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MEDICAL SAVINGS ACCOUNT PROVISIONS IN HOUSE-PASSED PATIENTS' BILL OF RIGHTS COULD DRIVE UP THE PRICE OF HEALTH INSURANCE PREMIUMS AND INCREASE THE NUMBER OF UNINSURED

MSA Expansion Would Provide Attractive Tax Shelter to Healthy, Affluent Individuals

by Edwin Park and Iris J. Lav

Recent media accounts indicate that informal conference negotiations have commenced on the Patients' Bill of Rights legislation, which passed both the Senate and the House last year.[1] The House-passed version (H.R. 2563) includes provisions that would make Medical Savings Accounts (MSAs) universally available and substantially alter MSA policy in a number of other ways, with the goal of dramatically expanding use of MSAs. Conservative activists have promoted this MSA expansion proposal for several years. It also is included in the Administration's fiscal year 2003 budget (as it was in the budget the Administration submitted last year).

Medical Savings Accounts are tax-advantaged personal savings accounts that may be used by persons covered by high-deductible health insurance policies.[2] Funds in MSAs may be used to pay for a wide range of health care expenditures. The funds also may be retained in MSA accounts and invested in stocks and bonds (or other investment vehicles), with the investment earnings accumulating free of tax. Eventually, the funds in the accounts may be withdrawn not only for medical purposes but also for *non*-medical purposes such as retirement.[3]

Supporters of this proposal are expected to argue during conference negotiations, as they have in the past, that expanding MSAs will expand health care coverage and reduce the ranks of the uninsured. Most health analysts disagree. A substantial expansion of MSAs would be much more likely to drive up premiums for conventional health insurance ─ thereby making insurance

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[1] Robert Pear, "Kennedy and Bush Negotiates on Patients' Rights, Alarming Their Allies," *New York Times*, January 23, 2002. The House bill, H.R. 2563, was passed on August 2, 2001. The Senate bill, S. 1052, was passed on June 29, 2001.

[2] In 2002, high deductible plans are defined as those plans that have deductibles of not less than $1,650 or more than $2,500 for individual coverage and not less than $3,300 or more than $4,950 for family coverage.

[3] A penalty applies to the withdrawal of funds from MSAs for some, but not all, non-medical purposes. There is no penalty for withdrawal for retirement. MSA accounts can serve as a tax shelter, however, even in many cases in which a penalty would apply.

unaffordable for some individuals and causing them to become uninsured — than to make progress on this front.

- Research by some of the nation's leading research institutions suggests that widespread use of MSAs would be likely to result in substantial increases in health insurance premiums for conventional health insurance coverage. Widespread MSA use is expected to lead to "adverse selection" in insurance markets, a circumstance in which healthy and less healthy segments of the population tend to become separated into different types of insurance plans. This would be expected to occur because the combination of high-deductible policies and MSAs would be most attractive to healthier people; such individuals generally do not expect to require costly health care services and thus are much less likely to be deterred by the high-deductible policies. Moreover, since they do not expect to incur hefty health care costs, such individuals could anticipate accumulating substantial sums in their MSAs on a tax-advantaged basis.

- When adverse selection occurs, health insurance premiums necessarily rise for the less-healthy individuals who remain in conventional health insurance, because they are no longer pooled with the healthier individuals who instead have opted into MSAs and high-deductible policies. The resulting increase in costs for conventional health insurance could cause some employers to cease offering comprehensive coverage — or in the case of new employers, to elect not to offer coverage in the first place. It could cause other employers to raise the share of premiums they require their employees to pay. Such actions would tend to make conventional insurance less available and less affordable, with the likely result that more people would become uninsured.

Congress established an MSA demonstration project in 1996 to secure information on the effects of MSAs and directed the General Accounting Office to evaluate these effects. The demonstration is scheduled to run through 2002. While the data collected to date from the demonstration project are limited, the GAO has found evidence that MSAs are indeed encouraging adverse selection in health insurance markets. If MSAs are greatly expanded, as would occur under the House bill — which would make MSAs broadly available and substantially increase their appeal as a tax shelter to affluent, healthy people with low medical bills — the types of problems the GAO found during the demonstration are likely to become more widespread. That, in turn, would almost certainly lead to higher costs for conventional health insurance.

Research conducted by RAND, the Urban Institute, and the American Academy of Actuaries suggests that because of adverse selection, premiums for conventional insurance could

more than double if MSA use becomes widespread.[4] Increases of that magnitude would likely cause substantial numbers of older and sicker individuals who incur substantial health care expenditures and rely on conventional insurance to lose their coverage.

