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HEALTH SAVINGS SECURITY ACCOUNTS: A COSTLY TAX CUT THAT COULD WEAKEN EMPLOYER-BASED HEALTH INSURANCE

HSSAs Could Shift Employer Coverage to Less Comprehensive Insurance and Adversely Affect Low-Income, Older and Sicker Workers

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Executive Summary

On June 26, the House of Representatives passed tax legislation (H.R. 2596) that includes a proposal to establish Health Savings Security Accounts — new tax-advantaged personal savings accounts that could be used to pay for out-of-pocket medical expenses. This legislation constitutes an expensive and unaffordable tax cut. The Joint Tax Committee estimates its cost at \$173.6 billion over 10 years.

These new Health Savings Security Accounts (HSSAs) would be available to taxpayers who are either uninsured or covered through a high-deductible health insurance policy, without regard to whether the policy is provided through an employer. The health insurance policy would need to have a minimum deductible of \$500 for individuals and \$1,000 for family coverage. Taxpayers could make annual tax-deductible contributions to these Health Savings Security Accounts of up to \$2,000 for individuals and \$4,000 for families, whether or not they itemize their tax deductions.

Only certain taxpayers would be eligible to make HSSA contributions; income limit rules would apply. Married couples with incomes up to \$170,000, for example, could contribute to an HSSA and receive a tax deduction. They could not contribute to an HSSA if their incomes are above these limits.¹ Like a traditional IRA, the funds in an HSSA could be placed in investment vehicles such as stocks and bonds, and earnings would grow free of tax. Withdrawals from HSSAs would never be subject to tax if they were used to pay for qualified medical expenses. (Withdrawals for non-medical purposes are subject to a penalty.) However, once an individual reached the age of 65, funds could be withdrawn for *non-medical* purposes without penalty.

The proposed Health Savings Security Accounts not only would place a major, costly new tax cut in the tax code but also would represent one of the largest changes in recent years in health insurance policy. The proposed accounts could significantly alter how employers provide health insurance coverage to their workers. HSSAs would likely weaken traditional employer-based coverage and shift a greater proportion of the costs of health insurance from firms to

¹ Couples could make the *maximum* allowable contributions only at somewhat lower income levels, as the deduction phases out over a \$20,000 income range starting at \$150,000. Among single individuals, the deductions phases out between \$75,000 and \$85,000.

employees, with resulting adverse effects on low-income, older and sicker workers. (H.R. 2596 also includes provisions to expand Flexible Spending Accounts and provisions to expand Medical Savings Accounts substantially and rename them “Health Savings Accounts.” The MSA expansion also poses substantial risks to the employer-based health insurance system and is further analyzed in a companion analysis.²)

Despite their potential to restructure the employer-based health insurance market, no hearings were conducted on the merits of these Health Savings Security Accounts before they were suddenly unveiled the night of June 18 and then included in legislation the House Ways and Means Committee passed the following day. Nor had any HSSA bill had previously been introduced. Despite the lack of any examination of the implications of these costly and far-reaching provisions, the House leadership substantially expanded the scope of the provisions (by opening up HSSAs to more higher-income individuals) in the House Rules Committee the night of June 25, and rushed them to the House floor for a vote June 26. The House passed this legislation and the House leadership subsequently merged the bill into the Medicare prescription drug legislation, which was also passed on June 26, before the Medicare drug bill was sent for conference with the Senate.

- **Health Savings Security Accounts constitute one more costly tax cut even as the federal budget outlook sharply deteriorates.** The Joint Committee on Taxation estimates that these accounts will cost \$163.4 billion through 2013. (The legislation containing these provisions costs a total of \$173.6 billion because of the Medical Savings Account and Flexible Savings Accounts provisions it also includes.) Moreover, the long-term cost of this package is even higher than these estimates imply because the proposal is backloaded. The Joint Tax Committee estimates show that nearly three-quarters of its cost occurs in the second half of the ten-year period. The cost of the HSSA proposal is \$32.2 billion just in 2013, the last year of the ten-year period, with costs still rising substantially from year to year. This indicates the cost in the second ten years would exceed \$300 billion, and possibly significantly more. (Moreover, if this measure is enacted, supporters of tax-free savings are likely to push in subsequent years to remove the already-high income limits for use of HSSAs. Employers would likely support lifting these limits to eliminate the substantial difficulties they are likely to encounter in administering the HSSA income limits. If these limits are ultimately removed so families at the highest-income levels can take advantage of this tax break, its long-term cost will become still greater.

The cost of this proposal must be seen in the context of other tax cuts the House has passed since the end of May. None of these tax cuts — “officially” costing nearly \$770 billion — has been offset; all add to the deficits that now dominate

² See Edwin Park and Iris J. Lav, *What’s in a Name? House of Representatives Would Change Name but not the Substance of a Proposed Expansion of Medical Savings Accounts*, Center on Budget and Policy Priorities, revised July 8, 2003. In addition, establishment of HSSAs could also reduce state revenues by up to \$30 billion over the next ten years. See Iris J. Lav and Andrew Lee, *New Health Savings Security Accounts Could Reduce State Revenues by Up to \$30 Billion over the Next Ten Years*, Center on Budget and Policy Priorities, July 8, 2003.

the fiscal landscape. A range of analysts and institutions now project that deficits over the next ten years are likely to total \$4 trillion or more when more realistic budget estimates are used, taking into account, for instance, the cost of continuing dozens of tax cuts that are slated to expire artificially and a \$400 billion Medicare drug plan. The new Health Savings Security Accounts worsen this bleak outlook and make it even more difficult for the nation to prepare its finances to cope with the retirement of the baby boom generation.

- **Health Savings Security Accounts could offer tax-shelter opportunities for higher-income individuals.** Under the HSSA provisions, married couples with incomes up to \$170,000 could make tax-deductible contributions to HSSAs (the maximum amount of \$4,000 that can be contributed phases down starting at incomes of \$150,000). As a result, higher-income individuals who are unable to make tax-deductible contributions to traditional Individual Retirement Accounts (IRAs) because of the IRA income limits — \$75,000 in 2004 and rising to \$80,000 in 2007 and after — would be able to make deposits to HSSAs, receive tax deductions for these deposits, accumulate savings tax-free in these accounts, and withdraw the funds for non-medical purposes upon retirement. (Note that the bill passed by the Ways and Means Committee set the HSSA income limits at similar levels as the traditional IRA limits but these income levels were raised dramatically in the House Rules Committee on the night of June 25.)

The Joint Committee on Taxation assumes that “given the favorable tax treatment of HSSAs compared to IRAs, we expect that, over time, significant numbers of individuals who would have saved in an IRA or similar vehicle will instead use an HSSA. In addition, individuals who are already making the maximum possible contributions to tax-favored savings vehicles and who wish to shelter more income from tax will contribute to HSSAs and other vehicles.”³

- **Health Savings Security Accounts could encourage employers to move away from traditional health insurance plans — which include low deductibles and modest copayments and cover a wide array of comprehensive benefits — to less comprehensive, high-deductible insurance, where employees bear a greater proportion of health care costs.** Under the HSSA provisions, employers could offer Health Savings Security Accounts if they are provided in conjunction with high-deductible health insurance policies; deductibles must be at least \$500 for individuals and \$1,000 for family coverage.

