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## **USING TAX CREDITS TO CREATE AN AFFORDABLE NATIONAL HEALTH SYSTEM**

### **INTRODUCTION**

**Demands are growing for reform of America's health care system. To be sure, the quality of care available in the United States surpasses that of any other nation. Still, as many as 37 million Americans are without health insurance during at least part of any year. Millions more have insurance that pays for routine care, but would not cover the catastrophic financial impact of a prolonged, serious illness.**

**Even those with adequate insurance provided through their place of work face increases in out-of-pocket charges, or cutbacks in coverage for family members, as employers try to contain surging insurance costs. Insurance companies complain that physicians persistently order unnecessary tests and procedures. Physicians complain that insurance company officials are interfering with the practice of good medical care. The result: a \$600 billion health care system with which nobody, it seems, is happy.**

**Disenchantment with the system has spawned several high level government task forces and commissions charged with finding ways to improve U.S. health care. The ideas being considered by these bodies are in three broad categories:**

◆ **Social insurance programs, based on the Canadian system. These would provide every American with universal access to a comprehensive package of health services, dictated and paid for by government and financed through taxation.**

◆ **Employer mandates. These would require all employers either to provide at least a standard package of health insurance to employees and their**

families, or to pay into a fund to finance insurance for families not covered at the place of work. This often is referred to as the "play or pay" approach.

◆ **Consumer-based systems.** In these, changes in the tax treatment of health care purchases would provide families with the funds to buy adequate insurance and medical care directly, rather than depending on their employer or a government program. Such a consumer-based proposal was unveiled last year by The Heritage Foundation.<sup>1</sup>

In the vigorous debate between proponents of these rival proposals, questions are raised about each approach. Close examination of the Canadian system, for example, reveals not only that it holds down health costs by systematically rationing care, but also that costs have been controlled far less than commonly believed.<sup>2</sup> Similarly, the mandated employer benefits proposal has encountered strong opposition from businesses, who claim that it rapidly will escalate company health costs, prompting layoffs and undercutting U.S. global competitiveness.

Concerns also have been raised regarding the Heritage Foundation proposal. Examples: Are families typically capable of making informed decisions when purchasing health insurance or medical services? Would not insurance companies tend to compete only for healthy families needing fewer services, leaving higher risk families with enormous premiums to pay? Would Americans accept such a seemingly radical change in their health care financing system?

While these and others are legitimate concerns, they are fully addressed in the Heritage proposal. Indeed, the Heritage proposal is the only one advanced to date that would assure affordable access to health care for all Americans with little or no additional cost to the federal Treasury and with built-in, market-driven incentives to keep costs under control.

## THE GOALS OF HEALTH CARE REFORM

While there are differences of opinion on the details of what an ideal health care system would achieve, four features are broadly accepted as goals of such a system:

1) **The system should assure affordable access to adequate health care for all Americans.**

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1 . Stuart M. Butler and Edmund F. Haislmaier (editors), *A National Health System for America* (Washington, D.C.: The Heritage Foundation, 1989); see also Butler, "Assuring Health Care for All Americans," *Heritage Lectures* No. 218, October 2, 1989.

2 Michael Walker, "Why Canada's Health Care System Is No Cure for America's Ills," *Heritage Foundation International Briefing* No. 19, November 13, 1989.

The notion that all citizens should be able to obtain adequate health care services at reasonable cost to the family budget is the central feature of most Americans' picture of an ideal system.

**2) The system should contain incentives to economize.**

The rapidly rising cost of today's health system has led lawmakers to insist that any serious reform must contain strong incentives to economize and keep costs under control — without cost becoming a barrier to necessary care.

**3) Government help should go mainly to those who need it most, as measured by income or medical condition.**

Many socialist countries base their health systems on the doctrine that government should provide the same quality and quantity of care to rich and poor alike. In the U.S., however, it is generally accepted that the more needy a family is, in terms of the cost of necessary medical care compared with the family's income, the more governmental help that family should receive.

**4) As far as possible, crucial medical decisions should be made by the patient and his or her physician.**

In addressing such basic medical questions as whether a major operation shall be performed, or who shall perform that operation, or how much shall be done to save a baby born prematurely, most Americans feel that these decisions should be made as much as possible by the individuals directly concerned. It is they, it is broadly believed, who should have the right to weigh the benefits and the risks, with proper medical advice and with some attention to the costs involved. These decisions are not to be left to some distant official whose life is not on the line.

