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How One Income-Tax Policy Screwed Up American Health Care

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Michael Cannon of the Cato Institute argues in a new study that the root cause of U.S. health-care problems is the exclusion of health benefits from the income tax. That might sound strange at first glance, but it's really a classic story of unintended consequences.

The 16th Amendment permitted the creation of the modern federal income tax in 1913. As Cannon writes, modern health insurance yet didn't exist then, so Congress didn't think about how it should be taxed.

In the 1920s, officials at the Department of the Treasury, tasked with enforcing the income tax, had to decide whether health benefits should be taxed. Modern employer-provided group insurance was still rare, and they decided to leave it out of the tax base. "From that moment, the federal government effectively penalized workers unless they let an employer control their health insurance," Cannon writes.

That penalty comes in the form of removing choice from the individual and reducing wage compensation. Rather than getting money from their employers to spend on anything, including health insurance, most working Americans have part of their pay withheld from them and used by their employers to purchase group health insurance. Maybe that's what some people want, but people who would rather purchase their own health insurance end up being taxed extra, which creates strong incentive to go with the employer plan.

Other forms of insurance are not treated this way. People don't risk losing their home insurance if they lose their jobs. Employers don't select car-insurance plans for employees to use. Only employer-provided health insurance is exempt from the income tax, so workers' health insurance is entangled with employment in a unique way.

As Cannon notes, this entanglement got worse during World War II, when wage and price controls also exempted health benefits. That meant that employers that could no longer legally compete by offering higher wages could compete by offering more generous health benefits. By the 1950s, a larger number of workers enjoyed tax-free health benefits, and Congress codified the income-tax exclusion of employer-provided health insurance in 1954.

One argument for school choice is that government should not hold all the power when it comes to deciding where students attend school: Parents should be able to use the money that would be spent on education anyway wherever and however they choose to. Cannon makes a parallel argument about health insurance, except that instead of the government's holding the decision-making power, employers hold it as a result of government intervention.

In total, employers spend about $1 trillion on health benefits each year. "The U.S. tax code threatens workers with $352 billion in additional taxes if they do not let employers control that $1 trillion," Cannon writes.

Transferring control from workers to employers, as the tax code effectively does, distorts the health-care market in all sorts of ways. It lowers price sensitivity among consumers, which contributes to high prices. Employer-provided coverage is more likely to drop beneficiaries than individual coverage is. People can't find health insurance they like and keep it for their entire lives, unless they work for the same employer their entire career — and even then, the employer might change providers anyway.

Cannon also points out distortions outside of health care. "By diverting $1.3 trillion annually away from workers to employers and insurance companies," he writes, government-encouraged employer-provided coverage prevents "savings institutions from competing to manage those funds." It also distorts the labor market in every sector "by diverting compensation away from cash wages to health benefits; obscuring total compensation; and trapping workers in bad jobs."

Cannon isn't arguing that health coverage should be taxed. Instead, he proposes that the money employers currently spend buying group insurance be given to workers in individual, tax-free health savings accounts. This reform is similar to school-choice advocates' argument for education savings accounts. It better aligns the incentives so that consumers have the decision-making power, allowing them to use the money to buy the coverage they like and keep it when they change jobs.

The unintended consequences of early-20th-century income-tax policies have snowballed into massive overspending on health care with lackluster customer service and outcomes. Any true fix for the U.S. health-care system must take decision-making power away from government and employers and put it back in the hands of individuals, where it belongs.