Tax Credits for Health Insurance

Leonard E. Burman and Jonathan Gruber

The tax system may not be the most efficient way to expand health coverage, but tax subsidies appear the only game in town for increasing the federal role in health insurance provision.

Health insurance provided by employers is a tax-free fringe benefit that costs the government over $140 billion annually. Subsidizing employer-sponsored insurance (or ESI) has worked in one sense: ESI now covers almost two-thirds of workers and their families. However, the subsidy is poorly targeted. The value of the tax exclusion grows with income and is worth little or nothing to those with low incomes, even though they are most likely to be deterred by the cost of insurance.

Numerous proposals would provide additional tax subsides for health insurance. Most notably, for the past four years President Bush has proposed a refundable tax credit for the purchase of health insurance by lower-income individuals not covered by ESI or a public insurance program such as Medicare or Medicaid. Although critics have complained the subsidy is far too small to substantially expand coverage among those who most need help, it would represent a major new expenditure on behalf of the poor.

Expanding health coverage through the tax system may not be the most efficient path, but tax subsidies appear the only game in town for expanding the federal role in the provision of health insurance. This brief examines the implications of major expansions in tax credits, starting with the president's refundable tax credit proposal. A microsimulation model is used to examine the effects of the proposals on health insurance coverage. At least in the short run, the president's proposal would modestly increase the number of people with health insurance. However, many people currently covered by health insurance at work would lose that coverage and would not be covered by alternative insurance. Still, many currently uninsured people would gain coverage and many

low-income people would see their insurance costs lowered by the president's proposed subsidy.

This brief also details the impact of other, more generous tax subsidies. The basic model is a tax credit, designed to mimic a voucher, equal to the difference between the cost of insurance and 10 percent of a household's income. This plan, unlike the president's proposal, assumes that affordable health insurance would be available to individuals through something similar to the Federal Employees Health Benefits Plan (FEHBP), a successful program that gives all federal workers and retirees access to a range of health insurance plans.

We examine the effect of policies that would allow the credit only for individual non-group coverage (as in the president's plan), only for ESI, and for insurance acquired in either market. Each option would reduce the number of uninsured by far more than the president's proposal, but at greater cost. The non-group-only credit would also cause millions of people to become newly uninsured, although two people would gain insurance for every one who loses it. The other two policies would not cause significant numbers of people to lose insurance, but their costs would be commensurately greater. All reform options are much more progressive than the current tax subsidy.
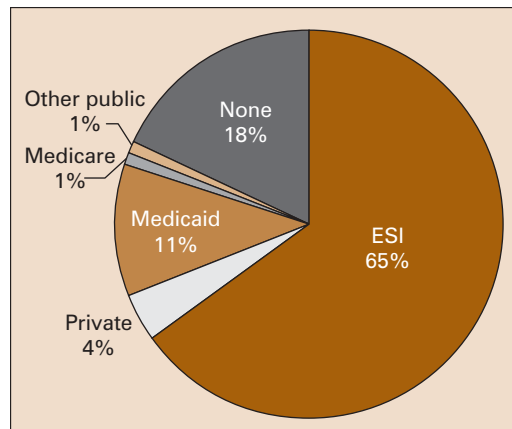
Background

Most working-age Americans and their families receive health insurance through employers. According to the March 2004 Current Population Survey, 164 million Americans under age 65 (65 percent) received primary health insurance in 2003 from either their own or a family mem-

FIGURE 1. Primary Source of Insurance for
Nonelderly Americans in 2003

Source: Urban Institute estimates based on data from the
March 2004 Current Population Survey.
Note: "Other public" includes Indian Health Service, CHAM-
PUS, CHAMPVA, and any government-sponsored military
health insurance plan.

ber's employer (figure 1). Of the 35 percent
without ESI, about half were uninsured
and most of the rest were enrolled in a
public health plan. Only 4 percent were
covered by private non-group insurance.

The probability of having insurance
coverage increases with age, income, and
firm size. Only 10 percent of workers
between ages 50 and 64 were uninsured in
2003, but nearly 28 percent of workers
between ages 18 and 29 lacked health
insurance coverage. Workers in poor
households are much less likely to have
insurance coverage than those in house-
holds with modest or higher incomes.
Almost half of poor workers (workers in
families with incomes below the federal
poverty level) and about 40 percent of
near-poor workers (workers in families
with incomes up to twice the federal
poverty level) lacked insurance in 2003. In
contrast, only 22 percent of workers with
incomes between two and three times the
federal poverty level and 7 percent of those
with incomes greater than three times the
federal poverty level were uninsured.

