Summary of Testimony for Senate Finance Committee Hearing:
“Health Benefits in the Tax Code: the Right Incentives”
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Tax Expenditures for Health Care

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Sources of Insurance Coverage for Americans Under Age 65

2008
[Numbers in Millions]

- Uninsured, 44.2
  16.7%
- TRICARE, 11.5
  4.3%
- Medicare (disability), 5.8
  2.2%
- Medicaid and SCHIP, 42.1
  15.9%
- Non-group, 8.4
  3.2%
- Self Employed, 6.6
  2.5%
- Employer Sponsored Insurance, 163.8
  61.8%

Source: JCT calculations based on Medical Expenditure Panel Surveys (2001-3), and Internal Revenue Service Statistics of Income 2005 data; Congressional Budget Office March 2008 baseline).
### Annual Federal Subsidies for Healthcare Delivered Through the Tax Code

- **Estimated value of Federal subsidies for 2007 (rounded):**
  - **Employer-Sponsored Insurance** $245 billion
    - (Includes health component of cafeteria plans)
      - Income tax exclusion (w/o deduction) ($145 billion)
      - FICA exclusion (pre-benefits reduction) ($100 billion)
  - Exclusion of Medicare benefits from taxable income $40 billion
  - Exclusion for self-employed individuals $5 billion
  - Deduction for expenses > 7.5% AGI $10 billion
  - HSAs <$1 billion

- Technical term for a Federal subsidy delivered through the Tax Code is a *tax expenditure*
Employer-Sponsored Insurance Dominates the Picture

- 164 million individuals receive health insurance through ESI plans

- Tax system used to deliver $245 billion federal subsidy for ESI plans in 2007 alone

- Employee health benefits paid by an employer are just another form of compensation
  - So employer gets tax deduction, like other compensation

- But ESI plans are tax-favored compared to other compensation:
  - Employees exclude this compensation from income (so not taxed)
  - Employees and employers both exclude this from wage base for FICA

- Substantial evidence that this favorably asymmetrical tax result largely explains dominance of ESI plans in health coverage
ESI Plans are Group Plans

- Powerful advantages to group health plans
  - If the group is determined by factors other than morbidity, the group structure mitigates problems of adverse selection
  - Group has superior negotiating power with insurer than an individual does
  - Group can achieve administrative savings

- So what’s wrong with ESI Plans?
  - That is, once decision is made to subsidize healthcare, why not deliver the Federal subsidy through tax incentives for ESIs?
ESIs and Other Tax Expenditures
Distort Government and the Economy

- ESI plans distort apparent size of budget and government
  - Make official federal budget and overall size of government look smaller than they are
  - True of every example of targeted tax relief

- ESI plans distort taxpayer behavior
  - Employer and employees jointly prefer nontaxable health benefits and low employee deductible over equivalent cash compensation
  - Employee insensitivity to cost of health insurance (because it is largely invisible and tax-favored)
  - Employees therefore indirectly ‘overspend’ on healthcare (because it is cheap compared to cash compensation)
Government Cannot Control Its Own Subsidy

- No cap on value of ESI plans, and few other limitations on design of those plans

- Employers/employees, not Federal government, define amount of Federal spending

- Subsidy varies with tax brackets of different employees (The “upside-down” subsidy problem)

- Subsidy varies with changes in individual tax rates: tax rate hikes increase the subsidy’s economic distortions
Subsidy is Not Universally Available

- *Everyone* pays for the ESI subsidy, in form of higher overall tax rates to fund the $245 billion/year in implicit subsidy payments

- But subsidy is *not* available to everyone — only employees of employers that offer ESI plans get it

- Contrast this to 7.5% of AGI medical expense deduction—at least that is universally available

- Economic “job lock” of employee with chronic illness (or with sick dependent)