The 180-Degree Approach to Medical Benefits Reform

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ABSTRACT

President Bush has proposed a plan for insurance reform that would provide a standard income-tax deduction to cover medical expenses. The amount of the deduction would be the same, regardless of the amount of out-of-pocket medical expenditure, and would require purchase of a government-qualified plan with a Health Savings Account. Under this proposal, harmful government interference in the medical marketplace would continue. An alternate proposal, with the same cap on the tax benefit, would abolish tax favoritism for third-party expenditures and restore a true competitive marketplace.

The Bush Medical Benefits Policy Reform Proposal

President Bush has proposed a standard income-tax deduction of $7,500 per individual, or twice that amount per family, which would be claimed when filing one's income tax form. Since the full deduction could be claimed, regardless of what is spent out of pocket for medical care, it does not tie the tax benefit to the degree that citizens take responsibility for their own medical needs. Aside from this universal deduction, the Bush plan would have the government tax all spending on medical care or insurance, including that paid for by the employer. It is not clear whether the payroll tax paid by the employer would be recovered when filing for the deduction.

President Bush has said: "The best decisions are made by providers and patients, not by governments and insurance companies, which makes it hard to find a product that either suits your needs, or you can afford." However, President Bush's plan would require that the individual purchase a Health Savings Account qualified insurance plan in order to save any tax-free dollars for future medical needs. This means that government would define what insurance is. Government and special interests would set the requirements all plans would have to meet in order to qualify. It is a one-size-fits-all approach and would not encourage the development and marketing of new products that fit individual needs and financial resources.

So-called consumer-directed plans are already adding the cost of "preventive services," showing how government is in the position of designing, directing, or dictating what insurance plans are available for individuals to choose. A truly consumer-directed marketplace would offer critical-illness policies, or those that pay subscribers according to a table of allowances. The benefit dollars from such policies could be used at any doctor's office or hospital in the country, without penalty to the insured. The policy owner would thus control payments over the full continuum of care.

For more than 50 years, tax law has encouraged insurers and employer plans to control virtually all of workers' medical dollars. The Bush plan at least requires that employers determine and inform employees of the employer's exact benefit cost per employee for those enrolled in a specific program. This would help educate workers about the total cost of their medical benefit program, and help them realize that they are capable of managing their own medical expenses at least as well as government or their employer does.

The proposed deduction of $15,000 per family or $7,500 per individual would grow at the same rate as the Consumer Price Index for "all goods."

The Bush plan does not help married couples who lose the benefit earned by one spouse when the couple is forced to choose one policy to cover both. It is not clear how retired persons would be permitted to tax-shelter money for medical needs.

The 180-Degree Approach to Medical Benefits Policy Reform

At the present time, dollars spent by employers for medical benefit programs are "excluded" from all taxes. This means that neither the employer nor the employee pay any payroll or income tax on these benefit dollars. Economists agree that all the money spent by the employer for the benefit of the employee or on employment-related taxes is actually earned by the employee. If the employer provides the money as wages, however, the cost is greater to the employer by the 7.65% "employer's share" of the payroll tax, and the amount received by the employee is less by both the payroll tax and the employee's income tax. In order to treat all citizens fairly, all should have the funds now taken by payroll and federal income taxes on income below the capped amount available to apply to their medical expenses.

Rather than taxing all employment-based medical benefits, consider an approach that does just the opposite—that is 180 degrees different. It would extend the right to tax-free money for medical care to all employed Americans, capped at the same level as the Bush plan deduction. This 180-Degree Approach would place spending by individuals and by third parties on an equal footing. Giving responsible citizens, rather than third parties, control over medical spending will significantly reduce that spending, as citizens can benefit personally from prudent saving. It will stimulate competition, which will moderate medical prices for all. One must assume that all citizens have a responsibility to pay for their own medical care to the best of their abilities. Since government grants tax exclusions to help people meet this major human need, we must assume that it is especially important and thus should be a high priority item in the individual's budget.