According to the projections of the Joint Committee on Taxation, under the HSSA legislation the Ways and Means Committee approved June 19, the *majority* of employers would modify their health insurance plans to conform to HSSA requirements. These Joint Tax Committee estimates reflected the impact of the legislation at a time when the Joint Tax Committee estimated its cost at \$62.6 billion or well under half of its current cost. The Joint Tax Committee’s estimate of the bill’s cost more than doubled when the bill was changed in the House Rules

³ Joint Committee on Taxation Memorandum, June 26, 2003.

Committee to raise the HSSA income limits dramatically. The Joint Tax Committee expects that at least *42 million* HSSAs would be established by 2013.⁴

As a result, employer-based health insurance with deductibles of \$1,000 or higher for family coverage would become widespread and could very well become the norm. In addition, employers would likely make their health insurance plans less comprehensive in other significant ways. Many employers would likely take such steps as scaling back the benefits covered and increasing the copayments required, noting that their workers could cover these increased out-of-pocket costs from funds in their tax-advantaged HSSAs.

- **This shift to less comprehensive employer-based health insurance would disproportionately affect low-income, older and sicker workers.** Many low and moderate-income workers would be unable to offset the greater out-of-pocket costs they would incur (if their employers switched to high-deductible policies that imposed higher copayments and covered fewer medical services) with the tax benefits they would receive for HSSA contributions they made. Nearly 75 percent of all households incur no tax liability or are in the 10 percent or 15 percent brackets. Low-income families that incur no income tax liability would receive *no tax benefit* from any HSSA contributions. For families in the 10 percent or 15 percent brackets, the deduction made available under HSSAs would offer a tax subsidy of only 10 cents or 15 cents of each dollar they contributed to HSSAs, making it highly unlikely that HSSA tax subsidies would offset the higher out-of-pocket expenses that families would face. Moreover, such families may not have sufficient income or resources available to make substantial contributions to HSSAs.

As a result, the higher out-of-pocket expenses such families would face could discourage access to medically necessary care. Substantial cost-sharing has been shown to have a disproportionate impact on lower-income families because such families have less disposable income available to pay for out-of-pocket health care expenses.

In addition, individuals in poorer health who use health services at a significantly higher rate would be disproportionately affected. According to one study from the Employee Benefit Research Institute, the loss of comprehensive coverage would leave many people who need significant amounts of health care, such as individuals with chronic conditions, underinsured.

- **As a result, enactment of the HSSA provisions is likely to create substantial winners and losers.** Younger, healthy individuals would tend to come out ahead as they could make tax deductible contributions to HSSAs and accumulate funds in those accounts. However, people with low incomes would get little or no tax benefit from HSSAs but could face a significant increase in out-of-pocket medical costs. Similarly, sicker individuals could incur a substantial increase in their out-

⁴ Joint Committee on Taxation Memorandum, June 26, 2003.

of-pocket costs that significantly exceed the tax benefits of HSSAs and any funds that their employers might contribute to these accounts.

- **The premiums for traditional health insurance could increase over time due to “adverse selection.”** The availability of Health Savings Security Accounts could make the costs of traditional comprehensive health insurance plans unaffordable for employers still willing to provide such plans to their workers. What is known as “adverse selection” occurs when healthier, younger individuals abandon one type of health insurance for another. When this occurs, the people who remain in the traditional type of insurance become a group that is less healthy, and hence more expensive, on average, to insure. Consider firms offering workers a choice of two plans: a less comprehensive, high-deductible plan with a HSSA and a traditional plan. Younger, healthier workers who anticipate facing few health care costs in the year ahead could choose to participate in the less comprehensive, high-deductible health insurance plans provided in conjunction with HSSAs. They would get to accumulate tax-free savings in these accounts and would secure a tax deduction for deposits they make into their HSSAs. Older and sicker people who judge they are likely to incur significant health costs, by contrast, and low-income workers who would receive no tax deduction because they do not earn enough to owe income tax, would tend *not* to participate in HSSAs. They would be better off remaining in traditional health insurance plans. Because the population in traditional coverage would become sicker, on average, as a result of the departure of substantial numbers of healthier employees from such coverage, health insurance premiums for traditional plans would necessarily rise over time. The increased premium costs would make it more difficult for employers to continue to offer such coverage.
- **Health Savings Security Accounts would do little to help uninsured individuals obtain health coverage and could encourage firms to eliminate any subsidy of employer-based coverage or no longer to offer health insurance.** Under the HSSA provisions, funds in HSSAs could be used to pay the premium costs of health insurance (whether offered through an employer or purchased in the individual market) as long as *no portion* of the cost is paid by an employer. This apparently is intended to help expand coverage to some of the uninsured. It is unlikely, however, that many uninsured people would gain coverage through this provision. Most uninsured families would receive, at best, only a 15 cent tax subsidy for each dollar they would have to spend on health insurance premiums. That is unlikely to be sufficient to make coverage affordable.

Furthermore, since workers with HSSAs could use funds in these accounts to pay health insurance premiums if — and only if — the coverage is not subsidized by an employer, employers could have an incentive to reduce their existing health insurance premium subsidies to zero. (A significant proportion of small employers already provide a subsidy of less than 50 percent of premium costs.)

Even with the tax subsidy for employee deposits in HSSAs and possible modest employer contributions to HSSAs, many low- and moderate-income families would likely be unable to afford to maintain their existing coverage if their employers eliminated premium subsidies and the employees had to pay 100 percent of premium costs. Finally, some employers (especially smaller ones) could decide not to offer health insurance altogether, citing the availability of HSSAs to help workers purchase health insurance on their own.

- **Medical Savings Accounts (MSAs) would also be expanded and pose additional risks to traditional employer-based health insurance coverage.** Renamed “Health Savings Accounts” and expanded significantly under an Administration budget proposal, MSAs could also lead to adverse selection. Like under HSSAs, younger and healthy individuals could take up MSAs in conjunction with high-deductible health insurance policies while older and sicker people remain in traditional health insurance plans. As a result, if MSA use becomes widespread and substantial numbers of younger, healthy people participate, the pool of people who remain in traditional health insurance will be sicker. Premiums charged for traditional policies could increase significantly. Expanded MSAs would also provide a lucrative tax shelter for all high-income individuals. Unlike HSSAs, there would be no income limits on participation. Expanded MSAs could also allow high-income taxpayers to bypass the HSSA income limits. Individuals can hold both MSAs and HSSAs. If individuals find that annual income exceed the HSSA limits, they could begin to make contributions to MSAs instead. Employers may offer both HSSAs and MSAs in order to ensure that all workers gain tax advantages irrespective of income.
- **Higher income workers ineligible for HSSAs would also receive greater flexibility under Flexible Spending Accounts (FSAs), which could facilitate the transition to less comprehensive employer-based coverage.** Currently, employees can make pre-tax contributions (up to a limit) to medical care FSAs, which they can use to pay out-of-pocket health care costs. Any FSA funds that remain unused in the FSA account at the end of the year cannot be rolled over into the following year. The House legislation would change the law governing FSAs, and would allow up to \$500 in unused FSA funds to be rolled over to the following year or be distributed to HSSAs, MSAs (renamed Health Savings Accounts), or retirement plans (if HSSAs are not available to an employee). The Joint Committee on Taxation estimates the cost of these provisions at \$8.7 billion over 10 years. While very high-income managers and officers would not be able to take advantage of HSSAs because of the income limits on tax-deductible contributions to HSSAs, employers could feel more comfortable scaling back their health insurance coverage (by raising deductibles and copayments and reducing benefits) knowing that their highest-income employees could use their expanded FSAs to help defray the greater out-of-pocket costs they would have to incur.