In short, the MSA expansions in the House bill could jeopardize health insurance coverage for significant numbers of Americans because these expansions risk making comprehensive health insurance unaffordable for sizeable numbers of employers and employees. The House MSA provisions also would open up tax sheltering opportunities that would constitute another tax cut targeted toward the affluent.

These effects differ sharply from those that would be expected under a bill introduced by Senators McCain, Kennedy, and Edwards (S. 284) to extend and modestly enlarge the current MSA demonstration project. S. 284 would improve and expand the MSA demonstration project (and require the GAO to evaluate the expanded demonstration) to secure better information on MSAs' effects. It would do so without risking destabilization of health insurance markets and sharp increases in the cost of conventional health insurance, and also without eliminating the current safeguards in the MSA demonstration project that limit the use of MSAs as tax shelters. (See box on page 6 for more information on S. 284.)

MSA Use and Costs

The MSA provisions of the House version of the Patients' Bill of Rights have a significant cost. Last summer, the Joint Committee on Taxation estimated the cost of these provisions at about $4.7 billion over ten years. The Administration's fiscal year 2003 budget includes a similar proposal and places the cost at $5.7 billion over 10 years. Some have assumed that the fact that these cost estimates are not still higher suggests that the impact of the proposed MSA expansion would be relatively modest, but such an assumption is unwarranted. Instead of the federal government bearing a large cost, much of the "cost" of the policies the House bill would put in place would effectively be borne by individuals who would pay more in future years for conventional insurance or become uninsured or underinsured.

Moreover, if the House provisions led to more widespread use of MSAs than these cost estimates anticipate, the cost to the federal budget would substantially exceed the cost estimates. This is a distinct possibility if MSAs are aggressively marketed by financial institutions as tax shelters, something the GAO found has already begun to occur under the demonstration project, albeit on a much more modest scale. If the changes the House bill would make in expanding the

[4] Emmett B. Keeler, et. al., "Can Medical Savings Accounts for the Nonelderly Reduce Health Care Costs?" Journal of the American Medical Association, June 5, 1996, p. 1666-71; Len M. Nichols, et. al., *Tax-Preferred Medical Savings Accounts and Catastrophic Health Insurance Plans: A Numerical Analysis of Winners and Losers*, The Urban Institute, April 1996; and American Academy of Actuaries, *Medical Savings Accounts: Cost Implications and Design Issues*, May 1995.

MSAs and Adverse Selection

A major concern is that if MSA use becomes widespread and substantial numbers of healthier people choose high-deductible insurance with MSAs, the pool of people who are covered by conventional, comprehensive health insurance will be sicker, on average, than it otherwise would be. If the pool of people with conventional insurance has higher-than-average health care costs because some of the healthier people are no longer in the pool — having switched to MSAs instead — the premiums for conventional insurance will necessarily increase.

MSAs pose a strong risk of engendering this type of effect. Young, healthy people who anticipate having low health care costs in the near future would likely choose to participate in MSA plans. They would do so because the MSA expansion allows participants to retain unspent health care dollars in their own accounts. By using MSAs, people with low health care costs can accumulate tax-free earnings on these funds and use them as retirement savings or for other purposes.

By contrast, older and less healthy people who judge they are likely to incur significant health care costs would be better off financially if they remained in conventional health insurance, which generally has lower deductible amounts and relatively low caps on out-of-pocket expenditures. As a result, the pool of workers that would retain conventional insurance if MSA use becomes widespread would incur higher health care costs on average than the pool of workers covered by conventional insurance today. To accommodate these higher average health care costs, the premiums charged for conventional insurance policies would have to increase, perhaps quite substantially.

At the higher premium rates, it is likely that significant numbers of employers would be unwilling to offer their employees conventional insurance or would be forced to increase the share of the premium cost that employees must bear, which could make insurance unaffordable for some workers. In addition, the resulting decline in the market for conventional insurance could lead some insurers to cease selling it. Rather than addressing the needs of the uninsured, an MSA expansion proposal of the type reflected in the House bill thus threatens to increase the ranks of the uninsured, especially among older and sicker individuals who most need health-care coverage.

availability of MSAs and increasing their value as a tax shelter become law, more widespread marketing of MSAs is likely.

