**Brilliant Deduction**
By John F. Cogan, **R. Glenn Hubbard** and Daniel P. Kessler
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The coming tax-reform debate will bring forth discussion of saving and investment and cries for simplification to be sure. This is all to the good. But our politicians and policy makers in Washington and beyond should bear in mind that the tax code lies at the heart of the problems in America's largest market -- accounting for one-seventh of the nation's GDP -- health care.

We propose a simple change to tax law that would cut unproductive health spending, reduce the number of uninsured and promote greater tax fairness. For anyone with at least catastrophic insurance coverage, all health-care expenses -- employee contributions to employer-provided insurance, individually purchased insurance and out-of-pocket spending -- would be tax-deductible. The deduction would be available to those who claim the standard deduction and to those who itemize.

The most important effect of tax deductibility would be to reduce unproductive health spending. Under current law, medical care purchased through an employer's insurance plan is tax-free, while direct medical care purchased by patients must be made with after-tax income. As we and many others have observed, this tax preference has given patients the incentive to purchase care through low-deductible, low-copayment insurance instead of out-of-pocket, which in turn leads to cost-unconsciousness and wasteful medical practices. In addition, the tax preference for insurance creates incentives for the health-care system to rely on gatekeepers rather than deductibles and copayments when it does try to control costs. The cost of gatekeepers are financed out of insurance premiums that are paid with before-tax dollars; deductibles and copayments are paid with after-tax dollars.

According to our calculations, based on research from the RAND Health Insurance Experiment and others, we estimate that tax deductibility would reduce spending by approximately $40 billion in 2004 dollars, or 6% of total private health spending. These savings could be achieved without significant adverse consequences for health outcomes. This occurs in spite of the fact that tax deductibility makes health care overall look cheaper relative to all other goods, which leads to higher spending. By making insured health care look more expensive relative to out-of-pocket health care, tax deductibility leads patients to choose health plans with higher deductibles and copayments, and therefore to reduce spending enough to more than offset this effect.

Tax deductibility also will reduce the number of people who are uninsured. Tax deductibility decreases the price of insurance for a large number of uninsured persons. We estimate that approximately 20 million uninsured live in a household with a working member who pays federal income taxes. For the approximately 12 million uninsured taxpayers who are not offered insurance by their employer, the increase in the incentive to purchase insurance is especially large. By purchasing insurance, such an individual could deduct both his or her insurance premiums and any out-of-pocket expenses, neither of which is deductible under current law. For example, consider someone who is contemplating the purchase of an insurance plan that costs $1,000 and would leave him or her with expected out-of-pocket expenses of $1,000. Assuming a marginal tax rate of 15%, he or she would receive a tax reduction of $300, which translates into a 30% reduction in the price of insurance. Depending on how price-sensitive uninsured people are, we calculate that tax deductibility would reduce the number of uninsured by two million to six million people.

Finally, tax deductibility will make the tax system fairer. Current tax law penalizes workers whose employer does not offer them health insurance. They must buy insurance with after-tax dollars. Also, in spite of the fact that a $1 deduction benefits a high-income taxpayer more than a low-income one, tax deductibility is not a tax break for the rich. As our calculations from the Medical Expenditure Panel Survey show, percentage tax reductions from deductibility for low-income households are three to five times the size of reductions for high-income households. This outcome occurs because low-income taxpayers are more likely to have high levels of out-of-pocket spending.

Under any reasonable set of assumptions about how doctors, patients and health plans would respond to this unprecedented change in tax law, tax deductibility is a sound economic policy with benefits that outweigh its costs. We calculate that tax deductibility would lead to approximately $8 billion per year in foregone federal revenue. The gross revenue loss from making current out-of-pocket expenses tax deductible is approximately $27 billion. But tax deductibility will also create a revenue gain by changing how health spending is financed and by reducing health spending overall. Tax deductibility will redirect some health spending from insurance (which is excludable from both income and payroll taxes) to out-of-pocket (which is deductible only from income taxes). This creates a revenue gain of $8 billion.

In addition, tax deductibility will redirect some health spending from insurance to other, non-health consumption. Just as increases in health-insurance spending are borne by workers in the form of lower wages, decreases in insurance spending will accrue to workers in the form of higher wages. Because these higher wages will be subject to both income and payroll taxes, this creates a revenue gain of $11 billion.

Thus, full deductibility would lead to approximately $5 less spending on relatively unproductive care for each dollar of foregone tax revenue. That's right -- a progressive tax cut would lead to an efficiency gain in the larger economy about five times as great. This fails to give any weight at all to the other benefits of deductibility.

There is good reason that deductibility of health-care spending should figure prominently in the tax-reform debate. It will be a critical step in achieving objectives of both conservatives and liberals in health-care policy -- greater reliance on market forces, increased efficiency, fewer uninsured and greater fairness. It is an idea whose time has come.

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Mr. Cogan, a senior fellow at the Hoover Institution, was deputy director of the Office of Management and Budget. Mr. Hubbard, dean of Columbia Business School, was chairman of President Bush's Council of Economic Advisers. Mr. Kessler, a senior fellow at Hoover, is a professor at Stanford.