

FREQUENTLY ASKED QUESTIONS (FAQs) ABOUT THE AMA PROPOSAL TO EXPAND COVERAGE AND CHOICE THROUGH TAX CREDITS AND INDIVIDUALLY OWNED HEALTH INSURANCE

1. What are the basics of the AMA proposal?

Answer: Under the AMA proposal, a system of income-related, refundable tax credits for those who purchase health coverage would replace the current federal income tax exclusion for employer-based health benefits. Individuals and families with health insurance coverage would be eligible for tax credits regardless of whether or not their coverage was through an employer-based program. Tax credits could be available to those who are employed, self-employed, or unemployed. Patients, rather than their employers, would choose health plans either within a employer-based framework or through health insurance marts—new markets created to give more choices and group purchasing power to individuals and their families.

2. Is the intent of the AMA Proposal to destroy the employment-based system?

Answer: No. The AMA Proposal does not require the dismantling of the employment-based system. The AMA supports a system of individually selected and owned health insurance in which employment-based coverage remains an option to the extent that employees demand it. Given the advantages of group purchasing through the work place, many employees will freely choose to continue with employer-based coverage. The AMA approach builds upon the strengths of the current system while allowing for a natural evolution toward greater individual choice.

3. Won't employers drop health insurance benefits under this proposal?

Answer: Employers who currently offer health benefits do so voluntarily in order to attract and retain workers, and this will continue to be the case. Further, health benefits for employees will continue to be deductible business expenses, regardless of whether those employment-based health benefits are based on defined benefits or defined contributions. Employers are unlikely to stop offering health insurance benefits just because of the employees' tax change. Even with the tax change for employees, employment-based insurance can still hold significant advantages over the individual market, such as reduced administrative costs and convenience.

Some employers will decide to change their health benefits to defined contributions. In this case, instead of continuing to arrange and offer specific health plans, the employer contributes a certain dollar amount (defined contribution) toward the employee's choice of plan. Employees would be able to combine defined contributions with tax credits to obtain group coverage through health insurance marts.

4. What if employers want to drop their health insurance benefits anyway?

Answer: Many employees think that health benefits are “free” under the current system when, in fact, there is a tradeoff between wages and benefits costs. In principle, employers should not care whether they pay a dollar for wages or a dollar for benefits—it’s total compensation that affects their bottom line. In short, workers generally bear the burden of health benefit costs; they would receive higher wages if health benefits costs were eliminated.

Some employers may consider dropping health benefits. For such cases, the AMA Proposal includes a "maintenance of effort" period, such as one or two years, during which employers would be required to add to the employee's salary the cash value of any health expense coverage they directly provide if the employer drops that coverage or if the employee opts out of the employer-based plan. Since such wage increases would add to employees’ adjusted gross income—thus subjecting employers to higher payroll taxes and employees to higher state income and FICA taxes—many employers will be discouraged from dropping health benefits.

5. As an employer, won’t my payroll taxes go up under the AMA Proposal?

Answer: No. If you are an employer, there will be no change in your business taxes. The only tax affected by the AMA Proposal is the federal income tax paid by employees. From the employer’s perspective, employment-based health benefits would continue to be excluded from taxable compensation, and would therefore not be subject to employer payroll taxes.

You will not have to “cash out” any current health benefits offered to your employees. The tax status for the employer costs of those benefits will not change—those costs remain a deductible business expense; those costs will not be subject to the business portion (50%) of payroll taxes. This remains the case whether those benefits are provided as defined contributions or defined benefits. Your business operations will not change; withholding for taxes and the employee shares of insurance premiums will continue on a periodic basis. Employees’ health benefits will no longer be excluded from their compensation for federal income tax purposes, but your accounting of employee health benefits will also serve as proof of their eligibility for tax credits.

6. How do tax credits differ from the current tax exclusion?

Answer: Currently, the federal government subsidizes the purchase of private health insurance by excluding from taxable income the portion of an employee’s total compensation that the employer gives in the form of health benefits. The tax exclusion is sometimes loosely referred to as a tax exemption or tax deduction. (The differences are that an exemption or deduction is taken at the time of income tax filing, whereas with the exclusion health benefits are simply not reported as taxable income.) In contrast with the tax exclusion for employment-based health insurance, health insurance tax credits—

available only to those who obtain health insurance—would be subtracted from the individual's tax bill.

