CALIFORNIA BUDGET PROJECT

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HEALTH SAVINGS ACCOUNTS: NO SOLUTION FOR THE UNINSURED

Health Savings Accounts (HSAs) are savings accounts that are coupled with high-deductible health plans. This *Budget Brief* finds that HSAs would not make health coverage affordable for most uninsured Californians for two reasons. First, most uninsured Californians have low incomes and would not likely benefit from tax breaks for individuals with HSAs. Second, individuals with high-deductible health plans face substantially *higher* health costs than those with lower deductible plans and tend to have problems accessing needed health care services. In addition, HSAs pose substantial risks for workers with comprehensive job-based health coverage and provide an unprecedented tax sheltering opportunity for high-income, healthy individuals. Due to these concerns, lawmakers should consider other options to expand health coverage.

What Are HSAs?

Health Savings Accounts (HSAs), established as part of the 2003 Medicare prescription drug bill, are savings accounts that allow individuals to deposit money to pay for out-of-pocket medical costs associated with high-deductible health plans. The minimum deductibles are $1,100 for an individual and $2,200 for a family in 2007.[1] Most employer-based high-deductible plans have significantly higher deductibles, averaging $1,901 for individuals and $4,070 for families in 2005.[2] Individuals with high-deductible plans must pay all medical expenses up to the deductible, after which point the health plan begins paying for medical costs. HSAs generally cannot be used to pay for health plan premiums.

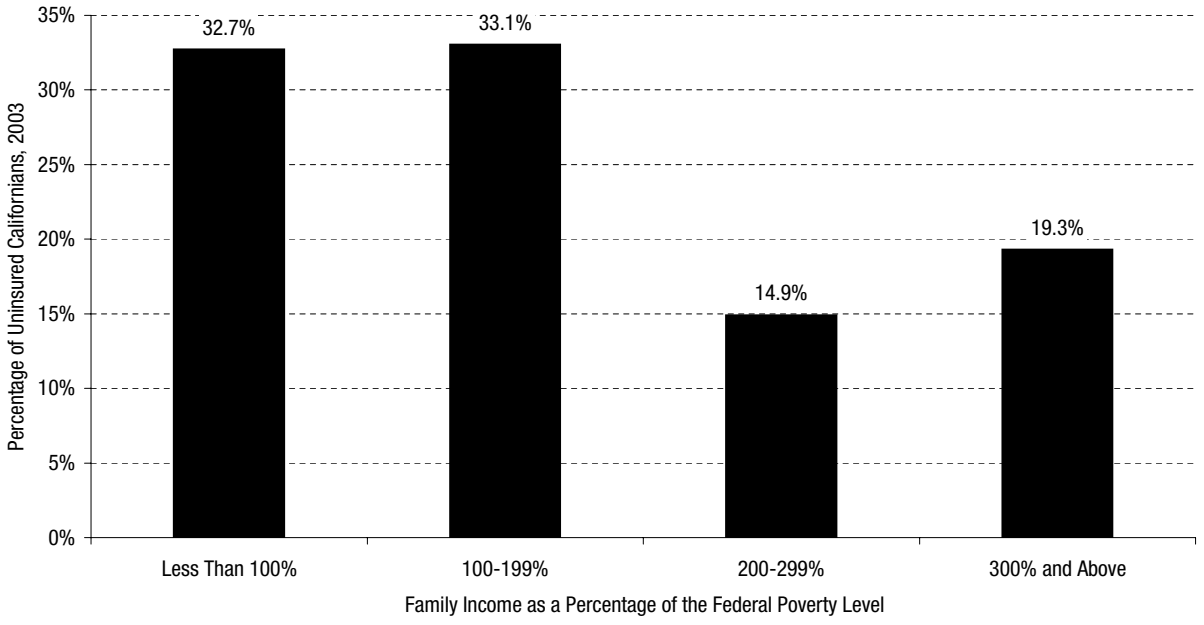
Individuals with high-deductible plans can annually contribute up to $2,850 to an HSA in 2007. Families can contribute up to $5,650.[3] Funds in an HSA can be invested in stocks, bonds, or other investments. Withdrawals from an HSA, including accumulated investment earnings, are not subject to federal income tax if they are used to cover the deductible or other out-of-pocket medical expenses, such as copayments. Unused HSA balances can be carried over for use in future years. In addition, HSA owners can withdraw funds for non-medical expenses once they reach age 65. However, these withdrawals are subject to federal income tax similar to many retirement plans. When an HSA owner dies, the balance in an HSA can be left to his or her heirs. HSA contributions are deductible for federal, but not state, income tax purposes.[4]

