The LEWIN GROUP
www.lewin.com

President Bush's Health Care Tax Deduction Proposal: Coverage, Cost and Distributional Impacts

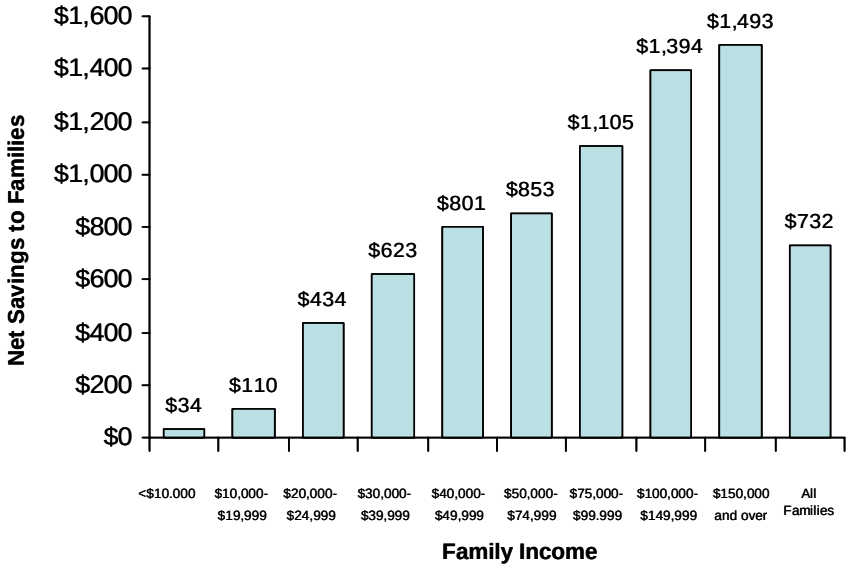
John Sheils and Randy Haught

President Bush proposes to replace the existing tax exemption for employer-sponsored Insurance (ESI) with a single tax deduction ($7,500 single; $15,000 family). The tax deduction is available to people with private health insurance, regardless of whether it is ESI or non-group coverage. Allowing a deduction for non-group coverage would help people without ESI purchase insurance, thus reducing the number of uninsured.

Tax filers would count employer spending for ESI as taxable income for both income and payroll taxes, but would receive the full amount of the deduction as long as they have private insurance. Using a fixed deduction amount eliminates existing tax incentives that reward people for taking comprehensive coverage that encourages increased health spending. Key findings include:

- The proposal would reduce the number of uninsured - projected to be 48.4 million people in 2009 - by about 9.2 million people;
- Replacing the existing tax exclusion with the deduction would reduce tax revenues by $61.8 billion in 2009 (includes $0.4 billion in adjustments to other programs);
- Families would save an average of $732 in taxes, premiums and out of pocket spending; although savings would be concentrated among higher income groups (***Figure 1***);

Figure 1
Average After-Tax Savings in Health Spending for Families under President's Proposal [a/]



a/ Estimates are for families with a family head under age 65 and include changes in premiums, out-of-pocket spending, taxes and wages under the proposal.

- About 70 percent of the reduction in taxes would go to families with incomes above $50,000 per year. Only 20 percent would go to currently uninsured people;
- Only about 3.8 percent of uninsured people with incomes below $10,000 would become covered, compared with 38.6 percent of the uninsured with incomes above $100,000 taking coverage;
- About 12.1 million workers and dependents would lose employer coverage, about 79.3 percent of whom would be in firms with fewer than 100 workers:
  - 2.3 million would become uninsured;
  - 1.1 million would become covered under Medicaid or SCHIP; and
  - 8.7 million would buy individual non-group coverage with the tax deduction.
- The proposal would increase the federal deficit in 2009 by $61.8 billion. This is an average federal expenditure of $6,720 per newly insured person;
- The initial increase in the deficit would decline from $61.8 billion in 2009 to a net reduction in the deficit of $45.3 billion in 2018. This is because the tax deduction would increase with the Consumer Price Index (CPI) of about 2.4 percent per year, while the tax exclusion that it replaces would have grown with health care cost growth at about 7.5 percent per year;
- The net cost of the program over the 2009 to 2018 period would be $153.8 billion; and
- The newly created incentives for people to enroll in lower-cost health plans would reduce health spending by about $24.5 billion in 2009, which is about 0.2 percent of health spending for the under age 65 population.