Unlike HSSAs, FSAs do not have income limits. Higher income taxpayers can make deductible contributions to FSAs. Thus, a taxpayer in the 35 percent tax bracket receives a subsidy of \$35 for every \$100 contributed to a FSA. Currently, the degree to which individuals can use FSAs for this purpose is limited in part by the inability to roll over funds. The changes in H.R. 2596 would make it easier for individuals to make larger contributions to FSAs and would provide thereby a larger tax break for higher-income individuals who could face higher out-of-pocket medical costs if employers move away from comprehensive coverage.

The provisions to make FSAs more flexible should be viewed as a companion proposal to Health Savings Security Accounts. Taken together, the HSSA and FSA proposals would provide strong incentives for employers to move away from traditional employer-based health insurance, under which employers generally offer comprehensive coverage with relatively low deductibles and cost-sharing and pay a significant majority of the cost, to a system where individuals bear a larger share of the burden of paying for their own health care.

Description of Health Savings Security Accounts Provisions in H.R. 2596

H.R. 2596 would establish Health Savings Security Accounts, which are new personal savings 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, without regard to whether the policy is provided through an employer. The health insurance policy would need to have a minimum deductible of \$500 for individuals and \$1,000 for family coverage. (There would be no maximum deductible.) These minimum deductible amounts would be adjusted annually in accordance with general inflation.

Taxpayers could make annual tax-deductible contributions to these Health Savings Security Accounts of up to \$2,000 for individuals and \$4,000 for families, whether or not they itemize their tax deductions. (These amounts would not be adjusted for inflation.) Both taxpayers and their employers could make contributions to the accounts in the same year, except that the total of such contributions could not exceed these maximum dollar limits. The HSSAs could be provided by employers as a benefit for their employees; individuals could also establish HSSAs on their own.

Certain taxpayers would not be eligible to make HSSA contributions; income limit rules would apply. Married couples with incomes up to \$170,000 could contribute to an HSSA and receive a tax deduction. Couples could not contribute to an HSSA if their incomes are above these limits.⁵

⁵ Couples could make the *maximum* allowable contributions only at somewhat lower income levels, as the deduction would phase out over a \$20,000 income range starting at \$150,000. Among single individuals, the deductions would phase out between \$75,000 and \$85,000.

House Tax-Cutting Flurry Continues

If the House of Representatives enacts the provisions of H.R. 2596 that establishes Health Savings Security Accounts, it will have adopted four tax-cut bills in the space of a month that together “officially” cost about \$770 billion through 2013. Moreover, these bills — which, in addition to the \$174 billion cost of H.R. 2596, include the \$350 billion tax cut the President signed on May 28, an \$82 billion expansion of the child tax credit, and a \$162 billion permanent repeal of the estate tax — represent the beginning, rather than the end, of the House’s tax-cutting plans. The House Republican leadership appears determined to pass the full \$1.3 trillion in tax cuts allowed under this year’s Congressional budget plan. House Majority Leader Tom DeLay, referring to the tax-cut allocation in the budget resolution, told *Congress Daily* that, “We intend to use every dollar of it.”

This tax-cut drive continues despite a worsening budget outlook. The nation’s fiscal position has deteriorated sharply since 2001. The Congressional Budget Office estimates that the \$5.6 trillion budget surplus that was projected at that time for the years 2002 to 2011 has completely disappeared. According to the March baseline, the budget outside of Social Security is projected to be in deficit for each year through 2011.

Moreover, even these estimates are widely regarded as much too optimistic. Since these CBO projections were made in March, Congress has provided funding for the war in Iraq and approved the \$350 billion tax-cut package; in addition, CBO estimates that revenues in the current year are likely to be \$50 billion to \$80 billion below the levels assumed in its March projections. Furthermore, under the rules it follows in making its projections, CBO is required to exclude a range of expected future costs. It does not include the cost of extending any of the tax cuts enacted in 2001 and 2003 that expire artificially or of extending other popular tax breaks that are scheduled to expire over the coming decade but have been routinely extended in the past. Nor does CBO include the cost of reforming the Alternative Minimum Tax to prevent it from affecting 40 million taxpayers (assuming the 2001 tax cuts are extended), up from fewer than three million taxpayers today. On the spending side, the CBO projections do not include the cost of a Medicare prescription drug benefit or the full cost of the Administration’s plans for defense spending, Iraq’s reconstruction, and homeland security. Altogether, using more realistic assumptions adds more than \$4 trillion to the deficit between 2004 and 2013, leaving the budget mired in deficit throughout the next decade and beyond.

A range of respected analysts concur with these more realistic assumptions and have expressed growing alarm over the nation’s fiscal condition. The investment firm Goldman Sachs recently concluded that the ten-year budget outlook is “terrible, far worse than official projections suggest,” estimating a deficit of over \$4 trillion for the period. Former Nixon Administration Commerce Secretary and chairman of the New York Federal Reserve Bank Peter Peterson also warned in recent congressional testimony of the “grave deterioration in the budget outlook over the past two years and the long-term injury resurgent deficits threaten to inflict on the economy and on future generations.” Peterson, too, estimates the deficits at \$4 trillion over the coming decade.

The nation already faces severe long-term budget challenges. Demographic changes related to the retirement of the baby boom generation mean that the cost of Social Security, Medicare, and Medicaid long-term care will rise substantially in the decade after 2013. The Administration’s 2004 budget itself acknowledges that budget projections over the long run “show clearly that the budget is on an unsustainable path.” The additional tax cuts the House continues to push will deprive the Treasury of needed revenues and further aggravate the dismal long-term budget picture the nation faces.

The funds in an HSSA could be placed in investment vehicles such as stocks and bonds, and earnings would grow free of tax. Withdrawals from HSSAs would never be subject to tax if they were used to pay for qualified medical expenses. (Withdrawals for non-medical purposes are subject to a penalty.) Moreover, once an individual reached the age of 65, funds could be withdrawn for *non-medical* purposes without penalty; starting at age 65, withdrawals for non-medical purposes would be treated the same as withdrawals from traditional IRAs — they would be subject to tax, but no penalties would apply. As a long-term, tax-preferred savings vehicle, HSSAs would be much more generous than traditional IRAs if used to cover medical costs after age 65, and essentially identical to IRAs if used for non-medical retirement costs.

