RECOMMENDATION
√ Improve rules for valuing gifts of property to charities.

In cases where property is donated to charities, the Panel believes that it is necessary to implement better standards for appraisals. The Panel recommends (1) new rules requiring clearer standards for appraisals; (2) information reporting by appraisers to the IRS, the donor, and the charity of the appraised value of property; and (3) new penalties for appraisers who misstate the value of property. Additional information regarding the Panel's recommendations for appraisal standards can be found in the Appendix.

The Panel is also concerned that the current rules for contributions of used clothing and household items create the potential for overvaluation and cheating on small deductions. The current system of self-reporting has led to the use of "do it yourself" receipts and third-party valuation guidelines that sometimes provide overly generous values. The Panel suggests that consideration be given to curbing the use of "do it yourself" receipts and inflated valuations by allowing deductions only when the taxpayer receives a price list and an itemized receipt from the charity.

Better Oversight of Exempt Organizations

RECOMMENDATION
√ Effective action should be taken to ensure better oversight and governance of exempt organizations.

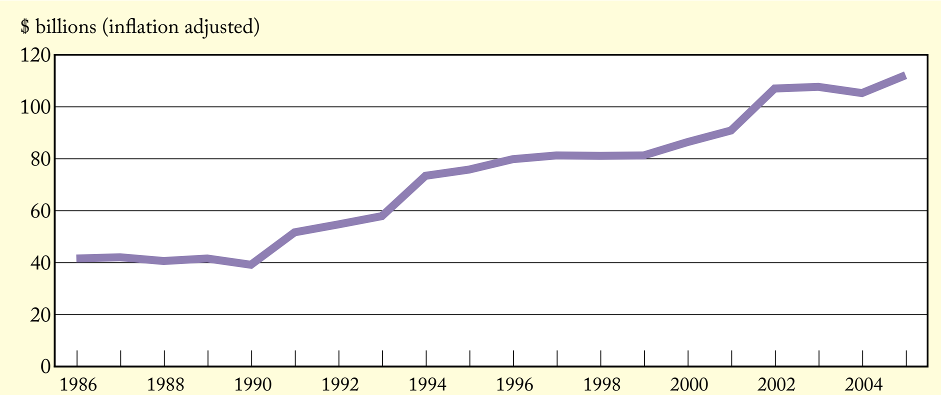
The Panel believes that it would be appropriate and desirable for lawmakers to review the types of organizations that qualify for tax-exempt status. A tax exemption, which is paid for by all Americans, should be extended only to organizations that are truly serving the public interest. The Panel recommends that Congress review the standards for qualifying and maintaining status as a charitable organization. Although the Panel does not make specific recommendations for changes to rules governing exempt organizations, the Panel recommends that effective action be taken to ensure greater oversight and better governance of exempt organizations.

Incentives for Health Insurance Coverage

Under current law, several provisions provide benefits for health care spending. First, compensation paid to workers in the form of employer-paid health insurance premiums is excluded from taxable income and payroll taxes. Second, to the extent that an employee pays a portion of the health insurance premiums, these payments may be shielded from income and payroll taxation through so-called cafeteria plans, which permit employees to put pretax dollars into benefits of their choosing. Third, many employers now offer flexible spending accounts that are funded with pretax dollars and can be used to pay uninsured medical costs. Fourth, medical expenditures above a certain level can be deducted from taxable income as itemized deductions. Finally, the introduction of health savings accounts, coupled with health insurance covering major medical events (such as catastrophic coverage), has given taxpayers another way to use pretax dollars on health care expenses.

Taken together, tax preferences for health care represent the largest tax expenditure and have an outsized impact on health care spending in America. The United States has the highest per capita health care spending in the world – $1.5 trillion, or $5,400 per person in 2002. Tax benefits associated with health care will cost approximately $141 billion, or 12 percent of all federal income tax revenue in 2006. The largest component of this cost is the employee exclusion for employer-provided health insurance and medical care, a tax expenditure of $126 billion. As illustrated in Figure 5.8, even after adjusting for inflation, the cost of this exclusion has tripled since 1986.

Figure 5.8. Growth of Tax Expenditures for Health Care



Source: Department of the Treasury, Office of Tax Analysis.

