
The Potential Impact of Consumer Health Savings Accounts as a Market-Based Approach for Improving Quality and Reducing Costs

by Paul Fronstin, Ph.D.

Director, Health Research and Education Program
Employee Benefit Research Institute, Washington, DC

Consumer Health Savings Accounts (HSAs), created by Congress in 2003, are tax-exempt trusts that an individual can use to pay for health care expenses. An employer's contributions are excluded from a worker's taxable income, and an employee's contributions are deducted from adjusted gross income. Only employees with a high-deductible health plan (a minimum of \$1,000 for self-coverage and \$2,000 for family coverage) are eligible to contribute to an HSA. Advocates for HSAs believe that they will reduce overall health care spending, because consumers will become more responsible and discriminating users of health care services. However, unless HSAs include incentives designed to affect the spending of chronically high users of health care, it is not likely that they will significantly reduce the cost of providing health benefits. Because annual contributions cannot exceed the plan's deductible, the amount of money that an individual can accumulate in an HSA for retirement health care costs is typically limited. Early evidence suggests that HSAs may be more attractive to healthy employees, which could lead to adverse selection and consequently, increase the cost of traditional health plans. HSAs may be more attractive to individuals than families, especially if some family members are significantly less healthy than others.

Consumer Health Savings Accounts are part of a larger movement toward more consumer involvement in the financing and delivery of health care. Health Savings Accounts (HSAs), the newest type of tax-favored savings account, were created as part of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA, P.L. 108-173). Supporters believe that if consumers have more control over the funds used for their own health care, they will spend the money more wisely, especially after they are educated about the actual price of health services. In addition, these accounts are thought to be a tax-favored means of saving for health care expenses in retirement.

In a 2004 study, 61% of 270 employers would like to offer HSAs in the near future.¹ In December 2003, 73% of 256 small business owners were interested in the HSA concept.² Currently, however, few employers offer and few individuals have an HSA. Because of the delay in Treasury Department and IRS guidance, most employers are not expected to begin offering HSAs until 2006.

In the meantime, HSAs remain a controversial health care option. Supporters believe they will encourage individuals to become more astute and responsible health care consumers. Opponents worry that, rather than saving money, they will shift costs from employers to employees. Also, if HSAs attract only the healthiest

and wealthiest employees, they may draw relatively low-risk employees away from conventional health plans and ultimately make health insurance more expensive for those who remain.

This report examines Health Savings Accounts, outlining what they are, in what ways they differ from other health accounts, how they are being regulated, and what the implications are for employers and employees. The chapter concludes by discussing how health savings accounts may affect the use and cost of health care in the United States.

What are Health Savings Accounts?

A Health Savings Account (HSA) is a tax-exempt trust that an individual can use to pay for health care expenses. HSAs, like other account-based plans, are trusts into which individuals can make tax-free monetary contributions. Contributions to the account are deductible from taxable income, even for individuals who do not itemize. In addition, distributions (withdrawals) for qualified medical expenses are not counted in taxable income.

HSAs are owned by the individual and are completely portable from job to job. Also there is no “use-it-or-lose-it” rule. Thus, any money left in the savings account at the end of the year can be rolled over and may be used for medical expenses in subsequent years. However, only employees with a high-deductible health plan are eligible to contribute to an HSA. Specifically, employees must be covered by deductibles of at least \$1,000 for self-coverage and at least \$2,000 for family-coverage. Certain preventive services can be covered in full and are not subject to the employee’s deductible. Out-of-pocket costs (including the deductible) may not exceed \$5,000 for individual coverage or \$10,000 for family coverage. The minimum deductible and maximum out-of-pocket costs will be indexed to inflation.

Who Contributes to Health Savings Accounts and How Much?

Both employees and employers can make contributions to the employees’ accounts. An employer’s contributions are excluded from a worker’s taxable income, and an employee’s contributions are deducted from adjusted gross income. The maximum annual contribution is \$2,600 for self-only coverage and \$5,150 for family coverage in 2004. However, the maximum amount of money contributed annually cannot exceed the plan’s deductible. For instance, if an individual’s deductible is \$1,000, then the amount contributed to his account cannot be more than \$1,000.

To be eligible for an HSA, individuals may not be enrolled in other health coverage, such as a spouse’s plan. However, supplemental coverage, even without a high deductible, is allowed for such needs as vision and dental care, specific diseases, and hospitalization.

