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Medical Savings Accounts

The efficacy of medical savings accounts will be determined, in large part, by their plan design. However, young and healthy employees could be big winners with an MSA. Depending upon plan design, approximately two-thirds of current workers would gain financially if employers combined MSAs with high-deductible plans.

In an American Academy of Actuaries study, the 17 percent of employees who have no medical expenses reimbursed by their current health plan would have the highest gain—possibly more than $600 under an illustrative plan examined by the Academy. The 8 percent of employees who have high medical expenses would have the greatest loss—as much as $900 under the same plan. Administrative costs, which now account for approximately 15 percent of claims payments, also would be considerably lower under MSAs.

This brief is based on the full report, "Medical Savings Accounts: Cost Implications and Design Issues," which is available from the American Academy of Actuaries.

1. Introduction: What Is an MSA?

A medical savings account (MSA), as envisioned in most current proposals, is an individual medical account that employees can draw from to pay medical expenses. It is set up by an employer for an employee who is eligible for health insurance coverage and is funded by employer and/or employee contributions.

Funds in the MSA would be designated as the employee's own money. Any portion of the fund that is not used to pay for current medical expenses can simply accumulate in the MSA. There it is allowed to earn interest and will be available for any future medical expenses.

Funds in an MSA usually would not be sufficient to cover the cost of major illness. So MSAs will almost always be combined with a health insurance plan that covers medical expenses above a fairly high deductible.

Deductibles that have been discussed range from $1,000 to as high as $3,000. Above the deductible, the catastrophic insurance plan might also have some co-insurance, say 20% of all medical expenses up to $5,000. Amounts in the MSA could be used to pay expenses up to the deductible and copayments above the deductible, provided the MSA had sufficient funds.

As a general rule, MSA funds would come from annual tax-free contributions made by the employer to each employee's account. Initially, the employer would probably contribute an amount equal to the difference between the per-employee cost of the high-deductible insurance and the per-employee cost of the employer's lower-deductible plan. If the combined MSA/high-deductible plan generated further future savings, the employer might or might not choose to pass the savings on to workers through higher MSA contributions.

Because MSAs cannot be established under current law, there are many theories about how MSAs might

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affect the U.S. health care system. Employers, employees, health care providers, and the IRS all would be affected. Determining their preferences is critical to predicting how MSAs would affect U.S. health care.

2. Effect of the High Deductible

The high-deductible component of the MSA/high-deductible coverage will have one very important feature. It will include copayments from the patient (such as deductibles or co-insurance) substantially higher than those typical in today's health insurance market. This could exert a potent effect on how MSA owners decide to spend their MSA funds.

Available research indicates that the demand for traditional health care depends to a considerable extent on how much of a provider's bill must be paid out of one's own pocket. In 1978, when Newhouse et al. investigated the two extremes, total coverage and no coverage, individuals with full coverage of medical expenses made twice as many physician visits as those without coverage.

Copayments exert two significant effects. Higher copayments cause a decrease in insured health care expenses because less of each medical bill is paid by the insurer. Also, having to pay more out of one's own pocket discourages people from using health care services.

How will employees think about their MSAs? If they think of them as little more than another type of insurance, then utilization might be much the same as with a typical low-deductible plan. In some cases, utilization might actually be greater. By contrast, if employees consider their MSAs to be personal savings accounts, utilization might be depressed to almost the same level as a high-deductible policy without an MSA.

If workers look upon their MSA as savings, potentially countervailing motivations would arise. Having control of how health care dollars are spent, through an MSA, could make individuals smarter shoppers for medical care.

On the other hand, insurers generally place limits on what they will reimburse. Without these limits, MSA funds will be available for more services than plans currently cover. In many proposals, all the services recognized by the IRS as legal for income-tax-deduction purposes are considered appropriate for MSA expenditures. Services for routine physicals, eyeglasses, psychological consultations, and cosmetic services are often excluded or limited.

Other plan design elements can also modify the cost-deterring impact of a high deductible. These include limitations on cost-sharing like out-of-pocket maximums. Also, provisions stipulating whether deductibles include or exclude certain kinds of services can alter the effect of the deductible.