President Bush's Health Insurance Tax Deduction Proposal

President Bush has proposed to replace the existing tax exemption for employer-sponsored Insurance (ESI) and other tax benefits with a single tax deduction that would be available to all people with private health insurance (except Medicare supplemental coverage). Tax filers would count the cost of employer health benefits as taxable income for both income and payroll taxes. Tax filers with either ESI or private non-group coverage would then receive a tax deduction of $7,500 for single individuals or $15,000 for families for both income and payroll taxes, regardless of the amount actually spent on coverage. The proposal is designed to expand coverage and to reduce costs by eliminating tax incentives that reward higher spending for health coverage.

Under the proposal, people in the individual market would now be able to receive the same tax benefits provided to people with ESI. Under current law, the cost of employer health insurance is tax exempt, which means that the worker does not pay taxes on the amount spent for health insurance.[1] People who purchase non-group coverage receive no comparable tax benefit. President Bush's proposal would provide the tax deduction to all people with private coverage regardless of whether it is in the form of ESI or non-group insurance. This is intended to help

[1] The employer contribution for health benefits is exempt from the income tax and the social security payroll tax, as are employee contributions in firms with Section 125 flexible benefits plans.

people without access to ESI purchase non-group insurance, resulting in a reduction in the number of uninsured. This also reverses the inequity in the tax code that favors ESI.

Another feature of the proposal is that it eliminates tax-based incentives that reward increased health spending. The current tax exclusion for ESI applies to the full cost of ESI (or in some cases the employer's share) regardless of the amount spent, while out-of-pocket spending for health services generally is not tax exempt.[2] This creates incentives for people to obtain comprehensive coverage to maximize the share of their health spending paid from pre-tax (i.e., tax exempt) income. However, comprehensive coverage promotes increased utilization of health services because people face little or none of the cost of care at the point of service.

The President's proposal is designed to eliminate the tax incentive to enroll in more comprehensive plans by providing a fixed health care deduction that can not be increased by spending more on health care. In particular, the entire cost of health plans in excess of the deduction amount would be subject to taxation, which would further reduce incentives for people to spend more on health care.

Basis of Estimates

We estimated the impact of the President's proposal using The Lewin Group Health Benefits Simulation Model (HBSM). HBSM is a micro-simulation model of the US health care system designed to estimate the impact of alternative health reform models on coverage and expenditures for employers, governments and households. It is based upon the Medical Expenditures Panel Survey (MEPS) that we use together with the March 2006 Current Population Survey (CPS), and several other data sources.

These data provide a representative sample of households in the US, which includes information on the economic and demographic characteristics of individuals as well as their utilization and expenditures for health care. We also use the Kaiser/HRET survey of employers for policy scenarios involving employer level decisions. We adjusted these data to show the amount of health spending by type of service and source of payment as estimated by the Office of the Actuary of the Centers for Medicare and Medicaid Services (CMS) and other government agencies.

HBSM models the effects of proposals designed to subsidize the cost of insurance to employers, workers and families. These include deductions, tax credits, premium subsidies and other approaches that subsidize and/or reduce the cost of insurance to individuals and employers. Our central assumption is that changes in personal income and payroll taxes related to health benefits will be seen as a change in the price of insurance, thus affecting the likelihood of taking or offering coverage. We estimate these price responses based upon research and multivariate analyses of how the likelihood of offering or taking coverage varies with the price of insurance. HBSM also simulates eligibility and enrollment under Medicaid.

---

[2] Tax filers are permitted to deduct the amount of spending for insurance and out-of-pocket payments for health services in excess of 7.5 percent of adjusted gross income (AGI).

The model also simulates changes in spending for other payers due to these proposals. The model estimates changes in health spending as the uninsured become covered and savings resulting from cost-containment initiatives under each proposal. HBSM also estimates changes in uncompensated care and savings to safety-net programs as uninsured people obtain coverage. In addition, it simulates changes in spending for employers and families resulting from the proposal.

Detailed analyses tables for the President's proposal are presented in ***Attachment A.*** A description of HBSM and key assumptions is presented in ***Attachment B***.