What Are the Rules for Using Funds?

The funds in an employee’s accounts can be used at any time. Payments made using money in the account are called “distributions.” Individuals need not be currently covered by a high-deductible plan to take distributions from their

A Health Savings Account is a tax-exempt trust that an individual can use for health care expenses.

account as long as they set up a Health Savings Account when they had a high-deductible plan. Further, payments made on qualified medical expenses (i.e., expenses approved by the health plan) using money from these accounts are tax-free. HSAs funds can also be used on a tax-free basis for premiums for COBRA, long-term care insurance, health insurance while receiving unemployment compensation, and insurance while eligible for Medicare (other than Medigap). However, distributions for nonqualified medical expenses are subject, not only to regular income tax, but also to a 10% penalty. This penalty is waived if the owner of the HSA dies, becomes disabled, or is eligible for Medicare.

How Do Health Savings Accounts Compare to Other Tax-Favored Health Accounts?

Three other account-based health plans are currently available to employees: Flexible Spending Accounts (FSA), Medical Savings Accounts (MSA), and Health Reimbursement Arrangements (HRA). Although these account types are similar, they do have important distinctions. Table 1 summarizes a comparison of the four plans.

Flexible Spending Accounts

Flexible Spending Accounts can be offered alone or as part of a larger “benefits cafeteria plan,” which allows employees to pick and choose (like a buffet style meal) from a selection of different benefits. Flexible Spending Accounts are the most well known type of health spending account with 80% of employers with 500 or more employees offering them in 2003.³

Flexible Spending Accounts are a simple and inexpensive way whereby employees can use pre-tax dollars to pay for health care services not covered by health insurance. They are funded through employee pre-tax contributions, but employees must designate their contribution in the prior year. Money that is put into the spending account is withdrawn in equal amounts from each paycheck throughout the year, but employers must make the full amount available at the beginning of the year. If an employee receives more money than he/she has contributed and then leaves the job, the employer ends up losing that money. To reduce losses due to turnover, employers usually set an upper limit on annual contributions to the plan.

Contributing to a Flexible Spending Account also reduces the wages on which Social Security and Medicare taxes are paid for both the employee and the employer. The savings to the employer are often enough to offset the cost of administering the benefit.

Few restrictions apply to the distribution of money in the Flexible Spending Account; withdrawals can be made at any time and are excluded from taxable income if used on qualified medical expenses. However, in contrast to a Health Savings Account, employees lose any money that is left over at the end of the year. In other words, the contributions do not “roll over.” Forfeiting unused funds may explain, in part, why only 19% of eligible employees participate in these plans.⁴ However, according to one study, few employees lost substantial amounts in their accounts.⁵

In contrast to a Health Savings Account, employees lose any money left over in their Flexible Spending Account at the end of the year.

Table 1: Comparison of Various Features in Health Savings Accounts

	HSA^a	HRA^b	FSA^c	MSA^d
Overview	Tax-exempt trust or custodial account to pay for qualified medical expenses of account holder and dependents	Employer-funded account that reimburses employees for qualified medical expenses	Employee-funded account to pay health expenses on a pre-tax basis	Tax-exempt trust or custodial account to pay for qualified medical expenses of account holder and dependents
Eligibility	Individuals covered by a qualified high-deductible health plan	Employee whose employer offers an HRA	Employee whose employer offers an FSA	Self-employed and employees at firms with 50 or fewer employees covered by a high-deductible health plan
Ownership of funds	Employee	Employer	Employee	Employee
Use-it-or-lose-it by end of benefit year	No, funds roll over	No, funds roll over	Yes	No, funds roll over
Access to account upon end of job	Yes	Depends on employer	Limited	Yes
Who contributes	Both	Employer	Employee	Both, but not in same year
Must be paired with high deductible	Yes	No, but often is	No	Yes
May be used with other accounts	Yes, but limited	Yes	Yes	Yes
Money can be used for non-health expenses	Yes, subject to tax and penalties	Yes, subject to tax and penalties	No	Yes, subject to tax and penalties
Tax treatment	Reduces taxable income	Tax free	Reduces taxable income	Reduces taxable income
<p>^aHealth Savings Accounts ^bHealth Reimbursement Arrangements ^cFlexible Spending Accounts ^dMedical Savings Accounts</p>				

Source: Employee Benefit Research Institute

Medical Savings Accounts

Medical Savings Accounts are a tax-exempt trust or custodial account that an individual can use to pay for health care expenses. Employees are eligible to set up a Medical Savings Account if employed at a firm of 50 or fewer employees. Self-employed individuals are also eligible. To have a Medical Savings Account, however, you must have a high-deductible health plan. Individual coverage must have a deductible between \$1,700 and \$2,600 and family coverage must be between \$3,450 and \$5,150. Certain preventive services can be fully covered and are not subject to the deductible. The out-of-pocket costs cannot exceed \$3,450 for self-only coverage and \$6,300 for family coverage.

