The Henry J. Kaiser Family Foundation

Coverage and Cost Impacts of the President's Health Insurance Tax Credit and Tax Deduction Proposals

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THE HENRY J. KAISER FAMILY FOUNDATION

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Introduction

Over 43 million people in America did not have health insurance in 2002, an increase of almost 2.5 million people over the previous year. As the number of uninsured continues to grow, policymakers continue to debate appropriate policy responses. President Bush, in his 2005 federal budget, proposed several new programs to increase the affordability of health insurance. This issue brief looks at the coverage impacts and costs of the two largest components of the President's proposal: a new tax credit for people purchasing non-group health insurance and a new tax deduction for premiums for high-deductible, non-group health insurance policies.[1]

The estimates presented below were prepared by Jonathan Gruber, Ph.D., Professor of Economics at the Massachusetts Institute of Technology, using a microsimulation model developed in conjunction with the Kaiser Family Foundation. The model, described in more detail in Appendix 1, predicts how individuals and firms would respond to changes in the health insurance market induced by changes in government policy.

Overall, this analysis finds that the President's tax credit and tax deduction proposals for non-group health insurance, when fully implemented, would increase the number of people with health insurance by almost 1.3 million, at a cost of more than $4,700 per newly insured person.[2] As discussed in more detail below, while the net change in the number of people with insurance is relatively small, these policies would result in a substantial movement of individuals away from employer-based coverage and into the non-group market, or in some cases, into being uninsured. Also of significance, the tax credit and tax deduction policies together result in a lower number of newly insured people, and a higher cost for each person newly insured, than the tax credit policy would achieve standing alone.

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[1] See Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2005*, at 151-2 (Helping the Uninsured). President Bush also proposed to permit small business to group together to jointly purchase or fund health coverage through entities call Association Health Plans. See *Id*, at 229. We did not estimate the potential coverage or cost impacts of this proposal. The Congressional Budget Office, in 2000 estimated a similar proposal as increasing the number of people with insurance by about 330,000. Congressional Budget Office, CBO Paper, "Increasing Small-Firm Health Insurance Coverage Through Association Health Plans and Healthmarts," January, 2000.

[2] Results are in 2003 dollars.

The detailed findings of the microsimulation are presented after a description of President's proposed policies. A discussion of the policy issues raised by these results follows.

President Bush's 2005 Budget Proposals

The President's 2005 budget includes several proposals that would subsidize the premium costs of individuals and families purchasing non-group health insurance, including a tax credit for lower-income people purchasing non-group health insurance and a new, above-the-line deduction for premiums paid for high-deductible, non-group health insurance policies.[3]

Tax Credit. The 2005 budget proposes to create a refundable tax credit of up to 90 percent of the premium for non-group health insurance, with a maximum credit of $1,000 per adult and $500 per child for up to 2 children in a family (e.g., the maximum credit for a two adult family with at least two children would be $3,000). Low-income individuals and families (income below $15,000 for individuals and $25,000 for families) would receive the 90 percent credit; the subsidy percentages would then decline with income, phasing-out at $30,000 for individuals with no dependents, $40,000 for single adults with dependents, and $60,000 for two-adult families.[4] The credit could be claimed either as part of the normal tax-filing process or in advance at the time that the insurance is purchased. In addition to non-group health insurance, the tax credit could be applied toward the cost of coverage purchased through private purchasing groups, state high-risk pools, and state-

Examples of Maximum Tax Credits Under Proposed Policy in 2005:

One Adult w/o Dependents			
Adjusted Gross Income	$15,000 and Less	$20,000	$30,000
Maximum Credit	$1,000	$556	$0

Two Adults, Two Children			
Adjusted Gross Income	$25,000 and Less	$40,000	$60,000
Maximum Credit	$3,000	$1,714	$0

[3] The information in this section is taken from U.S. Department of Treasury, *General Explanations of the Administration's Fiscal Year 2005 Revenue Proposals*, February 2, 2004.

[4] The proposed policy establishes a maximum premium that is eligible for the credit, which in 2005 would be $1,111 for adults and $556 for children. Establishing a maximum premium means that the maximum credit amount also declines with income, as demonstrated by the examples above.

sponsored insurance purchasing groups, although the analysis here looks only at the use of the credit in the non-group health insurance market.[5]

Tax Deduction for High-Deductible Health Insurance Premiums. The 2005 budget also proposes to permit individuals to take a deduction from adjusted gross income for 100% of the premiums that they pay for high-deductible, non-group health insurance purchased in combination with a Health Savings Account (HSA). An HSA is an individually owned account, similar to an IRA, which can be funded with contributions by individuals or their employers to pay for health care on a pre-tax basis (i.e., the funds contributed to the HSA are not subject to income or, for employee contributions, payroll taxes). HSAs were authorized by the recently enacted Medicare Prescription Drug, Improvement and Modernization Act.[6] Only individuals with qualifying high-deductible health insurance policies are permitted to create and make contributions to an HSA. A high-deductible health insurance plan is generally a health insurance policy that has a deductible of at least $1,000 for self-only coverage and at least $2,000 for family coverage.[7] Under current law, an individual may take an itemized deduction for non-group health insurance only if the individual has unreimbursed medical expenses that exceed 7.5 percent of his or her income. The 2005 budget would permit individuals to deduct premiums for high-deductible, non-group plans purchased in conjunction with an HSA without regard to the 7.5 percent threshold.