Most of the Uninsured Have Low Incomes and Would Not Benefit from State HSA Tax Breaks

Most uninsured Californians have low incomes. Nearly two in three Californians (65.8 percent) who were uninsured in 2003 had incomes below twice the federal poverty level (FPL), equivalent to $31,154 for a family of three in 2005 (Figure 1). Similarly, many young uninsured adults, often cited by proponents as likely users of HSAs, have low incomes. Three in five uninsured Californians ages 19 through 26 (60.4 percent) have incomes below twice the FPL, equivalent to $20,320 for an individual in 2005. Given their low incomes, uninsured individuals are unlikely to be able to pay for premiums and out-of-pocket expenses for high-deductible plans associated with HSAs.[5]

Most uninsured families and individuals would not benefit from a state HSA tax deduction that is modeled on the federal tax

Figure 1: Nearly Two-Thirds of Uninsured Californians Have Incomes Below 200 Percent of the Federal Poverty Level



Source: 2003 California Health Interview Survey

deduction. California has a high income tax threshold – the income level at which a taxpayer begins to owe tax – and a progressive rate structure – whereby low-income individuals and families are taxed at a lower rate than high-income individuals and families. Therefore, low-income individuals and families have little or no state income tax liability that a state HSA tax deduction would offset. For example, a married couple with two children would not owe 2006 state income taxes if their income was below $47,671.[6] Since these families and individuals do not owe state taxes, they would not benefit from a state HSA tax deduction.

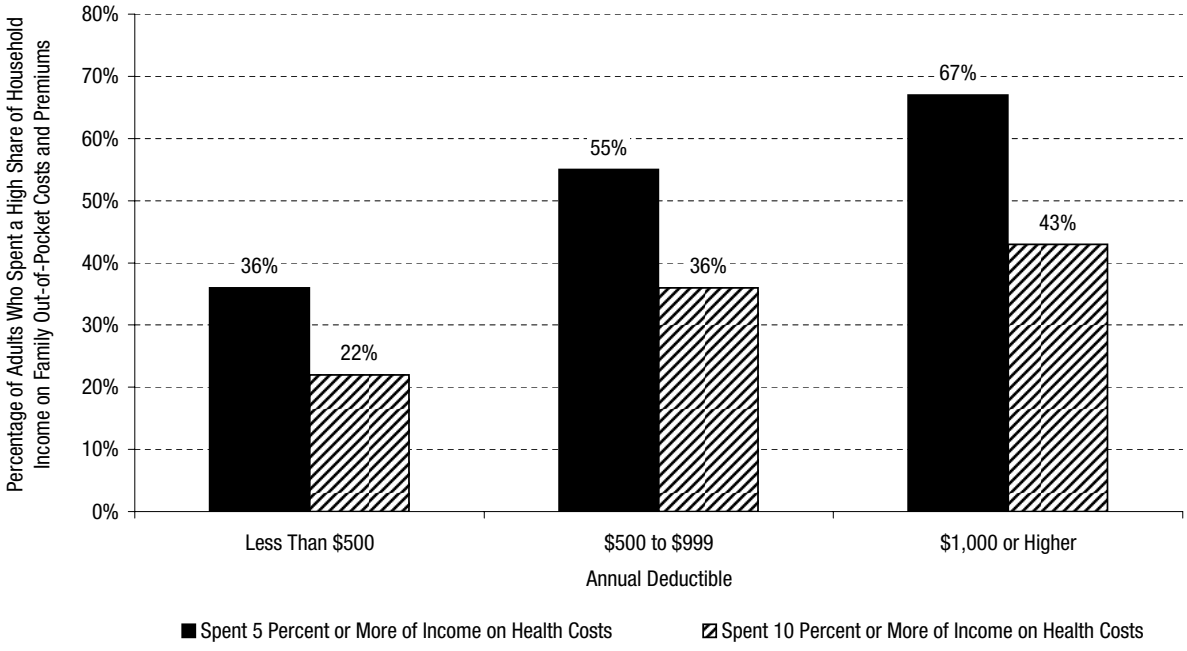
High Deductibles Are Associated with High Costs and Access Problems

