



VIEWPOINT

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IRS Gives One to the Little Guy in Health Care Reform

By: Michael Bond

Summary

Ohio is looking for ways to spend \$700 million in surplus welfare money and is being bombarded with ideas about how to do this. In evaluating these ideas, the state should make sure the funds go to programs and services that provide a direct connection between the money being spent and moving a person off welfare.

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Recently consumers of health care in the U.S. received a boost in their efforts to control costs and increase their choice of medical services from an unlikely source: The Internal Revenue Service.

The IRS ruled last summer that employers can claim spending from Health Reimbursement Arrangements, or HRAs, as a health-care expenditure in the same way they deduct traditional health insurance. In an era where most experts are forecasting double-digit health-care inflation, this is good news for everyone.

The HRA concept is simple one. The employer establishes an employee controlled health-care account and deposits funds in it annually of, say, \$2,000. Employees use the HRA for “low dollar” medical expenses such as visits to the doctor, routine exams, and relatively inexpensive illnesses.

This is then combined with a major medical policy that covers all expenses

over, say, \$3,000 in any given year. Employers finance their contribution to the health-care plan through lower premiums that come from higher deductible insurance plans.

The key to the HRA is its use of unused funds. If savings are rolled over to the next year, HRA's can create a financial cushion in the event of a major illness in the future. This gives workers and families a strong incentive to economize on their medical expenditures. The effects could be revolutionary.

As early as the 1980s, the heralded Rand Health Insurance Study found health-care consumers acted prudently and rationally when given the choice. The Rand Institute studied a large group of individuals, splitting them up into one with traditional comprehensive coverage and the other with a high-deductible plan similar to an HRA. The high-deductible group spent approximately 30 percent less than those with no deductible. The two groups experienced no difference in health outcomes!

HRA plans also increase consumer choices. Those with HRAs become their own gatekeepers for health care, choosing how to



HRA plans increase consumer choices.

Source: Corbis

spend their money on the services they believe they need with the doctors they choose. A well designed plan will allow unused balances from previous years to cover out of pocket expenses or expenses incurred when someone changes jobs. Similarly, HRA savings could be used to purchase health, disability, or Medigap insurance when someone retires. Simple legislation by Congress could also allow these funds to be rolled into an IRA for use as additional retirement income.

But what will happen to the small number of individuals who incur high medical expenses in any given year? In most cases, they will still be better off with an HRA.

Lower overall utilization and reduced costs, combined with lower administrative costs, would likely create significant savings to the employer. These savings would be sufficient to cover the costs of the very small number of chronically sick individuals without increasing total medical costs.

Moreover, the National Bureau of Economic Research found that, on average, 10 percent of employees accounted for 80 percent of medical expenses in any given year. As the time period was extended to a work life of 35 years, NBER found that 55 percent of employees accounted for 80 percent of expenditures. In other words, many of the relatively few “sick” individuals with high expenses dropped to low or no usage when they either recovered or, unfortunately, passed away.

The result was that over 95 percent of individuals would have unused HRA balances after a period of 35 years!

Adopting HRA’s on a wide scale thus has enormous implications for improved, more cost-effective health care. Employers would have health-care coverage that gives their employees strong incentives to control costs. Healthy employees would build up large unused funds for future medical and/or insurance purposes (and, with legislation, an additional source of retirement income). Individuals with acute illnesses would also build up substantial accounts. The relatively small number of those with chronic sicknesses and conditions would have the freedom to deal with these problems effectively and with little or no increase in their out-of-pocket expenses.

HRAs help control medical inflation and, perhaps more fundamentally, change the health-care system to one where your doctor’s first question is “How can I help you?” instead of “What kind of insurance do you have?”.

While a small number of firms had been experimenting with this concept despite no assurances on its tax status, the IRS decision opens the path for an unlimited number of firms to offer this type of medical coverage to employees. Employees and companies will benefit from their widespread adoption.

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