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LIKELY MEDICAL SAVINGS ACCOUNT AMENDMENT TO PATIENTS' BILL OF RIGHTS COULD DRIVE UP THE PRICE OF HEALTH INSURANCE PREMIUMS AND INCREASE THE NUMBER OF UNINSURED

Amendment Would Create New Tax Shelter for Healthy, Affluent Individuals

by Iris J. Lav and Edwin Park

Summary

When the Senate considers the Patients' Bill of Rights, perhaps as early as this week, a floor amendment may well be offered 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. The amendment is based on a proposal that conservative activists have promoted for several years and that is included in the Administration's budget.

Medical Savings Accounts are tax-advantaged personal savings accounts that may be used by persons covered by high-deductible health insurance policies.[1] 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 Eventually, the funds in the accounts may be withdrawn not only for medical purposes but also for *non*-medical purposes such as retirement.[2]

Supporters of this proposal are expected to argue, 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. Substantial expansion of MSAs would be much more likely to degrade health insurance coverage — and to increase the number of uninsured — than to make progress on these fronts.

- Research by some of the nation's leading research institutions suggests that widespread use of MSAs would be likely to increase health insurance premiums for conventional health insurance coverage. This is because 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 segregated in different types of insurance plans. When adverse selection occurs, health insurance premiums rise for the less-healthy individuals because they are no

[1] In 2001, high deductible plans must have deductibles not less than $1,550 and not more than $2,350 for individual coverage and not less than $3,100 and not more than $4,650 for family coverage.

[2] 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.

longer pooled with the healthier individuals. The resulting increase in costs can cause some employers to cease offering comprehensive coverage (or not to offer coverage in the first place) or to raise the share of premiums that employees pay, with the result that insurance becomes less available and affordable and more people become uninsured.

- Congress established an MSA demonstration project in 1996 (which is scheduled to run through 2002) to secure information on the effects of MSAs and directed the General Accounting Office to evaluate these effects. While the data 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 anticipated Senate floor amendment, which would make MSAs broadly available and 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 and may lead to much higher costs for conventional health insurance.

- Research conducted by RAND, the Urban Institute, and the American Academy of Actuaries suggests that premiums for conventional insurance could *more than double* if MSA use becomes widespread. The American Academy of Actuaries noted that: "The greatest saving [from MSAs] will be for the employees who have little or no health care expenditures. The greatest losses will be for the employees with substantial health care expenditures. Those with high expenditures are primarily older employees and pregnant women."

- In short, the MSA expansions that the amendment would be likely to generate could jeopardize health insurance coverage for substantial numbers of Americans because these expansions would risk making comprehensive health insurance unaffordable for many employers and employees. At the same time, the amendment would open up tax sheltering opportunities that would constitute another tax cut targeted toward the affluent.

These effects differ sharply from the effects that would be expected under legislation introduced by Senators McCain, Kennedy, Edwards and others (S. 284) to extend and modestly enlarge the current MSA demonstration project. S. 284 would improve and expand the demonstration project — and require GAO evaluation of the revised demonstration — to secure better information on the effects of MSAs. It would do 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 discourage the use of MSAs as tax shelters. (See box on page 5 for more information on S. 284.)

The anticipated Senate floor amendment is likely to have a relatively modest cost in terms of the federal budget. (The Joint Tax Committee has estimated the cost of the Administration's

MSA proposal at $5 billion over ten years.) This does not mean, however, that the amendment's consequences would be minor. Instead of the federal government bearing a large cost, much of the "cost" of the policies that the amendment 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. Furthermore, if the amendment leads to more widespread use of MSAs than the current cost estimates anticipate — a distinct possibility if MSAs are aggressively marketed by financial institutions as tax shelters — the cost to the federal budget could substantially exceed the official cost estimates.

Amendment Likely to be Based on Administration Proposal

As noted, the anticipated amendment is likely to be patterned on an MSA expansion proposal that is one of the tax cuts in the Administration's budget that was not included in the recently enacted tax legislation. The Administration's proposal would effectively replace the MSA demonstration project that Congress established in 1996 with a policy making MSAs available to anyone who wants them. Currently, MSA use is limited to people who work for small employers, are self-employed, or are uninsured.[3]

The Administration proposal also would make MSAs much more attractive as a tax shelter 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 Administration's proposal would increase the amount an individual could deposit each year in an MSA. This 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.[4]

[3] Technically, the Administration's proposal 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.

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

- Consequently, opening up MSAs to all individuals and increasing the amounts that may be deposited in them — as the Administration's proposal 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 Administration's proposal also would circumvent rules now in effect under the MSA demonstration project that prevent employers from setting up MSAs in a manner that primarily benefits highly paid executives and effectively discriminates 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 anticipated MSA floor amendment moves in the opposite direction. It represents a sharp departure from the current design of MSAs and would be likely to have adverse consequences for health-care consumers. It carries the strong potential to drive up the cost of conventional, comprehensive insurance to such an extent — possibly more than doubling — that many Americans, including those most in need of health services because they are in poorer health, may no longer be able to afford health coverage. Instead of increasing coverage, such an MSA expansion 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), thereby facilitating their participation in MSAs and further compounding the risk of triggering adverse selection in the health-insurance marketplace. Because of its potential to lead to sharp increases in health insurance costs, the anticipated MSA amendment could, if enacted, end up injuring consumers more than the other provisions of the Patients' Bill of Rights would assist them.

