O’Neill Institute
for National and Global Health Law

Legal Solutions in Health Reform:
Tax Credits for Health Insurance

EXECUTIVE SUMMARY

This Legal Solutions in Health Reform paper discusses the role that tax law can play in the implementation of health reform. The tax code has served as the primary vehicle for subsidizing health care in the U.S., with subsidies averaging $245 billion per year. Use of the tax code to support or implement health policy is extremely common in proposals at both the federal and state levels. Subsequently, the tax code will certainly play a role in any future health care reform efforts.

INTRODUCTION

While there are no legal barriers to modifying the tax code, the interplay between tax law and health policy presents a series of critical design and implementation challenges with which any health care reform package must grapple. Thus, this paper does not examine whether the federal government has legal authority for using the tax law for health reform, but rather how it can use the tax law under various health reform proposals.

REPLACING THE EXCLUSION FOR EMPLOYER-PROVIDED HEALTH INSURANCE WITH A REFUNDABLE TAX CREDIT

A progressive refundable credit, specifically aimed at providing a larger credit for low- and middle-income individuals/families and scaled down for upper income taxpayers, could serve as a tool for reforming the U.S.’s system of providing and subsidizing health care. Tax-based health care reform could also support other proposals to facilitate access (e.g., purchasing pools or some form of insurance exchange, restrictions in pricing or access based on pre-existing conditions).

- **A Costly and Regressive Subsidy**: The government distributes the tax expenditures associated with the current tax framework regressively; under the existing structure, taxpayers in higher brackets receive larger subsidies, varying by bracket from zero to 35 percent of any deductible amount. Given that almost 40 percent of all taxpayers have no positive income tax liability, exclusions and deductions have no value to many lower-income individuals. In contrast, refundable credits provide subsidies and create incentives that become relatively more valuable farther down the income ladder. Individuals without federal income tax liability may receive the credits in cash or cash equivalents.

- **Distortions in the Market for Health Insurance and in Health Care Consumption**: There is general agreement among health care experts that the current configuration of subsidies and government-sponsored health insurance programs, and the existing tax subsidy framework, have caused distortions in the market for health care, contributing significantly to escalating health care costs. Any meaningful effort to control the growth of health care costs must reflect more rational pricing and financial incentives; the place to begin is repeal (or substantial reform) of the current exclusion for employer-provided health insurance and its progeny. Supporters argue that a refundable credit regime could make a significant contribution to controlling health care costs because individuals would receive a credit for any health plan selected and would have reduced incentives to limit themselves to the “one size fits all” and “gold-plated” options that have characterized employer- and government-based plans.

- **Preserving the Employer-Based System**: Any move to repeal the exclusion for employer-provided health insurance and replace it with some form of refundable credit would have to account for the need to maintain the current system in some form, while facilitating a transaction to alternative health insurance platforms, especially for the tens of millions of Americans who are not currently covered by employer-based plans.
Any U.S. health care reform package must confront a series of core design issues. Many of these problems demonstrate the challenges of setting up a health care reform package in light of the current tax system and situating the reform package within that system.

**Eligibility Standards and Administration of Standards:** Appropriate eligibility criteria are key to the success of any plan. In the context of a credit or subsidy allocated to individuals and families, possible criteria could include measure of ability to pay, family size, marital status, number of dependents, age, or the nature of local or regional insurance markets.

**Changes in Eligibility Criteria from Year to Year:** As long as eligibility for a tax code-based health program turns at least in part on individual or family income, timing anomalies may arise. In particular, recipients may not be able to take advantage of available benefits at the time of medical need. Program design should account for the hardship this problem may create for families; models could be drawn from the Health Care Tax Credit program, among others.

**Tax Payer Cash Flow Considerations:** The gap between eligibility determinations and payments may create cash flow problems for recipients even where their status or circumstances do not change. As with taxpayers whose eligibility and benefits fluctuate because their circumstances change, general reliance on the tax return filing process raises potentially significant cash flow issues for individuals and families of limited means who might be the primary intended beneficiaries of an enacted subsidy, but who also may be less able to “pre-fund” their purchases of health insurance.

**Mandates:** A mandatory-coverage requirement raises a number of design questions that are beyond the scope of this paper. What is relevant for purposes of this paper is the enforcement mechanism: how is information compiled to determine compliance and how are sanctions enforced? As a practical matter, the IRS is the only federal agency that comes close to reaching a substantial portion of those potentially subject to mandates; therefore, the IRS may be best situated to collect data on compliance.

**Flow of Funds:** The matter of who should claim a tax credit turns out to be a very important design consideration that has the potential to address the timing and mandate issues noted above, while building on the current employer-based system. The options include providing subsidies directly to the beneficiary or to third parties (e.g., employers) on behalf of beneficiaries.

**Interaction with Existing Tax Law Subsidies:** Comprehensive health reform, whatever shape it takes, must deal with the panoply of health care provisions embedded in current tax law. Existing provisions range from the exclusion for employer-provided health insurance and the deduction for health insurance purchased by the self-employed, to an alphabet soup of special deductions and exclusions. Also, any reform program would interact with non-health-care tax law provisions. Policy designers would thus have to determine how individual tax liability calculations would account for any new subsidy.

**CONCLUSION:**

Tax law has played a major role in shaping health care policy for more than 50 years; it is the primary factor contributing to our current system of employer-provided health care. From an administrative standpoint, the IRS is the one institution that deals regularly with virtually all citizens. It also functions in many ways as the largest financial institution in the world, collecting funds and information from, and disbursing funds to, all of those with a stake in health care policy—individuals and families, employers and workers, the self-employed, purchasing cooperatives and health insurance providers. Within this framework, implementation of health policy reform would likely include leveraging the existing infrastructure provided by the IRS. While there are no legal barriers to modifying the tax code to facilitate health reform, there are key design and implementation issues that should be considered to ensure success.