Goodman Institute
Turning Ideas Into Policy

A Universal Health Tax Credit: The Right Way to Subsidize Health Insurance

Replace current subsidies with a simple, fixed dollar subsidy universally available to everyone.

Although most of us think our health care system is predominantly a private system, government is heavily involved. Close to one in every two health care dollars is spent by government. And even spending that counts as private is heavily subsidized.

A back-of-the-envelope estimate puts federal subsidies for private health insurance at roughly $4,000 a year for every household in America, on the average.

Having the federal government subsidize private insurance is not a bad thing. If government is going to be involved, private insurance is almost always better than public insurance. The trouble is: the way we subsidize insurance is wasteful, inefficient and harmful to the economy as a whole.

Take the insurance you get at work. Employers are able to do something that we can't do on our own. They can pay insurance premiums with pre-tax dollars. When we buy our own insurance, we have to pay federal income taxes, state and local income taxes, and payroll (FICA) on the wages we earn and then buy the insurance with what's left over. If our employer pays premiums instead of paying us taxable wages, all those taxes are avoided.

Here's the problem: the way in which we get this subsidy encourages all of us to over-insure, obtaining wasteful coverage that we would have avoided if we were spending our own, unsubsidized dollars.

Consider an employee getting $20,000 of family coverage from an employer. Since the benefit is tax free, if this employee is in the 30% tax bracket (payroll and income tax combined) the tax subsidy is $6,000. That is, had the $20,000 been paid as wages, government at all levels would have taken $6,000. But since the money was spent on health insurance instead, government took nothing.

To get the entire subsidy, the employer must spend $20,000, however. Suppose the employee and the employer chose a more economical plan, costing, say, $15,000. They would save $5,000 that would then be available to pay additional wages. But since the tax bite will be $1,500, take home pay will rise by only $3,500.

Here is the bottom line: under the current system we can always lower our taxes by buying more health insurance. If we buy less health insurance, our taxes go up. Further, for someone in the 30% tax bracket, the incentive is to buy insurance until it's worth only 70 cents on the dollar. For someone in the 50% bracket (which is where most of the decision makers are) the incentive is to buy insurance until its worth only 50 cents on the dollar.

No wonder health insurance is so wasteful.

How could things be different? Suppose we let people at work have the tax subsidy in a different way. They can have a dollar-for-dollar subsidy for the first $6,000 of insurance, but all remaining insurance must be purchased with after-tax dollars. Under this approach, employers and employees can have the same tax relief they had before without having to buy expensive health insurance. When the last $14,000 of insurance is completely unsubsidized (all paid with after-tax dollars) the alternative is more take home pay. Any newly discovered efficiencies or economies or even a less generous package of benefits can be turned into more income for the employee without any adverse tax consequences. With this new and better way to subsidize health insurance, people at work can get 100% of the benefit of eliminating waste and eliminating insurance benefits that have marginal value.

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When John Goodman and Mark Pauly described this approach in Health Affairs 20 years ago they called the subsidy a "fixed dollar tax credit." And ironically, the Obama administration used this idea in developing the second major way the government subsidizes private insurance: through the ObamaCare exchanges.

In the health insurance exchange, the subsidy available to an individual is determined by his income and the premium for the second cheapest silver plan. The individual is free to choose any plan. But the tax credit remains fixed, regardless of the choice.

So far so good. But then Obamacare takes this very good idea and couples it with a slew of bad provisions that discourage employers from hiring and workers from working. ObamaCare imposes a health minimum wage (in addition to the money minimum wage) that can reach almost $6.00 an hour for family coverage. It encourages companies to stay small, because below 50 employees, the employer mandate doesn't apply. It encourages employers to reduce the amount of hours employees can work and to limit the number of employees they hire.

But even more insidious than all that is the fact that the ObamaCare subsides are phased out very quickly as income rises. When you earn an extra dollar, you not only pay income and payroll taxes on that dollar, your take home pay also goes down because the health insurance subsidy you get goes down. Economists call this extra loss of take-home pay for each dollar earned an implicit marginal tax rate. (The explicit rates are the income and payroll tax rates.)

Under ObamaCare, the effect is quite large. According to University of Chicago economist Casey Mulligan, ObamaCare imposes the third largest increase in marginal tax rates in the past 70 years. As Harvard economics professor Greg Mankiw explains, that implies a long term loss to the economy on the order of 5% of GDP.

The indirect cost to the economy equals more than $8,000 per household per year!

How could ObamaCare subsidies be changed to avoid this heavy burden on the economy as a whole? By giving everyone the same tax credit regardless of their income and getting rid of the employer mandate at the same time. That would eliminate all of the anti-work incentives in Obamacare, while retaining the fixed dollar credit with its very good incentive effects.

A tax credit of $2,500 for an individual and $8,000 for a family of four would allow almost everyone to obtain insurance equivalent to a well-managed Medicaid plan. They could add additional funds to obtain insurance that gives them more options. States should have the freedom to give everyone the opportunity to use their credit to buy into Medicaid (the public option the left keeps clamoring for) and they should be able to give everyone in Medicaid the opportunity to obtain private insurance instead (an option favored by those on the right).

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Let's recap. By replacing the current subsidies with a simple, fixed dollar subsidy universally available to everyone we would (1) eliminate all the perverse incentive to over-insure, (2) eliminate all of the perverse incentives not to hire and not to work, and (3) come about as close to universal coverage as we are ever going to get.

An earlier version of this document was posted by John Goodman at *Forbes.*

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