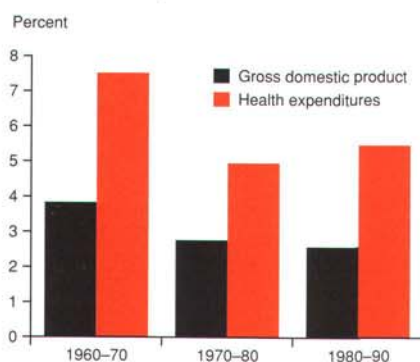


# The Uneven Distribution of Health Insurance

Health care expenditures have grown faster than the nation's income for the past three decades (*Chart 1*). This increase, together with concerns about the 35 million Americans without health insurance, has made reform of the U.S. health care system a national priority.

Closer inspection reveals that some of the concerns about health care may be misplaced. Roughly one-third of the increase in health care expenditures can be attributed directly to the demands of an aging and increasingly wealthy population. Some individuals are uninsured by choice; they choose not to pay for insurance because they perceive that their health risks are low. Furthermore, being uninsured does not necessarily imply a lack of health

**Chart 1**  
Average Annual Growth of Domestic Product and Health Care Spending (in 1987 Dollars)



SOURCE: Health Care Financing Administration

care. To the extent that increasing expenditures and an uneven distribution of health insurance across the population reflect the actions of an undistorted market, most economists would see little cause for alarm.

However, economic research suggests that the market is distorted in ways that affect the distribution of health insurance, and that the distribution of insurance strongly influences the level of spending. The government distorts the health insurance market by subsidizing the insurance purchases of some Americans (by not taxing employer-provided health benefits) and by insuring the health care of the poor (through Medicaid and county hospitals). These distortions can contribute to rising health care expenditures because increasing insurance coverage generally leads individuals to increase their health care consumption substantially.<sup>1</sup> To be effective, reform must address the distortions in the health insurance market.

## The Distribution of Health Insurance

Eighty-six percent of Americans were covered by either public or private health insurance in 1990. Most individuals in the higher income brackets received private health insurance through their employers as part of their labor compensation package (*Chart 2*). Most individuals in the lower income brackets received public health insurance through Medicaid. Most Americans over 65 were covered by both private insurance and Medicare.

The remaining 14 percent of the population—individuals not covered by health insurance in 1990—consisted primarily of the working poor. One-fourth of the uninsured, however, had incomes three times the poverty level or greater. Twenty-six percent of young adults between the ages of 18 and 24 were uninsured, while less than 1 percent of the elderly were uninsured.

## How the Government Distorts the Distribution of Insurance

For nearly 50 years, employer-provided fringe benefits have been exempt from personal income taxes. Thus, employees reduce taxes by taking some of their compensation in the form of health insurance. If the tax rate is 15 percent, an employee can receive \$1's worth of health care instead of 85 cents' worth of after-tax take-home pay (*Table 1*). The difference represents an implied tax subsidy. As *Table 1* shows, those in the highest tax bracket receive the largest tax subsidy, while those in the zero-percent tax bracket, which includes a large number of the uninsured, receive no tax subsidy.<sup>2</sup>

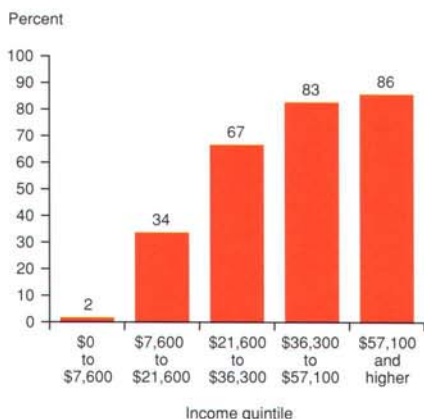
Because employees will tend to buy more health insurance at 85 cents than at \$1, the exclusion of health-related fringe benefits from taxable income increases expenditures on health insurance by those receiving the subsidy. Researchers estimate that the subsidy costs the federal government \$65 billion per year in foregone revenue and increases private health insurance spending by one-third.<sup>3</sup>

While the tax subsidy encourages people in higher income brackets to purchase more insurance, it discourages insurance purchases by people in lower income brackets. Increased demand by people whose premiums are subsidized increases the insurance premiums for people who lack subsidies.<sup>4</sup> Therefore, some of the working poor have been priced out of the market for health insurance by the tax subsidy given to workers in higher income tax brackets.

Public insurance programs, such as Medicaid and public hospitals, also discourage individuals in lower tax brackets from purchasing private insurance or from paying out-of-pocket for preventive medicine. People who can rely on public insurance or charitable organizations to provide care during serious illnesses have less incentive to pay for pre-



**Chart 2**  
Percentage of Americans Receiving Employer-Provided Health Insurance (by Income Quintile)



SOURCE: U.S. Department of Commerce, Bureau of the Census

ventive care or to purchase insurance. But because the prevention of an illness is usually cheaper than the treatment of it, the health care safety net provided by public insurance programs can have the unintended consequences of increasing health care expenditures and discouraging private insurance coverage.

Some government participation in the health care market can be justified from an economic standpoint. Generally, people consider their personal welfare rather than the welfare of others when deciding how much health care to purchase. If society benefits from having individuals receive health care—either from preventing contagious diseases like tuberculosis or from altruism—then the individuals disregard important societal benefits, purchase too little care and should be encouraged to consume more. However, there is little evidence that the government's actions in the health insurance system target those individuals who underconsume health care, so health insurance reform is still necessary.