In addition, if the House MSA provisions are enacted, employers are likely to have greater interest in offering Medical Savings Accounts than is sometimes assumed. In the past, employers have tended to view high-deductible health insurance policies similar to those required under MSAs as unattractive products for their employees because such policies impose significant out-of-pocket costs and may not provide comprehensive benefits. As the cost of health insurance premiums continues to rise, however, an increasing number of firms are starting to offer health accounts attached to high deductible insurance policies that are similar to MSAs —

but *without* the tax advantages — rather than conventional insurance plans.[5] These employers believe the contributions they make to these accounts will cost them less than subsidizing a large percentage of the premium cost of conventional insurance.[6] These developments suggest that if MSAs were made broadly available — providing tax advantages that the health accounts these firms are already offering do not possess — a significantly larger number of employers may pursue this course and begin to offer MSAs. If that occurred, use of MSAs would likely become considerably more widespread than the cost estimates assume.

What the House Provisions Would Do

The MSA provisions included in the House bill (H.R. 2563) would effectively replace the MSA demonstration project that Congress established in 1996 with a policy that would make MSAs available to anyone who wants them. Currently, MSA use is limited to no more than 750,000 participants, and only individuals who work for firms with fewer than 50 employees or are self-employed are eligible.[7]

The House provisions also would make MSAs much more attractive as tax shelters to healthy, affluent individuals by removing or weakening many of the safeguards that Congress wrote into the MSA demonstration to prevent that from occurring. For example, the House bill would increase the amount an individual could deposit each year in an MSA, which would increase the attractiveness of MSAs as tax shelters.

- MSAs are similar to tax-deductible Individual Retirement Accounts, in that contributions to MSAs are deductible from income, the contributions can be left in the accounts for years and invested in stocks, bonds, or similar assets, and tax is deferred on the amounts that the accounts earn (i.e., earnings on an MSA compound free of tax each year). Furthermore, *unlike IRAs*, there are *no* income limits on MSAs that prevent wealthy people from using them as tax shelters. And the higher an individual's tax bracket, the more the MSA tax break is worth. The tax advantages of MSAs can be substantial for a wealthy individual even if the funds in the accounts are eventually withdrawn and used primarily or exclusively for *non*-medical purposes.[8]

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[5] Barbara Martinez, "Health Plan That Puts Employees in Charge of Spending Catches On," *Wall Street Journal*, January 8, 2002.

[6] Milt Freudenheim, "A New Health Plan May Raise Expenses for Sickest Workers," *New York Times*, December 5, 2001; Julie Appleby, "New Insurance Plans Turn Patients into Shoppers," *USA Today*, January 8, 2002; Martinez.

[7] Technically, the House bill would make the demonstration project permanent, but this nomenclature is essentially meaningless. MSAs would no longer be a demonstration project in any meaningful sense of the word.

[8] Note: If deposits are held until retirement age, they may be used without penalty for *any* purpose, including non-medical purposes.

MODEST MSA EXPANSIONS IN S. 284 DO NOT POSE THE SAME RISKS OF ADVERSE SELECTION AND HIGH-INCOME TAX SHELTERING

Legislation introduced in the Senate (S. 284) by Senators McCain, Kennedy, and Edwards includes modest MSA expansions. Because these provisions would not make MSAs available to anyone who wants one and would not eliminate safeguards that discourage the use of MSAs as tax shelters, S. 284 does not carry the same risks of higher health insurance premiums and extensive tax shelter benefits for higher-income taxpayers that the House bill does. S. 284 would:

- Extend the MSA demonstration through 2004.
- Increase the limit on the number of MSA policies from 750,000 to 1 million.
- Expand the definition of small businesses whose employees can use MSAs from firms employing 50 or fewer workers to firms employing 100 or fewer workers.
- Require a new GAO study to determine the impact of MSAs on the cost of conventional insurance, on adverse selection, and on health care costs generally.

The original demonstration project required the GAO to evaluate MSAs and their impact on conventional insurance and health care costs. Insufficient data have prevented GAO from fully conducting this study. Extending the life of the demonstration in this manner may permit the collection of the data the GAO needs to conduct the evaluation as Congress intended. To establish universal availability of MSAs and weaken the tax shelter safeguards *in the absence of such a study* — as the House bill would do — would be a highly imprudent policy. It would pose significant risks to the availability of affordable health insurance coverage in future years for some of those Americans most in need of it.

- Consequently, opening up MSAs to all individuals and increasing the amounts that may be deposited in them ― as the House provision would do ― would enable high-income individuals who cannot use IRAs because of the IRA income limits to circumvent those limits by using MSAs as tax shelters that accumulate substantial assets over time.
- The House-passed bill also would circumvent rules now in effect under the MSA demonstration project that prevent employers from setting up MSAs in a manner that would benefit highly paid executives much more heavily than is now the case (and in so doing, effectively discriminate against lower-paid employees).