Unlike most other provisions that allow certain medical expenses to be deducted, tax-deductible contributions to HSSAs also could be used to purchase certain types of health insurance.⁶ Funds could be used to pay the premiums for a high-deductible policy so long as no portion of the cost of the policy is subsidized by an employer or a former employer. The HSSAs would be available starting in tax year 2004.

A Costly Tax Cut Likely to Be Expanded Further

The Joint Committee on Taxation estimates that H.R. 2596 would cost \$173.6 billion through 2013. Of this ten-year total, \$163.4 billion reflects the cost of establishing the new Health Savings Security Accounts, \$5.7 billion reflects the cost of expanding Medical Savings Accounts, and \$8.7 billion reflects the cost of a provision that would expand existing Flexible Spending Accounts. Due to interactions among these provisions, the bill's total cost is \$173.6 billion over ten years. These tax cuts would come on top of other tax cuts that the House has recently passed and amidst growing concern over the worsening budget outlook; see box on page 8.

Moreover, this ten-year cost estimate of the HSSA provision *understates* its long-term cost. About one-quarter of the cost would occur in the first five years, while three-quarters of the cost would occur in the second half of the decade. By 2013, this tax cut carries an annual cost of over \$32 billion.

These costs would be still higher if the income limits in the bill were removed, allowing more high-income families to take advantage of the tax shelter opportunities that HSSAs provide. Although the income limits for making contributions to HSSAs already are at \$170,000, there likely would be pressure in subsequent years by supporters of expanded tax-preferred savings to raise or remove these income limits. (We note that some of this pressure resulted in the income limits for HSSAs being increased substantially after the Ways and Means Committee originally reported its tax bill.) The current Medical Savings Accounts, on which the HSSAs are modeled, have no income limits for participation. Similarly, in its budget, the

⁶ HSSAs could be used for the purchase of long-term care insurance, COBRA health insurance coverage, health insurance if the taxpayer is unemployed, high-deductible health insurance if no portion of the cost of such coverage is paid for by the employer or former employer, and retiree health insurance coverage for workers starting at age 65.

Health Savings Security Accounts Very Difficult to Administer

The rules surrounding the income limits for Health Savings Security Accounts are likely to be difficult to implement and to prove frustrating to employers trying to administer them. As the Joint Committee on Taxation notes, determining which employees are eligible for employer contributions to their HSSAs “would be difficult (if not impossible) for most employers.” The administrative problems these income limits are likely to create would lead ultimately to strong pressures to remove the income limits, which would transform HSSAs into a tax-advantaged savings vehicle that more disproportionately benefits high-income individuals.

Under the HSSA proposal, an individual and the individual’s employer can contribute to an HSSA. Contributions by the individual are deductible for income tax purposes, while contributions made by the employer are exempt from both income and payroll taxes. The bill also indicates that, when individuals file their tax return for the year, they must “return” to their employer any employer contributions made to their HSSAs during the year for which the individuals were not eligible, or face a penalty.

Employers who want to offer HSSAs as part of their benefits packages will be put in the awkward position of having to pry into their employees’ finances to determine eligibility, because the income limits in the bill apply not simply to the employee’s salary but to the employee’s income from all sources, including investment income and income earned by the employee’s spouse if the employee files a joint return. Many employees may be uncomfortable providing their employer with information about additional sources of income, fearing it may reduce their chances for future pay increases. Yet failure to project an employee’s total income accurately will result in a cumbersome and likely unpleasant year-end reconciliation process.

One can easily imagine a situation in which an employer makes regular contributions to an HSSA on behalf of an employee who estimates at the start of the year that his family income will be within the HSSA income limits. But when the year is over, and all the contributions have been made, the employee finds when doing his taxes that his family income is higher than expected and exceeds the HSSA limit. Ineligible to contribute to an HSSA, the employee would be required to return the employer’s contributions to his or her employer. Yet the employee may have spent some or all of these funds during the year to cover out-of-pocket health expenses, which will be higher than in the past because the coverage now has higher deductibles.

The employer could, presumably, let the employee keep the funds, but then these dollars would have to be treated as ordinary income, on which both income and payroll taxes (including the employer share of payroll taxes) would need to be paid. In addition, because this problem was only discovered after the end of the year, tax forms (such as W-2s) that have already been prepared would have to be altered to reflect the changed status of the employer’s HSSA contributions to earnings that are subject to tax.

As a result, if the House legislation is enacted, employers can be expected soon to begin pushing for elimination of the bill’s income limits entirely in order to ease administration and make the benefits of HSSAs available to all of their employees. Removing these limits would not only further increase the cost of this proposal but also would increase the likelihood that it would be used as another lucrative tax shelter for those with very high incomes, who could put away another \$4,000 a year in a tax-advantaged vehicle.

Administration proposed creation or expansion of a range of tax-preferred savings vehicles. A key distinguishing feature of all of these proposals is that none would impose an income limit.

Moreover, employers are likely to support lifting the income limits so they can provide a single health insurance plan — a less comprehensive, high-deductible plan in conjunction with HSSAs — to all of their employees irrespective of income. Employers would also likely want to eliminate the complexity of administering HSSA income limits. Employers would have to keep track of employees' total taxable income — a task they do not do now and which they are not likely to welcome — to avoid providing excess contributions to a worker's HSSA in violation of the income limits (see box on page 10). Eliminating the income limit, however, would significantly raise the proposal's already large cost. Very high-income taxpayers would be in a better position to make contributions to these tax-advantaged accounts and would gain larger tax breaks by doing so. And not only would there likely be a significantly higher participation rate among this high-income group, but the cost of their deductions to the Treasury would be greater than for those with less affluent incomes. The cost of a deduction to the Treasury, and its value to the taxpayer, rises as income rises, because at higher levels of income, taxpayers move into higher tax brackets. A \$100 deduction reduces taxes by \$10 for a person in the 10 percent bracket but by \$35 for someone in the 35 percent bracket.

High-income taxpayers also would be more likely to be able to let funds accumulate in these accounts and grow tax-free over time. And, to the extent that high-income taxpayers ultimately used these funds to cover medical costs, the tax benefits they would receive would be much more generous than the tax benefits provided under any other tax-preferred savings vehicle currently available, since the funds in the accounts would *never* be taxed.

Shift to Less Comprehensive Employer-Based Health Insurance

Perhaps the most troubling aspect of the Health Savings Security Account provisions is its potential to restructure fundamentally the employer-based health insurance system, with adverse implications for low-income, older and sicker workers.

