Tax Policy and the Uninsured
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Mr. Chairman, thank you for the opportunity to present an explanation of how tax policy affects the uninsured. The connection between tax policy and health care policy is not obvious. In fact, federal tax policy on health insurance is one of the most important health care policies in our nation. It has many implications for the uninsured and for the choices that Montana faces in helping the uninsured.

The Tax Treatment of Health Care Benefits

In considering how to assist Americans without health insurance, it is important to understand how Americans with insurance acquire it. At first blush, the answer seems obvious: most Americans get their health insurance through a job. But why do we get health insurance through a job? That question is more difficult to answer.

Health insurance is the only type of insurance that is available primarily through a job. Auto insurance and homeowners insurance are purchased individually (although people are often required by law to have auto insurance or by a mortgage company to have homeowners insurance). Life and disability insurance are sometimes a job benefit, but they are also easy to purchase individually. In contrast, individually-purchased health insurance is unusual except for the self-employed.

It would be nice if all employers had sufficient reasons to cover their workers' health care costs. But the harsh reality is that when employers have a choice, they often do not provide coverage. Higher wage workers expect health care benefits, and employers almost always provide them coverage. Lower wage workers often do not ask for benefits, and employers with low wage workers often do not provide them. Health insurance is one of the ways that employers compete for workers.

How did job-based health insurance become so widespread? The answer goes back to World War II wage and price controls. Wages were frozen, so employers began to compete for workers by increasing health care benefits. In order to maintain the illusion that the wage controls were working, the IRS ruled that benefits were not part of wages, and therefore exempt from government controls and taxes. After the war, the tax-free treatment of health care benefits became a permanent law.

Employers often provide health care benefits because benefits can be less expensive than wages for attracting and keeping workers. Not only do workers avoid paying federal and state income taxes on job-based coverage, neither they nor the employers pay Social Security and Medicare payroll taxes on health care benefits. Employers can deduct the costs of benefits as a business expense, too. But that deduction itself doesn't encourage employers to provide benefits because wages are equally deductible.

If this convoluted tax policy sounds confusing, that's because it is. It has created the impression that employers pay for health insurance. While employers write the checks for health insurance, economists widely agree that the cost of health insurance comes out of workers' wages. Because workers do not have to itemize this deduction, few are even aware of this tax break.

Despite its obscurity, the tax treatment of health insurance has set in place the basic structure for health care coverage in the United States. Since a job has historically provided most workers with insurance, Medicare was needed for retirees. And Medicaid was created initially for people without jobs. Medicaid has since been expanded to include low-income workers (specifically pregnant women and their children) whom are often left out of job-based coverage. Most recently, the State Children's Health Insurance Program (SCHIP) was launched in part because job-based coverage for children has been eroding.

The Strengths of Health Care Tax Policy

The tax treatment of health care benefits is far from perfect, but it has three main advantages. It creates a strong incentive to buy insurance, a convenient way to purchase insurance, and stable insurance pools for large employers.

Incentive to Purchase Insurance. For millions of Americans, the tax exemption for health care benefits reduces the price of insurance by half. Consider a man earning $35,000, which is just slightly more than the national median income for male workers. If he has employer-paid health care benefits, then he saves 28 percent in federal income taxes, 15 percent in payroll taxes that he and his employer would normally have to pay on his wages, and perhaps 5 percent in state income taxes. For a $2,650 insurance policy, which is the national average, he receives a $1,272 tax break each year.

This subsidy mitigates a fundamental problem with health insurance. As long as health care is guaranteed to be available through hospital emergency rooms, some people won't buy health insurance. They may think they can afford to pay for their health care directly. Others might not be able to afford coverage. Still others who are young may plan to live forever. To be viable, a health insurance market needs subsidies to purchase insurance, penalties for not purchasing insurance, or some combination of subsidies and penalties.

Convenient Purchasing System. Since health insurance is often not a personal priority, job-based health insurance helps extend coverage by making the enrollment and payment for health insurance nearly automatic. Many employers put workers in a health plan by default unless they take the initiative to opt out. In a recent study of pension plans published by the National Bureau of Economic Research, the simple act of making participation automatic in a 401(k) plan (with no employer contribution) increased participation from 37 percent to 86 percent. The increases were even greater for young and low-income workers.

Stable Insurance Pools for Large Employers. In any given year, the health care costs for small businesses and individuals can vary widely and unpredictably. That creates the challenge for insurance companies who must insure that premiums are set high enough to pay the bills. For a large group of

workers, the costs are easier to predict, which makes the insurance pool stable and less costly to insure. In fact, most large employers self-insure because the health problems of their workers are very predictable from year to year and there's no need for insurance. Another advantage of large groups is that they tend to have benefits that cover the full spectrum of health care problems that are more likely to arise in large groups. Finally, large groups are the most innovative purchasers of health care because they can make and recoup investments to improve the efficiency of health care delivery. Examples include the Pacific Business Group on Health in San Francisco and the Buyers' Health Care Action Group in Minneapolis.