7. Since individuals are used to having employers choose their health insurance, won't they do a poor job choosing?

Answer: People are just as capable of choosing their own health insurance plan as they are of choosing their own cars, homes, mortgages, and many other goods and services. Presently, employers choose health insurance plans and do a poor job of it. Only 21.5% of employers survey workers on their satisfaction with health care benefits, and only 4.5% give employee satisfaction a top priority in choosing plans. More than half of all employees say that they want either more or less health coverage in the mix of benefits they receive from their employers.

Giving employees a wider range of choice would allow them to better tailor coverage to their particular needs. Furthermore, if they found that the plan they chose was not responsive to their needs or did not perform as expected, they would have the option of switching to a different plan that might serve their interests better. This is not an option when employees are offered only one or a limited number of plans selected by their employers, as is the case with most employees today. Americans have grown accustomed to choosing their own home-owners, auto, and life insurance. There is no reason that they could not learn to choose health insurance in equally intelligent ways.

8. Will individuals get any help in choosing health plans?

Answer: When individuals are able to choose among a variety of competing plans, the information they need to make informed choices will be forthcoming. The current absence of such information is due to the fact that health plans cater to employers, not employees. Much more consumer-friendly information will become available when health plans have to compete for individuals. For example, Federal employees get to choose among numerous competing health plans. They get comparative information on health plans from word-of-mouth, as well as from non-governmental consumer publications geared specifically toward helping them choose among health insurance options. Under individually based insurance, health insurance marts would also play a key role in helping consumers make informed choices. Finally, recent developments on the Internet are giving more workers a greater number of health plan choices, with more information on those choices, and allowing workers to make their selections online.

9. Won't an individual mandate be necessary to make the system work?

Answer: The AMA approach is to make tax credits contingent on obtaining health insurance coverage. With appropriately structured tax credits, virtually all individuals will face powerful incentives to obtain and maintain coverage. Imposing a mandate on individuals to purchase health insurance lacks political viability; further, an individual mandate would entail an unreasonable administrative burden to enforce. In fact, under the guise of an individual mandate that creates the illusion of universal coverage, it would

be easier for the government to reduce resources committed to subsidizing health insurance.

10. Isn't insurance on the individual market terribly expensive and inadequate?

Answer: The current individual market for health insurance *is* characterized by high prices and spotty coverage. However, the AMA Proposal calls for individual *choice and ownership* of health insurance—not for people to necessarily buy on the individual market. Furthermore, today's individual insurance market will be transformed.

Individual choice and ownership of health insurance does not preclude group purchasing. The AMA supports federal legislation to encourage the formation of small employer and other health insurance markets by exempting insurance plans offered by such entities from selected state regulations regarding mandated benefits, premium taxes, and small group rating laws, while safeguarding state and federal patient protection laws.

The change to tax credits and the shift to individual coverage will bring about a significantly different individual insurance market than exists today. Both the size and the extent of the market for individually purchased health insurance will increase dramatically. With individuals empowered to pool risks independent of employers, the benefits and premiums of the individually purchased market will initially mirror those in the employer market. As the individual market expands, the array of health plans will expand. The Internet will continue to facilitate both group and individual purchasing of health insurance. Compared to the current individual market, market-driven benefit packages and corresponding premiums will more fully accommodate the diversity of consumer demands. As a result, premiums in all markets may fall.

11. Will health insurance be affordable under the new system?

Answer: Affordability of health insurance depends not only on health coverage choices and premiums in the transformed market, but also on the size of tax credits. The size of tax credits should be large enough to ensure that health insurance is affordable for most people. This principle acknowledges the need for tax credits that are large enough to empower virtually all individuals to obtain and maintain health insurance coverage. The credits would be both income-related and refundable. That is, larger credits would be available to lower income families and individuals, and if the credit were bigger than total tax, the difference would be returned to the taxpayer. The credit must be sufficient to cover a substantial portion of the premium costs for individuals in the low-income categories. At the lowest income levels, the credit could approach 100% of the premium.

