A Flexible Benefits Tax Credit For Health Insurance And More

Policymakers have a unique opportunity to do the right thing for the uninsured in a way that could benefit all Americans.

by Lynn Etheredge

ABSTRACT: This essay outlines a concept for a "flexible benefits" tax credit for expanding health insurance coverage and other purposes such as retirement savings plans (with potential withdrawals for higher education, first-home ownership, and catastrophic medical expenses). Two examples are presented. The advantages of a flexible benefits tax credit are considered in terms of efficient use of the budget surplus to help meet the varied (and changing) needs of American families, to eliminate major national gaps in health insurance and pension coverage, and to advance other objectives. If the budget surplus is used wisely, political decisionmakers could achieve health insurance coverage for most uninsured workers and children and assure a future with real economic security for American families.

The nation now has the best opportunity in decades to expand coverage for forty-two million persons without health insurance and address other public needs. Many proposals are being put forward to use part of the $2.7 trillion projected budget surpluses, such as separate tax credits for expanding health insurance, for retirement savings accounts, and for other purposes.[1] Nevertheless, in the new legislative session there will be many competing tax cut and spending ideas, and the potential uses of the budget surpluses, even with recent upward revisions, will greatly exceed the funds that will be available. Political decisionmakers face a difficult challenge to achieve the most public value with the available funds and to build broad political support to enact proposals.

As a possible solution to these problems, a flexible benefits tax credit has important advantages. (1) A flexible benefits tax credit offers American families assistance that can adapt to their differing circumstances, as well as to how their needs change over time. While forty-two million Americans now lack health insurance cov-

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erage, measured at a point in time, lack of health insurance coverage is most often a short-term problem—for example, six months to a year.[2] At other times, a family's financial needs may include paying for higher education or first-home purchase. With about half of the workforce lacking employer-sponsored retirement plans, retirement savings becomes an important issue for older workers, such as the baby-boom generation.

(2) A flexible benefits tax credit in the range of $1,000–$1,500 per worker can make basic health insurance affordable for workers (with a Medicare-level benefit) and offer a financial future with real retirement security (several hundred thousand dollars per couple). A flexible benefits tax credit would achieve the broadest extension of health benefits and economic security for American workers—via private health insurance and retirement accounts—since the enactment of Social Security and Medicare. Individuals who already have health insurance and retirement plans could elect to take the credit as a tax rebate.

(3) A flexible benefits tax credit can broaden benefits and political support without additional budget costs. If there were a $1,000–$1,500 single-purpose tax credit per worker, for example, expanding it into a flexible benefits tax credit would not increase government's budget costs (which would still be $1,000–$1,500 per worker). But it would offer workers more opportunities to use such credits and would appeal to advocates for more causes. Since a flexible benefits tax credit could broaden support for a comprehensive tax bill, without adding to its costs, it would be a logical amendment to be considered in Congress as one of the elements of tax legislation. Although it starts without the strong constituencies for single-purpose tax credits, a flexible benefits tax credit offers a potential model for a broadly supported compromise.

This paper seeks to promote discussion of flexible benefits tax credit ideas. It considers two examples of how such proposals could be constructed and outlines potential advantages compared with stand-alone health insurance tax credit proposals. Since there are many individual proposals for tax credits, general tax cuts, and many other tax reform ideas that are potential candidates for a comprehensive tax bill, this paper focuses on general observations that would be applicable to a range of specific legislative proposals.

The first option describes how a flexible benefits tax credit could achieve expanded health insurance coverage for workers and their families. The second option describes how a flexible benefits tax credit could also be expanded to include retirement savings, with withdrawal options for higher education, first-time home purchase, and catastrophic medical expenses.