The Weaknesses of Health Care Tax Policy

The tax treatment of health care benefits is also fraught with problems. It is unfair to low-income workers, workers between jobs, and small businesses. It restricts consumer choice of health care insurance and providers. It encourages excessive health care spending.

Inequitable for Low-Income Workers. The value of the tax exemption for health insurance declines for lower income workers who are in a lower tax brackets. Consider a someone earning the minimum wage (an annual income of $10,712). That worker would save only 15 percent in federal income taxes and perhaps 2 percent in state income taxes. The payroll tax savings would be the same at 15 percent. For a $2,650 policy, he or she would save only $848, which is one-third less than the worker earning $35,000 in the previous example.

Chart A shows the distribution of the health insurance tax break by income. It shows a much more regressive distribution than the example above because it also accounts for the fact that lower income workers are less likely to have good benefits or any insurance at all. The chart does not, however, represent the fact that to be truly equitable, health insurance benefits would have to be greater for lower income workers. Otherwise, they would face higher out-of-pocket costs, which can be a major impediment for the poor in getting access to care.

Inequitable for Unemployed Workers. Workers who are between jobs receive no relief from the tax exemption for health care benefits. Workers often qualify for COBRA coverage, which is a federal requirement that employers offer for short term coverage for workers who leave a job. Workers must pay the employer's portion of the premium and their own with after-tax dollars.

Inequitable for Small Businesses and Individuals. Small businesses compete for workers just as large businesses do, but they must pay more for health care coverage because marketing and administrative costs are higher for small group insurance. In addition, small businesses that are organized as sole proprietors or subchapter S corporations can deduct only 70 percent of the cost of insurance from federal income taxes. While that percentage will increase to 100 percent over the next few years, those small business will still not be able to deduct health insurance from payroll taxes. Workers who buy their own insurance outside the job receive a federal income tax deduction only to the extent their total health care costs exceed 7.5 percent of their gross income each year.

Restrictions on Consumer Choice. The health insurance plan selected by an employer may not be the first choice of each worker. The plan may not include a patient's doctor on its network. It may have more cost sharing than a higher income workers needs. About 60 million workers and their families – two of every five – have no choice in their health care coverage because their employer chooses for them instead of offering a menu of choices.

Encourages Excessive Health Care Spending. The tax exemption for health care benefits is unlimited. The more that an employer spends on health care coverage, the bigger the tax break. Given a choice between paying workers higher wages and spending more on health care, the tax exemption encourages employers to spend more on health care coverage. That's especially true when workers are unhappy with the lower-cost coverage available through HMOs. In addition, the tax exemption encourages over-insurance because it applies only to insurance and not to out-of-pocket expenses (except under limited circumstances). Some routine health care costs might be less if they were paid directly by workers. The advantage of direct payment, however, is limited by the ability of individuals to negotiate prices and evaluate the benefits of medical services. Even in a non-emergency, it is a challenge for people to second guess what doctors order and charge.

The Impact of Federal Tax Policy on Montanans

The weaknesses of federal health care tax policy are magnified in Montana. Montana's median income is about 20 percent less than the national median income. As a result, the regressive distribution of the federal tax exemption is even more regressive for Montanans.

Montana has more small businesses. Workers at small businesses with under 20 employees constitute 34 percent of the workforce, which is the highest rate in the nation and almost twice the national average of 19 percent. All the inequities that apply to small businesses nationally are worse in Montana.

The impact on Montana is dramatic. The uninsurance rate is 20 percent higher in Montana than the national average (18.6 percent among non-elderly Montanans compared to 15.5 percent nationally). Fifty-nine percent of non-elderly Montanans are insured through job-based coverage compared to 67 percent nationally (see Chart B).

Chart C shows that 86 percent of uninsured Montanans are workers and their dependents compared to 82 percent nationally. This result is also consistent with the fact that job-based coverage is weaker in Montana.

Clearly, much of the uninsured problem in Montana stems from federal tax policy. The inequitable distribution of the federal tax exemption is a sizeable sum of money. The net total value of the exemption is an estimated $120 billion for 2000. This tax break is the federal government's second most expensive health care program, falling in between Medicare ($215 billion) and Medicaid/SCHIP ($118 billion). The loss of Montana's fair share could be in the hundreds of millions of dollars.