Impact of President Bush's Proposal on Coverage

We project that under current policy there will be about 48.4 million people without health insurance in 2009. Under the President's health care tax deduction proposal, about 11.5 million of the uninsured would become covered, mostly due to an increase in the number of people taking individual non-group coverage (***Figure 2***). However, about 2.3 million people would become uninsured when their employer coverage is discontinued as a result of eliminating the tax preference for ESI (see discussion below). Thus, there would be a net reduction in the number of uninsured of 9.2 million people. About 39.2 million people would continue to be uninsured.

Figure 2
Change in Number of Uninsured under the President's Proposal (millions)

	Number of People
Uninsured Under Current Law in 2009	48.4
Newly Covered	(11.5)
People who Become Uninsured	2.3
Total Uninsured Under Proposal	39.2
Net Reduction in Uninsured	**9.2**

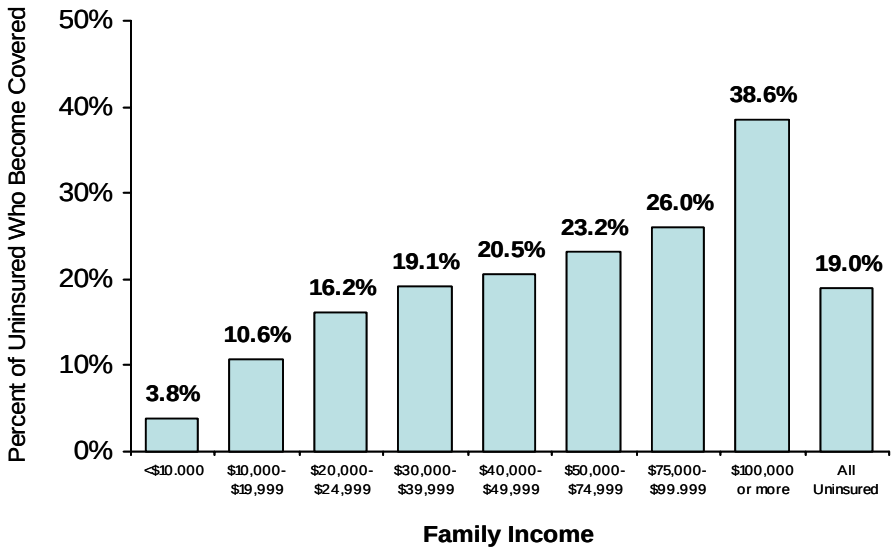
Source: The Lewin Group estimates using the Health Benefits Simulation Model (HBSM).

The proposal would disproportionately increase coverage among higher income groups. Only about 3.8 percent of uninsured people in families with incomes below $10,000 would become insured (***Figure 3***). The percentage of uninsured taking coverage would increase as income rises. For example, about 38.6 percent of uninsured people with incomes of $100,000 or more would take insurance due to the new tax deduction.

Changes in Employer Coverage

The President's proposal eliminates the relative tax advantage of employer provided insurance, resulting in fewer employers offering coverage, and a net reduction in the number of people with employer coverage of about 11.0 million people. Under current law, the tax exclusion for employer health benefits effectively reduces the cost of insurance to workers. Creating a tax deduction of an equal amount for both employer and non-group coverage eliminates the relative tax advantage of providing coverage through the employer, resulting in a shift of people away from ESI to private non-group coverage.

Figure 3
Percent Reduction in Uninsured by Income under President Bush's Tax Deduction Proposal: 2009



Source: The Lewin Group estimates using the Health Benefits Simulation Model (HBSM).

With the elimination of the relative tax advantage of employer coverage, some employers are expected to discontinue their coverage, particularly in cases where their workforce can obtain individual coverage for less than what the employer would have to pay in the small group market. This would typically occur among small firms with younger and healthier workers in states where insurers are permitted to provide greater discounts for age and health status in the individual market than are permitted in the small group market.[3] We estimated the number of such firms in this circumstance that would discontinue their ESI using HBSM and a multivariate model of how changes in price affect the selection of health plans.[4]

Under current law, we project that there will be about 153.7 million workers and dependents with ESI in 2009.[5] Using the assumptions discussed above, we estimate that about 12.1 million covered workers and dependents would be in a firm that discontinues health insurance (***Figure 4***). This would be partly offset by about 300,000 people in firms where the employer is simulated to start to offer coverage.[6] Also, we estimate that there are about 800,000 workers and dependents that have declined the coverage offered to them at work who would now take ESI in cases where the value of the tax deduction is greater than the value of the existing tax exclusion.[7] Thus, we estimate a net reduction in ESI enrollment of about 11.0 million people.

