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NEW HEALTH SAVINGS SECURITY ACCOUNTS COULD REDUCE STATE REVENUES BY UP TO $30 BILLION OVER THE NEXT TEN YEARS

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On June 26, the House of Representatives passed a proposal that would establish Health Savings Security Accounts, which are new tax-advantaged personal savings accounts that could be used to pay for out of pocket medical expenses. The legislation also would expand current-law Medical Savings Accounts (renamed Health Savings Accounts) and Flexible Spending Arrangements for medical expenses. This package of new tax breaks is slated to receive serious consideration, because the House attached the provisions to its version of the Medicare prescription drug legislation that now is headed for conference with the Senate version of the prescription drug bill.

The proposed Health Savings Security Accounts (HSSAs), in conjunction with the other two, smaller provisions, could significantly alter how employers provide health insurance to their workers. They could weaken traditional employer-based coverage and shift a greater proportion of the costs of health insurance from firms to employees, with adverse effects on low-income, older, and sicker workers. These issues are analyzed in two recently released Center reports: *Health Savings Security Accounts: A Costly Tax Cut that Could Weaken Employer-Based Health Insurance*, and *What's in a Name? House Bill Would Change Name But Not the Substance of a Proposed Expansion of Medical Savings Accounts.*

In addition to the problems related to health insurance, these provisions would have substantial fiscal implications.

- The provisions are costly and would add significantly to the already burgeoning federal deficit. The Joint Committee on Taxation estimates that these provisions will cost the federal government $173.6 billion over 10 years, with annual costs reaching more than $33 billion in 2013.

- States would also lose substantial amounts of revenues as a result of these provisions. Over the next 10 years, states would lose $20 billion to $30 billion in revenues. State revenue losses would occur because the deductions allowed for deposits into these tax-advantaged accounts reduce taxpayers' adjusted gross income (AGI). Most states link their own income tax calculations to federal AGI, and, as a result, income subject to taxation at the state level also would be reduced.

- In addition, some states that do not link to federal AGI nevertheless allow deductions for current-law Medical Savings Accounts. These states could lose

revenue as a result of the expansion of this provision. Since HSSAs are similar to MSAs, these states may exempt the new accounts as well.

- Over the next three years, in state fiscal years 2004 through 2006, states stand to lose a total of between $1.5 billion and $2.3 billion in revenues. These revenue losses would come at a time when states are struggling to bring their budgets into balance in the wake of three years of deep fiscal crisis. By state fiscal year 2013, the annual state revenue loss could be as high as $6 billion.

- As noted, HSSAs would have particularly adverse effects on low-income, older, and sicker workers. If some low-income people ultimately lose access to comprehensive health insurance through their employment as a result of these policies, that could increase the number of people who are reliant on state Medicaid and SCHIP programs for part or all of their health coverage. Yet the revenue loss states would experience as a result of these new accounts could weaken the ability of states to finance coverage through Medicaid and SCHIP.

- States could choose to "decouple" from the federal tax treatment and deny the deduction for deposits into HSSAs or the newly renamed MSAs, as well as deny the tax-free treatment for earnings on funds in the accounts. Decoupling could be extremely difficult on both political and policy grounds, however. The Joint Committee on Taxation's estimates assume that use of such accounts would become widespread and that by 2013 the majority of employers would modify their health insurance plans to conform to the HSSA requirements. If employers move to offering primarily or solely the high-deductible insurance plans with which these tax-advantaged accounts may be used, then the accounts would become an integral part of the way employers offer health insurance. Were that the case, it is likely that few states would feel comfortable taxing the accounts.

- Moreover, it is unclear whether there would be a practical way for states to tax the annual earnings on the accounts, which would be tax free for federal tax purposes. If some states did try to tax the annual earnings, taxpayers making withdrawals for non-medical purposes (allowed without penalty after age 65) could be subject to double taxation on those earnings if they moved to a state that followed the federal treatment of taxing the withdrawals but not the annual earnings.

