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PRESIDENT PROPOSES TO MAKE TAX BENEFITS OF HEALTH SAVINGS ACCOUNTS MORE LUCRATIVE FOR HIGHER-INCOME INDIVIDUALS

Proposal to Allow HSA Participants to Deduct Premium Costs of High-Deductible Insurance Plans in the Individual Market Would Do Little to Help the Uninsured and Could Further Weaken Employer-Based Coverage

by Edwin Park and Robert Greenstein

The President's budget proposes to expand Health Savings Accounts (HSAs) by allowing HSA participants to claim a tax deduction for the premium costs of high-deductible health insurance policies if they purchase such policies in the individual health insurance market. The stated intent of the deduction proposal is to help more of the uninsured purchase health insurance, albeit less comprehensive high-deductible coverage.

Health Savings Accounts were established by the recently enacted Medicare drug legislation. Under these accounts, individuals who enroll in high-deductible health insurance plans — whether through their employers or on their own — may establish tax-favored savings accounts. Contributions to these accounts are tax-deductible, earnings on funds in these accounts accrue tax-free, and withdrawals from the account are not taxed if they are used to pay for out-of-pocket medical costs.[1]

Current HSA rules do not permit tax-free withdrawals from the accounts to be used to pay premium costs for health insurance.[2] Under the Administration's proposal, however, HSA participants would be able to take a separate deduction for the premium costs of a high-deductible health insurance policy if it is purchased in the individual market. (HSA participants obtaining high-deductible coverage through their employer would not be allowed to use the deduction.) This deduction would be available without regard to whether the individual itemizes deductions. The Administration estimates the cost of this proposal to be $24.8 billion over ten years.

[1] Contributions to the accounts are exempt from the payroll tax if they are made from earnings through an employee's cafeteria plan. Employer contributions are also exempt from the payroll tax. For an analysis of the Health Savings Accounts, see Robert Greenstein and Edwin Park, "Health Savings Accounts in Final Medicare Conference Agreement Pose Threats Both to Long-Term Fiscal Policy and to the Employer-Based Health Insurance System," Center on Budget and Policy Priorities, revised December 1, 2003.

[2] There are limited exceptions to the rule that tax-free withdrawals from HSAs may not be used to pay premiums for health insurance. Tax-free withdrawals from HSAs may be used to pay for health insurance premiums under COBRA or while an individual is unemployed, for long-term care insurance premiums, or for premiums for private supplemental coverage under Medicare.

The proposed deduction would benefit people at higher income levels much more than other households.

- Because the value of a tax deduction rises with an individual's tax bracket, the proposed deduction would provide significant additional tax benefits to high-income individuals, the group to which HSAs already provide the largest tax subsidies.

- The deduction would provide little or no tax benefit to low- and moderate-income workers and thus would do little to help them afford to purchase high-deductible health insurance in the individual market. Workers who do not earn enough to owe income tax would receive no benefit from the deduction. For modest and middle-income taxpayers in the 10 percent or 15 percent tax brackets, the deduction would reduce the cost of health insurance policies by only 10 percent or 15 percent, generally too little to make health insurance affordable.

- About three-quarters of all U.S. households and an even larger percentage of the uninsured are either in the 10 percent or 15 percent tax bracket or earn too little to owe income tax. A General Accounting Office analysis issued in 1998 found that more than 90 percent of the uninsured were either in the 15 percent tax bracket or had no tax liability.[3]

As a result, the proposed deduction would do little to make insurance affordable to those who lack it. In addition, the deduction would be likely to have several deleterious effects.

- The deduction could prompt some employers to drop existing employer-sponsored coverage or, in the case of new employers, to elect not to offer coverage. Employers could cite the availability of HSAs and the new deduction, which workers could use to purchase health insurance in the individual market.

- The proposal would increase budget deficits. The Administration expects the HSA provisions of the Medicare drug legislation to cost two-and-a-half times as much as the Joint Committee on Taxation estimated when the legislation was enacted — a cost-estimate which the Congressional Budget Office incorporated in its overall Medicare estimate. This is a view that many experts broadly share. (HSA use is now expected to be significantly more widespread than the Joint Committee on Taxation assumed when it developed the cost estimate for the HSA provision in the Medicare legislation.) The proposed deduction, by substantially enhancing the already-generous tax benefits that HSAs offer to higher-income individuals, would cause use of HSAs to become still more widespread. This is one of the reasons the deduction proposal carries such a hefty price tag.