**Why the Current System Does Not Reach These Goals**

The current health care system does not achieve these or many other goals. Most of the uninsured, and even many of those with basic insurance, find they cannot afford certain necessary health services. Few would contend, moreover, that the current system promotes efficient use of medical services. It seems unfair to many Americans that affluent workers and top executives enjoy unlimited tax-free medical services through their companies, while low-paid workers in other firms have no company insurance, and get no help from the tax code to offset the cost of buying the most basic services or insurance. And there is growing anxiety that basic medical decisions are being made by distant government or insurance company officials, or in response to rules determined by such officials. Thus elderly Americans, for instance, fear they may be "dumped" by a hospital because the hospital considers the Medicare reimbursement rate to be too low; unionized workers strike against the attempts of company health benefits managers to limit coverage for families; mothers of newborn babies grumble that insurance companies refuse to cover more than three days in hospital after the birth.

These shortcomings of the system have a common root: the powerful, perverse incentives created by the tax treatment of health care spending. Under the federal tax code, company-provided health services and insurance plans are excludable from each worker's taxable income. For example, if a worker's compensation is an annual cash salary of \$25,000 plus \$3,000 in the form of a company-paid health plan, for a total of \$28,000, that worker pays income and payroll taxes on only \$25,000 of income. This makes the health plan, in effect, tax-deductible at the worker's marginal rate of tax. If the firm does not provide a health plan, however, the worker can only obtain tax relief to the extent that his family's health expenses exceed 7.5 percent of adjusted gross income, and then only if the family itemizes its tax return. Most self-employed individuals can claim tax relief on just 25 percent of their health insurance costs.

This tax treatment means that the lion's share of tax relief goes to higher-paid employees with generous health plans. Meanwhile, casual workers or those in small firms without plans, who tend to incur relatively high medical costs compared with their income, typically receive no tax relief at all. When these latter workers buy health insurance they must do so with after-tax dollars, and normally they must pay relatively high premiums for individual coverage. It is little wonder that so many of these workers and their families lack insurance.

**"Free Fringe Benefit."** The tax treatment of health spending also helps boost total health costs, encourages inefficiency, and provokes labor disputes. Company plans, for example, have grown rapidly in recent decades for understandable reasons: both management and labor have favored contracts that offer more compensation in the form of tax-free health insurance than in the form of taxable cash. This means that for most Americans, in terms of after-tax dollars, it costs less to buy health care than to buy other goods and services — even if both carry exactly the same price tag. The result: workers tend to demand far more, often non-essential, health services than they would choose were they to pay for them in after-tax dollars. In addition, many workers and their unions have pressed employers to include routine, minor services in health plans because that allows these services to be paid for with pre-tax dollars. By contrast, workers tend to be less inclined to press for insurance covering highly unlikely, but financially crippling, medical situations. Thus many American workers have very generous and expensive health plans, yet lack catastrophic insurance.

In the minds of most workers, these company-paid plans, like other fringe benefits, seem to be free — even though an employer rightly treats health insurance as part of the overall compensation. Thus there is little or no incentive for workers to curb their demands for health services or to question hospital or physician prices, especially if deductibles and copayments in the plans are small.

This has several effects. A lack of any real incentive to economize is, of course, a recipe for health care cost inflation, and indeed the cost of medical

care for years has been rising at roughly double the average inflation rate. This means, of course, higher prices for those who do not have company-provided insurance and consequently reduces their ability to obtain medical care. Meanwhile, corporate efforts to constrain rising health costs by increasing the employee's share of costs normally are strongly resisted by workers, who see these direct payments as a cut in pay, forcing them to pay in after-tax dollars for care that previously was "free." Bitter strikes over company attempts to scale back health benefits are an increasingly common feature of labor disputes.

### **Why Mandated Benefits or a Canadian System Is No Answer to These Problems.**

Neither a mandate on all employers to "play or pay," nor a Canadian-style universal social insurance program would solve all these problems, or achieve the four basic objectives of an ideal health system. Moreover, in many important ways, each would be less attractive than America's current system.

Under employer mandates or a Canadian system the government would legislate a right of access to a certain level of health care, through the private sector in the first case and the public sector in the second. But to control total costs, various regulations would be imposed by bureaucrats to restrict that supposed right of access. Such regulation would be necessary because the illusion of virtually free care would encourage far more demand for services than companies or the government would be willing to pay.

