

Discussion of Vistnes, Jack and Levinson

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Jessica Vistnes, William Jack and Arik Levinson (VJL) have written a very timely paper on a critically important topic. There is enormous interest in current policy debates in “leveling the tax subsidy playing field”: that is, in offering the same kind of tax subsidies to spending outside of employer-sponsored insurance (ESI) as we offer to employer-sponsored insurance. There are a variety of ways to accomplish this goal, and their paper focuses on one particular approach: flexible spending accounts (FSA), whereby employees can use a wage deduction to pre-finance their out-of-pocket spending.

The central economic question addressed by their paper is whether the existence of an FSA plan at a firm leads that firm to raise the cost sharing charged to employees under insurance plans. The logic is the following. Absent an FSA, health insurance premiums are subsidized, but out of pocket spending is not. As a result, firms distort their compensation toward first dollar health insurance coverage, since they can deduct the resulting higher premiums. But if the playing field were leveled, and both ESI premiums and out of pocket spending were deductible, then employees would demand more efficient high cost-sharing policies.

Their empirical analysis models firm cost-sharing as a function of FSA availability, and they find that having an FSA is associated with higher patient cost-sharing, although their findings are fairly sensitive to variations in the empirical specification. In this discussion, I first review some issues with the VJL’s data and empirical analysis. I then turn to the larger policy issues raised by their discussion.

Data & Empirical Strategy

VJL have used great data: the MEPS-IC data. This is really the best source of information available on the details of health insurance plans for a very large set of employers. Its value is heightened by the fact that only select researchers have access to the data! But there is one data issue on which the paper could have been clearer: what is an FSA? Some employers offer section 125 accounts that only allow for pre-tax premiums – are those captured as well? Or does the employer need to allow for pre-tax treatment of all health costs to qualify as an FSA in their sample?

The larger problem with their paper is the empirical strategy, where the authors are faced with the age-old simultaneity problem: employers jointly choose whether to have an FSA and what co-insurance rate to offer – so how can you say what caused what? They attempt to solve this problem by using three instruments: the age of the firm; whether this is a multi-plant firm; and the percent of workforce eligible for health insurance. In fact, as the authors note, really only one instrument matters: the age of the firm – the others are only weakly correlated with offering an FSA.

An appropriate instrument is one which is highly correlated with the endogenous regressor (in this case FSA offering) and otherwise not correlated with the dependent variable (in this case co-insurance rates). Unfortunately, none of these instruments, on their face, seem to me more naturally associated with FSA offering than co-insurance rates – it seems they would be equally likely to affect both. For example, why should the age of the firm matter for FSA availability but not, independently, for co-insurance rate in the firm's health insurance plan? So while the authors have an excellent data source here, I would challenge them to think harder about how it might be used to devise a more convincing empirical strategy

Policy Issues

An important accomplishment of this paper is to raise a host of interesting policy issues which are quite timely. The first is: should we try to level the playing field for out of pocket costs? As noted earlier, we have a clear bias here in favor of employer insurance spending from the ESI tax subsidy. And the policy prescription recommended by many is to equally subsidize equally out of pocket spending

But this seems to me to violate a rule I have been teaching my children since they were very small: two wrongs don't make a right – they make a wrong-wrong! In particular, I see two major problems with this solution. First, as the authors highlight, if you offer subsidies to out of pocket spending, you have two competing effects. The first is the one the authors try to measure: the reduction in spending through more rational plan design. But the second is the more direct effect: if you subsidize out of pocket spending there will be more of it. In fact, there is still enormous uncertainty about the indirect channel proposed by the authors – despite their valiant efforts, I would still argue we know very little about this key elasticity. But we do have solid evidence on the more direct effect from the RAND Health Insurance Experiment and other studies that subsidizing out of pocket costs will lead to higher spending. The HIE suggested fairly modest elasticities of out of pocket spending in their randomized trial, but recent work by Amy Finkelstein on the introduction of Medicare suggests that these effects can be ten times as large in general equilibrium. Given that we know for sure that out of pocket spending will rise, and we don't know whether plan design will improve, this seems a pretty weak case for concluding that we should add more tax breaks.

But the hurdle for adopting this policy is even higher, because there is a second problem: the tax break has a social cost because we are using net government resources to pay for the new subsidy. This has a deadweight loss that offsets any potential gain to health spending efficiency. Moreover, this is highly regressive policy, since tax break rises with income. So the bottom line is that it is hard to make the case based on existing evidence that social efficiency will rise with this new tax break for out of pocket spending.

The second policy issue is: how do we think about a tax deduction for out of pocket costs (such as with an FSA) vs. tax subsidies tied to high deductible health insurance plans (such as with Health Savings Accounts, or HSAs)? There is an

interesting tradeoff in evaluating these alternatives. On the one hand, at least HSAs force you to buy the type of high deductible plan held by few consumers currently – so they are more clearly having an effect on insurance design.

On the other hand, HSAs are even more expensive – and even more regressive – than are FSAs. HSAs are useless to low income individuals who can't afford the high deductible. And for many high income individuals they are just a tax shelter; these individuals can afford to pay out of pocket for their medical care in any case, so the HSA is used simply as a tax shield. As Jason Furman has shown in past work, this is the most generous tax shield available, since money is tax free going in *and* coming out.

So, in the end, HSAs amount to a more expensive and regressive bribe to hold a particularly cost efficient type of insurance. An important question is the welfare implications of using that mechanism rather than just allowing health cost deductibility. But, once again, the bottom line is that it is hard to justify the subsidization of out of pocket costs in general on efficiency grounds.

The final policy issue relates to another old adage: two wrongs don't make a right – but three lefts do! In this case the three lefts that may be in place in 2009 are the *Senate, the House and the Presidency*. And the right that they may tackle is transforming the ESI tax break into something more productive. As I have showed in my work for the Hamilton project, we could move to universal health insurance coverage in the U.S., using the type of plan in MA or proposed by candidates Edwards and Clinton, and easily finance this by getting rid of the ESI exclusion. Indeed, by my estimates, we could have universal coverage AND about \$70 billion/year left over to do other fun things with – without spending one more cent of federal government revenues. Along the way we would move to a much more progressive system and get rid of the incentives for excessive insurance coverage. Can these three lefts come together to make that right?