12. Why should tax credits be inversely related to income?

Answer: The current tax exclusion is socially inequitable because it provides a higher subsidy for those with higher incomes. In fact, two-thirds of the current tax subsidies for health insurance go to the one-third of Americans with the highest incomes. A large portion of the 42 million uninsured Americans are low-income wage earners who earn

slightly too much to be eligible for Medicaid. Under the AMA plan, the tax subsidy would be redirected toward those who need it most. Furthermore, compared to a tax credit that does not vary with income, a sliding scale tax credit reduces the federal spending necessary to expand coverage.

13. Would those with no tax liability be able to receive the credit?

Answer: Yes. The AMA proposes that tax credits for the purchase of health insurance be *refundable*, which would allow anyone who purchases health insurance to be eligible to receive a tax credit. To the extent the credit exceeds taxes owed, the individual would receive a payment. Examples of existing refundable tax credits include the federal earned income tax credit and the child care tax credit for families with children.

14. What about people who cannot afford the monthly out-of-pocket premium cost? If they can't afford to purchase insurance up-front, would they have to forfeit their eligibility for the credit?

Answer: No. The AMA recognizes that those most in need of a tax credit to purchase coverage live on tight budgets. Therefore, the AMA proposes a voucher system, much like that used for food stamps, for the distribution of health insurance premium funds. For example, welfare agencies, health insurance marts, and other entities could be authorized to verify income eligibility for such vouchers, and either the same or different appropriate agencies could issue vouchers for the amount of tax credit that is due to the individual. The entities could then collect the tax credit due to the individuals whose vouchers they provided. Another way to ease the purchase of insurance would be to continue the current practice of automatic paycheck withholding for direct payment of premiums for employed workers.

15. Would entities that provide advance funding have to wait until year's end to receive the tax credit due to individuals for whom they provided vouchers?

Answer: Not necessarily. Depending on the level of public commitment to expand health insurance coverage and the budget environment in any given year, periodic interim payments could be made to those entities to receive the credit due the individuals to whom they issue vouchers. An end of year accounting mechanism would be needed to resolve final payments.

16. If I am a high income professional, how much more will I pay in taxes under the AMA Proposal?

Answer: The average value of the federal income tax exclusion of employment-based health benefits is approximately \$1,700 for families with incomes between \$100,000 and \$200,000, and approximately \$2,100 for families with incomes above \$200,000. That would be the approximate maximum increase in tax for families in those income brackets that received employer-based health benefits. This would be offset by any tax credit available to those families that maintained health insurance coverage. (To lower the total

cost of the tax credit program, an upper income cutoff may be imposed. Under such a design, tax credit recipients would be limited to those whose family incomes are below the cutoff.)

17. How might a given family be affected by replacing the existing tax exclusion with tax credits?

Answer: Unlike many of the tax credit proposals introduced in the U.S. Congress, there is no specific single tax credit in the AMA plan. How an individual or family would be affected by the switch from the tax exclusion to income-related, refundable tax credits depends on existing coverage, the relevant tax bracket, and the specific amount of tax credit for given income levels.

The following examples illustrate how a family of four in the middle-to-upper income brackets might be affected by replacing the tax exclusion with tax credits. As the examples show, any changes will depend on income levels and both current and future coverage choices.

To understand the examples, one needs to know that:

- a) The Current Tax Subsidy = (Federal Tax Rate) x (Employer Share of Premium) x (Premium); and
 - b) The Effective Premium (or After-Tax Premium) = Premium – Tax Subsidy
- Case I: A family of four with annual taxable income of \$40,000, in the 15% tax bracket, filing taxes jointly, with employer-based insurance. The employer's share is 75% of a \$5,600 health insurance premium.

Current Tax Exclusion

Current tax subsidy	$(0.15) \times (0.75) \times (\$5,600) = \$630$
Effective premium	$\$5,600 - \$630 = \$4,970$
Effective premium	
as a share of taxable income	$(\$4,970/\$40,000) = 12\%$

Under the current exclusion, the family receives a subsidy of \$630 by not paying taxes on the portion of compensation given as the employer's share of the health insurance premium. Thus, the effective premium is reduced from \$5,600 to \$4,970, representing 12% of the family's income.

Now let's say that the exclusion were replaced with tax credits for the purchase of health insurance, and that a family with \$40,000 taxable income qualified for a \$2,800 tax credit. The employer's share of the premium becomes subject to federal income tax but now the family subtracts the tax credit from its tax bill.

