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Health Savings Accounts: Answering the Critics, Part I

by John C. Goodman and Devon M. Herrick

Critics of Health Savings Accounts (HSAs) have a litany of complaints. They are essentially the same complaints critics made a decade ago, at the dawn of the consumer-driven health care revolution. We now have evidence that consumer-driven health care works. In addition to the decade of experience with Medical Savings Accounts (MSAs) in South Africa, Americans have had six years' experience with an MSA pilot program, four years with similar accounts called Health Reimbursement Arrangements (HRAs) and two years with HSAs themselves.

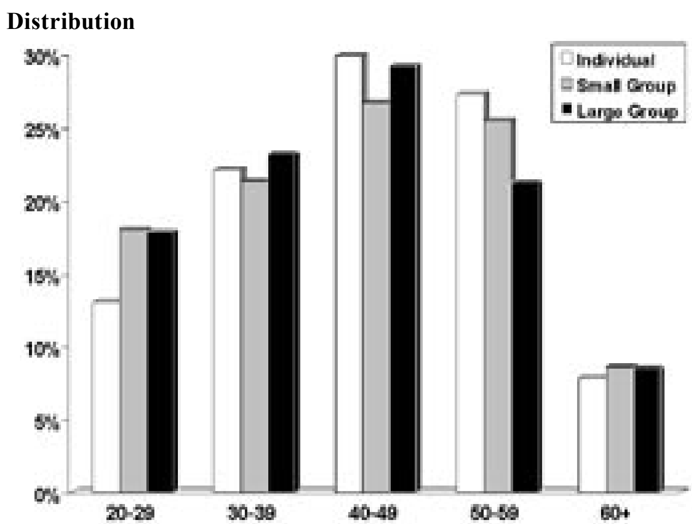
What follows are answers to some of the most important criticisms.

Criticism: HSA plans are merely high-deductible health insurance in a different guise. Reply: Like other forms of insurance, health insurance is cheaper if the deductible is higher; and many people choose higher deductibles in order to reduce their premiums. Well before HSAs were available, the average deductible was $2,500 for individual and family policies sold by Mutual of Omaha, and about 40 percent of the policies had deductibles of $5,000. High deductibles mean that the patient may have to pay a significant amount of money out of pocket. This is a problem for individuals who are living paycheck to paycheck and do no not have the funds to pay expenses when they arise.

The idea behind HSAs, however, is very different: People should have a way to set aside some of their own health care dollars through accounts they own and control. This allows them to use pretax dollars to pay for deductibles and copayments, services not covered by their health plan, and future health care expenses as well. In this way, individual patients manage health care dollars instead of having those dollars managed by employers, insurance companies or government agencies. The evidence shows that people do this job very well.

Criticism: HSAs only benefit the young. Reply: A representative cross-section of people are signing up for HSAs. The largest group of adults in HSAs is in their 40s. In fact, nearly 60 percent of adults in these plans are 40 years of age or older. [See the figure.]

Adults Covered by HSA Plans by Age



Source: Hannah Yoo and Teresa Chovan, "January 2006 Census Shows 3.2 Million People Covered by HSA Plans," America's Health Insurance Plans, March 2006.

Critics could cite two recent Government Accountability Office reports that appear to bolster the claim that HSAs favor the young. The GAO found that the average enrollee in new HSA plans offered under the Federal Employees Health Benefits Program is younger than the average enrollee in traditional plans. However, this finding is based on all enrollees, including retirees who are not eligible for HSA plans. Excluding retirees, the average age of current federal workers enrolled in both types of plans is not significantly different: 44 to 45 years for HSA plans versus 47 years for the PPO plans.

Criticism: HSAs primarily benefit the healthy. Reply: Unfortunately, all insurance is designed for the healthy. Look in the Yellow Pages. Go on the Internet. You won't find any ads for health insurance for diabetics. Or asthmatics. Or other patients with chronic diseases. With HSAs, however, we at least have the potential to usher in a radically new approach.

Numerous studies have shown that diabetics, for example, can manage their own care with results as good as or better than traditional therapy. HSAs can align

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financial incentives with health incentives: diabetics who make good choices about their care will not only reap health benefits; they will also realize monetary benefits. For people who never see a doctor, an HSA is a savings account. For people with an ongoing health problem, an HSA is an opportunity to manage their own care and reap rewards from doing so.

People with significant health problems also benefit from HSA plans in another way. HSA plans have a maximum out-of-pocket expenditure, whereas traditional PPO plans have no such limit. That is why out-of-pocket spending for such patients often goes down when they switch to HSA plans.

Criticism: HSAs primarily benefit the wealthy. Reply: Because HSA deposits are either deducted or excluded from taxable income, the tax advantage depends on one's tax bracket. Higher-income people face higher marginal tax rates.

Someone in the 15 percent federal tax bracket gets less of a tax subsidy than someone in the 35 percent bracket. But this is true of all deductions in the tax code — from home mortgages to interest payments. It is also true of the exclusion for all other employee benefits — from pensions to day care to post-retirement health care and disability benefits. Moreover, this tax subsidy is provided for all health coverage obtained though one's job, not just for HSAs. So allowing a tax deduction for HSA contributions merely places self-insurance on an even playing field with third-party insurance.

Many HSA critics are highly selective — complaining about the regressivity of HSA deductions while not uttering a whimper of protest over the same regressive feature of all other exclusions, including employer-paid premiums to HMOs. The regressivity of tax subsidies for HSAs would vanish, by the way, if they were incorporated into a flat tax; but the critics rarely mention this fact.

Further, the ability to shelter funds in a tax-free growth account is a lot less attractive today — given that dividends and capital gains are taxed at 15 percent, whereas HSA withdrawals for nonhealth-care uses are taxed as ordinary income. In general, the wealthy do not need HSAs. We developed the HSA concept because many families are not good at saving for health needs. They tend to live pay-check-to-pay-check and do not have extra money to pay for a doctor visit when they need one. HSAs make sure that the funds are there when the health need arises.

Criticism: HSAs are the "Mother of All Tax Shelters." Reply: HSAs are the only account in the tax code that allows tax-free deposits, tax-free growth and tax-free spending (that is, on health care). Does this mean the account is getting undue tax relief? No.

If people never spend their HSA funds on health care, the account functions just like a 401(k) account — and the same tax rules apply. On the other hand, if the account owner has medical expenses, the tax treatment is the same as that accorded to third-party health insurance. Premiums paid by an employer to Blue Cross or some other insurer are made with pretax dollars, which are placed in a reserve fund that grows tax free. When medical bills are paid, they are paid with dollars that have never been taxed. The tax treatment of HSAs is exactly the same.

Criticism: HSAs are a costly tax break we can't afford. Reply: Federal and state tax subsidies for health insurance already total $209 billion each year. By contrast, all of President Bush's health proposals combined will cost only $15.6 billion a year. Since the tax deduction for group insurance is unlimited, employers have had an incentive to offer "Cadillac" plans that cover every type of service and encourage unnecessary spending. A cap on these subsidies could easily pay for HSA expansion and other Bush health initiatives.

Also, the president's proposal to make health insurance more affordable will reduce the number of people who depend on Medicaid, the State Children's Health Insurance Program or free care programs. Thus, the tax break must be balanced against money the government saves in other programs.

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