



Upjohn Institute Press

Public Financing Approaches to Improve Access to Health Care: Alternative Revenue Sources

John E. Anderson
University of Nebraska



Chapter 7 (pp. 183-206) in:

Improving Access to Health Care: What Can the States Do?

John H. Goddeeris, and Andrew J. Hogan, eds.

Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 1992

DOI: [10.17848/9780880995733.ch7](https://doi.org/10.17848/9780880995733.ch7)

Copyright ©1992. W.E. Upjohn Institute for Employment Research. All rights reserved.

7

Public Financing Approaches to Improve Access to Health Care Alternative Revenue Sources

John E. Anderson
University of Nebraska

Improved health care access is not free. States wishing to provide improved access must address the question of how to pay the added costs involved. If the cost of improved access is to be funded through a general tax mechanism, the questions to be asked are: What tax sources may be tapped and what revenues may be reasonably expected? In addition, it is important to question both the equity and efficiency aspects of the proposed tax sources of funding. We need to know both who will pay the tax and how the tax will affect economic decisions and the allocation of resources. The goal of tax policy is to design tax mechanisms that are fair and nondistortionary.

Tax policy changes which could fund health care access are identified in this chapter for each of the typical state's major taxes—sales and excise taxes, personal income or payroll taxes, and business taxes. Each tax is defined by its base (what is taxed) and its rate (how much is taxed). We will consider changes in the rate of taxation and in the definition of the tax base, which could be used to generate revenue for improving access to health care. As part of the base change proposals, we will consider elimination of some specific tax expenditures—exemptions or deductions—as potential revenue sources.¹

Sales and Excise Tax Sources

State and local governments rely on sales and excise taxes for a substantial portion of their own-source revenue. The general sales tax accounts for about 14 percent of state-local general revenue in the United

States. The percentage ranges from a high of 29 percent in Washington State and 25 percent in Tennessee to a low of 7 percent in Vermont.² There are also five states without a general sales tax: New Hampshire, Delaware, Montana, Oregon, and Alaska. In addition to the state sales tax, many states permit local sales taxes, making the combined state-local sales tax rate higher. The highest combined rate is that of New York City—8.25 percent.

With this reliance on the general sales tax, it is natural to ask whether improved access to health care could be funded through increased general sales taxes. There are two basic ways to increase the sales tax. One is to raise the tax rate, say, from a state's current 5 percent to 6 percent or 7 percent. The other is to broaden the tax base, taxing more goods or services than the tax is currently levied against. We will discuss each of these possibilities in turn.

Sales Tax Rate Change

A sales tax rate increase will raise revenue, the precise amount depending upon the size of the tax base. As an example, consider the Michigan sales tax at its current rate of 4 percent. The sales tax generates \$2.6 billion (FY89 DMB estimate) in revenue. Including the state use tax puts the total at \$3 billion.³ The combined tax base is therefore \$75 billion (\$3 billion divided by .04). Hence, a 1 percent increase in the tax will generate \$750 million in revenue. This estimate overstates the revenue that will be generated, however, since as prices rise due to the higher tax, fewer goods will be demanded, reducing the tax base. The precise reduction in the tax base will depend upon the elasticity of demand for those commodities being taxed.

One potential problem in raising a state sales tax rate is the border effect, when neighboring states have substantially lower tax rates. Taxable economic activity may be shifted to the lower tax state when the potential tax saving is large enough to cover the added expense of moving the transaction site.

Sales Tax Base Changes

A direct way to increase general sales tax revenue is to tax goods or services not currently taxed. Most states exempt food and prescription drugs from the general sales tax for equity reasons—to make the sales tax less regressive. (A tax is regressive when the portion of income paid in tax falls as income rises and progressive when the opposite holds.) Other common exemptions designed to relieve the regressivity of the sales tax are those for clothing or household gas/electric. While some revenue could be gained by eliminating these exemptions, they are a necessary part of the sales tax base definition intended to reduce the regressiveness of the tax.

Tax General Services

The major way to change the sales tax base is to extend the tax to services. Presently, the sales tax applies to commodities but not to services (at least not to very many services). Economists have suggested that this differential treatment of commodities and services causes distortions in the economy's allocation of resources between the two. There is a clear incentive to shift resources into services and away from commodities to avoid the tax. For example, the present system taxes a new shirt purchased at a retail store, but exempts the laundering of the shirt from taxation. Why should the tax system distort the decision on whether to purchase a new shirt or launder old shirts? On efficiency grounds, we would like the tax system to be neutral, not affecting such decisions. If we were to broaden the base of the sales tax to include services, we could either reduce the tax rate and collect the same revenues or make available additional revenues. As an example, if the State of Michigan were to tax all services, an additional \$1 billion in revenue would be generated at the state's present 4 percent tax rate.⁴ The largest category of services is health services, taxation of which would generate \$479.8 million annually in Michigan.