The Patients' Bill of Rights is supposed to be legislation that makes health care more accessible and responsive to consumers' needs. The House MSA provisions move in the opposite direction. They represent a sharp departure from the current design of MSAs and would likely have adverse consequences for health-care consumers. These provisions carry the potential to drive up the cost of conventional, comprehensive insurance to such an extent ― possibly doubling it eventually ― that many Americans, including those most in need of health

services because they are in poorer health, may no longer be able to afford coverage. Instead of increasing coverage, an MSA expansion of this nature is likely to enlarge the ranks of the uninsured.

Of particular concern are provisions that would significantly increase the appeal of MSAs as tax shelters for higher-income individuals (who tend to be healthier than average), facilitating their participation in MSAs and further compounding the risk of triggering adverse selection in the health insurance marketplace. Because of their potential to lead to sharp increases in costs for conventional health insurance, the MSA provisions of the House bill, could end up injuring health care consumers in coming years more than the other provisions of the Patients' Bill of Rights would assist them.

The remainder of this analysis provides more information on the MSA demonstration, current MSA rules, and how the House provisions would alter these rules.

The MSA Demonstration and the Current MSA Rules

The bipartisan Health Insurance Portability and Accountability Act of 1996 established a demonstration to test and evaluate Medical Savings Accounts. The demonstration was designed to provide information about the effects of MSAs on workers, employers, and insurers and to do so without creating widespread, irreparable harm to the participants or the insurance market as a whole. Participation in the demonstration was limited to no more than 750,000 participants who are either employees of small businesses (businesses with 50 or fewer employees) or self-employed individuals. Participants could take tax deductions for contributions to MSAs in amounts up to certain specified levels. Other rules governing use of MSAs during the demonstration were designed to assure that these tax-advantaged savings accounts were used largely for the purpose of obtaining medical care and would not become a general-purpose tax shelter. The demonstration was originally scheduled to run through 2000 but was extended through December 31, 2002.

The 1996 legislation required an evaluation by the GAO to determine the effects of MSAs on the insurance market and consumers. Among other issues, the evaluation was to study the extent to which MSAs fostered "adverse selection" ─ a situation in which younger and healthier individuals find MSAs financially advantageous and choose MSAs while older and less healthy individuals remain in conventional insurance. Such adverse selection would be highly problematic; if younger, healthier individuals (who generally have below-average medical costs) shift from conventional insurance to MSAs while older, less healthy individuals (who generally have above-average medical costs) remain in conventional insurance, the cost of conventional insurance rises, making it harder for employers and employees to afford. The GAO also was charged with studying the effect of MSAs on health care costs, including the cost of health insurance premiums. The intention was that Congress would be able to examine the results of the evaluation and, on the basis of those results, determine future policy regarding MSAs.

Relatively few individuals, however, have chosen to use MSAs during the demonstration period. The IRS estimates that in 2000, some 62,000 tax returns reflected MSA contributions.[9] As a result of this low utilization, the GAO has been unable to conduct a full evaluation of the effects of MSAs. Nevertheless, one portion of the GAO evaluation was completed — a survey of insurers, conducted by Westat under contract to the GAO.

MSA proponents attribute the lack of popularity of MSAs during the demonstration period in part to various statutory safeguards included in the legislation that may have discouraged participation. Those rules were put in place to prevent abuse of MSAs as a tax shelter. MSAs are likely to gain much greater popularity if the rules are changed to allow greater use of the accounts as tax shelters.

How the MSA Provisions of the House Bill Would Alter the MSA Rules

The MSA provisions in the House bill would open up MSAs to use by all individuals and employees working in any size business, make MSAs a permanent part of the tax code, remove the limit on the number of people who may participate in MSAs, lower the deductibles required under MSA high-deductible policies, and make other changes in MSAs that would increase their attractiveness as tax shelters.

Making MSAs universally available and more attractive as tax shelters would likely result in their use becoming much more widespread. That, in turn, could mean that the adverse effects that MSAs are likely to have on the insurance market could become pervasive and difficult to reverse.

Evidence from the survey of insurers conducted for GAO suggests that insurance companies set premiums for MSAs based on the assumption that adverse selection *will* take place. According to the report, "Insurers expect relatively better health status and lower service utilization by [MSA] enrollees...and price their products accordingly. Insurers confirmed this conclusion in the survey."[10]

The House-passed bill also would increase the maximum amount that can be deposited in an MSA each year. The current demonstration project places strict limitations on such deposits to prevent use of MSAs as general-purpose tax shelters.[11]

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[9] IRS Bulletin 2001-42 (October 15, 2001).

[10] U.S. General Accounting Office, *Medical Savings Accounts: Results From Surveys of Insurers*, December 31, 1998, GAO/HEHS-99-34, Appendix, p.14.