---

[3] For example, some states restrict the amount by which premiums may vary with age and health status in the small group market, but permit insurers to vary premiums with age, health status and other risk factors in the individual market.

[4] Firms were selected to discontinue coverage based upon multivariate analyses of the likelihood of moving to an alternative health plan in response to a change in the relative price of that plan.

[5] This is an estimate of average monthly enrollment in employer plans.

[6] We assume that employers would offer coverage if employer coverage would be less costly than non-group coverage, in cases where at least 75 percent of the workers in the firm would have taken non-group coverage.

[7] Workers get the full amount of the deduction regardless of the actual premiums, while the value of the tax exclusion is limited to only the cost of insurance.

Of the 12.1 million people who would lose their employer coverage, about 2.3 million would become uninsured (19 percent). About 1.1 million would become covered under Medicaid and 8.7 million would take individual coverage (***Figure 4***).

Figure 4
Changes in Employer Coverage under President Bush's Tax Deduction Proposal (millions)

Change in Employer Coverage	
Current law ESI coverage	153.7
Firms discontinuing ESI	(12.1)
Firms that start offering ESI	0.3
Increased take-up for existing ESI	0.8
Net change in ESI enrollment	**(11.0)**

Coverage Status for Those Losing ESI	
People losing ESI	12.1
Coverage Status	
Take non-group	8.7
Enroll in Medicaid	1.1
Become uninsured	2.3

Source: The Lewin Group estimates using the Health Benefits Simulation Model (HBSM).

The loss of employer coverage would be greatest among small employers. The number of workers and dependents with ESI in firms with fewer than 10 workers would fall by about 25.9 percent (***Figure 5***). About 79.3 percent of workers losing coverage are in firms with fewer than 100 workers. This reflects that administrative costs for larger groups can be substantially lower than in both the small groups and individual markets, thus retaining a financial incentive for large groups to provide ESI.

Figure 5
Percent Change in Workers and Dependents with Employer Coverage by Firm Size

Source: The Lewin Group estimates using the Health Benefits Simulation Model (HBSM).

Impact on the Federal Budget

The President's proposal would increase the federal deficit by about $61.8 billion in 2009 (***Figure 6***). The total amount of tax revenue lost due to the new deduction would be $297.2 billion, including income and Social Security taxes. These revenue losses would be largely offset by about $236.1 by requiring workers to count the value of their ESI coverage as taxable income. Thus, there would be a net reduction in federal tax revenues of $61.8 billion in 2009.

Figure 6
Changes in Federal Deficit under President Bush's Health Care Tax Deduction Proposal in 2009 (billions)

New Program Costs		
Private Insurance Tax Deduction		$297.2
Income Tax	$179.1	
Payroll Tax	$118.1	
Medicaid Spending		$1.6
Revenue Offsets		
Revenue From Taxing ESI		$236.1
Income Tax	$138.3	
Payroll Tax	$97.8	
Other Adjustments		$0.9
Net Increase (Decrease) in Deficit		
Deficit Increase		$61.8

Source: The Lewin Group estimates using the Health Benefits Simulation Model (HBSM).

