Issue BRIEF

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What's Wrong with Tax-Free Savings Accounts for Health Care?

Tax-free personal savings accounts for health care—which have an alphabet soup of different acronyms (MSAs, HRAs, HSAs, HSSAs)[1]— have become the latest cure-all for the problems facing our health care system.[1] For some policymakers, they function as a "free lunch" solution: The tax cuts don't appear to cost anything, they don't add to "big government," and they seem to foster individual self-responsibility. And what's not to like about a simple, ready remedy for rising health insurance costs?

Well, for starters, there's the matter of fairness. Tax-free health savings accounts are, in essence, a federal tax cut that offers the greatest benefits to those who need them least (because they are healthy) and who can profit from them most (because they have extra income to shelter from federal taxes).

The second part of the answer is harder to grasp (and more difficult to explain). It is that tax-free health savings accounts move our nation's health care system towards new types of health coverage plans that *isolate* the old, the sick, and others who are more likely to need health care, thus undercutting the basic concept of insurance—which is the sharing of risk (in this case, of health care costs). Those of us who are healthy today contribute to the system because we may become unhealthy—and need help paying for our health care—tomorrow.

These new plans, often marketed as "consumer-driven health plans" or "consumer-choice health plans," combine a tax-free personal savings account for health expenses with a high-deductible health insurance plan. Some employers, determined to rein in mounting health care costs, are contemplating the adoption of such plans.

These plans may indeed save money for employers and for healthy workers with minimal health care needs—at least in the short-term. However, the savings that employers and healthy workers achieve through these plans will primarily come from shifting more of the costs of health care to workers who are sicker or need more health care services.

To see how these plans undermine the pooling of risk that is the basis for insurance, we look at a hypothetical company, American Widgets. Here's what we find:

- Some American Widget workers will get a bonus for being healthy.
- Other workers, however, will be financially penalized for being sick or needing health care services.
- And, at the same time, the total dollars available to pay for health care services in our health care system will be significantly cut; who will feel the axe and how it will swing are uncontrolled.

FamiliesUSA
The Voice for Health Care Consumers

Who Saves What?

American Widgets has a workforce of 1,000 workers. In response to growing health costs for employees, American Widgets is considering two different approaches to employee health insurance: a traditional plan of the type they have offered for years and a new-fangled plan that combines a high-deductible insurance policy with a tax-free health savings account.

Option 1: The Traditional Plan

The typical traditional health insurance plan provided by American Widgets has annual premiums that have risen to $5,000 per worker. American Widgets pays 80 percent of the premium, and the worker pays the remaining 20 percent. The plan has an annual deductible of $1,000, and workers pay, on average, 15 percent of the cost of doctor visits and other services.

Option 2: High-Deductible Plan with Health Savings Account

Compare this to the new-fangled plan that combines a high-deductible insurance plan with a health savings account. Under this new plan, American Widgets provides a $1,000 savings account that the worker can spend on medical expenses. If the worker does not use this money during the year, the funds roll over and stay in the account; they are not returned to the employer. Accumulated funds can be used for non-medical expenses with no tax penalty after the worker reaches the age of 65.

Because employers are moving toward these plans to save money, American Widgets will shop for a high-deductible plan with a total premium of $3,750—making the company's share $3,000 per worker (80% of $3,750)—to combine with the company's $1,000 deposit to employees' health savings accounts. This keeps American Widgets' total spending to $4,000 per worker.

Premiums do go down as the size of the deductible grows, but it takes a significant jump in the deductible to bring down premiums this much. Thus, American Widgets selects a health insurance plan with a deductible of $3,000, leaving a "gap" of $2,000 workers must cover after they use up the $1,000 in their health savings account before plan coverage kicks in. Once the worker meets the deductible, this health insurance plan provides the same coverage as the traditional plan, with the worker paying coinsurance of, on average, 15 percent of the cost of services.

From the Employer's Perspective

Here's a comparison of the basic elements of these two health insurance alternatives from the employer's perspective:

	Traditional Plan (per worker)	**High-Deductible Plan with Account** (per worker)
Premium	$4,000 (80% of $5,000)	$3,000 (80% of $3,750)
Contribution to Savings Account	none	$1,000
Total Employer Spending	$4,000	$4,000

From the Workers' Perspective

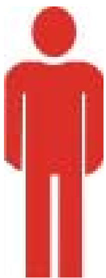
Now let's see how these plans work for two different workers: Harriet, who is relatively healthy, and Earl, who has an illness. Healthy Harriet, whose only health spending is for a visit to her doctor for the flu and an annual check-up, will come out happy:

Healthy Harriet

	Traditional Plan	High-Deductible Plan +Account
Premium	$1,000 (20% of $5,000)	$750 (20% of $3,750)
Spending before the deductible is met	$500	$500
Coinsurance	$0	$0
Harriet's total spending	$1,500	$1,250
But $500 is from her health savings account provided by her employer	N/A	-$ 500
Harriet's bottom line	**$1,500**	**$ 750**

Wow! Healthy Harriet comes out ahead under this new plan—saving $750! Plus, she still has $500 in her health savings account that, with luck and good health, will make her retirement easier. "Aren't these new plans great! Sign me up!" says happy, healthy Harriet.

But who pays for happy, healthy Harriet's savings? Look at what happens to her not-so-lucky co-worker, ill Earl. Ill Earl has $21,000 in health care bills during the year.



