JOINT ECONOMIC COMMITTEE DEMOCRATS

REPRESENTATIVE PETE STARK (D-CA) – SENIOR DEMOCRAT

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THE PRESIDENT'S COSTLY TAX DEDUCTION FOR HIGH-DEDUCTIBLE HEALTH INSURANCE OFFERS LITTLE TO THE UNINSURED AND COULD UNDERMINE EXISTING COVERAGE

The Administration's proposal for a new income tax deduction for high-deductible health insurance premiums—available only to individuals who contribute to health savings accounts and purchase high-deductible insurance in the non-group insurance market—fails as meaningful health care reform. The new deduction squanders resources—$25 billion over the next 10 years by the Administration's own estimate—that could be better spent to provide health insurance to some of the nearly 44 million Americans who lack coverage. The new deduction does little to make health insurance more affordable for the vast majority of families. It could conceivably undermine insurance coverage if some employers use the availability of the deduction as a reason to drop coverage and push workers into the more expensive non-group market.

Together with health savings accounts enacted in last year's Medicare prescription drug legislation, the new tax deduction is another tax advantage available only to the healthy and wealthy who can afford the higher out-of-pocket expense and risks of high-deductible insurance. It would raise the combined 10-year cost of these high-income tax-subsidies to $41 billion.

Background: High-Deductible Health Insurance and Health Savings Accounts

The recently enacted Medicare Prescription Drug Improvement and Modernization Act of 2003 established health savings accounts (HSAs)—a new tax-advantaged account for health care spending. While seniors will need to wait until 2006 before they receive prescription drug coverage, access to health savings accounts starts this year. Access, however, is limited to those under age 65. Anyone eligible for Medicare cannot contribute to an HSA.

Only people with qualified high-deductible health insurance coverage can open an HSA. A qualifying high-deductible plan must have an annual deductible of at least $2,000 for family coverage and $1,000 for self-only coverage, and limit out-of-pocket expenses to $10,000 for families and $5,000 for singles.

Contributions to an HSA are tax-deductible, even if the person does not itemize deductions on his or her tax return. Contributions made by employers to an employee's HSA are excluded from gross income and thus escape income and payroll taxes. Contributions can remain in the account from one year to the next until withdrawn. Earnings on amounts in the accounts accumulate tax-free. Withdrawals are also tax-free, if used to pay for qualified medical expenses. Withdrawals for other purposes are fully taxable and, if the account holder is under age 65, subject to an additional 10 percent penalty.

A participant with self-only high-deductible insurance coverage can make an annual tax-deductible contribution of up to $2,600 to an HSA, but in no case more than the amount of the annual health plan deductible. A participant with family coverage can make a tax- deductible contribution of up to $5,150, but again, no more than the amount of the insurance plan deductible.

Under existing rules, account holders cannot make tax-free withdrawals to pay for health insurance premiums, except in certain limited circumstances. The Administration's new proposal would allow an income tax deduction for insurance premiums paid by certain HSA participants. Only HSA participants who individually purchase high-deductible health insurance coverage in the non-group market could take the tax deduction for insurance premiums. Individuals covered by employer-sponsored health insurance plans would not qualify for the deduction.

HSAs Are a Costly Tax Subsidy for the Healthy and Wealthy

The combination of high-deductible health insurance and health savings accounts is a costly tax subsidy for those who can already afford to pay higher out-of-pocket costs—generally the wealthy and healthy.

Estimates done when HSAs were enacted in December of last year projected that the accounts would lose $6.4 billion in income tax revenue over the next ten years. The Administration's budget estimates, released in January of this year, now show a revenue loss of $7 billion from HSAs in just the next five years. In testimony before the Ways and Means Committee on February 3, Treasury Secretary Snow stated that the 10-year cost is in the neighborhood of $16 billion. Adding the cost of the newly proposed tax-deduction for the required high-deductible health insurance policy to the underlying cost of HSAs raises the total cost to $41 billion over 10 years. Because revenue losses grow over time as funds accumulate in the accounts, the cost beyond the 10-year budget window will be even higher.

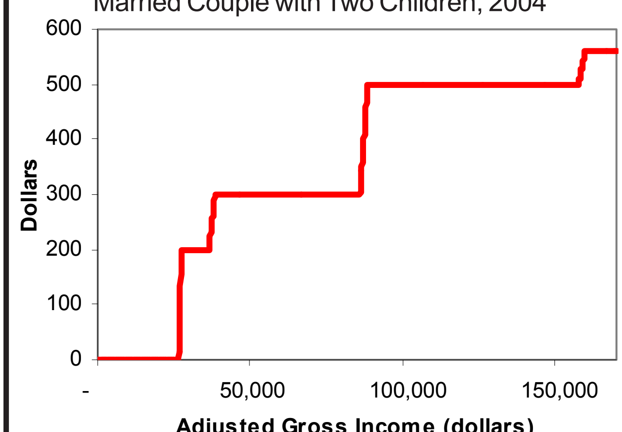
The tax subsidy for very high-income families is substantial. Each dollar contributed to an HSA saves up to 35 cents in taxes—more if state and local income taxes apply. For example, a high-income family with a combined federal and state tax rate of 40 percent would save $2,000 in taxes if it contributed $5,000 to an HSA. Earnings on amounts carried over from year to year are tax free, as are withdrawals used to pay for qualified medical expenses. The combination of tax-deductible contributions, tax-free earnings, and tax-free withdrawals is unique to HSAs. Other tax-advantaged saving accounts such as traditional IRAs, Roth IRAs, or 401(K) type plans allow either tax-deductible contributions or tax-free withdrawals, but not both. Flexible spending arrangements allow tax-exempt contributions and tax-free withdrawals, but funds in flexible spending accounts cannot carry over from year to year.

