

Tax Deductible Health Insurance for Individuals: Just What the Doctor Ordered

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Whether the topic is the recent addition of a prescription drug benefit for Medicare, a “Patients Bill of Rights,” or the myriad of “reform” plans now being offered by Democratic Presidential hopefuls, health care is the theme of much discussion inside and outside the Beltway. Unfortunately, although many politicians espouse free-market rhetoric and Congress has even passed two significant tax relief packages in recent years based on the philosophy that individuals best know how to spend their hard-earned money, most lawmakers apparently do not share this belief when health care is the issue. After all, the health care debate in Congress has been over how to inject bigger doses of federal intervention into Americans’ health care decisions. The idea of granting additional freedom to individuals within the health care marketplace as a method of reform has been largely ignored.

Fortunately, solutions do exist, and if implemented, they would inject a needed “antidote” of consumer decision-making into the system and help remedy our nation’s health care woes. One important piece of legislation is H.R. 1117, “The Health Care Freedom of Choice Act,” which has been introduced by Rep. Christopher Cox (R-CA). Instead of offering complicated, inefficient, big-government solutions, Cox’s legislation would allow consumers to choose their own health care options on a tax-deductible basis. The legislation would fill an important gap for Americans who do not receive health care through their employers, and are not able to write off their health coverage as the owner of a small business.

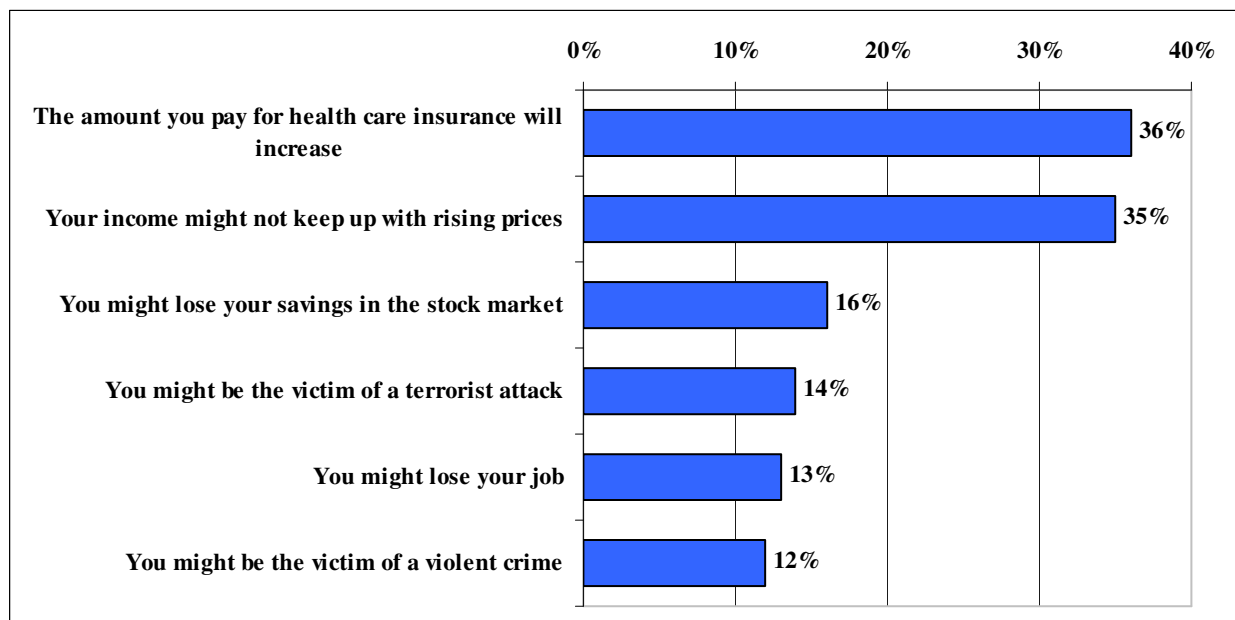
Employer-provided health insurance and medical expense coverage are tax-exempt under current policy, but the same insurance premiums and medical expenses, if paid for by an individual, are not tax deductible. Currently, only 4.5 percent of taxpayers claim a health expense deduction because in order to qualify for the deduction, they must spend 7.5 percent of their Adjusted Gross Incomes on health care. This tax discrimination effectively forces working and retired Americans to seek health insurance through their jobs, denying them the freedom to choose their own health care options, and often limiting their employment options due to health care considerations.

