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

Edward D. Kleinbard
Chief of Staff
Joint Committee on Taxation

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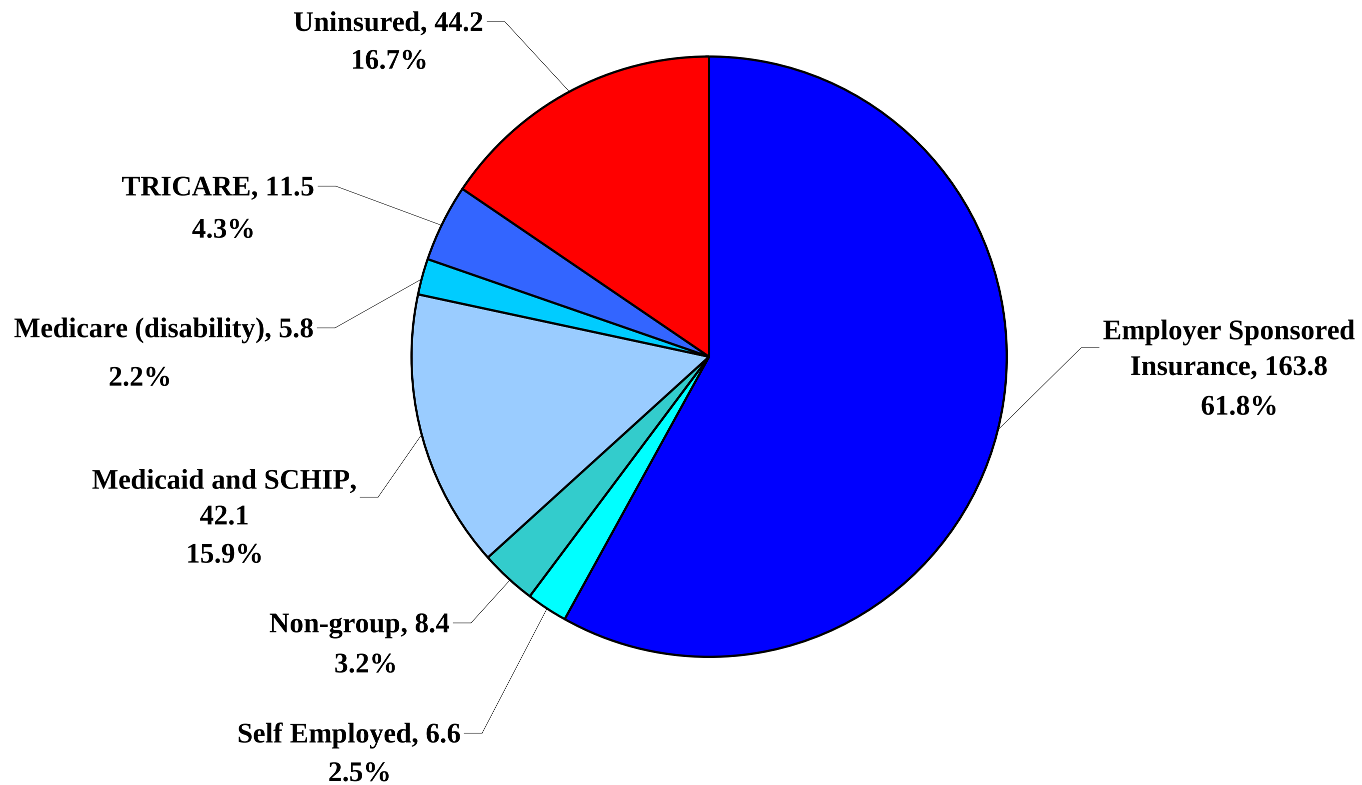
Sources of Insurance Coverage for Americans Under Age 65

2008

[Numbers in Millions]



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).

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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*

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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

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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)

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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

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Subsidy is Not Universally Available

- *Everyon*e 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)

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