

WHAT WOULD A GOOD HEALTH CARE TAX CREDIT LOOK LIKE?

To promote ends that are deemed socially desirable—increasing home ownership, for example, or reducing the number of uninsured Americans—policymakers often rely on tax policy. Through the tax system, individuals can be offered subsidies in the form of tax deductions or credits. In the case of health insurance coverage, a well-structured tax credit could enable many uninsured Americans to obtain coverage that they would otherwise be unable to afford. (For definitions, see page 6.)

What are the elements of a well-structured health insurance tax credit? A tax credit that is poorly structured would not only waste money, it could also undermine effective programs such as Medicaid and the State Children’s Health Insurance Program (SCHIP). In order to offer meaningful help to the uninsured while minimizing harm to safety-net programs, a health care tax credit should meet the following criteria:

1. The credit should be available only to people who do not qualify for public coverage programs.
2. The tax credit must be available to all eligible people, including those who owe no federal taxes.
3. The credit should apply to employer-based health insurance coverage.
4. The credit should help people obtain good, comprehensive coverage and should encourage employers to maintain comprehensive coverage for workers.
5. Comprehensive and efficient state fallback plans should be established.
6. The size of the credit must be meaningful.
7. The credit must provide funds to people at the time that they pay their health insurance premiums—the first month that a person enrolls in a health plan, and as soon as premiums are due.
8. A strong rate review mechanism should be established.
9. Applying for the tax credit and paying premiums must be simple.
10. The public should be properly informed about the credit.

Tax credits can assist people who can afford to pay some amount for their health coverage but cannot pay the full price of insurance—people just above the income limits for public programs. For a health care tax credit to work, it must have the following important features:

1. **The credit should be available only to people who do not qualify for public coverage programs.** Public programs have a track record of success in assisting vulnerable people, whereas tax credits are a newer, less proven system for providing affordable coverage. It therefore makes sense to extend tax credits to people who are completely uninsured, but it would be foolish to put vulnerable people at risk by moving them from a proven system that works well.
2. **The tax credit must be available to all eligible people, including those who owe no federal taxes.** Unlike tax deductions, which provide the most help to people in higher tax brackets, tax credits can provide a dollar-for-dollar reduction in the amount of taxes owed based on the amount that people pay for health insurance premiums. To benefit people in low or zero tax brackets, the credit must also be “refundable,” which means that it is available in full to all who qualify, including those who owe little or no federal income tax. If an individual owes less in taxes than the amount of the credit, he or she would receive a refund of the difference.
3. **The credit should apply to employer-based health insurance coverage.** In most states, health coverage that is offered through employers includes many more consumer protections than coverage purchased by individuals. For example, insurers set a single premium price for all employees in a company regardless of their health or age. In contrast, for individuals who buy their own policies, insurers in many states base premium prices on age and health, charging higher prices to individuals who

A Good Tax Credit Should Not Overlap with Existing Public Programs

Tax credits should supplement—not undermine—public programs. Public programs have been successful in providing comprehensive coverage to a segment of the population while limiting administrative expenses. Therefore, programs such as Medicaid and the State Children’s Health Insurance Program (SCHIP) should be expanded to cover more people with low incomes, and tax credits can assist other people whom public programs do not reach.

In public programs, the government negotiates prices and is able to obtain cost-efficiencies because it is buying services for a large group of people. In addition, programs such as Medicaid and SCHIP ensure that children have access to services that promote their healthy growth and development. These programs also ensure that children will not be denied needed care even if their families cannot afford cost-sharing. Similarly, Medicaid ensures that people with disabilities get an appropriate range of services, including home- and community-based care, which is often not covered by commercial insurance companies. Finally, Medicaid and SCHIP offer a way for people to apply for health coverage that is not linked to their jobs. This is especially important for people who are in low-wage jobs that have frequent worker turnover.

Programs such as Medicaid and SCHIP offer a number of benefits and protections that are useful and appropriate for people with low incomes. These programs should be strengthened. States should maintain the investment they now have in Medicaid and SCHIP, and the federal government should provide funding so states can expand coverage. In addition, income guidelines for parents should be raised so that parents and children can get their coverage from the same source, and low-income childless adults should also be eligible for public coverage.

are older or sicker. Furthermore, insurance companies cannot refuse to cover a particular worker in a company due to that worker's health status, whereas in most states, insurers can refuse to sell a policy to an individual based on the individual's health. Finally, many firms now cover some or all of the costs of employee health insurance, and neither individuals nor the government can readily raise enough money to replace the value of employers' premium contributions.

For all of these reasons, employer-based coverage that meets certain standards should be eligible for a tax credit. When individuals do not have an offer of employer-based coverage, the government should offer an alternative plan that can be used with the tax credit. This alternative plan should incorporate similar protections: It should neither deny coverage nor price coverage based on factors over which the consumer has no control, such as prior health history, age, or gender.

