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PRESIDENT'S HEALTH CARE TAX CUT PROPOSALS ARE LIKELY TO WEAKEN EMPLOYER-BASED HEALTH INSURANCE, PRIMARILY BENEFIT HIGH-INCOME PEOPLE, AND WORSEN DEFICITS

By Edwin Park and Jason Furman

In tonight's State of the Union address and as part of the upcoming fiscal year 2007 budget, President Bush is expected to propose major new tax cuts related to health care.[1] Chief among them could be major expansions of Health Savings Accounts (HSAs) and a new income tax deduction for out-of-pocket medical costs. These proposals raise serious concerns on health, tax and fiscal policy grounds.

- The new health care tax cuts are likely to weaken the employer-based health insurance system through which the vast majority of Americans now obtain health coverage. One tax cut related to HSAs could actually increase the number of the uninsured by encouraging employers to no longer offer health insurance to their workers.

- The proposed tax cuts would be targeted primarily to higher-income taxpayers who would have new tax sheltering opportunities and potentially new tax breaks to cover out-of-pocket medical costs. The majority of Americans would get little (or nothing) from these tax breaks.

- These proposals will be costly and add substantially to already-large budget deficits.

This analysis briefly considers several of the health tax cut proposals the President may announce tonight.

The President's Health Care Agenda

The President's new health tax should be seen as part of a broader agenda to shift health insurance coverage to high-deductible plans with less comprehensive benefits so that individuals pay more for their health care. The Administration has long criticized traditional, low-deductible health insurance that provides comprehensive benefits and limits co-payments to relatively modest

[1] See, for example, Sarah Lueck, "Bush to Seek Bigger Health-Savings Tax Break," *Wall Street Journal*, January 21, 2006; Peter G. Gosselin, "Health Plan to Revive Debate," *Los Angeles Times*, January 23, 2006; and Amy Goldstein, "New Tax Breaks for Medical Expenses," *Washington Post*, January 25, 2006.

amounts, arguing that consumers may unnecessarily use health-care services because they are too heavily shielded from the economic costs.

Yet for many low- and moderate-income individuals and families — especially those in poorer health — high deductibles, significant cost-sharing, and lack of coverage of essential medical services can lead to prohibitive out-of-pocket expenses that discourage access to medically necessary care. Substantial premiums and cost-sharing have a disproportionate impact on lower-income families and individuals and their use of medical services when such services are needed, since these people have less disposable income available for out-of-pocket health-care expenses. If a medical condition or illness goes untreated because individuals are unable to pay for appropriate care out of pocket, this can eventually lead to greater use of expensive services like hospitalization. As a result, the high-deductible insurance policies required under Health Service Accounts could even result in some increases in health care costs over time for individuals who subsequently become sicker as a result of forgoing care.

Moreover, the high deductible policies associated with of HSAs are unlikely to do much to reduce overall health spending. That is because the vast majority of medical costs are for catastrophic illness or end of life, at levels well in excess of these deductibles. For example, the top 10 percent of health care users account for about 70 percent of total health expenditures in the United States, while the bottom half account for only three percent of total expenditures.[2]

Expansion of Health Savings Accounts

Health Savings Accounts were created as part of the 2003 Medicare drug legislation.[3] Under that law, individuals who enroll in high-deductible health insurance plans with deductibles of at least $1,050 for individual coverage and $2,100 for family coverage — whether through their employers or on their own — may establish tax-favored savings accounts. These accounts provide a lucrative tax shelter for those in higher tax brackets — contributions to the accounts are tax-deductible, earnings on funds in the accounts accrue tax-free, and withdrawals from the account are not taxed if they are used for out-of-pocket medical costs. The tax-free withdrawals may be used for deductibles, co-payments, and uncovered medical costs. Both employers and employees may make deductible contributions to an employee's HSA in the same year; the combined contributions made on behalf of an individual may not exceed the plan deductible or an annual contribution limit, whichever is lower.

Many leading health care analysts and economists have warned in the past that HSAs pose a high risk of causing "adverse selection" under which healthy people and less-healthy people separate into separate insurance arrangements and the cost of insurance for the less-healthy consequently rises placing such individuals at greater risk of becoming uninsured or underinsured.[4] In addition, health

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[2] Linda J. Blumberg, Lisa Clemans-Cope, and Fredric Blavin, "Lowering Financial Burdens and Increasing Health Insurance Coverage for Those with High Medical Costs," Urban Institute, December 2005.

[3] For further analysis of Health Savings Accounts, see Edwin Park and Robert Greenstein, "Latest Enrollment Data Still Fails to Dispel Concerns About Health Savings Accounts," Center on Budget and Policy Priorities, Revised January 30, 2006.