### How Reform Proposals Affect the Distribution of Health Insurance

Many reforms have been proposed to reduce the number of uninsured individuals and to slow

the growth in health care expenditures. However, effective health care reform must address the distortions the government has introduced into the health insurance market.

The reform proposals can be classified into three categories: voluntary private insurance, mandatory private insurance, and government-sponsored insurance. Some of the proposals reduce the distortions in the health insurance market, while others add new distortions or make the distortions worse.

#### Voluntary Private Insurance Proposals.

As the name implies, voluntary private insurance plans provide incentives to firms and individuals to increase coverage voluntarily. To reduce the number of uninsured individuals, voluntary private insurance plans offer tax credits for insurance premiums and subsidies to low-income households. However, unless the subsidies are extremely large, they will not have a significant effect on the number of uninsured people. Research suggests that to cut the number of uninsured people by 6 million, the price of insurance must be cut in half.<sup>5</sup> Such extensive subsidies would also benefit insurance companies and eligible individuals who are already insured.

Furthermore, many of the voluntary private insurance programs simply add the subsidies for lower income groups without eliminating the subsidies for higher income groups. Thus, they expand the expenditures problems created by excess consumption of health insurance.

#### Mandatory Private Insurance Proposals.

Mandatory private insurance plans, also called play or pay plans, require firms that do not currently offer health care coverage either to offer it (play) or pay a tax that goes into a general health insurance pool. Both public and private parts of the plans are administered by private insurance companies. Private coverage is financed through the contributions of employers and individuals. Public coverage is financed through dedicated employer taxes and other

government revenues. Medicaid is extended to cover all people who are not covered by their own or a family member's employer-provided insurance.

Although mandatory private insurance plans ensure universal coverage, they will most likely lead to higher health care expenditures. Most mandatory private insurance plans do not eliminate the tax subsidy for health care premiums and compound the distortion by forcing all employers to provide a minimum level of insurance. The continuation of the tax subsidy, along with the inclusion of all individuals in the insured pool, will increase the demand for health care and lead to higher health care expenditures.

Furthermore, by requiring all employers to provide a minimum health care package, mandatory private insurance plans introduce a new set of health insurance distortions. Standardizing insurance coverage could lead to a minimum level of health insurance that may be too high for many Americans. Individuals who prefer less insurance may not be able to opt out of the plan and may be forced to pay premiums for the mandated higher level of minimum coverage.<sup>6</sup>

**Government-Sponsored Insurance Proposals.** With government-sponsored insurance, government provision of health insurance replaces the present employment-based system. The cost of health care services is financed through taxes on individuals and businesses, and the plan is administered and regulated by the government.

**Table 1**  
The Subsidized Price of Health Care

Wage	Effective tax rate (Percent)	Effective price of health care
\$1	0	\$ 1.00
\$1	15	\$ .85
\$1	28	\$ .72
\$1	31	\$ .69



Government-sponsored insurance programs would achieve universal coverage by design—that is, the government would provide health insurance to all residents. Most plans also remove the tax distortions in the current income tax code. However, universal government-sponsored insurance may provide a basic health care package that is too extensive, introducing the problems already discussed with respect to mandatory private insurance.

Furthermore, government-sponsored insurance plans could suffer from all the efficiency problems associated with noncompetitive government enterprises.<sup>7</sup> Without the discipline of competition or a profit motive, the government insurer could become an expensive and inefficient bureaucracy. Hence, universal government sponsorship could increase health care expenditures.

## Conclusion

The distortions built into the health care market alter the efficient distribution of health insurance. Among these are tax subsidies for employer-provided health insurance and government safety nets for the poor. Symptoms of these distortions include rising health care spending and the 35 million uninsured Americans. Unless reform proposals attack the market distortions that may be causing much of the problem, the symptoms will persist.

On the surface, expanding insurance coverage and decreasing total health expenditures may seem to be incompatible goals. But attacking the distortions that alter the insurance distribution toward over-consumption by some and under-consumption by others may be a first step toward a rational and efficient health care reform policy.

—Beverly Fox  
Lori L. Taylor  
Mine Yücel

<sup>1</sup> See, for example, Stephen H. Long and Jack Rodgers (1990), "The Effects of Being Uninsured on Health Care Service Use: Estimates from the Survey of Income and Program Participation," Congressional Budget Office Working Paper No. 9012; Emmett B. Keeler and John E. Rolph (1988), "The Demand for Episodes of Treatment in the Health Insurance Experiment," *Journal of Health Economics* 7(4):337–67; and W.G. Manning et al. (1987), "Health Insurance and the Demand for Medical Care," *American Economic Review* 7(3):251–77.

<sup>2</sup> Residents of cities and states that levy income taxes receive additional subsidies because their fringe benefits are also exempt from local income taxes.

<sup>3</sup> Leonard E. Burman and Jack Rodgers (1992), "Tax Preferences and Employment-Based Health Insurance," *National Tax Journal* 65(3):331–46.

<sup>4</sup> Increased demand for health insurance increases the demand for and price of health care and, therefore, causes higher premiums.

<sup>5</sup> Martin Holmes (1984), "Tax Policy and the Demand for Health Insurance," *Journal of Health Insurance*, 3 (December).

<sup>6</sup> Although employers technically pay the insurance premiums, the costs ultimately fall on the employees. Health benefits would increase while wages and salaries decreased to keep total labor compensation unchanged. Minimum-wage employers who could not offer benefits without increasing the total compensation package might reduce staff.

<sup>7</sup> Dennis C. Mueller (1979), *Public Choice*, Cambridge Surveys of Economic Literature (Cambridge, U.K.: Cambridge University Press).

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