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McCain's Health Credit: The Intersection of Health Policy and Tax Policy

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Both candidates for President have spoken a great deal about the nation's health care system, focusing on high costs and the large number who go without health insurance coverage. Health care costs continue to rise more rapidly than incomes, and the number of adults without health insurance persists at roughly 45 million. But while Senators Obama and McCain may agree on the problem, they propose very different solutions.

Senator Obama has focused his policy on increasing the government's role in the nation's health care system. In contrast, Senator McCain proposes to improve today's private health care markets by reducing the imbalances that arise from the tax treatment of health care.

Specifically, he takes aim at the substantial tax subsidy the federal government has provided for employer-based health insurance since World War II. This tax subsidy, at roughly $300 billion to $400 billion per year, is the single largest tax preference in the tax code today, ahead of even the political third rail of the home mortgage deduction.[1]

What may be particularly surprising to some is that despite this enormous tax subsidy, we still have the dual, but related problems of high cost growth and a large segment of the population without any health insurance. Indeed, some have suggested that the tax subsidy may be at least partly responsible for these problems.[2]

Replacing a Tax Exclusion with a Refundable Tax Credit

Although Senator McCain's health care plan has other provisions—changes to insurance regulation, expanded health savings accounts, and a new purchasing pool for people with chronic conditions are a few—the centerpiece of McCain's health policy is a large health tax credit of $5,000 for family coverage and $2,500 for individual coverage. This credit would replace the current income tax exclusion for employer-based insurance.[3] Taxpayers would have to show that they have health insurance to get the credit, and of utmost importance, they would get the full $5,000 or $2,500 even if they bought a less expensive policy. This feature of the policy substantially reduces the link between the size of the tax subsidy and the amount spent on health insurance, and by so doing, sharply reduces the tax-driven biases in our health care system.

Many Would Be Enticed to Buy Health Insurance

The credit creates a very substantial incentive for many to purchase insurance. The credit is fairly sizeable and could cover more than the full cost of health insurance for many, particularly those without chronic conditions. Because people would receive the full credit even if the insurance cost less, the proposal simultaneously provides a powerful incentive to purchase insurance and to purchase an amount of insurance without regard to income tax considerations. Less generous proposals have already been estimated to decrease the number of uninsured by over 15 million, so the McCain health credit would likely at least decrease the number of uninsured from the current 45 million to less than 30 million and probably much further.[4]

People Wouldn't "Overconsume" Health Care Services

What does "overconsumption of health care" mean? Under current tax policies, it's always cheaper for a company to give its employees more generous health care benefits than wages. That's because neither payroll nor income taxes apply to health insurance premiums.

Consider a low-to-middle income employee. If his wages go up, he'll lose 15.3 percent to the payroll tax and another 15 percent to the federal income tax. So he keeps only about 70 cents of each dollar (not counting state taxes). But if his company gives him a more generous health plan, he keeps the full dollar. Thus, the current tax treatment encourages the payment of employee compensation as employer-based health insurance rather than wages.

This creates a health care system where people are encouraged to funnel more health care spending, regardless of how routine, through insurance policies, rather than paying for health care with after-tax wages. Moreover, this treatment also creates an incentive for health insurance to be purchased through employers because that is the most common way to receive the full tax advantage.

More broadly, the current tax treatment reduces the cost of health care relative to other types of consumption. The McCain credit would give people the "cash,"[5] but reduce the tax biases that have contributed to the high cost growth.

Low-Income Workers Would Benefit the Most from the McCain Health Credit

If the McCain health credit would benefit an employee in the 15-percent tax bracket (low and middle incomes), what about a higher-income employee in the 25 percent or 35 percent tax brackets? The current tax treatment is actually more valuable to these higher-income taxpayers who are subject to higher tax rates. This is simply because the value of the current exclusion is equal to a person's insurance premium multiplied by his marginal tax rate.

What this means is that a good deal of the current $300 billion to $400 billion tax subsidy is channeled to middle- and high-income taxpayers—those who face higher tax rates. In contrast, because the McCain health credit is simply a fixed amount—either $5,000 for family coverage or $2,500 for individual coverage—it is worth the same regardless of a person's income. As a consequence, the McCain health credit channels much more of the tax subsidy to low- and moderate-income taxpayers.

