



Health Care Hooey

Student Handout #3: **Center for American Progress Action Fund, “John McCain’s Radical Prescription for Health Care”**

John McCain’s Radical Prescription for Health Care

Plan Would Raise Taxes on Many Middle-Class Families and Fail to Make Insurance Affordable

By James Kvaal, Peter Harbage, and Ben Furnas
July 2, 2008

Introduction and Summary

Sen. John McCain (R-AZ) has proposed a far-reaching plan to fundamentally reshape our health care landscape. The presumptive Republican presidential candidate’s plan raises taxes on millions of families—with the largest increases falling on middle-class households—and fails to make insurance affordable for many households, especially low-income families and individuals with pre-existing conditions.

Today, workers with health insurance through their jobs enjoy largely tax-free benefits. McCain’s plan treats these benefits like wages, making them subject to income and payroll taxes, and creates a new tax credit for insurance premiums worth \$2,500 for individuals and \$5,000 for families.¹ In the process his plan rewrites well over \$200 billion in health subsidies provided through the tax code—a massive sum that is about three times larger than any Cabinet agency other than the Department of Defense.² Our analysis of the dramatic changes McCain proposes reaches three conclusions.

- **For most taxpayers, McCain’s tax credit quickly becomes a tax increase.** McCain’s new tax credit grows only at the rate of inflation (about 2 percent a year), while current tax subsidies keep up with health insurance premiums (about 7 percent a year).³ As a result, the value of the tax credit quickly falls behind rising health care costs, meaning most households with employer coverage today would soon see a tax increase. Families earning \$40,000, for example, would receive a small tax cut in 2009, but by 2018 they will be paying over \$2,800 more a year in taxes.
- **Many middle-class households under the McCain plan pay higher taxes immediately.** Households with employer-sponsored coverage, higher incomes, and higher premiums are the most likely to see immediate tax increases. The largest tax increases fall on middle-class families, which pay the highest combined payroll and income tax rates.

- **The “one-size-fits-all” design of McCain’s tax credit is ineffective at making coverage affordable for Americans with low incomes or pre-existing illnesses.** Most uninsured Americans live under or near the poverty line and cannot afford high premiums. By providing the same \$5,000 subsidy to every family, the McCain plan falls far short of the help that low-income families need. It also ignores the higher premiums faced by individuals with existing illnesses, who are approaching middle age, or who live in states with higher medical costs and are likely to find premiums still out of reach.

Reforming the tax treatment of health insurance could be an important part of a broader health care reform effort. A better approach would include larger tax increases on high-income households, effective cost containment, and accessible and affordable coverage options for everyone. The McCain plan instead upends the current health insurance system, increases middle-class taxes, and fails to make coverage affordable and available to everyone.

Rewriting Tax Subsidies for Health Insurance

Health insurance in the United States has been organized around workplaces from the beginning. Businesses first offered health benefits in the 1930s, and benefits grew more common during World War II due to their exemption from wartime wage controls. In the 1950s, strong unions and favorable tax treatment solidified the link between employment and insurance. Today, 158 million people—the majority of non-elderly Americans—receive insurance from their own or a family member’s job.⁴

Current Law

Tax benefits continue to provide a strong rationale for employers to offer health insurance. Premiums paid by employers are not subject to either income or payroll taxes. Premiums paid by employees are usually also tax-free.⁵

A typical middle-class worker pays 15 percent in federal income taxes, about 5 percent in state income taxes, and 15.3 percent in payroll taxes (including taxes nominally collected from employers but actually borne by workers).⁶ As a result, each additional dollar earned in wages is worth only about 65 cents after taxes. However, a dollar in health insurance premiums is worth a full dollar because it is tax-free. In other words, compensation paid in the form of health insurance is worth nearly 50 percent more than compensation paid as wages.

The tax exemption is a major federal commitment to expanding health insurance. The U.S. tax codes delivers well over \$200 billion a year in subsidies that make insurance more affordable.⁷ The tax exemption supports the employer-based system of health care, which (despite its flaws) delivers insurance to the majority of Americans with relatively low administrative costs, and includes people who have existing illnesses or are at a greater risk of developing them.