Small firms are much less likely to
offer health insurance than large firms. In
2003, less than 32 percent of workers at
firms with fewer than 10 employees were
covered through their own employer.
Another 24 percent were covered by a
spouse's ESI, but 31 percent were unin-
sured. In contrast, 72 percent of workers at

firms with more than 1,000 employees
were enrolled in a health insurance plan
sponsored by their employer, while 10 per-
cent remained uninsured.

There are also significant differences
between adults and children: children are
much more likely to be insured. While
20 percent of adults lack insurance, less
than 12 percent of children do. This pattern
holds across income levels. Poor children
are about half as likely to be uninsured as
poor adults (23 percent versus 45 percent).
There are several factors behind this
dichotomy. Families without children do
not generally qualify for Medicaid. Also,
the supplemental State Children's Health
Insurance Program (SCHIP) covers some
children ineligible for Medicaid.

As a tax subsidy, ESI overwhelmingly
favors middle- and upper-income house-
holds. Families in the lowest-income group
received an average tax subsidy (includ-
ing both income and payroll taxes) worth
9 percent of their premiums in 1998, com-
pared with a subsidy of 33 percent of pre-
miums for the highest-income group.[1]
Consequently, while high-income families
on average receive ESI worth three times as
much as that received by low-income fam-
ilies, it only costs 2.3 times as much after
tax savings are considered.

The bottom line is that the tax subsidy
is not at all targeted to those who most need
help paying for health insurance. Health
insurance premiums took up 40 percent of
income for the poorest households in 1998,
but the subsidy rate among these house-
holds was less than 10 percent. Households
with incomes over $200,000 received subsi-
dies equal to 33 percent of premiums even
though premiums took up only 3 percent of
their income without a subsidy.

Tax Credit Simulations

One response to the shortcomings and
inequalities of the current system is to
provide refundable tax credits to help
low-income households acquire health
insurance, either at work or in the private
non-group market. Because the credits
would be refundable, they would be tanta-
mount to a voucher based on income.[2] The
credits could be limited to purchases in the
individual non-group market, as under the
president's proposal, to insurance spon-
sored by employers, or to both. The most
expansive credits would increase coverage

the most and cause the fewest disruptions, but would also be most costly to implement.

We consider four policy options. The first option is President Bush's proposal to allow a credit of $1,000 per covered adult and $500 per covered child (up to two children) for a maximum family credit of $3,000. The credit rate phases out at certain income levels: between $15,000 and $30,000 for singles, $25,000 and $40,000 for single parents, and $25,000 and $60,000 for joint filers. In principle, the taxpayer could elect to take the credit in advance based on prior-year income, producing a kind of voucher that could be transferred to an insurer, although the exact mechanism to accomplish this is unclear. A taxpayer who participates in an employer's health insurance plan or in a public insurance plan would be ineligible for the credit.

The other three options are more generous credits to individuals and families covered by ESI, those covered by non-group insurance, or both groups. These options assume a refundable tax credit equal to the difference between the cost of modest health insurance coverage and 10 percent of income. We assume that individuals use the credit to buy health insurance from an FEHBP-like pool, and we assume the cost of the policy is the same as the FEHBP Blue Cross option (the most popular option among federal employees), which is $3,951 for singles and $9,255 for families in 2004. For purposes of simulation, we assume eligibility is based on the current year's income, although it could be structured the same as the president's plan (i.e., with an option to base eligibility for a transferable credit on the prior year's income).

Bush Credit

As table 1 shows, the credit proposed by President Bush in his FY 2006 budget proposal is much less expensive than any other policies examined. Only 3.12 million uninsured people take up the credit, but a large portion of those who take up the credit were previously uninsured.

However, many employers choose to drop coverage because the credit favors non-group insurance over ESI. Almost 3.4 million individuals lose ESI. Most of these people switch to non-group insurance, but 1.3 million previously insured people become uninsured as a result of this policy. On balance, 1.8 million people gain health insurance.

Note that these estimates are based on a number of assumptions about economic behavior. Altering those assumptions could result in qualitatively important changes. For example, under different assumptions, more employers could drop coverage or individuals could face much higher premiums in the non-group market, in which case President Bush's proposal could actually increase the number of people without insurance.