A Flexible Benefits Tax Credit With Health Insurance Options

For this proposal, let us assume that the federal government offers to make available a $1,000 per worker ($2,000 per couple) tax credit for low-to-moderate-income workers. This amount was supported by George W. Bush during the presidential campaign for expanding health insurance coverage and had support in the 106th Congress.[3] As part of a flexible benefits strategy, this tax credit could be made available to workers for optional uses, as follows: (1) Workers who do not have health insurance for their children would need to sign them up for Medicaid or the State Children's Health Insurance Program (SCHIP) (which cover most uninsured children free or at reduced cost), or they could use this tax credit to purchase private health insurance for them. (2) Workers who do not have basic health insurance for themselves would be expected, via "automatic enrollment" and sign-up at their workplace and payroll withholding, to use these tax credits to buy basic health insurance for themselves. (3) If they decline to do so, a third option, the "default option" for use of these tax credits, would transfer them to state government for safety-net coverage. (4) Workers who have health insurance coverage for themselves and their children could elect a fourth flexible benefits tax credit option: to take the amount as a "refundable tax credit," that is, cash income, to be used at their discretion.

These flexible benefits options are structured to foster personal responsibility for individuals to provide for their own health insurance needs and those of their children. A tax bill adopting this flexible benefits model would assist both the uninsured (via health insurance coverage) and the majority of workers with health insurance (via cash rebates). Compared to across-the-board tax cuts and to a separate health insurance tax credit, a flexible benefits strategy also offers the following advantages.

■ **Expanded children's coverage.** This flexible benefits tax credit is intended to guarantee affordable coverage for workers and their families by combining new tax credits (for workers) with Medicaid and SCHIP benefits (for children in low-to-moderate-income households).[4] A recent analysis of census data indicates that 94 percent of the 7.1 million uninsured children with incomes below 200 percent of poverty are now eligible for Medicaid or SCHIP but are not enrolled.[5] For uninsured children, this proposal creates a strong new incentive—$2,000 for a two-adult family—for parents to enroll their children for the (free or reduced-cost) Medicaid/SCHIP coverage, or for private health insurance, to qualify for the flexible benefits tax credit.[6] The initiative would be accompanied by literature on Medicaid and SCHIP eligibility standards, explaining how to enroll and providing other relevant information.[7]

■ **Expanded coverage for workers.** A $1,000 tax credit, by itself, would buy only a basic health insurance product. Nevertheless, it would be sufficient to finance a Medicare-level benefit package for uninsured workers if it were combined with a $500 annual worker premium (less than $10 per week). Since Medicare's retired workers, with average Social Security benefits of about $10,000 per year, are expected to pay a $600 annual Medicare premium (2001), it seems reasonable also to expect a significant premium from employed workers. It also seems reasonable to use current Medicare benefits as a benchmark for tax credit financing, since it is the closest we have to a national standard for basic coverage, to which all workers are now contributing through payroll taxes. Although it falls short of most employer-based private health insurance, the Medicare benefits package offers enough financial protection to be a serviceable "bridge" policy for short-term periods of uninsurance, and it would be a major advance from the status quo (lack of insurance). Individuals as well as state governments would be able to supplement this coverage.

A stand-alone $1,000 per worker tax credit, without complementary efforts to encourage individuals to obtain health insurance coverage, would probably have a low take-up rate.[8] To address this issue, this flexible benefits example includes an "automatic enrollment" feature whereby each worker without employer-offered health insurance will be enrolled in an insurance plan of his or her choice, financed by the tax credit and worker payroll withholding, unless the worker signs a written form declining these options. The Medicare Supplementary Medical Insurance (SMI), or Part B, program has successfully used an automatic enrollment feature (premium withholding from Social Security checks, unless declined by the beneficiary) to achieve take-up rates of greater than 90 percent, and recent experience with introducing an automatic enrollment feature for employer pension plans has also shown 90 percent take-up rates, much higher than if workers are simply offered optional enrollment.[9]

Finally, if workers decline in writing to make use of the tax credits to purchase private health insurance for themselves, or do not provide for their children's health insurance, this selection (the "default option") will direct that their funds be transferred to state governments for purchase of whatever safety-net coverage can be made available. Thus, a flexible benefits tax credit will ensure that all eligible workers have at least a basic health insurance benefit, either through their use of these tax credits and their own premiums to purchase private health insurance or through state safety-net programs.

A flexible benefit for lower-income workers would further the objectives of encouraging individuals to work instead of remaining on welfare. For low-income workers, Medicaid could pay all or part of a worker's premium share, as it does for low-income Medicare enrollees (qualified Medicare beneficiaries [QMBs] and specified low-income Medicare beneficiaries [SLMBs]).

