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Current Tax Laws Hamper Consumer-Driven Health Care

A few simple reforms could give consumers greater freedom

By: Devon Herrick

Consumer-driven health care has advanced more in the past decade than in any other period in history. Health reimbursement arrangements (HRAs), for example, received a boost from the Internal Revenue Service in 2002. IRS Revenue Ruling 2002-41 clarified that unused amounts from reimbursement arrangements can be carried forward tax-free. HRAs were already in existence, but many firms were afraid to use them because of questions about whether such carry-forwards were taxable. A medical savings account (MSA) pilot project in 1996 led the way to enactment of federal legislation making health savings accounts (HSAs) possible in January 2004.

These consumer-directed reforms are just the first steps. Additional reforms

would help consumers take control of their health care dollars.

Flexibility for HSAs

HSAs are giving millions of Americans the opportunity to control some of their health care dollars. Yet HSAs could easily be made more flexible. The design is codified in tax law in ways that unnecessarily restrict consumers.

Under current law, for example, employers cannot establish low deductibles for drug coverage or wellness programs. Nor can they create accounts designed specifically for patients with chronic diseases, such as asthma or diabetes. MSAs in South Africa

currently have such flexibility.

According to a 2002 National Center for Policy Analysis study by Shaun Matisonn, "Whereas a U.S.-type MSA plan has an

across-the-board deductible covering all medical services, South African MSA plans typically have varying deductibles. For example, a representative plan has no deductible for hospital care on the theory that patients exercise little discretion within hospitals, but a \$1,100 deductible for annual outpatient care on the theory that patients have far more discretion in that setting.

"The high deductible also applies to prescription drugs. However, for chronic conditions, for which skimping on medication could lead to more expensive care later on, the deductible drops back to zero."

In addition, HSAs have a maximum annual out-of-pocket expenditure limit of \$5,000 for individuals and \$10,000 per family. A person with pre-existing conditions might be unable to obtain an HSA because his or her yearly expected

out-of-pocket costs exceed the maximum allowed. To solve that problem, the federal government could allow people to deposit pre-tax funds into HSAs even if they want to self-insure for higher amounts or cannot obtain insurance at all.

Flexibility for FSAs

At the end of each year, hundreds of thousands of U.S. workers scramble to spend down their flexible spending accounts (FSAs). Some buy designer eyeglasses; others schedule a last-minute appointment for teeth cleaning ... all because current federal regulations governing FSAs force them to "use it or lose it" at the end of each year. President George W. Bush has proposed allowing up to \$500 in unused FSA funds to roll over each year. An even bolder reform could allow workers to carry forward unspent FSA balances of nominal size until retirement, as long as the system was not used for sheltering non-health care funds from tax liability. Workers also could be allowed to roll over accumulated balances into other tax-deferred accounts, including HSAs, Individual Retirement Accounts, 401(k)s, and 403(b)s.

Adding Portability

In addition, allowing workers to contribute to FSAs as needed, rather than just once a year, would make them more attractive. Workers could deposit funds to pay for dental insurance premiums and routine teeth cleaning, as now, but also could later put in additional funds to cover the cost of an unexpected root canal. Federal law allows only employers to create FSAs. Workers whose employers do not provide these plans cannot purchase them through a third-party administrator. A useful reform would be to allow workers in firms that do not have FSAs, and the unemployed, to obtain FSAs from third parties such as banks. Another problem with FSAs stems from an IRS requirement that employers give workers immediate access to an entire year's contributions even though their balances in January might be low. To limit the risk of departing employees leaving negative FSA balances that are uncollectible, many employers place limits on the amount of funds workers may place in their account. But workers with chronic conditions may have greater needs. A better solution would allow employees to contribute

more and employers to limit the availability of funds until actual contributions have been made.

Flexibility for HRAs

HRAs are another type of personal account from which employees can pay directly for their medical care. Currently, HRA funds must be spent only on qualified medical services. This means employees can never withdraw HRA funds as cash for non-medical uses and hence are barred from choosing between health care and other uses of the money. Without clear-cut incentives, however, employees will not modify their behavior and become wise consumers of health care. To create these incentives, employees could be given a clear property right to their HRA balances and permitted to withdraw unused balances in cash--after paying income and payroll taxes on the funds. These accounts also could be made portable, traveling with employees from job to job. Employees who know they may not benefit from prudent consumption of health care services have less incentive to consume wisely. Finally, contribution restrictions could be relaxed. Currently, only the employer can fund an HRA program, and no such

Current Tax Laws Hamper CDHC

HEALTH CARE NEWS

April 1, 2005

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program can be tied to salary reduction or deferred compensation. These restrictions serve no useful purpose.

Freeing Employer-Purchased Insurance

Under current federal law, employers cannot buy individually owned insurance for their employees. Specifically, lawyers interpret the Health Insurance Portability and Accountability Act of 1996 (HIPPA) as saying that if employers pay for employee health insurance with untaxed dollars, the insurance purchased must be group insurance.

This type of insurance ends when the employee changes jobs, and it often changes every 12 months anyway, even with the current employer.

A better alternative would be to allow employers to purchase personal and portable insurance that is individually owned by their employees. Even though employers would pay some or all of the premiums, employees could take the insurance with them if they moved to a new job.

Accommodating Different Households

Two-earner households are common these days. Part-time work is also common, especially for single

mothers and spouses in two-earner couples.

Employee benefits law, however, operates on outmoded assumptions about how families live and work.

Employees who turn down employer-provided health insurance because they have coverage at a spouse's place of work should be able to get higher wages instead. Part-time workers should likewise be able to choose between health insurance and higher wages. Under current law, employers cannot give employees that option without jeopardizing the tax-free status of their entire health benefits program.

Any one of these health reforms would expand consumer choice and increase the efficiency of health care markets. Implementation of all of them would not solve all our health care financing problems--but it would be a good start.

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