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Fölster, Stefan; Gidehag, Robert; Orszag, Mike; Snower, Dennis J.

Article

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CESifo DICE Report

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Suggested Citation: Fölster, Stefan; Gidehag, Robert; Orszag, Mike; Snower, Dennis J. (2003) : Health Accounts and Other Welfare Accounts, CESifo DICE Report, ISSN 1613-6373, ifo Institut für Wirtschaftsforschung an der Universität München, München, Vol. 01, Iss. 3, pp. 9-14

This Version is available at:
https://hdl.handle.net/10419/166773

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Health Accounts and Other Welfare Accounts

Stefan Fölster, Robert Gidehag, Mike Orszag and Dennis J. Snower*

In many countries increasing costs for health care and sick leave insurance are forcing governments to cut back or implement higher user fees. Germany and Sweden are just two recent examples. In many developing countries large segments of the population are not covered by health insurance at all. It is feared that universal coverage places too large a burden on public expenditure.

This paper discusses health accounts as a way of financing some of the costs of health care and at the same time providing economic incentives to use health care and sick leave insurance more efficiently. In the course of this article we discuss some basic principles of savings account based social insurance and experience from other areas of social policy.

Pension systems have been reformed in many countries in recent years, moving from public, pay-as-you-go schemes with defined benefits toward systems in which contributions are deposited in a notional or funded personal savings account.

Similar reforms for other types of social insurance are much more modest. In Sweden, for example, educational savings accounts are being implemented voluntarily by some firms. In the U.S., the Clinton Administration introduced medical savings accounts (MSAs) for the self-employed and employees of small firms. MSAs combine retirement-type savings with high-deductible health insurance policies. As discussed below, as of summer 2003 there were proposals under discussion to expand the scope of these medical accounts.

Unemployment savings accounts have been in place in Brazil since 1986 (Cunningham 2000) and have been introduced in Chile in 2002. Severance pay systems such as exist in Italy, South Korea and many other countries are also quite similar to unemployment savings accounts.[1]

Proposals for more comprehensive savings account based reforms have been argued (e.g. Fölster, Gidehag, Snower & Orszag, 2002). An example of a more comprehensive system in existence is the Singaporean Central Provident Fund, originally designed to increase savings and to provide retirement security. It has since been extended with a number of schemes, e.g. saving for medical needs, financing of higher education, insurance of dependents and a variety of other social needs.[2]

This paper gives an overview of the basic principles behind savings-account based social insurance in section 2. In section 3 health accounts are discussed. Finally, section 4 summarizes a few other examples of savings account based social insurance, including a comprehensive welfare account.

The basic principles behind welfare accounts

The basic idea of welfare accounts is that individuals make contributions to individual accounts. In return, individuals' welfare benefits are paid from their accounts. The contributions may replace general taxes by mandatory saving to finance the requisite welfare benefits. In some systems the contributions are voluntary, but are encouraged by lower insurance premia or other incentives.

* Stefan Fölster, Confederation of Swedish Enterprise, 114 86 Stockholm, Sweden; Robert Gidehag, The Swedish Research Institute of Trade (HUI), 103 29 Stockholm; Mike Orszag, Watson Wyatt, UK; Dennis J. Snower, Department of Economics, Birkbeck College, 7 Greese Street, London WIT ILL, UK.

[1] Severance pay systems differ from accounts in that they define the benefit in terms of final salary rather than in terms of accumulated assets on the account.
[2] See Watson Wyatt (2003), McCarthy, Mitchell, and Piggott (2002), Choon and Tsui (2003) and Asher (1994) for a description of the Singaporean Provident Fund.

The welfare accounts are hence like ordinary savings accounts with two key exceptions. First, to avoid problems of moral hazard, there are restrictions on withdrawals from the welfare accounts. And second, the welfare accounts also serve a redistributive function, so that individuals receive specific minimum welfare benefits regardless of how low their account balances may be. In order to enable individuals to use their welfare accounts to perform their lifecycle redistributions, some types of welfare accounts allow negative balances during individuals' working lifetimes, thereby enabling them to shift purchasing power through time. In accordance with the government redistributive objectives, people with negative account balances at the end of their working lives are eligible for public support. For those people, the incentives to work and save will inevitably be impaired, but various studies indicate that they may be expected to be small in number in comparison with those who have negative account balances in any particular year. Since lifetime incomes are distributed more equally than annual incomes, as noted, welfare accounts tend to impair incentives of far fewer people than do the traditional tax-based systems.

In order to motivate the introduction of welfare accounts, we note that social insurance programmes involve a combination of savings, insurance and redistribution. In traditional social insurance programmes, this combination is often far from transparent to the average consumer (or anyone else, for that matter!). Individuals receive a panoply of benefits, but neither the cost of each nor the degree of cross-subsidy is transparent.

