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Health Savings Accounts Are Crucial to Medicare Reform

by Michael F. Cannon

Last month, the House of Representatives and its Ways & Means Committee Chairman Bill Thomas (R-Calif.) advanced legislation to create tax-preferred savings accounts for medical expenses that would reform private health care *and* retiree health care. The health accounts legislation was attached to a bill adding a prescription drug entitlement to Medicare and then sent to a conference with the Senate. The only way this crucial reform will become law is if it remains attached to the underlying Medicare expansion.

Self-Insurance vs. Third-Party Insurance. Under current law, every dollar an employer pays in third-party health insurance premiums escapes the taxes levied on employee wages. Yet each dollar an employer puts into savings accounts for employees so they can self-insure against medical expenses is taxed (exceptions noted below).

Health Savings Accounts *Are* Medicare Reform

- Contain Medicare spending by empowering millions of patients to control medical inflation.
- Allow tomorrow's seniors to prefund retirement health expenses today.
- Build a constituency for future Medicare reforms based on competition and choice.

This encourages employers and employees to turn all of their health care dollars over to a third-party insurer instead of allowing employees to manage some of their own health care dollars in an account that they own and control. In this way, the tax law is biased toward the managed care model of health care delivery.

Exceptions to the Rule: FSAs and MSAs. Two health accounts excepted from taxation are Flexible Spending Accounts (FSAs) and Medical Savings Accounts (MSAs).

Employees who have access to FSAs can make monthly, pretax contributions and use the funds for medical expenses not paid by their health insurance. At year's end, however, participants forfeit unused FSA funds. This "use-it-or-lose-it" feature encourages people to engage in wasteful year-end spending.

The law also allows certain employers or their employees to make tax-deferred contributions to MSAs for medical expenses provided they also obtain a high-deductible insurance policy. Participants pay expenses from their MSA and out-of-pocket until they reach the deductible, at which point insurance takes over. MSA holders have an incentive to be prudent consumers, because unspent funds remain in their account and grow tax-free.

The problem with MSAs is too many unnecessary rules. The law restricts *who* may open an MSA, *how many* people may open an MSA, *what type* of health insurance they must purchase, *who* may contribute to an MSA, and *how long* MSAs may be opened. (For example, MSAs are currently restricted to the self-employed and employees of small business.) The law also creates a "doughnut hole" in MSA coverage by restricting MSA contributions to a fraction of the insurance deductible.

As a result, very few insurers, employers, and employees have found MSAs attractive. There were about 100,000 MSA accounts at last count. Nonetheless, MSAs rate high in customer satisfaction, and the Internal Revenue Service reports that 73 percent of those purchasing MSA plans previously had no health coverage.

Health Savings Accounts (HSAs). H.R. 2596 would improve dramatically on existing law by creating Health Savings Accounts (HSAs). Unlike MSAs, HSAs would face no caps on participation and no expiration date, and would be available to anyone under age 65. HSA holders would have to obtain a health insurance policy, but the policy could have first dollar coverage for preventive care and lower deductibles than are allowed with an MSA — for

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individuals, $1,000 vs. $1,700, and for families, $2,000 vs. $3,350. HSAs would close the "doughnut hole" by allowing contributions equal to the deductible. The bill would permit joint employer-employee contributions to HSAs, whereas dual contributions are not permitted for MSAs.

Finally, the bill would remove some of the wasteful incentives built into FSAs by allowing workers to transfer up to $500 of unused FSA funds into an HSA at the end of each year.

Health Savings Security Accounts (HSSAs). Health Savings Security Accounts (HSSAs) promise even more options. Under H.R. 2596, HSSA holders would not be required to purchase health coverage, and those who do could select deductibles as low as $500 for individuals and $1,000 for families. Annual tax-preferred HSSA contributions of up to $2,000 for individuals and $4,000 for families are allowed, and 55-to-64-year-old workers could make additional contributions, starting at $500 per year and rising to $1,000 in five years.

Individuals could make after-tax contributions to other family members' HSSAs; these contributions also would grow tax-free. Unlike MSAs and HSAs, HSSAs could be used to pay health insurance premiums, thus granting tax-preferred status to individually-purchased health insurance. They could also be used to pay retiree health expenses, including premiums, deductibles, and copayments under Medicare and Medigap plans.

Unlike other health accounts, however, HSSAs under H.R. 2596 would be subject to an income test. An individual with self-only coverage who earns $75,000 could contribute $2,000 to his HSSA, but the allowed contribution phases out at an income of $85,000. The contribution limit for those with family coverage would drop from $4,000 at $150,000 of income to $0 at $170,000 of income.

Health Accounts *Are* Medicare Reform. Private health accounts are a crucial component of Medicare reform. First, they would contain medical inflation to the benefit of all payers — including Medicare — by making millions of consumers more price-sensitive. Second, they would enable tomorrow's seniors to save for their retirement health expenses, including premiums, deductibles and copayments under Medicare and Medigap plans. Finally, health accounts are an investment in Medicare reform. H.R. 2596 would accustom Americans under age 65 to exercising more control over their own health care dollars. This would create an enormous constituency for future Medicare reforms based on choice and competition, rather than rationing and controls. [See the Table.]

Improving the Proposals. H.R. 2596 could be improved in several ways. First, Congress should quit trying to design private health insurance by specifying deductibles. Instead, it should allow the market to determine cost-sharing arrangements and allow the savings accounts to fund the patient's share of the cost.

Secondly, the income test on HSSAs must be removed. Like the restrictions on MSAs, income testing would constrict demand and discourage insurance products from entering the market. Millions of workers would be ineligible outright, and others would be deterred by confusion over eligibility — including, for example, workers paid on commission, who do not know their income until year's end. Meanwhile, employers would not want to offer a benefit to some employees but not others, much less collect data on the income of employees' spouses to determine who is eligible.

Conclusion. If Congress insists on adding obligations to an already unsound program, it has a duty to help all Americans save for the day when Medicare is unable to keep the promises it has made. Chairman Thomas' health accounts are a crucial component of Medicare reform. If the Thomas proposal is separated from the pending Medicare expansion, seniors and nonseniors alike will be worse off, and it will be decades before this crucial reform has any chance to become law.

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