[4] See Emmett B. Keeler, et. al., ACan Medical Savings Accounts for the Nonelderly Reduce Health Care Costs?@ *Journal of the American Medical Association*, June 5, 1996, p. 1666-71; Len M. Nichols, et. al., ATax-Preferred Medical Savings

and tax policy analysts have concluded that HSAs are likely to be used extensively as tax shelters by high-income individuals, especially since, unlike IRAs, there are no income limits on who can make tax-deductible contributions to the accounts. The tax treatment of HSAs crosses a bright line in tax policy by providing tax-deductible contributions, tax-free earnings, *and* tax-free withdrawals on the same accounts. In contrast, IRAs, 401(k), and other tax-favored savings accounts all impose taxes either on initial contributions or subsequent withdrawals.[5]

The President is expected to propose several tax cuts to expand HSAs but two proposals particularly merit discussion: a proposal to allow HSA participants to claim a tax deduction for the premium costs of high-deductible health insurance policies that they purchase in the individual health insurance market in conjunction with HSAs, and a proposal to increase significantly the size of the tax-deductible contributions that HSA participants may make to their accounts each year.

Tax Deduction for High-Deductible Health Insurance Premiums

This proposal is likely to be similar to those included in the last two Administration budgets. It would provide a tax deduction for 100 percent of the premium costs of a high-deductible insurance policy attached to a HSA that was purchased in the individual health insurance market. The deduction would be available to individuals whether or not they itemize their deductions on their income tax return. The deduction is likely to have a number of adverse effects.

- Because the value of a tax deduction rises with an individual's tax bracket, the proposed deduction would provide the largest tax benefits to high-income individuals who can already afford health insurance. It would provide little or no tax benefit to low- and moderate-income workers and consequently would have only small effects in helping such individuals 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 moderate- and middle-income taxpayers in the 10 percent of 15 percent tax brackets, the deduction would reduce the cost of health insurance policies by only 10 percent or 15 percent, too little in most cases to make health insurance affordable. This is significant because about three-quarters of all U.S. households — and an overwhelming majority of the uninsured — are either in the 10 percent or 15 percent tax bracket or earn too little to owe income tax.[6] In estimating a similar proposal included in the fiscal year 2005 budget, noted

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Accounts and Catastrophic Health Insurance Plans: A Numerical Analysis of Winners and Losers,@ Urban Institute, April 1996; American Academy of Actuaries, AMedical Savings Accounts: Cost Implications and Design Issues,@ May 1995; Daniel Zabinski et. al., AMedical Savings Accounts: Microsimulation Results from a Model with Adverse Selection,@ *Journal of Health Economics*, April 1999, p.195-218; and Gail Shearer, AThe Health Care Divide: Unfair Financial Burdens,@ Consumers Union, August 10, 2000 (relying on Lewin Group estimates).

[5] Preliminary enrollment data offered by HSA proponents have not refuted these adverse selection and tax sheltering concerns and some recent data show that HSAs are primarily attractive to healthy, affluent individuals. Park and Greenstein, *op cit*.

[6] In an analysis issued in 1998, the General Accounting Office found 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. Another study states that roughly half of the uninsured have no tax liability. Jonathan Gruber, "Tax Policy for Health Insurance," National Bureau of Economic Research, December 2004.

M.I.T. health economist Jonathan Gruber found that only 1.1 million individuals — 13 percent of the nearly eight million expected individuals taking such a deduction — would become newly insured.[7]

- While few of the uninsured are likely to gain health insurance as a result of this deduction, the deduction would likely prompt some employers to drop existing employer-sponsored coverage or, in the case of new employers, to elect not to offer it. The combination of existing HSAs and the availability of the new tax deduction to workers who obtain health insurance in the individual market (rather than through their employer) would almost certainly be regarded by some employers as lessening the need for them to offer coverage. In addition, some employers would be expected to retain coverage but to scale back their contributions to the premium costs of coverage, on the grounds that the new deduction lessens the need for as significant an employer contribution.

  Some workers currently with health insurance may thus become uninsured. In his analysis of a similar proposal in the Administration's budget last year, Professor Gruber estimated that 1.4 million individuals who currently have health insurance coverage would become uninsured as a result of this proposal. Gruber's analysis concluded that the net effect of the deduction thus would be to increase the number of uninsured people by about 350,000. (Some 1.1 million currently uninsured people would gain insurance, while 1.4 million who now have insurance coverage would lose it.)[8]

- The deduction also could encourage a significant number of healthy workers to switch voluntarily from employer-based coverage to the individual market. Some healthy, high-income individuals who work for a firm that offers comprehensive health insurance and requires employees to pay a significant share of the premium costs could decide to shift to the individual market to take advantage of the tax benefits that HSAs and the proposed deduction would provide. Those who leave employer-based coverage for HSAs and the individual market would primarily be healthier, more affluent workers. Sicker workers would be unlikely to follow this path; the high-deductible policies that accompany HSAs would be risky for them. They also would tend to face very high premium costs for insurance policies in the generally unregulated individual market, as a result of their age or less-healthy status. In many states, insurers can also exclude individuals in poorer health entirely.