**Shortages and Rationing.** Economists recognize that when services are free of charge, or nearly so, and controls are placed on the total costs of providing the service, the result invariably is shortages and rationing. Recent studies of the Canadian system reveal that government cost control leads to rationing by waiting list and a pervasive system of physician price controls. This policy has limited significantly the availability of procedures and technology and has encouraged a rising number of Canadians to seek health care services in the U.S.

An employer mandate simply would shift the tab to business without correcting the underlying incentives that lead to the problems of the current system. Corporate health benefits managers would become the reluctant regulators of a business-financed national health service, caught between stockholders determined to check costs and employees with the legal right to demand services. Very likely the majority of frustrated employers eventually would follow the lead of some of today's business leaders who argue that corporations should not be expected to manage and finance a national health system, and that the job should be turned over entirely to government.

## THE HERITAGE FOUNDATION PROPOSAL

Last year, The Heritage Foundation published a proposal to achieve universal access to affordable health care.<sup>3</sup> This proposal, unlike the Canadian system or mandated benefits, seeks to cool health care inflation and assure access by strengthening market incentives in health care and restructuring the tax treatment of health care spending. Specifically, the proposal calls for two major steps:

### **1) End the link between health care tax breaks and the place of work.**

Under the Heritage proposal, the unlimited tax exclusion for company-provided health benefits would be phased out over several years. Thus, while companies could continue to provide benefits and count them as tax-deductible labor costs, the value of such benefits now would be included in the employee's taxable compensation. If the employer chose to reduce or eliminate the health benefits provided, he would be required by law to add the savings to each employee's paycheck so that the worker's total compensation would be unaffected.

Offsetting this change in the tax code, a new system of personal tax credits for family health spending would be introduced. Under this new arrangement, a family could claim a credit when filing its 1040 tax form. The credit would be available for both insurance and out-of-pocket costs. It also would be an "above-the-line" credit, so the family would not have to itemize its return to claim the credit. It would be refundable, meaning that if the credit exceeded the family's total tax liability, the taxpayer would receive a check for the difference from the IRS.

The credit would be based on the family's health and insurance spending compared with its income. Thus a 20 percent credit might be available in most instances, but may rise to 30 percent of medical and health insurance expenses if these costs exceeded, say, 5 percent of family income in a year; a 50 percent credit if spending reached 10 percent of family income, and so on. For very affluent families spending only a small proportion of their income on health, the percentage credit would be less than 20 percent, and perhaps phased out completely for those above a certain income.

### **2) Establish a "Health Care Social Contract."**

The second central element in the Heritage proposal is a two-way commitment between government and citizen. Under this "social contract," the federal government would agree to make it financially possible, through refundable tax benefits or in some cases by providing access to public-sector health programs, for every American family to purchase at least a basic package of

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<sup>3</sup> Butler and Haislmaier, *op. cit.*

medical care, including catastrophic insurance. In return, government would require, by law, every head of household to acquire at least a basic health plan for his or her family. Thus there would be mandated coverage under the Heritage proposal, but the mandate would apply to the family head, who is the appropriate person to shoulder the primary responsibility for the family's health needs, rather than employers, who are not.

## **EFFECTS OF THE HERITAGE PROPOSAL**

By no longer restricting tax relief for medical care to employer-provided plans, and by restructuring tax assistance to help those Americans most in need, the Heritage proposal significantly would improve the American health system. Among the most important effects:

**1) Good health care not dependent on employers.** Employees would be able to acquire health coverage for their families, and obtain government tax help to pay for it, wherever they happen to work. Casual or part-time workers, employees of small firms, or dependents of workers — those who comprise a major share of the uninsured — would receive a refundable tax credit based on health costs compared with income — exactly the same form of government assistance to buy health services as Americans working in large firms. Thus the Heritage proposal would solve much of the current uninsurance problem.

The Heritage proposal also would allow complete “portability” of a worker's health coverage, since it would no longer be tied to the place of employment. If a worker changes jobs, or has a spell of unemployment, he or she would not lose the insurance or have to change coverage, nor would his or her family face the possibility of exclusions for pre-existing conditions and similar insurance restrictions common today when a worker changes jobs.

**2) Incentives to economize.** Under the current system of employer-provided health benefits, if an employee decides to make sensible economies in his or her use of a health plan, the employer saves. Under the Heritage proposal, the employee pockets the savings. Thus Americans would have the incentive to “shop around” for the most economical health plan to meet their legal obligation and their other health care preferences.