The large cost of this tax preference is due, in part, to the fact that employment-based health insurance is the primary source of health insurance for Americans. In 2003, 64 percent of individuals under age 65 were covered by a health plan sponsored by their employer or the employer of a family member. In contrast, 17 percent of taxpayers were covered by a government health plan (e.g., Medicaid, Medicare, or military health care programs), and only 7 percent purchased health insurance directly.

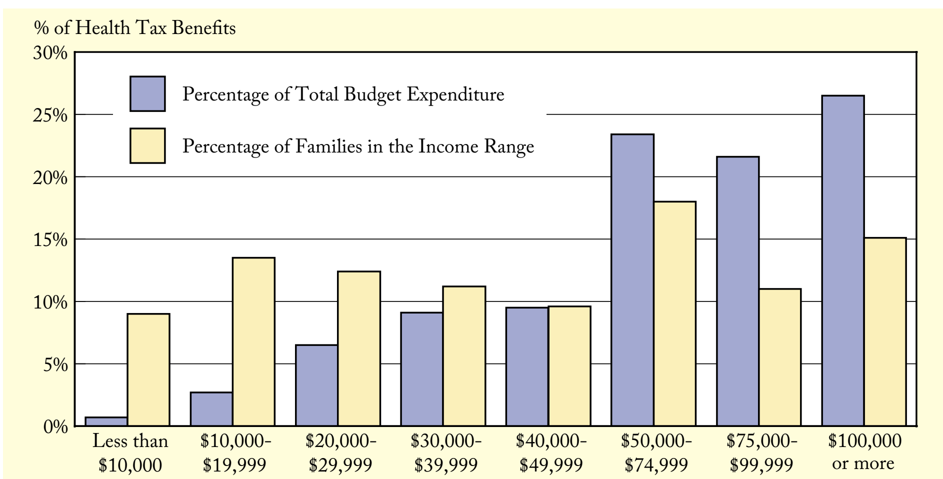
Employer-provided health insurance now constitutes a substantial proportion of a worker's total compensation. Employees and employers ultimately share the burden of rising health insurance premiums; these rising costs tend to come out of the pool of cash available for all worker compensation, including cash wages.

As with housing-related tax subsidies, tax benefits related to health care tend to benefit higher-income households more than lower-income households. This is true not only because a health-care-related deduction or exclusion is worth more to a higher-income taxpayer in a progressive income tax system, but also because higher-income people are more likely to have insurance. In 2004, families earning more than $100,000 received 27 percent of the tax benefits for health spending. Figure 5.9 demonstrates how health tax expenditures disproportionately benefit higher-income taxpayers.

The current structure of the health insurance exclusion creates incentives that lead to inefficiencies in the market for health care. Because of the tax-preferred status of health insurance, people are more likely to buy health insurance that provides more coverage than they would in the absence of the incentive. Workers who purchase more health insurance may, in turn, use more health services, thereby increasing overall health spending. Estimates are imprecise, but removing subsidies for employer-provided health insurance could lower private spending on healthcare by 5 to 20 percent.

In addition, these tax subsidies for higher-income taxpayers may raise premiums for lower-income people thereby increasing the number of uninsured Americans. Ultimately, the tax treatment worsens disparities in insurance coverage, in use of care, and potentially in health outcomes.

Figure 5.9. Distribution of Health Tax Benefits by Family Income (2004)



Source: Lewin Group.

RECOMMENDATIONS

√ Make tax benefits for health insurance fairer by allowing a deduction for the purchase of health insurance in the individual market.

√ Limit the exclusion for employer-provided health coverage to the average cost of health coverage.

The Panel evaluated whether the exclusion for employer-provided health insurance should be retained in each of its options. Although the current exclusion for employer-provided health insurance is costly and has some negative impact on the market for health care, the Panel concluded that an immediate elimination of tax incentives for health insurance would adversely affect many Americans who currently receive health coverage through their employer. In addition, several members of the Panel felt that some incentive for health insurance should be provided through the tax code.

