

# Maryland Policy *Reports*

Analysis from the Maryland Budget and Tax Policy Institute

## Expanding Health Coverage Through State Tax Credits

Several Challenges Face Forthcoming Maryland Proposal

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### Summary

- The Maryland Department of Health and Mental Hygiene is reportedly working on a proposal to reduce the number of Marylanders without health insurance through a new state tax credit. This credit may be offered to individuals, employers, or both.
- A tax credit is unlikely to cost-effectively reduce the number of uninsured in the state. A small credit for individuals would help few people buy insurance. A large credit would be costly and could undermine existing, employer-provided coverage by providing a government-subsidized alternative.
- A tax credit for employers may be seen as unfair if it is limited to those that do not now provide health insurance. A more general credit for all employers would be much more costly, and only have a marginal impact on the number of uninsured.
- A tax credit may be more administratively burdensome and complicated than existing, government-provided health insurance programs like Medicaid and the Maryland Children's Health Insurance Program.
- A significant health care tax credit may divert limited funds from other state health care programs. Depending upon which existing programs are cut, it may reduce the state's share of Medicaid funding or other health-related federal grants.

## Introduction

This report reviews state-level tax credits as a policy option to expand health care coverage in Maryland.

Staff within the Department of Health and Mental Hygiene are reportedly working on a plan that will use such tax credits to reduce the number of Marylanders without health insurance. A

comprehensive reform plan is unlikely to be offered before 2005.<sup>1</sup> However, an initial draft may be presented to the General Assembly as early as January, 2004.

In general, a tax credit for health insurance can be implemented in two ways: (1) as a personal income tax credit for individuals to cover the cost of

### Three Plans for the Uninsured

Maryland, like the rest of the nation, is experiencing a crisis in the number of people who do not have health insurance. In 2001-2002, the latest years for which data are available, one out of eight Marylanders lacked health insurance for the entire year.<sup>3</sup> In addition to these 660,000 Marylanders who go the entire year without health insurance, thousands more experience shorter periods without coverage.

Despite this crisis, policymakers have actually reduced access to publicly-funded health insurance in the last year. For example, the Maryland General Assembly lowered income eligibility levels and increased premiums in Maryland's Child Health Program, which serves children in low-and moderate-income families. In July 2003, the Board of Public Works approved Gov. Ehrlich's proposal to reduce spending on Medicaid by approximately \$80 million—mostly by limiting care and payment rates to service providers (e.g., doctors and hospitals).

Despite recent state cuts and the ongoing state revenue shortfall, policymakers are endorsing or exploring plans that would provide health services to more Marylanders.

Three prominent plans under development or consideration include:

- A comprehensive plan created the Maryland Citizen's Health Initiative that would expand Medicaid, encourage employer provided health insurance, and fill the remaining gap with a state program financed by a cigarette tax increase and a payroll tax on employers who do not provide health insurance for their employees.<sup>4</sup>
- An expanded role for public health centers in providing primary care and other health services to Marylanders who do not have access to health insurance. This plan is being developed by Del. John Hurson (D-Montgomery), who chairs the House Health and Government Operations Committee.
- A state income tax credit that would be used to offset the costs of purchasing health insurance. This plan is being explored by Gov. Ehrlich and Health Secretary Nelson Sabatini.

premiums, copayments, and other out-of-pocket expenses, and (2) as a tax incentive for employers to subsidize the cost of employment-based coverage. Either or both of these approaches could be integrated into the tax credit plan.

Supporters of expanding health insurance through a tax credit argue that it could provide more choice among health plans, more choice among doctors, and an increased degree of continuity from one job to the next that is not now available with employer-based coverage.<sup>2</sup> Despite such assertions, it is not clear whether health care tax credits are workable at the state level, particularly during a period of budgetary austerity. No other state has implemented a significant health care expansion through tax credits. Such a plan would break new ground.