Results of Analysis

The tax credit and tax deduction proposals were analyzed using a microsimulation model that predicts how individuals and employers would respond to policy changes affecting the health insurance market. The model assumes that the policy changes were effective in 2003 and that all behavioral changes occur in that year. To make the relative impact of each of the two proposals clearer, the results are presented in two parts: the first part presents the impacts of the tax credit proposal alone and the second part presents the combined impacts of the tax credit and tax deduction proposals.

Tax Credit Analysis

A little over 10 million people would use the tax credit proposed by President Bush, comprising about 4.5 percent of the population below age 65 (Table 1). About 3.1 million of the tax credit users would be from the previously uninsured, with the remainder being people who were previously insured in the non-group market, through an employer, or by Medicaid. Almost one-half (48%) of people previously insured in the non-group market would use the tax credit.

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[5] States would also have the option, beginning in 2006, of allowing the credit to be used toward the purchase of coverage in privately contracted state-sponsored purchasing groups, such as Medicaid or SCHIP purchasing pools.

[6] P.L.108-173, Sec. 1201 (2003).

[7] *Id.* In addition, to qualify as a high-deductible health plan, the sum of the deductible and the maximum allowable out-of-pocket expenses under the health plan cannot exceed $5000 for self-only coverage and $10,000 for family coverage.

Table 1: TAX CREDIT TAKE UP

	People in Millions
Total Persons Using the Tax Credit	10.3
Previously Uninsured	3.13
Previously Non-Group	4.81
Previously Employer Coverage	1.82
Previously Medicaid	0.53

Despite over 10 million people using the tax credit, including over 3 million previously uninsured people, the proposed policy would reduce the total number of uninsured under age 65 by only a little over 1.8 million people. As shown in Table 2, the proposed policy would result in almost 3.4 million people losing employer-based coverage. While most of the people losing employer-based coverage would remain covered either by non-group health insurance or by Medicaid, over 1.3 million of them would become uninsured under the policy.

Table 2: CHANGE IN SOURCE OF INSURANCE

	People in Millions
Change in Uninsured	-1.82
Moved to Non Group	-3.13
Moved from Employer Coverage To Uninsured	+1.32
Change in Non-Group Enrollment	+5.49
Moved from Uninsured	+3.13
Moved from Employer Coverage	+1.82
Moved from Medicaid	+0.53
Change in Employer Coverage	-3.38
Moved to Non-Group	-1.82
Moved to Medicaid	-0.24
Moved to Uninsured	-1.32
Change in Medicaid	-0.3

Those gaining insurance under the tax credit policy would on average be younger, and somewhat healthier than the uninsured population overall (Table 3). They also would be younger on average than the total population under age 65. Interestingly, those who lose coverage and become uninsured under the policy also would on average be healthier than the uninsured overall, while their average age is somewhat higher than the average for the uninsured overall or the total population under age 65 (Table 3).

Table 3: AGE AND HEALTH STATUS CHARACTERISTICS OF PEOPLE GAINING AND LOSING COVERAGE UNDER TAX CREDIT POLICY

	Population Under Age 65	Uninsured Before Policy Change	Newly Insured Under Policy	Newly Uninsured Under Policy
Total (millions)	230.79	38.31	3.13	1.3
Average Age	29.9	30.0	25.0	33.8
Excellent Health	38.6%	28.6%	40.1%	38%
Very Good Health	32.8%	31.8%	34.4%	34.5%
Good Health	22.1%	30.6%	23.3%	21.3%
Fair or Poor Health	6.6%	9.1%	2.2%	6.2%

The tax credit policy standing alone would have a one-year cost of about $4.7 billion (Table 4). About one half of the new spending would go toward people already insured through non-group health insurance, with the other half going to subsidize the previously uninsured. Some of the new spending would be offset by savings that would occur from a reduction in tax expenditures for people who previously would have been covered under employer-based coverage and from a small reduction in Medicaid enrollment. Overall, the tax credit policy would cost about $2,570 for each of the 1.8 million who become newly insured.

