New Healthcare Tax Proposals: Costly and Counterproductive

By Leonard E. Burman

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President Bush's budget for fiscal 2007 contains a package of new tax incentives for individuals and employees who are covered by high-deductible health insurance policies and contribute to health savings accounts (HSAs). The new proposals would make the tax system more complex and less fair, and add to the country's budget woes, especially over the long run. The proposals would reduce revenues by $156 billion over 10 years. Perhaps most problematic, they are likely to exacerbate the problems in the healthcare market.

Enacted in 2003 as part of the Medicare prescription drug legislation, HSAs allow a tax exemption for contributions by both employers and employees to special savings accounts tied to high-deductible health plans (HDHPs). Plans must have a deductible of between $1,050 and $2,700 for individual coverage and between $2,100 and $5,450 for family coverage to qualify as an HDHP. Contributions to an HSA up to the plan deductible made by an employer on an employee's behalf are excluded from taxable income; contributions made by individuals are tax deductible. Earnings in an HSA accumulate tax-free and withdrawals used to pay for medical expenses are also untaxed. Other withdrawals are subject to income tax; a 10 percent penalty tax is also assessed for withdrawals made before age 65.

The president's proposal would expand the tax benefits associated with HSAs in several ways. First, it would increase the contribution limit to the out-of-pocket maximum for HDHPs (for 2006, $5,250 for individuals and $10,500 for families). Second, it would allow individuals a refundable tax credit of 15.3 percent for contributions made to HSAs (intended to offset the payroll tax associated with the earnings earmarked for the accounts). Penalties on nonmedical withdrawals would increase to 30 percent for preretirement withdrawals and 15 percent for those made at age 65 and older.[1] Third, low-income families (those with less than $25,000 of income) would be able to receive up to $3,000 in refundable tax credits against HDHP premiums.

According to HSA supporters, high-deductible health insurance will unleash competitive forces that drive down healthcare costs and expand access. In theory, with their own money on the line (rather than their insurers' money), consumers would be more discriminating in choosing providers and deciding what medical services to consume. Market forces would for the first time make medical providers compete and innovate, driving down medical costs. What's more, because consumers with HDHPs have an incentive to economize, those plans would be much cheaper than traditional insurance. As a result, more people would be able to afford coverage.

In fact, the proposals are likely to have exactly the opposite effect. Insurance works by pooling high- and low-risk people together. The employer market, although rife with problems, is the best existing mechanism for doing that.[2] People choose their jobs for reasons other than their health status, so an employer group (especially a large one) pools many people who spend little for healthcare with a few who spend a lot. Healthy people have an incentive to participate because employer-sponsored health insurance is exempt from income and payroll taxes, and similar tax subsidies do not generally exist outside the employer group.

Under the Bush proposals, individuals who purchase HDHPs would have access to tax benefits outside work at least as generous as the tax-free fringe benefit. Employees who are healthy and have high incomes will find HSAs enormously attractive. If employees stay healthy, the accounts would turn out to be turbocharged retirement vehicles. The tax credit is a subsidy not available for contributions to 401(k)-type plans and, as long as the withdrawals can be allocated to qualifying medical expenditures, they will be untaxed, unlike withdrawals from a traditional retirement plan. Because the range of qualifying expenses includes Medicare premiums, out-of-pocket expenses, and long-term care services, someone who lives long enough should be able to make virtually all of his withdrawals tax-free. Jason Furman

[1]The higher penalties are intended to recapture the 15.3 percent payroll tax credit.

[2]*See, e.g.*, U.S. Congressional Budget Office, "The Tax Treatment of Employment-Based Health Insurance" (Washington: U.S. Government Printing Office, 1994).

has shown that the tax subsidy in an HSA can be more than 50 percent greater than the tax subsidy in a 401(k) account.[3]

As a result, healthy higher-income employees will put pressure on employers to offer HSAs (or drop coverage altogether so they can purchase the policies on their own). When the healthy people drop out of the pool, the insurance costs for the remaining, sicker employees will increase (because their average spending is higher). That will drive more healthy people to HSAs, pushing premiums for traditional low-deductible insurance up still more. Eventually, the employer is likely to drop the low-deductible option altogether.[4]

In addition, by offering the same tax subsidies outside work as inside, fewer healthy employees will want to participate in the employer group. They will have access to low premiums in the nongroup market and will pressure employers to drop the fringe benefit and raise wages instead. Perhaps even more troubling, small employers will have much less reason to offer insurance to their employees if they can get the same tax benefits in the individual market. Currently, more than 40 percent of employees in firms with fewer than 100 employees get their insurance at work.[5] If the Bush tax incentives are enacted, that percentage is likely to plummet.[6] As a result, the proposal would probably increase the number of workers without health insurance.

Would the demise of traditional health insurance be such a bad thing? It would be for modest-income people who suffer from chronic illnesses. They will hit the deductible year after year, which represents a huge financial burden. Moreover, if their employer does not offer coverage and they are thrust into the individual nongroup market, they will find their premiums quickly become unaffordable.[7] Even for healthy people, nongroup insurance tends to be much more expensive than employment-based health insurance because of high costs for administration, marketing, and underwriting.

Finally, HDHPs are likely to have little effect on healthcare costs. The vast majority of medical expenses are incurred by people who are very sick, often in the last six months of life. They would have little incentive to limit spending because almost all of it is above the deductible. Moreover, evidence from the Rand Health Insurance Experiment in the 1980s suggests that people facing high deductibles are as likely to curtail important preventive screenings as more optional care. The result may be, in some cases, more health spending over time, not less. And evidence from behavioral economics suggests that consumers armed with HSA credit cards, substantial HSA balances, and no managed care requirements may actually be *more* prone to spending money on healthcare than patients with more comprehensive insurance who face a small copayment or require approval by an insurer.

In short, the proposals promise to control healthcare costs by spending more federal dollars on healthcare for the healthy and wealthy. That oxymoronic approach won't work. A better strategy would be to retarget existing health subsidies to those who truly need help affording coverage — those with low incomes or with chronic illnesses — without undermining the employer-based market that currently covers more than three-quarters of American workers.

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[3]Jason Furman, ''Expansion in HSA Tax Breaks Is Larger — and More Problematic — Than Previously Understood,'' Center on Budget and Policy Priorities, Feb. 4, 2006.

[4]The well-known problem of low-risk people opting out of insurance pools is known as ''adverse selection.'' The effect on premiums, as higher premiums drive out more low-risk individuals, which in turn drives premiums up higher, is sometimes called a ''death spiral.'' In the extreme, it can cause an insurance market to fail altogether.

[5]*See* Leonard Burman and Jonathan Gruber, ''Tax Credits for Health Insurance,'' Tax Policy Center Discussion Paper No. 19 (2005). (*Available at* http://www.taxpolicycenter.org/publications/template.cfm?PubID=411176)

[6]Critics would point out that percentage is already declining because of the rapidly rising cost of health insurance for small employers, many of whom already offer high-deductible plans because they are more affordable. That argument is tantamount to responding to ''Man overboard!'' by throwing the rest of the passengers into the sea.

[7]Employers who continue to offer coverage would be permitted under the president's proposal to subsidize the HSAs of chronically ill employees. It is unlikely that many would do so. Firms are in the business of making money, not offering welfare programs to employees in need. Even altruistic employers will face enormous pressures from competition to keep costs down, which would preclude subsidizing sick employees. And, from a pure business perspective, employers have little incentive to offer programs designed to attract and retain unhealthy employees.

(Footnote continued in next column.)