Further, the amount of new savings possible from adding a high deductible depends greatly on how much cost savings has already been achieved by the plan that preceded the new high-deductible plan. Perhaps the old plan, through tightly managed control, such as in an HMO, has already eliminated most of the excess utilization. Then, the high deductible will likely not yield very much in further savings. Hospital costs, in particular, may not be susceptible to further savings. Data show that utilization has already dropped by 25% in the last 10 years. There will, however, be more room for savings in other areas such as drugs, outpatient care, and professional services.

Conclusion. The extent to which MSAs will generate savings is far from certain. When consumers are offered only catastrophic coverage through high-deductible plans, health care spending falls. However, when MSAs which work so as to offset the high deductible are introduced, health care spending may or may not fall, depending on a number of factors. Spending could decrease if the law governing MSAs is well-conceived, if employers design their MSA options carefully, and if workers eventually view their MSAs as their own personal savings.

3. Tax Treatment of MSAs

It will be critical, in promoting the widespread introduction of MSAs and ensuring that they are financially sound, to establish a well-thought-out roster of tax regulations to foster these objectives.

Under most MSA proposals, both contributions to MSAs and payments for health expenses from MSAs would come from before-tax monies. However, employees would have to pay taxes if they used their MSA funds for nonmedical purchases, in addition to a penalty if the money was taken out before some specified age.

Right now, health care expenses paid by employers are fully tax deductible. Current proposals stipulate that all contributions to MSAs would be tax deductible as well. However, some specify that an employer's total tax deduction for the new MSA/high-deductible plan would be limited to what

the employer pays in insurance premiums for the current health care plan.

There are substantial differences among proposals concerning the tax treatment of the investment income that would accumulate on unspent MSA funds. Some proposals would tax the interest earnings on MSA account dollars. Others would allow investment earnings to accumulate tax free.

Proposals also differ in regard to how much money could accumulate in an MSA. And there are differences in what is specified as appropriate nonmedical circumstances for making withdrawals from the MSAs.

Conclusion. If either contributions to or medical withdrawals from MSAs were taxed, there would be no particular advantage to having one. Few employees would want an MSA, and few employers would establish them. On the other hand, if there are no limits on pre-tax contributions and the tax-free buildup of funds, MSAs would lead to greater government subsidization of health care and lost tax revenues. MSAs could then become a tax shelter for the well-to-do and a tax-free vehicle for special-purpose savings (e.g., down payments on first homes). The tax treatment of MSAs must be skillfully crafted to encourage their adoption, while discouraging their use as mere tax-planning devices.

4. Administrative Expenses

Currently, administrative expenses for all the insured plans in the United States average 15% of claims payments. MSAs could reduce some of this expense. Employees would have direct access to the funds in their MSA account, so they would not need to file any claims.

However, the administrative costs of the high-deductible component must be considered, too. With a standard (low) deductible plan, there are many low-cost claims. For these, administrative expenses represent a high percentage of the claim payments. The low-cost claims are avoided with a high-deductible plan. But insurers will absorb considerable expense in managing the complex cases under the high-deductible plan. For example, a $2,100 claim with a $2,000 deductible in place will be expensive to administer. The insured amount is only $100, but the entire $2,100 of expenses must be verified as covered expenses.

For the MSAs themselves, however, administrative costs will probably be much lower than with a standard low-deductible plan. In fact, if MSAs are not subject to expenses like premium taxes, sales commissions, or extensive reporting for tax purposes, administrative expenses could be as low as 2%.

Conclusion. Administrative expenses, which now account for approximately 15% of claims payments, would be about the same for high-deductible replacement plans. There would be overall administrative cost savings, however, because there would be fewer claims to process. The administrative expenses for MSAs would be lower than the expenses for other types of health insurance. Thus, for a combined MSA/high-deductible plan, administrative costs will be less than the current 15%.

5. Health Plan Options

Adverse selection is one possible consequence of employers offering MSAs as one of a range of health coverage options for their employees.

Roughly defined, adverse selection results when individuals attempt to figure out, and then opt for, the insurance coverage that provides them with the greatest financial benefit. Presented with a range of health plans, the healthier people would tend to pick the high-deductible, low-cost plan. The less healthy would usually choose a low-copayment plan. The effects of this selection process are increased premiums for the low-copayment plans and corresponding decreases in premiums for the high-deductible plans.