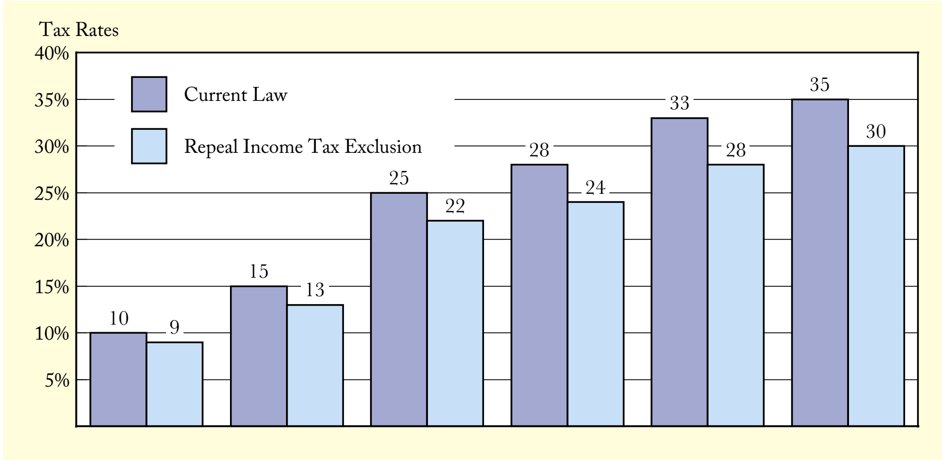
The Panel also recognizes that a strong system of employer-provided health insurance provides many benefits and may lead to a greater percentage of the population with health insurance. In addition, employer-sponsored group coverage reduces transaction costs and may lower premiums for some by pooling the risks of large numbers of individuals.

The Panel recommends that employers continue to be able to deduct the cost of employee compensation, whether in the form of cash compensation or health insurance premiums, and that employees be allowed to receive a base amount of health insurance free of tax. To level the playing field between workers who have access to employer-provided health insurance plans and those who do not, the Panel recommends that workers be allowed to purchase insurance either through their employer or on their own with pretax dollars up to the average cost for health insurance. Taxpayers who, for example, do not have access to employer-provided plans would be allowed a new deduction for health premiums equal to the exclusion enjoyed by workers whose employers provide health insurance.

To ensure that the tax benefits for health insurance are distributed more evenly, however, the Panel recommends that the amount of tax-free compensation an employee could receive in the form of health insurance be limited. The exclusion for employer-provided health insurance would be limited to $11,500 for families and $5,000 for single individuals, which is the national average annual amount projected to be spent on health insurance premiums in 2006. These amounts are also roughly equal to the maximum amount of tax-free health insurance coverage provided to members of Congress and other federal employees.

Figure 5.10 shows that if the exclusion for employer-provided health insurance were completely eliminated, there would be an across the board tax rate cut of approximately 14 percent. A lower cap also would allow for lower rates. For example, capping the exclusion for health insurance to $8,400 – about 75 percent of the amount proposed by the Panel – would result in a 3 percent across the board rate cut.

Figure 5.10. Impact of Eliminating the Exclusion for Health Insurance Premiums on Individual Income Tax Rates



Source: Department of the Treasury, Office of Tax Analysis.

The Panel discussed whether the limit for health insurance would be indexed based on increases in the cost of health care or increases in overall inflation. The Panel recommends that the limit for health insurance be indexed for annual increases in overall inflation like other inflation-adjusted amounts in the tax code.

The Panel's objective is to preserve the incentive for firms to maintain health insurance for their employees without encouraging them to provide excessively generous – or "Cadillac" – health insurance plans. Under the current system, an individual in the top tax bracket tends to prefer to receive additional compensation in the form of health insurance, rather than cash, even if the individual values health insurance at only two thirds of its purchase price. This is because health insurance is not taxed, while cash is. Placing a cap on the tax preferences for health insurance coverage would likely make workers more cognizant of the amount they spend on health insurance. This increased visibility might, in turn, lead some workers to reduce the amount of insurance purchased and pay more health care costs directly. For example, the insured might have higher co-pays and deductibles, or pay a greater share of the bill for lab tests and brand-name pharmaceutical drugs. This change would help stem the out-of-control costs of health care in America, which is making basic insurance harder for more Americans to afford.

Most importantly, under the Panel's proposal, some currently uninsured Americans would have a new tax deduction so they could finally afford health insurance. The Treasury Department estimates that the Panel's recommendation to cap the health insurance amount at the average premium and provide an equal deduction to all taxpayers would reduce the number of uninsured Americans by 1 to 2 million people.