This would reduce the rate of medical cost inflation by encouraging cost-consciousness and discouraging over-use of medical services. A family may choose a more restrictive Health Maintenance Organization (HMO), for instance, rather than a plan with an unlimited choice of physician and hospital, to save money for other things. Healthy families would have the incentive to buy coverage with a larger deductible than is typical today and pay directly for routine minor medical bills. Healthy families today have the incentive to press employers to provide first-dollar coverage and then to overuse the “free” benefits.

**3) Budget neutrality.** For most Americans, the way in which government currently provides financial help to obtain health care is by excluding the cost of company-based plans from the employee's taxable income.<sup>4</sup> This means the government foregoes tax revenue. The Heritage Foundation proposal would reallocate these revenue losses as refundable income tax credits. Depending on the design of the credits, the proposal could be budget neutral, or decrease tax revenues only slightly.

The Congressional Budget Office, in its annual review of possible budget savings, calculates that if the current tax exclusion for company-based plans were ended, and a 20 percent tax credit introduced into the individual tax code for health insurance costs up to \$250 per month for a family (\$100 for an individual in 1990 dollars), the government would collect an extra \$89.4 billion in tax revenue over the next five years, or an average of \$17.9 billion per year.<sup>5</sup> Thus if budget neutrality is a goal, the CBO figures suggest that this sum would be available to provide a refundable credit to those not now covered, and to give a more generous credit for those Americans facing high medical costs compared with their incomes.

The table that follows compares the implications for individual workers and their families of the Heritage plan, compared with current law, the mandated benefits proposal, and the Canadian system.

## CONCERNS ABOUT THE HERITAGE PROPOSAL

While many lawmakers, physicians, and workers see the attraction of individual credits for health insurance, they also imagine there are various practical problems with such an approach. But these concerns either misunderstand the nature of the Heritage proposal, or they can be dealt with through small modifications of the basic approach.

Among the most common concerns:

**1) Since medical care is such a complex product, can average Americans really be expected to make sensible purchasing decisions regarding medical care and insurance?**

This concern overlooks the way in which competition and consumer choices actually would work in a reformed health care system. If out-of-pocket medical costs were given the same tax breaks as insurance premiums, more Americans would pay directly for routine minor services now often cov-

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<sup>4</sup> For the very poor, the state and federal government pays directly for approved care, veterans are covered under the Veterans Affairs health system, while most hospital care for the elderly is reimbursed through Medicare.

<sup>5</sup> Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options*, (Washington, D.C.: U.S. Government Printing Office, 1990), pp. 145, 146.



## HOW HEALTH REFORM PROPOSALS WOULD AFFECT WORKERS AND THEIR FAMILIES

	Current Law	Mandated Benefits	Canadian System	Heritage Proposal
Tax benefits to employee.	Unlimited company-paid services tax-exempt at marginal tax rate. No tax benefits for out-of-pocket costs.	Same as current law	All health care "free" and untaxed.	Individual tax credits, based on income and health costs, for insurance and out-of-pocket costs.
What if employee below tax threshold?	No special tax benefits.	Same as current law.	Irrelevant, since services are "free".	Tax credits are refundable.
Who decides basic package of services?	Company/union negotiators.	Government.	Government.	Government.
Who decides additional services?	Company/union negotiators.	Company/union negotiators.	Government.	Worker.
What if company does not provide health insurance?	Employee and family is uninsured or buys insurance and services with after-tax dollars.	All companies must provide family coverage or pay into government fund to provide coverage to uninsured.	Companies have no role in system.	Individual tax credits to buy family coverage — purchase of basic coverage mandatory for families.
Unhappy with health plan?	Complain to union or switch jobs.	Complain to union and government.	Complain to politicians.*	Change plans.
Switch jobs?	May lose certain benefits or become uninsured for existing conditions.	Basic package unaffected. Additional benefits may change.	Coverage unaffected.	Coverage unaffected.
Dependents not covered under plan?	Uninsured, or buy extra coverage with after-tax dollars.	Law requires family coverage by basic plan.	Everyone covered.	Head of household must, by law, buy basic family coverage. Tax credits offset cost.