This paper outlines several of the challenges and questions that any proposed tax credit must overcome before it can substantially, and cost effectively, reduce the number of people lacking health insurance in Maryland.

## **Key Challenges for a Health Care Tax Credit**

What impact would a new state tax credit have on the level of the health coverage in Maryland? The answer to this question depends on how it is designed.

### **Targeting the Uninsured**

One of largest determinants of a tax credit's impact on the number of uninsured is the degree to which it targets people who lack insurance. An untargeted tax credit is likely to have only a small impact on those who are currently uninsured because most of the resources would be consumed by individuals who already have insurance, or employers that already provide it.<sup>5</sup>

An untargeted tax credit for individuals may pose worse problems than a high price tag. It could actually erode existing employer-provided health insurance.<sup>6</sup> Employers that now offer coverage could direct their employees to the credit instead, possibly offering higher non-health care related compensation or benefits to offset the change. Multiple studies confirm that untargeted tax credits are likely to undermine existing private coverage.<sup>7</sup>

A health tax credit can be targeted, but doing so poses its own difficulties. An employer-based credit could be limited to those businesses that do not provide insurance, but this would be unfair to other businesses that do, particularly if they are competitors. Such newly created competitive disparities could prompt some employers that previously provided insurance to drop it. Moreover, even among those new businesses that decide, because of the credit, to provide insurance that did not do so previously, some of the positive impact could be eroded if many of their employees were already receiving coverage through a spouse.

A targeted tax credit for individuals is also problematic. An individual tax credit could be limited to individuals below a specified income threshold who currently lack health insurance. However, much like an untargeted credit, the existence of such a credit could further erode the already-low incentive for employers of low-wage workers to provide insurance. It could also undermine incentives for low-income workers to seek employment with businesses that provide this benefit.

By comparison, public programs like Medicaid and MCHP are already targeted. Each of these two programs uses a variety of categorical and income-based eligibility guidelines and restrictions to focus limited resources on those most in need. If a health care tax credit is adopted, similar rules can and should be put into place.

## Access and Affordability

One of the principal obstacles to success for both an employer-based or individual health care tax credit is the availability of affordable health insurance plans. Fortunately, much work has already been done in this area in Maryland.

By state law, all insurance carriers in the state must offer employers the Comprehensive Standard Health Benefit Plan (CSHBP), a plan comparable to what is available to large employers. Benefits and cost-sharing (i.e., deductibles, copayments, and coinsurance) are regulated by the Maryland Health Care Commission (MHCC). This standard plan helps protect small employers from higher rates, which would be important to the success of any credit targeting employers.

Such barriers may be more problematic for individuals. In general, health insurance rates for individuals are much higher than for those in the employer-based, group market because insurers assume that individuals seeking insurance are more likely to have costly health problems.<sup>8</sup> Individual plans offer less comprehensive coverage to discourage seniors and people with greater health needs from purchasing them. Very high deductibles and lower benefits are typical. Prescription drug coverage and specialty services such as mental health are generally not offered. Group coverage also covers a higher percentage of costs, generally 75 percent versus 50-60 percent for individual plans.<sup>9</sup> Individual rates can also increase rapidly after the onset of illness.<sup>10</sup> For these reasons, any new health insurance tax credit should be accompanied by a plan to ensure the availability of affordable, group-based coverage to those who use the credit.

Beginning in July, 2003, individuals in Maryland may purchase coverage through the Maryland Health Insurance Plan, a high-risk insurance pool primarily for individuals who can not purchase commercial coverage due to pre-existing medical conditions. The costs of this plan are partly offset

by general state tax revenues, but premiums are still more expensive than a typical individual plan because of the high costs associated with the population that is being covered. Research indicates that high-risk pools like the one in Maryland are typically subject to spiraling costs because only those with the highest health care needs are willing to pay the high premiums that are usually charged.<sup>11</sup>

To the extent that the proposed tax credit focuses on individuals or on small businesses with few employees, any new tax credit should be tied to some form of group-based purchasing plan, though more work may be needed to ensure the availability of affordable coverage.