Such a change in the tax will, of course, generate criticism, as Florida's recent experience has clearly illustrated (Hellerstein 1988). Florida's attempt to broaden the state sales tax to include services was vigorously opposed by advertising firms whose products would have been

subjected to the tax. Despite the potential for political opposition, the notion of taxing services deserves careful consideration.⁵

The taxation of health care services would have the effect of increasing the price of such services and reducing the equilibrium quantity of the services. Estimates of the elasticity of demand for hospital care services are in the range of 0.7 or less, which indicates that consumers are not very sensitive to price changes. In addition, if the supply of health care services is relatively elastic (responsive to price changes), the incidence of the tax on health care services would be borne mostly by the consumers of the care, not the producers. Improved access to health care financed in this way would raise the price of care for *all* in order to provide access for *some*.

The distributional effects of broadening the sales tax base to include health-related services can be investigated using recent research on the sales tax base. Bohm and Craig (1987) have simulated service-sector expenditures as a percentage of income for a number of services, including several health-related services. Their estimates of the distribution of expenditures indicate that extending the sales tax to health-related services will be regressive.⁶ Consumption expenditures as a percent of income fall as income rises. Consequently, applying the sales tax to these services will disproportionately fall on the poor.

This problem could be partially corrected by applying a refundable credit on the state income tax for sales taxes paid. The income tax credit could be designed to phase out with income, relieving the regressivity of the sales tax for low income levels. Net revenue from the sales tax on services less the income tax credit for sales tax paid on health services could then be used to fund improved access to health care.

Table 1 provides aggregate U.S. data on several alternative sales tax bases. The first alternative is to tax consumption, less expenditures on food and all services. This results in a narrow tax base, \$998.3 billion, similar to the present tax base used by most states. A somewhat broader tax base could be constructed by taxing consumption less expenditures on food, housing, medical care and household gas and electric. The resulting tax base is \$1,784.1 billion, or a tax base about 1.79 times larger than the present tax base. An even broader tax base to consider would be taxing consumption less expenditures on housing and medical

care. In that case, the tax base is \$2,467.5 billion, a tax base 2.47 times larger than the present tax base. These data indicate that substantially more revenue can be generated from the sales tax by including services. These figures are broadly suggestive of the potential revenues that would follow from sales tax base-broadening at the state level, although regional differences in consumption patterns would affect the revenues involved.

Table 1
Alternate Sales Tax Bases, 1989

	\$ billions
Personal income	4,396.2
Disposable personal income	3,744.5
Personal consumption	3,437.9
Consumption expenditures	
Food	588.6
Clothing	198.5
Services	1,851.0
Housing	527.5
Medical care	442.9
Gas and electric	94.8
Alternate tax bases	
1. Consumption less expenditures on food and all services	998.3
2. Consumption less expenditures on food, housing, medical care, and household gas and electric	1,784.1
3. Consumption less expenditures on housing and medical care	2,467.5

SOURCE. U.S. Department of Commerce, *Survey of Current Business*, July 1989, pp. 50, 51

Tax Amusements and Recreation Services

By extending the sales tax to amusements and recreation services, additional revenue could be generated. This base-broadening would apply the state sales tax to theater and athletic tickets and other such recreation or amusement admission charges. The distributional consequences

of such taxation are not known with precision. While theater ticket taxation would probably fall on the wealthy, athletic contest ticket admission taxation would probably affect lower-income consumers. Recent work by Blair, Giarratani, and Spiro (1987) indicates that an amusement tax may not be shifted to ticket purchasers (through higher ticket prices) at all in the case of sports franchises, may only be shifted partially in the case of nonprofit concert and theater series, and is only partially shifted in the long run for movie theaters. Overall, we do not know how the tax would be borne by low-income residents relative to high-income residents of a state, but this work indicates only partial shifting of the tax burden.

Tax Interstate Sales

Taxing interstate sales would generate additional revenue. Currently, state sales taxes typically apply to those businesses with a tax nexus in the state, i.e., retail outlets in the state. As a result, national retailers such as L.L. Bean who do not have such nexus in the state do not collect sales or use tax on purchases by customers in the state. Hence, present tax administration and policy favors purchase of a shirt from the L.L. Bean catalog over purchase of the same shirt from a local department store.⁷ Such differential tax treatment of the same commodity is inefficient, encouraging tax avoidance activity, and should be remedied. There are substantial administrative difficulties in taxing interstate sales, although these problems have been a topic of discussion at the state and national levels for several years and expedient solutions are being formulated.⁸

The incidence of such a tax is likely to be the same as that for the sales tax on intrastate sales. There is no particular reason to believe that consumers ordering from retailers outside a given state differ substantially from those purchasing goods from retailers within that state. To the extent that some of the interstate sales are attributed to upscale catalog retailers, the incidence may be somewhat more progressive than the normal sales tax.

Cigarette Excise Tax Rate Change⁹

States vary widely in their taxation of cigarettes. Table 2 illustrates the current rate of taxation in the states, varying from a low of \$.02 per package in North Carolina to a high of \$.40 per package in Connecticut. The southern tobacco-producing states tend to have very low rates of taxation; for example, the tax is \$.03 in Kentucky and \$0.025 in Virginia.