- If substantial numbers of healthy, affluent workers opt out of comprehensive employer-based coverage while less healthy workers remain in it, however, premiums for comprehensive employer-based coverage will necessarily rise, since those who remain in such coverage will constitute a pool that is sicker and more costly 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.

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[7] See Edwin Park and Robert Greenstein, "Proposal for New HSA Tax Deduction Found Likely to Increase the Ranks of the Uninsured," Center on Budget and Policy Priorities, May 10, 2004.

[8] Park and Greenstein, *op cit*.

- In addition to being ineffective in covering more of the uninsured and likely weakening employer-based coverage, the deduction would be costly. Last year's deduction proposal was estimated to cost $33 billion over 10 years, according to the Joint Committee on Taxation. The proposed deduction also would place a strain on state budgets. State income tax codes generally conform to the definition of taxable income in the federal income tax code, and many states consequently would experience revenue losses if the proposed deduction became law.

Increasing the Limit on Tax-Deductible Contributions to HSAs

Under current law, an individual with a HSA may take a tax deduction for contributions that he or she makes to the account (up to the amount of the deductible in his or her high-deductible insurance policy), as long as the contributions do not exceed an annual limit, set at $2,700 for individuals and $5,450 for family coverage. The President is expected to propose increasing these annual limits, potentially setting them as high as the out-of-pocket limits required of high-deductible plans under HSA rules: $5,250 for individuals and $10,500 for families. This would nearly double the amount of tax-deductible contributions to a HSA that would be permitted each year.

- HSAs, however, already provide unprecedented tax-sheltering opportunities. That is because they violate a long-standing bright line rule in the tax code — that if contributions to a savings or retirement account are tax deductible and earnings on the account compound tax-free, withdrawals from the account are treated as taxable income. This is how traditional Individual Retirement Accounts (IRAs) and 401(k) plans have long worked. (Other accounts like Roth IRAs allow tax-free withdrawals but the contributions are *not* tax deductible.) HSA's, by contrast, allow *both* tax-deductible contributions *and* tax-free withdrawals, as long as the withdrawals are used to pay for out-of-pocket medical costs.

- Moreover, unlike under traditional IRAs, there are *no income limits* on participation in HSAs. As a result, affluent individuals who have reached the maximum annual contribution limits on their IRA or 401(k) plans — or who are ineligible to make tax-deductible contributions to IRAs because their incomes exceed the IRA income limits — can use HSAs to shelter a greater share of their income for retirement.

- As a result, this proposal could allow high income individuals in tax year 2006 to shelter tax-free up to an additional $10,500 a year in a HSA, in addition to a maximum of $15,000 in their 401(k) plan ($20,000 of they are age 50 or over). This provision thus would make it more likely that HSAs would be used as a tax shelter by affluent taxpayers.

- Making the tax sheltering opportunities with HSAs more attractive could significantly increase participation in HSAs and increase the ongoing revenue losses to the U.S. Treasury related to these tax-free accounts.

- The official 5-year and 10-year cost estimates of this provision will mask some of its actual long-term costs. That is because some high-income individuals may shift a portion of contributions to IRAs (or 401(k) plans) to HSAs instead. Because a large percentage of retirement income goes to pay for health care, affluent individuals are likely to find contributions to HSAs more attractive than contributions to IRA (and 401(k) plans), since

withdrawals in retirement from traditional IRAs and 401(k)s are taxed as ordinary income, while withdrawals from HSAs would be tax free to the extent that the amount withdrawn in any year did not exceed the individual's out-of-pocket health care costs in that year. (To the extent that withdrawals from HSAs in retirement exceeded the individual's out-of-pocket costs, the additional amount withdrawn would be taxed as ordinary income, just as would occur with IRA and 401(k) withdrawals.) If, as a result, funds are shifted from IRAs and 401(k)s to HSAs and withdrawn in retirement on a tax-free basis, an already grim long-term fiscal outlook will become still worse.

- As with the premium deduction, this is likely to have large, lasting effect on state budgets. Because many state tax laws are tied to the federal tax code, deposits to HSAs would be deductible for income tax purposes as well and withdrawals would be free.

