



# CENTER ON BUDGET AND POLICY PRIORITIES

820 First Street, NE, Suite 510, Washington, DC 20002  
Tel: 202-408-1080 Fax: 202-408-1056 center@cbpp.org www.cbpp.org

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## HEALTH SAVINGS ACCOUNTS IN FINAL MEDICARE CONFERENCE AGREEMENT POSE THREATS BOTH TO LONG-TERM FISCAL POLICY AND TO THE EMPLOYER-BASED HEALTH INSURANCE SYSTEM

by Robert Greenstein and Edwin Park

The Medicare conference report that the President will soon sign into law greatly expands Medical Savings Accounts and renames them as Health Savings Accounts. As explained below, this provision would represent a profound change in tax policy and would establish a dangerous precedent that could lead to severe long-term fiscal damage. The HSA provision also threatens to weaken traditional employer-based insurance and to place older and sicker workers at risk. Studies by three highly respected institutions have found that if use of Medical Savings Accounts becomes widespread, this could cause premiums for comprehensive employer-based health insurance to *more than double*.

### The Threat to Fiscal Policy

Under the tax code, a basic principle governs: If contributions to a savings or retirement account are tax deductible and earnings on the account compound tax-free, then withdrawals from the account are taxed as ordinary income. This is how 401(k)s, traditional IRAs, and similar accounts long have worked. (There are several types of accounts from which withdrawals are tax-free, but contributions to those accounts are *not* tax deductible.)

Under the Health Savings Accounts provision of the Medicare conference agreement, this fundamental principle would be abrogated. Not only would deposits to HSAs be tax deductible and earnings then compound on a tax-free basis, but *withdrawals also would be tax free* so long as they were used for medical costs. To allow an account to feature *both* tax-deductible contributions *and* tax-free withdrawals is unprecedented. (Note: This is a feature of current Medical Savings Accounts, but MSAs now operate only as a demonstration project on a very limited basis and are not available to most people. The Health Savings Account provision of the final conference agreement essentially takes the current MSA structure, removes all of the key limitations designed to keep MSA usage low and to limit the attraction of MSAs as tax shelters to higher-income individuals, and both opens up MSAs to widespread use without restriction and makes MSAs more lucrative as a tax shelter.)

- Recent long-term budget forecasts from GAO, Goldman Sachs, Brookings, and the Center on Budget and Policy Priorities in conjunction with the Concord Coalition and the Committee for Economic Development all project long-term deficits of massive proportions. Such deficits would eventually be damaging to the economy.

- The budget “baseline” that these forecasts use includes the large amounts of revenue (literally trillions of dollars in revenue) that the federal government will collect over the course of future decades as tens of millions of Americans retire and withdraw funds from 401(k)s and IRAs. If federal policy is changed so that a portion of the withdrawals from these accounts becomes tax free, the already-grim long-term fiscal picture will grow markedly worse.
- Financial services industry lobbyists have already begun promoting the idea of letting workers designate a portion of their 401(k)s and IRAs as “Retirement Medical Benefit Accounts” (or RMBAs), from which funds could be withdrawn in retirement *on a tax-free basis* for out-of-pocket medical costs. Such a step would open the floodgates for proposals to allow steadily increasing shares of 401(k) and IRA assets to be set aside for various favored purposes and then withdrawn tax-free for those purposes in retirement. The long-term fiscal consequences could be very large.
- The HSA provision in the final Medicare conference agreement is a major step in this direction. Once the precedent is established of allowing both tax-deductible contributions into *and* tax-free withdrawals out of an account if the withdrawals are used for medical costs, it may be only a matter of time before conservatives and the financial services industry succeed in getting Congress to take what would seem the logical next step and allowing something like RMBAs to be established within 401(k)s and IRAs. Moreover, proposals would likely proliferate to allow taxpayers to set up tax-deductible savings accounts comparable to HSAs for education, home purchases, or other such purposes — and to allow tax-free withdrawals for such purposes.
- In fact, efforts to use HSAs as a precedent to establish other tax-sheltered accounts have already begun. The Associated Press reported on November 23 that Stephen Moore, President of the Club for Growth, branded as a great idea the notion of establishing a range of accounts into which deposits are tax deductible and from which withdrawals are tax free. “I’m in favor of dramatically broadening tax-free savings accounts,” Moore declared, proposing that individuals be allowed to establish tax-free accounts for education, child care and other needs. Moore also observed that establishing a plethora of such tax-sheltered accounts is a way “of short-circuiting the left’s ability to create new government programs, because if people have enough money in these accounts, they don’t need new government programs.”<sup>1</sup>

