Joint Economic Committee Democrats

Senator Jack Reed (D-RI) – Ranking Democrat

Economic Policy Brief

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Administration's Proposed Tax Deduction for High-Deductible Health Insurance: A Boon to the Healthy and Wealthy but No Help for the Uninsured

Health care proposals are likely to be prominent in the President's State of the Union address, but it appears that the Administration will mostly recycle many proposals from previous years. Among those proposals is an income tax deduction for high-deductible insurance premiums paid by those who contribute to a health savings account (HSA), but only for insurance purchased in the non-group insurance market.

This limited tax deduction would do little to increase insurance coverage or make health insurance more affordable for the vast majority of families. It could conceivably undermine existing employer-sponsored insurance coverage for some families if small businesses use the availability of the tax deduction as an excuse to drop group coverage, pushing workers into the more expensive non-group market.

Rather than addressing the serious issues of health insurance access and affordability that most families confront, the President's proposal would spend $30 billion in the next 10 years on a tax break that largely benefits families fortunate enough to be healthy and economically secure. HSAs are already attractive to healthy and well-off people who either expect to spend little on health care or who can afford to pay higher out-of-pocket medical expenses. Allowing an additional tax deduction for the high-deductible health insurance required in order to have an HSA further increases the subsidy to high-income households.

Background: High-Deductible Health Insurance and Health Savings Accounts.

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (P.L. 108-173) established health savings accounts—tax-advantaged accounts for health care spending. Only people with qualified high-deductible health insurance coverage can open an HSA. In 2006, a qualifying high-deductible plan must have an annual deductible of at least $2,100 for family coverage and at least $1,050 for self-only coverage, and limit out-of-pocket expenses to $10,500 for families and $5,250 for singles. Access is generally limited to those under age 65. Anyone enrolled in Medicare cannot contribute to an HSA.

Household contributions to an HSA are tax-deductible, even if taxpayers do not itemize deductions on their tax returns (an "above-the-line" deduction). 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 $2,700 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 $5,450, 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 proposal would allow an income tax deduction for high-deductible insurance premiums paid by HSA participants who purchase health insurance in the non-group market. Workers covered by employer-sponsored plans would not qualify for the new deduction.

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, and who face high premiums in the non-group market. In 2004, one-third of the uninsured were from households with income under $25,000, and almost two-thirds were from households with income under $50,000 (**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. A tax deduction for most middle-income families would reduce the cost of health insurance by 15 percent. Even with the tax deduction, families purchasing high-deductible insurance in the non-group market will still 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. Some small businesses 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 for higher-earners, lower-income families will bear a disproportionate share of the costs.

Table 1

People Without Health Insurance for All of 2004

Household Income	Number of Uninsured (thousands)	Percentage of the Uninsured
Less than $25,000	15,102	33%
$25,000 to $49,999	14,784	32%
$50,000 to $74,999	7,842	17%
$75,000 or more	8,092	18%
Total	45,820	100%

Source: U.S. Census Bureau, *Income, Poverty, and Health Insurance Coverage in the United States: 2004*, Table 7.

Health Saving Accounts Are a Costly Tax Subsidy for the Healthy and Wealthy

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

The Treasury Department estimated that the Administration's proposal in last year's budget for an above-the-line deduction for high-deductible insurance premiums paid by certain HSA participants would cost $28.5 billion in lost revenues over ten years.[1] 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 Treasury Department also estimated that existing HSAs together with Medical Savings Accounts (a smaller, experimental, precursor plan) will cost about $16 billion in lost revenues over the next 5 years. Assuming conservatively that the 10-year cost of HSAs is only twice the 5-year cost, adding in the additional cost of the proposed tax-deduction for the required high-deductible health insurance policy to the underlying cost of HSAs raises the total cost of the subsidy to $60 billion in the next 10 years.

The tax subsidy for 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-deductible contributions and tax-free withdrawals, but funds in flexible spending accounts cannot carry over from year to year and do not accumulate tax-free earnings.

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 the couple's income was over $24,000. Families with incomes above that level would see modest tax savings. A middle-income family with income over $40,000 would save only $300 in taxes by contributing $2,000 to an HSA. A family of four would need income of nearly $85,000 before its tax saving exceeded $300 (**Chart 1**).

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 insurance deductible required to have an HSA, other insurance co-payments, and the cost of non-covered medical expenses.

High-Deductible Insurance Could Undermine Traditional Insurance and Fail to Control Spending

By increasing the incentives for healthier people to choose high-deductible plans over traditional plans, additional tax incentives for high-deductible policies could undermine traditional insurance. As healthier individuals leave traditional plans, those remaining in the plans will be those who are more expensive to insure. Insurers will have to raise premiums to cover their expenses, driving more people into high-deductible plans. In the extreme, such a vicious cycle could result in a market in which high-deductible plans are the only real option.

Being forced into a high-deductible insurance plan would increase the out-of-pocket health care costs of families whose medical costs are already greater than their deductible in a traditional plan. Meeting a minimum deductible of $2,100 or more would be a particular burden for lower-income families.

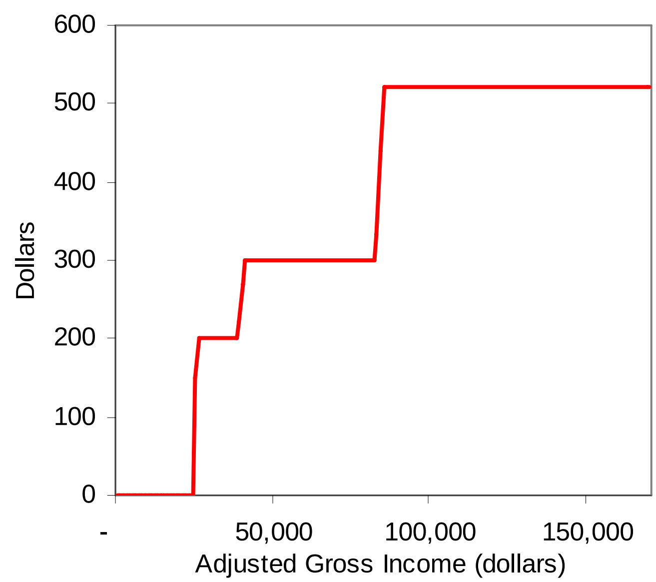
Proponents argue that high-deductible insurance will restrain health care spending, but there are a number of reasons why it may not.

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 federal subsidy – the family's marginal income tax rate – for 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 limits

Chart 1

Expected Tax Savings from a $2,000 HSA Contribution for a Married Couple with Two Children, 2006, by Income



Source: Joint Economic Committee Democrats calculations required in the law.[2] High-deductible policies would not have any effect on spending in excess of the deductibles.

Finally, by requiring consumers to pay for medical expenses up to the high-deductible amount, high-deductible insurance discourages 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. There is little evidence to suggest that people successfully differentiate between necessary and unnecessary procedures when choosing how to spend their health care dollars.

Conclusion

The lack of health insurance coverage for more than 45 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 associated with health savings accounts would cost billions in lost tax revenues and fail to accomplish these goals.

Endnotes

[1] Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2006 Revenue Proposals," February 2005, p. 24.

[2] Economists from the Urban-Brookings Tax Policy Center found that more than 95 percent of medical expenditures by insured working families exceeded the HSA-required deductibles. See Linda Blumberg and Leonard E. Burman, "Most Households' Medical Expenses Exceed HSA Deductibles," *Tax Notes*, August 16, 2004, p. 759.

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