

Scott Hodge: Thank you for tuning in today. I'm Scott Hodge, President of the Tax Foundation. I'm pleased to be joined today for our weekly podcast by Dr. Katherine Baicker, who is a member of the President's Council of Economic Advisors. Dr. Baicker is an associate professor in the department of public policy at the School of Public Affairs at UCLA and a research associate at the National Bureau of Economic Research. Kate, thank you very much for joining me today. I'm sure you've had a very busy schedule talking about the President's tax reform recently.

Katherine Baicker: Well, thank you so much for having me.

Scott Hodge: Well, obviously the President's tax reform or health care reform plan is in the news. I understand that it was designed to address very particular issues in the health care market. I think a lot of economists understand that some of the current problems in the health care market today go way back to World War II when employers were given an exclusion for providing health insurance. Can you tell us a little bit about how that all came about and what market distortions it has caused and why we're in the position we're at today?

Katherine Baicker: I think you've got it exactly right. The reason we're in a lot of the health care trouble that we are today is that back in World War II there were wage and price controls that prevented employers from raising wages but allowed them to raise health insurance benefit and not be taxed on those. That's the genesis of our employer-based health insurance system. So today most of the people insured in the private market get their health care through their employer. That sounds fine on the surface but it raises a lot of problems that lead to both unfairness and inefficiency. The President's proposal aims to correct both of those.

So let's start with the problems with the current system. Right now if you get any kind of health insurance from your employer, that insurance is tax-preferred. That means that neither you nor your employer are paying taxes on those health insurance premiums but any other wage compensation that you get from your employer is taxed, which means there's a strong incentive for you to get more of your compensation in the form of health insurance and less in the form of wages.

The problem with that is that things that you wouldn't normally cover by insurance are much more affordable to you if you get them covered by your employer policy than if you get them on your own now. That's both unfair and inefficient. If you go to the

doctor's office now and pay out of pocket, you get no tax subsidy, no help through the tax code, but if that doctor's office visit is covered by your employer-provided plan then it's tax preferred. You pay for it with pre-tax dollars.

So that means we all have health insurance that looks nothing like any other kind of insurance that we get. There is first-dollar coverage of routine things that you could afford to pay for out of pocket through your health insurance plan that you would never do through your auto insurance or through your homeowner's insurance. That doesn't mean that you're just getting better, higher-value health care through your employer plan. It means that we are artificially subsidizing people with the most generous gold-plated Cadillac plans at the expense of people who are struggling to buy basic plans on their own.

Scott Hodge:

Well, the President has set out a couple of key policies in order to try to change the market functions here. Could you go through them bit by bit and how they're intended to overcome some of the distortions we have today?

Katherine Baicker:

Yes. Thanks. The current system, as we laid out before, has these biases built in where people who get insurance through their jobs get a tax subsidy but people who don't, don't. People who get more generous plans get a bigger tax subsidy than people with more basic plans. So the President's proposal aims to level that playing field in two ways. It would give the same tax advantage to people struggling to get insurance on their own that people who currently get it through their jobs enjoy. It would also give the same tax advantage to people who purchase a basic plan as to people who get a more gold-plated plan.

The way the proposal accomplishes that is by giving everybody who's covered by a private health insurance plan a standard health insurance deduction. If you're covered by a family policy it's a \$15,000 deduction. If you're covered by a single policy it's a \$7,500 deduction. You get that same deduction no matter where you get your insurance and no matter what your insurance premium is. So for anybody who's uninsured right now this gives them enormous help in getting an insurance policy. Even if they're low-income they get a big subsidy because it's payroll and income tax free.

The standard deduction would exempt the first \$15,000 of income from both payroll taxes and income taxes. So low-income people who might not be paying income taxes would still get the

advantage of the payroll tax back. So anybody who's uninsured gets a big tax advantage. Anybody who's currently struggling to purchase insurance on their own gets a big tax advantage that they would have no help with under the current system. People getting policies from their employer, as long as their policy is less than the standard deduction, would see their tax bills go down immediately and people whose policies are more generous than the current deduction would have ample time to adjust their compensation packages before the proposal takes effect in 2009.

Scott Hodge: I think it's important to point out a difference that you addressed with the standard deduction that I think all of us are used to in our 1040, which applies only to income tax. This would apply also to payroll taxes. Is that correct?

Katherine Baicker: Yes. So you would take your first \$15,000 compensation home income and payroll tax-free as long as you were covered by at least a basic insurance policy.

Scott Hodge: Now I'm sure that there are people out there who want to know how it's going to affect them. Obviously there are really a couple of types of folks out there. There are people who already have insurance through their employer, there are the self-employed or the small business owners and then there are currently the under-insured or uninsured. Could you address how each one of those people would be affected?

Katherine Baicker: Yes. The uninsured right now face the prospect of buying insurance with after-tax dollars. That means whatever they earn they have to pay their taxes and then they have to try to get insurance. Under this policy they would get a standard deduction of \$15,000 for a family policy or \$7,500 for an individual policy, which would immediately lower their tax bills as long as they purchased insurance. In fact the standard deduction is high enough that for a lot of people who are currently uninsured they could get a policy virtually for free if they got a basic policy through the individual market. The cost of that policy would be roughly the same size as the tax benefit they would get.