## Tax Credit Adequacy

Ensuring that low-cost insurance is available is one piece of the affordability puzzle. Making the tax credit generous enough to cover much or most of this cost is another. According to one estimate, in 2003 the average annual health insurance premium nationwide for an individual enrolled in an employer plan is \$3,383. The average family premium is \$9,068.<sup>12</sup> The rates in Maryland are about the same as the national average.<sup>13</sup>

These estimates suggest that, even in a group-based plan, any credit should be worth at least \$2,000 per adult and \$1,000 per child (perhaps significantly more for lower-income families) to offset most of the cost of premiums. Any tax credit set substantially below that amount is unlikely to substantially reduce the ranks of the uninsured. A study by the Center on Budget and Policy Priorities determined that premiums above five percent of income discourage enrollment (see chart).<sup>14</sup>

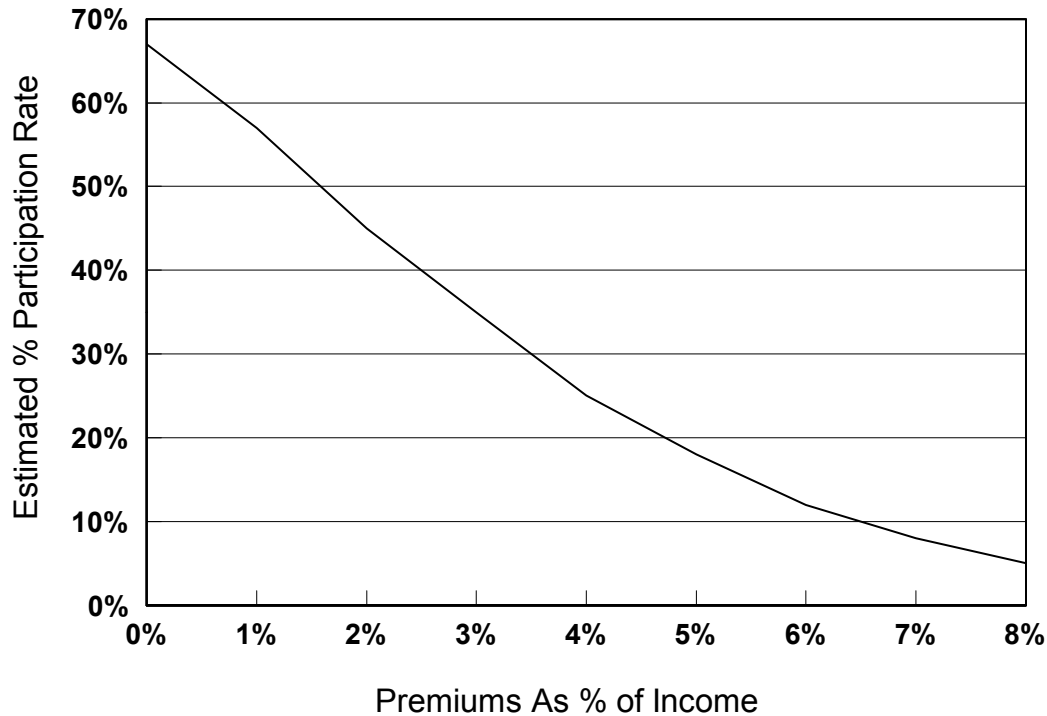
To ensure maximum affordability, particularly given the generally low incomes of people without health insurance, any individual-based tax credit should also be made refundable. Advance

refundability, where the funds needed to pay for premiums and other costs are available before the end of the tax year, is better still. However, advance refundability can make an already complex process even more so, and it may increase the possibility of error. Advance refundability is available for the federal Earned Income Tax Credit, but relatively few people take advantage of it.

Finally, even if all other hurdles are overcome, a workable tax credit can quickly become unworkable if it is not flexible enough to adjust to increasing health care costs. The real value of a tax credit worth \$1,000, \$2,000, or some other fixed amount would be quickly eroded by health care inflation if it is not regularly adjusted.