Both employees and employers are allowed to contribute to the account, but not within the same year. Further, neither employee or employer contributions can exceed the annual earned income or net self-employment income of the individual. Like Health Savings Accounts, distributions are tax free if used to pay for qualified medical expenses including premiums for COBRA, long-term care insurance, and health insurance while receiving unemployment compensation. Withdrawals for nonqualified medical expenses are subject to regular income tax and also a penalty of 15%.

Health Reimbursement Arrangements

Health Reimbursement Arrangements are employer-funded health plans that reimburse employees for qualified medical expenses rather than using already existing savings to pay for those expenses, as is the case with the other account-based plans. In 2003, only 1% of all employers offered a plan with a Health Reimbursement Arrangement, although take-up rates were 9% among larger employers.

Though it is not required, these reimbursement arrangements typically accompany high-deductible plans. Health Reimbursement Arrangements often provide “first-dollar” coverage until funds in the account are exhausted. For example, an employer with an insurance plan with a \$2,000 deductible might also provide a Health Reimbursement Account that an employee could use to meet the first \$1,000 of the deductible. Employers may also cover certain preventive services and can also set up an HRA so that employees can purchase health insurance directly from an insurer.

Contributions to Health Reimbursement Arrangements usually exist only “on paper.” Employers do not incur expenses associated with the arrangement until an employee makes a claim. Leftover funds at the end of the year can be rolled over to the following year at the employer’s discretion; however, employers can place restrictions on the amount that can be carried over. As with the other tax-favored account plans, distributions from a reimbursement arrangement are tax-free when used for qualified medical expenses.

Distributions from tax-favored account plans are tax-free when used for qualified medical expenses.

What Guidance have the Department of Treasury and the IRS Given about HSAs?

The Treasury Department and IRS released guidance on four separate occasions on a number of issues associated with Health Savings Accounts:

- ❖ December 22, 2003: A notice was released that provided guidance on definitions, contributions, distributions, and other aspects of Health Savings Accounts.
- ❖ March 30, 2004: A “safe-harbor” list of preventive care benefits not subject to a deductible under a high-deductible health plan was released.
- ❖ May 11, 2004: Guidance was issued on how Health Savings Accounts interact with Health Reimbursement Accounts and Flexible Spending Accounts. Generally, individuals cannot contribute to a Health Savings Account if they have also set up one of the other two accounts. The guidance addresses the exceptions.
- ❖ July 23, 2004: Guidance was issued addressing questions related to the interaction among high-deductible health plans, Health Savings Accounts, and preventive care.

Can Employers Make Different Contributions for Different Employees?

No. The Treasury Department and IRS ruled that employers who contribute to Health Savings Accounts must make the same contributions for all comparable employees. Employers may not merely give employees the option of getting the contribution. Moreover, employers cannot use the contribution as an incentive to get employees to participate in a health assessment or prevention program.

Is Preventive Care Covered?