- Finally, because expanding the tax benefits of HSAs is likely to greatly increase participation in HSAs, it is more likely that adverse selection will occur, drive up premiums for comprehensive insurance and make such coverage less affordable over time.

Deduction for Out-of-Pocket Medical Costs

The President also may propose a new deduction for all out-of-pocket medical costs. The White House is reportedly following to some extent a health plan developed by economists John Cogan and Glenn Hubbard and law professor Daniel Kessler as a "blueprint" for health reform.[9] Cogan, Hubbard, and Kessler argue that the current tax system biases people towards the purchase of "pre-paid" health care through generous insurance plans, because it allows employees to exclude health insurance premiums from their taxable income but requires health expenses to be paid out of after-tax dollars. They argue that making health expenses tax deductible would "level the playing field" between paying for health care through insurance and paying for health care out of pocket. The result, they argue, is that people would choose plans with higher deductibles and copayments and would spend less on health care as a result.

The argument for "leveling the playing field" may have some merit, but the Cogan, Hubbard, Kessler plan would accomplish it in an inequitable and costly manner that would extend the existing inequities in the health tax system rather than ameliorate them.

- The plan would be a highly regressive subsidy for health expenditures. The existing tax exclusion for employer-provided health insurance is already regressive and, as a result, may not be the most effective use of federal resources to providing coverage and controlling health care costs. (The vast majority of Americans, however, obtain their health insurance coverage through their employers, and employer-sponsored insurance remains the primary in the United States to pool risk across healthy and less health individuals.) Instead of modifying the existing exclusion to increase health care coverage among low- and moderate-income individuals, the Cogan, Hubbard, Kessler proposal would instead extend similar tax treatment to all out-of-pocket medical costs. This means that the government would pay 35

[9] John Cogan, R. Glenn Hubbard, and David Kessler, 2006, *Healthy, Wealthy and Wise: Five Steps to a Better Health Care System*, Washington, DC/Stanford, CA: AEI/Hoover Institution Press."

percent of medical costs for households in the top tax bracket (generally those making over $350,000 or more) while paying only 15 percent of costs for the plurality of Americans in the 15 percent bracket. A large number of Americans, including half of the uninsured, would get no help at all paying health expenses because they pay no taxes.

- The plan also could contribute to employers dropping health insurance. There is a strong policy rationale for the lack of a "level playing field" between health insurance and other health costs, in that it gives employers a strong incentive to offer health insurance, helping to overcome potential adverse selection problems and leading to more pooling of risk among healthier and less-healthy people. The Cogan, Hubbard, Kessler plan would take away most of that incentive.[10] A plan like it would require some alternative mechanism for pooling people in health insurance, such as a buy-in to the Federal Employees Health Benefits Program (FEHBP). The President does not appear likely to propose any of these mechanisms.

- The availability of the deduction also could encourage employers to scale back the health insurance plans they offer to their workers on the theory that the deduction better enables employees to incur greater cost-sharing and to pay for services not covered by the insurance. Such steps by employers would be especially disadvantageous for low- and moderate-income workers, for whom the deduction would provide no assistance or only a small tax subsidy to help pay for the resulting increase in out-of-pocket costs for medical care.

- The proposal also could be very expensive. Cogan, Hubbard, and Kessler estimate the gross cost of their proposal as $27 billion a year. They contend that savings it would generate would lower the net cost to $8 billion annually. Respected Princeton University health economist Uwe Reinhardt, however, estimates that the annual cost in 2007 could be about $50 billion to $72 billion. These tax cuts also would reduce state revenues.

- Finally, the proposal would make the tax code substantially more complicated. The President's Tax Reform Commission argued, with merit, that the tax code is overly complicated, warning that "tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers create complexity and instability, impose large compliance costs, and can lead to inefficient use of resources."[11] The Cogan, Hubbard, Kessler proposal would further these inefficiencies. Douglas Holtz-Eakin, the former CBO Director and Chief Economist of President Bush's Council of Economic Advisers, described the proposal as "really bad tax policy" citing the administrative complications inherent in determining what expenses would qualify as medical deductions.[12] As Holtz-Eakin observed, this could even extend to items like running shoes which, it could be argued, are "preventative medicine." This would not only give substantial discretion to the IRS, but would open a huge window for lobbyists to push for purchases of the services or products their clients provide to be classified as deductible.

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[10] Cogan et al argue that there would still be some incentive: under their proposal employer contributions to health insurance would still be excludable from payroll taxes while out-of-pocket health costs would not be. This, however, is considerably smaller than the incentive in existence today. With less of an incentive, there would be less employer coverage.

[11] President's Advisory Panel on Tax Reform, 2005, *Simple, Fair & Pro-Growth: Proposals to Fix American's Tax System.*

[12] Gosselin, *op cit*.