A recent survey finds that adults covered by health plans with high deductibles face higher combined premium and out-of-pocket costs than adults with lower deductibles.[7] Two-thirds of adults (67 percent) with high-deductible plans spent at least 5 percent of their income on premiums and out-of-pocket costs, and more than two in five (43 percent) spent at least 10 percent (Figure 2). In contrast, approximately one in three adults (36 percent) with deductibles of less than $500 spent 5 percent or more, and one in five (22 percent) spent 10 percent or more of their income on these costs.

Individuals with high-deductible plans are more likely to delay seeing a doctor, filling prescriptions, or taking preventive tests because of costs.[8] More than two in five adults with these plans (44 percent) failed to seek needed medical care, such as seeing a doctor or filling a prescription, due to cost – much higher than the rate for adults with deductibles of less than $500 (25 percent, Figure 3). In addition, adults with high-deductible coverage were four times as likely to delay or skip preventive screening tests, such as mammograms or colonoscopies. One in five adults (20 percent) with high-deductible plans delayed or did not receive such tests, compared to 5 percent of adults with deductibles of less than $500. These findings are consistent with other research on high-deductible plans and the RAND Health Insurance Experiment of the 1970s, which found that higher out-of-pocket costs caused individuals to seek less health care, including preventive services.[9]

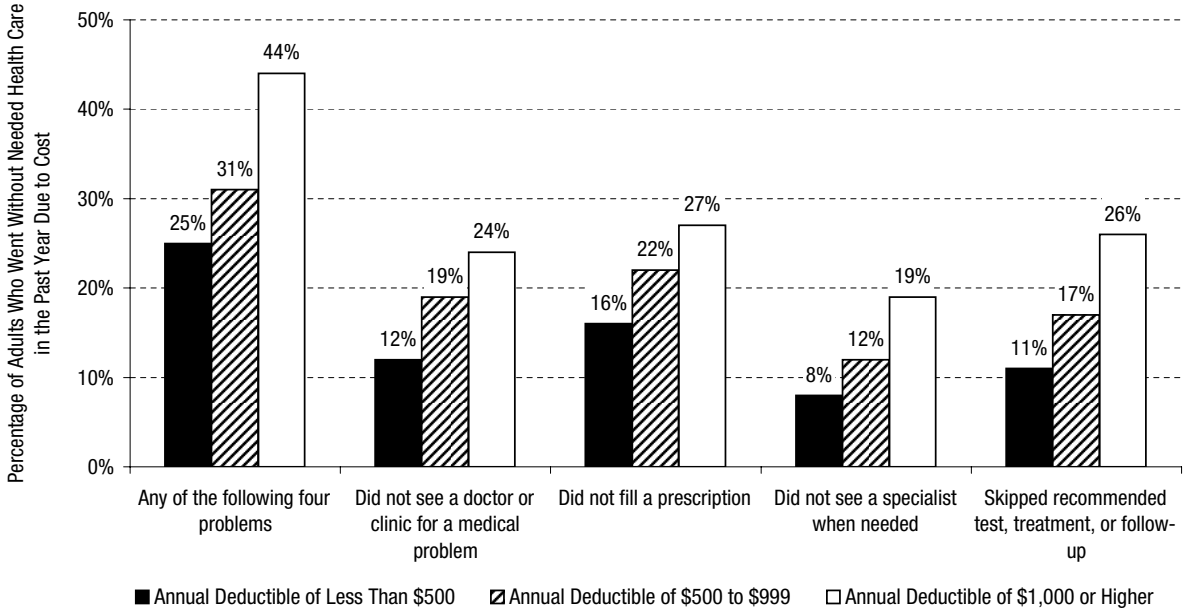
Given the access and affordability issues associated with high-deductible plans, it is not surprising that they are associated with lower quality health care. Two in five adults (41 percent) with annual deductibles of at least $1,000 rated their current coverage