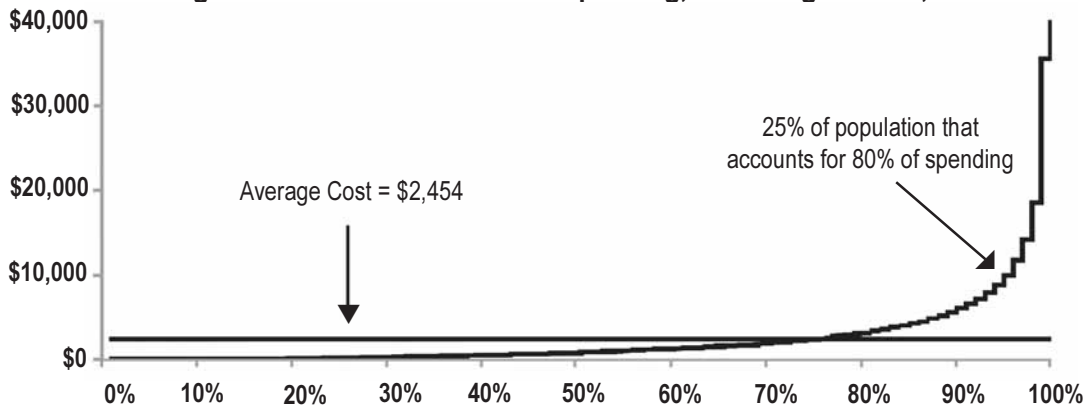
The original guidance on preventive care provided a safe-harbor list of preventive benefits that are not subject to a deductible. The new guidance adds that any treatment of a condition that is a byproduct of the original condition also falls within the safe harbor list. For example, if polyps are found during a colonoscopy that was a preventive screening, removal of the polyps would be considered preventive care and, thus, not subject to a deductible.

Can Employers Recoup Their Contributions?

Employers are not allowed to recoup unused Health Savings Accounts contributions. As soon as the money is contributed, it automatically becomes the property of the employee. If the employee terminates employment before the end of the plan year, the employer may not recoup any portion of their yearly contribution.

The Treasury Department and IRS provided a list of preventive services that are not subject to the deductible.

Figure 1. Distribution of Health Spending, Adults Ages 18-64, 2001



Source: Employee Benefit Research Institute estimates from the 2001 Medical Expenditure Panel Survey.

How Will Health Savings Accounts Affect Use and Cost of Health Care?

It is too soon to know how HSAs will impact the use and cost of health care. However, employers have been using Health Reimbursement Arrangements for a few years and evidence is emerging on their impact. When available, research evidence is also discussed.

Will Health Savings Accounts Curb the Growth in Health Care Spending?

Advocates for Health Savings Accounts believe they will reduce overall health care spending because individuals will understand the need for becoming more responsible and discriminating users of health care services. However, it is well known that about 25% of the population accounts for about 80% of total health care expenditures (see Figure 1). It is unlikely that this 25% of the population can make decisions to substantially reduce health care costs,⁶ because they are sicker and need more services. Therefore, unless HSAs include incentives designed to affect the spending of chronically high users of health care, it is not likely that the cost of providing health benefits will be reduced significantly.

Health Reimbursement Arrangements (HRAs) and other high-deductible health plans are also unlikely to reduce low users' consumption of health care services. If employees do not view the HRA as their own money, they may use health care services unnecessarily. Unless the HRA is portable—and it usually is not—employees only get value from the HRA when they use health care services. In contrast, HSAs probably will not increase the use of health care because the funds in the account belong to them, not the employer, and are completely portable from job to job.

Over time, the accumulation of funds in an HRA will be enough to cover the entire deductible and even more. These additional funds could be spent on services that do not count toward the deductible such as Lasik eye surgery. Employers that cap the amount in an HRA may see employees increasing their use of health care services to “make room” for additional HRA contributions.

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Similarly, if funds are not portable, employees anticipating a job change or retirement might have an incentive to spend down the funds in the account for expenses that may not be necessary.

Will Health Savings Accounts be More Attractive to Healthier Employees?

Because of the high deductibles, opponents believe Health Savings Accounts will be most attractive to healthy employees. If so, this would lead to “adverse selection.” If healthy people are more likely to choose account-based plans, the overall costs for these plans will decline. Conversely, if unhealthy employees are more likely to remain in traditional plans, the overall cost of these plans will increase. However, adverse selection could be offset if Health Savings Accounts are attractive to wealthy employees, who tend to be older and less healthy.

Studies on Health Savings Accounts are limited, but early evidence on Health Reimbursement Arrangements suggests that adverse selection may be a problem. Research shows that higher-income employees are more attracted to plans with an HRA than are lower-income employees.^{7,8} What’s more, employees with fewer health claims in the previous year are more attracted to an HRA than those with more past health claims.⁹

Will Employers Move to Offer Health Savings Accounts?

Small and large employers may adopt HSAs and HRAs for different reasons. Large employers may find Health Reimbursement Arrangements more attractive than Health Savings Accounts. This is because with reimbursement arrangements, employers pay the employee for medical costs only when they occur. In Health Savings Accounts, the employer makes immediate contributions to the employees’ account and it becomes the property of the employee, regardless of whether the employee actually needs or uses it.

