

THE WHITE HOUSE

WASHINGTON

October 13, 1995

MEMORANDUM FOR THE PRESIDENT

FROM: LAURA TYSON AND CAROL RASCO

RE: Medical Savings Accounts

---

**PURPOSE:**

To reach a decision on an Administration position on the use of Medical Savings Accounts for the private insurance market and the Medicare program.

**OVERVIEW AND BACKGROUND:**

A few nights ago, CBS News broadcast a scathing attack on Medical Savings Accounts (MSAs), suggesting that their popularity was due largely to the financial contributions of their backers rather than their actual merit. Yet, while concerns about the concept have also been raised by the elite print media, by CBO, and by Lewin-VHI, MSAs continue to ride a wave of support in the Congress.

Both the House and Senate budget bills contain some version of an MSA option. The concept has also received strong support from certain elements of the insurance industry, particularly those firms that once excelled at the traditional underwriting method of "cherry picking" beneficiaries from low-risk populations. While these methods have been rejected by the public and by policy makers, MSAs offer a subtle way of accomplishing much the same effect. Given the depth of financial and Congressional support behind this concept, some form of MSA proposal likely will be included in any reconciliation bill that reaches your desk.

Medical Savings Accounts, as their name suggests, are special accounts used primarily to pay personal medical expenses. Typically, these accounts offer tax benefits or other financial incentives. But, in return, they impose one basic requirement: Participants must switch their health insurance from a "comprehensive" plan to a "catastrophic" plan with a high deductible, sometimes as high as \$10,000.

Supporters in Congress contend that, by forcing individuals to bear more of the direct costs of health care, MSAs discourage the use of unnecessary or excessively costly medical procedures, thus reducing medical expenditures. Opponents counter that the plans simply allow healthy and well-to-do populations to self-select out of the traditional insurance pools -- thereby increasing costs for those left behind. Other criticisms are that MSAs: (1) are untested; (2) are extremely difficult to administer; and (3) may discourage use of cost-effective preventive care.

## **DISCUSSION:**

In general, MSAs have been proposed for both the private health insurance market and the Medicare system. These two options are described briefly below. The pros and cons of the MSA concept are then examined in greater detail.

### **Private Market MSAs**

Various MSA proposals have been introduced for the private (under 65) insurance market. One of the most significant, Representative Archer's proposal (H.R. 1818), allows individuals to open an MSA whenever they enroll in a health plan with a minimum deductible of \$1,500 for a single plan and \$3,000 for a family plan.

H.R. 1818 provides a significant benefit for individuals who open an MSA: Not only are employer and employee contributions into an MSA deemed tax exempt, but withdrawals from an MSA for medical expenses are also tax free. By comparison, under current law, an individual must generally spend after-tax dollars on medical expenses (with a few exceptions).

### **Medicare MSAs**

Both the House and Senate Medicare plans allow beneficiaries to withdraw from the traditional fee-for-service system and set up a Medicare MSA account. When a beneficiary opens an MSA, Medicare gives the subscriber a voucher equal to the amount of money that the Medicare program spends on the average beneficiary per year -- roughly \$5,200 per beneficiary in 1995. (Under some proposals, this average would be "risk adjusted" to take into account the beneficiary's demographic characteristics, like age or gender). This voucher can be used only for the purchase of a high deductible insurance policy -- with deductibles ranging from up to \$3,000 in the Senate version to up to \$10,000 in the House version. Any remaining credit is then deposited into the Medicare MSA.

MSA funds can be used to pay for both medical and non-medical expenses. When used for medical expenses, withdrawals from the account are tax-free. However, when used for non-medical expenses, the withdrawals are taxed as income and, under the House plan, subject to an additional penalty whenever the MSA balance falls below a specified threshold (60% of the deductible amount).

## **GENERAL PROS AND CONS**

### **Pros -- Private Market and Medicare MSAs**

The advantages of the MSA concept for the Medicare and private market system are relatively straightforward:

- More Choice. MSAs may offer new options for private health insurance consumers and Medicare beneficiaries.

- Ideological appeal. MSAs resonate with the anti-government mood of the 104th Congress. Medicare MSAs, for example, appear to eliminate the federal middle-man in the Medicare system -- replacing a government-run insurance program with what seems to be a more market-oriented one. Moreover, MSAs in general enable individuals to decide how to cut costs, rather than imposing institutional rules such as those found in managed care programs.
- Incentives to reduce unnecessary procedures. By requiring individuals to bear more of the direct cost of medical expenses, MSAs probably lead people to become more cost-conscious consumers. A reduction in the use of unnecessary procedures would reduce aggregate health care spending and could benefit the entire economy. As such, MSAs provide an initial attraction to many economists who worry that the existing preferential tax treatment encourages the purchase of excessively comprehensive insurance coverage. Nonetheless, the effect on medical expenditures is unlikely to be as dramatic as some proponents claim: MSAs do not address the principal cause of increased spending -- the rising costs of catastrophic illness. Roughly 20% of individuals account for 70% of all medical spending. MSAs would do little to reduce spending on the small number of very sick individuals responsible for most medical expenditures.
- Popular among certain segments of the population. MSAs appeal particularly to the healthier and wealthier segments of the population, and their inclusion in a final budget package would avoid confrontation with their fierce supporters on Capitol Hill.

#### **Cons -- Private Market MSAs**

The MSA concept raises a number of concerns when applied to the private insurance market.

