Are tax exemptions for nonprofit hospitals an efficient way to fund indigent care?

An Uncertain Prescription

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As health care expenditures increase faster than inflation and as federal and state legislatures and executive branches face competing claims on their budgets, policymakers have been reassessing the effectiveness of financing mechanisms that provide health care for the poor. In turn, hospitals—traditionally the principal providers of indigent care—have faced uncertainty over whether government programs such as Medicare and Medicaid will continue to subsidize indigent services.

Scrutiny is also intensifying for a lesser-recognized public subsidy for indigent care: the exemption of private, nonprofit hospitals from property, sales, and income taxes. The tax exemptions are, in the words of researcher D. Pellegrini, part of a "bargain" that was "struck between the hospital and the community: a hospital would treat patients who were unable to pay, and the government would grant a tax exemption to the hospital."

Legislators and patient advocacy groups have been asking whether nonprofit hospitals are fulfilling their end of the bargain. "What is the taxpayer getting in return for the tens of billions of dollars per year in tax subsidy?" Bill Thomas, chairman of the House Ways and Means Committee, recently asked at hearings on tax exemption standards for hospitals. The Senate Finance Committee is conducting a survey of at least 10 tax-exempt hospital systems to gather information on actual practices regarding the provision of charity care and collection behavior.

In addition, increased scrutiny by the Internal Revenue Service is likely to affect nonprofit hospitals, which account for close to half of the total revenues of Section 501(c)(3) organizations in the United States. More than 30 lawsuits have been filed in federal court against nearly 300 tax-exempt hospital facilities in 15 states, alleging that the hospitals have "failed to meet their charity care requirements because of certain billing and aggressive collection practices against uninsured patients." State and federal legislators and officials are increasingly keen, it seems, on ensuring that nonprofit hospitals stick to the bargain.

The quid-pro-quo of community benefits in return for tax exemptions is only one of several financing mechanisms that municipalities can adopt to ensure the provision of health care services for the poor. For example, the community could operate the hospital itself, as in the case of county hospitals, or allow private hospitals to charge all patients regardless of their income and then the community would reimburse the providers for the indigents' hospital visits, as in the case of the Medicaid program.

From this perspective, nonprofit hospitals' tax-exempt status is justified only if its benefit to the community outweighs its cost and if it is the most efficient means to finance healthcare for the poor.

MEASURING THE VALUE OF TAX EXEMPTIONS

In many local markets, nonprofit hospitals compete with for-profit hospitals, which are not tax exempt and have become increasingly similar to nonprofit hospitals in terms of services offered, populations served, and overall management practices. Thus, for-profit hospitals' tax revenue offers an alterna-

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tive option for governments to finance community benefits, suggesting that for-profit hospitals are the appropriate comparison group for evaluating nonprofit charitable behavior.

In the existing literature, there is neither a consensus on the services that should be included in the calculation of community benefits nor agreement on the appropriate benchmark that should be used to assess whether the community benefits provided by nonprofit hospitals are large enough. Most studies ignore for-profit hospitals altogether. For example, N. M. Kane and W. H. Wubbenhorst, in a 2000 *Milbank Quarterly* article, compared potential tax revenues to the hospital's value of tax exemptions. Yet, the value of tax exemptions for an individual hospital may exceed their social cost.

In this article, we introduce an internally consistent method to assess the value of granting tax-exempt status to a nonprofit hospital. We ask whether the community would be better off if the nonprofit, tax-exempt hospital were obligated to pay taxes.

THE COST OF A TAX EXEMPTION

The value of a private nonprofit hospital's tax exemption is typically calculated by applying the pertinent tax schedule to the balance sheet of the hospital as it currently operates. Yet this amount does not necessarily represent the tax revenue that the government would receive if it revoked the hospital's tax exemption. The reason is that the hospital would most likely modify the scale and scope of the services it delivers so as to lessen its tax exposure, as argued by A. M. Morrisey, G. J. Wedig, and M. Hassan in a 1996 *Health Affairs* article.

Specifically, the hospital may decide that, without the tax exemption, it can operate more efficiently if it reduces capacity or stops offering certain services. This, in turn, may reduce the hospital's taxable net assets and income, and thus its tax payments. As a result, the tax revenue that the government foregoes by granting a tax exemption is likely to be less than what a mechanical application of the tax schedule to the hospital's current balance sheet would suggest. In the extreme case, revoking a hospital's tax exemption may prompt the hospital to shut down. In that case, the government revenue effect of revoking the tax exemption would be zero.