In a recent study, 39% of employers reported that they would not contribute to the employees’ HSA. Employers may reject HSAs because the best way to save money is to offer only a high-deductible health plan and pocket the savings in premium costs. Moreover, some employers may prefer to direct resources toward the high users of health care, rather than funding an account of a healthy employee who has few health care needs.

Small employers may not move to account-based plans at all, because they are typically slower to change health benefits. In 2002, after three years of double-digit premium increases, only 19% of small employers made a change to their health plan.¹⁰ Many employers find that maintaining their current benefits has a positive impact on employee recruitment, retention, productivity, health status, and the overall success of the business. Studies indicate that employers will make other cutbacks in staffing, employee pay, equipment, bonuses, and the like to maintain health benefits.

Are Health Savings Accounts More Attractive to Individuals than Families?

Health Savings Accounts can have negative consequences for some families. HSAs are likely to be more attractive to individuals than to families, especially if some family members are significantly less healthy than others. No one in the

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family can have a separate deductible lower than the minimum family deductible of \$2,000. In high-deductible plans, this means that for a married couple with no children, the healthier family member who uses very few health care services would leave the unhealthier member with a \$2,000 deductible to “work off.” In this case, it would make more sense to enroll the sicker family member in single coverage so that the deductible is only \$1,000.

Will Health Savings Accounts Reduce Participation in Other Tax-Favored Health Accounts?

According to the Treasury Department, individuals with a general purpose Flexible Savings Account cannot contribute to a Health Savings Account. Because Flexible Spending Accounts do not allow for roll over from year to year, it is likely that Health Savings Accounts will result in less employee participation in some other tax-favored accounts.

How Much Can Employees Save for Retirement?

The amount of money that an individual can accumulate in a Health Savings Account for retirement health care costs is limited. Because there are maximum limits on how much individuals can contribute, this restricts the amount that employees are able to accumulate over time. For example, an individual who contributes \$1,000 each year (and makes the maximum allowed catch-up contribution) can accumulate about \$23,000 after 10 years, \$47,000 after 20 years, \$81,000 after 30 years, and about \$137,000 after 40 years (see assumptions in Fronstin, 2004).¹¹ An individual aged 55 in 2004 can save a maximum of \$44,000 in an HSA by age 65. This is far from the \$137,000 needed for retiree health care if the person lives to age 80.

Further, individuals may need to use the money in their accounts to pay for health care services during their working years or to pay for services while they are unemployed. For instance, if an individual rolls over 90% of a \$1,000 contribution every year for 40 years, they will have accumulated only \$25,000. If they were able to roll over 100% of that contribution in the same time, they would accumulate \$137,000

The amount of money that an individual can accumulate in Health Savings Accounts for retirement health care costs is limited.

Conclusion

Recently, some employers have begun using high-deductible health plans with tax-favored accounts as one way of encouraging consumers to become more involved in and responsible for their own health care. Health Savings Accounts are one recent market-based approach which supporters hope will improve quality and reduce costs. To date, there are theories on how these plans will affect the health care system, but evidence is lacking.

One thing is clear, however. Currently, health care accounts for about 14% of the nation’s Gross Domestic Product (GDP). Making changes in 14% of GDP is bound to result in winners and losers, and many issues to grapple with. More research is needed to understand the real-world benefits and costs of Consumer Health Savings Accounts.

This chapter is based on the following issue brief. Complimentary copies of the full report are available from the Wisconsin Family Impact Seminars at (608) 262-0369 or from the web site of the Employee Benefit Research Institute at www.ebri.org.

Fronstin, P. (2004, September). *Health savings accounts and other account-based health plans*. Washington, DC: Employee Benefit Research Institute.

Paul Fronstin is the Director of the Health Research and Education Program at the Employee Benefit Research Institute, a private, nonprofit, nonpartisan organization in Washington, DC committed to original public policy research and education on economic security and employee benefits. He currently serves on the advisory council for Emeriti/Health, the subcommittee on the Status of the Uninsured for the Institute of Medicine of the National Academies, and the Maryland State Planning Grant Health Care Coverage Workgroup. He has published 112 papers, edited 3 books, testified before Congress 10 times, and made 108 presentations to various groups across the country.

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