The expenditures on the Bush plan are modest compared with the other options. The total federal cost is $4.9 billion, representing additional federal spending of $2,654 per newly insured person. The states actually save money because 300,000 fewer people are covered by public insurance. We estimate that the federal and state governments together save an average $2,300 per person who leaves public insurance. Overall, states save $425 million under this option.

Nonetheless, the federal government would spend more than two dollars for every dollar of insurance value provided under this option because the newly insured tend to be younger and healthier than the population at large and those losing employer coverage tend to be less healthy than average. The average age of the newly insured under this plan is 24.9 years old, and only 2.1 percent are in fair or poor health, while 40.2 percent are in excellent health. By comparison, the average age of all uninsured persons is 30 years old, 9 percent of whom are in fair or poor health, and 29 percent of whom are in excellent health.

As a result, the average health cost is only $1,431 for the newly insured. Thus, on balance, total spending equals $2.23 per dollar of insurance provided. Put differently, the excess spending—over and above the incremental health cost of the insured population—is $1.23 per dollar of coverage provided.

By design, subsidy dollars are targeted at lower-income individuals; 69 percent of subsidy dollars go to those with incomes below 200 percent of the poverty level. As a result, lower-income individuals experience the largest declines in uninsurance

The expenditures on the Bush plan are modest compared with the other options.

TABLE 1. *Simulation Results for Illustrative Health Insurance Tax Credits, 2004*

Policy	Bush credit	Employer credit	Non-group credit	Employer and non-group credits
Changes in population (millions of persons)				
Newly insured	3.12	9.69	10.46	14.19
as percentage of all credit recipients	30.3	6.1	39.4	8.6
Newly uninsured	1.29	0.0	4.87	0.30
Net decrease in uninsured	1.83	9.69	5.58	13.9
Net change in employer-insured	–3.36	15.09	–14.11	3.55
Net change in non-group-insured	5.5	–2.65	20.38	12.96
Net change in publicly insured	–0.31	–2.74	–0.69	–2.61
Costs ($2004)				
Federal cost per year (millions)	4,865	141,057	39,669	155,429
Change in state spending (millions)	–425	–2,288	–1,440	–2,692
Federal cost per newly insured	2,654	14,558	7,106	11,186
Targeting				
Average age of newly insured (years)	24.9	29.7	26.3	27.4
Percentage of newly insured in fair or poor health	2.1	8.2	2.9	4.7
Average cost of newly insured ($)	1,431	1,984	1,549	1,694
Spending per dollar of insurance provided ($)	2.23	7.22	5.74	6.50
Distribution of subsidy dollars (%)				
To those with incomes below poverty level	24	11	22	13
To those with incomes 100–200% of poverty level	45	27	37	28
To those with incomes 200–300% of poverty level	23	27	24	27
To those with incomes 300–400% of poverty level	6	18	10	17
To those with incomes 400+% of poverty level	2	16	6	15
Change in employer-insured population (millions of persons)				
Among those with incomes below poverty level	–0.29	3.06	–0.89	1.17
Among those with incomes 100–200% of poverty level	–0.88	4.57	–3.02	1.24
Among those with incomes 200–300% of poverty level	–0.91	2.90	–3.46	0.36
Among those with incomes 300–400% of poverty level	–0.56	1.81	–2.57	0.20
Among those with incomes 400+% of poverty level	–0.71	2.74	–4.17	0.58
Change in uninsured population (millions of persons)				
Among those with incomes below poverty level	–0.73	–2.00	–2.58	–3.44
Among those with incomes 100–200% of poverty level	–1.29	–3.17	–3.62	–5.24
Among those with incomes 200–300% of poverty level	–0.35	–1.92	–1.41	–3.02
Among those with incomes 300–400% of poverty level	0.11	–1.15	0.10	–1.31
Among those with incomes 400+% of poverty level	0.43	–1.44	1.93	–0.89

Source: Authors' calculations.

rates. In contrast, the number of people with incomes above three times the poverty level who lack health insurance increases on average. This occurs because their employers drop coverage and they are ineligible for the health insurance credits, so their cost of insurance increases substantially.

The president's proposal would significantly reduce the number of people covered by employer-sponsored insurance. More than 8 percent of those currently covered by ESI, or 3.36 million people, would no longer be covered by employment-based health insurance. Of those losing employer coverage, 1.84 million purchase non-group coverage and 0.23 million become covered by Medicaid. Another 1.29 million become uninsured—1.13 million because their employers drop coverage and 0.16 million because the employer contributions toward health insurance premiums are reduced.