Under this approach, all citizens who do not have employment-based medical benefits valued at $7,500 or more for a single person, or $15,000 or more for a married couple, would be able to set up a

Health Financing Account (HFA). The employee would set up the HFA with a bank or other qualifying financial institution. Payments from the account would be limited to qualified medical expenses under Section 213(D) of the Internal Revenue Code, plus health insurance premium payments. An HFA would differ from a Health Savings Account (HSA) in that it would not require purchase of an insurance policy rigidly designed by government, with coverage, deductibles, and co-payments set by bureaucrats. All options would be available to the individuals, who could purchase an individually owned and portable insurance plan that fits their needs and budget, buy an HMO or PPO offering, buy a plan to supplement their employer-owned plan, or simply save the money to pay for medical care or an insurance product designed to meet future needs such as long-term care.

Self-employed persons could simply place any amount they choose, up to the cap, in their HFA, escaping all payroll and federal income tax on that amount.

There should be no direct tie between the HFA and any insurance plan the individual buys. The HFA would be tied to the individual's Social Security number, and deposits reported annually to the Internal Revenue Service (IRS). For married couples, the HFA would be tied to both Social Security numbers so deposits can be accurately determined and reported. Payments from the account would be by check or debit card. An individual's account could be programmed to record and send an itemized report of expenses to any insurance plan the individual designates when expenses total the amount of the plan's calendar-year deductible. Those who pay directly would not be required to produce the functional equivalent of an insurance claim every time the HFA is accessed.

Current law permits employers to require a married couple to choose one insurance program for both, and one spouse loses any benefit he or she has earned. It is a "choose it or lose it" situation. Under the 180-Degree Approach, the dollar value of the spouse's medical benefit program would be added to his or her salary as taxable income. This reduces the amount of money available to the employer to spend for overly generous insurance coverage, thus helping to correct current distorted incentives to overspend on benefits instead of wages. The total payroll tax, 15.3%, on the difference between the value of any employer-paid benefit and the cap would be added by the employer to the couple's HFA, instead of paying it to the IRS. The couple could add dollars up to the cap and obtain a refund of the income tax on those dollars at the time of tax filing, as explained in Example 1. This permits them to maximize the number of tax-free dollars available for their medical needs, and also permits them to decide how to allocate their funds for medical and other uses. Responsible citizens will not go without purchasing an insurance product that fits their needs and budget. Lower-income persons might prudently decide to purchase a more economical insurance product and use the savings to pay reasonable fees directly to their physician.

One of the principles underlying this approach is that all medical expenses should be treated the same, whether paid directly or with insurance benefit dollars. The emphasis should not be on treating all medical *insurance* purchases equally under the tax code, but rather on treating all medical *costs* equally. Purchasing insurance does not increase the total number of dollars available for care; it decreases them significantly. Having medical insurance does not equate to having medical care when needed. In countries that mandate universal insurance coverage, patients are waiting many months for needed care. Care delayed can become care denied!

Using the same cap as the Bush proposal, we present below two accounting examples to illustrate that the 180-Degree Approach grants all citizens the same opportunity to provide for their medical needs. Employment-based medical plans are a benefit in addition to salary. Since citizens with the best-paying jobs, and thus the best ability to pay for their own medical needs, have the payroll and income tax savings spent for their benefit program, we believe tax policy should grant all citizens the same advantage when they provide for themselves.

Example 1

This example concerns working persons whose employment-based benefit program has an employer cost of $4,000, in addition to salary, completely tax free. All tax savings (payroll and income tax) are part of the $4,000.

For a single person, the payroll tax on the difference between the benefit cost of $4,000 and the cap of $7,500 (15.3% of $3,500, or $535.50) would be deposited into the individual's HFA by the employer, instead of paying it to the IRS, for a total benefit of $4,535.50. The worker could then contribute up to $2,964.50 ($7,500 minus $4,535.50) to his or her HFA in after-tax dollars, and deduct this contribution from taxable income to recover the income tax.