Illustrative Tax Credit

New tax subsidy	\$2,800
Change in tax subsidy	$\$2,800 - \$630 = \$2,170$
Effective premium	$\$5,600 - \$2,800 = \$2,800$
Effective premium as a share of taxable income	$(\$2,800/\$40,000) = 7\%$

With a \$2,800 tax credit for the purchase of family health insurance coverage, the change in subsidy would be $\$2,800 - \$630 = \$2,170$. The tax credit reduces the effective premium from \$5,600 to \$2,800. The effective premium now represents 7% of the family's income.

- Case II: A family of four with annual taxable income of \$100,000, in the 31% tax bracket, filing taxes jointly, with employer-based insurance. The employer's share is 75% of a \$6,200 health insurance premium.

Current Tax Exclusion

Current tax subsidy	$(0.28) \times (0.75) \times (\$6,200) = \$1,302$
Effective premium	$\$6,200 - \$1,302 = \$4,898$
Effective premium as a share of taxable income.....	$(\$4,898/\$100,000) = 4.9\%$

Because of the current exclusion, this family receives a subsidy in the form of a \$1,302 reduction in income taxes. The subsidy makes the effective premium \$4,898, or 4.9% of family income. (Note that under the current system, Family II effectively pays a lower premium than Family I, despite having more expensive coverage.)

If the exclusion were replaced with tax credits, and there was an income cutoff for tax credit eligibility of \$75,000, then this family would not receive a tax credit.

Illustrative Tax Credit

New tax subsidy	\$0
Change in tax subsidy	$\$0 - \$1,302 = -\$1,302$
Effective premium	$\$6,200 - \$0 = \$6,200$
Effective premium as a share of taxable income	$(\$6,200/\$100,000) = 6.2\%$

With a \$0 tax credit for the purchase of family health insurance coverage, the change in subsidy would be minus \$1,302. Thus, the effective premium is simply the full \$6,200 premium, or 6.2% of the family's income.

18. In addition to federal income taxes, won't individuals' state income and FICA taxes go up?

Answer: No. Under the AMA Proposal, the value of health benefits will not be added to adjusted gross income. Therefore, there will be no additional individual payroll tax (FICA) obligation, nor will there be additional state income taxes owed under the AMA Proposal.

19. What about the self-employed?

Answer: The self-employed would benefit greatly under the AMA Proposal. Currently, the self-employed do not enjoy the tax subsidy provided by today's exclusion. (Health coverage purchased by the self-employed will not fully qualify for deduction from taxable income until 2003.) Our proposal would level the playing field for the self-employed by making everyone eligible for the same tax subsidy regardless of employment status (or whether one's employer offers health benefits). Furthermore, most self-employed individuals do not have access to group insurance. Under the AMA Proposal, the self-employed would be able to purchase group insurance through health insurance marts.

20. What will happen to the level of federal tax subsidies for health insurance?

Answer: The impact on the level of federal tax subsidies for health insurance depends on the net effect of rescinding the tax exclusion and introducing the tax credits. On the one hand, tax revenues will increase because employment-based health benefits will become subject to federal income tax. The Office of Management and Budget estimates that the level of subsidy currently provided in the form of foregone federal income taxes was approximately \$80 billion in 1998. On the other hand, the federal government will spend revenue to subsidize health insurance through tax credits. (Increased government spending on tax credits will be partially offset by reduced spending on what is now uncompensated care for the uninsured.) Most policy analysts agree that achieving health coverage for all Americans will require a net increase in government subsidies for health insurance.

21. Haven't researchers shown that tax credits won't work to reduce the number of people without insurance?

Answer: Estimating the impact of health insurance or other tax credit proposals is not an exact science. As a result, estimates of the impact of tax credit proposals on the number of uninsured do vary. For example, one recent study found little effect, whereas another found that credits averaging one-half of the premium substantially reduce the number of uninsured. Differences in estimated impacts can be accounted for by differences in the levels and structures of tax credits researchers model (e.g., whether or not tax credits vary with income), as well as different underlying assumptions about employer and individual behavior in response to tax credits, and different assumptions about long-term impacts on insurance markets. There is general agreement among researchers, however, that tax

credits and delinking insurance from employment would be more equitable, and improve the functioning of the insurance and labor markets.

