THE LEADERS' PROJECT
On the State of American Health Care

Financing the U.S. Health System

Issues and Options for Change

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Health reform proposals across the spectrum include changes in how the U.S. health system is financed. Yet changing the way health care is financed could have a major impact on our health insurance system. New financing approaches could affect health spending by changing where people get health insurance and the nature of the coverage they buy, improving transparency and awareness of pricing, and altering the share of health spending borne by government.

Financing the U.S. Health System: Issues and Options for Change explores the implications of five recently proposed ideas for financing the health system. These include: continuing current financing and redirecting health spending to more effective uses; rolling back high-income tax cuts; modifying the current tax exclusion for health benefits; a play-or-pay model; and a value-added tax.

Despite their differences, the proposals all share the goals of improving the value, sustainability, quality, and coverage of health care for all Americans. All five would be linked to policies that would reduce health care spending and increase the value of health care, to lessen the demand for revenue. The various financing options have a number of implications for the economy broadly, and the health system specifically.

Options for Change

Continue Current Financing Structure

One way to finance health reform is to keep the current mix of revenue intact and redirect the funds to more effective uses. Federal health programs would continue to be funded largely by general revenue and payroll taxes, with additional funding from premiums and cost-sharing paid by enrollees in the programs. Increases in Federal spending for new or existing health programs would be offset by reductions in other spending, or would increase the Federal deficit. Private insurance would continue to be financed through premium contributions from employers and individuals, and through out-of-pocket spending by individuals.

Proponents of this approach argue that the health system does not need substantial funding increases, but instead that the money should be spent more wisely. However, the option of continuing the current financing structure assumes that improvements in health insurance coverage and the delivery of health services can be made within the financing resources currently available. Moreover, improving quality, access, and value in the health system would likely require an upfront investment and additional spending by both the private and public sectors.

Rollback of High-Income Tax Cuts

Some proposals rely on revenue generated from the expiration of certain tax cuts. Three major pieces of tax legislation, each of which resulted in significant tax breaks, were supported by President George W. Bush and enacted by Congress in his first term of office. The tax cuts are generally scheduled to expire in 2010. Instead of extending all of the tax cuts, some health reform proposals, including Sen. Obama's, would return high-income tax rates to 2000 levels. Some of the increased Federal expenditures on health reform could then be financed without creating a larger fiscal gap.

Because rates would be raised only for the highest-earning taxpayers, the proposal would be progressive in nature. However, increases in marginal tax rates could retard economic growth by reducing the incentive for productivity and innovation. What's more, rollback of the tax cuts represents a one-time revenue change that may not keep pace with what is needed to sustain health spending in the long run. It largely continues the current reliance on general revenue, employer, and individual financing for health care.

Reform the Health Benefit Tax Exclusion

A number of proposals, including Sen. McCain's, would limit or eliminate the exclusion of employer premium contributions from employees' taxable income. This tax exclusion comprises the single largest Federal tax expenditure and plays a major role in how health insurance is financed in the United States. Because the value of the health benefit tax exclusion increases with income, limiting or eliminating this tax expenditure would result in more revenue from high- than low-income workers. After the high-income tax-cut rollback, this financing option is the next most progressive.

Because of its link to health benefits, the tax exclusion is considered "within-the-system" financing. In other words, it is a source of revenue with a connection to health spending. The tax exclusion has been a major factor in the development of employer-based health insurance. If the exclusion is capped, employers would likely scale back benefits (and reduce premiums). In addition, if employers' contributions to health benefits were no longer tax preferred, employers would no longer have the tax incentive to provide benefits, although the labor-market demand for it may persist.

Institute a Play-or-Pay Model

Under play-or-pay models, employers would be required to offer insurance to their employees (and contribute a specified minimum amount) or pay a tax equivalent to support the cost of insuring workers through an alternative source. The play-or-pay model provides a direct way for companies that do not provide health benefits to otherwise insure their employees, thereby strengthening the link between health coverage and employment.

This approach broadens the pool of employers that would contribute to health financing. Theoretically, it increases equity across firms by ensuring that all pay a comparable minimum amount for health benefits. Firms that offer coverage now will be less likely to drop coverage if faced with an assessment for doing so. At the same time, firms unlikely to provide health insurance in the current system tend to be small and/or new, operate in the service sector, and are not unionized. Faced with new or higher costs for health insurance under play-or-pay, employers would tend to pass the additional health-financing costs on to employees.

Implement a Value-Added Tax

Several current proposals incorporate a Value-Added Tax (VAT) as a method of financing health reform. Some use it to supplement existing forms of financing, while others propose that it replace today's major forms of financing. Generally speaking, a VAT is collected at each stage of the production process, in contrast to a retail sales tax, which is collected only at the final sale. There are several ways to administer it, with the "credit-invoice" being the most common. Here, each step of manufacturing pays VAT to the government.

A VAT is an example of a flat tax that is viewed by many economists as an efficient way to finance government programs. Unlike an income tax, a flat tax on consumption does not discourage saving and investment. In addition, a VAT applies to a broad base—anyone who purchases goods in the economy—spreads the burden of health care financing across the whole population. Because it taxes consumption, the VAT is regressive. The VAT has no direct connection to health reform, but it is the primary source of support for the health systems of our global competitors.

Key Considerations

In considering these proposals, policy makers will face several fundamental questions. These include:

- Should changes be incremental or comprehensive?
- How should public and private financing be balanced?
- Should financing changes be tightly linked to desired health system changes?

Some of the answers will be informed by policy analysis and tradeoffs described in this paper. The answers will also be shaped by policy makers' goals, values, politics, and circumstances.

To read the full version of *Financing the U.S. Health System: Issues and Options for Change* please go to http://www.bipartisanpolicy.org/healthfinancing

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