To compute the effects of an increased tax rate requires knowledge of the tax base. As an example, the current rate of taxation in Michigan is 12.5 mills per cigarette, or \$0.25 per package of 20 cigarettes. At this rate the tax generates \$268 million (FY89 DMB estimate) in revenue. The tax base is therefore 1.072 billion packages of cigarettes. A contemplated tax increase of \$.05 would then be expected to raise approximately \$53.6 million in revenue. This, of course, assumes present rates of consumption will hold constant, which is not a realistic assumption.

Research on smoking indicates that the price elasticity of demand is about -0.35 , indicating that a 10 percent change in price would lead to a 3.5 percent reduction in the quantity of cigarettes demanded. This relatively weak price response reflects the addictive nature of cigarettes and suggests that efforts to reduce smoking by raising the price of cigarettes (within politically acceptable limits) through higher taxes may be ineffective. It also indicates that an increased tax on cigarettes would lead to some reduction in the quantity demanded and therefore less tax revenue than might first be expected. In addition, with smoking habits on the decline, the tax base may be diminishing over time.

Continuing the example of a \$.05 increase, we would expect that tax increase to reduce consumption of cigarettes by about 1.4 percent (.35 times .05), making the new tax base 1.057 billion packages of cigarettes. Hence, the tax will raise \$52.8 million in revenue, not \$53.6 million as first supposed.

This elasticity estimate is also useful in assessing the extent to which the tax increase will reduce smoking and thus improve health. It is often argued that a tax increase on cigarettes will be beneficial due to its effect of discouraging smoking. As the above estimates indicate, the impact of the tax increase is modest, however. Any substantial reduction in smoking would require very large increases in taxation. Taxation

Table 2
State Cigarette Tax Rates Per Package, 1989
(local taxes not included)

New England		Southeast	
Connecticut	.40	Alabama	.165
Maine	.31	Arkansas	.21
Massachusetts	.26	Florida	.24
New Hampshire	.21	Georgia	.12
Rhode Island	.37	Kentucky	.03
Vermont	.17	Louisiana	.16
		Mississippi	.18
Mideast		North Carolina	.02
Delaware	.14	South Carolina	.07
D.C.	.17	Tennessee	.13
Maryland	.13	Virginia	.025
New Jersey	.27	West Virginia	.17
New York	.33		
Pennsylvania	.18	Southwest	
		Arizona	.15
Great Lakes		New Mexico	.15
Illinois	.30	Oklahoma	.23
Indiana	.155	Texas	.26
Michigan	.25		
Ohio	.18	Rocky Mountain	
Wisconsin	.30	Colorado	.20
		Idaho	.18
Plains		Montana	.18
Iowa	.31	Utah	.23
Kansas	.24	Wyoming	.12
Minnesota	.38		
Missouri	.13	Far West	
Nebraska	.27	California	.35
North Dakota	.30	Nevada	.30
South Dakota	.23	Oregon	.28
		Washington	.34
		Alaska	.29
		Hawaii	40 percent of wholesale price

SOURCES: ACIR's *Significant Features of Fiscal Federalism*, 1989 Edition, Volume 1; and Tobacco Institute of America data.

is simply a very ineffective method of reducing smoking. That is not to say, however, that a tax increase will not be more or less important in affecting the smoking behavior of a given group of people in society. It has been suggested that young smokers, just getting started in the habit, may be more responsive to prices than older smokers. If that is the case, a tax increase may be somewhat more effective for that group.

Recent studies, such as Manning et al. (1989), also suggest that the present level of cigarette taxation, both state and federal, in the United States is at the correct level to compensate for the social costs imposed by smoking. This result, together with potential border problems associated with differential state cigarette tax rates, suggests that other revenue sources be investigated for improved health care access.

The cigarette tax should be levied in an *ad valorem* manner, perhaps as a percentage of the wholesale price of the product, in order to avoid the problem that a unit tax generates less real revenue over time as inflation erodes the value of the tax. A unit tax must be adjusted periodically to maintain its real revenue-generating ability. This process is time-consuming and politically troublesome as the question of the level of taxation is re-examined. Currently, Hawaii is the only state to levy a cigarette tax in an *ad valorem* manner. Their tax is 40 percent of the wholesale price per package of cigarettes.

Alcoholic Beverage Tax Rate Change

Taxation of alcoholic beverages typically includes excise taxes on beer, wine, and liquor. A specific tax is sometimes also applied to liquor. Rates of taxation on these commodities can be adjusted to generate more revenue and also help pay the costs associated with externalities caused by their consumption. Recent studies of the social costs associated with the consumption of alcoholic beverages suggests that present levels of federal and state taxation only cover about half of the external costs. As a result, a substantial increase in taxation may be justified at either the federal or state (or both) levels. See Pogue and Sgontz (1989) and Manning et al. (1989) on this issue.