The Health Insurance-Related Tax Provisions of the House Bill

The House bill would create new tax-advantaged savings accounts known as Heath Savings Security Accounts that could be used to pay for certain out-of-pocket medical expenses. These accounts would be available to taxpayers who are either uninsured or covered through a high-deductible health insurance policy, either as individuals or through their employers. Taxpayers could make annual tax-deductible contributions to these HSSAs of up to $2,000 for individuals and $4,000 for families, whether or not they itemize their federal tax deductions. Contributions could be made by individuals, their employers, or both. (Only certain taxpayers

would be eligible to make HSSA contributions; income limit rules would apply.[1]) The "above-the-line" deductions for deposits into these accounts reduce the taxpayer's adjusted gross income (AGI).[2]

Funds in an HSSA could be placed in investment vehicles, including stocks and bonds, and earnings would grow free of tax. This, too, would reduce taxpayers' adjusted gross income. Withdrawals from HSSAs would never be subject to tax if they were used to pay for qualified medical expenses. Starting at age 65, funds could be withdrawn from the accounts without penalty for any purpose, although with withdrawals for non-medical purposes would be subject to income tax. The HSSAs would be available starting in tax year 2004.

The legislation also would make Medical Savings Accounts — renamed Health Savings Accounts (HSAs) — universally available and increase the amounts that can be deposited annually into these accounts. There are some differences between the HSSAs and the HSAs in the amount of contributions allowed, the type of insurance policy with which they could be used, and the qualifications for using the accounts. For example, there are no income restrictions on who can use an HSA. Nevertheless, the mechanism by which the accounts operate to reduce revenues are similar.

Finally, the legislation would change some provisions related to flexible spending arrangements used for health care costs. FSAs are accounts into which employees can deposit a portion of their wages (up to a limit) and from which they may pay for out-of-pocket medical costs. Funds deposited into these accounts do not count as wages or income for the employee for income tax purposes. Under current law, an employee may not carry over funds remaining in an FSA at the end of the year. The proposed legislation would permit amounts of up to $500 in a health care FSA to be carried forward from one year to the next. The bill also would allow employees to transfer up to $500 in funds that remain in their FSA accounts at the end of the year to the new HSSAs, to HSAs, or to retirement accounts. This provision would encourage employees to increase their deposits to FSAs, since it would diminish the risk that employees would lose funds that remained unused at the end of the year. As a result, it also would act to reduce AGI.

State Revenue Losses

The federal revenue loss expected as a result of these new and enhanced tax- advantaged health savings accounts is $174 billion over the next 10 years. Three components of federal revenue will be affected: personal income taxes, corporate income taxes, and payroll taxes for Social Security and Medicare. Personal income tax revenue and payroll tax revenue may be expected to decline under this proposal. Corporate income tax revenue may rise modestly,

[1] For married couples, the contribution amount begins to phase out at income of $150,000, and no contributions are allowed by couples with incomes over $170,000. For single individuals, the deduction phases out between $75,000 and $85,000.

[2] "Above the line" means the deductions may be taken regardless of whether the taxpayer itemizes deductions or uses the standard deduction.

because the sum of the high-deductible insurance plans that employers would increasingly offer and the deposits they would make into HSSAs or HSAs is likely to be less than the deductible insurance premiums employers currently are paying.

Most states use federal definitions of income as the basis for their personal and corporate income taxes. As a result, personal and corporate income tax revenue in most states will be affected by these proposals.

In 36 states and the District of Columbia, federal definitions of income are used for personal income taxes. All of these states currently allow the federal deduction from income for deposits into Medical Savings Accounts to flow through as a state deduction, and all of these states also exempt funds deposited into an FSA from taxation.

In addition, three other states that do not use federal adjusted gross income as the basis for their own tax calculations – Arkansas, New Jersey, and Pennsylvania — do allow taxpayers to take the same deduction for Medical Savings Accounts on their state personal income tax returns as they do on their federal return. These states would be affected by the expansions of MSAs. Moreover, these states would be likely to expand their permitted deductions to encompass the new HSSAs, since it makes little sense to allow a deduction for MSAs but not the closely related HSSAs.[3] Thus, up to 39 states could experience significant revenue losses as a result of this legislation.