■ **Protection for employer-group health insurance.** One of the concerns about providing separate tax credits for individuals without employer-group health insurance is that this could lead to some unravelling of employer coverage. This can require such proposals to add expensive increases in tax subsidies for employer coverage to maintain that coverage, which just makes the current subsidies more expensive. A flexible benefits tax credit handles these issues directly and with potential public appeal. It provides the same tax credit for workers with and without employer health insurance and thus maintains the existing tax advantages for employer insurance. For workers who now have health insurance, these tax credits could be elected as cash income for the workers themselves. This gives workers, rather than employers or health insurers, the additional income.[10]

This health insurance tax credit option will need to be coupled with a basic set of health insurance market provisions. These include assured availability of coverage, which can be accomplished by extending national portability and preexisting condition standards in group insurance under the Health Insurance Portability and Accountability Act (HIPAA) to the population eligible for tax credits. Some health insurance rating rules will also be needed to assure affordability. This can be accomplished with minimum new federal regulation by providing that states, if they do not adopt community rating for this new market, should adjust subsidies for the same factors as health insurance companies are allowed to use in setting rates.[11]

Adding A Retirement/Savings Option

This option would be similar to Option 1, but it would also include more individual choices for use of the federal tax credit—as a contribution to a tax-qualified retirement/savings plan for workers who do not have such a plan sponsored by their employer. This proposal recognizes that the national savings rate has fallen to its lowest level in more than forty years and that many Americans—particularly in the baby-boom generation—are not saving enough for their retirement needs.[12] It also recognizes that nearly half of the workforce

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now lacks an employer-provided pension. Distributions from individual retirement accounts (IRAs) are now allowed for purposes such as higher education expenses, first-time home purchase, and catastrophic medical expenses (above 7.5 percent of adjusted gross income).[13] Early distributions from a tax credit–related retirement/savings plan could similarly be available for these purposes.

Given these broader objectives, let's assume that a $1,500 per worker tax credit is available for this option. The higher amount is certainly reasonable to consider, given its broader purpose and support for a $1,000 tax credit for health insurance alone and for expansion of retirement savings.

This flexible benefits tax credit would offer the same health insurance options as before. In addition, a new retirement option would be available. Workers who already have health insurance coverage for themselves and their children—but do not have an employer-sponsored retirement plan—could elect to have the $1,500 tax credit paid into a qualified retirement savings account (such as an IRA) as a matching contribution, if they also contributed $500; or they could take a $1,000 tax credit as cash income, to be used at their discretion. Workers who already have health insurance coverage for themselves and their children, as well as an employer-sponsored retirement plan, could elect the option to take the amount as cash income, to be used at their discretion.

In Option 2, health coverage is accorded a higher-priority option than retirement savings. This is appropriate for several reasons: (1) Health insurance can help to maintain and improve health of enrolled individuals and is especially important for children; (2) lack of health insurance shifts costs on to others in society; and (3) absence of health insurance is a huge gap in basic financial security, so that a family's savings are much in jeopardy if they lack such coverage. Once basic health insurance is acquired, savings for other purposes, such as home ownership, higher education, and retirement, can be more secure. As with Option 1, this option also encourages individuals to take personal responsibility for their health insurance and retirement needs.

Option 2 shares the same health insurance advantages as Option 1: children's health insurance coverage, workers' health insurance coverage, and protection of employer-group health insurance. To these benefits it adds the following:

■ **Expansion of retirement/savings plans.** A flexible benefits tax credit that includes options for investing these amounts in retirement accounts provides an incentive to have such an account. The Option 2 proposal goes further to provide a $1,500 tax credit if workers invest $500 of their own funds but provides only $1,000 in a cash payment if they choose not to save the funds. If a worker invests $2,000 per year in a tax-qualified retirement plan ($1,500 from a flexible benefits tax credit plus $500) for thirty-five years, the total account balance available at retirement would be about $150,000 in today's purchasing power; a two-worker family could invest twice that amount and have twice the total account balance.[14]

There is widespread agreement about the desirability to expand private pension coverage, particularly in light of projected financing needs of Social Security and Medicare. There is also experience that worker participation rates in savings plans are much higher if there is automatic enrollment, automatic payroll withholding, and matching incentives. This flexible benefits tax credit example uses these attributes of employer-sponsored plans to fill in the gaps in private retirement coverage.