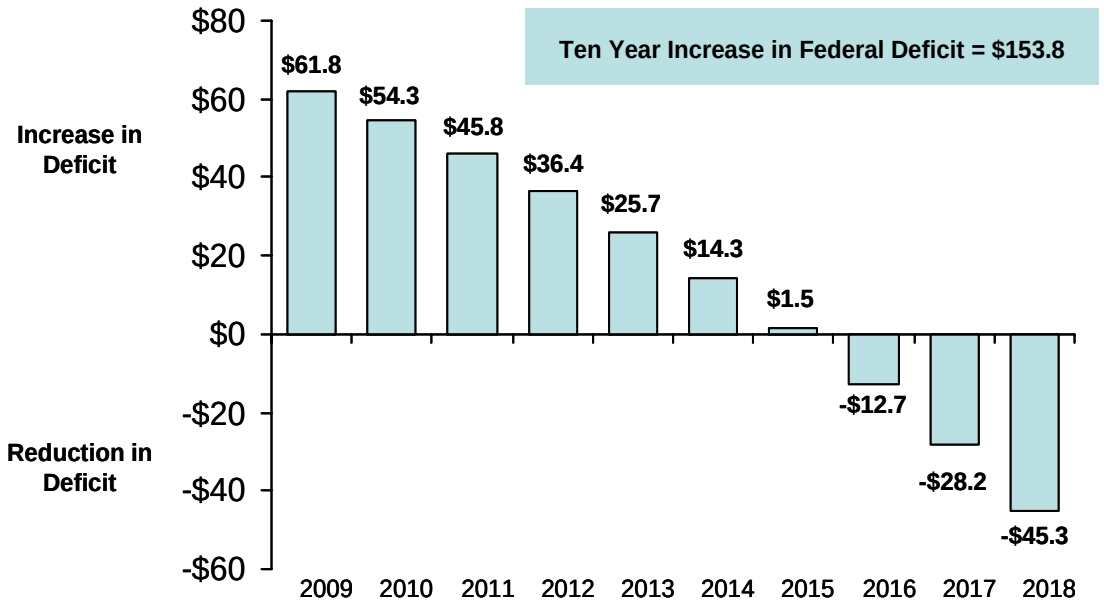
We estimate that there would be some changes in spending for Medicaid and other government health programs under the proposal. Medicaid spending would increase by about $1.6 billion for the 1.1 million people who would enroll in Medicaid or the State Children's Health Insurance Program (SCHIP) after their employer coverage is terminated. After accounting for this and other adjustments, the program would result in a net increase in the federal deficit in 2009 of $61.8 billion.

The increase in the deficit would diminish in the following years because of the way the tax deduction amount is indexed. The deduction amount (i.e., $7,500 single; $15,000 family) is indexed each year to the growth in general price levels as measured by the consumer price index (CPI), which is about 2.8 percent per year. Because health care costs are projected to grow at about 7.5 percent per year, the revenue gain from taxing employer benefits will grow faster than the revenue loss due to the deduction.[8]

[8] Estimate based upon projections of health care cost growth developed by the Office of the Actuary of the Centers for Medicare and Medicaid Services (CMS).

Consequently, by 2015 the proposal would result in a net reduction in the federal deficit of about $12.7 billion. The net effect of the proposal over a ten-year period from 2009 through 2018 would be a net increase in the federal deficit of about $153.8 billion (***Figure 7***).

Figure 7
Change in Federal Deficit under President Bush's Health Care Tax Deduction Proposal: 2009 – 2018 (billions)



Source: The Lewin Group estimates using the Health Benefits Simulation Model (HBSM).

Impact on Family After-Tax Health Spending

We estimate that the President's proposal would reduce family after-tax health spending by an average of about $732 in 2009 for families with a family head under the age of 65 (i.e., non-elderly families). This includes changes in taxes, premiums, out-of-pocket spending and wages resulting from the proposal. Family spending for health insurance premiums would increase by about $252 per family, reflecting an increase in the number of families purchasing private health insurance in the non-group market. Family out-of-pocket spending for health services would also increase, reflecting a shift to plans with higher deductibles (***Figure 8***).

Tax subsidies for health benefits would increase by about $730 per non-elderly family under the proposal. This is the average amount of tax savings to families due to the deduction, less the average increase in family taxes due to the taxation of employer provided health benefits.

In addition, we estimate an increase in after-tax wages averaging $404 per family due to the reduction in employer spending for health benefits. This includes savings to employers who discontinue their health plans and savings resulting from a shift to lower-cost health plans. In this analysis, we assume that reductions in employer spending for health benefits would be passed back to workers in the form of increased wage growth.