Less Comprehensive, High-Deductible Policies Could Become the Norm

Currently, traditional health insurance offered through an employer typically provides comprehensive coverage, with relatively low deductibles, modest copayments and a wide array of comprehensive medical benefits. As a result, the Joint Committee on Taxation assumes that only a “small number” of individuals now have health insurance coverage that could meet the high deductible requirements of HSSAs and immediately participate in HSSAs.⁷

According to the Kaiser Family Foundation and the Health Research and Educational Trust, the average individual deductible was \$270 for single coverage in 2002 and \$665 for family coverage in conventional employer plans. Among preferred provider organization (PPO) plans, the average annual deductible was \$276 for single coverage. With regard to copayments,

⁷ Joint Committee on Taxation Memorandum, June 26, 2003.

How are Health Savings Security Accounts Different from Existing MSAs, FSAs, and HRAs?

Some supporters of the Health Savings Security Account legislation may argue that employers are already permitted to provide a number of other health accounts in conjunction with health insurance coverage — for example, Medical Savings Accounts (MSAs), Flexible Spending Accounts (FSAs) and Health Reimbursement Accounts (HRAs) — so the availability of HSSAs should not substantially transform the employer-based health insurance system.

However, the existing accounts have a number of restrictions that limit participation and thereby ameliorate, in part, the detrimental effect they would otherwise have in weakening traditional health insurance. HSSAs merge aspects of these various accounts and eliminate a number of the limitations placed on their usage, and thus are likely to encourage far greater use by employers and employees, as the Joint Committee on Taxation assumes. Higher participation rates would serve to intensify the risks that HSSAs are likely to pose to the traditional health insurance market.

For example, like HSSAs, Medical Savings Accounts are tax-advantaged savings accounts provided in conjunction with a high-deductible health insurance plan that pose significant risks of adverse selection. Until now, however, MSAs have been provided through a time-limited demonstration project and can be used only by employees of small businesses and the uninsured. Moreover, there has been an overall cap on MSA participation of 750,000 policies nationally. H.R. 2596 would not only establish HSSAs but also lift the limits on MSA use and rename MSAs as Health Savings Accounts; see box on p.19.

Under Flexible Spending Accounts, like HSSAs, employees can make tax-deductible contributions and use the funds in FSAs to pay for out-of-pocket medical costs. However, FSAs are available only if the employer has elected to offer them, and employers can not make contributions of their own to these accounts. In addition, employees must set their contribution level at the beginning of the year, and until now, employees have not been able to roll over unused funds to the following year or withdraw funds for non-medical purposes. FSAs can be used by workers irrespective of income.

Recently permitted by the Internal Revenue Service, Health Reimbursement Accounts are another form of accounts provided alongside high-deductible health insurance plans. However, employees may not make tax-deductible contributions to them. In addition, while workers may continue to have access to HRAs after they terminate employment or upon retirement, HRAs can be used only to pay for medical expenses. They cannot be used, for example, for non-medical purposes after retirement.

the vast majority of health insurance plans charge no more than 20 percent coinsurance or no more than \$15 or \$20 copayments per service.⁸

The availability of HSSAs could encourage firms to alter their existing health insurance arrangements. Instead of providing traditional health insurance plans, firms could instead provide less comprehensive, high-deductible health insurance plans in conjunction with HSSAs.

⁸ Kaiser Family Foundation and Health Research and Educational Trust, *Employer Health Benefits: 2002 Annual Survey*, September 2002.

Employers could conclude that they could reduce their health insurance premium costs by providing less comprehensive plans that impose high deductibles and increased copayments and cover fewer benefits. These firms could make a modest contribution to workers' HSSAs and then assume the workers would make further tax-deductible HSSA contributions. Together, these employer and employee contributions to HSSAs could help workers offset the increased out-of-pocket costs that employees would incur.

As a result, traditional health insurance could increasingly be replaced by less comprehensive high-deductible policies and HSSAs. Employer-based health insurance with deductibles of at least \$500 for individuals and \$1,000 for family coverage could well become the norm. In addition, employers could scale back the benefits covered and increase the copayments required under their health insurance plans, arguing that their workers could cover the increased out-of-pocket costs from their tax-advantaged HSSAs.

Would such restructuring of the employer-based health insurance system be likely to occur? At the markup of the HSSA provisions in the House Ways and Means Committee, the Joint Committee on Taxation stated that the *majority* of employers would modify their health insurance plans to conform to the high-deductible requirements of HSSAs. And, that estimate was conducted prior to the expansion of HSSA to higher-income taxpayers through the substantial increase in the income limits included in H.R. 2596. The Joint Committee on Taxation expects that under H.R. 2596, as passed by the House, at least *42 million* HSSAs would be established by 2013 and that many employers would consider modifying their insurance coverage to conform to HSSA requirements. As a result, the Joint Committee on Taxation's estimates of the cost of the HSSA legislation increased from \$72 billion under the Ways and Means Committee bill to \$163 billion for the bill passed the House approved.⁹

Employers Are Already Scaling Back Health Insurance Coverage

Why would the Joint Committee on Taxation expect such a large shift in employer-based coverage to occur as a result of HSSAs? Recent developments indicate that many employers would be likely to make such a shift if something like HSSAs becomes available.

Rapidly increasing health care costs and the current economic slump already have encouraged some employers to offer less comprehensive health insurance coverage to their workers and/or to increase the portion of the cost of insurance that their workers must shoulder. Employer-based health insurance premiums rose 12.7 percent between 2001 and 2002 and a Commonwealth Fund survey found that 41 percent of workers reported that in 2002 they faced higher employee premiums, received fewer benefits under their policies, or were required to make larger copayments for services used than the year before.¹⁰

Moreover, as a result of rising health care costs, an increasing number of larger firms are starting to offer a health insurance package that combines health accounts known as Health

⁹ Joint Committee on Taxation Memorandum, June 26, 2003.

¹⁰ Jennifer Edwards, Michelle Doty and Cathy Schoen, *The Erosion of Employer-Based Health Coverage and the Threat to Workers' Health Care*, The Commonwealth Fund, August 2002.

Reimbursement Accounts (which are similar to HSSAs except that they lack many of the tax advantages of HSSAs) with less comprehensive, high-deductible insurance policies, in lieu of offering traditional insurance.¹¹ As with HSSAs, these health accounts are intended to help defray the higher out-of-pocket medical costs associated with high-deductible plans. The employers that have instituted this policy generally have concluded that the contributions they make to these health accounts and less comprehensive high-deductible plans cost them less than continuing to subsidize the premium costs of traditional low-deductible, comprehensive insurance.

Employees offered these HRAs cannot make tax-deductible contributions to them; only their employers can contribute funds to these health accounts. Nor are employees permitted to withdraw funds from these accounts upon retirement for non-medical purposes. In these respects, these health accounts are considerably less attractive than HSSAs. They lack many of the tax advantages of HSSAs.

But this suggests that if HSSAs are made available, their use by employers would become quite widespread, as the Joint Committee on Taxation assumes. The HSSA provisions thus likely would induce a large number of firms to pursue this course and to begin offering HSSAs in conjunction with less comprehensive high-deductible plans. To reduce their overall health insurance costs, it is likely that employers would contribute less in aggregate to subsidize workers' health insurance premiums and make contributions to workers' HSSA accounts (from their own funds) than they would otherwise contribute for the premium costs of traditional health insurance.

