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Rollover Flexible Spending Accounts: More Health Choices for Americans

Robert E. Moffit and William W. Beach

Members of Congress have the opportunity to put Americans in charge of their own health care decisions and to make health insurance and medical services more accessible, more accountable, and more affordable for working families. That opportunity lies in making a slight revision to Section 125 of the Internal Revenue Code, which governs flexible spending accounts (FSAs). These tax-free accounts allow workers to save for unexpected medical costs of services or benefits not covered by their employer-provided health insurance package. Today, both employers and employees can contribute to FSAs, and the money in these accounts can be used to pay for out-of-pocket medical expenses or for the copayments and deductibles of their employer-provided packages. Any money remaining in an FSA at the end of the year must be forfeited, however.

Currently, American workers and families obtain the most tax relief for the cost of their health care by purchasing health insurance through their employers. Those workers fortunate enough to enjoy this option realize tax savings by purchasing insurance with pre-tax dollars, thus reducing their taxable income. The tax code, however, should not discriminate against employees based on the status or condition of their employment. Good tax policy should ensure tax equity—a level playing field for different types of health insurance and health care options. Tax policy that supports economic efficiency would remove the ability of the tax code to influence directly the competitive and economic processes that could improve consumer choice and quality in health care services, and that would restrain a future increase in health care costs.

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Short of embarking on a comprehensive reform of the outdated tax treatment of health insurance this session, Members of Congress should take some interim steps to expand health care choices for patients and restore economic efficiency in the market. Senator Robert F. Bennett (R–UT) and Representative David Dreier (R–CA) soon will introduce legislation that would allow workers and their families to roll the money they set aside in employer-provided, tax-free FSAs into the fund for the following year, and to take the

Table 1 B1159

Federal Revenue Changes After Excluding FSA Health Care Rollovers from Taxation

	Millions of Dollars						
	FY1998	FY1999	FY2000	FY2001	FY2002	FY1998–FY2002	FY1998–FY2007
Change in Federal Revenue If Annual Rollovers of FSA Health Care Balances Are Excluded from Taxation	-$164.4	-$456.6	-$473.0	-$490.1	-$507.7	-$2,091.8	-$4,706.5

Source: Center for Data Analysis, The Heritage Foundation. Estimates of federal revenue change reflect assumptions and methodology described in the Technical Appendix of this paper.

funds with them when they change jobs, would enable more working families to pay for their medical expenses directly—without having to maneuver through the administrative apparatus governing corporate insurance policies.

MENDING A FRACTURED TAX POLICY

The current construction of Section 125 in the tax code has a structural defect. Under its "use-it-or-lose-it" rule, employees who do not use all of the pre-tax money they set aside each year for medical needs must lose any excess money in the accounts at the end of that year. From the standpoint of cost control, this policy is counterproductive and has an unintended consequence. It creates an incentive for working families to expend all the funds in their FSAs, even if the medical services they purchase are only marginally desirable or beneficial, rather than lose the money entirely.

Congress could correct this flaw with ease by modifying Section 125 to allow workers to roll any unused FSA funds over, year after year, tax-free. The direct results of such a change would be an increase in the direct purchasing of medical services from doctors and other providers, a change in the dynamics of the current insurance market, and an increase in personal savings for future health care spending or retirement.

As more funds are saved through such rollover FSAs and used for retirees' health care coverage, the future obligations of the government's health care programs would decline proportionately. The change in revenue to the federal Treasury in the meantime, based on Heritage Foundation calculations, would amount only to an average revenue decrease of $482 million per year, or $2.1 billion over 5 years (Table 1). This relatively small revenue change should make this policy more attractive to Members of Congress and to American workers and their families.

THE IMMEDIATE ADVANTAGES OF ROLLOVER FSAs

Revising Section 125 of the Internal Revenue Code would result in immediate benefits for a significant portion of the American workforce. According to the Bureau of Labor Statistics, as of 1994, 21.7 million private-sector employees chose to take advantage of employee-provided FSAs—14.8 million employed in medium to large establishments and 6.9 million in small establishments. In addition, 50 percent of state and local government employees had FSAs.[1]

Because FSAs by law must apply to all employees equally, they do not give a tax break to the "healthy wealthy." All Section 125 plans must pass

1. "Talking Points on Section 125," The Employers Council for Flexible Compensation, Washington, D.C., 1997.

a nondiscrimination test, which enforces rules that specifically prohibit discrimination in favor of highly compensated participants or key employees. But there are several other advantages to rolling over FSAs:

1. **It would encourage rational health care spending.** The unfair "use-it-or-lose-it" rule of the current tax code is a powerful incentive for workers to spend all the accumulated funds in their FSAs before the end of the plan's year. This incentive to spend discourages the kinds of cost-conscious decisions that are crucial to controlling health care expenditures and creates a false demand for unnecessary services, which further distorts an already muddled health insurance market. From the standpoint of cost control, then, the current FSA arrangement is bad health care policy. "Carryover" FSAs would encourage the efficient utilization of medical benefits and would be better at enabling employees to deal with natural fluctuations in their health care needs.

2. **It would enhance portability.** Refunding an employee's contributions to an FSA tax-free if that employee changes jobs would establish a measure of portability in employer-based health insurance. True portability is far superior to any jury-rigged regulatory scheme currently imposed by federal and state officials on the individual insurance market.

3. **It would enhance consumer choice.** A change in the tax code allowing FSA funds to be carried over to the next year and refunded when the employee changes jobs would create a stable framework for him to save for medical services within his employer-based insurance. Instead of locking employees into options defined or restrained by a health insurance plan, a rollover FSA enhances employee choice over a wide range of medical benefits and services.