Figure 8
Changes in Average After-Tax Health Spending with a Family Head under Age 65 under President Bush's Health Care Tax Deduction Proposal in 2009

Family Income	Current Law Premiums and Out-of-Pocket Spending	Changes Under Proposal				
		Change in Premium Payments	Change in Out-of-Pocket Payments	Net Increase in Tax Subsidies [a/]	Increased Wages [b/]	Total Net Change in Family Spending for Health
less than $10,000	$1,462	$39	$36	$2	$107	-$34
$10,000-$19,999	$1,736	$132	$155	$255	$142	-$110
$20,000-$29,999	$2,603	$232	$106	$479	$293	-$434
$30,000-$39,999	$3,004	$262	$134	$629	$390	-$623
$40,000-$49,999	$3,568	$300	$114	$771	$446	-$803
$50,000-$74,999	$4,324	$309	$175	$859	$478	-$853
$75,000-$100,000	$4,897	$294	$280	$1,130	$549	-$1,105
$100,000-$149,999	$5,218	$312	$133	$1,240	$599	-$1,394
$150,000 or more	$5,865	$407	$194	$1,390	$704	-$1,493
All families	$3,582	$252	$150	$730	$404	-$732

a/ This is the amount of tax savings from the new tax deduction less the tax savings from the current tax exclusion. This is counted here as a reduction in health spending for the family.
b/ Wage increase for workers in firms that discontinue health benefits. These wage increases are counted here as an offset to health spending.
Source: The Lewin Group estimates using the Health Benefits Simulation Model (HBSM).

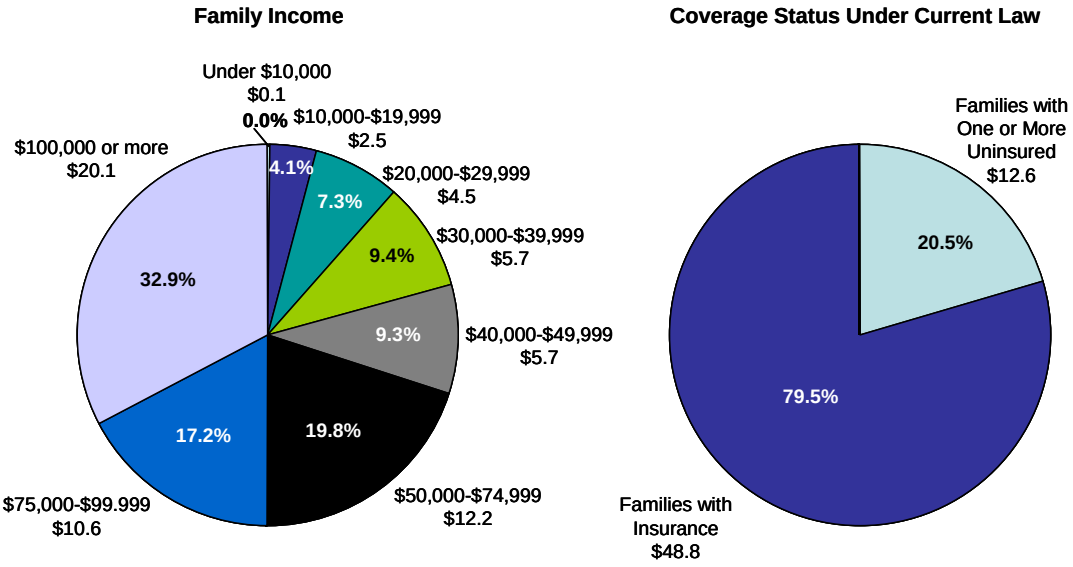
The savings to families would vary with income. People with less than $10,000 annual income would save an average of about $35 per family. Average savings increase steadily with income, reaching an average savings of about $1,493 per family among those with incomes of $150,000 or more. This is because the value of the deduction would be greatest for those in higher income-tax brackets. This also reflects that the percentage of uninsured people who take-up coverage due to the tax credit is greatest among those in higher income groups (see ***Figure 3*** above).

Distribution of Tax Subsidies

As discussed above, the tax savings to families from the health care deduction ($297.2 billion) would be greater than the loss of tax subsidies due to the taxation of employer provided health benefits ($236.1 billion). This results in a net increase in tax subsidies for private insurance of about $61.1 billion in 2009 (excludes cost of other effects).