This adjustment could be made automatic, perhaps through a tie to the medical consumer price index, which is released by the Bureau of Labor Statistics in the U.S. Department of Labor. The Bush administration proposed a tax credit that contains such a tie in its FY 2004 budget submission. Some analysts believe even this adjustment will be insufficient to keep pace with increasing health care premiums.<sup>15</sup> Indexing the credit to increases in insurance premiums may be a better approach. Absent a sufficient automatic adjustment, or regular statutory increases, the credit would fail to keep pace with rising costs and result in a steady decline in coverage over time.

### Health Insurance Participation by the Uninsured, by Premium Levels



Source: Leighton Ku and Teresa Coughlin, "Sliding-Scale Premium Health Insurance Programs: Four States' Experiences," *Inquiry* 36: 471-480 (Winter 1999-2000).

## How Will It Be Financed?

To date, health care spending cuts have played a major role in recent efforts to balance the Maryland state budget. In July, the state Board of Public Works cut health care spending by over \$80 million out of a total \$208 million in cuts.

Given the current budgetary environment, any new plan to expand health insurance through tax credits may need to be cost-neutral. More likely, it will be part of a plan that cuts state health spending overall. Given these limitations, where will the money come from to pay for the proposal?

### Cutting Existing Programs or Benefits

By necessity, any cost-neutral plan to expand health insurance will have winners and losers. The key question is: what programs or benefits will be cut to cover the cost of expanded coverage? Will the cuts result in a reduction in services? Will they shift costs to local governments or the private sector through increased uncompensated care? Are high cost beneficiaries, such as seniors and people with disabilities, more likely to suffer under such a plan?

Public statements by the governor and Secretary Sabatini indicate that benefit cuts will be part of the mix. In early June, Governor Ehrlich remarked that it may be time to reign in the state's health care programs, saying "If you can afford a Cadillac, that's terrific. But for some folks, you need to start out with the Pinto."<sup>19</sup> Secretary Sabatini apparently agrees, calling

health insurance benefits for children "richer than anything offered by private insurers."<sup>20</sup>

Despite these public claims, there is no evidence that significant savings can be achieved by cutting benefits in the primary programs targeting the uninsured: Medicaid and the Maryland Children's Health Program (MCHP). According to a Department of Legislative Services analysis, less than one quarter of spending on Maryland Medical Care Programs (Medicaid and MCHP) is for optional services that are not required by federal law. Moreover, much of this optional spending may actually save the state money. Some services, like psychiatric rehabilitation, developmental disabilities-related services, and services for the mentally retarded, represent a shift of programs that the state would fund anyway into the Medicaid program, where federal dollars pay for half of the total cost. Other optional services, like prescription drugs and nursing home placements (personal care, medical day care), are believed to save money by preventing more costly illnesses in the future.<sup>21</sup>

More recently, Secretary Sabatini has said he is examining ways to limit malpractice costs and unnecessary emergency room visits as ways to lower the existing costs in the system.<sup>22</sup> It is unclear how much savings these efforts would generate.

### Federal Matching Grants

Spending on Medicaid and MCHP is heavily subsidized by federal matching grants.

Federal funds currently cover 50 percent of Medicaid and 65 percent of MCHP costs.

It is unlikely that a state tax credit would qualify for a similar federal subsidy. Some analysts believe that if it were converted into a voucher it might be possible to obtain a waiver from the Bush administration that would allow a federal match under Medicaid. The Bush administration has not yet endorsed such a voucher, but has been supportive of waivers generally. There is no evidence, however, that the Department of Health and Mental Hygiene is moving in this direction.

