$15,000. The credit amount is phased down by 2 percentage points for every \$250 increase in modified AGI between \$15,000 and \$20,000. For instance, for \$20,000 of AGI, the available credit rate would be only 50 percent of the premium amount. The credit amount is phased down by 1.25 percentage points for every \$250 increase between \$20,000 and \$30,000. The credit is not available to individuals with AGI of \$30,000 or more.

Married individuals filing jointly, with modified AGI up to \$25,000 are also eligible for the full credit. The credit amount phases out for married individuals with modified AGI in excess of \$25,000. For policies covering only one adult, the credit rate would be phased down by 1.5 percentage points for every \$250 increase in modified AGI and phased out completely at \$40,000 of modified AGI. For policies covering more than one adult, the credit rate would be phased down by 0.643 percentage points for every \$250 increase in modified AGI, with the credit percentage being rounded to one decimal place and phased out completely at \$60,000 of modified AGI.

***Credit Amount*** – The Administration proposal offers a credit equal to 90 percent of the private market premium up to a \$1,000 maximum credit amount for single tax filers. Eligible single filers with dependents may take an additional credit up to \$500 for each dependent insured under the policy. Married individuals filing jointly may tax a credit equaling 90 percent of private market premiums up to \$3,000 for a family of four or more.

The Administration proposal includes monthly limits for individuals with part-year coverage. For each coverage month, the maximum premium for credit purposes would be limited to 1/12 of the annual maximum allowable premium.

***Refundable/Advance Payments*** – The credit amount is refundable and eligible individuals could receive advance payments of the credit through their employer payroll system.

**Reconciliation issues** – The Administration proposal does not include provisions for reconciliation. The rationale for no reconciliation relies on experience with the earned income credit (EIC). Few EIC recipients applied for the advance credit because it required year-end reconciliation.

**Definition of Insurance Coverage** – The current Administration proposal establishes minimum standards for benefits of any insurance plan that receives benefit of the tax subsidy. Preliminary indications suggest insurance coverage could not include benefits excepted under the HIPAA definition of insurance. The tax credit would be available for (1) individual market health insurance; (2) private purchasing group coverage; (3) State-sponsored insurance purchasing pools; or (4) State high-risk pools. Individuals in states that do not offer privately contracted Medicaid or SCHIP purchasing groups or state employee programs for which Medicaid and SCHIP do not contract with private plans could also claim the credit for purchasing private coverage.

In addition, a definition of catastrophic coverage is necessary to set stands that limit deductible amounts and total out-of-pocket exposure. Catastrophic coverage must either (1) have a \$5,000 maximum out-of-pocket limit for single plans and a \$10,000 maximum out-of-pocket limit for all other plans or (2) have a \$1,000 maximum deductible per person (and \$2,000 limit per policy). Co-payments for individual policies could not exceed 30 percent of the first \$18,000 of expenses beyond the deductible amount. Co-payments for other policies could not exceed 30 percent of the first \$36,000 of expenses beyond the deductible amount. No co-payments are permitted beyond the \$18,000 and \$36,000 expenses. All dollar amounts are indexed for inflation.

Benefits under the catastrophic plan must include inpatient care, outpatient care, emergency care, and physician visits. An insurance policy could not be excepted benefits under HIPAA (e.g., not dental-only, eyeglasses-only, auto, long-term care). Annual and lifetime maximum benefits could not be less than \$700,000 (indexed). Catastrophic policies would have to be guaranteed renewable and these policies are subject to state insurance regulation and are permitted to be offered in that state.

**Information Reporting** -- Employers would be required to report whether an employee was covered by group health insurance at any time during the year on the W-2 form. The Secretary of the Treasury would have the authority to prescribe regulations or guidance on this reporting requirement. For example, employers could be further required to specify the number of months for the coverage and/or the type of coverage. All issuers of qualified health insurance would be required to make a 1099 return to individuals ever covered under the issuer's qualified policies during the year. Qualified health insurance issuers would report the months of coverage, the amount of premium paid, and other information the Secretary may prescribe on the return.

#### **IV. Design Issues**

As the Administration's tax credit proposal undergoes the scrutiny of Congressional tax-writing committees, it is likely that some changes in the basic

approach will be recommended. Of course, this is, in part, a natural consequence of the political realities of crafting tax legislation. But it may also be necessary to consider modifications to the basic tax credit proposal that address important economic and distributional effects. These are likely to include (1) cost containment, (2) more effective targeting of specific population groups, and (3) minimizing or alleviating unintended or distortionary impacts.

In this section we review the broad outlines of the tax credit proposal and highlight those aspects that could be modified, if necessary, to address broader tax policy objectives. Where appropriate, we suggest alternative approaches that fit within, and are consistent with, the Administration's objectives.

Crafting good tax policy means assessing how a particular proposal addresses the three fundamental principals of public finance: equity, efficiency and administrative simplicity. Considerations of tax equity relate to the ability to pay, how similarly-situated individuals are treated under the law (horizontal equity) and how tax burden changes with income (vertical equity). Tax efficiency relates to issues of resource allocation and how taxes create distortions in individual decision-making. A good tax policy will minimize these distortions. Administrative simplicity means just that: a policy should not impose undue burden or complexity on the taxpayer.

We organize this section according to provisions that relate specifically to (1) tax law, (2) tax administration, and (3) the integration and coordination with other health insurance programs. This breakdown is for convenience and presentation only; there is quite a bit of overlap among each of these topics.

***Issues Relating to Tax Law*** -- The key parameters that define the structure of the tax credit determine the actual calculation of the refundable portion. These include the credit rate, maximum amount, phase-out points, and eligibility criteria. These are the policy levers that will have the most impact on the cost of the proposal and the number of eligible taxpayers. Similarly, these parameters will also play a major role in determining how individuals (and businesses) will alter their behavior in response to the credit (e.g., take-up rates).