[3] The General Accounting Office analyzed 1996 census data and determined that more than 90 percent of the uninsured had no tax liability or were in the 15 percent tax bracket. General Accounting Office, Letter to the Honorable Daniel Patrick Moynihan, June 10, 1998. The 10 percent tax bracket, which was carved out of the 15 percent bracket by the 2001 tax legislation, did not yet exist.

The Administration projects that the combined cost of the HSA provision of the Medicare drug legislation and its new deduction proposal would be nearly $41 billion over the next ten years. By contrast, when Congress passed the Medicare bill, it thought the cost of the bill's HSA provisions would be $6.4 billion over ten years, based on the JCT estimate.

- The proposed deduction also would impose a drain on *state* budgets. State income tax codes generally conform to the definition of taxable income in the federal income tax code. Many states would experience revenue losses if the proposed deduction became law.

Rising Costs for HSA Tax Breaks

The Joint Committee on Taxation, Congress' official "scorekeeper" on tax legislation, estimated last year that the HSA provisions of the new Medicare drug law would cost $6.4 billion over ten years. The Congressional Budget Office incorporated the JCT estimate into its overall estimate of teh cost of the new Medicare law.

The Joint Committee on Taxation estimate was based on an assumption that HSA use would start at one million participants in 2004 and rise to three million by 2013. Most analysts now believe this estimate substantially understates likely HSA use, given the widespread attention that HSAs are receiving and the plans of various insurance and financial investment companies offering HSAs and high-deductible policies to market them heavily.

In its new budget, the Administration estimates that the HSA provisions of the new Medicare law will cost $16 billion over ten years — two-and-a-half times what Congress assumed when the law was enacted.* The deduction that the Administration is now proposing would further increase HSA costs in two ways: 1) through the direct costs of the deduction itself, and 2) by causing participation in HSAs to increase further and thereby raising the use — and cost — of the HSA tax breaks included in the new Medicare law. The 16 million individuals who currently purchase health insurance in the individual market would have a strong incentive to establish HSAs in order to secure the tax advantages of both HSAs and the new deduction. (Many plans purchased in the individual market impose high deductibles that could meet the requirements of HSAs.) Currently, only the self-employed can deduct the premium costs of health insurance purchased in the individual market.

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* Office of Management and Budget, *Analytical Perspectives: Fiscal Year 2005*, p.292. The OMB budget documents show that the existing Health Savings Accounts will have ongoing costs of $7 billion over the next *five* years. Treasury Department staff have indicated to Congressional staff that the 10-year cost is approximately $16 billion over 10 years.

Value of the Deduction Would Rise with Income and Primarily Benefit High-Income Taxpayers

As with any deduction, the higher an individual's tax bracket, the greater subsidy the proposed deduction would provide.

- Uninsured low-income families that do not earn enough to incur income tax liability would receive no tax benefit from the deduction. A large share of the uninsured would be left out.

- For uninsured moderate- and middle-income families in the 10 percent or 15 percent tax brackets, the deduction would defray no more than 10 cents to 15 cents of each dollar they would have to spend to purchase a high-deductible health insurance policy in the individual market, generally not enough to make even a less-comprehensive plan affordable.

  Assume, for example, that a moderate-income, healthy uninsured family of four living in the Washington D.C. metropolitan area is considering whether it can afford a high-deductible family plan available in the individual health insurance market that carries a $3,350 deductible. Such a policy could carry an annual premium cost of approximately $4,000.[4] If the family is in the 10-percent tax bracket, it would receive a tax benefit of $400 from the proposed deduction. The family would still have to incur $3,600 in premium costs, which likely would cause the high-deductible coverage to remain unaffordable. (The costs are likely to be even higher for families that contain members who are older or in poorer health, because the individual market is generally unregulated. Insurers can — and do — vary premiums based on age and health status and can exclude people entirely.)