Figure 1 below illustrates this point with an example: a married couple with two children. The straight line is the McCain health credit. It's straight because everyone would receive the same health credit—either $5,000 for family coverage or $2,500 for individual coverage—regardless of their tax rate or income. The sloping line is the value of the current tax exclusion for employer-provided health insurance. It slopes upward most of its length because its value generally rises with the couple's marginal tax rate, and most people with high marginal tax rates have high incomes. There is one group in the $15,000-to-$40,000 range for whom the exclusion becomes particularly valuable because that's the income level at which the taxpayer faces an unusually high marginal tax rate due to the phase-out of the earned income tax credit (EITC).

Two points need to be stressed here. First, the McCain credit channels a much higher percentage of the subsidy to low- and moderate-income taxpayers and is therefore a much more progressive policy than the current tax treatment. Second, the McCain health proposal is a net tax cut for most taxpayers because the new health credit exceeds the value of the existing income tax exclusion. Again, the generous credit provides a powerful incentive to purchase health insurance.

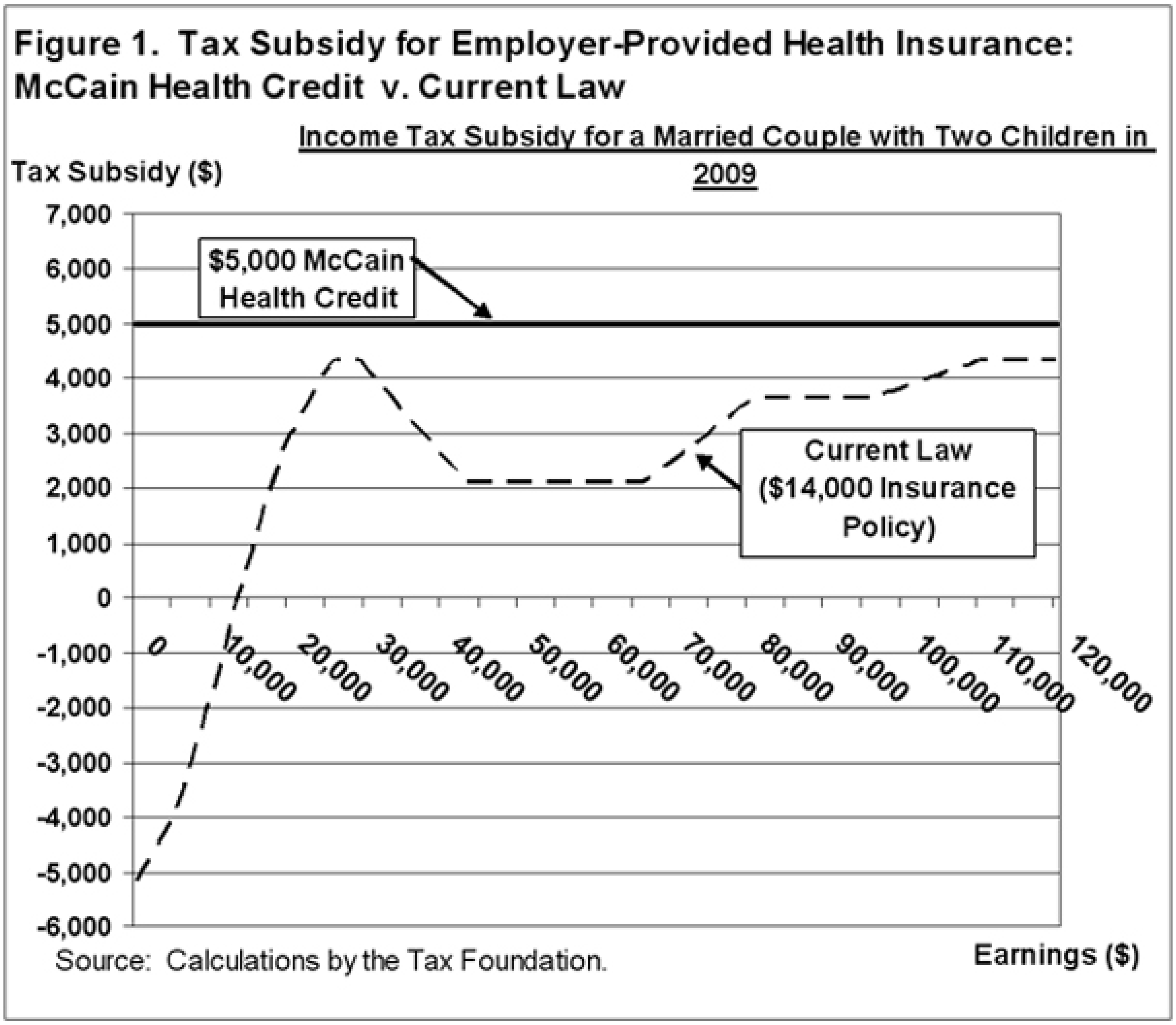
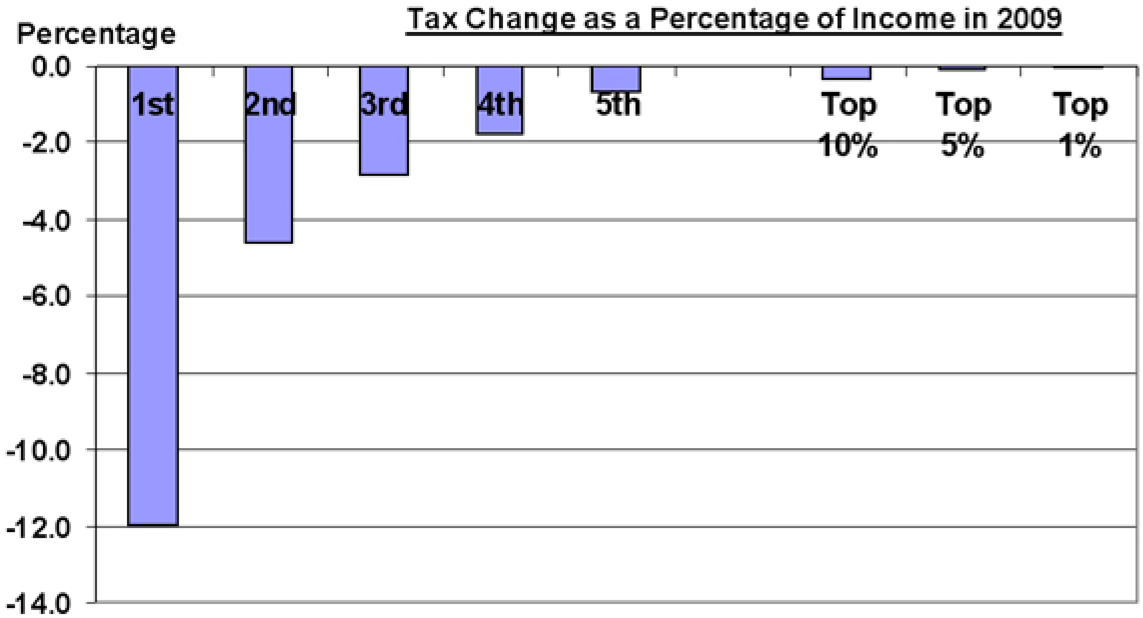