**Credit Amount** – The basic credit amount is controlled by the interaction of several parameters: the maximum allowable premium, the credit rate, the income at which the credit rate begins to phase-out and the rate at which the credit phases-out. Taken together, these policy levers will have a significant impact on the ultimate cost of the credit and the number of uninsured who will potentially qualify for the credit. These parameters are also allowed to vary by type of taxpayer (single or married) and by the number of dependent children claimed on the tax return.

This interaction of these parameters will also have important consequences for how individuals and businesses respond to the credit. For example, if the credit is made more generous – by increasing the maximum allowable premium limits – then this could result in companies dropping existing health insurance coverage so employees can take advantage of the higher tax subsidies. This crowding-out of existing employer-based coverage is concern of many policyholders.

### **Additional Options**

- The credit amount could vary by risk category. The maximum credit (\$1,000 for single individuals, \$3,000 for married couples) may not be sufficient for high risk and difficult to insure individuals. One obvious and easy to administer variation on the basic credit would be to allow for the maximum amount to vary by the age of the taxpayer.
- The credit amount could vary by region, allowing for the fact that there are wide disparities in the cost of health care across the country.
- As written, the credit is only available for the cost of Qualified Health Insurance (defined in the legislation). Alternatively, the maximum credit amount could apply to premiums paid and out-of-pocket expenses. This modification would allow the taxpayer some flexibility in choosing plan types that vary the deductible portion. A further refinement of this approach would make the definition of out-of-pocket expenses conform to the definition of allowable (itemized) medical deductions on Schedule A (Section 213 deductions).
- The credit could be made non-refundable.

***Definition of Income*** – Income for purposes of determining the credit amount is defined as Modified Adjusted Gross Income in the *current* year which is AGI plus excluded tax-exempt interest and excluded Social Security income. More importantly, in the revised proposal this income concept relates to current year income so individuals claim the credit on the tax return for the year in which they are eligible. This “end of year” credit amount is not known with certainty for some taxpayers who may be near the income phase-out points. In addition, taxpayers wishing to claim the credit must pay premiums in advance of actually receiving the credit. It may be unrealistic to assume that very many low income taxpayers will have sufficient funds available to afford the credit in the current year. (This issue is addressed in the “Advanced Payments” option discussed below.)

***Indexing*** – The maximum allowable premium is indexed for inflation using the medical component of the Consumer Price Index.

### **Additional Options**



- The ultimate cost of the credit could be reduced by relying on an alternative price index such as the index used presently in the tax code to adjust tax brackets.
- Alternatively, the maximum credit amount would not adjust for changes in the price index.

***Eligibility*** – The taxpayer must not be a participant in a group health plan to be eligible for the credit. In addition, the credit is available on a monthly basis only for those months the taxpayer is covered by Qualified Health Insurance as defined in the proposal. Specifically, premiums paid to existing employer-based health plans are not eligible for the credit.

**Additional Options**

- The credit could be further limited to individuals for whom employer-based coverage is not offered.
- The credit could be expanded to cover existing premium payments to employer-sponsored plans.

***Issues Relating to Tax Administration***

***Claiming the Credit*** – The tax credit would be administered by the IRS and income determination would be made according to the taxpayer's current year reported income. Individuals who are not legally required to file an income tax return would have to file to obtain the refundable portion of the credit.

**Additional Options**

- The tax credit could be administered through employers in the form of payroll deductions for eligible employees.
- Alternatively, the credit could be administered by insurance providers.

***Advance Payments*** – Beginning in July of 2005, individuals may claim an advance payment creditable towards the purchase of Qualified Health Insurance based on the prior year's income. Presently, there is no provision for reconciliation should current year income result in a reduced credit amount.

**Additional Options**

- Allow for reconciliation of the advanced payment on the tax return for the year in which the credit is claimed. The reconciliation mechanism would include information reporting on the part of insurance providers.

***Reinsurance Provisions*** – The existing proposal contains provisions relating to federally financed reinsurance which would limit the liability of insurance providers above certain limits. The rationale for this reinsurance option is that the premiums charged by private insurers would be lower if the federal government picked up insurance costs above certain limits.

***Additional Options***

- Federal reinsurance caps could be set high enough that only catastrophic, high cost cases would be affected.
- Provisions relating to federal reinsurance could be dropped.

***Coordination and Integration with Other Health Insurance Programs --*** Presently, the tax credit is unavailable to individuals already enrolled in Medicare, Medicaid or SCHIP. Additionally, the amount of the credit is unaffected by other tax credits the taxpayer may claim. Finally, the existing tax subsidy afforded employer-sponsored insurance is unaffected by the credit.

***Additional Options***

- Coverage could include coordination with COBRA or Medicaid premium support programs.
- Consider using multiple definitions of eligibility. For example, prior year income for the working poor, documentation of unemployment in the current year, or documentation of reduced earning ability in the current year.
- Coordination with other credits. Some type of overall limit on allowable credits – much like present-law flexible spending arrangements – could be implemented to help reduce the cost of the credit.
- Alternatively, an overall limit on refundable credits could be imposed. This approach would also dictate the stacking order of allowable (refundable) credits.
- A portion of existing employer-provided premiums could be included in income to help offset a portion of the cost of the credit. These revenues could also be used to expand coverage of the credit to more uninsured individuals.

## V. Summary of Alternative Reform Proposals

Reform proposals vary greatly based on the objectives of the proposed changes. Many proposals simply want to address the issue of the uninsured, leaving the other current programs in place. Others would like to eliminate the current system, replacing it with a comprehensive health system for all individuals currently not receiving Medicare benefits. Somewhere in between these two extremes are proposals that work through existing public or private sector infrastructure to implement broader changes.

Recently, the Lewin Group, through the Economic and Research Institute, classified ten reform proposals into five categories.<sup>3</sup> These five categories provide a clear framework for classifying reform. We borrow from this classification, but will expand the number of proposals through our literature review. In any event, it is likely that any successful health care reform proposal may embody characteristics of several approaches, due to the various needs and concerns raised by each separate group that could be affected by the proposal.