It is important to note, however, that states with weak job-based coverage and low incomes do not

necessary have high uninsurance rates. For example, Vermont has a five percent greater proportion of job-based coverage and 19 percent greater median income, but it has a 45 percent lower proportion of uninsured. Vermont has reduced its uninsured population through expansions of government programs.

Choices for Montanans

Montana has several choices for reducing the uninsured. All of them – including doing nothing – involve trade-offs. Below are some of the many options and a brief discussion of each.

Create a Voice for Montana on Federal Health Care Policy. Given the major disadvantage imposed on Montana by federal tax policy, one reasonable course would be for state leaders to call for Congressional action. Several Congressional proposals have been introduced to compensate for the weaknesses of the current job-based system. Health policy leaders in the Democratic and Republican parties have expressed support for a health insurance tax credit. A tax credit would be worth more to lower income workers because its value wouldn't decline in the lower tax brackets. It could be "refundable" for those who earn too little to pay income taxes and "advanceable" for those who could not afford coverage prior to receiving a tax refund check. Few Congressional leaders, however, see tax credits are the sole solution. Some would combine tax credits with other reforms to improve access to insurance. Others would add the expansion of government programs.

In the wake of the September 11th tragedy, it is unclear what shape federal action might take. But any number of issues could drive the country to a new debate about the uninsured: the need for an improved public and private health care system to counter bioterrorism, a weakened economy and additional layoffs, and rising health care costs that threaten everyone's coverage.

Expand Existing Programs and Policies. The Montana legislature could expand or reform many existing programs and policies ranging from Medicaid and SCHIP to tax credits for small businesses. On the one hand, federal government programs can bring to Montana three to four federal dollars for every state dollar spent. On the other hand, tax credits can be a less bureaucratic method for expanding coverage. Perhaps a tax credit that draws down federal matching funds could be developed. It might also be helpful to develop several scenarios for expanding coverage based on varying budgets and program options.

Make Better Use of Existing Programs and Opportunities. There are many ways to make current dollars and activities go farther. Since many workers are not aware of the existing tax break for health care, they may have an inflated perception of the cost of coverage provided through a job.

According to the Urban Institute, the participation in Medicaid among eligible Montanans is 74 percent compared to 81 percent nationally. Enrollment in Medicaid and SCHIP could become more convenient and less stigmatized by using the worksite to identify and enroll low income workers and their families. States like Wisconsin and Oregon have begun to develop such options.

Another existing opportunity is discount cards for the uninsured or for older Americans who lack

prescription drug coverage. These low-cost programs can act as stepping stones to full coverage by giving the uninsured and retirees the same discounts for health care products and services that are available to people with insurance. The uninsured and rich, foreign dignitaries are the only people who full retail prices for health care in the U.S.

Yet another initiative involves making the safety net for the uninsured more effective. Because the uninsured tend to use the emergency room or end up in the hospital with an expensive, but preventable condition, it is possible to shift some of this spending toward coverage for primary and preventive care and chronic disease management without an infusion of new funds. In fact, the community around Asheville, NC has adopted this approach and achieved near universal access to basic health care at no additional cost.

Finally, public health care programs and community health providers can be very effective in improving people's health. For example, the Missoula Partnership Health Center has leveraged federal, state, and local funding to provide low-cost health care services. Another type of initiative could be getting dental sealants on grade school children to prevent cavities, a measure that is proven to be highly cost-effective.

Do Nothing. Any major expansion of coverage and service will require some additional expenditures and/or effort, but the cost of doing nothing is also high. A typical uninsured person consumes about 60 percent of the health care resources of an insured person. While savings are possible by preventing ER visits through primary care and better management of chronic conditions, it is also true that more costs more. Health insurance means not only better financial protection for individuals and society but also longer and healthier lives.

The health consequences of being uninsured are tragic. Here are some key facts from scientific studies, which have been summarized by Harold C. Sox, M.D, a health care educator and researcher at Dartmouth University:

?? The uninsured are 25 percent more likely to die prematurely than the insured. This analysis and the others have factored out the demographic differences between the uninsured and insured.
?? The uninsured who are admitted to the hospital are 50-100% more likely to die in the hospital.
?? The uninsured are more likely to delay going to the hospital.
?? The uninsured are 50-100% sicker at the time of hospital admission.
?? The uninsured receive less care in the hospital for some conditions.
?? The uninsured chronically ill are half as likely to have seen a doctor in the past year than the insured.
?? Uninsured women are 50% more likely to die of breast cancer during the first six years after diagnosis.
?? Insured children in poor health have 16 doctor visits per year. Uninsured children have 4 visits per year.

Surely, the uninsured deserve better as do we all.