Figure 2 below shows how much each income group would benefit from the McCain health credit, measured by the tax change as a percentage of income. Figure 2 reinforces the message of Figure 1 that the McCain health credit makes the tax system considerably more progressive. Not only does the credit disproportionately increase the after-tax incomes of lower-income households, but it also decreases the number of taxpayers who have any personal income tax liability (i.e., with positive tax liability) by 13.2 million.[6]

Figure 2. The McCain Health Credit Disproportionately Benefits the Low and Moderate Income



Note: Quintiles begin at cash income of: Second $14,251; third $29,882; fourth $52,270; Fifth $88,363; top 10% $126,776; top 5% $177,996; top 1% $463,293.

Source: Tabulations from The Tax Foundation's Individual Tax Microsimulation Model.

What are the Potential Downsides for the McCain Health Credit?

One downside is that the direct cost of the McCain health credit exceeds the revenue from repeal of the income tax exclusion for employer-based health insurance and this difference may well be large. The Tax Foundation estimates that over ten years, the net effect of the McCain health credit would be to reduce tax collections by $1.4 trillion. Some of this shortfall might be made up by slower-growing health care costs; the McCain campaign optimistically asserts that it will make up the full difference when its entire plan is in place. But if a gap remained, it could, of course, be made up by reducing the size of the credit. Even with a smaller credit, the proposal would still retain much of its improvement in incentives, but with a smaller credit the extent of redistribution would be less.

One concern expressed about proposals that remove or reduce the existing bias for employer-based health insurance is that they may hasten the already ongoing decline of the employer-based system and further reduce the accompanying pooling of risk. Perhaps to help allay these concerns, the McCain health plan retains the existing exclusion of employer-based health insurance premiums from payroll taxes. Thus, the policy would undo part of the existing tax bias for employer-based health insurance, but not all of it.

Another concern with the McCain health credit is that it *increases* the net subsidy for health care by $1.4 trillion (as discussed above) and, all else equal, might well encourage greater health care spending.[7] The success of the policy depends critically on whether the benefits from improved efficiency—reducing the linkage between the tax subsidy and health care spending—exceed the effect of increasing the overall subsidy for health care. This potential shortcoming could be remedied by also eliminating the current payroll tax exclusion for employer-based health insurance premiums. This change would also make the overall policy roughly deficit-neutral over ten years. Of course, such a change would completely eliminate the existing bias for employer-based insurance and would likely need to be combined with more aggressive reform of insurance markets to ensure adequate pooling of risk outside of the employer system and risk-adjusted subsidies to help those with the greatest needs (e.g., those with chronic conditions).

Finally, the McCain proposal would increase marginal tax rates for some taxpayers. When the value of employer-based health insurance premiums becomes taxable, some taxpayers will move into higher tax brackets. Higher marginal tax rates interfere with a variety of household and business decisions, but this downside of the policy needs to be contrasted and compared with the improved incentives the policy provides for health care markets.

Conclusion

Health care costs and tax policy are major preoccupations of the American people, and that is reflected in the proposals of the presidential candidates. Senator McCain's tax credit approach to health insurance would give every citizen a powerful incentive to purchase health insurance: $2,500 (individual coverage) or $5,000 (family coverage), no matter what the cost of the insurance. Moreover, it reduces systemic biases in our health care system that have contributed to high cost growth. The improved efficiency that should result from the McCain credit, combined with a powerful incentive to purchase health insurance and a beneficial effect for low-income people, would seem to make this policy particularly attractive to both sides of the political spectrum. Few government programs kill two birds with one stone, but the McCain health credit seems to be one that could.

Notes

1. The tax subsidy is the exclusion of employer-based health insurance premiums and other tax-sheltered health care spending from taxpayers' taxable income. The exclusion applies for purposes of both the income and payroll taxes. The Joint Committee on Taxation has estimated that repeal of the exclusion would raise roughly $3.6 trillion over ten years, or, on average, $360 billion per year ("Estimating the Revenue Effects of the Administration's Fiscal Year 2008 Proposal Providing a Standard Deduction for Health Insurance: Modeling and Assumptions," Joint Committee on Taxation, JCX-17-07, March 20, 2007, p.20).

2. For example, see Jonathan Gruber, "The Tax Exclusion for Employer Sponsored Health Insurance," Paper prepared for NBER Conference on Incentive and Distributional Consequences of Tax Expenditures, March 2008, p. 5.

3. Senator McCain's proposal would retain the current exclusion of employer-based health insurance under the payroll tax.

4. Estimates for a less generous proposal would have increased the number of newly insured by 15 million. See, for example, Robert Carroll, "The Economic Effects of the President's Proposal for a Standard Deduction for Health Insurance," *National Tax Journal* Vol. 60(September 2007), p. 419-31.

5. To the extent the McCain health credit exceeds the cost of health insurance, individuals would be required to deposit the excess into an expanded health savings account (HSA). This makes the proposal more complex and difficult to administer, and, by tying strings to the use of the funds, possibly reduces the incentive to purchase insurance.

6. The number of taxpayers with positive tax liability would fall from 98.2 million to 85.0 million under the McCain health credit.

7. The policy also requires that any credit in excess of the cost of the premium be deposited into an HSA. Aside from the complexity this introduces, it also would weaken the efficiency gains from the proposal because it loosely ties the full credit to health care spending.

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