Figure 2: Adults with High-Deductible Plans Spent a Higher Share of Their Income on Health Costs, 2005



Note: Includes adults age 19 to 64 insured all year with job-based or individually purchased health coverage.
Source: The Commonwealth Fund

Figure 3: Adults with High-Deductible Plans Were More Likely to Avoid Needed Health Care Because of Cost, 2005



Note: Includes adults age 19 to 64 insured all year with job-based or individually purchased health coverage.
Source: The Commonwealth Fund

as fair or poor, compared to approximately one in six adults (15 percent) with deductibles of less than $500.[10]

HSAs Tend to Benefit High-Income, Healthy Individuals

HSAs provide larger tax breaks for high-income individuals and families because the value of a deduction depends on the taxpayer's income tax bracket. For example, if the state provided tax breaks for HSAs that were similar to those in federal law, a $2,000 HSA contribution would reduce the state tax liability of an individual with taxable income of over $1 million by $206 because that individual is in the state's highest tax bracket – 10.3 percent. The same contribution would reduce the state tax liability of a married couple with no children with taxable income of $40,000 by $80 since that family is in the 4.0 percent state tax bracket. In contrast, a married couple with two children and taxable income of $40,000 would receive no benefit from making an HSA contribution. That is because tax preferences to which they are entitled would offset any state income taxes the family would otherwise owe.[11]

A study by the US Government Accountability Office (GAO) confirms that high-income individuals are more likely to enroll in HSAs. An analysis of federal tax returns indicated that over half (51 percent) of HSA participants had an adjusted gross income (AGI) of $75,000 or more, compared to 18 percent of all tax filers under age 65 in 2004.[12] The average AGI of tax filers with HSA contributions was $133,000, compared to $51,000 for all non-elderly tax filers. The study also found that high-income families make larger HSA contributions. Tax filers with an AGI of at least $200,000 made an average HSA contribution of $3,010.[13] In comparison, the average contribution by tax filers with an AGI of less than $50,000 was less than half that amount ($1,370).

HSAs are particularly attractive to healthy individuals. Healthy individuals who do not have high medical expenses may be able to reduce the amount they spend on health care by switching to high-deductible plans and HSAs. In addition, healthy individuals are more likely to benefit from HSA tax breaks: they can reduce their federal tax liability by making contributions to HSAs and owe no federal tax on earnings from those contributions. These individuals can accumulate substantial balances in their HSA if they contribute more than they need each year to cover their out-of-pocket medical costs. High-income individuals can use HSAs to increase their tax-deferred retirement savings above the otherwise allowable levels and use these funds for any purpose at retirement.[14]

In contrast, individuals with substantial costs for medications, doctors' visits, hospitalizations, or other medical needs would likely face higher out-of-pocket costs with an HSA than if they had traditional low-deductible health coverage. Research supports the notion that healthier individuals are more likely to choose HSAs or other high-deductible coverage.[15] The GAO also found that most participants would recommend high-deductible plans to healthy individuals, but not to people who regularly use prescription drugs, have chronic illnesses, or have children.[16]

HSAs Could Become Lucrative Tax Shelters

A fundamental principle of a fair and efficient tax system is that all income should be subject to taxation. HSAs violate that principle because neither contributions nor withdrawals, including accrued earnings, are taxed unless they are not used for health-related purposes. Healthy, affluent individuals can use HSAs to shelter retirement income above the amounts currently allowed for Individual Retirement Accounts (IRAs) and 401(k) plans. For example, a healthy individual could contribute up to $2,850 in 2007 to an HSA, knowing that he or she would be unlikely to need that amount for out-of-pocket health costs. The individual could continue to make HSA contributions each year without paying any federal income taxes on those amounts. After reaching age 65, the individual could withdraw funds from the HSA and pay taxes on these funds at a rate that would likely be lower than what he or she paid when employed. Furthermore, high-income individuals who are not allowed to invest in IRAs can invest in HSAs for retirement purposes because, unlike IRAs, HSAs have no income limits for participants. HSAs could also be used to shelter income intended to be left as an inheritance, since the income would not be taxed before the HSA owner dies.