Estimates of the price and income elasticities of demand for alcoholic beverages are presented in Table 3 (Marshall 1985). The own-price

elasticities of demand are small for both beer and wine (-0.76 and -0.50 respectively) indicating that the quantity demanded is not very sensitive to changes in the good's own price. A 10 percent increase in its price would lead to a 7.6 percent reduction in the quantity of beer demanded, and for wine, a 5 percent reduction in the quantity demanded. The price elasticity of demand for spirits is unitary, indicating that a given percentage change in price will lead to a proportionate percentage change in the quantity demanded.

Table 3
Alcoholic Beverage Elasticities

Beverage	Beer price	Wine price	Spirits price	Income
Beer	-0.76	0.12	0.63	0.23
Wine	0.09	-0.50	0.31	2.00
Spirits	0.61	0.33	-1.00	1.27

SOURCE. Marshall (1985)

There are several implications that follow from these elasticity estimates. First, since the demand for beer and wine is inelastic, tax increases on these commodities will result in higher revenues. As the price rises due to a tax increase, the quantity demanded falls, but not proportionately. Consequently, tax revenues rise with tax rate increases. A second implication of the elasticity estimates for alcoholic beverages is that a tax increase on beer or wine will be borne by the consumer to a greater extent than an increase in the tax on spirits. With relatively inelastic demand, the consumer bears a greater share of the tax burden than the producer (for a given elasticity of supply). The final implication is that the cross-price elasticities indicate the strength of substitutability among the alcoholic beverages. Note that beer and wine are not close substitutes, since their cross-price elasticities are nearly zero. The cross-price elasticities are greater for spirits and beer, but are still less than unitary. In general, the cross-price elasticities indicate that the three forms of alcoholic beverages are not very close substitutes.

As a result, an increased tax on one form of alcoholic beverage will not affect the quantity of other beverages demanded to a significant degree.

The income elasticity estimates indicate that beer consumption does not rise proportionately with increased income, while wine and spirits rise more than proportionately with income. Increased taxes on beer will be regressive, while increased taxes on wine and spirits will be progressive.¹⁰

Border crossing due to alcoholic beverage tax rate differentials may be a problem, as with cigarette tax differentials. The problem is expected to be smaller in the case of beer, wine, and liquor taxes, however, due to the higher cost of transporting the goods.

Many states are currently proposing increased taxes on alcoholic beverages, however. The Distilled Spirits Council reports that 30 states have proposed tax increases in 1989, while 7 have actually adopted increases, 2 states having increased their taxes by 50 percent.¹¹ If neighboring states were also to increase their taxes on alcoholic beverages, the potential border problems would be lessened.

Taxation of alcoholic beverages cannot be analyzed in the absence of information on the state distribution methods as well. States either have a controlled distribution system (monopoly distribution) or an open method of distribution (relying on licensing of distributors). The taxation of alcoholic beverages is closely tied with the pricing of the beverages, which is directly tied to the distribution method. While a full discussion of the issues involved is beyond the scope of this chapter, it must be stressed that both sets of issues should be considered. See Fisher (1988) for a good discussion of the issues involved.

Income and Payroll Tax Sources

Payroll Tax

A natural way to pay for health care access is through a payroll tax mechanism. Wages and salaries would be subject to a tax of a given percentage, perhaps shared equally by employer and employee. The tax would apply to personal earnings only. Capital income is not taxed

under the payroll tax. The social security tax is a good example of this type of tax; employer and employee both pay 7.65 percent, up to a maximum taxable wage of \$51,300. The precise tax rate needed would depend upon the tax base and the revenue needs of the access improvement program. A payroll tax is simple to administer and capable of generating large amounts of revenue.

As an example of the potential application of payroll taxes to fund health care access, consider Ohio House Bill 425, introduced during the 1989-90 regular session of the General Assembly. That bill establishes a universal health insurance plan funded through a payroll tax of 8 percent to be paid by employers together with a 1 percent wage tax and a 2 percent tax on interest and dividends to be paid by individuals. In this case, the distribution of tax burden is affected by the combination of taxes and differing rates.

Of course, the incidence of a payroll tax is not what it appears. If we first consider personal earnings, it is clear that the specification of a cap, beyond which the marginal tax rate is zero, means that the tax is proportional up to the cap and regressive thereafter. Taking a broader view of income, and including capital income (interest and dividends), makes the payroll tax even more regressive overall. Musgrave and Musgrave (1989) note that the payroll tax is largely a regressive tax since the share of capital earnings rises with income. Further, while employer and employee appear to share the tax burden equally, the employer is able to shift part of the tax to the employee through lower wages than would be paid in the absence of the tax.

As an example of a payroll tax approach to fund improved health care access, consider such a tax on uninsured workers to provide access. Simulating such a tax for the State of Michigan, Goddeeris finds, in chapter 4 of this volume, that a tax of 10 percent on wages and salaries for adult workers not covered by group insurance in their own names would generate \$430 million in revenue.