The tax savings from HSAs for ordinary families are much smaller. A married couple with two children, for example, would not receive any tax benefit from contributing to an HSA unless their income was at least $26,400. Even families with incomes above that level would see minimal tax savings. A middle-income family contributing $2,000 to an HSA would save only $200 in taxes—$300 if their income was high enough to put them in the 15 percent income tax bracket. A family of four would need income of at least $80,200 before they were beyond the 15 percent bracket in 2004 (**Chart 1**).

Chart 1

Limited Tax Savings From HSAs for Most Families

Tax Savings from a $2,000 HSA Contribution for a Married Couple with Two Children, 2004



Source: Joint Economic Committee Democrats calculations.

Ordinary families will have little chance to benefit from the tax advantages of carrying over funds from one year to the next after meeting the expenses of out-of-pocket health care costs. There will be little remaining of annual HSA contributions once families withdraw funds to pay for health care expenses up to the higher deductible, other insurance co-payments, and the expense of non-covered medical expenses.

A Tax Deduction for Premiums Won't Make Health Insurance Affordable for the Uninsured

Most uninsured lack coverage because it is not affordable. The uninsured predominantly are from working families with low or moderate incomes who do not have access to health insurance coverage through their employers, or who cannot afford premiums. In 2002, about one-third of the uninsured were from households with income under $25,000, and two-thirds were from households with income under $50,000 (**Table 1**).

Table 1

Most People Without Health Insurance Are in Low- and Moderate-Income Households

Household Income	Number of Uninsured (thousands)	Percentage of the Uninsured
Less than $25,000	14,776	33.9%
$25,000 to $49,999	14,638	33.6%
$50,000 to $74,999	6,904	15.8%
$75,000 or more	7,256	16.7%
Total	43,574	100.0%

Source: U.S. Census Bureau, Health Insurance Coverage in the United States: 2002, Table 1.

A tax deduction offsets little or none of the cost of insurance for these families. A tax deduction provides no benefit to low-income families—those most likely to be uninsured. The tax subsidy for middle-income families reduces the cost of health insurance by 10-15 percent at most. Even with the tax deduction, families purchasing high-deductible insurance in the non-group market will still will face substantial after-tax costs for premiums.

Providing a tax subsidy for health insurance purchased only in the non-group market could hurt workers who currently have employer-provided insurance coverage. Small employers may choose to drop coverage entirely, forcing workers to purchase insurance in the high-cost non-group market, if the government is willing to pick-up part of those costs through tax subsidies. Because the tax subsidy for the same annual premium is smaller for low-earners than higher-earners, lower-income families will bear a disproportionate share of the costs.

Added Tax-Incentives for High-Deductible Insurance Undermines Traditional Insurance and Fails to Control Spending

Increasing tax incentives for the purchase of high-deductible insurance could eventually lead to a world where high-deductible policies are increasingly common. As healthier families and individuals opt out of traditional coverage, those remaining in comprehensive health plans will be more expensive to insure. They will see their premiums rise, often substantially. This will cause even more people to choose higher deductible coverage, driving up premiums for traditional coverage even further. A significant rise in the cost of traditional low-deductible plans could result in a market in which high-deductible plans became the only real option.

A shift to high-deductible insurance will increase out-of-pocket health care expenses for families that spend more than the deductible in their current plan. Meeting a minimum deductible of at least $2,000 will be a particular burden for lower-income families.

Proponents argue that high-deductible insurance will restrain health care spending, but there are a number of reasons why it may not.

First, while higher deductibles may provide an inducement to reduce spending on covered expenses up to the deductible limit, HSAs create an incentive to increase spending on medical expenses and procedures that health insurance plans typically do not cover. Health savings accounts in effect provide a 10 to 35 percent subsidy—the family's marginal income tax rate—on these uncovered medical expenses, creating an incentive for families to increase spending.

Second, a significant portion of health care spending is for major and costly procedures that exceed the deductible levels required in the law. High-deductible policies would not have any effect on spending in excess of deductible limits.

Finally, by requiring consumers to pay for medical expenses up to the high-deductible amount, high-deductible insurance can discourage lower-income individuals and families from receiving preventive care that could prevent illness or diseases in the future. Existing rules for health savings accounts permit qualifying high-deductible plans to waive the deductible for preventive care, but plans are not required to have this feature.

Conclusion

The lack of health insurance coverage for nearly 44 million Americans and inadequate coverage for millions more is a serious concern, as is the rising cost of health care. Real health care reform should be structured in a way that lowers costs, increases access (especially for the uninsured), and improves the quality of coverage. Tax incentives for the purchase of high-deductible health insurance, either through health savings accounts or the added tax deduction for insurance premiums associated with HSAs, squander tens of billions in scarce resources and fail to accomplish these goals.

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