Disproportionate Impact on Low-Income, Older and Sicker Workers

Such changes in employer health insurance could have substantial adverse effects on some workers and in particular, on low-income workers and older and sicker workers.

- Many low- and moderate-income workers would be unable to offset the greater out-of-pocket costs that they would be likely to incur if their employers switched to less comprehensive, high-deductible policies with the tax benefits they would receive for HSSA contributions they made. Low-income families that do not earn enough to incur income tax liability would receive *no income tax benefit* from making contributions to HSSAs. A married couple with two children with an annual income below \$23,290 would receive no tax benefit from making a

¹¹ Kaiser Family Foundation and Health Research and Educational Trust, *Employer Health Benefits: 2002 Annual Survey*, September 2002; Melody Simmons, "It's Your Money, You Decide," *Washington Post*, October 29, 2002; Albert B. Crenshaw, "Proposed Health Accounts May Give Employees More Control," *Washington Post*, July 7, 2002; Milt Freudenheim, "A New Health Plan May Raise Expenses for Sickest Workers," *New York Times*, December 5, 2001; Employee Benefit Research Institute and Consumer Health Educational Council, *Consumer-Driven Health Benefits: A Continuing Evolution*, 2002.

Table 1
Estimated Health Savings Security Account Tax Benefits in 2004 by Income
for Married Couple with Two Children¹²

Income Range for Married Couple with Two Children	Income Tax Benefit For Each \$1 Contributed to HSSA
\$0 to \$23,290	Zero Benefit
\$23,291 to \$36,400	Up to 10 cents
\$36,401 to \$88,100	Up to 15 cents
\$88,101 to \$150,000	Up to 25 cents
\$150,001 to \$170,000	Phaseout to Zero Benefit

contribution to a HSSA (see Table 1).¹³ This family would have to bear in full any increase in out-of-pocket costs (other than costs covered by an employer contribution to the family’s HSSA).

- For low- and moderate-income families in the 10 percent or 15 percent tax brackets, the tax deduction from a HSSA would defray no more than 10 cents to 15 cents of each dollar they would incur in greater out-of-pocket costs. A couple with two children earning about \$30,000 annually would receive a tax benefit of only \$400 from making a maximum HSSA contribution of \$4,000 (see Table 1). Furthermore, this assumes such a family would have sufficient income or resources available, in light of other household demands, to be able to make the \$4,000 maximum contribution to an HSSA. For many such families, the sum of the modest tax benefits that they would receive for the deposits they made in an HSSA plus their employer’s contribution to their HSSA probably would not be sufficient to offset the increased out-of-pocket medical costs they would face if their employer shifted to a less comprehensive, high-deductible plan.
- For most low- and moderate-income individuals and families — and especially for those who are older and sicker — high deductibles, significant cost-sharing, and lack of coverage of essential medical services under less comprehensive policies can lead to prohibitive out-of-pocket expenses that discourage access to

¹² These calculations are based on the family’s marginal tax rate and the interaction between tax liability and the child tax credit. The examples assume that families with income at or below \$50,000 use the standard deduction while families with income above \$50,000 take itemized deductions equal to 20 percent of gross income. The examples also assume that the child credit refundability percentage will be increased to 15 percent and that the child credit phaseout threshold for married couples will be increased to \$150,000 in 2004 (as passed by both the House and Senate but not yet enacted). If the percentage is not increased to 15 percent, a married couple with two children would receive no income tax benefit from HSSA contributions until the income exceeded \$26,420. If the phaseout threshold for married couples is not increased to \$150,000, some families with incomes between \$110,000 and \$150,000 would receive up to 30 cents in income tax benefits for each \$1 contributed to a HSSA.

¹³ Families of four with annual incomes below \$23,290 derive no benefit either because they incur no tax liability or they would have a corresponding decrease in the child tax credit that they would otherwise receive if they made tax-deductible contributions to a HSSA.

medically necessary care. Furthermore, substantial cost-sharing has a disproportionate impact on lower-income families and individuals and their use of medical services when such services are needed, since these people have less disposable income available for out-of-pocket health-care expenses.

Recent studies by the Commonwealth Fund heighten these concerns. One study found that so-called “bare-bone” health plans — which generally are comparable to less comprehensive high-deductible plans — can leave some lower-wage individuals and families with catastrophic costs well in excess of their annual incomes.¹⁴ Another Commonwealth Fund study reported that older individuals who have purchased policies in the individual health insurance market similar to less comprehensive high-deductible plans are *twice as likely* as comparable individuals with traditional employer-based coverage to fail to see a doctor when a medical problem develops or to skip medical tests or follow-up treatment.¹⁵

- Similarly, analyzing the general effects of moving away from traditional to less comprehensive coverage (not specifically in relation to HSSAs), a study from the Employee Benefit Research Institute concludes that the loss of comprehensive coverage would result in many people who need significant amounts of health care, such as individuals with chronic conditions, becoming underinsured or uninsured.¹⁶

Adverse Selection and Higher Premiums for Traditional Health Insurance

The availability of Health Savings Security Accounts could make the costs of traditional, comprehensive health insurance plans unaffordable for some employers that otherwise remain willing to provide such plans to their workers. As noted above, HSSAs pose a substantial risk of “adverse selection,” under which healthier, younger individuals abandon one type of health insurance for another. When this occurs, the people who remain in the traditional type of insurance constitute a group that is less healthy and hence more expensive, on average, to insure.

Consider a firm that offers two health insurance plan choices to its workforce. The first plan is a traditional health insurance plan with a low deductible, comprehensive benefits, and modest cost-sharing. The second plan is a less comprehensive high-deductible health insurance plan provided in conjunction with a HSSA.

- Younger, healthier workers who anticipate facing few health care costs in the year ahead may choose to participate in the less comprehensive high-deductible/HSSA

¹⁴ Sherry Glied, Cathi Callahan, James Mays, and Jennifer Edwards, *Bare-Bones Health Plans: Are they Worth the Money?*, The Commonwealth Fund, May 2002.

¹⁵ Elizabeth Simantov, Cathy Schoen, and Stephanie Bruegman, *Market Failure? Individual Insurance Markets for Americans*, Health Affairs, July/August 2001.

¹⁶ Laura Tollen and Robert Crane, *A Temporary Fix? Implications of the Move Away from Comprehensive Health Benefits*, Employee Benefit Research Institute, April 2002.

plan in substantial numbers to secure a tax deduction for deposits they make into the accounts and to accumulate tax-free savings.

- By contrast, older and sicker people who judge they are likely to incur significant health care costs, and low-income workers who would receive no tax deduction because they do not earn enough to owe income tax, would tend *not* to participate; they would be better off remaining in the traditional health insurance plan.
- Because of the higher-risk population that remains in the traditional plan, health insurance premiums for traditional coverage would rise over time. That, in time, would make it increasingly difficult for the employer to afford to continue offering such coverage as a plan option.

