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ECONOMIC VIEWPOINT

By Glenn Hubbard

A Prescription For Health-Care Reform

An "Ownership Society" agenda has taken center stage in President George W. Bush's agenda for a second term, with proposals for Personal Accounts in Social Security, expanded incentives to save for retirement, and Personal Reemployment Accounts to aid workers in finding a new job. But a central plank of this agenda, and one that can be enhanced to improve markets for health care, is already law: the Health Savings Accounts (HSAs) passed in the recent Medicare reform.

HSAs, which let individuals set up tax-preferred accounts to pay for health care -- so long as they buy high-deductible health insurance -- allow citizens, as the President says, to "own their own health care." Under current law, people can use pretax dollars to fund a deductible of at least \$2,000 for a family and insurance pays expenses above that amount. HSAs can also shore up troubled Medicare and mimic the economic advantage of the Social Security Personal Accounts.

HSAs help make health-care markets work better by removing the tax bias toward third-party payments.

PATIENT-CENTERED HEALTH CARE is a hard concept to implement when direct patient payments make up only \$1 out of every \$6 of expenditures. With insurers paying for even routine care, consumers lack incentives to shop for low-cost, high-value care. Middle-income families receive a huge tax discount by buying employer-sponsored insurance: A household earning \$50,000 gets a subsidy equal to its combined marginal income and payroll tax rate of about 40%.

In the short run, markets cope with this situation by shifting and managing costs. Small employers will probably drop coverage. In the long run, the problems will lead to calls for more government intervention -- bringing price controls and a system responding slowly to innovation.

But a simple change can improve HSAs as a tool of health policy and the Ownership Society: Let all Americans deduct expenditures on insurance and out-of-pocket expenses as long as they purchase at least insurance against catastrophes. That is, people already covered by employer plans could deduct

out-of-pocket expenses. The self-employed with insurance may deduct out-of-pocket expenses. Those now without coverage may deduct both insurance premiums and out-of-pocket expenses if they purchase an individual plan.

The change would level the playing field between medical care through employer insurance and direct out-of-pocket outlays. Acquiring insurance would be encouraged since the tax break is available only with insurance. Importantly, the tax-code bias for high-cost, low-deductible insurance would be removed, allowing for deductibility of out-of-pocket expenses. The tax change reduces the bias against buying insurance on your own, either through your employer or individually.

Such an enhancement of HSAs raises two policy questions. First, as expanded HSAs make individual coverage more attractive, would employer-based insurance unravel? No. Expanded HSAs just remove much of the difference between buying insurance through one's employer or on one's own.

Second, by making more out-of-pocket outlays deductible, wouldn't an enhanced HSA raise costs? No. People will shift to plans with higher deductibles and co-insurance, reducing health-care utilization. John F. Cogan, Daniel P. Kessler, and I have estimated the net decline in spending at more than \$65 billion a year. That drop is achievable without price controls.

But resources no longer spent on health would flow to other, taxable activities: Wages will climb by the amount of the decline in employer premium payments. Besides putting cash in workers' pockets, new income and payroll tax collections will rise enough to cover much of the revenue loss from tax deductibility. HSAs also offer a vehicle through which health assistance to low-income households could be distributed, helping families buy insurance in private markets and save for old-age medical expenses.

Finally, HSAs, and the ownership agenda they represent, are a stark contrast to the vision offered by John F. Kerry. The Kerry plan would spend \$1 trillion over 10 years, expanding government's role in health care. This requires more than the tax increase on high-income earners that Kerry has outlined. And carrying the debate to shoring up Medicare, the Senator's "solve it with tax increases" theme bodes ill for growth, and does little to put the consumer in the driver's seat.

To the patient and voter: Read the prescriptions carefully.

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