***Incremental Reform*** – Expanding such existing programs as Medicaid and SCHIPs or offering credits to cover health premiums, are considered incremental reform. These proposals address specific issues (low income individuals, children, and uninsured). Further, they use existing systems, State Medicaid programs and the Federal income tax system to implement their reform proposals. The primary goal of these proposals is targeted assistance.

In addition to targeted tax incentives or expanding existing systems, health savings plans are another example of proposed incremental reforms. One health saving proposal would create health savings accounts. These accounts provide tax-preferred savings accounts that allow funds to accumulate on a tax-free basis. In general, amounts contributed to the account are tax-deductible and withdrawals for qualified health expenses are not included in taxable income. Another proposal that encourages individuals to accumulate funds for health expenses would allow amounts that remain in FSAs to rollover to the following year. Currently, contributions to FSAs are tax deductible, but the individual would lose the money if it is not spent during the year.

Health savings initiatives attempt to encourage individuals to save for future health expenditures and are believed to encourage more responsible health care spending. However, they do little to expand coverage to those individuals without insurance and tend to target benefits on individuals with current insurance coverage.

***Voluntary Insurance Pools*** – Many proposals establish state-run voluntary insurance pools. These pools would offer a menu of private plans that are open to both individuals and employers. The plans offered in the pools charge premiums that are community rated. Community rating generally would make insurance coverage available

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<sup>3</sup> See *Covering America, Coverage and Cost Analysis*, The Lewin Group, Economic and Social Research Institute, 2003.

to individuals with higher than average health care costs. In addition, many proposals offer subsidies to lower income individuals that participate. The primary goals of voluntary insurance pools are to make insurance affordable to all state residents and to create incentives for the uninsured to obtain insurance.

***Pay or Play Models*** – Several proposals rely on the existing employer-provided system by making insurance coverage mandatory. The employer must choose between offering a health plan to all employees and paying a mandatory payroll tax that funds coverage. The payroll tax funds a newly created public plan available to all individuals not covered by their employers. Individuals not covered by their employers, must participate in the public plan. These proposals are believed to cover the greatest number of uninsured, but tend to lack support from the business community.

***Tax Credits/Replace Employer Deductions*** – Many proposals would like to eliminate the tax preference for health benefits received through employer sponsored insurance plans. This tax benefit is estimated to cost the Federal government approximately \$472 billion per year in tax expenditures.<sup>4</sup> Clearly, eliminating the employer deduction makes available a large pool of funds that could be allocated in a more uniform or equitable fashion, than the current system that concentrates the benefits to those in the ESI systems.

In general, these proposals would replace the current deduction with a refundable tax credit. Individuals receive the full credit regardless of the cost of their ESI. Those individuals not receiving ESI would also receive the full credit amount allowing for the purchase of insurance. Expected coverage under these proposals varies greatly, as some proposals would make mandatory the purchase of health insurance while others would make such purchases voluntary.

These proposals do, however, make uniform the tax benefits for health insurance as all individuals would receive the credit regardless of the source of their health benefits. In addition, the perception is that by providing credits, the individual becomes a better consumer of health insurance and attempts to use the funds more efficiently.

***Tax Finance System*** – Some proposals would require states to establish programs to cover the vast majority of state residents. The State could establish a new public program or establish voluntary insurance pools, but the program would be financed through the Federal government. The Federal government would collect payroll taxes and provide support to the State programs.

These plans often prescribe the percentage of the state's population that must receive coverage, minimum benefits received by such coverage, and some 'zero-premium' plan that offers that minimum benefit.

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<sup>4</sup> See JCS 1-02, Estimates of Federal Tax Expenditures for Fiscal years 2002 through 2006, prepared by the Joint Committee on Taxation.

## VI. Methodological Issues and Data Limitations

Certain methodological issues arise when analyzing potential revenue and economic effects of providing (refundable) tax credits to uninsured individuals. Our purpose here is threefold; to (1) discuss revenue estimating terminology and conventions that will guide the process; (2) examine the characteristics of the unemployed and evaluate alternative data sources; and (3) review the types of behavioral effects that such a proposal is likely to induce.

### *Overview*

To motivate and guide the discussion, we created a simple microsimulation model based on the March 2003 Current Population Survey (CPS). This model allows us to explore alternative modeling strategies and examine data issues that arise in a precise specification of the tax credit proposal. This approach has two advantages. First, it provides a consistent and familiar framework for analysis of the cost and distributional effects of similar proposals. Second, this approach highlights areas where data limitations may prevent a more comprehensive analysis and suggest the need for alternative methods.

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There are several reasons to begin this analysis with a look at the CPS:

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- As a principal data source for policy analysis, the CPS is familiar and well-understood by ASPE staff;
- It has become the *de facto* standard for much current research on the uninsured;
- Recent increases in sample sizes make the file more valuable for detailed distributional analysis;
- As you are aware, the CPS is the basic data source for the TRIM model;
- The CPS is used to enhance other, more specialized, tax policy models;
- The file is current and provides an up-to-date snapshot of the uninsured population that is not available from other sources.

We point out, however, that there are some limitations with this approach, especially within the context of tax policy analysis. For example, the CPS is a household survey but the Administration's proposal is directed at taxpayers. (Below we explain how we deal this issue.) Also, the CPS contains no information on health insurance premiums and very little information on health status. Both of these are likely to be important determinants of the ultimate cost of the credit. Nevertheless, we believe this approach works well in providing a "first look" at the potential cost of the Administration's tax credit proposal. However, it may be necessary to consider alternative methods and data sources for more comprehensive approaches to providing health insurance to the uninsured.

### *Issues in Calculating Revenue Effects*

A topic currently generating considerable debate is whether the Congress will use “dynamic scoring” to estimate the revenue and economic effects of tax bills. This is in contrast to the “static” models that are currently in use. This terminology is unfortunate, as it causes confusion over the measures contained in the official estimates and often casts doubt on their usefulness.