Reform of the tax exemption could be an important part of broader health care reform legislation. As a method of making insurance affordable, today's tax benefits are "upside down" because they give the most help to the middle-class and high-income households that pay the highest tax rates and offer little help to low-income workers who pay only payroll taxes.⁸ Some analysts believe that the tax subsidy encourages people to purchase more coverage than is needed, leading to wasteful health care spending.⁹

The McCain Plan

Sen. McCain's plan repeals the tax exclusion for employer-provided insurance, requiring workers to pay income and payroll taxes on their health benefits. In its place, his plan creates a new refundable health insurance tax credit worth \$5,000 for families, and \$2,500 for individuals.¹⁰ The new credit would be fully funded by repealing the existing health care tax benefits.¹¹

The McCain plan's new credit would be available to taxpayers buying insurance individually as well as those who buy it through their jobs. It would be refundable to taxpayers with low incomes who pay little or no income taxes. Families who buy "innovative" policies that cost less than the value of the credit would be able to keep the whole credit by depositing the excess into health savings accounts. Each year, the value of the credit would be adjusted for inflation, growing more slowly than the current tax break for employer-provided health insurance, which grows with health care premiums.¹²

The proposal is similar to one that President Bush proposed in 2007 and 2008.¹³ The Bush tax benefit was structured as a deduction rather than a credit, but administration officials indicated that Bush was open to either approach.¹⁴

While some workers would lose health benefits from their jobs, the standard economic assumption is that these workers would gain higher wages and their overall compensation would not change. The McCain plan's impact on coverage is not yet clear, but some analysts suggest that the proposal is likely to expand coverage. McCain advisors say that 20 million uninsured Americans would gain coverage under the plan, while Emory professor Ken Thorpe estimates that number at 5 million to 7 million.¹⁵

McCain also proposes a number of complementary health care policies. Most notably, he would encourage the deregulation of health insurance by allowing insurers to sell across state lines to avoid state consumer-protection laws. His health care proposals are available at www.johnmccain.com.

SKIPPED PAGES 4 THROUGH 14

Methodology and Assumptions

Public information available from the McCain campaign lacks clarity on several important details forcing us to make several assumptions before conducting our analysis. First, we assume that the McCain campaign would repeal the exemption for payroll taxes as well as for income taxes. While campaign aides have not stated Sen. McCain's policy definitively, it has estimated that subjecting health benefits to taxation would raise \$3.6 trillion over 10 years, a figure apparently based on a congressional estimate that includes higher payroll taxes.⁵³ A campaign advisor has also estimated its impact on a typical family by using a 35 percent tax rate; tax rates faced by typical families are close to 35 percent only if payroll taxes are included.⁵⁴ As with the Bush plan—which served as the model for the McCain plan—the revenue from additional payroll tax revenue is needed to ensure that the proposal has no net cost to the federal government over 10 years, a stated goal.

Second, we assume that the proposal would prevent employees from shielding health benefits from taxation through cafeteria plans, which allow workers to choose between additional salary and tax-free benefits like insurance. Without such a step, employees would be able to continue receiving tax-free health benefits while receiving McCain's new tax credit, making the proposal enormously expensive and inconsistent with the campaign cost estimate. The Bush proposal that serves as a model for McCain's plan also eliminated this tax preference.⁵⁵

Finally, we assume that the proposal is not optional: Workers would not be allowed to choose between McCain's tax credit and the current tax treatment. Because every taxpayer would choose to minimize their taxes—taking either the current exclusion or the new tax credit, whichever was better for them—allowing such a choice would also have a large cost, defeating the McCain campaign's stated objective of a revenue-neutral reform.

The households described in this report are typical, but the actual impact on real taxpayers will vary. All income is assumed to be salary or wages. Households have no dependents. Workers are assumed to bear the burden of all payroll taxes, even though employers are nominally responsible for half of these taxes.⁵⁶ Unless stated otherwise, state income taxes are assumed to be 5 percent above an additional \$5,000 exemption.

Individuals and families are assumed to receive the tax exemption for the average premium on an employer-based plan. Premiums for family policies are projected by the Congressional Budget Office.⁵⁷ Premiums for individual policies are based upon the 2007 figures reported by the Kaiser Family Foundation and are assumed to grow at the same rate as family policies.⁵⁸

All premiums on employer-provided plans are assumed to be tax-exempt under current law. Premiums paid by employees are tax-free if paid through a cafeteria plan under Section 125 of the Internal Revenue Code. According to the Joint Committee on Taxation, in 2004 active employees paid \$120 billion on a tax-preferred basis while active employees, COBRA enrollees, and retirees paid \$57 billion in premiums and contributions to health flexible spending arrangements on an after-tax basis.⁵⁹