In contrast, retirement investments with favorable treatment under federal tax laws are typically taxed either when funds are deposited or when they are withdrawn. For example, withdrawals from a traditional IRA or 401(k) are taxable, and the income used to make contributions to a Roth IRA is taxable at the time the contribution is made. On the other hand, neither contributions to nor withdrawals from flexible spending accounts, such as so-called "cafeteria plans," are taxed. However, flexible spending accounts differ substantially from HSAs because they do not accumulate tax-free earnings, and any amount left in these accounts is lost at the end of the year if not spent on an allowable purpose.

Recent federal changes allow individuals to use HSAs to shelter even more income from taxation.[17] Beginning in 2007, individuals can make HSA contributions that exceed the deductible for their high-deductible health plan, which was not previously allowed.[18] This change could increase the use of HSAs as tax shelters since individuals could contribute funds not needed to cover health costs incurred under their high-deductible plans. In addition,

individuals can now make one-time transfers from IRAs to HSAs without paying any taxes or penalties, another benefit for high-income individuals.

HSAs Pose Risks to Job-Based Comprehensive Health Coverage

HSAs could, over time, lead to higher premiums for job-based health coverage. Most Americans with comprehensive health insurance are covered through job-based health plans, which keep the cost of health insurance relatively affordable by pooling healthy and sick workers together. If a substantial number of employers offer HSAs and high-deductible plans and healthy individuals leave comprehensive health coverage for these plans, the individuals remaining with comprehensive health coverage would tend to be less healthy and therefore more expensive.[19]

As the cost of comprehensive coverage increases, employers currently struggling to pay for health coverage for their workers may stop providing comprehensive health coverage altogether. If employers drop comprehensive coverage, workers and their families could be forced to choose between having a lower level of coverage through an HSA and a high-deductible health plan or going without health coverage. Both choices would be problematic for low-income workers and those with substantial health needs. So while HSAs offer potential benefits to the healthy, they risk undermining the foundation of job-based comprehensive coverage.

Cost of State HSA Tax Breaks Could Be Used Instead to Increase Coverage

Providing state tax breaks for HSAs would reduce state revenues that could be used in other ways to expand health coverage. The Franchise Tax Board estimates the cost of providing state tax breaks for HSAs that are modeled on those in federal law would be approximately $15 million in 2007-08.[20] Rather than provide state HSA tax breaks with no guarantee that they would expand health coverage, lawmakers could spend the same amount in other ways that would reduce the number of uninsured. For example, eligibility for the Medi-Cal Program could be expanded to cover approximately 10,000 children at approximately the same cost as providing HSA tax breaks.

Expanded HSA Tax Breaks Could Increase the Number of Uninsured

MIT economist Jonathan Gruber finds that HSAs could *increase*, not decrease, the number of uninsured. Professor Gruber finds that a proposal by President Bush to give expanded tax breaks to people with HSAs and high-deductible coverage would increase the number of uninsured individuals by approximately 600,000. While he estimates that 3.8 million previously uninsured individuals would *gain* health coverage as a result of the President's proposal, approximately 4.4 million would lose health coverage because some employers would no longer provide coverage to their employees.[21] Rather than help reduce the number of uninsured, expanded tax breaks for HSAs could increase the ranks of the uninsured.

Conclusion

HSAs raise a number of policy concerns and are unlikely to significantly reduce the number of uninsured individuals. While HSAs can provide benefits for some – such as healthy, high-income individuals – they are unlikely to make health coverage affordable for most uninsured Californians. Californians without health coverage are unlikely to have sufficient incomes to afford the premiums and out-of-pocket expenses for the high-deductible plans associated with HSAs, and their incomes are likely too low for them to benefit from tax breaks associated with HSAs. In addition, HSAs pose long-term risks to job-based health coverage if healthier individuals leave comprehensive health plans and opt for HSAs.

David Carroll prepared this Budget Brief. The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the CBP is provided by foundation grants, individual donations, and subscriptions. Please visit the CBP's website at www.cbp.org.

ENDNOTES

[1] US Department of the Treasury, *Health Savings Accounts* (November 2006), downloaded from http://www.ustreas.gov/offices/public-affairs/hsa/pdf/HSA-Tri-fold-english-07.pdf on November 14, 2006.