Overall, it appears that the state would lose substantial federal funding, increasing either

its own overall costs or statewide uncompensated care, if the new tax credit was funded through cuts in Medicaid, MCHP, or other federally subsidized programs. State health programs that are not federally funded are more likely targets for offsetting spending cuts. Although the administration has not explicitly targeted any programs, several public health programs fit this description, including the Breast and Cervical Cancer Diagnosis and Treatment Program and the Maryland AIDS Insurance Assistance Program, among others. Even if cuts were made in these programs, however, redirecting the savings into Medicaid or MCHP, where federal matching funds are available, may make more financial sense than using them to fund a tax credit.

## Complexity

One issue that is intertwined with accessibility is complexity, particularly if the credit is aimed at individuals. How difficult is the tax credit to understand? Is it likely to generate a high error rate, where people apply who do not qualify, others are too intimidated, and some mistakenly believe that they do not qualify? What paperwork will be required?

Many individuals avoid this complexity now because they are either enrolled in employer plans, where the employer serves as an intermediary, or are enrolled in public programs like Medicaid or MCHP, where public employees can help them through the process. Are unsophisticated users of the tax credit likely to be taken advantage of or make poor choices about the kind of health insurance they need? Will the state pre-approve health insurance plans to ensure that users of the tax credit receive at least a minimally adequate level of insurance?

## Administrative Costs

While a high overall price tag is a more significant obstacle to any health care tax credit (see box), high administrative costs are another major barrier. Nationally, administrative costs for employer-provided health plans range from about 10 percent for large employer groups to 15-25 percent for the small group market. Administrative costs for individual coverage are even higher, about 25-40 percent, because of the precautions that insurance companies take (repeated physical exams and medical record reviews) to ensure that they are not offering coverage to someone who is a poor health risk.<sup>16</sup> By contrast, administrative costs for public programs like Medicaid and Medicare have been estimated at 5 and 2.9 percent, respectively.<sup>17</sup>

Administrative costs for private insurance in Maryland may be particularly high. According to the Maryland Health Care Commission, administrative costs for enrollees in CareFirst and Mid Atlantic Medical Services Inc. (MAMSI), the

two leading private health insurers in Maryland, range from 22-28 percent.<sup>18</sup> These costs are built into their state-regulated rate structure.

Any proposal to expand health coverage through a tax credit would rely upon privately provided health insurance, and must therefore address and overcome these high administrative costs.

## Conclusion

Reducing the number of Marylanders lacking health insurance is a worthy goal. While tax credits are one possible option, they are not necessarily the best or most cost effective, particularly at the state level.

Depending on how it is designed, a plan based on tax credits could fail to significantly expand health coverage to those who lack it. Perhaps more importantly, it could undermine existing private coverage, resulting in a negative net impact. Moreover, funds spent on such an initiative would be diverted from existing programs, like Medicaid and MCHP, that directly address the health care needs of these populations.

Policy makers must consider all of the costs, consequences, and alternatives before proceeding with such a plan.

## End Notes

<sup>1</sup> M. William Salganik, "Health Coverage for Uninsured is Focus," *Baltimore Sun*, October 29, 2003.

<sup>2</sup> Jeff Lemieux, "Using Tax Credits to Expand Health Insurance Coverage," Progressive Policy Institute, February 13, 2002. Available online at <http://www.ppionline.org>.

<sup>3</sup> The share of Maryland's population over the two-years 2000-2001 was 12.0 percent. According to Census Bureau estimates, there were approximately 5.5 million people in Maryland in 2002, resulting in an estimated 660,000 Marylanders without health insurance. See US Census Bureau, "Health Insurance Coverage in the United States: 2002," September 30, 2003, p. 10.

<sup>4</sup> See Maryland Citizens Health Initiative web site at <http://www.healthcareforall.com/>.

<sup>5</sup> Edwin Park, "Administration's Proposed Tax Credit for Purchase of Health Insurance Could Weaken Employer-Based Health Insurance," Center on Budget and Policy Priorities (revised April 22, 2003), p. 14.

<sup>6</sup> *Ibid.*, pp. 1, 5.

<sup>7</sup> *Ibid.*, pp. 5-6.

