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Will Obama Raise Middle-Class Taxes to Fund Health Care?

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President Barack Obama is promoting a big expansion in federal health care spending, and Democratic leaders are scrambling to find ways to pay for it. The plan is expected to cost about $1.5 trillion over the next decade, but the administration has promised that health care legislation won't add to already huge federal budget deficits.

Obama has also made strong promises that he won't raise any taxes on lower- and middle-income Americans. Tax increases are a bad idea in general, but the Democrats are finding out that there is no way to fund their vision of expansive government health care without walloping average families with higher tax burdens. Some of the middle-class tax increases under consideration by the Democrats to fund health care are discussed here.[1]

Taxing Employer-Provided Health Insurance

Employer-provided health insurance is currently not taxed under the federal income or payroll taxes. But Democrats are considering proposals to limit or repeal this tax exclusion, which could affect the 163 million people who currently have employer-based coverage.

The current exclusion is a solidly middle-class tax benefit. More than 70 percent of middle-income nonelderly Americans have employer-based health coverage.[2] And about half of people with employer-based coverage have family income of less than $75,000.

Limiting the tax exclusion for employer-based health care is a good idea if it is part of a plan to shift the overall system toward market-based individual coverage. Under such a plan, individuals would get a tax deduction or credit for purchasing health insurance on their own or through an employer. The result would be that most workers would pay about the same in taxes, but health markets would be more efficient and coverage would be expanded and made more portable. John McCain proposed such a reform in the 2008 election campaign. Obama criticized the idea at the time, but he should reconsider this approach if he wants to pursue true reform with bipartisan support.

Unfortunately, some of the plans under consideration in Congress would simply limit or repeal the exclusion to fund a bigger federal role in health care. For example, if the income tax exclusion were repealed, it would impose a huge $2.3 trillion tax increase over 10 years.[3] Employers currently pay average health insurance costs of about $8,800 per worker, thus someone in the 25 percent tax bracket would have an annual tax increase of $2,200.[4]

Rather than full repeal, a health package might put a cap on the tax exclusion. For example, limiting the income and payroll tax exclusion to the cost of an average health plan in 2009, and indexing the cap to health care inflation, would raise taxes about $165 billion over 10 years.[5]

Eliminating HSAs and FSAs

About 8 million Americans have health savings accounts, which allow people with high-deductible insurance to save in tax-free accounts used for health expenses. HSA usage is quite heavily weighted to people with modest incomes. A recent study estimated that 83 percent of HSA users were in lower, lower-middle, and middle-income households.[6] In addition, millions of workers participate in flexible spending accounts, which allow workers to pay for health expenses on a tax-advantaged basis. Democrats are considering proposals to restrict or end HSAs and FSAs. Disallowing all future HSA contributions would raise taxes by about $11 billion over the next decade.[7]

Limiting the Deductibility of Medical Expenses

Medical expenses are currently deductible for taxpayers who itemize if they exceed 7.5 percent of adjusted gross income. About 11 million tax filers take advantage of this deduction, generally people who have high unreimbursed health expenses. Usage of this deduction is heavily tilted toward those with moderate incomes. Indeed, 73 percent of total medical deductions are taken by households with incomes under $75,000.[8]

Democrats are considering various ways to cap or end this deduction. Ending it would increase taxes by roughly $210 billion over the next decade.

Alcohol and Beverage Taxes

In February, President Obama broke his pledge not to raise taxes on lower- and middle-income Americans when he signed into law a 62-cent-per-pack tax increase on cigarettes. That increase will hit the poor hard because they smoke at twice the rate of middle- and higher-income Americans.

The Democrats are considering further large increases in "sin" taxes. Proposals being discussed would raise federal beer taxes from 33 to 81 cents per six-pack, wine taxes from 21 to 70 cents per bottle, and taxes on spirits from $2.14 per fifth to $2.54.[9] Those increases would raise about $60 billion over 10 years.