- 4. The credit should help people obtain good, comprehensive coverage and should encourage employers to maintain comprehensive coverage for workers.** Consumers should be able to use the credit for comprehensive, low-deductible health plans. Full credits should apply only to plans that include coverage for inpatient and outpatient hospital services, physicians' surgical and medical services, laboratory and x-ray services, well-child care, prescription drugs, mental health services, vision care, dental care, and hearing services. State legislatures should continue to have the capacity to further specify minimum benefits as they, and the consumers they represent, note gaps in care.

To avoid creating a possible incentive for employers to downgrade the health insurance they offer to less comprehensive coverage or to drop coverage altogether (because their workers can enroll in a state fallback plan), a tax credit system must have effective mechanisms to discourage employers from reducing or dropping coverage. One way of doing this is by linking the credit to a strong employer-responsibility requirement, often referred to as a "pay or play" arrangement. Under such an arrangement, employers that do not pay a specified amount for their employees' health care are assessed a fee to fund public coverage. An adequate financial penalty would provide a disincentive for employers who might cut coverage and leave employees to take their tax credit to the state fallback plan. For those employers who do downgrade or cut coverage, the penalty fees collected would help subsidize the cost of coverage in the state fallback plan.

- 5. Comprehensive and efficient state fallback plans should be established.** If coverage meeting federal and state standards is not available through an employer-sponsored plan, people should be able to use their credit for a fallback plan that contracts with the state to serve them and that does not discriminate based on age, gender, or health status.

States should choose a manageable number of plans selected through a competitive bidding process that they would sponsor.¹ The state-contracted fallback plan must have an actuarial value at least equal to one of the following: the Federal Employees Health Benefit Program (FEHBP) Blue Cross Standard plan, the coverage generally available to state employees, or the commercial plan with the largest enrollment in the state. (These are the benchmarks now used for SCHIP coverage.)

As long as people begin the enrollment process within two months of losing other coverage or of becoming eligible for the tax credit, the plan should not exclude coverage of pre-existing conditions. To encourage enrollment among people who were previously uninsured and who had no affordable options for obtaining health insurance, the government should consider waiving pre-existing condition exclusions entirely for state-contracted fallback plans in the first years of operation.

6. **The size of the credit must be meaningful.** The size of the tax credit should be determined on a sliding fee scale: It must equal the full cost of health insurance premiums for people in the lowest tax brackets, and it must be sufficient to make health insurance affordable to people in somewhat higher tax brackets. Some public programs, such as Medicaid and SCHIP, now use the guideline that total out-of-pocket health care spending for premiums and cost-sharing should not exceed five percent of family income. The credit must be large enough so that when families use it with their typical plans, their overall out-of-pocket costs (including premiums and cost-sharing) are similarly limited to no more than five percent of income.²
7. **The credit must provide funds to people at the time that they pay their health insurance premiums—the first month that a person enrolls in a health plan and as soon as premiums are due.** Since many people cannot afford premium payments at all, they cannot afford to wait until the end of the year to get a credit through the tax system. In order for the tax credit to assist people in paying their premiums from the beginning, the credit must be “advanceable.” This means that consumers can be deemed eligible before they enroll in plans, and when they do enroll, they pay their share of premiums, and the government pays the appropriate subsidy.
8. **A strong rate review mechanism should be established.** Establishing premium rate review mechanisms allows the government to control the overall price of health insurance and to make sure that most of the money collected by insurance companies is actually used for medical care. For example, the federal government and/or the states could set a minimum percentage of premium dollars that must be spent on medical care (as opposed to administrative costs), called a medical loss ratio. When insurers initially set their premiums, they must estimate what they will spend on medical claims over the course of the year. If

an insurer's expenses for medical claims are lower than anticipated and do not meet the medical loss ratio, the insurer must refund the excess premium dollars to consumers at the end of the year. It is recommended that plans be required to spend at least 85 percent of their premium dollars on medical care rather than on administration or profit.

In addition, to protect consumers from plans that are bankrupt or otherwise financially unhealthy, the government could require that premiums be "actuarially sound." This means that insurers must follow standards, such as those set by the American Academy of Actuaries and the Actuarial Standards Board, to determine if premiums can reasonably be expected to cover losses and if the plan has adequate financial reserves. The test for actuarial soundness in health insurance often includes a medical loss ratio, but insurers could be allowed to make further adjustments to premiums based on their predictions of medical inflation over a several year period, anticipated swings in the economy, and other factors. Insurance companies would file forms and memoranda explaining how their rates are calculated, and these filings could be subject to government review.

- 9. Applying for the tax credit and paying premiums must be simple.** An applicant should be able to file one form with one government agency to get coverage. He or she should also be able to appoint a friend, family member, or agency to help with this process, and the IRS should be authorized to then communicate with that representative about the application, sharing otherwise confidential data about the status of the application. With authorization from the applicant and appropriate safeguards for privacy, the agency that determines eligibility should be able to use electronic data exchanges to verify eligibility. Plans should agree to bill enrollees only for the enrollees' share of premiums and to accept IRS tax credits for the remainder. This is in contrast to the current Health Care Tax Credit system in which the IRS obtains enrollee payments, adds the tax credit amount, and then pays plans the full premium. Streamlining this system will both lower government administrative costs and make the credits easier for consumers to use.
- 10. The public should be properly informed about the credit.** Vigorous public education and outreach should be undertaken to make sure taxpayers learn about the new credit. The government should fund outreach, education, and consumer counseling efforts, similar to the counseling now performed by SHIPs for Medicare beneficiaries. Linkages should be established with other public programs so that people who have already been found eligible for programs such as energy assistance and food stamps will receive targeted outreach and individual enrollment assistance. People receiving the Earned Income Tax Credit or whose tax returns or withholdings indicate that they are eligible for the health care tax credit should be asked if they wish to automatically enroll.