Corporate income taxes are levied in 44 states and the District of Columbia. These states generally follow federal definitions and would experience small revenue gains as a result of these proposals. Michigan's Single Business Tax and Texas' Franchise Tax also allow deductions for employers' health insurance costs and would be affected. South Dakota has a limited corporate income tax that applies to certain banks; it may or may not be affected. The states without corporate income taxes that would not be affected by the tax consequences of this legislation are Nevada, Washington, and Wyoming.

Taking account of the effect on both personal and corporate income taxes, up to 39 states and the District of Columbia would lose revenues and seven or eight states would likely experience very small revenue gains.[4] Overall, the total state revenue loss would be between $20 billion and $30 billion over the next 10 years.[5] (See methodology below.)

[3] The two other states with income taxes that have no federal starting point for their state income tax calculations are Alabama and Mississippi. In addition, nine states do not levy a broad-based personal income tax. They are Alaska, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming.

[4] Tax revenue in Nevada, Washington, and Wyoming would not be affected by the legislation.

[5] In eight states, federal personal income taxes paid are fully or partially deductible in calculating state personal income taxes. In these states — Alabama, Iowa, Louisiana, Missouri, Montana, Oklahoma, Oregon, and Vermont — the lower federal taxes paid would mitigate somewhat the potential revenue loss. Similarly, Alabama, Iowa, Louisiana, Missouri, and North Dakota allow a deduction for federal corporate taxes paid on their state corporate income tax returns. This would tend to lower the gain from increased corporate income tax payments. These offsets are not included in the revenue gain and loss calculations in this report.

Federal Revenue Effects of H.R. 2596, 2004 - 2013 Millions of Dollars	
Health Savings Security Accounts	-163,448
Health Savings Accounts (expanded MSAs)	-5,658
Flexible Spending Arrangement/Cafeteria Plan	-8,662
Interactions Among health provisions	4,392
Other	263
Total	**-173,639**

The revenue loss would be small in state fiscal year 2004, but it would grow rapidly over time. The total state revenue loss over the next three years would be between $1.5 billion and $2.3 billion. By 2013, states could be losing as much as $6 billion annually.

The range provided here for the projected revenue loss reflects the fact that not all states may follow the federal changes. California has in recent years remained out of conformity with a variety of federal tax changes and — given its current fiscal condition — is unlikely in the near term to conform to any revenue-losing provisions. Virginia has passed legislation saying it will not accept federal tax changes at this time. The three states do not use federal AGI as the basis for their personal income tax but do allow an MSA deduction are also included in the category of states that may or may not conform.

Could States Avoid the Revenue Loss?

States do have some options for avoiding this revenue loss. As noted above, not all of the states that use federal definitions of income automatically accept federal tax changes. In some states, federal changes have to be adopted legislatively. In addition, states that conform automatically to federal changes have the option of enacting legislation to require that the federal deduction be added back for state tax purposes.

Nevertheless, it is likely to be quite difficult for most states to decouple from these new tax breaks. As noted, the 39 states that could lose revenue already allow deductions for MSAs and must allow the FSAs. In addition, if this legislation in enacted, HSSAs are likely to become a widely used component of the provision of health coverage in this country. The Joint Committee on Taxation estimates that by 2013, the majority of employers would modify their health insurance plans to conform to HSSA requirements, and that tens of millions of HSSAs would have been established. If HSSAs become such an integral part of health insurance coverage, it likely would be very difficult for states to deny the deduction for the accounts.

Moreover, there would be administrative problems associated with decoupling. Only part of the revenue loss would come from deductions from deposits to the accounts. The other portion of the revenue loss occurs because the earnings on funds in the accounts are not subject to tax. In theory, it would be possible for states to tax those earnings if sufficient reporting were required. But compliance could be difficult to achieve in the absence of federal taxation because taxpayers would have to report interest and other investment income to the states that likely would not be not shown on their federal return.