- By contrast, for individuals in the top income tax bracket of 35 percent, the deduction would subsidize 35 percent of the cost of the high-deductible health insurance in the individual market. A high-income family of four purchasing the same high-deductible policy described above would receive a premium subsidy of $1,400 (35 percent of the premium cost of $4,000).

  Moreover, that tax subsidy would be in addition to the tax benefits that the high-income family would secure from making annual tax-deductible contributions to its HSA equal to the deductible of $3,350; those maximum contributions would provide a income tax benefit of about $1,173, bringing the family's combined HSA-related tax benefits to $2,573. (The family's overall HSA tax subsidy actually would be still higher, since earnings on the amounts in the HSA would accrue tax free.)

- The high-income family in the top tax bracket thus would *more than double* its already substantial tax benefits if the proposed deduction were added to HSAs,

[4] An illustrative high deductible health insurance policy being marketed by the Golden Rule Insurance Company as a plan meeting HSA requirements was located on ehealthinsurance.com for both the Northern Virginia and Maryland suburbs of Washington D.C. The policy is a high-deductible health insurance plan available in the individual market for a hypothetical non-smoking healthy family of four (two 35 year-old adults with two 8 year-old children). This high-deductible plan includes a deductible of $3,350, zero percent cost-sharing after the deductible is met, and a maximum out-of-pocket limit of $3,350. The policy does not include maternity coverage or well-baby care and has a lifetime limit of $3,000 in mental health benefits per family member.

This premium quote assumes the family is in *excellent* health. In most states, the premium is likely to be adjusted higher, in some cases significantly higher, to reflect the health status of family members if any are in less-than-excellent health. In some cases, families with members in poor health would not be able to purchase such a high-deductible health insurance plan at any price.

despite the fact that such a family does not need large government subsidies to be able to afford health insurance.

High-income individuals are the people already most likely to take advantage of HSAs. They can use HSAs as a lucrative tax shelter, because HSAs provide them with unprecedented tax advantages. Unlike other tax-advantaged savings accounts, HSAs allow *both* tax-deductible contributions *and* tax-free withdrawals, as long as the withdrawals are used to pay for out-of-pocket medical costs. And, unlike Individual Retirement Accounts, *there are no income limits on who can participate in HSAs*. Providing an additional deduction to HSA participants for the premium costs of health insurance would make HSAs even more advantageous for high-income individuals.

In short, the proposed deduction would be valuable for high-income individuals but would likely do little to reduce the ranks of the uninsured, since it does little to make insurance affordable for most people who lack it. Moreover, the small number of low- and moderate-income people who might gain coverage through the deduction would generally be underinsured, as a result of the less comprehensive high-deductible policies they would have. A Commonwealth Fund study found, for example, that older individuals who enroll in less comprehensive high-deductible health insurance plans commonly found in the individual market are twice as likely as older people with comprehensive employer-based coverage to fail to see a doctor when a medical problem has developed or to skip medical tests or follow-up treatment.[5]

Deduction Could Encourage Some Employers to Drop Coverage Entirely

The proposed deduction might encourage some employers to drop existing health insurance coverage or to decide not to offer coverage in the first place, on the assumption that their employees could use the tax benefits of the new deduction, in tandem with those of a HSA, to obtain coverage through a high-deductible plan purchased in the individual market.

- Previous studies have concluded if a broader deduction for the purchase of health insurance in the individual market were established generally, some firms would drop coverage and a number of the individuals currently insured through employer-based coverage would become uninsured as a result.

- Professor Jonathan Gruber of M.I.T., one of the nation's leading health economists, has found that a general deduction for the purchase of health insurance in the individual market (not just a deduction tied to a high-deductible plan associated with a HSA) would cause employers to drop health coverage for approximately 600,000 workers, of whom an estimated 340,000 would become uninsured.[6]

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[5] Elisabeth Simantov, Cathy Schoen and Stephanie Bruegman, "Market Failure? Individual Insurance Markets for Older Americans," Health Affairs, July/August 2001.

[6] Jonathan Gruber, "Tax Subsidies for Health Insurance: Evaluating the Costs and Benefits," National Bureau of Economic Research, February 2000.