In short, the risks of crossing what is now a bright yellow line in the tax code — namely, that if contributions to an account are tax deductible, withdrawals from the account are treated as taxable income — are great. The HSA provision in the final Medicare conference agreement should be seen for what it is — part of a larger conservative agenda to shield saving and investment income from taxation, a policy shift that would predominantly benefit those who

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<sup>1</sup> Mary Dalrymple, “Medicare Bill Has New Tax-Free Accounts”, Associated Press, November 23, 2003.

have high incomes or substantial wealth, while starving the federal budget to an even greater degree of revenue it will sorely need in future decades.

## **The Threat to Comprehensive Employer-based Health Insurance**

Under the Medicare conference agreement, HSAs could be used only in conjunction with high-deductible health insurance policies. They could not be used by people covered under traditional comprehensive employer-based coverage. (This is true of the existing Medical Savings Accounts as well.)

The new HSA accounts will be extremely attractive to healthier, more affluent workers, and the use of such accounts could become widespread in coming years. Workers in the higher tax brackets would secure large deductions for deposits into HSAs. In addition, their firms would be able to make deposits into their HSAs on their behalf. (Firms would get the full employer health-insurance deduction for such deposits.) As noted, the earnings on the accounts would accrue tax free, and withdrawals from the accounts would be tax free. Moreover, there would be no income limits on who could use HSAs. As a result, these accounts would be quite lucrative as tax shelters. The GAO has found that even under the current restrictions on MSAs, various insurers have been marketing MSAs more for their tax shelter advantages than as health insurance policies.

As a result, healthier, more affluent workers are likely to enroll in HSAs in substantial numbers, and employers may come under increasing pressure to offer HSAs and high-deductible insurance policies either as an option or as their basic form of health insurance coverage. (Indeed, many well-paid business owners and executives may initiate efforts for their firms to offer HSAs and high-deductible policies, given the lucrative tax shelter opportunities that HSAs provide to those who are affluent.) The Joint Committee on Taxation has informed Congressional staff that it expects HSA use to expand significantly, starting at one million participants in tax year 2004 and rising to three million by 2013. (By comparison, in tax year 2001, the most recent year for which IRS data are available, fewer than 80,000 people participated in the Medical Savings Account demonstration project). Moreover, these Joint Tax Committee projections could turn out to underestimate HSA use substantially if the health insurance and financial investment companies that offer HSAs and high-deductible policies market them aggressively, as is likely to be the case.

As HSA use becomes more widespread, the health policy consequences are likely to become increasingly serious, especially for older and sicker workers. As healthier, more affluent workers shift to HSAs in substantial numbers to take advantage of the tax shelter opportunities while older and sicker workers remain in comprehensive insurance (the high-deductible insurance policies that accompany HSAs would be risky and inappropriate for such workers), the pool of workers remaining in comprehensive insurance will become older and sicker, on average. When this process (known as “adverse selection”) occurs, premiums for comprehensive insurance rise. That, in turn, can drive still more of the healthier workers to HSAs, which then makes the pool of workers left in comprehensive coverage even more expensive to insure.

Past research by RAND, the Urban Institute, and the American Academy of Actuaries found that premiums for comprehensive insurance could *more than double* if MSA use becomes widespread. If that occurred, the results would be very damaging, especially for older and sicker workers. The number of Americans who are uninsured or underinsured would likely increase as more employers and employees alike dropped out of comprehensive coverage because they could no longer afford it.