In addition to lack of transparency, another problem with traditional welfare systems is lack of flexibility. Whereas private compensation and benefit arrangements have moved increasingly towards benefits that are responsive to individuals' personal circumstances, public welfare benefits remain relatively rigid in this regard. Single individuals implicitly pay for insurance against spouses' death, while childless couples pay for education and benefits for children they do not have.

The lack of transparency and flexibility in the traditional welfare systems have adverse incentive effects, since individuals do not have to bear the consequences of their own actions. If an individual claims social insurance, it does not affect his or her subsequent contribution rates. The costs of claiming social insurance are thus not internalised and as a result have excessive incentives to claim social benefits.

Yet another major problem is that the benefits provided by traditional welfare systems are devoted, in large part, to redistributions across individuals' lifecycles, rather than to promoting income equality or providing insurance against adverse economic circumstances in a lifetime perspective. Lifecycle redistributions – enabling income smoothing over an individual's lifetime – can be performed more efficiently through comprehensive welfare accounts than through traditional welfare benefits.[3] A major insight in recent economic research is that life-time income tends to be much more equally distributed than income in any particular year. An OECD study on income mobility, for example, indicates that the majority of individuals in the lowest income quintile in 1986 had moved up five years later (Sawyer, 1997). In fact, one in five had moved up at least two quintiles. [4]

Studies from several welfare states indicate that as little as 20 to 25 percent of social transfers may actually redistribute between individuals, while the remaining 75 to 80 percent merely smoothes income over the individual's life cycle (Hussénius and Sélen 1994; Fölster 1998). The taxes that need to be levied to finance these transfers inevitably distort economic incentives, reducing the incentive to work, save and invest. In addition, the tax-and-transfer systems are run by costly bureaucracies. Thus, there could be substantial efficiency gains from a reform that focuses public welfare provision on the 20 to 25 percent of current expenditure devoted to the achievement of interpersonal redistribution and social insurance against adverse economic circumstances with significant lifetime income implications.

When the welfare state was first introduced, family structures were more uniform, benefits were more basic and technology was simpler. In such a setting it was both unnecessary to have differentiated benefits and technologically not possible. Flexible ben-

[3] This is shown in more detail in Fölster, Gidehag, Orszag and Snower (2002) as well as in a number of theoretical analyses of welfare accounts in Orszag & Snower (1997), Orszag, Orszag, Snower and Stiglitz (1999), Stiglitz and Yoon (2001) and Fölster & Trofimov (1999).

[4] A Swedish study (Hussenius & Selén 1994) that estimated income distributions over the entire life cycle concluded that the lowest quintile only had 31 percent lower life time income than the highest quintile, while annual incomes were four times higher in the highest quintile than in the lowest.

efits and transparency requires good and transparent information technology. While it would have been inconceivable to implement a transparent, flexible benefits policy in the interwar period or even in the 1950s and 1960s, it is technologically possible today.

In short, welfare accounts promise a number of significant advantages over the traditional welfare systems. In particular, by permitting the government to focus on interpersonal redistribution and social insurance against economic circumstances with significant lifetime income implications, the reform may allow substantial reductions in taxes and thereby improve people's incentives to work, save, and invest. Furthermore, by helping people internalize the social cost of their welfare expenditures, welfare accounts discourage people from making excessive welfare claims. In so doing, welfare accounts also improve people's incentive to work.

Health accounts

In many countries the fraction of health costs that patients pay themselves has been increased in recent years. This development has often been necessitated by a lack of public funds. But often it is also seen as a way of reducing demand for health care above and beyond what is medically necessary. A problem with this approach has been, however, that a large fraction of families have almost no liquid savings and find it hard to make even small payments, especially if they are not anticipated. A risk is therefore that demand is cut even for medically necessary treatment.

As a solution to this dilemma some economists have recommended combinations of catastrophic health insurance with individual health accounts. The central idea is that individuals pay health care costs below a certain deductible from the individual health account; costs above the deductible are paid by the insurance, which may be private or public. The assets in the account belong to the individual.

Some countries, such as Singapore, have had health accounts for many years. Other countries have introduced similar elements covertly. In Sweden, for example, individuals can receive credit to pay for medication which has to be repaid at a later date.