The value of foregone tax payments to the community should be assessed in exactly the same way as the payments by non-exempt, for-profit hospitals. If only a fraction of the taxes paid by for-profit hospitals is counted as community benefits (perhaps because it is earmarked for indigent health services), then the same fraction must be applied to the estimated value of the foregone taxes that a nonprofit hospital would pay if it were not tax-exempt:

$$\text{cost of tax exemption to community} = \text{fraction of taxes counted as community benefits} \times \text{tax rate} \times \text{expected surplus under taxation}$$

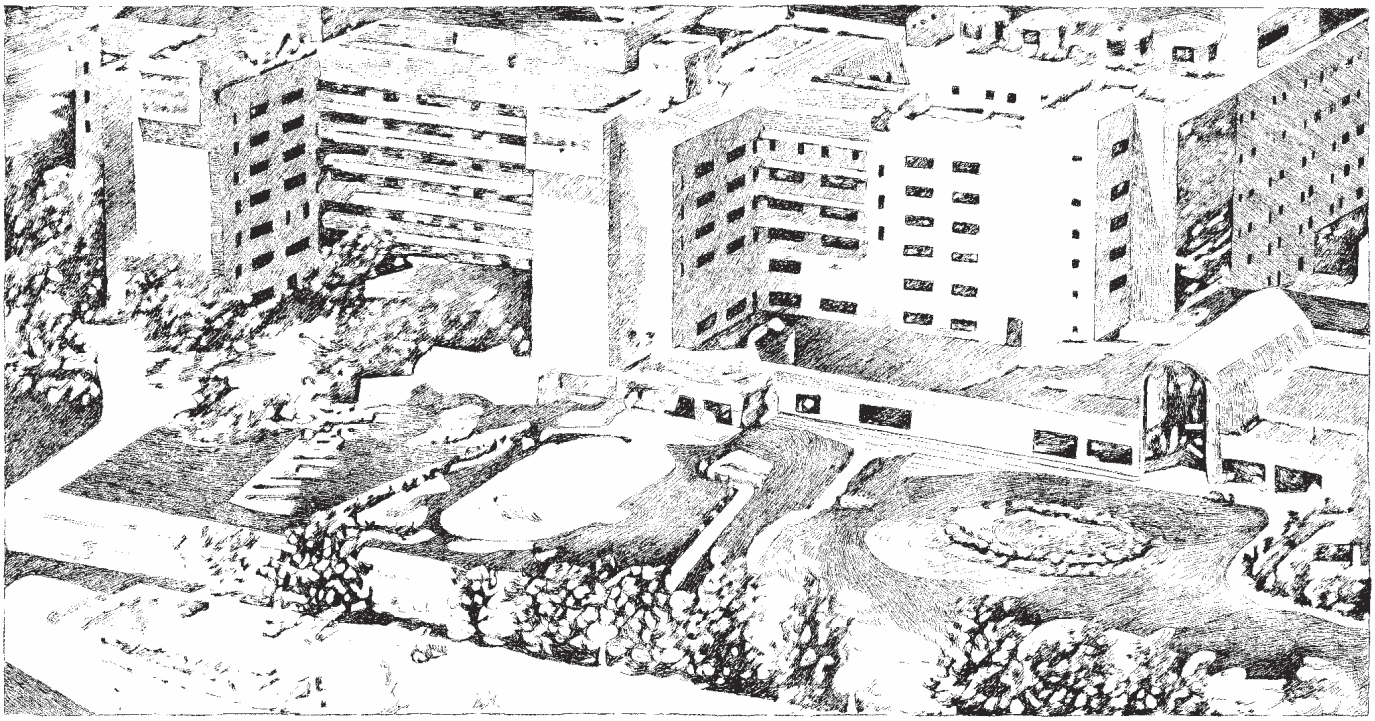
In the extreme case, if the tax payments by for-profit hospitals are not counted as community benefits, then it would be inconsistent to count a nonprofit hospital's tax exemption as a cost to the community against the community benefit provided by the nonprofit hospital.

THE BENEFIT OF A TAX EXEMPTION

The benefits of a tax exemption should be measured analogously: the decrement in community benefits that would result from a change in the taxation status. The appropriate equation would be:

$$\text{benefits of tax exemption} = \text{community benefits under tax exemption} - \text{community benefits under taxation}$$

An illustration of this measure is given by the case of uncom-



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pensated care, in which the hospital provides services free of charge (charity care) or generates a bill but collects only a fraction of the money owed (bad debt). Although survey data from the American Hospital Association indicate that the amount of uncompensated care provided by hospitals, regardless of ownership status, has increased by $5.3 billion (more than 25 percent) since 2000, nonprofit hospitals provide only slightly more uncompensated care than for-profit hospitals.