\*It is unlawful for Canadians dissatisfied with the quality of government-financed health services to purchase private insurance in Canada for these same services. Canadians may, however, buy private insurance or services in the U.S. or any other country.

ered by insurance, such as dental work, annual physical, eyeglasses, and treatment for minor injuries. In these cases the required medical knowledge is small, and consumer decisions would tend to be based on such issues as cost, waiting time, choice of doctor and other important, but non-technical factors.

Consumer choice would work just as well in buying insurance. Knowledgeable consumers carefully would select the plan providing the features they want at the most competitive price. Less knowledgeable Americans either would take the advice of an expert in whom they had confidence, such as their family physician or a consumer organization, or they could join a purchasing group that they felt would represent their interests.

**2) Wouldn't individual insurance be more expensive than company-based group insurance?**

Individual health insurance policies today generally are more expensive than company-based plans. This is mainly because administrative and marketing costs tend to be high when the market is small and potential buyers widely dispersed, as with today's individual insurance. But if individual buyers were the largest segment of the market, these overhead costs would fall, making individual coverage more competitive. It is likely under the Heritage proposal, however, that group insurance would continue to be the typical form of health coverage because groups could bargain most effectively with physicians, hospitals, and insurers. What would be different is that the group probably would not be composed of the employees of a particular company.

Today's tax laws make the place of work virtually the only group that Americans can join to have the bargaining power and the economies of scale to obtain affordable insurance. Under the Heritage proposal, by contrast, families could join other groups as the basis for insurance, with the group administrators perhaps charging a management fee.

**Forming Groups.** The group presumably would be an organization that the family felt would act in its interest, such as a union, a church, a group representing minority workers, or women business owners. It could also be a group of individuals with special medical needs, such as diabetics, needing plans with particular services. In each case the individual would gain the economies of scale and bargaining power of the larger group, and he or she could choose a group that arranged the desired package of insurance and services at the best price. Today a worker and his family normally must accept the plan services selected by the employer, whether or not they are ideal.

It is almost certain that a wide range of groups would emerge. One reason for confidence is that non-employer groups exist today even with only very limited tax breaks available. Examples: various state farm bureaus offer group plans for agricultural workers; in Washington, D.C., TANS/MED markets low cost plans for young workers without company insurance, such as full time babysitters; and a number of labor unions sponsor plans. Indeed, unions very likely would become major group managers under the Heritage proposal, offering good rates as a membership inducement.

The shift to a system encouraging consumer-driven choice and competition would reduce the general cost of insurance. Today's company-based insurance necessarily involves a considerable amount of costly paperwork because insurers and health benefits managers must try to regulate or restrict the use of medical care by families who have no natural reason to economize, given the nature of company-based plans. Under a market-based system, however, the user has strong incentives to economize, since he or she keeps the savings. Thus the bureaucratic controls of the current system would be replaced in large part by the "controls" of the market, reducing administrative costs.

**3) But if such groups did form, wouldn't insurers compete for the lowest risk families? Wouldn't such "adverse selection" leave many Americans with prohibitively high premiums?**

The problem of adverse selection is seen by many as a fatal flaw of a system based on individual selection, even if groups did form to buy insurance or bargain with providers for good rates. It is true that many insurers would compete for healthy families, leaving other families to choose from more expensive plans under the Heritage proposal. Yet this is not a problem; it is actually a benefit of the proposal.

There may be an initial tendency for insurance companies to compete for groups of healthy families, to reduce their benefit payouts. But of course that competition, with wide consumer choice, would drive down premiums and profit margins for insurers. So the low-risk portion of the market might not in fact be particularly attractive for insurers. The conventional wisdom is that insurers would not be interested in high-risk families, because high benefit payouts would mean high premiums that families would not be able to pay. This certainly is the case today, given the tax treatment of individual and non-company group insurance. But under the Heritage proposal, the government would give generous refundable tax credits to families facing high premiums or out-of-pocket expenses. And since the higher-risk family thus would be able to afford the higher premiums needed to provide extra services, that part of the insurance market would be just as attractive to insurers as the low-risk (but low premium) family.

**Specialized Plans.** It is also very likely that insurers and hospitals under the Heritage proposal would develop special health plans, including insurance and specialized medical services, for Americans with chronic medical problems, such as diabetics, the handicapped, the mentally ill, and cancer sufferers. These plans would be far better products for these special-needs Americans than the typical "one-size-fits-all-employees" company plans. Most such plans no doubt would be expensive, but some would be able to keep costs down by substituting special services in place of other services not used by most of the group. Example: older diabetics probably would have a plan without pregnancy benefits. Patients under such plans would have tax credits to offset the extra costs. If a family today has to obtain special services not provided under the employer's plan, it must usually do so without any tax relief. Consumer-driven competition would be just as strong among these high-cost

plans as among low-benefit plans for the healthy, assuring good value for money.