Income Tax Rate Change

Forty of the states have comprehensive income taxes with marginal tax rates ranging from about 1 percent to 12 percent.¹² Five of these states have flat rate taxes, while the remainder have progressive rate

structures.¹³ One method of raising revenue is to raise tax rates. To estimate potential revenues, one must know the tax base—the state definition of taxable income—and apply the increase in rate to it to compute new revenues that would be generated. State income tax structures are often complex, and detailed knowledge of the specific provisions of tax law are required. As an example, Michigan's flat rate income tax is applied at the rate of 4.6 percent to taxable income based on the federal definition of adjusted gross income. The tax generates \$3.6 billion (FY 1989 estimate). Taking the broadest possible definition of the tax base (no effective exemptions, no credits, no deductions), an additional 1 percent tax will generate nearly \$1 billion in revenue. Other state income tax structures can be analyzed similarly to determine the revenue response likely from a given change in tax rate. It should be noted that such rough rules of thumb ignore elasticity responses. Higher income tax rates will alter the level of economic activity in the state and ultimately affect the tax base.

Income Tax Base Changes

Twenty-three of the 40 states with comprehensive income taxes use federal adjusted gross income (AGI) as the starting point in defining taxable income.¹⁴ As a consequence, federal tax preferences generally apply at the state level as well. For example, the favorable tax treatment of benefits compared to wages applies to state tax structures as well. Since benefits are not included in the definition of AGI, they are generally not taxed at the state level either. As a result, the tax system distorts the choice between wage/salary income and benefits. Another large tax preference is provided for owner-occupied housing, because the value of housing services provided by a home is tax-exempt. Other capital assets generating income are taxed.

Other examples could be cited but these two are sufficient to make the point that the current definition of income is rather narrow.¹⁵ Taxing some of these forms of income would generate additional revenues for health care access.

Economists have suggested several base-broadening measures for the federal income tax which may also be relevant for state income taxes.

Table 4 provides Joseph Pechman's estimates of the broadening in taxable income which would follow from less liberal personal deductions, taxing some transfer payments, taxing fringe benefits, and alteration of the two-earner deduction. These base-broadening measures would increase federal taxable income by 15.7 percent, compared to the 1986 definition. The amount by which a state's tax revenue would rise depends upon several factors, including: (a) the nature of the state's tax base and the link between the state's tax code and the federal code (i.e., whether the state has adopted the federal definition of AGI for taxable income); and (b) the state's marginal tax rate structure. State-specific estimates of the revenue implications of base-broadening measures require this information, together with assumptions regarding the behavioral changes likely to be prompted by the change in tax base.

Table 4
Alternative Personal Income Tax Base
(billions of dollars)

Item	Adjusted gross income (AGI)	Taxable income
Tax Reform Act of 1986	\$3,545	\$2,407
Plus:		
Personal deductions	0	68
Transfer payments	226	164
Fringe benefits	187	185
Two-earner deduction	-82	-81
Other	43	42
Equals: comprehensive tax	\$3,919	\$2,785

SOURCE: Congressional Budget Office, as reported in Pechman (1987).

Tax Benefits

The suggestion to tax fringe benefits alone would generate an additional \$37 billion in federal revenue, assuming an average marginal tax rate of 20 percent. More specifically, consider the taxation of health insurance premiums provided by employers. The rationale for this approach lies in the observation that the present income tax base includes

wage and salary income but not benefits provided by the employer. An additional dollar of salary is taxed at a 15 percent, 28 percent or 33 percent rate by the federal government, plus a state tax rate of perhaps 5 percent, while additional benefits are not taxed at all. As a result, there is a clear incentive for employees to request benefits in place of some money income.¹⁶ From an individual's point of view, the choice is clear. If a person would have purchased a \$1,200 health insurance policy anyway, receiving the benefit of the policy rather than \$1,200 in salary saves the typical taxpayer \$336 in federal income taxes (assuming the individual is in the 28 percent tax bracket). To remove this distortion from the tax system, and to take away the substantial subsidy involved, the insurance premium paid by the employer on behalf of the employee could be counted as taxable income.

States can consider several variants of this proposal: (a) taxing the first x dollars of coverage; (b) taxing all coverage provided; or (c) taxing coverage over x dollars. The first approach was included in the 1981 proposal for federal tax reform, which contained a provision taxing the first \$10 per month (\$120 per year) for a single filer or \$25 per month (\$300 per year) for a married filer. As an example of the state level impact, that proposal would have increased the Michigan income tax liability of Michigan residents by \$24 million. In addition to the revenue impact of the proposal, a state needs to consider the distributional consequences. Simulations performed by the Michigan Department of Treasury indicated that this proposal would have reduced tax liability for 20,688 Michigan income tax filers by a total of \$51,000 while increasing tax liability for 2,309,740 filers, raising their taxes by \$24.305 million.¹⁷ Most of the impact of this proposal would have been felt by taxpayers with adjusted gross income in the \$30,000 to \$50,000 range. In fact, 60 percent of the total tax increase is borne by taxpayers with AGI of \$30,000 or more. Low-income taxpayers, with AGI less than \$15,000, would bear 12 percent of the tax burden.