Table 4: COST OF TAX CREDIT PROPOSAL

	$ Billions
One Year Total Cost	4.67
Cost for Previously Uninsured	3.32
Cost for Previously Non Group	3.45
Savings from Previously Medicaid	-.18
Savings from Previously Employer Coverage	-1.93
Cost Per Newly Insured	$2,570

Combined Tax Credit and Tax Deduction Analysis

Over 15 million people would use either the tax credit or the tax deduction proposed if the two policies were offered together (Table 5). Almost 4 million previously uninsured people would benefit from one of the policies, along with 11.6 million people previously insured by non-group health insurance, through an employer or by Medicaid. Combining the tax deduction with the tax credit policy adds an additional 5 million people to the total number of users; almost 4.5 million of these additional users would have been previously insured while just under 800,000 would have been previously uninsured. Over three quarters (78%) of people previously insured in the non-group market would use either the tax credit or deduction.

Table 5: COMBINED CREDIT AND DEDUCTION TAKE UP

	People in Millions
Total Persons Using the Credit or Deduction	15.6
Previously Uninsured	3.90
Previously Non-Group	7.82
Previously Employer Coverage	3.25
Previously Medicaid	0.57

Although the combined tax credit and tax deduction policies would have significantly more users than the tax credit policy alone, the number of people who would become newly insured, 1.3 million, actually is less than the 1.8 million that would become newly insured with tax credits alone (Tables 6 and 2). Relative to the tax credit policy alone, the combination of the policies would increase the number of previously uninsured who take up coverage by almost 800,000, but this increase in coverage would be more than offset by an additional 1.3 million people who would lose employer-based coverage and become uninsured (2.6 million under the combined policies v. 1.3 million under the tax credit alone). There also would be an additional 1.4 million people moving from employer-based coverage to non-group health insurance (3.3 million v. 1.8 million) under the combined policies as compared to the tax credit alone (Tables 6 and 2).

Adding the tax deduction to the tax credit policy would not affect the average age, health status or health care costs of those gaining or losing coverage, as compared with the impacts of the tax credit alone.

The net one-year cost of the tax credit and tax deduction policies together would be about $6.0 billion dollars, which is about $1.3 billion higher than the tax credit policy alone (Tables 7 and 4). A substantial share (59%) of the new spending would go toward people previously covered by non-group health insurance, with the remainder going to subsidize the previously uninsured. A fairly significant amount of the new spending would be offset by savings that would occur from a reduction in tax expenditures for people who previously would have been covered under employer-based coverage ($3.8 billion) and from a small reduction in Medicaid enrollment.

Table 6: CHANGE IN SOURCE OF INSURANCE

	People in Millions
Change in Uninsured	-1.27
Moved to Non Group	-3.90
Moved from Employer Coverage To Uninsured	+2.63
Change in Non-Group Enrollment	+7.72
Moved from Uninsured	+3.90
Moved from Employer Coverage	+3.25
Moved from Medicaid	+0.57
Change in Employer Coverage	-6.25
Moved to Non-Group	-3.25
Moved to Medicaid	-0.37
Moved to Uninsured	-2.63
Change in Medicaid	-0.21

Table 7: COST OF TAX CREDIT PROPOSAL

	$Billions
One Year Total Cost	6.05
Cost for Previously Uninsured	4.10
Cost for Previously Non Group	5.96
Savings from Previously Medicaid	-.20
Savings from Previously Employer Coverage	-3.82
Cost Per Newly Insured	$4,780

Overall, the tax credit policy would cost about $4,780 for each of the 1.3 million who become newly insured, which is about 85 percent higher than the cost per newly insured under the tax credit policy alone (Tables 7 and 4).

Implications for Policy

This analysis of President Bush's tax credit and tax deduction proposals shows that they would increase the number of people with health insurance, although the tax credit proposal, standing alone, would have a larger impact on coverage than the two proposals combined. Given that an important goal of the tax deduction policy is to level

the playing field[8] under federal tax law between employer-based coverage and non-group health insurance, the fact that the tax deduction policy raises federal costs without increasing coverage may be an acceptable outcome for its proponents.[9]

Two findings in particular raise important questions for policymakers considering these proposals. The first is the impact of both the tax credit and tax deduction proposals on people with employer-based coverage. By offering tax subsidies for non-group health insurance, the policies would reduce the preference under current tax law for employer-based coverage over non-group insurance, with the likely result that fewer employers would offer health benefits to their employees.[10] In some cases, these employees would not find other insurance, either because they would not want to pay the premiums for non-group insurance or because health problems could make it difficult for them to find affordable coverage in some states. This is not to say that any new problems encountered by people who would lose insurance under these proposed policies are necessarily greater or more important than the financial access problems faced by the people who would benefit from the tax credit and deduction policies, but policymakers need to be aware of the potential for disruption in the group insurance market. In particular, people with health problems who lose employer-based coverage would likely face higher premiums and more coverage restrictions in the non-group health insurance market than they currently face when receiving health benefits through work. These same problems—relatively high premiums and coverage restrictions—already exist for people with health problems purchasing non-group health insurance in most states today. Policymakers may want to consider whether current market responses for people with health problems, such as state high risk pools, are sufficient to assure the availability and affordability of coverage for this population