Employer-dropping would be a particular concern among small businesses. Among firms with fewer than 200 workers, the costs of health insurance premiums rose by 15.5 percent between 2002 and 2003. Due in part to these premium increases (and in part to financial pressures resulting from the economic slump), the number of small firms with fewer than 200 workers that offer health coverage declined from 68 percent in 2000 to 65 percent in 2003.[7] Moreover, among small firms that do offer coverage, 31 percent provided less than a 50 percent subsidy for the premium cost of family coverage for their workers. The availability of the proposed deduction could provide an incentive for some of these small employers to drop coverage.

The deduction also could encourage some healthy, more affluent workers to leave employer-based coverage for the individual market. Some healthy, higher-income individuals who work for a firm that offers comprehensive low-deductible health insurance and requires employees to pay a significant percentage of the premium costs may shift to the individual market to take advantage of the tax benefits that HSAs and the premium deduction provide. Older and sicker workers, however, would be highly unlikely to follow this path. The high-deductible policies that accompany HSAs would be risky for them, and they would tend to face very high costs for insurance policies in the individual market, as a consequence of their less-healthy status.

If this process occurs — under which some healthy, affluent workers opt out of comprehensive employer-based coverage while less healthy workers remain in it — then premiums for comprehensive insurance will rise, since those who remain in comprehensive coverage will constitute a pool that is, on average, sicker and more costly to insure. The resulting premium increases for comprehensive insurance may, in turn, drive more of the healthier workers out of such coverage, which would make the pool of workers left in comprehensive coverage still more expensive to insure. This process, known as "adverse selection," could ultimately lead significant numbers of employers to drop coverage altogether or to drop *comprehensive* coverage and replace it with high-deductible insurance and HSAs.

It already is expected that as healthier, more affluent workers become increasingly aware of HSAs and their tax advantages, growing numbers of employers will come under pressure to offer HSAs and high-deductible insurance policies either as an option or as their sole form of health insurance coverage. Indeed, many well-paid business owners and executives may initiate efforts for their firms to offer HSAs and high-deductible policies, given the lucrative tax-shelter opportunities that HSAs would provide them.

Whether employers dropped coverage altogether, eliminated comprehensive coverage and offered only high-deductible coverage and HSAs, or offered options for *both* comprehensive coverage and a high-deductible policy/HSA combination, the consequences would be adverse for older and sicker workers, who generally rely on comprehensive coverage. If their employers no longer offered comprehensive coverage, such workers would be adversely affected. But such workers also would likely be harmed if their employers sought to offer options for both

[7] Kaiser Family Foundation and Health Research and Educational Trust, "Employer Health Benefits: 2003 Annual Survey," September 2003.

comprehensive coverage and high-deductible coverage tied to HSAs. Healthier, more affluent workers would tend to gravitate to the high-deductible coverage coupled with the HSA tax breaks. Since the pool of workers remaining in comprehensive coverage would become sicker, on average, premium costs for the comprehensive coverage would rise, possibly by quite large amounts.

Past research by RAND, the Urban Institute, and the American Academy of Actuaries found that if the use of health savings accounts becomes widespread, premiums for comprehensive insurance could *more than double*.[8] If that occurs, many more employers and employees ultimately are likely to drop (or to drop out of) comprehensive coverage, because they can no longer afford it.

As a result, many older and sicker workers would become uninsured. Others would have some coverage through less comprehensive high-deductible health insurance plans that would likely leave them underinsured. As noted above, research from the Commonwealth Fund has determined that unlike in comprehensive coverage, the substantial cost-sharing that high-deductible plans such as those in the individual market impose and the fewer benefits that the plans cover significantly limit many workers' access to medically necessary services.

Conclusion

The proposed deduction would do little to reduce the ranks of the uninsured. Its primary effect would be to enlarge the already-generous tax benefits that HSAs offer to higher-income individuals who purchase insurance in the individual market. That would have two principal consequences. It would further swell budget deficits. And it would be likely to encourage more employers to drop coverage or not to offer it in the first place.

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[8] This research related to "Medical Savings Accounts." The "Health Savings Accounts" established by the Medicare drug legislation are essentially MSAs with a slightly different name and without the restrictions originally put in place to limit the risk of adverse selection under MSAs, as well as the risk of abuse of MSAs as tax shelters by high-income individuals.