The Budget Act requires that estimates of the fiscal impact of all tax and spending bills prepared by the Joint Committee on Taxation (JCT) and the Congressional Budget Office (CBO), respectively, use a common set of assumptions regarding the future course of the macro economy. In particular, this means that neither tax nor spending bills themselves can have any effect on this forecast. This is sometimes referred to as the “constant GDP” assumption and is the reason the estimating models are referred to as static models. Requiring the use of a common set of macroeconomic assumptions ensures that all tax and spending proposals will be “scored” in a consistent manner.

Confusion arises over what types of economic effects are legitimately included in the official estimates of tax and spending bills. Revenue estimates of tax bills always include estimates of changes in taxpayer behavior when there is a general consensus as to the magnitude and direction of this response. For example, proposals to raise the excise tax on cigarettes will incorporate estimates of reduced purchases in response to the higher price. Similarly, estimates of the revenue cost of lowering the capital gains tax rate include a large behavioral response as investors are assumed to “unlock” existing assets and pay additional taxes on these newly induced and realized gains. These behavioral effects can oftentimes be the most significant component of the overall economic impact of certain proposals.

Dynamic scoring means incorporating macroeconomic effects into the official cost estimates. That is, one attempts to model the increase (decrease) in federal tax receipts that would be observed if the economy grew at a faster (slower) rate because of the tax change. Parenthetically, most of the current debate revolves around the dynamic scoring of tax bills, but the same argument is often made with respect to spending bills.

We believe most economists, at least in theory, support the notion of dynamic scoring. Disagreements arise over the ability to accurately and consistently capture all of the complex interactions that might affect the estimate; data requirements necessary to implement the models; and whether any macroeconomic “feedback” is even measurable for most tax proposals.

### *Static Effect of the Administration’s Tax Credit Proposal*

It is useful to examine the cost and distributional impacts of the Administration’s tax credit proposal under some very simple assumptions. Table 1 shows these effects under the assumption that all presently uninsured taxpayers claim the credit. The figures

show that about 18.3 million taxpayers would benefit from the credit with an average tax benefit of \$1,292 and at an annual cost to the federal government of about \$23.6 billion. The figures also show that the size of the credit varies by filing status, with married couples receiving a higher average credit amount (about \$1,704). The figures also demonstrate how the size of the credit declines over the income range in which the maximum credit amount is phased-out.

There are several problems with this type of analysis. First, it assumes that the take-up rate for the credit is 100 percent; our own review of the literature suggests this is likely to be much smaller. Second,

**Table 1. - Revenue Effect of Administration's Tax Credit Proposal, By AGI and Filing Status**

*(Returns in Thousands; Dollar Amounts in Millions)*

Adjusted Gross Income Class	Filing Status									All Taxpayers		
	Single			Joint			Head of Household					
	Returns	Amount	Average	Returns	Amount	Average	Returns	Amount	Average	Returns	Amount	Average
Less than \$10,000	2,964	-3,156	-\$1,065	485	-1,115	-\$2,300	775	-1,338	-\$1,725	4,224	-5,609	-\$1,328
\$10,000 TO \$20,000	3,753	-3,468	-\$924	1,923	-3,967	-\$2,063	1,335	-2,292	-\$1,717	7,012	-9,728	-\$1,387
\$20,000 TO \$30,000	1,780	-628	-\$353	2,068	-3,977	-\$1,923	759	-1,206	-\$1,589	4,607	-5,812	-\$1,261
\$30,000 TO \$40,000	-	-	-	1,500	-1,723	-\$1,149	243	-155	-\$639	1,742	-1,878	-\$1,078
\$40,000 TO \$50,000	-	-	-	459	-504	-\$1,100	-	-	-	459	-504	-\$1,100
\$50,000 TO \$75,000	-	-	-	250	-106	-\$423	-	-	-	250	-106	-\$423
\$75,000 TO \$100,000	-	-	-	-	-	-	-	-	-	-	-	-
\$100,000 TO \$200,000	-	-	-	-	-	-	-	-	-	-	-	-
\$200,000 and Over	-	-	-	-	-	-	-	-	-	-	-	-
<b>Total, All Returns</b>	<b>8,497</b>	<b>-7,252</b>	<b>-\$853</b>	<b>6,685</b>	<b>-11,393</b>	<b>-\$1,704</b>	<b>3,112</b>	<b>-4,991</b>	<b>-\$1,604</b>	<b>18,294</b>	<b>-23,637</b>	<b>-\$1,292</b>

the analysis ignores the fact that some insured taxpayers who presently purchase private, non-group coverage are eligible to claim the credit. Third, individuals presently covered under Medicaid or CHIP/SCIP are assumed to remain in the program(s). And fourth, individuals who are presently not required to file income tax returns are assumed to remain non-filers despite the availability of the credit. Some additional details relating to this analysis are the following:

- The model is written in SAS<sup>®</sup> with the eligibility criteria and calculation of the credit (including phase-out amounts and rates) specified as in the most recent description of the Administration's proposal and described in more detail in our earlier memorandum.
- The principal data source is March 2003 Current Population Survey.
- We constructed Tax Units according to tax filing rules in place for Tax Year 2002, for which CPS income is reported.
- For purposes of this analysis, we refer to "static" as meaning no behavioral response other than for those taxpayers who are eligible for the credit.
- Filing thresholds adjusted to approximate Tax Year 2002 filings. This is necessary to adjust for underreporting of certain types of income on the CPS.
- Health Insurance Status is determined on a person-level basis according to CPS variables.
- Non-filers are not assumed to become filers to claim the credit. This is consistent with the static assumption.