Cross-subsidization thus would occur under the Heritage proposal. Under today's health care system, virtually the only way that Americans needing medical care are subsidized is through equal premiums for all workers in a company group. Healthy families subsidize less healthy families because all pay the same premium while using very different quantities of medical services.

One problem with this is that employers, particularly small firms, are understandably unenthusiastic about hiring a new worker who may incur unusually high medical bills, since the company's insurer eventually will raise the group's premium if usage increases. Under the Heritage proposal, most cross-subsidization would occur through the tax system, not through premiums, so the problems now facing insurers – and less healthy Americans seeking work – would disappear. Moreover, subsidizing through the tax code is a far more precise and efficient method than the imprecise cross-subsidization achieved through equal premiums in company plans.

**4) But if the government provides generous credits for expensive insurance and treatment, wouldn't that increase the tax revenue losses to government and encourage Americans to buy extra, but unnecessary coverage?**

Tax revenue losses would indeed be relatively high for credits provided to an unhealthy family needing expensive insurance. On the other hand, the losses would be sharply reduced on insurance and medical care purchases by healthy Americans.

But total revenue losses on average would be lower under the Heritage proposal than under current tax law for three reasons. First, the increased consumer sensitivity to cost would slow general medical costs, and hence tax losses on medical insurance purchases. Second, healthy families no longer would have the incentive to overuse medical services, again reducing tax losses. Although the Heritage proposal does not envision a cap on the total amount of insurance or services eligible for credit, families would still have to contribute toward the cost. Although the credit would encourage a certain amount of over use, it would almost certainly be a less than is common today under company-paid plans. And third, even though millions of additional families would be eligible for tax relief, or refunds, this would cost the government less than it does today when most of these families turn to Medicaid or receive uncompensated medical care with the cost usually added to the medical bills of patients with tax-free company insurance.

**5) Most Americans today have their medical insurance premiums paid directly by their employer, and they do not have to worry about claiming back tax relief. Wouldn't the Heritage proposal lead to many Americans not buying insurance, or missing premium payments, and wouldn't lower-paid workers be unable to wait until the end of the tax year for their credits?**

Under the Heritage proposal, it would be illegal not to buy basic catastrophic insurance, and credits would be available only for actual purchases of insurance or medical care during the tax year. When tax returns were filed, the family would receive a "proof of insurance" form from its health insurance company, much like a W-2 form, and this would have to be appended to the return. This form would indicate the cost of insurance, and certify that at least the legal minimum is bought. If the proof of insurance forms were not attached, or did not indicate that the family was insured throughout the year, a financial penalty would be imposed.

The problem of workers avoiding this requirement in the first place, or finding themselves unable to make payments, would be eliminated in most cases through a modest book-keeping requirement for employers. The tax credit available under the Heritage plan would be blended into the tax withholding system for employees. Thus a worker would claim adjustments based on his family's anticipated insurance and out-of-pocket expenses (just as he does today, based on such factors as the size of his family, and his mortgage interest payments), and withholding would be adjusted accordingly. If medical and insurance costs begin to run higher than expected, the withholding amount could be changed. Similarly, if the worker is entitled to a refundable credit, meaning that the credit exceeded his or her normal tax liability, a monthly amount would be added to the paycheck by the employer, and deducted from the total tax withholdings sent by the employer to the IRS. At the end of the year, of course, the family would complete a 1040 tax form, including actual medical expenses that year, and the taxes would be adjusted.

In addition, employers could be required to take a deduction from each employee's paycheck to pay for health insurance, and send a check to the health insurance company of the worker's choice — much as many employers today deduct voluntary contributions for 401(k) pension plans. The amount of the check would depend on the insurance package chosen by the worker. Thus the employer would not pay the premium, but would assure that it was paid.