Employer Credit

The employer credit would cover many more people, but at much greater cost. About 9.7 million uninsured persons would gain coverage under this proposal. But those who already have insurance will claim most of the credits: only about 6 percent of those who take up the credit were previously uninsured, while 94 percent already had insurance—mostly ESI. The employer credit is a windfall for them.

According to the simulations, nobody loses insurance because of this policy. Qualifying individuals who start with ESI have an even stronger incentive to participate in their employers' plans after the credit is enacted, so no employers drop coverage and many are induced to offer it for the first time. Individuals with non-group coverage have no incentive to drop their coverage unless they can find an employer that offers insurance. About 2.7 million individuals with non-group coverage acquire ESI; another 2.7 million with public insurance switch to ESI. On balance, 15.1 million people get ESI who did not have it before, but more than 5 million simply switch from other insurance coverage.

The employer credit costs the federal government $141 billion a year. With just under 10 million people gaining insurance coverage, this implies that the policy costs

the federal government $14,558 per person gaining coverage. This policy is the least cost-effective but also the least disruptive.

As with the president's proposal, people gaining coverage under this proposal tend to be slightly younger and healthier than average. The average age of the uninsured person who gains insurance is 29.7 years old; 8.2 percent are in fair or poor health and 30 percent are in excellent health. The average cost for those gaining insurance through the employer credit is $1,984, about $100 less than the average cost of insuring all uninsured people.

The government spends $7.22 per dollar of insurance value provided. Roughly speaking, the extra spending associated with this approach to providing insurance is $6.22. This large cost arises from the fact that most of the dollars spent on this policy are going to those who are already insured.

This subsidy is not well targeted by income either. Only 11 percent of subsidy dollars go to those with incomes below the poverty level, less than half the share under the president's plan. In contrast, 45 percent goes to those with incomes two to four times the poverty level, and 16 percent to those with incomes over 400 percent of the poverty level. Relative to other policies, this distribution represents a large portion of subsidy dollars that go to upper-income individuals, primarily to those already employer-insured who take advantage of the credit.

Nonetheless, the employer credit would significantly expand coverage for lower-income people. More than 3 million people below the poverty level gain employer-sponsored insurance, and another 4.57 million with incomes between one and two times the poverty level gain ESI. At the same time, many higher-income people gain coverage—2.74 million people above 400 percent of the poverty level gain employer insurance, in part due to the considerable size of the pool of higher-income people who could gain from the credit.[3]

Reductions in the number of uninsured occur across all income levels. These reductions are somewhat concentrated in the lower income categories, with 2 million people below the poverty level and 3.17 million people between 100 and 200 percent of the poverty level

The employer credit would cover many more people, but at much greater cost.

gaining insurance. However, a significant number of higher-income people also gain coverage.

Non-group Credit

A generous non-group credit can greatly expand coverage, but with significant disruptions. Several differences from the employer credit are immediately apparent. Although a similar number of uninsured individuals take advantage of the credit, this number represents 39 percent of those who take it up. Unlike the employer credit, almost half as many people lose insurance coverage as gain it under this option. About 10.46 million previously uninsured people gain non-group coverage, but 4.87 million who had employer coverage become uninsured. Although the magnitude of this response may seem large in response to a fairly small credit, remember that this drop comes off a very large base of more than 160 million employer-insured workers. Other responses are a large increase of 20.38 million non-group insured, and corresponding decreases of 14.11 million employer-insured and 0.69 million publicly insured.

The most striking difference between the two credits is the cost. The non-group credit costs more than $100 billion less than the employer credit. Moreover, the cost per newly insured individual is considerably lower—$7,106. This increase in cost-effectiveness is driven by spending geared much more effectively toward the uninsured.

The newly insured under the non-group credit are on average younger and healthier than those who would be newly insured under the employer credit, with an average age of 26.3 years old and only 2.9 percent in fair or poor health. This is reflected in the average cost of each newly insured person, $1,549, and the spending per dollar of insurance provided, $5.74. The partial subsidy to non-group insurance considered here is much more attractive to healthy individuals for whom the subsidy equals a large portion of non-group insurance premiums. As a result, the average value of insurance to those who take up these kinds of credits is often less than that provided by other types of policies. This explains why the non-group credit appears much more efficient than the employer

credit when looking at the "cost per newly insured" measure as opposed to the "spending per dollar of insurance provided" measure.