However, most of the increase in tax subsidies will go to higher-income people who already have private health insurance. Only about 20.5 percent of these subsidies would go to those in families where one or more family members are currently uninsured (***Figure 9***). About 70 percent of the increased tax subsidies would go to families with incomes of $50,000 or more.

Figure 9
Distribution of the Net Increase in Tax Expenditures by Family Income and Coverage Status in 2009 (billions)



a/ The change in tax expenditures for a family is the difference between the tax reduction under the deduction and the tax reduction under the current tax exclusion.
Source: The Lewin Group estimates using the Health Benefits Simulation Model (HBSM).

Increased State Flexibility in Expanding Coverage

The President also proposes to give states greater flexibility in using existing federal payments to institutions to fund expansions in coverage. Under Medicaid, states are permitted to make supplemental payments to hospitals serving a disproportionate share of Medicaid patients called Disproportionate Share Hospital (DSH) payments. The Medicare program also makes DSH payments to hospitals serving a large portion of Medicaid patients. These DSH payments have become an important source of revenues for safety-net providers and programs serving uninsured people.

The President's proposal would permit states to use these DSH payments to fund expansions in coverage. Several states have been granted waivers to use Medicaid DSH funds to cover groups not otherwise eligible for federal matching funds such as non-disabled adults who do not have custodial responsibilities for children. Massachusetts and California have passed legislation that would use these funds to expand coverage. However, states have never before been allowed to use the Medicare DSH payments in this way. These funds could be used for a range of Medicaid coverage expansions to children, parents and/or childless adults.

Federal DSH payments are about $8.8 billion under Medicaid and $9.5 billion under Medicare. To illustrate, this is enough to cover about 4.9 million low-income uninsured adults under Medicaid, which would be equal to about 48 percent of all uninsured adults living below the

Federal Poverty Level (FPL).[9] However, this would be merely a shift in funds from safety-net programs serving the uninsured to the group of these uninsured who would become covered, without any increase in the funds available for serving this population.

Eliminating existing DSH payments to hospitals would be controversial. Even with a coverage expansion of this magnitude, there still would be 35 million or more people who would continue to be without insurance. Redirecting DSH to a coverage expansion for a small share of the uninsured would diminish the resources available to serve the millions of people who would remain uninsured. Thus, it is difficult to estimate the number of states that would take this approach and the number of people who would become insured as a result.

Savings Due to Changes in Incentives under the Proposal

A key feature of the President's proposal is that it eliminates incentives that encourage enrollment in comprehensive health plans that lead to higher health spending. We estimated the savings from these changes in incentives assuming that the program has the effect of moving people to lower cost health plans such as HMOs or high deductible plans. We simulated the shift to lower cost plans based upon research on the effect that increases in price for a given insurance product have on the likelihood of moving to an alternative lower-cost health plan.[10]

We assumed that savings in total health spending would be about 12 percent for HMOs and about 4 percent for high deductible plans.[11,12] We assume that half of those selected to shift to lower price plans would enroll in an HMO (unless already in an HMO) with the remaining half enrolling in a high deductible plan (average deductible of $2,000). We estimated total savings of about $24.5 billion in 2009 under the new incentives, which we incorporate into our premium estimates.

---

[9] This estimate assumes that about 3.0 billion in Medicaid DSH funding is already being used to fund coverage expansions. We assume an average cost of about $3,120 per adult.

[10] On average, a one percent increase in the price of an insurance product causes about 2.5 percent of members to shift to lower cost products. No savings are calculated for people currently in HMOs. Source: Stombom, B., Buchmueller, T., Feldstein, P. "Switching Costs, Price Sensitivity and Health Plan Choice", *Journal of Health Economics* 21 (2002) 89-116.

[11] Stapleton, D., "New Evidence on Savings from Network Models of Managed Care", (a report to the Healthcare Leadership Council), The Lewin Group, Washington, DC, May 1994.

[12] Assumes a price elasticity for health spending of -0.2. See: W. G. Manning, J. P. Newhouse, N. Duan, E. B. Keeler, A. Leibowitz, and M. S. Marquis. "Health Insurance and the Demand for Medical Care: Evidence from a Randomized Experiment". *The American Economic Review*, Vol. 77, No. 3, June 1987, pp. 251-277.