A second question raised by these findings relates to who benefits from the proposed policies. As shown in Table 3, the newly insured under the tax credit policy (and the results for the combined policies are almost identical) tend to be younger and healthier than the uninsured overall, and tend to be younger than the under 65 population as a whole. This raises the question of whether these policies could be modified to provide more assistance to older or less healthy uninsured people, or whether an additional policy response, such as a public coverage expansion, would be needed to increase insurance access for these more costly groups of uninsured people.

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[8] Under current law, employer contributions, and in some cases worker contributions, to employer-based health insurance are not includable in workers' incomes. The proposed tax deduction policy would give almost equal treatment to non-group insurance.

[9] The President's budget documents are somewhat unclear about the primary policy justification for the tax deduction policy. The policy is presented under the title of "Helping the Uninsured" in Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2005*, at 151-2; while in the Treasury Blue Book, the justifications offered for the policy are to level the playing field with employer-based insurance under the tax code and to encourage people to use more cost-effective high-deductible health plans in conjunction with HSAs. U.S. Department of Treasury, *General Explanations of the Administration's Fiscal Year 2005 Revenue Proposals*, February 2, 2004.

[10] If the tax preference to workers for receiving health benefits through work were reduced or eliminated, worker demand for employer-based coverage would be reduced, with the result that fewer employers would see the need to offer health benefits to attract the workers that they want. Note that a similar result would occur under other tax credit proposals that would offer a credit to individuals (rather than to employers) to join a group purchasing arrangement such as the Federal Employees Health Benefits Program.

The President's budget proposals continue and expand the debate over how to help people without health insurance. The proposed approach draws public attention to the lack of public subsidies under current law for people who buy non-group insurance, despite the fact that many of them have low incomes. This report suggests that the proposed policies would provide substantial new public financial support for non-group purchasers, with some important implications for other parts of the market. The findings presented here should assist policymakers as they grapple with alternative approaches for dealing with this very difficult problem.

Appendix 1

Description of Gruber Microsimulation Model

The model allows the user to input a set of policy parameters, and output the impact of that policy on public sector costs and the distribution of insurance coverage. The modeling approach used here is the type of "microsimulation" modeling used by the Treasury Department, Congressional Budget Office, and other government entities. This approach consists of drawing on the best evidence available in the health economics literature to model how individuals will respond to the changes in the insurance environment induced by changes in government policy.

The model takes as its base the February and March, 2001 Current Population Surveys (CPS). The March survey contains information on family demographics, tax rates, and insurance coverage. The February survey contains information on insurance offering by employers. Information from these surveys is matched to information on:

- Group insurance costs and the distribution of premiums across employers and employees, imputed by firm location and firm size using data from the 2003 Employer Health Benefits Survey by the Kaiser Family Foundation and Health Research and Educational Trust.
- Non-group insurance costs, which use a base cost estimated from existing non-group insurance pricing, adjusted by age, sex, and health status.
- Public insurance costs, estimated as a function of age, sex and health status from the Medical Expenditure Panel Survey (MEPS).

This base set of data are then used to compute, for possible policy changes, the impact of those policy changes on the eligibility for, and price of, various types of insurance. These price and eligibility changes are then run through a detailed and integrated set of behavioral equations that relate them to behavioral responses by individuals, families, and firms. These behavioral responses are modeled using the best available evidence from the health economics literature, and include responses such as:

- The extent to which the currently uninsured will purchase newly subsidized insurance coverage or take up newly available public coverage.
- The extent to which those with existing insurance coverage will take up subsidies for that type of insurance coverage (e.g. to what extent will the non-group insured take up subsidies to non-group insurance?)
- The extent to which those with one form of insurance coverage will switch to another form if it is subsidized.
- The extent to which firms will react to the subsidies to non-employer insurance by dropping their offering of insurance to their employees, or by cutting back on employer premium contributions to insurance.
- The extent to which those employees dropped from group coverage will then take up other forms of insurance coverage.

The model estimates potential firm responses to these policy changes. To capture firm responses, "synthetic" firms have been created in the CPS by drawing for each worker other "co-workers" in the CPS based on that worker's wage, industry, firm size, and health insurance offering status. These synthetic co-workers are grouped together to form firms, and firm responses are modeled based on the average effects of policies on their workforce.

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