

## Understanding the Tax Implications of Single-Payer Health Care

By Jason Clemens and Adam Frey

### Ignoring the Cost of Taxes

Many studies have examined the costs and benefits of replacing the current health care financing model with a single-payer system fully funded by taxpayers. Most of these studies, including the most prominent, ignore a key component: the significant economic costs of taxes, which would be necessary to pay for government-provided health care. This edition of *Health Policy Prescriptions* surveys some of this research.

*Impacts of Health Care Reform* by professor W. Woodruff and published by the National Coalition on Health Care, for example, contained a cost analysis of four different proposals to achieve universal coverage, some of which contained expanded or new roles for state-provided funding of health care.<sup>1</sup> The study explicitly assumed that there were no costs associated with raising existing taxes or creating new ones.<sup>2</sup> This assumption played a critical part in the paper's conclusion that savings of \$125 to \$182 billion could be achieved by implementing their recommended reforms.

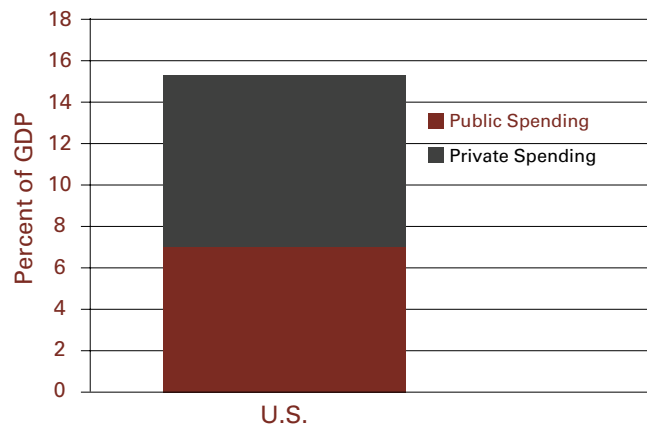
Similarly, a prominent study by the Lewin Group of *The Health Care for All Californians Act (SB 921)* in 2005 also ignored the costs of taxation.<sup>3</sup> This study examined the proposal to replace all private health insurance and existing government programs with a single-payer model paid by the state of California. The proposal called for a number of new taxes, including an employee-employer payroll tax, a self-employment business income tax, a tax on unearned income, and a surcharge on personal income.<sup>4</sup> All of these new or higher taxes were assumed to be implemented without any costs. The program was calculated to result in a net savings of \$8.0 billion.<sup>5</sup>

There are costs associated with taxation, however, and any realistic discussion of a single-payer system, or one with more taxpayer financing than at present, cannot ignore these costs. Before delving into the specifics, it's important to understand the magnitude of the tax increases being contemplated.

### Health Spending Basics

According to the Organization for Economic Cooperation and Development (OECD), in 2006, the latest year for which comparable data are available, the United States spent 15.3 percent of GDP on health care (figure 1).<sup>6</sup> Of the 15.3 percent of GDP spent on health care (2006), 45.8 percent was spent by the government. In other words, 7.0 percent of GDP in the United States is already spent on government programs such as Medicaid and Medicare.<sup>7</sup>

Figure 1: U.S. Health Care Spending as a Share of GDP



Even if one assumes that proponents of single-payer health care are correct about the potential magnitude of savings from reduced administration and compliance costs, the rise in taxation required to finance a single-payer system is still substantial. It is, therefore, essential that the debate include all the costs associated with increasing taxes.

### Costs of Taxation

The private funds currently spent on health care will have to be financed by some combination of current and deferred taxes.<sup>8</sup> The true costs of taxation are not simply the money raised by the tax itself. There are three additional costs: (1) efficiency costs, (2) compliance costs, and (3) administrative costs.<sup>9</sup>

## 1) Efficiency Costs<sup>10</sup>

Taxes impose efficiency costs on society because they distort behavior. Individuals and firms make decisions based on prices. Taxes change the relative prices of goods, services, and inputs by making some more expensive and others relatively less expensive. Raise the price of a good and consumers will likely purchase less and substitute alternatives. Similarly, if the government raises the price of an input for business, firms will search for ways to compensate for the increased cost. These changes distort production decisions—what to produce and how, where and when to produce it. Taxes reduce workers' return on their labor, training and education. Taxes also reduce the returns people get from investing their savings. These distortions result in losses to an economy, whether it is less productive labor, less investment, or less entrepreneurship, which combine to make the economy less prosperous.