- Any tax unit with at least one uninsured person (Head or Spouse) was considered eligible for the credit.
- Dependent filers were deemed ineligible for the credit.
- Income thresholds and phase-out points were as proposed by the Administration for 2004. In future analyses these will be adjusted to approximate the same levels had the proposal been in effect for 2002.
- All taxpayers eligible for the credit are assumed to claim the credit (i.e., take-up rate is 100 percent).
- Amount of the credit is calculated as the allowable credit rate times the maximum premium amount, given the facts and circumstances of the taxpayer (i.e., no allowance for lower-cost policies).
- Single and Head of Household taxpayers with dependents were allowed the additional \$500 credit for each dependent (up to a maximum of 2).

### *Creating Tax Units from the CPS*

As a necessary first step in constructing the simulation model, we transform the CPS from a household-based survey into a sample of individual income tax returns. This is done one household at a time and only individuals residing in a particular household during the interview period were included in the composite tax returns.<sup>5</sup> Generally speaking, this process proceeds as follows:

1. Determine the head of a family unit in a particular household (there will be at least one) and make this person the tax unit head.
2. If this person is married, find the spouse within the household and identify this tax unit as a joint return.
3. Search the remaining records in each family and identify dependents, adding these dependents to the tax unit.
4. Repeat Steps 1 to 3 for each family in the household.
5. For each tax unit defined in Steps 1 to 3, determine if there are dependency relationships among them and identify and combine these tax units as necessary.

We point out that that this procedure works very well for more than 85 percent of households and families in the CPS. For the remaining households, the algorithm is necessarily ad hoc since we know very little about the personal, financial and familial bonds among household members. Nevertheless, approaches similar to this have been used for many years with generally satisfactory results.

Once tax units have been created from the CPS, there are still several reasons why weighted control totals do not match published data from the IRS. These include:

- Dependent Filers. The CPS does not collect income information on children under sixteen years of age.

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<sup>5</sup> As a practical matter, tax units can be comprised of individuals residing in one or more households. For example, a divorced parent living alone may claim his or her children as dependents. This is one reason why it is difficult to use the CPS for some types of tax policy analysis.



- Head of Household returns. After applying the statutory filing requirements, taxpayers claiming Head of Household status are always underrepresented.
- Institutionalized Population. Certain taxpayers residing in institutions that file tax returns are not in the CPS sample frame.
- Foreign taxpayers. Some non-resident individuals, as well as certain U.S. citizens living abroad, that are required to file income tax returns are not captured in the CPS.

Table 2 shows the number of tax returns by filing status, dependency status, aged status and presence of dependents, created from the CPS for tax year 2002. Table 3 shows the same figures for non-filers. Whether a tax unit was classified as a filer or non-filer was determined first by statutory filing requirements based on income. Next, these income thresholds were adjusted slightly so the resulting the population of tax filers approximates the numbers reported by the IRS for 2002.

**Table 2. - Tax Units Created From the March 2003 Current Population Survey: Filers**

Type of Filer	Filing Status						Total, All Returns
	Single Returns		Joint Returns		Head of Household		
	No Dependents	With Dependents	No Dependents	With Dependents	No Dependents	With Dependents	
Non-Dependent							
Non-Aged	40,165,634	1,495,077	20,406,484	28,415,689	780,735	12,559,077	103,822,697
Aged	6,735,397	86,780	7,980,700	646,851	77,897	255,163	15,782,787
Total	46,901,031	1,581,857	28,387,184	29,062,540	858,632	12,814,240	119,605,484
Dependent							
Non-Aged	6,575,072	n.a.	84,031	n.a.	n.a.	n.a.	6,659,102
Aged	94,936	n.a.	6,190	n.a.	n.a.	n.a.	101,126
Total	6,670,008	-	90,221	-	-	-	6,760,229
Total, All Returns							
Non-Aged	46,740,706	1,495,077	20,490,515	28,415,689	780,735	12,559,077	110,481,799
Aged	6,830,334	86,780	7,986,890	646,851	77,897	255,163	15,883,914
Total	53,571,040	1,581,857	28,477,405	29,062,540	858,632	12,814,240	126,365,714

**Table 3. - Tax Units Created From the March 2003 Current Population Survey: Non-Filers**

Type of Filer	Filing Status						Total, All Returns
	Single Returns		Joint Returns		Head of Household		
	No Dependents	With Dependents	No Dependents	With Dependents	No Dependents	With Dependents	
Non-Dependent							
Non-Aged	5,439,212	742,911	2,226,068	859,838	254,499	763,451	10,285,979
Aged	6,661,668	n.a.	2,790,476	60,029	147,142	526,964	10,186,280
Total	12,100,880	742,911	5,016,544	919,867	401,641	1,290,415	20,472,258
Dependent							
Non-Aged	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Aged	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total, All Returns							
Non-Aged	5,439,212	742,911	2,226,068	859,838	254,499	763,451	10,285,979
Aged	6,661,668	n.a.	2,790,476	60,029	147,142	526,964	10,186,280
Total	12,100,880	742,911	5,016,544	919,867	401,641	1,290,415	20,472,258

## Characteristics of the Uninsured

Below we discuss factors that are likely to influence whether or not eligible taxpayers are induced to purchase health insurance and claim the tax credit. These take-up rates are likely to vary across any number of dimensions. The following tables, from the March 2003 CPS, provide a snapshot of the characteristics of this targeted group. Table 4 shows the distribution of the uninsured by age; Table 5 breaks down this population by Total Family Income; Table 6 by (self-reported) health status and gender; Table 7 by size of employer<sup>6</sup>. Table 8 shows the number of uninsured by tax filing status and income class, after tax units have been constructed from the CPS.