In addition, disparate treatment of the accounts by different states could be a problem for taxpayers who move from state to state. Consider a taxpayer who made deposits while living in a state that taxed deposits into the accounts and annual earnings on the accounts. After age 65, the taxpayer moves to a state the follows federal treatment of the accounts. If the taxpayer wants to withdraw the money from the account for a non-medical purpose, he or she would have to pay tax a second time on both the principal and the earnings.[6]

Consequences for States

States are struggling through a deep fiscal crisis that is expected to extend at least another year and perhaps beyond. Even if the economy again starts to grow at a healthy rate, many of the actions states have taken during this crisis to close deficits — such as borrowing and shifting expenditures to future years — will continue to reduce available state revenues.

States also are struggling to maintain strong Medicaid and SCHIP programs in the face of flagging revenues and the escalating costs of health care and health insurance that are being felt in the public and private sectors alike. These new and expanded health savings accounts will make that task more difficult in two ways.

First, the people who are most likely to be affected adversely by the new proposals include lower-income people and older people, as well as people who have significant health problems. These are the same segments of the population that are most likely to come onto the Medicaid/SCHIP rolls if they no longer can obtain comprehensive insurance through their employer or if that insurance becomes prohibitively expensive.[7]

At the same time, this proposal would reduce state revenues and make it more difficult for states to maintain adequate Medicaid/SCHIP programs. As has been evident in the current fiscal crisis, Medicaid is often one of the first programs to be cut when gaps emerge between available revenues and the cost of state government.

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[6] In theory, a state could grant an exemption for taxpayers in this situation. In practice, however, the exemption could be complicated to calculate because taxpayers could have lived in several states with different treatment at varying times in their lives, and old records may or may not be available.

[7] The availability of coverage for low-income working adults, children in such families, and older people with high medical expenses varies by state. For example, in some states people who qualify for Medicaid are encouraged or even required to take employer-provided coverage if it is available, and Medicaid pays the cost sharing for which the person is obligated. In addition, some states have "medically needy" programs which cover people whose health care expenses are very high relative to their incomes.

Methodology

The state-by-state estimates of revenue losses resulting from the health savings account proposals passed by the House of Representatives (H.R. 2596) were estimated as described below. All estimates should be view as approximate only; these are complicated proposals that could evoke a variety of behavioral responses that are different from the ones we have assumed.

First, for the HSSAs, it was necessary to determine the portion of the federal revenue changes (as estimated by the Joint Committee on Taxation) that is attributable to the three affected taxes: the personal income tax, the corporate income tax, and the payroll tax; only the changes to the personal and corporate income taxes can affect state revenue. This was accomplished by building a simplified model of potential account usage by different types of taxpayers, and then calibrating the model to match the JCT estimates. The cost of the expanded HSAs (the renamed MSAs) was distributed on the same basis as the HSSAs, because the provisions are similar and because the HSA revenue loss ($5.7 billion) is small relative to the HSSA loss ($163.4 billion). The FSA expansion affects only the personal income tax and the payroll tax, and the loss was apportioned between those taxes.

Next, the amount of federal adjusted gross income (AGI) reduction associated with the federal personal income tax changes was calculated. This AGI loss was distributed to the states on the basis of the share of federal AGI that was reported in each state in tax year 2001, the most recent data available. *Internal Revenue Services: Statistics of Income.* "Individual Income and Tax Data, by State and Size of Adjusted Gross Income, Tax Year 2001." Unpublished version, April 2003 and revised in May 2003. The AGI loss for each state was then multiplied by each state's tax rate to determine the potential personal income tax revenue loss.

Our model suggests that federal corporate income taxes may increase slightly. As employers provide less costly high-deductible insurance rather than comprehensive insurance, their deduction for health insurance premiums would decline. The deposits that employers make to HSSAs or HSAs, which also are deductible, are unlikely to equal the full amount by which their health insurance premiums decline. Thus, employer deductions associated with health insurance are likely to decline, causing corporate income taxes to rise slightly.

The corporate income base associated with the rise in corporate income taxes was estimated and distributed among the states on the basis of the share of total corporate taxes paid by corporations in each state in 2002. *Internal Revenue Service Data Book 2002*, Publication 55B, Washington, DC, Issued March 2003 and revised in May 2003. Each state's corporate tax rate was applied to the corporate income change to determine the offsetting corporate income tax gain in each state. These gains are small.