Similarly, adverse selection might be injurious to some firms that continue to provide traditional health insurance plans to their workforces. Such firms could become relatively more attractive to older and sicker workers, while firms offering high-deductible plans and HSSAs could become relatively more attractive to younger, healthier workers. The greater risks associated with an older, sicker workforce would increase the premium costs that such firms incur for traditional coverage. Firms that continued to offer traditional, comprehensive health insurance plans could face rising premiums and ultimately be forced to drop such coverage.

Finally, the availability of HSSAs for use in purchasing health insurance policies not subsidized by an employer (as discussed below) could create an additional incentive for younger and healthier workers not to participate in employer-based coverage. Economists have noted that some young and healthy workers already do not participate in employer-sponsored health coverage because they expect to incur little or no health expenditures over the course of the year. The tax benefits of a HSSA, which would be available to purchase insurance in the individual market, may increase the incentives not to participate, with the result that the pool of workers in employer-based coverage would become older and sicker, on average. That, in turn, would likely lead to rising premiums for employer-based health insurance and thereby increase pressure for employers to cease providing a subsidy for insurance they provide or to cease offering health insurance altogether.

“Backdoor” Deduction for the Purchase of Health Insurance in the Individual Market Unlikely to Help Cover the Uninsured

As noted, uninsured taxpayers would be able to establish HSSAs and use funds available in the HSSAs to purchase a high-deductible health insurance plan, as long as no employer paid for any portion of the premium cost of such insurance. This provision apparently encompasses both the purchase of unsubsidized health insurance provided through an employer and the purchase of health insurance in the individual market.

This would essentially establish a partial deduction for the purchase of health insurance in the individual market. Instead of claiming a deduction directly for health insurance premium costs, a taxpayer would make tax-deductible contributions to a HSSA and then use the funds in

the HSSA to purchase health insurance. But while this provision may be intended to expand coverage for the uninsured, it is likely to be largely ineffective in this regard.

- As discussed above, under the HSSA provisions, uninsured low-income families that do not earn enough to incur income tax liability would receive no deduction to help them purchase insurance. A large percentage of the uninsured would therefore be left out entirely. For example, among all uninsured adults and children in families of four, about one-third are in families with incomes below \$23,290 — the income level below which such families would derive no tax benefit from making tax-deductible contributions to HSSAs.¹⁷
- For uninsured moderate-income families in the 10 percent or 15 percent tax brackets, the deduction would defray no more than 10 cents to 15 cents of each dollar they would have to spend to purchase a health insurance policy, generally not enough to make insurance affordable.
- According to the General Accounting Office, the mid-range premium for comprehensive family insurance in the individual market exceeded \$7,300 in 1998.¹⁸ (Due to health care inflation, this amount is virtually certain to be higher today.) If a family earning about \$30,000 a year could contribute the maximum \$4,000 contribution to a HSSA, this would provide the family a \$400 tax subsidy and reduce the premium cost by only a little more than five percent. The remaining premium cost of \$6,900 for purchase of a \$7,300 policy would likely be beyond the family's reach.

Another study looked at premium costs in 17 cities for policies in the individual market for a single healthy adult aged 55 that are comparable to traditional policies provided in employer-based coverage. It found the median annual premium for such policies to be approximately \$6,100.¹⁹ Yet, an individual in the 10 percent tax bracket making the maximum HSSA contribution would receive a subsidy of only \$200 to help pay for the costs of health insurance.

- Furthermore, many older and sicker uninsured individuals likely would not be able to secure health insurance in the individual market unless they paid considerably more than these already high amounts. More than one quarter of all uninsured adults suffer from serious medical conditions such as cancer, heart disease or diabetes. Over half (53 percent) have a history of serious medical conditions, smoke, or are obese.²⁰ Among lower-income uninsured adults over

¹⁷ CBPP analysis of March 2002 Current Population Survey.

¹⁸ U.S. General Accounting Office, *Private Health Insurance: Potential Tax Benefit of a Health Insurance Deduction Proposed in H.R. 2990*, GAO/HEHS-00-104R (April 2000).

¹⁹ Jon Gabel, Kelly Dhont, Heidi Whitmore and Jeremy Pickreign, *Individual Insurance: How Much Financial Protection Does It Provide*, Health Affairs (Web Exclusive), April 17, 2002.

²⁰ CBPP analysis of 1997 Health Interview Survey.

H.R. 2596 Would Also Expand and Rename Medical Savings Accounts

H.R. 2596 also includes provisions to establish “Health Savings Accounts.” These new accounts are virtually identical to the Medical Savings Accounts and the HSA proposal in H.R. 2596 is virtually identical to the proposed expansion of MSAs contained in the Administration’s fiscal year 2004 budget. Like the Administration’s proposal, these MSA provisions would cost \$5.7 billion over 10 years. (For further examination of the MSA expansion, see our companion analysis entitled: *What’s in a Name? House of Representatives Would Change Name but not the Substance of a Proposed Expansion of Medical Savings Accounts.*)

In 1996, Congress established a Medical Savings Account demonstration project. Under the demonstration, participation is limited to no more than 750,000 individuals, and only employees of small businesses or self-employed individuals can participate. Participants must be enrolled in a high-deductible health insurance policy and may take tax deductions for contributions they make to MSAs in amounts up to certain limits. H.R. 2596 would eliminate the limits on MSA participation, which were enacted in 1996 to reduce the risks that the availability of MSAs would lead to adverse selection and to the use of MSAs as tax shelters. The MSA provisions of H.R. 2596 would make MSAs available to all individuals, increase the amount that can be contributed on a tax-deductible basis to MSAs and make MSAs permanent. This MSA expansion poses significant risks.

Like HSSAs, expanded MSAs could trigger adverse selection. Widespread use of MSAs could jeopardize coverage for substantial numbers of Americans in traditional health insurance plans by causing premiums for traditional insurance to rise markedly. Research by the RAND Corporation, the Urban Institute and the American Academy of Actuaries has found that premiums for traditional insurance could more than *double* if MSA use becomes widespread. Like HSSAs, MSAs can be attractive to younger, healthier individuals who expect to incur few health care costs over the course of the year. Older and sicker people who judge they are likely to incur significant health care costs would tend not to participate; they would be better off remaining in traditional health insurance. As a result, if MSA use becomes widespread and substantial numbers of younger, healthy people participate, the pool of people who remain in traditional health insurance will be sicker, on average, and more expensive to insure than it is today. As a result, premiums charged for traditional plans could increase significantly.

Expanded MSAs would provide a lucrative tax shelter for all high-income individuals. Unlike HSSAs, there would be no income limits on MSA participation. Expanded MSAs would enable all high-income individuals to circumvent the IRA income limits by using MSAs for the same purpose, as tax shelters to accrue substantial assets over time on a tax-advantaged basis. Furthermore, the MSA expansion would enlarge the value of MSAs as tax shelters by increasing the amount that can be deposited in a MSA each year on a tax-deductible basis. If MSAs are made universally available, the tax advantages of MSAs to healthy higher-income taxpayers are likely to be marketed by banks and investment houses leading, to further growth in MSA use as tax shelters.