Ill Earl

	Traditional Plan	High-Deductible Plan + Account
Premium	$1,000 (20% of $5,000)	$750 (20% of $3,750)
Spending to cover the deductible	$1,000	$3,000
Coinsurance	$3,000 (15% of $20,000)	$2,700 (15% of $18,000)
Earl's total spending	$5,000	$6,450
But $1,000 is from his health savings account provided by his employer*	N/A	- $1,000
Earl's bottom line	**$5,000**	**$5,450**

Ill Earl is going to be irritable—he is going to spend an extra $450 (9 percent increase) above and beyond his account just because he is now covered under the new plan.

But wait a minute you health care accountants and economists—under the new high-deductible plan with a health savings account, some health care spending dollars are missing. Healthy Harriet saved $750 under the new plan and got a $500 windfall to boot—but her savings are not completely balanced by ill Earl's increased costs of $450.

* Earl may feel like this money did not come out of his own pocket because the employer provides the $1,000 in his health savings account. However, because Earl must spend all the money in his health savings account, he loses the opportunity to hold on to this money for later health expenses or for his retirement. If he thinks about himself as compared to Harriet, he will realize that these plans actually create a *pay* inequity between sick and healthy workers.

From the Health Care System's Perspective

If we assume that American Widgets has 1,000 workers and that 70 percent of them are very healthy, then look at the impact on the health care system of the company's move from a traditional health insurance plan to a health savings account plus high-deductible plan:

Dollars going into the health care system under traditional health insurance plan:	
Premiums paid the employer $4,000 x 1,000 workers	$4,000,000
Total spending by healthy workers $1,500 x 700 workers	$1,050,000
Total spending by sick workers $5,000 x 300 workers	$1,500,000
TOTAL dollars going into the health care system	**$6,550,000**
Dollars going into the health care system under the health savings account/ high deductible health insurance plan:	
Premiums paid by the employer $3,000 x 1,000 workers	$3,000,000
Total spending[1] by healthy workers $1,250 x 700 workers	$ 875,000
Total spending[2] by sick workers $6,450 x 300 workers	$1,935,000
TOTAL dollars going into the health care system	**$5,810,000**

[1] $750 employee share of premium plus $500 health expenses paid from health savings account.

[2] $750 employee share of premium plus $1,000 health expenses paid from health savings account plus $2,000 paid out-of-pocket by employee before coverage begins plus $2,700 in coinsurance payments.

The impact of moving to the new high-deductible/health savings account plan on our health care system—our hospitals and doctors and other health care providers—is an 11.3 percent cut in total dollars ($6,550,000 minus $5,810,000 equals $740,000).

How will a cut of this magnitude be apportioned? Whose ox will be gored? We cannot know in advance. Insurers may raise premiums or shift more health care costs to sick workers through larger deductible "gaps" or higher coinsurance. Or insurers may pay hospitals and doctors and other health providers less to recoup the lost dollars. In reaction, hospitals may close emergency rooms and providers may refuse to treat any uninsured or underinsured patients. The trend of health insurers to avoid contracting with higher cost facilities—our nation's teaching and research hospitals—could be accelerated. That could mean less training for new doctors and less medical research and fewer clinical trials. The vital contributions that these institutions make to our health care system—cancer research, diabetes research, life-saving clinical drug and treatment trials, the development of new techniques of surgery and treatment, just as examples—would be in jeopardy.

While cost-containment is an important goal, we should cut costs in our health care system very carefully using a scalpel, not swinging an axe.

But Wait – Why Not Give Workers a “Choice” of Plans?

Proponents of high-deductible/health savings account plans sometimes argue that everyone can come out ahead if we just give workers the chance to choose between a traditional plan and these new plans. At American Widgets, we could let the ill Earls stay in the traditional Plan A and let the healthy Harriets select the new fangled Plan B that saves them money.

While that might work the first year, what happens in the long run? Adverse risk selection, that’s what. What’s that? “Adverse risk selection” happens when all the sick workers end up in Plan A and all the healthy workers end up in Plan B. That won’t hurt Plan B. No, indeed. In fact, as the insurer keeps collecting premiums for the healthy workers in Plan B, who don’t have many expensive claims to be paid, the insurer will actually see its profit margin grow and may even reduce the premiums for Plan B. But the experience of Plan A will be just the opposite. The gap between what is collected in total premiums and what is paid out for claims will sink into the red. Plan A will have to raise premiums. So the ill Earls at American Widget will see their health care costs escalate. And so will American Widget (remember, they are paying 80 percent of those escalating premiums). For American Widget, at some point or other the only solution is to stop offering a choice of plans.

Fun and Frivolous Treatment and Trips to the Doctor?

Proponents of health savings account/high-deductible plans believe that these plans will generate savings, possibly in the form of reduced premiums, because workers, newly aware of the costs of care and desirous of building up funds in their health savings accounts, will shop more carefully, buying fewer and cheaper services. However, there is very little empirical evidence for the notion that people are over-utilizing health care services now and that there are unnecessary services they can eliminate. Some people may eliminate annual check-ups, tests, and other preventive care to save money—but such avoidance of preventive care is likely to result in higher long-term health care costs when health conditions go undiscovered until an expensive health crisis arises. Indeed, some employers who are trying these new plan structures are covering expenditures for preventive care separately to discourage the *under*utilization of preventive care. In fact, the vast majority of health care utilization (and attendant costs) result from a small number of people with very high utilization of services for chronic or serious health conditions. As a rule of thumb, in any one year, 5 percent of the people use 50 percent of the health care services. Most of the utilization by this population is not affected by health savings accounts—the great proportion of their health costs are covered by the high-deductible plan.

[1] For more information about this alphabet soup, see Kathleen Stoll, *Tax-Free Savings Accounts for Medical Expenses: A Tax Cut Masquerading as Help to the Uninsured* (Washington: Families USA, July 22, 2003).

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