**Table 4. - Distribution of the Uninsured by Age**

*(Thousands of Persons)*

Age	Number	Percent
Under 5	2,198	5.0%
5 lt 18	6,334	14.5%
18 lt 25	8,128	18.7%
25 lt 35	9,769	22.4%
35 lt 45	7,781	17.9%
45 lt 55	5,586	12.8%
55 lt 65	3,521	8.1%
65 and Over	258	0.6%
Total, All Persons	43,574	100.0%

**Table 5. - Distribution of the Uninsured by Family Income**

*(Thousands of Persons)*

Total Family Income	Number	Percent
Less than \$10,000	7,972	18.3%
\$10,000 TO \$20,000	8,573	19.7%
\$20,000 TO \$30,000	7,744	17.8%
\$30,000 TO \$40,000	5,157	11.8%
\$40,000 TO \$50,000	3,741	8.6%
\$50,000 TO \$75,000	5,062	11.6%
\$75,000 TO \$100,000	2,447	5.6%
\$100,000 TO \$200,000	2,325	5.3%
\$200,000 and Over	553	1.3%
Total, All Persons	43,574	100.0%

<sup>6</sup> Children and other individuals not in the labor force are not represented.

**Table 6. - Distribution of the Uninsured by Health Status and Gender***(Thousands of Persons)*

Health Status	Gender			
	Male		Female	
	Number	Percent	Number	Percent
Excellent	7,017	30.1%	5,889	29.1%
Very Good	7,515	32.2%	6,525	32.2%
Good	6,748	28.9%	5,932	29.3%
Fair	1,609	6.9%	1,441	7.1%
Poor	438	1.9%	459	2.3%
Total, All Returns	23,327	100.0%	20,246	100.0%

**Table 7. - Distribution of the Uninsured by Size of Employer***(Thousands of Persons)*

Size of Employer	Number	Percent
Not in universe	17,457	40.1%
Under 10	9,178	21.1%
10 - 24	3,531	8.1%
25 - 99	3,749	8.6%
100 - 499	2,662	6.1%
500 - 999	823	1.9%
1000+	6,173	14.2%
Total, All Persons	43,574	100.0%

**Table 8. - Distribution of Uninsured Taxpayers, By AGI and Filing Status***(Returns in Thousands; Dollar Amounts in Millions)*

Adjusted Gross Income Class	Filing Status						All Taxpayers	
	Single		Joint		Head of Household			
	Returns	Percent	Returns	Percent	Returns	Percent	Returns	Percent
Less than \$10,000	2,964	28.8%	485	5.0%	775	22.8%	4,224	18.0%
\$10,000 TO \$20,000	3,753	36.5%	1,923	19.8%	1,335	39.2%	7,012	29.9%
\$20,000 TO \$30,000	1,980	19.3%	2,068	21.3%	759	22.3%	4,808	20.5%
\$30,000 TO \$40,000	706	6.9%	1,552	15.9%	287	8.4%	2,545	10.9%
\$40,000 TO \$50,000	346	3.4%	955	9.8%	113	3.3%	1,415	6.0%
\$50,000 TO \$75,000	308	3.0%	1,275	13.1%	86	2.5%	1,668	7.1%
\$75,000 TO \$100,000	115	1.1%	653	6.7%	21	0.6%	788	3.4%
\$100,000 TO \$200,000	83	0.8%	604	6.2%	22	0.7%	710	3.0%
\$200,000 and Over	30	0.3%	215	2.2%	8	0.2%	253	1.1%
Total, All Returns	10,286	100.0%	9,730	100.0%	3,407	100.0%	23,423	100.0%

## How Different Groups Benefit From the Tax Credit Proposal

One benefit of using microsimulation for analyzing public policy initiatives is the ability to assess how different subgroups of the population are affected. Tables 9 through 11 show how the static effect of the credit is distributed by income class and, respectively, by age, region and health status.

**Table 9 - Revenue Effect of Administration's Tax Credit Proposal, By AGI and Age of Head**

*(Returns in Thousands; Dollar Amounts in Millions)*

Adjusted Gross Income Class	Age of Head								
	Less Than 25			25 to 35			35 to 45		
	Returns	Amount	Average	Returns	Amount	Average	Returns	Amount	Average
Less than \$10,000	1,697	-2,015	-\$1,188	1,040	-1,470	-\$1,413	768	-1,185	-\$1,543
\$10,000 TO \$20,000	1,713	-2,022	-\$1,180	2,176	-3,137	-\$1,441	1,493	-2,378	-\$1,592
\$20,000 TO \$30,000	735	-724	-\$984	1,356	-1,755	-\$1,295	1,204	-1,753	-\$1,456
\$30,000 TO \$40,000	121	-121	-\$997	494	-572	-\$1,159	491	-601	-\$1,226
\$40,000 TO \$50,000	27	-28	-\$1,039	133	-155	-\$1,161	148	-168	-\$1,133
\$50,000 TO \$75,000	13	-6	-\$443	62	-28	-\$452	91	-44	-\$481
\$75,000 TO \$100,000	-	-	-	-	-	-	-	-	-
\$100,000 TO \$200,000	-	-	-	-	-	-	-	-	-
\$200,000 and Over	-	-	-	-	-	-	-	-	-
<b>Total, All Returns</b>	<b>4,306</b>	<b>-4,915</b>	<b>-\$1,141</b>	<b>5,261</b>	<b>-7,117</b>	<b>-\$1,353</b>	<b>4,195</b>	<b>-6,129</b>	<b>-\$1,461</b>

*(Returns in Thousands; Dollar Amounts in Millions)*

Adjusted Gross Income Class	Age of Head									All Taxpayers		
	45 to 55			55 to 65			65 and Over			Returns	Amount	Average
	Returns	Amount	Average	Returns	Amount	Average	Returns	Amount	Average	Returns	Amount	Average
Less than \$10,000	463	-607	-\$1,311	198	-249	-\$1,257	59	-83	-\$1,421	4,224	-5,609	-\$1,328
\$10,000 TO \$20,000	991	-1,377	-\$1,389	506	-665	-\$1,315	132	-149	-\$1,128	7,012	-9,728	-\$1,387
\$20,000 TO \$30,000	787	-988	-\$1,254	386	-457	-\$1,185	139	-135	-\$968	4,607	-5,812	-\$1,261
\$30,000 TO \$40,000	354	-371	-\$1,048	225	-191	-\$849	58	-22	-\$380	1,742	-1,878	-\$1,078
\$40,000 TO \$50,000	98	-104	-\$1,066	52	-50	-\$946	-	-	-	459	-504	-\$1,100
\$50,000 TO \$75,000	51	-18	-\$346	32	-10	-\$318	-	-	-	250	-106	-\$423
\$75,000 TO \$100,000	-	-	-	-	-	-	-	-	-	-	-	-
\$100,000 TO \$200,000	-	-	-	-	-	-	-	-	-	-	-	-
\$200,000 and Over	-	-	-	-	-	-	-	-	-	-	-	-
<b>Total, All Returns</b>	<b>2,744</b>	<b>-3,464</b>	<b>-\$1,262</b>	<b>1,399</b>	<b>-1,622</b>	<b>-\$1,159</b>	<b>388</b>	<b>-389</b>	<b>-\$1,002</b>	<b>18,294</b>	<b>-23,637</b>	<b>-\$1,292</b>