In the U.S. the President's budget included two proposals a tax-favored health account, which would permit them to pay these out-of-pocket costs more easily. They would also allow Americans to build up an account to cover high medical costs when needed. The first is to improve and expand medical savings accounts, removing excessive restrictions on Medical Savings Accounts (Archer MSAs), transforming them into a coverage option that is consistent with recent trends in private health insurance. Under the proposal, employees who have a health plan with a significant deductible (up to $ 1,000 for individuals and $ 2,000 for all other cases) could deposit funds into the account, tax free, up to the insurance policy's deductible. The insurance plan could cover preventive care without counting against the deductible. Such plans are increasingly common as employees have become dissatisfied with restrictions on their care in HMO-style, low-deductible plans. Employees who choose these plans would still be protected against high medical expenses with a more affordable premium than in a low-deductible plan. The proposal would make health accounts available to all employees, and would not discriminate, as current law does, on the basis of how many employees their employer has.

The MSA arrangement would be made a permanent program in law, providing more incentives for insurers, financial organizations, and others to spend the start-up money and effort to create MSA products and integrate them effectively with the other health plan options they offer. The proposal costs $ 5.7 billion over 10 years.

The second proposal are concerns so-called Flexible Spending Accounts. Flexible Savings Accounts (FSAs) are tax-free accounts that many employers have set up to help give employees more control over their medical expenses as well as better protection against out-of-pocket spending. However, FSAs are subject to an end-of-the-year "use it or lose it" requirement that limits their value for protecting against unexpected out-of-pocket medical expenses. Under the proposal, employees could roll over as much as $ 500 in unspent health care contributions to an FSA for use in the following year or to their 401(k) plan for retirement income or health expenses at older ages. The proposal costs $8 billion over 10 years.

A more comprehensive and perhaps more equitable proposal is based on our previous work in

Fölster, Gidehag, Orszag, and Snower (2003) and Orszag and Snower (1997). Under this proposal people would make mandatory minimum monthly contributions to their health accounts, and the resulting balances in these accounts would cover both the deductible and the insurance premia. People could voluntarily contribute more than the specified minimum amounts to their accounts.

The deductible and premia are to be set in the market, under competition between the public and private sectors. To make such competitive possible, public sector expenditures on health would be financed solely from the payments people make for public health services from their health accounts. Thus the government could not use the tax-transfer system to finance public health provision, artificially driving down prices of public health services, and thereby discouraging private-sector provision. Instead, the public and private sectors would compete on an equal footing. Such competition is particularly desirable in the health service provision, since the public and private sectors have different strengths and weaknesses in these areas. For example, the government has the advantage that it can trace people through the tax system and thus can avoid monitoring costs and default risks usually faced by private providers. The private sector, for its part, is often better able to provide more highly diversified services.

In order to prevent the private sector from "cream-skimming" (providing services only to those who are unlikely to receive large payouts and leaving the others to the public sector), private-sector providers would be required to make their deductibles and premia depend on only a restricted set of individual characteristics, such as people's age and income, and to ignore all others (such as past medical history).

The government could meet its equity objectives by redistributing income across people's health accounts, taxing the accounts of the accounts of high earners and subsidizing the accounts of low earners. However, as noted, these redistributions would have to be of the balanced-budget variety: economy-wide taxes on the accounts would be equal to economy-wide transfers into the accounts. Thus the government would have no incentive to manipulate the contribution rates and withdrawal rates of the welfare accounts in order to ease fiscal pressures outside the welfare state (e.g. to use tax receipts from health accounts to finance spending on transportation).

These equity considerations deserve careful attention. To the extent that individuals experience different health shocks over many years, the plan could lead to large differences in account accumulations. If illness over working life is distributed very unequally the plan could look like a savings account for the healthy, and self-insurance for the ill. In order to investigate how equally medical expenses are distributed over working life Eichner et al. (1996) use health insurance claims data to calculate the effects of a health account system. They show that medical expenses over an entire working life are more evenly distributed than is often assumed. More than eighty percent of the people in the sample would retain over 50 percent of their contributions. Only five percent would retain less than 20 percent of their contributions. Thus, although the inequality issue may not be as large as some have imagined, some people would undoubtedly be seriously disadvantaged in the absence of taxes and transfers on health accounts.

The health accounts could finance all types of health problems, ranging from short-term illness to disability. The deductible could be applied on an annual basis, or perhaps even over a longer period.

Other examples of savings-account based social insurance

Unemployment savings account

An unemployment savings account has been discussed in several countries (e.g. Orszag and Snower 1997). As noted above this already exists in Brazil and Chile. Such schemes are essentially defined contribution variants of the quite prevalent defined benefit severance pay systems for unemployment which exist in many countries.

In the most simple version, each employee saves a fraction of her wage on the individual unemployment savings account. As in the case of the educational account contributions can be split between the employee and the employer. If the individual loses her job she may withdraw an amount from the account that corresponds to unemployment compensation in traditional systems. If the funds in the account are not sufficient to pay the benefit,

the government lends the necessary amount. At retirement a positive balance on the account can be withdrawn, or used to top up pensions. The government cancels the debt of those who reach retirement age with negative account balances.