Making health care expenses tax deductible to employers was first implemented during World War II and became official federal policy in 1954.¹ Although bestowing tax benefits exclusively on employer-sponsorship of health care in order to expand health coverage made sense in the era of large corporations and job stability, times have changed. Today, the average 32-year-old has changed jobs seven times already and is likely to change jobs several more times during a career.² Rather than worrying about the consequences for their health care coverage each time they change jobs, workers should be able to rest secure knowing that they, as well as their families, will be covered regardless of their job status. Workers could also choose the plan that best fits their needs and the needs of their family while protecting them against gaps in coverage when they change or lose their jobs.

Aside from changing jobs more than ever, more workers are also employed by small businesses. With small businesses being forced to drop coverage, in many instances due to rising health care costs, relying exclusively on employers for health coverage is becoming less effective as a federal policy and is more burdensome for business owners themselves. According to the National Federation of Independent Businesses, this year, health care cost concerns became the single biggest problem for small businesses for the first time since 1986.³

Health care costs are getting so out of control that, according to an April 2003 poll by the Henry J. Kaiser Family Foundation, paying for health care is now the number one fear Americans have.⁴ As indicated in the following chart, most people are more concerned that health care costs will increase than they are that their incomes will not keep up with rising prices, that their stock market investments will suffer a loss, or even that they will fall victim to a terrorist attack.

Americans' Fears, Ranked by Level



Source: Henry J. Kaiser Family Foundation

Cox's legislation offers an individual tax deduction for 100 percent of health care expenses. Since about 90 percent of those under age 65 with private health insurance are covered through their employer, their employer makes the decision as to who gets covered, for what, and for how much. To this end, the Cox bill would increase choices in health care by allowing a significant group of consumers to make their own coverage and purchasing decisions. The bill would lower overall health care spending through increased efficiency, since most employers offer one-size-fits-all health plans. More freedom of choice means more competition, which lowers costs for everyone.

According to data from the Cato Institute, current federal tax exemptions and deductions for health care spending reduced federal reserves by an estimated \$126 billion in 2000 with employment-based health insurance benefits claiming nearly all of those tax subsidies (\$121 billion).⁵ Unfortunately, job-based tax benefits for health care spending put employers, not employees, in charge of selecting health care benefits. Not only do current policies exclude individual choices by subsidizing health care for the majority of Americans, they increase costs disproportionately for individuals who do not receive health benefits from their employer.

Additionally, the limited tax exclusion that exists under current law favors the financing of medical services through insurance. Thus, it distorts health care purchasing choices by providing the greatest tax benefits for the most costly versions of employer-sponsored coverage. It also encourages workers to think that someone else (their employer) pays for their health care and it reduces their sensitivity to the cost of health insurance.

Tax subsidies, like those currently in place for health care, can stimulate demand and, perversely, increase its cost relative to other expenses. This results in "welfare" losses estimated at 20 percent to 30 percent of total insurance spending.⁶ In other words, the current system wastes between 20 and 30 percent of total insurance spending through warped incentives and the misallocation of resources. The most obvious outgrowth of this situation is the fact that health care costs have risen by double digits in recent years.⁷

Ideally, the tax system should be simpler and should feature a single low rate of taxation on a broad base. However, while using the Tax Code for policy goals isn't always desirable, it is preferable to creating new entitlement spending programs. Until a new tax system is put in place, it only makes sense to provide tax treatment for health care that minimizes economic distortion and maximizes economic freedom.

Rising health care costs and reduced benefits mean that more consumers need to purchase individual plans; both for their own coverage and to fill in the gaps left by employer-based coverage. Bestowing the same tax benefits on individuals as Congress has on businesses is only fair. Because purchasing power and decision-making are restored to individuals, it will also go a long way toward resolving our health care problems. Rather than federalize health care and create a costlier, more bureaucratic, less innovative health care system that stays afloat by rationing services, it is time to give individuals the same tax benefits as their employers receive. H.R. 1117 would recognize and help achieve this important component of tax – and health care – fairness.

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¹ Healthcare Leadership Council, "The Uninsured Q & A," http://www.hlc.org/html/q_a5.html.

² Nina Owcharenko, "Tax Credits for Health Care Coverage," *Capitalism Magazine*, December 14, 2002, <http://www.capmag.com/article.asp?ID=2229>.

³ Jim Hopkins, "Health Care Tops Taxes as Small Business Cost Drain," *USA Today*, April 20, 2003, www.usatoday.com/news/health/2003-04-20-small-business-costs_x.htm.

⁴ Henry J. Kaiser Family Foundation, "Health Care Worries in Context With Other Worries," *Health Security Watch*, March/April 2003 Edition.

⁵ Cato Institute, "Cato Handbook for Congress, 107th Congress," 2001.

⁶ *Ibid.*

⁷ Congressman Paul Ryan, "Health Care," <http://www.house.gov/ryan/issuepapers/healthcareissuepaper.html>.