[2] Gary Claxton, et al., "What High-Deductible Plans Look Like: Findings From A National Survey Of Employers, 2005," *Health Affairs - Web Exclusive* (September 14, 2005).

[3] Prior to 2007, individuals and families could not contribute an amount greater than the deductible of their high-deductible plan to an HSA. For example, an individual could not contribute the maximum of $2,700 in 2006 unless he or she had a health plan with a deductible of that amount or higher. Employers can also contribute all or part of the maximum amount to employees' HSAs. US Department of the Treasury, *Health Savings Accounts* (November 2006), downloaded from http://www.ustreas.gov/offices/public-affairs/hsa/pdf/HSA-Tri-fold-english-07.pdf on November 14, 2006.

[4] California has not adopted the changes that would permit individuals to deduct HSA contributions from state taxes.

[5] Karen Davis, Ph.D., Michelle M. Doty, Ph.D., and Alice Ho, *How High Is Too High? Implications of High-Deductible Health Plans* (The Commonwealth Fund: April 2005).

[6] Franchise Tax Board. Assumes taxpayers claim the renter's tax credit and do not itemize their deductions.

[7] Sara R. Collins, et al., *Squeezed: Why Rising Exposure to Health Care Costs Threatens the Health and Financial Well-Being of American Families* (The Commonwealth Fund: September 2006). These data include adults who do not have HSAs. They also include adults with job-based coverage, the cost of which is generally shared between employers and workers, and those with health care policies purchased on the individual market.

[8] Sara R. Collins, et al., *Squeezed: Why Rising Exposure to Health Care Costs Threatens the Health and Financial Well-Being of American Families* (The Commonwealth Fund: September 2006). These data include adults who do not have HSAs. They also include adults with job-based coverage, the cost of which is generally shared between employers and workers, and those with health care policies purchased on the individual market.

[9] See, for example, Jonathan Gruber, Ph.D., *The Role of Consumer Copayments for Health Care: Lessons from the RAND Health Insurance Experiment and Beyond* (The Henry J. Kaiser Family Foundation: October 2006) and Melinda Beeuwkes Buntin, et al., "Consumer-Directed Health Care: Early Evidence About Effects On Cost And Quality," *Health Affairs – Web Exclusive* (October 24, 2006).

[10] Sara R. Collins, et al., *Squeezed: Why Rising Exposure to Health Care Costs Threatens the Health and Financial Well-Being of American Families* (The Commonwealth Fund: September 2006). These data include adults who do not have HSAs. They also include adults with job-based coverage, the cost of which is generally shared between employers and workers, and those with health care policies purchased on the individual market.

[11] Based on 2006 California tax rate schedules. Assumes taxpayers claim the renter's tax credit and do not itemize their deductions.

[12] US Government Accountability Office, *Consumer-Directed Health Plans Early Enrollee Experiences with Health Savings Accounts and Eligible Health Plans* (August 2006).

[13] This amount does not include contributions made by employers into workers' HSAs.

[14] Withdrawals that are not used for health-related purposes are considered taxable income.

[15] See, for example, Melinda Beeuwkes Buntin, et al., "Consumer-Directed Health Care: Early Evidence About Effects On Cost And Quality," *Health Affairs – Web Exclusive* (October 24, 2006).

[16] US Government Accountability Office, *Consumer-Directed Health Plans Early Enrollee Experiences with Health Savings Accounts and Eligible Health Plans* (August 2006).

[17] Congress approved these changes on December 9, 2006 as part of a bill that extended several tax provisions.

[18] However, contributions to HSAs cannot exceed $2,850 for individuals ($5,650 for families) in 2007, even if their deductibles are higher.

[19] Edwin Park and Robert Greenstein, *Latest Enrollment Data Still Fail to Dispel Concerns About Health Savings Accounts* (Center on Budget and Policy Priorities: Revised January 30, 2006).

[20] Franchise Tax Board analysis of SB 1584 (Runner and Ackerman) as amended March 27, 2006 (April 7, 2006).

[21] Jonathan Gruber, *The Cost and Coverage Impact of the President's Health Insurance Budget Proposals* (Center on Budget and Policy Priorities: February 15, 2006).