Such a proposal is misdirected, however, being very regressive in only taxing the first \$120 or \$300 of benefits. Above these levels, the marginal tax rate would be zero. From a state tax policy perspective, it would be better for a state to exempt the first x dollars of benefits and to tax benefits above that level. In this way, the tax would be

somewhat progressive and treat wages and benefits equally, above some basic level of benefits.

The exclusion of health care benefits from taxation results in substantial loss of revenue. Pechman (1987) reports that the tax expenditure associated with the exclusion of employer contributions to medical insurance premiums and medical care at the federal level is \$30.205 billion (1988 estimate). Additional revenues are involved at the state level as well. For example, the Michigan Department of Treasury estimates that taxing all employer contributions to health and life insurance would generate \$296 million in state income tax revenue.¹⁸ Removing the life insurance portion of this total may reduce the current tax expenditure to \$250 million. For equity and efficiency reasons, however, there is no reason to separate the two types of insurance—both should be taxed.

Tax Lottery Winnings

States with lotteries can consider broadening the income tax base to include lottery winnings, if they are not currently taxed. Lottery winnings are taxable at the federal level, but not at the state level in all states with lotteries. At the federal level, gamblers are permitted to deduct losses, paying tax on net winnings, which cannot be done on some state income taxes. As an example of the revenue potential here, consider the Michigan case where taxation of lottery winnings is estimated to generate \$24 million in revenue.

The incidence of the lottery tax has been investigated by Suits (1982). He found that the lottery is twice as regressive as the second most regressive tax—the sales tax. From this perspective, additional reliance on a very regressive tax is not a just change in tax policy. Arguments that the regressivity of the lottery does not matter because it is a voluntary tax are specious.

Tax Employer Contributions to Pensions or Social Security

The exclusion of net pension contributions and earnings results in a sizable amount of lost tax revenue. Pechman (1987) reports that the exclusion of employer plans results in a tax expenditure of \$58.185

billion at the federal level, while the exclusion of IRA contributions results in a loss of \$11.635 billion, and Keogh plans add another \$1.715 billion. The exclusion of social security income also results in a substantial revenue loss. Taxing OASI benefits for retired workers would generate an additional \$12.025 billion in federal revenue, while taxing benefits for dependents and survivors would generate \$3.545 billion, and disability insurance benefits would generate \$1.040 billion. State revenues involved are less, of course, depending upon state tax base definition and marginal tax rates.

Taxing employer contributions to pension plans or taxing social security income would generate large revenues for states, but both of these tax expenditures have strong political support and are unlikely targets for added revenue. States can at least conform to the federal definition of taxable income in this regard. For example, a state could at least tax that portion of social security income which the federal government taxes. In Michigan, for example, this would generate an additional \$27.5 million in revenue.¹⁹

A recent Supreme Court ruling requires that states tax state and federal pension income alike, rather than exempting state pension income and taxing federal pension income as some states currently do.

Business Taxation

Table 5 illustrates the many ways in which states have chosen to tax business activity. While all states tax business activity, and a number tax it several different ways, there is a wide variety of tax mechanisms employed. Most states rely on a corporate income tax for about 4 to 5 percent of state general revenue. Some states use gross receipts taxes (Hawaii, Indiana, West Virginia, and Washington) and one state uses a value-added tax (Michigan). Forty-nine of the states also have corporate license taxes, and all 50 tax insurance premiums. In addition, 33 states levy severance taxes on natural resources.

Since states use very diverse methods of taxing business activity, it is difficult to generalize about potential revenues. Revenues can certainly be raised by increasing the rate of taxation, whether it be based on corporate profits, gross receipts, or value-added. Aside from rate

change, though, most states' business tax structures are replete with myriad forms of business tax expenditures. Consideration should be given to repeal of specific exemptions which may no longer be effective in accomplishing the stated objective. Tax preferences for specific industries, or for specific firms for that matter, may not serve legitimate state policy objectives and may be targeted for potential revenue. Analysis of the incidence of the state business tax structure is a necessary prerequisite for making such changes. After determining that specific industries pay more or less than their share of state business taxes, tax policy changes can be recommended.

Table 5
State Business Taxes

Type of tax	Number of states	Tax revenue (\$ billion, 1985)	Percent of state general revenue
Corporate income tax	45	16.915	4.3
Gross receipts tax	4	1.670	0.4
Value-added tax	1	1.448	0.4
Corporate license tax	49	3.065	0.8
Severance tax	33	6.125	1.6
Insurance premiums tax	50	5.489	1.4

SOURCE: Fisher (1988), p 215

Transition From Business Provision of Health Insurance to State Insurance Plan

An important policy suggestion which states are grappling with centers on the question: Who pays for health insurance? The tradition, coming from years of collective bargaining and cultural expectations, has been that the employer provides health insurance and other benefits. This is quite reasonable, especially in light of the tax incentives involved. Employees can receive insurance at substantially subsidized rates by having the employer pay the premium, which is exempt from federal and state income taxation. Recent pressures for U.S. industry to become

more competitive in world markets, however, force firms to reconsider the provision of such benefits. A specific proposal to move from employer-provided health benefits to a more universal health care system, provided by the states, has been suggested (see chapter 3). Of course, the major economic stumbling block in this proposal lies in the fact that the health insurance benefits become taxable when moved out of the workplace under current tax law. With changes in tax law, creative solutions to the transition may be forthcoming. In the absence of such changes, the penalty for such a change is severe.

