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Not a Panacea...

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In his State of the Union, President Bush proposed to gradually change the way U.S. health care is purchased. For individuals, his proposals to expand Health Savings Accounts (HSAs) offer immediate relief from the high cost of health care and the means for gaining more control over medical decisions. For the U.S., the president's proposals offer an opportunity to rein in the rising costs of care.

Under the president's plan, anyone who buys a qualifying health-insurance policy with a minimum annual deductible of \$1,050 (\$2,100 for a family) would be able to exclude all premiums and any copayments from income used to compute both income and payroll taxes. It applies equally whether an individual buys insurance through an employer or on his own. And the tax exclusion applies to all out-of-pocket expenses for covered health-plan services, including the policy's deductible or coinsurance requirements.

This would go a long way to correcting a fundamental flaw in federal health policy. Currently, employer-provided health insurance is exempt from income and payroll taxes. But, with few exceptions, out-of-pocket spending and individually purchased health insurance must be financed with after-tax dollars. This is bad public policy. The tax preference for health insurance over out-of-pocket spending has helped create a system dominated by employer-provided insurance with low deductibles and low copayments -- a system in which five out of every six dollars are spent by someone other than the person receiving the care. Not surprisingly, this is excessively costly and wasteful.

The president's proposals will reduce health costs by expanding the tax incentives to purchase insurance policies that have high deductibles and coinsurance rates. Such plans, while providing protection against catastrophic expenses, require individuals to use their own money to finance routine costs. Consumers therefore will be more cost-conscious and curtail their use of wasteful and unproductive health-care services.

The president's plan would also expand the number of people covered by HSAs and the amount that can be contributed to these accounts. First, it would allow individuals who purchase a qualifying health-insurance policy on their own to set up an HSA and make tax-free contributions to the account. Currently, HSAs are limited to health-insurance policies purchased by an employer; the proposed expansion will make HSAs available to a broad class of individuals who do not have employer-provided insurance, including the unemployed, early retirees and workers in firms that do not offer health insurance.

Second, the proposal allows contributions to HSAs to cover coinsurance and deductibles. As of now, HSA contributions are limited to the amount of a policy's deductible. This has had the unfortunate result of tilting qualifying plans toward those with high deductibles and either no or low coinsurance rates. Yet coinsurance is as effective as insurance deductibles at curbing the use of unnecessary services. By removing the limitation, the president's plan allows employers and workers to strike a better balance between deductibles and coinsurance rates. It will also provide financial relief to the chronically ill, who bear a greater burden from coinsurance payments than from deductibles.

Third, the president proposes a refundable tax credit to low-income persons to encourage them to

purchase insurance and set up an HSA. Although we are concerned about the size of the credit, it will nonetheless provide the incentive and the opportunity for low-income people to choose a private plan tailored to their needs, instead of relying on heavily bureaucratized, state-run Medicaid programs.

The criticisms levied against HSAs are at odds with the evidence. Some claim that higher deductibles and copayments don't restrain spending overall, because spending is disproportionately concentrated among people who have already exceeded their policy's annual deductible or out-of-pocket maximum. Others claim that higher deductibles lead people to postpone critically needed care. Although the extent to which higher deductibles and copayments limit spending is a matter of debate, the fact that they do is not. In addition, as studies show, these reductions can be achieved without significant adverse consequences for health outcomes.

Critics also claim that higher deductibles and copayments will lead employers to shift health-care costs to workers. But they ignore the fact that health insurance policies with higher deductibles and copayments have correspondingly lower premiums, and that these reductions will be passed on to workers in the form of higher wages. Indeed, the same critics acknowledge that employers shift increases in insurance premiums to workers. If so, why shouldn't workers reap the benefit of lower premiums?

Finally, some observers claim that HSAs serve mainly as a savings vehicle for high-income people. Yet, according to a recent survey by the Employee Benefits Research Institute, one-third of people with HSAs have household incomes less than \$50,000.

The president's proposals take a significant step toward equalizing the tax treatment between health insurance and out-of-pocket spending, and between employer-provided and individually purchased insurance. Thus, the plan improves the ability of natural market forces to reign in rising health-care costs. Although we would have preferred that the president's proposals not be limited to high-deductible insurance plans, his proposals are a marked improvement over current law. Of course, the HSA proposal is not a panacea. The president recognized in his remarks that expansion of HSAs is only one tool among many to help ensure that our country's health system remains vibrant. Congress should also consider his proposals to make insurance more portable, test innovative methods of covering the chronically ill, and make the liability system fairer and more predictable.

Health-care spending accounts for about one-sixth of U.S. economic activity, and resolving our long-term fiscal challenges requires reducing health-care costs. The challenge of reforming our health system will only grow more difficult the longer we delay.

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