A flexible benefits tax credit can be coordinated with various Social Security reform models. The suggested option is for private retirement plans to be "plus" accounts, on top of Social Security, thus assuring an increase in retirement security beyond current benefits. A second option would be to allow eligible workers to allocate part of their Social Security taxes as an element of the $500 matching contribution to receive the $1,500 retirement/savings tax credits.[15]

■ **Budget costs.** As in Option 1, the low marginal costs of adding flexible benefits options are a potentially attractive feature. If there is a $1,000–$1,500 per worker health insurance tax credit, for example, adding a flexible benefit for retirement/savings simply affects the allocation of these funds, rather than the government's costs.

■ **Protection for employer-group pension coverage.** As with Option 1, this broadened flexible benefits credit provides equal amounts of new tax credits for individuals with and without employer-based health and pension benefits and maintains the existing differential in favor of employer-based coverage.

■ **Higher education, home ownership, and catastrophic medical benefits.** A provision for families to elect early withdrawal for these purposes conforms these new savings arrangements with current IRA options. Thus, a flexible benefits tax credit can expand educational opportunities, as well as home ownership. In view of the limited health insurance benefit, it is desirable to have available additional savings from which to pay uncovered expenses.[16]

Retirement savings and other potential uses of a flexible tax credit will need a basic set of related provisions, such as the definition of a "qualified" savings plan. Such provisions can simply extend current rules applied to pensions, IRAs, 401(k) plans, and Employee Retirement Income Security Act (ERISA) protections to these similar plans.[17]

Impact On The Federal Budget

The flexible benefits tax credit options discussed above are designed to fill in major gaps in health insurance and pension coverage that lie between low-income individuals eligible for public programs, such as Medicaid or SSI, and the approximately one-half of the workforce that has employer-sponsored health insurance and pension coverage and is already assisted by more than $140 billion annually in federal tax subsidies for such plans. As part of a tax bill, a basic tax credit per worker would be particularly useful for lower-income workers who do not have income tax liabilities or would not benefit much from lower marginal tax rates.

Although there are a number of details involved in costing a specific tax credit plan, the key policy decisions include eligibility; the basic amount of the credit; and the income range over which it would be phased. For illustration, let us assume that a $1,000 multi-use credit would go to the lowest-income one-third of workers and that it would then be phased down, with the next-highest-income one-third of workers receiving a 50 percent benefit, on average. On this basis, with about 140 million workers, the costs would be approximately $70 billion annually, with about 35–40 percent of the expenses going for basic health insurance for about thirty-two million uninsured (predominantly low-income) workers (twenty-four million) and self-pay workers (eight million), on a yearly average. In addition, six to seven million Medicaid- or SCHIP-eligible uninsured children would likely be covered because of new worker incentives to enroll them. In total, about ninety million workers would benefit each year: from new health insurance financing, including forty to forty-five million workers who may be uninsured or self-pay during part of a year; and/or from new tax credits paid into a qualified savings plan or as tax rebates. Most workers would be eligible for some tax credits during their careers; savings accounts built up during these periods could provide continuing financial security. On a ten-year basis, with inflation adjustments, the budget expenses would be about $785 billion of the $2.7 trillion, less than 30 percent of the available surplus. A $1,500 per worker tax credit, with the same targeting and phase-out, would use about 45 percent of the available surplus.

The current budget surplus of $2.7 trillion offers a unique opportunity for political decisionmakers. As part of a national strategy for using these funds, a flexible benefits tax credit could achieve health insurance coverage for most uninsured workers and children; assist in financing higher education and first-home purchase and paying catastrophic medical expenses; and offer a future with real economic security for American families.