For a married couple, the $4,000 cost of their employment-based program would be subtracted from $15,000, leaving $11,000. The payroll tax on the difference (15.3% of $11,000, or $1,683) would be deposited into the couple's HFA by the employer, instead of paying it to the IRS, for a total of $5,683. The couple may contribute any amount up to $9,317 ($15,000 minus $5,683) in after-tax dollars to the HFA and deduct the contribution from their taxable income to recover the income tax.

Example 2

This concerns workers with no employment-based medical benefit program.

The employer pays the payroll tax on the first $7,500 of earnings into the employee's HFA ($1,147.50 for a single person or $2,295 for a married couple) instead of paying it to the IRS.

A single person may contribute up to an additional $6,352.50 ($7,500 minus $1,147.50) to his or her HFA and claim the amount as a deduction from taxable income.

A married couple may contribute up to $12,705 in after-tax dollars ($15,000 minus $2,295) to their HFA and deduct the amount contributed from taxable income.

The net result is that all earned dollars dedicated to medical costs are tax-free up to the cap of $7,500 or $15,000.

Restoring a Competitive Market

In a competitive market, the only thing government can do to make medical care more affordable is to not tax dollars dedicated to that need, thereby leaving more dollars in the hands of the citizen, who earned them, to spend for that need. Government interference in how the money earner uses it in the medical marketplace adds to the total cost, because it decreases competition among those providing the services. To restore market competition, insurers

must compete for the economic support of our citizens as well as doctors, hospitals, and others in the medical industry.

Restoration of a competitive market is essential. It creates better value for the medical expense dollar whenever the citizen chooses to spend it. Since government does not take any tax out of these earned dollars, there can be no wealth transfer from one economic group to another as a result of untaxed medical dollars. An untaxed dollar will purchase the same amount of goods or services, regardless of the earner's tax bracket.

Regional monopolies are developing as a result of third-party control of the payment system. When states mandate specific benefits and require coverage for specific providers, insurers lack the ability to design and market innovative policies at affordable prices. Without a mandate, plans that have universal application and are not tied to a network of providers will emerge. Innovative providers will create products, and services will be offered outside the third-party payment system. This will create the needed market competition that will moderate total cost by eliminating unneeded overhead and overuse of services.

Retired citizens would be permitted to deduct from their taxable income the difference between the dollar value of their medical retirement benefit plan and the established cap by placing the money in an HFA, where it would grow tax-free. Alternately, seniors could simply deduct, up to the difference, any out-of-pocket expenses from their taxable income. It permits the individual, who takes responsibility, to decide how much to tax-shelter for medical and other uses of the money.

Harvard economist Arnold Kling, in his book *The Crisis of Abundance*, makes the generalized statement in his concluding remarks that in a truly cost-effective medical market, about half of all medical expenses would be paid for directly, and about half with benefit dollars provided by insurance. This suggests that routine, diagnostic, and preventive services are most economically purchased directly from the individual's HFA when a competitive market exists.

Major unwanted and unanticipated medical needs are what we should insure against. This is essentially how insurance worked more than 60 years ago, when what was considered to be the best medical system in the world consumed only 4.7% of GDP. After those who earn the money lost control over how it is spent in the medical marketplace, medical costs started increasing at a rate that is now more than three times the rate of inflation. Medical expenditures now consume 16% of GDP, and many experts predict that the amount could rise to 20%.

Conclusion

As citizens, not the state, are sovereign over their own bodies, their rights and freedom of choice in medical care should be restored to the degree that they accept the responsibility for providing for their own needs The 180-Degree Approach would restore individual rights and freedom, while reducing costly over-insurance and overutilization of services. It would treat all medical expenditures alike under the tax code, thus restoring a competitive marketplace.

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