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**CHANGES IN THE DEMAND FOR PRIVATE MEDICAL  
INSURANCE FOLLOWING A SHIFT IN TAX INCENTIVES**

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## CHANGES IN THE DEMAND FOR PRIVATE MEDICAL INSURANCE FOLLOWING A SHIFT IN TAX INCENTIVES<sup>a</sup>

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### Abstract:

The 1998 Spanish reform of the Personal Income Tax eliminated the 15% deduction for private medical expenditures including payments on private health insurance (PHI) policies. To avoid an undesirable increase in the demand for publicly funded health care, tax incentives to buy PHI were not completely removed but basically shifted from individual to group employer-paid policies. In a unique fiscal experiment, at the same time that the tax relief for individually purchased policies was abolished, the government provided for tax allowances on policies taken out through employment. Using a bivariate probit model on data from National Health Surveys, we estimate the impact of said reform on the demand for PHI and the changes occurred within it. Our findings suggest that the total probability of buying PHI was not significantly affected. Indeed, the fall in the demand for individual policies (by 10% between 1997 and 2001) was offset by an increase in the demand for group employer-paid ones, so that the overall size of the market remained virtually unchanged. We also briefly discuss the welfare effects on the state budget, the industry and society at large.

**Keywords:** Private health insurance, tax reform, Spain.

**JEL Codes:** I10, H31

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## 1. Introduction

Until 1998 the Spanish Personal Income Tax (PIT) regulations permitted taxpayer units (individuals or families) to deduct 15% of their annual private medical expenses from their gross income tax liability, as long as the deduction was no higher than their net tax liability. In the nineties both the number of taxpayer units claiming this deduction and the total amount deducted increased rapidly and steadily. According to the annual tax reports<sup>1</sup>, in 1990 a mere 2.4 million taxpayers (22% of the total) applied for tax relief for medical expenditure while in 1998 this number had gone up to 7.1 million (46% of all taxpayers) (Ministerio de Economía y Hacienda, 1991 and 1999). In terms of monetary volume the tax expenditure rose from 28,866 million pesetas (173.5 million euro) in 1990 to 109,254 million pesetas (656.6 million euro) in 1998; that is a 278.5% rise, compared to a 52.2% growth in PIT deductions in general over the same period (IEF, 2003). In other words, the 656.6 million euro of revenue forgone in 1998 represented 1.57% of total Personal Income Tax gross liabilities, or enough to cover that year's public health care for one million people.

Naturally, the size and evolution of this fiscal benefit started to be a matter of concern to the government. Signs that it was the higher income groups that were availing more of the relief (Martínez García et al., 1999) added still further doubts with respect to its appropriateness. Finally, such deductions were eliminated by the 1998 Personal Income Tax System reform (Act 40/1998, dated of 9<sup>th</sup> of December, effective as of 1<sup>st</sup> of January 1999), along with certain other specific deductions and allowances. The main argument used to justify the measure was that medical and other personal expenses were encompassed in the new general allowance -a minimum amount of family and personal income exempt from taxation- introduced in the same Act.

The 15% deduction had been applicable both to direct out of pocket medical expenses such as payments for visits, hospitalisation, medical appliances, medicines, etc. and to indirect medical expenditure, that is, payment of private health insurance premiums. While the government clearly wanted to eliminate the tax relief on private medical expenditures in general, it is apparent from the complementary measures that were taken that it did not want to remove the incentives to taking out private health insurance (PHI) altogether. The reasons the government had for not wanting to put a brake on the demand for PHI were, most likely, a wish to avoid a sudden increase in the flow of patients to the public sector and the desire not to harm the sizeable Spanish private health insurance market. Due to a substitution effect, eliminating the

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<sup>1</sup> Figures do not include the Basque Country and Navarre, that collect their own taxes.





























































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