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NOTES

1. Recent CBO projections estimate the ten-year surplus to be $5.6 trillion. Excluding Social Security and Medicare surpluses, there would still be $2.7 trillion available. Congressional Budget Office, *The Budget and Economic Outlook, FY 2002–2011* (Washington: CBO, January 2001).
2. Census Bureau studies indicate about 50 percent of the uninsured are without coverage for six months or less. R. Bennefield, *Who Loses Coverage and for How Long?* Current Population Reports, P70-54 (Washington: U.S. Bureau of the Census, May 1996). Other studies indicate an average duration of about a year. S. Glied, *Challenges and Options for Increasing the Number of Americans with Health Insurance*, Pub. no. 415 (New York: Commonwealth Fund, December 2000). During a year, several studies suggest that fifty-five million to sixty-six million persons may be uninsured for some period.
3. The credit would be phased down for middle-to-upper-income taxpayers. A flat credit is easier to administer for low-to-moderate-income workers who do not file a tax return. Starting a phase-down at income levels where individuals already file a form 1040 permits using the existing tax reporting system to adjust the tax credits.
4. SCHIP targets children up to 200 percent of poverty (about $33,000 for a family of four).
5. M. Broaddus and L. Ku, "Nearly 95 Percent of Low-Income Uninsured Children Now Are Eligible for Medicaid or SCHIP," Center on Budget and Policy Priorities, 6 December 2000, <www.cbpp.org/12-6-00schip.htm> (10 January 2001).
6. The income tax criteria for claiming a child as a dependent could be used as a criterion for responsibility to assure health insurance coverage.
7. If employers did not make affordable options available for children's coverage, states could provide such an option for workers to elect. Premiums for a low-cost children's health benefits package (Medicare benefits, plus well-child and preventive services) would be about $900 per child. Workers above the SCHIP income level ($33,000 for family of four) should be able to afford such coverage from their own earnings and the new tax credits.
8. See, for example, J. Gruber and L. Levitt, "Will Tax Subsidies Really Work?" *Health Affairs* (Jan/Feb 2000): 72–85.
9. B. Madrian and D. Shea, "The Power of Suggestion: Inertia in 401(K) Participation and Savings Behavior," NBER Working Paper no. 7682 (Cambridge, Mass.: National Bureau of Economic Research, May 2000).
10. If an employer dropped health insurance coverage, it would reduce a worker's cash income by $1,000 (since he or she would be required to use the tax credit

to purchase health insurance), as well as costing them the employer's health insurance premium payment. In a competitive labor market, the firm's workers would start looking for other places to work.

11. See, for example, L. Etheredge, *Tax Credits for Uninsured Workers*, HIRP Research Agenda Brief (Washington: Health Insurance Reform Project, George Washington University, September 1999).
12. For a discussion, see P. Yakoboski, *Retirement Plans, Personal Saving, and Saving Adequacy*, EBRI Issue Brief no. 219 (Washington: Employee Benefit Research Institute, March 2000).
13. *Individual Retirement Arrangements (IRAs)*, Pub. 590 (Washington: Internal Revenue Service, 2000).
14. The account would accumulate to $275,000, assuming a 7 percent average rate of return. In "real" terms (a 4 percent per year rate of increase), the retirement account balance would be worth approximately $150,000 in today's purchasing power. If the $2,000 limit (and the $1,500 tax credit plus $500 matching) were allowed to rise with the cost of living, the retirement account balances after thirty-five years would be greater: $395,000 per worker (at a 3 percent inflation rate), or about $225,000 per worker in today's purchasing power.
15. It would also be possible to allow individuals to allocate the $1,500 tax credit to purchase supplemental Social Security benefits, which could provide additional cash benefits, or a "cafeteria plan" menu of options at retirement, including cash income, prescription drug and Medigap coverage, long-term care insurance, and other options.
16. In this sense, a flexible benefits tax credit has similarities to a "medical IRA," in that the amounts beyond a basic health insurance package could be used for a savings account. The basic health insurance plan suggested (Medicare-level benefits) is more generous than a catastrophic-only plan, and the flexible benefits feature protects employer-group coverage and adds more optional uses.
17. With a flexible benefits tax credit, new administrative systems for tax credits to expand health insurance and retirement/savings can be designed together. Unless an eligible worker elects cash, the tax credits would not be paid to the worker but to his or her selected health insurance plan, state program, or retirement savings plan. Employers' responsibilities would simply be to provide sign-up/explanatory materials and remit any worker-requested payroll withholding, either directly to a health insurance or savings plan or through an intermediary, such as a bank. Various health insurance (for example, health insurance exchanges, cooperatives, or alliances) or pension service centers could be contracted with to assist workers and employers.