What Is a Tax Credit?

A tax credit is a dollar-for-dollar reduction in the amount of taxes an individual owes. Some tax credits are “refundable,” meaning that if an individual owes less in taxes than the amount of the credit, he or she receives a refund and benefits from the full amount of the credit. The Earned Income Tax Credit is an example of a well-known federal program that works in such a manner: Individuals with low incomes may either have their taxes reduced, or they may get a refund if the amount of the credit exceeds their tax liability (the amount of tax they owe). If individuals received a tax credit to put toward health insurance premium costs, their taxes would be reduced by the exact amount of such costs. If they did not owe taxes, they would receive a refund.³

How Does a Tax Credit Differ from a Tax Deduction?

With a tax deduction, individuals subtract a certain amount from their gross income before calculating their tax liability. Tax deductions reduce the amount of taxes owed by a percentage of the amount deducted, but they do not result in a refund. Further, tax deductions are regressive: People who have such low incomes that they do not pay taxes do not get any benefit from a deduction, and people in higher tax brackets benefit more than people in lower tax brackets. This is because tax liability is computed based on a percentage of net income. People with the lowest net incomes do not pay taxes; people with slightly higher incomes pay 15 percent of their incomes in taxes; and people in the next tax bracket pay 25 percent of their incomes in taxes, etc. Thus, if people are allowed to deduct health insurance costs from their income before computing their tax liability, a person in the 15 percent bracket gets her taxes reduced by 15 percent of the premium, while a person in the 25 percent bracket gets her taxes reduced by 25 percent of the premium.

What Is an Advanceable Tax Credit?

Most tax credits are paid out after people file their annual income tax returns. In this context, credits either reduce the amount of tax that is owed or provide a tax refund. However, some tax credits can instead be paid in advance based on a per-month estimate of the amount of the credit. An example of such a credit is the Health Care Tax Credit for people who receive Trade Readjustment Assistance from the federal government or, for early retirees, payments from the Pension Benefit Guaranty Corporation. Under this system, eligible individuals have 65 percent of their health plan premiums paid by the tax credit. Since some people need help paying premiums every month instead of when they file their taxes, the advance credit option allows them to receive the Health Care Tax Credit in the form of a monthly payment to their health plan administrators as premium payments become due.

ENDNOTES

¹ Polling data show that people want some plan choices, but not too many. For example, a recent poll found that most seniors favor simplifying Medicare Part D by reducing the number of available plans. The Kaiser Family Foundation and Harvard School of Public Health, *Seniors and the Medicare Prescription Drug Benefit* (Washington: Kaiser Family Foundation, December 2006), available online at <http://www.kff.org/kaiserpolls/upload/7604.pdf>.

² The Department of Labor's audit of the Health Care Tax Credit illustrates the problems with not setting tax credits and the participant's share of premium payments in a reasonable relationship to income. Under the Trade Adjustment Act, Health Care Tax Credits currently pay 65 percent of premiums for those eligible, leaving them responsible for the remaining 35 percent. The Department of Labor found that this is too costly for many people and is the primary reason for low enrollment in the tax credit. In some places, after the tax credit paid its share, participants are still left spending 87 percent of their monthly unemployment incomes on health insurance premiums. Office of the Inspector General, Department of Labor, *Performance Audit of Health Coverage Tax Credit Bridge and Gap Programs*, No. 02-05-204-03-330, September 30, 2005, available online at <http://www.oig.dol.gov/public/reports/oa/2005/02-05-204-03-330.pdf>. Similarly, studies show that when states raise premiums for poor and near-poor people in public coverage programs, enrollment declines significantly. Samantha Artiga and Molly O'Malley, *Increasing Premiums and Cost Sharing in Medicaid and SCHIP: Recent State Experiences* (Washington: Kaiser Family Foundation, May 2005), available online at <http://www.kff.org/medicaid/upload/Increasing-Premiums-and-Cost-Sharing-in-Medicaid-and-SCHIP-Recent-State-Experiences-Issue-Paper.pdf>.

³ Rather than exactly offsetting every dollar spent, tax credits can be based on a percentage of expenditures. For example, the existing Health Care Tax Credit (which helps people pay health insurance premiums when they lose jobs due to trade policies) pays 65 percent of premiums, leaving participants liable for the remaining 35 percent. However, this leaves people responsible for an expense that may be quite high relative to their incomes. Alternatively, tax credits can be structured to provide a large benefit to low-income people and progressively smaller benefits to people with higher incomes. For example, the Child and Dependent Care credit allows lower-income people to credit a somewhat higher percentage of their child care expenses than higher-income people.

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