With this system all unemployed individuals receive the same cash amounts during spells of unemployment as they would under existing unemployment insurance rules. Their full protection is thus maintained. Any person who expects to retire with a positive balance completely internalizes the cost of unemployment benefits. For individuals who expect to retire with negative balances additional unemployment has no greater personal cost than in current unemployment insurance. Therefore an unemployment savings account will have little effect if unemployment over a lifetime is concentrated to a small group of individuals who also tend to end up with negative balances on their account. But if unemployment spells more commonly affect people who work most of their life and expect to end up with a positive balance, then the account can lead to substantial reduction of public outlays for unemployment insurance and improved incentives.

In order to study this question empirically Feldstein and Altman (1998) analyzed how Americans represented in the Panel Study of Income Dynamics would have fared under an unemployment savings account system. The analysis indicates that merely five percent of employees would retire or die with negative account balances, and that only about half of all benefits from the savings account would be paid to such individuals. Most individuals have positive account balances even after their unemployment spell. In the end the unemployment account would save more than 60 percent of the current tax-payer burden, not counting dynamic effects due to improved incentives. Further, effects on income distribution are shown to be quite small.

Educational savings account

In Sweden an educational savings account has been debated and, in fact, embraced by several political parties, labour unions and employers. A number of firms have introduced educational savings accounts on a voluntary basis. A recent evaluation indicated that they were working well (Hansson och Färm 2002). In Great Britain so called "educational learning accounts" were introduced decoupled from employers. They have since been temporarily suspended due to an increasing problem with misuse of funds.

The problem that an educational savings account aims to solve is that a growing group of people need additional education throughout their career. Employers' willingness to pay such education is often below what is socially optimal because of the risk that the employee will leave with the human capital investment, perhaps to a competing firm. Most people's own financing of such education is limited by liquidity. Also student loans are often not enough to finance education and living expenses later in life when many have high expenses for children and housing. The need for complementary education cannot be easily met by public subsidies because experience shows that such offers are often taken up by people who seek a break rather than an investment in their future career.

The basic idea of an educational savings account is that employees and employers contribute to the individual savings account. Contributions to the account should be tax free. Savings on the account can be used to finance education and income support during education. Withdrawals that are made to finance the costs of education are tax free, while withdrawals that are made for income support are taxed as income. The balance on the account at retirement can be freely withdrawn or used to bolster one´s pension. When an employee changes employer she takes the account with her, but retains only the part contributed by herself, while the employer retains his/her contributions.

A comprehensive welfare account

While a piecemeal approach to introducing savings accounts into social insurance probably is the only practically and politically possible way, there has been some interest in a more comprehensive savings account based social insurance. In Singapore, for example, the Central Provident Fund was originally designed to increase savings and to provide retirement security. But it has since been extended with a number of schemes, e.g. saving for medical needs, financing of higher education, insurance of dependents and other social needs (Asher 1994).

But could such a comprehensive welfare account perform the tasks expected in a welfare state? In

order to analyze this question we examined a longitudinal database of 100,000 Swedes, simulating a switch to welfare account that would provide pensions, sick leave, unemployment insurance, parental leave, housing benefits, child benefits and social assistance. This has been reported in detail in Fölster, Gidehag, Orszag and Snower (2002).

We find that under fairly general assumptions, if accounts were introduced in Sweden, only a small number of individuals would have negative balances. Under the proposed reform, it is this small group that would be the beneficiary of the government's redistributive policy. Because accounts would allow redistribution based on wealth levels rather than period by period income, they would be cheaper to finance and hence the payroll tax burden on the economy would be lower.

We have developed a projection model to simulate the likely effect of accounts. If the unemployment rate remains the same as at present, then our results suggest that accounts would be associated with considerably lower marginal taxes on labor. The gains are even greater if positive employment effects of lower marginal taxation are taken into account.

Conclusion

Health accounts and other types of welfare accounts are gradually coming to use in a number of countries. Considerable evidence suggests that they can improve economic incentives, and help to provide insurance in a more efficient way.

As the experience of the British educational accounts shows, however, careful attention has to be paid to a number of design issues. One is that funds on the accounts must be managed in a way that minimizes the risk of misuse or withdrawals for purposes other than those intended. A second important design feature concerns the insurance element in accounts. Should it be possible to have a negative balance on the account? Under what circumstances should these loans be forgiven?

Undoubtedly there will be some experimentation with various designs, and not all will work perfectly from the start. That should not stop more from trying.

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