Health and Taxes

By Martin Feldstein

The Health Savings Accounts that President Bush recently signed into law may well be the most important piece of legislation of 2003. These new tax and medical insurance rules have the potential to transform health-care finances, bringing costs under control and making health care reflect what patients and their doctors really want. It is remarkable that this legislation has received so little public attention.

One thing is certain: HSAs are good for you.

Today's high cost of health care reflects the way that the tax law has subsidized the use of insurance to pay for health care. Private insurance now pays 70% of all nongovernment health-care costs and more than 90% of nongovernment hospital costs. Because out-of-pocket payments at the time of care are only a small fraction of the total cost of producing that care, individuals naturally want "the best care" that medical science can provide. And the demand for that high-tech care drives medical innovation toward new and more expensive modes of treatment.

The demand for the typical health-insurance policy reflects the tax provision that allows employees to exclude payments for health insurance from their taxable income. Since the annual premium for a family may be as much as $10,000, the resulting tax saving is a very large subsidy for the purchase of the kind of comprehensive, low-deductible insurance policy that drives up health-care costs and that has led to the imposition of controls on patient choice. In the aggregate, this exclusion reduces Federal income-tax collections by $120 billion a year, essentially a $120 billion subsidy for purchasing the wrong kind of insurance.

Although HMOs and other forms of managed care that aim at controlling health costs have become increasingly common in recent years, health costs continue to take a growing share of GDP. And neither patients nor doctors are happy when HMOs restrict the health care that can be given, or limit the time that doctors can spend with each patient, or appear to deny patients information about the care that might benefit them.

The new HSA law (a part of the recent Medicare reform bill) eliminates the preferential subsidy for comprehensive insurance by giving the same tax treatment to individuals who set aside income to pay cash for a larger share of their own health care. Anyone under the age of 65 can establish a Health Savings Account if they have a "qualified" health-insurance plan. A "qualified" plan is an insurance policy that has a minimum deductible of $2,000 for a family and a $10,000 limit on the family's annual out-of-pocket expenses. The deductible is designed to make individuals more cost-conscious in their consumption of health care, and the annual limit on out-of-pocket expenses is there to prevent financial hardship or a lack of care because of an inability to pay. Individuals or their employers can make annual pretax contributions to Health Savings Accounts of up to 100% of the health-plan deductible, with a maximum of $5,150 in 2004.

An individual can withdraw funds from his HSA without paying tax if the money is used for any kind of health bills, including prescription drugs, dental care and long-term care. Any funds not used in one year are automatically carried forward to the future. Individuals can also withdraw funds from these Health Savings Accounts for nonmedical expenses by paying tax as they would for any IRA withdrawal. And the individual pays no tax on the interest, dividends or capital gains earned on the HSA investment.

Here's an example of how such a "qualified plan" and an HSA can substantially reduce costs for a family without increasing its financial risk. California Blue Cross now offers a traditional low-deductible plan (a deductible of $500 per family member, up to a maximum of two) with an annual premium of $8,460. It also offers a high-deductible plan that is similar except that the deductible is $2,500 per family member, also up to a maximum of two. The annual premium for the high-deductible plan is only $3,936, a premium saving of $4,524. The premium saving is so large that it actually exceeds the maximum additional out-of-pocket cost that the family would face if it reached the maximum deductible for both individuals!

The traditional tax rules are the only reason why someone in the past would have chosen the low deductible policy. A family that earns $50,000 faces a marginal tax rate of about 45% (a 27% federal income tax rate, 15% payroll tax rate and a state income tax rate of about 5%) . If the $4,524 premium saving was turned into taxable salary, the individual's net income would rise by only 55% of $4,524, or $2,488. But when the saving of $4,524 is put into a Health Savings Account, there is no tax to pay and the funds can accumulate tax-free.

High-deductible policies give individuals and their doctors an incentive to avoid wasteful health spending. When spending comes from the individuals' own Health Savings Accounts, individuals and their doctors have a strong reason to balance the costs of medical procedures against the potential favorable impact on health. The same incentive can influence the choice among hospitals and among different prescription drugs. And

because these cost incentives reduce the need for HMO rules that limit the availability of care, individuals can have greater scope for choosing the care that they want.

In short, the new HSA tax and insurance rules can be the beginning of successfully controlling medical spending and bringing it in line with what patients and their doctors really think is best.

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