But even more problematic is the case in which the MSA is offered alongside other plans whose fundamental philosophy and design differ dramatically from that of the MSA—managed care plans.

The current environment is built around a system of management controls and discounts. The extreme approach, traditional HMOs, combines both of these. Integrating the MSA concept into this environment presents significant problems. The goal of the government and employer should be to preserve the savings achieved by the current environment while offering the employee more influence in the purchase of health care.

The simplest solution for employers would be to offer the managed care plan as a totally separate option. It would be possible, but difficult, to integrate managed care into the framework of the MSA itself. The latter approach would require a major restructuring of the copayment and reimbursement structure of the traditional HMO. State and federal law would have to be modified to permit HMOs to compete within this changed environment.

Conclusion. Employers, insurers, and providers have built a complex web of management controls and discounts that have already squeezed much of the savings out of the health care industry. Most of these programs offer several ways for the employee to opt out of the highly managed care but with control mechanisms that overcome the effect of adverse selection. The major problem for employers and insurers will be to expand and restructure their programs to fold in an MSA/high deductible option without losing the savings already achieved by the current program.

6. Effects on Health Care Costs

To estimate what savings (or losses) might be anticipated from the new MSA/high-deductible plans, three actuarial assumptions are needed. These are (1) the distribution of health care expenditures under current plans; (2) the change in utilization and cost that would ensue from the higher copayments of the high-deductible components; and (3) the extent to which the availability of an MSA fund would offset the savings from high deductibles.

The work group compiled the best available data on how health dollars are spent today. The group selected a range of factors used in predicting how much utilization and cost might decline when copayments increase. This information was employed to determine the consequences of substituting a new MSA/high-deductible plan for a fee-for-service plan that has little or no management of care.

The new MSA's effect could range, on average, from almost full offset of the expected dampening impact of a higher copayment to little impact at all. The key is the employees' perception of their MSAs. Do they think of their MSAs as their own personal savings which must be conserved for medical emergencies? Or do they view their MSA as merely additional insurance money to spend as they like on health care? It is this spectrum of differences in how employees would view their MSAs that requires the use of ranges in the estimates below.

Bearing this in mind, we can anticipate the impact of increasing a deductible for an individual from $200 to $1,500. Co-insurance above the deductible is 20%. Then, total expenditures for health care costs would decrease from $3,041 per employee to a range of $2,695 to $2,976.

Also, the premium for the health plan would drop by a range of $585 to $690. Assuming that the employer holds constant how much it spends for its employees' health care, this is the amount that the employer would pay into each employee's MSA.

The *average worker's* out-of-pocket expenditures would fall from $882 to a range of $536 to $817. However, the range of out-of-pocket charges for *individual workers* would be much greater.

The largest average savings for the 17% of employees who have no medical expenses reimbursed by their current health plan would be $574 to $676. This money would actually accrue for those workers, personally, in their MSA accounts.

At the other end of the spectrum, the largest cost increase would be experienced by the 8% of employees who have high medical expenses. They could see an average increase in their cost ranging from $827 to $926. And an individual worker could have a much higher increase than the average. These are their incurred out-of-pocket expenses that would be added to the out-of-pocket expenses under their old plan, less the employer MSA contribution.

These numbers are predicated on two assumptions. First, all employees are covered by the MSA, so there is no adverse selection. Second, managed care in the current plan is minimal. Under this scenario, roughly two-thirds of all employees would stand to gain financially by the introduction of MSAs. The other one-third would lose, because less of their high medical costs would be covered.

Conclusion. It is reasonable to expect some savings in health care expenses from the introduction of MSAs. However, that expectation is predicated on a favorable outcome with a long list of factors. Some of these factors will be within the control of the individual company (plan design features). But others (notably, tax treatment) are external to the company.

Therefore, achieving the greatest possible savings via MSAs will require well-designed legislation. It will also rest upon careful planning on the part of those employers that decide to establish health care plans with MSAs. Finally, the savings will depend on the extent to which individuals believe they have some stake in spending their MSA dollars wisely, along with their ability to become more sophisticated, cost-conscious health care shoppers.