In 1994, nonprofit hospitals provided uncompensated care equivalent to 4.5 percent of revenues, while for-profit hospitals provided care worth 4.0 percent of revenue, according to the federal Prospective Payment Assessment Commission's 1996 Report to Congress. G. J. Young and K. R. Desai's study, published in a 1999 issue of *Health Affairs*, of 43 hospital conversions from nonprofit to for-profit status between 1981 and 1995 in California, Florida, and Texas found that "conversions do not, on average, have an appreciable impact on community benefits." Similarly, K. E. Thorpe, C. S. Florence, and E. E. Seiber conclude in a 2000 *Health Affairs* article that "all things considered, it is uncertain whether more or fewer funds flow to a community as a result of an ownership conversion" from nonprofit to for-profit status. To be sure, the conversions in the Thorpe et al. study were all voluntary and thus not representative of outcomes under mandatory revocation of the tax exemption, but the evidence does not support the simple-minded notion that nonprofit hospitals are the only provider of services to the medically indigent and that for-profit hospitals do nothing.

LARGER ISSUES

Uncompensated care consists of not only genuine charity care but also lack of debt collection from patients who are not poor. Under current reporting rules, losses from indigent patient care are virtually indistinguishable from losses from inefficiencies. Thus, uncompensated care is an imperfect measure of how much health care the poor receive. Nonprofit hospitals can easily increase uncompensated care and not provide any more indigent care.

If a nonprofit hospital generates a surplus in addition to its provision of community benefits, it cannot distribute the "profit" to its owners. It must reinvest the money in new facilities or more charity care. In other words, this "nondistribution constraint" forces the hospital to purchase goods and services on behalf of the intended beneficiaries and limits those purchases to hospital-related items. Presumably, the beneficiaries would derive greater value from the hospital's purchases if they received the cash equivalent directly and could exercise full discretion in the way they spent this amount, including buying health care from the hospital.

Poor people might be better off if they could decide for themselves how tax revenue earmarked for their medical care was spent. Under the current system, this decision is the responsibility of the hospital administrators who, in effect, offer the poor a take-it-or-leave-it menu of services. In this way, the public offloads the contentious challenge of achieving its equity objectives to hospital administrators who cannot rely on price signals to determine which services the poor would value most. At the same time, hospitals are under pressure from, and held accountable by, legislators with the power to revoke a tax exemption. Yet those lawmakers must balance the many competing interests of their constituents, among which low-income patients may represent only a small fraction. If, instead, the indigent were given personal medical budgets that could be spent on their provider of choice, competition for their business would align the preferences of the poor more closely with the medical care they receive.

On balance, therefore, the right question to ask nonprofit hospitals is not whether the value of community benefits that they provide exceeds the community's payment of foregone tax revenue. The right question is whether the value of community benefits exceeds the value of all alternative health care delivery options that the community could purchase for the same amount of tax revenue.

CONCLUSION

In this article, we propose that the net contribution of a nonprofit hospital to the community be assessed by examining whether the community would be better off if the nonprofit hospital were stripped of the legal provisions that differentiate it from its for-profit counterparts.

The net benefit to the community of granting a tax exemption is computed as follows:

$$\text{net benefits of tax exemption} = \text{community benefits under tax exemption} - \left[\text{community benefits under taxation} + \left[\text{fraction of taxes counted as community benefits} \times \text{tax rate} \times \text{expected surplus under taxation}\right]\right]$$

Specifically, the cost that a hospital's tax exemption imposes on the community should be measured by the value to the community of the additional taxes that the hospital would pay if the tax exemption were eliminated. This method takes into account that typically the hospital will choose a smaller scale when faced with higher tax rates. Once the hypothetical tax payments are computed, their value to the community should be computed in the same way that the value of for-profit hospitals' actual tax payments is computed, by recognizing, for example, that the community may only receive a fraction of the new tax revenue and that perhaps only a fraction of the tax payments is earmarked for health services. The benefit that the tax exemption represents to the community also should be measured by the amount by which the hospital would decrease its provision of community benefits if the tax exemption were eliminated.

Tax exemptions were introduced originally to compensate nonprofit hospitals for providing medical care to the poor. The fact that nonprofit hospitals traditionally provided the only place where the poor could turn for medical care does not imply that nonprofit hospitals are the only guarantors of medical care for today's indigent. Tax exemptions for nonprofit hospitals are just one of several alternatives that offer care to the poor. R

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