## Research on Marginal Efficiency Cost (MEC)<sup>11</sup>

Many studies have estimated the economic cost of different types of taxes. Much of the research examines what is referred to as the marginal efficiency cost (MEC). The MEC calculates the efficiency cost of raising one additional dollar of revenue.<sup>12</sup>

Among the most widely cited calculations of marginal efficiency costs are those estimated by Harvard professor Dale Jorgensen and his colleague Kun-Young Yun.<sup>13</sup> Their estimates of the MEC of select U.S. taxes indicate significant variation in the economic costs. Specifically, capital-based taxes (MEC = \$0.92) and corporate income taxes (MEC = \$0.84) were shown to impose much higher costs than other, more efficient types of taxes such as sales tax (MEC = \$0.26). In other words, it costs the economy \$0.26 to raise an additional dollar of revenue using consumption taxes and \$0.92 to raise an additional dollar of tax revenue using capital-based income taxes. Regardless of the nature of the tax, there are additional incentive-based costs incurred.

**Table 1: Estimates of Marginal Efficiency Costs (MEC) for Select U.S. Taxes**

	MEC (U.S.\$)
Capital Income Taxes (Individual & Corporate)	\$0.92
Corporate Income Tax	\$0.84
Individual Income Tax	\$0.60
Payroll Tax	\$0.48
Sales Tax	\$0.26

Source: Jorgenson and Yun, 1991.

Harvard professor Martin Feldstein published a paper examining the effect of taxes on efficiency and economic growth.<sup>14</sup> He examined the cost of financing additional government spending by increasing marginal tax rates across the board. He concluded that additional government spending cost \$1.76 per \$1.00 of additional spending. In other words, the effects of higher tax rates imposed \$0.76 worth of additional costs on the economy.

There are clearly costs associated with imposing new taxes or expanding existing ones through the economic distortions created by higher taxes. When these costs are considered, the proposition that a single-payer system actually yields net savings becomes more tenuous. For example, the study of California estimated a net savings of \$8.0 billion but acknowledged increased taxes amounting to \$166.8 billion. Any costs linked with these new taxes that exceeded \$0.05 per dollar raised would negate the calculated savings.

## 2) Compliance Costs

Individuals and businesses must spend time and energy to comply with tax regulations. Direct costs include attorneys, accountants, and tax preparers' fees. Indirect costs involve the time individuals and businesses spend on tax preparation, completion, reporting, and follow-up. A number of studies have estimated the costs of tax compliance. For example, in 2004 leading scholar Joel Slemrod estimated that the costs for individuals and businesses to comply with the federal tax code alone totalled \$135 billion.<sup>15 16</sup> The specific increase in compliance costs will be to some extent driven by the nature of the increased or new taxes imposed to finance new government spending. Nevertheless, there are clearly costs associated with tax compliance, and those costs need to be considered.

## 3) Administrative Costs

These are the costs incurred by the government (paid for by taxpayers) to maintain the tax-collection system. It includes a variety of basic administrative costs (record keeping, correspondences, bill assessments, etc.) as well as more complicated costs such as judicial reviews and proceedings. The costs of increasing existing taxes in terms of administrative costs would be much less than the costs associated with introducing a new tax. Regardless of the nature of the tax, however, the analysis should include additional administrative costs.

## Conclusion

As the health care debate continues, it is imperative that policy makers, the media, and the public be fully and accurately informed. The costs associated with taxes, namely efficiency costs, compliance costs, and administrative costs, all need to be included in reform evaluations that include the introduction of new taxes or extension of existing taxes. Ignoring these costs leads to inaccurate results and faulty conclusions and will hinder genuine efforts to improve health care in the United States.

