Health Savings Accounts and Health Tax Credits

by

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For most of the post-World War II period, the tax law favored third-party health insurance over individual self-insurance. The reason: employer-paid premiums were excluded from the employee's taxable income, while employer deposits to a savings account from which to pay medical bills directly were subject to income and payroll taxes. The Medicare Modernization Act of 2003 changed that, by allowing HSA deposits to receive the same tax treatment as third-party health insurance premiums. Today the tax law is essentially neutral.

Health Insurance Tax Credits. There are a number of proposals to replace the current system of tax subsidies for health insurance with a universal, refundable tax credit. Other proposals would limit the amount of the tax exclusion, In all its forms, these proposals would focus the tax subsidy on core insurance that we want everyone to have, leaving them to purchase additional insurance with after-tax dollars. The incentive effects are straight forward: at the margin, people will be encouraged to compare a dollar's worth of insurance to a dollar's worth of other goods and services. Also, if people find ways to economize on their health insurance costs, each dollar they save is a dollar they can devote to other purposes. As a result, people will reap the full benefits and bear the full costs of the decisions they make. Under the current system, roughly one-third to one-half of any dollar of waste is borne by the IRS and, roughly, from one-third to one-half of the benefit of every dollar of waste eliminated accrues to the IRS. Under the tax credit system, people cannot lower their taxes by buying more insurance. Nor do they face higher taxes if they buy less insurance.

What is the role of the Health Savings Accounts under this new tax regime? Should we try to maintain tax neutrality? Or, should we bias the choice between third-party insurance and self-insurance in one direction or the other.

Options for the Tax Treatment of HSA Deposits. Given a lump sum, refundable health insurance tax credit, there are basically three alternatives for HSA deposits:

a. *Allow before-tax deposits to a tax favored account* (Current System). Clearly, this is not neutrality. If additional third-party insurance must be purchased with after-tax dollars, but HSA deposits can be made with pretax dollars, this option would clearly bias the system in favor of self-insurance. Further, if we change the HSA design by allowing more flexible, wrap-around accounts (see below), this option runs the risk of allowing employers and employees to undo the good incentive effects we hope to achieve by the credit in the first place.

b. *Let after-tax deposits be made to nontax-favored accounts.* Essentially, this is like asking your employer to send part of your take home pay to your savings account. On the surface, this may appear to be a neutral option, but it really isn't. One way to think about third-party insurance is to realize that the average enrollee gets back in benefits an amount equal to what he pays in premiums. But the premiums are steady from year to year, while the benefits gyrate — depending on episodes of sickness. The insurer is able to carry over unspent funds (untaxed) from year to year in order to match spending and premium income over the long haul.

   For self-insurance to be equally attractive, the individual also needs to be able to carry over unspent HSA funds from year to year. Neutrality implies tax-free growth.

c. *Let after-tax deposits be made to a tax-free account (the Roth HSA)*. With this account, there are after-tax deposits, tax-free withdrawals for health purposes (during the insurance period), and tax-free withdrawals for any purpose (after the insurance period).

Economists like this idea because it gets the incentives right at every margin. (See my attached *Health Affairs* paper with Mark Pauly.) The choice between third-party insurance and individual self-insurance, the choice between health care and other goods and services, the choice between current health care and future health care and between future health care and future other goods and services — all these choices are made on a level tax playing field.

The Design of Roth HSAs. The most important impediment to the growth of HSAs is that the design required is highly rigid. It makes no economic or insurance sense to require the same deductible for every service. Ideally, the account should be completely flexible, wrapping around any third-party insurance plan — serving as a source of funds for any expense not paid by the third-party insurer.

Of course, there must be some limit to what can be deposited, say, $2,500 per person. If there is a worry that this option would disproportionately benefit wealthier taxpayers, we could impose an overall cap on the amount of tax sheltered deposits any individual can make (IRA & 401(k) & HSA, etc).

Uses of the Tax Credit. The primary purpose of the tax credit is to provide dollar-for-dollar tax relief against the expenses of core insurance. However, some people may be able to

purchase catastrophic major medical insurance for the less than full value of the credit. In that case, any excess credit amount should apply against deposits to Roth HSAs.

Some Technical Issues. How should the employer's costs be assigned to individual employees (for tax purposes)? Many employers make risk-rated premium payments to the plans their employees choose (if only *de facto*). However, in assigning insurance costs to employees for the purpose of applying the tax credit, we do not want the employer to assign actual costs or risk-rated premiums. Instead, we want an average cost (over all employees, or over all employees in the same age group). This same principle should apply to Roth HSA deposits. Employers should be encouraged to make risk-rated HSA deposits just as they pay risk-rated premiums. The taxable amount assigned to employees, however, should be averaged over the entire group.

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