The number of people covered by employer-sponsored health insurance decreases in all income groups. The smallest change is for those with incomes below the poverty level, primarily because relatively few of them have employer-sponsored insurance before the credit is implemented. The non-group credit also causes significant numbers of low- and moderate-income people (those with incomes below 300 percent of the poverty level) to become uninsured. This is a paradoxical result for the group that qualifies for the largest credits. Many of those with incomes over 300 percent of the poverty level also lose insurance coverage, largely because of firm dropping.

Employer and Non-group Credits

A credit for both ESI and non-group insurance would expand coverage the most, but at the greatest cost. The combined credit avoids the implicit tax on ESI (or non-group) insurance that occurs with a selective credit. In this case, ESI retains a small tax advantage over non-group insurance because the tax exclusion remains, although that factor is small for the lower-income people who are most likely to be uninsured.

A total of 14.19 million uninsured people gain coverage under this alternative, representing only 8.6 percent of those who take advantage of the credits. The low percentage is primarily the result of the large number of previously employer-insured who take advantage of the employer credit. With this reduction in the uninsured comes a small increase of 0.3 million individuals who lose their insurance, mostly because of firm dropping. This figure represents a far smaller increase in the uninsured than under the non-group credit alone, indicating that the pressure for employers to drop workers off their insurance plans is almost wholly mitigated by the incentives to retain and expand their plans in the employer credit. The remaining increase of 3.55 million employer-insured and 12.96 million non-group-insured and the net decrease of 2.61 million publicly insured are consistent

The newly insured under the non-group credit are on average younger and healthier than those who would be newly insured under the employer credit.

with the changes induced by the selective credits.

The annual cost to the federal government of this plan is $155 billion, considerably less than the sum of the costs of the employer and non-group credits taken separately. With more than 14 million people gaining insurance coverage, this implies a cost of $11,186 per person for each newly insured individual. This figure is close to the mean of the figures for the employer and non-group credits. Similarly, the spending per dollar of insurance value—$6.50—lies between the values for the two separate credits.

The distribution of subsidy dollars, however, closely resembles that of the employer credit. This is because of the much larger takeup of the employer credit than the non-group credit and, to a lesser extent, the higher average health spending of those who take advantage of the employer credit.

The number of employer-insured increases somewhat at all income levels, but especially in the lower-income categories. The number of uninsured at all income levels also decreases significantly. The reductions are also the largest at lower income levels.

Conclusion

The government provides over $140 billion a year in tax subsidies for employment-based health insurance. Consequently, almost two-thirds of Americans under age 65 are insured through an employer (Americans age 65 and over are primarily covered by Medicare). However, there are significant gaps in coverage, especially among small firms and low-income workers. Current tax subsidies are poorly suited to addressing those gaps because they favor higher-income workers and large firms that face the lowest insurance costs.

Proposals have been made to provide tax credits or deductions for the purchase of insurance outside work. Those proposals could improve equity between people who are and aren't currently covered by ESI, but they threaten to cause many middle-income people to lose insurance coverage and could even reduce the number of people with insurance under plausible assumptions.

In short, there is no magic bullet to expand health insurance coverage with minimal disruptions and low cost to the Treasury. The president's plan is relatively frugal, but would cause millions of workers to lose their employment-based health insurance. It might not even reduce the number of people without insurance. The generous credit for non-group health insurance would allow many more people to acquire insurance than under the president's plan, but would also cause more people to lose coverage, and the budget cost would be much greater. The other options minimize disruption, but would vastly increase the deficit.

Notes

This brief is an abbreviated version of "Tax Credits for Health Insurance," Tax Policy Center Discussion Paper No. 19, June 2005.

1. For more information, see Leonard E. Burman, Cori E. Uccello, Laura Wheaton, and Deborah Kobes, "Tax Incentives for Health Insurance" (Washington, DC: The Urban Institute, 2003), Tax Policy Center Discussion Paper No. 12.

2. This assumes that the credits would be available for use at the time the individual must pay premiums for health insurance, rather than after the end of the year at tax filing time. At least in theory, this is feasible. President Bush has proposed credits that would be transferable to insurers who sell qualifying insurance at a discount that reflects the credit amount. In principle, a similar mechanism could allow employers to pay all or a portion of premiums on behalf of qualifying employees using transferable credits. In practice, such a mechanism is likely to be very difficult to implement effectively.

3. Compared with the president's proposal, this option provides subsidies to people with much higher incomes. Households with incomes up to $92,550 would qualify for at least a partial credit toward their family health insurance premiums.

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