**6) Why would a worker with a generous company health benefits package have any reason to support the Heritage proposal?**

Workers in some industries have very generous health benefits. For instance, automobile workers typically have approximately \$3,000 in tax-free employer-paid health benefits.<sup>6</sup> They, however, would accept a credit proposal that probably would give them less total tax relief for several reasons. First, if they had the choice, many workers would accept less in benefits if they could have more in cash, even taxable cash. The Heritage proposal allows them to make that choice. Second, they could choose the benefits they

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<sup>6</sup> Aldona Robbins and Gary Robbins, *What a Canadian-Style Health Care System Would Cost U.S. Employers and Employees* (Dallas, Texas: National Center for Policy Analysis, 1990), p. 5.

want, rather than the company-provided benefits. Under the Heritage proposal, workers could increase coverage or spending for certain services they want or need, such as better coverage for a child, while perhaps reducing others, and obtain the same tax relief. Third, if a worker moves to another job, his coverage would not have to change. And fourth, the worker would not have to face pressure to reduce benefits by financially-strapped employers, a common problem in some industries today.

**7) What does the Heritage proposal do for the very poor?**

The Heritage proposal's incentives to reduce medical cost inflation through more active consumer choice would benefit the poor by tapering general medical costs. In addition, the proposal would grant refundable tax credits for health insurance and services to workers in those firms unable to offer health insurance. This would be particularly beneficial to low-paid workers in small firms. It would also make employment more attractive to many Americans now on welfare who are reluctant to leave the rolls because their Medicaid benefits are phased out and often they do not have health insurance provided by their new employer.

Medicaid for the very poor would be retained under the Heritage proposal, and the plan contains recommendations for reforming the program.<sup>7</sup> Besides these reforms, aimed at encouraging more state experimentation in alternative delivery arrangements and promoting state-subsidized risk pools for difficult-to-insure Americans, the proposal would permit states to enroll welfare recipients in the competitively-priced private health plans emerging under the new tax incentives for working Americans. That would enable states and the federal government to achieve savings that could be used for new services or for deficit reduction.

**8) Isn't the Heritage proposal too radical to be adopted by Congress?**

The Heritage proposal would lead to a radical change in America's health care system. But so would the introduction of a Canadian-style system, or a system in which employers operated a nationwide comprehensive system. Lawmakers and policymakers now recognize the need for radical reform.

An understandable worry about the Heritage proposal is that it has never been tried on a large scale — although modest individual deductions are available under the tax code for some Americans. But an advantage of the proposal is that it could be introduced gradually, so that it could be tested and so that Americans would have the opportunity to become familiar with its key elements before a complete transition. Thus although the proposal would constitute a major reform of America's health care system — and only fundamen-

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<sup>7</sup> Terree P. Wasley, "Health Care For The Poor, Unemployed, and High Risk," in Butler and Haislmaier, *op. cit.*, pp. 91-119.

tal reform will address the system deep problems – it could be introduced in stages.

**Beginning Step.** Moreover, Congress is poised to take the first step in creating a system of credits for health purchases. A provision in the Senate-passed version of the child care legislation (S.5), in fact, would be a significant step toward enacting the Heritage plan. Authored by Senator Lloyd Bentsen, the Texas Democrat who chairs the Finance Committee, the measure would grant a 50 percent tax credit to low-income families for the purchase of insurance for children not covered under a company plan. If this becomes law, it would introduce the concept of an individual tax credit for health care.

The next step would be to establish a refundable credit for all dependents not covered under company plans, not just children, recouping the revenue loss by placing a ceiling on the value of a company-based plan that would be free of tax. The third step would be legislation to phase out entirely the tax exclusion for company plans and to introduce the full individual credit.

Senator William Cohen, the Maine Republican, has introduced a bill (S. 2032) that would accomplish some of these steps. The bipartisan bill is co-sponsored by such Democrats as David Boren of Oklahoma and Sam Nunn of Georgia. The Cohen legislation would establish a refundable credit of up to 60 percent of yearly health insurance expenses for low- and moderate-income families without company-provided plans. The legislation would not, however, reform the tax treatment of employer-provided insurance.

## CONCLUSION

Americans are less satisfied with their health care system than are the citizens of most major industrialized countries. Their dissatisfaction is understandable. The American system may deliver the world's best medicine, but millions lack adequate coverage, the cost of care is skyrocketing, and even those with good insurance often are anxious about many features of their coverage.

The Heritage proposal addresses the central deficiencies of the current system. By changing the tax treatment of health care spending, it would introduce powerful incentives to control costs and make it possible for those currently without adequate insurance to afford protection. It would create a consumer-driven and market-based national health system for America, without the heavy regulation or explosive costs of the other major proposals now being examined by Congress.

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