The MSA Demonstration

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), self-employed individuals, or the uninsured. Participants could deduct contributions to MSAs in amounts up to

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

Senators McCain, Kennedy, Edwards and other sponsors of the Patients' Bill of Rights legislation coming to the Senate floor (S. 283, S. 872) also support legislation (S. 284) that includes modest MSA expansions. Because these provisions do not make MSAs available to anyone who wants one and do not eliminate safeguards that discourage the use of MSAs as tax shelters, S. 284 does not engender the same risks of higher health insurance premiums and extensive tax shelter benefits for higher-income taxpayers as the Administration's proposal does. S. 284 would:

- Extend the MSA demonstration from 2002 to 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.

It should be noted, however, that S. 284 also contains various other tax and spending provisions unrelated to MSAs, some of which may have significant costs and budgetary impacts.

Extending the life of the demonstration in this manner may permit the collection of the data the GAO needs to evaluate MSAs and their impact on conventional insurance and health care costs. To date, lack of greater MSA utilization has prevented GAO from conducting the study mandated in the original demonstration project. The absence of such a study makes moving to universal availability of MSAs with weakened safeguards a particularly dangerous policy that poses serious risks to the availability of affordable health insurance coverage for those most in need of it.

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 last year to 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 have below-average medical costs) shift from conventional insurance to MSAs while older, less healthy individuals (who have above-average

medical costs) remain in conventional insurance, the cost of conventional insurance necessarily 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 MSA during the demonstration period. The IRS estimates that in 1999, some 54,000 tax returns reflected MSA contributions.[5] 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 demonstration legislation to prevent abuse of MSAs. Another possible interpretation of the sparse usage of MSAs under the demonstration project is that MSAs are not attractive as a health insurance product *per se* and can gain acceptance only if MSA policies allow substantial abuse of the accounts as tax shelters. The Administration's proposal would make MSAs considerably more attractive as tax shelters.

MSAs and Adverse Selection

As noted, a major concern is that universal access to MSAs would trigger widespread adverse selection in the insurance market. If healthier people choose high-deductible insurance with MSAs, the pool of people covered by conventional, more comprehensive health insurance will tend to be sicker on average than it otherwise would be. If the pool of people who are conventionally insured incurs 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 legislation allows participants to retain unspent health care dollars in their own accounts. Thus, people with low health care costs can accumulate tax-free earnings on those funds and use them as retirement savings or for other purposes.

On the other hand, older and less healthy people who judge they are likely to incur significant health care costs would be better off financially if they remained covered by 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 average health care

[5] IRS Announcement 99-95 (October 1, 1999).

costs than the larger pool of workers covered by conventional insurance today. To accommodate those higher average health care costs, the premiums charged for conventional insurance policies would have to increase, perhaps dramatically.

At the higher premium rates, it is likely that significant numbers of employers would be unwilling to offer their employees conventional insurance. In addition, the resulting decline in the market for conventional insurance could lead some insurers to cease selling it. Instead of addressing the needs of the uninsured, an MSA expansion proposal of this nature thus threatens to increase the ranks of the uninsured, especially among the older and sicker individuals who most need health-care coverage.

The Administration's MSA Proposal

The Administration's proposal is likely to serve as the basis for a floor amendment to the Patients' Bill of Rights. The proposal would open up MSAs to use by all individuals and employees working in any size business, allow MSA use on a permanent basis, remove the limit on the number of people who may participate in MSAs, and make other changes in MSAs that would increase their attractiveness as tax shelters.

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

- The evidence from the survey of insurers conducted for GAO in conjunction with the MSA demonstration project 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."[6]

The Administration's proposal 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.[7]

- MSAs are similar to conventional Individual Retirement Accounts: contributions are deductible from income, and tax is deferred on the amounts that the accounts

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

[7] 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.

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 proposal 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 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."[8] 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.[9]

- The report conducted by Westat for the GAO contains indications that MSAs already are starting to be seen as tax shelters. The report noted that: "The entry of Merrill Lynch and other investment firms into the MSA trustee arena and the maturing of the market have led to increased investment choices for MSA holders. This trend may be affected as well by some insurers' perceptions that MSA enrollees are using their accounts primarily as tax-sheltered savings vehicles rather than as sources of tax-sheltered funds for paying medical expenses."[10] The Westat report also states that "Insurers reported targeting some segments of the insurance

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

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

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

market [for MSAs], including highly-paid professionals, farmers and ranchers, partnership firms, and association groups."

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

Finally, the Administration's proposal 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 Administration's proposal 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 Administration proposal likely to serve as the basis for a floor amendment to the Patients' Bill of Rights would greatly increase the potential for abuse of MSAs as tax shelters. The proposal would make MSAs more attractive as tax shelters and likely lead to more widespread use of MSAs by healthy, affluent individuals. As a result, the proposal would compound the risk that MSAs will result in health insurance becoming unaffordable or unavailable for many Americans, particularly those most in need of affordable, comprehensive health care coverage. The proposal consequently is likely to increase rather than reduce the number of Americans without health insurance.