Alcohol excise taxes are regressive, meaning that they hit lower- and middle-income families the hardest. An estimate for 2001 found that federal alcohol taxes amounted to roughly about 0.37 percent of income for poorer families, 0.12 percent for middle-income families, and 0.02 percent for higher-income families.[10]

The Democrats are also considering new excise taxes on sugar-sweetened beverages, such as soft drinks, fruit juices, sports drinks, and iced teas. Such a tax increase would also be regressive. A tax of three cents per 12-ounce drink would raise about $50 billion over 10 years.

Higher Corporate Taxes

America has the second highest corporate income tax rate in the world and uncompetitive rules for taxing multinational companies.[11] Yet the Obama administration plans to make matters worse by raising taxes on U.S. multinational corporations by $210 billion over 10 years to pay for health care. A corporate tax increase would damage average families because it would reduce capital investment and curb worker productivity, leading to lower wages and benefits over time. Obama's plan would also mean fewer domestic jobs—Microsoft Corporation, for example, says that it will move U.S. jobs offshore if these tax hikes go through.

Observations and Conclusions

Adding up the possible increases listed above to income taxes, payroll taxes, excise taxes, and corporate taxes would raise about $700 billion over the next decade. But that large tax increase would be less than half of the $1.5 trillion needed to fund the new health care spending being considered by the Democrats.[12]

A further concern is that initial cost estimates of federal health programs are usually very optimistic. When Medicare was launched in 1965, Part A was projected to cost $9 billion by 1990, but ended up costing $67 billion. When Medicaid's special hospitals subsidy was added in 1987, it was supposed to cost $100 million annually, but it already cost $11 billion by 1992. When Medicare's home care benefit was added in 1988, it was projected to cost $4 billion in 1993, but ended up costing $10 billion. Or consider that when Massachusetts Commonwealth Care was put into place in 2006, it was expected to cost about $725 million annually, but the expected cost for 2009 is now almost $1 billion.

In sum, expanding government health care will likely involve huge tax increases on the middle class. Aside from the tax options discussed above, there has also been talk of using revenues from a cap-and-trade global warming plan to fund health care. Obama's budget included an $80 billion per year revenue increase for cap-and-trade, and economists calculate that the relative burden of such a plan would be far greater on lower-income than higher-income families.[13] Thus, as Americans consider the current health care debate in Congress, they should remember the words of humorist P.J. O'Rourke: "If you think health care is expensive now—just wait until it's free."

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[1] Numerous tax options are examined in Senate Finance Committee, "Financing Comprehensive Health Care Reform," May 20, 2009.
[2] Employee Benefits Research Institute, Issue Brief no. 321, September 2008, Figure 14.
[3] Len Burman, Tax Policy Center, Testimony to the Senate Committee on Finance, May 12, 2009, Table 4.
[4] Jennifer Jenson, "Spending by Employers on Health Insurance," Congressional Research Service, October 10, 2007.
[5] Burman, Table 4.
[6] America's Health Insurance Plans, "Estimated Income Characteristics of HSA Accountholders in 2008," May 2009.
[7] Congressional Budget Office, "Budget Options: Volume 1, Health Care," December 2008, p. 31.
[8] Joint Committee on Taxation, JCS-2-08, October 31, 2008.
[9] Ricardo Alonso-Zaldivar, "Beer Tax on Tap for Health Care," Associated Press, May 20, 2009.
[10] Scott Moody, "Federal Excise Taxes," Tax Foundation, January 1999. Updated by Moody in 2001.
[11] Chris Edwards and Daniel Mitchell, *Global Tax Revolution*, (Washington: Cato Institute, 2008).
[12] Ricardo Alonso-Zaldivar, "Health Care Overhaul May Cost About $1.5 Trillion," Associated Press, March 18, 2009.
[13] Andrew Chamberlain, "Who Pays for Climate Policy," Tax Foundation, March 2009.