MSAs would allow high income taxpayers to bypass the income limits applied to HSSAs. Individuals could hold MSAs and HSSAs at the same time. If individuals found that their annual income exceeded the income limits under HSSAs, they could begin to make contributions to MSAs instead. In addition, employers may offer both HSSAs and MSAs in order to ensure that all workers gain tax advantages irrespective of income. Having both options could be a factor in inducing more employers to move towards offering less comprehensive, high-deductible insurance.

age 50, some 39 percent report a limited disability, and 66 percent have been diagnosed with a chronic condition. Among all uninsured people aged 50-64, some 64 percent report at least one chronic condition.²¹

These sicker and older individuals who constitute a substantial percentage of the uninsured population would likely be unable to access adequate health insurance in the individual market without paying exorbitant amounts. The individual market is largely unregulated and generally permits individual medical “underwriting”. In other words, insurers can vary premiums based on age and medical history and can deny coverage entirely.

Not only would the HSSA provisions thus be unlikely to have large effects in enabling uninsured individuals to gain coverage, but they actually would risk *increasing* the ranks of the uninsured.

- The provisions could encourage employers to stop subsidizing the health insurance coverage they offer to their workers. Knowing that workers with HSSAs could use funds in these accounts to pay for premiums *if* the cost of such coverage is not subsidized by the employer, an employer would have an incentive to eliminate the premium subsidies it has been providing. This may be especially relevant with regard to small employers that already pay a smaller-than-average percentage of workers’ health insurance premiums. (On average, in 2002, firms with fewer than 200 workers that offered insurance subsidized 66 percent of the cost of family coverage, and 29 percent of such firms provided less than a 50 percent subsidy for family coverage.²²) As discussed above, the tax benefits of HSSAs are not likely to be sufficient for a family to afford the premium cost of completely unsubsidized employer-based coverage.
- Moreover, the provisions could induce some employers to drop health insurance altogether. Such employers could cite the availability of HSSAs to help workers purchase health insurance in the individual market. Previous studies have concluded that there would be some dropping of coverage by firms, with a number of currently covered individuals becoming uninsured as a result, if a deduction for the purchase of health insurance in the individual market were established.²³

²¹ Simantov, Schoen and Bruegman.

²² Kaiser Family Foundation and Health Research and Educational Trust.

²³ See, for example, Jonathan Gruber, *Tax Subsidies for Health Insurance: Evaluating the Costs and Benefits*, National Bureau of Economic Research, February 2000.

Expanded Flexible Spending Accounts Could Facilitate the Shift to Less Comprehensive Coverage

H.R. 2596 also includes provisions related to flexible spending arrangements (FSAs) used for medical care. 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. An employee may not carry over any funds left in an FSA at the end of the year.

H.R. 2596 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 Health Savings Security Accounts, to Medical Savings Accounts, or to retirement plans if HSSAs are not available. (The total amount carried over in a FSA or transferred to a HSSA or a retirement account could not exceed \$500 in a year.) Both of these FSA provisions would be effective starting in tax year 2004. According to the Joint Committee on Taxation, their combined cost would be \$8.7 billion over 10 years.

- As with any deduction, the value of a FSA rises with a taxpayer's tax bracket. The higher the tax bracket, the greater the tax subsidy that FSAs provide. As a result, the individuals who would gain the most from these FSA provisions would be higher-income taxpayers who can afford to contribute more of their wages on a tax-free basis to a FSA.
- The purpose of these FSA provisions is to encourage workers to deposit more funds than they currently do into their FSAs by promising them they can make other uses of the funds if the funds are not needed for medical care in the current year. Like the Health Savings Security Accounts, such provisions would likely encourage employers to offer health insurance with higher deductible amounts, less generous benefits and greater copayments, on the theory that employees could pay for costs not covered by insurance through their FSAs and could deposit more funds in their FSAs with less concern that they would lose unused funds at the end of the year.
- Some higher-income managers and officers would not be able to take advantage of HSSAs because of the income limits on HSSAs. But employers may feel more comfortable scaling back their health insurance coverage — by raising deductibles and copayments and reducing benefits — if these higher-income employees can turn to the expanded FSAs to help pay for the greater out-of-pocket costs they would incur. As discussed earlier, steps by employers to scale back the health insurance coverage they offer would be especially disadvantageous for low-income workers, especially those who are older and sicker. HSSAs and FSAs provide no or only a small tax subsidy to these workers to help defray the increase in out-of-pocket costs they would incur for medical care.

Could HSSAs Affect Eligibility for Public Programs Like Medicaid and Food Stamps?

The HSSA provisions may also affect low-income families' eligibility for public benefit programs. In determining eligibility, public programs generally impose an assets test, in addition to basing eligibility on income. For example, under Medicaid, 29 states impose an assets test on parents in low-income families. Similarly, the Food Stamp and the Supplemental Security Income (SSI) programs have stringent asset limits. While federal law excludes certain assets from such assets tests and states have some flexibility in this area in some low-income programs, the general rule is that assets are countable if they are accessible to a family.

For example, under Food Stamps and Medicaid, because funds in Individual Retirement Accounts can be withdrawn with a penalty before retirement age, IRA funds (net of the penalty amount) are usually counted as assets. Since funds held in HSSAs also could be withdrawn for non-medical purposes, with a penalty, it is likely that HSSAs would be treated in a similar manner. As a result, many low-income families could become ineligible for basic assistance because the funds in their HSSAs placed them over the low asset limits for these programs. The asset limit in Food Stamps, for example, is \$2,000 for a household without an elderly member. (This issue could be addressed if the HSSA legislation contained a provision excluding HSSAs from being treated as a countable asset for purposes of public program eligibility. The legislation, however, contains no such provision.)

This may be especially problematic for low-income families that lose their jobs and health insurance during an economic downturn and consequently need to access public benefits such as Medicaid and Food Stamps during their period of unemployment.

The provisions to make FSAs more flexible should be viewed as a companion proposal to Health Savings Security Accounts. Taken together, the two proposals would help move the health insurance system away from traditional employer-based health insurance — under which employers generally offer comprehensive coverage with relatively low deductibles and cost-sharing and pay a significant majority of the cost — to a system where individuals bear a significantly larger share of the burden of paying for their own health care.

Conclusion

The House-passed bill (H.R. 2596) establishing Health Savings Security Accounts constitutes an additional costly tax cut — with a total cost of \$174 billion over 10 years — at a time when the federal budget outlook continues to deteriorate.

HSSAs also pose considerable health policy risks. HSSAs could lead to the restructuring of the existing employer-based health insurance system through which the vast majority of Americans obtain their health insurance coverage. By encouraging employers to move away from traditional health insurance to less comprehensive high-deductible plans, HSSAs could shift a greater proportion of the costs of health care from firms to employees, with particularly adverse consequences for the low-income, older and sicker workers most in need of traditional health insurance coverage.

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