**Table 10 - Revenue Effect of Administration's Tax Credit Proposal, By AGI and Region**

*(Returns in Thousands; Dollar Amounts in Millions)*

Adjusted Gross Income Class	Region												All Taxpayers		
	Northeast			Midwest			South			West			Returns	Amount	Average
	Returns	Amount	Average	Returns	Amount	Average	Returns	Amount	Average	Returns	Amount	Average	Returns	Amount	Average
Less than \$10,000	613	-747	-\$1,220	868	-1,104	-\$1,272	1,749	-2,430	-\$1,389	994	-1,328	-\$1,336	4,224	-5,609	-\$1,328
\$10,000 TO \$20,000	1,106	-1,447	-\$1,309	1,218	-1,594	-\$1,308	2,878	-4,095	-\$1,423	1,810	-2,592	-\$1,432	7,012	-9,728	-\$1,387
\$20,000 TO \$30,000	870	-991	-\$1,139	807	-910	-\$1,128	1,822	-2,459	-\$1,349	1,108	-1,452	-\$1,310	4,607	-5,812	-\$1,261
\$30,000 TO \$40,000	280	-274	-\$979	283	-292	-\$1,032	670	-727	-\$1,085	509	-585	-\$1,149	1,742	-1,878	-\$1,078
\$40,000 TO \$50,000	69	-76	-\$1,091	83	-88	-\$1,065	197	-222	-\$1,124	109	-119	-\$1,089	459	-504	-\$1,100
\$50,000 TO \$75,000	48	-20	-\$420	47	-19	-\$399	91	-38	-\$411	64	-29	-\$459	250	-106	-\$423
\$75,000 TO \$100,000	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
\$100,000 TO \$200,000	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
\$200,000 and Over	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
<b>Total, All Returns</b>	<b>2,986</b>	<b>-3,555</b>	<b>-\$1,191</b>	<b>3,305</b>	<b>-4,006</b>	<b>-\$1,212</b>	<b>7,408</b>	<b>-9,970</b>	<b>-\$1,346</b>	<b>4,595</b>	<b>-6,106</b>	<b>-\$1,329</b>	<b>18,294</b>	<b>-23,637</b>	<b>-\$1,292</b>

**Table 11. - Revenue Effect of Administration's Tax Credit Proposal, By AGI and Health Status**

*(Returns in Thousands; Dollar Amounts in Millions)*

Adjusted Gross Income Class	Health Status						All Taxpayers		
	Excellent/Good			Fair/Poor					
	Returns	Amount	Average	Returns	Amount	Average	Returns	Amount	Average
Less than \$10,000	3,782	-4,950	-\$1,309	442	-660	-\$1,492	4,224	-5,609	-\$1,328
\$10,000 TO \$20,000	6,352	-8,766	-\$1,380	660	-962	-\$1,458	7,012	-9,728	-\$1,387
\$20,000 TO \$30,000	4,113	-5,171	-\$1,257	495	-640	-\$1,294	4,607	-5,812	-\$1,261
\$30,000 TO \$40,000	1,569	-1,706	-1,088	174	-172	-\$992	1,742	-1,878	-\$1,078
\$40,000 TO \$50,000	419	-460	-1,098	39	-44	-\$1,125	459	-504	-\$1,100
\$50,000 TO \$75,000	236	-99	-419	14	-7	-\$494	250	-106	-\$423
\$75,000 TO \$100,000	-	-	-	-	-	-	-	-	-
\$100,000 TO \$200,000	-	-	-	-	-	-	-	-	-
\$200,000 and Over	-	-	-	-	-	-	-	-	-
<b>Total, All Returns</b>	<b>16,471</b>	<b>-21,152</b>	<b>-\$1,284</b>	<b>1,823</b>	<b>-2,485</b>	<b>-\$1,363</b>	<b>18,294</b>	<b>-23,637</b>	<b>-\$1,292</b>

***Take Up Rates and the Cost of the Credit***

To assess the effect of take-up rate assumptions, we make simple assumptions about the likelihood that certain presently uninsured taxpayers will elect to purchase private insurance and claim the credit under the Administration’s plan. Table 12 shows an *illustrative set of take-up rates*. As discussed in the next section, these assumed rates are somewhat on the low end of what has been estimated in the literature. However, we feel they are a more accurate reflection of what is likely to occur under the Administration’s proposal, given the targeted population.

Generally, the take-up rates increase with age and for those in poorer health. (Both these assumptions are borne out in the literature.) Table 13 is identical to Table 1 except that the illustrative take-up rates replace the initial 100 percent take-up rates assumed earlier. The figures indicate that the (static) cost of the credit is reduced by close to 90 percent with a corresponding reduction in the number of taxpayers claiming the credit. The average credit received is slightly higher under this alternative scenario.