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## Endnotes

- <sup>1</sup> Kenneth E. Thorpe, *Impacts of Health Care Reform: Projections of Costs and Savings*, (Washington, D.C: National Coalition on Health Care, 2005).
  - <sup>2</sup> See pages 9 through 12 of the study for a discussion of the underlying assumptions used to calculate the costs and benefits of the four reform models considered in the paper.
  - <sup>3</sup> John F. Sheils and Randall A. Haught, *The Health Care For All Californians Act: Cost and Economic Impacts Analysis*, (Health Care for All Education Fund, 2005). Available at [www.healthcareforall.org/lewin.pdf](http://www.healthcareforall.org/lewin.pdf).
  - <sup>4</sup> See pages 52 and 53 of the Sheils and Haught (Lewin Group) study for details of the various proposed tax plans.
  - <sup>5</sup> See pages 27 through 31 of the Sheils and Haught (Lewin Group) study for more details on the calculated cost savings.
  - <sup>6</sup> OECD (2008a). OECD Health Data 2008, Frequently Requested Data, available at [http://www.oecd.org/document/16/0,3343,en\\_2649\\_34631\\_2085200\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/16/0,3343,en_2649_34631_2085200_1_1_1_1,00.html); calculations by the authors.
  - <sup>7</sup> What is not generally known is that the United States spends roughly the same percent of the economy (GDP) on public health care as Canada. Again, relying on OECD data from 2006, public health care expenditures represented 7.0 percent of GDP in the United States compared to 7.1 percent of GDP in Canada. This essentially identical public spending on health care as a fraction of the economy translates into different levels of spending in dollar terms because the U.S. has a higher level of economic output. Specifically, American governments spent \$3,073 per capita on public health care in 2006 while Canadian governments spent \$2,590 per capita, a difference of \$483 or 18.6 percent.
  - <sup>8</sup> Deferred taxes refer to deficit-financed spending in the current period, which must be ultimately paid for by future taxes.
  - <sup>9</sup> For an overview and review of research on the various costs associated with taxation see U.S. GAO 2005.
  - <sup>10</sup> Efficiency costs are also referred to as the deadweight loss of taxation or the excess burden of taxation.
  - <sup>11</sup> For further information on MEC see Charles L. Ballard, John B. Shoven, and John Whalley, "General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States," *The American Economic Review* 75 (1), 1985, pp. 128-138.
  - <sup>12</sup> It is critical to note that MEC of taxes are estimates of the cost of raising one additional dollar of revenue. They are, therefore, measures of marginal or incremental cost and should be used to measure the benefits of small or incremental tax shifts. MEC cannot be used to measure the total or even average cost of taxes. In other words, MECs should be used cautiously, if at all, when estimating large scale tax shifts when the relationship between the tax rate and efficiency cost is non-linear.
  - <sup>13</sup> Dale W. Jorgensen and Yun Kun-Young, "The Excess Burden of Taxation in the United States," *Journal of Accounting and Finance* 6, 1991, pp. 487-508.
  - <sup>14</sup> Martin Feldstein, *The Effect of Taxes on Efficiency and Growth*, Working Paper 12201, (Cambridge, MA: National Bureau of Economic Research). Available at [www.nber.org/papers/w12201](http://www.nber.org/papers/w12201).
  - <sup>15</sup> Joel Slemrod, testimony submitted to the Committee on Ways and Means, Subcommittee on Oversight. Hearing on tax simplification, June 15, 2004. As summarized in the U.S. GAO.
  - <sup>16</sup> For an overview of recent studies examining tax compliance costs see U.S. GAO 2005. United States General Accountability Office (2005). *Tax Policy: Summary of Estimates of the Costs of the Federal Tax System*. (Washington, DC: General Accountability Office.) GAO-05-878.
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