<sup>8</sup> Jon Gabel, Kelly Dhont and Jeremy Pickreign, "Are Tax Credits Alone the Solution to Affordable Health Insurance?," The Commonwealth Fund, May 2002.

<sup>9</sup> Jon Gabel, Kelly Dhont, H. Whitmore, and Jeremy Pickreign. "Individual Insurance: How Much Financial Protection Does It Provide?" *Health Affairs* web exclusive (April 17, 2002), available at [www.healthaffairs.org](http://www.healthaffairs.org).

<sup>10</sup> Scott Graham, "Insurer Comes Back to Life," *Baltimore Business Journal*, December 20, 2002, p. 10.

<sup>11</sup> Lori Achman and Deborah Chollet, "Insuring the Uninsurable: An Overview of High-Risk Insurance Pools," The Commonwealth Fund, August, 2001.

<sup>12</sup> Kaiser Family Foundation, "2003 Employer Health Benefits Survey," September 9, 2003; See also James Bransome, "Statistical Brief #20: State Differences in the Cost of Job-Related Health Insurance - 2000," Agency for Health

- Care Research and Quality, July, 2003. Available online at: <http://www.meps.ahrq.gov/papers/st20/stat20.htm>
- <sup>13</sup> Agency for Health Care Research and Quality, “2000 Employer-Sponsored Health Insurance Data,” August, 2002. See Table II.C.1 - Average total single premium (in dollars) for exclusive-provider plans per enrolled employee at private sector establishments that offer health insurance by size and state: United States, 2000. See also Maryland Health Care Commission, “Spotlight on Maryland: Explaining the Growth of Private Health Insurance Expenditures in Maryland,” April 2003, pp. 3-4.
- <sup>14</sup> Leighton Ku and Teresa Coughlin, “Use of Sliding Scale Premiums in Subsidized Insurance Programs,” Urban Institute, March 1, 1997. Available online at: <http://www.urban.org/Template.cfm?NavMenuID=24&template=/TaggedContent/ViewPublication.cfm&PublicationID=6201>
- <sup>15</sup> *Supra* note 5, p. 13.
- <sup>16</sup> Jon Gabel, Kelly Dhont, H. Whitmore, and Jeremy Pickreign. “Individual Insurance: How Much Financial Protection Does It Provide?” *Health Affairs* web exclusive (April 17, 2002), available at [www.healthaffairs.org](http://www.healthaffairs.org).
- <sup>17</sup> Kaiser Commission on Medicaid and the Uninsured, “The Medicaid Resource Book,” July 2002, p. 133; Mark Litow and the Technical Committee of the Council for Affordable Health Insurance, “Rhetoric vs. Reality: Comparing Public and Private Health Care Administrative Costs,” March 1994, Council for Affordable Health Insurance.
- <sup>18</sup> Scott Graham, “Insurer Comes Back to Life,” *Baltimore Business Journal*, December 20, 2002.
- <sup>19</sup> C. Fraser Smith, “State’s Health Care Jalopy Needs a Major Tune-up,” *Baltimore Sun*, June 15, 2003.
- <sup>20</sup> Nelson Sabatini, “A Parental Responsibility,” *Baltimore Sun*, August 21, 2003.
- <sup>21</sup> Maryland Department of Legislative Services, “Operating Budget Analysis: Medical Care Programs Administration,” January, 2003, pp. 27-28.
- <sup>22</sup> *Supra* note 1.

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## **About the Maryland Budget & Tax Policy Institute**

The Maryland Budget and Tax Policy Institute is a nonpartisan research organization that provides timely, accurate, and accessible analysis of state budget and tax issues. In addition to general budget and tax research and analysis, the Institute examines issues affecting vulnerable populations and the important community programs that serve them. For additional information on the Institute or to receive this newsletter on a regular basis, contact us at 301-565-0505 or visit our web site at [www.marylandpolicy.org](http://www.marylandpolicy.org). This report was written by Patrick Lester.

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