Issues of Federalism

Deductibility Issues

Federal deductibility of state taxes has several important implications for state tax systems.²⁰ First, with federal deductibility states may have more progressive tax structures than they would otherwise. The high-income taxpayers, who pay the higher marginal tax rates at the state level, are also more likely to itemize on their federal returns, deducting the state taxes and lowering their federal tax liability. A second implication of deductibility is that states can collect more revenue than they could in the absence of deductibility. Deductibility can induce some taxpayers to support higher state taxes than they otherwise would since it reduces the net marginal tax price of an added dollar of increased state expenditure. Finally, deductibility dampens interstate tax differences. If taxes are \$300 higher for a given individual in State A compared to State B, the deductibility of state taxes reduces that difference to \$216 (assuming the taxpayer is in the 28 percent marginal tax bracket and there is no deductibility at the state level).

Understanding these deductibility implications has relevance to the choice of a tax instrument for financing improved health care access. Choosing a deductible tax, such as the income tax, brings with it all of these implications. Choosing a nondeductible tax, such as the sales tax, does not. While there are certainly other issues to consider, these implications must be part of the policy discussion in selecting a tax-based financing method.

Since the Tax Reform Act of 1986, state (and local) sales taxes are no longer deductible from federal adjusted gross income. As a result, increases in the sales tax rate would cost itemizing taxpayers an additional 15 percent, 28 percent, or 33 percent, depending on their tax bracket, when compared to financing that relies on a deductible tax. Nonitemizers, of course, would not be affected by the nondeductibility of the sales tax. As an example of a typical case, consider a state where 35 percent of federal income tax returns filed by taxpayers included itemization. If the average marginal tax rate for those taxpayers is 20 percent, then an additional dollar of revenue raised in the state through a nondeductible sales tax would cost the taxpayers \$1.00 compared to \$0.93 if the same revenue were raised using a deductible tax. The 7 percent difference is the premium a state pays if it chooses to fund health care access using the nondeductible tax. The federal government has given states the clear incentive to finance new activity with income or property taxes, not sales taxes.

Tax/Revenue Limitations

A number of states have enacted revenue or expenditure limitations since California led the way with Proposition 13 in 1978. Notable among the state limitations are Massachusetts' Proposition 2-1/2, which is a property tax limitation, and Michigan's Headlee Amendment, which limits all state revenues. With such limitations in place, states must consider the implications of new funding mechanisms proposed to improve health care access. For example, a new tax source that would generate several hundred million dollars in revenue in Michigan would violate the Headlee Amendment, requiring either dramatic reductions in other taxes or a change in the state constitution, neither of which is attractive.

Summary and Conclusions

A number of potential revenue sources for financing improved access to health care have been identified in this chapter. The choice of which funding mechanism is best for a given policy proposal is complex. For access proposals that are relatively cheap (\$100 million), some

combination of increased taxes on alcoholic beverages, prescription drugs, or amusement services can be used. More comprehensive policy proposals carrying higher price tags (\$400 to \$600 million) will require correspondingly more substantial tax policy changes. Including some services in the sales tax base (perhaps coupled with a sales tax credit on the income tax to relieve regressivity), taxing employer contributions to health and life insurance under the state income tax, or levying a payroll tax are all possibilities. For any given policy proposal, the appropriate funding mechanism should be identified not only on the basis of the revenue generated, but also with regard to the incidence and incentive effects of the mechanism.

NOTES

1. The notion of a tax expenditure comes from a budgeting perspective that acknowledges that when a tax system exempts certain activity from taxation, the preferential treatment is equivalent to a direct budget expenditure for that activity. Hence, the amount of the tax exemption or preferential treatment is termed a tax expenditure.
2. ACIR (1991).
3. A use tax is a form of sales tax due on goods used but not purchased in the state. For example, a sales tax is levied on a pair of shoes purchased in the state, but a use tax is levied on a pair purchased from a mail order firm in another state. As another example, a sales tax is applied to the purchase of a new car, a use tax is applied to the lease of a new car. The use tax is designed to close common sales tax loopholes.
4. State of Michigan Executive Budget, Tax Expenditure Appendix, 1987-88 Fiscal Year, p. 39.
5. For a discussion of the economic issues involved, see Fox and Murray (1988).
6. It should be noted that recent research using computational general equilibrium methods finds that taxing services under the sales tax may be less regressive than traditional theory suggests. The reason is due to the reduction (increase) in labor supply by lower- (higher-) income households. For the low-income households, the income effect of a higher cost-of-living due to the sales tax on services appears to dominate the income effect of wages, resulting in upward sloping labor supply curves with respect to both wages and the cost-of-living. For further discussion of this view, see Baum (1991).
7. It must be noted that transportation costs are a factor to consider as well.
8. See ACIR (1986).
9. This section discusses taxation of cigarettes, but other forms of tobacco should be taxed in similar ways. That would include cigars, pipe tobacco, and chewing tobacco products. To avoid distortions in the system, all tobacco products should be taxed at the same rate.
10. Some caution is needed in making this generalization, since the elasticity estimates are point estimates—evaluated at a mean level of income—and do not hold precisely over the income distribution.
11. *Wall Street Journal*, July 12, 1989.

