Impact of financial literacy and liquidity constraints on Health Savings Account use

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Introduction

Many employers now offer a choice between a High-Deductible Health Plan (HDHPs) and a standard health insurance plan. Compared to a first dollar coverage health insurance plan, an HDHP generally has a lower premium but a much higher deductible that must be met before insurance begins paying for eligible health care expenses. However, HDHPs may be paired with a Health Savings Account (HSA). An HSA is a tax-preferred account in which contributions are tax-deductible, investments grow tax-deferred, and withdrawals are tax-free if used to finance health care expenses otherwise known as qualified medical expenses. Unlike FSAs, funds in HSAs are not “use-it-or-lose- it”: any remaining balance at the end of the year will automatically roll over from one year to the next. Many employers have a benefit where they contribute to employees’ HSAs if they choose an HDHP, and most HSA administrators allow participants to invest their funds once they hit a threshold minimum balance, usually $1,000.

Companion to: Fungibility in workplace benefits choices: Evidence from Health Savings Accounts

This data brief summarizes the results of the relationship between financial literacy, individual liquidity constraints, and Health Savings Account use from Davis, Leive, and Gellert (2022). In 2023, the IRS maximum HSA contribution amount is $3,850 for participants with individual coverage and $7,750 for participants with family coverage (and an additional $1,000 catch-up contribution for those 55 and older). Because of the triple-tax advantage of HSAs, individuals can increase their retirement security by financing current health care consumption from other liquid cash accounts and investing their HSA funds, then reimbursing themselves in retirement for past-incurred health care expenses or health expenses in retirement. Effectively using HSAs requires individuals to have enough liquidity to pay for current health consumption as well as financial literacy to know how HSAs function. We studied how financial literacy and liquidity constraints are related to how participants use HSAs.[1]

Methodology

We surveyed 2,157 workers in higher education across 15 institutions about their health insurance choices and how they use Health Savings Accounts. In addition to demographic information, we surveyed 5 areas of HSA use among participants; 1) HSA contributions, 2) total HSA balance, 3) why individual chose the HSA/HDHP, 4) did individuals withdraw some, all, or most of their HSA balance, 5) do they know if or how their HSA funds are invested.

Results

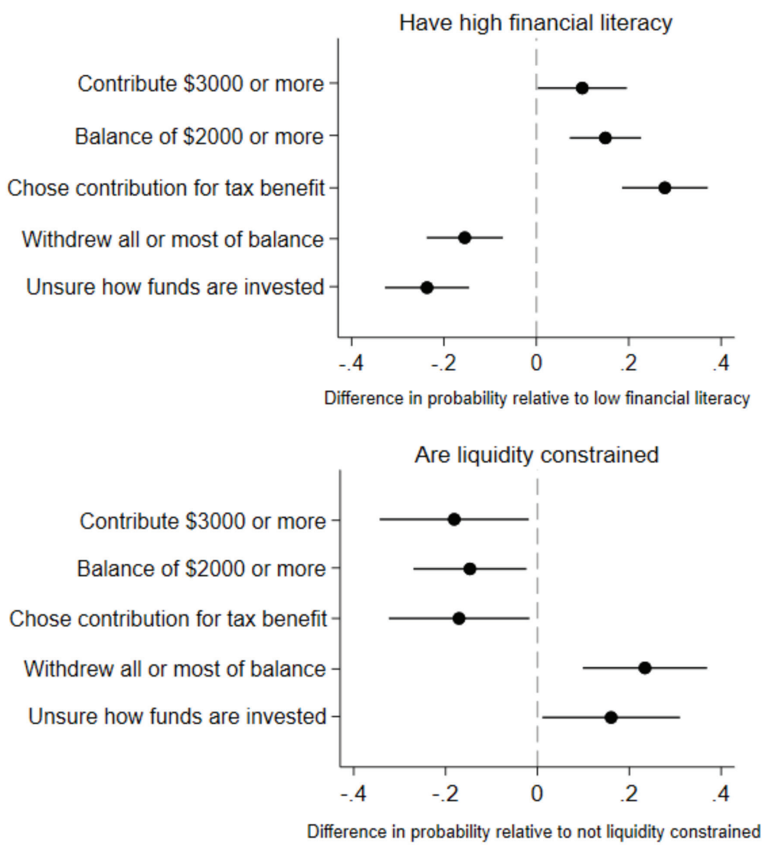
- **HSA Contributions**: We document the proportion of participants contributing over $3,000. We found 32% of participants contributed $3,000 or more. As shown in Figure 1, individuals with high financial literacy are 10% more likely to contribute more than $3,000 and individuals who are liquidity constrained are about 20% less likely. Additionally, individuals with high financial literacy are significantly more likely to select their contribution level because of tax concerns.
- **HSA Balance**: About 50% of respondents report a balance below $2,000. Individuals who are either liquidity constrained or have low financial literacy are much less likely to have $2,000 or more in their account.
- **HSA Withdrawals**: 27% of respondents withdrew most of their funds in the year, but individuals with high financial literacy are 16% less likely to do so while individuals without liquidity constraints are 18% to 22% less likely to do so. This result compared with the result on balances indicates many individuals are ‘washing’ funds through an HSA to finance health-care tax free instead of using it as an investing or savings vehicle. Still, the ability to finance health care consumption tax free increases the household budget compared to when no HSA is available.
- **HSA Investment Behavior**: Less than 15% of respondents invested their HSA accumulations. 66% did not know how they were invested, which included knowing whether their investments were held in cash. Over 80 percent of those with low financial literacy did not know how their HSA balance was invested.

1 We define high financial literacy as answering each of the “Big 3” questions on interest, inflation, and investment diversification correctly (Lusardi and Mitchell 2014). We classify an employee as liquidity constrained if they were certain or probably thought they could not come up with $2,000 on short notice (Lusardi et al 2011) or if they have an out-standing retirement account loan from TIAA.

Discussion

We fielded this survey to better understand how individuals use their Health Savings Account. We find that most people do not take full advantage of their accounts, from a lifetime tax liability perspective. We find large and statistically significant differences in behavior by those who have higher financial literacy compared to individuals with lower financial literacy, and by whether respondents are or are not liquidity constrained. Our research adds to the limited number of empirical studies[2] on HSAs and suggest that greater education, guidance, and advice are needed in this area. Individuals may not be aware of the benefits of an HSA, confuse it with other workplace benefits such as a medical Flexible Spending Account (FSA), or understand how versatile HSAs are for financing health-care.

Figure 1. HSA behavior by financial literacy and liquidity constraints



Note: Linear regressions plotting the marginal effect of high financial literacy (liquidity constrained) compared to low financial literacy (not liquidity constrained) with 95% confidence intervals for each of the five outcomes listed.

2 The main additional empirical studies in this area are Helmchen et al. (2015), Spiegel and Fronstin (2021), Leive (2022), Leive, Friedberg, and Davis (2022), Friedberg, Jang, Leive, and Young (2022),, and Fronstin, Roebuck, and Fendrick (2022).

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