The personal income tax loss and corporate income tax gain were summed to determine the change in taxes for each state in each federal fiscal year from 2004 through 2013. The revenue losses were then converted to approximate the revenue loss by state fiscal year.

Table 1
State Near-Term Revenue Changes
Millions of Dollars

	State Fiscal Year			
	2004	**2005**	**2006**	**Total 2004-06**
Alabama	$0.1	$0.3	$0.5	$0.9
Alaska	$0.0	$0.0	$0.0	$0.1
Arizona	-$1.3	-$8.6	-$15.4	-$25.3
Arkansas	*-$1.1*	*-$7.2*	*-$12.9*	*-$21.2*
California	*-$31.8*	*-$206.4*	*-$369.4*	*-$607.7*
Colorado	-$2.2	-$14.2	-$25.3	-$41.6
Connecticut	-$2.1	-$13.5	-$24.2	-$39.9
Delaware	-$0.4	-$2.2	-$3.9	-$6.4
Florida	$0.1	$0.7	$1.3	$2.1
Georgia	-$4.2	-$27.1	-$48.5	-$79.9
Hawaii	-$0.9	-$5.5	-$9.9	-$16.3
Idaho	-$0.7	-$4.7	-$8.6	-$13.7
Illinois	-$3.6	-$22.9	-$40.9	-$67.3
Indiana	-$1.7	-$10.9	-$19.5	-$32.1
Iowa	-$2.0	-$13.1	-$23.4	-$38.5
Kansas	-$1.5	-$9.5	-$16.9	-$27.9
Kentucky	-$1.7	-$11.2	-$20.1	-$33.1
Louisiana	-$1.8	-$11.8	-$21.0	-$34.6
Maine	-$0.9	-$5.7	-$10.2	-$16.8
Maryland	-$2.8	-$18.2	-$32.6	-$53.7
Massachusetts	-$4.2	-$27.0	-$48.4	-$79.6
Michigan	-$5.6	-$30.0	-$48.1	-$83.6
Minnesota	-$3.6	-$23.2	-$41.4	-$68.2
Mississippi	$0.0	$0.1	$0.1	$0.2
Missouri	-$2.7	-$17.6	-$31.5	-$51.9
Montana	-$0.6	-$4.1	-$7.3	-$12.1
Nebraska	-$0.9	-$5.8	-$10.3	-$17.0
Nevada	$0.0	$0.0	$0.0	$0.0
New Hampshire	$0.0	$0.1	$0.1	$0.2
New Jersey	*-$2.4*	*-$15.3*	*-$27.3*	*-$45.0*
New Mexico	-$1.0	-$6.7	-$11.9	-$19.6
New York	-$5.2	-$43.7	-$128.8	-$177.7
North Carolina	-$4.6	-$29.5	-$52.8	-$86.9
North Dakota	-$0.2	-$1.1	-$2.0	-$3.4
Ohio	-$4.9	-$31.6	-$56.6	-$93.1
Oklahoma	-$1.6	-$10.4	-$18.5	-$30.5
Oregon	-$2.6	-$17.1	-$30.5	-$50.2
Pennsylvania	*-$2.9*	*-$18.4*	*-$32.9*	*-$54.2*
Rhode Island	-$0.5	-$2.9	-$5.2	-$8.6
South Carolina	-$2.1	-$13.6	-$24.3	-$40.0
South Dakota	$0.0	$0.0	$0.0	*

Tennessee	$0.1	$0.4	$0.8	$1.2
Texas	$0.0	$0.0	$0.0	*
Utah	-$1.2	-$7.8	-$14.0	-$23.1
Vermont	-$0.3	-$1.7	-$3.0	-$4.9
Virginia	*-$4.2*	*-$27.0*	*-$48.3*	*-$79.4*
Washington	$0.0	$0.0	$0.0	$0.0
West Virginia	-$0.7	-$4.4	-$7.9	-$13.0
Wisconsin	-$3.2	-$20.4	-$36.5	-$60.0
Wyoming	$0.0	$0.0	$0.0	$0.0
District of Columbia	-$0.9	-$4.5	-$7.2	-$12.6
Total				**1,457 to -$2,265**

Notes:
States in italics are those judged least likely to conform to the federal changes. The range for the three-year totals reflects that fact.