- Untested. The MSA concept is a largely untested concept. It makes little sense to implement the idea nationally without better understanding its implications.
- Adverse Selection. Adverse selection is one of the most significant defects associated with MSAs in general. Adverse selection refers to the fact that MSAs will likely attract wealthier and healthier beneficiaries -- those rich enough to risk a high deductible and healthy enough to be confident that they will do better with their own catastrophic policy than in a comprehensive pool of riskier and sicker individuals. Adverse selection could lead to a situation where people left in comprehensive insurance coverage are sicker than average, leading to increasing costs for such coverage as the risk pool shrinks and becomes less favorable. This problem is a variation on cost-shifting, but it does not necessarily mean that aggregate spending on health care increases. It is unclear how severe the adverse selection problem would be in the private market because employers who provide MSAs as part of a benefit package would have some flexibility to adjust an employee's wages or other fringe benefits in order to limit the amount of adverse selection that occurs. (Existing flexible spending accounts and cafeteria plans are not associated with large adverse selection problems.)

- Possible reduction in preventive care. High deductible policies may discourage families from spending funds on certain services, like preventive care, that have short term costs, but long-term benefits. In many cases, providers may be better positioned to recognize the benefits of cost-conscious and medically effective preventive care.
- Administrative problems. According to the Treasury Department, private market MSAs will lead to significant administrative problems, increase the paper-work burden on taxpayers, and create the potential for significant non-compliance. (Imagine the difficulties in distinguishing between a legitimate medical expense and a feigned one.)
- Loss of federal revenues. Since private market MSAs allow individuals to pay for medical expenses with tax-free dollars, a significant revenue loss for the Treasury can be expected. The Joint Tax Committee projects that H.R. 1818 will cost \$1.8 billion over 7 years. The Treasury Department estimates that the seven-year loss would be \$3.5 billion.
- No significant increase in coverage. Private market MSAs are unlikely to expand insurance coverage to any significant extent. Although some individuals who are currently uninsured may participate in an MSA plan, others who are currently in comprehensive health insurance plans may drop coverage because of changes in the risk pool. Moreover, by encouraging healthy and wealthy individuals to self-select into segregated insurance groups, MSAs would probably make it more difficult in the future to achieve comprehensive health care reform that depends on large community-rated insurance pools.

#### **Cons -- Additional Concerns about Medicare**

While the Medicare MSA has many of the same drawbacks as the private market version, most health policy analysts (including Alain Enthoven and others with influence with the Democratic Leadership Council) have pointed out that adverse selection problems will pose a particularly serious problem for the Medicare system:

- Under both the House and Senate Medicare plans, an MSA subscriber receives a voucher equal to what the average beneficiary costs the Medicare system each year -- even though these healthy subscribers cost the system far less than average. In this way, MSAs boost spending on healthy beneficiaries, thus increasing costs. The only way to address the adverse selection problem is by adjusting the Medicare contribution to more accurately reflect a subscriber's cost. As Lewin-VHI notes, however, such "risk adjustment" methods are "still under development and largely untested." Moreover, modifying Medicare contributions based on factors like gender or age would likely face serious obstacles in the political process. Because it is skeptical about the development of an effective risk-adjustment method, Lewin-VHI projects that Medicare MSAs will cost between \$15 and \$20 billion over 7 years.
- The GOP Medicare plan imposes an overall entitlement cap on Medicare expenditures. As a result, the higher cost of Medicare MSAs must be offset by cuts of an equal magnitude in Medicare's pay-for-service program.

- The GOP Medicare plan allows MSA-holders to transfer back into the traditional pay-for-service system on an annual basis. As a result, subscribers will be tempted to enroll in MSAs during their healthy years, and then opt back into the traditional pay-for-service program when their health declines. This feature exacerbates the adverse selection problem. To address this problem, some have suggested extending the "lock-out" period beyond one year, but such proposals obviously would prove unpopular with beneficiaries.

Taken together, the negative effects of MSAs should be a concern for the overall health insurance market. But adverse selection problems raise particularly serious questions for the Medicare system. Even Senator Dole has expressed some misgivings about Medicare MSAs. Acknowledging reports about the cost of MSAs, Senator Dole recently said,

"I picked up the paper this morning, the New York Times said the Medical Savings Accounts are a rip-off, when it costs \$2.9 billion. They're only for healthy people. Well, should we spend \$2.9 million (sic)? I don't think so. We're going to check it out." (quoted at the Business Week Symposium of Chief Executive Officers, 9/28/95).

## CONCLUSION AND RECOMMENDATIONS

There is opposition to the concept of Medicare MSAs throughout the Administration (NEC, DPC, OMB, HHS, Treasury), although the CEA sees some possible benefit. Similar concerns have also been raised about MSAs for the private market, but with the exception of the Treasury Department division with responsibility for administering MSAs, the depth of this opposition is not as great.

In all likelihood, some form of the MSA concept will likely pass the Congress. The question arises how best to position the Administration on this issue to ensure that the final compromise is acceptable. There are a range of options available to the Administration, including the following:

OPTION A: Oppose MSA concept for both Medicare and private industry and suggest that proposals might attract a veto. At most, suggest possibility of establishing a demonstration project for the private market.

OPTION B: Oppose Medicare MSAs and raise concerns about private market MSAs, but leave open the possibility of compromise -- perhaps a demonstration project for MSAs in either the Medicare or private market.

OPTION C: Indicate need for more information to evaluate proposals, but express preliminary interest in MSAs as a concept.

### DECISION:

OPTION A       OPTION B       OPTION C       DISCUSS