Recent research by the AMA's Center for Health Policy Research shows that in combination with increased enrollment of those uninsured who are eligible for existing government programs, a system of income-related, refundable tax credits could result in coverage of the vast majority of Americans for an additional \$30 billion to \$60 billion in federal spending. This approach measures up to other approaches in terms of expanding coverage and choice at a reasonable cost.

22. Won't individually owned health insurance destroy "the risk pool"?

Answer: Some people fear that existing employment-based risk pools will break down if individuals have greater choice in health plans beyond those offered by employers. These fears are exaggerated for several reasons:

- There is no single risk pool. For health insurance, there are thousands of risk groups.
- Recent research has shown that the cross subsidy in employment-based pools is less than previously supposed, while the cross subsidy in the individual market is larger than commonly assumed.
- Risk pooling does not depend on employment-based purchasing. All insurance policies are based on the pooling of risk. Group purchasing of health insurance will also occur through health insurance marts. Affinity groups that currently offer insurance such as life, automobile, and Medicare private supplemental ("medigap") insurance may offer health insurance to their members.
- As pools in the individual insurance market expand, collecting the information to risk rate premiums for individuals will yield less and less benefit and may be phased out.
- Policies exist to promote cross-subsidization across risk groups, e.g., high risk pools, modified community rating, and benefits management.
- Cross-subsidization will improve for people who are unemployed due to disability, employees of small firms, the low-income, and the uninsured.

23. For purposes of qualifying for a tax credit, what constitutes coverage?

Answer: Although the issue of what constitutes health insurance can be resolved a number of ways, the AMA suggests that to qualify for a tax credit, health insurance must provide coverage for hospital care, surgical and medical care, and catastrophic coverage of medical expenses as defined by Title 26 Section 213(d) of the United States Code: "For purposes of this section, the term 'medical care' means amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body."

Beyond requiring that they broadly cover standard medical services and provide catastrophic protection, the AMA does not endorse any insurance mandates unrelated to patient protection. This approach maximizes the affordability of basic coverage, as well as flexibility for developing insurance choices that meet the needs of various groups of

consumers, whether through a traditional insurance or managed care plan or a medical savings account (MSA).

24. How would MSAs work under the new system?

Answer: MSAs would be another option available for individuals and families purchasing coverage in the non-employer market. Individuals purchasing a high-deductible policy would be eligible for the tax credit accruing to those who are covered by health insurance. Contributions to the MSA could be made from the residual of the tax credit not used to purchase insurance as well as from other funds. In general, contributions to the MSA would not be subject to federal income tax.

25. Won't changing such a major tax subsidy program necessarily take benefits away from the middle class, dooming the proposal politically?

Answer: Not only do two thirds of the existing subsidies with the tax exclusion go to the highest-income one third of all families, 41% of the benefits go to families with incomes above \$75,000 per year. Almost one quarter of the benefits go to the top 10% of families, those with incomes above \$100,000 per year. While benefits are likely to be reduced and perhaps eliminated for upper-income individuals, the AMA proposal is not purely redistributive. An additional \$30-\$60 billion will be needed to extend coverage to those who are currently uninsured, bringing the national coverage rate up near 95%. Whether specific middle-income families gain or lose will depend on the range of credits and the relationship between credits and income—design parameters that as yet are not set in concrete. All income groups will benefit from lower medical inflation rates because greater patient choice will foster competition among insurers, and improved coverage will reduce the incidence of uncompensated care.

26. Is the AMA Proposal politically feasible right now?

Answer: Yes. The AMA Proposal represents a vision shared by many of today's policymakers and innovators. Recent articles in the *New York Times* (September 24, 2000) and the *Atlantic Monthly* (October 2000) extol the virtues of individual health insurance tax credits, including economic and political viability. Tax credits have gained bipartisan political support, as evidenced by seven bills in the 106th Congress and tax credit proposals by both major party presidential candidates. Leading health care economists and health policy analysts from a wide range of think tanks advocate tax credits for individuals and families to purchase health insurance. The marketplace is already responding to growing pressure for more consumer choice and control of health plans. Entrepreneurs are using the Internet to create virtual health insurance marts, thereby expanding health plan options that employers offer employees as part of defined contribution programs. Right now there is a window of opportunity to correct the distortions in the current health system, expand coverage, expand choice, and put patients in the driver's seat.