Alabama, Iowa, Louisiana, Missouri, Montana, Oklahoma, Oregon, and Vermont allow some or all of federal taxes paid to be deducted in calculating state personal income taxes. This feature would lower somewhat the revenue loss shown seven of these states and increase the revenue gain in Alabama. Similarly, Alabama, Iowa, Louisiana, Missouri, and North Dakota allow a deduction for federal corporate taxes paid on their state corporate income tax returns. This would tend to lower the gain from increased corporate income tax payments. These effects are not included in the revenue gain and loss calculations above.

* Texas would have a modest revenue gains and South Dakota might have a small gain. These are not calculated here.

Table 2
State Long-Term Revenue Changes
Millions of Dollars

	SFY 2013	SFY 2004-2013
Alabama	$1.9	$10.3
Alaska	$0.2	$0.9
Arizona	-$65.9	-$323.0
Arkansas	*-$55.2*	*-$270.2*
California	*-$1,579.3*	*-$7,747.9*
Colorado	-$108.2	-$530.9
Connecticut	-$103.8	-$508.5
Delaware	-$16.7	-$81.5
Florida	$5.2	$26.1
Georgia	-$207.7	-$1,018.5
Hawaii	-$42.4	-$208.0
Idaho	-$35.7	-$175.1
Illinois	-$175.2	-$858.1
Indiana	-$83.5	-$409.3
Iowa	-$100.0	-$490.4
Kansas	-$72.4	-$355.0
Kentucky	-$85.9	-$421.5
Louisiana	-$89.9	-$441.0
Maine	-$43.6	-$213.7
Maryland	-$139.5	-$684.5
Massachusetts	-$206.8	-$1,014.4
Michigan	-$185.9	-$959.1
Minnesota	-$177.5	-$869.4
Mississippi	$0.4	$2.2
Missouri	-$134.9	-$661.4
Montana	-$31.3	-$153.6
Nebraska	-$44.3	-$217.1
Nevada	$0.0	$0.0
New Hampshire	$0.4	$1.9
New Jersey	*-$117.3*	*-$574.1*
New Mexico	-$51.0	-$250.1
New York	-$695.5	-$3,062.7
North Carolina	-$226.0	-$1,108.1
North Dakota	-$8.7	-$42.8
Ohio	-$242.2	-$1,187.2
Oklahoma	-$79.2	-$388.8
Oregon	-$130.4	-$640.0
Pennsylvania	*-$141.3*	*-$691.6*
Rhode Island	-$22.3	-$109.3
South Carolina	-$104.0	-$510.2
South Dakota	*	*
Tennessee	$3.1	$15.5
Texas	*	*
Utah	-$59.9	-$294.2
Vermont	-$12.6	-$62.0
Virginia	*-$206.6*	*-$1,013.0*

Washington	$0.0	$0.0
West Virginia	-$33.7	-$165.6
Wisconsin	-$155.9	-$764.8
Wyoming	$0.0	$0.0
District of Columbia	-$28.1	-$144.7
Total	-$3,989 TO - $6,089	-$19,267 to -$29,564

Notes:
States in italics are those judged least likely to conform to the federal changes. The range for the three-year totals reflects that fact.

Alabama, Iowa, Louisiana, Missouri, Montana, Oklahoma, Oregon, and Vermont allow some or all of federal taxes paid to be deducted in calculating state personal income taxes. This feature would lower somewhat the revenue loss shown seven of these states and increase the revenue gain in Alabama. Similarly, Alabama, Iowa, Louisiana, Missouri, and North Dakota allow a deduction for federal corporate taxes paid on their state corporate income tax returns. This would tend to lower the gain from increased corporate income tax payments. These effects are not included in the revenue gain and loss calculations above.

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