4. **It would enhance the doctor–patient relationship.** By allowing greater freedom for employees to choose their own doctors and medical specialists, rollover FSAs would ensure that health care decisions are made within the physician–patient relationship. In this way, the patient would make cost-effective decisions, usually in consultation with a physician, rather than with corporate executives or insurance companies far removed from the patient. The quality of health care services workers want would become the primary objective, not the company's bottom line on compensation costs. This means patients would spend their own money on services provided by the specialist of their choice, at a time and under circumstances of their choosing, rather than being subjected to restrictions, exclusions, or conditions imposed by employer-based health insurance. Expanded FSAs allowing private agreements between doctors and patients also would avoid the perverse incentives that encourage many managed care plans to pay doctors or specialists more if they provide fewer services. Employers should be encouraged to promote FSAs in the workplace by adding additional tax-free funding for their FSAs, reducing insurance claims for routine medical services, and backing up their employees with solid catastrophic coverage.

5. **It would help control health insurance costs.** If employees could roll over their FSA account balances from year to year, FSAs would become more popular and widespread within the employer-provided health insurance field. Like medical savings accounts, they would stimulate further improvements in the health care delivery system. For example, the growth of stronger FSAs could foster the expansion of high deductibles in insurance policies, as employees and companies realize better values on their health insurance premiums because routine medical expenses would be paid out of FSAs more frequently.

6. **It would enhance the savings rate in the United States.** Because pre-tax salary contributions are exempt from federal income and Social Security taxes, the use of FSAs would increase the disposable income of their participants.

Today, FSAs are gaining popularity in the marketplace. They have been proven to meet the needs of a diversified pool of workers. If FSA funds can be rolled over tax-free, and if employees can take those funds with them when they move to a new company, then they will become a great boon to stimulating employee savings and enhancing employee security. Savings and job security are positive forces for economic growth.

CONCLUSION

The health care system in the United States is undergoing dramatic changes. From the standpoint of health care, however, the health insurance market is not a true market based on real consumer choice in which patients can choose the plan they want at the price they wish to pay.

Today, the federal tax code almost exclusively favors employer-based health insurance. With their health care decisions being made by bureaucrats, many Americans simply do not know the cost of their employer's contribution to their health benefits package. Furthermore, too many do not care to know because they mistakenly believe their benefits paid by their employers are "free." But benefits, like wages, are part of the cost of employing a worker, and every increase in the cost of health benefits must be offset by a decrease in wages or other compensation to that employee. For employers, the incentive to provide the best benefits package is offset by the need to control the cost of those benefits. The result often is unwise health care policies, such as was the case when mothers and newborns were forced to leave the hospital the day after delivery. The solution is not to micromanage the health care system even more; rather, it lies in the reestablishment of normal market incentives and consumer choice. Restoring control of health care benefit choices to employees, wherever possible, is the best remedy for the profound distortions in the health care market and the perverse incentives inherent in today's tax treatment of health insurance.

Members of Congress should revisit the entire treatment of health insurance in the tax code. Short of that, they should seek reforms that build on the best mechanism for controlling costs and ensuring consumer protection in health care: choice. Allowing working families to invest in flexible spending accounts to spend on health care needs later, and ensuring the money they invest is available year after year, regardless of how much is used in a calendar year or where they work, is a valuable yet easily achieved reform. By revising Section 125 of the Internal Revenue Code and passing sound health care and tax policies, Congress will enable working families to make rational economic decisions about their health care needs. It also will improve the quality of their care.

—Robert E. Moffit is Director of The Domestic Policy Studies Department at The Heritage Foundation.

—William W. Beach is Director of The Center for Data Analysis at The Heritage Foundation.

TECHNICAL APPENDIX

For the data in Table 1, Heritage economists estimated annual revenue changes stemming from Section 125 reform by constructing a model based on publicly available data and technically derived tax rate and program participation assumptions. This Technical Appendix describes the data and assumptions used to create the model's revenue estimates.

Heritage used data on worker participation in FSA plans published by the Bureau of Labor Statistics. The bureau's *Earnings and Employment Report* for 1993 and 1994 contain participation data for small, medium, and large private firms. These estimates were confirmed by survey data developed in 1997 by Hewitt Associates, a national benefits consulting company. Heritage calculated a weighted midpoint participation rate of 20 percent, and applied this percentage against an estimate of total establishment payroll employment for 1998. This employment estimate total (123,859,000 establishment employees) was taken from a forecast produced by WEFA, Inc., a nationally recognized economics consulting firm in Philadelphia, Pennsylvania, and is available upon request from The Center for Data Analysis at The Heritage Foundation. The participation rate estimates from Hewitt Associates also are available upon request.

The average annual amount of FSA health care coverage purchased by participating workers ($744) comes from studies prepared by the General Accounting Office in 1988, 1990, and 1992. Heritage analysts confirmed these estimates by comparing them with an estimate of average participation produced by Hewitt Associates for 1997. Heritage assumed that the rollover provision would lead participating workers to purchase an additional $89 in annual health care coverage. Assuming this additional purchase raises the level of revenue decreases from the policy change. Average effective tax rates were derived from data contained in the IRS Public Use File for 1994.

Heritage's estimate for fiscal year 1998 were projected forward into fiscal years 1999 through 2002 by an formula that contains annual estimates of price changes and employment growth among participating employees. All values in Table 1 are expressed in nominal or current millions of dollars.