12. Those states with no income tax are: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. States with limited income taxes are: Connecticut, New Hampshire, and Tennessee.
13. Those with flat rate taxes are: Massachusetts, Pennsylvania, Illinois, Indiana, and Michigan (ACIR 1989).
14. ACIR (1988; 1989).
15. See Pechman (1987).
16. See Woodbury (1989).
17. Michigan Department of Treasury (1986)
18. Michigan Department of Management and Budget (1987-88).
19. Federal income tax liability occurs when half of the social security benefits plus modified adjusted gross income is more than \$32,000 on a joint return (\$25,000 on a single return) The federal tax applies to half of the excess, or half of the social security income, whichever is less. Michigan does not tax this income.
20. The reasons cited here are adapted from Fisher (1988).

References

- Advisory Commission on Intergovernmental Relations (ACIR). 1986. *State and Local Taxation of Out-of-State Mail Order Sales*, Report A-105, Washington, DC.
- _____. 1989. *Significant Features of Fiscal Federalism*, Volume 1, Washington, DC.
- Baum, Donald N. 1991. "Economic Effects of Including Services in the Sales Tax Base: An Applied General Equilibrium Analysis," *Public Finance Quarterly* 19(2): 166-92.
- Blair, Andrew R., Frank Giarratani, and Michael H. Spiro. 1987. "Incidence of the Amusement Tax," *National Tax Journal* 60(1): 61-69.
- Bohm, Robert A. and Eleanor D. Craig. 1987. "Sales Tax Base Modification, Revenue Stability and Equity," National Tax Association-Tax Institute of America, *Proceedings of the Eightieth Annual Conference*, pp. 167-74.
- Fisher, Ronald C. 1988. *State and Local Public Finance*. Glenview, IL: Scott Foresman.
- Fox, William F. and Matthew Murray. 1988. "Economic Aspects of Taxing Services," *National Tax Journal* 61(1): 19-36.
- Hellerstein, Walter. 1988. "Florida's Sales Tax on Services," *National Tax Journal* 61(1): 1-18.
- Manning, Willard G., Emmett B. Keeler, Joseph P. Newhouse, Elizabeth M. Sloss, and Jeffrey Wasserman. 1989. "The Taxes of Sin: Do Smokers and Drinkers Pay Their Way?" *JAMA* 261(11): 1604-1609.
- Marshall, Gary L. 1985. "Developing a State Alcohol Beverage Simulation Model," National Tax Association-Tax Institute of America, *Proceedings of the Seventy-Eighth Annual Conference*, pp. 180-86.
- Michigan Department of Management and Budget. 1987-88. *State of Michigan Executive Budget, Tax Expenditure Appendix*. Lansing, MI.
- Michigan Department of Treasury, Taxation and Economic Policy Office. 1986. "The Impacts of Federal Tax Reform in Michigan: Analysis of House and Senate Plans." Lansing, MI.
- _____. 1985. "Analysis of the Michigan Single Business Tax." Lansing, MI.
- Musgrave, Richard A. and Peggy B. Musgrave. 1989. *Public Finance In Theory and Practice*. NY: McGraw-Hill.
- Ohio House Bill #425, 118th General Assembly Regular Session, 1989-90.
- Pechman, Joseph A. 1990. "The Future of the Income Tax." *American Economic Review* 80(1): 1-20.
- _____. 1987. *Federal Tax Policy*, 5th ed. Washington, DC: The Brookings Institution.

- Pogue, Thomas F. and Larry G. Sgontz. 1989. "Taxing to Control Social Costs: The Case of Alcohol," *American Economic Review* 79(1): 235-43.
- Suits, Daniel B. 1982. "Gambling as a Source of Revenue." In *Michigan's Fiscal and Economic Structure*, eds. Harvey E. Brazer and Deborah S. Laren. Ann Arbor: University of Michigan Press.
- Woodbury, Stephen A. 1989. "The Use of Tax Reduction or Subsidies to Encourage Coverage of the Employed Uninsured—Supplement to Preliminary Report to the Governor's Task Force on Access to Health Care." Lansing, MI.