**Table 12. - Alternative Assumptions Regarding Take-up Rates by Health Status and Age of Head**

Age of Head	Health Status	
	Excellent/Good	Fair/Poor
Less Than 25	5.0%	10.0%
25 to 35	12.5%	15.0%
35 to 45	15.0%	20.0%
45 to 55	20.0%	22.5%
55 to 65	25.0%	30.0%
65 and Over	25.0%	30.0%

**Table 13. - Revenue Effect of Administration's Tax Credit Proposal, By AGI and Filing Status: Under Alternative Take-Up Rates**

(Returns in Thousands; Dollar Amounts in Millions)

Adjusted Gross Income Class	Filing Status									All Taxpayers		
	Single			Joint			Head of Household			Returns	Amount	Average
	Returns	Amount	Average	Returns	Amount	Average	Returns	Amount	Average			
Less than \$10,000	309	-328	-\$1,060	62	-142	-\$2,274	82	-140	-\$1,716	453	-610	-\$1,345
\$10,000 TO \$20,000	348	-332	-\$953	274	-540	-\$1,971	173	-296	-\$1,709	795	-1,168	-\$1,469
\$20,000 TO \$30,000	70	-28	-\$392	269	-492	-\$1,830	80	-133	-\$1,654	420	-652	-\$1,555
\$30,000 TO \$40,000	-	-	-	103	-138	-\$1,342	14	-11	-\$835	116	-149	-\$1,282
\$40,000 TO \$50,000	-	-	-	22	-24	-\$1,100	-	-	-	22	-24	-\$1,100
\$50,000 TO \$75,000	-	-	-	3	-2	-\$496	-	-	-	3	-2	-\$496
\$75,000 TO \$100,000	-	-	-	-	-	-	-	-	-	-	-	-
\$100,000 TO \$200,000	-	-	-	-	-	-	-	-	-	-	-	-
\$200,000 and Over	-	-	-	-	-	-	-	-	-	-	-	-
<b>Total, All Returns</b>	<b>728</b>	<b>-687</b>	<b>-\$944</b>	<b>733</b>	<b>-1,338</b>	<b>-\$1,824</b>	<b>349</b>	<b>-580</b>	<b>-\$1,664</b>	<b>1,810</b>	<b>-2,605</b>	<b>-\$1,440</b>

Estimates in Table 13 rely on the following conventions:

- Take-up rates are calculated first according to the probabilities in Table 12. This is considered the “baseline” take-up rate.
- These baseline rates are then adjusted by multiplying by the effective credit rate. For example, someone with a baseline take-up rate of 20 percent, but whose allowable credit rate was 50 percent, would have a credit rate of 10 percent. This adjustment reflects the notion that take-up rates should be higher the higher the effective credit rate.
- All taxpayers are assumed to get the maximum allowable credit.

***Behavioral Effects – Take-up Rates and Revenue Effects (From the Literature)***

- Take-up rates will vary by demographic characteristics as well as with the financial incentives (will vary with individual characteristics and effective credit rate).
- Behavioral responses will vary depending upon the individual’s situation:
  - Uninsured individuals purchasing private non-group insurance
  - Insured individuals with employer-sponsored insurance purchasing private non-group insurance
  - Insured individuals with public coverage purchasing private non-group insurance
- Estimating the behavioral response depends upon numerous characteristics not captured in microsimulation models.

### Uninsured – Characteristics Affecting Take-up Rates

Characteristic	Factors	Relevant Studies	Results
Demographics	health status, age, gender, income cutoff	Gruber and Levitt (1)  Wozniak and Emmons (2)  Lewin Group (3)  Pauly and Herring (4)	10 – 20 percent overall take-up, comparable credit amount, income cutoff 60/100 40 – 65 percent overall take-up, double credit amount, income cutoff 75/100 15 – 42 percent overall take-up, double credit amount, income cutoff 150/200 33 – 67 percent overall take-up, up to 100 percent (depending upon design, \$1,000/2,000 refundable, available for employer and individual coverage)
Premium rates	State insurance markets, availability of zero (net) premiums, guaranteed issue	Pauly, Song, and Herring (5)	21 – 85 percent overall take-up, \$1,000 refundable, available for employer and individual coverage, assumes zero or low level insurance premiums are available
Financial incentives	credit design, administrative ease, net premium as a percent of total income	Etheredge (6) Etheredge (7)  ITUP SB 480 Paper (8)	Require families to enroll children in SCHIPs if eligible, and payroll deduction of premiums Estimates of financial burdens, premium contribution as a percentage of income

### Insured with Employer-sponsored – Factors Affecting Take-up Rates

Characteristic	Factors	Relevant Studies	Results/Conclusions
Employer characteristics	size of the employer, cost of benefits relative to payroll costs	Farber and Levy (9)  HIAA Issue Brief 10 (10)	Offer rate of employer coverage declining (1979 – 1997) Small firm employees have lower take-up rates than comparable workers in larger firms
Cost sharing provisions	required employee contributions	Pauly and Herring (11)  Cunningham (12)	Most uninsured could have taken advantage of employer provided benefits Cost is most important factor affecting decision to decline employer-sponsored insurance
Plan design	available benefits, health status	Hadley and Reschovsky (13)	Benefit design plays an important role in decision

### Insured with Public Coverage – Factors Affecting Take-up Rates

Characteristic	Factors	Relevant Studies	Results/Conclusions
Extent of their coverage	part-year versus full-year coverage	Ham (14)  Etheredge (6)	Evaluation of SCHIPs program and impact on coverage Tying coverage of children to availability of tax credits for uninsured parents would decrease uninsured
Availability of free health care services	Access, regional differences, personal preferences	Cunningham (12)	Availability of free services associated with high cost of insurance were strong determinants
Disutility of seeking free services	available benefits, health status	Hadley and Reschovsky (13) Chernew and Hirth (15)	Utility and disutility of seeking free care determinants in behavior



## Special Issues Affecting Take-up Rates

- Pre-Medicare population (poor health and poverty factors, see Pre-Medicare Fact Sheet, Illinois Department of Insurance.)
- Younger women (child bearing ages, lower income, availability of affordable premiums, see The Commonwealth Fund, “Health Insurance Tax Credits: Will They Work for Women.”)

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