[11] For individuals, the maximum amount that can be contributed annually under current law is 65 percent of the health insurance policy's deductible amount; for family coverage, it is 75 percent of the deductible amount. The House bill would raise the maximum contribution for individuals and families to 100 percent of the deductible.

- MSAs are similar to conventional Individual Retirement Accounts: contributions are deductible from income, and tax is deferred on the amounts that the accounts earn. While deposits and earnings are never taxed if MSA funds are used to pay medical costs, the tax advantages of MSAs can be substantial even if the funds in the accounts are later withdrawn and used primarily or exclusively for *non*-medical purposes.

  If deposits are held until retirement age, for example, there is no penalty for withdrawal for non-medical purposes. Even if funds are withdrawn for non-medical purposes *before* retirement age, there are a number of circumstances under which the value of the tax-free compounding of the deposits for some years outweighs the penalty on a non-medical withdrawal.

- MSAs differ from IRAs in one key respect ─ there are no income limits on MSAs that prevent wealthy people from using them as tax shelters. As a result, opening up MSAs to all individuals and increasing the tax-deductible contributions that may be deposited into them, as the House bill would do, would enable high-income taxpayers who cannot use IRAs because of the income limits to begin using MSAs as significant tax shelters.

When the MSA demonstration was first established, a number of financial experts pointed out the possibilities for use of the accounts as tax shelters for those with high incomes. An Associated Press article cited Eclipse MediSave America Corp., an MSA servicing company, as having calculated that "a family making $3,375 annual MSA contributions and earning 8 percent interest a year could accumulate $1.4 million in the account over 45 years. Even if they withdrew $1,000 a year, they still would accumulate $991,000."[12] The family would have accumulated these amounts tax-free. A *New York Times* article at about the same time featured an example of a relatively well-off MSA holder who chose to pay medical expenses with *other* funds, leaving his MSA deposits to grow tax-free.[13]

Furthermore, the report conducted by Westat for the GAO contains indications that MSAs are starting to be seen as tax shelters. The report noted that investment firms managing MSAs have begun offering more investment choices for MSA holders and that insurers have found that many MSA participants are using their accounts primarily as tax shelters rather than as accounts to pay for out-of-pocket medical expenses.[14]

If MSAs become available to anyone who wants one, the tax advantages of these accounts to higher-income taxpayers are likely to be marketed widely by banks and investment

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[12] Associated Press release by Vivian Marino, August 15, 1997.

[13] Margaret O. Kirk, "Medical Accounts: Mixed Reviews," *The New York Times*, July 5, 1998.

[14] U.S. General Accounting Office, *Medical Savings Accounts: Results From Surveys of Insurers*, December 31, 1998, GAO/HEHS-99-34, Appendix, pp. 15-16.

houses, much as IRAs are advertised. Such advertising of MSAs is less feasible under current law, since only small businesses and the self-employed now are eligible to use MSAs. This advertising could promote use of MSAs as tax shelters and make healthier persons more aware of the possibility and tax advantages of using MSAs. Such advertising would likely lead to further adverse selection and thereby heighten the risk of significant increases in the cost of regular health insurance policies.

Finally, the House provision includes changes that would circumvent the rules under the current MSA demonstration that prevent employers from setting up MSAs in a manner that primarily benefits highly paid executives and effectively discriminates against lower-paid employees.

- Under the current MSA demonstration, deposits can be made in an MSA account either by an employer or an individual, but not by both in the same year. The demonstration also includes nondiscrimination rules requiring employers to make comparable contributions for all participating employees.

- The House bill would allow both employees and employers to make deposits in an MSA in the same year. That would make the nondiscrimination rules meaningless. An employer could make small, token deposits to the MSA accounts of all employees. Higher-income employees could add substantial additional funds to their accounts and exclude these additional amounts from their taxable income. Most lower-paid staff would not be able to afford substantial additional contributions.

Conclusion

The House version of the Patients' Bill of Rights would make MSAs considerably more attractive as tax shelters and likely lead to more widespread use of MSAs by healthy, affluent individuals. As a result, the proposal would heighten the risk that MSAs would result in health insurance becoming unaffordable or unavailable for many Americans, particularly those most in need of affordable, comprehensive health care coverage.

If enacted as part of a final conference report on the Patient's Bill of Rights, the proposal is more likely over time to increase than to reduce the number of Americans without insurance and to have its most adverse effects on those with health problems. If final Patients' Bill of Rights legislation includes such provisions, there is a substantial risk that the legislation as a whole would ultimately do more harm than good, with the adverse effects of the MSA provisions outweighing whatever positive effects other provisions of the legislation have.