So that would be an enormous help to them in getting insurance. For the self-employed or the independent contractors who are trying to get insurance on their own, if you're self-employed you can get your premiums without paying income taxes on that premium but you're still paying your self-employment taxes on the premium in the current system. This proposal would let you pay

your premiums both income and self-employment tax-free. So that would be a big help for them as well.

Scott Hodge: Now I think there's been some confusion on how the plan would affect someone's Social Security benefits because there is obviously this offset for FICA or payroll taxes. The Council has looked at this I'm sure in great detail along with the Treasury. How do you respond to some of those worries that someone might lose somewhere down the line some Social Security benefits?

Katherine Baicker: The way the current system works people are treated differently in the Social Security system based on whether they're getting their insurance from their employer or buying their insurance on their own because they're paying payroll taxes and accruing benefits based on their premiums if they're getting it on their own but not if they're getting it from their employer. This proposal would level that inequity and treat all people the same based on their total compensation from their employer. Now the only people—some people would see their payroll taxes go down because of this. Anybody who's buying a policy that's under the standard deduction would see their payroll taxes go down. Their benefits are based on their payroll taxes paid in.

So this would level an inequity in the way people are treated based on their form of compensation and some people would indeed be paying less into the payroll tax Social Security system because they would be getting to take more of their compensation tax-free. That would be treated in a parallel way. The important thing to understand for the system as a whole is that this in no way harms the solvency of the Social Security system. In fact it improves the solvency of the Social Security system in the long run.

Scott Hodge: Let's focus on the long run because I know that you've been doing some long-term modeling of the effects of this on both the economy itself but also on the wages and how people might be over time shifting their compensation away from health care and toward actual salary and wages. Could you talk about the long term?

Katherine Baicker: Sure. First thing to note is that this proposal is budget-neutral over the 10-year budget window. What that means is that on average taxes are not going to be going up. They're not going to be going down. It's a revenue-neutral tax reform. So a great feature of this proposal is that is both very good health policy and very good tax policy.

Now what does that mean for individual people and their health insurance? Well, right now there's a bias in the tax code that's pushing people towards higher health insurance premiums and holding down wages. So people have been taking an increasing share of their compensation in the form of higher health insurance premiums and that keeps wage increases down. In the long run we expect people to make decisions about how much of their compensation they want as wages and how much they want as health insurance based on what's best for them and their families without the tax code pushing them one direction or the other.

Now that means some people are going to want more health insurance. Some people are going to want more basic policies and to save for routine expenditures on their own and people are going to make that choice based on how much they value different features of their health insurance. Some people might want to see any doctor they want for the same price. Some people might want to have a more restricted pool of doctors in exchange for a lower premium. Some people might want more cost sharing at the beginning in exchange for really good financial protection at the high end. People will make those choices based on how much they value different features of their insurance package and they'll trade that off against how much of their compensation they'd like to take as wages to spend on anything they like and how much they'd like to take as health insurance.

Scott Hodge: Do you see this having a long-term affect on dampening the health care inflation-, if you w---ill?

Katherine Baicker: Absolutely. Part of the reason that health care costs are spiralling out of control is that the tax code is pushing people into insurance policies that increasingly cover care of marginal value. If that bias weren't there, people would be shopping around for the highest-value plans for them. That doesn't mean the cheapest plan.

People value health insurance and it's a wonderful thing that everybody should have access to but that means that they will be choosing the plan that provides the highest quality at the best price, covering things in the highest-value way for them. That would eliminate a bias that pushes people towards inefficient first-dollar coverage that drives up health care costs for them, making health insurance increasingly unaffordable for employers and employees and also increasingly out of reach of the uninsured and putting much more pressure on Medicare and Medicaid and federal budgets. So the goal of this policy in leveling the playing field is not only to make the system more fair to people who currently

aren't getting any tax benefits but also to eliminate the inefficiencies that are driving health care costs up and up and up. So in the long run health care costs should grow much more slowly because of this policy.

Scott Hodge: One last question—and I suppose it's more of a political than an economic—but certainly the President is going to have to get the interest of members of Congress and work with them on this. Do you see areas in which you can reach some agreement with members of Congress and find some say bi-partisan support to advance this issue?

Katherine Baicker: I'm really excited about the President's proposals but you're talking to somebody who's a bit of a policy geek and less experienced in the political realm. I've been really excited to read about the enthusiastic responses of policymakers across the spectrum to getting a much more rational treatment of health insurance in our tax code. I think that anybody who's taken some time to really think through the proposal is excited and intrigued by having this much more efficient option put on the table. I'm looking forward to any way that I can help in that debate.

Scott Hodge: Well, Kate, thank you very much for taking time out of your enormously busy schedule. This is a very, very bold plan and I wish you the best of luck in trying to move it forward.

Katherine Baicker: Well, thank you for the opportunity.

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